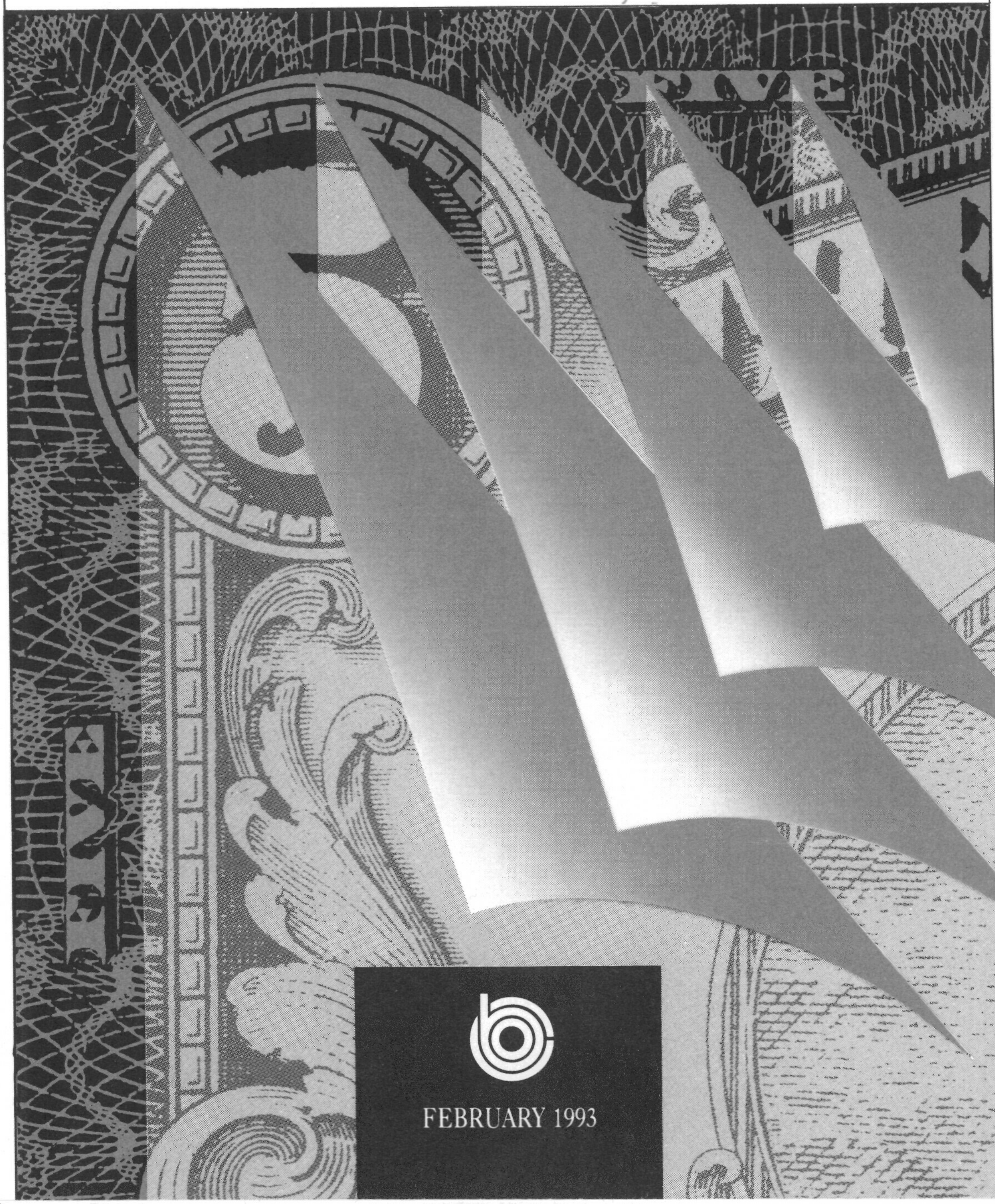
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget

As Required by Public Law 93-344



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February 1993

CBO REPORT ON REDUCING THE DEFICIT

In *Reducing the Deficit: Spending and Revenue Options*, the Congressional Budget Office (CBO) compiles in one volume more than 200 specific options for increasing federal revenues or reducing spending in a wide variety of federal programs. The report is intended as a resource for the Congress in developing budget legislation for fiscal year 1994.

This edition of *Reducing the Deficit*, Volume II of CBO's annual report to the Congress, is the 14th such compendium furnished to the House and Senate Committees on the Budget. Over the years, this report has become a standard reference for developing deficit reduction plans. This year's volume contains 198 alternatives to current spending policies in the major budget categories of discretionary spending--national defense, international, and domestic--and entitlements and other mandatory spending. It also includes 41 alternatives for revenue policy. Each option gives a brief description of the current policy, the proposed change, and the possible consequences, along with the estimated savings or revenues to be generated over a five-year period. Savings in each spending category are calculated from CBO baseline projections. The economic assumptions underlying the analysis are the same as in Volume I of CBO's annual report, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, where they are described in detail.

Options included in *Reducing the Deficit* are not CBO recommendations, as is often reported. The material presented here is intended to be informational, an aid to the Congress as it proceeds with the federal budgeting process. Most of the options included in the analysis have been considered by the Congress at some time in the past. Many worthy options for reducing the deficit may have been omitted because of constraints of time or space, not because they lack merit. To make the report more accessible, it includes an appendix listing the spending options under the budget functions that would be affected.

Reducing the Deficit is an agencywide effort, and questions regarding the various aspects of the analysis can be directed to CBO's Congressional liaison office, the Office of Intergovernmental Relations, at (202) 226-2600. For additional copies of the report, please call the Publications Office at 226-2809.

As part of a pilot project, CBO is making the report available in electronic form through a bulletin board service. The CBO Electronic Bulletin Board System (BBS) can be accessed at (202) 226-2818. For additional information about the BBS service, call 226-2829. The Department of Commerce is including *Reducing the Deficit* in its National Economic, Social and Environmental Data Bank; it is available on CD-ROM. To order, call 482-1986.

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REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS

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NOTES

Unless otherwise indicated, all years referred to in this report are fiscal years.

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

Preface

This volume compiles more than 200 specific policy options for increasing federal revenues or reducing spending in a wide variety of federal programs. This is the 14th such compendium that the Congressional Budget Office (CBO) has prepared as part of its annual report to the House and Senate Committees on the Budget. Over the years, this report has become a standard reference for developing deficit reduction plans.

The 239 specific policy options included in this report come from many sources, and most have been considered by the Congress at some time in the past. Three-quarters of the options were included in last year's edition; many of them have been revised or updated to reflect recent Congressional action.

In accordance with CBO's mandate to provide objective and impartial analysis, the discussion of each option presents the cases for and against it as fairly as possible. CBO does not endorse the options included, nor does exclusion of any proposal imply a recommendation.

The report begins with an introductory chapter that provides general background information on CBO's latest deficit projections and reviews various procedural changes that have been proposed as solutions to the deficit problem. The next three chapters present 198 options for reducing spending, organized by broad categories that have become the focus for deficit reduction efforts--defense and international discretionary spending, domestic discretionary spending, and entitlements and other mandatory spending. The last chapter presents 41 revenue-generating options. The report concludes with an appendix listing the spending options by the budget functions that would be affected.

The economic assumptions and baseline budget projections underlying the estimates of spending reductions and revenue increases contained in this volume are described in more detail in the first volume of CBO's annual report, *The Economic and Budget Outlook: Fiscal Years 1994-1998* (January 1993).

All divisions of the Congressional Budget Office contributed to this report, which was coordinated by James L. Blum. Philip Joyce prepared Chapter 1. Chapters 2 through 5 were coordinated by Neil M. Singer, David H. Moore, Sandra Christensen, and Mark B. Booth, respectively. Budget authority and outlay estimates were coordinated by Michael A. Miller, William P. Myers, Charles E. Seagrave, and Robert A. Sunshine. Revenue estimates were prepared by staff of the Congressional Budget Office and by the Joint Committee on Taxation and were reviewed by the Tax Analysis Division of CBO under the supervision of Rosemary D. Marcuss.

Paul L. Houts and Sherry Snyder supervised the editing and production of the report. Major portions were edited by Paul L. Houts, Sherry Snyder, Sherwood Kohn, and Leah Mazade. Christian Spoor provided editorial assistance during production and coordinated the graphics. The authors owe special thanks to Mary Braxton, Jill Bury, Sharon Corbin-Jallow, Judith Cromwell, Denise Jordan, Ronald Moore, Simone Thomas, and Donna Wood, who typed the many drafts. Kathryn Quattrone, Christian Spoor, and Martina Wojak-Piotrow prepared the report for publication.

Robert D. Reischauer
Director

February 1993

Contents

Transportation

Community and Regional Development

Education and Social Services

Income Security

Social Security

Veterans' Benefits and Services

Restrict the Tax-Favored Treatment of
Income from Employment and Household Investments

Restrict the Tax-Favored Treatment of
Provided Health Benefits

Increase Taxes on Income from Worldwide Activity

Broaden Taxes on Wealth and Capital Gains

Increase Taxes Dedicated to Social Insurance Trust Funds

Curtail Income Tax Preferences for Businesses

Increase Excise Taxes, Sales Taxes, and Miscellaneous Fees

TABLES

FIGURES

Chapter One

Policy Actions, Not Process Changes, Are the Key to Reducing the Federal Budget Deficit

The federal budget deficit has plagued decisionmaking on the national budget for most of the last decade. Despite numerous legislative efforts to reduce the deficit and despite its prominence in the recent Presidential campaign, a genuine solution has proved elusive. In fact, by virtually any measure, the mismatch between revenues and spending keeps growing.

Up until now, most proposals for addressing the deficit have been procedural. Proponents hope to force the political system and the public to face the difficult choices that are necessary to reduce the budget gap. Unfortunately, changes in the budget process alone are unlikely to force the decisions about taxes and spending needed to reduce the deficit. This volume provides a menu of options that policymakers can use to identify the difficult actions necessary to reduce federal red ink.

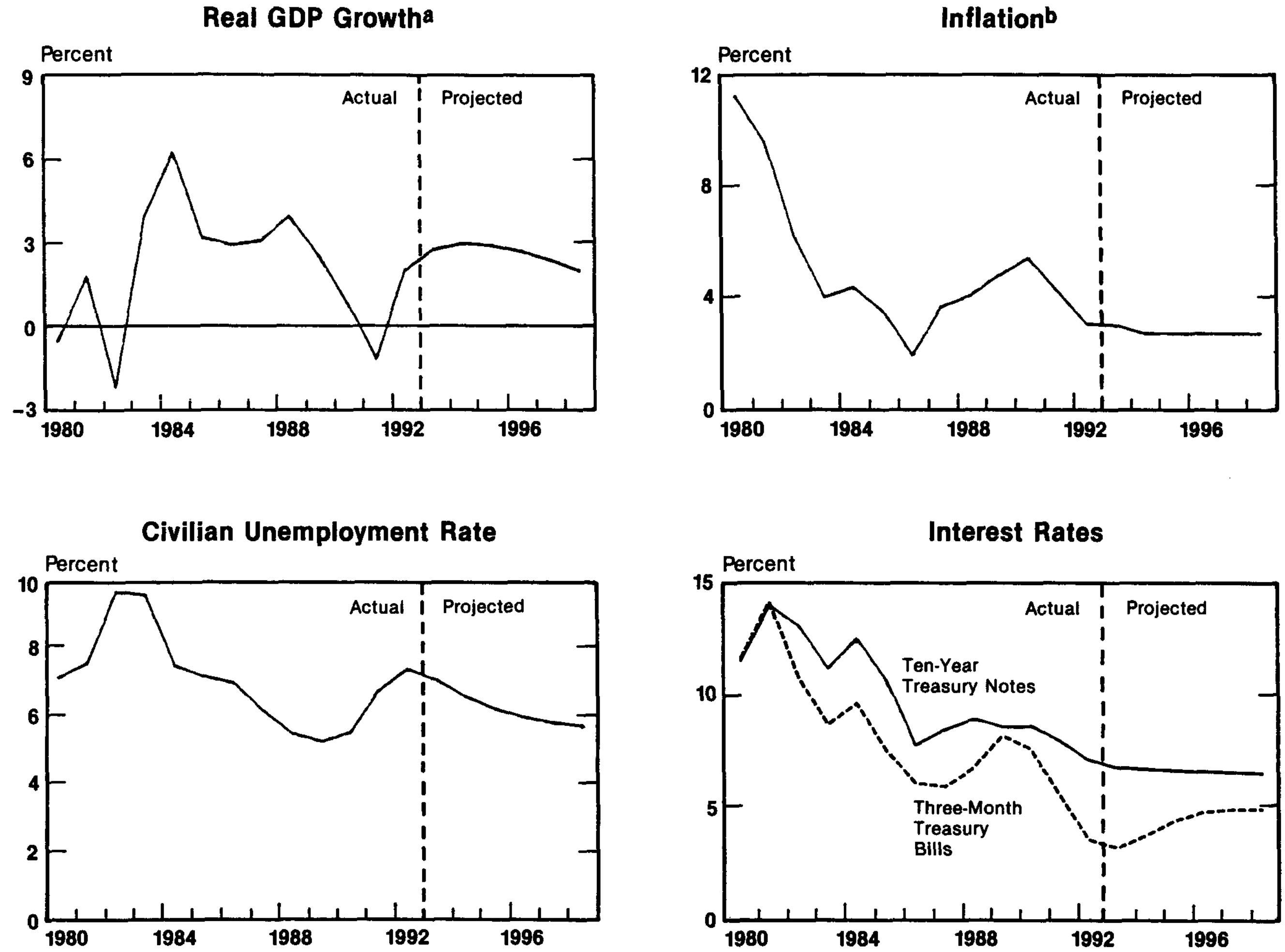
The Economy and the Deficit

According to the latest Congressional Budget Office (CBO) forecast, the economy finally appears to have reached a long-awaited stage of self-sustained growth. CBO expects this growth, however, to be far less robust than usually occurs early in an expansion. By 1994, the rate of growth of the gross domestic product (GDP) should be around 3 percent, and the unemployment rate should fall to 6.6 percent. The mild pace of the recovery will keep a lid on inflation rates; in fact, CBO expects that they will remain flat at about 2 3/4 percent through 1994. Long-term interest rates on government bonds will average almost 7 percent over this same period (see Figure 1).

Over the medium term (1995 through 1998), CBO projects that real GDP will grow at an average annual rate of about 2.5 percent--or about one-half of one percentage point faster than the rate of growth CBO projects for potential real GDP. Given these growth rates, the gap between actual and potential real GDP will reach its historical average of about 0.6 percent of real GDP by 1998. Because the gap is greater than its historical average throughout the projection period, inflation is not likely to rise, even though the economy is growing faster than its potential. Therefore, CBO projects inflation to continue to remain steady throughout the medium term at about 2.7 percent. The unemployment rate is projected to fall in the projection period to a low of 5.7 percent by 1998. Long-term interest rates are also projected to remain steady at about 6.5 percent.

One factor that can significantly affect the ability of the economy to sustain real growth and remain healthy in the long run is the federal budget deficit. Amid the concern that U.S. living standards may grow more slowly in coming decades than they did during most of the postwar period, reducing the budget deficit continues to be an important focus of attention because it will increase national saving. In fact, reducing the deficit is the most reliable way to improve national saving. Over the long run, a per-

Figure 1.
The Economic Forecast and Projection



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

NOTE: All data are annual values; growth rates are year-over-year.

a. The annual value for real GDP growth for 1992 is estimated by CBO.

b. Consumer price index for all urban consumers (CPI-U). The treatment of home ownership in the official CPI-U changes in 1983. The inflation series in the figure uses a consistent definition throughout.

manently higher rate of saving will stimulate new investment, increase productive capacity, lower real interest rates, and raise the nation's standard of living.

True, decreasing federal spending on consumption and increasing spending on well-chosen investments, as some economists have suggested, might also spur economic growth. A deficit that resulted from a greater reliance on investment spending would be less of a problem than the current budget deficit represents.[1] Nevertheless, most economists believe that the increased private investment that would accompany a lower federal deficit would have an even greater positive effect on the long-term health of the economy.

1. For more details about the trade-off between deficit reduction and investment spending, see Box 5-1, p. 70, in Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998* (January 1993).

The Recent History of and Outlook for the Budget Deficit

The federal budget deficit represents the difference between what the federal government spends and how much revenue it collects during a fiscal year. CBO projections show that the deficit, which has remained high for the past decade, will continue to represent a large percentage of GDP for the foreseeable future, at least without actions to arrest it.

The three most common measures of the deficit are the unified deficit (a measure of the difference between all government revenues and spending), the standardized-employment deficit (which removes cyclical factors from the deficit calculation), and the on-budget deficit (which excludes the transactions of the Social Security trust funds and the Postal Service from the deficit calculations). (See Table 1 for a review of actual experience since 1977 using each of these measures.)

The deficit has increased over the past decade under any of these measures, despite several laws designed to arrest its growth, including the Balanced Budget and Emergency Deficit Control Act of 1985 (also known as Gramm-Rudman-Hollings) and the Budget Enforcement Act of 1990 (BEA).

As Figure 2 indicates, mandatory spending has a far more pronounced effect on the deficit than does discretionary spending. Discretionary spending is governed by annual appropriation action; limits set by appropriations constrain the total amount of this spending each year. Mandatory spending is driven by statutory formulas and eligibility requirements and is not limited by any specific dollar ceiling.

Discretionary spending has declined as a percentage of GDP since 1980. Growth in mandatory spending, however, has overshot this decline for a couple of reasons. First, spending for the federal government's health care programs--Medicare and Medicaid--has grown rapidly, almost doubling as a percentage of GDP since 1980. Second, spending for deposit insurance, driven by the savings and loan bailout, increased at a phenomenal rate in the late 1980s. Total deposit insurance outlays for 1992 and 1993, however, are estimated to be much lower than the rate of spending between 1988 and 1991. In addition, as federal debt has risen, the percentage of the budget devoted to paying interest on that debt has increased as well, from 2 percent of GDP in 1980 to 3.5 percent in 1992.

The Budget Process and Deficit Reduction

The increase in the deficit has spawned several attempts to design processes either to force deficit reduction actions or to carry out actions that have already been agreed on. Gramm-Rudman-Hollings (GRH), passed in 1985, had a simple goal--to reduce the deficit to zero by setting a series of declining targets over a five-year period until expenditures were in balance with revenues. The Budget Enforcement Act of 1990 established procedures to enforce the actions agreed to in that year's budget summit agreement.

Under Gramm-Rudman-Hollings, deficit targets were to be enforced through automatic across-the-board spending cuts--a process called sequestration. According to the targets specified in the legislation, the budget was to be balanced by fiscal year 1991, although 1987 amendments to the law pushed the timetable back to fiscal year 1993. However, in an effort to live within the short-term budget constraints, the President and the Congress embraced overly optimistic economic assumptions and employed questionable budget techniques that enabled the government successfully to evade the restraints placed by the deficit targets.

Largely because of the failures of GRH to reduce the deficit as planned, a five-year budget agreement was enacted into law in November 1990, with two major components. First, the agreement included specific measures to cut the deficit by roughly $500 billion over a five-year period. Second, the agreement established the BEA, whose primary purpose was to ensure that the savings agreed to in the deficit reduction accord would be realized.

Two major sets of procedural rules were included in the BEA to police the deficit reduction established in the budget agreement. The first of these are the discretionary spending caps for fiscal years 1991 through 1995. For fiscal years 1991 through 1993, annual ceilings on budget authority and outlays were established for the three categories of discretionary spending--defense, international, and domestic. After 1993, budget authority and outlay caps exist only for total discretionary spending. Violation of the spending caps results in a sequestration of discretionary spending.

The second major enforcement mechanism included in the BEA is the pay-as-you-go (PAYGO) process. This set of rules requires that legislative actions affecting mandatory spending and revenues not increase the deficit in any year. If this condition is not met, the PAYGO discipline is triggered by a separate sequestration of the resources available to a prescribed and limited number of mandatory programs.

The BEA has been successful in its first two years in enforcing the deficit reduction actions of the

Table 1.
Deficit Under Alternative Measures, 1977-1992 (By fiscal year, in billions of dollars)

Year	Unified Deficit	On-Budget Deficit	Standardized-Employment Deficit
1977	53.7	49.8	38.4
1978	59.2	54.9	55.3
1979	40.2	38.2	42.7
1980	73.8	72.7	47.7
1981	79.0	74.0	37.4
1982	128.0	120.1	46.7
1983	207.8	208.0	105.2
1984	185.4	185.7	133.1
1985	212.3	221.7	177.4
1986	221.2	238.0	184.7
1987	149.8	169.3	118.9
1988	155.2	194.0	151.2
1989	152.5	205.2	145.7[a]
1990	221.4	278.0	161.0[a]
1991	269.5	321.7	179.8[a]
1992	290.2	340.3	201.5[a]

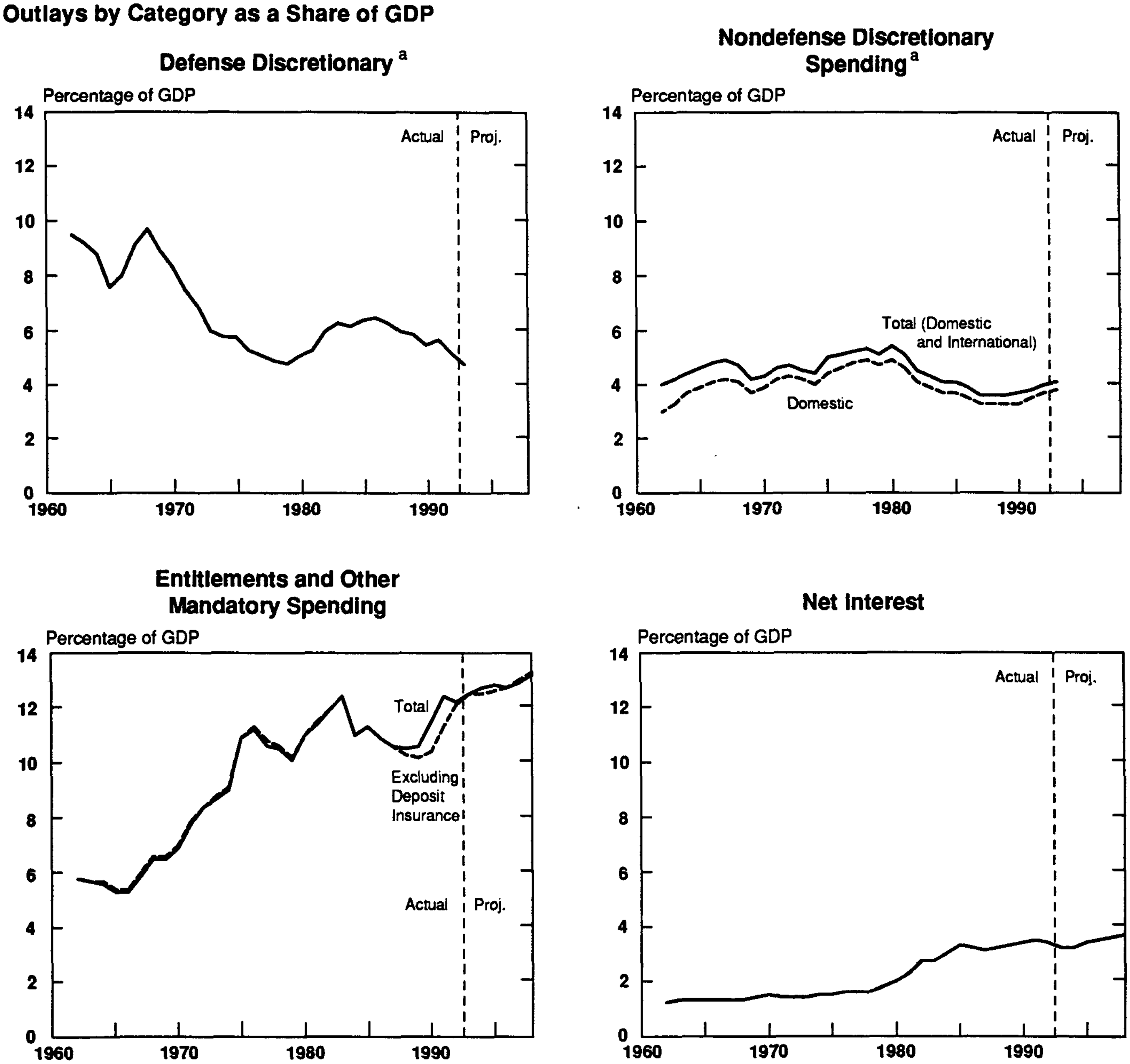
SOURCE: Congressional Budget Office.

a. Excludes deposit insurance.

summit agreement. The discretionary spending caps are holding; the appropriations committees and the Congress lived within their limits in fiscal year 1992 and actually reduced spending to a level below the caps in fiscal year 1993. The pay-as-you-go process has discouraged major efforts either to increase entitlement spending or to cut taxes.

Nonetheless, the deficit has not come down. When the BEA was enacted, policymakers believed that the budget summit agreement would lower the deficit substantially; the BEA included no requirement for additional deficit reduction if this outlook deteriorated. The factors that have led to an increase in the projected deficit since 1990 have largely

Figure 2.
Outlays by Category as a Share of GDP



SOURCE: Congressional Budget Office.

a. Assumes compliance with discretionary spending caps in the Budget Enforcement Act. Caps are not specified in detail after 1993.

to do with the deterioration of the economy and technical reestimates of revenues and spending, primarily for Medicare and Medicaid. Virtually none of the worsening in the deficit outlook results from policy actions.[2]

The Outlook for the Deficit Over the Next Ten Years

The growth of the deficit over the past decade might not be a concern if this pattern were temporary. But CBO's projections indicate that, under current policy, the deficit is unlikely to diminish between now and fiscal year 2003. These projections, which assume that laws are not changed and that discretionary spending keeps up with inflation once the BEA's caps expire, show that deficits will leap from $310 billion in fiscal year 1993 to $653 billion by fiscal year 2003 (see Table 2). As a percentage of GDP, the federal deficit would decline from 5 percent to 4 percent between 1993 and 1996, rising again to almost 7 percent by 2003. In 2003, the federal debt will have reached its largest fraction of gross domestic product in more than 50 years.

The projected growth in the deficit will continue to be fueled on the spending side by the growth of spending for the government's health care programs, which is projected to almost triple in dollar terms and increase substantially as a percentage of GDP over the period. In contrast, discretionary spending is projected to decline as a percentage of GDP through 2003 under current law, assuming that the caps for 1994 and 1995 are complied with and that discretionary spending does not grow in real terms between 1996 and 2003. The projections show that if current law is not changed, revenues remain a fairly constant percentage of GDP throughout the period.

Although all budget projections (particularly those extending far into the future) are imprecise, these projections represent CBO's best judgment of where the federal budget is headed if policies are not changed. (For more details on both the economy and the budget, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, January 1993.)

Table 2.
Baseline Deficit Projections, Fiscal Years 1993-2003

	Total Deficit Assuming Discretionary Caps	
	Billions of Dollars	As a Percentage of GDP
1993	310	5.0
1994	291	4.5
1995	284	4.1
1996	287	4.0
1997	319	4.2
1998	357	4.5
1999	404	4.9
2000	455	5.3
2001	513	5.8
2002	579	6.2
2003	653	6.8

SOURCE: Congressional Budget Office.

Clearly, if the budget deficit is to be dealt with, inaction is hardly the appropriate course. But what kinds of actions are in order? Ultimately, the deficit can be reduced only by taking policy actions to cut spending or raise taxes. But, unfortunately, attention is once again being focused on proposed procedural fixes.

Procedural Options to Reduce the Deficit

The budget process has an important role to play in any effort to reduce the deficit. But that role is generally limited to providing information to policymakers (on the costs of proposed actions, for example) and to enforcing previously agreed-upon actions to reduce the deficit. The process has not

2. See Box 6-1, p. 85, in Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998.*

proved nearly as useful in forcing agreement on policy actions that would reduce federal debt. The proposals that have generated the most interest over the past several years indicate the woefully limited ability of process to substitute for policy. They can be divided into rules that focus on the overall process, those that target discretionary spending, procedural devices to control mandatory spending, and formula-based approaches to taxation.

The Balanced Budget Amendment and Other Overall Budget Rules

The first category of rule-based reforms would set targets for the budget as a whole. Recently, proposals that would require a balanced budget amendment to the U.S. Constitution have generated considerable attention. Such an amendment would set an annual target of zero for the budget deficit.

During the 102nd Congress, proposals for a balanced budget amendment were considered in each House. H.J. Res. 290 fell only nine votes short of the two-thirds majority needed to win House passage in June 1992. Later that month, the Senate also considered, but did not pass, a proposed balanced budget amendment to the Constitution.

Although such an amendment would clearly make balancing the budget the guiding principle behind federal fiscal policy, lawmakers would still have to make the specific hard decisions about spending cuts and tax increases. In all likelihood, a balanced budget amendment would not bring about these changes, and it could actually make things worse. Such an amendment would offer too many opportunities for evasion, would be hard to define and apply precisely, and would provide little flexibility for carrying out fiscal policy.

The most important problem with a balanced budget rule is that it inevitably invites avoidance and evasion, as do all fixed annual deficit targets. There are four primary ways that the President and the Congress could get around an apparently rigid balanced budget constraint:

- Timing mechanisms and other budget gimmicks could be used to achieve short-run budget targets, including such actions as shifting payment dates between fiscal years, accelerating or delaying tax collections, delaying needed spending until future fiscal years, and selling government assets.

- The budget could be based on overly optimistic economic assumptions, if the amendment applied (as many proposals do) only to estimated revenues and outlays. A major step forward was made in the 1990 Budget Enforcement Act, which removed this incentive; a balanced budget amendment would reinstate it.

- Off-budget agencies might be created that would have authority to borrow and to spend but whose transactions would not be directly recorded in the budget. Off-budget agencies could be misused simply to avoid having to make large cuts to meet a balanced budget rule.

- Costly spending could be passed on to state and local governments or private businesses through mandates or regulations.

These methods, and others, were used to circumvent the annual deficit targets in Gramm-Rudman-Hollings. There is no reason to expect that the balanced budget rule would not fall prey to the same sorts of maneuvers.

Furthermore, no consensus exists on what should be included in the budget that has to be balanced under such a strict rule, or on how conformity with the balanced budget rule should be measured. Should the federal government be permitted to borrow to finance capital spending--perhaps at the cost of imposing less budget discipline on this spending? Should transactions that embody commitments to future costs and benefits be recognized only insofar as they affect cash flows, or should the accrual of future liabilities and benefits also be recognized? How should the balanced budget rules treat Social Security and other trust funds? Though the subject of considerable debate, these questions are not resolved in the proposed amendments.

Finally, a balanced budget amendment would not provide sufficient flexibility to allow for responses to shocks, such as recessions or natural disasters. Such an amendment could hobble the ability of the federal government to stabilize the economy. Economists are less convinced than they used to be that the federal government can undertake timely countercyclical fiscal policy. But the economy is automatically stabilized when a recession temporarily lowers revenues and increases spending on Unemployment Insurance benefits and welfare programs. This automatic stabilizing occurs quickly and is self-limiting--it goes away as the economy recovers--but it temporarily increases the deficit. It is an important factor that dampens the amplitude of economic cycles.

Other proposals have focused on changing the structure of the budget in a way that might promote policy actions to reduce the deficit. These proposals include (1) establishing a separate capital or investment budget that would permit borrowing for investment purposes but would require a balanced operating budget, and (2) removing trust funds from the calculation of the deficit in order to encourage policy actions to reduce the so-called federal funds deficit. Although structural reforms could possibly encourage reductions in federal borrowing, they are similar to the balanced budget amendment in that they do not themselves prescribe specific actions to achieve that result.

Discretionary Spending Reforms

Currently, discretionary spending accounts for 40 percent of total federal spending. Because discretionary appropriations represent the only part of the budget that must be acted on each year, they receive a great deal of attention. Discretionary spending has been declining as a percentage of GDP, and the prospects are for this trend to continue for the immediate future, under current policy. Several types of procedural devices have been enacted or proposed that would focus on the discretionary portion of the budget. These include the aforementioned caps on discretionary spending, Presidential authority to propose removing particular items from the budget, and formula-based approaches to reducing administrative expenses or the number of personnel in federal agencies.

Spending Caps. Limits on discretionary spending, such as those included in the Budget Enforcement Act, focus on constraining the overall amount of money that the Congress may appropriate in a given year. In the BEA, limits were set on both budget authority and outlays for fiscal years 1991 through 1995. Caps do not prescribe which spending is to be cut. Rather, they establish an overall limit in an effort to force action to reduce individual appropriations to comply with that limit. This overall limit is effective since appropriators must act every year to fund discretionary programs. They cannot, therefore, evade the caps by simply failing to act. Caps do not themselves reduce the deficit, but are intended as triggers to policy changes that will reduce discretionary spending, such as those found in this volume.

Item Veto and Expanded Rescission Power. Many Presidents have sought the authority to reduce or eliminate specific items in appropriation bills, a power possessed by 43 of the 50 state governors. The President currently has only two options--to either sign or veto a bill in its entirety. Proponents of the item veto say that this limits the President's ability to eliminate wasteful spending. Accordingly, they propose giving the President the power to reduce some low-priority or locally oriented--so-called "pork-barrel"--projects, thus trimming the deficit. They argue that the President, as a representative of the general interest, should have the power to strike provisions that serve only a narrow interest.

Although the item veto has often been proposed as a constitutional amendment, various statutory alternatives have been offered that are designed to have largely the same effect as the item veto. The most common of such proposals call for enhanced or expedited rescission procedures (a rescission rescinds--or cancels--an appropriation). Enhanced rescission would provide the President with the same authority as the item veto and would ultimately require a two-thirds vote to override a Presidential disapproval of spending items. Expedited rescission proposals (such as H.R. 2164, which passed the House in the last days of the 102nd Congress) are more limited in their grant of authority to the President. They would require the Congress to vote on rescissions proposed by the President; a simple majority vote would prevail.

Whether enacted as an amendment to the Constitution or statutorily, the item veto would have little effect on total spending and the deficit. Since the veto would apply only to discretionary spending, its potential usefulness in reducing the deficit or controlling spending is limited.

Indeed, appropriated spending has already been restrained by other means. The BEA's discretionary spending caps represent a statutory agreement between the President and the Congress on the level of discretionary spending. The item veto is not a substitute for such an agreement and is unlikely to lead to additional reductions in a regime in which spending is capped. Even if such limits were not in place, only Presidents who value reduced spending over pursuing their own spending priorities are likely to use the item veto for deficit reduction. The item veto in this case would not necessarily lead to a smaller deficit through reducing discretionary spending. It would give the President bargaining power to use with the Congress, but whether that arrangement would lead to a decrease in spending depends on the degree to which the President supports reduced deficits rather than increased spending.

Because an item veto would shift the balance of power between the President and the Congress, it probably would affect the distribution of spending by substituting some Presidential budget priorities for Congressional ones. Evidence from studies of how states use the item veto supports this claim; state governors have used it to shift state spending priorities rather than to decrease spending. Some analysts would argue that shifting spending priorities is sufficient reason to adopt the item veto if the President is less likely to engage in pork-barrel spending.

Formula-Driven Cuts in Spending. In many cases, proposals to reduce discretionary spending take the form of across-the-board cuts in whole categories of federal expenditures. Proposals to cut federal overhead and federal employment are typical examples. Such efforts are, like process-oriented deficit reduction strategies, approaches that avoid the tough choices involved in cutting specific programs in favor of using formulas. In general, however, targeted reductions in low-priority programs are likely to lead to a more efficient use of resources than are across-the-board cuts.

Consider, for example, across-the-board cuts in federal overhead--a term referring to federal costs not directly related to program delivery. (Such costs might include those covering Congressional liaison offices, public affairs staff, and personnel administration.) Efforts to cut overhead appear to affect only bureaucratic bloat and not the delivery to the public of essential services. In this sense, cuts in overhead are thought of as just a way to reduce federal waste. But federal budget and accounting practices do not even identify overhead (much less wasteful overhead) as a separate category of expense. In some cases, expenditures that are considered overhead represent the necessary costs that accompany the management of large and complex organizations. Such across-the-board cuts make no distinction between those expenses that are justified in terms of assisting with the delivery of important government services and those that are not. Many of the same general concerns arise in the case of cuts in federal employment. No doubt some excess employment exists, but if reductions affect programs that have expanding work loads--for example, law enforcement--the level and quality of critical services can decline.

Certainly the government should eliminate any excessive overhead and employment, but the across-the-board approach is probably not the best strategy. Instead, the Congress might consider focusing on the type of reductions in programs outlined in the following chapters. The major changes in programs described in this volume would, generally, lead to some reductions in travel, printing, and other overhead-type costs as well as reductions in personnel. Moreover, the reductions would occur in overhead and employment rendered surplus or waste by virtue of the program changes adopted.

Proposals to Control Mandatory Spending

Approximately half of all federal spending goes for entitlements and other mandatory spending. Payments for these programs are governed by eligibility criteria and funding formulas that are set in law. The programs are not constrained by annual appropriation acts. Mandatory spending, particularly for health care programs (primarily Medicare and Medicaid), has grown much faster than virtually any other spending.

The Budget Enforcement Act's pay-as-you-go process has improved the ability of the Congress and the President to ensure that actions affecting mandatory spending do not make the deficit any worse. PAYGO does not, however, restrain the growth in entitlement spending stemming from increases in the number of beneficiaries or greater costs of providing existing benefits. Many analysts now argue that, given the continued hemorrhaging of the deficit, it is necessary to go further than the BEA did. Proposals have surfaced for changing the process in a way that attempts to force additional deficit savings by holding mandatory spending below the level allowed by current law.

One procedural approach to pursuing deficit reduction for entitlement programs is to expand the pay-as-you-go process to require a stated level of annual saving resulting from revenue and mandatory spending actions. This approach was included in H.R. 5676, which then House Budget Committee Chairman Leon Panetta introduced in the 102nd Congress. Failure to achieve the required level of deficit reduction would result in across-the-board reductions in mandatory spending and increases in taxes. This approach could achieve these savings either through specific policy choices to reduce mandatory spending or through the sequestration process.

Another procedural proposal would place a limit, or cap, on the growth of mandatory spending. During the 102nd Congress, the Bush Administration and various Members supported the concept of placing an enforceable cap on mandatory spending. This proposal for a cap would have tied the growth of spending for individual programs to the increase in the eligible population and inflation, plus a transitional percentage that would allow the change to be phased in. A sequestration procedure would be established to enforce a breach of that cap. Savings would be achieved if spending were held to the cap level, because the costs of some programs, notably Medicare and Medicaid, are estimated to grow at a rate substantially higher than either the increase in their beneficiary populations or general inflation.

The startling growth in Medicare and Medicaid is primarily the result of increases in the use of hospital and physician services, changes in the quality of care, and inflation in medical care that exceeds inflation in the rest of the economy. Without a fundamental restructuring of Medicare and Medicaid, holding the growth of their costs to the cap level would require real cuts in the health care services that would be available to the elderly, disabled, and poor.

The advocates of this approach often do not accompany the call for a mandatory cap with the necessary proposals for reducing benefits in individual programs. For example, President Bush's 1993 budget indicated that a cap limiting the growth in mandatory programs to a level that accommodated increases in the recipient population, inflation, and a transitional percentage would save an estimated $293 billion between fiscal years 1993 and 1997. The same budget, however, proposed policy changes that would have resulted in a reduction of less than $25 billion in mandatory spending over that five-year period.

A sequestration of mandatory programs--whether it is to enforce a cap or a deficit reduction target--is anything but easy to carry out. Government benefit checks and other mandatory spending cannot simply stop flowing after the cap is reached without disrupting, and possibly endangering, the lives of millions of citizens. Agencies in the executive branch could estimate the likely shortfall resulting from the cap and adjust all future payments to account for the effect of the limit. Such action, however, would involve an enormous amount of bureaucratic discretion and uncertainty about the benefits that will actually be provided. In any case, the courts may be asked to respond to the conflict between the legislation that authorized the mandatory spending and a sequestration of that spending.

Regardless of these implementation issues, however, the mandatory cap (so long as it includes costly programs, such as Social Security and Medicare) would at least focus on the portion of spending that is currently not subject to annual, direct budgetary control. Whether a specific enforceable cap will achieve that control is open to some debate, however. Either reductions in specific programs (such as those that are contained in Chapter 4) or a workable sequestration mechanism would be necessary if the cap were to hold down mandatory spending and the deficit.

If the growth in health care costs is not curbed, it would be extremely difficult to comply with a stringent mandatory cap. Greater control of federal health care spending probably could not be achieved without significant changes to the overall health care system--changes that would have significant disadvantages as well, such as limiting freedom of choice of providers, rapid access to new technologies, and research and development.

Further, those cuts will be hard to achieve because many lawmakers will want to use any savings from improving the efficiency of Medicare and Medicaid to provide greater and more affordable access to medical care for citizens who are not covered by government health care programs and do not have access to, or cannot afford, private health insurance. A mandatory cap might increase the prospect for health care reform, but a cap would be a very blunt instrument to use in this delicate task.

Revenue Actions

Few procedural ways have been offered to increase the contribution of revenues to deficit reduction. Nonetheless, several recent proposals to enforce deficit reduction would rely on automatic tax surcharges, in addition to spending cuts, in order to enforce these actions. For example, deficit reductions targets in some of these bills would have been enforced in part by imposing a higher top marginal income tax rate.

Most formula-based revenue proposals have another goal in mind. They tend to aim at tax reduction rather than decreases in the deficit. These proposals would typically limit either the overall level of taxation (tying it to a percentage of GDP, for example) or the amount of annual revenue growth (such as capping it at no more than 4 percent a year). Although these proposals may have merit on their own, they do not advance the cause of deficit reduction. If reducing the federal deficit is the goal, the only way to address that using revenue actions is by enacting the kinds of options suggested in Chapter 5.

Conclusion: Reducing the Deficit Through Policy Actions

Process changes have an important, yet limited, role to play in efforts to reduce the deficit. First, they can provide information to policymakers concerning the budgetary impacts of proposed actions. Second, they can enforce previously agreed-upon deficit reduction actions. The process is not as useful when used to force the adoption of these actions. No process can substitute for the fact that further deficit reduction will necessitate cutting spending, raising taxes, or both. A process--whether it is Gramm-Rudman-Hollings, the BEA, or something new--can make it marginally easier or more difficult for politicians to explain these decisions to voters, but it will not make the decisions significantly easier to make.

How to Use This Report

The policy options for reducing the deficit, which include both decreasing spending and increasing revenues, are presented in the four remaining chapters of this report. Chapters 2 and 3 cover the discretionary programs--national defense (including international programs) in Chapter 2, and domestic programs in Chapter 3. Chapter 4 covers entitlements and other mandatory programs and also presents options that involve raising fees. Chapter 5 discusses options that would raise revenues.

Each of the options starts with a table showing annual and cumulative five-year savings. For an entitlement program, the numbers in these tables show the difference between what the program would cost under the CBO baseline, which assumes continuation of current law, and what it would cost (in millions of dollars) under the proposed modification. In the case of revenues, the entries show the increase in revenues (in billions of dollars)--over and above those due under current law--that would take place if the option were enacted.

For discretionary programs, the tables record the savings compared with a baseline in which the assumed level of appropriations equals the actual 1993 appropriation increased for projected inflation. Because this baseline does not incorporate the discretionary spending limits imposed by the Budget Enforcement Act for 1994 and 1995, it is termed the uncapped baseline. In contrast, the CBO baseline assumes that the discretionary spending limits are met (see Table 3).

In developing a deficit reduction plan, users of this volume should subtract the savings for their chosen options from the deficits in the uncapped baseline. Just to reach the deficits in the CBO baseline, they will have to select options that reduce discretionary outlays by $13 billion in 1994, $25 billion in 1995, and $107 billion over the 1994-1998 period.

The Bush Administration's defense budget of last year offers much of the savings needed to reach the CBO baseline from the uncapped baseline. Compared with the uncapped baseline, the Bush Administration's 1993 budget would reduce outlays by $10 billion in 1994, $13 billion in 1995, and $80 billion

Table 3.
Required Reductions in Discretionary Spending (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Cumulative Five-Year Total
Uncapped Baseline Deficit[a]	304	310	313	347	387	1,662
Reductions Required to Meet CBO Baseline						
Discretionary spending	-13	-25	-24	-23	-23	-107
Debt-service savings	b	-1	-3	-5	-6	-16
Subtotal	-13	-26	-27	-28	-29	-123
CBO Baseline Deficit[c]	291	284	287	319	357	1,539

SOURCE: Congressional Budget Office.

a. The assumed level of discretionary appropriations in 1994 through 1998 equals actual 1993 appropriations increased for projected inflation and excludes emergencies.

b. Less than $500 million.

c. Discretionary appropriations are held to the limits established by the Budget Enforcement Act for 1994 and 1995 and are adjusted for inflation thereafter.

over the 1994-1998 period (see Table 5 in Chapter 2). Many users of this volume may want to start by assuming all of the reductions inherent in last year's budget request. In fact, most of the options are constructed with last year's request in mind.

How much further should the deficit be reduced? There is no optimal level of savings. By way of comparison, the budget summit agreement of 1990 provided a total of almost $500 billion in spending cuts and tax increases over five years. Another $500 billion package would hold the 1998 deficit to about $180 billion, or 2.3 percent of GDP. Because of the rapid rise in the baseline deficit at the end of the decade, however, such a package would have to be followed by much deeper cuts in later years to keep the deficit on a downward path. Eliminating the deficit over the next five years would require about $1 trillion in cuts below the CBO baseline--twice as much as the 1990 effort (see Table 4).

The specific options included in this volume came from various sources, such as past Presidential budget proposals, past legislative proposals, and the suggestions of various private groups. Others have been developed by CBO staff. In none of these cases should the inclusion of an option be taken as an endorsement by CBO. Furthermore, this particular menu is meant to cover a broad range of options, and the exclusion of options does not necessarily

Table 4.
Illustrative Deficit Reduction Alternatives (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Cumulative Five-Year Total
			$500 Billion in Five-Year Savings			
CBO Baseline Deficit	291	284	287	319	357	1,539
Illustrative Savings						
Policy changes	-30	-60	-90	-120	-150	-450
Debt-service savings	-1	-4	-8	-15	-25	-53
Subtotal	-31	-64	-98	-135	-175	-503
Resulting Deficit	261	220	188	184	183	1,036
			$1 Trillion in Five-Year Savings			
CBO Baseline Deficit	291	284	287	319	357	1,539
Illustrative Savings						
Policy changes	-60	-120	-180	-240	-300	-900
Debt-service savings	-2	-7	-17	-31	-49	-105
Subtotal	-62	-127	-197	-271	-349	-1,005
Resulting Deficit	230	157	90	49	8	533

SOURCE: Congressional Budget Office.

indicate their lesser worth. Finally, variations of these options are also possible; for example, tax rates could be raised by more or less than is contained in a specific option, or a decision could be made to change policies that affect spending by a lesser or greater amount than is indicated in a spending option. For each option, this volume presents the pros and cons. The decision as to whether to carry out any of them is for elected officials to make.

Virtually all of the options presented here would, in isolation, reduce employment temporarily. Accordingly, this particular drawback is not noted in each discussion. Similarly, since all the proposals that would reduce grants to state and local governments would make their financial status worse, that fact is not repeated in each discussion.

A last caveat is that some options may not be counted in meeting the BEA's requirements for implementation, even though they would reduce the deficit. An example would be a reduction in Social Security spending, which would not enter either the discretionary or PAYGO calculus since Social Security is governed by separate rules under the BEA. Generally, if the savings cannot be counted under the BEA, this is noted in the write-ups.

Finally, though all of the options, if devoted to deficit reduction, would reduce federal interest costs, these savings are not part of the calculations made. When CBO is presented with a detailed budgetary plan, the individual options are "costed" as in this book, but a supplementary additional saving is scored for the effect of the whole package on net interest spending. Moreover, when such budget packages are put together, adjustments can be made for any interactions among the parts that would raise or lower the savings--something that could not be done for the options discussed here. The estimates do not take into account the possible economic gains or losses associated with large-scale deficit reduction.

Other Proposals Not Covered by These Options

Some proposed actions, although they could certainly result in substantial deficit reduction, are beyond the scope of this report and are therefore not included. Three of these actions that have received considerable attention can serve as examples:

- o The restructuring of the defense budget to reflect post-Cold War realities could result in large savings that are beyond the five-year time horizon of this volume. Canceling weapon systems, for example, could save substantial money over the long term, but not necessarily within the five-year window.

- o A redefining of the role of the national government within the federal system could have wide-ranging long-term effects on federal, state, and local budgets. Ultimately, it could involve a wholesale reexamination of both revenue sources and functional responsibilities at all three levels. But such a plan would have to be very broad and therefore could not easily be presented as a deficit reduction option in this report.

- o Raising the retirement age would reduce both Social Security and federal retirement costs. Most savings, however, would occur far beyond the five-year savings period identified in the options included in this report, because such a reform would necessarily need to be phased in over several years.

The exclusion of these policy options is primarily a reflection of the time horizon chosen for budget savings rather than a statement concerning the viability of these proposals. Once again, however, they represent genuine policy choices that might, like the options specified in this volume, result in deficit reduction.

Chapter Two

Defense and International Discretionary Spending

The advent of a new Administration is only one of the factors that will affect Congressional deliberations on the budget for national security in 1994. As noted in Chapter 1 of this volume, the budget rules that applied for 1992 and 1993 are somewhat altered for 1994 and 1995, leading to the possibility of trade-offs between defense and nondefense spending that were prevented by the separate appropriation caps in the Budget Enforcement Act. Meanwhile, the Congress has overruled several of the Bush Administration's proposals to eliminate particular weapon systems; the Congress took these actions out of concern for defense workers, who might be better able to find new jobs if the economic recovery continues and strengthens.

With President Clinton having focused in his campaign on a $60 billion, five-year cumulative cut below the Bush Administration's January 1992 defense budget request, the prospect for 1994 and beyond is that the Congress will have to consider many ways to cut defense spending. This chapter presents 61 such options from a wide range of defense and international programs. This introduction sets these choices in the broader context of the United States' national security objectives and economic constraints, and discusses some of the criteria that might be applied in judging the merits of the individual options.

Threats to National Security

It is axiomatic that U.S. military forces must be strong enough to deter threats to national security at an acceptable level of risk and to defeat such threats if deterrence fails. In practice, this axiom translated for many years into strategic forces able to deter nuclear threats, chiefly from the former Soviet Union, and conventional (nonnuclear) forces capable of fighting one major and one lesser war simultaneously in widely separated theaters. Smaller commitments, such as fighting insurgencies or projecting power in isolated parts of the globe, were largely subsumed in the major force requirements.

Geopolitical changes during the last few years have fundamentally altered the threats from which these requirements were derived. The dissolution of the Warsaw Pact virtually ended the chances of a major East-West conventional war in Europe, thus eliminating the rationale for maintaining large U.S. standing forces there and large reserve forces at home that could be rapidly mobilized. Even before its breakup into separate republics, the Soviet Union had reached agreement with the United States on wide-ranging reductions in strategic and conventional forces. Following that breakup, an era of enhanced East-West cooperation has been characterized by such landmark events as joint support for military action in the Persian Gulf, agreement between Presidents Bush and Yeltsin on continued cuts in strategic weapons, and Western economic assistance in the restructuring of Eastern Europe and the former Soviet Union.

These changes in the perceived threats to U.S. national security have already been reflected in some Congressional decisions. For example, once again, in 1992, the Congress declined to grant in full the Bush Administration's request for drawing down the size of the reserve components and called instead for cutting the number of U.S. troops in Europe substantially below the level in the Administration's plan. These actions are consistent with the view that the threat of a European war has receded, letting the

United States both reduce force levels in Europe below those in the Bush Administration's "base force" and accept the somewhat lower level of readiness implicit in a heavier reliance on the reserves. The base force itself, as enunciated by the Bush Administration in 1991, represented a reduction of about 20 percent in manpower and of about 20 percent to 33 percent in different types of active military forces from 1990 levels; under the original proposal, for example, active-duty personnel would decline from close to 2.05 million to about 1.65 million by 1995.

Similarly, only a year after agreeing on the need to deploy defenses quickly--by 1996--to protect the United States against ballistic missile attack, the Congress cut 30 percent ($1.6 billion) from the Administration's request for 1993 and specifically removed the requirement to deploy defenses early. Underlying this action was recognition that the threat of an unauthorized or accidental launch from the former Soviet republics or an attack from a developing country was not likely enough to justify rushing the development of the system. In addition, some Members of Congress expressed a desire to reorient missile-defense efforts to regional threats, such as the shorter-range Scud ballistic missiles used by Iraq in the Persian Gulf War.

Changes in threats might well lead to the reexamination of other defense programs. For example, much of the Navy's fleet of surface ships has been sized and structured in part to counter the submarine capabilities of the former Soviet Union. The number and type of Air Force and Navy fighter and attack aircraft have been determined largely by the strength of Soviet tactical air forces. The Army and Marine combat elements required to counter heavily armored Soviet forces in Europe are different from the units needed to protect relief workers from armed gangs in Somalia or even from well-armed irregulars in Bosnia-Herzegovina.

More fundamentally, reductions in global threats could lead to basic changes in the size and composition of U.S. forces. Last year, the chairmen of both the Senate and House Committees on Armed Services called for cuts of up to 10 percent in the Bush Administration's base force. A much more far-reaching plan proposed by defense analysts at the Brookings Institution would slash defense spending to about 60 percent of the level in the Bush Administration's plan, with attendant reductions in force size and modernization. The common theme in these analyses is that the proposal for the base force does not fully reflect the extent to which world events have eased U.S. security needs and commitments.

Changes in threats might also lead to reconsideration of the basic organization of the Department of Defense (DoD). In this connection, last year's Congressional debate generated a number of suggestions for changes in the department's structure and administration, the most far-reaching of which may have been Congressional direction to the Joint Chiefs of Staff to review the services' roles and missions, with the objective of eliminating overlaps in responsibility. A number of other, more modest changes were also proposed by the committees with DoD oversight.

Congressional deliberations in 1992 concerning tactical aircraft offer an example of the Congress's concern about overlapping roles and missions. The Air Force and Navy plan to develop or procure four types of fighter or attack aircraft, and the Army plans to develop a new helicopter (see DEF-18 through DEF-20 and DEF-25). Several committees raised concerns about the affordability of these plans, and the Senate Committee on Appropriations took the dramatic step of directing DoD to combine funding for the several planes into a single account for tactical aircraft. This action would have compelled the department to face the issue of overall affordability and presumably also to set priorities within its plan for the planes. But this approach did not find its way into final legislation on the 1993 budget; instead, the Congress directed DoD only to provide a plan for combined procurement of tactical aircraft that addressed a number of issues, including affordability. The Congress stipulated that limits be placed on the funds that DoD can spend for these programs before the department submits a comprehensive plan.

Economic and Budgetary Constraints

Both in the Congress and elsewhere, many voices have called for defense spending to be reallocated to other national needs. Suggested uses for the peace dividend have included virtually every type of federal program: tax relief, increased grants to states and localities, rebuilding the nation's transportation systems, aid to education, additional research on the acquired immune deficiency syndrome (AIDS), higher payments for Aid to Families with Dependent Children (AFDC), space programs, and countless others.

As was discussed in Chapter 1, the Budget Enforcement Act (BEA) precluded any wholesale reallocation of funds from defense to nondefense programs in 1992 and 1993. For 1994 and 1995, however, the caps on discretionary spending will apply only to the aggregate of defense and nondefense appropriations. The Congressional Budget Office's (CBO's) projections suggest that to comply with the BEA caps while maintaining nondefense discretionary spending at its inflation-adjusted 1993 level, the defense budget authority proposed in the Bush Administration's January 1992 plan would have to be cut by an additional $7 billion in 1994 and $12 billion in 1995.

There could well be pressure for significantly larger defense cuts. Even if discretionary spending is limited to the BEA levels, the projected deficit will remain substantial (see Chapter 1). Further cuts in defense may be proposed as part of a package aimed at reducing that deficit. It is also possible that increases in nondefense investments, favored by President Clinton during the campaign, could be financed in part through further cuts in the defense budget.

Yet large reductions in the defense budget may be difficult to achieve. They might reduce defense forces below the level of even the most ambitious option offered last year by Secretary of Defense Les Aspin, who was then Chairman of the House Committee on Armed Services. President Clinton might also oppose such large cuts, which would go beyond the reductions he advocated during the campaign.

Another factor that influenced Congressional debate over the defense budget for 1993 was the macroeconomic and employment consequences of large reductions in spending. Members of Congress proved reluctant to terminate some major weapon systems that the Bush Administration had sought to cancel, because doing so would eliminate the jobs of workers in the defense industry. Instead, the Congress enacted a substantial package of programs aimed in part at helping defense firms convert to nondefense production. The Congress also protected defense military and civilian personnel by enacting incentive programs for early retirement and other voluntary separations.

CBO's analysis indicates that a $1 billion cut in annual defense outlays would lead to the loss of about 20,000 jobs. Most of the losses would be in direct defense employment of military and civilian personnel, but further employment effects would be spread throughout the economy. In time these losses would be reversed through either the longer-run expansionary effect of lower federal deficits leading to increased national saving and investment or the offsetting effects of other expenditures funded by the defense reductions. The long-run effect of using defense cuts to reduce the deficit thus could actually be one of a net gain in new jobs. In a slack economy, however, the combination of short-run job losses and longer-run costs of retraining displaced workers might offer an argument for avoiding larger reductions in defense spending. Improvement in the economy might ease some of these concerns but probably will not eliminate them.

Effects of Alternative Reductions on Military Capability

Employment consequences notwithstanding, the combination of budgetary constraints and reductions in the threat to U.S. security seem sure to lead to proposals to cut military forces and programs. This prospect raises the question of whether the remaining forces would be sufficiently capable to defend against foreseeable military threats. At issue are the size of these forces, their readiness to fight early in a war, and modernization of their weapons.

Size of Forces

Based on judgments expressed by the Bush Administration, cuts in force levels below the size of the base force would not fully meet U.S. military requirements. Those judgments reflected the desire to have enough active forces for a large regional conflict such as Operation Desert Storm and to be able simultaneously to meet the needs of a small contingency elsewhere. Such a goal might well require all the units planned for the base force. But the changes in threats that have occurred since the Bush Administration formulated the base force may well have diminished the need for forces of this size.

Forces smaller than the base force would still be substantial in comparison with those of other countries that maintain large military forces, including the former Soviet Union's constituent republics, North Korea, and China. A smaller active force also would be large enough to meet the needs of a large regional conflict such as Operation Desert Storm if reserve forces were called to active duty as backups for other contingencies.

Moreover, such forces should be adequate to handle smaller contingencies of the sort that have occurred in the past. Leaving aside Operation Desert Storm and wars for which the United States has used conscription to build up its military, the largest previous deployment of U.S. forces consisted of the 27,000 troops used in Panama in 1990 for Operation Just Cause. (At its inception, Operation Restore Hope in Somalia was planned to involve about 28,000 U.S. troops.) Military forces as large as the base force would far exceed those required to handle such relatively small contingencies.

Readiness

Readiness for war is another criterion used to judge military capability. During the transition to a smaller force, military readiness would probably be reduced in comparison with that of the base force. As additional units are eliminated, the services will have to reassign and perhaps retrain personnel and either redistribute equipment or prepare it for storage. Larger reductions would mean a greater disruption in training and readiness.

Once this transition is over, however, training and readiness probably would depend on the amount of operating funds available for a typical unit. In the past, the Congress has resisted making disproportionate cuts in funds for operation and maintenance, arguing that training and readiness needed to be maintained even in a period of budget reductions. Unless this position is reversed, funding should be sufficient to permit training, maintenance, and other activities related to readiness to continue at current levels.

Readiness also depends on the number, quality, and experience of military and civilian personnel. Unless the military services draw down their forces in a balanced manner, they might be left with more senior personnel and fewer recruits than they need. That could result in assignment mismatches, slower promotions, lower morale, and--in the long run--a shortage of midcareer commissioned and noncommissioned officers. Under the base force, for which the overall drawdown presumably would be smaller than for some of the options discussed in this chapter, these problems might not be as severe.

Modernization

During the next decade or so, the Bush Administration planned to equip many military units with new and expensive weapons. Additional reductions in funding for procurement would force many of these modernization plans to be abandoned or delayed significantly. Systems affected could include those in all four services and strategic as well as conventional (nonnuclear) forces. The Bush Administration's January 1992 defense plan proposed some cutbacks in modernization, some of which the Congress rejected or modified. But all these cutbacks and more might be needed if the Congress decides to control or even reduce the federal deficit through cuts in defense spending.

Canceling or delaying weapon systems could adversely affect the viability of many defense contractors. Procurement budgets have already fallen sharply from levels of the 1980s. Coupled with the high prices of many new weapons, lower procurement budgets would cause the industrial base for weapons production to shrink even more than under the Bush Administration's January 1992 plan, perhaps jeopardizing the ability of the United States to produce weapons in large quantities in the future, should that be needed.

The reductions in capability associated with slower modernization could be offset, at least for some types of forces, by making disproportionate cuts in other types of units. For example, the diminution of the threat in Europe might permit additional savings from the demobilization of European forces to be reallocated to Army or Air Force modernization. Strategic forces might be subject to larger-than-planned reductions if the arms reduction treaty negotiated by Presidents Bush and Yeltsin goes into effect.

Specific Options for Reducing Defense Spending

Many of the issues touched on briefly in this introduction are discussed at greater length in connection with the specific options presented in the remainder of the chapter. Those options are grouped according to topic. Options numbered DEF-01 through DEF-33 address changes in investment plans and force structure. These options include possible reductions in funding for strategic systems, Navy ships and related systems, tactical aircraft in the Navy and Air Force, and Army units, as well as other issues related to procurement.

Options for reducing the costs of manpower, both military and civilian, and support activities are presented in DEF-34 through DEF-54. Some of these options would reduce pay, and others would change personnel policies, funding for operation and maintenance, and military medical care. Finally, options dealing with international affairs (budget function 150) are presented in DEF-55 through DEF-61.

These options are neither recommendations about nor a comprehensive list of ways to reduce the defense budget. Options were included here because CBO judged that they met one or more of several criteria: they had previously been the subject of Congressional debate, the need for them might be affected by recent changes in threats, or the option's efficacy was supported by analysis. Other analysts applying the same criteria might well reach different conclusions about which options to include; still others might use wholly different criteria.

One way that readers might choose to use this chapter is to combine options to meet a target for deficit reduction. The deficit projections in Table 3 on page 12 include defense spending as reflected in the uncapped (inflation-adjusted) baseline shown in Table 5. The Bush Administration's January 1992 budget plan, however, incorporated five-year reductions of some $82 billion in budget authority and $80 billion in outlays below the uncapped baseline. These savings are reflected in most of the options in this chapter, which assume adoption of the programmatic changes included in that plan unless later Congressional action modified them. (As an example of such action, the Congress did not lower 1993 personnel levels for the reserves by as much as the Bush Administration wanted. CBO's baseline for reserve strength--the number of people in the reserves at the end of the fiscal year--thus is higher than last year's budget request by the cost of the 73,000 people the Congress added to the Administration's request for 1993.)

Since most of the options in this chapter reflect the savings in the Bush Administration's plan, deficit reductions using these options generally should be made relative to that plan rather than the uncapped baseline. To reach a deficit reduction target, the reader could start from the uncapped baseline deficit projections in Table 3 and subtract the Bush Administration's planned outlay savings. Thus, the five-year total of defense outlays would be reduced from $1,501 billion (in the uncapped baseline) to $1,421 billion by subtracting the savings of $80 billion in the Bush Administration's plan, as shown in Table 5. Budget authority similarly would be reduced from $1,520 billion to $1,438 billion.

Savings associated with particular options then would be subtracted from the remainder--that is, from $1,438 billion for budget authority and $1,421 billion for outlays. For example, DEF-16 discusses the option of reducing the number of aircraft carrier battle groups. In 1993, the Navy will operate 13 aircraft carriers, the number consistent with the uncapped baseline. Last year's budget proposed eventually cutting the number of deployable carriers by one, to a total of 12, and DEF-16 would realize $16.4 billion in five-year savings in federal budget authority and $13.0 billion in outlays by cutting three more, to a total of nine operational carriers. Relative to the uncapped baseline, savings from DEF-16 would be larger, because that baseline assumes deployment of 13 carriers rather than the 12 in the Bush Administration's plan. A reader choosing this option thus would reduce the five-year totals of budget authority and outlays to $1,422 and $1,408 billion, respectively, by subtracting the savings from the amounts in that plan.

Table 5.
Comparison of the Uncapped Baseline with the Bush Administration's January 1992 Defense Plan (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Total
			Uncapped Baseline			
Budget Authority	287	295	304	312	321	1,520
Outlays	289	293	300	306	314	1,501
			Savings Under the Bush Administration's Plan			
Budget Authority	-5	-11	-18	-22	-25	-82
Outlays	-10	-13	-15	-19	-23	-80
			Bush Administration's January 1992 Defense Plan			
Budget Authority	282	284	286	291	296	1,438
Outlays	279	280	284	288	291	1,421

SOURCE: Congressional Budget Office.

NOTE: The uncapped baseline assumes that individual discretionary appropriations increase at the rate of inflation and excludes emergency appropriations. Data shown are for budget function 050 (national defense).

DEF-01 LIMIT SDI TO ABM-COMPLIANT DEFENSE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	2,000	3,100	3,100	3,600	1,900	13,700
Outlays	860	2,050	2,680	2,980	2,340	10,910

In June 1992, the Bush Administration proposed deploying a system to defend the nation against attacks by ballistic missiles that can carry nuclear warheads or other weapons of mass destruction. Initially, the proposed system would use ground-based radars to detect incoming warheads; eventually, the ground-based radars would be aided by sensors based in space. Warheads would be attacked by ground-based interceptor missiles and, eventually, by interceptors based in space. These defenses would be developed under the Strategic Defense Initiative (SDI).

Under the Bush Administration's plan, which responded to Congressional action in the Missile Defense Act of 1991, prototype hardware would be used as early as 1997 to field a defensive system at a single site. The system would consist of a ground-based radar and ground-based interceptors. Deployment of production hardware would begin in 2000, distributing 750 ground-based interceptors over four to six additional sites and, if necessary, replacing prototypes at the initial site. The deployments of satellite-based sensors would enhance the capabilities of these ground-based defenses around the turn of the century. The space-based sensors could track incoming warheads at greater distances and help discriminate between warheads and decoys. Up to 1,000 space-based interceptors--satellites carrying miniature interceptor missiles--would be deployed shortly after 2000 to increase the defenses' capability even further. Several aspects of the Bush Administration's plan would require abrogating or renegotiating the Anti-Ballistic Missile (ABM) Treaty of 1972. The entire plan, along with a complementary effort to develop defenses against shorter-range or theater missiles, is designated the Global Protection Against Limited Strikes (GPALS) system.

In contrast to the Bush Administration's SDI plan, this option would deploy only 100 ground-based interceptors and a radar at a single site near Grand Forks, North Dakota, and would comply with the 1972 ABM treaty. Defenses would be deployed at that site beginning in 2003--six years after the Bush Administration's plan would deploy prototype defenses at its first site and three years after it would begin to deploy production hardware at the first additional site. Also in contrast to the Bush Administration's plan, this option would not deploy space-based sensors or space-based interceptors, both of which would violate the ABM treaty. Instead, it would deploy the ground-based surveillance and tracking system (GSTS) or a comparable system of sensors that would be based on the ground but could be launched into space after enemy missiles had been launched at the United States. Whether GSTS complies with the treaty is still a subject of debate and depends on its capabilities.

In addition to deploying a single defensive system, this option would continue research and development on promising technologies such as space-based sensors, but at only about half the level envisioned in the Bush Administration's plan. Funding for defenses against theater missiles (like the missiles Iraq used during the Persian Gulf War) would remain unchanged.

This approach may be more consistent with Congressional intent as expressed in the National Defense Authorization Act for Fiscal Year 1993, though the language was not explicit. The Congress apparently supports deployment of an initial site of defenses at a time later than the early fielding called for by the Bush Administration, and this option would delay the fielding of that initial site. The Congress also expressed concern about deploying space-based interceptors, which this option would not deploy. The Congress, however, did not explicitly endorse a system like the one outlined in this option.

Compared with the SDI funding the Bush Administration proposed in January 1992, this option would save $2 billion in 1994 and a total of $13.7 billion from 1994 through 1998. (That plan called for SDI funding of $6.4 billion in 1994 and a total of $38.6 billion through 1998.) These savings would be realized by delaying the deployment of the initial site at Grand Forks, not deploying defenses at other sites, and not deploying space-based interceptors or space-based sensors. Nearly half of these five-year savings--about $6 billion not spent because of the delay in deployment of the initial site--would have to be spent in years beyond 1998. The remainder of the savings represent permanent reductions in costs unless, in the future, the Congress chooses to deploy large defenses. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would restructure the SDI program--largely in response to Congressional action--to delay deploying the first national missile defenses site until 2004 (or 2000 if prototype hardware is used) and to increase spending on theater defenses. These changes would largely eliminate the savings from this option.

At a minimum, the system of defenses outlined in this option would be able to defend a large portion of the interior of the United States against most small attacks--a few tens of warheads--launched from intercontinental distances in the Northern Hemisphere. Thus, once in place, this system should provide a defense against the type of attacks that could someday be launched by regional powers, such as those in the Middle East, that appear potentially hostile to the United States.

Whether the defense paid for by this option could protect the coastal regions of the continental United States against a small attack depends on the exact nature of the attack and on one's interpretation of the ABM treaty. The system could not protect against warheads launched close to the United States --for example, from Russian submarines near the U.S. coast--but this threat now seems greatly reduced. For warheads launched from farther away, the system could protect the coastal regions under certain interpretations of the ABM treaty. Those interpretations, which many arms control experts vigorously reject, would permit unlimited use of tracking data from the GSTS sensors and early warning radars to enable the system to intercept warheads completely outside the view of the radar at Grand Forks. Under other interpretations, which would limit the use of that data, coastal regions could not be defended. In any case, the system in this option could not defend Alaska or Hawaii.

That single-site system would also not be able to protect against a large missile attack. For example, an unauthorized attack by a rogue commander of a Russian submarine could launch 100 or more warheads, well beyond the capability of this option's 100-interceptor defense. Without space-based sensors, the defenses under this option would also have only limited ability to overcome countermeasures (such as decoys) that an attacker might use.

Opponents of this option would emphasize the undesirability of these limitations, arguing for a larger system of defenses such as the one envisioned by the Bush Administration. Such a system could defend all of the United States, including Alaska and Hawaii, and could protect against a larger missile attack. Substantial portions of this larger system would also be in place sooner than under this option. Supporters of the Bush Administration's program insist that an early deployment is crucial because of the instability in the former Soviet republics as well as the potential proliferation of ballistic missile technology to the developing world.

Supporters of this option would argue that a single-site, 100-interceptor defense would be significantly cheaper. This smaller system, they would argue, should also be sufficient to meet any reasonable threat that is likely to occur in the foreseeable future, even if development is not rushed to achieve deployment in 1997. Supporters assert that the threat of unauthorized launch by one of the former Soviet republics will have diminished by the time defenses would be deployed under the Bush Administration's plan, as governments stabilize and missiles are removed from Belarus, Ukraine, and Khazakstan under the terms of the Strategic Arms Reduction Talks (START) Treaty. They also reject the notion of an imminent threat from radical regional powers in the developing world, pointing to recent testimony by then Director of Central Intelligence Robert Gates that other countries would not develop long-range ballistic missiles for at least another decade. Furthermore, supporters of this option would argue that U.S. offensive nuclear forces represent a powerful deterrent to any nation that developed the means to attack this country.

DEF-02 FOCUS MISSILE DEFENSE EFFORTS ON THEATER DEFENSES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	3,300	4,400	4,500	5,100	5,500	22,800
Outlays	1,480	3,200	4,000	4,360	4,800	17,840

The preceding option (DEF-01) described the Bush Administration's plan for developing a system to defend the nation against ballistic missile attacks that are launched from other countries and so travel over intercontinental distances. In addition to this system of national missile defenses (NMD), the Bush Administration planned to deploy several systems that would defend U.S. troops deployed overseas against attacks by ballistic missiles of less-than-intercontinental range--so-called theater missiles.

Deployment of theater defenses enjoys strong Congressional support because of the threats to U.S. troops demonstrated in the Persian Gulf War. Fielding a system of improved theater defenses will involve development of several types of ground-based interceptors and a ground-based radar. Interceptors based on ships and aircraft may also be included. Deployment of the simpler of these interceptor systems will begin in the mid-1990s under the Bush Administration's plan. Deployment of the more complex radar and interceptors designed to defend a wider area will begin shortly after the turn of the century.

This option would focus most funding for ballistic missile defenses on theater defenses. Funding for theater defenses would be unchanged from that proposed by the Bush Administration in January 1992 and would consume roughly $2 billion a year from 1994 through the end of the decade. Funding for national missile defenses would be sharply limited to an amount sufficient to carry out a modest program of research. This option assumes that the real level of funding would be roughly $1 billion a year through 1998. Although significantly lower than the levels proposed by the Bush Administration, it is roughly the same amount (after adjustment for inflation) that was provided for research on national missile defenses in 1975 through 1983, the eight years before President Reagan's 1983 decision to develop national missile defenses.

Compared with the funding proposed by the Bush Administration in January 1992, this option would save a great deal of money--$3.3 billion in 1994 and $22.8 billion from 1994 through 1998. (The Bush Administration proposed funding of $6.4 billion in 1994 and a total of $38.6 billion through 1998.) If funding for theater missile defenses was increased, however--as then Secretary of Defense Dick Cheney proposed in the budget revisions he suggested in January 1993--savings from this option could be lower.

Limiting the NMD program to research would effectively delay deployment of a national missile defense until at least the middle of the next decade unless the Congress reversed the research-only choice and increased funding sharply beyond 1995. Indeed, as long as funding continued at a research-only level, the delay in deployment would be indefinite.

Opponents of this option would argue that the nation cannot afford a long delay, certainly not an indefinite delay, in deployment of a system to defend the nation against attacks from ballistic missiles. Although proliferation of the technology necessary to launch long-range ballistic missiles might not occur for several years, in their view it seems likely that nations in the developing world will begin to acquire and deploy intercontinental missiles before defenses could be deployed under this option.

Advocates counter that this option's wait-and-see approach saves a lot of money at a time of tight budgets and still provides a robust system of defenses against the more pressing threat of theater missiles. The option would also preserve a healthy research base and an advanced technology development effort that would allow the United States to deploy national missile defenses in the event that other countries develop intercontinental ballistic missiles (ICBMs). Proponents argue that U.S. intelligence could provide ample warning of any efforts by hostile regional powers to develop ICBMs, because their development would require many flight tests. If intelligence revealed that a potential adversary was developing long-range ballistic missiles earlier than expected, the program of national missile defenses could be accelerated. Proponents also argue that in the worst case, in which a hostile country develops an ICBM capability before U.S. defenses have been deployed, the United States could rely on its strong nuclear deterrent and its conventional precision weapons to parry any threat until defenses are in place.

Moreover, the experience gained over the next 10 years as theater missile defenses are developed and deployed would reinforce the effort to maintain a robust program of NMD research. Several technical areas are common to both theater defenses and defenses against intercontinental ballistic missiles. Both systems include radars (in fact, the Bush Administration planned to develop the theater and national missile defense radars as a "family"). Both systems also include interceptors with sensors for homing in on the missiles, and command and control units to integrate data from early warning satellites and radars and to direct interceptors to their targets. But the similarities should not be overstated: theater missiles travel more slowly than ICBMs; theater missile interceptors tend to make more intercepts within the atmosphere because of the shorter missile flight paths; and theater defenses are designed to be rugged and mobile so that they can survive the demands of air transport and combat. Nevertheless, NMD research would certainly benefit from efforts to develop and deploy theater defenses.

DEF-03 SCALE BACK DOE'S WEAPONS PRODUCTION AND MAINTENANCE ACTIVITIES TO SUPPORT AN ARSENAL OF ONLY 4,000 WARHEADS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	400	800	1,200	1,700	2,150	6,250
Outlays	250	650	1,100	1,500	1,950	5,500

The Department of Energy (DOE) designs, tests, manufactures, and maintains nuclear weapons and is responsible for the safety of its production and manufacturing sites as well as the disposal of the wastes it generates. The department received some $13 billion for atomic energy defense activities for 1993, about $5 billion of which is intended for cleaning up contaminated sites and nearly $1 billion for fueling naval nuclear reactors. The remaining $7 billion is for weapons work--about $5 billion for activities and facilities related to weapons maintenance and production (the focus of this option) and the remainder for research, development, and testing.

Recent developments in arms control have raised questions about the proper scale for DOE's weapons activities. A major accord reached in June 1992 to limit the size of strategic arsenals, which culminated in the START II treaty, followed the signing in 1991 of the Strategic Arms Reduction Talks (START) Treaty and unilateral cuts in short-range nuclear weapons announced by Presidents Bush and Gorbachev. DOE is responding to these changes by canceling some programs and adjusting others. But how these programmatic changes will be translated into overall budget requests is not yet clear. CBO now estimates that, under current plans, DOE may be able to cut spending on weapons production and maintenance over the next several years to a steady-state level of about $3 billion a year (in 1993 dollars).

This option would go even further, sharply reducing the U.S. nuclear arsenal to a level of 4,000 warheads--about half the level that is otherwise likely to be maintained. The cuts would be made with the expectation that Russia's arsenal would be similarly limited in the near future through a bilateral treaty, probably verified through some form of cooperative monitoring. By the end of the decade, spending on warhead production and maintenance thus would be cut to about $2.5 billion per year. Total savings from this option and from recent progress in arms control thus would exceed $2 billion a year. (For other DOE savings, see DEF-04, which would reduce spending on warhead research, development, and testing.)

A limit of 4,000 warheads would go beyond the START II treaty recently signed by Presidents Bush and Yeltsin. The treaty would not constrain surplus warheads or tactical warheads for shorter-range aircraft, surface ships, and the like. Although exact numbers are classified, the United States would probably keep some 8,000 or more nuclear warheads under START II. Moreover, DoD's plans call for the United States to retain the capacity to build an even larger arsenal, should global security conditions deteriorate.

With a total inventory of some 4,000 nuclear warheads (enough to reach the START II ceiling of 3,500 and allow for routine maintenance and the like) and with a decision to forgo the capacity to rebuild a large arsenal, DOE could achieve further economies in its operations. It could build, on a small scale, the successor to the Rocky Flats plutonium processing and pit manufacturing site at one of a number of existing DOE facilities. DOE also could reduce by two-thirds the warhead production and maintenance activities at the Oak Ridge, Savannah River, and Kansas City sites or, to save even more money, could close one of the sites permanently. Activities to dismantle warheads at Pantex in Texas would be unaffected, however, because that facility would continue retiring and dismantling unneeded weapons.

In addition, DOE could shut down the K reactor at the Savannah River site near Aiken, South Carolina, saving some $200 million a year effective almost immediately. That reactor is now being refurbished in order to be placed on standby status in case the United States decides that it needs additional tritium in the next decade or so. Tritium, a key ingredient in modern nuclear weapons, decays with a half-life of 12 years and therefore must be periodically replenished over a warhead's lifetime (generally 20 to 30 years). But tritium is currently quite abundant because of the number of recently retired warheads whose tritium reservoirs can be "mined." Present plans based on the Bush-Yeltsin accord do not anticipate a need for tritium for over a decade; this option would extend that horizon until after 2010. By that time, a new production reactor or particle accelerator could be operational, provided that construction had begun a few years earlier (under present plans, construction would begin later this decade).

A reduction in the U.S. arsenal to 4,000 warheads, though substantial, would allow the United States and Russia to remain the world's nuclear superpowers, each with an arsenal dwarfing that of any other power. It also would permit each country to retain the capability to attack large and diverse target sets, including a rather comprehensive range of key industrial and conventional military facilities, as well as many nuclear-weapons-related sites. (For a more detailed discussion of nuclear targeting, see Congressional Budget Office, *The START Treaty and Beyond*, October 1991.) It also would preserve retaliatory forces consisting of several different types of nuclear delivery vehicles.

Critics of this option might argue that it would prejudge the outcome of arms control negotiations in an imprudent manner, since Russia has not agreed to reduce its arsenal to 4,000 warheads. They also might note that it would cut U.S. nuclear forces too deeply to fulfill some existing military requirements. How one views these arguments depends on what role one sees for nuclear weapons in future U.S. defense policy. Those who believe that a large and highly modern nuclear arsenal is important for deterrence, and that it improves U.S. prospects for extracting concessions from Russia in negotiations, may oppose this option. So might those who continue to think that Russia is likely to commit major violations of arms control agreements. Those who see nuclear deterrence as depending more on the existence of reliable retaliatory forces than on the details of force structure are more likely to favor the option.

DEF-04 REDUCE DOE'S NUCLEAR RESEARCH AND DEVELOPMENT AND STOP TESTING

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	150	150	150	300	700	1,450
Outlays	100	150	150	250	600	1,200

As noted in DEF-03, the Department of Energy (DOE) designs, tests, manufactures, and maintains nuclear weapons and is responsible for the safety of its production and manufacturing sites as well as the disposal of the wastes it generates. Nearly $2 billion of its annual funding goes to weapons research, development, and testing (RD&T)--the vast bulk of it being spent at Los Alamos National Laboratory, Lawrence Livermore Laboratory, Sandia National Laboratory, and the Nevada Test Site.

The Energy and Water Development Appropriations Act for Fiscal Year 1993 mandates a temporary moratorium on nuclear testing, intended as a precursor to a permanent ban that would start in 1996 and remain effective as long as no other country tests a nuclear weapon. This option would use that legislation as a basis for long-term planning. Consistent with the reduction in testing, the option assumes a 10 percent reduction in RD&T through 1996 (compared with its 1990 level) and then a 40 percent reduction beginning in 1997. The cuts would be accomplished by drastically scaling back or eliminating the nuclear weapons work done at either Lawrence Livermore or Los Alamos and economizing on some operations at Sandia. The option would also stop most operations at the Nevada Test Site after the end of fiscal year 1996. Savings eventually could reach $700 million a year.

A permanent international cessation of nuclear testing seems likely to occur only if mandated by an international comprehensive test ban (CTB) treaty, which President Clinton advocated during his campaign. If the United States announced plans to stop testing permanently, or at least for a long period, the prospects for some type of a CTB should improve.

Working toward a comprehensive test ban would probably bolster the prospects for extending and expanding the Nuclear Non-Proliferation Treaty. This 1970 treaty, due for renewal in 1995, calls for an end to all nuclear testing. By agreeing to a CTB, the United States might improve the prospects for a strengthened nonproliferation treaty that allowed challenge inspections on the territories of potential proliferators. Whether such a treaty would do a great deal to prevent proliferation is a matter of considerable debate. But with nuclear proliferation now one of the key threats to U.S. national security, pursuing all available avenues to limit it is important.

Even under this option, the United States still would be able to conduct 15 to 18 nuclear tests over the next three years. In this way, it could improve the safety of several existing weapons in a manner consistent with recommendations of the Drell Commission on nuclear safety and of many weapons designers. After conducting those tests, moreover, the United States would have other means of evaluating the reliability of warheads, including computer simulations and tests on the individual electrical and conventional explosive components of nuclear weapons. Underground tests of fully assembled warheads are necessary for developing new warheads but may not be needed to assure the reliability of existing designs.

Opponents of this option probably would argue that a ban on testing would not allow the United States to retain complete confidence in the reliability of its nuclear deterrent or to develop new nuclear warheads designed for optimal performance and maximum safety. The Department of Energy argues, for example, that some nuclear testing will be absolutely essential--at least at some point in the future--in order to retain high confidence that warheads have not atrophied with age or that the addition of new components (perhaps because a firm that formerly built a certain component went out of business) has not adversely affected the warhead's ability to detonate properly. Although a CTB treaty theoretically could be written in such a way as to allow a very small number of tests to ensure reliability every few years, negotiating such an accord would be diplomatically challenging.

DOE also argues that it should be allowed to keep designing and making safer warheads. At present, for example, the safety characteristics of the W76 warhead for the C4 missile are considered less than optimal, but a successor for it probably cannot be designed and fully tested in three years. Under this option, therefore, the United States would have to make do with a warhead whose resilience to accidents that could disperse plutonium--a highly toxic substance--is not state of the art. It also would be unable to develop new special-purpose warheads--for example, a low-yield, earth-penetrating warhead that theoretically could attack extremely hardened, deep-underground nuclear weapons storage sites in a rogue country that managed to develop nuclear weapons and appeared highly threatening.

DEF-05 TERMINATE PRODUCTION OF D5 MISSILES AFTER 1994

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	1,400	1,200	1,200	1,800	5,600
Outlays	0	210	580	1,030	1,220	3,040

The D5 missile (also called the Trident II missile) is the most accurate and powerful submarine-launched ballistic missile in the U.S. inventory. The result of more than 15 years of research and development, it is the keystone of the Navy's plan to modernize its ballistic missile force. Because of its accuracy and the size of its warheads, the D5 is the first submarine-launched missile that has a high probability of destroying counterforce targets--that is, targets such as missile silos and command bunkers that are hardened against nuclear attack. This capability will allow the Navy to assume some of the counterforce missions that could previously be carried out only by the Air Force's land-based intercontinental ballistic missiles and long-range bombers.

The Bush Administration planned to procure 779 D5 missiles and to install 24 of them on each of the 18 Trident submarines that are now either deployed or being built. The first eight deployed submarines were originally designed to carry the older C4 missile (also called the Trident I missile), which is less accurate and has a shorter range than the D5. The Navy plans to modify (backfit) these submarines beginning in 2001 so that they can carry the larger D5 missile. The remaining 10 submarines--five of which are still under construction--are designed to carry the D5 missile. Thus, by 2010, the Navy will have D5 missiles deployed on all 18 Trident submarines.

In sharp contrast to the Bush Administration's plan, this option would terminate D5 production at the end of 1994 after buying 343 missiles. This option would also terminate the backfit program. The first eight submarines, which would have been backfitted with D5 missiles, would continue to carry the C4 missile. A new program would extend the life of the aging C4 missile so that it could remain in the fleet until the C4 submarines are retired. Even though changes under this option would not begin until 1995, a decision on this approach should be made during debate over the 1994 budget to allow for an orderly termination of the D5 program.

This option would require the Navy to make several changes in order to reduce requirements for D5 missiles. One of the changes would be consistent with the START II treaty recently signed by Presidents Bush and Yeltsin. That agreement limits the number of warheads on submarine-launched ballistic missiles to 1,750--only half of the 3,456 warheads planned for the Trident force under the previous Strategic Arms Reduction Talks (START) Treaty. To comply with this agreement, and to reduce requirements for D5 missiles, this option would modify the Trident submarines to carry only 12 C4 or D5 missiles rather than the 24 missiles now planned and deploy them with eight warheads each. In contrast, the Bush Administration planned to comply by reducing the number of warheads per missile from eight to four.

To reduce requirements for D5 missiles further, this option would cut the flight test program from the 12 flights per year planned by the Navy to six. The smaller program would still meet the requirements the Joint Chiefs of Staff established for ensuring the missiles' reliability. Reducing D5 flight tests would also be consistent with the Navy's recent decision to reduce flight tests for the C4 missile to six per year.

Relative to the CBO baseline, which for specific programs generally follows the Bush Administration's plan set forth in January 1992, net savings under this option would begin in 1995 and would total $5.6 billion through 1998. Most of the savings are attributable to reducing the D5 flight test program and the number of tubes per submarine. Canceling the backfit generates only small net savings because of the added costs required to extend the life of the C4 missiles. Savings are also offset modestly beyond 1998 by the cost of modifying the submarines to carry 12 missiles in a way that the changes can be verified. Beyond 1998, this option would save almost $1 billion a year through 2004. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney called for the D5 program to be terminated after 1997, sharply reducing the planned number of missiles from 779 to 437. That proposal would therefore eliminate much of the savings in this option.

There are drawbacks associated with terminating D5 production. Because this option would not deploy D5s on the first eight submarines, it would reduce the number of warheads on D5 missiles by 44 percent below planned levels, which would reduce the capability of the fleet to destroy hardened targets. Also, the smaller number of flight tests would increase the time required to detect any problems that might affect reliability. In addition, deactivating 12 tubes on each submarine could raise verification issues--specifically, what must be done to assure the Russians that the deactivated tubes could not easily be reactivated--that would have to be resolved in negotiations. Russian hard-liners might insist on removing the entire section of the hull that contains the missile tubes to be deactivated. The cost of such extensive modifications would eliminate much of the option's net savings.

With the end of the Cold War, however, terminating D5 production may be acceptable. The chances of nuclear war between the superpowers appear to have been markedly reduced. In this environment, the counterforce capability remaining aboard Trident submarines under this option, which is comparable with the capability that exists today in the entire fleet of ballistic missile submarines, may be judged sufficient to deter nuclear war. Less emphasis on counterforce, which demands high accuracy and reliability, may also render a smaller number of flight tests acceptable. Indeed, the Navy itself is seriously considering reducing the D5 flight test program from 12 to eight or fewer tests per year.

Finally, it may be possible to address the verification issues associated with deactivating missile tubes and moving from 24 to 12 missiles by making small changes to the START II treaty and the verification provisions of the START treaty on which it depends. Furthermore, expensive modifications to the Trident submarines may not be needed to move from 24 missiles to 12 missiles. Inexpensive modifications--for example, filling and capping the deactivated tubes--may be possible and would cost a total of roughly $1 billion after 1998. Moreover, these inexpensive modifications may be acceptable in that they may give both Russia and the United States as much confidence that there is no cheating on arms control agreements as do the current provisions in the START treaty for verifying the number of warheads on each missile.

DEF-06 REDUCE OPERATING TEMPO OF BALLISTIC MISSILE SUBMARINES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	290	330	360	390	430	1,800
Outlays	240	310	350	380	420	1,700
			Savings in Defense Budget			
Budget Authority	330	370	410	450	490	2,050
Outlays	270	350	400	440	480	1,940

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The Navy plans to maintain a force of 18 Trident submarines for another 20 to 30 years. These submarines are armed with ballistic missiles that carry nuclear weapons and are an important component of the U.S. nuclear deterrent. At any given time, the United States keeps roughly two-thirds of its submarines at sea--a 67 percent operating tempo. The remaining one-third of the force either is undergoing overhaul or maintenance or is preparing for another 70-day deployment at sea. The Navy considers a high operating tempo, which the United States has maintained for many years, an efficient way to ensure that the United States has enough submarines at sea so that they can retaliate with substantial force against a nuclear attack. The threat of substantial retaliation is intended to deter an attack.

To keep two-thirds of the submarine force at sea while making Trident duty bearable for sailors, the Navy assigns two crews to each submarine. These crews alternate deployments. When a submarine comes back from patrol, a new crew takes over, readies the submarine, and takes it for the next patrol. The crew members left behind rest, spend time with their families, and train.

To reduce costs, this option would end the use of double crews and would halve the operating tempo of the Trident fleet. Only about one-third of the submarines would be at sea at any one time, which would leave the time that sailors spend at sea roughly unchanged. This approach is analogous to a decision the Bush Administration made last year to reduce the operating tempo of strategic bombers.

By 1998, when all 18 Trident submarines have entered the fleet, this option would save roughly $500 million per year. Savings would be lower over the next several years because the last five Trident submarines are still under construction. Savings in 1994 defense budget authority would be $330 million, and total savings over five years would be $2.1 billion. The savings reflect the smaller direct and indirect military personnel costs resulting from the smaller crew size. Savings also reflect lower operating and maintenance costs resulting from the reduced time at sea.

During peacetime, the number of Trident submarines at sea under this option would be reduced from about 12 submarines to six (assuming that all 18

Tridents have entered the fleet). This option would also roughly halve the number of warheads that could retaliate in the event of a nuclear attack that occurred without warning. Nor would all six at-sea submarines be able to retaliate immediately against targets throughout Russia. Some would be in transit to or from their patrol areas and consequently would be out of range to attack their targets. Furthermore, with only six submarines at sea, the retaliatory capability of the United States would be measurably reduced if Russian submarines could detect and track some of them long enough to destroy them.

The end of the Cold War, however, may have made a smaller retaliatory capability acceptable, for three major reasons. First, the significant lessening of tension between the United States and Russia has profoundly reduced the likelihood of nuclear war in general and a surprise attack in particular. Thus, the United States may not need to keep as many submarines at sea during peacetime in order to deter nuclear war. Second, under the START II treaty recently signed by Presidents Bush and Yeltsin, Russia would have smaller nuclear forces and, therefore, the Trident force would have fewer targets to cover. Third, the threat to U.S. ballistic missile submarines--never considered acute even during the Cold War--has diminished because Russia now keeps virtually all of its attack submarines in port. In addition, no other potential adversary has adequate antisubmarine capability to threaten U.S. submarines. Therefore, there may be less need to keep a large number of submarines at sea just to ensure that enough survive to launch their missiles.

Moreover, the changes in this option could be reversed if relations between the United States and Russia deteriorate. This option would not affect the number of available submarines, so if tensions increased during a crisis the United States could deploy 12 or more submarines in a matter of days or a few weeks by curtailing crew leave and training. Furthermore, most analysts assume that a nuclear war would begin only after a period of crisis, so this option might not significantly affect the U.S. retaliatory capability that would be available. If tensions increased over several years, after a period of training the United States could once again put two-thirds of its force to sea on a permanent basis by reassigning second crews.

DEF-07 RETIRE ALL ICBMS BY ELIMINATING MINUTEMAN III FORCE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	290	350	600	980	1,070	3,290
Outlays	150	270	460	760	930	2,570
			Savings in Defense Budget			
Budget Authority	290	370	650	1,070	1,170	3,550
Outlays	150	280	500	840	1,040	2,810

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Since the 1960s, the United States has possessed three major types of nuclear weapon platforms: long-range bombers based at airfields in the United States, intercontinental ballistic missiles (ICBMs) deployed in missile silos, and submarine-launched missiles (SLBMs) deployed at sea. Together they have constituted the strategic nuclear triad. In addition to carrying weapons with slightly different capabilities and uses, these intentionally redundant systems have given the United States something even more important--confidence that at least part of its nuclear retaliatory force would remain invulnerable to any technological breakthrough or successful surprise attack.

This option would modify the long-standing view that the United States requires three such legs to its strategic nuclear forces and would retire all land-based ICBMs by 1997. Because the United States is already retiring its 450 Minuteman II missiles, savings under this option reflect only the retirement of the remaining ICBMs--500 Minuteman III missiles, and the 50 MX missiles that now must be retired under the recently completed START II treaty. Savings in defense budget authority would be $290 million in 1994 and $3.6 billion over the 1994-1998 period. Were CBO's calculations to exclude savings from retiring the MX, annual savings would decline by as much as $100 million a year.

The Minuteman III missile carries three warheads today, but would be deployed with only one warhead under the START II treaty. Either way, the missiles cost about $1 billion a year simply to operate; annual savings under this option would eventually be of that magnitude. Moreover, during the next decade or so, DoD could realize almost $5 billion in additional savings, which are not captured in the above table, by canceling the upgrade of the missile and its guidance system.

Even if the United States retired all its land-based nuclear missiles--and even if it also retired most of its B-52 bombers, as discussed in DEF-08--it still could deploy some 3,500 strategic nuclear weapons, as permitted under the START II treaty. That number would keep the United States at parity with Russia and would exceed by a considerable amount the combined nuclear inventories of all other countries in the world. Trident submarines would carry some 1,750 warheads, a large fraction of which would be invulnerable to attack at any time because U.S. missile submarines at sea cannot be systematically located by any country. Another 1,750 would remain deployed on various strategic bombers.

This option, however, would eliminate the insurance associated with a triad of strategic offensive forces. Does the United States still need that level of insurance? Its perceived requirement for such forces during the Cold War was largely a function of facing a very determined major industrial power with an inimical ideology. Under such circumstances, neither the possibility of surprise attack nor the possibility of a major technological breakthrough in antinuclear technology seemed wholly out of the question. Moreover, ICBMs and SLBMs were new inventions, and doubts persisted about their endurance as viable military systems.

Today, technical realities have become more reassuring. Missiles based on submarines have become more accurate and are highly capable of penetrating an adversary's airspace. The submarines themselves remain highly invulnerable to attack when deployed at sea, as was recently confirmed in a major study by the General Accounting Office, and are able to communicate quite effectively with authorities based in the continental United States. In addition, bombers based in the interior of the United States remain capable of escaping a surprise attack when on runway alert and remain highly capable of delivering munitions against an adversary once airborne. (Although they are not on runway alert today, they could be returned to that type of deployment in a crisis or in the event of a technological breakthrough that rendered the submarine fleet partially vulnerable.)

Most important, of course, is the fundamental change in the basic political relationship between the nuclear superpowers. It had already moderated--at least insofar as nuclear weapons and nuclear crises were concerned--by the latter decades of the Cold War. With the end of that era, the deterrent that even small numbers of warheads offer seems more than adequate for the types of disputes that still could arise between modern states.

Still, there are counterarguments to be made. The ICBM leg remains completely dedicated to the nuclear deterrent mission, unlike most of the bomber fleet. It also remains quite capable, with accurate warheads and rapid responsiveness. Moreover, reports of its vulnerability to attack probably have been exaggerated. Nuclear analysts almost uniformly postulated, without empirical support for their assumption, that two Soviet warheads could be exploded at each U.S. silo simultaneously. This tactic would have greatly reduced the ability of U.S. ICBMs to survive an attack, but there are many reasons to think that it would have been impossible to execute and that it will remain impossible into the foreseeable future. On the whole, one might argue that $1 billion a year--considerably less than one-half of one percent of the defense budget--may not be an unreasonable amount of money to spend for a highly capable and reliable weapon system that provides deterrence against nuclear war.

DEF-08 RETIRE ALL BUT FOUR SQUADRONS OF B-52 BOMBERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	30	110	260	480	620	1,500
Outlays	20	80	190	370	510	1,170
			Savings in Defense Budget			
Budget Authority	30	120	300	550	700	1,700
Outlays	20	90	230	430	590	1,360

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The United States owns several hundred B-52 bombers, the "Stratofortress" strategic aircraft that have been part of the U.S. Air Force since the 1950s. The Air Force, however, is reducing the size of the deployed B-52 force. According to official plans as of January 1992, it will operate only 95 B-52H aircraft, which have both nuclear and conventional capabilities, as well as 33 B-52Gs dedicated to conventional missions.

This option would retire--in a gradual and orderly fashion over the next five years--33 of the 95 B-52H aircraft that the Pentagon now intends to keep. All B-52G aircraft also would be retired. The remaining B-52H aircraft would be available for both nuclear and conventional military missions. Compared with the plans the Bush Administration submitted in January 1992, savings would be roughly $700 million a year once the option was fully in place and would total $1.7 billion over the next five years.

In the spring of 1992, the Air Force released a document--the "Bomber Roadmap"--in which it unveiled a decision to retire the B-52G aircraft dedicated to conventional missions. These aircraft constitute two of the four squadrons of B-52s that would be retired under this option. Thus, against this new Air Force plan--not yet codified in any official budget document--the savings from this option would be only about half as large as shown above.

Even without the benefit of a large B-52 fleet, the United States could retain 3,500 long-range nuclear warheads on a wide variety of weapon platforms, including its fleets of Trident submarines, B-1 bombers, and the remaining B-52H bombers. (The United States could find ways to retain that number even if it also retired all its land-based intercontinental ballistic missiles, as discussed in DEF-07.) The 3,500 deployable strategic nuclear weapons, the maximum allowed under the recently signed START II treaty, would exceed the levels that the United States possessed when the Strategic Arms Limitation Talks began two decades ago. And the U.S. B-52 fleet still would be large enough to deliver some 1,000 air-launched cruise missiles--nuclear or conventional--in a single mission. That number of cruise missiles would contribute substantially to U.S. nuclear deterrence and would exceed the total number of all types of conventional cruise missiles launched during the 1991 Persian Gulf War.

Opponents of this option might focus on two key points. First, they might have difficulty with the notion that further cuts in strategic nuclear forces are warranted at this time. Under its new plans for nuclear forces, the United States would have considerably fewer vehicles for delivering nuclear weapons than in 1990. Some analysts might prefer to wait, and reflect, before committing the United States to any further cuts.

Second, opponents might object to forgoing the B-52's carpet-bombing capabilities. U.S. forces used 68 B-52s during Operation Desert Storm to attack, from high altitude, locales in which Iraqi forces were deployed. This option would leave nearly enough B-52s in the force to conduct such operations, but certainly not enough to do so in two theaters simultaneously or to conduct more intensive carpet-bombing as it did during the Vietnam War. Although other aircraft such as B-1 bombers could also conduct broad-area bombing, the U.S. military plans to use these aircraft to deliver precision-guided munitions from low altitude. Thus, if the chance of two major regional wars occurring at once is perceived as great, there may be good reason to keep more than four squadrons of B-52s simply for their conventional military capabilities.

DEF-09 REDUCE SPENDING ON INTELLIGENCE ACTIVITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	1,260	2,880	4,570	6,350	6,810	21,870
Outlays	770	2,210	3,830	5,550	6,520	18,880

U.S. intelligence activities are conducted by a variety of organizations, most notably the Central Intelligence Agency (CIA), the National Security Agency (NSA), the National Reconnaissance Office (NRO), the Defense Mapping Agency (DMA), the Defense Intelligence Agency (DIA), and the intelligence arms of the four military services and the 10 military commands. These agencies assess the military and economic capabilities of foreign countries, monitor the trade in specialized technologies as well as other activities related to the proliferation of nuclear weapons, and monitor arms control treaties. In war, they are instrumental in devising tactics and carrying out operations; for example, the U.S. advantage in intelligence and communications technologies made possible the "left hook" maneuver that bypassed entrenched Iraqi forces and helped the U.N. coalition quickly destroy much of Iraq's Republican Guard. Although much of the requested funding for these activities is classified, statements in the press and at open intelligence hearings suggest that current funding remains near $30 billion a year.

This option would reduce the number of intelligence personnel by 20 percent and make cuts of equal magnitude in intelligence-gathering equipment and operations. Savings eventually could exceed $6 billion a year. In estimating savings, CBO assumed that the Bush Administration's plans called for funding to be kept nearly constant, at $30 billion a year in 1993 dollars. Actual plans, however, might call for somewhat lower spending; some press reports suggest that 1993 funding for intelligence was cut about 5 percent below the Administration's request, to less than $29 billion. But intelligence reportedly continues to receive a high priority--even systems and functions that focused primarily on the Soviet threat during the Cold War. Thus, CBO's assumption seems reasonable. Regardless of what actual 1993 funding levels may be, this option would cut total spending on intelligence to about $25 billion (as measured in 1993 dollars) by 1998.

Large cuts in intelligence programs and spending already have been proposed by individuals with direct access to information about intelligence operations. The National Defense Authorization Act for Fiscal Year 1991 called for cuts in intelligence personnel of 5 percent a year for five years relative to a budget that at that time reportedly was about $30 billion. Because detailed information on intelligence activities is highly classified, it is not clear whether these reductions were begun immediately--though reports about the 1993 budget suggest that they now will have to begin.

Some of these cuts could be made as part of the broader effort to reorganize the smaller U.S. military of the future to be more efficient. For example, the intelligence organizations of the individual services could be reduced drastically in size, with most of their analytic and data-gathering capabilities transferred to the DIA or in some cases eliminated. The services' intelligence agencies then would effectively function as "informed customers"; information would be gathered and analyzed primarily by the DIA, CIA, NSA, NRO, and the intelligence units of the military commands.

Selected reductions in equipment also seem possible and could produce comparable savings. Reducing the steady-state number of imaging satellites from the reported level of eight to four--a number still above the average deployed by the United States during most of the Cold War--might save up to $1 billion annually. Cutting other types of technical equipment that focused largely on the Soviet threat--such as those concentrations of sound surveillance system (SOSUS) underwater listening arrays and P-3 maritime patrol aircraft near Russian naval waters, and electronic monitoring stations and aircraft based in Europe--should make it feasible to reduce overall spending on hardware by roughly 20 percent. (For another specific suggestion for reducing intelligence spending on hardware, see DEF-10, which discusses the early warning satellite known as FEWS and compares it with the less expensive current system known as the Defense Support Program.) Coupled with additional savings from reduced personnel, total savings could exceed $6 billion a year.

Cuts of this magnitude would not prevent the United States from maintaining traditional activities that remain critically important in the post-Cold War world, such as tracking arms shipments between countries, monitoring proliferation activities, and supporting U.S. and allied forces engaged in regional conflicts. Even after these reductions, U.S. intelligence spending would remain, in real terms, comparable with its Cold War average.

Major changes in U.S. intelligence operations, though probably feasible given the dissolution of the Soviet threat, must be made with a good deal of caution. Most intelligence assets cannot be directly and exclusively related to the Soviet threat. Even if that was their primary focus in the past, they generally had other important missions that have lasted beyond the end of the Cold War. Moreover, in a period of increased trust and disarmament between the United States and the former Soviet republics, having very substantial intelligence capabilities--even if they involve some redundancies and some capabilities that may be larger than historical norms--may provide a prudent and economical form of insurance against volatility in central Eurasia. Consequently, reductions in intelligence funding, though they may be feasible, should be attempted only if waste or inefficiency has been clearly identified.

Still, there may be room for major cuts. Intelligence budgets continued to grow throughout the 1980s--at least according to various press reports and quotes from former intelligence officials such as General William Odom. Moreover, when pressed, some officials have estimated that a full 50 percent of intelligence activities were focused on the Soviet Union during the Cold War. With the end of that era, an overall cut of 20 percent in intelligence spending may be reasonable.

DEF-10 CANCEL THE FOLLOW-ON EARLY WARNING SYSTEM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	230	290	770	880	560	2,730
Outlays	110	220	510	750	760	2,350

Since the early 1970s, the Air Force's Defense Support Program (DSP) has reportedly maintained a constellation of five satellites in geosynchronous orbit to provide early warning of a ballistic missile attack. These satellites are designed to detect the infrared radiation emitted by the rocket motors of ballistic missiles launched from land or sea. Detection occurs during the first or boost phase of flight. If a launch is detected, the DSP satellites relay data within a minute or two to command centers such as the North American Air Defense Command (NORAD) and the Pentagon.

The Air Force is developing a new generation of early warning satellites to replace DSP. As originally planned, this Advanced Warning System (AWS) would have featured a new "staring" sensor technology, developed in part for the Strategic Defense Initiative, that would permit faster detection and more accurate tracking of fainter objects. This system also would have included other improvements such as enhanced multispectral capability, global coverage, satellite-to-satellite communication, sophisticated on-board data processing, and direct transmission of processed data to commanders in the field. Once in place, this new early warning system would have increased U.S. capability to detect missile attacks such as those that occurred in the Persian Gulf War.

Because of budget constraints, however, the Air Force now plans to deploy instead the Follow-on Early Warning System (FEWS), which would be less sophisticated than AWS. FEWS requires an entirely new series of satellites with new sensors, but it would not include many advanced features planned for AWS. The Air Force intends to upgrade FEWS later to incorporate these features if budget conditions permit. After reviewing the details of the classified FEWS program, the General Accounting Office reported that the initial version of FEWS would be significantly less capable than AWS.

This option would terminate all acquisition funding for FEWS, including demonstration and validation of a prototype satellite. Instead, the Air Force would upgrade additional DSP satellites. The FEWS program currently is not fully funded: unclassified budget planning documents suggest a shortfall of about $3 billion through 1998 and over $8 billion through the early part of the next decade. The Congress, however, has directed the Secretary of Defense to fully fund all requirements for 1994 and beyond. This option computes savings by assuming that the program will be fully funded.

Savings under this option could be substantial. Net savings could be about $230 million in 1994 and could total about $2.7 billion through 1998. These savings reflect the reduction in costs associated with developing and buying FEWS, offset by the added costs of developing and buying upgraded versions of DSP. Between 1994 and the early part of the next decade, when the first FEWS satellites would be launched, gross savings associated with canceling FEWS could total $9.4 billion, and net savings could total about $6 billion. This option is one example of the type of savings that could be achieved under a broader reduction in intelligence programs as discussed in DEF-09. Relative to the Bush Administration's plan, the savings from this option would be substantially lower because of the shortfall mentioned above.

Indeed, the savings associated with this option might actually be much larger. Other state-of-the-art satellites, such as MILSTAR and the GOES-Next weather satellite, have experienced schedule delays and large growth in costs beyond the levels anticipated early in development. FEWS costs might therefore grow sharply. In contrast, the costs of upgrades of an existing satellite like DSP should be less subject to unanticipated growth.

FEWS would offer a number of important advantages compared with the current generation of DSP satellites or even the upgraded DSP. For example, FEWS would permit more precise location of the launch point of missiles such as the Iraqi Scuds. Coupled with faster delivery of data to field commanders, that increased accuracy would improve the ability of U.S. forces to locate and destroy the launchers. Faster and more accurate tracking data would also allow commanders to pinpoint impact zones, providing better warning to affected citizens and reducing the number of troops that must undergo the time-consuming task of preparing themselves for chemical or biological attack. Better tracking data might also be used to cue ground-based ballistic missile interceptors, increasing the range at which interceptions might take place.

More advanced sensor and spacecraft design would also provide a basis for future improvements that would respond to the changing threats of the next century. DSP satellites, in contrast, are based on less efficient and less flexible technology developed in the 1960s. Eventually, upgrades to DSP satellites may no longer be economical or even feasible.

But the increased capability of the FEWS satellites, particularly the improvements offered by the initial satellites, may not translate into improved performance on the ground. FEWS reportedly will increase warning time by sending information directly to commanders in the field. However, testimony suggests that this "direct down-link" will not be able to accomplish the stereo processing that allows for high accuracy. Such sophisticated processing will still be done in command centers, where most of the delay for DSP occurred during the Persian Gulf War. Although the Air Force plans eventually to provide FEWS satellites with an on-board system that can process stereo data, those capabilities are not reflected in the current budget.

FEWS will also provide more accurate estimates of the location of mobile launchers that are firing missiles like the Scud. But, unless transmitted and acted upon quickly, the improved estimates may not be useful because of the mobility of the launchers. Finally, satellite data would not increase the range of interceptors such as the Patriot. Such a capability would have to be included in future systems such as the Theater High-Altitude Area Defense System (THAAD).

Even if the advanced features planned in FEWS upgrades could substantially improve capability, the initial version of the FEWS satellites apparently will not include many of these features. Shelving the program until the advanced features can be incorporated may therefore be a reasonable course. Also, relying on a new generation of hardware for a mission as important as early warning could lead to gaps in U.S. capability.

While development of the FEWS program is delayed, the upgraded version of DSP that would be procured under this option could provide adequate capability. The current version of DSP apparently performed well in the Persian Gulf War. Existing DSP satellites reliably observed Iraqi Scud launches in the Gulf War within 90 to 120 seconds of launch and reportedly provided the location of launch within about 2.2 miles. Nor is DSP limited to detecting missiles; unclassified sources claim that it can track the afterburner trail of military aircraft. The upgraded version of DSP would provide some further enhancements, perhaps by improving the sensors, increasing the rate of data transfer, and allowing satellite-to-satellite communication. Indeed, after reviewing the program's classified details, the General Accounting Office (GAO) stated that an upgraded DSP may be nearly as effective as the initial version of FEWS and would cost less.

Air Force testimony claims that significant improvements in DSP capability are expected even with the current generation of satellites. Research and development funds are already programmed for further improvements. Another GAO study suggested that large additional savings could be realized by slowing down the DSP procurement and launch rate to better reflect the long operational lifespan of DSP satellites. These savings are not included in the estimates given above.

DEF-11 REDUCE THE NUMBER OF NAVY ESCORT SHIPS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	280	900	1,570	2,320	2,760	7,830
Outlays	200	690	1,280	1,970	2,470	6,610
			Savings in Defense Budget			
Budget Authority	310	1,020	1,770	2,610	3,110	8,820
Outlays	230	790	1,470	2,250	2,810	7,550

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

In addition to aircraft carriers, the primary surface combatants of the U.S. Navy are cruisers, destroyers, and frigates. Cruisers and destroyers often form part of a carrier battle group, escorting and protecting the carrier. Destroyers and frigates can escort the ships of an Amphibious Ready Group, which carries Marine troops and equipment. Frigates also can escort both the Underway Replenishment Groups that resupply naval forces and the convoys of merchant ships that resupply troops fighting in a foreign theater. Under the Bush Administration's January 1992 plan, the U.S. Navy would have 157 cruisers, destroyers, and frigates in its inventory in 1997.

This option would reduce the number of ships in these three classes by 57 vessels, leaving 100 such ships by 1997. Reductions would be carried out in equal increments from 1994 through 1997. Relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, the reduction would save $280 million in operating and support costs in 1994 and $7.8 billion through 1998. The reduction of surface combatants might also permit a cut in the number of combat logistics ships and, hence, in their associated operating and support costs. These savings, however, are not included in this option. In addition, costs to decommission these ships would offset some of these savings, but CBO did not estimate the magnitude of these offsets.

With the dissolution of the Soviet Union, the threats facing Navy ships from enemy aircraft and submarines operating in the open ocean have greatly diminished. The most likely opponents the United States would face in a regional war generally have only modest naval assets and no heavy bombers that could attack U.S. ships at long ranges. The United States may be able to counter these threats even while substantially reducing the number of surface combatants. Indeed, last spring, the Chairman of the House Committee on Armed Services recommended cutting large numbers of surface vessels.

The reductions assumed in this option reflect changes in the threats facing the Navy. A carrier battle group normally consists of two cruisers and four destroyers accompanying an aircraft carrier. The cruiser's main mission is to provide medium-range air defense for the battle group. With the decline of the Soviet air threat, one cruiser per battle group might suffice. If so, the Navy could retire 23 older cruisers by 1997, leaving all 27 of the more capable AEGIS cruisers still in the fleet.

The Navy might also reduce the number of frigates, which specialize in antisubmarine warfare. Because war in Europe has become much less likely, the United States may no longer need frigates to escort convoys of war supplies. In addition, because submarines now pose less of a threat to underway replenishment ships in transit to carrier battle groups, fewer frigates might be needed to act as escorts. The Navy might retire early 34 of the older FFG-7 class frigates so that by 1997 the fleet would be left with 16 of the most modern ships of that class.

Under this option, however, the Navy would have fewer surface combatants to deploy independent of the battle group or during regional conflicts. This reduced capability could be of concern in the unlikely event that two or more regional wars occurred simultaneously and involved regional powers that had significantly increased their naval capability--for example, by buying submarines or other ships from Russia.

Although it also seems quite unlikely, the Russian air and submarine threat could reemerge. If that is of concern, some of the ships that are retired early under this option could be placed in the naval reserves, perhaps using the new reserve arrangements the Navy is trying under its Innovative Reserve Concepts Program. The savings estimated above do not include any offsets for such a program.

DEF-12 REDUCE PROCUREMENT OF DDG-51 DESTROYERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	900	1,780	1,830	1,890	1,950	8,350
Outlays	50	210	510	850	1,170	2,790

The DDG-51 destroyers of the Arleigh Burke class would be used in a war to protect aircraft carrier battle groups and to attack land- and sea-based targets. The DDG-51s incorporate the AEGIS combat system and other improvements in speed, weapons, and armor. The Navy states that the DDG-51s also will be more difficult for enemy forces to detect because of design features that reduce their radar, sonar, and infrared signatures. To date, the Congress has funded 26 of the DDG-51s. The Bush Administration requested an additional three for 1994 and, based on last year's plan, a total of 15 through 1997.

This option would buy only 10 DDG-51s from 1994 through 1998, at a rate of two a year. Relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, buying two new destroyers a year would save about $900 million in budget authority in 1994 and a total of $8.4 billion from 1994 through 1998. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would cut the DDG-51 program slightly over the next five years and would reduce the savings from buying only two of the ships per year. The smaller fleet of DDG-51s in the next decade would result in savings in operating and support costs, which are not included in this option.

Even with the slower rate of construction in this option, the Navy would come close to meeting its goal for surface combat ships. The Navy has testified to the Congress that it seeks to maintain a force of 150 surface combatants (cruisers, destroyers, and frigates). CBO estimates that, under the Bush Administration's plan, the Navy would exceed its goal in 2002, the year in which the DDG-51 ships funded in 1997 would enter the fleet. In that year, the Navy would have 152 surface combatants. This option would result in a fleet of 145 in 2002, slightly below the Navy's goal of 150 ships.

Because of the declining Soviet threat, the Congress might mandate a reduction in the number of naval aircraft carriers (see DEF-16). Procuring fewer DDG-51 destroyers would be in keeping with that decision. But even if the number of carriers is not reduced, the decline in the threat affects the need for additional DDG-51 destroyers. The sophisticated combat systems that these ships incorporate, such as the AEGIS system for air defense, would have been needed most in a major war with the Soviet Union. The Soviet breakup has significantly diminished the hostile air threat to the U.S. Navy.

This option could have disadvantages, however. Only two shipyards build surface combatants, and reducing procurement to two of these vessels a year would probably force one of the two shipyards out of the business of building these ships, and possibly out of business altogether. The shipbuilding industrial base has declined markedly over the past decade, and the Congress would have to weigh carefully the possible effects of further reductions to the country's naval shipbuilding capabilities.

DEF-13 CUT THE ATTACK SUBMARINE FORCE TO 40

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	110	330	560	810	1,060	2,870
Outlays	70	240	450	680	920	2,360
			Savings in Defense Budget			
Budget Authority	120	360	620	900	1,170	3,170
Outlays	80	270	510	760	1,030	2,650

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

During the Cold War, the primary missions of U.S. attack submarines were to trail and, if necessary, attack Soviet nuclear ballistic missile submarines in their protected bastions in Soviet home waters, and to control the sea in order to defend convoys headed for Europe during a war. Both missions required U.S. vessels to fight Soviet attack submarines. Antisubmarine warfare, which is carried out using attack submarines and other platforms (see DEF-21), was therefore a high priority of the U.S. Navy.

With the end of the Cold War, both a nuclear war and a conventional war in Europe seem much less likely. Furthermore, the Russian navy reportedly plans to reduce its number of nuclear-powered submarines by 150, leaving it with a maximum of 25 to 30 ballistic missile submarines (SSBNs) and 50 nuclear multipurpose and attack submarines. The Russian navy has already curtailed its submarine operations in many oceans.

The reduced threat has made the primary Cold War missions of attack submarines less important. Navy leaders have reportedly emphasized that the size of the Russian submarine force is no longer a major factor in determining the number of U.S. attack submarines. Instead, the Navy will now emphasize missions for attack submarines in the coastal areas of developing countries, such as gathering intelligence, transporting covert forces, firing missiles aimed at land, and fighting those countries' ships and submarines to protect aircraft carriers and gain control of regional waters. In addition, attack submarines could continue to track Russian SSBNs.

Because the regional missions are not as demanding as the Cold War tasks, the Navy is reducing the current inventory of attack submarines. The Navy had 90 submarines in 1993; the Bush Administration's plan for the base force reduced the goal for attack submarines to 80. A study by the Joint Chiefs of Staff reportedly supported a goal of 55. But the force could be even smaller. Indeed, in 1992 the Chairman of the House Committee on Armed Services recommended maintaining only 40 attack submarines.

This option would reduce the force to 40 vessels by 1998--five years before the new Centurion submarine would enter the fleet after beginning scheduled production in 1998. Compared with the CBO baseline, which for specific programs generally follows the plans submitted by the Bush Administration in January 1992, this option would reduce operating costs by $110 million in 1994 and by a total of $2.9 billion in the 1994-1998 period. These savings are the total costs of operating and supporting the submarines. Some of these savings, and maybe all of them in the first few years, would be offset by the costs of decommissioning the submarines or keeping the vessels in caretaker status until they could be deactivated.

A fleet of 40 submarines might be sufficient in a post-Cold War world. Attack submarines often accompany aircraft carrier battle groups to protect them; they also operate independently. If 40 vessels were the goal and two submarines were assigned to operate with each deployed battle group, a substantial number of attack submarines would still be available in peacetime to search independently for Russian SSBNs or to perform other independent missions. Reducing the size of the carrier force (see DEF-16) would make available more attack submarines for independent duty.

More submarines also would be available for other independent missions if the mission to search for Russian SSBNs were eliminated. Some analysts feel this mission should be discontinued because it may reduce nuclear stability by potentially forcing vulnerable Russian SSBNs into a "use-or-lose" situation, increasing the probability that these vessels would preemptively fire their nuclear weapons.

If the mission against Russian SSBNs were not eliminated and a nuclear crisis arose, a fleet of 40 U.S. boats might not provide enough submarines to search for SSBNs and also to assign two submarines per carrier battle group. The number of submarines available for the anti-SSBN role might be augmented, however, by shifting attack submarines from carrier duty to independent patrol. Conversely, if a regional crisis erupted that required a substantial number of submarines, some vessels could be diverted from the anti-SSBN mission.

DEF-14 CANCEL PROCUREMENT OF ADDITIONAL TAGOS SHIPS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	160	290	20	160	10	640
Outlays	10	40	70	100	100	320

In its inventory, the Navy currently has 18 TAGOS surveillance ships that search for enemy submarines. Each TAGOS ship is equipped with a sophisticated sonar system that captures the distinctive sounds created by the submarines of potential enemies and reports their location to ships or aircraft that can attack them.

There are three different classes of TAGOS ships. The Navy purchased 18 TAGOS-1 class ships from 1979 through 1987 and bought four TAGOS-19 class ships from 1987 through 1989. The Congress funded the first TAGOS-23 class ship in 1990 and the second in 1992. The Bush Administration's 1992 budget planned to buy a total of six TAGOS-23 class vessels. The TAGOS-19 and TAGOS-23 class ships are larger than the TAGOS-1 vessels and have a unique dual hull (Small Waterplane Twin Hull or SWATH) design, which makes them more stable in rough seas. The TAGOS-23 class ships also house more effective sonar systems.

Despite these advantages, this option would cancel the procurement of four new TAGOS-23 class ships. Relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, this option would save $160 million in 1994 and a total of $640 million in 1994 through 1998. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would cut the TAGOS program over the next five years and would therefore reduce significantly the savings from canceling it.

A reduction in the TAGOS mission is already apparent. The Navy's plan indicates that it intends to remove six TAGOS-1 class ships from active duty in 1992 and 1993. According to press reports, an additional 12 TAGOS ships will be mothballed or placed in reserve status before 1997. These ships are relatively new. For example, the six ships that the Navy planned to remove from the active fleet in 1992 and 1993 will average only eight years of service. Canceling procurement of new TAGOS ships may therefore reflect priorities implicit in the Navy's force planning.

If the TAGOS-23 program were canceled, the Navy would lose the ships' superior ability to operate in rough seas and their more advanced sonar systems, which are designed to counter threats from technologically advanced submarines. Thus, the loss of these vessels would be especially worrisome if the submarines of the former Soviet Union posed an increased threat in the future.

Unless this threat is renewed, however, fewer TAGOS ships might be needed. Only the republics of the former Soviet Union have submarines of sufficient quantity and quality to pose a serious threat to U.S. submarines and ships.

Until very recently, the Navy stated that antisubmarine warfare was its most important wartime priority. In light of the reduced threat from submarines, however, the Navy now places higher priority on other missions. Since the only mission of the TAGOS ships is antisubmarine warfare, the Navy's change in priorities might argue against further investment in that ship. Canceling the TAGOS-23 program, however, would derail plans to add a sensor that will provide at least some surveillance of submarines of regional powers in shallow waters.

DEF-15 CANCEL PROCUREMENT OF THE MHC(V)

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	220	0	270	0	490
Outlays	0	10	30	60	70	170

The coastal mine-hunting ship (MHC) was designed to clear Soviet mines from U.S. ports during a U.S.-Soviet conflict. By the end of 1993, the Navy had purchased 12 MHCs. The end of the Cold War, however, greatly diminished the likelihood of needing to clear U.S. harbors. Instead, mine-hunting ships most likely would be deployed to regional conflicts, as they were in Operation Desert Storm. The Navy, therefore, proposed purchasing a variant of the MHC--the MHC(V)--which would have better endurance for deployment overseas.

The Bush Administration originally intended to purchase one MHC(V) in 1995 and two in 1997. This option would cancel production of the MHC(V). Relative to the CBO baseline, which for specific programs generally follows the plan the Bush Administration submitted in January 1992, forgoing procurement would save $220 million in 1995 and $270 million in 1997. Having fewer ships in the fleet would also result in lower operating and support costs after 1998.

The Navy itself has apparently decided not to procure the MHC(V), a decision that was reflected in the budget revisions proposed by then Secretary of Defense Dick Cheney in January 1993 but was not incorporated in the Bush Administration's January 1992 plan. After analyzing the designs and capabilities of the MHC(V) and the lessons learned from Desert Storm, the Navy determined that the most cost-effective option was to make minor modifications in the existing MHCs to increase their endurance--the time they can remain at sea without added provisions or maintenance--rather than to purchase the MHC(V). Installing a relatively inexpensive food storage and refrigeration system, for example, could increase the endurance of the MHC by five to 15 days. In addition, based on its experience in Operation Desert Storm, the Navy decided to transport all of its mine-clearing ships to the theater of conflict on heavy lift ships and provide in-theater replenishment support (maintenance, loading supplies, and so on), thus increasing the MHCs' endurance and making them deployable assets for regional conflicts in developing countries. Desert Storm showed, according to the Navy, that smaller mine-clearing ships with lower magnetic and acoustic signatures, when properly supported, are as effective as larger ships such as the MHC(V).

The smaller total inventory of mine-clearing ships that would result from canceling procurement of new MHC(V)s should not be a problem. According to the Navy, the deficiency in its mine-clearing capabilities stems more from the slow response time in getting ships to where they are needed than from having too few ships.

DEF-16 REDUCE THE NUMBER OF AIRCRAFT CARRIER BATTLE GROUPS TO 10

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	570	4,980	2,680	3,690	4,460	16,380
Outlays	410	1,510	2,670	3,850	4,560	13,000
			Savings in Defense Budget			
Budget Authority	650	5,210	3,030	4,180	5,040	18,110
Outlays	480	1,730	3,010	4,310	5,130	14,660

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The aircraft carrier is the centerpiece of the U.S. Navy. The Bush Administration called for a modest reduction in carrier forces, from 14 in 1993 to 13 by 1995. Of these, 12 would be active and one, the USS Forrestal, would be used to train pilots. Thirteen air wings--11 active and two in the part-time reserve--would provide combat punch for these ships. (Carrier air wings typically contain about 80 aircraft of various types.) The carriers would be accompanied by a mix of surface combat ships--destroyers, cruisers, and frigates--that can attack planes, ships, and submarines that threaten the carrier. These surface combatants can also attack targets on land.

Some policymakers have argued that the United States does not need a force of 13 carriers in the aftermath of the Cold War. Even after the reductions proposed by the Bush Administration, the total capability of all U.S. tactical aircraft in the Navy and Air Force substantially exceeds that of any regional power that seems potentially hostile. U.S. naval capabilities are unsurpassed worldwide. The Navy also has ships other than carriers, including large amphibious vessels, that can assist in maintaining a U.S. naval presence overseas in peacetime. Perhaps for these reasons, several key policymakers have recommended reductions in the carrier force beyond those proposed by the Bush Administration. When he was Chairman of the House Committee on Armed Services, Secretary of Defense Les Aspin suggested reducing the carrier force to 12. In 1990, before the breakup of the Soviet Union, the Chairman of the Senate Committee on Armed Services recommended a force of 10 to 12 carriers. And during the 1992 campaign, President Clinton called for a Navy with 10 carriers.

In addition to cuts in carriers, the Navy may be able to reduce the number of surface combat ships that escort its carriers. Surface combatants accompany carriers in part to defend them. Yet the threats facing carriers, particularly threats from aircraft and submarines, came primarily from the former Soviet Union and are now much less serious. Last year the Chairman of the House Committee on Armed Services suggested reducing the number of surface combatants associated with each carrier.

This alternative would retire three carriers early so that by 1997 the Navy would have 10 carriers, including nine active ships and one for training. The reduction would be accomplished by accelerating the retirement of conventionally powered vessels using the following schedule: one additional retirement in 1994, one in 1995, and one in 1997. Under its current retirement schedule, by 1998 the Navy will have only three conventionally powered carriers. The rest will have nuclear propulsion, which enables them to steam quickly to trouble spots without refueling.

The alternative would also cancel additional funding for the next planned new carrier, CVN-76, because the Navy would no longer need it to replace retiring carriers within this smaller force. It would also eliminate the three air wings no longer needed by the retiring carriers. Finally, this option would retire early 27 older surface combatants--18 associated with the three battle groups that are eliminated and nine additional ships that the Navy might not need if it faces only the relatively less capable threats of the post-Cold War world. (See DEF-11 for a discussion of a larger reduction in the number of surface combatants.) This option would also retire nine supply ships and six submarines that are associated with the battle groups.

Compared with the CBO baseline, which for specific programs generally follows the plan proposed by the Bush Administration in January 1992, the combination of all of these changes would save nearly $600 million in 1994 and $16.4 billion in the period from 1994 through 1998. About $13 billion would be saved as a result of operating changes and $3.3 billion from reductions in procurement funding. Costs to decommission the returning ships would offset some of these savings, but CBO does not have the data to estimate their magnitude. But additional procurement savings, also not included in the savings shown above, might be realized. For example, the Navy might not need to buy as many DDG-51 destroyers for the smaller fleet (see DEF-12 for a discussion of the DDG-51). Also, the cut in air wings would reduce the number of required aircraft (see DEF-19 and DEF-20 for a discussion of changes in naval aircraft procurement).

With a smaller carrier force, fewer ships could be deployed overseas in peacetime. In peacetime, some carriers spend time in repair; others are kept at U.S. ports to provide stateside duty time for their crews; still others are in transit. The Navy, citing a newly published formula, argues that only one-quarter or less of the carrier fleet can be deployed overseas in peacetime. Thus, a reduction to a fleet of only 10 carriers might mean that about one less carrier could be deployed overseas compared with the level under the Bush Administration's plan. In some circumstances, this reduction could increase the time before a carrier and its aircraft became available during a crisis.

But the factors the Navy used throughout the 1980s implied that about a third of the carrier fleet would be deployed overseas. Moreover, the Navy kept five carriers overseas out of a fleet of only 12 or 13 ships in the late 1970s. Although such intensive use of carriers led to a number of problems according to the Navy, this experience suggests that the fraction of the carrier fleet that might operate overseas routinely is larger than the Navy's current formula would suggest.

In addition, a reduced overseas presence may be acceptable. The United States would still have at least two carriers deployed overseas at any one time, and possibly more if the Navy deployed a larger fraction of its carrier fleet. Therefore, response times in the event of a crisis might be increased by only a few days or, depending on the exact timing of the crisis, not at all. The Navy could also use surface combatants other than the carriers to maintain a naval presence in peacetime and to assist in crisis response. For example, it could use some of the 13 large amphibious ships that are designed to transport Marines and their equipment; these ships can embark helicopters and Harriers (Marine Corps attack aircraft that can land and take off vertically) and are as large as other countries' aircraft carriers. Amphibious vessels are fully capable of handling some missions usually performed by carriers. Indeed, when six carriers were occupied during Operation Desert Storm, the Navy used three amphibious ships to conduct a rescue mission in Liberia.

DEF-17 REDUCE THE NUMBER OF AIR FORCE TACTICAL FIGHTER WINGS TO 18

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	400	1,240	1,710	1,760	1,820	6,930
Outlays	260	880	1,360	1,570	1,700	5,770
			Savings in Defense Budget			
Budget Authority	450	1,390	1,920	1,980	2,040	7,780
Outlays	310	1,030	1,570	1,780	1,920	6,610

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The military forces proposed by the Bush Administration include 26 tactical fighter wings--15 active and 11 in the part-time reserves. (Traditionally, Air Force tactical air wings have consisted of 72 combat aircraft, plus about 28 aircraft for training and maintenance, though the service may be revising this concept.) There is, however, substantial disagreement about whether all of these wings are needed. U.S. tactical aircraft enjoy overwhelming superiority compared with the forces of those regional powers that appear potentially hostile to the United States. Perhaps for this reason, in 1992 the Chairman of the House Committee on Armed Services recommended that the Air Force retain only 18 tactical wings--10 active and eight reserve.

This alternative would follow the Chairman's recommendation and reduce the tactical fighter forces in the Air Force to 18 wings. The reductions beyond those proposed by the Bush Administration are assumed to take place rapidly; four additional wings would be eliminated in 1994 and four more in 1995. That schedule should be feasible; the Air Force has reduced the size of its fleet quickly in the past. For example, a total of six wings were eliminated between 1991 and 1992. Moreover, most of the Administration's planned reductions will be completed by 1994.

Reducing the Air Force's wings to 18 would cut the service's operating costs by $450 million in 1994 and by almost $8 billion through 1998. Additional savings might accrue from reductions in the procurement of aircraft, but those savings are not included in the table above. (See DEF-18 for a discussion of changes in procurement of Air Force tactical aircraft.)

In addition to achieving substantial savings, a reduction to 18 Air Force wings should still leave the United States with an acceptable level of military capability in a post-Cold War world. "Balance and Affordability of the Fighter and Attack Aircraft Fleets of the Department of Defense," an April 1992 CBO analysis of several potential adversaries--North Korea, postwar Iraq, and Cuba--found that, even after the reductions in tactical aircraft proposed by the Bush Administration, the capability of the tactical aircraft in the Air Force exceeded those of the other countries by factors of 22, 24, and 56, respectively. (The analysis was based on a scoring system The Analytic Sciences Corporation developed for the

Department of Defense.) The large margin of superiority suggests that additional reductions may be feasible without sacrificing the U.S. advantage.

A reduction to 18 wings might also help the Defense Department solve a long-range cost problem. Under the Bush Administration's defense plan, the Air Force and the Navy expect to buy new aircraft that are significantly more expensive than the aircraft they will replace. CBO's analysis suggests that the average cost of Air Force and Navy fighter aircraft bought from 1998 through 2010 could exceed available funding by 25 percent even under optimistic assumptions, and by as much as 45 percent if less optimistic, but still plausible, assumptions are made. Force reductions such as the one in this option would mitigate this problem by lowering operating costs, which would make more money available for procurement, and also by reducing the need to procure replacement aircraft.

Retaining only 18 wings in the Air Force, however, would not meet the military's current estimate of its requirements. General Colin Powell, the Chairman of the Joint Chiefs of Staff, stated last year that the base force, which includes the 26 wings, is needed to "implement the new National Military Strategy--to deter potential aggressors, fulfill our forward presence requirements and respond to any crisis." This assessment assumed that the United States must be prepared to fight simultaneous wars in two regions of the world--in the Middle East and, perhaps, in Asia. If one accepts this requirement, then the Air Force may well require more than 18 wings.

Some analysts would also argue that additional cuts in Air Force wings ignore a major lesson from the war with Iraq: aerial bombardment by tactical aircraft can be quite effective and may greatly accelerate the end of a war, thus reducing the loss of lives among U.S. ground troops. A sizable inventory of tactical aircraft, perhaps more than would be maintained under this option, may therefore be a wise investment.

DEF-18 CANCEL THE AIR FORCE'S F-22 AIRCRAFT PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	2,550	2,550	2,810	2,670	4,350	14,930
Outlays	1,290	2,130	2,090	2,020	2,590	10,120

The F-22 aircraft is being developed as the Air Force's next premier fighter. It will begin replacing the F-15 aircraft by the late 1990s. Fighter aircraft are designed primarily to destroy enemy planes, thus guaranteeing the United States and its allies control of the air. The Air Force wants the F-22 aircraft to have supersonic cruise speed as well as stealth characteristics that make it difficult for enemy sensors to detect. The F-22 aircraft would also be designed to fly long distances and to have highly effective avionics that could make it more capable than other fighters in many types of combat. The F-22 entered full-scale development in 1991, and the first F-22s were to be bought in 1996 according to last year's plan.

This option would cancel the F-22 program on the grounds that its additional capability may be both unnecessary and too expensive. Compared with the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, and assuming no further cost increases, canceling the F-22 would save $2.6 billion in 1994 and $14.9 billion for the 1994-1998 period. The total estimated savings include procurement, research and development, and military construction. The budget revisions proposed in 1993 by then Secretary of Defense Dick Cheney would delay F-22 procurement and therefore would reduce the savings from this option by a total of $2.6 billion for 1994 through 1998.

The improved capabilities of the F-22 aircraft will be costly. The 650 aircraft that the Air Force plans to buy will cost a total of about $52 billion in 1993 dollars ($77 billion in current dollars). The average unit procurement cost of the F-22 will be about $81 million in 1993 dollars, about 75 percent more than that of the F-15 aircraft in 1991, the last year that fighter was in production. Since the costs of many weapon systems increase during the full-scale development phase that the F-22 entered in 1991, actual costs could be even higher. And unit costs may rise if F-22 procurement is reduced below the planned level.

The F-22's cost could also rise if the Air Force has to fix design flaws. The only flying prototype of the F-22 crashed in April 1992. The Air Force argues that the crash was caused by the way the aircraft was operated and that certain operating restrictions, or at most minor software changes, should prevent future problems, but such mishaps may portend costly production problems.

Events in the Persian Gulf suggest that current Air Force aircraft are able to counter any threat less severe than that formerly posed by the Soviet Union, which many analysts consider to have been the only country whose air force had the capability to threaten U.S. fighters. In view of that reduced threat, the F-22 may provide more capability to attack enemy fighters than the United States needs.

Moreover, other types of aircraft may prove to be more useful in future conflicts. The extensive use of tactical bombing in the Persian Gulf War emphasizes the value of aircraft that can attack land targets, perhaps in preference to aircraft such as the F-22, which is designed to combat enemy fighters. Given the changes in the nature of the threat, strategies other than buying expensive F-22 aircraft might better meet the Air Force's future needs. Such strategies might include upgrading existing aircraft or developing a new plane that is less capable but cheaper than the F-22 aircraft.

Nor does the Air Force need to buy the F-22 any time soon to support the reduced size of its tactical forces. CBO analysis suggests that even if the Air Force procured no fighter aircraft after 1993, it would have more than enough aircraft to support the currently planned force of 26 tactical wings through 2005.

The Air Force counters that the improved capabilities of the F-22 aircraft would be required even in a world in which U.S. tactical air forces are smaller and the former Soviet threat is much reduced. If the United States canceled the F-22 program, then the capability of fighters in the first decade of the next century would be similar to that of today's F-15 aircraft, which entered development in the 1960s. By the next decade, regional powers such as Iraq may possess fighter aircraft that are at least the equal of the F-15. Thus, to maintain its edge, the Air Force believes that the United States needs the improved capability the F-22 aircraft offers.

DEF-19 CANCEL THE UPGRADE OF THE NAVY'S F/A-18 FIGHTER

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	1,390	1,340	1,250	2,260	1,880	8,120
Outlays	770	1,200	1,110	1,030	1,240	5,350

For the foreseeable future, the F/A-18 aircraft will account for the bulk of the Navy's fleet of carrier-based aircraft that perform fighter and attack missions. The F/A-18 attacks targets both in the air (the fighter mission) and at sea or on the ground (the attack mission). The current version of the F/A-18 is designated the C/D model.

In 1991, the Navy announced plans to develop a new E/F variant of the F/A-18. The E/F version features several modifications: a longer fuselage, a larger wing, and a more powerful engine than are now on the C/D version. These changes should enable the E/F version to carry a larger load of weapons than the C/D version, or to carry the same load about 50 percent farther. Both attributes are important factors in determining the plane's capability in the attack role. The new engine should also enable the heavier E/F aircraft to retain the speed and maneuverability of the earlier version, important performance considerations in fighter combat.

Though more capable, the E/F version will also be more expensive than the C/D model--about 40 percent more by some estimates--and the Navy will have to pay about $4.3 billion from 1994 through 1998 to develop the plane. This option would cancel development and procurement of the new E/F model and instead would buy sufficient additional C/D aircraft to maintain the Bush Administration's planned production rates. Relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, savings would total $1.4 billion in 1994 and $8.1 billion over the next five years.

Savings may be even larger if unanticipated cost increases occur. The Bush Administration's request for research and development increased 15 percent ($770 million) from January 1992 through June 1992. Estimates the Navy first provided to CBO in April 1992 for procurement of the first 648 aircraft had grown nearly 8 percent ($4.3 billion) by June 1992.

The requirement for an upgraded F/A-18 aircraft may be questionable in view of today's reduced military threat. It seems highly unlikely that the United States will find itself in direct conflict with the republics of the former Soviet Union, at least for many years to come. In other conflicts, current U.S. fighters probably will continue to have an edge in capability for quite some time.

Canceling the upgrade might also address some concerns raised in the Congress. In its 1991 report, the Senate Committee on Appropriations reduced proposed funding for the upgrade, questioning the need for it. The committee challenged the clarity of the Navy's plans for combat aircraft and the role of the E/F version of the F/A-18 aircraft in those plans; questioned the accuracy of the Navy's projections for the cost of the plane, the accelerated pace of the program, and the legitimacy of the Navy's claims for improvements in capability; and in particular, expressed concern about whether, in an era of tight budgets, the Navy needs to develop this plane when it is also developing the AX aircraft, a new plane that would be designed primarily as an attack aircraft but might also have fighter capability. If the AX has some capability as a fighter, then according to the committee the costly benefits derived from modifying the F/A-18 aircraft would be short-lived because the Navy would substitute the more capable AX aircraft in the fighter role as soon as it was available.

In 1992, all Congressional committees with defense oversight continued to express concern about the affordability of the Bush Administration's plan for tactical aviation. The Congress therefore directed the Department of Defense to produce a study that considered a number of alternatives to current plans and selected one that would be affordable. A portion of the funding for the F/A-18's development cannot be spent until that study is completed.

Canceling the E/F development program would have some disadvantages. Even in conflicts with smaller nations, improvements in the F/A-18's range might be useful in the attack mission; indeed, critics of the C/D version believe its relatively short range limits its usefulness. Moreover, the E/F upgrade could provide the Navy with a fallback if the AX program runs into cost or performance problems that lead to its cancellation or if production of the AX aircraft is delayed (see DEF-20 for a discussion of this issue).

DEF-20 CANCEL THE NAVY'S AX AIRCRAFT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	480	480	170	540	1,890	3,560
Outlays	260	420	290	400	1,250	2,620

In early 1991, then Secretary of Defense Dick Cheney canceled the Navy's plan to buy the A-12 aircraft. According to Secretary Cheney, the A-12 --a carrier-based aircraft that was to replace the aging A-6 aircraft and was designed to be stealthy, or difficult for enemy sensors to detect--was canceled because of cost overruns and slippage in the schedule. The A-12's mission of attacking sea or ground targets, including targets that are far away from the carrier, continued to be an important one, however.

Soon after the A-12's cancellation, the Navy initiated the AX aircraft program to produce a new plane to carry out this mission, with plans to field the plane by around 2005. In enacting the Department of Defense's 1993 budget, the Congress directed the Navy to build prototypes of the AX aircraft, which would delay the fielding of the plane. This delay may decrease the number of years during which the Navy will be buying both the AX and the new and more costly version of the F/A-18 aircraft (the E/F model). Nevertheless, the Navy may still have problems affording the AX.

The capabilities the Navy seeks for the AX could be very expensive. The Navy wants the aircraft to be stealthy and to be able to fly long ranges while carrying a large payload of munitions. According to press reports, the service may also want the new plane to be able to fire several types of air-to-air missiles, thus adding a fighter capability. This capability, which the A-12 aircraft was not expected to possess, would permit the AX aircraft to carry out part of the mission of today's F-14 fighter, which is designed to defend aircraft carriers from attack by destroying long-range enemy bombers before they are close enough to fire their own air-to-surface missiles. The Navy has also apparently expressed an interest in having AX aircraft perform a variety of other missions, such as electronic warfare. And the Air Force may buy a version of the AX for its tactical forces.

Because of these improvements in capability, the Navy expects the AX to be very costly. Estimates the Navy provided to CBO in April 1992 indicate an average procurement cost of about $120 million, in 1993 dollars, based on total procurement of 1,002 AXs for the Navy and the Air Force. AX costs could be even higher because procurement costs typically exceed estimates made during the development phase. In an April 1992 analysis, "Balance and Affordability of the Fighter and Attack Aircraft Fleets of the Department of Defense," CBO estimated that AX costs could reach $165 million per aircraft if the program experiences cost growth typical of some defense programs.

This alternative would cancel the AX program, but it would provide $150 million a year plus inflation for the Navy and the Air Force to study designs for a future top-of-the-line plane and perhaps for producing a few models to demonstrate technologies. Savings in 1994 would total $480 million compared with CBO's baseline, which is generally consistent with the Bush Administration's January 1992 plan, and would total about $3.6 billion during the 1994-1998 period. (The budget revisions proposed in January 1993 by then Secretary of Defense Cheney contain about $1.2 billion more for AX funding than the previous year's plan.)

Canceling the AX might be acceptable if the Navy expects to be involved primarily in regional conflicts. The capability afforded by F/A-18 aircraft, particularly the new E/F model, might be sufficient against such regional threats. The longer flight ranges of the AX might also be less important if the Navy's role is primarily one of assisting the Marine Corps in amphibious operations, which generally take place relatively close to shore. More sophisticated fighter capabilities associated with the Navy's plans for the plane may be less important against the less capable tactical aircraft of regional powers. The modest design funds included in this option would still allow the Navy to experiment with new aircraft designs that might be needed if security threats increase.

There are, however, disadvantages to canceling the AX. The Navy would not have a new stealthy aircraft. The value of stealth was proved by the performance of the F-117 in the Persian Gulf War. According to the former Secretary of the Air Force, more than 30 percent of the targets struck in the first 24 hours were attacked by F-117s, which accounted for less than 3 percent of all aircraft deployed. Eventually, when the venerable A-6 retires, the Navy would no longer have a medium-range bomber. Some of its missions could be carried out by the new E/F model of the F/A-18, which would provide the carriers with longer range than would the C/D models. But even the improved range of the E/F model will be shorter than that of the A-6. Although range may be less important if the Navy plans primarily to attack targets on or near beaches, the need to keep carriers out of the range of shore-based missiles may increase the distance that carrier-based planes must travel. Canceling the AX would also hurt the U.S. industrial base because the United States would produce only one entirely new tactical fighter or attack aircraft--the F-22--for the foreseeable future.

Canceling of the AX aircraft might be particularly undesirable if cost and other problems lead to termination of the E/F model of the F/A-18 (see DEF-19). In that case, the Navy would have neither the extended range of the AX nor the increased range of the E/F model.

DEF-21 REDUCE EMPHASIS ON THE NAVY'S ANTISUBMARINE WARFARE MISSION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	700	1,000	1,300	1,500	1,800	6,300
Outlays	190	600	1,030	1,320	1,590	4,730
			Savings in Defense Budget			
Budget Authority	700	1,100	1,400	1,700	2,000	6,900
Outlays	210	660	1,120	1,440	1,740	5,170

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Soviet attack submarines posed a major threat to U.S. naval forces during the Cold War. The U.S. Navy maintained several types of forces designed to provide a multilayered defense against this Soviet threat, an approach it termed "defense in depth." But the breakup of the Soviet Union has substantially diminished the potential threat from enemy submarines. Although Russia may keep some fraction of the submarines operated by the former Soviet Union, fiscal woes seem likely to prevent continued large-scale operations. Lessened tensions between the United States and Russia also suggest that the submarines that are retained would pose less of a threat to this country. Other potential adversaries have few, if any, attack submarines, and this situation is not likely to change markedly even if Russia sells a few submarines to Iran. For example, North Korea today has 22 submarines, Cuba has three, and Iran has one (and is attempting to acquire more). Moreover, these countries' submarines are typically less capable than U.S. vessels and are probably operated by less capable crews.

The Bush Administration recognized this reduction in the threat and lowered the priority of the antisubmarine warfare (ASW) mission. It also planned some reductions in ASW forces. Further reductions may be possible, however.

These further reductions might affect several of the various platforms that perform ASW. The first layer of the Navy's defense in depth against enemy submarines is the land-based P-3 aircraft. Surface ships house the next layer of ASW defenses. FF-1052 frigates equipped with ASW helicopters, such as the SH-60B, perform this mission, as do a number of other surface ships. Finally, as a last layer of protection, each carrier air wing contains about eight SH-60F ASW helicopters. In addition to these platforms, fixed arrays of listening devices are located in ocean areas through which Soviet attack submarines would have traveled to attack U.S. shipping.

Reductions in each of these forces, discussed in the following sections, would reduce the Department of Defense's budget by $700 million in 1994 and almost $7 billion through 1998. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would alter the structure of several of the programs discussed below and make some interim force reductions. Savings from this option might therefore be somewhat lower if compared with Cheney's proposals. (Attack submarines, which also contribute to the ASW mission, are discussed in DEF-13.)

Retire Land-Based P-3 Aircraft. During the Cold War, P-3 aircraft were expected to investigate whenever arrays of ocean-based listening sensors (termed the sound surveillance system, or SOSUS) detected a submarine. The P-3's mission is to locate the submarine and to destroy it by launching depth charges and torpedoes. The Navy operates 37 P-3 squadrons. Retiring half of the 37 squadrons would eventually save $1.1 billion in annual operating costs. The savings assume that these P-3s are retired evenly over four years starting in 1995, with all 18 P-3 squadrons retired by the end of 1998. Such a retirement schedule would reduce DoD's operating costs by $2.4 billion through 1998.

Procurement savings could also be realized, but their magnitude is difficult to estimate. P-3s are very old (more than 40 percent are 20 years of age or older), and the Bush Administration's 1992 plan contained funding for minor modifications for the P-3 to extend its life and improve its capability. Retiring half of the P-3 fleet might enable the Navy to defer about $1 billion in investment costs in 1994 through 1998 because the Navy could retain only those planes that are in acceptable condition. (Even larger cost savings might be realized beyond 1998 but are not included in these estimates.) Eventually, when the P-3 aircraft needs an extensive modification program or perhaps even a replacement aircraft, the smaller number of P-3s would mean smaller modernization or replacement costs. These savings could be large, although they would not be realized until after 1998. Savings might also accrue because of reduced spending on munitions, since the Navy would need to buy fewer weapons for the smaller force. In addition, SOSUS listening arrays might be reduced in number, resulting in lower operating and investment costs.

Retiring the P-3 aircraft would have several disadvantages. Although the P-3s' primary mission is ASW, the planes have also been used for other purposes, including surveillance and attacking enemy surface ships. Halving the P-3 fleet would reduce the number of U.S. forces that would be available for these other missions. But the Navy would still retain a substantial number of P-3 aircraft, in addition to a number of other Navy and Air Force systems that provide these services. The loss of the P-3s, therefore, may result in only a modest reduction in capability.

Retire the Navy's Eight FF-1052 Class Frigates. The Navy is deactivating 38 of its 46 FF-1052 class frigates, retaining the other eight as trainer ships for the reserves. Each training frigate's crew totals more than 300 people, about 55 percent of whom are reservists serving full time or active-duty personnel. The Navy also plans to train about 60 part-time reservists for each of 32 of the deactivated ships. These reservists would provide trained crews that could help reactivate the entire fleet if that were ever necessary. Manning for the 40 frigates the Navy will retain would total about 4,600 people.

Reflecting the reduced threat, this option would decommission the last eight frigates in 1994, saving $100 million in 1994 and $1.4 billion over the five years. Costs to deactivate these ships would offset some of the near-term savings, but CBO does not have the data to estimate their magnitude.

Retaining these frigates as training ships may be unnecessary because of the low probability that the entire fleet of FF-1052s would ever have to be reactivated. The Department of Defense might claim, however, that the program provides a cost-effective means to rebuild force structure in the event of an increase in the ASW threat. Furthermore, the FF-1052 program is part of a new initiative by the Navy to make greater use of the reserves. Many Members of Congress have strongly supported such initiatives and may be reluctant to terminate this one.

Cancel Further Procurement of SH-60B/F Helicopters. The Navy has bought 174 SH-60B helicopters for its surface combat ships and plans to buy 60 more through 1998. These helicopters--together with older SH-3s--are deployed on about 120 ships of various types. Two-thirds of the ships have space for two helicopters. Canceling future SH-60B purchases, as this alternative would do, would give the Navy more than enough SH-60Bs to meet its peacetime deployment needs without using the helicopters more intensively than is now planned, assuming these ships routinely carried only one helicopter.

Canceling the SH-60B would save about $300 million in 1994 and $1.6 billion through 1998. (The alternative might also produce some modest operating savings not included in these estimates.) Since the Navy deploys no more than a third of its fleet in peacetime, it could also keep deployments at two helicopters per ship if it were to move aircraft from one ship to another.

The Navy also plans to buy SH-60F ASW helicopters for its aircraft carriers. It has bought 85 SH-60Fs through 1993 and plans to buy 60 more through 1998. The Navy would need about 145 SH-60F helicopters to equip its 11 active carrier air wings with eight SH-60Fs each, provide six SH-60Fs for its two reserve carriers, and buy enough helicopters for training and maintenance. But, as with the surface combatants, a small fraction of the total carrier fleet (as low as one carrier in four or five according to some Navy estimates) is typically deployed in peacetime. A decision to provide ASW helicopters only for deployed carriers would substantially reduce requirements. If such a policy resulted in overly intense use of the helicopters, the Navy could deploy some wings without ASW aircraft or reduce the number of helicopters per wing. Either change could lower requirements for SH-60F aircraft and allow the Navy to cancel the remaining procurement, saving $300 million in 1994 and $1.4 billion over five years. This change would also produce some modest operating savings that are not included in these estimates.

Although they would save money, these changes would reduce the capabilities of the ships on which the helicopters would have been fielded, particularly in wartime. In war, fewer helicopters would be available to meet the high demand. The cancellation would also provide fewer aircraft to replace those lost during peacetime accidents, which means the Navy could run short of aircraft for peacetime needs sooner than would occur under the plans of the Bush Administration. Furthermore, it would also eliminate U.S. capacity to produce ASW helicopters.

In addition to the specific disadvantages of each action, there may also be general concerns about eliminating the forces described above and so deemphasizing the ASW mission. In recent policy statements, the Navy has suggested that it plans to restructure its forces to fight in regional contingencies in which conflict is likely to occur in littoral areas (that is, areas close to shore where water is shallow) rather than in the open ocean. Although the submarine fleets of regional powers are much less threatening than those of the former Soviet Union, the acoustic properties of these shallow waters may make submarines harder to find. Thus, substantial ASW forces might still be needed, especially if Russia begins large-scale sales of its submarines to regional powers in the Middle East or elsewhere.

The specter of a reconstituted Soviet or Russian threat might also be a rationale for keeping a substantial ASW capability. If this option were carried out, the United States would need a number of years to rebuild its ASW forces. Yet such forces would be needed early in a war against a military power that had many submarines. As insurance against this risk, the equipment retired under this option could be stored in lightly manned units rather than simply being retired. The mission of these units would be to maintain the equipment and to retain some basic ability to operate it. Storing equipment might entail costs of perhaps 5 percent to 10 percent of those for active units, which would result in only modest reductions in the savings shown above.

DEF-22 ELIMINATE FOUR ARMY LIGHT DIVISIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	270	870	1,600	2,750	3,560	9,050
Outlays	220	720	1,370	2,330	3,110	7,750
Savings in Defense Budget						
Budget Authority	330	1,040	1,910	3,260	4,190	10,730
Outlays	270	880	1,670	2,820	3,730	9,370

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The active portion of the U.S. Army consists of 14 divisions, seven of which are generally regarded as "heavy"--that is, equipped with tanks and other armored vehicles. The seven heavy divisions are primarily intended to defend Europe from armored attack. The other seven divisions, referred to as "light" divisions, are useful against less heavily armored forces and were designed to be dispatched quickly and transported easily to trouble spots around the world. They include one airborne division, one air assault division, one infantry division, and four light infantry divisions (LIDs).

The utility of the four light infantry divisions has been questioned in the Congress and elsewhere since their creation eight years ago. The Reagan Administration justified the LIDs by emphasizing the need to respond to events anywhere in the world by rapidly dispatching U.S. forces. But recent history indicates that the United States may not need four of these divisions. Between 1945 and 1978, 215 incidents required some sort of U.S. military action, but only about 5 percent of them required a force of division size or larger. Furthermore, one can argue that other units--including the Army's airborne and air assault forces and three Marine Corps divisions--provide sufficient rapid response.

Other questions arise about the capability of the LIDs once they have been transported, presumably to a hostile location. With 870 jeeps, 135 motorcycles, and 41 utility helicopters for transportation, a light infantry division has limited mobility, and most of its 10,000 to 11,000 soldiers would have to move by foot. A LID also has limited firepower, particularly against an enemy with any kind of armored vehicles. Each division has only 44 long-range antiarmor missiles, 62 howitzers, and 29 armed helicopters; the most numerous antiarmor weapon in the LID--162 Dragon medium-range antitank missiles--has limited capability against modern tanks.

Perhaps the strongest statement about the utility of the LIDs in combat was made by the Department of Defense when it failed to use any light infantry forces during Operation Desert Storm. That conflict was initiated by a relatively unsophisticated foe and occurred halfway around the world with very little warning. The need to establish some military presence in theater very rapidly would seemingly have argued for the use of light infantry forces. Nevertheless, none of the LIDs were deployed.

Questions could also be raised about the Army's need for both an airborne and an air assault division.

The former is designed to be dropped by parachute into hostile territory when no seaport or airport is available for debarkation; the latter is designed to be deployed by helicopter to relatively remote locations, although the deployment must be staged from a protected area. The United States has not conducted a parachute assault involving an entire division since World War II. Drops including one brigade--about one-third of a division--were carried out in Korea and Vietnam and in Panama in 1990. In Operation Desert Storm, portions of the 82nd Airborne were sent to the Middle East early in the operation, but they did not parachute in and, once reinforced by later-arriving heavy combat units, were assigned supporting roles and were not involved in any major battles. Additional paratroop-qualified units exist in the special forces branch of the Army, so it is not obvious why the Army also needs an entire division designed to be dropped by parachute.

This alternative would eliminate four light divisions--three light infantry and portions of the airborne and air assault divisions--from the Army's active forces. To permit an orderly drawdown, one division would be eliminated each year, starting in 1994. The alternative would retain one light infantry division and one airborne division consisting of two air assault brigades and one airborne brigade. About 59,000 soldiers, including both personnel directly associated with the divisions and people who support them, would be eliminated from the active Army. Total savings would be $270 million in 1994 and nearly $9.1 billion over the five-year period.

Despite these savings and the shortcomings of the light infantry divisions, eliminating them would reduce U.S. defense capability in certain situations. For example, the 10th Light Infantry Division was deployed recently to Somalia to assist in the humanitarian relief effort. In a more hostile environment, LIDs might be useful during combat in urban areas where armored vehicles cannot operate easily. LIDs might also be useful for defending areas such as airports or seaports if the enemy did not have armored capability. In some circumstances, the one LID that would remain in the Army under this option might not provide sufficient capability. A proposal to eliminate three of the four LIDs might also encounter political opposition because it would mean closing some military facilities that have been activated and refurbished in recent years.

DEF-23 WITHDRAW AND ELIMINATE 2ND INFANTRY DIVISION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	540	1,110	1,150	1,180	1,220	5,200
Outlays	410	920	1,050	1,130	1,180	4,690
			Savings in Defense Budget			
Budget Authority	640	1,320	1,360	1,400	1,450	6,170
Outlays	510	1,120	1,260	1,340	1,410	5,640

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The United States currently stations some 35,300 troops in Korea primarily to deter North Korea from acts of aggression against its southern neighbor. These forces are configured in one Army division, two Air Force tactical aircraft wings, and supporting units. Should hostilities erupt, these forces would act in alliance with the forces of South Korea to contain an invasion until U.S. reinforcements could arrive. The likelihood that a North Korean attack will occur and succeed has diminished over the past several years, however, and calls for reductions in the level of U.S. troops stationed in Korea have become louder and more frequent.

As early as the summer of 1989, Members of Congress requested a shifting of the burden for defense of the Korean peninsula to the South Korean military. In fact, the United States has reduced its troop levels in Korea by almost 8,000 since 1989, but has put plans to bring an additional 6,500 home by 1995 on hold. Nevertheless, many analysts feel that these planned reductions should proceed apace and eventually result in a greatly reduced U.S. presence, particularly with respect to ground forces.

Several factors support this position. Compared with North Korea, South Korea has a larger base from which to support its military, both economically and demographically, with a gross domestic product that is almost five times larger and a population that is almost twice as big. During the past 15 years, South Korea has also embarked on an ambitious plan to modernize its military, outspending North Korea by a factor of 2 to 1 in recent years. Indeed, some analysts have concluded that South Korea also enjoys a military advantage over its neighbor to the north. Although the size of the two countries' forces may be roughly equal, South Korea has a significant edge in the sophistication and capability of its weaponry. The advantages of sophisticated ground and air forces, particularly in the hands of well-trained troops supported by an ample logistics base, were graphically demonstrated in Operation Desert Storm. Some analysts would argue, therefore, that South Korea is approaching self-sufficiency in defending its end of the peninsula.

Finally, many analysts of international politics feel that North Korea is beginning to chafe under its economic and political isolation and wishes to become more involved in global affairs. These factors may reduce the likelihood of North Korea's attacking South Korea.

This option, then, would withdraw the U.S. Army division currently stationed on the Korean peninsula. The withdrawal would occur over two years to permit time for negotiations with South

Korea and an orderly departure. Some Army artillery units and tactical Air Force wings currently stationed in Korea would remain there to support allied forces in case of hostilities. Because the 2nd Infantry Division is of a structure unique in the active U.S. Army and is not well suited for either armored warfare or rapid deployment around the world, this option would eliminate it from the U.S. force structure. As a result, the active Army would be reduced by about 21,000 personnel, saving $540 million in 1994 and $5.2 billion over the next five years.

An obvious drawback of this alternative is the reduced deterrent to aggression by North Korea. Although the North has made attempts at rapprochement with the Western world over the past two years, it remains a closed society, recalcitrant in its dealings with negotiators and nuclear inspectors and difficult to predict. For these reasons, and in the belief that North Korea may be actively attempting to develop nuclear weapons, the Department of Defense announced a moratorium in planned U.S. troop reductions. Whether the recent progress in relieving the tensions between North and South Korea will continue or be reversed remains to be seen. For this reason, the Bush Administration and some analysts have argued that the United States should maintain current U.S. troop levels in Korea until the nuclear weapons issue, at least, has been resolved.

DEF-24 CANCEL THE ARMY'S TANK UPGRADE PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	70	230	450	650	710	2,110
Outlays	10	30	140	310	490	980

The shrinking of the U.S. military, coupled with the disappearance of a long-time foe and the unprecedented peacetime investment in modern weapons that occurred in the 1980s, has sharply reduced the need for new weapons. In particular, the Army now has enough of the latest type of tank, the Abrams, to equip the forces it plans to have in 1995 and thereafter and so has no plans to buy new tanks for at least the next 15 years. At the urging of the Congress, the Army has proposed instead to upgrade slightly more than 1,000 M1s--the first model of the Abrams tank--to a later configuration designated as the M1A2. This program is intended, in part, to increase the capability of some of the tanks that the Army will have in the field for the next 20 years and in part to keep producers of tanks and tank parts in business, pending the need for a tank to replace the Abrams.

The Army's rationale for upgrading tanks, based on the need for better tanks, was disputed by members of the Bush Administration. The Chairman of the Joint Chiefs of Staff, General Colin Powell, testified before the Congress in March 1992 that the Army's current tank is the best in the world. Indeed, although the M1A2 is 20 percent more capable than the M1 model--as measured by one scoring system developed for the Defense Department--converting 1,000 M1 tanks to the M1A2 model would increase the total capability of the 7,880 Abrams tanks in the Army's inventory by only 3 percent. This slight increase in capability would come at a high price--a total of almost $2.5 billion over the next five years.

This alternative would cancel the Army's upgrade program but would retain the components of the tank industrial base in a mothballed status. Mothballing the government-owned facilities that manufacture tanks and components could cost nearly $400 million over the next five years. By preserving the facilities, however, the United States would retain the capability to produce tanks again when the next generation is needed to replace the Abrams or in the event of a crisis that would require more Abrams tanks. Savings from adopting this alternative would amount to about $70 million in 1994 and would total $2.1 billion over the next five years.

Closing the tank line would also have some disadvantages. Without an upgrade program, the U.S. inventory would include almost none of the most capable M1A2 tanks. As regional powers acquire improved tanks, the absence of M1A2s might erode the U.S. advantage in a war, even though the M1A1 remains a highly capable tank. Closing the tank line would also end U.S. capability to produce new tanks quickly. The Army estimates that producing a new M1A2 tank from a mothballed line could take more than four years--one year more than to produce a new tank from a line involved in modifying tanks.

Perhaps the most important drawback of this option is that some businesses that currently manufacture tank components might close and so be unavailable to produce tanks in the event of a crisis. A related concern is the potential loss of workers whose skills are unique to tank manufacture and who would have to be retrained in order to perform up to government standards. Even though Defense Department officials have stated that the United States currently has enough capable tanks to meet any foreseeable contingency and that there would be enough time in the event of a major crisis to restart the tank line, shutting the tank line down completely carries some risks. These risks have to be weighed against the hundreds of millions of dollars that would need to be spent annually to provide insurance against them.

DEF-25 CANCEL THE ARMY'S RAH-66 PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	160	130	100	30	0	420
Outlays	160	210	150	80	-50	550

The Army fields about 8,600 helicopters, some of which are approaching the end of their expected 20 years of service life or have exceeded it. About 3,000 of the helicopters, the OH-58 Kiowa scout helicopters and the AH-1 Cobra attack helicopters, are Vietnam-era aircraft that the Army is anxious to replace with the RAH-66 Comanche helicopter. The Comanche will fill both the reconnaissance and attack roles that these two helicopters now perform.

The Comanche program, when it was conceived in 1983, was intended to develop one aircraft that, in two different configurations, could replace not only the Vietnam-era scout and attack helicopters described above, but also the UH-1 utility helicopters of the same vintage. The Army originally planned to buy over 5,000 Comanches of various configurations. The utility version was dropped in 1988, however, because the program had become too costly; since then, the program has included only the attack and scout version, and the quantity has been reduced further, from a planned purchase of over 2,000 aircraft to just under 1,300 helicopters. The helicopter is still in the development stage, which will continue at least through 1997. The Army, which as recently as last year had planned to start buying Comanches in 1996, has since delayed the start of procurement by three years.

As a consequence of changes in the objective and size of the program, the cost of each Comanche helicopter has increased substantially since the program began. In constant 1993 dollars, the cost for each Comanche has grown by a factor of two, from $10 million in 1985 to $20 million in 1992, and the Comanche has become more expensive to acquire than the Army's current generation of attack helicopter, the AH-64 Apache, which is bigger and heavier than the RAH-66. This growth is significant, particularly in a helicopter whose development was originally justified on the basis of its being inexpensive to purchase, operate, and maintain. Indeed, the Comanche's high cost calls into question the prudence of pursuing this yet undeveloped aircraft instead of continuing to buy existing helicopters such as the AH-64 or later models of the OH-58.

The General Accounting Office (GAO) has questioned the wisdom of continuing the Comanche program. A recent report noted not only the increase in the cost to acquire the Comanche, but also the potential for increases in the maintenance costs to three times the original estimates. These factors, plus the risk of additional cost growth as technical issues are resolved, caused the GAO to question the Army's underlying rationale for the Comanche program. In addition, the Comanche, which was conceived at the height of the Cold War, will no longer need to counter threats of the same scale or sophistication as those it was designed to thwart. Indeed, the Comanche is now so similar in capability to the Apache, the aircraft it is supposedly designed to complement, that it is unclear what unique role it would play in Army aviation. Without a mission that existing Army helicopters cannot perform, it is hard to justify the continued development of an aircraft that is more expensive to acquire than existing helicopters.

Based on these various concerns, this alternative would provide other means for filling the Comanche's role, at reduced cost. It would cancel the RAH-66 program, thereby saving $1.2 billion in research and development funds over the next five years. Some added costs would be associated, however, with buying more helicopters of other types. The Army has already purchased enough Apaches to fulfill the attack role assigned to seven of its 14 divisions. During Operation Desert Storm, Apaches performed their missions without scout helicopters, and this alternative accordingly provides no replacements for the aging OH-58s currently assigned this role in these divisions. The Army, however, needs to replace the aging AH-1s assigned to the attack aviation units of its remaining seven divisions. Armed scout helicopters, known as armed OH-58Ds, were used effectively in the Persian Gulf and could replace the AH-1s still in service. The Congress has supported purchase of these aircraft in the past, and the Army has proposed a program to field a limited number (255) of these helicopters over the next few years. This alternative would buy 36 armed scout helicopters each year, leading to a total procurement of 399 helicopters through 1997. After taking into account the cost of buying these helicopters, net savings would be $160 million in 1994 and would total $420 million over the next five years.

The disadvantage of adopting this alternative would be the loss of new aviation technology incorporated in the Comanche. Some analysts would argue that the threats the Comanche is likely to face would not demand the very sophisticated stealth, avionics, and aeronautic technologies slated for the new helicopter, but others would support the program as a way to maintain the U.S. lead in helicopter technology. Some of the Comanche's new technologies already are being incorporated into current U.S. helicopters like the Apache. Abandoning the RAH-66 program, however, would mean that the Army would have to rely on helicopters designed in the 1960s and 1970s for years to come.

DEF-26 CANCEL THE KINETIC ENERGY ANTI-SATELLITE WEAPON PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	20	20	20	20	20	100
Outlays	10	20	20	20	20	90

In 1989, the Department of Defense initiated a program to develop a rocket interceptor to attack Soviet satellites. The Army's Kinetic Energy Anti-Satellite Attack (ASAT) program is the latest in a series of antisatellite research and development programs that date back to the 1970s. Under the current program, the Army plans to begin producing land-based ASAT missiles in 1999 and expects to deploy them at a single, fixed site in 2002. The Air Force plans to develop a battle management capability as well as command, control, and communications to assist in operating the ASAT system. DoD has spent more than $1.8 billion over the past decade to develop an antisatellite capability.

Because of recent changes in the former Soviet Union and tight U.S. defense budgets, the ASAT program may now be of lower priority. For example, shortly after awarding an initial research contract in August 1990, the Army recommended canceling funding for ASAT. DoD and the Bush Administration initially concurred, and plans were made to terminate the program. The Bush Administration subsequently revised its position and restored enough funding for the program to support near-term research while the Army restructured the overall program to reduce its cost.

Disagreement within the Congress over the need for the program during the past year has led to further restructuring. The House Committee on Armed Services concluded that the program was no longer necessary because the Soviet threat had dissolved and the United States was seeking greater cooperation with the Commonwealth of Independent States. The committee also stated that the $25 million requested for 1993 was insufficient to support the program and voted to terminate it. Members of the Senate Committee on Armed Services, however, voted to fund the Bush Administration's request. The conference report on the 1993 defense authorization act directed DoD to review and revise the requirements for the program as necessary, to restructure the program accordingly, and to report to the Congress in March 1993. The Congress appropriated $20 million for 1993 to permit the program to proceed while DoD reexamined its requirements and structure.

This option would terminate the Army program and related support efforts elsewhere in the department. Compared with the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, canceling the ASAT program would save about $20 million in 1994 and about $100 million over the next five years. These savings are small because the Administration requested nominal funding annually through 1997 while it reformulates the ASAT program. Compared with a possible restructured program similar to the Army's 1991 plan, canceling ASAT could save around $2 billion. (In 1991, DoD estimated that the ASAT program would cost about $2.3 billion.) Most of these savings would be realized beyond 1998.

The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would cancel the program and achieve the savings projected in this option. Canceling the restructured ASAT program would reduce future budget problems that could affect other Army weapon systems. Since current funding for the program functions as a placeholder while the Army makes new plans, the restructured program will require additional funds beyond the current request when it is included in future budget requests. To afford the revised ASAT program and remain within its budget, the Army would have to find offsets from other programs.

The diminished threat of a world war between the superpowers may have reduced the military justification for the ASAT program. Indeed, the program still lacks an approved operational military requirement based on an updated assessment of the threat. In addition, alternative programs (including the Mid-Infrared Chemical Laser and the Strategic Defense Initiative's interceptor rockets) are under way that could meet the requirements of the antisatellite mission.

However, proponents of the Army's ASAT program might contend that, when deployed, it could destroy satellites operating at low and middle altitudes. Satellites at these altitudes could provide important intelligence information and communications capability. The ASAT program might also be useful in regional conflicts, should nations other than those in the former Soviet Union develop and deploy military satellites or avail themselves of services provided by Russian satellite coverage. In addition, unlike the other antisatellite programs that are being designed, the ASAT program would provide this protection without violating the Anti-Ballistic Missile Treaty.

DEF-27 CANCEL THE C-17 AIRLIFT AIRCRAFT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	3,210	3,330	3,040	2,790	3,040	15,410
Outlays	180	930	2,080	2,630	2,810	8,630

The C-17 is a four-engine transport aircraft that can carry its maximum payload of about 162,000 pounds of cargo for a distance of 2,400 nautical miles without aerial refueling. It is being produced as the next-generation airlift aircraft to replace the C-141 Starlifter. Because it is designed to land at relatively small airfields with short runways, the C-17 also is expected to play an important role in meeting transport needs within a combat theater and will lessen requirements for aircraft such as the C-130 that traditionally perform that role.

Canceling the C-17 program would save $3.2 billion in budget authority in 1994 and $15.4 billion over the 1994-1998 period. These savings are relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, as amended by Congressional action. Specifically, the Congress would limit future production to no more than 12 aircraft per year; the Bush Administration planned to build 18 aircraft per year.

The C-17 program has a long and troubled history. The development program began in 1981, but the first aircraft were not authorized for procurement until 1988. Funds have been appropriated for a total of 20 C-17s since then. The Air Force's original plan was to purchase 210 C-17s by 1998, but the program was among those subject to the Secretary of Defense's Major Aircraft Review in 1990. After that review, the Secretary announced a reduction of 43 percent in the number of C-17s, to only 120 aircraft. That reduction meant forgoing the Department of Defense's goal of raising airlift capability to 66 million ton-miles a day. Instead, the Bush Administration's announced goal was to maintain airlift capability at its current level of about 48 million ton-miles a day.

The C-17 program has experienced major cost growth in both its development and production phases. In September 1990, the Administration estimated that the average program unit cost for each C-17 would be nearly $261 million. The average program unit cost in the 1993 budget was estimated at $298 million--a 15 percent increase. The full-scale development contract signed in 1985 was for $3.4 billion; the Air Force's current estimate to complete full-scale development is $5.7 billion. Because the contract limits the government's cost liability to $4.9 billion, the prime contractor, McDonnell Douglas Corporation, and its partners will have to absorb the difference of around $800 million. Production of the first six aircraft--for which government costs are also capped--is also expected to result in losses. Those losses, coupled with McDonnell Douglas's potential liability to the government resulting from the cancellation of the A-12 aircraft development effort, have caused some industry analysts to wonder whether the company can weather those financial shocks.

More recently, the wings of the C-17 test article (a full-scale, nonflying version of the aircraft meant for developmental testing) buckled under a test load equal to 130 percent of maximum operating weight. Specifications call for the airframe to withstand loads of up to 150 percent. Under the terms of its contract, McDonnell Douglas will be responsible not only for the costs of identifying and correcting the deficiency but also for repairing or rebuilding the test article so that the correction can be tested. How much this will add to the losses discussed above is not yet clear.

Canceling the C-17 aircraft program would have little immediate effect on U.S. airlift capability.

Today's fleet gives the United States an unparalleled capability to move forces overseas rapidly. That fleet includes 109 C-5s, 234 C-141s, 57 KC-10 cargo/tanker aircraft, and some 150 civilian cargo aircraft that are available to DoD in an emergency. These intertheater aircraft designed for long hauls are supplemented by over 500 C-130 aircraft for shorter airlift missions within a combat theater. U.S. airlift capability was amply demonstrated during Operation Desert Shield, when about 99,000 tons of equipment and material were delivered in the first 45 days of operations.

Within a few years, however, cancellation of the C-17 program could adversely affect U.S. airlift capability. The C-141 fleet is currently about 27 years old, on average, and older C-141 planes might begin retiring in 1997. Without C-17s or other aircraft as replacements, U.S. capability would begin to decline.

But the decline in capability could be offset. The Department of Defense could put in place programs to extend the service life of the C-141 aircraft for another 10 to 15 years by replacing elements of the aircraft's wing structure. The cost of such modifications is at issue: a DoD official has testified that the cost might be $12 billion or more if new engines and new wing boxes were procured; the Lockheed Corporation claims that a more modest program could fix the wings for about $3 billion and that new engines are not necessary.

Extending the C-141's life is not the only alternative. Production of C-5B aircraft could be resumed at a procurement unit cost of about $200 million, compared with roughly $240 million (both in current dollars) to buy each of the remaining 100 C-17s. (The estimate for the C-17 assumes that the Administration will buy no more than 12 aircraft per year.) Because the average payload of a C-5 is about 40 percent greater than that of a C-17, fewer C-5s would be needed to replace the 100 C-17s still to be purchased. CBO's calculations, based only on payload comparisons, suggest that matching the capability of 100 C-17s would require 70 C-5s at a total cost of $14.4 billion. That amount compares with an estimate of $24.7 billion to complete the C-17 program.

Buying more C-5 aircraft, however, is strongly opposed by the Air Force and the Office of the Secretary of Defense. Their analyses conclude that, because the C-17 is being designed to operate at a higher rate of use than the C-5, 100 C-5Bs would be required to offset the loss of the 100 C-17s. Approximately 100 C-130 aircraft would be required to fill the role the C-17 would play in moving cargo over shorter ranges. Including these additional factors, costs for the C-5 alternative could run as much as $24.8 billion, about the same as the cost to complete the C-17 program. In addition, DoD officials have expressed concern about the higher cost of operating the C-5 in peacetime, when its greater lift capabilities are generally less useful, and about its inability to use smaller airfields efficiently because of its size.

DEF-28 RETIRE EXCESS KC-135 TANKERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	70	210	360	510	580	1,730
Outlays	50	170	310	450	540	1,520
			Savings in Defense Budget			
Budget Authority	80	250	430	600	680	2,040
Outlays	60	210	370	540	640	1,820

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The U.S. Air Force owns a large fleet of aircraft to refuel transport, fighter, and bomber planes while they are airborne. Being able to do so is critically important for battlefield operations and for continuous long-range journeys from the United States to other parts of the world. The United States owns about 600 KC-135 aircraft, based on the Boeing 707 airframe, and about 60 KC-10 aircraft, related to the McDonnell Douglas DC-10.

The Air Force plans to upgrade a total of nearly 400 of the KC-135 aircraft to the more capable KC-135R version. This option would retire, over the next four years, the 155 KC-135 aircraft that were originally slated to receive new engines and other modifications but have since been dropped from the KC-135R modernization program. Doing so would leave the military with about 460 tanker aircraft, ultimately saving some $700 million a year in defense spending and $2 billion through 1998.

The Air Force is already retiring some of the old KC-135 aircraft in accordance with overall Department of Defense plans for reducing the size of the U.S. military. However, in actual capability--defined as the aggregate fuel payload of the entire fleet--these cuts amount to less than 10 percent from current levels.

These modest reductions stand in contrast to much steeper cuts in the aircraft that are serviced by refueling tankers. In particular, as a part of the Bush Administration's plan for reducing the military to its base force levels, DoD is cutting the tactical Air Force (encompassing fighter and attack aircraft) by about 25 percent as measured in combat units, and the strategic bomber force by some 30 percent, relative to 1990 levels. (DEF-08 discusses even deeper cuts in strategic bombers, and DEF-16 and DEF-17 in tactical aircraft.)

By retiring another 155 tanker aircraft--representing slightly more than 15 percent of today's total refueling capacity--this option would make cuts in tankers that, in conjunction with the retirements of KC-135s the Bush Administration decided to implement, would be commensurate with the above-noted plans for reductions in combat aircraft. It would focus on specific types of refueling aircraft, the older KC-135s, whose engines and other characteristics make them difficult to use--as evidenced during Operation Desert Storm. After these cuts, the total fleet would still be as capable as it was in the early 1980s, when the United States had no KC-10s and no KC-135s with new engines.

A drawback of this option is that it would leave the United States unable to wage a conventional war and a major nuclear war involving strategic bombers at the same time. However, in light of the very low probability of nuclear war and the availability of other reliable platforms for delivering nuclear weapons that do not depend on tankers (particularly missiles based on submarines), this loss of capability may not be a problem.

Perhaps more important, this option might also preclude the United States from prosecuting two major conventional wars simultaneously. Current force planning is premised on such a two-war scenario--perhaps one in the Middle East and the other in Asia. Recent history suggests that the 460 tanker aircraft maintained in this option would not be enough for two wars at once, but that the planned 600 or so might be. In the Persian Gulf War, the military deployed about 300 refueling aircraft of various types--46 KC-10s as well as different versions of the KC-135. A total of 460 refueling aircraft in the U.S. inventory would be sufficient for a future deployment of similar size; it would also be enough for a simultaneous, smaller conventional deployment in some other theater or to provide some level of nuclear deterrence. But such a force would not permit the United States to fight two simultaneous wars on the scale of Operation Desert Storm--unless, of course, the role of refueling aircraft in military operations could be reduced or made more efficient than was the case in the Gulf War.

Still, many analysts question the need to prepare for two major, simultaneous wars at a time when the United States faces no major geopolitical threat and continues its alliances with most of the great economic and military powers of the world. Even if war broke out in more than one place at the same time, the United States would have many options: it could prosecute the two wars sequentially, initially maintain a strictly defensive deployment in one theater while fighting all-out in the other, or, perhaps most desirable of all, decide not to become militarily involved in one of the two conflicts unless major support from the larger European allies proved forthcoming.

DEF-29 DELAY DEVELOPMENT AND PRODUCTION OF NEW WEAPONS FOR ONE YEAR

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	600	0	0	0	0	600
Outlays	240	190	90	40	20	580

The significant changes in the international politico-military and domestic budgetary environments suggest that a more gradual approach to purchasing weapons may be appropriate. Some analysts have proposed that the acquisition process proceed more methodically to ensure that new weapons being developed will meet performance and cost goals even if more time is required to do so. Others have been concerned that projected reductions in the procurement budget will make existing and planned weapon systems more difficult to afford in the future. Delaying by one year the start of all new research and development (R&D) programs, full-scale development programs, or programs of initial or full-rate production could yield near-term savings, improve overall affordability, and provide time to reassess military priorities consistent with changing national security needs.

This option identifies seven R&D and production programs the Department of Defense has planned for 1994. Measured against the CBO baseline, which is generally based on the Bush Administration's January 1992 plan, delaying the acquisition process for these programs for one year could save as much as $600 million in 1994.

Research and Development Programs. In its January 1992 plan, the Bush Administration's budget for 1994 requested $39.7 billion for research and development--roughly equivalent in real terms to R&D funding for 1993--to preserve technological superiority for future military forces. DoD has proposed four new R&D programs or programs entering full-scale development for 1994. Total funding requested for those programs is about $300 million in 1994--about 1 percent of the total budget request for research, development, test, and evaluation. Although the funding request for most programs is modest--exceeding $10 million in 1994 for only one of the programs--funding requirements historically have accelerated rapidly for many programs in the later stages of development. In fact, most of the proposed funding would support full-scale development of the ground-based components of strategic defenses. Research and development for these components could eventually cost over $1 billion a year beginning in 1997.

Delaying the funding for all of these programs for one year could save about $300 million in 1994. A one-year delay, however, would probably add to the overall cost of these programs, assuming that administrative, labor, and material costs experience real increases in the future. In addition, a delay would extend the time until a weapon could be deployed.

New Production Programs. Through fiscal year 1993, funding for defense production programs has decreased in real terms each year since 1985. The Bush Administration's January 1992 budget for DoD procurement in 1994 reversed this trend, however, with increases in production funding through 1995.

If future procurement budgets do not meet DoD's projections, production programs will become less affordable. As a result, DoD may have to cut back or cancel production of weapons to accommodate unanticipated budgetary constraints. Reflecting both the reduced military threat and increased budgetary constraints, DoD has canceled or discontinued many weapon programs in recent years, including systems such as the small intercontinental ballistic missile and the Seawolf attack submarine. In addition, DoD is purchasing other weapons, most notably the C-17 and B-2, in smaller quantities to save money.

In the January 1992 plan, the Bush Administration's budget request for 1994 contained funding leading to initial or full-rate production for only three weapon programs. Delaying production but providing requested research funds would save $300 million in 1994.

DEF-30 ELIMINATE PAYMENTS FOR INDEPENDENT R&D

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	3,100	3,400	3,500	3,600	3,700	17,300
Outlays	1,590	2,840	3,270	3,450	3,590	14,740

One of the categories of Department of Defense funding for research and development is known as independent research and development (IR&D). This program allows contractors to undertake research of their own choosing and to be reimbursed by DoD if the research meets eligibility criteria outlined in section 802 of the National Defense Authorization Act for Fiscal Years 1992 and 1993. Among the allowable categories of cost are expenses of preparing certain bids and proposals (B&P). In 1990, DoD subsidies for IR&D totaled about $3.6 billion, of which $1.4 billion compensated contractors for their B&P costs.

The act significantly changed the IR&D program to encourage contractors to pursue additional R&D projects. It eliminated most of the detailed administrative controls formerly limiting IR&D and B&P reimbursements and also authorized a 5 percent annual increase in funding for IR&D for 1993 through 1995. (The legislation also permits additional funding--up to the rate of inflation--beyond the 5 percent cap for selected IR&D projects.) Despite these incentives to increase emphasis on research and development, some industries have indicated that these changes might not stimulate any additional R&D spending even if DoD reimbursed firms for 100 percent of their costs. With fewer major defense production contracts in the offing, some firms may prefer to invest R&D funds in other ways, particularly in nondefense areas.

On the grounds that the program's value is uncertain and its costs are substantial, this option would cancel it and would instead provide direct subsidies for defense basic research. Savings would amount to $3.1 billion in 1994, relative to the CBO baseline, and would total $17.3 billion through 1998. These savings estimates assume that IR&D costs will grow 5 percent in real terms each year during the 1993-1995 period relative to the level in 1990, the latest year for which IR&D costs are available.

Despite the substantial cost of the IR&D programs, empirical analyses of IR&D present mixed views of how much additional research has been undertaken (besides what contractors would have done on their own), whether DoD could have obtained the same research at lower cost, and whether the subsidies are being spent on projects of the highest priority to DoD.

How much additional research does IR&D create? A Congressionally mandated study by the RAND Corporation concluded that IR&D subsidized less than 25 percent of contractors' costs and that each dollar spent on IR&D increased total R&D spending by contractors by $2.20. These results suggest that DoD spending on IR&D is an efficient way to generate additional defense-related research. RAND's analysis, however, may reflect the past willingness of defense contractors to spend their own funds on R&D to win anticipated procurement contracts. Given the prospects for reduced spending for defense procurement during the remainder of this decade, IR&D may not generate as much additional defense-related research in the future.

Moreover, other studies have differed with RAND's conclusions. Two studies found that the average subsidy to contractors was much larger--up to 80 percent--and that, even so, the subsidy caused only a negligible increase in total R&D spending by contractors. Critics also argue that IR&D spending on at least some projects is unnecessary because contractors would undertake these projects even without subsidy.

As to whether the funds are spent on projects of importance to DoD, the evidence is also mixed. Advocates of the program contend that it provides a hedge against the narrow decisions of agency research managers by letting private contractors develop their own research ideas. Case studies of the transfer of technology support the use of IR&D to give contractors an incentive to pursue R&D.

The bulk of IR&D spending, however, appears to be allocated to development rather than to basic research that might arguably be of greater long-run benefit to DoD, though of less value to contractors. And the amount of subsidy that any individual contractor receives depends more on that company's total contract volume with DoD than on the merits of the contractor's research program.

About 40 percent of IR&D spending compensates contractors for preparing bids and proposals. In many cases, particularly for highly technical projects, B&P costs may include considerable supportive research and development. In others, bids and proposals may require little if any additional research by the firm, so IR&D spending clearly would not be appropriate.

This option takes a moderate position with regard to the effectiveness of the IR&D program. It assumes that each dollar of IR&D subsidy increases R&D spending by 30 cents--less than the $2.20 found in the RAND report, but more than the negligible amounts estimated by the other two analyses. It assumes that at least some of the specific research subsidized by IR&D meets the criteria set forth in the 1992 and 1993 defense authorization act, so that cancellation of the program should be accompanied by an alternative provision for supporting the same type of research.

The assumption that each dollar of IR&D subsidies expands total R&D spending by 30 cents implies that cancellation could reduce total spending on DoD research and development over the next five years by about $7.5 billion. To offset this consequence, the option provides for a substitute program of $7.5 billion in direct R&D grants that DoD would use primarily for basic research. The overall volume of DoD's research and development efforts would thus be unchanged, but the focus of that R&D would be shifted away from development projects selected by contractors and toward basic research selected by DoD. The savings from the CBO baseline reflect this substitute program.

DEF-31 CANCEL THE NATIONAL AEROSPACE PLANE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	150	150	150	150	150	750
Outlays	80	130	140	150	150	650

In January 1986, the Department of Defense initiated a joint effort with the National Aeronautics and Space Administration (NASA) to design and build a National Aerospace Plane (NASP) that can deliver civilian and military payloads into orbit from conventional runways. The NASP, or X-30 aircraft, is envisioned as an experimental hypersonic aerospace aircraft that will employ highly advanced propulsion, structures, and materials technologies.

In 1987, DoD estimated that it would cost $3.1 billion to develop, build, and flight-test two experimental vehicles by 1994. Since then, however, the program has encountered numerous problems, including technical difficulties, budget reductions, changes in management structure, and major adjustments to scope and schedule. In a 1991 report to the Congress, DoD estimated that the cost of the program had increased to about $10 billion. Total spending through 1992 was nearly $2.5 billion, of which nearly $1 billion has been provided by industry. Costs could reach $15 billion, and recent estimates indicate that producing a minimum fleet of operational aircraft could cost an additional $20 billion.

The NASP's planned first flight in the atmosphere has been redefined into a two-stage program. The first flight of the Minuteman II boosters could occur as early as 1994, with follow-on flights of hypersonic vehicles beginning around 1998.

None of the government entities involved with the program appear to be strongly committed to it. According to the Senate report on the defense authorization act for 1993, DoD has not budgeted for the program in its Future Years Defense Program, and "it is unlikely that DoD can afford to do so." In December 1990, the NASA Advisory Committee on the Future of the U.S. Space Program concluded that, although the program was valid for technological reasons, it did not merit "high schedule urgency." Conferees for the defense authorization act of 1992 and 1993 observed that future DoD budgets should focus on meeting military requirements and that the NASP program has no clearly defined military utility. They warned the Administration that they would not permit the NASP to become a civilian space program funded by DoD.

The Congress, however, remains divided over the program. During the past several years, for example, the House Committee on Armed Services has approved DoD's requests for funding, and the Senate Committee on Armed Services has voted to terminate the program. The Congress has continued to fund the program each year, but at levels below those requested by the Bush Administration. In 1993, the Congress authorized and appropriated $150 million of the $175 million DoD requested and denied NASA's request for $80 million.

This option would cancel further funding for the NASP. Compared with the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan, the option would save about $150 million in 1994 and a total of $750 million over the next five years.

The NASP is intended to provide the technological base for the nation's long-range plan for space transport for both civilian and military missions. The plane's speed and ability to operate both in space and in the Earth's atmosphere could provide important capabilities for various military missions. Although the Air Force has not approved a military requirement for the NASP because it is a technology demonstration program, its missions might include delivering payloads into space, attacking enemy targets with weapons (including nuclear weapons), intercepting high-value targets such as enemy strategic aircraft, and performing space control and reconnaissance.

DoD could still accomplish these missions without the NASP. For example, payloads are now delivered into space by lift programs that include the space shuttle and Titan IV rockets. Strategic attack missions can be accomplished by the existing strategic forces. The Strategic Defense Initiative is planned to meet the need for intercepting strategic attack vehicles and would provide some space control. Intelligence satellites and planes currently provide reconnaissance capability.

The NASP, however, could enhance the performance of some missions. The aircraft's hypersonic capability, combined with its ability to operate from a conventional airfield, promises quicker execution of various military missions. Unlike other delivery vehicles such as rockets, the NASP could be recalled or reassigned during a military operation. The NASP also could provide important spinoff benefits to other programs as a result of advanced technology research in the areas of propulsion, materials, and aeronautics.

DEF-32 CUT FUNDING FOR MILITARY SPACE PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	800	800	900	900	1,000	4,400
Outlays	340	590	740	840	910	3,420

Military space programs, as defined by the Department of Defense, consist of launch vehicles, satellites, communications systems, navigation systems, space shuttle vehicles, and various space-related projects. The Congress has expressed concern about the affordability of these programs in light of DoD's plans to spend about $5 billion in 1993 on selected major space programs, excluding the Strategic Defense Initiative. In the 1993 defense authorization act, the Congress directed DoD to review space programs and policies and to develop alternative plans that could save up to 15 percent compared with the Bush Administration's January 1992 plan. In fact, the National Launch System was terminated because of anticipated budget deficiencies. The Congress is to receive a report by the Secretary of Defense in April 1993.

Some Members of Congress have called for savings larger than 15 percent. Last year, the Senate Committee on Armed Services offered an amendment to the defense authorization act that would have required DoD to propose a space program that cut costs as much as 25 percent by 2000. The conferees did not adopt the Senate provision; rather, they directed the DoD study noted above.

This option identifies the potential savings from a 15 percent cut in spending for military space programs. Compared with the CBO baseline, which for specific programs generally follows the Bush Administration's plan of January 1992, savings would approach $800 million in 1994 and would total $4.4 billion through 1998.

As mentioned above, the 1993 defense authorization act directed the department to identify ways to achieve savings by reducing, delaying, or terminating space programs that have a lower priority and are underfunded in the Future Years Defense Program. These programs could include the National Aerospace Plane (see DEF-31), the Follow-on Early Warning System (see DEF-10), the Titan IV missile, and the MILSTAR satellite system. The Congress also encouraged DoD to seek savings through greater efficiencies in the design, acquisition, and operation of satellites; in the technologies of launch systems; and in civil/military cooperation in satellite services. The Congress also directed DoD to seek savings by making greater use of non-space-based alternatives, especially for communications programs.

Cutting military space programs is not without risk, however. These programs play a critical role in various national security functions including military operations, intelligence reporting, and support during a crisis. Operation Desert Storm used various spaceborne capabilities that played vital roles in the coalition's success. Any reductions in spending for space programs should preserve the ability to perform these critical missions. In particular, imposing proportional reductions on all space programs could delay some that deserve high priority. Specific proposals for appropriate priorities within a declining budget may be identified in the forthcoming DoD report, which may also analyze the advantages and disadvantages of alternative programs, including their impact on the industrial base, their ability to meet requirements, and potential revisions to the military departments' roles and missions.

DEF-33 CANCEL FUNDING FOR SEMATECH

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	100	100	100	100	100	500
Outlays	50	90	100	100	100	440

In the National Defense Authorization Act for Fiscal Years 1988 and 1989, the Congress authorized the Department of Defense to fund SEMATECH, a consortium of U.S. semiconductor companies, to encourage technological improvements in developing and manufacturing semiconductors. In accordance with the initial plan, DoD has provided SEMATECH with $500 million for the 1988-1992 period. Private companies that are part of the consortium have matched the federal funding. The Congress has appropriated an additional $100 million to SEMATECH for 1993, but has not established any criteria for determining when federal funding for the consortium should be discontinued. SEMATECH plans to continue to seek funding at least through 1998.

This option would cancel further defense funding for SEMATECH after 1993. Compared with the CBO baseline, which assumes continued defense funding of SEMATECH at about $100 million a year, canceling defense participation in SEMATECH could save DoD $100 million in 1994 and $500 million through 1998.

According to the General Accounting Office's recent assessment of the program, SEMATECH has already achieved many of its original objectives. SEMATECH has reached its overall technical goal of manufacturing 0.35-micron semiconductors using only equipment made in the United States. This progress has enabled the U.S. semiconductor industry to match the manufacturing capability of Japan, its chief competitor. As a result, some analysts projected that by the end of calendar year 1992 U.S. suppliers would have passed, or at least tied, Japan in global market share. According to recent projections, the U.S. share will have increased from 34.9 percent in 1990 to 43.8 percent by the end of 1992. In addition, SEMATECH has met other initial objectives by establishing an important forum for the industry to share data, enabling firms to cooperate in research and development efforts, to establish industry standards and methods of evaluation, and to cooperate on strategic plans for the future.

Perhaps because SEMATECH has achieved many of its goals, the Defense Advanced Research Projects Agency (DARPA), which administers funding for the consortium, has proposed phasing out defense support for the program after 1997. DARPA believes that the industry should bear primary responsibility for the program because it is an industry-led consortium seeking to address industry needs. DARPA would prefer that DoD funding be directed more toward specific defense needs. This option would meet DARPA's objective to shift primary responsibility for the program from the defense sector, but would do so more quickly than DARPA has recommended.

Opponents of this option would argue that DoD should continue to fund SEMATECH because of the national security benefits associated with improving the ability of U.S. companies to manufacture semiconductors. Semiconductors are widely used in a variety of weapon systems. Indeed, in 1990 DoD purchased about $1.4 billion worth of semiconductors, or approximately 8 percent of all semiconductors produced by U.S. manufacturers. If defense funding for SEMATECH were canceled, DoD might be unable to meet future technology needs that rely on advances in semiconductor manufacturing.

Continued funding of SEMATECH could also be consistent with DoD's new acquisition approach. Under that approach, the department would fund programs that promote development and production of items that have both military and commercial applications.

SEMATECH has succeeded in other important respects, such as stimulating investment and encouraging cooperation among manufacturers. The consortium has stimulated significant private research and SEMATECH may also have helped foster understanding between producers and users of semiconductors about their respective needs. Finally, SEMATECH may help bolster employment in high-technology industries. Apart from any inherent benefits, spurring the growth of such jobs is one of the goals of both the Clinton Administration and the Congress as they seek to mitigate the effects of the defense drawdown.

DEF-34 LIMIT MILITARY PAY RAISES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	530	700	720	740	760	3,450
Outlays	500	690	720	730	750	3,390
			Savings in Defense Budget			
Budget Authority	720	950	970	990	1,010	4,640
Outlays	680	930	960	980	1,010	4,560

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Since 1982, military pay has not risen as fast as average pay in the private sector. Nonetheless, the approved raises have apparently been competitive--that is, sufficient for the military services to attract and retain the desired number and quality of personnel. Moreover, the Bush Administration planned to cut the active-duty military to roughly 1.6 million personnel from nearly 2.2 million in 1987, and even deeper cuts have been proposed. If fewer personnel are needed in the future, military pay could be even lower than it is today and still be competitive.

This option illustrates one possibility for limiting military pay. Holding the annual raise in 1994 to 2 percentage points below the previous year's rate of increase in the employment cost index (ECI) would yield savings of $4.6 billion in defense budget authority over the next five years relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan. These savings assume pay raises after 1994 that would match changes in the ECI, less one-half of a percentage point as permitted by law.

In past years, limited raises could have been expected to make the services' recruiting and retention goals more difficult to meet. With personnel cuts under way, however, these adverse effects are less worrisome. Indeed, large-scale personnel reductions create the problem of how to encourage experienced personnel to leave the military rather than how to convince them to stay. Recognizing this, the Congress in 1991 authorized two new programs of separation incentives for career personnel, and in 1992 authorized the Department of Defense to retire military personnel with as few as 15 years of service. Enlisted personnel responded well to the separation programs during 1992, but the near-term costs have proved greater than expected. Limiting military pay raises could accomplish the same goal of increasing voluntary separations but, unlike the incentives, would offer additional savings rather than offsetting costs.

The pay cut should not have a major effect on the quality of recruits in most of the services, a concern during the early 1980s. Lower pay would make it harder for the services to attract well-qualified recruits, but in the Air Force and Army at least, this effect should be offset by the sharply reduced numbers of new recruits required to sustain their smaller forces, relative to requirements in the 1980s. (The excellent recruiting results for 1992 demonstrate the impact of the lower requirements.) The Navy, however, could be adversely affected; its recruiting has lagged behind that of the other services in recent years, and its personnel levels are being reduced only modestly. Any recruiting problems that do occur could be offset by using some of the savings to increase recruiting efforts.

Limited raises would have several disadvantages. First, most of the additional separations would probably be among relatively junior personnel, who account for most reenlistment decisions and are the most sensitive to changes in pay levels. Thus, although this approach would reduce the size of the career force, it would allow that force to become increasingly senior and more expensive per person. Second, those most likely to leave might be some of the services' most productive people rather than poorer performers who could be targeted by tightened reenlistment standards and selective involuntary separations. Third, the higher separation rates caused by lower military pay might continue even after the desired personnel reductions had been achieved; thus, in the long run, both officer and enlisted forces could be more junior than they are today, with higher training costs, fewer people available for assignment to operational units, and diminished capability. A more junior force, however, would have lower average personnel costs.

Finally, the reduction in military pay under this option (relative to pay in the private sector) could lower the morale of military personnel, which could exacerbate problems with military readiness caused by the sharp drawdown in forces. If a decline in morale led to poorer retention, the services might have to expand recruiting or increase retention incentives. Either action would reduce the savings from this option below the amount shown in the table.

DEF-35 USE EARLY RETIREMENT TO REDUCE THE NUMBER OF MILITARY PERSONNEL

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	590	1,350	1,100	-190	20	2,870
Outlays	550	1,290	1,120	-120	10	2,850
			Savings in Defense Budget			
Budget Authority	950	2,070	1,580	-130	90	4,560
Outlays	900	2,010	1,600	-50	80	4,540

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The National Defense Authorization Act for Fiscal Year 1993 allows the service secretaries to permit members to retire with as few as 15 years of service. That provision differs from normal retirement at 20 or more years of service in two important respects: (1) the service secretaries may prescribe eligibility criteria involving factors such as grade, years of service, and skill; and (2) the member's annuity amount, although based on the same formula used for normal retirement, is reduced by 1 percent for each year short of 20 that the member retires. Authority for early retirement expires on October 1, 1995.

How the Department of Defense uses the new authority could have important effects on both near-term defense costs and long-term federal costs for military retirement. The services could use early retirement to avoid the need to separate involuntarily senior members who are eligible for normal retirement, to reduce the need for involuntary separations of more junior personnel, as a substitute for other incentives designed to encourage the voluntary separation of career members, or to speed up personnel reductions. All of these policies would tend to reduce near-term defense costs, but only the last--speeding up the reductions--would definitely reduce federal outlays in both the near and the long terms.

This option would link the services' use of the early retirement incentive to reduced personnel levels, thus ensuring long-term savings in retirement costs. The Congress would direct DoD to grant early retirement to at least 60,000 personnel by the end of 1994. That number represents the difference between the number of people now serving with 15 to 19 years of service and the number who would be serving in the long run in the smaller base force, given current retention rates; that is, it represents one estimate of the number of excess personnel in that experience range. Personnel levels at the end of 1994 and 1995 would then be reduced by the cumulative number of early retirements. Because this option is designed to accelerate the drawdown rather than deepen it, it would not reduce personnel levels in 1996 and beyond.

Savings in defense budget authority under this option could total $950 million in 1994 and $4.6 billion over the 1994-1998 period. These savings assume that approximately 62,000 people would be allowed to retire with 15 to 19 years of service in 1993 and 1994. The savings are net of the retirement benefits paid to the early retirees, which would total $2.1 billion over the five years. The defense savings include reductions in the accrual charges for military retirement that DoD pays into a trust fund.

These reductions in DoD outlays are offset in the total federal budget.

In addition to the near-term savings, long-term outlays for military retirement would decrease under this option. For each officer who retired at 15 years of service, total retirement payments would be reduced by at least $50,000 in present-value terms--$130,000 or more if the officer would have received another promotion had he or she not retired early. Comparable reductions for an enlisted member retiring at 15 years of service would be $22,000 and $60,000 or more, respectively.

If personnel levels are not reduced, long-term retirement costs could increase substantially. The services might then use early retirements to lessen the need for the voluntary or involuntary separation of other career personnel who were not eligible for retirement. If allowed to stay, many of them would eventually qualify for retirement at 20 years of service, costing the government much more than it would save as a result of the early retirements.

In addition to the savings, linking early retirement to reductions in personnel would facilitate personnel management. Without an early retirement program, the services would retain more personnel than needed with 15 to 19 years of service until they became eligible for normal retirement. DoD has already used existing management tools to eliminate such excesses in other years-of-service groups, creating in effect a bulge in the years that can now be targeted for early retirement. Arguably, the services would be better off without the people in that bulge, who merely slow the promotions of more junior personnel.

Critics of using early retirement to reduce the size of the military might argue that the primary obstacle to faster personnel reductions is not the availability of tools for separating personnel but the inability of the personnel management system to replace departing personnel rapidly in the units that need them. Increasing the number of separations compounds the problem, even if the services do not need the additional personnel in the long run. Critics might also argue that the early retirement program would not reduce the services' use of other separation programs; rather, early retirement would allow the services to raise the number of new recruits to levels consistent with their long-term needs. Finally, extensive use of early retirement, which this option would virtually guarantee, might create pressure to continue the program beyond its current expiration in 1995. Continuing the program could lead service members to view retirement after 15 years of service as the norm rather than as a temporary authority to meet extraordinary needs.

DEF-36 CUT RESERVE STRENGTH

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	220	690	1,190	1,720	2,030	5,850
Outlays	200	630	1,110	1,630	1,960	5,530
			Savings in Defense Budget			
Budget Authority	250	770	1,330	1,920	2,260	6,530
Outlays	220	710	1,250	1,830	2,200	6,210

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The National Guard and Reserve are an integral part of the military services, accounting for over one-third of the total force structure and providing essential support to the active forces. In 1993, the reserves will total 1.1 million personnel, compared with 1.8 million on active duty. As part of the overall downsizing plan in its January 1992 budget request, the Bush Administration proposed reductions of about 8 percent to the active forces and 9 percent to the reserves from 1993 through 1997. Active forces would decrease by 141,000, and the reserves would fall by 87,000.

The 1993 defense authorization act, however, includes language to restore most of the proposed reductions in reserve forces. For 1993, the Bush Administration proposed cutting 108,000 reservists, but the authorization cuts only 35,000. This action reflects the strong Congressional intent to keep reserve strengths up, despite significant reductions in the active forces.

This option would reduce reserve strength to the levels proposed in the Bush Administration's January 1992 plan, starting in 1994 and meeting proposed strength levels by 1997. In 1998, reserve strength would remain at its 1997 level of 920,000. Compared with the CBO baseline, which incorporates 1993 Congressional action and assumes modest cuts in reserve forces beyond 1993, savings would be substantial. This option would reduce costs for personnel and day-to-day operations by $250 million in 1994 and by more than $6.5 billion through 1998. Total savings could be even greater if the Congress reduced funds for purchasing equipment for the reserves in proportion to the cuts in reserve strength. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would impose reductions in reserve forces comparable with those under the Bush Administration's January 1992 plan over the next five years and would reduce significantly the savings from this option.

This option would not reflect the concern, clearly expressed by the Congress, that the Department of Defense has placed too little value on the contribution of the reserves. Some Members of Congress note that the cost of manning and operating reserve units typically ranges from about 25 percent to 80 percent of that of similar active units. The longer deployment and mobilization times that the reserves require may not pose a problem in light of the reduced threat of a major European war. According to this view, the additional capability obtained through smaller cuts in the reserves would be well worth the additional cost, which could be offset by modest additional reductions in active forces.

In an era of diminishing threats to U.S. security, however, the Bush Administration argued that reserve forces should be reduced along with active ones. According to the Administration, it makes little sense to retain all or most of the reserves--which in many cases supplement active units' combat capability or support the active forces--when many of the active units are being eliminated. Indeed, the opposite approach may be appropriate: as forces become smaller, a larger fraction may have to be on active duty so they can respond to crises on short notice. The Bush Administration also contended that, during a period of tight defense budgets, the extra expense associated with making only limited cuts in reserve forces would take away funds needed to operate and modernize active units.

DEF-37 MAKE ADDITIONAL REDUCTIONS IN THE OFFICER CORPS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	10	0	310	520	600	1,440
Outlays	10	0	290	510	590	1,400
			Savings in Defense Budget			
Budget Authority	10	30	380	630	730	1,780
Outlays	10	30	360	620	720	1,740

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

In authorizing the Department of Defense's budget for 1987, the Congress mandated reductions in the number of commissioned officers, responding in part to the growth in the officer corps relative to that of the enlisted ranks between fiscal years 1980 and 1986. One measure of this growth was that the ratio of enlisted personnel to officers declined from 6.4 in 1980 to 5.9 in 1986. In response to the Congressional directive, the enlisted-to-officer ratio rose slightly to 6.0 in 1987. However, the ratio slipped back to 5.8 in 1991. Although the services intend to reduce their officer corps steadily through 1995, they plan equal or slightly greater percentage cuts in enlisted personnel, so the enlisted-to-officer ratio will decline slightly, to 5.6.

This pattern is at odds with the intent that the Congress expressed in the 1987 legislation and gives rise to concern that the military services have failed to balance readiness adequately against equity. Among the concerns of DoD in carrying out the planned military drawdown is to maintain a combat-ready force and at the same time be fair to current service members, many of whom have built career expectations and financial plans on continued military service. Combat readiness, however, may require a more balanced pattern of officer separations than the services are able to impose, given the constraints of equity and the officer personnel management system.

To encourage a reduction that is more balanced between officers and enlisted personnel, this option would reduce the size of the officer corps through 1998 below the levels in the Bush Administration's January 1992 plan. The option would result in the separation of 15,200 additional officers, leaving the enlisted-to-officer ratio at the 1980 level of 6.4, in accordance with the Congress's intent. Savings in pay would initially be offset almost entirely by the cost of separation payments. Net pay savings in defense budget authority of $380 million would be realized in 1996, however, and a total of $1.8 billion would be saved through 1998.

The military services can draw on several management tools to reduce the size of the officer corps. They can encourage voluntary separations through specific actions such as tightening promotion criteria, liberalizing early-out procedures, and restricting the availability of regular commissions. In addition, the military services can rely more heavily on programs offering voluntary separation incentives (VSI), special separation benefits (SSB), and early retirement to assist them in drawing down their forces in a balanced manner.

Even with these incentives, however, it may be necessary to separate officers involuntarily. If so, the services can use liberalized authority for involuntary separations, as conferred by the Congress in the 1991 defense authorization act. They can conduct a reduction in force (RIF) of service members in pay grades O-3 and O-4. They can also impose selective early retirement (SER) on officers in the ranks of O-5 and O-6, although those officers are not subject to a RIF. This option assumes that, if necessary, the Congress grants DoD the authority, through 1998, to separate additional senior officers involuntarily through either expanded SER authority or a reduction in force.

The military services might argue that separating additional senior officers would constitute a breach of faith because it would cut short the careers of some service members. The services might further contend that requirements for officers and enlisted personnel have been affected unequally by both the drawdown and the changes in weapon technology and military doctrine. Newer weapons, and the research and maintenance they require, may demand that the force include more officers. For these reasons, the services could argue, the declining enlisted-to-officer ratio is not a basis for mandating further reductions in the number of commissioned officers.

Further reductions in the officer corps could be defended, however, on the grounds that the services' plans would result in a force that would be too senior and would contain more officers than needed to supervise the remaining enlisted personnel. Much of the expertise and combat readiness that senior officers provide could be obtained at lower cost from highly capable senior enlisted personnel and junior officers.

DEF-38 RESTRUCTURE RESERVE COMPENSATION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	280	250	220	180	170	1,100
Outlays	270	250	220	180	170	1,090
			Savings in Defense Budget			
Budget Authority	450	440	430	410	420	2,150
Outlays	430	440	430	410	420	2,130

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

In 1993, over 1 million people will serve part time in the reserves, at a cost of roughly $6 billion. These personnel typically participate in 48 training drills per year, which usually involve one weekend of reserve duty each month, and also serve on active duty for two weeks each year. These reservists are compensated with pay and allowances for time spent training as well as with credit toward military retirement benefits.

This alternative would make three changes to the reserve compensation system that would save $450 million in defense budget authority in 1994 and a total of $2.2 billion through 1998. Annual savings would continue to grow in the years beyond 1998. In addition to realizing savings, these alternatives would aim to simplify the reserve compensation system, treat different categories of reservists more equitably, and improve efficiency in personnel management.

Redefine and Reduce Drill Pay. During their two weeks of active training, reservists receive the same daily compensation as active-duty personnel, namely basic pay plus allowances for subsistence and housing. When reservists attend their weekend training, however, this parallel does not hold. In fact, reservists actually receive higher pay per day than their active-duty counterparts because reservists normally do their weekend training over 24 days but are credited with two drills per day for a total of 48. For each drill, a reservist receives a day's worth of basic pay and credit toward retirement, but no additional money for either subsistence or housing. Thus, the reservist receives two basic pays and double retirement credit for one day's work. That equates to being paid about 30 percent more per day than active-duty personnel.

This alternative would redefine drill pay so that two drills (one day's work) would be compensated with one day's total pay. Reservists would be treated on equal terms with active-duty personnel and would receive basic pay and cash allowances for subsistence and housing for each day of training, regardless of the type of training being performed. Savings in direct costs would average $590 million in each of the next five years. In addition, the Department of Defense's required contribution toward reserve retirement would decline, but it would not affect total federal outlays over the next five years. Eventually, however, savings in retirement costs could substantially reduce federal costs.

Eliminate Dual Compensation for Reservists Employed by the Federal Government. More than 120,000 reservists are employed in civilian jobs in the federal government. These individuals benefit from the government's strong support of reserve training and may experience fewer conflicts with employers than do reservists who work in the private sector. In addition, reservists employed by the government receive dual compensation--both their government and reserve pay--during their two weeks of annual training without having to use vacation time or annual leave. Although a few of the larger private-sector employers mirror this government pay practice, dual compensation is not the general rule for reservists who are employed outside the federal government.

This alternative would eliminate dual compensation for reservists who are given time off from their federal jobs to carry out their active-duty commitment. Instead, they would receive only the higher of the two payments during the service period. Savings would average $80 million in each of the five years.

Eliminate Reserve Retirement. The United States is the only country that offers retirement benefits to its part-time military personnel. These benefits parallel those provided for active-duty service and have remained largely unchanged since their enactment in 1948. Reservists are entitled to retired pay at age 60 after 20 years of active or reserve service, but at least the last eight years must have been spent in the reserves. The amount of retired pay is based on length of service and the average highest three years of pay. Payments to reserve retirees in 1992 were $1.7 billion. In 1994, DoD will set aside an amount equal to about 11 percent of reservists' basic pay, or roughly $400 million, to pay for their future retirement benefits.

This option would terminate reserve retirement for those entering the reserve components after the end of fiscal year 1993. The federal government would not realize savings for many years because the actual payments would not occur until these new reservists reach age 60. Officers would be affected most because they receive about 80 percent of the total amount of retirement benefits paid to reservists, even though they constitute only 15 percent of reservists.

Although these three changes offer potential advantages, they could also raise problems. The changes would be imposed during a period of considerable turmoil caused by the reduction in the number of military personnel, including reserve personnel. Broad changes in the compensation system may be easier to effect once the drawdown is complete.

More important, these changes would result in lower paychecks for reservists and would eliminate their retirement benefits, which could lead to recruiting and retention problems. Retention is already lower among reservists who are at the early stages of their reserve careers than among their active-duty counterparts; further increases in losses among reservists could leave some reserve units without enough junior personnel to be fully effective in wartime. Problems of recruiting and retention may be at least partially offset as forces are reduced, because many former active-duty personnel are now seeking reserve positions. Once the active drawdown is complete, though, some of the savings from the other options--perhaps a substantial part--might have to be used to pay bonuses to offset any recruiting and retention problems.

The military could target bonuses toward those reserves most in demand, making payments at various points during reservists' careers to retain those with needed skills. Bonuses could also be used to recruit new reservists into areas that are difficult to fill. Added costs could average $240 million a year and are reflected in the savings noted above. The bonuses could be even higher if the Congress mandates an increased emphasis on reserve forces, which may mean relatively small reductions in reserves compared with those in the active forces.

The military could also use these bonuses to phase in the retirement changes more quickly, by offering reservists a choice between continuing under reserve retirement or potentially receiving bonus payments. Reservists choosing bonus payments would then forgo any future retirement benefits.

DEF-39 REDUCE DRILLS FOR NONCOMBAT RESERVE UNITS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	90	90	90	90	90	450
Outlays	90	90	90	90	90	450
			Savings in Defense Budget			
Budget Authority	110	110	110	110	110	550
Outlays	110	110	110	110	110	550

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The National Guard and Reserve play an important role in U.S. defense policy by providing a trained, combat-capable force that can be mobilized in time of war. Some of these reserve units are included in the forces that deploy overseas early in a major conflict. Others would supplement existing active units to bring them to wartime strength and would provide much of the combat support needed to fight a war.

Some reserve units, however, have non-combat-related missions that may not be needed immediately or that may be available from the civilian sector. Included in this category are units such as bands, administration, food services, registration of combat casualties, and laundry services. Like units directly involved in combat, reservists in these noncombat units are paid to train full time for two weeks each year and to drill for one weekend each month (drills total 48 because there are four per weekend).

This alternative would reduce the number of weekend drills for the roughly 80,000 reservists in these noncombat units from 48 to 24. Members would still be paid to train full time for two weeks each year, but on average they would train for one weekend every other month instead of each month.

Compared with the CBO baseline, savings in the first year would be $110 million, with cumulative five-year savings totaling $550 million. Savings would be smaller relative to the Bush Administration's January 1992 plan, which assumes a smaller number of reservists. Included in these estimates are savings in retirement accrual costs. These funds are set aside to pay future retirement costs and would amount to about $12 million each year. Although they represent a real reduction in long-term costs, these retirement accrual savings appear only in the defense savings noted above because they would not affect government outlays for many years.

Reducing drills for these noncombat units may not harm readiness and war-fighting capabilities. In many cases, required skills could probably be maintained even with the reduced amount of weekend training. Because total pay would be reduced, fewer reservists might be willing to serve in these units, and shortages could occur. But most of the general skills required are readily available in the civilian sector, so qualified personnel could be recruited in the event of a war. Also, as levels of active-duty personnel are reduced, a larger pool of manpower will be available from which to meet requirements for the reserves.

A decline in the number of personnel willing to serve in these units, however, could create some problems in peacetime. Increased recruiting efforts may be needed to maintain the size of the noncombat units. Costs for this extra effort are not reflected in the savings shown above. If the size of these noncombat units declines, some of their peacetime functions--particularly administration and finance--might need to be transferred, resulting in increased work loads for other units or individuals.

DEF-40 DENY UNEMPLOYMENT COMPENSATION TO SERVICE MEMBERS WHO VOLUNTARILY LEAVE MILITARY SERVICE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	320	280	270	260	270	1,400
Outlays	320	280	270	260	270	1,400

Many military personnel who leave active-duty service are eligible for unemployment benefits. Their payment amounts are calculated in the same way as those of civilian personnel who qualify for unemployment benefits. However, eligibility of former military personnel differs from that of recipients in the civilian labor force in one important respect. Former military personnel can apply for and receive unemployment benefits even if they voluntarily leave military service, but civilian recipients must have lost their jobs involuntarily.

The majority of personnel who leave military service do so voluntarily. For example, many choose not to reenlist following completion of their term of service; others, who have completed a minimum of 20 years of service, opt for voluntary retirement. Still others may choose to leave military service in return for cash payments under the voluntary separation incentive and special separation benefits programs enacted in 1991. A much smaller group is separated involuntarily for reasons related to job or promotion performance or, in recent years, because of the drawdown of military forces.

This option would apply the same rules to former military personnel that other members of the civilian work force must follow by stipulating that only personnel who left service involuntarily because of force reductions would be eligible to receive payments. Eliminating payments to individuals who leave service voluntarily would reduce the number of recipients by at least 80 percent, resulting in savings of about $270 million annually. Because the Department of Defense ultimately reimburses the Department of Labor for the cost of unemployment payments to former service members, these savings would occur in the defense budget. Savings under this option are relative to the CBO baseline, which is generally based on the Bush Administration's January 1992 plan.

The Unemployment Insurance program was established with the intent of aiding those who lose their jobs involuntarily. Subjecting military personnel to the same rules as the rest of the work force regarding unemployment compensation thus could be seen as a more equitable use of an existing entitlement program. But if military service is considered to be fundamentally different from other types of employment, one could argue that voluntary separation from service is not comparable with voluntary termination of civilian employment and therefore should not be subject to the same restrictions on eligibility for unemployment compensation.

DEF-41 REDUCE PER CAPITA USE OF HOSPITAL SERVICES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	410	420	450	470	500	2,250
Outlays	310	390	430	460	480	2,070

The 2.2 million dependents of active-duty personnel who live in the United States receive most of their hospital care through the military health care system. Close to 65 percent of their hospital care is provided by military hospitals, with the rest coming from civilian hospitals that are reimbursed through the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS). In either case, the government bears most of the costs, for an annual total of more than $1.5 billion. The Department of Defense could lower those costs by about $2.3 billion over the next five years by lowering active-duty dependents' use of hospitals to rates more characteristic of the civilian sector. (These estimates assume that the number of active-duty dependents declines in proportion to reductions in active-duty personnel.) Savings in this option are measured relative to the CBO baseline, which is generally based on the Bush Administration's January 1992 plan.

Compared with the U.S. population at large, dependents of active-duty personnel make heavy use of the hospital. In 1990, civilians in the United States under the age of 65 used about 535 days of hospital care per 1,000 people. When adjusted for the age and sex distribution of that civilian population, active-duty dependents under the age of 65 living in the United States (fewer than 0.2 percent are 65 years or older) used about 720 days of direct care and CHAMPUS care. Thus, active-duty dependents use hospital care at a rate more than one-third higher.

This option would have the Congress set a goal under the Coordinated Care Program--DoD's current strategy for revamping the military health care system--of 535 hospital days (adjusted for the age and sex distribution of civilians) per 1,000 dependents. Each military installation's medical commander would be required to limit hospital use through measures now common in the private sector, such as preadmission review of all hospital admissions, review of care for medical necessity, prospective limits on length of hospital stays, and coverage of certain procedures on an outpatient basis. Curbing hospital use would save DoD about $450 million a year. Even greater savings are possible if medical commanders also curb hospital use by active-duty military personnel and by retired military personnel and their dependents.

Opponents of setting goals might argue that high rates of hospital use do not necessarily imply abuse of the medical care system. For example, because many civilians lack financial or geographic access to care, nationwide rates of hospital use by civilians may actually be lower than medical considerations warrant. Perhaps dependents of active-duty personnel are healthier than might otherwise be the case because of their unimpeded access to hospital care. That said, civilian health maintenance organizations have shown that high-quality care is achievable with rates of hospital use well below 400 days per 1,000 enrollees.

Another argument against setting goals is that the unique stresses of military life give active-duty dependents a relatively greater need for hospital services. Any arbitrary attempts to curb hospital access thus could jeopardize health and morale. Yet active-duty dependents' overall rates of use mask considerable variation across the country. In some catchment areas (the 40-mile circle around a military hospital), dependents use more than 1,000 days; in other catchment areas, fewer than 500. In the absence of evidence that dependents are less healthy in some areas than in others, such variation implies a degree of arbitrariness in rates of hospital use. Moreover, just as too low a rate of hospital use may be risky, so also may be too high a rate. Inappropriate admissions and needless surgeries may inadvertently harm patients' health.

Any savings from reducing dependents' use of hospitals might be offset by the costs of reviewing patients' use of care or of shifting patients to ambulatory settings. In the civilian sector, for example, some practices that restrict hospital admissions, such as preadmission authorization and concurrent review of hospital admissions, have been known to increase outpatient costs.

DEF-42 INCREASE CHARGES FOR DIRECT MILITARY HEALTH CARE SERVICES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	260	260	260	260	270	1,310
Outlays	200	250	260	260	260	1,230

When non-active-duty beneficiaries receive care in military hospitals and clinics, they pay very little. Hospital stays cost between $4.75 and $9.30 per day; outpatient visits and prescriptions cost nothing. Such low charges promote greater use of health care services, thus contributing to overcrowding and rising costs.

Higher charges for military health care benefits would both curb excessive use and raise revenue. This option would charge varying amounts for outpatient care in military clinics: outpatients from families of senior enlisted personnel (above pay grade E-4) would pay $5 for a visit to a military physician, and outpatients from officers' families would pay $10. Prescriptions filled in military pharmacies would cost $3. Dependents of enlisted personnel below pay grade E-5 and survivors of military personnel--the military's least well-off beneficiaries--would still pay nothing for visits to military physicians or for prescription drugs. To avert a shift of patients to inpatient care, this option would also raise the daily charge for a hospital stay to $25 for all non-active-duty beneficiaries.

Together, these changes could save the Department of Defense about $260 million a year. Some of these savings would be offset by the cost of modifying existing automated information systems to collect the higher fees. (Savings are relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan. Further savings would result if higher charges help to reduce use of outpatient and hospital services--see DEF-41.)

Because medical care is a key part of military compensation, military families would view increased charges as an erosion of benefits. Recruitment and especially retention could suffer, although the parallel trend in civilian medicine to wider cost sharing might allay beneficiaries' dissatisfaction. Indeed, increased cost sharing would bring the military health care system somewhat more in line with medical plans offered to civilian employees of the federal government. Nor should rising charges necessarily harm health, a potential concern, because evidence shows that people at ages and incomes typical of military beneficiaries seek needed care even when they share the costs.

DEF-43 CHARGE RETIRED MILITARY PERSONNEL PREMIUMS FOR MILITARY HEALTH CARE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	480	460	490	510	540	2,480
Outlays	360	440	470	500	530	2,300

When military personnel retire from active-duty service, they and their dependents remain eligible to use the military's health care system. They may visit physicians in military clinics, and have any prescriptions filled, for free. As inpatients in military hospitals, retired enlisted personnel pay nothing, retired officers pay about $4.75 a day, and dependents pay about $9.30 a day. When this direct military care is not available (or inaccessible because of distance), the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) will help retirees and their dependents who are less than 65 years old pay for civilian services. (Medicare helps those 65 years of age and older.) After beneficiaries pay a deductible of $150 a person or $300 a family, CHAMPUS covers at least 75 percent of allowable expenses, with a relatively high limit on out-of-pocket expenses of $7,500.

Retirees do not pay premiums for these benefits. Some of them, however, pay premiums for private insurance policies that supplement CHAMPUS. Although such policies offer needed protection against catastrophic expenses, they also insulate beneficiaries from CHAMPUS's requirements for cost sharing and thus undermine CHAMPUS's main instrument for controlling use.

This option would charge nondisabled retirees and their dependents under age 65 a monthly premium of $90 a family. As under the Federal Employees Health Benefits (FEHB) program, they would have an open season in which to enroll in the military health care system. In return for paying the premium--and as an inducement for beneficiaries to drop any supplemental insurance--the annual limit on out-of-pocket expenses would be reduced from $7,500 to $2,500, a level typical of the FEHB. Both premiums and the level of catastrophic protection would be updated annually to reflect the effects of medical inflation.

How many retirees would choose to enroll? The estimated savings shown in the table above assume an enrollment rate of 60 percent. Based on survey data, between 40 percent and 80 percent might choose to enroll: the lower figure represents the proportion of retired families who get all or most of their outpatient care directly at military health care facilities; an additional 40 percent get outpatient care from both military and civilian providers, but prefer the civilian system. (The rest never use military treatment facilities.)

If 60 percent of retired families were to enroll, then net revenue from the premiums and enhanced catastrophic protection would total close to $2.5 billion over the next five years. Savings are relative to the CBO baseline, which is generally consistent with the Bush Administration's January 1992 plan. (Though not reflected in this estimate, further savings would result from an expected decrease in the use of CHAMPUS.)

In addition to raising revenue, this option would give military health care planners a firm handle on the nature and composition of retirees' demand for health care. At present, the number and location of retirees interested in using the military's health care system are uncertain and therefore can vary from year to year. Once planners have that information, the process of allocating resources should become significantly easier and potentially more cost-effective.

Charging a premium could also create a risk of empty waiting rooms and idle active-duty physicians if too few retirees enrolled in the military health care system. More likely, many retirees would resent premiums as an erosion of the military health care benefit. Although $90 represents only about 7 percent of the average nondisabled retiree's monthly pension, and a smaller percentage of total family income, many would view the added cost sharing as a breach of faith. Some families, however, no longer would feel it necessary to pay for supplemental insurance and could therefore offset part of the premium.

Even modest premiums may be burdensome to lower-income retirees. Those families might suffer real financial hardship paying $90 a month, or might forgo military health care. The Department of Defense, however, could establish income-related premiums to offset the burden of a flat premium.

DEF-44 CLOSE THE UNIFORMED SERVICES UNIVERSITY OF THE HEALTH SCIENCES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	20	40	80	80	90	310
Outlays	20	40	70	80	80	290
			Savings in Defense Budget			
Budget Authority	20	50	90	90	100	350
Outlays	20	40	80	90	100	330

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

Historically, the Department of Defense has faced shortages in medical personnel, particularly physicians. To alleviate this situation, DoD has developed various programs to provide a supply of these personnel. One such program is the Health Professionals Scholarship Program (HPSP), which pays tuition and a stipend to people attending medical school and other health-related programs in return for a military service obligation. Another example is the Uniformed Services University of the Health Sciences (USUHS), a medical school operated by DoD.

The Congress created the university in 1972 to train physicians committed to long-term military careers. At an annual cost of about $90 million, the school provides a full education for its participants, including a stipend to cover room, board, and books. Based on figures from 1991, USUHS is the most expensive source of physicians at $562,000 per person; HPSP costs $111,000, and other sources, such as the Financial Assistance Program and the Volunteers Program, range in cost from $55,000 to $13,500.

USUHS has met only a small fraction of DoD's need for new physicians--less than 9 percent in 1991, for example. HPSP provided about 71 percent, and the remaining 20 percent came from other sources, including volunteers.

This option assumes that USUHS stops taking in new students in 1994 and closes fully in 1996. If USUHS were eliminated and other programs for obtaining physicians remained unchanged, net defense savings would be about $20 million in 1994 and $350 million over five years. These savings include reductions in military and civilian personnel, which would be in addition to planned drawdowns. Savings are measured relative to the CBO baseline, which generally reflects the Bush Administration's January 1992 plan.

Based on USUHS's 1991 share of physicians provided, closing USUHS would reduce the supply of DoD physicians by less than 10 percent. As part of the planned force drawdowns, the military services have already proposed reducing physicians by 5 percent from 1991 through 1995, so the loss of USUHS physicians could be partially absorbed by the lower number of physicians the smaller force would require. Expansion of existing programs could make up the rest of the loss.

This proposal has some drawbacks. Supporters of USUHS claim that its physicians are better trained for the special needs of the services because of the university's focus on the study of military medicine and preparation of military medical officers. In addition, some of the higher costs of USUHS are in effect repaid because USUHS-trained physicians have a longer service commitment than physicians from other sources. For example, graduates of USUHS must pay back seven years of active duty, whereas HPSP recipients must pay back roughly only one year of active duty for each year of health professional training. This tenure enhances stability in the medical corps and reduces demands on the other sources of physicians. Perhaps because of these considerations, the Congress strongly backed the creation of USUHS and has consistently given the institution full financial support.

A further consideration motivating the Congress in this regard may be its concern about the general state of military medical care. In particular, given past physician shortages, the Congress might be reluctant to reduce the number of medical personnel in line with the force drawdown. Other initiatives to improve military medical care might allay Congressional concerns on this score. For example, the Military-Civilian Health Service Partnership Program allows commanders of military treatment facilities to enter into agreements with civilian providers to compensate for staff shortages, thus improving access to services for beneficiaries.

Finally, direct cost comparisons between USUHS and other sources of physicians may be unfair to USUHS because of indirect subsidies that the federal government provides to medical schools, which in effect raise the true governmental cost of physicians from sources other than USUHS.

DEF-45 REVAMP MILITARY FAMILY HOUSING

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	800	750	790	820	770	3,930
Outlays	160	370	530	630	690	2,380
			Savings in Defense Budget			
Budget Authority	780	720	740	750	680	3,670
Outlays	150	340	480	560	600	2,130

NOTE: The difference between federal and Department of Defense savings reflects the combined effects of federal Impact Aid payments for schools, accrual accounting for military retirement, and other pay costs that are offset in the federal budget.

More than two-thirds of the military families in the United States receive cash housing allowances and either rent or purchase housing in the private sector. The rest (approximately 30 percent) forfeit their cash housing allowances and live in housing units provided by the Department of Defense. DoD's policy is to rely on cash allowances wherever the private sector is able to provide adequate, affordable housing. Nonetheless, CBO projects that the percentage of military families in the United States living in DoD housing will increase from 30 percent today to 35 percent by 1997. In the long run, that increase means higher costs for DoD because the average annual cost (including the amortized cost of construction) of providing DoD housing is approximately $11,000 per unit compared with approximately $7,000 for housing allowances.

Increased use of DoD housing could also push up costs over the next several years. Most of DoD's U.S. inventory of family housing was built early in the Cold War, when domestic housing was in short supply and when DoD first faced the task of rotating a large standing army between assignments in the United States and overseas. These units are near the end of their service lives. Significant budgetary savings are possible in the near term if, rather than replace or revitalize its existing stock, DoD were to retire these aging units and rely more on private-sector housing.

The current system of housing allowances, however, discourages reliance on the private sector. Families have a strong financial incentive to live in on-base housing because the allowances do not fully cover the cost of obtaining private-sector housing. Despite its stated policies, it is difficult for DoD to reduce its role as a direct provider of housing when there are long waiting lines for existing on-base units.

This option changes the incentives that military families and DoD housing managers face. Under this option, all military personnel eligible for family housing would receive the cash housing allowance regardless of whether they live in DoD or private-sector units. Families choosing to live on-base would be charged rent. Rents for each type of housing unit at each installation would be adjusted based on the actual demand for those units; rents would fall when there were vacancies and rise when there were waiting lists. DoD would continue to operate existing units as long as the rent--the value of the unit to military families--covered DoD's operating costs. It would authorize revitalization or replacement, however, only in locations where the value of the unit to service members (the rent level) is at least as great as the cost of operations plus amortized construction costs.

Savings compared with the CBO baseline, which is generally consistent with the plan submitted by the Bush Administration in January 1992, could amount to $800 million in 1994 and $3.9 billion through 1998. Over the very long run, estimated annual savings in the steady state could be $720 million. Some of these savings derive from more efficient management of existing units: for example, the metering of utilities lowers energy costs (metering becomes equitable under a rental system since units with low energy efficiency would rent for less than other units), and eliminating the waiting lists yields savings in turnover of units and moving costs. Other savings derive from lower revitalization and replacement costs, since existing DoD units would be revitalized or replaced only in locations where the rent that service members are willing to pay covers the full cost to DoD of providing the units. Still other federal savings derive from reduced school Impact Aid. Since on-base housing is not subject to local property taxes, the Department of Education pays federal Impact Aid for schools to local governments to offset the cost of educating the children who live on-base.

These savings assume that rents for only 25 percent of existing DoD units would meet the criteria for revitalization or replacement. The estimates reflect the cost of raising the housing allowances to hold constant the total out-of-pocket cost incurred by service members (the difference between their total expenditures on housing and the total amount of allowances provided). Holding those costs constant ensures that the savings shown above reflect real savings in resources, not just a transfer of dollars from the pockets of service members to DoD.

In the long run, a rental system for DoD housing would allow DoD to provide service members with the same quality of life at lower cost. It would provide better signals about the value of DoD housing to service members and would encourage them to take into account the full costs of their choice when considering whether to live in on- or off-base housing. A rental system also would eliminate the costs and frustrations associated with the current system of rationing through waiting lists. The quantity and location of DoD housing units would be determined based on the preferences of military personnel. For example, rent levels for DoD units could signal the value of additional DoD units in areas where service members prefer to live on-base because the crime rate is high in the surrounding civilian community.

Disadvantages to this option include the costs of determining initial rental rates, setting up utility metering, and collecting rents. Special arrangements would have to be made for historic units (units that DoD must maintain even if rents do not cover operating costs) and for personnel who are required to live on-base to be available in the event that military needs arise (approximately 3 percent of all personnel). Since a rental system might have to be phased in as individuals started new tours, inequities might exist initially between individuals under the old system and those under the new. The option would also redistribute benefits: families that prefer to live in the private sector would be better off because of the higher allowances; families that prefer the on-base lifestyle would for the first time face the full cost of their choice.

Questions arise, however, about whether this is an appropriate time to consider this kind of change. On the one hand, decisions about revitalizing and replacing the 40-year-old housing stock must be made soon, which suggests that the market signals a rental system could provide would be particularly helpful right now. A shift to a rental system could also boost the private housing markets at a time when these markets are depressed in many areas. On the other hand, a major change in housing policies may be inappropriate at a time when the services are conducting a large drawdown and many military personnel are anxious or uncertain about their careers. This may be one reason that DoD is not currently considering a change of the sort envisioned in this option, although it has done so in the past.

DEF-46 REDUCE OPERATING TEMPO AND UNIT TRAINING COSTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	380	380	380	390	390	1,920
Outlays	290	360	370	380	390	1,790
			Savings in Defense Budget			
Budget Authority	440	440	440	450	460	2,230
Outlays	330	420	430	440	450	2,070

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

In fiscal year 1993, the Department of Defense plans to spend about $18 billion for all field-level training worldwide by active-duty units of the military services. The cost of this unit-level training depends on the size of military forces (force structure) and the operating tempo (optempo), that is, the number and length of training exercises carried out by these forces. Such training ranges from large-scale exercises (for example, REFORGER, a joint deployment and training exercise by U.S. and North Atlantic Treaty Organization forces in Europe), to smaller battalion-level maneuvers at training ranges in the United States, to individual training sorties by military aircraft. Field-level training contributes to a unit's military readiness--that is, its ability to fight well early in a war.

In response to decreased tensions with the republics of the former Soviet Union, this option would reduce certain unit-level training to reflect recent changes in the threat, the amount of warning time, and the likelihood that a crisis would develop--a concept referred to as "flexible readiness" in 1990 by the Chairman of the Senate Committee on Armed Services. Just as the Bush Administration took strategic bombers off their alert status for the first time in over 30 years, this option assumes that current optempo levels and training schedules for selected conventional forces could also be reduced because of the decrease in international tensions.

The decision about which units would receive less field-level training would ultimately be made by the military services and the Secretary of Defense. To illustrate potential savings, CBO assumed that optempo levels would be set based on the Bush Administration's allocation of forces in its base force plan. Under this plan, forces are assigned to one of four military missions: deterrence of strategic nuclear war, response to worldwide contingencies, or defense of U.S. interests either in the Atlantic or in the Pacific. CBO assumed that no changes would be made in optempo levels for strategic forces, or for reserve forces, whose training is already limited by their availability. (For an option that reduces training levels for strategic forces, see DEF-06.) Nor would adjustments be made for forces in the Pacific or for contingency forces designed to respond to other regional conflicts. These forces are exempted because the likelihood of such a threat is unpredictable.

Because of the diminution in the former Soviet threat, however, this option assumes that training for active-duty units designated for defense in the Atlantic region could be cut 10 percent below current levels starting in 1994. Active units assigned to the

Atlantic portion of the base force would constitute about 40 percent of all active-duty military personnel in 1997. Training on the Navy's attack submarines and antisubmarine aircraft also would be reduced by 10 percent. The services could offset some of this reduction in training time by increasing the use of simulators, which may cost only one-fifth to one-tenth as much as other training.

With these assumptions, savings in the defense budget compared with the CBO baseline, which is based on the Bush Administration's January 1992 plan, would total some $440 million in 1994 and $2.2 billion over the 1994-1998 period. Savings would result primarily from reductions in operation and maintenance funds provided to support current optempo or training levels. Costs would be lower not only for the fuel and spare parts used during training but also for maintenance and logistical support (for example, purchase and distribution of supplies, or technical engineering support). This option could also be associated with lower personnel levels, though such savings are not included here. As is sometimes already the case, units could be manned below authorized levels as a matter of policy.

The Bush Administration's plan did not adjust training levels in response to the reduced threat. In fact, the 1993 Air Force budget shows higher operating tempos than before the Gulf War. The Bush Administration argued that with a smaller force, training of the remaining units must be maintained or even increased to reduce the risks that operating with lower force levels would entail.

The Administration also contended that although the risk of a European contingency has lessened, smaller contingencies could arise with little warning. When budgets are tight, the Navy and Army allocate funding for training based on which units are likely to be deployed first. The Air Force, however, maintains all units at the highest levels in order to deploy early unless equipment is being overhauled or deactivated. Some analysts would argue that since the risk of other contingencies may be as strong as before the changes in the former Soviet Union and the precise mix of forces to be deployed is unpredictable, all units should maintain high readiness levels. Finally, if military personnel have fewer opportunities to train realistically in peacetime, morale could also be reduced, in turn adversely affecting readiness.

Those supporting flexible readiness would argue that both operating tempo and force levels should be adjusted to reflect changes in the threat. Although high levels of training are clearly desirable, the current levels appear to be above even the historically high levels achieved in the 1980s. Furthermore, even with slightly less training time for selected units or particular types of ships, the military would retain sufficient forces fully ready to respond to likely contingencies. In fact, apart from Operation Desert Storm and military buildups based on conscription, the largest deployments of U.S. forces were to Panama in 1990, when approximately 27,000 troops took part in Operation Just Cause, and the current deployment to Somalia, expected to reach 28,000. If larger numbers of troops are needed, as was the case in Operation Desert Storm, there would probably be some warning before hostilities began. In that case, fully ready units would be deployed first, and units that had had less training would have time to "train up" before deployment.

DEF-47 REDUCE AND RESHAPE DOD'S CIVILIAN WORK FORCE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Savings in Total Federal Budget						
Budget Authority	380	1,220	2,430	4,060	5,170	13,260
Outlays	270	950	2,020	3,490	4,690	11,420
Savings in Defense Budget						
Budget Authority	420	1,370	2,740	4,590	5,840	14,960
Outlays	320	1,100	2,320	4,010	5,370	13,120

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The civilian work force of the Department of Defense provides support services to military forces that range from payroll administration to maintenance of weapon systems. In 1992, DoD's civilian work force was 3 percent smaller than in 1982. In contrast, the active-duty military that the civilians support had shrunk by 12 percent. Thus, on average, each DoD civilian supported 1.9 military personnel in 1992, compared with almost 2.1 in 1982. Under the Bush Administration's plan submitted in January 1992, that ratio is projected to fall still further by 1994, to 1.8.

Although the number of military personnel that civilian workers support has fallen, the average grade of DoD's white-collar civilian work force increased by one full grade (from just below GS-8 to nearly GS-9) between 1982 and 1992. This growth has been concentrated in supervisory grades (GS-13 through GS-15) and midlevel grades (GS-10 through GS-12).

Between 1994 and 1997, when the military drawdown is scheduled to be completed, this option would gradually reduce and reshape DoD's civilian work force to restore the ratio of military to civilian support personnel to 2.0--the level characteristic of the buildup during the first half of the 1980s--and to reduce the grade creep of the last decade. By 1997, DoD's civilian work force would decrease by 110,000 under this option (from 922,000 in 1994 to 813,000 in 1997) compared with a reduction of 29,000 under the Bush Administration's January 1992 plan. (DoD could further reduce its civilian work force by adopting the policy changes described in DEF-51, which would assign to military personnel certain peacetime duties that civilians currently perform.)

Compared with the Bush Administration's plan, this option would reduce civilian personnel costs in the federal budget by about $380 million in 1994 and $13.3 billion through 1998. If DoD used incentives to achieve one-quarter of the necessary separations, savings would be reduced to only $70 million in 1994 and $11.5 billion over the five-year period. The budget revisions proposed in January 1993 by then Secretary of Defense Dick Cheney would reduce the civilian work force by 5 percent rather than 3 percent over the next five years, which would reduce savings from this option by almost 30 percent.

The additional reductions assumed in this option could be accomplished by continuing the partial, modest civilian hiring freeze now in effect that limits replacements to roughly two of every three civilian employees who leave voluntarily. The 1993 defense authorization act also gave DoD new authority to offer monetary incentives to civilians affected by the defense drawdown; these incentives are designed to induce civilians to resign or to take regular or early retirement. Using these incentives would minimize the chance of layoffs but would also substantially reduce DoD's immediate and long-term savings.

To reverse grade creep, DoD would need to slow the rate of promotions and rehire at the lowest grade level appropriate to the position. The needed personnel reductions might concentrate on management and administrative positions, which grew by 33 percent (from 143,000 to 190,000) over the last decade, rising as a share of the work force from 15 percent to almost 20 percent. This option would restore the grade distribution existing in 1987, the peak year for civilian employment.

This option is consistent with former Secretary Cheney's view that DoD needs to increase the efficiency of its support services and streamline its headquarters. In response, DoD has adopted a wide variety of management reforms, including the consolidation of common support services (for example, centralization of finance and accounting administration) and a large number of smaller efficiency measures. Although these reforms would probably help DoD reduce the size of overhead functions to match the decreasing work load, the number of civilian positions DoD expects to save from these reforms is small--only 5 percent of its total civilian work force over the next five years.

To achieve the cuts assumed in this option, DoD would have to be more aggressive in carrying out the recently adopted management reforms as well as make significant efforts to reorganize and reduce other support activities consistent with a smaller work load. This option would also be analogous to Congressional direction in 1991 requiring DoD to reduce both military and civilian headquarters personnel by 20 percent between 1991 and 1995 to match overall reductions in the size of the military. Congress has also voiced considerable concern about DoD's inability to reduce overhead consistent with reductions in force structure.

Some analysts and policymakers might argue that the size of the civilian work force cannot be expected to fall at the same rate as that of the active-duty military, as this option assumes. Proportional cuts may be particularly difficult to achieve in the short term because some civilian functions--like maintaining buildings and grounds on military installations or supporting a unit--will decrease only when a building or base is closed or a unit is disbanded. Other types of support are reduced only when the work load falls below a certain point (for example, if class size is 20, one instructor fewer is needed when the number of students falls by 20). For this reason, the reductions in this option would be phased in gradually; savings associated with excess management and support personnel are assumed to come first and those associated with operating fewer facilities or reorganizing activities to reflect reductions in work load to come later.

Attempting to restore the ratio of military to civilian personnel support to that of the 1980s could also jeopardize the quality of support services that civilians provide. Changes in that ratio may in fact reflect changes in the type of services they provide. There is, however, little evidence of such a change over the last decade. In fact, the occupational makeup of the civilian work force has been relatively stable.

Although the decrease in the civilian work force might not keep pace with the reductions in military forces in the short term, it should adjust in proportion to the size of the military force in the long term if support functions are reorganized to reflect changes in work load, particularly when reductions are predictable and carried out gradually. In addition, the size of DoD's infrastructure is decreasing, which should aid in attaining civilian cutbacks. For example, some military installations are being closed or realigned in accordance with the recommendations of two Presidentially appointed commissions on base closure, and more facilities are likely to be closed in the future.

DEF-48 CONSOLIDATE AND DOWNSIZE THE RECRUITING ESTABLISHMENT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	110	260	290	320	340	1,320
Outlays	90	240	280	310	330	1,250
			Savings in Defense Budget			
Budget Authority	120	300	330	370	390	1,510
Outlays	110	270	320	360	380	1,440

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The Department of Defense spends $2 billion a year and devotes approximately 30,000 military and civilian work-years to recruiting new active and reserve personnel. Recruiting personnel are located at 6,600 recruiting stations, 700 recruiting management offices, and 68 military entrance and examination stations. These totals do not include recruiting offices for the reserve components located at military installations.

Since 1990, DoD has significantly reduced funding for advertising and recruiting bonuses. It has been less successful in reducing the size of the recruiting establishment and the number of recruiting personnel and, as a result, recruiting efficiency has declined. From 1984 through 1989, an average of 14 people entered active duty for each DoD employee dedicated to recruiting active-duty personnel. That compares with an average of 10 active-duty recruits per employee during the period from 1990 through 1993. The average cost per active-duty enlisted recruit, adjusted for inflation, rose from $4,900 to $5,700 between these same periods. A similar pattern appears in reserve recruiting; the number of recruits for each employee dedicated to reserve recruiting fell from 27 to 21.

This option would reduce recruiting resources so that the inflation-adjusted cost per active-duty and reserve recruit would be equal to the 1984-1989 average for each. The cut would be phased in over a two-year period; real recruiting resources would be reduced by 5 percent in 1994 and an additional 8 percent in 1995. Savings would be approximately $120 million in 1994 and $300 million in 1995. These savings assume that the total number of military personnel declines as the number of recruiters is reduced.

In addition, beginning in 1994, the option would make a change in budgeting procedures that might help hold down costs. At present, the salaries of the military personnel involved in recruiting do not appear in the budgets of recruiting commands. Under this option, the pay and benefits for recruiters and support personnel would be paid for out of recruiting funds. Managers of recruiting commands would receive a budget for day-to-day operations (that is, operation and maintenance funds) that would be used both to reimburse the military personnel account for the salaries of military personnel and to pay for advertising, recruiter support, and civilian personnel. This budgeting change would both increase the visibility of total recruiting costs and provide DoD managers with incentives to maintain a cost-effective balance between military personnel and other resources.

Some experts would contend that the smaller recruit cohorts needed in the 1990s cannot be obtained at the same average cost per recruit as the larger cohorts of the late 1980s. On the one hand, because some costs associated with the recruiting system are fixed, the cost per recruit may inevitably rise as the size of the recruit cohort shrinks. On the other hand, average costs might fall now that DoD is recruiting a smaller proportion of the nation's youth population. During the 1980s, DoD justified increases in recruiting resources on the grounds that the average cost per recruit tended to rise in tandem with increases in the proportion of the youth population that had to be recruited.

DoD may need to consolidate and restructure the current recruiting establishment in order to achieve the savings envisioned under this option. For example, DoD might reduce the number of supervisory and overhead offices, consolidate active and reserve recruiting commands in the Navy and Air Force, increase interservice cooperation through the joint provision of recruiter support (vehicles, automatic data processing, offices), increase coordination between planning for facilities and allocating recruiters, and use methods that do not require direct access to recruiters in areas of the country where recruiters' productivity is low. Phasing in the cut over a two-year period will give DoD an opportunity to respond to the new budgetary incentives and institute any needed changes.

The most important drawback to this option is that changes in recruiting resources and in the organization of the recruiting establishment could reduce the quality of DoD recruits and, ultimately, the nation's military capability. But some reduction in the quality of recruits might be acceptable; it was at a historical record level from 1984 through 1989 and has risen higher since then. In the 1984-1989 period, 93 percent of the enlisted recruits who entered active duty held high school diplomas, compared with an average of 97 percent from 1990 through 1992. The proportion scoring in the lowest acceptable category (category IV) on the Armed Forces Qualification Test fell from 5 percent to 2 percent between these same periods. Nevertheless, a sharp cut in recruiting resources carries some risk of jeopardizing these important recruiting successes.

DEF-49 REDUCE THE NUMBER OF RESERVE TRAINING DIVISIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	60	120	120	120	130	550
Outlays	50	110	120	120	130	530
			Savings in Defense Budget			
Budget Authority	70	130	140	140	150	630
Outlays	60	130	140	140	150	620

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The Army plans to use reserve training divisions to train new draftees and other recruits when forces are expanded during a full mobilization. These reservists are part-time personnel; during a war, they are called to active duty and fill in for active-duty trainers who are assigned other duties. The Army plans to reduce the 12 reserve training divisions by 25 percent by the end of 1993 in proportion to the current force drawdown. The remaining nine divisions would comprise about 30,000 reservists.

This option would eliminate five additional reserve training divisions, leaving four divisions with a strength of about 15,000 reservists. DoD's operating costs would be reduced by $70 million in 1994 and about $630 million over the five years.

The Army is considering expanding two training missions that reservists have performed in the past. One mission would be refresher training for certain inactive reservists. These so-called individual ready reservists do not drill in peacetime and would need extra training when they were activated. The Army used reserve training divisions for this purpose during Operation Desert Storm. The divisions performed well, but only about one-seventh of the reservists available in the training divisions were needed. Based on that experience, the training divisions remaining under this option would be able to handle such a mission.

This option would also expand the role of the reserves in training recruits who enter active duty during peacetime. Reservists currently train about 7 percent of new active-duty recruits. They provide this training while on their annual two-week period of full-time training. The Army plans to expand the reserves' mission to train 12 percent of incoming active-duty recruits. The additional training would require roughly 8,000 reserve trainers. Again, this option would provide enough reservists to perform this mission.

Although this option would eliminate divisions that arguably are no longer needed because old missions have declined in importance, it would maintain the reserve divisions necessary for these other training missions. The collapse of the Soviet Union and the demise of the Warsaw Pact have lessened the possibility of a global war. Should the United States have to mobilize for all-out war, warning time would probably be sufficient to increase training capacity. DoD is planning its future forces to deal primarily with regional conflicts that would probably not require an expansion of forces beyond those already in the active and reserve forces.

A future regional conflict is unlikely to pose a larger demand than did Operation Desert Storm, which the reserve divisions handled with fewer reserve personnel than this option maintains.

This approach is not without drawbacks, however. A regional conflict could become prolonged and result in additional training requirements beyond those that the reserve trainers available under this option could meet. Also, the reserves could further expand their active-duty training responsibilities, requiring more divisions. Finally, the Army is conducting an internal study of training; it may be premature to reduce training divisions before this report is published.

DEF-50 ELIMINATE FEDERAL SUPPORT OF COMMISSARIES

Savings from CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Annual Savings (Millions of dollars)					
Budget Authority	370	740	1,120	1,170	1,210	4,610
Outlays	290	620	1,000	1,120	1,180	4,200

The Department of Defense operates about 370 military commissaries in the United States and overseas. These commissaries are like grocery stores, selling food and other products to military members, retirees, and their dependents. Commissary shoppers save an average of 25 percent compared with shoppers in civilian grocery stores. Established in 1866 to provide food and other items to military personnel assigned to remote posts, commissaries now are viewed as a benefit of membership and are entrenched as part of military life.

The commissary system will cost the federal government about $1 billion in appropriated funds in 1993. These funds pay for military and civilian salaries for commissary employees, transportation of goods to overseas stores, contractors, and other operating costs. This option would eliminate the $1 billion in appropriated funds, forcing the commissaries to become self-sustaining. Based on projected sales of $6.5 billion in 1993, the commissaries could do that by raising current prices by 15 percent, thus generating the needed additional revenues of $1 billion. Commissary goods would still cost about 13 percent less than those in civilian stores, on average. DoD would retain some flexibility for raising or lowering prices in remote areas where military members have few alternatives for shopping.

Because 15 percent is a large price increase, the subsidy would be phased out gradually over three years. Over the next five years, total savings associated with eliminating the subsidy would be $4.6 billion.

Commissaries have far exceeded their original purpose of providing food items to active-duty military personnel in remote locations. They are open to many types of people including retired personnel and their surviving spouses, personnel involuntarily discharged from service, disabled veterans and their surviving spouses, reservists, and officers of the Public Health Service, among others. Moreover, although commissaries were established in remote locations, there are now seven stores in the Washington, D.C., area alone. Ending federal support for the commissaries might force the system back toward its original purpose. To keep prices down, the commissaries might improve efficiency by cutting costs and then pass their savings on to commissary users.

This option has important drawbacks. Commanders might argue that subsidized commissaries, along with other benefits unique to the military, foster a sense of esprit de corps that is important for retaining the cohesion necessary for combat. Eliminating this subsidy could be viewed as harmful to the quality of military life. The increase in commissary prices could lead to a significant reduction in sales and ultimately force the closing of some stores.

In addition, the higher prices that service members would have to pay would amount to a reduction in the net value of military compensation. DoD would probably argue for a comparable increase in pay to offset the resulting negative effects on recruiting and retention. If pay were not raised, military personnel might view their higher cost of living as an unfair erosion of their benefits, which could harm morale. Finally, subsidized commissaries are popular with military personnel. Terminating such a popular benefit in the midst of the turmoil associated with a major reduction in the number of military personnel may not be appropriate.

DEF-51 ASSIGN ADDITIONAL PEACETIME DUTIES TO MILITARY PERSONNEL

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	370	370	380	390	400	1,910
Outlays	260	350	370	380	400	1,760
			Savings in Defense Budget			
Budget Authority	410	420	430	440	450	2,150
Outlays	310	390	420	430	450	2,000

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The Department of Defense employs approximately 250,000 civilian personnel and 190,000 military personnel to provide operating support at its bases. This support includes activities such as base communications, base security, fire and police protection, the maintenance and repair of real property, minor construction, operation of utilities, operation and maintenance of family and bachelor housing, and activities related to morale, welfare, and recreation. Operating support, together with construction of facilities, costs DoD more than $20 billion annually.

This option would reduce the cost of construction and maintenance at DoD facilities by increasing the extent to which installations are supported, in peacetime, by the military personnel who are assigned to the deployable combat and combat support units located at the installation. Military personnel would carry out these duties only if these additional duties enhanced, or at least did not detract from, the required military capabilities of the individuals and units involved, and if it was in fact less costly than using DoD's civilian employees or private contractors. The intent is to allow DoD to maintain the quality of its facilities despite declining budgets.

The estimated savings from this option, approximately $400 million per year, assume that DoD eliminates 10,000 DoD civilian or contractor positions and assigns their work load to military personnel in existing deployable units. Because CBO cannot identify specific jobs at each base that might be subject to this new approach, this option assumes only modest reliance on the program. In particular, the 10,000 positions represent approximately 4 percent of the DoD civilian personnel engaged in base operating support and less than 1 percent of all active-duty military personnel. If this assumption understates the extent to which DoD would rely on this approach, then savings could be larger.

Peacetime support jobs selected for this approach should meet two tests: (1) the military personnel involved are assigned to combat or combat support units and would have to be kept on active duty in any case; and (2) participation in the activity contributes to or at least does not detract from required military skills. Peacetime jobs that appear to meet these criteria and to which this approach is already being applied include the use of military doctors in peacetime to provide routine medical services for DoD dependents, and the use of military personnel for drug interdiction and disaster assistance. The Air Force's deployable engineering support personnel, for example, in peacetime devote 70 percent of their time to civil engineering and maintenance activities at bases. These activities not only offer some value as training, but also directly benefit the military community. These personnel devote the remaining 30 percent of their time to military training targeted specifically at their wartime mission (for example, making emergency repairs on runways).

Increased reliance on military personnel to provide installation support would not only save money, but also might benefit the military and its uniformed personnel. There may be a fit between military skills and base support functions; individuals with combat arms skills might assist in base security, and construction engineers could build playgrounds and roads and renovate DoD-owned buildings. In such cases, military training would benefit. In other cases, on-the-job training might be used to provide military personnel whose combat skills do not have a close civilian counterpart (for example, tank drivers) with skills in property maintenance (for example, basic carpentry) that will be of both immediate value to DoD and potential long-run value to the individual.

Although this option offers advantages and savings, it also has a number of disadvantages. One risk is that, improperly applied, this option could lead to increased costs. Increases would occur if the military personnel used in maintenance activities did not have a wartime mission that required them to be on active duty but were instead kept on active duty to meet peacetime needs. In this case, using civilians to perform the task would generally be cheaper. Adverse effects on readiness are another potential problem. Personnel with skills or in units that require full-time military training to maintain adequate readiness for war could not undertake additional duties. Some critics of this option might argue that this qualification would exclude the use of all active-duty personnel.

The impact of this option on morale, though also a concern, is unclear. On the one hand, morale could suffer if the individuals and units involved feel that, though trained to protect national security, they are being used instead to maintain bases. On the other hand, morale could benefit if they feel that they are learning valuable skills or making a positive and visible contribution to their community.

DEF-52 ADOPT SHORT, UNACCOMPANIED TOURS FOR EUROPE

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	250	300	350	510	520	1,930
Outlays	230	270	320	480	510	1,810

Under current policy, military personnel in Europe generally remain for tours of three years and may be accompanied by their families. The U.S. government pays for the moving expenses of dependents (spouses and children) and for other costs associated with their stay in Europe. In 1990, about 310,000 military personnel were located in Europe along with some 317,000 dependents. By 1992, the number of military personnel in Europe had decreased to 207,000 with a similar number of dependents. Accompanied tours require that DoD maintain a large support infrastructure in Europe, including schools for dependents, commissaries, hospitals, family centers, and family housing. In countries like South Korea, where housing shortages and other factors make it difficult to support families, most personnel are assigned for only one year without their families.

This option assumes adoption of one-year unaccompanied tours in Europe for almost all U.S. military personnel assigned there. Longer, accompanied tours would still be permitted for a few key personnel who need to remain overseas longer to ensure continuity in U.S. operations. This change would be phased in over three years, starting in 1994. When fully in effect, the new policy should permit elimination of all overseas schools for dependents, family centers, family housing, and some commissaries and other support facilities. The added costs associated with moving military personnel more often would be offset by savings in other areas. Together, these actions would reduce overseas support costs by $250 million in 1994 and by a total of $1.9 billion through 1998 compared with costs under the CBO baseline. The baseline is generally consistent with the Bush Administration's January 1992 plan, but, unlike that plan, it reflects the Congressionally mandated limit of 100,000 U.S. troops in Europe by 1995.

Additional savings not reflected in these estimates might eventually be realized if the number of hospitals and other facilities that cater to dependents can be reduced. However, there could be greater costs, also not reflected in the estimates, for federal Impact Aid for schools in U.S. localities where military dependents would increase in number.

This option would primarily affect personnel in the Army and Air Force, who accounted for more than 90 percent of U.S. military personnel in Europe at the end of 1992. Even though many--perhaps as many as half--of the positions in Europe could be filled by unmarried personnel, the shift to short, unaccompanied tours would increase the portion of married Army and Air Force personnel serving without their families. By 1996, that share would rise from today's level of less than one-tenth to roughly one-eighth, which is the current level for Navy and Marine Corps personnel.

Coupled with the increased disruptions associated with the ongoing drawdown of U.S. military forces, this increase in time away from their families might cause some Army and Air Force personnel to leave the military. Although such departures would be unlikely to cause shortages of skilled personnel during the current drawdown, lower retention could be a problem in the future. Shorter tours would also increase turnover among personnel in Europe, which could adversely affect readiness by reducing the amount of time units train together. Finally, some headquarters or support positions could require the continuity provided by longer tours.

Some of the problems associated with shorter tours could be minimized by the force drawdown or policy changes. The Congress has mandated a reduction of troops in Europe of about 65 percent between 1990 and 1995, compared with the 20 percent decrease in overall forces. As a result, fewer military personnel will face the prospect of unaccompanied tours, thus reducing any negative effects on retention. To counter the effect of higher turnover on readiness, entire units rather than individuals could be rotated; in this way, individuals would already be accustomed to operating as a unit. Finally, for those positions that require continuity, longer accompanied tours could be permitted with special provisions for educational and other support.

Adverse effects of unaccompanied tours would be further reduced if U.S. forces in Europe were cut even more. Some military analysts and policymakers have suggested that 50,000 or 75,000 U.S. military personnel in Europe may be adequate in view of the greatly diminished threat to European security posed by the republics of the former Soviet Union. Moreover, if only a small force is stationed in Europe, the per capita cost of maintaining schools, commissaries, and other support facilities would grow sharply, thereby requiring a shift to unaccompanied tours. For these reasons, this option could be considered as part of an overall review of the composition of the smaller force that will be in Europe by 1995.

DEF-53 INCREASE SUPPORT OF U.S. FORCES BY HOST NATIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	1,520	2,610	2,700	2,790	9,620
Outlays	0	1,150	2,260	2,580	2,720	8,710

Countries in which U.S. troops are stationed provide varying amounts of support as the host nation. In 1991, for example, Japan signed an agreement with the United States that promises the most generous financial resources of any ally hosting U.S. troops. By the end of the five-year agreement, Japan will pay nearly all yen-denominated costs of stationing U.S. forces there. At that time, Japan's contribution will be 75 percent of the total cost of U.S. deployment, excluding salaries of U.S. armed forces and civilian personnel.

Japan provided over $3.3 billion in budgeted and nonbudgeted contributions to the United States in 1991. Budgeted items, which amounted to $2.5 billion, included payments for the wages of Japanese workers employed by the U.S. military, construction costs associated with U.S. bases and facilities in Japan, and utilities used by the U.S. armed forces stationed there. Nonbudgeted items included the value of land provided free to the U.S. military by the Japanese government and the value of forgone revenue from the waiving of taxes on imports, roads, petroleum products, items purchased locally, aircraft landings, and ship arrivals.

South Korea also signed an agreement with the United States in 1991 agreeing to pay, by 1995, one-third of the won-denominated costs that the United States expects to incur to station troops there. These won-denominated payments (estimated at $300 million in 1995) include expenses that South Korea historically has paid through budgeted funds ($180 million in 1992). In addition, South Korea has provided nonbudgeted support ($2.2 billion in 1989). Under the agreement, the budgeted expenses would be expected to increase.

In the conference report accompanying legislation appropriating 1993 funds for the Department of Defense, the conferees stated that the United States' European allies should emulate the level of Japan's burden sharing. They directed DoD to seek multiyear support agreements with host nations in Europe that, like the pact with Japan, would increase contributions over the life of the arrangements. The conferees reduced funding by $250 million for operation and maintenance and for the salaries of foreign nationals working at U.S. bases in Europe, and prohibited obligation of an additional $175 million until the Secretary of Defense notifies the Congress that negotiations to revise current support agreements with the European allies have yielded increased contributions. Moreover, the conference report accompanying the 1993 defense authorization act implicitly recognized Japan as a model by instructing that the United States should negotiate a new support agreement with each country that contributes less than 75 percent of total U.S. stationing costs (excluding U.S. personnel costs).

If the United States were able to persuade other allied nations hosting major concentrations of U.S. forces--Italy, Germany, the United Kingdom, and South Korea--that each should assume 75 percent of U.S. stationing costs (excluding the salaries of U.S. personnel), annual savings could reach $2.8 billion by 1998 and would total $9.6 billion over the 1994-1998 period. Reflecting current law, the savings assume a limit of 100,000 troops in Europe; the number of troops elsewhere is assumed to remain at its current level. Savings would amount to $0.7 billion in Italy (where it costs $31,000 on average to station one U.S. military person), $5.7 billion in Germany (where the average is $30,000), $1.4 billion in the United Kingdom ($54,000), and $1.8 billion in South Korea ($20,000).

To allow time for negotiations, this alternative assumes that savings from increased foreign contributions begin in 1995 and are phased in over two years. The Congress, of course, cannot mandate increased contributions from a foreign government. It could, however, cut funding for overseas basing, thus either requiring the withdrawal of U.S. troops or convincing nations to increase their support by the same amount. The conference report on the 1993 defense authorization act took this approach but limited the cut to $500 million.

Although increased support by host nations would help lower the U.S. defense budget, the process of seeking it could entail some disadvantages. Many U.S. allies spend a greater percentage of their gross domestic product on defense than does Japan. Therefore, some U.S. allies might feel unduly pressured by such negotiations, which could lead to less friendly relations with these nations. In a post-Soviet world, the allies, responding to the pressure of public opinion, might react to a request for increased contributions by asking that U.S. troops withdraw from their soil, thereby lessening U.S. influence.

DEF-54 INCREASE THE STATES' SHARE OF SPENDING FOR THE ARMY NATIONAL GUARD

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings in Total Federal Budget			
Budget Authority	520	510	510	500	520	2,560
Outlays	440	500	500	500	510	2,450
			Savings in Defense Budget			
Budget Authority	590	580	580	570	590	2,910
Outlays	510	570	570	570	580	2,800

NOTE: Savings in the federal and Department of Defense budgets differ because of the effects of accrual accounting for military retirement and other pay costs that are offset in the federal budget.

The 423,000 members of the Army National Guard serve two functions. They are part of the nation's reserve military forces, and the states use them for keeping order when other police and security forces are inadequate, for assistance after natural disasters, for holiday traffic patrols, and for other state purposes. The states pay salary costs only when the Guard is actively performing a state mission; they pay nothing else toward the cost of the insurance role the Guard fulfills.

This option would require the states to pay 10 percent of the operating costs of the Army Guard. Federal savings compared with the CBO baseline would amount to about $520 million in 1994 and would total $2.6 billion through 1998. Savings compared with the Bush Administration's January 1992 plan would be somewhat smaller because that plan called for a large cut in the reserves.

The arguments in favor of the change, aside from the federal savings that would occur, are that it is reasonable to ask state governments to bear at least a part of the ongoing costs of military units used primarily for state purposes and that, if the states had to pay some part of the costs, they would examine more carefully the desired size and capability of their Guard units. Opponents might well argue that the Guard's size is determined by federal mobilization requirements and that the Guard's state functions are simply auxiliary duties. Moreover, in view of the fiscal crises afflicting many states, this may not be an appropriate time to seek higher state payments.

DEF-55 REDUCE SECURITY ASSISTANCE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	140	310	550	790	990	2,780
Outlays	60	190	370	590	790	2,000

Security assistance, which includes funds for both military aid and economic support, is an important means of advancing the interests of U.S. national security and foreign policy. In 1993, funding for security assistance totaled $6.2 billion.

This option would reduce security assistance, saving $140 million in 1994 and $2.8 billion in 1994 through 1998 compared with the CBO baseline. These savings would be achieved through measures described below. Because Israel and Egypt receive the largest shares of security assistance--totaling over 80 percent, or $5.1 billion, in 1993--the reductions would fall most heavily on them.

Although the United States has provided assistance to Israel for decades, the high level of cash payments to Israel from the Economic Support Fund dates from the Camp David Accords of 1979. Since 1984, the Congress has promised to provide Israel with sufficient funds to repay Israel's debts to the U.S. government. The assistance was justified as providing the material support required to maintain Israel's security. It also constituted an expression of U.S. support that was intended to give Israel the confidence to pursue meaningful peace negotiations. That justification has not changed, even though the regional peace process stalled shortly after the Camp David Accords were signed and progress was not restarted for a dozen years. Nor has U.S. security assistance led to self-sustaining growth in the Israeli economy. Indeed, critics have argued that the cash payments have eased the pressure within Israel to undertake painful policy reforms, creating a relationship of dependency on the United States. Rather than increase U.S. influence, this outcome has generated its own friction. In practice, U.S. aid to Israel exceeds the amount needed to repay outstanding loans and loan guarantees for security assistance. The United States could save $40 million in 1994 and $1.0 billion over the next five years and still keep its promise by limiting cash payments to the level of loan repayments.

Economic assistance to Egypt is also associated with the Camp David Accords. Egypt was isolated from the other Arab nations after signing the peace treaty with Israel. The high level of U.S. assistance was justified in order to sustain Egypt's military forces, which faced hostility from other Arab states, and to maintain popular support by addressing Egypt's short- and long-term development needs. More recent justifications call for maintaining a strong and stable Egypt with close ties to the West and encouraging political and economic liberalization, but in practice, the funding level for Egypt is closely tied to the level of assistance to Israel. Critics note that high levels of appropriations have exceeded Egypt's ability to spend the funds, leading to the accumulation of large undisbursed balances, inefficient use of assistance, and delays in the reforms needed to foster self-sustaining economic growth. If aid to Egypt were cut in proportion to the cuts in aid to Israel described above, savings would total $30 million in 1994 and $690 million over the next five years.

Cuts in economic support for Israel and Egypt are not the only examples of potential reductions, though they may be the most likely area for cuts over the next few years. The two countries also receive $3.1 billion per year in foreign military financing (FMF), which also could eventually be reduced. Some critics argue that U.S. military sales and arms transfers to the Middle East, including FMF for Israel and Egypt, have contributed as much to sustaining a regional arms race as to regional security. Others have argued that the sophisticated weapon systems that the United States is financing will burden Israel's and Egypt's economies with their high maintenance and support costs. Nevertheless, this option does not assume reductions in FMF because both Israel and Egypt have obligated themselves to purchase military equipment that will be paid for out of future appropriations--a practice known as cash flow financing. At current levels of FMF, the next one and one-half years' worth of Israel's grants have already been obligated, as have the next four years' worth of Egypt's. Thus, reductions in FMF could be achieved only at the cost of canceling commitments that both countries have already entered or by forcing Israel and Egypt to reallocate funds from other programs to make up for the FMF cuts.

Opponents of reducing security assistance to Israel and Egypt argue that U.S. interests in the region have not diminished and that any cut would send the wrong signal at the wrong time. Israel is in the midst of difficult peace negotiations with the Palestinians and its Arab neighbors. Any reduction in assistance might be viewed by all parties as a weakening of U.S. support for Israel and interest in peace in the region, perhaps terminating the very peace process that the United States has carefully nurtured over the last two years. Israel is also bearing the extraordinary burden of absorbing up to 1 million migrants from the former Soviet Union while also attempting to move toward a more open market economy. Arguably, it can ill afford any reduction in external financing for the next three to five years without jeopardizing both efforts.

Egypt's need for development assistance is also great. The level of economic assistance to Egypt, though high, is lower than it was a decade ago in real terms and has remained stable for the last five years. Egypt is also continuing to undertake much-needed policy reforms such as reducing subsidies and relaxing price controls; a reduction in security assistance now could send the wrong signal.

Egypt and Israel are not the only recipients of U.S. security assistance. With the end of the Cold War, some reductions in assistance to other countries may be feasible. For example, savings could be realized by phasing out assistance to those countries--namely, Turkey, Greece, and Portugal--whose aid in part represents reimbursement for U.S. use of military bases on their territory. In 1993, the Congress converted FMF grants to concessional loans as a first step in helping these three base-rights countries "graduate" from foreign military financing. Providing the assistance as loans reduced 1993 budget costs by $500 million, from $650 million to $150 million. Eliminating all of the remaining assistance over the next four years would save $70 million in 1994 and $1.1 billion through 1998.

DEF-56 REDUCE STATE DEPARTMENT FUNDING AND ELIMINATE REDUNDANT FOREIGN AFFAIRS ACTIVITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	210	290	370	450	530	1,850
Outlays	150	230	310	390	470	1,550

The Department of State, which employs about 25,000 full-time personnel in the United States and in foreign countries, promotes U.S. foreign policy interests abroad. Other, smaller agencies also conduct research and activities relating to foreign affairs. This option would reduce State Department funding by $1.5 billion over the 1994-1998 period and would save an additional $340 million by eliminating the related functions of various other agencies dealing in foreign affairs.

The State Department will receive about $2.8 billion in 1993 to administer its foreign affairs programs. Ten years ago, this portion of the State Department's budget was $1.4 billion. Inflation was responsible for some of this increase, but the funding that was added to provide security for diplomats and to establish new posts in the republics of the former Soviet Union also contributed. Even when funding for added security and new posts is excluded, however, real growth from 1984 through 1993 amounts to about 20 percent. The increases in total funding mainly reflect growth in salaries and related expenses and in rental and acquisition costs of residences and office space.

Nor is the State Department the only federally funded organization that works on foreign affairs activities. Smaller agencies such as the U.S Institute of Peace, the Asia Foundation, the East/West Center, and the North/South Center perform functions that could be eliminated without directly affecting U.S. foreign policy. These agencies, which have combined budgets totaling about $60 million annually, conduct research and work to build better relations between the United States and various foreign countries.

This option would cut State Department funding by $150 million in 1994 and keep funding at the resulting level for the following four years. This reduction is relative to funding under the CBO baseline, which assumes that funding remains constant in real (inflation-adjusted) terms at its 1993 level. By 1998, State Department funding (excluding the cost of security improvements and new posts in the former Soviet Union) would return to its real level of 1984. The department could accommodate these cuts by eliminating or consolidating posts in less important areas of the world and by reducing the number of senior foreign service officers, which some studies have suggested is too high given the size of the foreign service. These changes would make the State Department more efficient and able to operate at a lower funding level. This option also would eliminate funding for the smaller agencies dealing in foreign affairs. Compared with the CBO baseline, funding would fall by about $60 million in 1994.

Opponents of this option would argue that more money--not less--will be needed to handle the new, complex issues that the United States now faces abroad. The current number of senior foreign service officers may be needed to represent the United States in the post-Cold War world in which economic superpowers will compete. Finally, the smaller agencies dealing in foreign affairs might be viewed as providing valuable independent analysis of issues and improving the United States' understanding of, or relations with, foreign countries.

DEF-57 REDUCE DEVELOPMENT ASSISTANCE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	580	600	610	630	640	3,070
Outlays	40	290	430	500	560	1,820

The Agency for International Development (AID) administers development-related projects and provides technical advice in 93 developing countries. Since the creation of AID in 1961, the United States has spent $114 billion on development assistance. AID and its programs have been criticized, however, for waste and ineffectiveness. This option would markedly scale back AID and the programs it administers, thereby allowing the agency to focus on more attainable goals in those countries most likely to benefit from U.S. development assistance. Reducing development assistance along the lines suggested below would save $580 million in 1994 and $3.1 billion over the five-year period.

Twenty years ago, the last major revision of the Foreign Assistance Act directed AID to focus on four objectives: alleviating poverty, economic growth, respect for civil and economic rights, and integrating developing countries into an international economic system. Since then, the Congress has added more than 30 new objectives that range from promoting biodiversity to reducing urban pollution. Reports issued by AID, as well as by the Congress and independent commissions, have stated that AID has too many objectives and supports projects in too many countries. These reports recommend that AID narrow its focus and fund fewer projects with more attainable goals.

Some critics of assistance offer an even harsher assessment. They contend that even if U.S. development assistance programs are properly managed and targeted, the resulting improvement in economic development would be marginal. These critics argue that countries whose economies have grown steadily have typically not achieved this growth through the use of foreign assistance but by adopting economic policies that promote markets and free trade. Furthermore, some analysts contend that because the performance of the U.S. economy affects the economies of developing countries, a healthy U.S. economy is the best type of development assistance the United States can provide. With a healthy economy, U.S. consumers will buy more imports from developing countries, thereby creating wealth and promoting markets and trade in those countries.

This option would limit the number of countries in which AID operates. It would eliminate development assistance to about 33 middle-income countries and would also terminate aid to those lower-income countries where U.S. assistance has shown no results. As a result of these changes, AID would be providing assistance to 60 countries, compared with 93 countries today. Its assistance would target lower-income countries that have economic policies designed to encourage growth through free markets and trade.

In addition, this option would narrow the scope of the agency's funding by providing assistance only to programs that focus on alleviating poverty and promoting economic development. In particular, it would eliminate the housing investment guarantee (HIG) program, which arguably is inconsistent with other U.S. objectives. The HIG program provides high-interest, hard-currency loans to developing countries for housing. Ten years after the recognition of the international debt crisis, the United States is not helping recipient countries by extending hard-currency loans to them for an activity that does not generate the foreign exchange needed to retire the debt. These changes in the focus of AID would save an additional $20 million in 1994 and $110 million over the five-year period.

Other programs would be shifted to agencies whose mission is closer to the objective. For example, private enterprise activities would be shifted to the Overseas Private Investment Corporation, and transnational concerns, such as the environment, would be devolved to the domestic agency dealing with the issue in the United States. These shifts would reduce the AID budget but would not affect total government spending.

Opponents of these reductions would argue that AID has technical expertise that the developing world finds valuable. Despite the mixed success of AID projects, its supporters contend that the United States should continue to fund development assistance programs in a large number of countries because many problems developing countries face cannot be solved by the free market alone. Among these problems are environmental pollution, the spread of the acquired immune deficiency syndrome, and immigration and refugee problems. These problems are international in scope and thus affect the United States. Opponents of cutting development assistance might argue that it is a foreign policy tool that can help solve these problems and ultimately help the United States itself. Finally, U.S. aid might be justified on purely humanitarian grounds.

DEF-58 ELIMINATE P.L. 480 TITLE I SALES AND TITLE III GRANTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	700	710	730	750	770	3,660
Outlays	500	680	700	720	740	3,340

The Agricultural Trade and Development Act of 1954 (P.L. 480) was enacted during a period when the inconvertibility of foreign currencies and the lack of foreign exchange held by potential customers limited commercial exports of large domestic surpluses of agricultural commodities. Sales for foreign currencies, concessional credit, and grants provided a mechanism for developing markets, disposing of surplus commodities, and furthering U.S. foreign policy interests.

Changes in the world over the past 40 years may have rendered the program obsolete, however, and it may now be an inefficient means of achieving each of these objectives. This option would eliminate sales under Title I and grants under Title III, reducing the federal budget by $700 million in 1994 and $3.7 billion over the next five years. Humanitarian and emergency feeding programs are funded under Title II of P.L. 480 and under section 416 of the Agricultural Act of 1949 and are not affected by this option.

The market development aspect of the P.L. 480 program is relatively insignificant for two reasons: exports under Titles I and III are a small portion of total U.S. agricultural exports, and the countries currently receiving P.L. 480 commodities are unlikely to become commercial customers. In fiscal years 1956 through 1965, the P.L. 480 program financed between one-quarter and one-third of all agricultural exports. Since the mid-1960s, the value and tonnage of shipments under Titles I and III have declined as commercial exports have grown. In 1992, these shipments represented less than 2 percent of the $42.3 billion in total agricultural exports. U.S. security or foreign policy interests largely determine which countries receive commodities under Titles I and III. To the extent that market development is still an objective of U.S. policy, it should focus on countries that are likely to become commercial customers in the near term. Other programs such as the Commodity Credit Corporation's short- and intermediate-term credits and the Export Enhancement Program are designed to protect old markets and to penetrate new markets at lower unit cost to the U.S. government.

Disposing of surpluses is no longer a primary concern of the program. The government no longer holds stocks of most of the commodities shipped under P.L. 480; they are managed instead through the Acreage Reduction Program. Any exports lost by eliminating Titles I and III could be counterbalanced by lowering production through an increased acreage set-aside, which would not build surpluses or affect the budget.

In some cases, the terms of credit granted under Title I of P.L. 480 may actually harm the economies of the countries that receive the credits. Credits under Title I have maturities as long as 30 years, and thus the obligation for repayment remains long after the item purchased has been consumed. The 1990 amendments to P.L. 480 recognized this problem and authorized the cancellation and reduction of old loans that had become a burden to the economies of the recipient nations.

Finally, providing assistance to developing countries through P.L. 480 is not always an efficient use of U.S. resources. Many of the U.S. agricultural commodities that foreign countries buy with P.L. 480 assistance are resold to generate local currencies. These funds are used in turn to support local budgets and local development. But the inexpensive food may discourage local investment in agriculture, may lower rural incomes, and may discourage the development of local stockpiles. To the extent that one or more of these effects occurs, the United States has paid high freight costs to ship commodities overseas that then hinder local development.

These drawbacks notwithstanding, Titles I and III of P.L. 480 also have their supporters who argue that the programs are a flexible, fast means of providing assistance to friendly countries. They point out that the programs also reduce the likelihood that surpluses of agricultural commodities will depress prices within the United States and that they offer some humanitarian benefits: agricultural products are shipped, and hungry people are fed.

DEF-59 REDUCE EXIMBANK'S CREDIT ASSISTANCE

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	260	270	270	280	290	1,360
Outlays	30	140	200	250	280	900

The Export-Import Bank (Eximbank) promotes U.S. exports by providing financing to foreign buyers of U.S. goods. The bank makes direct loans with below-market interest rates and provides guarantees of private lending without receiving full compensation for the contingent liability of future losses. The U.S. exporter and the foreign buyer share these subsidies. In the 59 years since its creation, Eximbank has lost $7 billion on its operations, practically all in the last 15 years.

Baseline projections of new subsidy costs for Eximbank are $760 million per year. The bank's credit assistance is driven by demand; it makes little effort to target specific regions or industrial sectors. The bank provides assistance on a first-come, first-served basis and tries to meet all requests for assistance. In 1992, 95 percent of the bank's subsidy appropriation was used to cover the risk of losses on loan guarantees.

Savings could be realized by increasing risk-related fees, cutting the bank's projected subsidy by one-third, and directing the remainder to the private sector in middle-income countries that pose a moderate credit risk and whose economies have the potential to grow. Savings would be $260 million in 1994 and $1.4 billion through 1998.

Supporters of Eximbank say that the subsidies it provides offset subsidies provided by foreign governments and that eliminating them would put U.S. exporters at a disadvantage. These subsidies, they argue, increase U.S. exports, thereby providing jobs to U.S. workers. Finally, supporters claim that the bank's subsidies help increase the output of high-technology industries and allow these industries to achieve economies of scale.

Critics of Eximbank dispute these claims. The bank, they point out, extends credit assistance to parties other than exporters facing foreign-subsidized competition. And little evidence exists suggesting that the credit creates jobs. Finally, since the United States encourages the creation of free-market economies throughout the world, providing subsidies to promote exports is contrary to the free-market policies the United States advocates.

DEF-60 ELIMINATE OVERSEAS BROADCASTING AND REDUCE EXCHANGE PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	250	280	650	740	760	2,680
Outlays	-70	310	660	750	750	2,400

U.S. overseas broadcasting is provided by several entities. Radio Free Europe (RFE) and Radio Liberty (RL) broadcast country-specific news to Eastern Europe and the former Soviet Union, respectively. The United States Information Agency (USIA) oversees television broadcasting services and the Voice of America (VOA) radio broadcasts that provide news and U.S.-related information to audiences worldwide. The USIA also manages a broadcasting service to Cuba. In addition, the USIA administers educational and cultural exchange programs, in which U.S. citizens travel to foreign countries and foreign citizens come to the United States to learn about the other country's institutions and culture. Terminating overseas broadcasting and reducing the size of exchange programs would save approximately $2.7 billion over the 1994-1998 period.

This option would close VOA and RFE/RL, would end broadcasting services to Cuba, and would reduce funding for exchange programs by 25 percent compared with baseline levels. Such reductions in exchange programs would eliminate all real growth that occurred between 1991 and 1993. The option would also end all overseas construction of broadcast facilities and would end U.S. overseas television broadcasting. When measured against the CBO baseline, closing RFE/RL and VOA, which have annual operating budgets of about $225 million each, would cost about $150 million in 1994 but would save about $1.35 billion over the five-year period. Over the five-year period, ending broadcasts to Cuba would save about $130 million; terminating construction of broadcast facilities would save $790 million; and stopping U.S.-sponsored television broadcasts would save about $110 million. Near-term savings for these programs are reduced by large termination costs, such as severance pay for employees. This option assumes a reduction of 25 percent in funding for exchange programs, leading to savings of $300 million in 1994 through 1998.

Proponents of terminating overseas broadcasting claim that RFE/RL and VOA are relics of the Cold War that are no longer necessary. RFE and RL continue to broadcast to countries of Eastern Europe and the former Soviet Union even though, after the fall of communism, these countries have ready access to world news. Most other countries also have access to world news. With the advent of satellite television broadcasting, most nations can receive world and U.S.-related news from private broadcasters, such as the Cable News Network (CNN). Some proponents also argue that the primary technology used by VOA and RFE/RL limits the effectiveness of U.S. overseas broadcasting; because shortwave radios are needed to receive most broadcasts, audiences are limited. Finally, foreigners may also distrust the accuracy of U.S.-sponsored broadcasts.

Critics of this option would argue that the current level of broadcasting should continue or even increase. The process of change in Eastern Europe and the former Soviet Union needs nurturing, and U.S. broadcasting can assist in that process. In other parts of the world, many countries remain closed. Supporters of VOA and RFE/RL argue that shortwave radio broadcasts are the best way to reach people in closed countries because very few people own satellite dishes, which are needed to receive television broadcasts such as those by CNN. They also note that VOA and RFE/RL are continuing to broadcast more programs over AM and FM frequencies.

Supporters also argue that broadcasting should be sharply increased to some countries, such as China and North Korea. Further, they believe that television is a powerful communications tool and that private television networks cannot adequately communicate U.S. policy and viewpoints.

Funding for U.S.-sponsored exchange programs has grown by 25 percent in real terms between 1991 and 1993. Critics of the programs argue that some of this growth may have been unnecessary because as increased communication and private travel make the world a smaller place, the need for exchanges decreases.

Advocates of exchange programs argue that exchanges provide participants with a unique perspective and an in-depth knowledge of foreign cultures and institutions. As the United States continues to build stronger economic and political ties with foreign countries, this knowledge, they argue, is invaluable and, thus, funding for exchange programs should be increased, not decreased.

DEF-61 ELIMINATE DEBT RESTRUCTURING UNDER THE ENTERPRISE FOR THE AMERICAS INITIATIVE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	90	100	100	100	100	490
Outlays	90	100	100	100	100	490

The Enterprise for the Americas Initiative (EAI) was proposed by the Bush Administration to increase trade, investment, and development within the Western Hemisphere. One element of the initiative involves the reduction of bilateral debt between the U.S. government and Latin American countries. As of 1993, seven countries will benefit: Argentina, Chile, Colombia, El Salvador, Jamaica, Paraguay, and Uruguay. These countries will devote some of their interest savings to environmental and child survival projects.

In 1993, the Congress provided $90 million as the first part of the Bush Administration's request for $900 million over four years for debt reduction. This option would eliminate debt restructuring under the EAI, saving $90 million in 1994 and $490 million over the next five years relative to the CBO baseline.

The program of debt restructuring is intended to demonstrate U.S. support for Latin America, to provide an incentive for economic reform, and to generate resources for environmental and child survival projects within the recipient Latin American countries. Critics of the plan, however, argue that the EAI program provides little debt relief for the world's most severely indebted countries, has costs that are understated in the budget, and provides less assistance to environmental and child support programs than would a direct appropriation of U.S. funds.

The countries eligible for debt restructuring under the EAI are not, for the most part, the 41 countries classified as severely indebted by the World Bank. Of the seven countries offered debt restructuring in 1993, only Argentina is considered severely indebted. The Bush Administration proposed to write off $4 million of Argentina's $61 billion external debt.

The EAI provides only modest debt relief to most recipients, for two reasons. First, the United States holds little of this region's external debt--less than 2 percent of the external debt of Argentina, Chile, Paraguay, and Uruguay, for example. As a bilateral effort, the EAI does nothing to relieve the region's burden of debt to its other major creditors. Second, most of the debt the EAI countries owe to the United States is in the form of long-term, low-interest loans, which are not as troublesome as loans with variable interest rates. The restructuring in 1993 would reduce the total external debt of Argentina, Chile, Paraguay, and Uruguay by less than 0.2 percent; Jamaica and Colombia, by slightly more. Only El Salvador, which owes more than a third of its debt to the United States, would see its external debt drop noticeably--by 20 percent.

The budget understates the actual cost to the United States of achieving these reductions. The Federal Credit Reform Act of 1990 requires the appropriation of the cost of the subsidy, which is the change in net present value of the loans being restructured. If these loans were valued on a basis consistent with the valuation of new lending to the same countries--instead of a fraction of that amount, as calculated by the Bush Administration--the EAI restructuring would cost $300 million in 1993 instead of $90 million, an increase of 330 percent over the amount included in the Bush Administration's budget.

Under the EAI program, repayments to the federal government will fall dramatically. Instead of paying principal and interest on the face value of the full debt, debtor countries are required to repay only the principal on that fraction of the face value that is not written off. The interest on the remaining debt's face value is paid, not to the U.S. government, but (at a reduced rate) into local trust funds that are earmarked for environmental and child survival projects within the debtor countries.

Debt restructuring, however, is an inefficient way to provide these benefits. The present value of the interest to be paid into the local trust funds is less than the amount appropriated for debt restructuring. Thus, a direct appropriation of $90 million in U.S. government funds earmarked for environmental and child survival projects in recipient countries would confer larger benefits than the debt restructuring program. At the same time, if the United States provided a $90 million direct appropriation and if the recipient nations' debt were not restructured, the budgetary cost to U.S. taxpayers would be smaller than under the EAI program.

Chapter Three

Domestic Discretionary Spending

Domestic discretionary programs include all those funded through appropriations except programs in defense and international affairs. An extremely varied category results, comprising such topics as science and space, transportation, energy, agriculture, environmental protection, housing, education and training, medical research, and law enforcement.

Spending for these programs will total an estimated $232 billion in 1993, or about 16 percent of federal outlays. Relative to the nation's gross domestic product (GDP), spending in the domestic discretionary category rose steadily from 3.0 percent in 1960 to a range of between 4.6 percent and 4.9 percent for 1976 through 1981 (see Figure 2 on page 5). This share fell during the first half of the 1980s, however, leveling off at around 3.3 percent between 1987 and 1990. In 1993, domestic discretionary spending accounted for 3.8 percent of GDP, continuing an upward movement that began with the higher priority granted these expenditures by the budget agreement of 1990.

Broad clusters of domestic discretionary spending have risen or fallen relative to GDP since the early 1960s (see Figure 3). Individual programs within these groups have fared better or worse than the groups as a whole: many programs have come and gone over this period. The clustering shown in the figure reveals something about how national priorities have shifted. Increasing spending for public investment, as President Clinton proposed during the 1992 presidential campaign, could again change the shares of different clusters of domestic discretionary spending.

Human services--encompassing such areas as education, training, social services, medical research, subsidized housing, and the administrative costs of many benefit programs--have accounted for the largest share of spending among domestic discretionary programs since the late 1960s. The education, training, and social service programs--budget function 500--dominate the category and account for much of the rise and fall observed since 1962.

Sharp increases in funding for programs to aid education and provide training and employment occurred during the late 1960s. Spending for education and training peaked at more than 1 percent of GDP in 1979 and has since declined to about 0.5 percent. A large part of the decline in the early 1980s stemmed from eliminating funding for public service employment, which had grown during the late 1970s. Federal funding for education also shared in the decline, as state and local governments took over a larger part of that responsibility.

Spending since 1962 in the areas of science, energy, natural resources, and agriculture shows two peak periods. The effort that placed a man on the moon caused the first peak. At their height in 1966, outlays for space and other general science activities reached nearly 1 percent of national income, but rapidly declined to their current level of about 0.25 percent of GDP. Energy programs initiated after the oil price shock of 1973 produced the second peak. Those programs, like many others in the domestic discretionary category, faced cutbacks during the 1980s.

Spending for commerce, transportation, and community and regional development remained roughly constant relative to GDP through the 1970s but now stands at half the share reached in 1980. Spending for general government activities, the final category shown in the figure, has not fluctuated greatly during the period. Federal law enforcement spending, which now accounts for about half of this total, grew during the 1970s as a share of GDP and did not undergo the reductions common to many other discretionary spending programs during the 1980s.

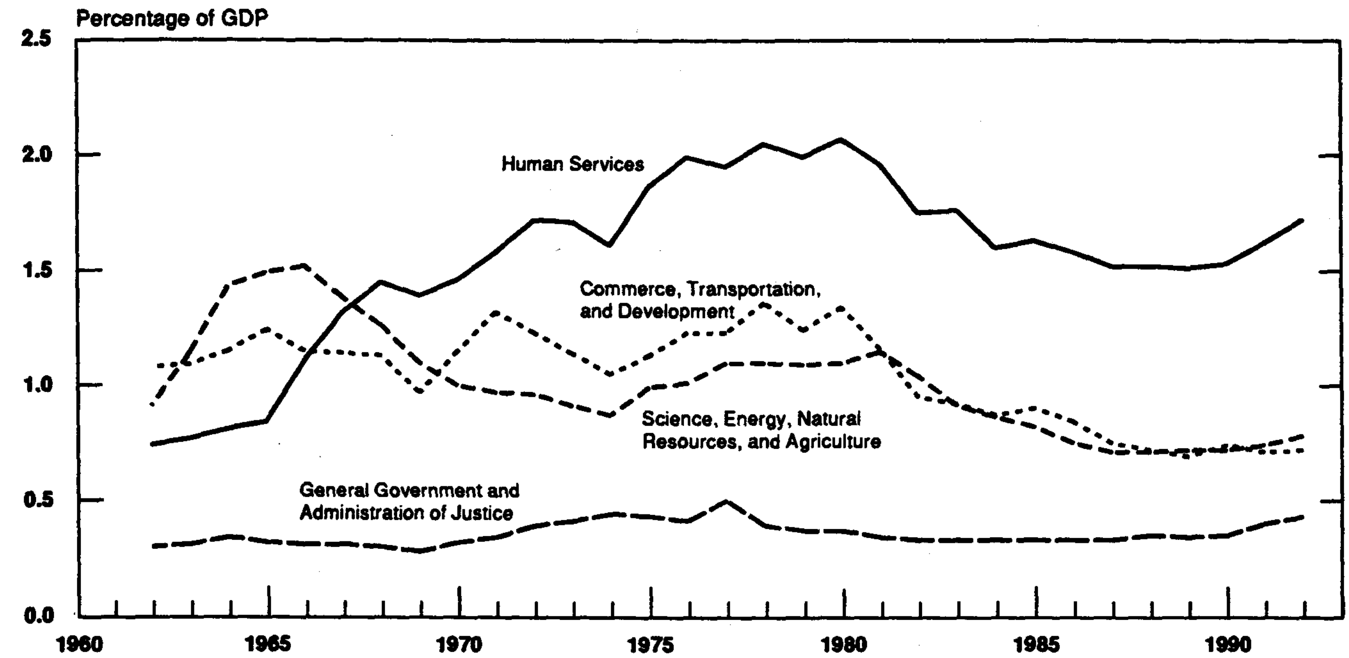
Because all of the options in this chapter affect discretionary spending, action taken in appropriation acts is required to achieve the budgetary savings. In some cases, however, the options describe changes in the laws establishing the programs, in addition to reductions in the amounts appropriated for them. The reduction in the appropriation rather than the change in the program causes spending to decline. This contrasts with options affecting entitlements or mandatory programs, discussed in Chapter 4, in which appropriation actions generally are not needed to produce budgetary savings.

The options involving authorizing legislation change the goals of a program or the methods of achieving them. An example of such an option is DOM-11, which would reduce the level of cleanup required in the Superfund program. The effect of the program change, combined with reduced appropriations, would be different from the effect of cuts in appropriations alone.

The text accompanying each option contains a description of the programmatic changes and their effects, and arguments for and against the changes. The estimated savings for each option are calculated from an uncapped baseline, in which the assumed appropriations for 1994 through 1998 equal the 1993 amounts adjusted for inflation. By contrast, the CBO baseline assumes that total discretionary appropriations in 1994 and 1995 are limited by the caps in the Budget Enforcement Act and are adjusted for inflation thereafter.

Several options contained in this chapter would affect spending in both the mandatory and discretionary categories of the Budget Enforcement Act. An example is DOM-08, which would eliminate below-cost timber sales in national forests. In this option, receipts from timber sales, which fall into the mandatory category, would be reduced, but the loss of

Figure 3.
Domestic Discretionary Spending as a Share of GDP



SOURCE: Congressional Budget Office.

receipts would be more than offset by lower discretionary funding for Forest Service activities.

Four options would affect spending for defense as well as for domestic discretionary programs. DOM-07 concerns the acquisition of crude petroleum for the Strategic Petroleum Reserve. DOM-59 would change rules that apply to government labor contracts. DOM-60 and DOM-61, pertaining to the compensation of civilian federal employees, would also affect both domestic and defense discretionary spending.

Federal budget functions define the order of the options in this chapter. DOM-01 through DOM-05 address reductions in space and science programs (function 250). DOM-06 through DOM-16 analyze reductions or changes in federal support and management of energy, natural resources and the environment, and agriculture (functions 270, 300, and 350). DOM-17 through DOM-22 cover commerce, housing, and credit (function 370). DOM-23 through DOM-26 describe options for transportation programs (function 400). DOM-27 through DOM-31 deal with community and regional development (function 450). DOM-32 through DOM-44 focus primarily on education and health (functions 500 and 550). DOM-45 through DOM-52 concentrate on housing and income security programs (function 600). DOM-53 through DOM-55 relate to veterans' programs (function 700). DOM-56 through DOM-58 center on the administration of justice (function 750). The final set of domestic discretionary options, DOM-59 through DOM-61, concern the compensation of federal workers and labor contract rules, and would affect all budget functions.

DOM-01 CANCEL NEW SPACECRAFT DEVELOPMENT PROJECTS IN A MAJOR NASA PROGRAM FOR SPACE SCIENCE AND APPLICATIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	260	270	280	280	290	1,400
Outlays	140	250	270	280	290	1,250

The National Aeronautics and Space Administration's (NASA's) space science and applications effort is currently funded at $2.9 billion for eight programs. Three programs--physics and astronomy, planetary exploration, and earth science and applications--account for 85 percent of 1993 funding. Canceling new activities in only one of the three programs could save about $1.4 billion in budget authority and $1.2 billion in resulting outlays over the 1994-1998 period, relative to the CBO baseline. To realize these savings, NASA would have to cancel immediately the Advanced X-ray Astrophysics Facility (AXAF) in the physics and astronomy program, the Cassini mission in the planetary exploration program, or the Earth Observation System in the earth science and applications program. NASA would also have to refrain from starting any new activities until after 1998 in the program experiencing the cancellation.

Canceling development of major new spacecraft in any of these programs need not endanger ongoing scientific work. In fact, the public purpose of gaining scientific knowledge may be better served by allowing intensified efforts in the programs in which new spacecraft development continues. In the physics and astronomy program, existing ground facilities and two orbiting observatories--the Hubble Space Telescope and the Gamma Ray Observatory--will provide the scientific community with new data, even if two additional planned orbiting observatories (the AXAF and the Space Infrared Telescope Facility) are canceled. In the planetary exploration program, although obtaining samples from other bodies orbiting the sun would require new missions, data from completed missions and those likely to be operating in the near future will be available to planetary scientists. In the earth science and applications program, multiple sources of new data will be available whether or not new spacecraft are developed and launched over the next five years.

Significant reductions in one space science program, rather than smaller reductions across all programs, would concentrate resources in those that remain. This kind of reduction strategy would avoid extending projects with no near-term results. Aggressively pursuing international cooperation in the program chosen for cutbacks could also decrease scientific losses.

Canceling new spacecraft development in a major program area, however, would undercut the nation's scientific and technical leadership in that field. National prestige would suffer. Once lost, leadership could be difficult to restore, and U.S. scientists and engineers would be discouraged from entering the field in which the cutbacks were made.

DOM-02 CANCEL THE NASA SPACE STATION PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	2,150	2,200	2,250	2,350	2,400	11,350
Outlays	1,400	2,100	2,250	2,300	2,350	10,400

In March 1991, the National Aeronautics and Space Administration (NASA) submitted to the Congress its plan for a restructured space station program--the latest in a program that, through 1993, will have spent almost $9 billion. The current plan reduces the size of the laboratory and habitation modules and the truss on which they are to be mounted. It also delays by several years the onset of sustained manned operations. By some estimates, these changes will reduce the total cost of the program--including development, transportation, operations, and ground facilities--from $38 billion to $30 billion during the 1990s. Canceling--rather than reducing--the program could save $11 billion in budget authority and more than $10 billion in outlays from 1994 through 1998, relative to the CBO baseline.

Advocates of canceling the space station point out that many of the traditional objectives of U.S. space policy will not be furthered by the current program. No significant national security purpose will be served, because the Department of Defense has expressed very limited interest in using the NASA station. Many civilian scientific goals could be met earlier, and at less cost, with a more modest program. Some scientists argue that the station will absorb funds that would be better spent on space science and exploration, which involve greater known returns.

Arguments for the current program emphasize its possibilities, both known and unknown, and U.S. commitments to cooperating countries. Manned exploration of the solar system requires the type of long-duration flight provided by the current program; more modest alternatives do not. Advocates contend that significant uses for a space station will be discovered once it is operational. Cancellation of the current program would force the United States to renege on agreements recently signed with European nations, Japan, and Canada. That would hurt the prospects for future international cooperative agreements in space, science, and other areas.

DOM-03 CANCEL THE NASA DEVELOPMENT PROGRAM FOR THE ADVANCED SOLID ROCKET MOTOR

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	370	380	390	400	410	1,950
Outlays	170	320	360	380	400	1,650

The National Aeronautics and Space Administration (NASA) is developing the Advanced Solid Rocket Motor (ASRM) to replace the redesigned solid rocket motor currently used to launch the space shuttle. Canceling the ASRM program could save $1.6 billion from 1994 through 1998, relative to the CBO baseline. President Bush's budget request for 1993 proposed canceling the program, but the Congress chose to continue funding.

NASA initiated the ASRM program to improve the safety of the space shuttle and to increase the weight of the payloads it can carry. But NASA's own Aerospace Safety Advisory Panel points out that the redesigned rocket booster is performing well. According to the panel, investments in other parts of the shuttle system--for example, the turbo pumps that provide fuel to the space shuttle's main engines--would enhance the safety of the shuttle more than would investment in the ASRM. As for increasing the carrying capacity of the space shuttle by 12,000 pounds, only the space station program benefits from the increase in capability. The ASRM would serve the space station program in two ways: the shuttle would be able to deploy the space station in fewer flights, and the risky activity of moving equipment from the shuttle to the space station's modules would be reduced because the modules could be more fully equipped when launched.

The ASRM program can be questioned as an investment regardless of its role in the space station program. It is unlikely that the shuttle system will be operated after 2020. If the program's anticipated cost of $3 billion were spread over 200 shuttle flights, a number sufficient to fly the vehicle eight times a year between 1996 and 2020, developing the ASRM would add $15 million to the cost of each flight. Predicted decreases in the acquisition cost of ASRM boosters compared with the cost of redesigned solid rocket boosters could offset part of these increased costs.

A 1991 report on the ASRM program by the National Research Council raised other questions. The report indicated that significant design and manufacturing problems may increase the cost of the program and delay the introduction of the booster. Indeed, a 1992 General Accounting Office report found that between January 1988 and July 1992, the cost of development for the ASRM increased by 95 percent; the rocket's first flight has slipped by more than 24 months. If the development of the ASRM is further delayed, it could not be used to deploy the space station unless the schedule for that also slips. If the booster costs more to develop than NASA has anticipated, its addition to the average cost of a shuttle flight would be even greater than the $15 million noted above.

The case for the ASRM program rests primarily on its ability to support the deployment of the space station. Additional benefits that could accrue from the program include demonstrating the application of advanced manufacturing technology to launch-vehicle production, and the possibility that the booster could be used in space launch systems developed in the future.

DOM-04 CANCEL THE SUPERCONDUCTING SUPER COLLIDER

	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Savings from CBO Baseline			
Budget Authority	530	540	560	570	580	2,800
Outlays	210	430	540	560	570	2,300
			Savings from Bush Administration's Plan			
Budget Authority	720	790	740	860	680	3,800
Outlays	290	610	760	800	770	3,200

The Department of Energy (DOE) is building a 54-mile proton accelerator--the Superconducting Super Collider (SSC)--to investigate the origin of mass and test current theories about the unity of electromagnetism and radioactive decay. DOE currently estimates that this accelerator will cost $8.2 billion, but other estimates are much higher. Canceling the SSC would save the U.S. taxpayer $200 million in 1994 and $2.3 billion over the 1994-1998 time frame relative to the CBO baseline. Using the Bush Administration's plan for future SSC costs, the savings would be $1 billion greater. (CBO used the Bush Administration's plan because a plan from the Clinton Administration was not available.)

The SSC is consuming a disproportionate share of U.S. science resources--according to the official DOE projection, 6 percent of all federal basic research spending over the next five years. Both the share and the absolute amount of federal funds devoted to this project are out of proportion to the likelihood of the SSC's producing usable science or technology in the near future, if ever. Nor is the SSC project likely to be the source of training for as many science graduate students as a project of its size would warrant. In short, in terms of the output that federal policy typically seeks from science--useful knowledge, useful technology, and training for students--the SSC is not likely to be an investment that provides society with a good rate of return.

In addition, there are large discrepancies in the cost estimates. First, because of needed design modifications, DOE raised its official estimate of the cost of the project by more than 50 percent. Then, the independent cost-estimate office within DOE announced that several items had been left out of the original estimate and that actual SSC costs were likely to be almost 50 percent higher still, or $11.8 billion. Recently, the General Accounting Office reported that, despite DOE claims that the project was "on time and under budget," early construction of conventional facilities was experiencing substantial cost overruns, in part the result of insufficient tracking of cost performance on the project. This report echoed an earlier report by the DOE Inspector General, which found that "initial construction costs are exceeding reasonable baseline estimates."

A further issue regarding costs is that DOE has been largely unsuccessful in attracting commitments for substantial amounts of foreign funds as it promised. Most of the foreign "contributions" to date have been in the form of cost savings that DOE has obtained by fabricating the magnets and other components of the SSC in low-wage countries like Russia and China. Recently, then Secretary of Energy James Watkins acknowledged that the federal government can count on only $400 million of the $1.7 billion that the SSC plan has budgeted as coming from foreign sources. The calculation of savings from the Bush Administration's plan discussed earlier assumes that these contributions will indeed total $1.7 billion. If they do not, then canceling the SSC would save even more than the estimates in the table indicate.

Proponents of the SSC claim that the project will be the centerpiece of high-energy physics research in the United States. The magnet problems that lay behind many of the major increases in costs have been solved. The most recent magnet tests involved industrially built magnets and were finished ahead of schedule. (However, whether industry can economically build 8,600 of these magnets--roughly one a day--to specification remains unclear.)

Proponents also argue that most of the cost increases have already occurred: the SSC to date has experienced the average level of cost increase associated with DOE accelerators throughout their entire construction. They consider the cost overruns now occurring during construction to be quite modest and easily absorbed by the contingency fund. DOE notes as well that improvements in its management system will prevent costs from escalating in the future.

DOM-05 REDUCE DEPARTMENT OF ENERGY FUNDING FOR ENERGY TECHNOLOGY DEVELOPMENT EFFORTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Reduce Fossil Energy R&D			
Budget Authority	65	130	200	280	360	1,050
Outlays	40	100	170	270	320	900
			Reduce Nuclear Energy R&D			
Budget Authority	45	100	150	200	260	760
Outlays	25	65	110	180	220	600
			Reduce Energy Conservation R&D			
Budget Authority	35	70	110	150	190	550
Outlays	10	35	70	140	150	400
			Reduce Fusion and Solar and Renewable Energy R&D			
Budget Authority	55	110	170	230	300	870
Outlays	25	70	130	200	250	680
			Total, All Programs			
Budget Authority	200	410	630	860	1,100	3,200
Outlays	100	270	480	780	940	2,550

The U.S. Department of Energy (DOE) and its predecessors have been funding technology development projects for several different energy sources since the first oil crisis in 1973. After two decades of spending, few successful energy technologies have emerged from these research and development (R&D) programs. Given this lack of success, DOE could cut back on programs for near-term development of energy technologies and concentrate its efforts on basic and applied science in these fields.

Reducing spending on new energy technologies can be accomplished in a number of ways; the table at the top of this page presents the savings associated with four such options. The estimates assume that funding for fossil energy R&D and funding for nuclear energy R&D are reduced to 25 percent of their baseline levels and that the reductions are phased in over the 1994-1998 period. Energy conservation, magnetic fusion, and solar and renewable energy R&D programs are all reduced to 50 percent of their baseline levels, phased in over the same five years. In total, these reductions could save $100 million in outlays in 1994 and almost $2.6 billion over the 1994-1998 period.

The justification for adopting each of these options rests primarily on the appropriate division of labor between federal programs and related activities in the private sector. In many instances, embarking on large-scale technology development projects may be premature: supporting basic and applied science projects instead would allow a better understanding of the phenomena at issue before trying to harness them to a technology. In several areas, DOE has a comparative advantage in developing the basic and applied science around a new energy source but is at a comparative disadvantage in the costly technology development and demonstration phases. Federal agencies like DOE lack the sensitivity to see when a new technology is too expensive (or esoteric) for commercial purposes.

In the area of fossil energy R&D, the first option in the table, commercial firms already spend a great deal to develop new technologies. The major new technologies for enhanced oil recovery, for example, have come from private industry, not DOE. In other instances, DOE continues to develop technologies in which the market clearly has no interest. As an illustration, DOE has spent tens of millions of dollars yearly on coal-powered magnetohydrodynamics--without any indication of when the program would end or who was interested in the product. (This option does not include the Clean Coal Technology Program, which is listed separately as DOM-06.)

For the second option, nuclear energy R&D, the wisdom of pursuing new technologies is questionable as long as electric utilities, the intended recipients, have no interest in new nuclear plants. Moreover, the Congress and the Bush Administration recently began to open the electricity generation market by obliging utilities to buy electricity from a wider group of suppliers. Having put into place incentives for the private development of new supplies of electricity, it may be time for the federal government to step aside and let the incentives encourage the private sector to take over the role of developing its own technology.

Energy conservation R&D, the third option, comprises many projects that are small and discrete enough--and have a clear enough market--to warrant private investment. In such cases, DOE may be crowding out private actors or, alternatively, conducting R&D that these actors are likely to ignore--a common fate of technology generated within DOE's national laboratories. (These funds are distinct from the technical and financial assistance programs, which would not be included in this option.)

For the fourth option, which deals with magnetic fusion and solar and renewable energy R&D, commercial markets for these technologies may be years, if not decades, away, and large-scale technology demonstration projects may be premature. In some cases, the technology is being pursued before the scientific phenomenon is completely understood. In other instances, the research is being conducted at expensive, heavily staffed national laboratories.

Proponents of these programs argue that energy markets are still far from perfect and thus federal intervention is still justified. The utilities area, for example, remains bounded by a wide array of federal and state regulations; these controls might distort the incentives facing private firms that want to undertake the R&D for a new technology. Supporters also note that progress is certainly being made, although it has taken more time to develop new energy sources than planners originally estimated. Researchers in magnetic fusion, for instance, are by no means close to producing a useful source of power, but they may be only a few years away from break-even--the point at which a controlled fusion reaction produces as much energy as is put in. In energy conservation, the Congress recently increased the funding for these efforts in accordance with the Energy Policy Act of 1992.

Given the reduction in DOE's programs for developing nuclear weapons, cuts for programs in energy R&D may be difficult to make. Many people are counting on such civilian spending to help in the conversion of DOE R&D personnel and facilities from military to commercial uses. Cutting these programs would leave fewer conversion alternatives for the DOE R&D infrastructure. In response, however, it could be argued that going from one unneeded federal program to another is not a helpful economic conversion.

As an alternative to eliminating these programs, the Congress could preserve technology development activities in those cases in which private industry was willing to share in the full burden--not just contribute a token percentage of the cost, as is now true for many programs. This strategy would conserve those programs that stood a chance of moving into commercial development but still help DOE with its military-to-civilian R&D conversion process. Some current DOE programs, most notably in energy conservation R&D, are already using this approach.

DOM-06 ELIMINATE FURTHER FUNDING FOR THE CLEAN COAL TECHNOLOGY PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	250	250	360	370	380	1,600
Outlays	5	10	50	70	160	300

The Clean Coal Technology Program (CCTP) was created in 1984 to assist private industry in developing commercial technologies that would use coal in environmentally sound ways. After four rounds of bid solicitations, the Department of Energy (DOE) will spend nearly $2.2 billion to fund and administer selected CCTP projects. The government's spending on these demonstration projects is limited to 50 percent of total costs. This option would complete projects already selected in rounds one through four of CCTP bid solicitations, but rescind the $600 million appropriation for round five (which has yet to select projects) and eliminate any future funding for projects. Savings would total about $300 million in projected outlays over the 1994-1998 period.

An initial goal of the CCTP was to reduce acid rain by supporting technologies that can lower the emissions of sulfur dioxide (SO_2) and nitrogen oxides (NO_x) that result from coal combustion. President Reagan declared that his Administration would honor an agreement with Canada to spend $2.5 billion on clean coal technologies aimed at helping curb acid rain in Canada. Another important goal of the program has been to promote the use of coal to contribute to national energy security (since greater use of domestic coal can reduce imports of crude oil) and to bolster the economies of coal-producing regions. Concerns about global warming and emissions of carbon dioxide have recently whetted policymakers' interest in increasing the efficiency of coal use.

Current practices that reduce SO_2 and NO_x emissions include cleaning the coal before burning it, scrubbing combustion gases to remove sulfur, switching to types of coal with a lower sulfur content, and switching to other fuels altogether. The new technologies that the CCTP supports fall into three general categories:

- Retrofit technologies that lower harmful emissions from existing coal-fired plants by cleaning the coal before combustion, by reducing the level of gases emitted during combustion, or by removing (or scrubbing) the gases emitted from combustion;

- Repowering technologies that replace all or part of existing boilers with advanced combustion systems that both reduce emissions and increase power output; and

- Conversion technologies that change coal into a liquid or gas.

Most of the CCTP-funded projects will demonstrate technologies to retrofit or repower coal-burning electricity generating plants.

Federal support for new clean coal technologies may no longer be necessary. In the past, supporters of the CCTP viewed it as an alternative to legislation controlling acid rain: the enactment of ill-timed controls could force industry to invest in current, high-cost abatement technologies when new, low-cost ones might be just around the corner. Since the passage of the Clean Air Act Amendments of 1990, however, the private sector has faced a clear legislative mandate for lowering coal emissions. Electric utilities and large industrial users of coal now have a clear economic motive for selecting from among current practices and new technologies the lowest-cost options for reducing emissions. DOE efforts may also be redundant in the light of independent research efforts by utilities themselves and by states that produce high-sulfur coal and want to maintain the product's sales.

Alternatively, continued CCTP funding could hasten the deployment of control and abatement technologies that will provide social benefits beyond what electric utilities would be willing to pay for under the Clean Air Act Amendments. Those benefits could come in the form of enhanced energy security, cleaner air, and economic support for electricity consumers in general and for coal-producing regions in particular.

DOM-07 HALT ACQUISITIONS OF CRUDE OIL FOR THE STRATEGIC PETROLEUM RESERVE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Halt Nondefense Purchases			
Budget Authority	0	0	0	0	0	0
Outlays	130	130	130	0	0	400
			Halt Defense Purchases			
Budget Authority	130	130	140	140	140	680
Outlays	100	130	140	140	140	640
			Total, Nondefense and Defense Purchases			
Budget Authority	130	130	140	140	140	680
Outlays	230	270	270	140	140	1,050

The Strategic Petroleum Reserve (SPR) was authorized in 1975 by the Energy Policy and Conservation Act to reduce the vulnerability of the United States to interruptions in oil supplies. Under plans developed in the 1970s, the SPR is a government-owned crude oil inventory stored in salt caverns in Texas and Louisiana. This option would halt all purchases of oil for the SPR and rescind any unspent funds for acquisitions. As a consequence, the SPR fill rate would drop from an initial rate of more than 30,000 barrels per day in 1993 to zero in 1994. The option would save $230 million in outlays in 1994 and $1.05 billion over the 1994-1998 period.

Current law establishes a fill target for the SPR of 1 billion barrels, but that target has never been vigorously pursued. Through fiscal year 1992, 571 million barrels of crude oil were stored in the SPR, and only a few million barrels of oil were added during that year. In 1991, the Department of Energy (DOE) even sold approximately 20 million barrels from the SPR as part of a coordinated international response to the United Nations' embargo of oil from Iraq and occupied Kuwait.

At the end of fiscal year 1993, DOE will have approximately $400 million in unspent funds for purchasing oil for the SPR; this total includes some unspent appropriations from earlier years plus some of the receipts from SPR sales during the Persian Gulf War. With these nondefense funds, DOE could support oil acquisitions of more than 15,000 barrels per day for about three years. The CBO baseline assumes no new DOE appropriations for SPR in 1994 because there were none in 1993. With respect to the Department of Defense (DoD), however, the baseline assumes that DoD would continue to receive annual appropriations of about $130 million for acquiring SPR oil. These new defense funds would also support acquisitions of about 15,000 barrels per day, but for five full years.

The principal advantage of this option is the savings in short-term costs. In addition, the option would not greatly diminish the nation's readiness to meet energy emergencies. If DoD and DOE spent all of the oil-purchasing funds that CBO assumes are available, the SPR would contain about 620 million barrels by the end of 1998. With acquisitions halted after 1993, the reserve would still contain 580 million barrels by that time.

A disadvantage of the option is that the final bill for filling the SPR may be greater as a consequence of delaying acquisitions. (DOE's forecasts for oil prices over the long term--that is, beyond CBO's five-year projections--indicate significantly rising prices.) And although the total amount of oil in the SPR at the end of 1998 under this option is not too different from the level of purchases supported in the CBO baseline, it is still short of the target of 1 billion barrels.

DOM-08 ELIMINATE BELOW-COST TIMBER SALES FROM NATIONAL FORESTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	20	40	50	65	80	250
Outlays	15	35	45	60	75	230

NOTE: Savings include changes in both direct spending and discretionary appropriations.

The Forest Service (FS) manages federal timber sales from 119 national forests in the national system. In 1992, the FS sold roughly 4.5 billion board feet of public timber under contract to private lumber companies. The total 1992 harvest, approximately 7.3 billion board feet providing about $1 billion in federal timber receipts, represented a continued decline in volume from previous years. In 1992, the FS spent approximately $900 million on timber management, reforestation, construction of logging roads, payments to states, and other timber program costs, resulting in net federal timber receipts of $100 million.

In seven of the nine National Forest System regions, however, annual cash receipts from federal timber sales have consistently failed to cover the FS's annual cash expenditures. These so-called below-cost timber sale regions include the Rocky Mountain, Northern, and Intermountain. On average over the past decade, cash expenditures in these three regions have exceeded cash receipts by a ratio of about 3 to 1. (Annual timber program costs in the three still exceed annual timber receipts if FS expenditures for road construction are excluded.) The FS does not maintain the data needed to estimate annual timber receipts and expenditures associated with each separate timber sale; it is therefore hard to determine precisely the budgetary savings that could be achieved by phasing out all below-cost timber sales in the National Forest System. As an illustration of the potential savings, however, eliminating all future timber sales from the three regions mentioned above would reduce FS outlays by $95 million annually by 1998, including savings in the timber road budget. Annual timber receipts would be reduced by about $20 million. Net savings in federal budget outlays over the 1994-1998 period would be about $230 million.

Below-cost timber sales have several potential disadvantages. They may lead to an increase in the federal deficit, wasteful depletion of federal timber resources through uneconomic harvests, unwarranted destruction of roadless forests valued by many recreational visitors, and government interference with private timber markets.

One advantage of the sales, however, is that the FS timber program generates other-than-financial benefits to the government. Among these is community stability in areas dependent on the federal timber industry for logging and other related jobs. Community stability could be particularly important in light of current court injunctions--to protect the spotted owl--that have reduced harvesting activities in some areas. The risk of economic hardship from eliminating the federal timber program in these areas could be reduced by gradually lowering the level of below-cost timber sales, providing federal job replacement skill programs, and encouraging greater development of other activities--such as tourism and recreation--in the national forests.

DOM-09 REDUCE SUBSIDIES PROVIDED BY THE RURAL ELECTRIFICATION ADMINISTRATION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	200	210	210	220	220	1,050
Outlays	45	95	140	180	200	660

The Rural Electrification Administration (REA), an agency within the Department of Agriculture, provides financial assistance to electric and telephone utilities that serve rural areas. Raising the interest rate on direct loans made by the agency and charging lenders a 1 percent origination fee on new loan guarantees could reduce outlays by $45 million in 1993 and $660 million from 1994 through 1998.

Most of the REA's borrowers that are electric utilities were established in the 1930s and 1940s, and most of the borrowers that are telephone companies were established in the 1950s. Many of the rural communities that these utilities serve are now much larger than they were in those years; but any utility that met the original service-area requirement--no more than 1,500 inhabitants--can continue to receive REA assistance. The agency's borrowers serve about 10 percent of the nation's electricity consumers and about 4 percent of its telephone customers.

The federal government provides three major types of assistance to rural electric and telephone borrowers: direct loans by the REA at a statutory 5 percent rate of interest (2 percent before 1973); direct loans by the Rural Telephone Bank (RTB), which charges an RTB cost-of-money rate (currently about 6 percent); and guarantees by the REA for loans that are provided by other lenders such as the Treasury's Federal Financing Bank, which charges a government cost-of-money rate (currently about 7.3 percent).

In 1992, the REA approved direct loans of $827 million at the 5 percent rate, $177 million in RTB loans, and $821 million in new loan guarantees. The government incurs large budgetary costs from such lending activities. There are two reasons: the government's cost of money is significantly higher than the interest rates charged on direct RTB and REA loans; and there have been a few large defaults on REA-guaranteed loans. Under the credit reform procedures enacted in 1990, the budget now shows the estimated subsidy costs of federal loans and loan guarantees. For fiscal year 1993, the Congress enacted appropriations totaling $197 million to cover the estimated subsidies of REA financial assistance. (Most of that amount is for the cost of the 5 percent loan program.)

This option includes two possible actions. The first, increasing the interest rate on REA 5 percent loans and on RTB loans, would achieve budgetary savings by eliminating the need for subsidy appropriations for direct loans. The second, charging an origination fee for new loan guarantees to cover the risk of defaults on guaranteed loans, would achieve additional savings. Collecting such fees would eliminate the need for subsidy appropriations to the REA guarantee program.

Raise Interest Rates. Eliminating the interest rate subsidy on direct loans, by raising rates to reflect the government's cost of borrowing for debt of comparable maturity, would save about $25 million in 1994 and $515 million over the 1994-1998 period, assuming total appropriations are reduced by the amount of the subsidy savings. These savings would be realized only in the event that loan amounts are not increased dramatically--to a point at which defaults become more likely. (There have been very few defaults on REA 5 percent and RTB loans.)

Charge an Origination Fee. Charging a fee of 1 percent on the amount of new loan guarantees provided by the REA probably would be sufficient to cover the risk of defaults on such guarantees. The Congress could thereby avoid providing some $190 million in subsidy appropriations over the 1994-1998 period. Savings on outlays over that period would be about $150 million.

The REA has largely fulfilled its original goal of making electric and telephone service available in rural communities. Yet many borrowers still depend on the low-interest REA loans to maintain and expand electric services to rural areas. Increasing the interest rate on those loans would raise the utility rates charged by REA borrowers, especially for the rural regions most affected. REA borrowers argue that they need interest rate subsidies to keep their service and utility rates comparable with those provided in urban regions. Raising the interest rate on new loans alone, however, would have little effect on the utility rates most borrowers charge their customers, since interest costs account for only a small percentage of the typical utility customer's bill.

With more than $16 billion in outstanding REA loans at rates of 5 percent and 2 percent, the additional interest cost for new loans of less than $1 billion a year would have only a small impact on customer rates. Similarly, although charging an origination fee on REA guarantees would eventually result in higher utility rates, the impact on individual customers would be small.

DOM-10 ELIMINATE FEDERAL GRANTS FOR CONSTRUCTION OF WASTEWATER TREATMENT PLANTS

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	2,600	2,700	2,750	2,800	2,900	13,750
Outlays	110	570	1,350	1,950	2,250	6,250

Construction grants for wastewater treatment plants were first authorized in 1972 under the Title II categorical grants program of the Clean Water Act. The federal share under Title II was 55 percent of project costs, with localities not obligated to repay the money. Title VI, which was added to the act as part of the 1987 amendments, initiated a program of grants--still in effect--to capitalize state revolving funds (SRFs). These SRFs make low-interest loans to local public agencies to construct municipal wastewater treatment facilities that help attain and maintain high water-quality standards. For each dollar of Title VI funds it receives, a state contributes 20 cents to its SRF. In 1992, nearly 95 percent of all money for construction of wastewater treatment plants under the Clean Water Act was appropriated to the SRFs. The remaining money went to fund the categorical grant program.

According to CBO baseline assumptions, federal support for the construction of local wastewater treatment facilities is projected to continue at the 1993 level of $2.6 billion, adjusted for inflation. The projected amounts for 1994 through 1998 exceed those actually authorized in the Water Quality Act of 1987. CBO estimates that the government would save approximately $110 million in 1994 and $6.3 billion through 1998 if all funding of new wastewater projects were ended after 1993.

Proponents of eliminating federal grants for wastewater treatment argue that the grants were intended to be temporary and that most of them have replaced, rather than supplemented, state and local spending. They also point out that in some cases the grants may have even encouraged inefficient treatment decisions by state and local governments. The prospect of a federal grant has apparently caused some communities to wait until federal assistance was available rather than clean up water problems promptly--thus delaying compliance with the Clean Water Act. Moreover, grants provided for construction, but not for operation and maintenance, have reduced incentives for local governments to find less capital-intensive and costly alternatives for controlling water pollution.

Opponents of such cuts make two rebuttal arguments. First, states and localities would find it more difficult to meet the Clean Water Act's treatment deadlines without continued federal contributions because repayments to the SRFs are insufficient to fund new projects and because states are unable to shoulder the additional cost of increased contributions to the SRFs. Second, the Title VI capitalization grant program may be more efficient than the old Title II categorical grant program because, under Title VI, states have some ability to tailor the terms of SRF loans to the particular circumstances of the agency receiving them.

DOM-11 DE-EMPHASIZE PERMANENCE IN SUPERFUND CLEANUPS; EMPHASIZE LAND-USE CONTROLS AND CONTAINMENT METHODS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	450	460	470	360	340	2,050
Outlays	95	210	320	290	310	1,250

Estimates of the size of the nation's hazardous waste problem and of the resources required to resolve it have grown substantially since the Superfund program was established in 1980. The Environmental Protection Agency (EPA) expects to spend a total of $27.2 billion on cleaning up the first 1,236 sites on the National Priorities List (NPL), including $16.4 billion in fiscal years 1993 and beyond. Substantial related expenditures will be required by the Energy and Defense Departments and by other agencies responsible for federally owned hazardous waste sites. Moreover, new sites continue to be added to the NPL: EPA projects 2,100 Superfund sites by the end of the century, and researchers at the University of Tennessee recently chose 6,000 sites as a plausible upper-end figure for the ultimate size of the "nonfederal" problem. Crude extrapolation suggests that the remaining Superfund liability for nonfederal sites may therefore be between $35 billion and $125 billion.

One way to reduce these large costs is to change the mix of methods used to protect health and the environment at Superfund sites. The present statutory preference for permanent treatment technologies could be dropped in favor of an emphasis on institutional controls (such as deed and access restrictions, monitoring, and provision of alternative water supplies) and containment methods (including caps, slurry walls, and surface water diversion). The University of Tennessee study estimated that a judicious shift toward these interim measures could reduce remediation costs by 40 percent, without sacrificing health or environmental protection. Such a shift would reduce federal expenditures on enforcement as well as on direct cleanup, since it would decrease the incentive for private parties to contest their hazardous waste liabilities. Given a reasonable transition period, Superfund outlays could be cut by $1.2 billion over five years. Total budgetary savings would be higher if the new standards were applied to federally owned waste sites; they would be lower if Superfund taxes were reduced.

Proponents of this option argue that it is wasteful to spend more on Superfund cleanups than is necessary to protect health and the environment, and that use of more permanent remedies (such as incineration, bioremediation, and vitrification) can be deferred until land-use needs are clearer and treatment technologies are better developed. Opponents argue that the option may not provide as much protection as supporters claim, and that invoking it would be unfair to local communities (which would bear the disruptive effects of the land-use restrictions) and to future generations (which would bear any costs of replacing interim cleanups with more permanent measures). Some opponents also assert that the lion's share of cost savings from any significant reduction in remediation requirements should take the form of cuts in the taxes that provide the primary financing for the Superfund trust account; modifying the proposal in that way would substantially reduce the net benefit to the federal budget.

DOM-12 SUBSTITUTE PRIVATE FINANCING FOR GOVERNMENT FINANCING OF THE SUPERFUND PROGRAM TO THE MAXIMUM EXTENT POSSIBLE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	460	470	480	340	290	2,050
Outlays	95	190	310	250	260	1,100

The Superfund program to clean up the nation's worst hazardous waste sites makes four groups of "potentially responsible parties" (PRPs) liable for cleanup costs, damages to natural resources, and the costs of health-impact studies. The PRPs include a site's past and present owners and operators, the generators of its hazardous substances, and any transporters who selected the site as a disposal location.

This proposal would minimize the use of money from the Superfund trust fund for cleanup work; the fund would be drawn on only when the collective resources of a site's PRPs are insufficient to cover the total costs. Specifically, the Environmental Protection Agency (EPA) would forgo the option of funding a cleanup and then seeking reimbursement, and it would avoid PRP settlements that covered less than 100 percent of cleanup work and past costs. In some respects, the proposal merely extends EPA's current "enforcement first" Superfund strategy by placing even more emphasis on leveraging private-sector dollars. However, it uses increased private spending as an opportunity to reduce federal expenditures rather than to increase the pace of the Superfund program.

The strongest version of this proposal includes short-term and emergency removal actions, as well as long-term remedial responses and their associated studies, in the definition of cleanup work. This variant would save $1.1 billion over five years, assuming that Superfund tax rates remain unchanged, that 30 percent of the sites have no financially viable PRPs, and that the enforcement budget rises by 20 percent. (Increased expenditures on negotiation, litigation, and searches for PRPs would be offset to some extent by reduced efforts to recover costs.) Focusing more narrowly on remedial actions and their preliminary studies would reduce the five-year savings to $680 million.

Proponents of this approach argue that it would better reflect the "polluter pays" conception of fairness that is a guiding principle of the Superfund law, and that it would reduce the overall cost of hazardous waste cleanup by taking fuller advantage of the efficiency of the private sector. Opponents counter that further emphasis on leveraging private dollars is likely to be inefficient, given the impact on enforcement costs, and could increase the risks to health and the environment by delaying cleanup; that prohibiting the use of joint Superfund and PRP financing is unfair, given that sites may involve "orphan shares" associated with parties that are insolvent or that cannot be found; and that increases in private-party contributions should continue to be used to increase the pace of the program.

DOM-13 REDUCE FEDERAL SUPPORT FOR AGRICULTURAL RESEARCH AND EXTENSION ACTIVITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	170	170	180	180	190	880
Outlays	110	150	160	160	170	750

The Department of Agriculture (USDA) has three agencies that conduct and support agricultural research and education. The Agricultural Research Service (ARS), the USDA's internal research arm, operates at locations around the country; its research focuses on maintaining and increasing the productivity of the nation's land and water resources, improving the quality of agricultural products and finding new uses for them, and improving human health and nutrition. The Cooperative State Research Service (CSRS) supports agricultural research conducted at land-grant universities and other state institutions. The Extension Service (ES) introduces farmers to new technology and educates low-income families about good nutrition; the ES also provides some services to urban residents.

The 1993 appropriations for these three agencies totaled $1.6 billion. Reducing funding levels by 10 percent below the baseline would save $750 million in outlays during the 1994-1998 period.

As it now stands, ARS and CSRS research grants may, in some cases, be replacing funding from the private sector. If, in those cases, the ARS and CSRS grants were eliminated, the private sector would be forced to finance more of its own research. A reduction in federal funding for ES activities would have a relatively minor direct impact on farmers. For example, both the Expanded Food and Nutrition Education Program and money earmarked for Youth at Risk programs could be deleted without undercutting the ES's basic mission of educating and assisting farmers.

Research and extension activities have long played important roles in the development of an efficient farm sector. A reduction in federal funding could compromise the sector's future development as well as its competitiveness in world markets. If the burden of funding is transferred to the private sector, agricultural research could be seriously reduced. In addition, agricultural research helps provide U.S. consumers with an abundant and relatively inexpensive food supply. In a recent report, the Board on Agriculture of the National Research Council proposed an increase in funding for agricultural research. The board argued for more research to maintain the competitive position of U.S. agriculture in world markets, to develop more convenient and nutritious foods that contribute to human health, and to create more environmentally sound farming practices to combat the degradation of water, air, and soil resources.

DOM-14 REDUCE USDA SPENDING FOR EXPORT MARKETING AND INTERNATIONAL ACTIVITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	15	15	15	15	15	65
Outlays	10	15	15	15	15	65

The Department of Agriculture (USDA) runs programs to promote exports and international activities through the Foreign Agriculture Service (FAS) and the Organization for International Cooperation and Development (OICD). FAS develops foreign markets by jointly funding--with U.S. trade and commodity organizations called "cooperators"--overseas advertising campaigns, trade show exhibits, and promotional materials. OICD collaborates on a variety of ventures, one of which provides training to foreign nationals with the objective of improving commercial relationships that will benefit U.S. agriculture.

Reducing funding levels for these programs by about one-third could save $65 million over the 1994-1998 period. FAS could significantly reduce its aid to the cooperator program, to which it currently contributes the bulk of direct and overseas costs (cooperator contributions tend to be in the form of services). In its other activities, FAS provides commodity analysis and information on access to foreign markets to U.S. producers and traders.

Although the cooperator program has served a useful purpose, it may be ready to revert to private enterprise, with minimal financial assistance from FAS. The program has tended to promote basic commodities, such as grains, oilseeds, and cotton. It is uncertain how much return in terms of market development the cooperator program is generating. In addition, private, brand-name advertising is sponsored in this program, and many people object to spending taxpayer money on such activities.

The OICD Middle-Income Country Training Program affords a select group of foreign midlevel managers a visit to the United States and training in agriculture and agribusiness. The benefits to U.S. agriculture are unknown, and although the program is popular among the recipients and their sponsors, it may be of marginal value to taxpayers.

Some observers maintain that U.S. agriculture, processors, and traders would suffer from less business abroad, especially over the long run, if funding for these activities were cut.

DOM-15 STREAMLINE THE OPERATION OF FARM AGENCIES' FIELD OFFICES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	25	70	130	140	140	510
Outlays	20	70	130	140	140	500

The Department of Agriculture (USDA) has four agencies that use extensive networks of local field offices to administer farm programs. The Agricultural Stabilization and Conservation Service (ASCS) administers commodity and land-use programs. The Soil Conservation Service (SCS) directs the national soil and water conservation program. The Farmers Home Administration furnishes credit to farmers and other rural residents. The Extension Service provides a diverse range of educational services, including introducing farmers to new technology and to improvements in farming practices.

A 1991 report by the General Accounting Office (GAO) found that the ASCS and SCS have offices in more than 85 percent of the 3,150 counties in the United States, the Farmers Home Administration has offices in more than 60 percent of the counties, and the Extension Service has offices in nearly all of the counties. Each agency employs state-level managers to oversee local operations. The GAO report concluded that this highly decentralized operational structure is inefficient and costly. The report recommended extensive administrative streamlining. It suggested that the USDA could improve efficiency and save money through the collocation and consolidation of field offices and through improvements in sharing resources. (Collocation involves two or more agencies sharing a common operating site; consolidation involves merging two or more field offices of a single agency into a single office.) Cost savings are realized when integrated field offices share administrative resources, structural facilities, personnel, equipment, and services.

The savings estimated for this option assume that consolidating or collocating agency offices could allow administrative funding to be cut by up to 5 percent, resulting in savings of $500 million over the 1994-1998 period. The large majority of these savings come from office consolidations and not filling positions that become vacant through normal attrition. Because the budgets of these offices are dominated by personnel costs, office consolidations would entail a reduction in federal employment in rural areas. The amount that could be saved without seriously hurting services to farmers is uncertain.

The USDA, in its response to the GAO report, claimed it would be difficult to realize substantial cost savings. The department said that many opportunities for sharing field office resources have already been realized, that many field offices have already been collocated or consolidated, and that full collocation is not always possible. If the USDA could not reduce its administrative costs through organizational streamlining, a reduction in federal funding would lead to a reduction in services.

DOM-16 REDUCE LOANS MADE BY THE FARMERS HOME ADMINISTRATION FOR FARM OWNERSHIP AND OPERATIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	120	120	120	130	130	620
Outlays	100	100	100	100	110	510

The Farmers Home Administration (FmHA) lends money directly to new farmers or farmers of limited means who cannot obtain loans elsewhere for purchasing land or materials to operate a farm. FmHA makes some of these loans at interest rates that approximate the Treasury's cost of borrowing money. Nearly 70 percent of the money spent on direct loans, however, is for loans made to so-called limited-resource borrowers at interest rates below that of the Treasury. Eliminating these below-cost loans would save the federal government about $500 million in outlays over five years.

In recent years, the amount of direct loans made by FmHA has fallen while the volume of commercial loans guaranteed by FmHA and used for the same purposes has increased. Guaranteed loans typically cost the government significantly less than direct loans; as a result, they allow more farmers to receive assistance from the same amount of funds. Eliminating the highly subsidized direct loans to limited-resource borrowers would accelerate the downward trend of funding but still provide a core amount of low-interest direct loans (but at no less than the Treasury's low rates) for those farmers who are unable to secure guaranteed loans from commercial lenders.

Proponents of eliminating the loans to limited-resource borrowers argue that there are too many farmers already and that the government should not be encouraging new farmers at a time when excess farm production triggers spending on other agricultural benefits such as subsidies. Furthermore, the Congress and FmHA intended direct loans to be available to borrowers only temporarily--until these farmers could improve their operations and qualify for commercial credit. But evidence reported by the General Accounting Office suggests that the "graduation rate" of current borrowers from direct to guaranteed loans is low, in part because incentives are lacking to encourage borrowers of FmHA money to shift from below-cost loans to guaranteed loans. One way to promote this move is to lessen the availability of direct loans.

Opponents of this option object to cutting limited-resource loans just after the enactment of the Agricultural Credit Improvement Act of 1992. The act requires FmHA to target a portion of direct loans and loan guarantees toward beginning farmers and to sign long-term agreements with them. (Beginning farmers now have access to FmHA credit for no more than 15 years.) Many believe that such assistance is necessary because people who are just entering farming may find it especially difficult to obtain or afford sufficient credit at commercial rates. Some observers are particularly concerned about the advancing average age of farmers and argue that assistance to younger farmers is needed. Moreover, only those farmers who have received loans in the past and who have not graduated to commercial credit (and for whom the 15-year limitation does not apply) would have to pay more for credit under the remaining available options.

DOM-17 END SMALL BUSINESS ADMINISTRATION LOANS AND LOAN GUARANTEES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			End All Credit Programs			
Budget Authority	600	600	630	650	670	3,150
Outlays	390	580	620	640	660	2,900
			Keep Minority and Disaster Programs			
Budget Authority	320	330	340	350	360	1,700
Outlays	210	310	350	350	360	1,600

The Small Business Administration (SBA) provides both direct loans and loan guarantees to qualified small businesses. The SBA's lending objectives are to promote business development generally, to aid economically disadvantaged groups, and to assist small businesses and homeowners in recovering from disasters. SBA outlays could be reduced by $2.9 billion over the 1994-1998 period by eliminating all SBA loan and loan guarantee programs. An alternative to eliminating all loans would be to retain only those that provide assistance to minorities and disaster victims. Continuation of those programs could be justified as aid to the socially or economically disadvantaged because of factors beyond their control. Following that course could reduce SBA outlays by $1.6 billion over the 1994-1998 period.

Under the loan guarantee program, the federal government guarantees 90 percent of the principal for business loans up to $155,000 and between 70 percent and 85 percent for larger ones. The interest rate on guaranteed loans is about 2.5 percentage points above the prime rate; in addition, the SBA guarantee has a charge equal to 2 percent of the amount guaranteed. In 1992, the SBA guaranteed 24,574 loans totaling nearly $6.4 billion; the SBA share of the guaranteed loans was roughly $5.3 billion. Holders of about 4,038 guaranteed loans defaulted, and the loans were subsequently purchased by the SBA. The SBA share of the outstanding balances of those loans exceeded $650 million.

Under the direct loan program, the SBA provides loans to businesses located in high-unemployment or low-income areas and to businesses owned by minorities, handicapped individuals, and Vietnam veterans or disabled veterans. It also offers direct loans to homeowners recovering from natural disasters. Direct loans generally do not exceed $150,000, although some disaster loans run as high as $500,000. In 1992, the SBA disbursed 22,814 direct loans totaling $325 million and bringing the total direct loan portfolio to more than $6 billion. In both the direct loan and loan guarantee programs, the SBA extends credit for up to 25 years--significantly longer than would otherwise be available to small businesses.

SBA assistance is favored by those who view it as a way of aiding small businesses, which, they argue, generally create more jobs, improve technology more rapidly, and satisfy some markets more efficiently than do large firms. When banks and other traditional sources of loans to small businesses tighten credit standards or become more conservative in their lending practices, SBA assistance can help fill a financing gap.

But others claim that SBA assistance tends to flow to the firms least likely to create stable employment, improve technology, or enhance national productivity. SBA loans and loan guarantees go primarily to businesses that have been rejected by conventional providers of financing. Perhaps as a result, they have a high default rate. It can also be argued that financial markets are now more efficient and less susceptible to the types of market failure that justified the SBA program when it first began.

DOM-18 DISCONTINUE POSTAL SUBSIDIES FOR NOT-FOR-PROFIT AND OTHER ORGANIZATIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	60	60	65	65	70	320
Outlays	60	60	65	65	70	320

The Postal Reorganization Act of 1970, which replaced the federal Post Office Department with the independent U.S. Postal Service (USPS), intended the mail system to operate as a largely self-sufficient enterprise, with mail users paying the full costs of service. However, certain mailers--notably charitable organizations, small-circulation newspapers, and state and national political committees--receive favored statutory treatment. These favored mailers pay reduced postage rates that, on average, cover only about 85 percent of the cost of the service they receive. Taxpayers subsidize the remaining costs through annual federal payments made by the Congress, referred to as revenue-forgone appropriations. For 1993, the Congress appropriated only $122 million of the $482 million requested by the USPS. Almost $320 million in federal outlays could be saved over the 1994-1998 period if the remaining payments were discontinued and most subsidized postage rates eliminated. (Subsidies supporting reduced rates for blind and otherwise disabled people, libraries, and others could be continued.)

Abolishing reduced rates for certain mailers would simplify postage-rate administration and further the goal of requiring mail users to pay for the costs of this service. (By contrast, the action that the Congress took for 1993--cutting the subsidy but maintaining the reduced rates--requires the financially strapped USPS to absorb the cost.) With regard to not-for-profit groups--the greatest beneficiaries of subsidies--abolishing reduced rates could lessen some overuse of mail services, which directs a steady stream of solicitations to many households, especially those with higher incomes. The Philanthropic Advisory Service, a branch of the Better Business Bureau that monitors the activities of charitable organizations, reports frequent complaints from citizens about the volume of solicitations--in particular, multiple solicitations from the same not-for-profit groups. Furthermore, the Advisory Service has found that, for some not-for-profit organizations, the costs of fund-raising consume too high a percentage of the contributions received from their direct mail campaigns.

Although discontinuing reduced rates could cause financial difficulties for some groups, for not-for-profits, the subsidy represents only a small part of the federal assistance they receive. In 1992, such organizations received about $5 billion in federal grants. Support in the form of tax deductions for charitable contributions costs the government, through forgone tax revenues, an additional $17 billion. Finally, subsidized postage in effect represents an additional "donation" by taxpayers who already contributed about $103 billion to charitable organizations in 1991.

Eliminating this postal subsidy and the reduced rates, however, could diminish the flow of news and of educational, cultural, charitable, and other information of genuine public interest. It could also raise mailing rates for not-for-profit organizations by an average of about 30 percent. Such rate hikes could pose severe financial difficulties for some organizations, especially those that depend heavily on mail solicitation for fund-raising. The impact would be particularly heavy when added to the effects of the recent economic slowdown and other recent rate increases.

DOM-19 SCALE BACK THE RURAL RENTAL HOUSING ASSISTANCE PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Stop Expansion			
Budget Authority	440	450	460	480	490	2,300
Outlays	40	260	330	370	400	1,400
			Increase Developers' Interest Rate to 5 Percent			
Budget Authority	150	160	160	160	170	800
Outlays	20	120	150	160	160	610

NOTE: Excludes savings in administrative costs.

The Section 515 housing program, administered by the Farmers Home Administration (FmHA), provides low-interest, 50-year mortgage loans to developers of multifamily rental projects in rural areas. These mortgages typically have interest credits that reduce the effective interest rate to 1 percent and, in turn, lower rental costs for Section 515 tenants.

Under current rules, assisted tenants contribute toward their housing expenses the greater of 30 percent of adjusted income or the minimum project rent. The minimum project rent for each unit includes a proportionate share of the amortization costs of the 1 percent mortgage and of the project's operating expenses. The developer keeps the minimum rent, and the FmHA collects any payments above this minimum and treats them as additional interest payments to reduce the program's cost. Additional subsidies are provided through the Rural Rental Assistance Payments (RRAP) program to many of the poorest tenants to reduce their rent payments to 30 percent of their incomes. During 1992, the Section 515 program made $574 million worth of new loans to finance about 14,920 new rental units.

Stopping all new commitments for assistance under the Section 515 program would reduce federal outlays by about $1.4 billion over the 1994-1998 period, including $150 million for RRAP payments that would otherwise have been made. (See DOM-46 for a similar option for housing programs administered by the Department of Housing and Urban Development.) Additional savings would be realized eventually as the cost of administering a shrinking loan portfolio decreased.

An argument in favor of this option is that expanding rural rental assistance is inappropriate at a time when many other federal programs are being cut. Also, turnover among current residents of existing projects would ensure that some new income-eligible families would be assisted each year. However, this option would reduce the proportion of rural families being assisted as the number of eligible families continued to grow. Moreover, growth in the supply of standard-quality, low-income rental projects in rural areas would slow down.

Savings in outlays could also be realized by increasing tenant rental payments. This result could be achieved by raising the interest rate on loans to project developers, who would pass along the increased interest costs in the form of higher minimum project rents. Raising interest rates to 5 percent would save $610 million over the 1994-1998 period. Alternatively, tenants could be required to pay at least 35 percent of their incomes instead of the current 30 percent. This policy change would apply to tenants in all projects in the inventory as opposed to the policy of raising interest rates on developers' loans, which would affect only tenants in newly built projects. Requiring tenants to pay 35 percent of their incomes might be of particular interest if a similar increase were enacted for subsidized urban renters (see DOM-45). Data are not available, however, to estimate the savings from this alternative.

Although raising tenants' rents would increase the share of their incomes spent on housing above 30 percent, they would still be better off than the typical unassisted but equally poor renter, who pays nearly 50 percent. Arguing against raising the interest rates (and thus the minimum project rent) is the fact that this approach would affect primarily those poorer tenants who do not receive RRAP subsidies and who must pay the minimum project rent because it exceeds 30 percent of their income.

In contrast, raising the minimum contribution toward rent to 35 percent would affect households in the higher-income brackets and those receiving RRAP subsidies. A disadvantage of the 35 percent approach is that it might prompt some stable, higher-income households to move out of assisted housing projects, changing the economic mix of the projects and possibly reducing their viability.

DOM-20 SCALE BACK THE HOUSING LOAN PROGRAM FOR RURAL HOMEOWNERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate New Lending			
Budget Authority	320	320	330	340	350	1,650
Outlays	260	320	330	330	340	1,600
			Reduce New Lending by 50 Percent			
Budget Authority	160	160	170	170	170	830
Outlays	130	160	160	170	170	790
			Increase Borrowers' Payments to 30 Percent of Income			
Budget Authority	270	270	280	280	290	1,400
Outlays	1,750	270	280	280	280	2,850

NOTE: Excludes savings in administrative costs.

The Section 502 housing program, administered by the Farmers Home Administration (FmHA), provides mortgages to rural, low-income borrowers, many of whom live in areas with shortages of private mortgage credit. The FmHA's costs for this program include the costs associated with any future defaults on the loans and with the subsidies arising from the difference between the interest rates it pays to finance the program and the rates borrowers pay to obtain the FmHA mortgages. The latter rates can be as low as 1 percent. During 1992, in the continental United States, almost 22,000 rural households with incomes averaging about $18,000 purchased single-family homes with loans at reduced interest rates from the FmHA. The total value of all new Section 502 loans in 1992 was nearly $1.2 billion.

Through this program, eligible borrowers can purchase homes by spending a portion of their income--generally 20 percent--on principal, interest, property taxes, and insurance (PITI) throughout the full mortgage term, usually 33 years. Eligible borrowers with relatively low incomes, however, have to pay somewhat more than 20 percent to amortize the loan at 1 percent. Incomes are recertified annually, and payments are adjusted as necessary. In contrast, almost two-fifths of all low-income homeowners in both metropolitan and nonmetropolitan areas spent more than 30 percent of income on housing in 1989.

The costs of this program could be cut by eliminating or reducing new lending or by increasing borrowers' payments. These options would reduce the present value of the mortgage interest subsidies and the cost of future defaults, which under credit reform are scored as outlays when the loans are originated.

Eliminate or Reduce New Lending by 50 Percent. If new lending under the Section 502 program were eliminated, federal outlays would be reduced by $260 million in 1994 and about $1.6 billion over the 1994-1998 period. Alternatively, if new lending were reduced by half, federal outlays would fall by $790 million over the same five-year period. Additional savings would be realized over time as the cost of administering a shrinking portfolio decreased.

The current program may not be the best use of scarce federal resources. It makes rather sizable payments to relatively few households that, although having low incomes, are better off than many that receive no housing assistance of any kind. Yet if either option were enacted, rural, low-income households would probably experience greater difficulty becoming homeowners, both because the cost of home ownership would rise and because shortages of private mortgage credit exist in some areas where the program operates.

Increase Borrowers' Payments to 30 Percent of Income. If these rural housing loans were continued at the current volume and borrowers' payments were increased to 30 percent of income, federal outlays would be reduced by an estimated $1.75 billion in 1994 and about $2.85 billion in the 1994-1998 period. This option assumes that the increase in payments would be effective immediately for new borrowers and would be phased in over 10 years--at 1 percentage point per year--for current borrowers. The relatively large amount of savings in 1994 reflects budgetary practices under credit reform, which would score the present value of all savings associated with currently outstanding loans in the year the option becomes effective.

Increasing the percentage of income that borrowers pay for FmHA loans would eliminate disparities between the FmHA Section 502 program and home ownership programs sponsored by the Department of Housing and Urban Development. Under the recently authorized Homeownership and Opportunity for People Everywhere program, homebuyers pay 30 percent of their income for PITI and up to 35 percent for total housing costs, including utilities. This option would also reduce unequal treatment of assisted homeowners and renters, who generally pay 30 percent of their adjusted income for housing (and who would pay 35 percent under options described in DOM-19 and DOM-45).

Increasing the percentage of income that rural households pay toward home ownership, however, would result in a shift in the composition of borrowers away from households with the lowest incomes. In addition, higher costs relative to income might raise default rates among borrowers; historically, the foreclosure rate has been around 2.5 percent.

DOM-21 REDUCE THE BUDGET OF THE EXPORT ADMINISTRATION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	10	10	10	10	10	55
Outlays	10	10	10	10	10	55

The Export Administration (EA) of the Department of Commerce enforces U.S. export laws to promote national security and foreign policy objectives. Its activities include ensuring availability of industrial resources for U.S. defense, licensing exports, and detecting and preventing foreign distribution of U.S. goods and technical data that are controlled for reasons of national security or foreign policy. Reducing the budget of the Export Administration by 25 percent would save $10 million in outlays in 1994 and $55 million over five years.

The enforcement activities of the EA reduce U.S. exports and thereby create economic inefficiencies that reduce U.S. gross national product. To the extent that they keep defense-related goods and technology out of the hands of potential adversaries, however, they promote U.S. security and foreign policy. The EA's activities to ensure availability of industrial resources (such as restricting foreign ownership of U.S. firms that are deemed to be defense related) also have their economic efficiency costs and corresponding national security and foreign policy benefits.

The EA's budget was cut for 1992 but largely restored for 1993. The agency may be able to absorb further cuts because of the demise of the former Soviet bloc and the elimination of sanctions against South Africa. Proponents may argue, however, that disclosures of Iraq's progress in developing the technology for nuclear, chemical, and biological weapons, and in obtaining the materials necessary for their construction, demonstrate a need for continued or even increased monitoring and enforcement. Further, the EA's work load is largely determined by laws, regulations, and agreements with other countries that specify the commodities to be controlled, the degree of control, and the recipient countries to which the controls apply. If the EA is to perform its job adequately with a reduced budget, it might be necessary to alter some of those laws, regulations, or agreements to reduce the number of commodities controlled and the stringency of the controls. Negotiations to revise the list of commodities controlled by the Coordinating Committee for Multilateral Export Controls were completed a little more than a year ago, so attempting further revisions could be awkward.

DOM-22 ELIMINATE THE U.S. TRAVEL AND TOURISM ADMINISTRATION AND THE TRADE PROMOTION ACTIVITIES OF THE INTERNATIONAL TRADE ADMINISTRATION, OR CHARGE THE BENEFICIARIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	170	170	180	190	190	890
Outlays	120	160	180	180	190	820

The U.S. Travel and Tourism Administration (USTTA) promotes the United States as a tourist destination for foreign travelers. The International Trade Administration (ITA) has four direct program activities: the Import Administration, which investigates antidumping and countervailing-duty cases; the trade development program, which assesses the competitiveness of various U.S. industries and runs various export promotion programs; the international economic policy program, which develops policy, provides marketing services, and identifies and develops remedies for long-range trade and investment problems; and the U.S. and foreign commercial service, which counsels U.S. businesses on exporting. The latter three activities also help fight foreign barriers to U.S. exports. That effort, and the efforts against dumping and foreign subsidies, are probably necessary to maintain public support for free-trade policies, and some of their elements can be defended on economic grounds. The ITA's export promotion, marketing, and counseling could be eliminated, however, or the beneficiaries could be charged fees to pay more of the costs. The same holds true for the USTTA's activities.

Eliminating or charging firms for the cost of these activities would reduce outlays or increase receipts by $120 million in 1994 and by $820 million over five years.

One might argue that such activities are best left to the firms and industries involved rather than to the ITA and USTTA. Alternatively, one might argue that there may be some economies of scale to these activities, especially for small firms and less popular tourist destinations. If so, having one entity (the federal government) counsel exporters on foreign legal and other requirements, disseminate knowledge of foreign markets, and promote U.S. products and tourist destinations abroad could make sense. In that case, net federal spending could be reduced by charging the beneficiaries their full cost.

To the extent that the beneficiaries are not charged the full cost, the ITA's and USTTA's activities effectively subsidize the industries involved. These implicit subsidies are an inefficient means of helping the industries because they are partially dissipated to foreigners in the form of lower prices for U.S. exports and for lodging and other tourist expenses. Because the current-account balance is determined by total saving and investment in the U.S. economy, over which the ITA and USTTA have no influence, the ITA's and USTTA's activities do not improve the current-account balance. As a result of changes they cause in exchange rates and other variables, all increases in exports and tourist expenditures resulting from the ITA's and USTTA's activities are completely offset by some mix of reduced exports of other industries and increased imports. Thus, other U.S. firms are hurt by the export and tourism promotion activities of these agencies.

DOM-23 REDUCE FEDERAL AID FOR MASS TRANSIT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	1,950	2,000	2,050	2,100	2,150	10,300
Outlays	530	950	1,300	1,600	1,850	6,250

In 1993, the principal federal transit assistance programs will provide about $2.8 billion in capital grants and about $0.8 billion in operating assistance to local mass transit agencies. Federal grants generally pay 80 percent of the costs of qualifying capital projects and offset up to 50 percent of local transit system operating deficits. In 1990, federal capital grants accounted for about 60 percent of all public capital spending for mass transit, and federal operating subsidies offset roughly 5 percent of the operating costs of transit systems nationwide (and about 9 percent of the systems' operating deficits). Reducing the federal share of qualifying investment costs for mass transit to 50 percent and eliminating operating assistance would save $0.5 billion in outlays in 1994 and $6.2 billion over the 1994-1998 period.

The high federal shares of investment spending and the subsidies for operating assistance appear to have had little effect on either transit productivity or the use of mass transit services. Despite modernization of transit systems, only 6.5 percent of journeys to or from work are made by mass transit. Transit agencies serve mainly downtown areas, whereas most of the growth in urban travel has been in the suburbs. At the same time, inflation-adjusted labor costs per mile of transit travel rose by 60 percent during the 1970s, when overall assistance levels were highest. Reducing the federal share of capital costs for mass transit might improve local investment choices, as a similar reduction seems to have done with federal subsidies for construction of local wastewater treatment plants. Similarly, ending operating assistance could encourage local authorities to make better use of existing capital by improving services, by using more cost-effective smaller vehicles, or by taking other steps to lower the operating costs of transit services.

Reducing federal transit subsidies, however, could harm some local transit services. The burden of diminished services would be borne disproportionately by people who are especially dependent on public transportation: the poor, the young, the elderly, and the disabled. Moreover, any reduction in transit service would occur just as the Clean Air Act of 1990 and the Intermodal Surface Transportation Efficiency Act of 1991 are placing increased pressure on states and localities to reduce their reliance on automotive transportation. Finally, an across-the-board cut in transit subsidies would be less efficient than targeted reductions, since certain transit investments, such as the rehabilitation of rail transit in older cities, could have a high payoff.

DOM-24 ELIMINATE AIRPORT GRANTS-IN-AID

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	2,100	2,150	2,200	2,250	2,350	11,100
Outlays	330	1,100	1,550	1,750	1,900	6,650

Each year, the Federal Aviation Administration (FAA) provides airports with grants for expanding capacity and improving terminals. The grants are allocated by formula. Up to 49.5 percent of them are reserved for primary, commercial service airports; another 12 percent go to the states for distribution to general aviation airports; and the remainder are allocated among all airports on a discretionary basis. Eliminating these grants would reduce the deficit by $330 million in 1994 and about $6.6 billion over the 1994-1998 period.

Recent trends in aviation have increased the importance of larger airports (as measured by the number of embarking passengers). If airport grants were eliminated, however, these airports would have little trouble financing capital improvements from the fees they collect or the additional bonds they could issue. In 1991, the Congress passed legislation allowing airports to levy passenger facility charges (up to $3 per passenger). Those charges will supplement the revenues received from concessionaire rents, landing fees, and airline lease payments. In addition, revenues from passenger facility charges, unlike federal grants, can be used to pay the interest on bonds issued by the airport. Passenger facility charges alone are estimated to bring in total annual revenues of about $1 billion to the 30 busiest airports. This revenue could be leveraged to support more than $12 billion in borrowing.

Small "reliever" airports, financed by the FAA with the expectation that they would draw general aviation aircraft away from major airports, have not done so. Thus some people would argue against federal subsidies to these airports.

Supporters of the current program argue that the benefits provided by the system of airports are nationwide in scope. They also argue that more assistance is needed to overcome airport congestion and to allow airports to construct new gates and terminals that will promote competition among airlines, with benefits accruing to passengers.

DOM-25 ELIMINATE REGULATION OF MOTOR CARRIERS AND ABOLISH THE INTERSTATE COMMERCE COMMISSION

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	30	30	30	30	30	150
Outlays	25	30	30	30	30	145

The Interstate Commerce Commission (ICC) regulates rates, operating rights, and mergers and acquisitions of interstate motor carriers and railroads. It also rules on rail abandonments and construction of new rail lines. The ICC's powers have diminished since the passage in 1980 of the Motor Carrier Act and the Staggers Rail Act, and its staff and budget have decreased accordingly. But the vestiges of regulation remain, including a large number of routine applications for ICC approval of operating rights, rates, and other business decisions.

Taking the final step of the motor carrier deregulation process begun a decade ago--eliminating all remaining ICC regulation of trucking and intercity bus companies--could save the federal government about $25 million to $30 million annually. Deregulation would apply only to economic regulation; motor carrier safety would continue to be regulated by the Federal Highway Administration.

Current regulations impose costs not only on the federal government but also--and in much greater magnitude--on carriers and shippers. In 1990, motor carriers filed 20,000 applications for operating authority, nearly 1,000 applications for approval to merge with or acquire other motor carriers, and more than 1 million tariffs; railroads filed 185,000 tariffs. Estimates of deregulation savings to the private sector run as high as $28 billion a year.

Proponents of deregulation note that the trucking industry is highly competitive and that competition can reduce costs and increase productivity far more efficiently than can regulation. Opponents contend that the remaining regulation is not burdensome and that the open filing of tariffs and applications for operating rights, rate changes, and mergers protects carriers and shippers.

As with motor carriers, eliminating requirements for railroads to file applications for routine matters could reduce costs to the federal government as well as to the industry. There is considerable debate, however, over whether the rail industry is sufficiently competitive to protect the interests of shippers. For instance, some shippers have access to only one rail line, and some communities depend on rail service for their economic vitality. Authority to handle cases involving market power could be shifted to the Department of Transportation if the ICC were abolished. Advocates of more extensive deregulation of railroads argue that the ability of shippers to enter into long-term contracts with railroads diminishes the railroads' market power. They also note that communities dependent on rail can provide subsidies or other incentives to keep rail operations in business.

DOM-26 ELIMINATE FUNDING FOR HIGHWAY DEMONSTRATION PROJECTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	1,550	1,500	1,500	1,550	1,550	7,700
Outlays	180	760	1,000	1,150	1,200	4,300

Under CBO baseline assumptions, the federal government will provide a total of $96 billion in highway grants to states during the 1994-1998 period. The states will obligate most of this money on highway projects of their own choosing. The Department of Transportation will distribute about $90 billion, or 93 percent of the total, according to broad statutory formulas and other procedures prescribed by law. The remaining $6 billion will be obligated on projects earmarked by the Congress in both the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) and annual appropriation bills. (ISTEA alone contains more than 500 separate projects.) If the Congress amended ISTEA to eliminate contract authority for the demonstration projects contained in the bill and refrained from funding demonstration projects through annual appropriation bills, it would lower the amount of budget authority by $7.7 billion and the amount of outlays by $4.3 billion over the 1994-1998 period.

Critics argue that in many instances demonstration projects cannot be justified by economic criteria. For example, a survey of demonstration projects authorized in the 1987 surface transportation act found that about half of these projects did not appear in state transportation plans. More than 10 percent of the projects would not have qualified for funding under the regular highway grant programs. Funding for demonstration projects therefore encourages construction that neither state transportation officials nor the broader federal highway program regard as being of primary importance.

Those who favor demonstration projects argue that the projects reflect important needs that are not addressed sufficiently by the regular process of highway funding. For example, demonstration projects can provide economic aid for particular geographic regions or fund construction that involves costs or risks too great for individual states. Thus, ISTEA provides funding for projects that are intended, among other things, to accelerate the construction of high-cost bridges, demonstrate innovative techniques for highway construction and finance, and improve methods to relieve congestion. Formal studies of the benefits expected from individual projects, however, are rarely available, making it difficult to assess whether demonstration projects achieve their intended purposes.

DOM-27 ELIMINATE CERTAIN RURAL DEVELOPMENT PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Eliminate Direct Loans and Loan Guarantees					
Budget Authority	120	130	130	130	140	650
Outlays	5	35	70	95	120	330
	Eliminate Grants					
Budget Authority	440	450	460	470	480	2,300
Outlays	15	90	210	330	410	1,050

NOTES: Programs include direct loans for rural development; direct loans and loan guarantees for water and waste disposal and for community facilities; loan guarantees for business and industry; and grants for water and waste disposal, rural development, fire protection, solid waste management, and emergency community water assistance.

Excludes savings in administrative costs.

The Rural Development Administration (RDA) assists rural development through a variety of programs. In general, the programs provide loans, loan guarantees, and grants for rural water and waste disposal projects, community facilities, rural development, and fire protection. Funds are generally allocated among the states based on their rural populations and the number of their rural families with incomes below the poverty threshold. Within each state, funds are awarded competitively to eligible applicants, including state and local agencies, nonprofit entities, and (in the case of loan guarantees for business and industry) for-profit organizations.

The amount of interest that loan applicants pay varies with the type of aid they receive and, in some programs, the economic condition of the area. For example, for rural water and waste disposal loans, interest rates average 5.6 percent but can range from 5 percent to market rates, depending on the median family income of the service area. If repayment of a loan would impose an undue financial burden on the residents of relatively poor areas, these areas may receive grants instead.

For 1993, the Congress appropriated a total of $120 million in budget authority to support the costs of $970 million in combined direct loans and loan guarantees. Under credit reform, those costs include the present value of interest subsidies and the cost of loans that go into default. In addition, a total of $430 million was appropriated for grants, of which $390 million is for water and waste disposal. Eliminating the loan programs would reduce federal outlays for subsidizing direct loans and loan guarantees by a total of $330 million over the 1994-1998 period. Additional savings would be realized gradually as the costs of administering a shrinking portfolio decreased. Eliminating grants would save $1.05 billion in outlays over the same period.

One argument for terminating these programs is that federal funds should be targeted toward activities whose benefits are national in scope, with state and local governments funding rural development. Moreover, research by the Center for Community Change found that two of the largest programs--the water and waste disposal program, and the business and industry program--are not well targeted toward low-income or distressed communities. Higher-income rural communities, the study found, were more likely to receive assistance--including higher subsidies--than were low-income ones.

Supporters of federal funding of rural development programs argue that, by sparking economic growth, the programs help to increase rural incomes. Eliminating these funding sources would probably reduce economic development activities because private credit may simply not be available in some areas, and many fiscally distressed states and localities would be unable to offset the loss of federal grants and interest subsidies.

DOM-28 ELIMINATE THE ECONOMIC DEVELOPMENT ADMINISTRATION

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	250	260	260	270	280	1,300
Outlays	50	120	190	240	260	870

The Economic Development Administration (EDA) provides grants to state and local governments for public works, technical assistance, and job programs, as well as loan guarantees to firms for business development. For 1993, appropriations for EDA programs total $244 million. No funds were appropriated for new loan guarantees for 1993. Disbanding the EDA would reduce federal outlays by about $50 million in 1994 and $870 million over the 1994-1998 period.

One criticism of EDA programs is that federal assistance should not be provided for activities whose benefits are primarily local and, therefore, whose responsibility should be that of state and local governments. In addition, EDA programs have been criticized for substituting federal credit for private credit and for facilitating the relocation of businesses from one distressed area to another through competition among communities for federal funds. The EDA has also been criticized for its broad eligibility criteria, which allow areas containing 80 percent of the U.S. population to compete for benefits, and for providing aid with little proven effect compared with other programs having similar goals. Furthermore, because of the competitive nature of EDA programs, local governments do not incorporate this type of aid into their budget plans; hence, eliminating future EDA funding would not impose unexpected hardships on communities.

Some of the reduction in aid associated with this option would, however, curtail economic development activities in financially distressed communities that have no other available resources. This cutback could result in the deterioration of infrastructure, the loss of prospective jobs, and decreases in local tax receipts in these areas, which are likely to be among the last to recover from the recent recession.

DOM-29 ELIMINATE THE APPALACHIAN REGIONAL COMMISSION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	200	200	210	210	220	1,050
Outlays	10	60	120	160	180	530

The federal government appropriates about $200 million annually for the Appalachian Regional Commission (ARC) to fund activities that promote economic growth in the Appalachian counties of 13 states. The states are responsible for filing development plans and for recommending specific projects for federal funding. The commission distributes the funds competitively, based on such factors as the area's growth potential, per capita income, and rate of unemployment; the financial resources of the state and locality; the prospective long-term effectiveness of the project; and the degree of private-sector involvement.

The ARC supports a variety of programs, including the Appalachian Development Highway System, to open up areas with development potential; the Community Development Program, generally to create jobs; the Human Development Program, to improve rural education and health; and the Research and Local Development District Programs, to provide planning and technical assistance to multicounty organizations. Federal funds also support 50 percent of the salaries and expenses of the ARC staff. Discontinuing the programs funded through the ARC would reduce federal outlays by $10 million in 1994 and by $530 million over the 1994-1998 period.

Those in favor of termination argue that the programs supported by the ARC duplicate activities funded by other federal agencies, such as the Department of Transportation's federal highways program and the Department of Housing and Urban Development's Community Development Block Grant program. Critics of the ARC also contend that, although it allocates resources to poor rural communities, those areas are no worse off than many others outside the Appalachian region and therefore no more deserving of special federal attention.

Nevertheless, eliminating federal funding of the ARC programs would reduce economic development activities in the region, because the fiscal distress of many states and localities would probably preclude their offsetting this loss of resources. Thus, fewer jobs might be created, and rural infrastructure, education, and health care conditions might deteriorate in a region that is likely to recover slowly from the recent recession.

DOM-30 ELIMINATE OR RESTRICT COMMUNITY DEVELOPMENT BLOCK GRANTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate CDBG Program			
Budget Authority	4,100	4,200	4,300	4,450	4,550	21,600
Outlays	160	1,850	3,600	4,250	4,350	14,200
			Restrict Eligibility and Reduce Funding			
Budget Authority	570	580	600	610	630	3,050
Outlays	25	260	500	590	600	1,950

The Community Development Block Grant (CDBG) program provides annual grants, by formula, to all metropolitan cities and urban counties through what is referred to as its entitlement component. Under the formula, jurisdictions with greater needs (as measured by factors such as population, poverty levels, and housing conditions) receive larger grants than those with lesser needs. The program also allocates funds, by formula, to each state. The latter funds are distributed among nonentitlement areas, typically through a competitive process. Nonentitlement areas generally are units of local government that have populations under 50,000 and that are not metropolitan cities or parts of urban counties.

Community Development Block Grants in general must be used to aid low- and moderate-income households, to eliminate slums and blight, or to meet emergency needs. In accomplishing these goals, they may be used for a wide range of community development activities, including rehabilitation of housing, improvement of infrastructure, and economic development. Funds from the entitlement component may also be used to repay principal and interest on obligations that are issued by local governments to finance certain activities--such as the acquisition or rehabilitation of public property--and that are guaranteed by the federal government under the Section 108 loan guarantee program.

For 1993, the appropriation for the CDBG program amounts to $4 billion. Of this total, $2.76 billion is allocated to metropolitan cities and urban counties, and $1.18 billion goes to nonentitlement government units, with the remainder earmarked for specific purposes described in the appropriation act. Substantial federal savings could be realized either by terminating the CDBG program or by restricting eligibility for the entitlement component to exclude the least needy jurisdictions while reducing funding levels. Least needy jurisdictions could be defined by measuring relative economic well-being and fiscal capacity using factors such as the number and percentage of families below the poverty level and per capita income.

Eliminate the CDBG Program. If the CDBG program were eliminated, savings in federal outlays would amount to $160 million in 1994 and a total of $14.2 billion over the 1994-1998 period. One argument for terminating the program is that federal funds should be targeted toward programs whose benefits are national rather than local. Accordingly, programs such as the CDBG program, which generate primarily local benefits, should be funded by state and local governments. Moreover, to the extent that local jurisdictions use CDBG funds to attract business by competing against each other, benefits are shifted away from local jurisdictions to private firms.

Without the CDBG program, however, a number of its activities would not be undertaken by most local governments--particularly the rehabilitation of low-income housing and, to some extent, economic development. Since the CDBG program is the largest source of federal aid for many cities, fewer resources would benefit low-income households. Furthermore, CDBG funding has presumably been figured into the budgets of entitlement recipients. Ending that support could impose at least temporary stress on many governments, some of which continue to experience fiscal difficulties.

Restrict Eligibility and Reduce Funding. If the entitlement component of the program were cut 20 percent by eliminating funding for the least needy jurisdictions, federal outlays could be reduced by $25 million in 1994 and $1.95 billion over the 1994-1998 period. Such a cutback would increase the proportion of funds going to the nonentitlement component from 30 percent to 35 percent, but the typically competitive nature of the distribution process would presumably ensure that these funds would be targeted toward the neediest areas. Carrying out this option would require both changing the authorizing legislation and cutting the program's annual appropriation.

An argument in favor of such a cutback is that no pressing interest is served by supporting jurisdictions that have above-average ability to fund projects themselves. For example, 19 of the 20 counties that had the highest per capita income in the nation in 1989 currently receive funds under the CDBG entitlement component. Eliminating funding for such jurisdictions, rather than reducing grants across the board, would ensure that the most distressed jurisdictions retained the same level of aid. However, a reduction in federal funds for affluent jurisdictions would probably curtail activities designed to aid low- and moderate-income households in any pockets of poverty in those areas, because local governments would probably not completely offset the reduction.

DOM-31 REDUCE FEDERAL SUPPORT FOR TENNESSEE VALLEY AUTHORITY ACTIVITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	140	140	150	150	160	740
Outlays	35	110	130	150	150	580

The annual appropriation for the Tennessee Valley Authority (TVA) provides federal support for the TVA's stewardship of its lands, facilities, and natural resources, and for other activities. Stewardship includes maintaining a system of dams and reservoirs and managing TVA-held land. In addition, the TVA provides recreational programs, promotes public use of its land and water resources, and operates the National Fertilizer and Environmental Research Center. In fiscal year 1993, the TVA received appropriations for these activities totaling $135 million and also received revenues from fees. Eliminating many of the activities supported by appropriations and increasing the funding from nonfederal sources could reduce federal outlays by about $35 million in fiscal year 1994 and $580 million for the 1994-1998 period.

Because many of TVA's stewardship activities are necessary to maintain its power system, their costs would more appropriately be borne by users of the power. For fiscal year 1993, the TVA will allocate about $90 million to stewardship activities, of which about $20 million will be derived from sales of power. Other stewardship activities not related to the power system could be discontinued, or their costs could be recovered from the beneficiaries. Direct costs to the federal government could be reduced by about $70 million annually if the TVA were to increase power rates or fees to cover costs of all stewardship activities, or if the activities were eliminated.

Some critics claim that other TVA activities, such as providing recreational facilities, are beyond the scope of the TVA and should not be federally supported. They could be underwritten by state or local governments, or by fee-for-service mechanisms. Critics also argue that most activities of the National Fertilizer and Environmental Research Center benefit the private sector and should be supported by private funds. By discontinuing its support of the center, the federal government could save about $30 million annually.

Supporters of continued federal funding argue that its removal would damage the TVA's ability to meet its federally mandated mission. That mission includes aiding the proper use, conservation, and development of the region's natural resources, as well as promoting its economic well-being.

DOM-32 ELIMINATE ANCILLARY VOCATIONAL EDUCATION PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Eliminate Community-Based Organizations Programs					
Budget Authority	10	10	15	15	15	65
Outlays	a	10	10	15	15	50
	Eliminate Consumer and Homemaking Education Program					
Budget Authority	35	35	35	40	40	190
Outlays	5	30	35	35	40	140

a. Less than $2.5 million.

Vocational education--occupationally specific instruction in such areas as business math, industrial arts, electronics, and office management--is widely offered in U.S. secondary schools. Federal legislation in the form of the Carl D. Perkins Vocational and Applied Technology Education Act is intended to help states ensure equal vocational education opportunities for traditionally underserved populations. The act also funds qualitative improvements in vocational education programs in order to increase work force productivity and promote economic growth. In addition to its core programs, this legislation established others that are ancillary to its larger purposes. Two of these are the Community-Based Organizations programs and the Consumer and Homemaking Education program. Eliminating them would probably not affect the accomplishment of the central purposes of the legislation and could save about $140 million over the 1994-1998 period.

Eliminate Community-Based Organizations Programs. These programs fund projects that include outreach efforts to locate likely recipients of vocational education; prevocational basic-skills training, guidance, and counseling; and career intern programs. In 1992, 53 grants were made to states and outlying areas for $12 million; most states then used competitive grants to fund local recipients. Eliminating these programs could save about $50 million in outlays over the 1994-1998 period.

People who argue for eliminating these programs have several criticisms. The services the programs fund are ancillary to vocational education in that they do not address the allocation or quality of occupationally specific instruction. In some cases, the services only supplement those funded by other sources. States tend to distribute funds among a large number of organizations located in different parts of the state, and many awards appear to be too small to make a significant difference. Furthermore, most states do not conduct formal evaluations of the projects they fund.

Proponents of the programs argue that they complement the efforts of the core Vocational Education Basic Grant program. For example, they fund efforts to inform disadvantaged individuals who may not be served by regular vocational education programs; these people include school dropouts, substance abusers, teenage parents, and immigrants with limited language skills. The services offered through community-based organizations can also provide beneficiaries with the attitudes and basic skills they need to succeed in mainstream vocational education programs.

Eliminate the Consumer and Homemaking Education Program. This program provides grants to states to prepare youths and adults to be homemakers. Federal funds are allocated according to a state's per capita income and population; one-third of each state's allotment must go to economically depressed areas. These funds can be used for instruction in family living and parenthood, food preparation and nutrition, child development and guidance, home management, and the like. In 1992, about $35 million was appropriated for this program, and grants were made to 50 states, the District of Columbia, and six outlying areas. Eliminating the program would reduce federal outlays by about $140 million over the 1994-1998 period.

Critics of the Consumer and Homemaking Education program argue that there is no essential federal role in educating people to be homemakers and that federal funds are not necessary to support these activities. Federal funds generally supplement state and local programs for elementary and secondary schools, where state and local dollars exceed federal dollars by more than 20 to 1. If they chose, states and localities could use funds from their Basic Grants to States to continue these services.

Proponents of the program see it as an important supplement to efforts to reduce sex bias and stereotyping in family life. The program also provides funds for ancillary services (including outreach) to ensure the quality and effectiveness of local programs. Without federal support, local consumer and homemaking educational services might be restricted or reduced in quality.

DOM-33 ELIMINATE EDUCATION PROGRAMS THAT HAVE LARGELY ACHIEVED THEIR PURPOSE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Public Library Construction			
Budget Authority	15	15	20	20	20	90
Outlays	a	10	15	20	20	65
			Follow Through			
Budget Authority	10	10	10	10	10	45
Outlays	a	5	10	10	10	35
			Law-Related Education			
Budget Authority	5	5	5	5	5	30
Outlays	a	5	5	5	5	25
			Law School Clinical Experience			
Budget Authority	10	10	10	10	10	55
Outlays	a	10	10	10	10	40
			Total Savings			
Budget Authority	40	40	45	45	45	220
Outlays	5	30	45	45	45	170

a. Less than $2.5 million.

The Department of Education funds about 145 programs that address a range of problems at all levels of education. Four of the programs continue to be funded even though they have largely or completely achieved their original purposes or could be supported by other funding sources. The annual cost of these four programs ranges from about $5 million to $20 million each. Eliminating all of them would save about $170 million over the 1994-1998 period.

Public Library Construction. This program is intended to fund facilities so that all people have access to local public library services. Eliminating it would reduce federal outlays by about $65 million over the 1994-1998 period.

The argument for elimination is that access to public libraries is now virtually universal, making continued federal funding for new library facilities unnecessary. Opponents of elimination argue that the program provides assistance that is still needed in building or modifying libraries, including alterations necessary to meet federal guidelines for access by the disabled.

Follow Through. This program's purpose is to develop educational practices that help low-income children in the early elementary grades fulfill their potential. Eliminating this program would reduce federal outlays by about $35 million over the 1994-1998 period.

Those who would eliminate Follow Through note that it was initiated in 1968 as a short-term experimental program. It generated many ideas, but now the Chapter 1 Basic Grant Program is the appropriate vehicle for funding state and local educational agencies to develop as well as to implement services for disadvantaged children in preschool and elementary-school grades. The counterargument is that Follow Through grants, now awarded competitively, are still being used to fund innovative projects to help disadvantaged children retain in the early elementary school grades the cognitive gains made in preschool programs.

Law-Related Education. This program aims to provide children, youth, and adults with knowledge and skills pertaining to the law and to the legal principles and values on which it is based. Eliminating the program would reduce federal outlays by about $25 million over the 1994-1998 period.

The argument critics make for eliminating this program, which was first funded in 1980 and supported 42 projects in 1991, is that it has successfully supported the institutionalization of law-related education, including teacher training. Past recipients of grants should be able to continue without federal assistance. Those who want to maintain the program argue that many of the funded projects support outreach efforts to disabled and minority youth. Without federal funding, these efforts could collapse.

Law School Clinical Experience Program. This program is intended to establish or expand law school programs to provide clinical experience in the practice of law, especially the preparation and trial of actual cases. Eliminating this program, which supported some 1,600 law students in 75 institutions in 1991, would reduce federal outlays by about $40 million over the 1994-1998 period.

Program critics argue that it should be eliminated because it was established to demonstrate the concept of clinical legal education, not to support it as a permanent federal responsibility. Most law schools now offer clinical education and would continue to do so in the absence of federal support. Program supporters argue that some law schools still make only a marginal commitment to clinical education in their budgets. If the program were eliminated, those law schools might drop their clinical education programs, depriving their students of this experience.

DOM-34 ELIMINATE STATE STUDENT INCENTIVE GRANTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	75	75	80	80	80	390
Outlays	5	75	75	80	80	315

The State Student Incentive Grant (SSIG) program helps states provide financially needy postsecondary students with grant and work-study assistance. States must match federal funds at least dollar for dollar, while also meeting maintenance-of-effort criteria. Unless excluded by state law, all public and private nonprofit postsecondary institutions in a state are eligible to participate in the SSIG program. In 1992, the federal government appropriated $72 million, which was matched by 50 states and seven outlying areas; the money was distributed to an estimated 240,000 students.

Eliminating SSIGs would save the Treasury about $315 million during the 1994-1998 period. If a portion of the resulting savings from eliminating this program were redirected to the Pell Grant program, which assists financially needy undergraduates, some of the adverse effects of eliminating SSIGs could be alleviated. In either case, the extent of the actual reduction in assistance would depend on the responses of states, some of which would probably make up part of the lost federal funds.

Proponents of eliminating this program argue that it is no longer needed to encourage states to provide more student aid. When the SSIG program was authorized in 1972, only 31 states had student grant programs; now, all 50 states provide student grants. Furthermore, state need-based aid for undergraduates increased from $870 million (in 1990 dollars) in academic year 1973-1974 to $1.6 billion in academic year 1989-1990, when about 1.4 million students received such aid.

Opponents of eliminating SSIGs argue that not all states would increase their student aid appropriations to make up for the lost federal funding and some might even reduce them. Eight states just met the SSIG matching provision in academic year 1989-1990. In addition, many other states are now having financial problems and might not be able to make up the loss of SSIG funds.

DOM-35 ELIMINATE OR REDUCE FUNDING TO SCHOOL DISTRICTS FOR IMPACT AID

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate All Impact Aid			
Budget Authority	770	790	810	830	850	4,050
Outlays	620	770	810	830	850	3,850
			Eliminate All But Half of Aid for "a" Children			
Budget Authority	480	480	480	460	440	2,350
Outlays	380	470	480	470	440	2,250
			Eliminate Impact Aid for "b" Children			
Budget Authority	130	130	130	140	140	670
Outlays	100	130	130	140	140	640

School Assistance in Federally Affected Areas--also known as Impact Aid--is intended to compensate school districts that have children who are enrolled because their parents live or work on federally owned or subsidized property. Since property of that type is tax-exempt, Impact Aid compensates school districts for the forgone property tax revenues that would have supported the schools.

Impact Aid goes to school districts for two categories of children: "a" children, whose parents both live and work on federal property; and "b" children, whose parents either live or work on federal property. A minimum of 3 percent of the children enrolled in a school district (or at least 400 children) must be federally connected for a district to be eligible. In 1990, Impact Aid went to approximately 2,500 school districts spread across all states. Payments for "a" children--at an average of $1,572 per child in 1990--have been found to go disproportionately to school districts with high expenditures per pupil and to school districts with low average property values. Payments for "b" children--at an average of $65 per child in 1990--have been found to be relatively evenly distributed across school districts with high and low expenditures per pupil. School districts in at least six of the 10 richest counties in the United States are among the beneficiaries of the Impact Aid program.

Eliminating all funding for Impact Aid would reduce federal outlays by about $4 billion in the 1994-1998 period. Opponents of the program argue that the economic benefits from federal installations outweigh the demands placed on the schools, making the program unnecessary. These economic benefits are considered so substantial that local jurisdictions compete vigorously for new federal installations and lobby intensely to forestall closing existing ones.

Proponents of the program counter that the presence of federal installations does not adequately compensate local governments and school districts for losses in property tax revenues. Additional revenues resulting from federal installations are collected primarily by the state through income and sales taxes. Moreover, many school districts--especially isolated ones having military installations with large numbers of "a" children--would face severe financial hardship if such funding were eliminated.

A second option would eliminate all Impact Aid except for half of the "a" payments. The remaining Impact Aid funds would be targeted toward school districts enrolling large numbers of "a" children. This alternative, which would require changes in authorizing legislation, would reduce federal spending by $2.2 billion over the 1994-1998 period; it would also ensure that scarce federal funds go only to the school districts most affected by federal activities. School districts with only "b" children or relatively few "a" children, however, would have somewhat less funding unless state or local resources were increased.

A third option would eliminate Impact Aid only for "b" children, thereby reducing federal outlays by $640 million over the 1994-1998 period. This alternative would significantly limit any negative effects on school districts, compared with ending larger portions of Impact Aid. Proponents of this alternative note that school district operations do not generally depend on "b" payments, which constitute less than one-half of one percent of total expenditures in more than half of the districts receiving them. The parents of "b" children also pay state and local taxes, which fund educational expenditures, at almost the same rate as the parents of children who are not federally connected. Opponents of this option argue that "b" payments are important for a few school districts--for example, those in which large numbers of military families live in the community but shop at military exchanges, which do not collect state and local sales taxes.

DOM-36 ELIMINATE UNTARGETED FUNDING FOR MATHEMATICS AND SCIENCE EDUCATION

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	280	290	300	310	310	1,500
Outlays	35	230	280	300	300	1,150

Most federal aid for elementary and secondary education is targeted toward students with special needs. Federal funds for compensatory education under Chapter 1 of the Elementary and Secondary Education Act of 1965, for example, are intended for low-achieving students in schools with many poor children. Federal funds are also provided to help educate children with disabilities.

Substantial amounts of federal money, however, are provided with no federal requirement for targeting funds toward students with special needs or toward the teachers who serve them. An example is the portion of the mathematics and science education grants not targeted toward students with special needs. Ending funding for this portion would reduce budget authority by about $1.5 billion, and outlays by about $1.1 billion, over the 1994-1998 period.

On the one hand, this option would generate significant federal savings and affect total spending for elementary and secondary education only minimally because the reduction would constitute considerably less than 1 percent of total local, state, and federal expenditures on education. Moreover, districts might offset part or all of the reduction in federal funding for the activities of special concern to them.

On the other hand, this program has a purpose other than increasing services to students with special needs--namely, to support several of the national education goals agreed to by President Bush and the governors in 1989. The reductions could pose hardships for some jurisdictions that are trying to meet those goals. In particular, the progress of students in mathematics and science might improve more slowly if federal funding were ended.

DOM-37 ELIMINATE OR REDUCE FUNDING FOR THE ARTS AND HUMANITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate Funding			
Budget Authority	1,050	1,100	1,100	1,150	1,200	5,600
Outlays	760	1,000	1,100	1,150	1,200	5,150
			Reduce Funding by 50 Percent			
Budget Authority	530	550	560	580	590	2,800
Outlays	380	500	540	570	590	2,600

NOTE: The savings shown for 1994 and 1995 would require a rescission of all or part of the advance appropriations for the Corporation for Public Broadcasting of $275 million in 1994 and $293 million in 1995.

The federal government subsidizes various arts and humanities activities. In 1992, federal outlays for the Corporation for Public Broadcasting, the Smithsonian Institution, the National Gallery of Art, the National Endowment for the Arts, and the National Endowment for the Humanities will total $1.1 billion.

Eliminating funding for these programs would reduce federal outlays by almost $5.2 billion in the 1994-1998 period, and cutting funding in half would save $2.6 billion during that period. The final effect of either option on arts and humanities activities would depend on the extent to which other funding sources--states, private individuals, firms, and foundations--increased their contributions and on whether admission fees to these activities were used to make up for reduced federal funding.

Proponents of this option argue that federal funding for the arts and humanities is not affordable in a time of fiscal stringency, especially when programs addressing central federal concerns are not fully funded. Moreover, because many arts and humanities programs benefit predominantly higher-income people, instituting or raising admission fees could substitute for federal aid in many cases. In many cities here and abroad, for example, museums charge fees.

Reducing or eliminating federal appropriations for the arts and humanities would probably result in fewer of these activities, however, because other funding sources would not be likely to offset fully the loss in federal subsidies. In fact, a substantial increase in private contributions is less likely now that tax reform has reduced the extent to which taxpayers benefit (through reduced tax liabilities) from their charitable contributions. As a result, activities that preserve and advance the nation's cultural heritage would be likely to decline.

DOM-38 ELIMINATE FEDERAL FUNDING FOR CAMPUS-BASED STUDENT AID

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Eliminate Campus-Based Aid						
Budget Authority	1,400	1,450	1,500	1,500	1,550	7,400
Outlays	140	1,350	1,450	1,500	1,500	5,950
Eliminate Campus-Based Aid and Redirect Half of the Savings to Pell Grants						
Budget Authority	700	720	740	760	780	3,700
Outlays	0	680	720	740	760	2,900

The federal government provides campus-based student aid through three programs: Supplemental Educational Opportunity Grants, Perkins Loans (formerly National Direct Student Loans), and Work-Study. Financial aid administrators at postsecondary institutions determine which eligible students receive aid under general federal guidelines. In 1993, the federal government provided $1.4 billion in campus-based aid, which will go to approximately 1.5 million students.

Eliminating federal funding of these programs would lower outlays by about $5.95 billion during the 1994-1998 period. Alternatively, half of the savings from eliminating these programs could be redirected to the Pell Grant program, which provides grants for undergraduate students on the basis of national standards of financial need. Accordingly, the Pell Grant program is more closely targeted toward low-income students. The extent of the reduction in total student aid would depend on the responses of postsecondary institutions, some of which would make up part or all of the lost federal funds. Moreover, since postsecondary institutions retain $5.7 billion in revolving funds under the Perkins Loan program, an estimated 678,000 students would receive loans, averaging about $1,325 in 1993, even if the federal government did not fund any new campus-based aid.

The primary justification for this option reflects the view that the main goal of federal student aid is to provide access to postsecondary education for those with low incomes. In contrast, campus-based aid is less closely targeted toward low-income students than is other federal student aid. In addition, because campus-based aid is tied to specific institutions, students with greater need at poorly funded schools may receive less than those with less need at well-funded institutions.

Postsecondary institutions object to this option, however, because it would reduce their discretion in packaging aid to address the special situations of some students while also reducing total available aid. Moreover, these programs disproportionately help students at private nonprofit institutions (whose students get over 40 percent of this aid, compared with about 20 percent of Pell Grant aid). Thus, cutting campus-based aid would make this type of school less accessible to needy students.

Redirecting half of the savings from eliminating campus-based aid to the Pell Grant program would mitigate the effects of less total aid on lower-income students. The Pell Grant appropriation provides for a maximum award of $2,300 in the 1993-1994 academic year. Redirected funds from campus-based programs could be used by the appropriations committees to increase the maximum Pell grant. Pell grants allow students to choose freely among postsecondary institutions rather than be limited to institutions that offer them campus-based aid. Redirecting one-half of the savings to the Pell Grant program would result, however, in only half the reduction in the federal deficit that could otherwise be accomplished by eliminating campus-based aid.

DOM-39 REDUCE PELL GRANT SPENDING

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	180	190	190	200	200	960
Outlays	35	180	190	190	200	800

The Pell Grant program provides grants to undergraduate students based on their financial need. Of all the federal student aid programs, it is the one most directly aimed at low-income students. Spending on Pell grants could be reduced by including house and farm equity in calculating a family's need for financial aid and by eliminating the $5 fee paid to postsecondary schools for each Pell recipient.

Include House and Farm Equity in Calculating Financial Need. The Higher Education Amendments of 1992 made it somewhat easier for many students to obtain Pell grants by eliminating house and farm assets from consideration in determining a family's ability to pay for postsecondary education. The amount a family is expected to contribute is determined by what is essentially a progressive tax formula. In effect, the need analysis performed for these grant decisions "taxes" family incomes and assets above those amounts assumed to be necessary to maintain a basic standard of living.

This option would include house and farm equity in calculating a family's need for financial aid for postsecondary education. House and farm equity would be taxed at roughly 5.6 percent after a deduction for allowable assets (see ENT-27 for related savings in the Stafford Loan program). In addition, the threshold below which most families with less than $50,000 in income are not asked to report these assets would also be lowered to its previous level of $15,000.

These two changes together would reduce federal outlays by $700 million during the 1994-1998 period--providing the federal appropriation for the program is cut by the same amount. Families whose houses appreciated during the 1980s are now financially better off than they would have been if they had not owned a house then. At the same time, not counting this equity gives families who own a house an advantage over those who do not.

There is concern, however, that the increases in housing prices over the past decade have made it difficult for some families to pay their mortgages if they borrow against the equity in their houses. In addition, having to assess the market values of houses would complicate the application process for many families.

Eliminate the $5 Fee Paid to Postsecondary Schools. Postsecondary schools receive a $5 fee for each Pell grant recipient to help defray the costs of administering the Pell Grant program. Federal outlays could be reduced by an estimated $95 million over the 1994-1998 period if this fee were eliminated and the federal appropriation cut by the same amount. Schools benefit by participating in the Pell program because the grants help pay for the tuition and living costs of their students. Faced with the loss of the Pell grant revenue, however, some schools might increase their tuition or reduce their services slightly, thus producing an unintended negative effect on students.

DOM-40 ELIMINATE THE SENIOR COMMUNITY SERVICE EMPLOYMENT PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	400	410	420	430	440	2,100
Outlays	70	370	410	420	430	1,700

The Senior Community Service Employment Program (SCSEP) funds part-time jobs for people age 55 and older who are unemployed and who meet income eligibility guidelines. Through SCSEP, which is authorized under Title V of the Older Americans Act, grants are awarded to nine nonprofit organizations, the U.S. Forest Service, and state agencies. The sponsoring organizations and agencies pay participants to work in part-time community service jobs for about 20 to 25 hours per week, up to a maximum of 1,300 hours per year. The Department of Labor estimates that about 60,000 such jobs would be created under SCSEP in program year 1993.

SCSEP participants work in schools, hospitals, and senior citizen centers and on beautification and conservation projects. They are paid the higher of the federal or state minimum wage or the local prevailing rate of pay for similar employment. Participants also receive annual physical examinations, personal and job-related counseling, and assistance to move into private-sector jobs when they complete their projects. SCSEP is not considered a training program, but in recent years it has put increasing emphasis on preparing its participants for unsubsidized employment. About 20 percent of enrollees move on to such jobs.

Eliminating SCSEP would reduce outlays by about $70 million in 1994 and by about $1.7 billion over the 1994-1998 period. Opponents of the program maintain that it offers few benefits aside from income support, and that the presumed value of the work experience gained by SCSEP participants would generally be greater if the experience were provided to equally disadvantaged young people who have longer careers over which to benefit. In additio n, the costs of producing the services now pro-vided by SCSEP participants could be borne by the organizations that benefit from their work; under current law, these organizations bear only 10 percent of such costs. This shift would ensure that only those services that were most highly valued would be provided.

SCSEP, however, is the major federal jobs program aimed at low-income older workers, and eliminating it could cause hardship for older workers who are unable to find comparable unsubsidized jobs. In general, older workers are less likely than younger workers to be unemployed, but those who are take longer to find work. Moreover, without SCSEP, community services might be reduced if nonprofit organizations and states were unwilling or unable to increase expenditures to replace the loss of federal funds.

DOM-41 CONSOLIDATE SOCIAL SERVICE PROGRAMS AND REDUCE THEIR BUDGETS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Reduce Funding by 5 Percent			
Budget Authority	a	270	270	270	280	1,100
Outlays	a	200	260	270	280	1,000
			Reduce Funding by 25 Percent			
Budget Authority	a	1,350	1,350	1,350	1,400	5,450
Outlays	a	1,050	1,300	1,350	1,350	5,100

NOTE: Savings include reductions in both direct spending and discretionary appropriations.

a. The option would not take effect until 1995.

Social services are provided to many individuals and families through an array of programs, each with its own rules and regulations. These programs may be administered at both the federal and state levels by separate agencies, even though they serve the same or a very similar clientele. In recent years, the number of separate programs has grown, particularly in child care, which has seen five new ones enacted since 1988.

This option would consolidate a number of social service programs into one or more block grants. For example, one grant could be for families with children and another for the elderly. A large array of programs could be consolidated. For the purposes of this estimate, the consolidation brings together the Social Services Block Grant, the Community Services Block Grant, Title IV-A "At-Risk" Child Care, the Child Care and Development Block Grant, and two activities of the Administration for Children and Families (ACF)--specifically, Title III services and meals for the aging and Dependent Care Planning and Development Grants.

Consolidating these programs and cutting their new budget by 5 percent would reduce federal government outlays by $200 million in 1995 and about $1.0 billion over the 1995-1998 period. A 25 percent cut would save $1.1 billion in 1995 and $5.1 billion over the four-year period. Implementation would be delayed until 1995 to allow time for consolidation options to be designed and evaluated.

With consolidation, localities could provide social services more efficiently. Duplicate services could be eliminated, and administrative costs would decline because of simpler rules and regulations plus a reduction in administrative personnel. States and localities would have more freedom to tailor programs to local needs. Moreover, different services provided to the same individual or family could be coordinated more easily, improving service delivery from the client's perspective.

There are, however, some risks. Despite improved administrative efficiency, a 5 percent cut in funding could lead to a reduction in services. Several of the ACF programs have state matching requirements, and state spending might decline with their removal. In addition, consolidation would diminish federal control over the spending.

The 25 percent cut would have further ramifications. States would be unlikely to replace all or most of the lost federal funding, although those individuals and families who are most in need could be protected, either by directing the consolidated grants toward states and areas with the lowest incomes or fiscal capacities or by federally mandating income limits for eligibility. In addition, much of the affected spending is for child care subsidies, and reducing these funds by 25 percent would make it more difficult for low-income mothers to work outside the home, which could increase spending on welfare programs.

DOM-42 REDUCE THE MATERNAL AND CHILD HEALTH CARE BLOCK GRANT AND THE PREVENTIVE HEALTH SERVICES BLOCK GRANT

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	420	440	450	470	480	2,250
Outlays	230	380	440	460	470	2,000

In its appropriations for 1993, the Congress provided about $810 million in block grants for programs in maternal and child health and preventive health services. Almost all of these funds are distributed to the states, with a small amount being used for federal initiatives. The block grants, which are funded through the Public Health Service, allow states considerable flexibility in choosing the programs to fund within the specified areas. These grants do not generally restrict benefits to categories of recipients, such as low-income families.

Each block grant supports a wide range of programs. The Maternal and Child Health Care Block Grant subsidizes programs that provide such services as preventive care, prenatal care, health assessments for children, rehabilitation services for blind and disabled children, and community-based services for children with special health care needs. The 1993 funding for this block grant was $660 million. The Preventive Health Services Block Grant supports programs in areas such as immunization, hypertension control, dental health, environmental health, and injury protection. Funding for 1993 was $150 million.

If funding for each of these block grants were reduced by half, the savings in outlays for the 1994-1998 period would be about $2.0 billion. The principal justification for this reduction is that the federal commitment to other programs directed at maternal and child health and preventive health services has increased substantially in recent years. For example, Medicaid's coverage of low-income women and young children has expanded in several ways. States are now required to provide Medicaid coverage to pregnant women and children under age six in families with incomes below 133 percent of the federal poverty level, and to older children under age 19 and born after September 30, 1983, with family incomes below the poverty line. Thus the block grants are not essential for ensuring access to health services for these individuals. In addition, states have the option of providing Medicaid coverage for pregnant women and infants in families with incomes up to 185 percent of the poverty line. As of July 1992, 30 states and the District of Columbia had set income thresholds above 133 percent of the poverty line for this population. Similarly, between 1990 and 1992, funding for programs of the Centers for Disease Control and Prevention for immunization, tuberculosis control, human immunodeficiency virus (HIV) prevention, and breast cancer screening increased by $200 million.

The major disadvantage of cutting the block grants is that, in the current fiscal environment, many states might be unable to assume a greater share of the financial responsibility for the programs that are affected. Cuts in the block grants could adversely affect the health of people--especially those in low-income families--who receive assistance from these programs.

DOM-43 REDUCE FUNDING FOR RESEARCH SUPPORTED BY THE NATIONAL INSTITUTES OF HEALTH

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	1,050	1,100	1,150	1,150	1,200	5,650
Outlays	460	1,000	1,100	1,150	1,150	4,900

The federal government provided $10.4 billion in 1993 for research funded through the National Institutes of Health (NIH). About 60 percent of the NIH research budget is awarded to universities and other nonprofit institutions through research grants and contracts. The rest is spent on research within the institutes, research contracts with industrial firms, research by state and local governments, foreign research, and administration.

A reduction in funding for NIH research could be justified by its rapid growth in recent years. Between 1982 and 1992, NIH expenditures increased by about 130 percent, or approximately 80 percent after adjusting for inflation. If funds for NIH research were reduced by 10 percent, the 1994-1998 savings in outlays would be about $4.9 billion.

The NIH could respond by limiting its overhead reimbursements for research grants and by funding research projects at a reduced proportion of their costs, thereby encouraging researchers to find additional sources of support (see DOM-44 for a related option). Alternatively, the NIH could cut the number of grants awarded. Since funding of projects is based on a rating system, proposals with the highest ratings would still be supported.

A reduction in NIH funding could, however, have adverse effects on biomedical research and might cause some researchers to leave the field. The NIH cannot currently fund the majority of grants that it approves; in addition, funding is insufficient to support some important areas of research.

DOM-44 REDUCE THE OVERHEAD RATE ON FEDERALLY SPONSORED UNIVERSITY RESEARCH

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	220	230	230	240	240	1,150
Outlays	100	200	230	230	240	1,000

Federal spending for research and development (R&D) performed at universities covers both direct and overhead costs (also known as indirect costs). The major direct costs of research are wages for scientists, engineers, and technicians, and payments for materials and specialized equipment. Overhead costs allocated to federal research include research-related administrative overhead, library and student services, building and equipment used in common, and operations and maintenance. The National Institutes of Health accounts for roughly half of federally sponsored university research. The National Science Foundation and the Department of Defense are also major sources of federal funds.

To calculate the overhead expenses that can be allocated to federal research, universities typically take most, but not all, of their direct costs (known as modified direct costs) and apply a prenegotiated payment rate to them in each of several categories. The sum of the rates from all of these categories is the overall payment rate for overhead expenses. Placing a cap of 50 percent on this rate would save $100 million in outlays in 1994 and $1.0 billion over the 1994-1998 period. To capture these savings, the Congress must reduce the appropriations for university research by an amount corresponding to the mandated reduction in overhead costs.

In 1972, each dollar of direct research funding paid to universities carried an additional 30 cents to cover the overhead costs allocated to federal research. Over the next decade, the share of overhead costs rose rapidly, finally leveling off at around 45 percent beginning in 1985. By 1990, 46 cents in indirect costs were paid for each dollar spent on direct research costs. (Because payment rates are applied only to a portion of the total direct costs and because some agencies pay lower overhead rates for certain grants, the overall payment rate is higher than the ratio of overhead costs to direct costs.) Clearly, the overhead payments for federally sponsored university research have increased faster than the direct costs of research, which have themselves increased faster than the general rate of inflation in the larger economy. Under current policy, the Department of Health and Human Services projects that overhead costs will rise as a percentage of direct costs--reducing the number of grants federal agencies can make. In response, the Office of Management and Budget has recently proposed changes in the rules governing indirect cost payments, in an attempt to simplify administration and reduce costs.

Overhead payments related to facilities have led the increase, contrary to the impression given by well-publicized instances of questionable charges by universities to overhead payment accounts. Such charges have not been a major factor in the long-term growth of the share of overhead costs; in fact, auditors estimate that they account for only about 1 percent of such costs. Increases in the costs of operating and maintaining facilities--utilities, repairs, and janitorial services--have been the major component of the escalation in facilities costs in the past decade. Growth in these costs has continued even in the face of substantial drops in energy prices. Higher costs for new buildings as a result of higher real estate prices, construction inflation, and interest costs have not been as significant.

The rise in the share of funding for federally sponsored university research that goes to pay for overhead has fostered a concern that each federal dollar spent is now producing less actual research activity. Imposing a 50 percent cap on the payment rate for these costs is meant to allay this concern. Some might argue that competition by universities for grants should be sufficient to control the growth of overhead, and that the increases in the share of these costs are an unavoidable outcome of market forces and reflect real cost increases. The market for university research, however, tends to be concentrated among a relatively small number of universities overall, and very concentrated in specific research areas. Because only a few institutions contend for a large share of federal spending for university R&D, it may not be reasonable to assume that competition is enough to hold down overhead costs. The higher overhead rates charged by the largest private universities that are major recipients of federal support may indicate a lack of competition. (There is also some evidence that these same schools may charge much lower overhead rates on private grants.) If competition is indeed lacking, regulatory rules are an appropriate response to ensure that federal dollars are spent in the most productive way. Capping overhead payment rates would supply the discipline that the market has been unable to provide and motivate those institutions that are above the overall cap to become more efficient and cost-conscious.

Defenders of the current system contend that the increases in the overhead costs of university research are legitimate and that the nation's system of research universities will be hurt if universities are not permitted to recover the total cost of the research they conduct. Financially strapped institutions could be forced to reduce investments in new facilities, library collections, and the like. For example, the success seen since 1985 in slowing the growth of overhead costs can be attributed in part to reduced spending on libraries. If inadequate library resources reduce the effectiveness of universities in performing their research and education missions in the future, the near-term savings gained by controlling overhead costs may not be worth the loss of future benefits to society as a whole.

University advocates make other points as well. The higher overhead payment rates of large private universities may not be due to a lack of cost discipline; instead, because these institutions lack state government appropriations, they may simply be more assiduous in claiming all that is rightfully theirs. Another argument made against a cap on overhead rates is that, because the data are lacking to determine the actual total costs of R&D, a cap could be set below the real cost-recovery point.

As an alternative to establishing a single cap for all universities, which would disproportionately affect the most prominent research universities, overall overhead payment rates could be set for all universities at 90 percent of their current level. This option would have the advantage of ensuring that no single university would experience a very large reduction; it would have the disadvantage of hurting small and state universities that have kept their overhead costs low. The option would reduce the deficit by $150 million in 1994 and $1.5 billion over the 1994-1998 period. Many in the research community would advocate reductions in the amount of overhead payments, but would apply the savings to increasing the number of research grants rather than reducing the deficit.

DOM-45 REDUCE FEDERAL RENT SUBSIDIES BY SHIFTING SOME COSTS TO THE STATES OR TENANTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Reduce Section 8 Subsidies			
Budget Authority	30	45	75	220	220	590
Outlays	210	440	700	990	1,300	3,650
			Reduce Public Housing Operating Subsidies			
Budget Authority	110	230	350	480	620	1,800
Outlays	50	160	280	410	540	1,450

Most lower-income renters who receive federal rental assistance are aided through the Section 8 programs or the public housing program, which are administered by the Department of Housing and Urban Development (HUD). These federal programs usually pay the difference between 30 percent of a household's adjusted income and either the actual cost of the dwelling or, under the Section 8 voucher program, a payment standard. In 1992, average federal expenditures per assisted household for all of HUD's rental housing programs combined were roughly $4,200. This amount includes both housing subsidies and fees paid to administering agencies.

Savings in outlays could be achieved by reducing federal payments on behalf of recipients. To diminish or eliminate the impact of this change on assisted tenants, state governments--which currently contribute no funds toward these federal rental assistance programs--could be required to make up some or all of the decrease as a condition of receiving assistance commitments from newly appropriated funds. This option would increase combined tenant and state rental contributions over a five-year period from 30 percent to 35 percent of a tenant's adjusted income. It would save $210 million in federal outlays for the Section 8 programs in 1994 and a total of $3.65 billion over the 1994-1998 period. Savings in outlays for public housing would amount to $50 million in 1994 and $1.45 billion over the five-year period. Realizing these savings, however, would require changing the authorizing legislation for these programs as well as cutting the annual appropriations for vouchers and public housing operating subsidies. (See DOM-19 for a similar option for the rental assistance program administered by the Farmers Home Administration.)

One rationale for involving states in housing assistance is that these programs generate substantial local benefits, such as improved quality of the housing stock. If all states paid 5 percent of the adjusted incomes of those receiving assistance, housing costs for assisted families would not rise. Moreover, since eligibility for housing assistance is determined by each area's median income, tying states' contributions to renters' incomes would ensure that lower-income states would pay less per assisted family than would higher-income states. Finally, if a state chose not to participate and consequently rental payments by its households increased to 35 percent of their adjusted incomes, these out-of-pocket costs would still be well below the nearly 50 percent of income that the typical nonassisted renter who is eligible for assistance now pays.

Absorbing part of the costs of housing assistance would be difficult for the states that are experiencing fiscal distress, however. Unless all states made up the reduction in federal assistance, this strategy would increase housing costs for some current recipients of aid, who are generally poor. Moreover, raising rental payments could prompt some stable, slightly higher-income households to leave assisted housing projects in areas of the country where unassisted housing of the same quality would now be cheaper. This outcome would change the economic mix of households in these projects, possibly reduce the projects' viability, and increase the average cost of subsidizing them.

DOM-46 STOP EXPANSION OF THE NUMBER OF RENTAL ASSISTANCE COMMITMENTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	3,650	3,750	3,850	3,950	4,000	19,150
Outlays	40	470	1,100	1,700	2,450	5,700

NOTE: The CBO baseline does not include budget authority to cover any increases in operating subsidies associated with public housing units to be constructed in the future. Therefore, relative to the CBO baseline, this option does not generate savings in such subsidies.

Each year since 1975, the Department of Housing and Urban Development (HUD) has made new commitments under the Section 8 and public housing programs. These new commitments, which cover periods ranging from five to 20 years, provide rental housing assistance for additional lower-income households, thereby increasing the total number receiving aid. At the end of fiscal year 1992, about 4.7 million commitments for rental assistance were outstanding for all housing programs combined.

Outlays for all rental assistance programs combined totaled more than $18 billion in fiscal year 1992. If those programs are funded for 1994 and thereafter at the rate assumed in CBO's baseline, total outlays will increase to more than $25 billion by 1998. Even if no budget authority is appropriated for 1994 and later years for commitments to assist additional households, outlays will rise to around $23 billion by 1998. That increase will take place because some outstanding commitments have not yet resulted in actual assistance; because subsidies per household increase annually as a result of inflation; and because costs will continue in order to meet such goals as restoring the public housing stock to standard condition and providing incentives to owners of certain housing projects to preserve them for low-income use.

Savings could be realized if the total number of commitments were frozen at the current level. Under this option, enough budget authority would still have to be appropriated to renew all expiring commitments and to fund enough additional ones in each of the next five years to replace commitments that would be lost for other reasons. Incentives to owners to preserve certain rental projects for low-income use would be funded each year at levels estimated by HUD. Modernization of public housing projects would be funded at the 1993 level, adjusted in later years for inflation. This option would reduce outlays by $40 million in 1994 and about $5.7 billion over the 1994-1998 period; additional savings would accrue for up to 20 years thereafter, when all contracts associated with 1994-1998 budget authority would have expired. (See DOM-19 for a similar option for the rental assistance program administered by the Farmers Home Administration.)

An argument in favor of this option is that expanding rental assistance programs is inappropriate in light of present cutbacks in other areas. Furthermore, existing commitments would continue to assist many new income-eligible households each year because of turnover among assisted renters. Finally, no current recipients would lose their housing assistance as a result of this option.

An argument against the option is that the upward trend in the proportion of eligible renters actually receiving assistance has almost leveled off at about 30 percent because the number of new commitments funded annually dropped significantly during the 1980s. If the number of commitments were frozen, the proportion of eligible renters receiving assistance would fall because of continued growth in the number of eligible households. As a result, the problem of homelessness might worsen.

DOM-47 SHIFT HOUSING ASSISTANCE FROM NEW CONSTRUCTION TO VOUCHERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Replace New Construction with Vouchers					
Sections 202 and 811						
Budget authority	960	990	1,000	1,050	1,050	5,050
Outlays	a	-30	-5	85	320	360
Public Housing[b]						
Budget authority	400	410	420	440	450	2,100
Outlays	a	-5	-95	200	320	610
	Partially Replace New Construction with Vouchers					
Sections 202 and 811						
Budget authority	480	490	510	520	530	2,550
Outlays	a	-15	-5	40	160	180
Public Housing[b]						
Budget authority	200	210	210	220	220	1,050
Outlays	a	a	50	100	160	310

a. Increase in outlays of less than $2.5 million.

b. The CBO baseline does not include budget authority to cover any increases in operating subsidies associated with public housing units to be constructed in the future. Therefore, relative to the CBO baseline, this option does not generate savings in such subsidies.

A number of federal programs administered by the Department of Housing and Urban Development (HUD) subsidize the housing costs of lower-income households. The programs provide rental assistance through two basic approaches: subsidies that are tied to projects specifically constructed for lower-income households and subsidies that enable renters to choose standard housing units from existing private housing. Since the early 1980s, construction of low-income housing has been sharply curtailed in favor of using less costly existing housing. The only construction programs under which new commitments are still being made are the Section 202 and Section 811 programs (for the elderly and disabled, respectively) and the public housing program. For 1993, fewer than one-third of additional assistance commitments are for construction of new dwellings, and the remaining ones are provided through the Section 8 existing-housing certificate and voucher programs.

Appreciable savings in the costs of housing programs could be realized by substituting vouchers for new construction. Total savings over the long run are evident when the cost of using vouchers is compared with the cost of new construction in terms of their present values, but not necessarily when they are compared in terms of year-by-year outlays as reflected in the budget. (Present values indicate the amounts of money that would have to be put in the bank today in order to cover the future streams of costs.) This apparent contradiction occurs because of differences in the patterns of outlays for the two approaches. Construction programs require large up-front federal outlays for building the projects, with relatively low annual outlays for operating subsidies thereafter. In contrast, annual outlays for vouchers are more constant over time but exceed those for annual operating subsidies.

The options shown here would eliminate new commitments for construction, or make only half as many, and in each case replace the eliminated commitments with vouchers on a one-for-one basis. The savings shown in the table are not measured in terms of present values, however, because of budgetary conventions. Nevertheless, the budget would show net savings in outlays over the 1994-1998 period for each of the options considered. Under the first option, outlays would decrease by $360 million for the Section 202 and Section 811 programs and by $610 million for the public housing program. Net savings under the second option would be half of those amounts. These savings reflect the elimination of up-front construction expenses. Under both options, savings in outlays would continue to occur for some time after 1998, but eventually the budget would reflect the higher annual outlays of vouchers compared with operating subsidies.

Substantially greater savings in budget authority would occur over the five-year period, but again, these short-term savings do not represent the complete picture. For example, in the Section 202 and Section 811 programs, the savings would derive partially from the shorter contract term of vouchers (five years) compared with rental assistance in the newly constructed projects (20 years). Consequently, they would be offset by higher budget authority after 1998, if expiring vouchers were renewed for 15 more years. (In the calculations of present values, on which the earlier discussion was based, this difficulty was avoided by using the same period of time for both types of aid.)

Proponents of these options see little need for subsidizing new construction. The overwhelming housing problem today, they argue, is not a shortage of rental units but the inability of poor households to afford existing units. For example, nationwide vacancy rates have consistently exceeded 7 percent since 1986, the highest levels since 1968. Furthermore, even if there are shortages, subsidizing new construction may merely displace private activity rather than add to the total housing stock. Also, the construction of subsidized housing is generally a slow process that, at best, has an impact only after a long lag. Vouchers could help the poor more quickly and at a much lower cost to the federal government than would new construction. In addition, vouchers would give the poor greater flexibility in choosing where to live.

National statistics on the supply of rental units, however, may mask local shortages in certain types of units that rent within HUD's guidelines for vouchers. Many elderly and disabled households, in particular, need housing that can provide special social and physical services that are not available in their current residences. Supporters of subsidized construction of units for elderly and disabled households contend that the private sector does not respond adequately to these demands because it produces units that those with low incomes typically cannot afford, even when vouchers subsidize rents. Similarly, a relatively large proportion of lower-income families with children live in crowded conditions. Many of them need units with three or more bedrooms. A number of the nation's large public housing authorities report that their jurisdictions have shortages of these large units with rents within the HUD guidelines.

DOM-48 ELIMINATE HOPE GRANTS FOR LOW-INCOME HOME OWNERSHIP

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	360	370	380	390	400	1,900
Outlays	5	110	200	270	320	910

The Homeownership and Opportunity for People Everywhere (HOPE) grants program, authorized in 1990, provides grants on a competitive basis to resident groups, private nonprofit organizations, local governments, and public housing agencies to enable them to undertake low-income home ownership programs. The eligible housing stock consists of public and Indian housing units, as well as multifamily rental projects and single-family units that are owned (or whose mortgages are now held) by the Department of Housing and Urban Development (HUD) or other federal, state, or local government agencies, including the Resolution Trust Corporation.

Grant recipients may use the funds to help pay for a variety of activities, including the costs of acquiring and rehabilitating these properties for the purpose of transferring ownership to eligible families. These families include current occupants of the units being purchased and others with incomes up to 80 percent of the median income in the area. To ensure affordability, the units must be priced so that monthly payments for principal, interest, taxes, and insurance do not exceed 30 percent of the purchaser's income after certain adjustments. Grants may also be used to provide operating subsidies for up to five years so that total monthly housing costs, which include utilities and maintenance expenditures, do not exceed 35 percent of the adjusted incomes of the purchasers.

For fiscal year 1993, the Congress provided a total of $351 million for HOPE grants. Eliminating these grants would reduce federal outlays by $5 million in 1994 and by $910 million over the 1994-1998 period.

One argument against low-income home ownership assistance is that it does not target scarce resources toward the poorest families. To serve them, purchase prices would have to be reduced nearly to zero, and additional subsidies would need to be provided--perhaps indefinitely--to cover operating costs. Thus, per-unit costs would be relatively high, making it unlikely that such projects would be selected under the competitive funding procedures. Another argument is that low-income families might have to default on their mortgages and face foreclosure if they encountered unexpected repair bills or reductions of income. Finally, some observers have raised concerns about converting public housing units to home ownership, which would reduce a readily available supply of rental units that have traditionally housed the poorest of the poor.

Supporters of direct federal aid for home ownership argue that it should be available to families whose incomes are too low to benefit from tax expenditures for housing. The current tax code effectively encourages home ownership only for middle- and upper-income families, many of whom would choose to own rather than rent even without added incentives. Supporters also argue that home ownership empowers low-income families to take control of their lives by potentially gaining financial equity in an asset that can be passed on to the next generation. Home ownership is also believed to strengthen communities by giving families a greater stake in them and by encouraging better maintenance of properties. Finally, home ownership opportunities in currently unassisted housing (such as that owned by the Resolution Trust Corporation) would give residents of assisted housing projects incentives to improve their economic circumstances, enabling them to leave the projects and making their units available for families on waiting lists for rental assistance.

DOM-49 ELIMINATE SPECIAL-PURPOSE HUD GRANTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	260	270	270	280	290	1,350
Outlays	25	160	260	270	280	990

As part of the 1993 appropriation for the Department of Housing and Urban Development (HUD), the Congress funded 215 special-purpose grants. The conference report accompanying the appropriation act specifies the activities funded by each grant, as well as the communities and organizations receiving them. Although the grants are part of the appropriation for rental housing assistance for low-income households, the overwhelming majority of them are aimed at community and economic development, infrastructure, and public service activities. Specific endeavors include academic research centers and social services and health care facilities.

Eliminating future funding of these types of grants would save $990 million in federal outlays over the 1994-1998 period. One argument for not funding them is that their benefits are strictly local and should be funded at the local level. Moreover, in last year's budget request, the Bush Administration stated that this type of grant violates the principles of open and fair distribution of HUD program resources that were adopted by the Congress in the 1989 HUD Reform Act. The Bush Administration further maintained that these grants were being awarded without authorization and without published selection criteria or competitive application procedures. Finally, they are not always well targeted toward states with low household incomes. In 1993, the nationwide average grant per capita amounts to about $1.00; but among the 15 states with the highest median household incomes in 1991, grants per capita range from zero to $4.76, with five states receiving $1.49 or more. By contrast, among the 15 poorest states, grants per capita range from zero to $10.69, with eight states receiving $0.53 or less.

Without these grants, however, fewer such development and service activities probably will be undertaken because fiscally distressed states and localities will have difficulty offsetting lost federal funds. Depending on the nature of the particular activity, therefore, fewer jobs might be created; various community development projects might not take place; some needed public services might not be provided; and infrastructure might not be developed or might deteriorate. To the extent that these activities would have benefited low-income households, this option would reduce resources available to these households.

DOM-50 MODIFY THE FEE STRUCTURE FOR LOCAL AND STATE AGENCIES THAT ADMINISTER FEDERAL HOUSING PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	85	50	55	110	85	380
Outlays	190	210	230	260	280	1,150

The Department of Housing and Urban Development (HUD) pays fees to local and state public housing agencies (PHAs) for administering the Section 8 existing-housing certificate and voucher programs. For each assisted household, PHAs receive an ongoing annual fee and a one-time fixed fee when the new assistance commitment from HUD is first issued. Under current policy, the annual fee for commitments funded from pre-1989 appropriations ranges from 6.5 percent (for vouchers) to 7.65 percent (for certificates) of the local two-bedroom fair market rent (FMR). The fee for commitments funded from appropriations since 1989 is 8.2 percent for both programs. The ceiling for the one-time fee is now typically $275 for each new commitment.

A 1988 study based on data from a sample of large urban PHAs estimated that annual administrative costs for both the existing-housing certificate and voucher programs averaged about 5 percent of the two-bedroom FMR. The average start-up costs, however, amounted to about $590 per household. Changing the current fee structure to reflect these estimated costs would reduce federal outlays by $190 million in 1994 and by $1.15 billion over the 1994-1998 period. In general, realizing these savings would require changing the authorizing legislation as well as cutting the appropriations for vouchers to reflect the lower fee payments. Even greater savings might be realized if other private or public entities were allowed to compete with the PHAs for the administration of the programs.

Such a fee structure would more accurately reflect the best available information about the costs of providing these types of housing assistance. Moreover, this option would equalize fees for programs that appear to have similar administrative costs and would eliminate the disparity among fees, which now vary according to the year the commitment was first funded. In doing so, the fees would also be easier to administer. Allowing other organizations to compete to administer these programs might lead to increased efficiency.

This option could, however, impose financial difficulties on some PHAs. For example, in areas where FMRs are low relative to the overall cost of living, reduced fees might not cover actual administrative costs. Also, some PHAs may now use their excess reimbursements to cover shortfalls in the funds for other subsidized housing programs that they administer. (Such problems would be exacerbated if the administration of certificates and vouchers were taken over by other organizations.) Moreover, it is unclear whether the study on which these estimated costs are based can be generalized. Smaller urban and rural PHAs may have patterns in their administrative costs that differ from those of the large urban PHAs covered by the study. Thus, some further modifications in the fee structure might be necessary, and that could change the ultimate federal savings.

DOM-51 USE INTERNAL REVENUE SERVICE INCOME DATA TO IDENTIFY UNREPORTED INCOME OF HOUSEHOLDS RECEIVING RENT SUBSIDIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	-5	65	240	230	250	780
Outlays	-5	20	320	630	680	1,650

The Department of Housing and Urban Development (HUD) currently spends more than $18 billion per year to provide rent subsidies to about 4.4 million lower-income households through a variety of programs, including public housing and several variants of the Section 8 program. To qualify for this assistance, a household's income (adjusted for household size) at the time of application typically must not exceed 50 percent of the median income in that geographical area. In general, the subsidy makes up the difference between 30 percent of the household's adjusted income and the unit's actual rent--or, under the Section 8 voucher program, a payment standard. Thus, the admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income.

Concern about the inaccurate reporting of income in other federal means-tested programs, such as Aid to Families with Dependent Children, prompted the Congress to pass legislation in the early 1980s granting federal and state administrators access to Internal Revenue Service (IRS) tax records to verify the incomes of program participants. In 1992, a report by the General Accounting Office pointed to misreporting of income by recipients of HUD's housing assistance as well. In particular, a computer match of IRS data with about 4 percent of the records of HUD-subsidized households revealed that, in 1989, about one in five of the matched households may have understated its income. The potential amount of excess federal subsidies for those matched households was about $40 million.

If HUD were authorized and required to use IRS data to identify households that underreported their income, outlays for housing assistance could be reduced potentially by $1.65 billion over the 1994-1998 period. Gaining these savings for the Section 8 voucher program and for operating subsidies for public housing would require cutting their annual appropriations. Based on current assessments of HUD's progress in centralizing its management information systems, the estimate of savings assumes that a computer matching scheme--which would have to contain strict safeguards to protect the confidentiality of the tax data--would be in place by the beginning of 1995 for the public housing program and by the beginning of 1996 for the Section 8 programs. The estimate accounts for the costs of administering such a scheme.

An advantage of this option is that reducing the subsidies that are now paid to households who underreport their incomes would result in fairer treatment of all recipients of housing assistance. In addition, because housing assistance is not an entitlement program (fewer than one-third of all income-eligible households are currently served), better methods of verifying income would ensure improved targeting of scarce resources. In particular, such methods would prevent new applicants who do not meet the income criteria for eligibility from being admitted to the programs and allow needier households to receive benefits.

Opponents of this option, however, are concerned that the IRS data might be misused, leading to violations of the financial privacy of assisted households. In addition, the IRS fears that wider use of its data for nontax purposes might lessen the compliance of these taxpayers in providing accurate information. The result might be some reduction in income tax collections.

DOM-52 ELIMINATE OR SCALE BACK LOW-INCOME HOME ENERGY ASSISTANCE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate Program			
Budget Authority	2,000	2,050	2,100	2,150	2,200	10,500
Outlays	1,550	2,300	2,100	2,150	2,200	10,250
			Scale Back Program			
Budget Authority	1,000	1,000	1,050	1,050	1,100	5,250
Outlays	780	1,150	1,050	1,050	1,100	5,150

NOTE: The CBO baseline includes $600 million of budget authority and associated outlays in fiscal year 1994 and $3.2 billion during the 1994-1998 period that are contingent on the President's designation of an emergency. In addition, the savings shown for 1994 and 1995 would require a rescission of part or all of the $1.437 billion advance appropriation in the 1993 appropriation act.

The Low Income Home Energy Assistance Program (LIHEAP) helps pay the home energy costs of some low-income households. Authorized by the Omnibus Budget Reconciliation Act of 1981 and administered by the Department of Health and Human Services, LIHEAP funding for block grants to states was $1.9 billion in 1993. States may use the grants to help eligible households pay their home heating or cooling bills, meet energy-related emergencies, or fund low-cost weatherization projects.

Households may be eligible if they receive assistance from certain other programs, such as Aid to Families with Dependent Children or Supplemental Security Income, or if their incomes are low. In addition, federal law requires that states give preference to households with the highest energy costs (relative to income) when disbursing LIHEAP funds. Only about one-third of eligible households actually receive assistance.

Eliminating LIHEAP would save almost $10.3 billion in federal outlays during the 1994-1998 period. Scaling back future appropriations by 50 percent would reduce outlays by about half that amount.

LIHEAP was created in response to the rapid increases in the price of energy used in the home in the late 1970s and early 1980s. Since its enactment in 1981, real energy prices have declined by about one-third, although they remain above their early-1970s levels. These lower real prices might now warrant either eliminating or reducing LIHEAP. Moreover, 30 states transferred up to 10 percent of their LIHEAP funds during fiscal year 1991 to supplement spending on five other social and community services block grant programs; the transfers indicate that some states believe that spending for energy assistance does not have as high a priority as other spending.

The most recent LIHEAP appropriation is 35 percent below the program's original 1981 level of funding in real terms, which is comparable to the decline in real energy prices. However, the appropriation includes $600 million that cannot be spent unless the President designates an emergency. If no such designation is made, the real decline in LIHEAP would be 55 percent, more than the drop in real energy prices. Additional reductions would create hardships for some low-income households, forcing them to choose between paying for energy or for other household necessities. A further argument for retaining LIHEAP at some level is the flexibility it provides to respond quickly to a future spurt in energy prices.

DOM-53 CLOSE OR CONVERT INEFFICIENT OR UNDERUSED FACILITIES IN VETERANS' HOSPITALS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	80	160	240	330	340	1,150
Outlays	65	150	230	320	340	1,100

The Department of Veterans Affairs (VA) operates a nationwide medical care system that in 1992 included 171 hospitals with 55,000 inpatient beds, 129 nursing homes, and 362 outpatient clinics. Most of the hospitals are large, modern, and well staffed, providing access to high-quality care for eligible veterans. Although many of the hospitals are treating increasing numbers of patients, other facilities have experienced a declining demand for services, such as major surgery or common acute care procedures. In response, the VA in 1993 plans to open additional nursing home beds that have been converted from hospital beds.

The VA could achieve greater efficiency by closing small hospitals or underused units within hospitals or by converting them into facilities that offer services in greater demand. The criteria for closure could include the existence of adequate alternative sources of care, as well as low numbers of veterans using the VA facilities. Carrying out this option would require changes in both the program's authorization and its appropriation (see also DOM-55).

The level of savings that could be achieved would depend on several factors: whether complete hospitals or merely wings within hospitals were closed or converted; whether conversions substituted for construction of new nursing homes that would otherwise have occurred; and the extent to which gross savings from closure or conversion would be absorbed by the increased costs for transportation or private care incurred for some veterans under the restructured arrangements. If overall savings were equal to those from the gradual closing of 4 percent of VA hospital beds, federal savings would total about $1.1 billion from 1994 through 1998.

This option would reduce the number of expensive surgical and other acute care medical facilities with low rates of use or occupancy. Closing or converting these facilities would not eliminate VA care for veterans--patients would be transferred to other VA hospitals or appropriate private facilities--but needed care would be provided more economically. To the extent that veterans were transferred to facilities that have greater professional resources or that undertake relevant surgical procedures more frequently, closure or conversion would also improve the quality of the care veterans receive.

This option could have the effect, however, of reducing access to health services for some veterans who receive care on a space-available basis within underused VA facilities. Some veterans might also find care more difficult to obtain if closures in rural areas without other facilities required them to travel greater distances to receive care.

DOM-54 PROMOTE MORE EFFICIENT MANAGEMENT AND DELIVERY OF HEALTH CARE FOR VETERANS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	230	470	720	1,000	2,400
Outlays	0	190	430	690	960	2,250

The Department of Veterans Affairs (VA) operates a nationwide medical care system that in 1992 spent $6.6 billion on inpatient health care services in VA hospitals. Evidence exists, however, that one-quarter or more of the 15.7 million inpatient days in these hospitals have been inappropriate or unnecessary. The excessive use has been attributed to inappropriate admissions and unnecessarily long stays. The latter stemmed both from inefficient management practices (such as performing certain diagnostic tests after, rather than before, admission) and from the lack of less costly levels of care (including nursing home care that could facilitate timely discharges). Moreover, the availability of empty or underused beds in some VA hospitals reduces the pressure to avoid unnecessary inpatient days.

The VA is developing a new system, known as Resource Planning and Management (RPM), to identify more efficient ways to allocate its health care resources. Beginning in 1994, this system is expected to replace the former Resource Allocation Methodology (RAM) system, which was suspended in 1991. However, the VA's undersecretary for health and its regional directors will retain discretion over the extent to which RPM in fact serves as the basis for allocating resources among facilities.

Under RPM, each person receiving VA health care would be assigned to one of seven broad diagnostic categories, based on which of the person's medical conditions is the most expensive to treat. The facility treating the person would receive a capitated annual amount equal to its average historical cost of treating such patients, adjusted for inflation. The VA would review those facilities whose costs for a particular diagnostic category placed them in the top or bottom 2.5 percent of all VA facilities, and would require them to justify the cost or quality, or both, of their care.

The Congress could require the VA to allocate resources for hospital care using a prospective payment system (PPS) similar but not identical to Medicare's system, while increasing the VA's freedom to allocate resources more efficiently. In essence, under a PPS, each patient would be classified in a diagnosis-related group (DRG), which would entitle the hospital to a fixed payment designed to reflect the average cost of efficient care for such a patient. In turn, the VA health care system would receive an overall level of operational funding related to the sum of these amounts. For this option to be effective, however, the VA would also have to be given considerably greater control over the nature and location of VA facilities, the total number of its health care beds, and its total staffing levels. If a PPS were introduced to the VA hospital system beginning in 1995 with a rate structure, for instance, that assumed gains in efficiency of 10 percent after full implementation, federal savings would total about $2.3 billion through 1998. Carrying out this option would require changes in both the program's authorization and its appropriation.

PPS-based funding for VA hospitals would strengthen their incentives to use resources efficiently. In the first year after a PPS was introduced within Medicare, estimated gains in efficiency averaged about 5 percent. Because the government cannot walk away from operating deficits, government health care facilities cannot be placed fully at risk. Nevertheless, this option would identify inefficiently managed hospitals, thereby providing strong incentives for better performance; it would also identify hospitals that would be better converted to other uses (for example, nursing homes) or closed entirely (see DOM-53). Finally, this option would promote efficient use of resources in the next century as the declining number but increasing age of World War II veterans alters the demand for veterans' health care.

One disadvantage of this option is that hospitals serving rural areas that have few alternative facilities might be among the underused hospitals on which a PPS would place the greatest financial pressure. Furthermore, implementing a PPS would be complex. For example, doing so would require defining patient categories covering a broader range of conditions than Medicare's PPS system covers, especially for psychiatric care, which accounts for about 30 percent of inpatient days in VA hospitals but only 20 percent of their costs. Improved review procedures would also be necessary to avoid inappropriate admissions and to ensure that quality of care remained satisfactory. Finally, under this option, the legislative branch would have less control over the nature and location of VA facilities.

DOM-55 PROHIBIT MAJOR CONSTRUCTION PROJECTS FOR VA HEALTH CARE FACILITIES WHEN CARE COULD BE PURCHASED FROM EXISTING FACILITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	50	50	55	55	55	270
Outlays	0	10	20	30	40	95

The Department of Veterans Affairs (VA) operates a nationwide medical care system that in 1992 comprised 171 medical centers with 55,000 inpatient beds, 129 nursing homes, and 362 outpatient clinics. The estimated total cost of construction projects planned or under way in October 1992 to replace or relocate hospitals or to modernize existing facilities was $1.8 billion.

Some of the facilities being constructed or modernized are in locations that contain underutilized non-VA facilities. For example, one 400-bed VA hospital is to be constructed in an area that in 1991 had approximately 2,400 short-term hospital beds, almost 800 of which were typically unoccupied. Another 500-bed VA hospital is being constructed to replace an older facility in an area that in 1991 had more than 4,500 short-term beds; in this case, about 1,350 beds typically were empty.

This option would confine major construction projects for VA medical facilities to areas in which existing medical facilities lack the capacity to provide needed care for veterans. In other areas that have underutilized non-VA facilities, the VA could contract with them to provide health care services. The contracts might cover defined portions of the facilities--for example, entire wards. This option would extend the VA's existing practice--in certain circumstances--of purchasing inpatient, outpatient, and nursing home care from non-VA sources.

If the VA carried out this option and reduced its projected expenditures on major construction projects by 10 percent, the resulting savings would be $95 million over the 1994-1998 period, provided the Congress reduced VA appropriations accordingly. The option would not achieve the forecasted savings if the construction funds were merely redirected to different projects. Some offsetting recurrent costs would arise, however, if contract care were to cost more than VA staff care.

The option would allow the VA to use its financial resources more effectively by not duplicating expensive health care facilities in locations in which comparable medical care for veterans could be purchased from existing non-VA facilities. The long economic life of medical facilities enhances the potential benefits to be gained from avoiding unnecessary capital projects. The arguments for implementing the option are further supported by projections that the number of hospital beds used by the VA for acute care could fall by about 25 percent between 1990 and 2010.

Some people may consider it important, however, for veterans to receive VA-sponsored hospital care in VA facilities. Their reasons might include that the VA can then control the quality of care directly and that care from alternative providers might cease to be available. In addition, using VA facilities assists those veterans who receive care only when space is available within those facilities. A further argument against the option is that, in some cases, prohibiting construction might mean that some veterans would have to travel to more remote VA facilities to receive certain types of specialized care.

DOM-56 REDUCE FUNDING FOR LAW ENFORCEMENT EFFORTS TO CONTROL ILLEGAL DRUGS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	790	1,650	2,550	2,600	2,700	10,300
Outlays	470	1,350	2,350	2,500	2,600	9,350

The federal government currently allocates $10.3 billion to the war on drugs (excluding funds to courts and prisons). Of that amount, about two-thirds is directed toward controlling the supply of illegal drugs in this country, and the remainder is allocated for research and development, treatment, education, and other efforts to control the demand for drugs. Interdiction and international activities account for $2.6 billion of the funds designated for efforts to control the supply of drugs. Since 1988, total federal resources aimed at controlling the drug supply have more than doubled, after adjusting for inflation.

The results of this formidable effort have been mixed, and both supporters and detractors of current law enforcement activities can find encouragement in recent trends. Some indicators show that drug use is significantly less prevalent than it was before the inception of the war on drugs, while others show that there has been no lasting decline. Moreover, different subgroups display widely disparate and uneven trends in use, even when measured by the same indicator. With no clear proof of the efficacy of law enforcement efforts against drugs, some critics argue that the federal government could drastically reduce the resources directed toward the problem without affecting drug use over the long term. A 33 percent cutback in annual appropriations for supply-side efforts, phased in over three years, would save $9.4 billion in outlays over the 1994-1998 period; the amount remaining after the cut would still be greater, in constant dollars, than the funds allocated in 1988.

An alternative would be to direct reductions at specific aspects of drug control instead of making an arbitrary, across-the-board cut. For example, all of the savings noted above could be gained by reducing interdiction and international activities, the two efforts for which critics find the most questionable results. The Congress has already moved to scale back funding for these activities, with the result that these appropriations for fiscal year 1993 were nearly 15 percent below the 1992 level in constant dollars.

Deriving the entire savings from interdiction and international activities would entail nearly eliminating them--not only those conducted by nondefense agencies but those of the Department of Defense as well. About one-third of the interdiction and international activities are defense-related; about half are split between the budget functions for transportation and the administration of justice; and the remainder are in the international affairs function. Another option would be to secure part of the total savings by scaling back other activities of lower priority or questionable value, such as state and local law enforcement assistance in drug control. (See DOM-57 for related cutbacks.) This option would leave unchanged the funding for treatment, education, and other activities focused on controlling the demand for drugs. If the funds being cut from law enforcement efforts to control the supply of drugs were shifted instead to treatment and education, near-term budgetary savings would fall. However, such transfers could have beneficial long-term effects.

Proponents of reducing federal spending for interdiction and international activities argue that these efforts have had little lasting effect on either the availability of or the demand for drugs. They have undoubtedly made it more difficult and more costly to grow, process, import, and distribute illegal drugs; but no hard evidence exists to support the hypothesis that intensified efforts have kept these drugs away from users or pushed prices up to levels that, in the long run, appreciably reduced the amount of drugs being purchased. In addition, current research shows that efforts to cut off the supply of drugs in the country of origin are not cost-effective, because at that point the producers have incurred only minimal costs. As drugs proceed further along the processing and delivery chain, disruptions cause greater financial hardship for the dealer and, one assumes, produce a greater deterrent effect. Therefore, to use law enforcement dollars to the greatest advantage, efforts should focus on the later stages of drug supply, particularly at the level of the street, where responsibility rests with neighborhood groups and local governments. Of course, any effort to control the supply and price of drugs on the street is tenuous for several reasons: competition among producers and distributors, the large markup from wholesale to retail prices, and the ability of distributors to dilute the drug and so maintain an end price that customers can afford.

Proponents of cutbacks in law enforcement efforts also argue that factors related to demand, rather than supply, are dominant in determining drug use. In the past 12 years, most measures of substance abuse show significant declines, including lower levels of serious drug use and reductions in the number of people needing treatment. Although causality cannot be assigned, one could argue that the declines are independent of the level of federal resources allocated to controlling drug use. Proponents of reducing enforcement efforts claim that perceptions of health risks and societal attitudes, not enforcement, have probably reduced the demand for drugs among casual users. They also argue that stepped-up levels of enforcement could not have controlled past increases in the number of people with serious drug problems because hard-core users tend to become immune to such efforts. The advocates of cuts point out as well that drug-related hospital admissions are climbing again, despite vigorous enforcement; however, that development does not necessarily portend a resurgence in hard-core drug use but may simply reflect a deterioration in the health of a small group of hard-core users. Other data, they note, suggest that young people still do not fully recognize the risks associated with the use of drugs. Instead of more enforcement, these critics argue for an expansion or reshaping of existing drug education programs and more attention to societal problems, such as dysfunctional families, that contribute to the overall problem.

Those opposed to cutting funds for drug enforcement and related efforts point to the successful side of these activities: the arrests of major drug traffickers and the large quantities of illegal crops and drugs that have been destroyed or seized. Law enforcement planners believe they can take some credit for the reductions seen in the use of drugs in 1990; they argue that street prices would have been much lower, and the availability of drugs much greater, without extensive funding for criminal justice efforts. Given that overall drug use remains at unacceptably high levels and that some indicators show recent increases in some categories of use, they contend that it would be premature and irresponsible to reduce or shift current resources away from enforcement. They point out, moreover, that criminal justice efforts are needed as much to keep some control over illegal drug activity as to reduce it, and that many programs are hard-pressed to maintain their existing levels of effort even with current funding. Finally, proponents of continued law enforcement resources for drug control maintain that the message of enforcement--that drug trafficking does not pay--is itself a key educational goal of any war on drugs.

DOM-57 ELIMINATE MOST BUREAU OF JUSTICE ASSISTANCE ACTIVITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	180	360	560	570	590	2,250
Outlays	40	140	320	470	560	1,550

The Bureau of Justice Assistance (BJA), a component of the Department of Justice, was created as part of the Omnibus Crime Control and Safe Streets Act of 1968. BJA provides financial and technical assistance to state and local governments to improve the way the criminal justice system operates. The bureau provides financial assistance to the states mainly in the form of grants, part of which must be passed on to local governments. (The specific amount is determined by a formula.) The Anti-Drug Abuse Act of 1988 gave further authority to BJA to make grants for enforcing state and local drug laws and for addressing the problems of violent crime and serious offenders.

Total funding for BJA will exceed $500 million in fiscal year 1993. The money will be used for a wide array of programs, the largest of which is the anti-drug abuse program (Edward Byrne Memorial State and Local Law Enforcement Assistance), which accounts for $475 million. Other major projects include state and local emergency law enforcement assistance, the National Crime Information Center, the Regional Information Sharing System, and the support of Mariel Cubans. (BJA pays the costs of incarcerating prisoners who were brought to America during the Mariel boatlift in 1980 and who subsequently committed felonies). BJA also sponsors initiatives in the investigation and prosecution of child abuse and judicial training to deal with child abuse. Phasing out all of these BJA activities over three years would reduce outlays by $40 million in 1994 and by about $1.6 billion over the 1994-1998 period.

Critics of BJA argue that many of the programs it funds--in particular, efforts dealing with street-level crime--should be handled and paid for exclusively by state and local governments. A further criticism has to do with cost-effectiveness. BJA's total funding constitutes less than 1 percent of the combined expenditures for law enforcement by all levels of government. Such modest funding probably has a limited effect in controlling crime and makes the programs a poor use of scarce resources. Moreover, in programs such as the anti-drug abuse grants, BJA's funding does not necessarily add to the total level of resources committed to the war on drugs. Instead, some recipients might shift funds to other areas of need while using the BJA grants to maintain a consistent level of funding for the targeted law enforcement problem.

The Department of Justice has already proposed terminating several of the less popular BJA programs--for example, the program that pays the incarceration costs of the Mariel Cubans. In addition, the department considers several efforts to be more appropriately the responsibility of state and local family service agencies; this category includes programs for missing Alzheimer's patients and child abuse.

Proponents of BJA counter these criticisms by maintaining that the agency's efforts enhance interjurisdictional cooperation and efficiency. For such activities as disseminating information and offering technical assistance with the latest in law enforcement technology, the federal government is the most effective provider. Many of the smaller programs were established to help with the costs that states have incurred to achieve federally mandated goals or to provide seed money to begin programs for which the states now shoulder most of the burden. BJA's supporters also note the requirement of several of the grant programs for matching funds, which may increase the resources available to combat particular problems. (Of course, these matching funds may already have been earmarked for similar programs and simply repackaged by the states to comply with the grant's mandate.)

Although the funding BJA provides is modest in scale, it has led to successes that have significantly influenced law enforcement at the state and local levels. BJA's supporters thus point to federally supported initiatives and materials (such as McGruff, the crime dog) that promote effective community crime prevention with minimal cost to the federal government. Similar low-cost, high-profile programs have been launched with the help of BJA funds in the areas of drug abuse education and antigang efforts. Without the incentive of federal funds, states might determine that these programs did not merit continued funding in the face of current widespread budget crunches.

DOM-58 END FUNDING FOR THE LEGAL SERVICES CORPORATION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	370	380	390	400	410	1,950
Outlays	320	380	390	390	400	1,900

The Legal Services Corporation (LSC), an independent, not-for-profit organization, supports free legal aid to the poor in civil matters. About 300 state and local programs receive LSC grants from federally appropriated funds. In 1991, more than 1 million of the nation's poor received assistance under such funding.

The Congress continued to support the LSC despite repeated attempts by the Reagan Administration to abolish the program. President Bush's budget for 1993 proposed freezing funds for the LSC at the 1992 level. Terminating federal appropriations to the LSC would save about $1.9 billion in outlays for the 1994-1998 period.

From its inception in 1974, the LSC has been the subject of much controversy. Critics charge that the activities of legal aid lawyers focus too often on the advancement of social causes rather than on the needs of poor people with routine legal problems. The Reagan Administration and others argued that the responsibility for legal aid to the poor should rest not with the federal government but with states and localities. From this perspective, support obtained from other federal grants and expanded support from private sources, including donated services, could help to meet local needs for legal aid. Federal funds for social services block grants totaled $2.8 billion in 1992, about eight times the funding level for the LSC. Such an approach would give localities more control over legal aid programs and therefore would make services more responsive to local needs.

Proponents of the LSC argue that relying on uncertain and indirect forms of support, rather than on a specifically targeted federal assistance program, cannot ensure that legal aid is available to the poor; the inadequacy of local and private support was one of the factors that led to direct federal financing in the first place. Supporters point out that a strong federal program also allows for oversight and national direction. Instead of eliminating the program, the Congress could continue to curtail activities that some observers find objectionable. Some analysts even argue that the level of federal support should be increased. In that regard, critics attacked the Bush Administration's August 1991 report on civil justice reform for not addressing what they viewed as a major problem--inadequate access for the poor.

DOM-59 MODIFY THE SERVICE CONTRACT ACT BY ELIMINATING THE SUCCESSORSHIP PROVISION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	170	180	180	190	190	910
Outlays	160	180	180	190	190	900

The McNamara-O'Hara Service Contract Act of 1965 sets basic labor standards for employees on government contracts whose principal purpose is to furnish labor, such as laundry, custodial, and guard services. Contractors covered by this act generally must provide these employees with wages and fringe benefits that are at least equal to those prevailing in their locality or those contained in a collective bargaining agreement of the previous contractor. The latter provision applies to successor contractors, regardless of whether their employees are covered by a collective bargaining agreement.

The cost of services procured by the federal government could be reduced by permitting successor contractors to pay lower wage rates or to provide less costly fringe benefits than those provided by their predecessors. Under this option, successor contractors would still be subject to the rules on prevailing wages and fringe benefits. This change in requirements would reduce outlays by about $160 million in 1994 and by about $900 million over the 1994-1998 period, provided federal agency appropriations are reduced to reflect the anticipated reduction in costs.

Federal procurement costs would fall because this option would promote greater competition among contractors. The current rule discourages potential successors from bidding on contracts in which the existing provider has a collective bargaining agreement, unless they have similar agreements.

The provision for successor contractors is intended, however, to prevent bidders from undermining existing collective bargaining agreements. Eliminating this provision would reduce the compensation of workers in some firms that provide services to the government. Some supporters of keeping the provision argue that a reduction in compensation would, in turn, reduce the quality of such services.

DOM-60 CUT SALARIES OF FEDERAL CIVILIAN EMPLOYEES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	1,900	1,950	2,000	2,050	2,150	10,050
Outlays	1,400	1,750	1,800	1,850	1,950	8,750

In 1992, the payroll for the government's 2.3 million civilian employees in all three branches of government totaled about $80 billion, or about 6 percent of total federal outlays for the year. (These figures do not include postal workers.) In the past, largely in response to budgetary pressures, the government has acted to reduce federal personnel costs, and the Congress could take such action again. This option describes one of many possible approaches. (DEF-34 presents another approach: limiting annual salary increases.) If the Congress, in October 1993, imposed a one-time reduction in federal salaries of 2 percent, the savings in federal outlays over five years would total $8.8 billion.

Cutting the salaries of federal employees may be viewed as part of a general belt-tightening brought on by the federal budget deficit. Such constraints on spending are not limited to the federal government; financially strapped firms in the private sector and local governments have been forced to cut personnel costs through layoffs, pay limits, or other measures. In the past, limits on pay would have raised major concerns about the ability of the federal government to recruit and retain workers. But such concerns appear less urgent with personnel reductions already under way at the Department of Defense, the potential for reductions in other agencies, and the continued sluggishness of the economy. Should the government experience trouble in hiring and keeping the workers it needs, the Federal Employees Pay Comparability Act of 1990 (FEPCA) offers a means to provide allowances, bonuses, and special pay rates that could help agencies deal with the worst of such problems. (The savings in outlays listed in the above table assume that FEPCA clauses would not be activated.)

Cutting the pay of federal workers, however, raises questions of fairness and worker morale when viewed in the light of the sacrifices federal employees have already made on behalf of the budget. Prior to the enactment of FEPCA, federal employees were entitled to annual adjustments under procedures that compared federal and private-sector salaries nationwide. Yet in 1986, no raise was allowed; in most other years, the increase was well below the level needed to achieve comparability with the private sector. Moreover, restricting pay would represent a revival of the same kinds of practices that led to the need for FEPCA and would undercut that long-deliberated reform. Data collected at the time of FEPCA's enactment showed that federal rates lagged behind comparable private-sector rates: after years of pay limitation, federal workers, on average, were paid 30 percent less. For some occupations and job levels, the gap was almost twice as large. Although the government has not yet experienced wide-ranging recruitment and retention problems, a revival of the practice of chipping away at federal pay rates that are already uncompetitive would likely hurt efforts to recruit and keep good workers in the future.

DOM-61 CHANGE VACATION LEAVE AND OVERTIME PRACTICES FOR CERTAIN MANAGERS AND SUPERVISORS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Eliminate Unlimited Leave Accumulation			
Budget Authority	5	5	10	10	15	45
Outlays	5	5	10	10	15	45
			Discontinue Special Overtime Practices			
Budget Authority	85	90	100	110	110	495
Outlays	85	90	100	110	110	495

Most federal employees may accumulate, and hold unused, no more than 240 hours of vacation leave--the equivalent of 30 working days. When employees leave federal service, they or their survivors are entitled to payment for this unused leave. By contrast, those top managers who make up the government's Senior Executive Service (SES) may accumulate unused leave without limit. If the federal government held the roughly 8,000 members of the SES to the standards that govern leave accumulation for most other employees, payments for unused leave would drop. If appropriations were reduced accordingly, the savings to the government in outlays would total about $45 million over five years.

Managers and supervisors engaged in criminal investigation also receive preferred treatment, but in the area of overtime practices rather than leave accumulation. They may charge the government for overtime, without prior permission. Other managers not involved in law enforcement, although entitled to overtime, generally put in the hours necessary to complete their work without receiving extra pay. (In addition, for these other managers, paid overtime must be approved in advance.) If the government discontinued special overtime practices for managers and supervisors engaged in criminal investigation, the savings in outlays over five years would be $495 million. (In its deliberations on appropriations for 1993, the Congress considered reducing special overtime payments. It finally decided on a general cut in funds without specifically mandating overall reductions in this category. CBO's estimate assumes that the Congress's action will not significantly change the amount of special overtime agencies would otherwise have allowed.)

Unlimited Leave Accumulation. Critics maintain that there is little justification for allowing members of the SES to accumulate unused leave without limit. First, the practice is not common in the private sector. Data from Hay/Huggins, a private actuarial company, indicate that two-thirds of the firms it surveyed allow either no accumulation of leave or the accumulation of no more than the leave earned in one year. Second, members of the SES already receive generous compensation. In addition to salaries that may range as high as $115,700, most senior executives can earn bonuses based on performance that can total as much as 20 percent of their regular pay. Vacations, moreover, are generally considered one way to help ensure that workers remain productive. From this perspective, federal policy should encourage employees to take the vacations to which they are entitled and not accumulate the hours of leave.

Supporters of the leave practice counter that senior managers should be able to spend as much time at the office as their work demands without fear of losing credit for the leave they earn but do not use. In addition, cutting leave for the SES at this time could cause even more members of the SES to leave government service than the large number already expected to begin leaving in January 1994. This projected exodus is the result of the federal retirement policy. Because pensions for most SES members are based on the average of their three highest years of earnings, many senior executives will significantly boost their pensions by remaining in service through January 1994, the third anniversary of a 25 percent raise authorized by the Ethics Reform Act of 1989. After that date, the "high-three" average earnings of SES members who are eligible to retire will rise slowly. Changing the policy on vacation leave accumulation may give SES members one more reason to leave. For some agencies, these departures could mean the loss of experienced leadership and might lead to recruitment problems. The countering argument to this point, however, is that the departure of some members of the SES could be an opportunity to trim the number of top-level jobs and introduce new talent.

Special Overtime Practices. About 33,000 federal employees, 5,000 of them managers and supervisors, may receive compensation for what the government calls administratively uncontrollable overtime (AUO). Most of these employees are criminal investigators working in agencies such as the Federal Bureau of Investigation, the Drug Enforcement Administration, the Internal Revenue Service, and the Customs Service. The government's practice of compensating employees for AUO recognizes that for workers in law enforcement, failing to continue working past normal quitting times may jeopardize public safety. Moreover, obtaining prior approval for overtime in the area of law enforcement is not always practical. (The example of a stakeout illustrates this point.) But for managers and supervisors in law enforcement, it is reasonable to assume that a significant amount of the work charged to overtime covers the same general management activities that other managers frequently perform without extra pay. Managers and supervisors who are eligible for AUO almost always take the maximum allowed--25 percent of base pay--which suggests that this practice may have become a hidden salary supplement.

Those observers who argue for keeping AUO compensation warn that if the government eliminates AUO, some criminal investigators may be reluctant to take management jobs. If it becomes evident, however, that base pay is inadequate to meet the government's recruitment and retention needs, an option would be to reform salary schedules rather than cover the deficiency through overtime practices. A mechanism already exists for such an adjustment: the Federal Employees Pay Comparability Act of 1990 provides authority to establish pay systems designed around the special needs and circumstances of law enforcement occupations.

Chapter Four

Entitlements and Other Mandatory Spending

This chapter focuses primarily on entitlement programs, but it also includes options to create or increase fees charged to private users of federal resources, services, or facilities. Entitlement programs provide benefits to all who are eligible to receive aid and choose to participate. Social Security, Medicare, Medicaid, food stamps, and farm price supports are major federal entitlements. Spending on these and other so-called mandatory programs (other than deposit insurance) accounts for about half of all federal outlays. In 1993, this category is expected to cost $770 billion, or 12.5 percent of gross domestic product (GDP).

Under current law, outlays for mandatory programs are expected to increase at an average annual rate of 6.4 percent between 1993 and 1998. The balance of federal spending is projected to rise by an average of 2.9 percent a year during the same period under the Congressional Budget Office's (CBO's) baseline assumptions, and discretionary spending is projected to increase at an annual rate of only 1.3 percent. Managing the growth of federal spending, therefore, will be largely a matter of controlling the growth of mandatory outlays.

Factors Affecting Entitlement Spending

Spending in entitlement programs is primarily determined by the program rules that govern eligibility, the extent of participation, benefit levels, and the cost of providing noncash benefits, and not by the annual appropriation process. A variety of other factors also cause outlays for entitlements to increase or decrease. These factors include demographic shifts, changes in providers' practices, and rates of inflation. Entitlement spending is, therefore, only partly under the direct control of the Congress.

Total spending on entitlements has grown rapidly since the early 1960s. As a share of GDP, however, most of the increase had already occurred by about 1975. Steadily increasing spending for retirement and disability programs, plus the creation of Medicare and Medicaid in 1965, spurred the growth of federal entitlement outlays from less than 6 percent of GDP in the early 1960s to about 10 percent in 1975. Since then, the share of national production committed to these programs has grown more slowly but is expected to exceed 13 percent by 1998. Federal health care spending grew rapidly during this latter period, offset in part by a relative decline in such other entitlements as aid to jobless workers, veterans' benefits, and farm price supports.

The Budget Enforcement Act of 1990 (BEA) links changes in federal spending on entitlements and other mandatory programs with changes in governmental receipts. Under the act, cumulative legislative changes in mandatory spending programs and federal receipts since 1990 may not increase the combined current- and budget-year deficits through 1995. Thus, an entitlement program can be increased only if another entitlement is cut or taxes or fees are raised. Similarly, a tax can be cut only if another is increased or if entitlement spending is reduced. This requirement, which is called pay-as-you-go, applies not to each new law individually, but to the total impact of all laws since 1990 affecting the relevant fiscal years.

This BEA rule is qualified in several ways. For instance, spending or tax cuts for designated emergencies are exempt from the requirement, although this provision has not been used so far. In addition, the BEA excludes the receipts and mandatory outlays of the Social Security retirement and disability trust funds from all calculations under the act, including the pay-as-you-go requirements. (Social Security is subject to its own set of rules, however, which are designed to protect the balances in these trust funds.)

If the BEA rule is violated, a targeted sequestration--automatic cutbacks applying only to selected mandatory programs--must take place. But many of the major benefit programs (such as Social Security, federal employees' retirement, and most means-tested programs) are wholly exempt from the automatic cuts. In addition, other programs (including Medicare and Stafford student loans) are subject to limited cuts. This leaves a relatively small portion of mandatory spending to bear the brunt of a large pay-as-you-go sequestration.

Program Trends and Options

Mandatory federal spending can be grouped according to its purposes and programs. The level and recent trend in outlays for each category provide a budgetary perspective on its changing importance over time. Outlay projections indicate the likely spending paths if the programs remain unaltered. Within this context, options can be identified that would curb the amount of federal resources going to each area.

Social Security and Other Retirement and Disability Programs

Social Security, the largest entitlement program, is expected to provide benefits of $302 billion to more than 40 million elderly and disabled workers and members of their families in 1993 (see Table 6). Outlays for benefits have grown over the years as a result of expansion in the groups deemed eligible for benefits, more recipients among existing eligible groups, cost-of-living increases in benefits, and the higher real earnings--hence higher benefits--of newly retired workers. The Social Security Amendments of 1983 made major changes in the program to improve its financial standing. Although most changes involved financing and coverage, some changes delayed annual cost-of-living increases to recipients and made some benefits subject to taxation. The amendments also increased the age of eligibility for full retirement benefits from 65 to 67, with the change phased in during the first quarter of the next century.

Baseline projections for Social Security spending reflect the influence of the above factors on the program through 1998. The growth of the beneficiary population will level off over the next few years, however, as the relatively small group of people born during the 1930s becomes eligible.

Although the Social Security program has special rules under the BEA and is not included in the pay-as-you-go budget discipline, it nonetheless represents a major component of federal spending; cutting it would reduce the total budget deficit. Options to alter the program's benefit structure are considered in ENT-68 through ENT-71. In addition, restraint on the annual cost-of-living adjustment (COLA) for Social Security is a major component of ENT-67, which considers all non-means-tested retirement and disability entitlements.

Other retirement and disability programs--which will cost $70 billion in 1993, or about 9 percent of entitlement spending--are dominated by the government's civilian and military retirement programs. Spending on these programs is affected by factors similar to those affecting Social Security, and outlays are expected to increase at like rates in CBO's baseline. Also included in this category are the government's fast-growing contributions for health benefits for civil service annuity recipients. ENT-37 and ENT-58 contain options that would modify benefits for former federal workers, as would ENT-67.

Table 6.
CBO Baseline Projections for Mandatory Spending, Excluding Deposit Insurance
(By fiscal year, in billions of dollars)

	Actual 1992	1993	1994	1995	1996	1997	1998
	Means-Tested Programs						
Medicaid	68	80	92	105	118	131	146
Food Stamps[a]	23	24	24	24	24	25	26
Supplemental Security Income	18	20	24	24	24	28	30
Family Support	16	17	18	18	19	19	20
Veterans' Pensions	4	3	3	3	2	2	3
Child Nutrition	6	6	7	7	8	8	9
Earned Income Tax Credit	8	9	10	13	13	14	14
Stafford Loans[b]	2	2	3	3	3	3	3
Other	3	3	3	3	4	4	4
Total, Means-Tested Programs	146	165	183	200	214	234	255
	Non-Means-Tested Programs						
Social Security	285	302	319	335	351	368	385
Medicare	129	146	167	188	211	234	259
Subtotal	414	449	486	523	562	602	644
Other Retirement and Disability							
Federal civilian[c]	37	39	41	44	48	51	54
Military	24	26	27	28	29	31	32
Other	5	5	5	5	5	5	5
Subtotal	67	70	73	77	82	86	91
Unemployment Compensation	37	33	26	25	25	25	25
Other Programs							
Veterans' benefits[d]	16	16	18	17	16	18	18
Farm price supports	9	16	10	9	9	9	9
Social services	5	5	6	5	5	5	5
Credit reform liquidating accounts	4	3	1	-2	-9	-6	-6
Other	13	13	14	11	9	9	9
Subtotal	47	54	48	40	30	36	36
Total, Non-Means-Tested Programs	565	605	633	666	699	749	796
	Total						
All Mandatory Spending, Excluding Deposit Insurance	711	770	816	866	913	984	1,051

SOURCE: Congressional Budget Office.

NOTE: Spending for major benefit programs shown in this table includes benefits only. Outlays for administrative costs of most benefit programs are classified as nondefense discretionary spending, and Medicare premium collections are classified as offsetting receipts.

a. Includes nutrition assistance in Puerto Rico.

b. Also includes Supplemental Loans for Students (SLS), Parent Loans for Undergraduate Students (PLUS), and the direct loan pilot program.

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

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

Medicare

Medicare was among the fastest-growing of the major spending programs during the 1980s, outpacing defense and Social Security and second only to net interest payments. It includes two related programs: the Hospital Insurance (HI) program, which covers certain costs of hospital stays and other institutional services used by elderly and disabled enrollees, and the Supplementary Medical Insurance (SMI) program, which primarily pays for services by physicians and other providers of outpatient health care. Spending has been fueled in recent years not only by growth in the eligible population, but by inflation in the medical sector that far outstrips general inflation. Increases in the number and complexity of medical services used by enrollees has also contributed to spending. Growth in Medicare spending has persisted despite repeated legislative efforts to control it.

CBO's baseline spending for Medicare projects that HI outlays will rise at a nominal rate of about 12 percent a year between 1993 and 1998. ENT-39 through ENT-49 consider a variety of options to reduce payments to providers of medical services; ENT-50 through ENT-56 discuss several ways to increase beneficiaries' payments.

Medicaid

Medicaid is a joint federal and state program that provides medical assistance for certain people with low incomes. It covers participants in such income support programs as Supplemental Security Income (SSI) and Aid to Families with Dependent Children (AFDC). Other people who have somewhat greater incomes and high medical expenses, and selected groups targeted by recent program expansions--such as low-income children and pregnant women--are also covered. About 70 percent of Medicaid spending goes to the aged and disabled, although they represent less than one-fourth of participants. Much of this money pays for long-term care in nursing homes.

With projected federal outlays of $80 billion in 1993, the size of Medicaid spending dwarfs that of other means-tested entitlement programs. Program outlays rose rapidly in the 1980s as a result of the rising costs of medical care, greater use of covered services, and growth in the size of the eligible population. Under CBO's baseline projections, federal costs are expected to continue their rapid growth. After rising by more than 50 percent between 1991 and 1993, federal Medicaid costs are expected to reach $146 billion by 1998, an average annual increase of 12.8 percent since 1993. At the same time, states' Medicaid outlays are expected to climb at an average annual rate of 12.5 percent--from $61 billion in 1993 to $110 billion in 1998. ENT-32 through ENT-36 describe options that would reduce spending on Medicaid.

Means-Tested Entitlement Programs Other Than Medicaid

In addition to Medicaid, means-tested entitlement programs include Food Stamps; SSI for the aged, blind, and disabled; family support payments (primarily AFDC); pensions for needy veterans who are aged or disabled; child nutrition (such as the School Lunch Program); and the earned income tax credit (EITC). At $85 billion in 1993, spending on these programs represents about 11 percent of entitlement spending. In recent years, caseloads in the AFDC and Food Stamp programs have increased significantly, while real AFDC benefit levels have declined. Largely as a result of expansions in the Tax Reform Act of 1986, federal spending for the refundable portion of the EITC--a federal program that benefits low-income working families with children--has risen from about $1 billion in the early 1980s to $9 billion in 1993. ENT-60 through ENT-66 and ENT-36 would reduce federal spending on certain means-tested programs by more narrowly targeting benefits and limiting federal payments for program administration.

Another means-tested entitlement program is the Stafford Loan program, which subsidizes loans for students attending postsecondary educational institutions. Although it is means-tested, this aid is not as sharply focused on those with low incomes as other means-tested entitlements. It is also less targeted than Pell grants, the main discretionary program providing aid to postsecondary students. The apparent cost of Stafford loans fell sharply between 1991 and 1992 as a result of a change in accounting practices brought about by credit reform. Henceforth, the annual budgetary cost of Stafford loans--as well as that of other federal loan and loan guarantee programs--will consist of the present value of current and expected future subsidies for loans that originate in a specific year.

After 1993, CBO's baseline projections for Stafford loans and other student loan programs show relatively steady program costs of about $3 billion through 1998. These costs are the result of relatively low projected interest rates and expected slow growth in the number of new borrowers. ENT-26 through ENT-29 would reduce the federal cost of Stafford loans by reallocating part of the costs to students and schools. ENT-30 would replace present student loan guarantee programs with a direct loan plan.

Aid to Jobless Workers

Two entitlement programs that provide assistance specifically to unemployed workers are the federal/state Unemployment Compensation (UC) program and the much smaller federal Trade Adjustment Assistance (TAA) program. Spending on UC declined in the mid- and late 1980s but rose significantly in 1990 and 1991 because of the economic slowdown; spending increased further in 1992 because of continued high claims and enactment of the temporary Emergency Unemployment Compensation program in November 1991.

CBO's baseline for the UC program projects relatively constant spending between 1994 and 1998. While lower unemployment is expected to reduce the demand for UC, increases in average benefits will tend to offset that effect. Although UC is included in the federal budget, state laws set most of the benefit and tax provisions in the regular state programs, which provide the vast majority of benefits. Thus, states can generally offset federal options that would reduce regular UC spending, and permanent budgetary savings cannot usually be attributed to federal changes in regular UC rules. As a result, this chapter does not include federal options limiting regular UC benefits. ENT-59 would reduce the TAA program, however.

Non-Means-Tested Veterans' Programs

Veterans' benefits constitute another substantial category of federal entitlement spending. CBO projects that non-means-tested spending for veterans' compensation, readjustment benefits, life insurance, and housing programs will total about $16 billion in 1993, with relatively slow growth projected through 1998. ENT-72 through ENT-75 would restrict federal spending on veterans' benefits by limiting eligibility for certain programs and raising costs to participants. In addition, ENT-71 would reduce Social Security disability payments for some of those also receiving veterans' compensation.

Farm Price Supports

Spending for farm price and income support programs and other mandatory agriculture-related programs is expected to be $16 billion in 1993, about half its peak of $29.5 billion in 1986. The price and income support programs administered by the Department of Agriculture's Commodity Credit Corporation (CCC) dominate this category. Reduced federal spending since 1986 reflects cuts in support rates and reductions in the amounts of land on which payments are based. Rising commodity prices also contributed to the decline in spending.

CBO's baseline for these programs projects further reductions in spending, to about $9 billion by 1998. Target prices are assumed to remain constant during this period; projected outlays decline mostly because commodity prices are expected to rise gradually. ENT-06 through ENT-09 and ENT-13 through ENT-17 consider ways to reduce federal spending by lowering outlays for commodity programs and the crop insurance program. ENT-10 through ENT-12 would lower federal spending by cutting programs that subsidize or promote exports of farm commodities.

User Fees and Other Changes in Direct Spending

Fees can be charged to users of resources, facilities, or services provided by the federal government to raise funds to help pay their costs and to promote their more efficient use. Options describing new or increased fees in a variety of areas are included in this chapter (ENT-01 through ENT-05, ENT-18 through ENT-25, ENT-48, ENT-65, ENT-66, and ENT-73). Receipts from fees would be treated under the Budget Enforcement Act like spending changes in entitlements or mandatory programs if the legislation changing the fees originated in an authorizing committee. In this case, the added receipts from fees would be credited to the pay-as-you-go scorecard.

In recent years, however, legislation originating in appropriations committees has changed some fees. If options in this volume were to be enacted in this way, the resulting spending reductions for the budget year would allow spending on discretionary programs to be raised by the same amount.

ENT-01 REQUIRE DEPARTMENT OF ENERGY TO RAISE RATES FOR FEDERAL HYDROELECTRIC POWER TO SPEED DEBT REPAYMENT

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	0	260	250	240	220	970

Hydroelectric power, generated at 129 plants owned and operated by the federal government, is sold by the Department of Energy (DOE) at wholesale rates to utilities for delivery to their customers and to certain large industrial electricity users in the Pacific Northwest. In 1991 these plants generated about 6 percent of the electricity sold in the United States, and DOE collected $3.3 billion from consumers. The cost of operating these systems was $2.6 billion in 1991. By law, the rate charged for electricity thus generated must be sufficient to recover the government's cost of operating and maintaining the facilities, as well as recouping the plants' construction cost plus interest. Under current regulations, however, DOE has great flexibility in determining when to collect power revenues to repay the outstanding debt on existing plants.

From the 1930s until 1991, the government invested $18.7 billion in the construction of hydroelectric projects and related facilities. The interest rate charged for the use of this appropriated construction money varied over the years, but averaged about 3 percent. Since 1933, the sale of federal hydroelectric power has generated $8.1 billion in interest and $4.7 billion in principal for the Treasury. The remaining debt of these federal hydroelectric projects is $14.1 billion.

Current regulations generally require that the cost of constructing federal power projects be repaid to the Treasury by the end of the project's useful life. DOE defers making any principal payments to the Treasury on many hydroelectric projects until 50 years after they have gone into service. By deferring principal payments on the debt of these federal hydroelectric facilities, the DOE increases the federal budget deficit.

Requiring DOE to repay the current hydroelectric debt of $14.1 billion (as well as future debt) with fixed annual principal and interest payments would increase Treasury receipts by about $1 billion over the 1994-1998 period. Regular annual principal payments would cause DOE to increase its electricity rates. CBO estimates that it would take DOE about 12 months to put into effect the electricity rate increases required under this proposal. Additional budget receipts would therefore start in 1995.

Even though applying a fixed repayment schedule as described would increase electricity prices for the consumers involved, rates in the Pacific Northwest would still rank among the nation's lowest. It has been argued that DOE needs the ability to defer principal payments to the Treasury because of the fluctuations in the water supply available for hydroelectric generation. Contingency funds or other mechanisms could be used to reduce the risk of revenue shortfalls. It should be noted that the Tennessee Valley Authority is also heavily dependent on hydroelectric power, but it has made annual principal payments on its outstanding Treasury debt since 1960. Granted, a fixed repayment schedule for DOE's debt to the Treasury would conflict with DOE's mandate to encourage the widest possible use of federal hydroelectric power at the lowest possible cost. But the current policy of deferring debt until the end of a project's lifetime may lead to large "balloon" payments and much higher electricity prices in the future. In addition, today's lower electricity rates at federal hydroelectric projects--made possible, in part, by deferring principal costs--are inconsistent with the government's energy conservation objectives.

ENT-02 IMPROVE PRICING FOR COMMERCIAL AND RECREATIONAL USES OF PUBLIC LANDS

Addition to CBO Baseline	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Raise Grazing Fees	5	15	20	20	20	80
Raise Charges for Federal Water	15	15	15	15	15	75
Raise Recreation Fees at Federal Facilities	160	170	180	190	190	890

The federal government owns and manages more than 700 million acres of land in the United States. This land is used in a wide range of ways, including grazing, water reclamation, and recreational activities. For most commercial and some recreational uses, the government is compensated--often by fees. In some cases, those fees may not provide the government with a fair return, and underpricing may lead to overuse. Better pricing could increase federal receipts and alleviate overuse by limiting commercial and recreational activity.

Grazing Fees. The Forest Service and the Bureau of Land Management (BLM) administer livestock grazing on approximately 268 million acres of public rangelands in the West. These lands provide ranchers with approximately 31,000 grazing allotments and, at current leasing rates, more than 17.5 million animal unit months (AUMs) of grazing each year. In 1990, the appraised value of public rangeland in six western regions varied between $5 and $10 per AUM. The Forest Service spends, on average, about $3.90 per AUM to manage its rangelands. By contrast, the 1992 permit fee was set at $1.92 per AUM under the fee formula established by the Congress. Thus the current fee structure may represent a large subsidy for many of the ranchers who participate in the program.

Various proposals have been introduced in the Congress to increase the grazing fee. These proposals would either adjust the fee-setting indexes to reflect livestock markets and private rangeland leasing rates, or replace the existing fee structure with a new, modified market value. The increase in federal receipts resulting from either measure depends on the degree to which ranchers reduce their grazing stock because of the increased fees.

A recent proposal called for an annual increase in the grazing fee, not to exceed 33.3 percent a year, with the fee reaching fair market value over a period of four years. The amendment would calculate the fair market value using the appraised value of grazing lands in the lowest valued of the six western regions. If passed into law in 1993, the amendment would lead to an increase in federal receipts of approximately $80 million over the 1994-1998 period. This figure is the amount that would be left in the Treasury after deducting the additional receipts that would be paid to states and counties because of the amendment, but it does not reflect any additional appropriations for range improvements that could result from the added receipts.

Increased fees for grazing on public lands may overstate the value of those lands when compared with private properties that might be in better condition or offer more favorable lease terms. In addition, low fees may encourage permit holders to invest in range improvements and to practice good stewardship over the land by grazing only at permitted levels. A potential disadvantage of increased fees is that they would cut ranchers' profit margins and thus might encourage them to break the grazing limits and forgo range improvements. Between 1979 and 1983, however, ranchers spent, on average, only 16 cents per AUM per year for range improvements. Increased funding from the Range Betterment Fund would offset any decrease in private range improvements. Providing ranchers with longer-term leasing agreements, regardless of their fee level, could promote efforts to combat overgrazing.

As an alternative to setting fees, grazing rights could be allocated through a competitive bid process similar to the system used by the Bureau of Indian Affairs. Disadvantages of this approach are high administrative costs and limited competition. In many cases, only the owners of private lands adjacent to federal lease tracts would be willing to bid for grazing rights. Permit holders do not normally have complete control over third-party access to the permit area. Thus, permit holders may hope to maintain control by owning and regulating the private lands that surround the lease tract. (In addition, current law requires permit holders to own a base property near the federal lease tracts.)

Water Sales. The Bureau of Reclamation provides water resources for industrial and agricultural uses in the western states and also supplies municipal water systems. This water is made available through long-term contracts with water-district commissions that are composed of individual private users. Water prices charged under these contracts generally run much lower than the true market value of the water. For many agricultural users, the charges rarely cover the federal costs associated with water projects. Federal water is often provided at less than its full costs for agricultural commodities, such as rice, that are subject to price support programs.

In recent years, the Congress has considered several reforms aimed at reducing the subsidy to agricultural users of federal water and at increasing receipts to the Treasury. In October 1992, H.R. 429 --a bill affecting the operation of the Central Valley Project (CVP)--was signed into law. H.R. 429 sets aside water for fish and wildlife, introduces a two-tier pricing system for agricultural users of CVP water, shortens the lengths of new CVP contracts, and prevents the Bureau of Reclamation from entering into new contracts until environmental goals are reached. There are, however, other opportunities for price reform that H.R. 429 does not address.

One reform would require that all farms of more than 960 acres be charged the full cost of federal irrigation water. (Current law contains this requirement but is often circumvented because of the vague definition of the term "farm.") Another reform would allow those who grow agricultural commodities that are in surplus to receive only one of the federal subsidies currently provided: either crop price support payments or federally subsidized water. These two reforms illustrate changes in the current system that could increase federal receipts from sales of water. Taken together, they could lead to increased receipts of $75 million over the 1994-1998 period.

Recreation Fees. All major federal landholding agencies allow recreational access and provide some visitor services. The services range from maintaining rough hiking trails to operating fully developed recreational facilities, such as campsites and marinas. Entrance and user fees are charged at some locations and will increase in 1993, but the fees will still cover only a small portion of the direct service costs. For example, in 1993, the National Park Service will spend an estimated $230 million on visitor services and will recover only about $75 million in fees. Requiring land management agencies to charge fees to cover these direct costs would shift the cost burden to the beneficiaries of the services and would result in improved pricing of public land use. Such fees would lower net federal costs by $160 million in 1994 and by $890 million over five years.

Arguments against additional increases in fees reflect the notion that the national parks and public lands are a vital and accessible part of the national heritage. The social benefits of visits to the parks far exceed the government costs. Visits should not be discouraged by increasing fees.

With additional increases, however, taxpayers would not have to bear costs for police protection and other services that benefit only the users. The overcrowding that is now a problem at many parks could be alleviated by an appropriate fee structure. And visits by the poor and the elderly could be encouraged by free-access days or cross-subsidies for urban parks, by which fees collected at some parks would be used to offset the costs of maintaining others that have lower charges or none at all.

ENT-03 CHANGE REVENUE-SHARING FORMULA FROM A GROSS-RECEIPT TO A NET-RECEIPT BASIS FOR COMMERCIAL ACTIVITIES ON FEDERAL LANDS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	170	170	180	190	200	910
Outlays	130	170	180	190	200	870

The federal government owns more than 700 million acres of public lands--nearly one-third of the U.S. land mass. These public lands contain a rich supply of renewable and nonrenewable natural resources: timber, coal, forage for livestock, oil and natural gas, and many nonfuel minerals. Private interests are given access to much of the federal land to develop the resources found there. Generally, private parties pay fees to the federal government based on the commercial returns realized. In many cases, the federal government allots a percentage of those receipts to the states and counties containing the resources, as compensation for tax revenues forgone from the federal lands within their boundaries.

The government typically calculates the allotments to states and counties on a gross-receipt basis before taking account of its program costs. This practice has an important disadvantage: providing federal receipts-sharing on a gross--rather than a net--basis sometimes causes the federal government's program costs to exceed its share of receipts.

By law, the U.S. Forest Service allots 25 percent of its gross receipts from commercial activities in the national forests to the respective states and counties. The Department of the Interior allots 4 percent of its timber receipts, about 12.5 percent of its grazing fees, and 4 percent of its mining fees from "common variety" materials to the states; the Department of the Interior, specifically the Minerals Management Service (MMS), allots 50 percent of its adjusted onshore oil, gas, and other mineral receipts to the states. (The MMS deducts 50 percent of its administrative costs from the gross-receipt calculation before distributing those payments. In effect, the states share 25 percent of the burden of these administrative costs.) On Oregon and California grant lands, gross federal receipts from all commercial activities, primarily timber sales, are shared with the states and counties on a 50/50 basis.

Federal savings would be substantial if the Congress required these agencies to deduct their full program costs from their gross receipts before making payments to states. The regional jurisdictions would continue to receive the same allotted percentage of net federal receipts and would accrue receipt shares totaling about $580 million in 1994.

Certain federal costs could increase, however, under the federal Payment in Lieu of Taxes (PILT) program, which was established in 1976 to offset the effects of nontaxable federal lands on the budgets of local governments. These PILT payments to the states are partially reduced by the amount of revenue-sharing payments from federal agencies. Payments under the PILT program would increase if the option to share the net program receipts was realized and if Congress appropriated such an increase. These additional payments have been netted out of the projected savings. Changing the revenue-sharing formula from a gross-receipt basis to a net-receipt basis would reduce net federal outlays by $870 million over the 1994-1998 period.

Changing the revenue-sharing formula to a net-receipt basis would probably affect the economies of some states and counties adversely. A significant source of revenue for them would be reduced. That reduction might lead to serious cuts in state and county spending. To help mitigate that hardship, the federal agencies could switch gradually to the net-receipt basis over a period of several years.

ENT-04 INDEX NUCLEAR WASTE DISPOSAL FEES FOR INFLATION

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	15	35	50	65	80	250

Electric utilities pay one mill (one-tenth of a cent) into the Nuclear Waste Fund for each kilowatt-hour of electricity sold from a nuclear power plant. The fund finances the development of storage and permanent disposal facilities for high-level radioactive wastes; the first permanent repository is projected to open in 2010. The fee has remained constant since its inception in 1983, although the price level (measured by the gross domestic product deflator) has risen 42 percent since then. Based on current CBO projections, indexing the fee for inflation would raise $250 million over five years.

The primary arguments in favor of this proposal are that the current fee may be insufficient to finance the necessary disposal facilities, especially because its value is eroded over time by inflation; and that indexing equitably allocates the costs between present and future operators of nuclear power plants. A June 1990 study by the General Accounting Office argued that historically plausible inflation and real interest rates (4 percent and 3 percent, respectively) could produce a present-value shortfall of $2.4 billion in 1988 dollars--roughly 10 percent of total system costs--if the fee remains fixed.

Against automatic indexing, the Energy Department argued in a November 1990 report that recent revenue estimates show the fund roughly in balance; that given present levels of uncertainty, the fund may in fact be collecting too much money; and that occasional "step" adjustments in the fee, introduced as new information is acquired, would be a better way to avoid any problems of under- or overfunding.

ENT-05 CHARGE ROYALTIES AND HOLDING FEES FOR HARDROCK MINING ON FEDERAL LANDS

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	50	130	130	130	130	560

The General Mining Law of 1872 governs access to hardrock minerals--gold, silver, uranium, copper, molybdenum, and most other metals--on the public lands. Once a claim is staked, the claimant must spend at least $100 on development a year on each claim (claims cover 20 acres). For fiscal years 1993 and 1994, a holding fee of $100 a year has replaced the development requirement.

After spending $500 on developing a claim, and once minerals are determined to be economically recoverable, the claim holder may apply to buy (patent) the claim by paying the federal government $2.50 or $5 an acre, depending on the type of claim, plus a small application fee.

Legislation to reform the Mining Law of 1872 has been introduced in the Congress for at least the last two sessions. Most recently, in the 102nd Congress, three committees in the House of Representatives approved a reform bill (H.R. 918). A similar bill (S. 433) was introduced in the Senate. These proposals were aimed at changing the hardrock mining system to resemble more closely the leasing system currently used for exploration and development of oil and gas on federal lands. Such a system would include requirements that claim holders continue to pay an annual holding or rental fee while exploring for minerals. In addition, mining operators on public lands would have to share the profits of mineral production with the federal government by paying a royalty based on the value of minerals produced. Finally, the proposals contain a moratorium on patenting, thus preventing mining operators from evading royalties by buying the land.

The Congressional Budget Office estimates that the $100 annual holding fee would increase receipts to the federal Treasury by about $50 million annually, beginning in fiscal year 1994.

Based on estimates by the General Accounting Office that the value of hardrock mining production on federal lands amounts to at least $1.2 billion annually, CBO estimates that an 8 percent royalty would provide the federal Treasury with $80 million a year in additional receipts, beginning in fiscal year 1995.

It is difficult to estimate rental and royalty receipts because the effect of imposing fees on hardrock mining on federal lands is uncertain. In order to prepare these estimates, CBO assumes that some claims would be relinquished and some production on federal lands would be cut back, at least in the short run.

Those in favor of mining law reform--primarily the environmental community--argue that because the current fees for maintaining a claim on public land are nominal, too much land is tied up in mining. They argue that although the principle of free access may have been an effective tool in encouraging the settlement of the West and the production of minerals vital to the development of this country, it is no longer necessary for either of these goals. Also, they argue that holding fees and royalties will compensate the federal government for the use of public lands and the extraction of minerals.

Finally, proponents of mining reform argue that charging for the use of federal lands and its resources will encourage the mining industry to focus on those lands most likely to yield profitable returns. This will free up land for other public purposes such as recreation and wilderness conservation. In addition, a portion of the receipts from rental fees and royalties could be dedicated to land reclamation after the completion of mining activities.

Opponents of mining law reform--primarily the mining industry--argue that in the absence of free access, exploration for hardrock minerals, particularly by small miners, would decline. They also argue that fees and royalties, by increasing costs to an industry that is already operating close to the margin of profitability, would decrease development of minerals and affect regional economies adversely. Since many mineral prices are determined on a world market, mining operators would be unable to pass along most of the royalty and holding fee costs to consumers. Thus some mines will be forced to shut down, and ripple effects would be felt throughout the regions where the mines are located.

Finally, opponents of reform contend that developing a system to collect fees and monitor mining activities more closely will be administratively expensive.

ENT-06 REDUCE DEFICIENCY PAYMENTS TO FARMERS PARTICIPATING IN USDA COMMODITY PROGRAMS BY LOWERING TARGET PRICES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	400	1,300	2,250	3,200	4,050	11,200
Outlays	400	1,300	2,250	3,200	4,050	11,200

Farmers who participate in federal commodity programs--those who produce corn and other feed grains, wheat, rice, and cotton--receive a deficiency payment, which is the primary form of direct government subsidy to growers. The size of the deficiency payment is calculated in part from the difference between the market price of a crop and a target price (see accompanying table for the target prices set by current law through the 1995 crop year). The CBO baseline assumes that target prices are maintained at these levels for the 1996-1998 crop years.

Budgetary savings could be achieved by reducing target prices in the years after 1993. The greater the rate of reduction, the greater would be the savings. One alternative (see Table 7), would be to reduce target prices by 3 percent per year starting with the 1994 crops. Outlay savings would be an estimated $11.2 billion over the 1994-1998 period.

An advantage of reducing target prices is that it would increase the degree to which farmers respond to market prices, rather than to government program benefits, in making their production decisions. U.S. competitors and trading partners view deficiency payments as trade-distorting. Target price reductions would be seen as evidence of an intention to reduce the effects of domestic farm policies on world trade in agricultural commodities, a goal of the United States in the General Agreement on Tariffs and Trade talks.

Lower target prices would reduce farm income by reducing direct government payments. Farm income would not fall as much as government outlays because some farmers would choose not to participate in the commodity programs. Although these farmers would give up all of their government payments, they would not be required to idle part of their acreage and thus would generate income from additional production. With additional grain production, livestock producers might benefit from lower feed costs.

Despite an improved outlook for agricultural markets, many farmers are still facing financial difficulties. In some cases, financial problems were worsened by droughts in recent years. Further reductions in target prices would intensify these difficulties. Providing financial assistance directly to needy farmers might, however, be more appropriate and would certainly be more cost-effective because the bulk of deficiency payments go to larger, usually wealthier, farmers.

Table 7.
Target Prices Under CBO Baseline Assumptions and Under 3 Percent Annual Reductions (By crop year)

	1993	1994	1995	1996	1997	1998
			CBO Baseline Assumptions			
Wheat	4.00	4.00	4.00	4.00	4.00	4.00
Corn	2.75	2.75	2.75	2.75	2.75	2.75
Rice	10.71	10.71	10.71	10.71	10.71	10.71
Cotton	0.729	0.729	0.729	0.729	0.729	0.729
			3 Percent Annual Reductions			
Wheat	4.00	3.88	3.76	3.65	3.54	3.43
Corn	2.75	2.67	2.59	2.51	2.43	2.36
Rice	10.71	10.39	10.08	9.77	9.48	9.20
Cotton	0.729	0.707	0.686	0.665	0.645	0.626

SOURCE: Congressional Budget Office.

NOTE: Wheat and corn in dollars per bushel; rice in dollars per hundredweight; cotton in dollars per pound.

ENT-07 ELIMINATE THE 0/92 AND 50/92 PROGRAMS FOR PARTICIPANTS IN USDA COMMODITY PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	130	300	290	320	400	1,450
Outlays	130	300	290	320	400	1,450

Current law allows participants in U.S. Department of Agriculture (USDA) price and income support programs to receive 92 percent of their deficiency payments, even though they may plant as little as 50 percent of their eligible acreage in the program crop (the 50/92 program available to cotton and rice producers), or even though they do not plant any of the program crop (the 0/92 program available for wheat and feed grain producers). Producers must leave the land idle or, under certain conditions, may plant minor oilseeds such as sunflower, flaxseed, and canola. This option would eliminate these programs. Producers would have to plant the program crop to receive deficiency payments. In the 1992 crop year, about 10 million acres that went unplanted to the program crops received payments under the 0/92 or 50/92 programs.

Eliminating these programs would save $1.5 billion over the 1994-1998 period. This estimate assumes that the Secretary of Agriculture would increase the Acreage Reduction Program requirement for each supported crop if it was anticipated that eliminating the 0/92 and 50/92 programs would increase plantings. Participation in the acreage reduction program, under which producers agree not to plant a portion of their eligible land in the supported crop, is voluntary and unpaid. Producers must participate, however, to receive deficiency payments and other program benefits.

Eliminating these programs (and maintaining production at a given level by increasing the acreage reduction programs) would in effect substitute unpaid acreage reduction for paid acreage reduction. The Secretary of Agriculture has considerable discretion to increase unpaid acreage reduction requirements under the current outlook for program commodities, and proponents of this option would argue that there is no need to pay farmers to cut acreage. The 0/92 and 50/92 programs were introduced at a time when unpaid acreage reduction requirements were high, and the Secretary had little discretion to increase them.

Those who are against eliminating these programs would argue that such a move would constitute "recoupling" program benefits with planting decisions, encouraging farmers to plant some land that might better be left idle from the perspective of market returns alone. Others would point out that these programs are a safety net for farmers who cannot plant their program crops because of poor weather conditions during planting time. Sign-up periods for the 0/92 and 50/92 programs extend well past normal planting times. Other forms of disaster assistance may be more appropriate in these cases, however.

ENT-08 RAISE THE PROPORTION OF EACH FARMER'S BASE ACREAGE INELIGIBLE FOR DEFICIENCY PAYMENTS FROM 15 PERCENT TO 25 PERCENT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	370	880	860	900	910	3,900
Outlays	370	880	860	900	910	3,900

Outlays of the Commodity Credit Corporation could be reduced by cutting the number of acres eligible for deficiency payments. This option could save $370 million in 1994 and $3.9 billion in the 1994-1998 period.

Currently, wheat, feed grains, cotton, and rice producers who participate in commodity programs receive a deficiency payment. The size of the deficiency payment is generally equal to the difference between the target price for the commodity and its market price times the program yield assigned to the farm, times "payment acres." Payment acres equal 85 percent of the farm's crop acreage base, less land idled to comply with the acreage reduction program that is in effect for the crop during that crop year.

This option would expand the changes made in the Omnibus Budget Reconciliation Act of 1990 by decreasing the amount of land eligible to receive deficiency payments from 85 percent to 75 percent of base acreage. Producers would be permitted to plant any program crop or oilseed on this additional unpaid acreage without losing eligibility for future program benefits. These changes would be introduced to reduce program spending and to increase the flexibility that farmers have in making planting decisions in response to the needs of the market rather than the rules of the farm programs.

A disadvantage of this option is that it would decrease farm income for most participants in commodity programs and for people raising crops that do not directly receive federal support. Program participants would generally shift production away from program crops on land no longer earning subsidies and toward alternative crops. As a result of these changing production patterns, the incomes of growers of nonprogram crops would be hurt by the new competition.

ENT-09 RESTRICT ELIGIBILITY FOR BENEFITS FROM PRICE SUPPORT PROGRAMS AND REDUCE THE PAYMENT LIMITATION

Savings from CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Annual Savings (Millions of dollars)					
Limit Payments to $50,000 per Person						
Budget Authority	70	140	150	160	150	670
Outlays	70	140	150	160	150	670
Limit Payments to $40,000 per Person						
Budget Authority	120	270	290	300	290	1,250
Outlays	120	270	290	300	290	1,250
Disqualify People Whose Adjusted Gross Income Exceeds $100,000						
Budget Authority	30	60	70	70	70	300
Outlays	30	60	70	70	70	300
Disqualify People Whose Gross Revenue from Commodity Sales Exceeds $500,000						
Budget Authority	70	140	150	160	160	680
Outlays	70	140	150	160	160	680

Current law limits participants in crop price support programs to no more than $100,000 in deficiency payment benefits from the Commodity Credit Corporation during any crop year. The maximum in deficiency payments that can be received is $50,000 for an individual, plus $25,000 as a shareholder in a maximum of two corporate farms (each of which is entitled to a maximum payment of $50,000). The maximum of $100,000 can be achieved only by those who are actively engaged in the operations of relatively large farms and who have organized their farm businesses to maximize government payments.

Government costs could be reduced by allowing each farm operator to receive only the individual payment and eliminating the two corporate farm payments. This option would reduce spending by an estimated $670 million during the 1994-1998 period. Outlays could be cut further by reducing the maximum direct payment from $50,000 to $40,000, with estimated savings totaling $1.25 billion over the 1994-1998 period.

Eligibility for payments could also be limited on the basis of income or gross sales. Disqualifying people with adjusted gross income from all sources over $100,000 would save an estimated $300 million over the five-year period. Disqualifying people with gross revenues from commodity sales over $500,000 would save an estimated $680 million over the period.

Support for these changes is based on the belief that current payment limits are too high. If reductions in program spending are required, they should come from relatively large farming operations rather than relatively small ones. In addition, reducing the limit on direct government payments would reduce their influence on the production decisions of operators of large farms, causing them to be more responsive to market returns. Operators of smaller farms, who are more likely to need government assistance, would continue to receive program benefits as before.

This change could harm farm operations of a relatively efficient size. In addition, until operating and price subsidies are reduced for producers in foreign countries, increasing the exposure of the most efficient U.S. farmers to market forces could hurt long-term prospects for the farm sector. Finally, the ability of farmers to reorganize their holdings to avoid the payment limitations increases the uncertainty of the estimated budgetary savings as well as the effect on farmers.

ENT-10 REDUCE LOAN GUARANTEES MADE UNDER THE USDA'S EXPORT CREDIT PROGRAMS AND ELIMINATE LOANS TO ESPECIALLY RISKY BORROWERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	-520	590	510	510	510	1,600
Outlays	-520	590	510	510	510	1,600

The U.S. government guarantees short- and intermediate-term loans made by commercial banks to finance foreign purchases of U.S. agricultural commodities and products. Legislation requires that a minimum of $5.5 billion in loan guarantees be made annually, although actual levels of guarantees have been lower. There is no limit on the total amount of guarantees, but there is a requirement that borrowers be creditworthy. The purpose of these programs is to encourage exports of U.S. goods. Credit terms, in addition to price, are an important element of competition in world markets.

When a foreign buyer misses a loan payment, the bank making the original loan submits a claim to the U.S. Department of Agriculture. The USDA reimburses the bank, takes over the loan, and attempts collection. The U.S. government guarantees 98 percent of the principal of the loan, except loans to the former Soviet Union. In these loans, the government guarantees 100 percent of the principal.

This option would limit annual guarantees to $4 billion--about $1 billion less than assumed in the baseline. The estimate of savings assumes that the entire reduction would derive from lowering the value of loan guarantees for sales to the former Soviet Union, which is now considered to be the world's most risky borrower receiving guarantees. This change would reduce outlays by $1.6 billion over the 1994-1998 period.

Proponents of reducing guarantees of credit would argue that they are overused and potentially extremely costly. The benefits of the first several billion dollars in guarantees--in terms of export promotion--may be substantial, but the net benefit diminishes, particularly since the additional guarantees are extended to countries that are at high risk of default.

Opponents of reducing credit guarantees argue that they are vital in retaining the U.S. share of competitive world markets. Opponents also argue that these guarantees are an important part of necessary aid to the republics of the former Soviet Union; during 1994 they are expected to receive $1.8 billion in guaranteed credit. Some supporters of more aid to these states, however, would prefer that they be given grain rather than sold it with money loaned at high risk of default. In addition, wheat and corn producer groups believe that total exports and prices that they receive for their crops would be substantially lower without these credits.

ENT-11 ELIMINATE THE EXPORT ENHANCEMENT PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	320	790	690	680	640	3,150
Outlays	320	790	690	680	640	3,150

The U.S. Department of Agriculture (USDA) subsidizes the export of agricultural commodities through the Export Enhancement Program (EEP). U.S. exporters participating in the EEP negotiate directly with buyers in a targeted country, then submit bids to the USDA for cash bonuses. The bids include the sale price, tentatively agreed to with the buyer, and the amount of the subsidy or bonus requested by the exporter.

Since its inception in 1985, more than $5 billion in EEP bonus payments have been made, mostly to assist wheat exports. The CBO baseline assumes that $4.65 billion in additional subsidy payments will be made during the 1994-1998 period. Eliminating the program would save nearly $3.2 billion during this period.

One disadvantage of eliminating the program is that it has been somewhat effective in increasing U.S. exports. In addition, one of the underlying motivations for the EEP has been to encourage competitors, particularly the European Community, to negotiate reduced subsidies in trade negotiations currently being conducted under the General Agreement on Tariffs and Trade (GATT). Unilateral elimination of the EEP would deprive U.S. negotiators of a bargaining chip in the GATT negotiations.

It is not clear, however, how much the program has increased U.S. grain sales. It has depressed world commodity prices. Competitors such as Australia and Argentina, which do not subsidize their exports, have been adversely affected by lower world prices even though they did not cause the United States to resort to export subsidies. The two largest recipients of subsidized grain sales under the EEP are the People's Republic of China and the republics of the former Soviet Union. Finally, many critics question the usefulness of the EEP in advancing the agricultural trade negotiations in GATT.

ENT-12 ELIMINATE THE MARKET PROMOTION PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	100	200	200	200	200	900
Outlays	100	200	200	200	200	900

The Market Promotion Program (MPP) was authorized under the 1990 Food, Agriculture, Conservation, and Trade Act to assist U.S. agricultural exporters, particularly when they face unfair trading practices abroad. Payments are made to offset partially the costs of market building and commodity promotion undertaken by state-related, private nonprofit, and private profit-making firms. The MPP continues the Targeted Export Program, which was aimed mainly at specialty crops such as fruits and nuts, but has also targeted wine, plywood, tobacco, feed grains, meat, eggs, and several other agricultural products for promotion. The current CBO baseline assumes that $200 million would be obligated annually for the program in the 1994-1998 period. Eliminating this program would reduce outlays by $900 million over the next five years.

An argument for reducing MPP funding is that the assisted groups benefit directly from the market development activities and thus should bear the full costs. The practice of subsidizing brand-name advertising by private firms has particularly come under fire. In addition, marketing funds are provided through other Department of Agriculture activities, such as the Cooperator Program of the Foreign Agricultural Service. Activities promoting exports of nonagricultural goods do not receive similar support. Therefore, why should agribusiness be singled out for this type of federal aid?

Eliminating the MPP could place U.S. exporters at a disadvantage in international markets. Those concerned about U.S. exports of high-valued agricultural products consider the program to be a useful tool for developing markets for these products.

ENT-13 REDUCE COSTS FOR THE DAIRY PRICE SUPPORT PROGRAM BY REQUIRING PRODUCER CONTRIBUTIONS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	130	250	260	280	300	1,200
Outlays	130	250	260	280	300	1,200

The incomes of dairy producers are protected and increased through the purchase of storable dairy products by the U.S. Department of Agriculture's (USDA's) dairy price support program. Their incomes are further supported by marketing orders, which set minimum prices for milk designated for various uses. The dairy industry is also protected from foreign competition by quotas on imports of dairy products.

Consumers may benefit because the dairy price support program helps to stabilize prices of milk and milk products. Some needy families, schools, and other institutions gain through the free distribution of dairy products that are purchased by the USDA. The program raises the prices of dairy products, however, and thus consumer costs, above the levels they would reach without government intervention.

One method of reducing the costs of dairy programs would be to increase the assessments levied on dairy farmers' production. During calendar year 1991, farmers were assessed $0.05 per hundredweight. By law, this assessment rose to $0.1125 per hundredweight in January 1992. Increasing assessments to $0.25 per hundredweight starting in January 1994 would save an estimated $1.2 billion over the 1994-1998 period.

This method of reducing dairy program costs would be straightforward and relatively easy to administer. Many dairy producers favor this approach to cutting program costs over such alternatives as reductions in federal price supports. A cut in the price support level for milk would cause a drop in the price that both consumers and the government pay for milk and milk products. Government purchases account for a relatively small portion of the total dairy market. Thus, in order to generate a significant amount of savings, the price cut would have to be relatively large. By contrast, an assessment would apply to the marketing of all milk. Therefore, a relatively small assessment would generate significant savings. As a result, the income of dairy farmers would be reduced less by the assessment than by a cut in support prices generating similar budgetary savings.

Raising these assessments, however, would reduce the net incomes of dairy farmers. Furthermore, the dairy industry would be paying part of the costs of federal government purchases of dairy products, much of which are used in domestic food assistance programs. Some would argue that this assistance should be paid for by the taxpayer rather than the dairy industry.

ENT-14 END THE FEDERAL CROP INSURANCE PROGRAM AND REPLACE IT WITH STANDING AUTHORITY FOR DISASTER ASSISTANCE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	770	520	590	650	620	3,150
Outlays	230	510	530	560	580	2,400

The federal government has offered crop insurance through the Federal Crop Insurance Corporation (FCIC) to farmers for many years to protect them against losses caused by natural disasters. This insurance is heavily subsidized. The government pays all administrative costs, subsidizes farmers' premium payments, and covers losses in excess of premiums. Even with this program in place, the government in recent years has reacted to crop shortfalls caused by drought and other natural factors by providing cash or in-kind disaster assistance. The Congress has enacted legislation providing such assistance in most years since 1986.

Participation in the federal crop insurance program has grown in the past few years, but it still covers less than half of the nation's eligible acres. Consistently low participation rates have, in part, encouraged enactment of the laws providing disaster assistance because so many farmers had no other protection. Some farmers may not have participated in the insurance program because they believed they would be covered by disaster assistance. And in fact, outlays for disaster assistance exceeded indemnity payments under the crop insurance program during the 1980s. Between 1981 and 1991, the federal government paid $8.6 billion for ad hoc disaster assistance and $2.6 billion for FCIC net indemnity payments.

This option would end federally subsidized crop insurance offered through the FCIC and replace it with federal disaster assistance, thereby saving $2.4 billion over the 1994-1998 period. Under this program, the Commodity Credit Corporation would make disaster payments to producers operating in counties with actual average harvested yields below 65 percent of the county's normal yield. Once a county was declared eligible, individual farmers would receive disaster payments for any shortfall in their own harvested yield below 60 percent of that county's normal yield.

Such a program structure would reduce expected federal outlays, compared with the current crop insurance program, primarily because it would provide benefits only in the case of substantial losses, and then only if the county, rather than just the individual, suffered significant losses as well. The program could be structured to save more or less with stricter or more lenient eligibility rules. A disadvantage of this option is that individual producers who use the current crop insurance program to control the risks they face in farming would no longer have that option.

The figures in the table contain both mandatory spending and discretionary savings. The crop insurance fund, which makes payments to satisfy farmers' crop loss claims, is categorized as mandatory spending. The administrative expenses of the crop insurance program are categorized as discretionary spending because they are controlled by annual appropriations.

The estimates of savings under this option assume that the crop insurance program ends with the 1993 crops. Savings from eliminating the crop insurance program are partly offset by costs of disaster assistance, which is estimated at $300 million per crop year.

ENT-15 REFORM MILK MARKETING ORDERS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	130	200	240	250	240	1,050
Outlays	130	200	240	250	240	1,050

Minimum prices paid by processors and handlers for most milk produced in the United States is regulated by federal milk marketing orders that evolved from legislation first enacted in the 1930s. The intended effect of these regulated prices is to increase returns to dairy farmers and stabilize supplies and prices of milk for fluid use.

The milk marketing orders and the milk price support program of the U.S. Department of Agriculture (USDA) are interrelated. The price support program provides a floor for prices of manufacturing grade milk by buying milk products (cheese, butter, and nonfat dry milk) if their prices fall below specified support levels. Marketing orders set minimum prices that must be paid for milk for fluid use, based on the manufacturing grade price plus differentials that are unique to each of the more than 40 regional orders.

This option would eliminate these pricing regulations. The average price received by dairy farmers would decline as a result, reducing their incomes and causing shifts in the pattern of production and processing throughout the country.

Proponents of deregulating the prices of milk claim that original rationales for regulating prices--apart from increasing producers' incomes--no longer justify federal intervention in the market for milk. The regulations were introduced when long-distance transportation of milk was prohibitively expensive. At that time, moving milk from one area to dampen price swings in other areas was often impossible. Local production, even in areas where production costs are high, is encouraged by the classified pricing system to ensure adequate supplies at reasonable prices.

Conditions have changed since the government introduced marketing orders. Now, with improvements in road systems and refrigerated transportation and changes in production technologies and consumption patterns, many analysts believe that regulated markets are no longer needed. Furthermore, using technology to reconstitute fluid milk--now discouraged by the regulated pricing system--would cut transport costs dramatically. Production would locate in the more efficient areas. This would lower milk prices for consumers. Greater variation in consumer prices might result, although fluid milk makes up a much smaller proportion of the food budget now than in the past. And benefits originally attributed to more stable prices would be less than at the time these regulated prices were first imposed.

This option would leave intact the USDA's milk price support program but would reduce its outlays by about $1.1 billion over the 1994-1998 period. Spending would fall because eliminating pricing regulations would cut average prices received by farmers, which would discourage milk production and reduce government purchases of dairy products. USDA's price support program would continue to protect incomes of dairy producers, but at lower levels than under current law.

ENT-16 REQUIRE REPAYMENT OF COMMODITY LOANS IN MARKETING LOAN PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	170	50	50	50	320
Outlays	0	170	50	50	50	320

The U.S. Department of Agriculture (USDA) uses commodity loans as a means of supporting the incomes of farmers. In commodity loan programs, farmers can use the commodity they produce as collateral for loans. The amount of the loan per unit of commodity is referred to as the "loan rate." Loan rates are determined by the Secretary of Agriculture, subject to constraints in the farm law. The loans are called nonrecourse, meaning that the terms of the loan can be satisfied by forfeiting to the government the commodity held as collateral rather than repaying the loan.

These nonrecourse loans were designed to enhance farm income by supporting market prices of commodities at or near their loan rates. In principle, if the market price tends to drop below the loan rate, some farmers forfeit the loan collateral, thus removing some of the crop from the market and supporting the market price. This mechanism works well but has two undesirable effects. First, government-owned stocks of commodities accumulate, which costs money and creates a disposal problem. Second, supporting the U.S. price above world market levels cuts U.S. exports.

Marketing loan programs, which change the repayment requirement for nonrecourse loans, were introduced to avoid stock accumulation and to allow U.S. prices to fall to world levels, thus improving exports. In marketing loan programs, the loan can be repaid at a per-unit rate that is lower than the rate used to compute the value of the loan when it was granted. If the prevailing market price falls below the original loan rate, the repayment rate also falls.

For example, a rice grower can place one hundredweight of rice under loan and receive the loan rate of $6.50. If the world market price, adjusted to the farm level according to a USDA formula, turns out to be less than $6.50 per hundredweight--say, $5 --the producer can satisfy the terms of the loan and regain clear title to the crop by paying $5 to USDA's Commodity Credit Corporation (CCC). In effect, this is as if the producer had sold the crop to the government for $6.50 per hundredweight and bought it back for $5. This is a form of price subsidy for producers that, except for soybeans and other oilseeds, is added to deficiency payments.

Producers can still forfeit the crop to the CCC instead of repaying the loan, even in these marketing loan programs. This budget reduction option would eliminate the opportunity to forfeit, requiring that the loan be repaid in cash. The option would reduce government outlays because the CCC must now set the farm-level repayment rate low enough to make repayment more attractive than forfeiture. That is, the repayment rate must be less than the producer can actually receive from the market. For example, the rice producer might repay the loan at $5 per hundredweight and sell it at $5.25 per hundredweight, netting an additional 25 cents per hundredweight. Some analysts argue that the CCC's discount on repayments is an unintended and unnecessary cost of the marketing loan program.

Eliminating the option to forfeit the loan to the CCC would eliminate the need for this additional repayment incentive. Program administrators would be free to set local repayment rates closer to prevailing market prices, which would reduce CCC outlays. Savings could be $320 million over five years. Savings could be greater if future prices of soybeans, wheat, and feed grains drop below loan rates and marketing loans in those programs became effective.

Savings from this option would reduce incomes of producers. But, as mentioned above, some analysts argue that the reduction would come from a benefit of the marketing loan program that was not intended when such loans were introduced.

ENT-17 ELIMINATE FEDERAL SUPPORT PROGRAMS FOR WOOL, MOHAIR, AND HONEY

Savings from CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Annual Savings (Millions of dollars)					
			Wool and Mohair			
Budget Authority	0	0	190	190	190	580
Outlays	0	190	190	190	190	760
			Honey			
Budget Authority	30	15	5	5	5	60
Outlays	30	15	5	5	5	60

The federal government supports prices of agricultural commodities and incomes of farmers by intervening in markets or making direct payments. This option would eliminate programs that provide support to producers of wool, mohair, and honey.

Wool and Mohair. The federal government makes direct support payments to U.S. producers of wool and mohair. The support price for shorn wool produced in 1991 was $1.88 a pound, and the market price averaged about 55 cents a pound. Total payments to wool producers for 1991 production, made in the spring of 1992, amounted to $130 million. Total payments to mohair producers for 1991 production, which are calculated like wool payments, were about $48 million. This option would eliminate the program beginning with the 1994 marketings, resulting in savings of $760 million over the 1994-1998 period.

Critics of the wool and mohair program claim that it is no longer needed. Originally this program was meant to encourage increased production of wool, which was considered a strategic material when direct payments were first authorized in 1954. Wool is no longer a strategic material. Moreover, in a March 1990 study, the General Accounting Office (GAO) found that the program does not greatly encourage production of wool or improve its quality. Wool payments supplement the market returns of wool producers and help stabilize their incomes. Consumers benefit little. Even if the program encouraged greater domestic production, domestic prices would not change substantially because they are largely determined by the world market.

The GAO study was critical of the mohair program primarily because it has no clear legislative objectives. Only in the past several years have payments become significant enough to attract attention to the program. Mohair payments were infrequent and relatively small before 1981. They were made in only eight years during the 1955-1980 period. But a combination of higher support and weakening market prices has made payments significant from the mid-1980s to the present.

Defenders of the wool and mohair programs argue that the payments are necessary to maintain a healthy domestic industry. They also argue that the payments contribute significantly to the economic survival of some rural areas and to the incomes of many farmers and ranchers, including Native Americans. Moreover, the program encourages lamb production, thus lowering meat prices for consumers.

Honey. The federal government supports honey producers by subsidizing the price of honey. Under a marketing loan program, producers pledge their honey as collateral for a federal loan at the rate of 53.8 cents per pound. The loan can be repaid, and the collateral redeemed, at the market price or the loan rate, whichever is lower. The loan repayment rate for the 1992 marketing year is estimated to average 47 cents a pound, which means that U.S. production is subsidized by an average of about 6.8

cents a pound for the year. This option would eliminate the honey program, yielding savings of $60 million over the 1994-1998 period.

Critics of the program, including the General Accounting Office, claim that price supports are no longer necessary to provide crop pollination services, one of the original motivations for the program. Critics also point to the relatively small number of beneficiaries; there are only 2,000 commercial beekeepers in the United States.

Supporters of the honey program claim that it is vital to the economic survival of many beekeepers, and that many types of crops, including commercial cash crops, would suffer if the number of bee colonies dropped significantly.

ENT-18 AUCTION LICENSES TO USE THE RADIO SPECTRUM

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	1,700	1,800	0	0	0	3,500

The Federal Communications Commission (FCC) is responsible for assigning licenses to private parties who use the radio spectrum. Recently, both the Congress and the Administration have considered making available additional licenses to provide land-mobile communications services. If enough appropriate spectrum--a band of 30 megahertz (MHz) to 50 MHz below 2200 MHz--were made available to create two additional licenses, a spectrum auction is estimated to generate $3.5 billion over the 1994-1998 period. This estimate is subject to considerable uncertainty; actual revenues could vary by $2 billion or more. The receipts would be scored as revenues or offsetting receipts, depending on how the option was applied. Depending on the specific frequencies allocated for private use, applying the policy could require new federal expenditures to relocate displaced users of the reallocated spectrum.

Currently, holders of licenses who use the radio spectrum do not pay (beyond an application fee) for the right to exploit the spectrum. Uses include traditional radio and television broadcasting as well as newer commercial areas, such as cable television, satellite and microwave communications, and cellular telephone and paging services. Technical progress continues to make possible a greater variety of spectrum uses. These uses require more spectrum than can be accommodated by current allocations (the designation of frequencies for a class of service) and assignments or licenses (the designation of specific frequencies for use by particular parties). Making available new allocations for land-mobile communications services, which would allow licensees to emulate the success of cellular telephone providers, is widely recognized as a high-value use of the spectrum. Many private firms would be likely to bid for these new licenses. How much they would bid is less certain, since major questions about the way bidders perceive technology, competition, and regulation can only be answered in an actual auction. The uncertainty about these factors accounts for the wide range from which the $3.5 billion estimate is drawn.

Until 1982, the FCC allocated the spectrum through an administrative hearing process that compared the relative merits of contending applicants. In 1982, responding to criticisms that the hearing process was too long and too costly for the government and did not demonstrably serve the public interest, the Congress permitted the FCC to experiment with assigning portions of the spectrum by lottery to all participants capable of meeting minimum eligibility criteria. Currently, the FCC employs both comparative hearings and lotteries for allocating non-mass-media licenses.

Initiating an auction process to assign new licenses for the radio spectrum, analogous to that used for oil-drilling rights on the Outer Continental Shelf, offers advantages in addition to federal revenues. Under most circumstances an auction would ensure that new licenses would go to the users who value them most. An auction process would decrease the cost to the government of assigning licenses and assign them more quickly than either the comparative hearing or lottery alternatives. Since an auction process need not include changes in licensee requirements or in the rights of the licensee, the FCC's role in guarding the public interest would not be compromised.

According to critics, the principal disadvantage of an auction process is that it may preclude small, less wealthy applicants--for example, local telephone cooperatives--from expanding their use of the spectrum. The financial strength of large firms, however, is already a determining factor in the hearing process (given regulatory and legal expenses) and also in the lottery process (given the secondary market for spectrum allocation that it creates). Public-sector users--such as police, fire, and other emergency providers--have expressed concern that an auction process, with its revenue-raising potential, would lead the Congress to transfer too much of the public spectrum to private use and ultimately leave the public with too small an allocation.

A disadvantage of an auction process as a deficit reduction measure is that it would not provide a stable, continuous inflow of revenues, since conditions in the telecommunications market do not require that new allocations and assignments be made on an annual basis. Some future revenues could be expected, however, if technological change created profitable uses for other parts of the spectrum or if the Congress made available to the private sector those portions of the spectrum currently reserved for public use.

ENT-19 IMPOSE A ROYALTY PAYMENT ON COMMUNICATIONS USERS OF THE RADIO SPECTRUM

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	1,850	2,000	2,050	2,150	2,250	10,300

This option would institute royalty payments on scarce portions of the radio spectrum used for private communications. To retain their licenses, private users of the electromagnetic spectrum who earn revenues from generating or relaying a signal would be charged an annual royalty payment equal to 4 percent of their gross revenues. Royalty payments by major communications users of the electromagnetic spectrum could raise $10.3 billion between 1994 and 1998. This estimate does not take into account reductions in income tax revenues. The receipts from these royalty payments could be considered tax revenues or offsetting collections, depending on the form of the enacting legislation.

The Communications Act of 1934 established the public nature of the radio frequency spectrum. The Federal Communications Commission (FCC) allocates frequencies to private users through a variety of licensing procedures. Although the FCC already charges user fees to cover the cost of the application and licensing process, license holders have profited from using this scarce public resource without compensating the public. Establishing a royalty payment would be consistent with federal policy in other areas--for example, petroleum production on the Outer Continental Shelf.

Since 1979, proposals have been made in the Congress to charge users of the radio spectrum. These legislative proposals would charge a royalty payment based on a market's population and number of license holders. This payment structure was designed to reflect the size and competition level of local markets. Basing the payment on gross revenues, however, would also reflect these conditions. Some experts have advocated charging license holders on the basis of the amount of spectrum they are assigned in relation to the intensity with which they use their portion. This approach is conceptually more effective in encouraging spectrum conservation than a gross royalties fee, but it is more difficult to carry out.

Arguments for a royalty payment emphasize the public nature of the radio spectrum and its role as a key unpriced factor in the production of communications services. The prices paid for licenses in the private market are indicative of the value of this public resource. Many holders of FCC licenses producing communications services earn higher-than-average profits, or economic rents, through their use of this public resource. In these circumstances, royalty payments to the government would not affect the economic efficiency of service providers. Combining a spectrum fee with policies that allow license holders increased flexibility in choosing which services to provide to consumers could increase economic efficiency.

Arguments against a royalty payment note that the radio spectrum had little or no value at the time most spectrum licenses were issued. The economic value of the resource was created only by the efforts of spectrum users and, thus, the public should not benefit. Regarding economic rents, the federal income tax already secures a portion for the government. In addition, in the many cases in which licenses have been sold by one private party to another, the buyer has already paid the original licensee for expected rents. Moreover, a royalty payment based on a formula is likely to capture only the average level of rents in the affected industries, permitting some licensees to continue to earn above-average profits. A final general objection to a royalty payment is that license holders in some markets will increase their prices and pass the cost of the payment along to consumers.

ENT-20 INCREASE FCC USER FEES

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	70	75	80	85	90	400

Increasing the level of fees charged by the Federal Communications Commission to holders of FCC licenses could increase receipts by $70 million in 1994 and by $400 million for 1994 through 1998. The Bush Administration's budget proposal for 1992 made such a proposal. In 1991 the House of Representatives passed legislation requiring increased user fees for FCC license holders that would have raised $20 million annually. The Senate, however, did not include fees in its companion to the House bill, and no fees were included in legislation that was enacted during the 102nd Congress. Under all proposals, the burden of increased FCC fees would fall on private radio, mass media, common carrier and local/interexchange carrier license holders.

Proponents of increasing licensing fees argue that they should cover the cost of the services that the FCC provides to license holders. These services include regulation, enforcement, rulemaking, providing information, and international activities. A recent legislative proposal would set the level of fees on the basis of the equivalent of full-time employees rendering service. The level would be adjusted for such factors as license holders' service area coverage and whether a license provides for shared or exclusive use. Fees could be set only high enough to equal the funds appropriated for FCC activities.

Those who argue against increasing FCC fees hold that such increases would break the implied contract between public and private license holders. Under this principle, the FCC grants license holders the right to use the electromagnetic spectrum in exchange for adherence to a broadly defined standard of public interest. The relevance of this argument to users' fees is only tangential, however, because user fees are designed to cover the cost of ongoing regulation rather than the value of a license to its holder. Moreover, the public-interest standard is difficult to apply to license holders outside of the broadcasting industry.

ENT-21 CHARGE FOR EXAMINATIONS OF STATE-CHARTERED BANKS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	200	280	290	300	310	1,380
Outlays	200	280	290	300	310	1,380

State-chartered banks regulated by the Federal Deposit Insurance Corporation (FDIC) could be charged to cover the cost of examining them. Charging the roughly 7,000 state-chartered banks for examination services would increase offsetting collections to the FDIC, thereby reducing outlays by roughly $300 million each year when fully applied. Savings from this option would not be counted in meeting the requirements of the Budget Enforcement Act because spending related to meeting current deposit insurance commitments is excluded from those requirements.

Bank supervision consists of monitoring an institution's activity and exerting informal pressure, often through the examination process, to modify behavior in a manner conducive to regulatory standards of safe operation. Examiners evaluate a bank's financial condition, review its compliance with laws and regulations, and survey its soundness of operation. In particular, the FDIC regularly examines insured state banks that are not members of the Federal Reserve to determine whether they pose risks to the deposit insurance fund.

The Federal Deposit Insurance Corporation Improvement Act of 1991 authorizes, but does not require, the FDIC to charge for examination expenses. The FDIC Board has not yet approved collecting examination fees from state banks. Currently, the FDIC charges all insured banks an average annual insurance premium of about 25 cents per $100 of qualifying deposits, which banks pay in two installments a year. These premiums not only provide resources to cover claims on the bank insurance fund, but also pay for the FDIC's cost of bank examinations. Since the FDIC already administers the collection of premiums, it would be relatively easy to impose a schedule of fees to recover examination costs.

Charging fees to cover the cost of examining state-charted banks will help make uniform all federal regulators' treatment of insured financial institutions. Other depository institutions such as thrifts, credit unions, and nationally chartered banks all pay a federal examination fee as well as a deposit insurance premium. State-chartered banks, however, only pay an insurance premium. (The Federal Reserve, which regulates state banks that are members of the Federal Reserve System, also does not charge for exams. To achieve full consistency, the Federal Reserve would have to collect a fee as well, but that is not part of this option.) In effect, part of the premiums paid by nationally chartered banks are applied against the cost of examining their state bank competitors. If the FDIC assessed a fee, it could cover regulatory costs without using insurance premium resources, putting state banks on the same footing as other federally regulated competitors. In the long run, however, the FDIC could offset the additional income from examination fees by reducing the amount of insurance premiums.

Opponents contend that because state banks already pay an examination fee to the state regulatory agency, an additional fee levied by the federal regulator would impose costs not faced by thrifts, credit unions, and nationally chartered banks that do not have to pay a state examination fee. (Because state exam frequency and fees vary so widely and because the FDIC often relies on state exam data and coordinates exam frequency with states, it is not obvious that state banks would have to pay more exam fees than their competitors.)

A disadvantage of this option is that it may weaken the economic position of marginal banks. The banking industry is experiencing structural change and has recently suffered through an economic recession. Such additional costs as examination charges could bring more bank failures and, by extension, increase losses to the Bank Insurance Fund. How much additional costs would influence bank failures depends, in part, on the ability of banks to pass along these costs to customers.

Imposing new charges could lead some state-chartered banks to apply for membership with the Federal Reserve or apply for a national charter, depending on the costs of meeting requirements for other agencies, the relative costs of membership, and services provided by the regulator. These estimates assume that the number of state-chartered banks examined by the FDIC will be relatively constant over the next five years. The figure does not account for bank failures or a change in the supervisory responsibilities of federal regulators.

ENT-22 CHARGE A USER FEE ON COMMODITY FUTURES AND OPTIONS CONTRACT TRANSACTIONS

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	45	60	60	65	70	300

The Commodity Futures Trading Commission (CFTC) administers the amended Commodity Exchange Act of 1936. The purpose of the CFTC is to allow markets to operate more efficiently by assuring the integrity of futures markets and protecting participants against abusive and fraudulent trade practices. A fee on transactions overseen by the CFTC could cover the agency's costs of operation. Such a fee would be similar to one now imposed on securities exchanges to cover the cost of the Securities and Exchange Commission (SEC).

The Bush Administration's budget for 1993 proposed a transactions fee, set at 15 cents per "round turn transaction." Such a fee, if imposed in 1994, could generate revenues of $300 million over the 1994-1998 period, which should be sufficient to cover the CFTC's operating expenses over that period. As proposed, the legislation to establish the fee would require the exchanges to remit the fee four times a year, based on trading volume during the previous quarter. The CFTC would collect the fee and deposit it as an offsetting receipt to the general fund of the Treasury.

The main arguments in favor of the fee are based on the principle that users of government services should pay for those services. Those engaging in transactions that the CFTC regulates are seen as the primary beneficiaries of the agency's operations and therefore users who should pay a fee. Furthermore, the principle of charging such a fee has already been established by the SEC. Considerations of equity and fairness suggest that not charging a comparable fee to support CFTC operations could give futures traders an unfair advantage over securities traders.

Those who argue against the fee say that such charges tend to generate evasion on the part of those who would be subject to them. Users might try to avoid fees by limiting or shifting transactions to activities that are exempt from charges, which could conceivably cause market participants to desert U.S. exchanges for foreign ones. The effect of such actions could substantially lower the revenue from the fee and, of more concern, lower the benefits that futures transactions provide to the economy.

ENT-23 ESTABLISH CHARGES FOR AIRPORT TAKEOFF AND LANDING SLOTS

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	300	300	300	300	300	1,500

The Congress considered imposing charges in fiscal year 1990 for the use of slots for taking off or landing at the four airports where the Federal Aviation Administration (FAA) has established capacity controls: Kennedy International and La Guardia in New York; O'Hare International in Chicago; and Washington National in the District of Columbia. That proposal would have required the FAA to raise $239 million through these charges for fiscal year 1990. An alternative measure would establish similar slot charges at the FAA-controlled airports on a permanent basis with a goal of $300 million in annual receipts. These receipts could be generated by auctioning the slots among the commercial airlines that use the airports. Receipts could be greater if this option were extended to other airports or if slots now reserved for commuter carriers and general aviation were also included in the auction.

Takeoff and landing slots were instituted in 1968 to control capacity and were allocated without charge by the FAA. A total of about 3,600 air carrier slots exist, with an additional 1,400 commuter and general aviation slots at the four FAA-controlled airports. Airlines are currently allowed to buy and sell slots among themselves, with the understanding that the FAA retains ultimate control and can withdraw the slots or otherwise change the rules on their use at any time. These slots have value because the demand for flights exceeds the capacity of the airports and of the air traffic control system at certain times.

The main argument in favor of establishing charges for slots is that since the slots reflect the right to use scarce public airspace, airports, and air traffic control capacity, private firms and individuals should not receive all the benefits of this scarcity. They should share it instead with the public owners of these rights. Further, the charges would serve as incentives to put these scarce resources to best use.

The main argument against this proposal is that the scarcity of slots at these airports arises principally from a lack of land and runway space; these fees are not intended to provide increased capacity. Further, if the current prices paid by airlines in the private sale of slots already accurately reflect their value, then a better allocation of these scarce resources might not occur as a result of this proposal. Only a redistribution of the benefits from their use between the private sector and the public would result.

A further argument against carrying out the proposal at this time is that new fees would worsen the already bleak financial condition of the airline industry. The airlines have had to contend recently with both excess capacity and a decline in passenger demand. In addition, aviation taxes were increased by 25 percent in fiscal year 1991.

ENT-24 ESTABLISH USER FEES FOR AIR TRAFFIC CONTROL SERVICES

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	680	1,400	1,500	1,550	1,600	6,750

The Federal Aviation Administration (FAA) manages the air traffic control (ATC) system, which serves commercial air carriers, military planes, and such smaller users as air taxis and private planes. Services provided include air traffic control towers that assist planes in takeoff and landing, air route traffic control centers that guide planes through the nation's airspace, and flight service stations that assist smaller users. The FAA has more than 17,000 air traffic controllers as well as sophisticated software to perform these tasks. The total cost of operating, maintaining, and upgrading the ATC system was about $5.3 billion in 1992.

Currently, one-half of FAA operations are financed through annual appropriations from the general fund, whereas revenues from aviation excise taxes are used for a variety of purposes: facilities and equipment, research engineering and development, and such non-ATC activities as airport improvement.

If users paid the marginal costs that the ATC incurs on their behalf, the deficit would be reduced by about $700 million in 1994 and $6.8 billion over the 1994-1998 period. This assumes that the new charges would be levied in the middle of fiscal year 1994.

Users would be charged according to the number of facilities they used on a flight and the marginal costs of their usage at each facility. The various classes of users would be affected differently. Smaller users, such as general aviation users, would experience comparatively greater increases in the cost of flying than larger users, such as commercial airlines.

Levying efficient fees presumably would oblige users to moderate their demands. Small users who are required to pay these costs would cut back on their consumption of ATC services, freeing controllers for other tasks and increasing the overall capacity of the system. An additional benefit of efficient fees is that, on the basis of user response, planners can judge how much new capacity is needed and where it should be located.

The main argument against this option is that flying could become too costly for some general aviation users, causing demand for small airplanes produced in the United States to decline.

ENT-25 IMPOSE USER FEES ON THE INLAND WATERWAY SYSTEM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	450	460	470	490	500	2,350
Outlays	280	440	470	480	490	2,150

The Congressional Budget Office estimates that the Congress annually appropriates about $560 million for the nation's system of inland waterways. Of this total, about $220 million is for operation and maintenance (O&M) and about $340 million is for construction. Current law allows up to 50 percent of inland waterway construction to be funded by revenues from the inland waterway fuel tax, a levy on the fuel consumed by barges using most segments of the inland waterway system. Revenues from the tax currently fund about 20 percent of federal outlays for inland waterway construction. All O&M expenditures are paid by general tax revenues.

Imposing user fees high enough to fully recover both O&M and construction outlays for inland waterways would reduce the federal deficit by $280 million in 1994 and about $2.2 billion during the 1994-1998 period. The receipts could be considered tax revenues, offsetting receipts, or offsetting collections, depending on the form of the implementing legislation. These estimates do not take into account any resulting reductions in income tax revenues.

The advantage of this option is the beneficial effect of user fees on efficiency. Reducing subsidies to water transportation should improve resource allocation by leading shippers to choose the most efficient transportation route rather than the most heavily subsidized one. Moreover, user fees would encourage more efficient use of existing waterways, reducing the need for new construction to alleviate congestion. Finally, user fees send market signals that identify the additional projects likely to provide the greatest net benefits to society.

The effects of user fees on efficiency would depend in large measure on whether the fees were set at the same rate for all waterways or according to the cost of each segment. Since costs vary dramatically among the segments, systemwide fees would offer weaker incentives for cost-effective spending. In 1989, for example, O&M costs on the inland waterways ranged from less than 50 cents per 1,000 ton-miles on the lower Mississippi River (between the Ohio River and Baton Rouge) to about $140 per 1,000 ton-miles on the Allegheny River. A systemwide fee of $1.75 per 1,000 ton-miles would recover all O&M outlays but would do little to ration use of the system. Fees set for specific segments, by contrast, could substantially change waterway use. A Department of Transportation study found that fees to recover even 50 percent of all federal outlays (both O&M and construction) would close four out of 12 waterway segments for lack of traffic.

An argument in favor of federal subsidies is that they may promote regional economic development. Assessing user fees would limit this promotional tool. Reducing inland waterway subsidies would also lower the income of barge operators and grain producers in some regions, but these losses would be small in the context of overall regional economies.

ENT-26 REDUCE INTEREST SUBSIDIES FOR STAFFORD LOANS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Require Students to Pay In-School Interest					
Outlays	1,300	1,950	2,050	2,100	2,150	9,550
	Reduce Lenders' Yields					
Outlays	220	330	330	320	320	1,500

The Stafford Loan program authorizes the federal government to guarantee loans for postsecondary students against default. The program pays the interest while students are enrolled in school plus a portion of the interest after they begin repaying their loans. Lenders receive a rate of return that varies with market interest rates and is equal to 3.1 percentage points plus the rate of interest on 91-day Treasury bills. These interest payments constitute more than half of the estimated subsidy cost of the program. Because students do not begin repayments on Stafford loans until after they leave school, they receive a substantial subsidy from the federal government. Lenders also benefit because the interest rate they are guaranteed exceeds the lowest rate at which most would probably be willing to lend in the program. (See ENT-30 for a proposal to achieve savings by replacing federal Stafford Loans with direct loans.)

Require Students to Pay In-School Interest. Federal subsidies could be reduced by requiring students to repay larger amounts than they do under current law. Charging interest on loans to new borrowers while they are in school, but deferring actual payments until they leave school, would reduce federal outlays by $9.6 billion between 1994 and 1998.

This measure would not cause cash flow problems for students while they are in school because students would be allowed to defer interest payments during that period. With the added costs generally occurring only after leaving school--when borrowers would be better able to afford them--most students would still be able to continue their educations. The larger repayments that would result from these changes might, however, cause some students not to attend school or to limit their choices to lower-priced institutions.

Reduce Lenders' Yields. A reduction of perhaps 1 percentage point in the yield on loans would lower federal spending by a total of $1.5 billion during the next five years and by substantially more in future years.

Reducing lenders' subsidies would lower federal expenditures and students' costs. Moreover, although some people argue that reducing the special allowance to lenders while borrowers are in school would limit the availability of loans for many students, others claim this fear is overstated. During 1989, the 100 largest lenders--making up less than 1 percent of all lenders--disbursed about 75 percent of all loans. Although small lenders might leave the program if the special allowance were reduced, large lenders currently receive a subsidy worth significantly more than the costs they incur (including the small risk they bear in relation to the likelihood of defaults on loans), and they would most likely remain in the program. However, if this option made most loans unprofitable for lenders in a few locations, students in those areas could have more difficulty arranging the financing of their educations.

ENT-27 REDUCE STAFFORD LOAN SPENDING BY INCLUDING HOME EQUITY IN THE DETERMINATION OF FINANCIAL NEED

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	95	100	100	100	100	500
Outlays	65	95	100	100	100	470

Many students applying for federal Stafford Loans this year will obtain them more easily because the Higher Education Act of 1992 eliminated house and farm assets from consideration in determining a family's ability to pay for postsecondary education. The Higher Education Act specifies formulas to calculate a family's need for Stafford loans. The amount the family is expected to contribute is determined by what is essentially a progressive tax formula. In effect, need analysis "taxes" family incomes and assets--excluding house and farm equity--above amounts assumed to be required for a basic standard of living.

Under this option, house and farm equity would be included in the calculation of a family's need for financial aid for postsecondary education. (It had been included before the Higher Education Amendments of 1992.) House and farm equity would be "taxed" at up to roughly 5.6 percent after a deduction for allowable assets (see DOM-39 for related savings in the Pell Grant program). In addition, the threshold, under which most families with less than $50,000 in income are not asked to report any assets, would also be lowered to its previous level of $15,000.

Outlays could be reduced by roughly $470 million during the 1994-1998 period by including house and farm equity if the simplified need test were also modified. Families whose houses appreciated during the 1980s are now financially better off than they would have been if they had not owned a house then. At the same time, not counting this equity gives families who own a house an advantage over those who do not.

There is concern, however, that the increases in housing prices over the last decade have made it difficult for some families to pay their mortgages if they borrow against the equity in their houses. In addition, having to value their assets would complicate the application process for most families.

ENT-28 REQUIRE POSTSECONDARY INSTITUTIONS TO SHARE THE RISK OF DEFAULTS ON STAFFORD LOANS

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
	Define the Allowable Default Rate as a One-Year Rate					
Outlays	30	45	45	45	45	210
	Lower the Allowable Default Rate to 20 Percent Over Three Years					
Outlays	25	40	40	40	40	190
	Lower the Allowable Default Rate to a One-Year Rate of 20 Percent					
Outlays	30	50	50	50	50	230
	Require Postsecondary Institutions to Pay a Loan Default Fee					
Outlays	85	125	125	125	125	580

Recently, in most years, the volume of defaults in the Federal Stafford Loan program has grown as the number of borrowers in repayment has increased dramatically. Default payments net of collections are about one-third of the estimated subsidy cost of the program. To reduce these costs, the Stafford Loan program no longer allows students attending schools that have default rates of 25 percent or more in each of the three previous years to take out loans. Historically black colleges and universities and tribally controlled community colleges are exempt from this requirement until July 1994. The options presented below suggest ways to lower the federal costs of defaults by further reducing the allowable default rate and by having postsecondary institutions pay a loan default fee.

Further Restrict Allowable Default Rates. One way to tighten standards would be to define the default rate cutoff as only the previous year's default rate, as is done in the federal Supplemental Loans for Students program, rather than use the default rate in each of the three previous years. Doing so would save an estimated $30 million in 1994. A second approach would be to decrease the threshold--to 20 percent, for example--without changing its calculation. This option would save an estimated $25 million in 1994. Combining these options would save about $30 million in 1994. The savings over the 1994-1998 period from the three approaches would be $210 million, $190 million, and $230 million, respectively. (These estimates are contingent on preventing operators of disqualified schools from regaining eligibility by a name change or similar device, and on not allowing exceptions for loan servicing and collection agency practices.)

Proponents of these approaches argue that the current restrictions still allow schools with excessive default rates to remain in the program, leading to higher federal costs and poor educations for their students. Opponents argue that schools with high default rates are often those that serve a disproportionate number of low-income students--students who are more likely to default, even when the program is of high quality--and that the default rate is a poor measure of which schools are providing inferior programs. In this case, these options would unfairly penalize some schools that offer useful programs.

Require a Loan Default Fee. Another option would be to charge postsecondary institutions a sliding annual fee related to the percentage of loans entering repayment on which their students default. In this option, institutions with default rates above 10 percent would have to pay a fee set at 25 percent of the value of defaults of their former students in excess of the first 10 percent of defaults. This alternative would save an estimated $580 million over the 1994-1998 period.

An advantage of this option is that it would provide institutions with strong incentives not to overstate the economic benefits that students will derive from their educations and to ensure that their students are aware of their obligation to repay loans. A disadvantage is that this approach could create financial stress or lower profits for some postsecondary institutions having high default rates--for example, proprietary schools, in which many students are disadvantaged. In addition, schools participating in the Stafford Loan program must certify their students' loan applications, thereby denying the schools a way of lowering their default rates.

ENT-29 REQUIRE POSTSECONDARY INSTITUTIONS TO PAY A CO-ORIGINATION FEE ON STAFFORD LOANS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	920	980	1,000	1,050	1,100	5,100

The federal government pays the interest on Federal Stafford Loans while the borrowers are enrolled in school. In addition, it pays a portion of the interest after students leave school and begin repaying their loans. To help pay for the interest costs, 5 percent of the value of the loans is deducted as an "origination fee" from the amounts the students borrow. This amount is remitted to the federal government. Requiring postsecondary institutions to pay the federal government a 5 percent co-origination fee on the amount of loans taken out by their students would save an estimated $5.1 billion in the 1994-1998 period.

The primary argument for sharing in the costs of the program is that postsecondary institutions benefit directly from these loans, which enable students to attend schools costing more than they could otherwise afford. Some schools with limited financial resources might, however, shift these costs to students by reducing the amount of financial aid they provide or increasing their tuitions.

ENT-30 REPLACE GUARANTEED STUDENT LOANS WITH DIRECT LOANS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	430	1,400	2,500	3,750	8,100
Outlays	0	280	1,050	2,100	3,250	6,700

The Higher Education Amendments of 1992 established a Federal Direct Loan Demonstration program under which selected postsecondary institutions would make federal loans comparable with existing guaranteed loans directly to eligible students and parents starting in 1994. This demonstration is intended to show the feasibility of replacing guaranteed student loans now made through the Federal Family Education Loan (FFEL) program, which includes Federal Stafford Loans, Federal Supplemental Loans for Students (SLS), and Federal Parent Loans for Undergraduate Students (PLUS). Now, students desiring a federally guaranteed loan establish eligibility through their schools to borrow from lenders, usually commercial banks. Lenders must obtain approval to make loans from guaranty agencies, which guarantee loans against default and monitor lenders and schools for compliance. The Department of Education reinsures guaranty agencies for loan defaults if program requirements are followed. Lenders may retain loans until repaid, or sell them in secondary markets to others to hold and service.

The 1992 amendments mandate that the Department of Education choose a cross section of institutions to participate in the direct loan demonstration. The department must enlist institutions at which total loan volume for Stafford, SLS, and PLUS loans has been $500 million or less, or about 4 percent of loan volume in 1991. A representative sample of schools will be selected out of the approximately 7,500 postsecondary institutions participating in FFEL programs to offer the same loans now available through the FFEL programs.

This option would phase out the FFEL program and phase in the Federal Direct Loan (FDL) program for all postsecondary institutions between 1994 and 1999. Acting as agents of the Department of Education, all eligible postsecondary institutions would originate and disburse student and parent loans using federal capital raised by issuing U.S. Treasury securities. The department would contract with private firms to service and collect the loans. Commercial lenders, guaranty agencies, and secondary markets would not be needed for new loans, but parts of the current system would have to remain in operation until the more than $50 billion in outstanding federally guaranteed loans are repaid. The federal government would achieve savings by eliminating subsidies to the lenders who now originate federally guaranteed loans and by charging students the same interest rates they would pay for guaranteed loans, which are greater than the government's cost of money. An estimated $6.7 billion would be saved between 1995 and 1998, assuming that all other features of the loan programs were retained. Additional savings would accrue over time from a fully operational direct loan program.

Advocates of requiring all postsecondary institutions to participate in the FDL program note that it would involve fewer participants and be easier to manage. The primary parties would be the Department of Education and postsecondary institutions. In addition, the direct loan program would simplify dealings for all students and parents. For example, a request for a student loan could be handled on the same form as an application for a Pell Grant. Loans would not be resold on the secondary market, as they are now, which sometimes causes students to lose track of whom they must repay.

Opponents of this option note that direct lending would impose significantly greater administrative burdens and responsibilities on postsecondary institutions and the Department of Education. Many schools do not want these responsibilities, and others are not capable of exercising them. The Department of Education, which has been criticized for poorly administering the current guaranteed loan programs, may not be capable of assuming the additional managerial responsibilities associated with a direct loan program. A mismanaged direct loan program could foster more fraud, waste, and abuse.

ENT-31 LIMIT THE GROWTH OF FOSTER CARE ADMINISTRATIVE COSTS TO 10 PERCENT A YEAR

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	40	70	90	100	110	410
Outlays	30	60	80	100	110	380

The federal foster care program, authorized under Title IV-E of the Social Security Act, is an open-ended entitlement program that provides federal matching funds to assist states in providing foster care to children who meet certain eligibility requirements. In 1994, the program is expected to serve about 250,000 children on average each month at a federal cost of $2.7 billion. Administration will account for about 42 percent of that total. Each state administers its own program within the federal mandates established in Title IV. The federal government reimburses states for one-half of certain administrative costs, including those for determining eligibility, certain preplacement services, and child placement services, as well as for administrative overhead.

Policymakers have been concerned about the rapidly escalating costs for administration in this program. Such costs (adjusted for inflation) increased from less than $50 million in 1981 to more than $700 million in 1991. This option would limit annual increases in payments to each state for administrative costs to 10 percent a year, reducing federal outlays by $30 million in 1994 and by $380 million in the 1994-1998 period.

During the 1980s, costs increased much more rapidly than caseloads. At some point in the past decade, many states' administrative costs increased sharply. In about one-half of the states, the annual increase in such costs per child exceeded 1,000 percent in at least one year, supporting the theory that much of the growth resulted from changes in states' methods for claiming funds rather than from expanded services to children.

It might not be advisable to slow the growth in federal funding to child welfare agencies now, however, when these agencies are struggling to deal with reported increases in child abuse and neglect. If states responded to the restriction by cutting back services, children in need of foster care could be harmed. Limiting the percentage increase that each state could receive would also lock in the current differences in costs per child. In 1992, estimates of average federal costs per child for Title IV-E administration ranged from less than $150 a month in three states to more than $500 a month in eight states.

ENT-32 TIGHTEN MEDICAID'S ESTATE-RECOVERY PROCESSES AND RULES FOR LONG-TERM CARE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	100	200	350	500	600	1,750
Outlays	100	200	350	500	600	1,750

Federal Medicaid spending in 1992 included $14 billion for nursing facility care. People cannot qualify for such assistance unless they satisfy Medicaid's income- and asset-test provisions, which are meant to ensure that people use their own resources to purchase care before qualifying for Medicaid assistance. Subject to certain restrictions, states have the authority, and sometimes the obligation, to take into account the asset transfers undertaken to achieve Medicaid eligibility; to place liens on the property of institutionalized Medicaid beneficiaries so that Medicaid payments on their behalf can be recovered; and to recover the costs of care from the estates of deceased recipients.

If prospective Medicaid beneficiaries dispose of their assets for less than fair market value, they are ineligible for nursing home care financed by Medicaid for the time (up to 30 months) during which the uncompensated value of the transferred assets would have covered the average cost of private nursing home care. The disqualification does not apply in certain circumstances, including transfer of the applicant's home or other resources to specific categories of close relatives. In addition, people may keep sufficient private assets to pay for 30 months of nursing home care, transfer the balance of their assets to others, and qualify for Medicaid-financed nursing home care 30 months later.

Partly in response to attempts to circumvent the policy governing transfers of assets and partly in order to recover more of Medicaid's current costs for nursing home care, the Inspector General of the Department of Health and Human Services proposed several changes in Medicaid's rules regarding estate recoveries and processes. (See Department of Health and Human Services, Office of Inspector General, *Medicaid Estate Recoveries*, June 1988.) These changes would reduce Medicaid's ultimate liability for the costs of nursing home care while, in certain circumstances, enabling close relatives of someone admitted to Medicaid-financed nursing home care to continue using assets, such as a house, that they had shared with the admitted person.

Based primarily on the Inspector General's recommendations, this option would strengthen transfer-of-asset rules to restrict further the giving away of property to qualify for Medicaid. It would also encourage state Medicaid programs to protect dependent or incompetent recipients and their property from financial exploitation by relatives. In addition, this option would require, as a condition of Medicaid eligibility, a legal instrument to secure property owned by recipients for later recovery, and it would allow a lien to be placed on the home of a Medicaid recipient if the state determined, subject to a fair hearing, that the person could not reasonably be expected to be discharged from the medical institution and to return home. The option would also require states to operate Medicaid estate-recovery programs and would allow states to recover from an individual's estate the amount of benefits that had been received before age 65. Furthermore, it would allow recoveries from the estates of a spouse or dependent adult child who had inherited or received assets from a Medicaid beneficiary or who retained assets that the beneficiary and his or her relatives had owned jointly. Carrying out the option would save $100 million in 1994 and $1.8 billion over the 1994-1998 period, and substantially more in the future.

Changing the estate-recovery processes and rules would have two main advantages. First, it would reduce Medicaid spending as more people used private resources to defray their nursing home costs, and as Medicaid payments for long-term care services were recovered from the estates of beneficiaries. Second, lien programs could enable relatives who might otherwise have sold a beneficiary's home to pay for long-term care to buy this care instead at Medicaid rates and still retain use of the house during their lifetimes.

One disadvantage of this option, for those who do not support a welfare approach to public financing of long-term care, is that it would make means-testing more, rather than less, stringent. In doing so, it would selectively curtail the inheritance of wealth, affecting only the heirs of people who develop a need for long-term care. In addition, more effective estate-recovery processes and rules might make it financially appealing for relatives of a person needing nursing home care to discourage that person from seeking it. Also, carrying out this option might prove difficult because of differences among states in laws governing liens, estates, and inheritance.

ENT-33 REDUCE THE 50 PERCENT FLOOR ON THE FEDERAL SHARE OF MEDICAID AND AFDC PAYMENTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
AFDC Outlays	860	880	910	940	980	4,550
Medicaid Outlays	5,050	5,700	6,450	7,200	8,100	32,500
Offsets in the Food Stamp Program	-160	-160	-170	-180	-180	-850
Total	5,750	6,400	7,150	8,000	8,900	36,200

The Aid to Families with Dependent Children (AFDC) program provides cash assistance to low-income families in which one parent is absent or incapacitated or in which the primary earner is unemployed. The Medicaid program provides medical assistance to current or recent AFDC beneficiaries, low-income people who receive Supplemental Security Income, and certain other low-income people.

The federal government and the states jointly pay for the AFDC and Medicaid programs. The federal share of the costs of these programs varies with a state's per capita income. High-income states pay for a larger share of benefits than low-income states. By law, the federal share can be no less than 50 percent and no more than 83 percent. The 50 percent federal floor currently applies to 13 jurisdictions: Alaska, California, Connecticut, Delaware, the District of Columbia, Hawaii, Illinois, Maryland, Massachusetts, New Hampshire, New Jersey, New York, and Virginia.

Under this option, the 50 percent floor would be reduced to 45 percent, generating savings of about $5.7 billion in 1994 and $36.2 billion over the five year period. Federal savings for the AFDC program would be $860 million in 1994 and $4.6 billion over the 1994-1998 period; outlays for Medicaid would be reduced by about $5 billion in 1994 and $32.5 billion over the five-year period. Both estimates assume, however, that states would partially offset their higher costs by reducing program benefits. Lowering AFDC payments would make some families eligible for larger Food Stamp benefits. Outlays for the Food Stamp program would, therefore, increase by $160 million in 1994 and $850 million over the five-year period.

Proponents of this change argue that high-income states that choose to be generous should bear a larger share of the burden. If the floor were reduced to 45 percent, federal contribution levels would be more directly related to state income, and eight of the 13 states would still be paying less than the formula alone would require. In January 1992, 10 of the 13 jurisdictions affected by this proposal paid AFDC benefits that were above the median when states were ranked by size of benefits (for a three-person family). The higher benefit levels in these states mean that more families are eligible for AFDC and thus for Medicaid.

Opponents of the change stress that the higher incomes and benefit levels in the affected states in part reflect higher costs of living. If this proposal were adopted, the affected states would have to compensate for the lost federal grants by reducing AFDC and Medicaid benefits, lowering spending on other state services, or raising taxes. If states chose to compensate by reducing AFDC and Medicaid benefits, as the estimates assume, program beneficiaries would be adversely affected.

ENT-34 MANDATE STATE REGULATION OF GROWTH IN THE NUMBER OF NURSING HOME BEDS

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	100	200	380	450	600	1,750
Outlays	100	200	380	450	600	1,750

In 1991, nursing home care absorbed about 75 percent of total long-term care (LTC) spending and about 85 percent of Medicaid LTC spending. The supply of nursing home beds varies widely across the country, however, and these variations can be explained only partly by differences in the number of elderly people among states. The rate at which available beds are used--on average, about 90 percent--also varies, but the occupancy rate seems not to be related to the number of beds per 1,000 people.

This option would mandate that states regulate growth in the number of nursing home beds eligible for federal funding through Medicaid, Medicare, or other federal programs by requiring that providers obtain a certificate of need (CON) to operate additional beds. For any specified area, states would issue a CON only if the ratio of the number of nursing home beds to the population likely to need them fell below certain guidelines. The guidelines would be set by the state, subject to federal approval. If the option were to reduce the growth rate of Medicaid nursing home beds by one-half, it would save $100 million in 1994 and $1.7 billion over the 1994-1998 period.

If adding nursing home beds increases the number used, the advantage of this option is that limiting the increase in the number of beds could help to curb further growth in Medicaid outlays for nursing home care in areas where the supply of nursing home beds is relatively high. In the process, regulating the number of beds could make nursing home outlays more predictable for state budget planners. Guidelines could also be used to help change the balance between nursing home and other forms of long-term care.

The option's disadvantages are that such guidelines might shift Medicaid nursing home costs to the hospital sector if nursing home beds were not available for hospital patients who are eligible for Medicaid, or to the home- and community-based care sector in states where Medicaid pays for such care. Moreover, by sheltering existing providers against competition from new entrants, certificate-of-need processes could increase rates of return for existing providers while reducing their incentives to be efficient and provide high-quality care. Furthermore, some might view such guidelines as program caps implying the loss of Medicaid's open-ended budgetary commitment and hence the weakening of Medicaid's assurance of access to health care for poor or medically needy people.

ENT-35 REDUCE THE RATE OF GROWTH OF MEDICAID PAYMENTS TO DISPROPORTIONATE SHARE HOSPITALS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	0	160	560	2,250	1,900	4,900

When setting Medicaid hospital payment rates, states are required to take into account the special costs incurred by hospitals that serve disproportionately large numbers of Medicaid or low-income patients. The Congress has established minimum criteria for states defining "disproportionate share" hospitals and determining the rates at which such hospitals must be paid. States may, however, use alternative methods to define disproportionate share hospitals and to set the additional payment amounts they receive, provided the total payment adjustment is at least as great as under one of the statutory options. Some states have taken advantage of this flexibility to increase their payments to disproportionate share hospitals dramatically in the last two years, frequently using taxes on providers or voluntary donations from providers to pay part or all of the state's share. By using such financing devices, states were able to generate large federal matching payments, at little or no cost to themselves, which could then be returned to providers in the form of disproportionate share payments.

Legislation passed in 1991 restricted the use of provider taxes and donations and placed a national cap of 12 percent of Medicaid expenditures on payment adjustments to disproportionate share hospitals. States in which disproportionate share payments were already above that ceiling could continue to make payments at the higher level but could not increase them until they fell below the 12 percent cap. Even with the new restrictions, however, Medicaid payments to disproportionate share hospitals are expected to grow at an average annual rate of 12.3 percent between 1994 and 1998.

This option would add additional constraints, namely that federal Medicaid expenditures for payments to disproportionate share hospitals could not exceed 20 percent of federal Medicaid expenditures in any state in fiscal year 1995 and could not exceed 12 percent in 1996. In subsequent years, moreover, the rate of growth of federal Medicaid expenditures for disproportionate share hospitals would be limited to the percentage change in the gross domestic product plus the percentage change in the combined Medicaid and uninsured populations in the states. The anticipated savings in the 1994-1998 period would be $4.9 billion.

Limiting the growth of disproportionate share payments could be justified by the fact that the recent extraordinary expansion of these payments in some states does not appear to reflect real growth in the costs of serving growing numbers of low-income people. In the 1990-1992 period, disproportionate share payments in 35 states rose more than 10 times faster than the number of people served by the Medicaid program. How the increased payments are being used is not always clear. Furthermore, disproportionate share payments vary widely, with some states making very small payments and others making very large payments. The variation in payments does not appear to be related to variation in need. This option would reduce these differences more rapidly than under current law. Limiting disproportionate share payments might, however, cause considerable financial hardship for some hospitals that serve large numbers of low-income patients. Disproportionate share hospitals in states that are currently making very large payments might experience significant reductions in their Medicaid payments. Insofar as disproportionate share payments are enabling hospitals to serve larger numbers of low-income uninsured patients as well as Medicaid beneficiaries, some low-income patients could be denied access to hospital services.

ENT-36 REDUCE THE MATCHING RATE FOR ADMINISTRATIVE COSTS IN AFDC, MEDICAID, AND FOOD STAMPS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Reduce Higher Matching Rates to 50 Percent					
Budget Authority	390	450	510	560	620	2,550
Outlays	390	450	510	560	620	2,550
	Reduce Matching Rates to 45 Percent					
Budget Authority	930	1,040	1,140	1,250	1,360	5,700
Outlays	930	1,040	1,140	1,250	1,360	5,700

The Aid to Families with Dependent Children (AFDC) program provides cash assistance to low-income families in which one parent is absent or incapacitated or the primary earner is unemployed. The Medicaid program provides medical assistance to low-income people who are recipients of Supplemental Security Income (SSI) or current or recent recipients of AFDC, and to certain other low-income people. The Food Stamp program provides coupons redeemable for food to low-income households so that they can buy nutritionally adequate, low-cost diets.

The federal government pays half of most administrative costs in all three programs; state and local governments pay the remaining share. Higher matching rates have been set up for some types of expenses as an incentive for local administrators to undertake more of a particular administrative activity than they would if such expenses were matched at 50 percent. For example, enhanced matching rates are applied in all of these programs to the costs of some computer operations and some antifraud activities.

The administrative activities matched at higher rates represent a relatively small proportion of all administrative costs in the Food Stamp and AFDC programs, but constitute a larger share of Medicaid administrative costs. In the Food Stamp and AFDC programs, administration consists mainly of determining eligibility and benefit amounts. In the Medicaid program, however, determining eligibility represents a relatively small share of administration, since the AFDC and SSI programs largely carry out this function. Consequently, activities that are matched at higher rates--including the costs of automated claims processing, reviewing medical and health care use, and establishing and operating a fraud control unit--constitute a much higher percentage of Medicaid's administrative costs.

Reducing the higher matching rates to 50 percent in the three programs would decrease federal outlays by about $0.4 billion in 1994 and by $2.6 billion over the 1994-1998 period. About four-fifths of the savings would be in Medicaid, one-tenth would be in AFDC, and the remaining one-tenth would be in the Food Stamp program.

Considerably greater savings would be generated if most of the matching rates were reduced to 45 percent, since an additional 5 percent of all administrative expenses would be shifted to the states. Federal outlays would fall by $0.9 billion in 1994 and by $5.7 billion over the 1994-1998 period. About two-thirds of the savings would be in Medicaid, with the remainder split about equally between the AFDC and Food Stamp programs.

Reducing the higher matching rates to 50 percent would be appropriate if the need to provide special incentives for these activities no longer exists. For example, all state Medicaid programs already have established computer systems and are currently operating units to control fraud and abuse. Reducing all matching rates to 45 percent would provide states with stronger incentives in all three programs to reduce administrative inefficiencies, since the states would be liable for a greater share of the cost of such inefficiencies.

States might respond to either option by reducing their administrative efforts, however, and might thereby raise program costs and offset some of the federal savings. Specifically, AFDC and Food Stamp benefits might increase if errors or fraud occurred more often in spite of the penalties states already face when errors exceed a certain rate. States might also make less effort to eliminate waste and abuse in payments to providers under Medicaid. In addition, this proposal might harm recipients by encouraging states to slow the growth of benefits over time or to limit services provided under Medicaid in order to constrain total state costs.

ENT-37 PREFUND THE GOVERNMENT'S SHARE OF FEDERAL RETIREES' HEALTH INSURANCE

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Outlays	n.a.	2,050	3,100	3,150	3,250	11,600

NOTE: n.a. = not applicable.

Upon retirement, more than 85 percent of federal workers elect to continue their employer-provided health insurance coverage under the Federal Employees Health Benefits (FEHB) program. The federal cost of continued protection, averaging 71 percent of annual premiums, is not recognized until a worker retires, when it is financed on a pay-as-you-go basis. As such, the true labor costs of delivering governmental services is understated. This distorts evaluations of a program's cost-effectiveness, comparisons with costs of comparable services in the private sector, decisions about the benefits of capital investment, and the setting of budgetary priorities.

Labor costs could be viewed more frankly if the government funded its share of annuity beneficiaries' (annuitants') health care premiums in advance by annually investing a scheduled amount to cover, with interest, the cost of future benefits earned for work performed during the year (current service charge) and a portion (one-twentieth per year) of the cost of earned benefits that active and retired employees have already accumulated as a result of prior service. Individual employing agencies would pay the scheduled amounts and deposit them into the government-wide FEHB fund. Prefunding would shift recognition of employer costs to provide health care for annuitants and their dependents from the years of retirement to the years of active employment. The pay-as-you-earn accounting under this option, like that for deferred compensation earned under the Federal Employees' Retirement System, would allow better management of human resources and view government operating costs more frankly.

The changes this option poses resemble changes emerging in the private sector's financial management of health care benefits. The Financial Accounting Standards Board (FASB), the private body that sets financial reporting standards, now recommends that statements of corporations recognize liability for postretirement health care. Moreover, nearly 70 percent of the large firms in a 1991 survey had adopted some form of prefunding or may do so in the future.

In general, the recorded deficit would not be changed by adopting this proposal, because the increased agency payments would simply represent transactions between accounts within the budget; they would neither increase nor decrease net federal spending nor generate offsetting income from the public. But the option's coverage of government enterprises (such as the Postal Service, the Tennessee Valley Authority, and various public power administrations) would reduce federal budget deficits in the near term. These agencies would incur higher current costs; assuming that the higher cost of current operations was recouped through increases in postage and utility rates, the deposits to the health benefits fund would decrease the budget deficit.

Quantifying the impact of this option is difficult because future health care costs and demographic changes are uncertain, but a conservative estimate shows outlays over five years decreasing by as much as $11.6 billion. Almost all of the savings would derive from the Postal Service, which is highly labor-intensive and which would need to incorporate the new costs into the next postage rate hike, assumed to occur in February 1995. For estimating purposes, the new scheme would apply to other agencies at the beginning of the year, and suitable adjustments would have to be made in appropriation requests.

Critics point out that calculating future liabilities for annuitants' health insurance is highly complex and uncertain. Because FEHB and national health care are currently under review by the Clinton Administration and the Congress, it also seems ill-advised and premature to enact financing reform at this time. The accounting practices in the private sector, moreover, need not apply exactly to most governmental operations, which, unlike the mail service, are not self-financing.

In addition, postal and public utility customers would probably claim that prefunding places an unfair burden on users of mail and power service simply to improve the near-term cash flow of the U.S. Treasury. Such burdens have already been levied as a result of recent changes, including annuitants' health care financing on a pay-as-you-go basis. The prefunding option could increase postage rates for letters by about 2 cents on top of forthcoming increases. It would also, because of the high price, initially reduce total demand for all types of mail service by about 1 percent from projected volume. This loss of business would come at a time when the Postal Service is experiencing financial difficulty brought on by other cost requirements and a softening of demand for its services.

The FASB rules for "pay-as-you-earn" accrual costing do not apply to firms participating in a multiemployer plan. In these cases, the participating employer simply pays the amount billed by the plan each year. The General Accounting Office finds that the FEHB program is similar to such a plan and thus the current pay-as-you-go scheme is the appropriate approach. Others feel that individual agencies are subsidiary activities and cost centers under the central policy direction of the federal government. As such, the government should assign annuitant health care costs on an "as-earned" basis (including interest and transition obligations) to the operating entities that deliver services, especially those, such as delivery of the mail, that are intended to be largely self-supporting. Postal managers, however, believe such treatment would place their organization at a great disadvantage because it would not have control over the costs and benefits for annuitant care. But some analysts believe that whether or not the FEHB program is like a single or multiemployer plan, failure of the Congress to adopt a pay-as-you-earn approach continues to subsidize today's operations at the expense of future customers and possibly taxpayers.

Finally, it should be noted that this proposal--although it would reduce the deficit in the initial years--would not save the federal government much money over the long term. For one thing, the total costs for annuitants' health benefits would not change. In the case of the Postal Service, moreover, the proposal would change only the timing of certain receipts, forcing current postage ratepayers, rather than future ones, to pay the full costs of services received. In the case of utilities, the shift would result in some small savings to taxpayers because public utility ratepayers currently cover none of the cost of health benefits for retired utility workers.

ENT-38 REFORM THE FEDERAL EMPLOYEES HEALTH BENEFITS PROGRAM BY MODIFYING REIMBURSEMENT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Costs for Active Employees (Discretionary Spending)					
Budget Authority	0	600	900	1,000	1,100	3,600
Outlays	0	550	850	950	1,100	3,400
	Costs for Federal Annuitants (Mandatory Spending)					
Budget Authority	0	550	900	950	1,100	3,400
Outlays	0	500	850	900	1,100	3,300

The Federal Employees Health Benefits (FEHB) program provides health insurance coverage for about 4 million federal employees, retirees, and their survivors at a yearly cost to the government of about $11.5 billion. Under the program, the 14 carriers that offer fee-for-service plans use a variety of systems for setting reimbursement rates to health care providers. For the most part the systems pay actual charges adjusted, by some combination of criteria, for prevailing market prices, reasonableness, and--to an increasing degree--negotiated discounts with preferred providers. (In 1992, the Office of Personnel Management (OPM) put into effect preset payment limits required by the Congress for insured hospital stays of the relatively few federal retirees over age 65 who are not covered by Medicare.)

Medicare, however, has developed a system of price controls that establishes preset fees. These fees are based--in the case of physician services--on the procedures performed, or in the case of hospital services, on a patient's diagnosis at discharge. In both cases, nationwide averages are adjusted to reflect local market conditions and other factors that influence costs. In recent years, price schedules have been restrained to hold increases in payment rates below cost increases. Because Medicare's system appears to make generally lower reimbursements than those typically made under FEHB, this option proposes that the fee-for-service plans under FEHB not reimburse providers in excess of Medicare's rates for hospitals and physicians. (Physician reimbursement rules would also follow Medicare's regulations limiting balance-billing in order to protect beneficiaries from providers shifting the liability to patients. The Medicare price controls would not apply to health maintenance organizations or other prepaid plans under FEHB. In the case of hospital services, the rates must be modified to cover the younger working population.)

The number and variety of participating carriers precludes accurate calculation of the average gap between health care costs for FEHB and Medicare. For estimating purposes, the Congressional Budget Office assumes that the savings potential averages 20 percent. (This estimate is derived from surveys of differences in fees paid by Medicare compared with those paid by private insurers.) If the new fee schedules were phased in over four years, beginning in the contract year starting January 1995, the proposal would lower federal outlays by an estimated $6.7 billion through 1998. In order to realize the cost savings to FEHB as budgetary savings, the Congress must reduce appropriations accordingly. The reductions in outlays on behalf of active employees would be counted as a decrease in discretionary spending. For annuitants, the reductions would be counted as a decrease in mandatory spending. (The estimates exclude amounts paid by the Postal Service because such costs are paid by mail users instead of taxpayers. Moreover, more than one-fourth of the savings would come from health care coverage provided to civilians involved in national defense.)

This proposal is expected to achieve some of the same savings realized under Medicare's preset fees as those paid by private insurers generally. In the case of physician payments, it is assumed that Medicare's rates for virtually all procedures are lower than FEHB rates because Medicare has used cost containment measures for several years. Surveys by government commissions set up to review Medicare suggest that fees paid by FEHB may be about 54 percent higher than those paid by Medicare for similar physician services and may be about 43 percent higher for similar hospital services. It is uncertain, however, that such cost containment potential still exists for physician payments for patients under age 65 or for hospital patients of any age, because of recent expansion of negotiated contracts with providers, price controls established by some state agencies, and the influence of Medicare on prices generally.

Adoption of Medicare fee schedules by FEHB could parallel the reforms undertaken by the Civilian Health and Medical Program for the Uniformed Services (CHAMPUS) in fiscal year 1988, when it adopted, with modification, Medicare's diagnosis-related group (DRG) system for hospitals. The modified DRG fee schedule used by CHAMPUS better reflects the hospital-related needs of younger patients and could be applied by FEHB carriers. CHAMPUS is in its third year of successive decreases to bring physician payments into line with the rates established under Medicare's Resource Based Relative Value Scale (RBRVS). FEHB's efforts could also parallel those of CHAMPUS to move toward Medicare rates for physicians' services. Phased adoption of DRG and RBRVS schedules established by Medicare would minimize disruptive impacts on the FEHB health care network.

With few exceptions, such as the Washington, D.C., area, FEHB enrollees represent a relatively small portion of health care patients. Accordingly, adoption of the Medicare fee schedules should save the government money without adverse financial effects on most providers. Still, this proposal would raise some of the same concerns about jeopardizing the quality and accessibility of health care that arise in debates over the schedule schemes for Medicare and CHAMPUS. Reflecting such concerns, the Congress last year barred OPM from applying preset physician fees to Federal Employees Health Benefits program participants over the age of 65.

Payment schemes are not yet so sophisticated as to recognize all of the appropriate cost variations for treating different patients with the same diagnosis or by the same procedure. Nor can they identify all of the relevant cost variations among providers. As a result, some hospitals and physicians might realize a profit from cases for which an identical diagnosis or procedure performed by a different provider could represent a financial loss. Such economic forces might, especially in localities with significant numbers of FEHB patients, cause some providers to alter the amount of care provided to FEHB patients. In fact, a recent study of DRG experience through mid-1986 suggests somewhat increased mortality risk due to early discharge and recommends intensified monitoring. On the positive side, the study found that the DRG scheme did not interrupt the trend toward better in-hospital services. In other cases, providers might try to collect "non-covered" excess expenses directly from FEHB patients or to augment the volume of care rendered; for example, by increasing the frequency or length of visits to the doctor's office.

Mandating regulations for insurers involves certain problems. One would be developing an appropriate data base for administering preset physician fees. In addition, many carriers have already developed effective cost-containment measures that could be disrupted by this change. Some carriers and providers might choose to withdraw from the FEHB program rather than modify their practices, thus limiting the choices available to employees and possibly diminishing the net savings to the government. In this respect, a more effective device for reducing federal outlays would be to lower the premiums and allow each carrier to find its own methods for containing costs.

The longer the federal government waits to adopt preset schedules for physicians and hospitals reimbursed by FEHB, the more vulnerable it becomes to providers who shift costs onto enrollees when those providers are faced with controls placed on them by other plans. Accordingly, the FEHB program may be the last large insurer not incorporating a prospective payment scheme, and the estimated long-term savings may be understated. (Payment rates, however, can be set to achieve whatever savings policy makers deem acceptable.) A counterargument posits that changing the way reimbursements are made under FEHB would be premature in view of increasing momentum for comprehensive reform of the nation's health care, including arrangements to control costs.

ENT-39 ELIMINATE THE DISPROPORTIONATE SHARE ADJUSTMENT FOR HOSPITALS IN MEDICARE'S PROSPECTIVE PAYMENT SYSTEM

Savings from CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Annual Savings (Millions of dollars)					
Immediately Eliminate the Disproportionate Share Adjustment						
Outlays	2,350	2,900	3,150	3,350	3,600	15,300
Gradually Eliminate the Disproportionate Share Adjustment						
Outlays	470	1,100	1,800	2,600	3,500	9,450

NOTE: The disproportionate share adjustment is based on an index that is the sum of two ratios: the proportion of all Medicare patient days that are attributable to Medicare patients receiving benefits from the means-tested Supplemental Security Income program, and the proportion of all patient days for which Medicaid is the primary payer.

Under Medicare's prospective payment system (PPS), higher rates are paid to hospitals with a disproportionately large share of low-income patients. In 1985, the Congress added this "disproportionate share" adjustment to account for the presumed higher costs of treating Medicare beneficiaries at these hospitals. One rationale for the adjustment is that low-income Medicare patients may be sicker and, therefore, more expensive to treat than other Medicare patients. Another rationale is that hospitals with large numbers of low-income patients may provide additional staffing, facilities, and services in response to such patients' needs. In 1993, disproportionate share payments are expected to total about $2.5 billion, or 4 percent of all PPS payments. Large urban hospitals--those with 100 or more beds--will receive more than 95 percent of the disproportionate share payments, compared with approximately 83 percent of all PPS payments.

Data on hospitals' costs provide only limited support for any disproportionate share adjustment. Although more than 1,500 hospitals receive disproportionate share payments, the only group for which such an adjustment would be supported by the data is large urban hospitals that have extremely high values of the disproportionate share index. This group contains approximately 150 hospitals and accounts for about one-fourth of all disproportionate share payments.

If the disproportionate share adjustment were eliminated immediately, outlays would fall by $15.3 billion over the 1994-1998 period. Phasing out the disproportionate share adjustment by the end of 1998 would reduce outlays by about $9.5 billion over the same five years. Alternatively, the adjustment could be eliminated for all hospitals except for large urban institutions with the highest disproportionate share indexes. If the adjustment were restricted to that group and set at 5 percent--the level suggested by the cost data--annual savings would be about $100 million less under the first option and about $50 million less under the second one.

Without the disproportionate share adjustment, Medicare's payments to all hospitals would be similar in relation to their costs of treating Medicare beneficiaries. Phasing out the adjustment over several years would give affected hospitals time to adjust. Nevertheless, many of those institutions are in poor financial condition and, since 1989, Medicare's PPS payments to hospitals have been less, on average, than the costs of treating patients who are covered. If eliminating the disproportionate share adjustment led some of them to cut back on charity care, or if some were forced to close, residents of the areas the hospitals serve could have less access to care.

ENT-40 REDUCE MEDICARE'S PAYMENTS FOR THE INDIRECT COSTS OF PATIENT CARE THAT ARE RELATED TO HOSPITALS' TEACHING PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Reduce the Teaching Adjustment to 6 Percent					
Outlays	580	720	780	840	970	3,900
	Reduce the Teaching Adjustment to 3 Percent					
Outlays	1,650	2,000	2,200	2,350	2,750	10,950

The Social Security Amendments of 1983 established the current prospective payment system (PPS) under which Medicare reimburses hospitals for inpatient services provided to beneficiaries. Higher rates are paid to hospitals with teaching programs to cover their additional costs of caring for Medicare patients. In particular, payments to these hospitals are raised by approximately 7.7 percent for each 0.1 increase in the hospital's ratio of full-time equivalent interns and residents to its number of beds. This adjustment was included both to compensate hospitals for their indirect teaching costs--such as the greater number of tests and procedures thought to be prescribed by interns and residents--and to cover higher costs caused by a variety of factors that are not otherwise accounted for in setting the PPS rates. These factors include severity of illness within diagnosis-related groups, location in inner cities, and a more costly mix of staffing and facilities--all of which are associated with large teaching programs.

Estimates of the indirect teaching adjustment based on data from the 1984-1989 period suggest that the teaching adjustment could be lowered to a value in the range of 2 percent to 7 percent, depending on which year's data are used and which of many possible estimating assumptions are chosen. If the teaching adjustment were lowered to 6 percent, outlays would fall by about $3.9 billion over the 1994-1998 period. Alternatively, if the teaching adjustment were lowered to 3 percent, outlays would fall by about $10.9 billion over that period.

This option would better align payments with the actual costs incurred by teaching institutions; between 1981 and 1984, these costs fell substantially in real terms relative to those of nonteaching hospitals. It would, however, considerably reduce payments to teaching hospitals. If these hospitals now use some or all of the excess payments to fund activities such as charity care, access to and quality of care could diminish for some people.

ENT-41 REDUCE MEDICARE'S DIRECT PAYMENTS FOR MEDICAL EDUCATION

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	180	190	200	200	210	980

Medicare's prospective payment system does not include payments to hospitals for the direct costs they incur in providing graduate medical education (GME), that is, residents' salaries and fringe benefits, teaching costs, and institutional overhead costs. Instead, these payments are made separately, but also prospectively, based on Medicare's share of a hospital's 1984 cost per resident indexed for subsequent increases in the level of consumer prices. Medicare's GME payments, which are received by about one-fifth of hospitals, totaled $1.3 billion in 1992.

This option would reduce teaching and overhead payments for nonprimary care residents in their initial residency period and eliminate these payments for nonprimary care residents beyond their initial residency period, but continue to pay their salaries and fringe benefits. Hospitals' GME payments would be based on the national average salary paid to residents in 1987, updated annually by the consumer price index for urban areas. Reimbursement for primary care residents would be based on 175 percent of the national average salary. This weighting provides a payment amount close to the average that Medicare pays per resident under the current system. The corresponding weights for nonprimary care residents in their initial residency period and nonprimary care residents beyond their initial residency period would be 145 percent and 120 percent, respectively. The savings over the 1994-1998 period would total about $1 billion.

Unlike the current system, in which GME payments vary considerably from hospital to hospital, this option would pay every hospital the same amount for the same type of resident. Efficient hospitals would be rewarded by being able to keep any excess reimbursement over the cost of training, and inefficient hospitals would be penalized. The overall reduction in the level of subsidies might be warranted since the United States as a whole is facing a projected surplus of physicians. Moreover, since physicians earn much higher incomes as a result of graduate training, they might reasonably contribute more to these costs themselves. This reallocation would occur if hospitals responded to the reimbursement changes by cutting residents' salaries or fringe benefits.

Reducing Medicare's GME payments could have some drawbacks, however. Some physicians incur substantial debts during their medical education, which they must pay off when they begin to practice. Requiring physicians to contribute to their residency costs might further discourage physicians from entering primary care or locating their practices in low-income areas. Decreasing GME reimbursement could force some hospitals to reduce the resources they commit to training, jeopardizing the quality of their medical education programs.

ENT-42 ELIMINATE MEDICARE'S ADDITIONAL PAYMENTS TO SOLE COMMUNITY HOSPITALS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	200	220	230	230	240	1,100

Under Medicare's prospective payment system (PPS) for inpatient hospital services, special rules apply to providers designated as sole community hospitals (SCHs). At present, there are about 660 SCHs, more than 95 percent of which are located in rural areas. Thus, about one-fourth of rural hospitals qualify for SCH status. Estimates indicate that in 1993 more than half of SCHs will receive higher payments as a result of being in this category.

Under the current rules, a hospital may be designated as an SCH if it meets specific criteria that define a sole provider of inpatient, acute care hospital services in a geographic area. In addition, many SCHs have been permitted to continue that status regardless of whether they meet the current sole-provider criteria.

Payments to SCHs are equal to the highest of three amounts: the regular PPS payment that would otherwise apply, an amount based on the hospital's costs in 1982 updated to the current year, or an amount based on the hospital's costs in 1987 updated to the current year. In addition, rural SCHs receive a higher "disproportionate share" adjustment--that is, a higher PPS adjustment for hospitals that treat a disproportionately large share of low-income patients--than other rural hospitals. As a result of the special rules, total PPS payments to SCHs for 1993 are estimated to be about 10 percent higher than they would be otherwise. If the special payment rules for SCHs were eliminated, total PPS payments would be $200 million less in 1994 and $1.1 billion less for the 1994-1998 period.

A primary objective of the SCH rules is to assist hospitals whose closings would threaten access to hospital care in rural areas, but the support is not well targeted toward essential providers. The group of hospitals qualifying for SCH payments, for example, includes many hospitals located in areas with other nearby providers. Moreover, whether an SCH actually receives higher payments under the special rules that permit payments to be based on a hospital-specific amount depends on whether its costs in either of the specified base years (1982 or 1987) were relatively high, but not on its current financial condition.

If the special payment rules were eliminated, however, revenues of many SCHs would be lower, which might cause financial distress for some of them. Because many SCHs are the sole providers of hospital services in their geographic areas, quality or access to care might be reduced in some rural locations.

ENT-43 ELIMINATE RETURN-ON-EQUITY PAYMENTS FOR PROPRIETARY SKILLED NURSING FACILITIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	90	100	110	120	130	560

Medicare pays for care in skilled nursing facilities (SNFs) for eligible people who need skilled nursing or rehabilitative care services after discharge from an acute care hospital. Following annual growth averaging about 5 percent between 1984 and 1987, Medicare's payments to SNFs grew by 11 percent in 1988, 214 percent in 1989, and 23 percent in 1990. They then shrank by 10 percent in 1991 and grew by 47 percent in 1992. The pattern of growth in the 1988-1991 period reflected the combined impact of administrative changes that were designed to clarify eligibility for benefits and the temporary expansion of eligibility under the Medicare Catastrophic Coverage Act of 1988. The Congressional Budget Office expects that, during the 1993-1998 period, annual growth in total outlays for SNFs will average 11 percent.

For-profit SNFs receive payments designed to provide a rate of return on equity capital that is equal to the average interest rate paid on securities issued for purchase by the federal Hospital Insurance Trust Fund. Equity capital is generally the difference between assets and liabilities after excluding certain specified items. In addition, a for-profit SNF that is certified by Medicare may depreciate capital investments over a specified period.

In 1993, CBO expects Medicare payments to for-profit SNFs for return on equity (ROE) to be $75 million. If these payments were eliminated, Medicare outlays would be about $90 million lower in1994 and about $560 million lower over the 1994-1998 period.

Eliminating ROE payments for proprietary SNFs would result in more consistent treatment of return on capital across the Medicare program. Currently, for-profit SNFs are the only providers to which Medicare makes ROE payments. This option would also result in more consistent handling of Medicare-certified SNFs because it would eliminate the different treatment of ROE for not-for-profit and for-profit SNFs.

By reducing the overall return on capital invested in SNFs, however, this option would reduce the incentive for private investment in the nursing home industry at a time when the demand for nursing home use is increasing rapidly. In addition, if for-profit SNFs responded to eliminating ROE payments by restructuring their capital to emphasize debt rather than equity, they would incur additional interest costs. These costs might be deemed allowable by Medicare and might partly offset the savings to Medicare from nonpayment of ROE. Finally, the Omnibus Budget Reconciliation Act of 1990 requires the Secretary of Health and Human Services to submit a proposal for prospective reimbursement of SNFs. Some people think it would be more appropriate to integrate changes in ROE payments with any move to pay SNFs prospectively.

ENT-44 SHIFT UPDATES TO JANUARY FOR ALL PAYMENT RATES UNDER MEDICARE'S HOSPITAL INSURANCE PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	1,100	1,300	1,350	1,450	1,500	6,700

Medicare uses predetermined rates to pay for most inpatient hospital services, hospice care, and some skilled nursing services. Medicare's prospective payment system (PPS) pays a preset amount for each patient treated in the hospital based on the patient's diagnosis. For hospice and some skilled nursing care, Medicare pays a fixed amount per day. These rates are usually updated on October 1.

Most skilled nursing services, inpatient hospital care not covered by the PPS, and home health services are reimbursed on a reasonable-cost basis, subject to specified limits. The limits for skilled nursing and hospital care are generally adjusted on October 1. The limits for home health services change on July 1. The updated limits apply to complete cost-reporting periods beginning on or after the date of the update. For example, if a skilled nursing facility's cost-reporting period begins on January 1, the October 1993 update would affect the limits applicable to its January 1, 1994-December 31, 1994, cost-reporting period.

Instead of the current dates, the updates for all rates and limits covered by the Hospital Insurance program could be made on January 1, although the limits would continue to apply on the basis of cost-reporting periods. If the change were made by delaying the updates scheduled for July 1993 and October 1993 to January 1994, Medicare outlays would be reduced by $1.1 billion in fiscal year 1994 and $6.7 billion during the 1994-1998 period. In addition, the change could simplify the administration of the Medicare program because the Hospital Insurance updates would occur at the same time as the increases in Medicare's copayment amounts and the adjustments to payment rates under Medicare's Supplementary Medical Insurance program. This modification would, however, reduce payments to providers who are reimbursed under the Hospital Insurance program, which might affect the quality of their services or reduce access for some Medicare beneficiaries.

ENT-45 FREEZE MEDICARE'S PROSPECTIVE PAYMENT SYSTEM RATES FOR ONE YEAR

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	2,050	2,850	3,150	3,450	3,750	15,250

Under Medicare's prospective payment system (PPS), payments for the operating costs of inpatient hospital services provided to Medicare beneficiaries are determined on a per-case basis, according to preset rates that vary with the patient's diagnosis and certain characteristics of the hospital. Separate rates apply to hospitals in three types of location: urban areas with populations of more than 1 million, other urban areas, and rural areas. The annual percentage increase in these rates, called the update factor, is usually based on the increase in an index of hospitals' costs known as the hospital market-basket index (MBI).

For fiscal year 1994, under the Omnibus Budget Reconciliation Act of 1990, the amount of the urban update factor (which applies to rates for both types of urban areas) will equal the percentage increase in the MBI, and the rural update factor will equal the percentage increase in the MBI plus 1.5 percentage points. Based on the Congressional Budget Office's current estimate of 4.1 percent growth in the MBI, the urban update factor will be 4.1 percent and the rural update factor will be 5.6 percent for fiscal year 1994. The estimated average PPS update factor will be about 4.3 percent.

Under this option, Medicare would freeze PPS hospital rates for 1994 at their 1993 levels by setting the update factors to zero, thereby saving $2.1 billion in 1994 and $15.3 billion over the 1994-1998 period. In response to the freeze, some hospitals could increase their efficiency. In addition, data on hospitals' revenues and costs during the past several years suggest that some hospitals could absorb the reductions even if they were unable to increase efficiency. In particular, estimates by the Prospective Payment Assessment Commission indicate that the overall margin for hospitals (defined as the difference between the total revenues of hospitals from all sources and their total costs, expressed as a percentage of total revenues) increased from 3.5 percent in 1987 to 4.2 percent in 1990. It increased even though total PPS payments declined during this period in relation to the costs of treating Medicare beneficiaries and were actually less than those costs for the last two years of the period.

The reduction in payments might, however, be difficult for some hospitals to absorb. As a result, some Medicare beneficiaries might encounter reduced access to hospital services or lower-quality care, and hospitals might cut back on uncompensated care.

ENT-46 FREEZE MEDICARE'S SMI REIMBURSEMENT RATES FOR ONE YEAR

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Outlays	1,270	2,820	3,570	3,990	4,430	16,080

Payment rates under Medicare's Supplementary Medical Insurance (SMI) program are generally increased every year. Rates are scheduled to rise next on January 1, 1994.

A new Medicare fee schedule for physician services became effective January 1, 1992. Under current law, the update for 1994 will be equal to the percentage increase in the Medicare economic index plus an adjustment based on the difference between actual growth in spending for 1992 compared with the 10 percent target rate of growth. Under the Congressional Budget Office's current projections, physicians' fees will rise by 8.7 percent in 1994.

Payment rates for clinical laboratory services and durable medical equipment are normally adjusted periodically on the basis of the consumer price index. The 1994 update is expected to be 3 percent for laboratory services and 2.9 percent for durable medical equipment.

Legislation could be passed directing that Medicare instead freeze the rates for these SMI services at 1993 levels by setting all these updates to zero. This one-year freeze would save nearly $1.3 billion in 1994 and $16.1 billion over the 1994-1998 period.

The freeze would reduce total SMI expenditures by 2.6 percent in 1994 and 4.9 percent over the 1994-1998 period. The reduction in payments might, however, be difficult for some providers to absorb. As a result, some Medicare beneficiaries might face a decrease in access to or quality of services.

ENT-47 CONTINUE MEDICARE'S TRANSITION TO PROSPECTIVE RATES FOR FACILITY COSTS IN HOSPITAL OUTPATIENT DEPARTMENTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	240	790	1,100	1,300	1,500	4,900

The Medicare program pays for services provided in hospital outpatient departments with separate payments to the facility and physician. The facility component includes reimbursement for the services of nonphysician personnel, drugs and biological products, other health services, rent, and utilities. Medicare used to reimburse hospital outpatient departments on a reasonable-cost basis for most services. The Omnibus Budget Reconciliation Act of 1986, however, changed Medicare's payment method for most surgical procedures performed in hospital outpatient departments. The reimbursement that hospitals receive for these procedures is now based on the lesser of reasonable costs or charges, or a blend of reasonable costs or charges and the prospective rate received by free-standing ambulatory surgical centers (ASCs) in the area. In 1987, a similar change was enacted for paying facility costs associated with outpatient radiology and diagnostic services. In both cases, the hospital-specific share is currently 42 percent and the prospective rate share is 58 percent.

Outpatient payments are one of the fastest-growing components of Medicare expenditures, accounting for a projected 22 percent of Supplementary Medical Insurance (SMI) payments in 1993. Between 1994 and 1998, SMI outlays for hospital outpatient services are expected to increase at an average annual rate of about 17 percent. A major factor in this increase is technological progress that allows hospitals and physicians to substitute outpatient surgical procedures and technologies for inpatient procedures. Furthermore, under the current reimbursement system, hospitals have little incentive to reduce the costs of ambulatory surgery or outpatient radiology because that would result in lower payments. By contrast, ASCs have strong incentives to control costs because they are reimbursed prospectively, as are physicians who provide radiology services in their offices.

Under this option, the hospital-specific portion of the blended reimbursement rate for the facility costs of outpatient surgery, radiology, and diagnostic services would be phased out in 1995, with a transitional blend for 1994 of 25 percent of costs and 75 percent of the prospective rate. Savings to the Medicare program would be $240 million in 1994 and $4.9 billion over the 1994-1998 period.

In addition to reducing Medicare's costs, this option would result in the same payment system for hospital outpatient departments and ASCs. Thus, it would reduce the incentive and ability of hospitals to compete for patients through costly capital acquisitions. Hospitals would also have stronger incentives to control the costs of outpatient surgery, radiology, and diagnostic services since they could no longer automatically pass part of these costs through to Medicare. Some people are concerned, however, that access to care for rural Medicare beneficiaries might deteriorate; small and rural hospitals are more dependent on outpatient revenue than larger hospitals, and there are fewer alternatives to outpatient hospital services in rural areas. In addition, if patients at risk of complications are advised to receive treatment in hospital outpatient departments rather than ASCs because of the ready availability of advanced support systems in hospitals, paying higher rates to hospitals than to ASCs might be appropriate.

ENT-48 CHARGE A FEE FOR SMI CLAIMS THAT ARE NOT BILLED ELECTRONICALLY

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Outlays	150	120	90	90	100	550

NOTE: Savings include reductions in both direct spending and discretionary appropriations.

About 47 percent of all claims under the Supplementary Medical Insurance (SMI) program are billed electronically; the rest are submitted on paper. In 1992, about 570 million claims were processed, with an average of two items per claim.

Medicare could create an incentive for providers to switch to an electronic system for submitting claims. Under this option, Medicare would reduce reimbursements by $1 for each item not billed electronically. (Medicare could provide electronic billing software to physicians at cost.) Net savings to Medicare would be $150 million for 1994 and $550 million over the 1994-1998 period. Net SMI outlays would be reduced by about 0.2 percent over the five-year period. About 16 percent of those savings would be on administration, and appropriations would have to be reduced to obtain them.

This option would cut Medicare's costs, not only because of the fee received for paper billing, but also because processing costs for Medicare's administrative agents would be lower on claims that were switched from paper to electronic billing. Manual entry of data by clerical personnel would no longer be necessary, reducing the chances of entering data incorrectly. Physicians could benefit as well because the software used for electronic submittal of claims automatically checks for missing or inconsistent entries, thereby helping to prevent problems that can delay Medicare payments.

Physicians would bear the additional costs of buying the equipment and software for submitting bills electronically, however. They might also incur additional costs to train office personnel to use the new equipment. Although these additional costs would be small compared with revenues for most physicians, they could be a hardship for physicians who provide a lot of charity care.

ENT-49 REDUCE MEDICARE'S PAYMENT FOR INTRAOCULAR LENSES TO $100

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	60	90	90	100	100	430

Medicare pays for nine-tenths of all surgical procedures for treating cataracts in the United States. During this surgery, the natural lens of the eye is removed and, in most cases, an intraocular lens (IOL) is implanted. Currently, for each IOL used, Medicare pays a flat fee of $200 to ambulatory surgical centers and an average of $215 to hospital outpatient departments. Total payments under Medicare for IOLs were about $200 million in 1992.

Some people argue that Medicare pays more than necessary for IOLs, often citing Canadian prices to justify reducing Medicare's payment. If Medicare's payment at all sites were reduced to $100 as of January 1, 1994, savings to Medicare would total $60 million for fiscal year 1994. If the payment rate were indexed to the consumer price index in subsequent years, savings over the 1994-1998 period would be $430 million, and net outlays under the Supplementary Medical Insurance program would be reduced by 0.1 percent.

This option would give providers an incentive to negotiate lower prices from companies that manufacture and sell IOLs. Whether or not providers were successful at negotiating lower wholesale prices, enrollees would benefit from Medicare's lower payment rate because patients pay 20 percent coinsurance on IOLs, and balance-billing for this service is rare.

If providers were unable to negotiate reductions in the prices they pay for IOLs, however, they would find it less profitable to perform cataract surgery. This fact, together with recent reductions in Medicare's payments to physicians performing the surgery, might reduce access to this procedure in some areas. Even if access did not become a general problem, the flat rate of $100 for IOLs might induce some providers to substitute lower-quality IOLs for the ones they now use, perhaps necessitating later replacement, with all the attendant costs of a second surgical procedure.

ENT-50 INCREASE AND INDEX MEDICARE'S DEDUCTIBLE FOR PHYSICIANS' SERVICES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	710	1,410	1,880	2,360	2,910	9,280

One way to achieve appreciable federal savings in Medicare's Supplementary Medical Insurance (SMI) program is to increase the deductible--that is, the amount that enrollees must pay for services each year before the government shares responsibility. The deductible is now $100 a year and has been increased only three times since Medicare began in 1966, when it was set at $50. The deductible has fallen in relation to average annual per capita charges under the SMI program from 45 percent in 1967 to about 5 percent in 1991. In relation to the average annual Social Security benefit, the deductible has dropped from 5 percent in 1967 to 1.4 percent in 1991.

Increasing the SMI deductible to $150 on January 1, 1994, would save $710 million in fiscal year 1994. If the new deductible were indexed to the rate of growth in SMI charges per enrollee for 1995 and later years, savings would be $9.3 billion over the 1994-1998 period, and net outlays for SMI would be reduced by 2.7 percent. By 1998, the deductible amount would be $235.

An increase in the deductible amount would enhance the economic incentives for prudent consumption of medical care, while spreading the burden among most enrollees. No enrollee's out-of-pocket costs would rise by more than $50 in 1994.

The additional out-of-pocket costs under this option might, however, discourage some low-income enrollees who are not eligible for Medicaid from seeking needed care. In addition, costs to states would increase because their Medicaid programs pay deductible amounts for Medicare enrollees who also receive Medicaid benefits.

ENT-51 INCREASE THE SMI COINSURANCE RATE TO 25 PERCENT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	1,510	3,430	4,460	5,170	5,930	20,500

Currently, the coinsurance rate on most services provided under the Supplementary Medical Insurance (SMI) program is 20 percent. One exception is outpatient psychiatric services, for which the coinsurance rate is 50 percent. The other exceptions are clinical laboratory services and home health care, which have no coinsurance requirements.

If enrollees were required to pay coinsurance rates of 25 percent on all services that are currently subject to a coinsurance rate of 20 percent, savings to Medicare would be $1.5 billion in fiscal year 1994. Over the 1994-1998 period, savings would be $20.5 billion, reducing net SMI outlays by 6.4 percent.

This option would reduce Medicare's costs for two reasons. First, the higher coinsurance rate would reduce use of services by Medicare enrollees who do not have supplemental insurance coverage. Second, Medicare would be responsible for a smaller share of the costs of the services that enrollees use.

This option would increase the risk of very large out-of-pocket costs for the 20 percent to 25 percent of enrollees who have no supplementary coverage, however, and would probably increase medigap premiums for the 30 percent of enrollees who purchase that kind of supplementary insurance. Moreover, it would increase states' Medicaid costs for the 15 percent to 20 percent of enrollees who receive full or qualified Medicaid benefits.

ENT-52 COLLECT 20 PERCENT COINSURANCE ON CLINICAL LABORATORY SERVICES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	770	1,350	1,600	1,900	2,240	7,850

Medicare currently pays 100 percent of the approved fee for clinical laboratory services provided to enrollees. Medicare's payment is set by a fee schedule, and providers must accept that fee as full payment for the service. Beneficiaries pay coinsurance of 20 percent for most other services provided under Medicare's Supplementary Medical Insurance (SMI) program (as they did for clinical laboratory services before July 1984, when a fee schedule that reduced payment rates was put in place).

Reimposing the coinsurance requirement for laboratory services could yield appreciable savings to Medicare. If coinsurance of 20 percent of laboratory fees were imposed beginning January 1, 1994, federal savings would be $770 million in fiscal year 1994. Savings would total nearly $7.9 billion over the 1994-1998 period, reducing net SMI outlays by about 2.3 percent.

In addition to reducing Medicare's costs, this option would make cost-sharing requirements under the SMI program more uniform and therefore easier to understand. Moreover, enrollees might be somewhat less likely to have laboratory tests with little expected benefit if they paid part of the costs.

Cost sharing probably would not substantially affect the use of laboratory services by enrollees, however, because decisions about what tests are appropriate are generally left to physicians, whose decisions do not appear to depend on enrollees' cost sharing. Hence, although a small part of the savings under this option might be the result of more prudent use of laboratory services, most of the expected savings would reflect the transfer to enrollees of costs now paid by Medicare. Further, billing costs for some providers, such as independent laboratories, could be greatly increased because they would have to bill both Medicare and enrollees to collect their full fees. Currently, they have no need to bill enrollees directly for clinical laboratory services.

ENT-53 COLLECT 20 PERCENT COINSURANCE ON ALL HOME HEALTH AND SKILLED NURSING FACILITY SERVICES UNDER MEDICARE

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Outlays for Home Health	2,400	4,010	4,700	5,220	5,700	22,030
Outlays for Nursing	-100	-150	-180	-210	-250	-880
Total	2,300	3,860	4,520	5,010	5,450	21,150

Currently, copayments are not required from enrollees for home health services under Medicare. Copayments for skilled nursing facility (SNF) services are required for each day after the first 20 days of care; the coinsurance amount per day is equal to one-eighth of the deductible amount for hospital care and is unrelated to SNF costs.

If enrollees were required to pay coinsurance amounts equal to 20 percent of the projected average cost for each home health visit and each SNF day, the net savings to Medicare would be $2.3 billion in fiscal year 1994, with higher Medicare costs for SNF services more than offset by savings for home health services. Over the five-year projection period, savings would total nearly $21.2 billion.

This option, together with the laboratory coinsurance requirement discussed in ENT-52, would establish a uniform coinsurance rate of 20 percent on almost all Medicare services. This uniform rate would make Medicare's copayment requirements easier for providers and patients to understand. Further, because coinsurance amounts would be based on the cost of services, it would encourage enrollees who lack supplementary insurance coverage to consider relative costs appropriately when choosing among alternative treatments. As a result, the use of home health services might fall and the use of SNF services might increase. Only hospital inpatient services would require no copayments (for most stays) except for the deductible amount. But under the prospective payment system, patients are unlikely to remain hospitalized longer than necessary because hospitals have strong incentives to discharge them quickly.

However, many enrollees have supplementary insurance coverage that eliminates their Medicare copayment costs, and this option would not affect the use of services by those enrollees. Moreover, this option would increase the risk of very large out-of-pocket costs for the 20 percent to 25 percent of enrollees who lack any supplementary coverage, and would probably increase medigap premiums for about 30 percent of enrollees who purchase that kind of supplementary insurance.

ENT-54 ELIMINATE MEDICARE PAYMENTS TO HOSPITALS FOR ENROLLEES' BAD DEBTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	300	375	410	450	490	2,050

Medicare beneficiaries are responsible for certain deductible and coinsurance amounts when they receive hospital inpatient services. Coinsurance payments are also required for most outpatient services. For example, in calendar year 1992, the deductible amount for inpatient services was $652 per spell of illness. Currently, if the hospital makes a reasonable effort to collect these copayment amounts, Medicare will reimburse it for any remaining unpaid amounts. Eliminating these payments for enrollees' bad debts would reduce Medicare's payments to hospitals by $300 million in 1994 and $2 billion over the 1994-1998 period.

This option would give hospitals a financial incentive to expand their collection efforts, which would probably increase their recovery of enrollees' deductible and coinsurance amounts. Hospitals would not be able, however, to collect all the owed amounts. In particular, low-income enrollees who are not covered by Medicaid or other insurance may not be able to pay their hospital bills. As a result, this option would reduce revenues most for those hospitals that are most likely to serve low-income Medicare patients. A drop in their Medicare payments might cause hospitals to cut back on the quality of their services or the amount of uncompensated care they provide, or to raise the rates they charge for other patients' care.

ENT-55 INCREASE THE PREMIUM FOR PHYSICIANS' SERVICES UNDER MEDICARE TO 30 PERCENT OF PROGRAM COSTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	2,090	3,330	5,530	8,180	11,010	30,140

Benefits under Medicare's Supplementary Medical Insurance (SMI) program are partially funded by monthly premiums paid by enrollees, and the remainder are paid from general revenues. Although the SMI premium was initially intended to cover 50 percent of the cost of benefits, between 1975 and 1983 premium receipts covered a declining share of SMI costs--falling from 50 percent to less than 25 percent. This drop occurred because premium increases were limited by the cost-of-living adjustment (COLA) for Social Security benefits (which is based on the consumer price index), but the per capita cost of the SMI program increased faster. Since 1984, premiums have been set to cover 25 percent of average benefits for an aged enrollee, although under current law the COLA will again limit the premium beginning with the 1996 increase.

If the premium were set to cover 30 percent of benefits for 1994 and for all years thereafter, $2.1 billion would be saved in fiscal year 1994 and $30.1 billion over the 1994-1998 period. Net outlays for SMI would be reduced by about 8.8 percent over this period. The premium for 1994 would be $49.10 a month, instead of $41.10. These estimates assume a continuation of the current hold-harmless provision, which ensures that no enrollee's monthly Social Security check will fall as a result of the Social Security cost-of-living adjustment (which is based on the whole benefit) being smaller than the SMI premium increase.

All SMI enrollees would pay a little more under this option, in contrast to proposals--such as increasing copayments--that could substantially increase the out-of-pocket costs of those who become seriously ill. This option need not affect enrollees with incomes below the federal poverty threshold because all of them are eligible to have Medicaid pay their Medicare premiums, although some who are eligible for Medicaid do not apply for benefits.

Low-income enrollees who are not eligible for Medicaid, however, could find the increased premium burdensome. A few might drop Supplementary Medical Insurance coverage and either do without care or turn to sources of free or reduced-cost care, which could increase demands on local governments. In addition, states' expenditures would rise because states would pay part of the higher premium costs for the nearly 20 percent of Medicare enrollees who are also eligible for Medicaid.

ENT-56 RELATE THE PREMIUM FOR PHYSICIANS' SERVICES UNDER MEDICARE TO ENROLLEES' INCOMES

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
50 Percent Ceiling						
25 Percent Basic Premium	0	30	1,620	3,700	5,970	11,320
Income-Related Premium	390	1,660	1,520	1,700	1,910	7,180
Total	390	1,690	3,140	5,400	7,880	18,500
100 Percent Ceiling						
25 Percent Basic Premium	0	30	1,620	3,700	5,970	11,320
Income-Related Premium	340	1,480	1,320	1,460	1,620	6,220
Total	340	1,510	2,940	5,160	7,590	17,540

Instead of increasing the basic premium to 30 percent of costs for all enrollees under the Supplementary Medical Insurance (SMI) program, this option would collect relatively more from higher-income people. Under one version, individuals with modified adjusted gross incomes of less than $50,000 and couples with incomes lower than $65,000 would pay only the basic premium, set at 25 percent of SMI costs per enrollee (or the value set in law through 1995, if higher). Premiums would rise progressively for higher-income enrollees, however. The maximum total premium would be set to cover 50 percent of costs for individuals with incomes exceeding $60,000 and for couples with incomes exceeding $80,000.

Under a second version, nearly the same five-year savings could be achieved by setting the maximum total premium to cover 100 percent of costs for individuals with incomes exceeding $125,000 and for couples with incomes over $150,000. Under this version, income-related premiums would begin at $100,000 for individuals and $125,000 for couples. In both cases, the income-related premiums would have to be collected through the income tax system so that rates could be aligned with income. Current premiums are deducted automatically from Social Security checks for most enrollees.

If the 50 percent option were carried out for 1994, savings would total $390 million in fiscal year 1994 and $18.5 billion over the 1994-1998 period. Under the 100 percent option, savings would total $17.5 billion over the five-year period. These estimates assume that the current hold-harmless provisions would continue only for those subject to the basic 25 percent premium. (The hold-harmless provisions ensure that no enrollee's Social Security check would decrease because an increase in the SMI premium exceeded the cost-of-living adjustment.) Under both options, more than 60 percent of the five-year savings come from keeping the basic SMI premium at 25 percent.

Most enrollees would be unaffected by the income-related portion of the premium. Under the 50 percent option, roughly 93 percent of enrollees would face the basic 25 percent premium, about 5 percent would pay the maximum premium, and 2 percent would pay a premium somewhere in between. Under the 100 percent option, only about 2 percent of enrollees would be subject to the income-related premium.

Enrollees subject to the income-related premium would pay substantially more, however. Under the

50 percent option, the maximum monthly premium for 1994 would be $82.20 instead of the $41.10 premium set by current law. Under the 100 percent option, the maximum monthly premium would be $163.50. This might lead some enrollees to drop out, although it is estimated that fewer than 0.5 percent of all enrollees would do so. Those with retirement health plans that do not require Medicare enrollment (largely retired government employees) would be most likely to drop out, but some healthy enrollees who have no other source of health insurance might do so as well.

ENT-57 EXTEND EXPIRING PROVISIONS FOR MEDICARE AS SECONDARY PAYER

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	0	0	960	1,400	1,540	3,900

Under current law, Medicare enrollees who are not retired and have employment-based health insurance are covered primarily by their group's private insurer. Medicare is a secondary payer for these people, although it assumes primary responsibility after 18 months for those with end-stage renal disease (ESRD). As of October 1, 1995, however, Medicare will become the primary payer for disabled enrollees whose coverage is employment-based because the existing secondary-payer provisions for this group will expire. And as of January 1, 1996, the Medicare program will assume primary-payer responsibility after 12 months for ESRD enrollees with employment-based coverage.

If current secondary-payer provisions were extended indefinitely, savings for 1996-1998 would total $3.9 billion. There would be no savings for fiscal years 1994 and 1995.

This option would continue current policies that make Medicare secondary to employment-based insurance held by enrollees (or their spouses) who still work. It would keep secondary-payer provisions uniform for aged and disabled enrollees, while continuing to limit the exposure of employment-based plans to health costs for ESRD enrollees.

The option would increase the costs of health insurance for employers, however, and might make it more difficult for Medicare enrollees to find or retain employment. The latter effect could be especially severe for ESRD enrollees, whose annual health care costs are very high, although laws prohibiting discrimination in employment on account of age or disability may provide some protection.

ENT-58 REDUCE FEDERAL EMPLOYEE RETIREMENT BENEFITS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Defer COLAs for Retirees Until Age 62			
Military Retirement	300	680	1,100	1,500	1,950	5,550
Civilian Retirement	80	150	200	240	260	920
			Limit Some COLAs Below Inflation			
Military Retirement	190	450	730	1,050	1,350	3,750
Civilian Retirement	130	310	500	700	900	2,550
			Modify the Salary Used to Set Pensions			
Military Retirement	30	70	100	140	190	530
Civilian Retirement	20	50	100	150	210	520
			Restrict Agency Match on Thrift Plan Contribution to 50 Percent			
Civilian Retirement	370	440	500	570	640	2,500
			Total: All Changes Combined			
Military Retirement	420	950	1,500	2,100	2,750	7,750
Civilian Retirement	590	910	1,250	1,600	1,900	6,250

About 4.3 million employees are covered by federal civilian and military retirement programs. The Federal Employees' Retirement System (FERS) covers civilian employees hired since January 1984 and others who elected to join. Most civilian employees not covered by FERS are covered under its predecessor, the Civil Service Retirement System (CSRS). (See REV-26 for related option of raising the contribution rate for CSRS-covered employees.) Uniformed military personnel are covered by the Military Retirement System (MRS). This system was last revised for personnel entering the service after July 31, 1986, and military personnel will continue retiring under the plan through the next century.

Alignment with the practices of private employers is a long-standing objective of federal personnel policy. Cutting selected federal retirement benefits, especially in light of recently enacted pay reform, would further this objective by producing a mix of current and deferred compensation more in line with that in the private sector. Even with the cuts described below, however, federal retirees would still receive benefits that exceed those typically received by employees retiring from private firms. In addition to better alignment with private-sector practice, the proposed changes could, in some cases, improve the ability of government to retain high-quality workers.

Opponents of changing the current system point out that alignment with private-sector practice has not been the only policy standard for federal compensation. In the past, the government has maintained generous retirement benefits as an incentive for keeping an experienced corps of career employees. Reforms in the last two decades have moderated certain benefit provisions, especially for new employees, while keeping a retirement package that competes with the best private-sector plans. Moreover, some of the options would produce substantial savings only if they applied to both current and future retirees. Currently, about 1 million nondisabled retirees under age 62 receive benefits under CSRS and MRS. These retirees, who would bear about 70 percent of the burden of proposed cuts in cost-of-living adjustments (COLAs), view their relatively generous pensions as recompense for working long years at below-market federal salaries that should now move toward parity as federal pay reforms are phased in over the remainder of the decade. Applying retirement cuts to military personnel would also meet with criticism. The lower benefits would cause some individuals to delay retirement--a counterproductive outcome in view of efforts to reduce the size of the armed forces.

Taken together, the measures described below would generate savings of about $1 billion in 1994 if applied to all former federal workers. The savings for the entire five-year period would amount to $14 billion. Exempting current retirees from the COLA proposals would shrink five-year savings to $1.5 billion. (The estimates exclude savings realized by the Postal Service because it is now off-budget and because its operating cost reductions eventually benefit only mail users.)

Defer Cost-of-Living Adjustments. CSRS and the prereform MRS (covering new recruits before August 1, 1986) provide full cost-of-living protection to employees who retire before reaching age 62. Such protection is expensive when compared with that available under the largest and most generous private pensions. Deferring COLAs until age 62 for all nondisabled employees who retire before that age would yield five-year savings of $6.5 billion. (Nearly 90 percent of the estimated savings would derive from MRS because over half of its annuitants are nondisabled retirees under age 62.)

Deferring COLAs would moderate the government's cost for early retirement, consistent with selected reform features enacted for new federal employees covered by FERS and in 1984 for personnel covered by MRS. (Consistent with the MRS reforms, this option allows a catch-up adjustment at age 62 for partial inflation protection since the date of retirement. Retirees under FERS receive neither protection nor a catch-up at age 62.) Deferring COLAs would also enhance federal efforts to keep experienced workers by discouraging early retirement. But changing the rules of retirement could cause significant hardships for some individuals--especially MRS employees who usually retire at a relatively young age. Many retirees targeted by this option, however, should be in a position to supplement their pensions by working--as most military retirees already do. (As an alternative to eliminating COLAs, those who retire before they are 62 could be granted COLAs equal to one-half of the inflation rate with no catch-up provision. This option would parallel changes mandated in 1982 but subsequently repealed, and would result in savings of about $3.6 billion over five years.)

Limit Some COLAs. Current indexing of benefits is expensive and generous when compared with private-sector practice. Most private pension plans that allow for any adjustment of postretirement benefits do so on an ad hoc basis that, over time, may cover about 30 percent of the erosion that would otherwise occur because of inflation. Inflation protection for other sources of retirement income, such as Social Security and employer-sponsored thrift plans, could boost the overall inflation coverage typically found in the private sector to as much as 70 percent. By contrast, CSRS and the old MRS provide 100 percent automatic protection from inflation.

This option would limit COLAs to 1 percentage point below the rate of inflation for the old MRS and to one-half point below inflation for CSRS. (The smaller half-point limitation for CSRS would apply to a more comprehensive benefit that, unlike the defined benefits under FERS and MRS, substitutes for both Social Security and employer-sponsored benefits. Therefore, the smaller cut would produce a reduction comparable with the one-point limit for MRS employees.) These changes would conform to the postretirement COLAs (1 percentage point below the rate of inflation) for employees under FERS and the revised MRS. This option, however, would hurt low-income retirees most. It would also renege on an understanding that workers in the CSRS who had passed up the chance to switch systems would retain their full protection against inflation. Savings would amount to $6.3 billion through 1998. (Savings would decrease to $3.7 billion if this option were coupled with the preceding one that would defer COLAs until age 62.)

Modify the Salary Used to Set Pensions. Under current law, the CSRS and FERS provide initial benefits based on an average of the employee's three highest salaried years. The MRS uses a different salary base for personnel hired before September 1980; benefits are calculated using the salary at the date of retirement. If, instead, a four-year average were adopted for CSRS and FERS and a 12-month average were adopted for MRS, initial benefits for most new retirees would decline by about 2 percent to 3 percent, producing total savings through 1998 of $1.1 billion. This option would align federal practice more closely with practice in the private sector, where five-year averages are commonly used. Moreover, it could encourage some employees to stay on another year in order to take full advantage, when calculating retirement benefits, of the higher salary under pay reform. (To discourage workers from accelerating their planned date of retirement to avoid the new formula, the change in base salary would have to be phased in. The estimates here assume that this would be done over 12 months.)

Restrict Matching Contributions. On behalf of any worker covered by FERS, federal agencies automatically contribute 1 percent of individual earnings to the Thrift Savings Plan. In addition, the employing agency matches any voluntary employee deposits dollar for dollar for the first 3 percent of pay and 50 cents for each dollar thereafter up to a 5 percent maximum. The entire federal contribution for employees putting aside a full 5 percent amounts to a sum equal to 5 percent of pay. If the government continued the automatic 1 percent contribution, but limited its matching contributions to a uniform 50 percent rate and retained the 5 percent maximum, savings over five years would total $2.5 billion. The government's approach would remain superior to those typically provided by private employers, which match an individual's voluntary thrift deposits up to 6 percent of pay at a 50 percent rate but provide no automatic contribution. Compared with the typical maximum employer contribution of 3 percent of pay in the private sector, this option would reduce the federal contribution to 3.5 percent, a cut of 1.5 percentage points. This cut would hit higher-salaried professional and administrative workers hardest because they use the thrift plan the most.

ENT-59 END OR SCALE BACK TRADE ADJUSTMENT ASSISTANCE

Savings from CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	Annual Savings (Millions of dollars)					
	End Trade Adjustment Assistance					
Budget Authority	190	180	180	180	170	900
Outlays	130	180	180	180	170	840
	Eliminate Trade Adjustment Assistance Cash Benefits					
Budget Authority	110	110	100	100	95	510
Outlays	110	110	100	100	95	510

The Trade Adjustment Assistance (TAA) program offers income replacement benefits, training, and related services to workers unemployed because of import competition. To obtain assistance, such workers must petition the Secretary of Labor for certification and then meet other eligibility requirements. Cash benefits are available to certified workers receiving training, but only after their unemployment insurance benefits are exhausted.

Ending the TAA program would reduce federal outlays by $130 million in 1994 and by $840 million during the 1994-1998 period. Affected workers could apply for benefits under Title III of the Job Training Partnership Act (JTPA), which authorizes a broad range of employment and training services for displaced workers regardless of the cause of their job loss. If funding for Title III were limited, however, it might be possible to eliminate only TAA cash benefits and shift the remaining TAA funds for training and related services to Title III. Savings under this option would total $510 million during the 1994-1998 period.

The rationale for these options is to secure under federal programs more equivalent treatment of workers who are permanently displaced as a result of changing economic conditions. Since Title III of JTPA provides cash benefits only under limited circumstances, workers who lose jobs because of foreign competition are now treated more generously than workers who are displaced for other reasons.

Eliminating TAA cash benefits would, however, cause economic hardship for some of the long-term unemployed who would have received them. In addition, TAA now compensates some of the workers adversely affected by changes in trade policy. Some argue, therefore, that eliminating TAA benefits could lessen political support for free trade, which economists generally view as beneficial to the overall economy.

ENT-60 INCREASE TARGETING OF CHILD NUTRITION SUBSIDIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	240	600	680	720	770	3,000
Outlays	210	550	670	720	760	2,900

Federal child nutrition programs were developed to improve the health and well-being of children by providing them with nutritious meals. The programs provide cash and commodity assistance to schools, child care centers, and family day care homes that serve meals to children.

Although most of the funds are earmarked for low-income children, some of the aid benefits middle- and upper-income children as well. For example, in the National School Lunch Program (the largest of the child nutrition programs), most schools receive $1.70 in cash reimbursement for each meal served to children from households with incomes at or below 130 percent of the poverty line; a smaller subsidy of $1.30 for each meal served to children from households with incomes from 131 percent to 185 percent of poverty; and a subsidy of 16 cents a meal for children with household incomes above 185 percent of poverty. Schools are also given 14 cents' worth of commodities for each lunch served, regardless of the household income of the child. Comparable reimbursement structures are used in the School Breakfast Program and in the portion of the Child Care Food Program devoted to child care centers. Reimbursements to family day care homes do not vary with the household income of the child.

This option, which includes provisions from recent budgetary proposals by the Bush Administration, would make three changes. Cash and commodity subsidies for school lunches served to children with incomes above 350 percent of the poverty level would be eliminated. Subsidies for meals served to children in family day care homes would be reduced by 20 cents for snacks, 30 cents for breakfasts, and 40 cents for lunches unless the family day care provider determines that the children are from families with incomes at or below 185 percent of the poverty level. And school lunch subsidies for children from families with incomes from 131 percent to 185 percent of the poverty level would be increased by 20 cents.

Together, these changes would reduce federal expenditures by $2.9 billion during the 1994-1998 period. Eliminating the cash and commodity subsidies for all lunches served to children from households with incomes above 350 percent of the poverty line ($48,825 per year for a family of four in 1992) would reduce federal expenditures by $50 million in 1994, by $440 million in 1995, and by $2.2 billion during the 1994-1998 period. (These estimates assume that the changes would be effective on July 1, 1994, except for the change in subsidies to family day care homes, which would have an October 1, 1993, effective date.) Reducing the subsidies for the children in family day care homes would lower federal expenditures by $160 million in 1994 and by $1.15 billion during the 1994-1998 period. The higher subsidies called for in the third part of the option would increase federal expenditures by $480 million during the five-year period.

In these estimates, the Congressional Budget Office assumes that the reduction in federal subsidies would lead a small number of schools--those serving relatively few lunches to children from families with low incomes--to discontinue the program for all students. The savings resulting from schools dropping out of the program are an estimated $230 million over five years.

Although most of the federal funds are earmarked for low-income children, about one-fifth of the children who participate in the school lunch program have household incomes above 350 percent of the poverty line and about three-quarters of the participating children in family day care homes have household incomes above 185 percent of the poverty line. These children are less in need of federal subsidies, and the targeting of this assistance would be improved by limiting it to those from households with the lowest incomes. Increases in the subsidies for meals served to children in households with incomes from 131 percent to 185 percent of poverty would, in effect, redistribute some of the child nutrition subsidies from higher-income students to this group.

Such changes would probably result in lower participation among nonpoor children because participation falls when prices are raised. Participating schools would probably increase the price charged to nonpoor children to make up the loss in reimbursements unless state and local governments provided additional support. Children who dropped out of the program could receive meals of lower quality, since the meals qualifying for reimbursement are nutritionally adequate, whereas those from alternative sources might not be. Moreover, if the decline in participation were substantial, low-income children could become the main recipients of the meals and thus would be identifiable as poor by their peers. Finally, a few schools where nonpoor children provide a large share of the total revenue for the meal program would probably drop out when participation fell, thereby eliminating federally subsidized meals for the low-income children attending them.

ENT-61 ELIMINATE SMALL FOOD STAMP BENEFITS

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	70	70	70	70	70	350
Outlays	70	70	70	70	70	350

The Food Stamp program provides coupons that enable low-income householders to buy a low-cost but nutritionally adequate diet. Among all programs providing assistance to low-income people, its reach is the greatest, encompassing all types of households, from the elderly living alone to two-parent families with children.

Because the benefits to which a household is entitled decline as its income rises, some households can receive only small amounts of food coupons each month. For one- and two-person households, a special rule increases the food coupons they receive to $10 a month even if their net income indicates a smaller coupon amount.

This option would eliminate the special rule that ensures a $10 minimum benefit for eligible households with one or two persons, and would also eliminate any food stamp benefits of less than $10 a month for all households, thereby reducing federal expenditures by $70 million in 1994 and by $350 million during the 1994-1998 period. These savings include an estimated $10 million a year from lower administrative costs. Approximately 500,000 households, of which two-thirds are composed of elderly people, would lose their food stamp benefits.

Carrying out this option would make administering the Food Stamp program more cost-effective because a large number of households that receive small monthly benefits would no longer have to be served. It would also eliminate the special treatment of one- and two-person households. Finally, such a change would foster consistency between the Food Stamp program and the Aid to Families with Dependent Children program, which has not paid benefits of less than $10 a month for the past decade.

At the same time, this option would reduce by as much as $120 a year the effective incomes of households in which incomes are already low. Even though the households that would be affected are those with the highest incomes among food stamp recipients, their incomes are usually close to the poverty threshold.

ENT-62 REQUIRE STATES TO REIMBURSE THE FEDERAL GOVERNMENT FOR A LARGER PROPORTION OF ERRONEOUS PAYMENTS IN THE FOOD STAMP PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	0	0	0	20	110	130
Outlays	0	0	0	20	110	130

Both the federal government and state governments are involved in the administration of the Food Stamp program, which provides food assistance to low-income households. The federal government determines most program rules, which generally are uniform throughout the country, and pays all of the benefit costs. States administer the program on a day-to-day basis, and pay half of the administrative costs.

Administering benefit programs inevitably involves errors, such as overpayments or underpayments to beneficiaries, payments to ineligible households, and improper terminations and denials. Error rates--erroneous payments as a proportion of total payments--have declined significantly in the Food Stamp program, from as high as 10.5 percent for overpayments in the early 1980s to 7 percent in fiscal year 1991. They remain higher, however, than error rates in the Aid to Families with Dependent Children and Supplemental Security Income programs, in which 1990 overpayment error rates were 6 percent and 3.2 percent, respectively. Because households that receive food stamps have more earnings and higher turnover, it is unlikely that the Food Stamp program's error rates would ever decline to the levels of the other two programs.

The federal government penalizes states for errors that exceed specified tolerance levels. In the Food Stamp program, this tolerance level, which was raised by the Hunger Prevention Act of 1988, is based on the lowest national average error rates ever achieved. In fiscal year 1991, the overall tolerance level was 10.3 percent: 6.96 percent for overpayments and payments to ineligible households, 2.35 percent for underpayments, plus one percentage point. States must return $1 to the federal government for every $1 paid in error above the tolerance level.

This option would reduce the overall tolerance level to 7 percent beginning with errors made in 1994, while retaining all other characteristics of the current system. As a result, penalties would increase from about $70 million a year to an estimated $570 million. For several reasons--the time it takes to measure error rates and allow for good cause waivers, the backlog of good cause waiver determinations for the 1986-1991 period, and expected appeals by states--federal savings would not be likely until fiscal year 1997. In 1997, savings are estimated to be $20 million and in 1998, $110 million. By the year 2000, savings would be about $240 million annually. This estimate assumes that less than 50 percent of the penalties would be collected after state appeals had run their course. An estimated 45 states would have to pay penalties each year, which is 34 more than under current law.

Because states do not share in the funding of benefits, they avoid any costs of errors if their error rates fall below the tolerance level. Paying more of the costs of errors would encourage states to improve administrative efficiency, thus reducing errors. At the same time, the process of measuring error rates and collecting penalties is complex, results in litigation, and thus raises administrative costs. Despite a penalty system that has existed for a decade, few penalties have ever been collected, making the estimated savings uncertain. Some people also argue that it is unfair to penalize states for errors when they have no control over the program rules or the frequent rule changes that set the stage for the errors.

ENT-63 ELIMINATE THE $50 CHILD SUPPORT PAYMENT TO AFDC FAMILIES

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	110	120	120	130	130	600
Outlays	110	120	120	130	130	600

The Child Support Enforcement program collects child support payments from absent parents on behalf of families receiving Aid to Families with Dependent Children (AFDC). These payments are largely used to offset federal and state costs for AFDC. Amounts up to the first $50 in monthly child support collected, however, are paid to the AFDC family, with no effect on the level of AFDC benefits. In essence, this policy means that AFDC families for whom absent parents contribute child support get as much as $50 more a month than do otherwise identical families for whom such contributions are not made.

Eliminating the $50 child support payment to AFDC families would save the federal government $110 million in fiscal year 1994 and $600 million through 1998. Stopping such payments would end the differential treatment of AFDC families that depends on whether the absent parent pays child support. Administrative complexity would also be reduced.

Nevertheless, the child support payment continues to provide incentives for custodial parents to make an effort to obtain support. If the payment were eliminated, recipients of Aid to Families with Dependent Children could be no better off when absent parents paid child support than when they did not, perhaps reducing recipients' cooperation in seeking such payments. Absent parents also might reduce their child support payments if this option were enacted, although new enforcement tools such as the withholding of wages would make it difficult for many to do so. In either case, the well-being of the children in these families would be adversely affected.

ENT-64 REDUCE THE $20 EXCLUSION FROM INCOME IN SUPPLEMENTAL SECURITY INCOME

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	170	180	190	200	210	960
Outlays	170	180	190	200	210	960

The Supplemental Security Income (SSI) program provides federally funded monthly cash payments, based on uniform, nationwide eligibility rules, to needy aged, blind, or severely disabled persons. As a means-tested program, SSI benefits are reduced by recipients' outside incomes, subject to certain exclusions. For unearned income, most of it from Social Security payments, the first $20 a month is excluded and any additional amounts reduce benefits dollar for dollar. Earned income is excluded more liberally, and any of the $20 exclusion not applied to unearned income is applied to earned income.

Reducing the $20 exclusion to $15 would save $170 million in 1994 and $960 million over the 1994-1998 period. A program that ensures a minimum living standard for its recipients need not provide a higher standard for people who happen to have unearned income, as illustrated by the absence of any standard exclusions for unearned income (other than child support) in the Aid to Families with Dependent Children program.

Nevertheless, reducing the $20 exclusion would decrease by as much as $60 a year the incomes of the roughly 2.5 million low-income people--50 percent of all federal SSI recipients--who now benefit from the exclusion. Even with the full $20 exclusion, incomes of most SSI recipients fall below the poverty threshold.

ENT-65 REDUCE THE FEDERAL MATCHING RATE AND INCREASE FEES IN THE CHILD SUPPORT ENFORCEMENT PROGRAM

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Reduce the Federal Matching Rate						
Budget Authority	a	a	540	590	650	1,800
Outlays	a	a	540	590	650	1,800
Charge Fees for Services						
Budget Authority	a	a	50	60	60	170
Outlays	a	a	50	60	60	170

NOTE: These estimates do not take into consideration the interaction between the two options, which is noted in the discussion.

a. The options would not take effect until 1996.

Enacted in 1975, the Child Support Enforcement (CSE) program provides administrative tools and funding that states can use to improve the payment of child support by absent parents. The federal government helps states finance their CSE efforts by paying 66 percent of the costs and making incentive payments. Because of this federal funding and because they keep a portion of child support collections, states saved an estimated $385 million in 1991. By contrast, the federal government incurred costs in 1991 of about $585 million, after accounting for its share of child support collections.

To improve the performance of the program, the Family Support Act of 1988 required several complex changes in child support practices, some of which need not be carried out until 1994 and 1995. In order to allow sufficient time for states and localities to put these changes into place without disruption, the options presented here would not take effect until 1996.

Reduce the Federal Matching Rate. Lowering the federal matching rate from 66 percent to 50 percent in 1996 and subsequent years is estimated to save $540 million in 1996 and $1.8 billion through 1998, although the amount of savings could vary, depending on how states reacted to the change.

Reducing the federal share of CSE costs would alter the balance of costs and savings between the federal and state governments, decreasing both federal costs and state savings. Although a higher matching rate may have been needed in the past to induce states to set up CSE programs, such programs are now operating and cannot be dismantled without financial penalty. Even with a 50 percent matching rate, states would continue to save money. Finally, this option would encourage states to improve the efficiency of their CSE efforts, since they would pay a larger share of the costs of inefficiencies, and could thus lead to even lower program costs overall.

Lowering the matching rate would entail some risks, however. Because caseloads per child support worker are already high, it is unlikely that states could improve efficiency enough to offset fully the reduction in federal payments. Thus, they might cut CSE services, thereby reducing child support collections. The lower CSE collections for AFDC families would decrease state revenues from that source, but some states still might be better off financially if they cut CSE services, since those with low per capita incomes may receive only a small share--as low as 20 percent--of child support collected. Further, states receive only small financial benefits from child support collections for non-AFDC families. They might, therefore, be even more likely to cut back on efforts for those families, thereby lowering the children's living standards.

Charge Fees to Some Families. Although states are required to charge application fees for furnishing child support services to non-AFDC families, many states charge only nominal amounts. In 1991, child support enforcement agencies collected fees amounting to $34 million, or less than 2 percent of total program costs. This option would require states to charge non-AFDC families fees of $25 at the time they applied for services and $25 each year in which child support was collected for them. Some flexibility could be given to states by allowing them to charge the annual user fee to either the custodial parent or the absent parent, to exempt low-income families but charge more to higher-income families, or to pay the fee directly to the federal government without charging families.

If the fee requirement were imposed beginning in 1996, the federal government would save $50 million that year and $170 million through 1998, at the current 66 percent federal matching rate. With a matching rate of 50 percent, as discussed above, savings would decline to $35 million in 1996 and $120 million through 1998.

Considering the substantial services many families receive from the child support enforcement agencies, these fees would be a modest contribution toward meeting their costs. Charging fees could discourage some custodial parents from seeking assistance, however, potentially reducing collections of child support. The families most likely to be discouraged would probably be those most in need of the income, unless states chose to exempt low-income families from paying the fees. In addition, states have often complained about the costs of collecting fees, particularly when they do not have adequate computerized systems. Under those circumstances, it is particularly desirable to delay the effective date for any fee requirements until after the enhanced automated systems required by the Family Support Act are in place.

ENT-66 IMPOSE A FEE FOR FEDERAL ADMINISTRATION OF SSI STATE SUPPLEMENTARY PAYMENTS

	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	160	170	180	180	190	870

The Supplemental Security Income (SSI) program provides federally funded monthly cash payments to needy aged, blind, or severely disabled persons. Established by the 1972 amendments to the Social Security Act and begun in 1974, SSI replaced the federal/state programs for Old-Age Assistance, Aid to the Blind, and Aid to the Permanently and Totally Disabled. The maximum federal payment is $434 a month for an individual and $652 a month for a couple. States may supplement the federal payment and choose to have the Social Security Administration (SSA) administer these supplements; the SSA does that--at no charge--for 27 states and the District of Columbia. This option would impose a fee for the service.

Fees could be levied in several ways: for example, per recipient of state supplements, or as a percentage of a state's total supplementary payments. This option sets a flat fee of $5 monthly for each recipient. The Congressional Budget Office estimates that the SSA would collect $160 million in fees in 1994 and $870 million in the 1994-1998 period. (About 40 percent of the money would be collected from California.)

Imposing an administrative fee would reimburse the federal government for a service it is providing to some states. If the states involved determined that they could administer their supplements at lower cost, they would be free to do so.

The increase in cost that the states would incur could, however, discourage some of them from supplementing the federal SSI payments; it could also result in smaller amounts being provided, although most states cannot reduce their nominal payments because of certain provisions of federal law. Opponents also note that the federal payments alone are insufficient to raise the incomes of SSI recipients to the poverty line and that state supplements help fill the gap; the federal government should therefore encourage them. Moreover, the two states that have chosen to substitute additional SSI payments for food stamps--California and Wisconsin--are saving the federal government its share of the costs of administering food stamp benefits for their SSI recipients.

ENT-67 RESTRICT COST-OF-LIVING ADJUSTMENTS IN NON-MEANS-TESTED BENEFIT PROGRAMS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Eliminate COLAs for One Year						
Social Security/ Railroad Retirement	6,600	8,950	8,900	8,700	8,350	41,500
Other Non-Means-Tested Programs	1,700	2,350	2,350	2,400	2,500	11,250
Offsets in Means-Tested Programs and Medicare Premiums	-1,450	-800	-380	-360	-360	-3,350
Total	6,850	10,500	10,900	10,700	10,450	49,400
Limit COLAs to Two-Thirds of the CPI Increase for Five Years						
Social Security/ Railroad Retirement	2,200	5,050	7,900	10,800	13,700	39,700
Other Non-Means-Tested Programs	580	1,350	2,050	2,800	3,650	10,450
Offsets in Means-Tested Programs and Medicare Premiums	-95	-230	-450	-750	-1,050	-2,600
Total	2,700	6,150	9,550	12,850	16,300	47,550
Limit COLAs to the CPI Increase Minus 2 Percentage Points for Five Years						
Social Security/ Railroad Retirement	4,400	10,550	16,800	23,050	29,300	84,100
Other Non-Means-Tested Programs	1,150	2,750	4,400	6,000	7,850	22,150
Offsets in Means-Tested Programs and Medicare Premiums	-260	-640	-1,050	-1,650	-2,300	-5,950
Total	5,300	12,650	20,100	27,400	34,800	100,250
Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years						
Social Security/ Railroad Retirement	0	740	1,750	2,800	3,850	9,150

NOTE: Reductions in Social Security spending or increases in Social Security taxes would reduce the total federal deficit and the amount of federal borrowing from the public. These savings would not be counted, however, under the pay-as-you-go provisions of the Budget Enforcement Act of 1990.

Under current policies, outlays for Social Security and other non-means-tested cash transfer programs whose benefits are indexed to the consumer price index (CPI) are expected to total $360 billion in 1994 and to rise to $430 billion by 1998. Reducing the automatic cost-of-living adjustment (COLA) for these programs is commonly proposed as one way to slow the growth in entitlement spending. Four strategies for reducing COLAs and the savings in outlays resulting from each are shown in the preceding table. The programs in which COLAs would be reduced under the first three options are Social Security Old-Age, Survivors, and Disability Insurance; Railroad Retirement; Civil Service Retirement; Military Retirement; federal employees' Workers' Compensation; veterans' benefits; and retirement benefits for the Foreign Service, the Public Health Service, and the Coast Guard. The fourth option would affect only Social Security and Railroad Retirement Tier I COLAs. (Other options for achieving savings in Social Security are given in ENT-68, ENT-69, ENT-70, and REV-13.)

COLA restrictions would achieve considerable savings by exacting small reductions in benefits from a large number of people, in contrast to other budget options that would impose large reductions in benefits on smaller groups of recipients. Moreover, limiting these options to the non-means-tested cash benefit programs would protect many of the poorest beneficiaries of entitlements--for example, recipients of Supplemental Security Income--from losses of income. Finally, because the benefit levels would be permanently lowered for those eligible when the COLA limitation was established, significant reductions in outlays would persist beyond the five-year projection period. The savings would eventually disappear, however, as beneficiaries died or stopped receiving payments for other reasons, unless the COLA limitation was accompanied by a permanent reduction in the initial benefits of newly eligible workers (see ENT-68).

Budget reduction strategies that institute less-than-complete price indexing would, however, result in financial difficulties for some recipients--particularly if COLAs were restricted for an extended period. Restrictions on COLAs also encounter opposition from those who fear that changes made to reduce budget deficits would undermine the entire structure of retirement income policy. For example, because private pension plans generally do not offer complete indexing, restricting Social Security COLAs would further reduce protection for beneficiaries against inflation. Some people also think that, because Social Security and other retirement programs represent long-term commitments to both current retirees and today's workers, these programs should be altered only gradually and then only for programmatic reasons. According to this view, any changes in benefits should be announced well in advance to allow people to adjust their long-run plans.

Unless restrictions on COLAs were accompanied by commensurate changes in determining initial benefits for new recipients, disparities in benefit levels would develop among different cohorts of retirees. This situation is particularly relevant for Social Security, where benefits for newly eligible individuals are based on an indexed benefit formula and on indexed earnings histories. For example, if prices rose by 4 percent in a year and the wage index used to compute benefits for newly eligible recipients increased by 5 percent, eliminating that year's COLA without any change in the calculation of initial benefits would result in benefits for new beneficiaries that were about 5 percent higher than for recent retirees; under current law, benefits would be only about 1 percent higher for the new retirees. To mitigate this problem and to achieve additional savings, efforts to slow the growth in benefits through COLA limitations might be extended to the formulas for determining initial benefits (see ENT-68).

There are several options that would restrict COLAs for current beneficiaries. Except for the option to limit COLAs to 2 percentage points less than the increase in the CPI, the magnitude of the savings in each case--as well as the impact on beneficiaries--would be very sensitive to the level of inflation in the years in which the COLAs would be reduced. If prices were to rise faster than currently assumed, savings would be greater than shown, and recipients would bear larger costs. If prices were to rise less quickly, both budgetary savings and the effect on recipients would be smaller.

The following are specific versions of COLA restrictions:

Eliminate COLAs for One Year. One option would be to eliminate COLAs in fiscal year 1994 for non-means-tested benefit programs, while allowing them to be paid in subsequent years, but with no provision for making up the lost adjustment. If this approach were taken, federal outlays would be reduced by about $6.9 billion in 1994 and $49.4 billion over five years, with Social Security and Railroad Retirement accounting for most of the total.

Limit COLAs to Two-Thirds of the CPI Increase for Five Years. Under this approach, recipients would be compensated for only a certain proportion of inflation, such as two-thirds of the annual CPI increase. Under current economic assumptions by the Congressional Budget Office, applying this restriction for five years would save about $2.7 billion next year and $47.6 billion over the 1994-1998 period. As a result, benefits for people who received payments throughout the five-year period would be about 5 percent less in 1998 than they would have been under full price indexing. Furthermore, this option would reduce the real incomes of beneficiaries at the same time that they were becoming less able to supplement their incomes by working.

Limit COLAs to the CPI Increase Minus 2 Percentage Points for Five Years. An approach similar to the proportionate COLA reduction would be to reduce the adjustment by a fixed number of percentage points--for example, set the adjustment at the CPI increase less 2 percentage points. Unlike other options to restrict COLAs, however, both savings and effects on beneficiaries would be roughly the same regardless of the level of inflation--about $100.3 billion over the next five years, if extended for the full period. As in the previous option, this approach would be cumulative and would therefore significantly reduce the real incomes of beneficiaries at the same time that their ability to supplement their incomes by working declined.

Pay the Full COLA on Benefits Below a Certain Level and 50 Percent of the COLA on Benefits Exceeding That Level for Five Years. Another alternative would tie the COLA reductions to beneficiaries' payment levels, starting in 1995. The example discussed here--based only on Social Security and Railroad Retirement Tier I benefits--would award the full COLA for benefits based on the first $600 of a retiree's monthly primary insurance amount (PIA) and 50 percent of the COLA on benefits above this level. The $600 per month threshold is about equal to the projected 1995 poverty threshold for an elderly person and would be indexed to maintain its value over time.

This approach would save about $0.7 billion in 1995 and $9.1 billion over the 1995-1998 period. Because of the time needed to implement this proposal, these estimates assume that it would be in place by January 1995. For comparison with other options--which could be carried out earlier--the 1994-1998 budget savings would be $13.8 billion if this option were effective for the January 1993 COLA.

Because the full COLA would be paid to beneficiaries with low PIAs, this option would ensure that low-income recipients would not be adversely affected. Moreover, its percentage impact would be greater for recipients with higher benefits. Nonetheless, benefit levels are not always good indicators of total income. Some families with high benefits have little other income, while some with low benefits have substantial income from other sources. Furthermore, many people object to any changes in retirement programs that might be construed as introducing a means test for benefits, even if the test is limited only to the COLA.

A variation would extend this approach to the other non-means-tested benefit programs besides Social Security; this variation is not shown in the table. Such an option would spread the effects among a wider group of recipients, although it might be somewhat more complicated to design because the different benefit structure in each program could require a separate determination of the appropriate benefit levels on which to pay reduced COLAs.

Eliminating COLAs for recipients whose benefits are based on PIAs above a certain level is another option. Because this reduction would affect the entire benefit of each recipient above the threshold, not just the portion of the benefit above that level, both the savings and the impacts on beneficiaries would be considerably greater. Unless adjustments were made at the threshold, however, recipients with benefits just below the threshold could be made better off than those with benefits just above it.Still another approach that would address some of the administrative problems of these two options would involve increased taxation of Social Security benefits (see REV-13).

ENT-68 REDUCE THE REPLACEMENT RATE WITHIN EACH BRACKET OF THE SOCIAL SECURITY BENEFIT FORMULA

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	120	470	990	1,600	2,350	5,500

NOTE: Reductions in Social Security spending or increases in Social Security taxes would reduce the total federal deficit and the amount of federal borrowing from the public. These savings would not be counted, however, under the pay-as-you-go provisions of the Budget Enforcement Act of 1990.

Under current law, the basic Social Security benefit is determined by a formula that provides workers with 90 percent of their average indexed monthly earnings (AIME) up to the first bend point (which defines the first earnings bracket), plus 32 percent of the AIME in the second bracket, plus 15 percent of the AIME above the second bend point. One method of reducing initial Social Security benefits would be to lower these three rates by a uniform percentage.

Lowering the three rates in the benefit formula from 90, 32, and 15 to 87.3, 31.0, and 14.6, respectively, would achieve an essentially uniform 3 percent reduction in the benefits of newly eligible workers starting in 1994. Thus, a 62-year-old retiree who has always earned the average wage would receive initial benefits in 1994 of about 33.7 percent of preretirement earnings, compared with 34.7 percent if no change were made.

This reduction in the replacement rates would lower Social Security outlays by about $5.5 billion over the 1994-1998 period and by more in later years. Moreover, this option would reduce the benefits of all future retirees by essentially the same percentage. Furthermore, the option could be combined with a cut in the cost-of-living adjustment to ensure that benefits for both current and future recipients would be reduced to a similar extent (see ENT-67). The combination would generate substantial budgetary savings, while having a relatively small impact on both current and future beneficiaries.

Opponents contend that the Social Security Amendments of 1983 have already sharply reduced the benefits of future retirees and that further reductions would be unfair. In particular, the age at which unreduced Social Security retirement benefits are first available will rise in stages from 65 to 67 for workers turning 62 between the years 2000 and 2022. As a consequence, benefits for workers retiring after the turn of the century will be less than what would have been received had the full retirement age not been increased. For example, a worker who retires at age 62 in 2022 will receive 70 percent of the primary insurance amount, compared with 80 percent for a worker who retired at age 62 in 1992.

An alternative method of reducing Social Security benefits would leave replacement rates unchanged but narrow the AIME brackets over which those rates apply, perhaps by reducing the pace at which the brackets are indexed for inflation. This approach would exempt beneficiaries with the lowest AIMEs from the cut, but would impose benefit reductions unevenly among other recipients.

ENT-69 ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN OF RETIREES AGED 62-64

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	75	240	420	520	540	1,800

NOTE: Reductions in Social Security spending or increases in Social Security taxes would reduce the total federal deficit and the amount of federal borrowing from the public. These savings would not be counted, however, under the pay-as-you-go provisions of the Budget Enforcement Act of 1990.

Unmarried children of retired workers are eligible for Social Security benefits as long as they are under age 18, or attend elementary or secondary schools and are under age 19, or become disabled before age 22. A child's benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64, beginning with retirees reaching age 62 in October 1993, the savings would total $1.8 billion over the next five years.

This option might encourage some early retirees to stay in the labor force longer. At present, though benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, children's benefits are not. Further, the younger the workers are, the more likely they are to have children under age 18. Thus, workers under age 65 now have an incentive to retire while their children are still eligible for benefits. This incentive is quite small, however, for families in which spouses are also entitled to dependents' benefits. For these families, the increase in total benefits attributable to all eligible children cannot exceed 38 percent of the worker's primary insurance amount.

However, for families with workers whose retirement was not voluntary--because of poor health or unemployment, for example--the loss in family income might cause some hardship. Moreover, since spouses under age 62 receive benefits only if their children under age 16 also receive benefits, eliminating children's benefits for families of early retirees would also result in the loss of entire benefits for spouses in some families. In such cases, the total loss of income would generally be large.

A different approach would apply the same actuarial reduction to children's benefits that is applied to the benefits of the worker on whom those benefits depend. Thus, for example, the child of a worker retiring at age 62 would receive a maximum of 40 percent of the parent's basic benefit, instead of the 50 percent that is currently allowed. Such an approach would avoid large losses in benefits for workers with young children, but would save less.

ENT-70 LENGTHEN THE SOCIAL SECURITY BENEFIT COMPUTATION PERIOD BY THREE YEARS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Outlays	35	160	370	680	1,050	2,300

NOTE: Reductions in Social Security spending or increases in Social Security taxes would reduce the total federal deficit and the amount of federal borrowing from the public. These savings would not be counted, however, under the pay-as-you-go provisions of the Budget Enforcement Act of 1990.

Social Security retirement benefits are based on the average indexed monthly earnings (AIME) of workers in employment covered by the system. The present formula computes AIME based on workers' best 35 years of employment. Lengthening the averaging period would generally lower benefits slightly by requiring more years of lower earnings to be factored into the benefit computation. This option would increase the AIME computation period gradually until it reached 38 years for people turning age 62 in 1996 or beyond. This approach would save $2.3 billion over the next five years and more in later years.

One argument for a longer computation period is that people are now living longer and the normal retirement age for the Social Security program will be raised beginning in the year 2000. Using more years to calculate the AIME would reduce incentives for early retirement. In addition, lengthening the averaging period would reduce the advantage that workers who postpone entering the labor force have over those who get jobs at younger ages. Because many years of low or no earnings can be ignored in calculating AIME, the former group currently experiences little or no loss of benefits for its additional years spent not working and thus not paying Social Security taxes.

Because some beneficiaries elect early retirement for such reasons as poor health or unemployment, an argument against this proposal is that a longer computation period would reduce benefits for recipients who are least able to continue working. Other workers who would be disproportionately affected include those with significant periods outside the Social Security system, such as parents--usually women--who interrupted their careers to rear children, and workers who experienced long periods of unemployment or employment not covered by Social Security.

ENT-71 CONSIDER VETERANS' COMPENSATION WHEN DETERMINING SOCIAL SECURITY DISABILITY INCOME PAYMENTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Coordinate Benefits for All Veterans Receiving Compensation			
Outlays	80	110	120	130	140	590
			Coordinate Benefits for Veterans Newly Awarded Compensation			
Outlays	10	20	30	40	55	150

People with disabilities may qualify for cash payments from more than one source, including the Social Security Disability Insurance (DI) program, veterans' compensation, workers' compensation, means-tested programs like the Supplemental Security Income program, and private disability insurance. If they are younger than 65 and covered under Social Security, workers who are unable to work because they are physically or mentally impaired may qualify for DI payments.

When Social Security beneficiaries are eligible for multiple disability benefits, ceiling arrangements limit combined public disability benefits to 80 percent of the workers' average earnings before they were disabled. The combined payment after the reduction is adjusted periodically for changes in the cost of living and in national average wage levels. Veterans' compensation payments for disabilities, however--as well as means-tested benefits and benefits based on public employment covered by Social Security--are not included when applying the ceiling.

Approximately 2.5 million veterans--about 1.2 million of whom are under age 65--receive compensation for service-connected disabilities. The amount of compensation is based on a rating of an impairment's average effect on a person's ability to earn wages in civilian occupations. Additional allowances are paid to veterans whose disabilities are rated 30 percent or higher and who have dependent spouses, children, or parents. An estimated 140,000 veterans who receive compensation also receive DI payments from the Social Security program.

This option, which has two variations, would include veterans' compensation within the scope of the ceiling. (The combined payment, however, would never be less than either the DI benefit or the veterans' compensation payment.) Under both versions, compensation would be totaled when determining how much the DI benefit of an individual under 65 would be reduced to keep the combined benefit from exceeding the ceiling. One version of the option would apply this change to all current and future recipients of veterans' disability compensation. The other version would limit application of the option to veterans newly qualifying for disability compensation in the future.

Applying the change to both current and future recipients of veterans' compensation would affect an estimated 30,000 recipients in 1994 and would save an estimated $590 million over the 1994-1998 period. Applying the change only to veterans newly awarded compensation payments in the future would affect an estimated 15,000 recipients by 1998 and would save an estimated $150 million over the 1994-1998 period.

These options would mean that an explicit policy would determine the total amount of public compensation for veterans with service-connected disabilities. Thus, the federal government would treat in a more consistent way people who receive cash disability payments from multiple programs that are not means-tested. Both versions of the option could, however, be seen as subjecting veterans' compensation benefits to a form of income testing. Moreover, under the variation of this option that would apply to current recipients of disability compensation, the incomes of some disabled veterans would drop.

ENT-72 RESTRICT ELIGIBILITY FOR VETERANS' COMPENSATION PAYMENTS

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
	End Compensation Payments for All Veterans with Low-Rated Disabilities and for New Veterans with Disabilities Unrelated to Military Duties					
Budget Authority	1,900	2,000	2,200	2,300	2,500	10,900
Outlays	2,000	2,000	2,000	2,300	2,400	10,700
	End Disability Benefits for Low-Rated Disabilities					
Budget Authority	1,700	1,700	1,800	1,800	1,900	8,900
Outlays	1,700	1,700	1,600	1,800	1,900	8,700
	End Dependents' Allowances for Veterans with Low-Rated Disabilities					
Budget Authority	250	250	250	250	260	1,260
Outlays	260	250	230	250	260	1,250
	End Disability and Death Compensation Awards in Future Cases When a Disability Is Unrelated to Military Duties					
Budget Authority	10	60	120	210	300	700
Outlays	10	60	110	190	280	650

Approximately 2.5 million veterans with service-connected disabilities receive veterans' disability compensation benefits. Service-connected disabilities are currently defined as those resulting from diseases, injuries, or other physical or mental impairments that occurred or were aggravated during military service, excluding those resulting from willful misconduct. Disabilities need not be incurred or aggravated while performing military duties to be considered service-connected; for example, disabilities incurred while on leave also qualify.

The amount of compensation is based on a rating of the individual's impairment that is intended to reflect an average reduction in the ability to earn wages in civilian occupations. Demonstrated loss of income, however, is not a requirement for eligibility. Veterans' disability ratings range from zero percent to 100 percent (most severe). Veterans unable to maintain gainful employment who have ratings of at least 60 percent are eligible to be paid at the 100 percent disability rate. Additional allowances are paid to veterans who have disabilities rated 30 percent or higher and who have dependent spouses, children, or parents. Receiving veterans' disability compensation does not affect the level of Social Security disability benefits to which an individual may be entitled (see ENT-71).

Currently, 1.2 million veterans have disability ratings below 30 percent and receive benefits of between $70 and $162 a month. Of the 654,000 veterans receiving dependents' allowances, about 402,000 have disability ratings of 30 percent, 40 percent, or 50 percent; their dependents' allowances average $49 monthly.

Some veterans receive compensation for disabilities that were not related to their military duties. For example, a 1989 survey by the Department of Veterans Affairs (VA) suggests that about 50 percent of veterans receiving compensation payments were being compensated for injuries or diseases not related to the performance of military duties, and the relationship to military duties was uncertain for an additional 5 percent. Separate data indicate that more than 390,000 veterans currently receive VA compensation payments totalling $1.2 billion a year for diseases that the General Accounting Office (GAO) reports are generally neither caused nor aggravated by military service. The diseases include arteriosclerotic heart disease, diabetes mellitus, multiple sclerosis, Hodgkins disease, chronic obstructive pulmonary disease (including chronic bronchitis and pulmonary emphysema), hemorrhoids, schizophrenia, osteoarthritis, and benign prostatic hypertrophy. Nearly half of the veterans who are compensated for disabilities unrelated to military duties, however, would be eligible for military retirement benefits if their veterans' compensation claims were denied. The Department of Defense would be responsible for contributing about $150 million more a year to the fund that pays retirees. This contribution is offset elsewhere within the budget and would not affect the deficit.

Federal outlays could be reduced by $10.7 billion during the 1994-1998 period by adopting three measures that would target veterans' compensation payments toward those with higher-rated disabilities and, for new veterans, toward those with disabilities related to military duties. Ending disability benefits for low-rated disabilities would, on its own, achieve more than three-quarters of these savings. None of these measures would affect veterans' eligibility for Social Security disability benefits.

Eliminating compensation benefits for those with disability allowances below 30 percent would target spending toward the most impaired veterans. Because performance in civilian jobs depends less on physical labor than when the disability ratings were originally set, and because improved reconstructive and rehabilitative techniques are now available, physical impairments rated below 30 percent may not reduce veterans' earnings. Low-rated disabilities include conditions such as mild arthritis, moderately flat feet, or amputation of part of a finger--conditions that would not affect the ability of veterans to work in many occupations today.

Similarly, eliminating dependents' benefits for veterans with disability ratings of 30 percent to 50 percent would target compensation toward the families of disabled veterans who are most impaired. In addition, the continuing increase in the proportion of households where both spouses work means that dependents' allowances for veterans with disability ratings below 60 percent may not be necessary to maintain adequate family incomes.

Ending disability and death compensation awards in future cases in which a disability is neither incurred nor aggravated while performing military duties would make disability compensation of military personnel comparable with disability compensation of federal civilian employees under workers' compensation arrangements. In both cases, diseases, injuries, or impairments unrelated to employment tasks would not entitle a person to compensation. The VA's formal appeals system could be extended to cover rulings that disabling conditions were unrelated to military duties.

An alternative method of settling compensation payments on veterans whose disabilities are more directly connected to their military duties would be to eliminate compensation for those whose disabilities result from diseases that, according to the GAO, are not connected with military service. This approach would have a more limited impact because it would not affect all veterans whose compensable disabilities are not connected with military service. It could, however, eliminate compensation for some veterans whose disabilities the GAO finds are not generally service-connected but whose circumstances constitute an exception from this general conclusion. The alternative approach would yield smaller savings than the previous measure--about $105 million over the 1994-1998 period--if it were applied only to new compensation awards, although it would yield $7.8 billion over the same period if it were applied to all veterans currently receiving compensation based on these diseases.

Some disabled veterans--especially older ones who have retired--might, however, find it difficult to increase their working hours or otherwise make up the loss in compensation payments. Moreover, removing dependents' allowances because a spouse may have income could be interpreted as an indirect means test on veterans' family income--a test that uses a poor proxy for this income. One objection to the last measure is that because military personnel are assigned to particular geographic locations where situations may sometimes be volatile, they have less control than civilians over where they spend their off-duty hours.

ENT-73 RAISE THE LOAN FEE FOR HOUSING LOANS GUARANTEED BY THE DEPARTMENT OF VETERANS AFFAIRS

Savings from CBO Baseline	Annual Savings (Millions of dollars)					Cumulative Five-Year Savings
	1994	1995	1996	1997	1998	
Budget Authority	320	260	270	280	280	1,400
Outlays	320	260	270	280	280	1,400

The Department of Veterans Affairs (VA) supports home ownership by veterans through the home loan guaranty program, which allows veterans to obtain mortgage credit from private lenders on more favorable terms than usual, such as without a down payment. In the event of foreclosure, the federal guarantee reduces the lender's potential loss. The proportion of the loan principal that is guaranteed varies with the size of the loan. In 1992, the Bush Administration estimated net federal outlays for the program at $740 million.

Since 1982, one-time loan fees have been assessed on borrowers. Currently, the fee is 1.25 percent of the mortgage amount for loans with down payments of less than 5 percent, 0.75 percent for loans with down payments of 5 percent up to 10 percent, and 0.5 percent for loans with down payments of 10 percent or more.

Even allowing for an additional 1 percent loan-origination fee that the private lender may charge the veteran for such loans, the maximum fee of 1.25 percent is appreciably below mortgage insurance costs for private loans with small down payments and without government guarantees. Program participants therefore receive a substantial benefit relative to borrowers obtaining private mortgage insurance.

This option would reduce net federal outlays for the VA mortgage guaranty program by increasing the fees paid by veterans (see ENT-74). Raising the maximum loan fee to 3 percent for borrowers with down payments under 5 percent would raise borrowers' costs closer to those prevailing in the private market. (Under the option, the loan fee would be raised to 2 percent for loans with down payments of 5 percent up to 10 percent, and to 1.5 percent for loans with down payments of at least 10 percent.) If this option were in place by 1994, it would reduce federal outlays by $1.4 billion over the next five years.

The primary justification for this option is that the amount paid by new participants in the VA program to obtain a mortgage guarantee would become closer to the costs of private mortgage insurance. The primary disadvantage of these measures is that increased charges might discourage participation by some low-income potential home buyers who are targeted for housing assistance.

ENT-74 RESTRICT MULTIPLE USE OF THE DEPARTMENT OF VETERANS AFFAIRS' HOUSING LOAN GUARANTY BENEFIT

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
Budget Authority	15	10	15	15	15	65
Outlays	15	10	15	15	15	65

The Department of Veterans Affairs (VA) supports home ownership by veterans through the home loan guaranty program, which allows veterans to obtain mortgage credit from private lenders on more favorable terms than usual, such as without a down payment. Under the program, veterans can obtain more than one guaranteed loan during their lifetimes, as long as any earlier loans guaranteed by the VA have been paid in full or assumed with VA approval. Approximately 15 percent of VA mortgage guarantees are used by individuals who have had their entitlements restored after paying off earlier guaranteed loans. When houses financed through VA-guaranteed mortgages are sold, the buyers--whether or not they are veterans--may assume the mortgages if they meet the VA's criteria for creditworthiness and pay an assumption fee of 0.5 percent of the loan amount. In that case, under the terms of its loan guarantee, the VA remains at financial risk for the assumed loan.

Under the option, veterans would be entitled to obtain a mortgage guarantee under the program only once during their lifetimes (see ENT-73). The option would only affect future applicants for guarantees who have used their entitlements in the past. Carrying out the option would save $15 million in 1994 and $65 million over the 1994-1998 period.

This option would aim assistance under the program at veterans who are, in most cases, first-time home buyers. This conforms with the program's principal purpose, which is to compensate veterans for the difficulty they may face in establishing creditworthiness and meeting repayment obligations. The option would also avoid situations in which the VA guarantees multiple loans that were originally issued to assist the same veteran, because the loan for the veteran's prior house had been assumed by the subsequent purchaser of that house.

The option, however, would place veterans who must move to a different house at a disadvantage. Such veterans would lose the financial benefits of the mortgage guarantee following the move; some might not have accumulated enough equity in their prior houses to make down payments on the next.

ENT-75 ELIMINATE "SUNSET" DATES ON CERTAIN PROVISIONS FOR VETERANS IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1990

Savings from CBO Baseline	Annual Savings (Millions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Savings
			Reduce Pensions to Medicaid Nursing Home Residents			
Budget Authority	0	0	0	0	540	540
Outlays	0	0	0	0	530	530
			Verify Income Reported for Pension Purposes			
Budget Authority	0	0	0	0	140	140
Outlays	0	0	0	0	140	140
			Recover Certain Medical Care Costs for Veterans from Third Parties			
Budget Authority	30	210	240	250	270	1,000
Outlays	30	210	240	250	270	1,000
			Impose Copayments for VA Medical Care			
Budget Authority	0	0	0	0	70	70
Outlays	0	0	0	0	70	70
			Eliminate All Sunset Dates			
Budget Authority	30	210	240	250	1,010	1,750
Outlays	30	210	240	250	1,010	1,750

A number of current provisions that achieved savings from prior law affecting veterans contain "sunset dates"--dates when the provisions cease to apply. The effects of four of the provisions have been to:

- o Limit to $90 the monthly benefit for certain pensioners without dependents who are eligible for Medicaid coverage for care they are receiving in nursing homes (expires September 30, 1997);

- o Authorize the Internal Revenue Service to help the Department of Veterans Affairs (VA) verify incomes reported by beneficiaries, for the purpose of establishing eligibility for pensions and benefits (expires September 30, 1997);

- o Authorize the VA to collect from any health insurer that contracts to insure a veteran with service-connected disabilities the reasonable cost of medical care that the VA provides to the veteran for the treatment of non-service-connected disabilities (expires August 1, 1994); and

- o Authorize the VA to charge copayments to certain veterans receiving inpatient care, outpatient care, and outpatient medication from agency facilities (expires September 30, 1997).

The option would make the effects of these provisions permanent by eliminating the sunset date in each case. If all four provisions were made permanent, savings during the 1994-1998 period would total about $1.7 billion.

The main advantage of this option is that it would convert the temporary savings achieved by these provisions into ongoing savings. The main disadvantage of the option is that certain veterans or their insurers would be worse off financially.

ENT-76 EXTEND USER FEES INCLUDED IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1990

Addition to CBO Baseline	Annual Added Receipts (Millions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Customs Fees	0	0	750	820	850	2,400
Nuclear Regulatory Fees	0	0	380	390	400	1,170
Patent and Trademark Fees	0	0	110	120	120	350
Coast Guard Fees	35	50	50	55	60	250
Vessel Tonnage Charges	0	0	65	65	65	195
Rail Safety Fees	0	0	50	50	55	155

The Omnibus Budget Reconciliation Act of 1990 included provisions creating user fees for a variety of services that the federal government provides to private parties. These fees were enacted for the years 1991 through 1995. All of the fees included in this option would expire after 1995, with the exception of the Coast Guard fee, which is to be phased out in 1993 and 1994 as mandated by legislation adopted during 1992. Reenacting the Coast Guard fees would increase offsetting collections by $35 million in 1994 and $250 million from 1994 through 1998. Extending the other fees could raise $4.3 billion in receipts for 1996 through 1998. The fees included in the table above would provide offsetting receipts in budget functions designated for energy, commerce and housing credit, transportation, and the administration of justice.

The general argument for user fees applies to each of the charges included in this option; namely, that the recipients of government services should bear the cost of those that clearly benefit a specific group rather than the general populace. Accordingly, customs fees applied to imported merchandise are adjusted to offset the salaries and expenses incurred by the Customs Service in conducting its commercial operations. The holders of licenses to operate nuclear facilities are required to pay fees sufficient to offset but not exceed the funds appropriated for the Nuclear Regulatory Commission. Patent and trademark fees are also used to cover the cost of services provided. The Coast Guard user fee includes both charges for direct services provided to recreational boaters, such as specific certificates and permits, and charges for indirect services provided to all boaters, such as general navigational aids. The vessel tonnage fee is collected on all vessels entering a U.S. port and is designated to support the general operations of the Coast Guard. The fees charged to railways offset the cost of the government's railway safety activity. An attractive feature of extending the fees covered by this option is that, with the exception of the Coast Guard's charges, each fee is already in place and, even if only grudgingly, is accepted by users.

Antithetically, it can be argued that the service provided by government ultimately benefits the general populace and should be paid for by all taxpayers rather than a specific group. The fee that boat owners are charged for indirect Coast Guard services may be a case in point. Those who advocate the repeal of specific fees argue that charges were unevenly applied among users or, directly or indirectly, inflicted undue costs on payers.

Chapter Five

Revenues

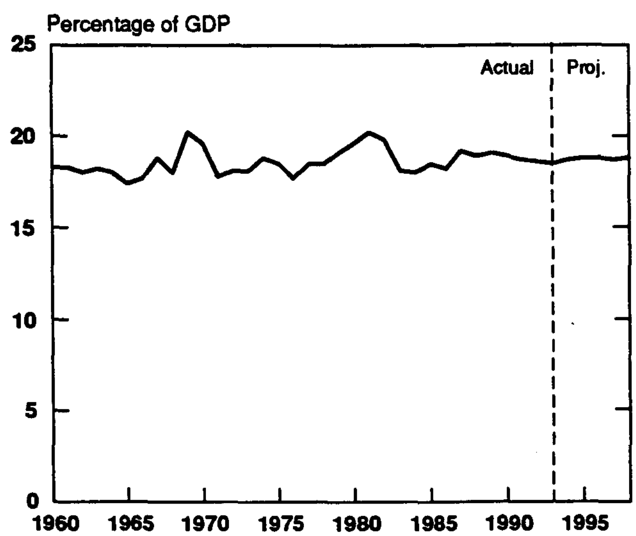
Concern about persistently growing deficits--even before the nation has addressed unmet social needs--compels policymakers to consider tax increases. The start of a new Administration with new priorities provides an opportunity to examine both new and old ways of raising revenue to reduce the federal deficit. This chapter presents roughly 40 revenue-raising options, affecting all the major revenue sources.

Currently, about 90 percent of federal revenue comes from income and payroll taxes. In 1992, the individual income tax raised 44 percent of federal revenue, the payroll tax 38 percent, and the corporate income tax 9 percent. In addition, excise taxes raised 4 percent of federal revenue. The rest came from estate and gift taxes, customs duties, and fees.

Under its baseline assumption that the Congress enacts no legislation affecting revenues, CBO expects the revenue share of gross domestic product to average 18.7 percent over the next five years, very similar to the average share recorded since 1960 (see Figure 4). Since that year, the revenue share of GDP has dropped as low as 17.4 percent and risen as high as 20.2 percent, with an average value of 18.6 percent. The revenue share surpassed 20 percent in the late 1960s when the Congress enacted an income tax surcharge during the Vietnam War, and again in 1981 after several years of rapid inflation pushed taxpayers' incomes into higher tax brackets ("bracket creep"). Large personal and corporate tax reductions enacted in the Economic Recovery Tax Act of 1981 (ERTA), combined with back-to-back recessions in 1980 and 1981-1982, brought the revenue share down to 18 percent in 1983. ERTA also removed most inflationary bracket creep from the personal income tax by enacting--starting in 1985--indexation for inflation of the personal income tax bracket amounts, the standard deduction, and the personal exemption. In subsequent years, the revenue share, bolstered by sustained economic growth and deficit reduction measures, climbed to 19 percent in 1989. As a result of the 1990-1991 recession and the slow recovery that followed, the revenue share fell to 18.6 percent in 1992.

The long-term stability of the overall revenue share of GDP masks some important shifts in the major sources of revenue: individual, social insurance, corporate, and excise taxes (see Figure 5). Individual income taxes, like overall revenues, have risen and dipped as a share of GDP since 1960, but are currently near their average level of 8 percent. But the GDP share claimed by social insurance taxes

Figure 4.
Total Revenue as a Share of GDP

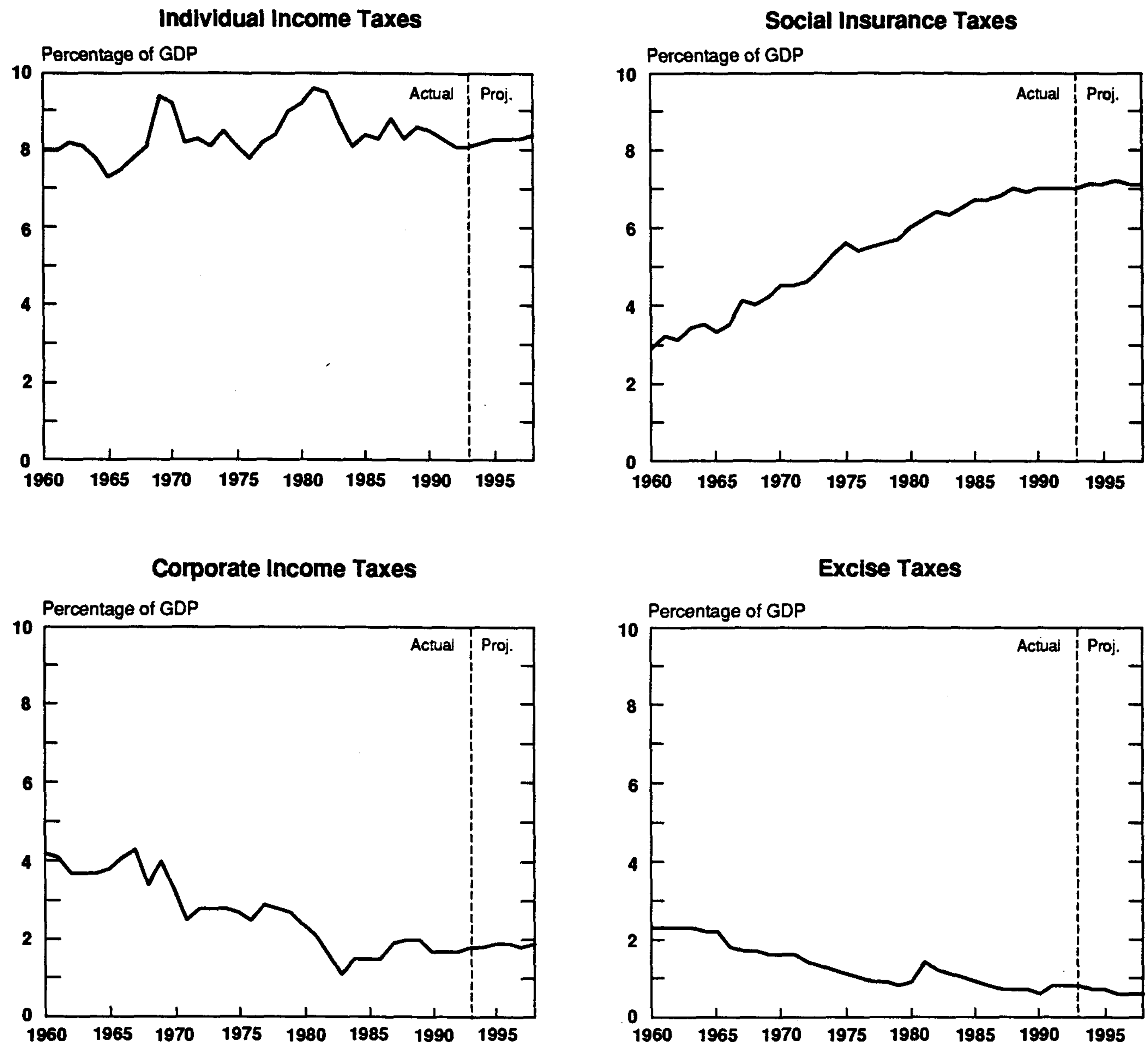


SOURCE: Congressional Budget Office.

(mostly Social Security taxes) has increased steadily since 1960 as tax rates, coverage, and the share of wages subject to taxation have increased. Social insurance taxes have increased from 3 percent of GDP in 1960 to about 7 percent today.

The GDP shares claimed by corporate income taxes and excise taxes have fallen since 1960. The corporate revenue share declined steadily until the mid-1980s because of both a decline in corporate profits as a share of GDP and legislated reductions in

Figure 5.
Revenue by Source as a Share of GDP



SOURCE: Congressional Budget Office.

tax liability. Corporate taxes as a share of GDP have risen slightly since the Congress raised corporate taxes in the Tax Reform Act of 1986. Excise taxes continue to be the smallest of the four major revenue sources. They have claimed a decreasing share of GDP largely because they are often levied on the quantity, not the value, of goods. Moreover, the Congrss has not in general raised the tax rates enough to keep pace with inflation.

The current mix of revenue sources translates to an overall burden of federal taxes that is moderately progressive, with higher-income families paying a greater share of their income in tax than lower-income families. CBO estimates that in 1993 families in the bottom income quintile will pay about 8 percent of their income in federal taxes, whereas families in the middle income quintile will pay about 20 percent and families in the top income quintile will pay nearly 27 percent. CBO measures the tax burden in relation to family income, which includes all cash income received by families plus their share of employer taxes and corporate income.

CBO expects that families will pay, on average, slightly more than 23 percent of their family income in taxes in 1993, almost identical to the proportion in 1979. Although more significant pieces of tax legislation passed into law between 1981 and 1990 than in any other comparable period in U.S. history, the distribution of tax burden today is very similar to the distribution in 1979 except at the very top of the income distribution. The income group comprising the 1 percent of families with the highest income is expected to pay 5 percent less of its income in taxes in 1993 than in 1979.

As a share of income, the burden of income taxes is relatively greater for higher-income families, while the burden of payroll and excise taxes is relatively greater for lower-income families. The Congress can change the distributional burden of the tax system either by changing the shares of tax from different sources or by changing the distributional burden of income and payroll taxes. It can make the individual income tax more or less progressive by changing either the tax base or the rate schedule and, to a lesser extent, can change the distribution of the payroll tax burden by changing the cap on wages that are subject to tax. Policymakers have little control over the distributional burdens of other tax sources.

Federal taxes also affect the allocation of economic resources in the private sector. Taxes inevitably create some distortion of private activities. For example, the individual income tax--whose tax base is widely accepted as a measure of the ability to pay tax--discourages work and saving by taxing their return. Similarly, the corporate income tax raises the cost of capital, discourages use of the corporate form of business, and encourages corporations to finance their operations with debt rather than equity. At the same time, the Congress has enacted certain incentives within the tax law to promote public policy goals. For example, one rationale for allowing people to deduct contributions to charity under the income tax is to encourage charitable activities.

This chapter presents a broad range of options for increasing federal revenue. The options raise different amounts of revenue and affect economic incentives differently. They also differ in the way they allocate economic resources among alternative uses and in the way they distribute the tax burden among taxpayers. Some options raise revenue from existing tax sources by increasing tax rates, broadening tax bases, or expanding tax coverage to include additional taxpayers. The government could put many of these options into place quickly and easily because the taxes are already in place. The other options raise revenue from new tax sources such as a federal value-added tax (VAT). Some of these options would impose additional compliance costs on taxpayers and administrative costs on the federal government because they would require additional tax computation methods and more Internal Revenue Service employees.

Although most of the spending options presented in this volume would take effect on October 1, 1993, all but one of the revenue options take effect on January 1, 1994. The VAT option has a later effective date because implementing the tax would take more time. The revenue estimates for the options, most of which the Joint Committee on Taxation prepared, may differ from estimates for similar provisions in specific tax bills as a result of differences in effective dates, transition rules, and technical details.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS AND CORPORATIONS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Individuals						
Raise Marginal Tax Rates to 16 Percent, 30 Percent, and 33 Percent	20.4	34.9	36.8	38.6	40.2	170.8
Add a 5 Percent Surtax	16.2	27.9	29.5	31.1	32.5	137.2
Raise the Top Marginal Tax Rates to 30 Percent and 33 Percent	9.8	16.7	17.6	18.5	19.3	82.0
Raise the Top Marginal Tax Rate to 33 Percent	3.9	6.5	6.7	6.9	7.1	31.1
Raise the Top Marginal Tax Rate to 33 Percent and Add a 38 Percent Bracket	9.2	15.6	15.9	16.2	16.5	73.4
Corporations						
Raise the Top Marginal Tax Rate to 35 Percent	1.8	3.1	3.2	3.2	3.2	14.5
Add a 5 Percent Surtax	3.6	6.0	6.4	6.7	6.9	29.6

SOURCE: Joint Committee on Taxation.

Rate increases have two advantages over other tax changes as a means for raising revenue. First, they do not add to costs of enforcement or compliance because they do not increase the complexity of the tax code or the recordkeeping requirements of taxpayers. Second, the Treasury begins to receive the additional revenues relatively quickly because it can incorporate rate increases immediately in withholding and estimated tax schedules. But rate increases have drawbacks as well. Higher tax rates reduce incentives to work and save, and increase any inefficiencies that tax preferences produce.

Individuals. Under current law, the income tax structure has three explicit marginal tax rates--15 percent, 28 percent, and 31 percent, with a maximum marginal tax rate on capital gains of 28 percent. (The marginal tax rate is the percentage of an extra dollar of income that a taxpayer must pay in taxes.) Until 1997, however, some high-income taxpayers will face effective marginal tax rates of more than 31 percent because of provisions that phase out their personal exemptions and limit their itemized deductions. The limitation on the itemized deductions expires at the end of 1995, and the exemption phaseout expires at the end of 1996.

Increasing all marginal tax rates on ordinary income by approximately 7 percent--to 16 percent, 30 percent, and 33 percent--would raise about $171 billion in 1994 through 1998. The option would not increase taxes for those who would continue to pay the alternative minimum tax (AMT), unless the Congress also increases the AMT rate (see REV-03). Families with tax credits would face a somewhat larger percentage increase in their tax liabilities than other taxpayers, and families whose earned income credit (EIC) gives them a tax refund might have to pay tax. (This option and all of the others that change the rate schedules assume that the maximum rate on capital gains would remain at 28 percent.)

An alternative to a rate increase is to impose a surtax on tax liability after credits including the AMT. A surtax would have a different effect on taxpayers than would higher marginal rates that raise an equivalent amount of revenues. A surtax would increase taxes on all taxpayers who now face a positive tax liability after credits, even those who pay the alternative minimum tax. A surtax would also increase taxes paid on capital gains. Those whose credits exactly offset or exceed tax liability under current law, including recipients of EIC refunds, would have no additional tax liability. Imposing a 5 percent surtax on tax liability after credits would increase revenues by about $137 billion in 1994 through 1998 and in effect increase the top statutory marginal tax rate to 32.6 percent.

Another option is to increase only the top two marginal tax rates. Increasing the current 28 percent rate to 30 percent and the 31 percent rate to 33 percent would raise revenues by about $82 billion in 1994 through 1998. For 1994, this option would increase taxes for married couples with taxable incomes of more than $38,000 and single filers with taxable income of more than $22,750.

The remaining two individual income tax options would affect only those taxpayers in the 31 percent bracket--less than 4 percent of all taxpayers. The first option would raise their tax rate to 33 percent. In 1994, this provision would affect couples with taxable income of more than $91,900 and single filers with taxable incomes of more than $55,150. The second option would raise the 31 percent tax rate to 33 percent and would also create a new 38 percent bracket for couples with taxable incomes above $200,000 and individuals with taxable incomes above $120,000. About 900,000 taxpayers would be in the new 38 percent bracket. Raising the 31 percent tax rate to 33 percent would increase revenues by about $31 billion dollars in 1994 through 1998. Raising the 31 percent tax rate to 33 percent and adding a 38 percent bracket would increase revenues by about $73 billion over the same time period.

Corporations. The top statutory tax rate on corporate income is 34 percent. Lower marginal rates apply to the first $75,000 of taxable income, but corporations with taxable income between $100,000 and $335,000 pay an additional 5 percent surtax, which phases out the benefits of the lower marginal rates.

Increasing the top marginal rate to 35 percent would raise about $15 billion in 1994 through 1998. Although only 10 percent of corporate taxpayers pay the top rate, these firms earn approximately 90 percent of all corporate taxable income. The change would not affect corporations that always pay the alternative minimum tax, and corporations on the regular tax, but with unused credits, could offset some of the tax increase.

Imposing a surtax on tax liabilities after credits is another way to raise revenue from corporations. A 2 percent surtax would raise about the same revenues as an increase in the top rate to 35 percent and would in effect increase the top rate to 34.7 percent. A 5 percent surtax would raise $30 billion in 1994 through 1998. In contrast to a rate increase, a surtax would apply to corporate liabilities from the AMT, and it would not expand the amount of credits that corporations could claim.

Increasing the top corporate and individual rates, either directly or through a surtax, would affect the decision a business makes about its form of organization. Under current law, the individual income tax rate for most filers is below the corporate rate. Owners of corporate businesses pay the corporate and individual income taxes on their business income. In contrast, owners of noncorporate businesses pay tax only at the individual level. As a result, the tax system discourages use of the corporate form of organization. Increasing the difference between the corporate and individual rates would increase this disincentive, causing more businesses to abandon the corporate form in order to reduce their tax liability.

REV-02 AMEND OR REPEAL THE INDEXING OF INCOME TAX SCHEDULES

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Suspend Indexing for 1994 (Except for earned income credit)	5.3	7.8	7.1	8.7	8.5	37.5
Repeal Indexing (Except for earned income credit)	5.3	13.5	21.3	31.0	41.0	112.1

SOURCE: Joint Committee on Taxation.

To offset the effects of inflation, current law automatically indexes annually the personal exemption, the standard deduction, the minimum and maximum dollar amounts for each tax rate bracket, the thresholds for the phaseout of personal exemptions, the limit on itemized deductions, and the earned income credit (EIC). A repeal of indexing (except for the EIC), beginning in 1994, would raise revenues by about $112 billion from 1994 through 1998, if the annual rate of inflation averages 2.7 percent over the period as CBO projects. Revenues from the repeal would grow rapidly as the cumulative effects of inflation drive up the consumer price index. Although suspending indexing only for 1994 would raise the same amount of revenues in the first year, it would raise much less in later years--about $38 billion over the five-year period.

Repealing or suspending indexing would not burden all taxpayers equally. Among families with the same income, taxpayers who itemize would generally bear a smaller tax increase than those who use the standard deduction, and families with children (and more personal exemptions) would be affected more than families without children. Low-income families would have a smaller percentage drop in after-tax income than other families because they have little or no taxable income. The percentage drop in after-tax income would also be small for families with the highest incomes because they receive no benefit from the personal exemption, and most of them do not take the standard deduction. A surtax or general rate increase would allocate additional taxes more equally among families with the same income than repealing or suspending indexing (see REV-01).

Another reason for retaining indexing is that it requires the Congress to decide explicitly on tax increases. Without indexing, inflation would cause the average income tax rate to increase without any legislative action.

REV-03 INCREASE THE ALTERNATIVE MINIMUM TAX RATE

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
			Individuals			
Raise the Alternative Minimum Tax Rate to 28 Percent	1.0	4.8	5.0	6.3	7.1	24.2
			Corporations			
Raise the Alternative Minimum Tax Rate to 25 Percent	1.9	3.0	2.6	2.3	2.2	12.0

SOURCE: Joint Committee on Taxation.

The alternative minimum tax (AMT) limits the use of tax preferences. Increasing the AMT rate would raise revenues from the individuals and corporations that make the most use of tax preferences. Revenue gains from these rate increases are uncertain, however, because taxpayers can avoid the AMT to some extent by careful tax planning.

Raise the Individual AMT Rate to 28 Percent. The AMT for individuals is 24 percent of alternative minimum taxable income (AMTI) in excess of an exemption amount--$40,000 for a joint return or $30,000 for a single return. The tax law phases out the AMT exemption for AMTI above $150,000 for a joint return and $112,500 for a single return. The AMTI base is broader than the regular tax base because some adjustments that taxpayers make to regular taxable income are not allowed for AMTI. These adjustments are of two types: deferrals from taxable income such as accelerated depreciation, excess intangible drilling costs, and profit or loss from long-term contracts; and exclusions from taxable income such as the charitable deduction for appreciated property, itemized deductions of state and local taxes, some tax-exempt interest, percentage depletion, and miscellaneous itemized deductions.

Taxpayers must pay the larger of the regular tax or the AMT. To the extent that a taxpayer must pay the individual AMT because deferrals are disallowed, the taxpayer can credit that against regular tax liability in future years. Thus, a portion of the revenue gain from a higher AMT rate results from a shift of some future tax liabilities to earlier years.

Increasing the AMT rate to 28 percent would raise about $24 billion in 1994 through 1998. The AMT prevents some taxpayers from taking full advantage of tax incentives. To the extent the Congress enacted these incentives to encourage certain kinds of behavior, the AMT lessens their effect. Raising the AMT rate would further reduce these incentives by lowering the maximum combined tax benefit from these preferences for upper-income taxpayers.

Unless taxpayers changed their behavior to avoid the AMT, this option would increase the number of filers who would owe an alternative tax from about 300,000 to over 1.5 million.

Raise the Corporate AMT Rate to 25 Percent. The AMT for corporations is 20 percent of their alternative minimum taxable income. Corporations receive minimum tax credits against future regular taxes for the entire AMT, not just the portion that deferral preferences produce--as is the case for individuals. Raising the AMT corporate rate to 25 percent would increase revenues by about $12 billion through 1998.

The corporate AMT largely ensures that corporations that report positive profits to shareholders pay some corporate tax. In this way, the minimum tax makes the tax system appear fairer.

The corporate AMT, however, places a greater tax burden on rapidly growing and heavily leveraged corporations and provides corporations with an incentive to engage in tax-motivated transactions. For example, a firm that expects to pay the AMT may be able to reduce its tax by leasing its equipment from a firm that can use accelerated depreciation deductions, rather than owning the equipment and claiming the accelerated depreciation deductions directly. Raising the AMT rate would increase the use of these nonproductive tax-minimization transactions. It would also increase the disparity in the tax burden on new investment between those corporations that must pay the AMT and those that do not.

REV-04 TAX ALL CORPORATE INCOME AT A 34 PERCENT RATE

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	1.9	3.3	3.4	3.6	3.7	15.9

SOURCE: Joint Committee on Taxation.

Under current law, corporations pay a 34 percent tax rate on most income, but corporate taxable income up to $75,000 is subject to reduced tax rates of 15 percent and 25 percent. The tax benefit to a corporation from reduced rates is worth up to $11,750. There is, however, a 5 percent additional tax on corporate taxable income between $100,000 and $335,000. This additional tax raises the marginal tax rate to 39 percent in that income range and phases out the tax benefit from the reduced rates for corporations with taxable income of more than $100,000. The result is that corporations with income of more than $335,000 pay an average rate of 34 percent.

The Congress enacted the reduced rates to provide tax relief to small businesses. Of the approximately 1 million corporations that have positive corporate tax liabilities each year, about 90 percent qualify for reduced rates, although these corporations earn only about 10 percent of total corporate profits. This provision provides a competitive advantage not only to some small businesses, but other taxpayers benefit as well. For example, high-income individuals benefit because the provision allows them to shelter income as retained earnings in a small corporation. The tax law does not allow owners of personal service corporations, such as physicians, attorneys, and consultants, to incorporate themselves in order to gain the tax benefit. Others still use these opportunities for tax shelters, however. Additional unintended recipients of the tax benefit are large businesses with low profits. Some of these large corporations, furthermore, may be able to control the timing of certain income and expenses in order to generate low taxable income--and the tax benefit--in certain years.

Even without the benefit of the lower corporate rates, low- to moderate-income owners of small businesses need not pay a double tax on their business income. As an alternative to incorporation, small businesses could operate as sole proprietorships or partnerships and pay tax only under the individual income tax. In addition, many small businesses could continue to enjoy the advantages of incorporation by operating as S corporations, which must have 35 or fewer owners and satisfy other requirements. Owners of S corporations also pay only under the individual income tax.

Eliminating the lower corporate rates and taxing all corporate income at the single 34 percent rate would raise an estimated $16 billion from 1994 through 1998.

REV-05 ELIMINATE OR LIMIT DEDUCTIONS FOR MORTGAGE INTEREST

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Eliminate Deductions for Mortgage Interest	25.9	43.1	44.8	47.9	51.1	212.8
Reduce Maximum Mortgage Principal Eligible for Interest Deductions to $300,000	0.9	2.3	2.7	3.1	3.5	12.5
Limit Deductions to $12,000 per Return (Single) or $20,000 (Joint)	1.4	3.8	4.4	5.0	5.8	20.5
Limit Deductions for Second Homes	0.2	0.3	0.3	0.3	0.3	1.4

SOURCE: Joint Committee on Taxation.

A home is both the largest consumer purchase and the main investment for most Americans. The tax code has historically treated homes more favorably than other investments. Current law allows homeowners to deduct mortgage interest expenses, even though homes do not produce taxable income, and exempts most capital gains from home sales (see REV-21). Such preferential treatment may benefit neighborhoods because it encourages home ownership and home improvement. The amount of preference, however, is probably larger than needed to maintain a high rate of home ownership. For example, Canada, which grants preferential tax treatment to capital gains from home sales, but does not allow deductions for mortgage interest, has achieved about the same rate of home ownership as the United States.

The tax advantages for owner-occupied housing encourage people to invest in homes instead of taxable business investments. This shift may contribute to a relatively low rate of investment in business assets in the United States compared with other developed countries that do not allow such large mortgage interest deductions. Currently, about one-third of net private investment goes into owner-occupied housing, so even a modest proportional shift of investment to other sectors could have important effects.

Limiting mortgage interest deductions would substantially reduce the preferential treatment of owner-occupied homes. Under current law, taxpayers may deduct interest on up to $1 million of debt they have used to acquire and improve first and second homes and interest on up to $100,000 of other loans they have secured with a home, regardless of purpose (home-equity loans). Since 1991, no other type of consumer interest has been deductible. Current law also limits the extent to which interest deductions for carrying assets other than first and second homes can exceed income from such assets. One way for taxpayers to circumvent the limits on consumer and investment interest deductions is to finance consumer purchases and investments in assets other than homes with home-equity loans.

The limits under current law on mortgage interest deductions are so high that the tax code provides a generous subsidy even for relatively expensive homes. Moreover, taxpayers with substantial home equity can also circumvent the limits on consumer and investment interest by using, for example, home equity loans with deductible interest to finance automobiles. In contrast, renters and those with small amounts of home equity cannot use this method to deduct interest on loans they use to finance auto purchases. Even the generous limits in current law apply unequally to families with the same housing needs because the limits are the same for single taxpayers as for larger households.

Eliminate Interest Deductions. Eliminating the deductibility of mortgage interest would raise the taxes of about 29 million homeowners by an average of about $1,600 in 1994 and increase tax revenues by about $213 billion over the 1994-1998 period. Housing as an investment would be made more nearly equal with other investment opportunities, thus reducing the incentive to overinvest in housing. Furthermore, eliminating the deduction would remove the opportunity for homeowners to circumvent provisions in the tax law that deny the deductibility of interest on other types of consumer expenditures. But eliminating the mortgage interest deduction would increase housing costs sharply for current homeowners, potentially making it impossible for them to afford their homes. Homeowners could not fully avoid these costs by moving because the prices of owner-occupied homes would fall.

Reduce the Principal Eligible for Deduction. Lowering the limit on the amount of principal eligible for the mortgage interest deduction from $1 million to $300,000 would reduce deductions for about 780,000 taxpayers with large mortgages and increase revenues by about $13 billion over the 1994-1998 period. This change would reduce the deduction only for owners of relatively expensive homes. It would not affect the vast majority of homeowners, but would impose large adjustment costs on some homeowners in high-cost housing areas.

Cap Interest Deductions. Capping the mortgage interest deduction at $12,000 per single return, $20,000 per joint return, and $10,000 per return for married couples who file separately would raise about $21 billion in revenues in 1994 through 1998. These limits are much higher than the deductions most taxpayers claim. Of the 27 million taxpayers who claimed the mortgage interest deduction in 1990, about 1.4 million (5 percent) had deductions that exceeded these limits; the average deduction for home mortgage interest was about $7,200. At current mortgage interest rates, the proposed $20,000 cap would allow full interest deductions on new fixed-rate mortgages as large as about $250,000. Only 4 percent of new mortgages originated in 1992 were for amounts of $250,000 or more.

Capping mortgage interest deductions would retain the basic tax incentive for home ownership without subsidizing the luxury component of the most expensive homes and vacation homes. Because the caps are higher than the deductions nearly all homeowners now take, the caps would affect home prices and homebuilding in only a small segment of the market. Moreover, because the proposal would not index caps for inflation, their real value would gradually decline. Phasing down the deduction gradually would cushion the effects on current homeowners and the homebuilding industry.

Like the other limits on interest deductions, the cap would be more restrictive in areas with higher housing costs. Further, in periods of high interest rates, the limits would affect recent homebuyers and those with adjustable-rate mortgages more than longer-term owners with fixed-rate mortgages.

Limit Interest Deductions for Second Homes. A final option is to limit deductibility to interest on debt taxpayers incur to acquire and improve a primary residence, plus $100,000 of other debt secured by that home. That approach would require interest deductions for second homes to qualify under the $100,000 limit on home-equity loans. The proposal would increase revenue by $1.4 billion in 1994 through 1998. The current-law deduction provides special treatment for taxpayers who borrow to own second homes, relative to taxpayers who cannot deduct interest when they borrow to finance education, medical expenses, and other consumer purchases.

REV-06 ELIMINATE OR LIMIT DEDUCTIONS OF STATE AND LOCAL TAXES

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Eliminate Deduction of State and Local Taxes	15.8	39.4	41.2	44.5	47.2	188.1
Limit Deductions to the Excess Over 1 Percent of Adjusted Gross Income	1.8	6.0	6.5	6.9	7.3	28.4
Prohibit Deductibility of Taxes Above a Ceiling of 9 Percent of Adjusted Gross Income	1.7	5.7	6.2	6.5	7.2	27.4

SOURCE: Joint Committee on Taxation.

Under current law, taxpayers may deduct state and local income, real estate, and personal property taxes from their adjusted gross income (AGI). For taxpayers who itemize, the deductions provide a federal subsidy of state and local tax payments. This subsidy may cause itemizers to support higher levels of state and local services than they would otherwise; consequently, the deductions indirectly finance increased state and local government spending at the expense of other uses of federal revenues.

The Tax Reform Act of 1986 reduced the subsidy to state and local governments directly by repealing the deduction for state and local sales taxes, and indirectly by increasing the standard deduction and lowering marginal rates. The latter changes reduced both the number of itemizers and the value of the deductions.

As a way to assist state and local governments, deductibility of state and local taxes has several disadvantages. First, the deductions reduce federal tax liability only for itemizers. Second, because the value of an additional dollar of deductions increases with the marginal tax rate, the deductions are worth more to higher-bracket taxpayers. Third, deductibility favors wealthier communities. Communities with higher average income levels have more residents who itemize and are therefore more likely to spend more because of deductibility than lower-income communities. Fourth, deductibility may discourage states and localities from financing services with nondeductible user fees, thereby discouraging efficient pricing of some services.

An argument against restricting deductibility is that a taxpayer with a large state and local tax liability has less ability to pay federal taxes than one with equal total income and a smaller state and local tax bill. But a taxpayer who pays higher state and local taxes often receives more benefits from publicly provided services, such as public recreational facilities. In that case, the taxes are more like other payments for goods and services (for example, private recreation) and should not be deductible. This comparision is not perfect because any higher public expenditures resulting from deductibility benefit all members of a community, including lower-income nonitemizers who do not receive a direct tax saving.

Eliminating or limiting the value of the state and local deduction could raise significant revenues. Eliminating deductibility would raise about $188 billion in 1994 through 1998. An alternative option would allow deductions only for state and local tax payments above a fixed percentage of AGI. The average itemizer's state and local tax deductions exceed 1 percent of AGI in every state. A 1 percent floor on deductions would increase revenues in 1994 through 1998 by about $28 billion. Another alternative would be to prohibit deductions above a fixed ceiling, which also might be a percentage of AGI. A ceiling set at 9 percent of AGI would increase revenues by a roughly similar amount--around $27 billion in 1994 through 1998. A floor and a ceiling, however, would have very different effects on incentives for state and local spending. A floor would retain the incentive for increased spending, but a ceiling would reduce it.

REV-07 ELIMINATE OR LIMIT DEDUCTIONS FOR CHARITABLE GIVING

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Eliminate Deductions for Charitable Giving	2.4	16.3	17.7	19.0	20.1	75.4
Limit Deductions for Appreciated Property to Its Tax Basis	0.1	0.8	0.8	0.8	0.8	3.3
Limit Deductions to the Excess Over 2 Percent of Adjusted Gross Income	1.1	7.4	7.9	8.5	9.0	34.0

SOURCE: Joint Committee on Taxation.

Under current law, taxpayers who itemize deductions can deduct the value of contributions they make to qualifying charitable organizations, but the amount of deductions cannot exceed 50 percent of adjusted gross income (AGI) in any year. In 1990, 29 million taxpayers claimed $57 billion of deductions for charitable contributions, reducing federal revenues by more than $14 billion.

In addition to cash donations, taxpayers currently can deduct the fair market value of a contribution of appreciated property that they have held for more than 12 months, regardless of how much they paid for the property. The difference between the market value and the basis--the price they paid--is a preference item under the alternative minimum tax.

Eliminating the deductibility of charitable contributions would increase tax revenues by $2.4 billion in 1994 and by about $75 billion over the 1994-1998 period. In 1994, it would increase tax payments of more than 30 million taxpayers by an average of about $500 per return.

The deduction provides significant government support for charitable activities. But one criticism of the deduction is that the electorate as a whole, and not individual donors, should make decisions about which activities deserve taxpayer support. Another criticism is that the deduction provides unequal federal matching rates for contributions by different taxpayers. The government subsidy rates are 31 percent of contributions for the highest-income taxpayers, but only 15 percent for taxpayers in the lowest tax bracket. There is no subsidy for donations by people who do not itemize deductions.

Nonetheless, the decisions of individuals about donations may be the best measure of which activities should receive government support and yield substantial contributions. Without deductibility, contributions might drop precipitously. Also, while taxpayers who choose to take the standard deduction receive no incentive to contribute, they do not pay higher taxes than itemizers because the standard deduction provides greater tax benefits than their deductible expenditures would allow.

Limiting the deduction to a taxpayer's cost of an asset under the regular income tax would increase revenues by about $0.1 billion in 1994 and by $3 billion over five years. The existing provision allows taxpayers to deduct the entire value of assets they contributed even though they paid no tax on the gain from appreciation. This outcome provides preferential treatment of one kind of donation relative to other kinds and expands the preferential treatment of capital gains (see REV-22). However, the provision encourages people to donate appreciated assets to eligible activities rather than passing them on to their heirs at death, when any gains also escape income tax.

Another way to limit the charitable deduction, while retaining an incentive for giving, is to allow taxpayers to deduct only those contributions in excess of 2 percent of adjusted gross income. This alternative would retain an incentive for increased giving by people who give large shares of their incomes but would remove the incentive for smaller contributors. It would completely disqualify the charitable deductions of about 19 million taxpayers in 1994 and reduce allowed deductions for an additional 11 million, increasing revenues by about $1.1 billion in 1994 and by $34 billion over the 1994-1998 period. Such a change would eliminate the tax incentive to donate to charitable causes for more than 60 percent of the taxpayers who currently make and deduct contributions. In addition, it would encourage taxpayers who planned to make contributions over several years to lump them together into one tax year to qualify for a deduction with the 2 percent floor.

REV-08 LIMIT THE TAX BENEFIT OF ITEMIZED DEDUCTIONS TO 15 PERCENT

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	23.3	52.8	57.9	63.4	67.5	264.9

SOURCE: Joint Committee on Taxation.

Current law allows taxpayers to reduce taxable income by the amount of itemized deductions in excess of the standard deduction. Taxpayers who itemize may deduct state and local income and property taxes, home mortgage interest payments, contributions to charity, moving expenses, casualty and theft losses, and medical and dental expenses. Current law limits some itemized deductions to the amount in excess of a percentage of adjusted gross income and reduces itemized deductions for high-income taxpayers.

The tax benefit of itemized deductions increases with a taxpayer's marginal tax bracket. For example, $10,000 in itemized deductions would reduce taxes by $1,500 for a taxpayer in the 15 percent tax bracket, $2,800 for a taxpayer in the 28 percent bracket, and $3,100 for a taxpayer in the 31 percent bracket. Most taxpayers do not itemize deductions. Among the one in four taxpayers who do itemize, however, half are in tax brackets above 15 percent. This option would limit the tax benefit of itemized deductions to 15 percent for these higher-bracket taxpayers. The limit would increase revenues by $265 billion over five years.

Limiting the tax benefit of itemized deductions would make the income tax more progressive by raising average tax rates on most middle- and upper-income taxpayers. The limit may also improve economic efficiency because it would reduce tax subsidies that distort the after-tax prices of goods, such as owner-occupied housing.

The itemized deductions for health expenses, casualty losses, and employee business expenses, however, are not subsidies to voluntary activities, but are, instead, allowances for costs that reduce the ability to pay income tax. Nonetheless, under this option, some taxpayers would pay tax on receipts they use to defray such costs because they would pay tax on their gross income at rates above 15 percent, but could only deduct 15 percent of the cost of earning income. Thus, an individual with unusually high medical bills, for example, would pay more tax than another individual with the same ability to pay but no medical bills.

Like other limits on itemized deductions, this option would create incentives for taxpayers to avoid the limit by converting itemized deductions into reductions in income. For example, taxpayers might draw down assets to repay mortgages, reducing both income and mortgage payments, or donate time or services rather than cash to charities. The option would also make calculating taxes more complex for itemizers, especially for those already subject to the high-income phaseout for itemized deductions.

REV-09 DECREASE LIMITS ON CONTRIBUTIONS TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Decrease Limits for Defined Benefit Plans to the Social Security Wage Base (With equivalent reductions for defined contribution plans)	1.0	3.1	3.4	3.6	3.4	14.5
Decrease the Limit for Deferrals in Salary Reduction Plans to $4,000	0.4	0.6	0.6	0.7	0.7	3.0

SOURCE: Joint Committee on Taxation.

Saving for retirement through employer-provided qualified pension and profit-sharing plans provides two tax advantages: it exempts from taxes the investment income earned by the assets in qualified plans, and defers tax on employer contributions to qualified plans until retirement, when an employee's marginal tax rate is often lower.

Decrease Limits on Employer Contributions. Current law limits the amount employers can contribute to qualified plans. The limits depend on the type of plan the employer offers.

Defined contribution plans specify how much the employer will contribute for each employee's retirement, for example, 5 percent of pay. The employee's pension depends on how much the employee's retirement fund accumulates by the time he or she retires. Current law limits annual contributions to such plans to 25 percent of compensation, or $30,000, whichever is less.

Defined benefit plans specify the pension amount employees will receive in retirement, which is usually a percentage of preretirement earnings. Employers adjust their annual contributions so that enough will accumulate by the time the employee retires to pay the promised pension. Current law limits contributions to defined benefit plans so that annual benefits for pensions that begin at age 65 are no more than 100 percent of preretirement wages or $115,641 for 1993, whichever is less. The tax law reduces this limit on an actuarial basis for pensions that begin at an earlier age. When an employer sponsors both types of plans, a higher limit applies--the lesser of 140 percent of wages or $144,551 for 1993.

The limits on employer contributions are intended to limit the size of the tax benefits received by highly paid people. These people are better able to provide adequately for retirement without the full tax benefits, and may use pensions to shelter nonretirement savings from taxation. Furthermore, providing full tax benefits for these people would reduce the progressivity of the tax code.

The main argument for lowering the current limits on contributions is that they fund pensions far higher than the preretirement earnings of most workers. Fewer than 2 percent of people who worked full time throughout 1991 earned as much as

$100,000. Workers who accrue pensions this large are unlikely to need the full tax advantage to provide adequately for their retirement. Limiting funding for defined benefit plans to amounts necessary to pay benefits equal to the Social Security wage base ($57,600 in 1993), and making proportionate reductions in limits for defined contribution plans, would raise $14.5 billion from 1994 through 1998 because more employment income would be subject to taxes. These limits would still be higher than the earnings of all but about 9 percent of full-time workers.

One argument against reducing funding limits is that it would make participation less attractive to high-income business owners and top managers, and thus might discourage them from sponsoring these plans for both themselves and their employees. Although the higher-paid managers and owners may not need tax-advantaged pension plans to save adequately for retirement, their employees might. A further argument against reducing the limits is a concern that national saving is too low. Limiting incentives for pension saving could reduce total saving.

Limit 401(k) Deferrals to $4,000. Section 401(k) of the tax code allows employees to choose to receive lower current (taxable) compensation and to defer the remainder of compensation as a contribution to the plan. Similar arrangements are possible for some workers in the nonprofit sector (403(b) tax-sheltered annuities), for federal workers, and for workers enrolled in some simplified employer plans (SEPs).

The Tax Reform Act of 1986 capped employee deferrals for 1987 at $7,000 in the case of 401(k) plans, SEPs, and the federal plan and indexed the cap for inflation. The cap reached $8,994 by 1993. A separate cap of $9,500 applies for 403(b) tax-sheltered annuities until inflation raises the other caps above $9,500. Limiting elective deferrals in all plans with cash or deferred arrangements to $4,000 in 1993 and indexing it thereafter would raise about $3 billion in 1994-1998.

Lowering the limit would affect higher-income workers who are likely to provide adequately for their own retirement without the tax incentive. In addition, many employers have added 401(k) plans on top of other pension plans that already meet the basic retirement needs of employees. The 401(k) plans provide supplementary saving for those who prefer higher retirement income. Thus, limiting contributions to 401(k) plans would not threaten the basic retirement security of these workers.

Alternatively, higher limits provide a greater incentive for employers to initiate the plans, which benefit employees at all income levels. In particular, 401(k) plans appeal more to small employers who have traditionally not established pension plans. Lower limits may discourage small employers from offering what could be the only retirement benefit available to their employees. Lowering limits on these plans and not on other plans encourages traditional pensions, which are primarily defined benefit plans. Unlike defined benefit plans, 401(k) plans and other defined contribution plans do not discriminate against workers who change employers or drop out of the work force temporarily. In addition, the voluntary nature of plans with cash or deferred arrangements allows workers with spouses without coverage to save more for retirement than other workers.

REV-10 IMPOSE A 5 PERCENT TAX ON INVESTMENT INCOME OF PENSION PLANS AND INDIVIDUAL RETIREMENT ACCOUNTS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	5.3	8.9	9.5	10.1	10.8	44.6

SOURCE: Joint Committee on Taxation.

Under normal income tax rules, the interest earnings of savings accounts are fully taxable each year. The absence of this annual tax is one of the tax advantages for employer pensions and IRAs. Instituting a low tax rate on their earnings would reduce the size of this advantage. A 5 percent tax on the investment earnings of employer pensions and IRAs would raise about $45 billion between 1994 and 1998. (The other tax advantage of pensions and IRAs is the deferral of tax on contributions until retirement, when an employee's marginal tax rate is often lower.)

The tax advantages for pensions and IRAs encourage firms and workers to provide for retirement. Most studies of pensions find that they increase saving; the studies of IRAs are less conclusive. Although the tax advantages promote a public objective, many people receive little or no benefit from them. Only about half of employees receive pension coverage or contribute to IRAs. Furthermore, the largest pension benefits go disproportionately to higher paid workers or to workers with long-term employment at large firms.

A low tax on pension and IRA earnings would reduce the tax advantage of saving for retirement through these vehicles. This tax would reduce the use of pensions and IRAs slightly and probably result in less retirement saving. The smaller tax advantage for pensions and IRAs would, however, make the tax burden between those with pensions and IRAs and those without them slightly more equal. It would also increase taxes relatively more for higher paid workers.

Taxing pension and IRA earnings would affect more taxpayers than would lower limits on employer contributions to pension plans (REV-09). Lowering the contribution limits increases taxes on a small number of the highest paid workers, and would increase taxes substantially for some of them. Taxing pension and IRA earnings affects workers throughout the income distribution, and because it affects so many more workers, it could raise more revenue with a smaller impact for each employee who pays more tax.

Taxing the annual earnings of pension funds and IRAs would encourage fund managers to shift their investments toward assets that appreciate in value, such as growth stocks and real estate, because they can defer tax on capital gains until realization (see REV-22). To obtain this tax deferral, however, pension funds would have to invest in riskier assets. Although this portfolio shift would reduce the security of workers' retirement funds, it would also lower the cost of capital for higher-risk sectors.

REV-11 TAX NONRETIREMENT FRINGE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Tax Some Health Insurance Premiums			(See REV-16)			
Tax Life Insurance Premiums						
Income tax	1.8	2.6	2.7	2.9	3.0	12.9
Payroll tax[a]	0.9	1.2	1.2	1.3	1.3	5.9
Impose a 3 Percent Excise Tax on the Value of Nonretirement Fringe Benefits[a]	4.2	6.4	7.0	7.7	8.4	33.7

SOURCE: Joint Committee on Taxation.

a. Estimates are net of reduced income tax revenues.

Employee compensation is taxable unless the tax code contains an explicit exception. Such exceptions apply to most employer-paid nonretirement fringe benefits because of provisions in the tax law that exclude them from the income and payroll tax bases even though they constitute current compensation to employees. Exempting fringe benefits from taxation reduces revenues substantially. For employer-paid health and life insurance premiums alone, the revenue loss will be about $47 billion in income taxes and $32 billion in payroll taxes in 1994. In addition, the law explicitly excludes from gross income employer-paid dependent care and miscellaneous benefits such as employee discounts, parking, and athletic facilities.

These exclusions reduce economic efficiency because employees receive tax-free benefits that they might purchase in lesser amounts with after-tax income. Moreover, the availability of tax-free services for some people can increase prices, thus depriving others who may value the services as much or more. For example, employer-paid health insurance plans have contributed to the demand for health care services, which in turn has contributed to sharp rises in health care costs. All consumers of health care pay the higher prices, not just recipients of tax-free insurance.

The tax treatment of fringe benefits provides proportionately greater benefits for higher-income people because they face higher marginal tax rates and typically receive more fringe benefits than do low-wage workers. It also creates inequities among people with the same income because people cannot convert income to tax-exempt fringe benefits easily or without cost. Thus, a taxpayer receiving no fringe benefits pays more tax than another with the same total income but a larger share in the form of fringe benefits. (If cash income and tax-exempt fringe benefits were closer substitutes, the exclusion would produce less inequity, but it also would reduce efficiency more.)

Making all fringe benefits taxable, however, would present problems in valuing benefits and in assigning their value to individual employees. Few appraisal problems arise when the employer purchases goods or services and provides them to employees, but it is more difficult to determine the value of a facility, such as a parking lot, that employers provide. Further difficulties arise if the employer must allocate to individual employees the total value of the fringe benefits they provide. For example, in cases where the employer provides a service, such as day care, it might be unfair to assign the same taxable value to all employees regardless of their level of use. It could be administratively complex, however, to assign values that depend on each worker's use. Further, the costs of collecting taxes on small fringe benefits (such as employee discounts) could exceed the revenue collected.

The per-employee value of employer-paid health and life insurance would be relatively easy to determine. Employers could report the premiums they pay for each employee on the employee's W-2 form and compute withholding the same as for wages. Employers already withhold taxes on some life insurance premiums (see below). Measuring insurance values would be more difficult for benefits that employers provide directly, such as medical care or reimbursement for medical costs that employees incur under self-insurance plans.

Another way to tax nonretirement fringe benefits would be to collect from employers a tax on the total cost of the fringe benefits they provide. Although determining the total cost of fringe benefits would still sometimes be difficult, this option would eliminate the need to assign the value of fringe benefits to individual employees.

Tax Some Employer-Paid Health Insurance Premiums. Health insurance premiums are subject to nondiscrimination rules that limit the extent to which employer-paid health plans may favor higher-paid workers. Still, the present exclusion for employer-paid health insurance premiums favors recipients of employer-provided insurance over taxpayers who must pay for their own health insurance. Although the former receive tax-free insurance benefits, the latter can only deduct medical expenses, including insurance payments, in excess of 7.5 percent of their adjusted gross income, and then only if they itemize. (REV-16 describes two options to tax some employer-paid health insurance premiums.)

Tax Employer-Paid Life Insurance Premiums. The tax law excludes from taxable income premiums that employers pay for group term life insurance, but limits the exclusion to the cost of the first $50,000 of insurance and applies nondiscrimination rules. Employer-paid premiums in excess of this amount are taxable under both the income tax and the payroll tax. The exclusion is not available to the self-employed. Making all employer-paid premiums taxable would add about $13 billion to income tax revenues and about $6 billion to payroll-tax revenues from 1994 through 1998.

A difficulty with this option arises because many employers provide death benefits under pension plans as substitutes for life insurance. Employees can defer income tax and pay no payroll tax on employer contributions to pension plans. Also, the first $5,000 of employee death benefits are tax-exempt. If the Congress made employer-paid life insurance plans taxable, employers might choose to offer less life insurance and larger death benefits on pension plans instead.

Impose an Excise Tax on the Value of Nonretirement Fringe Benefits. An alternative to including employer-provided benefits in the income of recipients would be to impose on employers an excise tax on the value of the specific benefits that they provide. These benefits would include the employer's share of health insurance, premiums to fund the first $50,000 of life insurance, dependent care, parking, athletic facilities, and employee discounts. A 3 percent tax, for example, would raise about $34 billion from 1994 through 1998. The bulk of these revenues would come from taxing employer-paid health insurance.

Under this option, employers would need to know only their total fringe benefit costs; they would not have to place a value on the benefits paid to each employee. Because the 3 percent excise tax rate would be much lower than the tax rate on wages, this option would maintain most of the incentive for employers to provide fringe benefits instead of taxable wages.

A flat-rate excise tax on employees would be relatively more favorable to higher-income employees than including fringe benefits in employees' taxable incomes. Under an excise tax, the rate would not rise with the income of employees, as it would if the benefits were subject to the income tax.

REV-12 TAX THE INCOME-REPLACEMENT PORTION OF WORKERS' COMPENSATION AND BLACK LUNG BENEFITS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	1.5	4.3	4.5	4.8	5.0	20.2

SOURCE: Joint Committee on Taxation.

Current law exempts Workers' Compensation and Black Lung benefits from income taxation. Taxing the portion of these benefits that replaces the income employees lose from work-related injuries or black lung disease would increase revenues by $20.2 billion from 1994 through 1998 (see also REV-17). The remaining portion, which reimburses employees for medical costs (about 40 percent), would continue to be exempt from taxation.

Taxing the income-replacement portion of Workers' Compensation and Black Lung benefits would make the tax treatment of these entitlement benefits comparable to the treatment of unemployment benefits and of the wage-replacement benefits that employers provide through sick pay and disability pensions. It would also improve work incentives for disabled workers who are able to return to work. (Under current law, the after-tax value of the wages they are able to earn may be less than the tax-free benefits they receive while disabled.)

An argument against taxing these benefits is that legal or insurance settlements for non-work-related injuries are not taxable, even if a portion of them reimburses lost income. Hence, taxing Workers' Compensation benefits would treat these two types of compensation inconsistently.

REV-13 INCREASE TAXATION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
			Retain the Current Income Thresholds			
Increase the Fraction of Benefits Included in Adjusted Gross Income to Tax up to 85 Percent of Benefits	2.8	6.0	6.8	7.5	8.3	31.5
			Eliminate the Income Thresholds			
Tax 50 Percent of Benefits	3.9	9.8	9.9	10.0	10.0	43.6
Tax 85 Percent of Benefits	10.6	24.1	25.0	25.9	26.9	112.5

SOURCE: Joint Committee on Taxation.

Social Security and Railroad Retirement (Tier I) together constitute the federal government's largest entitlement program. The government can reduce benefits from these programs by changing the benefit formula (see ENT-68 through ENT-71), reducing cost-of-living adjustments (see ENT-67), or including a greater portion of benefits in taxable income.

To achieve the same reduction in the federal deficit, taxing a greater portion of these benefits would impose relatively less burden on lower-income households than would, for example, freezing cost-of-living adjustments (COLAs), where the burden would be relatively larger on lower-income households whose principal income source is Social Security. Attempts to curtail the cost of COLAs and, at the same time, protect the poor reduce the deficit very little. Because the tax system is the only source of good information on people's total income, taxing benefits could reduce the deficit more without harming low-income people.

Increasing the tax on benefits would reduce the net benefits of retirees compared with what they may consider to be the implicit promises of the Social Security and Railroad Retirement programs at the time recipients were working. The government has, however, made numerous changes in the Social Security and Railroad Retirement programs over time, including changes in benefit formulas, taxation of benefits, and payroll taxes to finance the programs.

The 1983 Social Security Amendments made Social Security and Tier I benefits partially taxable to higher-income households. Current law includes in adjusted gross income (AGI) the lesser of one-half of Social Security and Tier I benefits or one-half of the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The amount of the threshold is $25,000 for single returns and $32,000 for joint returns. Because these thresholds remain fixed over time, inflation will increase the percentage of recipient households who pay tax on benefits. The Joint Committee on Taxation projects that the percentage of families who will pay taxes on their Social Security benefits will grow from 23 percent in 1994 to 30 percent in 1998.

Two ways of increasing taxation of Social Security and Tier I benefits are to increase the fraction of benefits included in AGI or to eliminate or reduce the thresholds.

Increase the Fraction of Benefits Included in AGI. Under current law, employers pay one-half of workers' combined payroll taxes from before-tax income, while employees pay the remainder out of after-tax income; that was the rationale for including half of Social Security and Tier I benefits in AGI.

Another standard is to treat these benefits like retirement income from public employee pensions and those few private-sector pensions in which individuals make contributions from after-tax income. Current law excludes a fraction of benefits from contributory pension plans from taxable income. The tax law bases that fraction (the exclusion ratio) on the nominal amount of after-tax contributions employees make. The remaining share of these benefits is fully taxable. Because the ratio of after-tax contributions (the employee share of payroll taxes) to Social Security and Tier I benefits varies with each worker's earnings history and marital status, no single exclusion ratio is correct for all beneficiaries. Requiring the Social Security Administration to calculate separate exclusion ratios for each beneficiary would be administratively burdensome.

Including up to 85 percent of benefits in AGI (a 15 percent exclusion ratio) would make the tax treatment of Social Security for workers with high earnings roughly comparable to that of contributory pensions under current law; it would also be more generous than contributory pensions for those with lower earnings. Increasing benefits to be included to 85 percent, while maintaining current thresholds, would raise about $31.5 billion from 1994 through 1998. That change would affect about 23 percent of the couples and individuals receiving benefits in 1994.

Eliminate or Reduce the Thresholds. In addition to the thresholds, the tax code protects lower-income elderly households from taxation of income through personal exemptions, the regular standard deduction, and an additional standard deduction for the elderly. Under current law, 77 percent of elderly couples and individuals with benefits pay no income tax on their benefits. Eliminating the thresholds on taxing benefits would raise $43.6 billion from 1994 through 1998. In addition, it would reduce the share of couples and individuals paying no tax on their benefits to 37 percent.

Eliminating the thresholds would remove a tax preference that is not well targeted toward those with lower incomes and would reduce tax disparities among middle-income households. Social Security beneficiaries receive a tax preference because they exclude a portion of their income--Social Security benefits less than or equal to the threshold amounts--from AGI, and taxpayers who are not Social Security recipients must include all of their income in AGI. As a result, the average income tax rate that middle-income elderly families pay is less than the tax rate that nonelderly families with comparable incomes pay under current law. At the same time, for a comparable deficit reduction, eliminating the thresholds would reduce the disposable incomes of the lower-income elderly less than curtailing cost-of-living increases.

An additional option is to eliminate the thresholds and raise the fraction of benefits included in AGI. Eliminating the thresholds and including 85 percent of benefits in AGI would raise $112.5 billion from 1994 through 1998.

Eliminating the thresholds without changing the fraction of benefits included would decrease the disposable incomes of about half of elderly people, but would not affect the upper-income elderly. Lowering the thresholds instead of eliminating them would reduce the effects on moderate-income recipients. With up to 50 percent of benefits includable in AGI, thresholds of $12,000 for single filers and $18,000 for joint returns would raise about $23.8 billion from 1994 through 1998--only 55 percent of the amount from including the same percentage with no thresholds. Lowering the thresholds to $12,000 and $18,000, while including 85 percent of benefits in AGI, would raise $72.4 billion--roughly 64 percent of the amount from including 85 percent of benefits with no thresholds.

REV-14 PHASE OUT THE DEPENDENT-CARE CREDIT

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Phaseout Starting at:						
$30,000	0.1	0.9	0.9	1.0	1.0	3.9
$50,000	a	0.5	0.5	0.5	0.6	2.1
$65,000	a	0.3	0.3	0.3	0.3	1.2

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Taxpayers who incur employment-related expenses for the care of children and certain other dependents may claim an income tax credit. The credit per dollar of allowed expenses declines from 30 percent for taxpayers whose adjusted gross income (AGI) is $10,000 or less to 20 percent for taxpayers whose AGI is above $28,000. The tax law limits creditable expenses to $2,400 for one child and $4,800 for two or more. Creditable expenses cannot exceed the earnings of the taxpayer or, in the case of a couple, the earnings of the spouse with lower earnings. In 1990, taxpayers claimed about $2.6 billion in credits on 6 million tax returns.

About one-third of the credit benefits families with incomes of $50,000 or more. Targeting the credit more narrowly toward lower-income families would reduce its revenue cost. One way to target the subsidy would be to reduce the percentage of credit as incomes rise. For example, reducing the credit percentage by 1 percentage point for each $1,500 of AGI more than $30,000 would raise about $3.9 billion from 1994 through 1998. This option would reduce the credit for about 40 percent of currently eligible families and would eliminate it for about another quarter of these families (those with AGI over $58,500). Alternatively, phasing out the credit between $50,000 and $78,500 would raise about $2.1 billion in the same period. This option would reduce the credit for about one-quarter of eligible families and eliminate it for another 10 percent. Finally, phasing out the credit between $65,000 and $93,500 would raise $1.2 billion in the same period, reducing the credit for about 10 percent of eligible families and eliminating it for another 5 percent.

The rationale for reducing the credit is that it provides a subsidy for high-income families who choose to have more children. An alternative comparison is between the treatment of different families who have children but in which the spouse may work at home or in paid employment. Under that comparison, the credit is not a subsidy, but instead an offset for the cost of paid employment that the tax code should recognize in measuring ability to pay. Moreover, phasing out the credit would raise the marginal tax rate for taxpayers with incomes in the credit phaseout range, discouraging some from working.

Limiting the credit could induce employees to seek other tax benefits for dependent care by asking their employers to provide plans for dependent care assistance. Current law allows workers to put up to $5,000 of annual earnings into flexible spending accounts, which they can use to pay for dependent care or other specified expenditures. Because the tax law excludes the earnings workers contribute to these accounts from taxable income, participants can use them to purchase dependent care out of pretax income. To preclude taxpayers from using this alternative, the Congress could limit the use of this fringe benefit.

REV-15 TAX INVESTMENT INCOME FROM LIFE INSURANCE PRODUCTS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Tax Inside Buildup	4.0	10.8	11.9	13.1	14.2	54.0
Disallow Corporate Interest Deductions from Policy Loans	0.4	0.6	0.7	0.8	0.9	3.6

SOURCE: Joint Committee on Taxation.

Whole-life insurance is both an insurance policy and a tax-preferred savings plan. In the early years of a policy, a policyholder pays a premium greater than needed to fund the death benefit, with the excess payment earning interest that averts the need for larger premiums as the insured person ages. The investment income, called the "inside buildup," is either tax-free or tax-deferred, depending on the circumstances under which the life insurance company remits the income.

If the company pays a death benefit, the inside buildup is not taxable either to the beneficiary or, with some tax planning, to the estate of the insured person. When a policyholder voluntarily cancels a policy, he or she receives a disbursement called the "cash surrender value," which includes the accrued interest. This amount is taxable to the extent it exceeds the policyholder's "basis" in the policy--that is, the cumulative premiums net of dividend and loan distributions. Even though the inside buildup is ultimately taxable in this case, deferral of the tax until cancellation of the policy confers a benefit to the policyholder.

Corporations can take advantage of inside buildup by taking out loans with the cash value of the policy as collateral. Corporations often purchase life insurance against the death of certain important employees. When corporations take out loans with the policy as collateral, a significant amount of the interest payments are tax deductible, even though the corresponding inside buildup is not taxable. This treatment provides a tax arbitrage opportunity in that corporations can generate interest deductions that they can use to shelter other taxable income. Individuals do not have that opportunity because they cannot deduct such interest payments. Moreover, corporations that pay the minimum tax receive only a limited tax arbitrage opportunity because they receive only a partial tax benefit from inside buildup. These corporations, therefore, tend not to purchase these insurance policies for tax purposes.

The Congress could raise revenue either by taxing the inside buildup on both new and existing policies or, more narrowly, by disallowing corporations from deducting the interest paid on loans with both new and existing policies as collateral.

Tax Inside Buildup on Life Insurance Policies. This approach would make the rules for taxing interest on the savings components of whole-life insurance just like the rules for taxing interest from ordinary savings accounts. The proposal would define the savings component as the excess of the cash surrender value (the refund the policyholder receives upon canceling or outliving the policy) over the policyholder's investment in the contract. The policyholder's investment in the savings component is the difference between premiums paid in excess of the true cost of the insurance provided (determined from mortality tables) and any policy dividends and other distributions the policyholder receives. To facilitate enforcement, the proposal could require the life insurance companies to collect the tax at a uniform 15 percent rate. Making the annual changes in the savings component of policies taxable in that way would raise about $54 billion in 1994 through 1998.

The major reason for taxing the inside buildup within whole-life insurance policies is to make its treatment more similar to the investment income from other financial assets that is taxed currently. The savings within whole-life insurance and ordinary savings accounts, for example, are both easily accessible with a readily measured and steadily growing value. The income from ordinary savings accounts, however, is currently taxed. Thus, the tax exemption for whole-life insurance encourages people to switch funds from ordinary savings accounts to whole-life insurance policies. The revenue loss from the tax preference for inside buildup is growing rapidly because life insurance companies are selling more policies that have investment income as their primary goal. These policies contain just enough of a death benefit to qualify for the tax preference for life insurance.

Another perspective that implies continuing to allow tax deferral is that inside buildup resembles the appreciation from a house or stock. Like these assets, whole-life insurance is also typically a long-term investment with significant transactions costs. The insurance companies usually charge sizable fees to set up the policies. Investors can defer the tax on income from equities and homes until realization. An analogous rule would continue to allow the same deferral benefit for inside buildup.

Disallow Corporate Interest Deductions From Policy Loans. In the Tax Reform Act of 1986, the Congress restricted the size of a loan that qualifies for the interest deduction to $50,000 per insured employee. The Congress could expand on those restrictions by denying the deduction by corporations of interest from all policy loans, regardless of loan size. Denying these deductions would raise an estimated $3.6 billion in revenues over the next five years. The Administration proposed this option in the budget for fiscal year 1993. The Congress would not need to enact this option if it decided to tax the inside buildup directly.

To circumvent the restrictions that the Congress enacted in 1986, corporations have spread smaller policies over a larger group of employees. The widespread use of policy loans implies that the companies are making increasing use of life insurance contracts for investment purposes rather than as protection against the death of key employees.

Disallowing interest deductibility from loans on existing policies would adversely affect corporations that purchased contracts expecting to receive interest deductibility. To ease the transitional burden, the Congress could decide to restrict interest deductibility only for the loans from new policies. Such a limitation would reduce the revenue pickup significantly over the first five years, but it would not affect revenue in the long term.

REV-16 TAX EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
	Tax Some Employer-Paid Health Insurance					
Income Tax	6.2	10.7	13.5	16.7	20.4	67.4
Payroll Tax	4.2	7.3	9.2	11.3	13.8	45.8
Total	10.5	17.9	22.6	28.0	34.2	113.2
	Tax All Employer-Paid Health Insurance, but Allow a Credit for Some Employer and Individual Contributions					
Income Tax	11.5	6.8	9.6	12.8	16.5	57.1
Payroll Tax	21.9	33.6	37.1	40.8	44.9	178.3
Total	33.4	40.4	46.7	53.6	61.4	235.4

SOURCE: Joint Committee on Taxation.

Employees do not pay taxes on income they receive in the form of employer-paid health insurance. In addition, health insurance premiums and health care costs paid through a cafeteria plan are generally excludable from income and payroll taxes. These exclusions will reduce income tax revenues and Social Security payroll tax revenues by a total of about $75 billion in fiscal year 1994.

Tax Some Employer-Paid Health Insurance. One way to limit the exclusion would be to treat as taxable income for employees any employer contributions for health insurance plus health care costs paid through cafeteria plans that exceed $400 a month for family coverage and $165 a month for individual coverage. These amounts are the estimated average amounts to be paid in 1994. The option would index these amounts to reflect future increases in the general level of prices. It would raise income tax revenues by about $67 billion and payroll tax revenues by about $46 billion over the 1994-1998 period. Including employer-paid health care coverage in the Social Security wage base, however, would lead to increased outlays on benefit payments that could offset most of the added payroll tax revenues from this option over the long run.

An advantage of this approach is that it would eliminate the tax incentive to purchase additional coverage beyond the ceiling. Without such coverage, there would be stronger incentives to economize in the medical marketplace, thereby reducing upward pressure on medical care prices and the provision of unnecessary or marginal services. Because the option indexes the ceiling amounts to the overall inflation rate, though in recent times health care costs have been rising faster than inflation, it could place increasingly tighter constraints on health care costs over time. The Congress has already limited the exclusion for employer-paid group term life insurance in a similar way.

One disadvantage of limiting the tax-exemption of employer medical insurance premiums is the difficulty of determining when extensive coverage becomes excessive. A given employer's contribution purchases different levels of coverage depending on such factors as geographic location and the characteristics of the firm's work force. As a result, a uniform ceiling would have uneven effects. Finally, if health insurance costs continue to rise faster than the general level of prices, indexing to reflect the general level of prices would gradually reduce subsidies for employer-paid health insurance. The result of all of these factors may be to increase the number of workers without health insurance.

Tax All Employer-Paid Health Insurance, but Allow a Credit for Some Employer and Individual Contributions. Another option would treat all employer-paid health insurance premiums as taxable income and disallow payments for health care costs through cafeteria plans, but offer a refundable individual income tax credit of 20 percent for health insurance premiums up to the amounts described above for family and individual coverage. The credits would be available to taxpayers whether or not their employers paid for or sponsored the coverage. The option would increase income tax revenues by about $57 billion over the 1994-1998 period. This amount would be the net result of $262 billion in revenues if there were no credit, less $205 billion in new income tax credits. Payroll tax revenues would also rise substantially, by about $178 billion over the same period. As under the first option, however, in the long run, increases in Social Security outlays could offset most of the added payroll tax revenues.

In addition to eliminating the tax incentive for excessive health insurance, as under the first alternative, an added advantage of this option is that the subsidy would be made available to all taxpayers who purchase health insurance, without regard to their employment status. Moreover, the subsidy per dollar of eligible health insurance premiums would no longer be relatively higher for taxpayers with higher marginal tax rates (and higher incomes). Limiting the amount of insurance eligible for credits to a fixed level, however, creates all of the same problems as in the first option. Moreover, by extending the subsidy to individual purchases of insurance, the option may induce relatively healthy employees to purchase insurance outside of the work place. Consequently, insurance would become more expensive for the remaining employees, especially at small firms, and this rise in cost could cause more firms to terminate coverage.

REV-17 TAX A PORTION OF THE INSURANCE VALUE OF MEDICARE BENEFITS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
			Without Income Threshold			
Hospital Insurance Only	1.3	4.5	5.0	5.6	6.2	22.6
Supplementary Medical Insurance Only	1.5	5.3	6.1	7.2	8.5	28.6
Both	3.0	10.5	11.9	13.6	15.6	54.6
			With Income Threshold			
Hospital Insurance Only	0.9	2.4	2.9	3.3	3.8	13.3
Supplementary Medical Insurance Only	1.0	2.8	3.5	4.2	5.1	16.7
Both	2.0	5.3	6.4	7.7	9.1	30.6

SOURCE: Joint Committee on Taxation.

Eligibility for Hospital Insurance (HI) benefits is based on working-year tax contributions, half of which are paid by employees from after-tax income and half by employers from pretax income. Hence, 50 percent of the insurance value of HI benefits might be treated as taxable income for all Medicare enrollees, reflecting the portion of contributions that was not originally subject to income tax. This proposal is analogous to taxing part of Social Security benefits, which is already in effect for higher-income beneficiaries whose modified adjusted gross income plus half of Social Security benefits exceeds $25,000 (for individuals) or $32,000 (for couples). In addition, that portion of the insurance value of benefits under the Supplementary Medical Insurance (SMI) program that is not covered by enrollees' premiums (currently about 75 percent) could be added to their taxable income.

If income thresholds were not used to limit the application of the tax, additional revenues from the HI tax alone would be $1.3 billion in 1994 and $22.6 billion over the 1994-1998 period. Revenues from the SMI tax alone would be $28.6 billion over the five-year period. If both the HI and the SMI tax were imposed, revenues would be $54.6 billion over the five-year period. The combined tax would generate more revenues than the sum of the HI and SMI taxes because some enrollees would become subject to higher tax rates.

Alternatively, the current income thresholds for the tax on Social Security benefits could be used to limit the application of the tax on Medicare benefits. In this case, 50 percent of the HI insurance value and/or that portion of the SMI insurance value not covered by premiums would be added to modified adjusted gross income plus half of Social Security benefits to compare with the threshold. Taxing HI benefits alone would then yield additional revenues of $0.9 billion in 1994 and $13.3 billion over the 1994-1998 period. Taxing SMI benefits alone would yield additional revenues of $16.7 billion over the five-year period, and a combined tax would yield $30.6 billion. In this instance, the combined tax would generate more revenues than the sum of separate HI and SMI taxes, not only because of progressive tax rates but also because more enrollees would exceed the threshold.

A tax on HI benefits would reduce the federal deficit and strengthen the HI trust fund if the proceeds were placed there. A tax on SMI benefits would shift some SMI costs from taxpayers to enrollees. If income thresholds were used, low- and middle-income enrollees would not be affected. In fact, fewer than 60 percent of enrollees in 1994 would be affected by this proposal even if no income thresholds were used. Furthermore, since this option would use the mechanism already in place for taxing Social Security benefits, it would present no additional administrative difficulties.

Unlike the tax on Social Security benefits, however, this tax would be imposed on the insurance value of in-kind benefits rather than on the dollar benefits actually received, thereby modifying current tax policy. (There would be little to recommend basing the tax on actual benefits received because it would then be directly related to enrollees' health care costs. Such a tax would reduce the insurance protection Medicare is intended to provide.) Some might object to this option unless enrollees could alter their tax liability by renouncing benefits not only under the SMI program, but also under the HI program, a choice that might be particularly important to enrollees for whom Medicare is a secondary payer to their employment-based coverage. For the approximately 10 percent of enrollees in or above the 28 percent tax bracket, the additional tax liability would be substantial--$817 in 1994 for individuals and $1,635 for couples, assuming the combined tax was imposed with no income thresholds.

REV-18 CURTAIL TAX SUBSIDIES FOR EXPORTS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	2.6	4.5	4.7	4.7	4.7	21.1

SOURCE: Joint Committee on Taxation.

The tax code subsidizes U.S. exports in two important ways. First, certain rules for allocating income between domestic and foreign business activities enable U.S. multinational companies to use excess foreign tax credits to offset as much as half of the U.S. tax on their export income by characterizing it as foreign-source income. Second, the tax rules for foreign sales corporations (FSCs) offer U.S. companies an opportunity to exempt about 15 percent of their export income from U.S. tax by characterizing it as foreign income that is not effectively connected with U.S. trade or business.

Sourcing Rules for Sales of Inventory. U.S. companies generally pay U.S. tax on their worldwide income, but they may claim a foreign tax credit. The foreign tax credit reduces the tax that U.S. companies owe on foreign-source income by the amount of income tax they pay abroad. To prevent the foreign tax credit from offsetting domestic-source income, the tax code limits the credit to the amount of tax owed on foreign-source income. When foreign tax payments exceed the U.S. tax on foreign-source income, U.S. companies accrue excess foreign tax credits that they cannot use. U.S. companies retain excess credits to offset taxes owed on future income from foreign sources, but only for five years. (One consequence of lowering corporate tax rates in the Tax Reform Act of 1986 is that many U.S. companies now have excess foreign tax credits that are likely to expire.)

In allocating worldwide income between domestic and foreign sources, sourcing rules determine how fully U.S. companies can use their foreign tax credits to reduce their U.S. tax liability. For example, when a corporation has excess foreign tax credits, treating a dollar of income as foreign-source income instead of domestic-source income allows the corporation to use excess credits that might otherwise expire to reduce the U.S. tax on its worldwide income by about 34 cents.

Sourcing rules allocate the income of multinational companies either on the basis of arm's-length transfer prices or by formula. The rules usually allocate income from the sale of inventory by formula. For example, when a U.S. company manufactures a good in the United States and markets it abroad, the rules allocate half the income earned from the sale to domestic-source income (to approximate the income from manufacturing) and half to foreign-source income (to approximate the income from marketing). When the company has excess foreign tax credits to offset the tax on its foreign-source income, half of the total income it derives from the sale is effectively exempt from U.S. tax. For inventory sales of generic commodities such as basic chemicals, the rules allocate income according to arm's-length transfer prices that approximate the sales price charged for similar goods to unaffiliated companies. To the extent that the formula allows companies to allocate more income to a foreign source than arm's-length transfer pricing would allow, companies with excess foreign tax credits receive an implicit export subsidy.

Foreign Sales Corporations. Under the General Agreement on Tariffs and Trade (GATT), export income can be exempt from U.S. tax only if the economic activity that produces the income takes place outside the United States. In response to

GATT, the tax law allows U.S. companies to charter FSCs in countries with low taxes and either supply goods to the FSCs for resale abroad or pay commissions to FSCs on export sales. Although the FSCs are largely paper corporations with very few employees, they have enough foreign presence and economic substance to meet GATT's requirements to exempt export income.

When a U.S. company sells exports through a FSC, about 15 percent of the total income from production and marketing is typically exempt from U.S. tax. (The size of the exempt share can vary slightly depending on the method for determining the transfer price between the U.S. company and the FSC.) The exempt income remains free from U.S. tax when it is repatriated by the U.S. company as a dividend from the FSC.

Economic Effects of Export Subsidies. Export subsidies increase investment and employment in export industries, but do not increase the overall levels of domestic investment and domestic employment. Stimulating exports increases the demand for U.S. dollars by foreigners, which raises the value of the dollar and lowers the cost of imports, causing imports to increase. In the long run, export subsidies increase imports as much as exports, which causes investment and employment in import-competing industries in the United States to decline about as much as they increased in the export industries.

Export subsidies reduce domestic welfare by distorting the allocation of economic resources at home and abroad. The subsidized production of export goods in the United States partially displaces the more efficient production of these goods abroad. Moreover, the subsidies increase the worldwide supply of goods that the United States exports and decrease the worldwide supply of goods that the United States imports. The shifts in supply lower the world price of U.S. exports and raise the price of U.S. imports. As a result, domestic welfare suffers because the United States receives fewer import goods in exchange for its export goods.

Curtailing the export subsidies provided by the favorable sourcing rule for the sale of inventory abroad and the favorable tax treatment of FSCs would raise about $21 billion from 1994 through 1998. The option would curtail the subsidy from the sourcing rule by requiring companies to allocate income according to the best available information on where the income is produced. Instead of using a formula, companies would generally have to compute arm's-length transfer prices. The option would also curtail the subsidy from FSCs by treating them like other foreign subsidiaries. In general, all of the income of FSCs would be subject to U.S. tax, but some of it would be foreign-source income. (Foreign tax credits could still be used to offset the tax on the foreign-source income.) The amount of foreign-source income would depend on arm's-length transfer prices between the U.S. company and the FSC.

Arm's-length transfer prices would be difficult to compute for exports that have proprietary features that make them unique. Unless these exports go to unaffiliated companies as well as affiliated companies, transfer prices cannot be determined on the basis of comparable sales. Without comparable sales, companies would have to use other methods to compute arm's-length transfer prices. Companies with excess foreign tax credits would have an incentive to adopt methods that allocated as much income as possible to a foreign source. Such methods could lead to protracted disputes between the companies and the Internal Revenue Service.

REV-19 IMPOSE A MINIMUM TAX ON FOREIGN-OWNED BUSINESSES

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	0.1	0.2	0.3	0.4	0.6	1.6

SOURCE: Joint Committee on Taxation.

Foreign-owned companies must pay tax on the income they earn from business activities within the United States. Treaties with other countries generally stipulate that the tax the United States levies on the income of foreign-owned businesses will not exceed the tax it levies on U.S.-owned businesses.

When foreign multinational corporations operating in the U.S. import materials and services from affiliated companies abroad, the "transfer price" of imports affects the amount of income that is subject to U.S. tax. (The transfer price is the price charged for goods sold between affiliated companies.) By raising the transfer price of imports, foreign-owned companies can shift income out of the United States to their foreign affiliates and reduce their U.S. tax liability. U.S. tax law requires companies to base the transfer prices of many goods and most services on comparable transactions between unaffiliated companies. But such prices are often difficult for companies to determine and even more difficult for the Internal Revenue Service (IRS) to enforce, especially when comparable goods and services are not routinely traded between unaffiliated companies.

There is some circumstantial evidence that foreign-owned multinational corporations may be manipulating transfer prices to shift income overseas and avoid U.S. tax. For example, studies have found that the reported profit rates (as a percentage of assets and as a percentage of sales) of foreign-owned multinational corporations operating in the United States are generally lower than the profit rates of U.S.-owned corporations in the same industry. Although foreign-owned corporations could be lowering their profits by manipulating transfer prices, there are other plausible explanations for the low profit rates. For example, foreign-owned companies may have newer plants and equipment than U.S.-owned companies in the same industry. Because accelerated depreciation methods allow companies to claim larger annual deductions on newer equipment than on older equipment, foreign-owned companies would have higher reported depreciation costs and lower reported profit rates as a percentage of sales. Moreover, because the absence of an inflation adjustment for the book value of plant and equipment undervalues older assets relative to newer assets, U.S.-owned companies with older assets would tend to have higher profit rates as a percentage of reported book value than foreign-owned companies with newer assets.

To discourage foreign companies from manipulating transfer prices to avoid U.S. tax, a minimum tax could be levied on foreign-owned businesses that have a sizable amount of trade with affiliated companies overseas. One provision in a bill introduced in 1992 (H.R. 5270) would impose a minimum tax on all companies that are at least 25 percent foreign owned and have transactions with foreign affiliates in excess of either 10 percent of their gross income or $2 million annually. Under the proposal, the foreign-owned company would compute its taxable income under the current income tax rules, but its taxable income would be subject to a floor. The floor would equal 75 percent of its gross business receipts multiplied by the average profit margin on gross receipts for U.S. companies in the same industry. If the foreign-owned company's operations spanned several industries, the floor would be based on the profit margins in each industry weighted by the company's gross receipts in the industry. The IRS could waive the minimum tax after examining a company's method of computing transfer prices and finding it acceptable.

The formula approach under the proposed minimum tax provides a simple way to ensure that foreign-owned companies conducting business in the United States pay an acceptable amount of U.S. tax. The simplicity of the approach may offer some advantage over the cumbersome rules for arm's-length pricing, which are extremely difficult to enforce. The formula approach, however, provides a very crude estimate of taxable profit.

The minimum tax would discriminate against foreign-owned companies, in violation of U.S. treaties, by taxing their income more heavily than the income of their domestic competitors. The minimum tax would be especially onerous on foreign-owned companies starting new businesses in the United States because new businesses are seldom profitable initially. Under the minimum tax, such businesses would still owe a sizable amount of income tax based on their gross receipts.

Other countries are likely to treat the minimum tax as a protectionist measure and retaliate with similar taxes on U.S.-owned companies conducting business within their borders. If so, then the minimum tax would stifle international trade and reduce economic welfare throughout the world. Imposing the minimum tax on foreign-owned companies would raise about $1.6 billion from 1994 through 1998.

REV-20 REPEAL THE POSSESSIONS TAX CREDIT

Addition to CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Addition
	Annual Added Revenues (Billions of dollars)					
Repeal the Credit	2.1	3.9	4.1	4.3	4.5	18.7
Replace the Credit with a Wage Credit	0.3	0.5	0.6	0.7	0.8	2.8

SOURCE: Joint Committee on Taxation.

The U.S. income tax treats income of U.S. corporations operating in Puerto Rico or any other U.S. possession as foreign-source income. Under general tax provisions, corporations may offset the U.S. tax on such income by claiming the foreign tax credit (FTC) for any tax they pay to the possession. A "possessions corporation," however, may claim a possessions tax credit instead of the FTC. A U.S. corporation may elect to be a possessions corporation if at least 80 percent of its gross income for the last three years comes from sources within Puerto Rico or another U.S. possession and if the active conduct of a trade or business produces at least 75 percent of such income. Because the possessions tax credit is equal to the U.S. tax on qualified income earned in U.S. possessions, the credit effectively exempts such income from federal tax.

The objective of the possessions tax credit has been to promote employment in U.S. possessions. A substantial fraction of employment in Puerto Rico is in possessions corporations. According to a study by the Internal Revenue Service (IRS) in 1989, 85 percent of manufacturing jobs were in possessions corporations. But the credit may have provided tax benefits to certain businesses that are overly generous for the jobs they have created. For example, chemical and drug manufacturers, who received 54 percent of the tax benefits in 1989, accounted for only 20 percent of employment in possessions corporations. According to the IRS, tax benefits averaged 217 percent of compensation for drug manufacturers and 109 percent of compensation overall for Puerto Rican possessions corporations.

Moreover, despite complex limits, the primary effect of the credit is to induce firms to recharacterize their income from intangible assets they develop in the United States as income earned in U.S. possessions instead of encouraging investment in tangible capital such as plant and equipment in possessions. Repealing the credit would increase revenues by $19 billion over five years.

A better-targeted subsidy, such as a wage credit, might be a more cost-effective way to promote employment in possessions. The Treasury Department in 1985 proposed a wage credit equal to 60 percent of wages up to the federal minimum wage and 20 percent of wages between one and four times the minimum wage. The 1985 Treasury proposal would have continued providing possessions tax credits for five years on the active business income of qualifying corporations. The wage credit would replace the possessions tax credit and the foreign tax credit on income from possessions for qualifying corporations. Despite the long phase-in period, the wage credit would raise almost $3 billion during the 1994-1998 period.

One argument against repealing the possessions tax credit is that the credit may stimulate investment by U.S. firms in Puerto Rican high-technology manufacturing, such as pharmaceuticals and electronics. The wage credit option, by shifting the tax subsidy from capital to labor, would tend to reduce the capital intensity of possessions corporations over the long run. However, by subsidizing only labor, the wage credit might stimulate more employment than the broader possessions tax credit. In addition, the wage credit would apply even at relatively high wages, thereby minimizing the substitution of low-wage for high-wage jobs.

Another argument against repeal is that it would cause unemployment in the subsidized industries, as well as in other sectors that sell products and services to the possessions corporations and their employees. The generous transition rule and new wage subsidies in the second option reduce these disruptions.

REV-21 TAX CAPITAL GAINS FROM HOME SALES

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Tax 30 Percent of Gain	0.6	6.5	6.8	7.2	7.5	28.6
Tax Lifetime Gains in Excess of $125,000	0.1	0.5	0.5	0.6	0.6	2.3

SOURCE: Joint Committee on Taxation.

When homeowners sell their home, they realize a capital gain or loss equal to the difference between the selling price and their basis. Their basis is the initial cost of the home plus the cost of home improvements.

Although capital gains on most assets are taxable when sold, capital gains on home sales generally escape taxation. A taxpayer can defer the capital gain from the sale of a principal residence if she or he purchases another home of at least equal value within two years. When a homeowner dies, the accrued gain on the current home plus any gain on previous homes escapes tax permanently. Further, the tax law allows taxpayers age 55 and older to exclude up to $125,000 of gain from one home sale even if they do not purchase another home of equal or greater value within two years. Replacing the above provisions with a rule that includes 30 percent of capital gains from home sales in taxable income would raise about $29 billion in 1994 through 1998. Alternatively, including all lifetime gains in excess of $125,000 in taxable income when realized would raise $2.3 billion over the same period.

The preferential treatment of capital gains from home sales is only one of the ways in which the tax code strongly favors owner-occupied homes over other investments (for a discussion of other ways, see REV-05). All of these tax preferences divert savings from business investment to housing. One way to make the tax treatment of housing more like that of other assets would be to replace the capital gains deferral and exclusion provisions with a low-rate tax on gains from home sales. Including 30 percent of the gain from home sales in taxable income would make the tax rate on such gains 9.3 percent for taxpayers facing a 31 percent marginal tax rate, 8.4 percent for those in the 28 percent tax bracket, and 4.5 percent for those who are in the 15 percent tax bracket.

A tax on gains from home sales would discourage home sales in the same way that current law discourages taxpayers from selling other capital assets. In the case of home sales, that might discourage workers from relocating to take advantage of better job opportunities. The tax might also deter some homeowners (especially older taxpayers with large accrued gains) from changing homes as family requirements change.

Another option would allow all taxpayers to exempt the first $125,000 of gains on all home sales from tax, while fully taxing the excess over this amount at the time of sale. This option would protect the mobility of most homeowners. Taxpayers who realize a gain of less than $125,000 on their first home could apply the unused portion to future home sales. This exclusion would increase the mobility of homeowners under age 55 relative to current law because they could move to homes of lesser value without incurring a tax as long as the gain on the home they sold was less than $125,000. Although this proposal would increase mobility for most homeowners, it would reduce it for those under age 55 whose gains from home sales exceed $125,000. Taxpayers could no longer defer additional gain by purchasing a larger home.

Taxing gains on home sales without the rollover and exclusion that current law allows would burden taxpayers with additional recordkeeping on home improvements. They would need to maintain these records to establish the tax basis of a home upon sale. Currently, many taxpayers do not keep such records because the probability of any future tax on gains from a home sale is low and the expected present value of such a tax is small. Allowing a lifetime exemption of $125,000 would complicate recordkeeping more, especially when people buy and sell successive homes with different spouses.

For many homes, most gain results from inflation, and by itself taxing inflationary gains is unfair because these gains are not income. Taxing inflationary gains may, however, be an appropriate way to offset the tax benefit that homeowners enjoy from inflation by being able to deduct fully their mortgage interest payments, which include a premium for inflation.

Any reduction in the tax benefit from home ownership would lower the value of existing housing relative to other assets such as corporate shares. The loss in value would be felt most by middle-income taxpayers because homes are their principal asset.

As a way of reducing the tax benefit to home ownership, the primary alternative to taxing gains on sale is to limit the mortgage interest deduction (see REV-05). Limiting the mortgage interest deduction has the advantages of not hindering mobility or requiring greater recordkeeping. Taxing gains on sale, however, has the advantage of preserving the greatest tax break for first-time home buyers.

REV-22 TAX CAPITAL GAINS HELD UNTIL DEATH

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Include Gains in the Last Income Tax Return of Deceased[a]	b	7.3	7.7	8.1	8.5	31.6
Enact Supplemental 10 Percent Estate Tax	b	0.7	0.8	0.8	0.9	3.2
Enact Carryover Basis	b	0.7	1.5	2.4	3.4	8.1

SOURCE: Joint Committee on Taxation.

a. Estimate is net of reduced estate tax revenues.

b. Less than $50 million.

A capital gain or loss is the difference between the current value of an asset and the owner's basis. The owner's basis is the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. When an asset is sold, the tax law normally requires that the owner include any realized gain in taxable income. The owner can deduct any realized loss against realized gains, and when the owner does not have gains in excess of losses, he or she can deduct up to $3,000 of the loss against other income.

An exception occurs when an owner holds an asset until death. In this case, the tax law allows the beneficiary to "step up" the basis to the asset's value as of the date of the decedent's death. When the beneficiary subsequently sells the asset, he or she pays tax on the gain that accrued after the decedent's death. The gain that accrued before the decedent's death is permanently excluded from taxable income. The estate of the decedent may pay taxes under the separate estate tax, but this tax applies equally to assets on which the decedent previously paid income tax and to assets with accrued capital gains that escape tax.

There are three ways of taxing gains held at death: the law could require that gains held at death be included as income on the final income tax return of the decedent, the estate of the decedent could be subject to a supplemental tax rate on accrued gains, or the law could require that beneficiaries assume the decedent's basis in the asset they inherit. Under this last method of carryover basis, the beneficiaries would include the decedent's unrealized gain in their taxable income when they sell the asset.

Tax Gains on Final Return of the Decedent. Taxing accrued but unrealized gains on the final income tax return of the decedent would raise $31.6 billion from 1994 through 1998. This option would exclude gains on assets that a spouse inherits. Instead, the spouse would assume the basis of the decedent and pay tax on the full gain only if the spouse sells the asset. Any gains on assets that the decedent leaves to charity would also be exempt. The option would include gains on other assets in taxable income. It would also allow three additional modifications. First, to ease the problem of documenting the basis, the option would allow the estate to use an alternative basis equal to one-half of the asset's current value in computing the gain to be included on the final tax return. Second, the estate could claim the existing $125,000 exclusion on the gain from the sale of a principal residence if the decedent had not already claimed it. Third, the estate could exclude an additional $75,000 of any remaining gains. With all these provisions, about one-tenth of the people who hold accrued gains when they die would pay taxes on those gains. Finally, taxes paid on gains realized at death would be deductible under the estate tax.

Tax Gains Under the Estate Tax. An additional estate tax on accrued gains of 10 percent would raise $3.2 billion from 1994 through 1998. This option would apply a flat 10 percent rate to the same tax base as in the previous option. In addition, however, taxpayers could offset the additional tax with any unused credits under the estate tax. Because of these credits, few people would owe additional tax under this option. Only about 1 percent of estates currently pay the estate tax and the fraction paying the additional tax on gains would be about the same.

Tax Gains Upon Realization by Heirs (Carryover Basis). A third option would carry over the decedent's basis in assets left to the heirs and tax the gains of the decedent when the heirs sell their assets. This option would raise $8.1 billion from 1994 through 1998. The option would also allow heirs to set the basis of inherited assets at one-half of their current value. In addition, if the estate of the decedent paid any estate tax, shares of that tax would be added to the basis of all the estate's assets in proportion to their shares of the estate's value. Carryover basis would make most gains held at death taxable, but the timing of the tax payments would depend on when the heirs sell the inherited assets.

Gains held until death have always been exempt from income tax. The Congress enacted a carryover basis in the Tax Reform Act of 1976 but postponed it in 1978 and repealed it in 1980. It was never in effect.

Taxing accrued gains at death, on either the last income tax return or the estate tax, would reduce the incentive for investors to hold assets until death in order to avoid tax. Current law encourages taxpayers to hold onto assets longer than they otherwise would. This "lock-in" effect distorts their investment portfolios and may hinder the flow of capital to activities with higher rates of return. The Tax Reform Act of 1986 worsened the lock-in effect by increasing tax rates on capital gains that taxpayers realize before death. Reducing the lock-in effect is one of the advantages of reducing the income tax on realized capital gains. Taxing gains at death would also reduce the lock-in effect, but, unlike a lower capital gains tax rate, it would reduce the preferential treatment of capital gains over ordinary income.

Using a carryover basis would not achieve the same unambiguous reduction of the lock-in effect that the other two options would achieve. Using a carryover basis lessens the incentive for the original owner to hold onto an asset until death. But an heir receiving an asset with a carryover basis has a stronger incentive to hold on to the asset than under current law.

A disadvantage of taxing gains at death is that the tax might force the family of the decedent to sell assets to pay the tax. Forced sales of illiquid assets at an inopportune time can reduce their value substantially. Forcing heirs to sell a family farm or business would impose a particular hardship on families wanting to continue the enterprise. Forced sales would not occur if a carryover basis were used because heirs could defer the tax on unrealized gains until they sell the assets. Taxing gains held at death through the estate tax would also reduce forced sales because the estate tax permits heirs who continue to operate a family farm or business to defer payment for five years and then spread payment over the next 10 years. In addition, the estate tax gives the estate the option of valuing a family farm or business on its current use instead of by its market value. A similar deferral could be allowed for family enterprises if gains were taxed on the final income tax return of the deceased.

Taxpayers and the IRS often have difficulty determining the basis of assets of closely held businesses, personal property, and assets for which the taxpayer did not keep adequate records. The difficulty in determining the amount of the basis was one of the main arguments that influenced the Congress to delay implementing carryover basis in 1978 and then to repeal it in 1980. Because people currently planning to hold assets until death might not have kept adequate records, documenting the basis would be particularly difficult immediately after passage of a law to tax gains held until death. Once a tax on gains held at death had taken effect, however, people would have a reason to keep better records. In the interim, allowing estates and heirs to set the basis at one-half of the market value at the time of death would ease compliance. Finally, if gains held at death were taxable under the estate tax instead of the income tax, most taxpayers would be exempt because of the high estate tax credit (see REV-23).

REV-23 ADJUST THE RATE STRUCTURE AND BROADEN THE BASE FOR ESTATE AND GIFT TAXES

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
			Adjust the Rate Structure			
Reinstate 1992 Top Marginal Rates	a	0.3	0.4	0.4	0.5	1.6
Lower the Federal Credit	a	2.5	2.8	3.6	4.5	13.4
			Broaden the Base			
Include Life Insurance Proceeds in the Base	a	0.2	0.2	0.3	0.3	1.0
Reduce Federal Offset to State Inheritance Taxes	a	0.5	0.6	0.6	0.7	2.4

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on transfers at death. The estate and gift taxes together constitute a unified tax: one progressive tax is imposed on cumulative transfers during life and at death. Generous credits built into the system, however, exempt most estates from taxation. Estate and gift taxes reduce the perpetuation of concentrations of large wealth across generations.

The estate and gift tax rates in 1994 will range from 18 percent on the first $10,000 of transfers to 50 percent on transfers of more than $2.5 million, but a unified credit of $192,800 effectively exempts the first $600,000 from taxation. As a result of the credit, taxable estates face an initial tax rate of 37 percent on the first $150,000 of transfers in excess of $600,000. An additional 5 percent surcharge applies to estates between $10 million and $18.34 million. The 5 percent surcharge phases out the benefit of graduated rates for these larger estates. In addition, current law phases out the unified credit for estates above $10 million. Another credit allows taxpayers to subtract a portion of state inheritance taxes from federal estate tax liability.

Adjust the Rate Structure. Two ways of changing the estate and gift tax rate structure are to alter statutory rates directly or to change the effective tax rates by lowering the unified credit. Raising the top marginal rates directly will increase the tax burden most on large estates, and lowering the unified credit will raise taxes relatively more on smaller estates, including some that are exempt from estate tax under current law.

The Congress reduced the top marginal rate on estate and gift transfers from 55 percent to 50 percent beginning in 1993. The 55 percent rate applied to transfers exceeding $3 million, and an intermediate 53 percent rate applied to the amount between $2.5 million and $3 million. Reinstating the 1992 rates would raise $1.6 billion from 1994 through 1998. Raising the marginal rate could slightly reinforce an incentive for taxpayers to shift wealth to nontaxable forms such as life insurance and annuities.

Lowering the unified credit from $192,800 to $87,800 would raise $13.4 billion from 1994 through 1998 and make an additional 15 percent of estates subject to tax. This lower credit is equivalent to an exemption of only the first $300,000 of transfers, instead of the current $600,000. Although the majority of estates would still be tax-exempt, some homes, family farms, and small businesses would become subject to tax.

A great deal of accumulated wealth is in the form of unrealized capital gains, and estate taxes bring the unrealized capital gains into the tax base. Because all transfers of wealth are subject to estate and gift tax, however, there is no distinction between unrealized gains and the gains that were already taxed as income to the decedent. (See REV-22.)

A problem with increasing effective tax rates on transfers is that it may force liquidation of closely held family businesses or farms. Reducing forced liquidation of assets was a primary concern of the Congress when it voted to raise the unified credit in 1981.

Broaden the Base. Another means of increasing revenues from estate and gift taxes is to broaden the base--for example, by including proceeds of life insurance policies or by substituting a deduction for the credit now available for state inheritance and gift taxes. Life insurance is an alternative way of transferring wealth to descendants, but is currently exempt from the estate tax if the policyholder is someone other than the person who died. Making life insurance proceeds subject to estate and gift tax would raise $1 billion from 1994 through 1998.

Another way to broaden the base is to reduce the federal offset to state inheritance taxes. Currently, state death taxes reduce federal tax liability by a credit that ranges from 0.8 percent on transfers of $40,000 to 16 percent on transfers of more than $10 million. When implemented in 1926, the credit could virtually eliminate federal tax liability because the top marginal rate on estate and gifts taxes was 20 percent. The credit acts as a state revenue-sharing system for estates taxed up to the 16 percent exclusion level. Consequently, a majority of states have adopted inheritance tax systems that simply redistribute estate tax revenues from the federal to state governments. This shift is accomplished by imposing state taxes that exactly match the amount of the federal credit. Changing the state inheritance tax credit to a deduction would raise $2.4 billion from 1994 to 1998, and would correspond to the itemized deduction that taxpayers receive for state and local income and property taxes.

An alternative change that yields the same revenue is to reduce the amount of state tax credited by half so that the maximum credit is 50 percent of the amount paid to states. The two alternatives are not equivalent for estates of different sizes, however, since the value of the deduction increases as the marginal tax rate rises.

REV-24 EXPAND MEDICARE AND SOCIAL SECURITY COVERAGE

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Expand Medicare Coverage to Include State and Local Government Employees Not Now Covered	1.2	1.6	1.6	1.5	1.5	7.3
Expand Social Security Coverage to Include All New State and Local Government Employees	0.2	0.8	1.4	1.9	2.5	6.9

SOURCE: Congressional Budget Office.

NOTE: These estimates do not include the effect of any increases in benefit payments that would result from the option. These estimates would be small over the five-year period. Estimates are net of reduced income tax revenues.

Government workers remain the largest group of workers not paying Medicare and Social Security payroll taxes, even though legislation during the past decade mandated participation by certain groups of federal, state, and local government workers. This legislation required all federal workers to pay Medicare payroll taxes beginning in 1983 and required federal employees who began work after December 31, 1983, to pay Social Security payroll taxes. Further legislation mandated that state and local workers who began employment after March 31, 1986, must pay Medicare payroll taxes. The Omnibus Budget Reconciliation Act of 1990 expanded Social Security and Medicare coverage to include state and local government workers not covered by any retirement plan.

Under current law, many state and local employees will qualify for Social Security and Medicare benefits based on other employment in covered jobs or their spouses' employment. These workers will thus receive benefits in return for a smaller amount of lifetime payroll taxes than those paid by people who work continuously in covered employment. This inequity is especially apparent for Medicare benefits: more than 90 percent of retired state and local government workers receive benefits, but only about 70 percent worked in a covered state or local government job. Inequitable treatment is less of a problem in the case of Social Security benefits because the benefit formula is adjusted for retired government workers who have worked a substantial portion of their careers in employment not covered by Social Security.

Requiring all state and local workers to pay Medicare payroll taxes, and all new state and local workers to pay Social Security payroll taxes, would make coverage of state and local workers resemble that of federal workers. This broader coverage would reduce the inequity from the high benefits these workers receive in relation to payroll taxes paid. Expanding Medicare and Social Security payroll taxes to include more state and local workers would increase the government's liability for future program benefits. The additional revenues, however, would more than offset increased benefits for a long time.

Expand Medicare Coverage to Include State and Local Government Workers Not Now Covered. Expanding Medicare coverage to include state and local government workers who began work before April 1, 1986, would raise more than $7 billion from 1994 through 1998. In recent years, the Administration has proposed this option and the Congress has considered it during the budget reconciliation process.

Expand Social Security Coverage to Include All New State and Local Government Workers. Expanding Social Security coverage to include all new state and local government workers would raise nearly $7 billion from 1994 through 1998, although in the long run higher Social Security benefit payments would offset the extra revenue. How states and localities revised their pension plans in response to mandatory coverage would determine which workers gained and lost from this change, but requiring coverage of new state and local government workers is likely to benefit many workers who spend only part of their careers in the government sector. First, because of the portability of coverage, newly hired workers would find it easier to qualify for disability and survivors' benefits under Social Security than under many public employee benefit programs. Second, Social Security eligibility is not lost if the state and local employees change jobs before they are vested. Third, Social Security benefits are calculated on the basis of indexed wages, but benefits from public pension plans are calculated on the basis of nominal wages for a given amount of covered wages. Consequently, workers who worked only when they were young would receive more generous retirement benefits from Social Security than from public pension plans.

State and local governments would have to pay the employer's share of Social Security taxes on new employees if coverage were made mandatory. Because state and local government participation in Social Security is now voluntary, those states with a low percentage of covered employees would bear more of the cost of expanded mandatory coverage, including the cost of setting up the system.

REV-25 REPEAL THE MAXIMUM TAXABLE EARNINGS LEVEL FOR MEDICARE

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	2.7	6.0	6.4	6.8	7.2	29.2

SOURCE: Congressional Budget Office.

NOTE: Estimates are net of reduced income tax revenues.

Current law exempts wages above the maximum taxable earnings level ($135,000 in 1993) from all payroll taxes, including the Medicare Hospital Insurance tax. The maximum taxable earnings level increases each year by the change in the national average wage. For workers now paying Hospital Insurance taxes, only about 5 percent of wages--earned by about 2 percent of workers--are above the maximum taxable earnings level. Repealing the maximum taxable earnings level for Medicare beginning in 1994 would increase revenue by about $29 billion from 1994 through 1998.

Repealing the Medicare maximum taxable earnings level would provide needed funds to the Medicare trust fund. In 1992, the fund's trustees projected that the fund will begin to show a negative cash flow in 1996 and will be exhausted by 2002.

Policymakers face two conflicting objectives in expanding the Medicare tax: progressivity and linking taxes to benefits received. Repealing the Medicare maximum taxable earnings level would lessen the regressivity of the Medicare payroll tax by ending the current situation in which workers earning more than the maximum taxable earnings level pay a smaller share of their income in payroll taxes than do other workers. The added progressivity would come at the cost of taking Medicare further from a system that links taxes to future benefits. High-wage workers already subsidize other workers through their higher tax payments because participants in the Medicare program receive the same benefits regardless of how much they pay in payroll taxes. Repealing the Medicare maximum taxable earnings level would broaden the gap between taxes paid and benefits received by high-wage workers.

Leaving the maximum taxable earnings level where it is and increasing the Medicare tax rate from 1.45 percent to 1.55 percent for employers and employees would raise about the same amount of revenue over five years as would repealing the maximum taxable earnings level. Funding Medicare benefits in this manner would maintain the regressivity of the Medicare payroll tax and lessen the overall progressivity of the federal tax system.

REV-26 INCREASE EMPLOYEE CONTRIBUTIONS UNDER THE CIVIL SERVICE RETIREMENT SYSTEM

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	0.4	0.9	1.0	1.0	1.0	4.2

SOURCE: Congressional Budget Office.

The Civil Service Retirement System (CSRS) covers most federal civilian employees who retired before 1984 or who were working at the time and elected not to join the newly created Federal Employees' Retirement System (FERS). Today, CSRS covers about 3.8 million people, of whom 1.6 million are still employed. The government finances CSRS pensions by withholding 7 percent from most employee salaries and an equal 7 percent from the employing agency, and by making other government payments to the CSRS fund that are currently worth about 40 percent of payroll. Just over one-fifth of these payments are made by the U.S. Postal Service (USPS).

According to Office of Personnel Management projections, these contributions, along with related interest earnings, will cover only about 90 percent of the cost of expected benefits, assuming no funding from other civilian retirement accounts. The shortfall occurs mainly because funds have not been set aside in advance to pay for inflation adjustments during retirement. Under current practice, only the U.S. Postal Service must contribute more to CSRS for the expense of postretirement cost-of-living adjustments (COLAs).

Cash flow projections indicate that CSRS will run out of funds in 2024. When that happens, current law provides that the government will finance the CSRS funding shortfall from general revenue. In total, the transfers could accumulate to around $95 billion in today's dollars. The two previous Administrations repeatedly sought to raise employee contributions for CSRS as a way to reduce the plan's future deficit and hence the burden it will place on the Treasury. Former President Bush's budget for fiscal year 1993 proposed raising, in two steps, the employee's salary withholding rate to 9 percent from 7 percent.

CBO estimates that enacting such a 2 percentage point increase for employee contributions would raise governmental receipts from employee salary withholdings by about $4.2 billion through 1998. The option would increase contribution rates by 1 percentage point in January 1994 and the other point a year later. The new rates would not apply to postal employees covered by CSRS because the USPS now makes special payments to cover postretirement COLAs. The estimates do not consider the effect of some increase in outlays for workers who leave the government and elect to withdraw their contributions.

An argument for increasing salary withholdings for CSRS is that the plan provides generous benefits and has not been fully funded. Benefits are fully protected against inflation during retirement. By contrast, private-sector workers typically receive both Social Security, with 100 percent indexing, and an employer-sponsored pension that provides only partial indexation on an ad hoc basis. (CSRS employees do not participate in Social Security.) Thus, Social Security and private pensions together protect private-sector retirees from inflation for only about 70 percent of their income. Other CSRS benefit features are also highly advantageous compared with defined benefit plans that private employers sponsor. They include normal retirement as early as age 55 and a benefit formula that produces a relatively high ratio of benefits to salaries. For these benefits, CSRS-covered employees currently pay 7 percent of earnings. Private-sector employees contribute 6.2 percent of pay (up to $57,600 in 1993) for Social Security and, according to Hay Associates, only about 13 percent of pension plans require additional employee contributions.

Cutting benefits is another way of dealing with CSRS's generous benefits and its underfunding (see ENT-58). As most CSRS participants are either retired or near retirement, however, such an approach could prove a particular hardship for individuals with few, if any, options to recoup the resulting lost income. Whether the Congress increased withholdings or cut benefits, employees in CSRS would most likely demand another chance to switch to FERS. Any resulting switch of employees to FERS from CSRS would diminish the savings, but the effect should be small because the CSRS benefits would remain attractive to current participants.

The downside of increasing withholdings, or any other cut in compensation, is that it threatens the government's ability to retain good workers. Higher salary withholdings for CSRS participants would represent a reduction in their take-home salaries, but not for those covered by FERS. An alternative is to reduce salaries for all federal workers. (See DOM-60 for a federal pay cut that would apply to all employees.) Available data, however, suggest that federal salaries already lag 30 percent behind private-sector salaries. For this reason, in 1990, the Congress enacted reform designed to achieve greater parity in current compensation as a means of enhancing the government's ability to attract and retain a highly qualified work force.

Another way of increasing current funding for CSRS is to require higher agency contributions. The Congress took this approach when it required the USPS to pay the full cost of postretirement COLAs for its former employees. Earlier reforms of military retirement required the Defense Department to pay the full cost of the program. Although agency funding would strengthen the program's financial condition, it would not reduce the long-term cost to the taxpayers of the CSRS.

REV-27 REDUCE TAX CREDITS FOR REHABILITATING OLDER BUILDINGS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Repeal Credit for Nonhistoric Structures and Reduce Credit for Historic Structures to 15 Percent	0.1	0.1	0.1	0.1	0.1	0.4
Repeal Both Credits	0.1	0.1	0.2	0.2	0.2	0.8

SOURCE: Joint Committee on Taxation.

The Congress enacted tax credits for rehabilitation to promote the preservation of historic buildings, encourage businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit rate is 10 percent for expenditures on commercial buildings built before 1936, and 20 percent for commercial and residential buildings that the Department of the Interior has certified as historic structures because of their architectural significance.

The credits favor commercial use over most rental housing and may, therefore, divert capital from more productive uses. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining additional housing and commercial buildings.

Rehabilitation may have social benefits to the extent that it discourages the destruction of historically noteworthy buildings. The government could promote this objective at a lower cost, however, by permitting a credit only for the renovation of certified historic buildings and lowering the credit rate. Some surveys have indicated that a 15 percent credit would be sufficient to cover the extra costs of both obtaining certification and undertaking rehabilitation of historic quality. Reducing the credit for historic structures to 15 percent and repealing the credit for nonhistoric structures would increase revenues over the 1994-1998 period by $0.4 billion. Repealing both credits would raise $0.8 billion over the same period.

REV-28 TAX CREDIT UNIONS LIKE OTHER THRIFT INSTITUTIONS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Tax All Credit Unions	0.2	0.4	0.4	0.4	0.4	1.8
Tax Credit Unions with More Than $10 Million in Assets	0.2	0.4	0.4	0.4	0.4	1.7

SOURCE: Joint Committee on Taxation.

Credit unions are nonprofit financial institutions that retain income on behalf of their members either as protection against unexpected events or as a source of financing expansion. The federal income tax treats credit unions more favorably than competing thrift institutions, such as savings and loan institutions and mutual savings banks, by exempting their retained earnings from tax. As a result, more credit unions and fewer taxable thrifts exist than would otherwise be the case. This reduces economic efficiency to the extent competing institutions might otherwise provide the same services at lower cost.

Credit unions, savings and loans, and mutual savings banks were originally all tax-exempt, but in 1951 the Congress removed the tax exemptions for savings and loans and mutual savings banks. It considered them to be more like profit-seeking corporations than nonprofit mutual organizations.

Since 1951, credit unions have come to resemble those other thrift institutions in certain respects. Credit unions no longer limit membership to people sharing a "common bond," which has usually been employment. Since 1982, the regulators have allowed credit unions to extend their services to others, including members of other organizations. In addition, most credit unions allow members and their families to participate permanently, even after members have left the sponsoring organization. Credit union membership has grown from about 5 million in 1950 to more than 60 million today. This leap in numbers is evidence that credit unions, like taxable thrifts, now serve the general public. Moreover, credit unions are becoming more like savings and loans and mutual savings banks in the services they offer. A significant number of credit unions now offer such services as first and second mortgages, direct deposit, automatic teller access, preauthorized payments, credit cards, safe deposit boxes, and discount brokerage services.

Many smaller credit unions, however, retain the characteristics of nonprofit mutual organizations and perhaps should not be subject to taxation. For instance, only volunteers from the membership manage and staff some of these credit unions. Moreover, these smaller credit unions often do not expand their membership beyond their immediate common bond or provide services comparable to competing thrift institutions. In order to protect these smaller credit unions, the Congress may choose to exempt from taxation those credit unions with assets below $10 million. Such an action would exempt about 75 percent of all credit unions from taxation, although they hold only about 10 percent of all credit union industry assets.

Taxing all credit unions like other thrift institutions would raise $1.8 billion in 1994 through 1998. Taxing only credit unions with assets above $10 million would raise about $0.1 billion less.

REV-29 MARK SECURITIES DEALERS' INVENTORIES TO MARKET VALUE

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	0.2	0.7	0.9	0.9	0.6	3.3

SOURCE: Joint Committee on Taxation.

Under the inventory accounting method called "lower of cost or market" (LCM), now available to all businesses, securities dealers can deduct accrued losses on year-end inventories currently and defer tax on gains until the year of sale. The option would require securities dealers to include in taxable income both accrued gains and losses on year-end securities inventories.

The current tax method is a vestige of outdated accounting practices. The Treasury regulations that established LCM in 1918 conformed to the method that prevailing accounting standards required businesses to use for financial reporting purposes. The conservative accounting standards then in effect erred on the side of underestimating profits. The financial accounting standard for securities dealers changed in 1973, however. Since then, the standards have required that securities dealers "mark-to-market" their inventories. But the tax law still applies the 1918 regulations as the method for computing inventory profits of securities dealers.

The current method represents a tax benefit because it does not treat inventory gains and losses symmetrically. The appropriate standard could arguably be either to treat accrued gains and losses as taxable income, as in the mark-to-market method, or to treat gains and losses as taxable income only upon sale. All businesses with inventories can take advantage of this tax benefit, although securities dealers are best positioned to do so because the market value of their inventory is easier to establish.

CBO estimates that the option would increase revenues by $3.3 billion over five years. The increase in liability consists of two components, a one-time increase from the revaluation of existing inventory to include unrealized (accrued) gains, and a smaller, permanent increase from the growth in unrealized gains over time. Because the option phases in the new rules, the one-time, revaluation component raises liability every year for four years. The permanent component increases over time because firms pay tax sooner on a base of unrealized gains that is growing annually. Until 1998, the one-time component dominates the revenue effect, but beyond 1998 only the permanent component continues. In 1998, the permanent increase in liability is about $0.3 billion.

The Administration's 1993 budget included this option with a 10-year phase-in. The Congress passed the proposal as part of H.R. 4210, which the President vetoed in March 1992. Later in the year, the Congress again included this option, but with the four-year phase-in, in H.R. 11, which the President also vetoed.

Another way of removing the tax benefit would be to use "cost accounting," which is more consistent with the conventional tax law principles of income recognition. The tax law does not typically require taxpayers to include unrealized gains or losses in income. Cost accounting would provide symmetric treatment of gains and losses because both would only be taxable upon sale. Cost accounting would be a more stringent method of inventory accounting than is available under current law, but it would be less stringent than the "mark-to-market accounting" that this option portrays.

Although a cost accounting rule is appealing in theory, securities dealers can easily use such a rule to report losses when in fact they have profits. Because they face small transactions costs, dealers would find it advantageous to sell the assets on which they have losses, recognize the losses for tax purposes, and then buy back the same assets. If the Congress changed the law to disallow these buybacks, the securities dealers could gain virtually the same effect by replacing the inventory with similar assets. This "churning" behavior could reduce the revenue gain from cost accounting to a very small amount. Rules to discourage churning would be complex and difficult to enforce. Imposing the mark-to-market accounting standard, therefore, is the only practical way to eliminate the tax benefit.

The option to impose the mark-to-market standard on securities dealers would, however, single out the dealers for different treatment than is accorded other industries, such as manufacturing and retail, that would still be able to use LCM. These other industries take less advantage of the tax benefit because their inventories are harder to value. Expanding the mark-to-market standard to manufacturing and retail firms would therefore impose a greater accounting burden than expanding the standard to securities dealers alone.

REV-30 REPEAL TAX PREFERENCES FOR EXTRACTIVE INDUSTRIES

Addition to CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Addition
	Annual Added Revenues (Billions of dollars)					
Repeal Expensing of Intangible Drilling, Exploration, and Development Costs	0.8	1.4	1.3	1.2	1.2	5.9
Repeal Percentage Depletion	0.5	0.9	0.9	0.9	0.9	4.1

SOURCE: Joint Committee on Taxation.

Under the normal tax rules for cost recovery, taxpayers cannot immediately deduct purchases of capital assets such as plant and equipment from taxable income. Instead, they must capitalize the purchase price and then deduct the cost at a prescribed rate over the asset's useful life either by depreciation or depletion. These rules also apply to assets that the user constructs instead of purchasing (self-constructed assets). Although oil and gas wells and mineral mines are self-constructed assets, they benefit from special cost-recovery rules. Taxpayers may immediately deduct (expense) certain exploration and development costs, including intangible drilling costs. Under general income tax rules, these costs would otherwise have to be capitalized and deducted more slowly.

Expensible exploration and development costs include costs for excavating mines and drilling wells. They also include prospecting costs for hard minerals, but not for oil and gas. Current law limits expensing to 70 percent of these costs for corporations engaged in extracting hard minerals and for integrated producers of oil and gas who also operate sizable refineries. These corporations may deduct the remaining 30 percent of costs over a 60-month period.

The percentage depletion method of cost recovery allows taxpayers to deduct a certain percentage of a property's gross income, regardless of the actual capitalized costs. Current law allows nonintegrated oil and gas companies to deduct 15 percent of the gross income from oil and gas production up to 1,000 barrels per day. (In contrast, integrated oil and gas producers must use the normal method of cost depletion to recover capitalized costs.) Producers of hard minerals may also use percentage depletion, but the statutory rates vary. Minerals eligible for percentage depletion include sand (5 percent), coal (10 percent), iron ore (14 percent), dimension stone and mollusk shells (14 percent), oil shale (15 percent), gold (15 percent), and uranium (22 percent). The tax law limits the amount of percentage depletion to 100 percent of the net income from an oil and gas property and 50 percent of the net income from a property with hard minerals.

Because percentage depletion depends on the value of production rather than the amount of capitalized costs, it is more akin to a production subsidy than a method of cost recovery. The subsidy provides little or no incentive to develop or expand production from marginal properties, however, because the amount of percentage depletion cannot exceed net income. Because marginal properties that are more costly to develop produce less net income, their percentage depletion deductions per dollar of gross income are smaller.

Percentage depletion and the expensing of exploration and development costs encourage oil and gas production and extracting hard minerals, but the incentives are not available to all producers on an equal basis. Integrated oil and gas producers may not claim percentage depletion deductions that independent producers can use. Furthermore, most corporations can expense only 70 percent of their exploration and development costs including intangible drilling costs, while noncorporate producers can expense all of them. Finally, because percentage depletion and expensed exploration and development costs are tax preferences under the alternative minimum tax, producers who pay the minimum tax must defer or even forgo these deductions, although producers who pay the regular income tax may take them currently.

There are several reasons to repeal expensing and percentage depletion. First, these provisions allocate capital to drilling and mining that firms could use more productively elsewhere in the economy. Second, they encourage the use of scarce domestic oil and gas resources, which may lead to a greater reliance on foreign energy producers in the future. Third, the provisions fail to provide all producers with the same incentive, which lessens their effectiveness in encouraging production.

Repealing the expensing of intangible drilling costs and other exploration and development costs would raise about $6 billion in 1994 through 1998, assuming that firms could still expense the costs of dry holes, unproductive mines, and worthless mineral rights. Repealing percentage depletion would raise approximately $4 billion over the same five-year period.

REV-31 ELIMINATE PRIVATE-PURPOSE, TAX-EXEMPT BONDS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Eliminate All Private-Purpose, Tax-Exempt Bonds	0.2	0.6	1.1	1.5	1.9	5.3
Raise the Cap and Extend Limits on Volume to New Issues of All Private-Purpose Bonds	0.1	0.2	0.4	0.6	0.8	2.1

SOURCE: Joint Committee on Taxation.

The tax law permits state and local governments to issue bonds that are exempt from federal taxation. For the most part, the bond proceeds have financed public investments such as schools, highways, and water and sewer systems. Beginning in the 1960s, however, state and local governments began to issue a growing dollar volume of tax-exempt bonds to finance quasi-public facilities, such as ports and airports, and private-sector projects, such as housing and shopping centers. These bonds eventually became known as "private-purpose" bonds because the ultimate users of the tax-exempt-financed facilities were private nongovernmental entities.

Private-purpose, tax-exempt bonds include mortgage revenue bonds for rental housing and single-family homes for low-income and middle-income households; industrial development bonds (IDBs), which private firms use for a wide variety of purposes; student loan bonds, which state authorities issue to increase the funds available for guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities.

Although private-purpose bonds provide subsidies for activities that may merit federal support, tax-exempt financing is not the most efficient way to provide assistance. With a direct subsidy, the benefit would go entirely to the borrower; with tax-exempt financing, the borrower of funds shares the benefit with the investor in tax-exempt bonds. In addition, because tax-exempt financing is not a budget outlay, the Congress does not routinely review it as part of the annual budget process.

The Congress has placed restrictions on tax-exempt financing several times, beginning in 1968. During the 1980s, these restrictions included limiting the volume of new issues of tax-exempt bonds for some activities and setting expiration dates on the use of tax-exempt financing for other activities. The Congress has frequently postponed some of the expiration dates, however.

The Tax Reform Act of 1986 included interest earned on newly issued, private-purpose bonds in the base for the alternative minimum tax (see REV-03) and placed a single state-by-state limit on the volume of new issues of IDBs, student loan bonds, and housing and redevelopment bonds. The new state volume limits, which are more restrictive than those previously in force, are the greater of $50 per resident or $150 million a year. Bonds for publicly owned airports, ports, and solid waste disposal facilities and bonds for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions) are exempt from the limits on issues of new bonds. Large private universities and certain other nonprofit institutions may not issue tax-exempt bonds if they already have more than $150 million in tax-exempt debt outstanding.

If the Congress were to eliminate tax exemption for all new issues of private-purpose bonds, the revenue gain would be about $5.3 billion in 1994 through 1998. This amount assumes that at least some construction of airports and sewage and solid waste facilities would qualify for tax-exempt financing as governmental in nature. Eliminating the tax exemption would eventually raise the cost of the services provided by nonprofit hospitals and other facilities that currently qualify for tax-exempt financing. The cost increase, however, would be small and gradual.

Including all bonds for private nonprofit and quasi-public facilities in a single state volume limit, while raising the limits beginning in 1994 to, say, $75 per capita or $200 million a year, would increase revenues by $2.1 billion in 1994 through 1998. Those changes would curb the growth of all private-purpose bonds without sharply reducing their use. The curb would primarily affect bond issues for nonprofit hospitals, which are not included in the current cap. The proposal would also apply to bonds for airport facilities, such as departure gates, which are for the exclusive private use of airlines under long-term leases, but would continue to allow unlimited tax-exempt financing of public airport facilities, such as runways and control towers.

REV-32 FURTHER RESTRICT DEDUCTIONS FOR BUSINESS MEALS AND ENTERTAINMENT

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
Disallow Deductions for Half of Expenses for Business Meals and Entertainment	2.0	3.3	3.4	3.7	3.9	16.3

SOURCE: Joint Committee on Taxation.

The tax code generally does not allow deductions for personal living costs, but it allows deductions for ordinary and necessary business expenses. Taxpayers may deduct 80 percent of expenses for meals, entertainment, and travel that are clearly related to business and the Internal Revenue Service does not deem to be "lavish and extravagant." The Congress imposed the 80 percent limit on deductions in 1986 out of a concern that some taxpayers were deducting personal living expenses as business expenses. Taxpayers may also deduct 100 percent of dues they pay to any social, athletic, or sporting club that they use primarily for the advancement of trade or business. The Congress could impose tighter limits on deductions for business meals and entertainment. Options include subjecting club dues to the deduction limit applied to business meals and entertainment and lowering the deduction limit from 80 percent of expenses. For example, limiting deductions to 50 percent of expenses for business meals and entertainment so defined would raise revenues by $16.3 billion in 1994 through 1998.

Some business entertainment unquestionably includes personal consumption. Separating the component of these expenses that represents ordinary and necessary business expenses from the part that represents personal consumption is necessarily arbitrary. Further limitation of the deduction, for example to 50 percent, may be reasonable under the circumstances.

REV-33 AMORTIZE A PORTION OF ADVERTISING COSTS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	3.2	5.7	4.3	2.8	1.6	17.5

SOURCE: Joint Committee on Taxation.

The income tax law allows taxpayers to deduct the ordinary costs of doing business when they incur them. At the same time, it requires taxpayers to capitalize expenditures to purchase assets with useful lives that extend beyond the current tax year. They may then deduct capital costs at prescribed rates as the assets wear out in order to match costs with income. Taxpayers may deduct advertising as an ordinary business cost.

Because advertising often contributes to brand recognition that may last for years, capitalizing a portion of advertising costs and deducting it over several years might improve the matching of business costs with income. Requiring 20 percent of all advertising costs to be capitalized and deducted on a straight-line basis over four years would raise nearly $18 billion from 1994 through 1998.

Because advertising is not always easy to identify, this option would require complex rules to distinguish advertising costs from other ordinary business costs. Some costs, such as those of notifying customers of price changes, redesigning product packaging, or changing store displays, might or might not fit within the definition of advertising. Moreover, because the useful life of advertising depends on its unknown effect on customers, any amortization rate would be arbitrary.

Amortizing a portion of advertising costs would raise the after-tax cost of advertising and discourage its use. To the extent that advertising is socially wasteful, causing consumers to change their preferences for essentially identical products, discouraging it could increase economic efficiency. But advertising is socially useful if it gives customers a greater choice of products by promoting real diversity among products.

REV-34 IMPOSE A VALUE-ADDED TAX

Addition to CBO Baseline	1994	1995	1996	1997	1998	Cumulative Five-Year Addition
	Annual Added Revenues (Billions of dollars)					
5 Percent Rate, with Comprehensive Base	0	68.2	107.5	116.3	125.3	417.3
5 Percent Rate, with Food, Housing, and Medical Care Excluded	0	35.7	56.1	60.4	64.8	217.0

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are based on an effective date of January 1, 1995. They are net of reduced income and payroll tax revenues, but do not reflect added administrative costs.

A value-added tax (VAT) is a form of general sales tax used in more than 50 countries, including 20 of the 25 members of the Organization for Economic Cooperation and Development. It is typically administered by taxing the total value of sales of all businesses, but allowing businesses to claim a credit for taxes paid on their purchases of raw materials, intermediate materials, and capital goods from other businesses. As a result, only sales to consumers end up being taxed.

A 5 percent VAT on a broad consumption base (as defined in Table 8) would increase net revenues by about $68 billion in fiscal year 1995 and by roughly $417 billion through 1998. Most VATs, however, do not tax such a broad base. The typical European VAT, for example, excludes food, housing, and medical care. It also partially excludes financial services because they are difficult to tax. A 5 percent VAT on a narrower base (as defined in Table 8) would net about $36 billion in 1995 and $217 billion through 1998. These revenue estimates assume that collections would not begin until January 1, 1995, because the Internal Revenue Service would need more than a year to set up a VAT.

A VAT might be preferable to an income tax increase because it would not discourage saving and investment by taxing their return. In addition, a broad-based VAT with a single rate would distort economic decisions less than would an equal revenue increase in selective consumption taxes. The VATs that have been enacted in other countries, however, include many tax preferences and multiple rates. Such a VAT would distort consumption choices more than a single-rate, broad-based VAT and could be more distorting than higher income tax rates.

A VAT makes the price consumers pay higher than the price sellers receive. Therefore, adopting one would cause an initial jump in the overall consumer price level because the government computes the consumer price index on a tax-inclusive basis. The increase in the price level, however, would not necessarily lead to further inflation, depending on how the Federal Reserve responded. Many experts believe that the Federal Reserve would adjust the money supply in a way that would maintain nominal income. Under this scenario, macroeconomic models generally predict little inflation beyond the initial price jump.

The VAT is a regressive tax in the sense that people with lower annual income pay a higher tax rate. This effect occurs because the ratio of consumption to annual income is higher for low-income families than for high-income families. CBO estimates that, as a percentage of their annual income, the burden of a broad-based VAT on families in the bottom quintile of income would be about three times as large as the burden on families in the top quintile of income. A VAT is less regressive over people's lifetimes than in a single year because income and consumption nearly match over a lifetime, even though income tends to fluctuate annually more than consumption does. Many economists believe that lifetime measures of tax burdens are more meaningful than annual measures.

A VAT could be made slightly less regressive by granting tax preferences for the goods and services low-income people generally consume. Such exemptions would, however, substantially increase costs of enforcement and compliance, and they would reduce revenues. Another way to lessen the VAT's

Table 8.
The Size of Two Possible Tax Bases for a Value-Added Tax, 1991

Items Included in Tax Base	Amount (Billions of dollars)
Broad Tax Base	
Total Personal Consumption in Gross Domestic Product	3,888
New Residential Construction	163
Subtotal	4,051
Exclusions from the Base[a]	
Rental value of housing	-574
Religious and welfare activities	-108
Subtotal	-682
Total	3,369
Narrower Tax Base	
Total Personal Consumption in Gross Domestic Product	3,888
Exclusions from the Base[a]	
Rental value of housing	-574
Religious and welfare activities	-108
All medical care (including insurance)	-656
Food consumed at home	-407
Food furnished to employees	-11
Food produced for farm consumption	-1
Brokerage, banking, and life insurance services	-237
Local transit (excluding taxis)	-6
Clubs and fraternal organizations	-9
Tolls for roads and bridges	-2
Private education and research	-93
Subtotal	-2,104
Total	1,784

SOURCE: Congressional Budget Office based on national income and product accounts.

a. The excluded amount assumes that the specified consumption is taxed at a zero rate.

regressivity would be to allow additional exemptions or refundable credits for low-income people under the federal income tax. But exemptions for low-income people would also reduce the revenue gain and would cause many people to file tax returns who otherwise would have no need to file.

Like any new tax, a VAT would impose additional administrative costs on the federal government and additional compliance costs on businesses. If the United States adopted a VAT that was similar to those used in Europe, these costs could be quite substantial. CBO estimates that administering such a VAT would cost $750 million to $1.5 billion annually, and complying with it would cost $4 billion to $7 billion annually. These costs would be lower if the VAT exempted small businesses from collecting the tax and if it taxed as many goods and services as possible at the same rate.

A retail sales tax is another way to tax consumption. Because a sales tax is collected entirely at the retail level, however, the incentive to evade a sales tax would be much greater than the incentive to evade a VAT. Moreover, because the sales tax lacks an effective credit mechanism for the taxes that businesses pay on their purchases, it taxes some business purchases by mistake. Given the drawbacks of a retail sales tax, most countries with general consumption taxes have chosen a VAT over the sales tax.

Other ways to tax a broad consumption base are possible, even though no country has ever tried one. A tax on consumed income, for example, would tax income but with an exclusion for net saving. Under a consumed-income tax, taxpayers could deduct all contributions to qualified savings accounts but would pay tax on net withdrawals. Because individuals would pay tax on a measure of their total consumption, the tax could include a graduated rate schedule, like the rate schedule of the individual income tax. This schedule would make the consumed-income tax less regressive than a VAT.

REV-35 INCREASE EXCISE TAXES ON TOBACCO AND ALCOHOLIC BEVERAGES

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Increase Cigarette Tax to 48 Cents per Pack	3.1	3.8	3.7	3.7	3.6	17.9
Increase All Alcoholic Beverage Taxes to $16.00 per Proof Gallon	3.7	4.7	4.7	4.7	4.7	22.6
Index Cigarette and Alcohol Tax Rates for Inflation	0.2	0.5	0.7	1.0	1.2	3.6

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are net of reduced income and payroll tax revenues.

Federal alcohol and tobacco taxes raised $13 billion in 1992, including $8 billion from taxes on distilled spirits, beer, and wines, and $5 billion from taxes on tobacco. The Omnibus Budget Reconciliation Act of 1990 increased the federal excise tax on tobacco and most alcoholic beverages.

Smoking and drinking can create costs to society that the prices of tobacco and alcoholic beverages do not reflect. Examples of these "external costs" include higher health insurance costs to cover the medical expenses linked to smoking and drinking, the effects of cigarette smoking on the health of nonsmokers, and the loss of lives and property in alcohol-related accidents.

To the extent that excise taxes raise the price and reduce consumption of tobacco and alcoholic beverages, tax increases can further reduce the total external costs that smoking and drinking produce. If those external costs primarily come from heavy or abusive consumption, however, then higher taxes on tobacco and alcoholic beverages might unduly penalize moderate and infrequent smokers and drinkers.

Increasing excise taxes to reduce consumption may be desirable regardless of the effect on external costs if consumers are either unaware of or underestimate the harm that their smoking and drinking does to them. Teenagers, in particular, may not be prepared to evaluate the long-term effects of smoking and drinking. Evidence suggests that teenage smoking and drinking declines in response to higher prices for tobacco and alcoholic beverages. A number of national medical organizations have supported a substantial increase in the existing federal excise tax on tobacco in the interests of reducing teenage smoking.

Taxes on tobacco and alcoholic beverages are regressive when compared with annual family income; that is, taxes are a greater percentage of income for low-income families than for middle- and upper-income families. (See Congressional Budget Office, *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990.)

Increase the Cigarette Tax. The current federal excise tax on cigarettes is 24 cents a pack. Raising the federal excise tax on cigarettes to 48 cents a pack on January 1, 1994, would increase net revenue by about $17.9 billion between 1994 and 1998.

Increase Taxes on Alcoholic Beverages. Current federal excise taxes on beer and wine remain much lower than the federal excise tax on distilled spirits in terms of the tax per ounce of ethyl alcohol. The current tax on distilled spirits of $13.50 per proof gallon results in a tax of about 21 cents per ounce of alcohol. The current tax on beer of $18.00 per barrel results in a tax of about 10 cents per ounce of alcohol (assuming an alcoholic content for beer of 4.5 percent), and the current tax on table wine of $1.07 per gallon results in a tax of about 8 cents per ounce of alcohol (assuming an average alcoholic content of 11 percent).

Increasing the federal excise tax to $16.00 per proof gallon for all alcoholic beverages effective January 1, 1994, would raise $22.6 billion between 1994 and 1998. A tax of $16.00 per proof gallon would result in a tax of about 25 cents per ounce of ethyl alcohol. It would raise the tax on a 750-milliliter bottle of distilled spirits from about $2.14 to $2.54, the tax on a six-pack of beer from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of table wine from about 21 cents to 70 cents.

Index Cigarette and Alcohol Tax Rates for Inflation. Indexing cigarette and alcoholic beverage tax rates annually beginning January 1, 1994, for inflation during the preceding year would raise $3.6 billion between 1994 and 1998. Indexing these taxes would prevent inflation from eroding real tax rates and would avoid the need for abrupt increases in the future.

An alternative to indexing would be to convert current unit taxes on quantities of these goods to ad valorem taxes, which equal a percentage of the manufacturer's price. This method would link tax revenues to price increases, although it would tie revenues to the price of taxed goods, not the general price level. A shortcoming of the ad valorem tax is that it might create incentives for manufacturers to lower sales prices artificially to company-controlled wholesalers in order to avoid part of the tax.

REV-36 INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Impose Tax on Domestic and Imported Oil ($5 per barrel)	15.8	22.6	22.7	22.6	22.6	106.2
Impose Oil Import Fee ($5 per barrel)	7.3	10.8	11.2	11.6	11.9	52.8
Increase Motor Fuel Taxes by 12 Cents per Gallon	8.8	12.0	11.8	11.7	11.8	56.0
Increase Motor Fuel Taxes by 10 Cents per Gallon Each Year for Five Years	7.4	17.2	26.7	35.4	43.7	130.4
Impose Broad-Based Tax on Energy Consumption (5 percent of value)	13.0	18.7	19.4	20.3	21.3	92.7

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are based on an effective date of January 1, 1994, and are net of reduced income and payroll tax revenues. Increases in federal government expenditures for energy products under these options are not estimated. The revenue estimates are based on CBO's baseline oil price forecast of $22.00 per barrel in 1994, rising to $25.50 per barrel in 1998.

Increasing energy taxes could raise significant amounts of revenue, encourage conservation by making energy more expensive, reduce pollution, and decrease the country's dependence on foreign oil suppliers. The United States depends on foreign sources for about 45 percent of its oil and about one-fifth of its total energy. Recent experience illustrates that this dependence on foreign sources exposes the U.S. economy to potential interruptions in energy supplies and to volatile energy prices.

Imposing new or higher energy taxes would raise energy prices and reduce energy consumption, thus helping to promote conservation. To the extent that taxes on oil reduce the demand for imported oil, foreign suppliers would absorb part of the tax through lower world oil prices. To the extent that energy taxes reduce energy consumption, the taxes would also reduce carbon dioxide emissions and could, therefore, contribute to efforts to reduce global warming.

Energy taxes would have different effects on taxpayers in different parts of the country and with different incomes. Taxes that increase the relative price of fuel oil would have the greatest impact on consumers in the Northeast, and taxes that increase the relative price of gasoline would have the greatest impact on consumers in the West. In addition, taxes on gasoline and other energy products are a greater percentage of income for low-income families than for middle- and upper-income families.

Taxing energy is not the only way of reducing dependence on foreign oil supplies. Stockpiling oil is arguably a better way of coping with the risks of increased dependence on imports because it would not artificially reduce current energy use by households and businesses. This argument is based on the premise that, aside from the problem of interruptions in supply, world energy prices accurately reflect real resource costs and thus already provide an appropriate incentive to conserve energy.

Impose an Excise Tax on Domestic and Imported Oil. An excise tax of $5 per barrel on all crude oil and refined petroleum products--both domestically produced and imported--would raise revenues by about $22.6 billion per year. It could increase the price of a gallon of gasoline or fuel oil by as much as 12 cents.

A tax on oil would increase the price that consumers must pay, giving them an incentive to use less oil either through conservation efforts or by switching to an alternative source of energy such as natural gas or coal. The tax would cause oil reserves to decline in value, and coal and gas reserves to increase in value. These shifts in value would discourage the exploration and production of oil and would encourage the production of coal and natural gas.

An oil tax, whether on all oil or only imported oil, would raise the costs for industries that use oil as the primary production input (for example, petrochemicals and paints). Consequently, domestic companies in these industries would find it more difficult to compete with foreign companies that would pay less for oil. To ameliorate this loss in competitiveness, it would be necessary to impose the same tax rate on the oil content of competing imports. Such a tax would be very cumbersome to design and administer.

Impose an Oil Import Fee. As an alternative to an excise tax on all oil, the Congress could impose the tax only on imported crude oil and refined petroleum products. An oil import fee of $5 per barrel would raise revenues by about $11.4 billion per year.

An oil import fee would allow domestic suppliers to charge a higher price and still remain competitive with imports, providing an incentive to increase domestic crude oil production and a windfall to some domestic oil producers. Like the tax on all oil, the fee would also maintain incentives for conservation by increasing energy prices. These effects would reduce U.S. dependence on foreign oil in the short term, although in the long term they might increase dependence by depleting U.S. oil supplies faster. Domestic and foreign oil are relatively close substitutes and, therefore, the difference in the prices consumers would pay for them would be slight. But foreign producers would receive a lower net price than domestic producers because of the fee. A large portion of this difference between the net price that domestic and foreign producers would receive represents a transfer of income from domestic consumers to domestic producers. Consequently, the federal government would receive only about half of the increase in consumers' expenditures for oil under an import fee because the U.S. imports nearly half of the oil it consumes and demand is price insensitive in the short run.

Because an oil import fee would reduce U.S. demand for imported oil, important U.S. trading partners might object to it. Under the terms of the Canada Free Trade Agreement, Canadian oil imports would be exempt from an import fee. (A similar exemption would not automatically apply to Mexican oil under the North American Free Trade Agreement, but the Congress could add the exemption in legislation that implements the agreement.) Exempting oil imports from both of these trading partners, however, would substantially reduce the fee's revenue potential because imports from these countries now account for about one-quarter of U.S. oil imports, and would require special rules to prevent other countries from avoiding the tax by shipping oil through Canada or Mexico. An import fee also might violate the

General Agreement on Tariffs and Trade (GATT), although disagreement exists on whether GATT exempts oil import fees that countries impose to protect national security.

Increase Motor Fuel Excise Taxes. Federal motor fuel taxes are currently 14.1 cents per gallon of gasoline and 20.1 cents per gallon of diesel fuel, of which 2.5 cents per gallon goes into the general fund. Under current law, revenue that goes to the general fund will expire on October 1, 1995. The rest goes into the Highway Trust Fund and several related trust funds.

State governments also impose gasoline and diesel taxes, ranging from 7.5 cents to 26 cents per gallon. Thirty-four states have increased motor fuel tax rates since 1989, and currently nine states have increases going into effect in 1993. However, in comparison with motor fuel tax rates in other countries, many of which are well over $1.00 a gallon, U.S. tax rates are still among the lowest in the world.

Each additional penny of tax would generate roughly $1 billion in revenues per year. A 12 cent increase would raise motor fuel prices by about the same as a $5.00 per barrel oil tax. A 50 cent increase that phases in at a rate of 10 cents per year for five years would raise about as much revenue as imposing a 5 percent income tax surtax from 1994 through 1998 (see REV-01). Although a 50 cent increase could increase the general price level, it would not permanently increase the rate of inflation.

The average national price of all grades of gasoline has dropped from a peak of about $1.39 per gallon in March 1981 to slightly more than $1.20 in the fall of 1992. This change represents a 14 percent price reduction in nominal terms and 55 percent in real terms. Therefore, an additional tax of 12 cents or even 50 cents per gallon would not put the total cost of gasoline above what consumers have already experienced in real terms.

If the Congress used the additional tax revenues to finance additional highway spending, then obviously that combined action would not reduce the deficit. One way to increase the likelihood that the additional revenues reduce the deficit would be for the Congress to designate them explicitly in the legislation for the general fund.

A tax increase would reduce consumption of gasoline and diesel fuel by encouraging people to drive less or purchase more fuel-efficient cars and trucks. In addition, the tax would offset, though imperfectly, the costs of pollution and road congestion that automobile use produces. A rate increase on motor fuel taxes would not adversely affect U.S. competitiveness because final consumers and the domestic transportation industry purchase most of the motor fuel.

Increasing motor fuel tax rates would impose an added burden on the trucking industry and on people who commute long distances by car, who are not necessarily the highway users who impose the highest costs of pollution and congestion on others. Pollution and congestion costs are much higher in densely populated areas, primarily in the Northeast and coastal California, whereas per capita consumption of motor fuel is highest in sparsely populated states, mostly in the West. A 50 cent tax increase would produce significant adjustment costs for businesses and people who have based decisions about where they live and work and their choice of vehicle on low gasoline prices. Phasing in the tax increase, however, would reduce these costs by allowing businesses and consumers more time to adjust.

An additional 12 cent per gallon federal tax on motor fuels would raise about $56.0 billion from 1994 through 1998. Alternatively, five successive annual 10 cent increases would raise $7.4 billion in 1994 and $130.4 billion from 1994 through 1998.

Impose a Broad-Based Tax on All Energy. An alternative to selective excise taxes would be a broad-based tax on all forms of energy consumption. A national energy tax would heighten incentives for conservation and reduce consumption of all forms of energy. In addition, it would raise much more revenue at a lower rate than selective taxes. The base for such tax could be the value of fuel consumers use, the number of units that U.S. firms produce or import (such as barrels of oil, tons of coal, or cubic feet of gas), or the heat content of the fuel consumers and businesses use, measured in British thermal units (Btus).

Unlike a Btu or per-unit tax, a tax on the retail value of energy would not change relative fuel prices and would not encourage consumers to switch from one form of energy to another. Enforcement, however, would be costly with such a tax because the Internal Revenue Service (IRS) would collect it from a large number of retailers. If the IRS collected the tax at an earlier stage of the distribution process, tax enforcement would be less costly. But the tax would then affect relative energy prices because different fuels have different markups at the retail level.

A 5 percent tax on the value of energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise revenue by about $20 billion per year.

REV-37 IMPOSE A CARBON-BASED EXCISE TAX ON FOSSIL FUELS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
CO_2 Stabilization Tax	25.9	38.7	40.1	41.6	43.1	189.4
Phased-In CO_2 Reduction Tax	10.4	26.4	43.1	61.0	80.1	221.0
EC Carbon/Energy Tax	22.3	40.3	51.8	63.3	75.2	252.9

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are net of reduced income and payroll tax revenues.

Recent scientific evidence on the potential for global warming through an intensified greenhouse effect has prompted international concern about the emissions of greenhouse gases. Changes in temperature could result from increasing concentrations of certain trace gases that trap excess solar heat in the atmosphere and thus affect the Earth's climate. The United States, along with some 150 nations, signed a climate treaty at the June 1992 "Earth Summit" conference in Brazil, agreeing to initiate steps aimed at controlling emissions of greenhouse gases. A leading greenhouse gas is carbon dioxide (CO_2), which industries and households produce when they burn fossil fuels--coal, oil, and natural gas. An excise tax proportional to the carbon content of fossil fuels could generate substantial revenues, promote conservation of energy, and reduce domestic emissions of CO_2.

Imposing a carbon-based tax at the points where fossil fuels enter the economy--mine-mouth, wellhead, or dockside for imports--could discourage the use of fossil fuels and reduce subsequent emissions of carbon dioxide. The Congress could impose tax rates on fossil fuels either at levels that would discourage future increases in CO_2 emissions or at levels that would reduce emissions from current levels by some target date. By indexing these tax rates for inflation, the Congress could maintain the incentive for CO_2 abatement. The relative carbon content of coal, oil, and natural gas would dictate the specific tax rate for each fuel. Coal, with the most carbon per unit of heat released, would have the highest tax rate followed by oil and then natural gas. Imposing the tax on amounts of carbon per unit of useful energy obtained would discourage fossil fuel use and also encourage switching from higher carbon-emitting fuels to lower ones.

Many countries are planning to stabilize CO_2 emissions at some base-year level by the year 2000. A tax of approximately $30 (in 1994 dollars) per ton of carbon content of the three fossil fuels could nearly eliminate the projected growth in carbon dioxide emissions by the year 2000. This tax rate, based on average carbon content, is equivalent to a tax of approximately $18.00 per ton of coal, $4.00 per barrel of oil, and about $0.50 per thousand cubic feet of natural gas (in 1994 dollars). In terms of current prices of fossil fuels, the tax equals about 55 percent of the delivered price of coal, and roughly 10 percent of the prices of refined petroleum and natural gas. Such a tax would raise $189.4 billion in additional revenue during 1994 through 1998.

Some countries plan to reduce emissions below current levels by the year 2000 and beyond. More stringent targets for emission would require higher tax rates. A tax of $120 (in 1994 dollars) per ton of carbon content of fossil fuels could reduce CO_2 emissions from current levels by about 15 percent in the year 2000. The potential shock to the economy of such a high tax rate, however, might warrant phasing it in over time. Phasing in this tax over 10 years could raise about $221 billion in revenues during 1994 through 1998, by which time the tax rate would be approximately $70 in 1994 dollars. A phased-in tax could reduce CO_2 emissions in the United States by about 3 percent to 5 percent below 1990 levels by the year 2000. Unfortunately, U.S. action might not significantly reduce global CO_2 concentrations, if other countries did not make similar efforts.

The European Community (EC), as one part of a strategy to stabilize emissions of CO_2 in the Community at 1990 levels by the year 2000, is proposing a hybrid carbon- and energy-based excise tax on consumption of primary energy sources. Renewable energy and feedstocks for industry (for example, hydrocarbons for the chemical industry) would be exempt from the tax.

The EC proposal would phase in the tax gradually, starting at $3 a barrel of oil equivalent beginning in 1993 and rising annually by $1 until it reaches $10 per barrel by the year 2000. The EC proposal specifies a tax rate with two components. The first component is a tax rate based on the energy content of the fuel. The second component is a tax rate based on the carbon content of the fuel. The composite base reflects a combined objective of promoting energy efficiency, and reducing carbon emissions without promoting nuclear power or overburdening the coal industry. The initial combined tax rate of $3 per barrel is equivalent to a tax of approximately $14.00 per ton of coal, $3.00 per barrel of oil, $0.50 per thousand cubic feet of natural gas, and about $2.46 per megawatt hour of electricity on average. If the United States were to impose such a tax starting in 1994, it would raise about $253 billion in additional revenue during 1994 through 1998.

The scientific evidence concerning the potential adverse effects of atmospheric CO_2 may not yet warrant aggressive efforts to reduce U.S. fossil energy use. Adjusting to lower energy use would be costly especially in energy extracting and processing industries and in energy-intensive manufacturing sectors. Moreover, the impact of making energy more expensive may slow national economic growth in the short to medium term. In recognition of these concerns, the EC proposal encourages members to (1) grant graduated tax reductions for energy-intensive industries based on energy costs as a percentage of value added to maintain international competitiveness and (2) offset revenues from the carbon tax by reducing other taxes so as not to increase the tax burden. Such graduated rate reductions could, however, substantially counter the tax's incentives to increase energy efficiency as well as reduce carbon emissions.

Taxes on the carbon content of fuels are similar to other excise taxes in that the costs of such taxes fall disproportionately on lower-income households. To reduce the adverse distributional effects of the tax, the Congress could combine it with cuts in other taxes and increased spending that return a portion of the revenues to adversely affected groups. This combination of policies would mitigate the hardships from higher energy prices and still provide an incentive to reduce CO_2 emissions.

There are several alternative means of controlling greenhouse gases including efforts to slow deforestation, increase research and development into new technologies for improving energy efficiency, and increase the use of alternative energy sources that do not emit CO_2. Another alternative to raising energy prices through an excise tax on carbon is to adapt to a warmer globe. This approach would be justified if the expected costs of adjusting to a warmer climate were less than the costs of adjusting to a tax or other methods of reducing greenhouse gas emissions.

REV-38 IMPOSE EXCISE TAXES ON WATER POLLUTANTS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Tax on Biological Oxygen Demand	1.2	1.8	1.8	1.8	1.8	8.5
Tax on Toxic Water Pollutants	1.0	1.5	1.5	1.5	1.5	7.0

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are net of reduced income and payroll taxes.

Major facilities that discharge pollutants directly into water or indirectly into sewer systems are currently subject to regulations that specify pollution abatement technology or impose concentration limits on their discharges. Taxes on water pollutants discharged by these facilities could provide a significant source of revenue and could encourage further reductions in pollution below the level that current regulations require. Generally, firms subject to water pollution standards do not pay taxes or fees on effluents (discharges) that regulations still allow. There are two major types of water pollutants, biological oxygen demand (BOD) and toxics. One option is to impose a tax on BOD discharges. BOD is a common measure of water quality because excessive levels of BOD make it difficult to sustain aquatic life. A second option would impose a tax of varying rates on certain toxic discharges.

Taxes can reduce pollution in a cost-effective manner because they encourage firms with the lowest abatement costs to reduce pollution, while allowing firms with high abatement costs to continue polluting and pay the tax. Reductions in discharges caused by the tax would increase welfare if the additional abatement costs were less than or equal to the social benefits from reduced pollution levels. However, accurate estimates of additional social benefits from reducing pollution levels do not exist in many cases. In addition, imposing a tax on one class of pollutants might reduce other pollutants, because some wastewater treatment processes reduce several pollutants simultaneously. In addition, constitutional issues concerning federal taxation of local governments may arise, requiring direct taxation of primary sources that discharge to publicly owned treatment works (POTWs) rather than taxing the POTWs themselves.

Tax on Biological Oxygen Demand. BOD measures the effect of pollutants that encourage algae growth, which in turn depletes oxygen necessary to sustain much aquatic life. Most of the high volume dischargers (sometimes referred to as point sources) are POTWs, paper and pulp mills, food processors, metal producers, and chemical plants. Total discharges by point sources are about 10.6 million pounds per day. About 9.6 million pounds of this amount are discharged by publicly owned treatment works.

The cost of controlling another pound of BOD at POTWs and many industries subject to the Clean Water Act regulations averages between 50 cents and 75 cents for each pound removed. A charge on BOD discharges of 62.5 cents per pound could encourage manufacturing facilities and POTWs that face lower abatement costs to reduce pollution. The tax would raise $8.5 billion between 1994 and 1998 if it does not affect BOD discharge levels. Imposition of the tax is likely to induce additional abatement, however. Therefore, these estimates probably overstate revenue collections under the tax.

Costs of administering a BOD water pollution excise tax would be small because allowable levels of BOD discharges are specified in the permits issued to every source of water pollution by state or federal governments. Levying a tax on effluents from POTWs, as well as from large industrial dischargers, would ensure that the tax base would include all of the largest dischargers of BOD. If a tax could not be levied for constitutional reasons directly on POTW discharges, the POTWs themselves could collect the tax directly from polluters that discharge into sewer systems.

Tax on Toxic Water Pollutants. The manufacturing sector in the United States discharged more than 190 million pounds of toxics into water directly in 1989 and over 550 million pounds of toxics into water indirectly through sewers. Toxic pollutants generally include organic chemicals (such as solvents and dioxins), metals (such as mercury and lead), and pesticides. These toxics may pose a threat to the aquatic environment and to human health.

The amount of environmental harm that toxic water pollutants cause depends on their "toxicity." The Environmental Protection Agency (EPA) has devised a weighting method to indicate the toxicity of various pollutants. Use of this weighting system makes it possible to measure the quantities of different types of toxics by their "toxic pound equivalents" (which the EPA defines as the pounds of the pollutant multiplied by its toxic weight).

This option adopts tax rates developed by the Congressional Research Service (CRS) in a study on manufacturing firms' discharges of 189 toxic pollutants emitted by over 22,000 firms. The CRS defined five different categories of pollutants based on their toxicities. The tax rates varied from 0.65 cents per pound for the least toxic category of pollutants to $63.40 per pound for the most toxic category. These rates correspond to a charge of $32.35 per toxic pound equivalent. The variable tax rates provide firms with a greater incentive to reduce their most toxic discharges.

According to the EPA, the cost of controlling another toxic pound equivalent varies among industries ranging from $1.50 to $606 per toxic pound equivalent (in 1991 dollars). This tax, therefore, could encourage industries and firms with low abatement costs to reduce their toxic discharges. Assuming that discharges of toxics remain the same, the tax would raise $7.0 billion from 1994 through 1998. Revenues could be lower, however, if the amount of toxic pollutants the firms discharge decreases as a result of the tax.

The Internal Revenue Service (IRS) could use information that the EPA's Toxic Release Inventory (TRI) provides on toxic discharges by manufacturing firms to assess tax payments or the EPA could collect the tax on behalf of the IRS. An important consideration, however, is that the accuracy of TRI data is questionable. The TRI contains self-reported data and many facilities that meet the reporting requirements fail to file reports or file inaccurate reports. In order to improve the accuracy of the TRI data base and enhance enforcement, it would be important to have frequent auditing.

REV-39 IMPOSE EXCISE TAXES ON AIR POLLUTANTS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars) 1994	1995	1996	1997	1998	Cumulative Five-Year Addition
			Stationary Sources			
Impose a Tax of $432 per Ton on SO_x	4.4	6.4	6.4	6.4	6.4	30.0
Impose a Tax of $1,170 per Ton on NO_x	7.0	10.1	10.1	10.1	10.1	47.4
Impose a Tax of $3,610 per Ton on Particulate Matter (PM-10)	7.3	10.6	10.6	10.6	10.6	49.7
Impose a Tax of $5,000 per Ton on VOCs	30.5	44.3	44.3	44.3	44.3	207.7
			Mobile Sources			
Impose a One-Time Emission Tax (Averaging $250 per Vehicle) on New Automobiles and Light Trucks	1.8	2.7	2.8	2.9	2.9	13.1

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are net of reduced income and payroll taxes.

The pollutants SO_x and NO_x are considered primarily responsible for acid rain, which the Environmental Protection Agency (EPA) believes degrades surface waters, damages forests and crops, and potentially increases the incidence of respiratory ailments. Large industrial sources, notably coal-fired electric utilities, emit significant quantities of these pollutants. Industrial production and the use of automobiles and trucks emit NO_x and volatile organic compounds (VOCs), which combine with sunlight and other compounds to produce ozone pollution. Electric utilities and motor vehicles emit particulate matter (PM) when they burn fossil fuels. Particulate matter can carry heavy metals and cancer-causing organic compounds into the lungs, thus increasing the incidence and severity of respiratory diseases. Carbon monoxide (CO) is produced primarily from the use of motor vehicles and residential woodburning, and it can also pose direct health hazards. In 1991, about 85 million people lived in areas that did not meet the EPA's National Ambient Air Quality Standards, which define acceptable levels of CO, NO_2, PM-10, SO_2, lead, and ozone.

With some minor exceptions, firms subject to air pollution standards must incur the costs needed to reduce emissions to comply with regulations. Most firms do not, however, pay taxes or fees on emissions that regulations still allow.

The marginal cost of pollution control for stationary sources varies, given the numerous industrial and other sources. The four options that tax pollution from stationary sources would base the tax rates on the average firm's estimated current cost of reducing pollution at the margin. Some firms with low abatement costs may reduce pollution below allowable standards in response to the taxes. The option that taxes emissions from mobile sources (vehicles) could also reduce pollution levels. (See REV-36 and REV-37 for other taxes that might reduce emissions of air pollutants.) Reductions in emissions caused by the taxes would increase welfare if additional abatement costs were less than or equal to the social benefits from reduced pollution levels. However, accurate estimates of additional social benefits from reducing pollution levels do not exist in many cases.

The revenue estimates cited here, however, do not assume any additional abatement from imposition of the taxes. If additional abatement were to occur, revenue collections would be lower.

Tax Emissions of SO_x and NO_x from Stationary Sources. Imposing taxes of $432 per ton of SO_x emissions and $1,170 per ton of NO_x emissions from all stationary sources would raise roughly $30.0 billion for SO_x and $47.4 billion for NO_x from 1994 through 1998. Basing the tax on the terms granted in air pollution permits would minimize costs of administration. The Internal Revenue Service (IRS) could collect the tax itself or the state and local government agencies that issue pollution permits could collect the tax on the behalf of the IRS. The present monitoring and reporting system for stationary sources that the EPA and state regulators operate could be used to enforce the tax. If polluters' actual emission levels were lower than permitted levels, polluters could apply for revised permits based on those actual levels. If the tax were based on permitted emissions levels, it would be equivalent to the government selling pollution permits.

The proposed tax on SO_x could reduce pollution below the mandated amounts contained in the Clean Air Act Amendments of 1990 (CAAA). Some electric utilities and manufacturing plants might switch to lower-sulfur coals because this would be less costly than paying the tax, and others might choose to operate their most heavily emitting plants less frequently or to install new SO_x control devices. The tax on NO_x could also reduce emissions below mandated levels contained in the CAAA if some firms adopt currently available abatement techniques whose capitalized costs per unit of reduced emissions are lower than the tax rate.

Tax Emissions of PM-10 from Stationary Sources. A tax of $3,610 per ton of particulate matter would raise roughly $49.7 billion from 1994 through 1998, based on levels of emissions that the EPA projects under current regulations. Some electric utilities and manufacturing plants might install improved electrostatic precipitators, wet scrubbers, or other equipment that reduces PM-10 emissions to lower their tax burdens. This tax could be administered in the same manner as the taxes on SO_x and NO_x.

Tax Emissions of VOCs from Stationary Sources. Stationary sources of volatile organic compounds range from huge industrial facilities such as chemical plants, petroleum refineries, and coke ovens to small sources such as bakeries and dry cleaners. Their vast number and diversity make it difficult to estimate emissions and costs of abatement. A tax of $5,000 per ton on all stationary-source VOC emissions might promote some abatement and would generate $207.7 billion in revenues from 1994 through 1998.

The advantage of a broad-based tax on VOCs is that it captures small sources, which the EPA estimates are responsible for approximately 80 percent all emissions from stationary sources. Because stationary sources emitting less than 2.5 tons of VOCs per year are not currently subject to federal regulation, a broad-based VOC tax would be administratively more difficult to carry out than a tax on large sources alone. Assessing the tax on small sources on technology-based estimates of emissions rather than on measured emissions would reduce administrative costs, but make the incentives less precise. Alternatively, imposing the tax only on large stationary sources would raise only $8.9 billion annually.

Tax Emissions of NO_x, VOCs, and CO from Mobile Sources. A one-time tax imposed on new automobiles and light trucks could be based on grams of NO_x, VOCs, and CO emitted per mile as estimated under the EPA emission certification tests required on every new vehicle. The tax could be administered like the "gas guzzler" excise tax. The EPA would determine the tail-pipe emissions for each new model light-duty vehicle and the tax would be based on these emissions rates. The auto dealer would collect the tax on behalf of the IRS from the vehicle purchaser.

Such a tax averaging $250 per vehicle could raise $13.1 billion in revenues from 1994 through 1998. The revenue estimates presented here are based on projected new car sales and assume that new cars meet, on average, current tail-pipe standards. Revenues would be lower than projected if the tax induced consumers to purchase more fuel-efficient vehicles. Also, if new cars become cleaner over time, revenues would be lower than projected. Vehicles made in earlier years have been excluded from the estimate above because of the administrative problems of collecting a tax on older vehicles. A disadvantage of excluding them, however, is that earlier-year vehicles represent more than 90 percent of the light-duty vehicles in use and an even greater share of emissions. In addition, the tax would encourage people to delay purchases of new vehicles by raising their price.

REV-40 TAX ADDITIONAL OZONE-DEPLETING CHEMICALS

Addition to CBO Baseline	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Impose ODC Tax on Methyl Bromide at Current Rates	0.1	0.1	0.2	0.2	0.2	0.8
Impose ODC Tax on HCFCs at Current Rates	a	0.1	0.1	0.1	0.1	0.3

SOURCE: Joint Committee on Taxation.

NOTE: Estimates are net of reduced income and payroll tax revenues.

a. Less than $50 million.

In 1989, the Congress imposed an excise tax on chlorofluorocarbons (CFCs) and halons, chemicals with high potential to deplete ozone. The Congress added carbon tetrachloride and methyl chloroform to the list of chemicals subject to tax in 1990. Furthermore, the Congress increased the tax rates on ozone-depleting chemicals (ODCs) in the Energy Policy Act of 1992. Current law imposes a separate tax rate on each ODC. This rate is a product of the base tax rate and the ODC's ozone-depleting factor--a measure of the chemical's potential damage to the ozone layer. The base tax rate is $3.35 per pound in 1993, increasing to $6.70 per pound in 1998.

Recent U.S. Environmental Protection Agency (EPA) regulations phase out most ODCs by 1996. The current tax could accelerate the phaseout.

The current tax excludes methyl bromide and hydrochlorofluorocarbons (HCFCs), chemicals that also damage the ozone layer. There are reasons these chemicals are exempt. Scientists only recently identified methyl bromide as a significant contributor to ozone depletion, and they still consider HCFCs to be much less harmful than CFCs. HCFCs are also the best near-term substitutes for CFCs, serving as a bridge for industrial users. Recent scientific studies conclude that HCFCs are more harmful than originally thought, however. At the end of 1992, 24 leading industrial countries recognized scientists' concerns about these ODCs by adding them to the Montreal Protocol, a 1987 accord that set international production limits and phaseouts on most of the known harmful ODCs.

Broadening the tax base to include methyl bromide and HCFCs could raise more than $1 billion from 1994 through 1998, and further spare the ozone layer. The new taxes would raise prices of the chemicals and some related retail prices, which could expedite the development of substitutes, alternative processes, and recycling programs.

Agricultural industries use methyl bromide as a pesticide and multipurpose fumigant. Its most prominent agricultural use is as a soil (fungicide) fumigant. Recent scientific evidence substantiates that methyl bromide is more harmful than many of the chemicals that current law taxes. EPA regulations phase out the production and importation of methyl bromide by the year 2000. Taxing it at current law rates could raise $0.8 billion from 1994 through 1998.

As industries phase out CFCs, their production of HCFCs will grow. EPA regulations, however, substantially reduce the production of HCFCs from the years 2003 to 2010 and completely phase out this

ODC by 2030. Taxing HCFCs could expedite this phaseout. Because HCFCs have a smaller ozone depleting factor than CFCs, their applicable tax rates would be lower and would not affect their prices as significantly. Taxing HCFCs at current law rates could raise $0.3 billion from 1994 through 1998.

REV-41 AUCTION OFF IMPORT QUOTAS FOR TEXTILES, APPAREL, AND SUGAR

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1994	1995	1996	1997	1998	
Addition to CBO Baseline	2.7	2.9	3.1	3.3	3.5	15.5

SOURCE: Congressional Budget Office.

The United States imposes quotas on various imports, including textiles, apparel, sugar, and several other products, to protect domestic producers. Such quotas increase the price of imports in the United States above the marginal cost of producing them overseas. (Without the quotas, the price would equal that cost.) This price difference represents an economic rent that different parties can capture, depending on the rules for allocating quota rights.

Currently, the U.S. government negotiates quotas for U.S. imports with foreign governments. This system allows foreign exporters or their governments to capture and keep the quota rents. If the United States were instead to sell the quotas at auction to the highest bidder, the U.S. government would receive the quota rents back from the foreign countries as revenues from the auctions. In addition, the prices at which the quotas would sell at auction would provide the information the Congress would need to calculate the tariff rates that would provide equivalent protection to domestic industry. For an equivalent amount of protection, tariffs are generally less damaging to the economy than quotas.

The United States and foreign governments have set many quotas by agreement, with the understanding that foreigners would receive the rents. Before holding quota auctions, the U.S. government would have to renegotiate these agreements and foreign governments probably would not willingly consent to the loss of rents without some form of compensation. Alternatively, the United States could hold the auctions without the consent of the countries with agreements, but doing so might lead to retaliation by those countries. Some of the quotas (in particular, the textile and apparel quotas) might be phased out over the coming years, so some of the rents might be temporary. Because there are tariffs as well as quotas on many of these products, however, the increased imports that would result from a phaseout should increase tariff revenue collections and thereby at least partially offset any lost rents.

CBO estimates that auctions of U.S. quotas on imports of textiles, apparel, and sugar would raise approximately $2.7 billion in 1994 and $15.5 billion over the 1994-1998 period. Auctions of other import quotas would raise much less revenue because the quotas are less substantial in scope or do not severely restrict the imports that they cover. The estimates of quota revenues are highly uncertain for several reasons. Adoption of proposals in the Uruguay Round of the General Agreement on Tariffs and Trade to phase out import quotas for textiles and apparel and to convert import quotas to tariffs for agricultural goods could substantially alter the estimates, as could proposals affecting the U.S. sugar market in the North American Free Trade Agreement. Even without policy changes, the values of all import quotas are sensitive to changes in exchange rates, the business cycle, and other economic variables that cannot be foreseen.

Appendix

Spending Options by Budget Function

150 International Affairs

350 Agriculture

370 Commerce and Housing Credit

400 Transportation

450 Community and Regional Development

500 Education, Training, Employment, and Social Services

600 Income Security

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