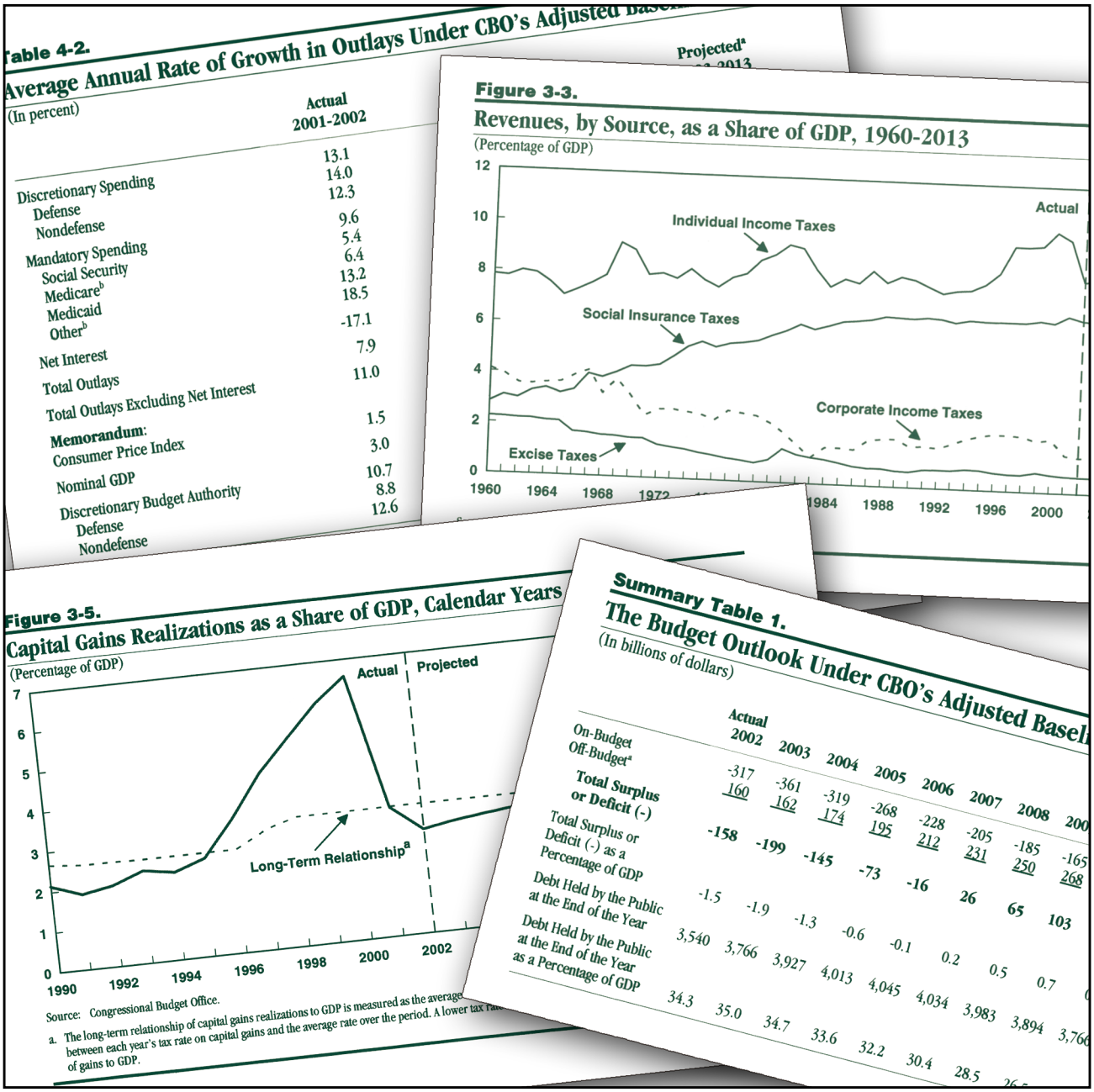
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

# Budget Options




MARCH 2003

A

CBO

STUDY

# Budget Options

March 2003

The Congress of the United States ■ Congressional Budget Office

# Notes

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

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

The options in this report do not reflect the governmental reorganization involved in the creation of the Department of Homeland Security.

The budgetary effects of the options are estimated in various ways. For options involving defense discretionary spending, savings are measured relative to the Department of Defense's most recent plan, as modified by lawmakers in enacting 2003 appropriations. For options involving nondefense discretionary spending, savings are measured in comparison with the level of 2003 appropriations adjusted for inflation. (In most cases, that level represents the appropriations outlined in the continuing resolution that was in effect when the options were prepared; in a few cases, it represents the appropriations enacted on February 20, 2003, in the Consolidated Appropriations Resolution for 2003.) For options that affect mandatory spending, savings are measured in relation to the Congressional Budget Office's (CBO's) current-law baseline. For revenue options, the effects are estimated relative to current-law projections; most of the estimates come from the Joint Committee on Taxation, although a few were produced by CBO. For the long-term Social Security and Medicare options in Chapter 4, savings are estimated by CBO and are measured in relation to the size of the economy (as a percentage of gross domestic product).

The tables and charts shown on the cover come from Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (January 2003).

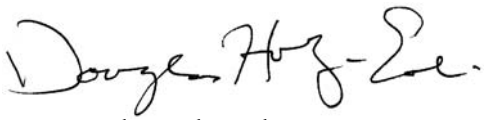
# Preface

This volume—one of the Congressional Budget Office's (CBO's) regular reports to the House and Senate Committees on the Budget—presents options to alter federal outlays and receipts, both in the near term and over a longer horizon. The report does not adopt a particular fiscal goal or budget target but presents a variety of options to help policymakers in their annual tasks of making budgetary choices, setting priorities, and adapting to changes in circumstances. It is the latest in a series of compendiums of policy options prepared by CBO over the years.

As a nonpartisan Congressional agency, CBO does not make recommendations about policy. Instead, the options discussed in this report stem from various sources. They are derived from legislative proposals, the President's budget, Congressional and CBO staff, other government entities, and private groups. The inclusion or exclusion of a particular idea does not represent an endorsement or rejection by CBO. The options are intended to reflect a range of possibilities; they are neither ranked nor comprehensive. In keeping with CBO's mandate to provide objective and impartial analysis, the discussion of each option presents the cases for and against it.

*Budget Options* begins with an introductory chapter that discusses the budget outlook, presents general rationales for the policy options that follow, and explains how to use the volume. Chapter 2 presents dozens of options to cut spending or add receipts, organized by the functional categories of the budget—national defense, international affairs, energy, and so on. The options for each function are introduced with a page of background information about spending trends in that function. Chapter 3 contains specific options that affect revenues. Chapter 4 presents a discussion of strategies for slowing the growth of Social Security and Medicare. The appendix lists the many contributors to this report.

This volume is available in multiple formats on CBO's Web site (www.cbo.gov), including a version that permits users to search and retrieve options by function, agency, and other criteria.



Douglas Holtz-Eakin
Director

March 2003

CONTENTS

**TABLES**



**FIGURE**



**BOXES**

# Options to Reduce Spending

## Function 050: National Defense

### Forces and Weapons



### Manpower, Logistics, and Support

**Function 300:**
**Natural Resources and Environment**

**Function 350:**
**Agriculture**



**Function 370:**
**Commerce and Housing Credit**



**Function 400:**
**Transportation**

## Options That Affect Revenues

**Restrict Itemized Deductions, Credits, and Exclusions Under the Income Tax**

**Restrict the Tax-Favored Treatment of Nonretirement Fringe Benefits**



**Restrict the Tax-Favored Treatment of Certain Household Income**



**Expand the Payroll Tax Base**



**Change Tax Rules for Income from Worldwide Activity**



**Curtail Special Provisions of Income Taxes for Businesses**

CHAPTER

# 1

# Introduction

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

## The Budget Outlook

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

### The Uncertainty of Projections

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

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

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

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

## Budgetary Choices and Fiscal Goals

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

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

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

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

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

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

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

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

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

## Rationales for Budget Options

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

### Options to Reduce Spending

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

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

### Options That Affect Revenues

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

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

Lessening the tax system's complexity would reduce its administrative costs as well as the costs of compliance for taxpayers. Consolidating the child credit and the personal exemption for children, for example, would make it easier for families to complete their tax returns. Similarly, replacing the panoply of tax rates that apply to long-term capital gains with a single tax rate applied to only a percentage of gains would greatly simplify the multipage

form that taxpayers must now complete. Such simplification would also increase the transparency of the tax system, thus making it easier for taxpayers to understand how much they are taxed on their income.

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

### Options to Slow the Growth of Social Security and Medicare

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

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

## Using This Volume

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

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

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

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

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

## Exclusions and Limitations

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

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

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

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

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

---

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

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

CHAPTER

# 2

# Options to Reduce Spending

# 050

# National Defense

Budget function 050 comprises spending for national defense. Although 95 percent of that spending is for the Department of Defense, function 050 also includes the atomic energy activities of the Department of Energy and smaller amounts in the budgets of other federal departments and agencies. For 2003, lawmakers have provided discretionary budget authority of $382 billion for function 050. CBO estimates that discretionary outlays for the function will total about $377 billion in 2003, the fifth consecutive year of growth in defense spending following several years of decline. Mandatory spending in function 050 usually shows negative balances because of payments made to federal agencies.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 303.9 | 332.2 | 299.1 | 276.1 | 262.2 | 262.9 | 265.0 | 266.2 | 272.4 | 288.3 | 300.8 | 331.7 | 360.8 | 381.6 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 300.1 | 319.7 | 302.6 | 292.4 | 282.3 | 273.6 | 266.0 | 271.7 | 270.2 | 275.5 | 295.0 | 306.1 | 348.9 | 376.6 |
| Mandatory | -0.8 | -46.4 | -4.3 | -1.3 | -0.6 | -1.5 | -0.2 | -1.2 | -1.8 | -0.6 | -0.5 | -0.6 | -0.4 | -0.2 |
| Total | 299.3 | 273.3 | 298.4 | 291.1 | 281.6 | 272.1 | 265.8 | 270.5 | 268.5 | 274.9 | 294.5 | 305.5 | 348.6 | 376.5 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 6.5 | -5.3 | -3.4 | -3.5 | -3.1 | -2.8 | 2.1 | -0.5 | 1.9 | 7.1 | 3.8 | 14.0 | 7.9 |

Note: n.a. = not applicable.

## Introduction to the Defense Options

The investment options that the Congressional Budget Office (CBO) has included in this volume are meant to do two things: be cost-effective and illustrate choices that the Department of Defense (DoD) might make, consistent with the Bush Administration's efforts to transform the military. Options emphasizing cost-effectiveness would provide a given capability at lower cost or cut programs that are particularly expensive for the capability they provide. In addition, many of the investment options represent ideas similar to ones that the Administration is considering to transform the military. CBO's options are designed to provide net savings.

DoD's noninvestment activities—which include providing compensation to military and civilian personnel, paying contractors for purchases of services, and paying for the fuel and other supplies routinely consumed during DoD's day-to-day operations—will account for $250 billion (or two-thirds) of DoD's budget authority in 2003. Several of the national security options that address those operating costs focus on the benefits provided to military personnel. The costs of those benefits are growing: under current policies, annual spending for military medical care would rise from $28 billion today to $38 billion by 2013 (in 2002 dollars). Other options would seek to improve DoD's use of military personnel. Those options might be viewed either as ways to reduce the number of service members and achieve budgetary savings or as ways to free up personnel for counterterrorism defense or other new missions without increasing the size of the force.

As readers examine the options, they will find that although the table in each option reports savings with respect to budget authority and outlays, the text refers to either one or the other. Some options that deal with weapon systems refer to budget authority because spending rates for those weapons programs tend to be quite slow. Other options, especially ones that deal with operation and support costs, report outlays since those funds are usually spent relatively quickly.

Readers of these options may also want to consult a recent CBO study, *The Long-Term Implications of Current Defense Plans* (January 2003). That report takes a comprehensive look at the long-term implications of the Bush Administration's plans for defense. It projects what level of resources might be needed to execute those plans and what the plans would imply about the size, composition, and age of future U.S. forces if they were carried out.

## 050-01—Discretionary

# Cancel Remaining Purchases of the Javelin Missile

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 174 | 142 | 9 | 116 | 1 | 441 | 441 |
| Outlays | 50 | 107 | 92 | 78 | 60 | 387 | 439 |

The Javelin missile was originally designed to counter the Soviet Union's heavily armored tanks. About 20,000 were produced from 1997 through 2003, at an average cost of about $160,000 apiece. Close to 4,000 more are due to be bought between 2004 and 2007, at an average cost of $125,000 apiece. The Congress, the General Accounting Office, and the Defense Department's Inspector General have all expressed skepticism about the continued, essentially unchanged investment in antitank munitions despite the significant changes in the threat since the end of the Cold War. Whereas potential targets numbered about 25,000 at the height of the Cold War, they now number fewer than 4,000.

The Army's current stated requirement for Javelin missiles stands at almost 35,000, including the amount needed for the new medium-weight Stryker brigades (also termed the interim brigade combat teams). However, the actual planned purchase is 23,850, partly reflecting the Army's acknowledgment of the limited number of Javelins that simulations have indicated would be fired at enemy tanks and other vehicles during a war—both because of the number of potential targets and the many other weapons with longer ranges that would be employed to fight a war. Despite the reduction, the Army's planned purchase of Javelin missiles would provide a number sufficient to fight 75 major theater wars. For other munitions, the Army buys enough for about 10 major theater wars, accounting for wartime usage, training, and other needs.

The Javelin overcomes several significant problems that its predecessor, the Dragon, had. That missile presented dangers at its launch and had to be manually guided to its intended target and therefore exposed the soldier using it to enemy counterfire. In contrast, the Javelin uses a "soft launch" (its motor igniting after the missile is ejected from the launch unit) and then guides itself to the intended target. Perhaps because of the Dragon's problems, the Army intends to use more than a third of the Javelin missiles, about 9,000, as "confidence rounds" fired by trainers to demonstrate to trainees that the missiles actually work. But that approach is unique to Javelin—for no other U.S. munition are confidence rounds used as a basis for the required inventory.

Eliminating the requirement for those confidence rounds and paring the extra missiles required for the maintenance pipeline would reduce the required number of Javelins to about 14,000, well below the 2003 inventory of about 20,000. Therefore, this option would cancel the remaining purchases but would leave the Army with an inventory sufficient for all of its needs, including equipping the Stryker brigades. The option would save $50 million in outlays in 2004 and $387 million over the 2004-2008 period.

Several arguments have been raised in support of continuing to purchase Javelin missiles. First, the Army's greater emphasis on light and medium-weight forces, including the Stryker brigades, makes Javelin more important now as both an offensive and defensive weapon because it provides such units with tank-destroying capability that they otherwise might not have. Second, because one cannot predict which units may actually expend their Javelins even if overall use is expected to be low, keeping a robust maintenance pipeline is a prudent hedge. Third, although having confidence rounds is a unique requirement for munitions, they are necessary to counteract the negative legacy of the Dragon. Finally, the Defense Security Cooperation Agency has notified the Congress that sales of the Javelin have been negotiated with Taiwan, and sales to the United Kingdom, Australia, Jordan, and Lithuania are being discussed. Canceling the remainder of the U.S. Army's purchases of Javelins could negatively affect those sales.

**RELATED OPTIONS:** 050-03 and 050-04

## 050-02—Discretionary

# Reverse Organizational Changes that Have Increased the Army's Support Tail Without Increasing Its Combat Tooth

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 231 | 478 | 493 | 507 | 522 | 2,231 | 5,076 |
| Outlays | 196 | 433 | 480 | 501 | 517 | 2,126 | 4,949 |

Over the past decade, the Army has pursued a number of reorganizations of its combat forces, several of which have increased the ratio of support staff positions (the Army's "tail") to direct combat positions (its "tooth"). In 1996, the Army implemented two reorganizations of field artillery units almost simultaneously. Batteries of 155-millimeter cannons in the artillery battalions were reduced from eight howitzers per battery to six. Batteries of multiple-launch rocket systems were reduced from nine launchers to six. At the division level, the reduction in firepower was approximately 30 percent. At the same time, the number of artillery brigades in the corps supporting each heavy division was increased from one to two. The effect was to distribute essentially the same amount of combat power among a larger number of units, substantially expanding headquarters units and staff and increasing fixed costs.

This option would reverse those reorganizations to what existed during Operation Desert Storm. Doing so would decentralize the command structure, thereby lessening the distance between fire control centers and the intelligence, surveillance, and reconnaissance functions and perhaps allowing quicker decisions on the battlefield. Those changes would save $196 million in outlays in 2004 and $2.1 billion over the 2004-2008 period.

Reversing the reorganizations would result in an overall reduction of approximately 12,000 personnel within the Army. Of those, 5,000 are active-duty personnel and 7,000 are reservists. In both pools, the proportion of personnel who are midranking officers is heavy, and noted shortages of midranking officers and unusually high promotion rates that have followed those shortages could be addressed by adopting this option. Because the earlier reorganizations occurred over a two-year period, this option would adopt the same amount of time for reversing them. Importantly, the option would cut administrative overhead without cutting "tooth." After two years and the reduction in personnel, savings would be approximately half a billion dollars annually.

But several arguments support the current organizational structure. For example, the artillery battalions that resulted from the reorganizations are lighter than the previous ones by about 25 percent and therefore are in accord with the widely agreed-upon goal of lightening the Army and making its operational units more deployable. Moreover, thanks partly to improvements in command, control, and intelligence, the higher number of headquarters personnel may be able to help commanders apply their firepower effectively across a wider area.

**RELATED CBO PUBLICATIONS:** *Making Peace While Staying Ready for War: The Challenges of U.S. Military Participation in Peace Operations*, December 1999, and *Structuring the Active and Reserve Army for the 21st Century*, December 1997

## 050-03—Discretionary

# Reduce the Number of Army Stryker Brigade Conversions

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 542 | 623 | 880 | 754 | 220 | 3,019 | 3,321 |
| Outlays | 157 | 380 | 592 | 714 | 597 | 2,438 | 3,180 |

The Army Transformation Plan envisions bridging a gap between today's heavy armored forces, which are slow to deploy but very powerful, and today's light infantry forces, which can be deployed rapidly but lack substantial combat power. The first element of that plan, called the objective force, is a long-term research effort to develop weapon systems with substantial combat power that can be deployed rapidly. The second element of the plan, called the interim force, is a near-term effort to convert six Army brigades into a medium-weight configuration. The two efforts are complementary, since the Army's experience with the interim force is intended to let the Army experiment with new ways of warfighting and new ways of organizing units that may prove useful for the objective force. Ultimately, the Army envisions converting all of its divisions to objective force units.

The Army's plans for the interim force are centered on the Stryker program, which intends to rapidly field a family of light armored vehicles capable of filling most of the combat roles in a brigade. The Army's goal is for the interim brigades equipped with Stryker vehicles to be light enough to deploy by air anywhere in the world within 96 hours and robust enough to handle the full range of combat missions. Converting each brigade to that configuration will cost about $1.5 billion, the Congressional Budget Office estimates. About two-thirds of that cost will be for procuring slightly more than 300 Strykers per brigade.

The Stryker vehicle has, however, attracted criticism. With less armor than some current fighting vehicles, it may not be as survivable on the battlefield as today's heavy forces. Moreover, the vehicle is too large and too heavy to be easily transported in the Air Force's C-130 transport planes and thus will not be as easy to deploy as the Army had initially hoped that it would be.

This option would reduce the number of interim brigades from six to three and reduce the procurement of Stryker vehicles accordingly, saving $2.4 billion in outlays over the next five years.

Proponents of this option note that the interim force is intended to be only a stepping-stone to the Army's future objective force. They argue that the three brigades that would be converted for the interim force would be sufficient to allow the Army to experiment with new ways of fighting, and the lower number of conversions would reduce the resources expended on what some people would characterize as a short-term expedient.

Opponents of this option contend that the Army's plan for the objective force is risky and may not be affordable and that conversions to the objective force are not scheduled to begin until 2008. In contrast, they say, the Stryker program has been executed rapidly, with little risk, and at a relatively low cost. Thus, the interim brigades could provide useful capabilities much sooner than the objective force will. Further, opponents argue, because most of the units that the Army plans to convert are light units, the Army will, in fact, increase its net combat power through the conversions, even though the Stryker may be less survivable than the fighting vehicles in heavy units. Finally, critics of this option note, although the Stryker vehicle cannot be easily transported by C-130s, it can be easily carried in C-5s or C-17s, the transport aircraft used for strategic deployments.

**RELATED OPTIONS:** 050-01, 050-04, and 050-05

## 050-04—Discretionary

# Delay the Fielding Date of the Future Combat System from 2008 to 2010

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 1,255 | 1,054 | 2,614 | 1,161 | 6,084 | 6,675 |
| Outlays | 0 | 569 | 781 | 1,474 | 1,170 | 3,995 | 6,493 |

As described in the previous option (050-03), the first element of the Army Transformation Plan is the objective force, a long-term research program to develop weapon systems with substantial combat power that can be deployed rapidly. The centerpiece of the objective force is the Future Combat System (FCS) program, which has the goal of developing a combination of ground and air platforms, linked together with advanced communications networks into an integrated combat system. Because the FCS program is still evolving, its full costs are not yet known; they are, however, likely to be more than $22 billion through 2009, according to the Army's most recent budget plan.

Such an effort carries with it substantial risks, including the need to develop many advanced new technologies. Furthermore, despite the lack of a firm cost estimate, the Army currently plans to field the FCS in 2008. Many external observers and technical experts believe that such a schedule is too aggressive, given the program's ambitious goals.

This option would delay the planned fielding date of the FCS by two years and reduce funding accordingly. That delay would reduce outlays by about $4 billion over the next five years.

Proponents of this option argue that the current program, with its many unknowns and technological risks, is likely to slip anyway within the next few years and that its overly aggressive schedule could diminish its chances for success. Since it is unlikely that many of the technologies that the Army is considering using in the FCS will be mature by the time production begins, an aggressive schedule may result in otherwise achievable capabilities being sacrificed to meet the fielding date.

The funding that would be diverted from the FCS under this option could be used to convert additional Stryker brigades, but that would reduce the option's savings. Those brigades, serving as stepping stones to the objective force, are intended to help the Army develop the new doctrine and methods of warfighting that are described as crucial to the objective force's success. Since those interim brigades will share many organizational features with objective force units, they also could serve as an embryonic objective force, providing a test environment for its new equipment and integrated approach to combat. The Army's transformation could thus be a more gradual and evolutionary process, with fewer risks.

Opponents of this option argue that transforming the Army into the objective force is the most important effort under way in the service's modernization and should be pursued as quickly as possible. Although defenders of the FCS program are likely to concede that it faces technical challenges, they see the aggressive schedule as motivation that inspires the FCS team to search for ways to overcome those challenges. They believe that delaying the FCS program will send a signal that the rapid transformation of the Army is not vital, threatening the bureaucratic and institutional momentum needed to sustain such a major set of changes. They also note that the longer the FCS is delayed, the more funding the Army will have to expend to recapitalize and sustain its existing fleet of aging platforms.

**RELATED OPTIONS:** 050-01, 050-03, and 050-05

## 050-05—Discretionary

# Cancel the Army's Comanche Helicopter Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,100 | 1,198 | 1,531 | 2,274 | 1,584 | 7,687 | 14,109 |
| Outlays | 589 | 1,040 | 1,140 | 1,426 | 1,752 | 5,946 | 12,736 |

Many of the Army's helicopters are beyond the end of their useful service life. In 1982, the Army had planned to replace some of those older scout, attack, and utility helicopters with more than 5,000 new Comanche (RAH-66) helicopters. However, the Comanche has had a troubled development program. The utility version of the helicopter was dropped in 1988 because the program had become too costly. In 1990, the size of the already-reduced planned purchase was cut from more than 2,000 aircraft to just under 1,300. Later, the Army delayed the projected start of production from 1996 to 2005. In 2002, the Army sought to extend the engineering and manufacturing development phase of the program by another two years. Subsequent restructuring of the program delayed the planned start of an initial operational capability by a year to 2009. It also eliminated the attack mission from the Comanche's primary requirements. As a consequence, the planned purchase has been halved to 650 aircraft, and reconnaissance remains the only primary mission.

Those changes have caused the average procurement cost per helicopter to more than double since the program began—from $11.5 million in 1985 to $25.1 million in 2002 (in 2003 dollars). With that cost growth, the Comanche is now more expensive than the Army's Apache (AH-64) attack helicopter, even though it was developed to be less costly to buy, operate, and maintain. Moreover, prior to the reduction to 650 aircraft, the General Accounting Office and the Department of Defense's Inspector General stated that costs could grow by as much as another 30 percent.

This option would cancel the Comanche program and instead buy 850 Predator B unmanned aerial vehicles (UAVs) for the Army's scout and reconnaissance missions, beginning in 2007. The additional 200 vehicles would provide reserves for attrition. If the Army configured its UAVs like the Air Force's, with the same distribution of ground control stations, sensors, and communications, the average cost per vehicle would be $7 million in 2003 dollars. If the Army selected a leaner configuration than the Air Force, relying more on line-of-sight communications or procuring fewer sensors, the unit cost would be less. To field the scouting capability rapidly, this option would buy the UAVs at the contractor's maximum rate of 100 per year, about 60 percent faster than the rate of production for the Comanche. At a procurement rate of 100 per year, more than 550 would be produced by 2013. Net savings would total $589 million in outlays in 2004 and almost $6 billion over the 2004-2008 period.

The primary advantage of the Comanche over existing rotary aircraft is its sophisticated stealth, avionics, and aeronautics technologies. In the interim, canceling it might require the Army to increase its reliance on older rotary airframes originally designed in the 1960s and 1970s. However, some analysts argue that the Comanche, which was conceived at the height of the Cold War, will no longer face threats of the same scale or sophistication as those for which it was designed. Whether it really does have a unique role to play in Army aviation is unclear. With or without Comanche, the Army is planning to use Apaches in both scouting and attack roles for the next 15 to 20 years, as it did successfully during the Persian Gulf War. The Army also used Kiowa Warriors in the Persian Gulf both as scouts for Apaches and as light attack aircraft. Many of the Kiowa Warriors have undergone substantial upgrades since then. Moreover, the Army has already used less capable UAVs than the Predator B for some scouting functions. In Kosovo and Afghanistan, U.S. forces used UAVs effectively as scouts, without the risk of losing aircrews. In addition, the evolution of capa-

bilities for the Predator B platform is expected to be very rapid, including the development of an attack system, which remains a secondary requirement for the Comanche. Finally, if the Comanche program were canceled, some of the savings could be used to fund a program to continue developing advanced helicopter technologies.

**RELATED OPTIONS:** 050-03 and 050-04

**RELATED CBO PUBLICATIONS:** *An Analysis of U.S. Army Helicopter Programs*, December 1995, and *Options for Enhancing the Department of Defense's Unmanned Aerial Vehicle Programs*, September 1998

## 050-06—Discretionary

# Reduce the Procurement of Virginia Class Submarines and Transfer Six More Subs to Guam

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Costs (-) or Savings | | | | | | | |
| Budget authority | -240 | -40 | 750 | 1,190 | 4,200 | 5,860 | 21,340 |
| Outlays | -130 | -250 | -60 | 240 | 720 | 520 | 12,380 |

In 1999, the Chairman of the Joint Chiefs of Staff released a study calling for a force of 55 to 68 attack submarines (SSNs), of which 18 should be the new Virginia class, by 2015. Subsequently, the Department of Defense decided that 55 submarines would be the goal, meeting both the minimum peacetime and wartime force levels identified in the study. To modernize its submarine force, the Navy plans to buy one Virginia class sub per year from 2003 to 2007 and two or three per year between 2008 and 2013. At the same time, it plans to retire early two Los Angeles class submarines in 2004 and 2005. Those subs would still have years of useful life remaining, however, if their nuclear reactors were refueled.

This option would refuel the reactors to keep those Los Angeles class submarines in service. Under the option, the Navy would procure 10 Virginia class submarines, 11 fewer than planned. In addition, the option would make permanent the Navy's plan to temporarily base three submarines in Guam and would also transfer six additional submarines there by 2012 to take advantage of being 3,300 nautical miles closer to their operating areas. Those changes would cost $240 million in budget authority in 2004 but would save about $5.9 billion in budget authority over five years.

To help bridge the gap between force levels and requirements, the Navy announced in 2001 that it would begin basing three attack submarines in Guam by early 2004. By moving those ships 3,300 nautical miles west of Pearl Harbor and employing an operating concept different from the one used for subs based in Hawaii or the continental United States, the Navy can get about three times the number of mission days from Guam-based SSNs as from other SSNs. However, the attack submarines being transferred to Guam will reach the end of their service life around 2015, and the Navy has not said whether they will then be replaced by other submarines. Basing nine attack submarines in Guam indefinitely, as this option describes, would require the construction of additional infrastructure on Guam to make the submarine facilities there equivalent to a submarine base. The Congressional Budget Office estimates the cost for that infrastructure to be around $200 million to $300 million.

This option would maintain a force of at least 55 SSNs through 2015, equivalent in the number of mission days they could perform to a force of 74 attack submarines (including 19 Virginia class) based only in the United States. Under the Navy's plan, the force would have 59 attack submarines by 2015, including 15 Virginia class, but would provide mission days equivalent to only 61 SSNs because two of the Guam-based submarines would have retired. (If the Navy replaced those two with new Virginia class subs, the force would provide mission days equivalent to 65 SSNs, including 19 Virginias.)

Proponents would argue that in addition to saving money, this option would be highly cost-effective. Attack submarines are expensive capital assets that perform a variety of missions, many of them covert. Although SSNs cost around $2.0 billion dollars apiece (in 2002 dollars), they spend an average of 36 days per year—or 10 percent of their service life—on-station performing missions. Like other Navy ships, SSNs spend the rest of their service life in training missions, port calls, transit, and maintenance. Consequently, the cost per additional mission day per year provided by building a new attack submarine is $2.7

million (in 2002 dollars). But the cost per additional mission day of transferring an SSN to Guam is only $0.2 million.

This option would have several disadvantages, however. First, with fewer submarines based in San Diego and Pearl Harbor, having SSNs to train with carrier battle groups and thus support them during their deployments may be more difficult. Attack submarines would also be less available to assist other Navy units, such as ones practicing antisubmarine warfare.

Second, because existing submarines are less capable than new Virginia class submarines, an attack submarine force with fewer Virginias might be somewhat less capable of prosecuting a war. However, that difference would probably matter only if the United States fought a sophisticated opponent with potent antisubmarine warfare capabilities.

Third, a potential difficulty with this option—as with the Navy's decision to base three submarines in Guam—is the quality of life for sailors and their families on that island. Guam does not offer the same homesteading opportunities as submarine bases in San Diego and Pearl Harbor do. At those large bases, it is relatively easy for members of a submarine crew to find other jobs in the Navy when they finish their sea tours. Thus, they and their families can put down roots and stay in one place longer than a few years. Such opportunities are few in Guam. In addition, the spouses of sailors have fewer opportunities to find jobs there. Still, if the Navy found that Guam-based duty led to much lower levels of retention for submariners, monetary bonuses might help. Even large annual incentives for each member of a submarine's crew would not significantly change this option's cost-effectiveness.

**RELATED CBO PUBLICATION:** *Increasing the Mission Capability of the Attack Submarine Force*, March 2002

## 050-07—Discretionary

# Cancel the DDX Program and Buy New Frigates Instead

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 870 | 1,270 | 3,060 | 2,580 | 2,900 | 10,680 | 19,670 |
| Outlays | 510 | 1,040 | 1,100 | 1,070 | 1,300 | 5,020 | 17,170 |

The Navy is developing a new generation of destroyer, the DDX, as well as a new surface combatant for inshore operations called the littoral combat ship (LCS). The destroyer, which is expected to carry about 130 missiles and one or two advanced gun systems, is being designed principally to attack targets on land, although it will be able to perform other missions. A small ship, the LCS is expected to counter either diesel-electric submarines; mines; or small fast attack craft in coastal regions—missions for which the Navy would prefer to not use a large ship like the new destroyer. Although the Navy has not formally announced how many of each type of ship it will purchase, some Department of Defense (DoD) officials have indicated that the service intends to buy 16 of the new destroyers and about 60 littoral combat ships. The total cost of purchasing 16 DDXs would be about $35 billion, the Congressional Budget Office (CBO) estimates. Buying up to 60 LCSs would add to those costs substantially.

This option would scrap the plans to build a new destroyer and littoral combat ship in favor of building a new frigate, a ship that would be considerably smaller than the DDX but larger and more capable than the LCS. Relative to the plans outlined in DoD's 2003 Future Years Defense Program, this option would save about $11 billion in budget authority between 2004 and 2008. Those savings do not include money from canceling the LCS, because that program was not included in the 2003 Future Years Defense Program, so the actual savings from this option would be substantially higher. (CBO did not include savings from research and development funding as a result of canceling the DDX because, according to the Navy, many of the new technologies being developed for that ship would eventually be used in other ship programs, including the future carrier, the Virginia class submarine, and the future cruiser. CBO assumed that the new frigate would incorporate them as well.)

Under this option, the Navy would initially purchase 17 multimission frigates through 2013 and eventually buy a total of 40. Over the long term, buying 40 frigates would completely offset the savings from not buying the 16 DDXs. If the Navy chose, it could use the savings from canceling the littoral combat ship to buy even more frigates.

The DDX is a ship that appears to be designed for major wars. With a reported displacement of 13,000 to 16,000 tons, it would be larger than any other surface combatant in the Navy. In addition to the missiles, its other major weapon system would be one or two 155-millimeter advanced guns to provide fire support to the Marine Corps up to 100 nautical miles away.

Supporters of this option would argue, however, that the most likely maritime challenges that the United States and its allies will face include terrorism, drug smuggling, violations of economic sanctions, illegal immigration, and arms trafficking. The DDX would be an exceptionally large and expensive ship to fulfill those missions.

Ironically, although a smaller warship would seem to make more sense to perform those missions, the littoral combat ship that Navy officials describe does not appear to be well suited for them. The LCS would be a single-mission ship with a modular combat system, which would be tailored to the mission that the ship was expected to take on. If it was being sent to counter mines, it would have a mine countermeasures payload. If it was being sent to counter diesel-electric submarines, it would have an antisubmarine warfare suite. However, countering mines might be better performed by ships dedicated

to the task, and countering submarines might be better done with submarines, as the Navy has thought since the Cold War. Similarly, the LCS does not seem particularly well suited to counter small, fast attack boats. Although the most effective weapon against such boats has been the helicopter, the LCS would at most be able to carry, operate, and sustain one medium-sized helicopter (rather than the two that today's frigates and destroyers can accommodate), nor would the LCS be fast enough in its own right to hunt down high-speed enemy boats. That deficiency might prove to be especially important since such boats are the most likely weapons for terrorists to use to attack U.S. Navy ships.

A new frigate would cost about twice as much as a littoral combat ship, CBO estimates. But in return for that money, the ship would be capable of performing multiple missions at the same time—including countering mines, submarines, and small boats—and would have a robust capability to defend itself.

Canceling the DDX program would have a number of disadvantages, however. First, the program is perhaps the most innovative in the Navy. The destroyer is intended to have a completely new design; to use a new, efficient power system; and to operate with a relatively small crew. Other development programs in the Navy are expected to benefit from the research and innovation being pursued in the DDX program. Restructuring that program could disrupt and slow the process of innovation in ship design for the Navy for several years, although many of the technologies being developed for the DDX could be used effectively in the new frigate.

Second, fire support for the Marine Corps would suffer in the absence of the DDX destroyer. The largest gun in the Navy today has a caliber of five inches. The 155 mm gun on the DDX (slightly larger than a six-inch gun) would provide better fire support for amphibious landings and Marine operations ashore. The 155-millimeter guns would have a much longer range and be three times as powerful as the current five-inch guns. However, it has been more than 10 years since a Navy ship carried a larger gun. During the Gulf War, the war against Serbia, and the operation to overthrow the Taliban in Afghanistan, as well as in numerous smaller military operations, any need for a larger naval gun was not plain. Furthermore, improvements in missile technology as well as the larger payloads that new Navy and Marine strike aircraft, such as the Joint Strike Fighter, will carry could make a larger gun unnecessary.

**RELATED CBO PUBLICATION:** *Transforming the Surface Combatant Force*, forthcoming

## 050-08—Discretionary

# Eliminate Research and Development Funding for the Second Future Carrier

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 10 | 11 | 12 | 17 | 7 | 57 | 995 |
| Outlays | 6 | 10 | 11 | 15 | 11 | 53 | 880 |

First designed in the 1950s and 1960s, the Nimitz class aircraft carrier lies at the center of the U.S. Navy. The Navy has bought 10 of the ships, each one being technologically a little better than its predecessor. Now, however, the Navy argues that the Nimitz's design, its propulsion system, and its power systems have nearly reached the limits of their usefulness for the future. Under the 2003 Future Years Defense Program (FYDP), the Navy planned to make a series of evolutionary upgrades to the Nimitz design so that, after three or four more ships, essentially a new class of carrier would exist. Under the 2004 FYDP, however, the Navy plans to incorporate all of the elements of the new design into the first new carrier (the CVN-21), to be authorized in 2007. The Navy's intent behind that change is to accelerate the arrival of new capabilities in the carrier fleet, although it will also make that first new ship much more expensive.

Under the previous plan, the development of a new class of aircraft carrier began with the CVN-77, ordered in 2001, with some relatively minor improvements and reductions in crew size. That ship is still considered part of the Nimitz class. The first of the new carriers, to be ordered in 2007, was designated as the CVNX-1 to indicate that it was the start of a new class of aircraft carrier and represented the most dramatic change from the Nimitz. The CVNX-1 would have received a new, more efficient, less manpower-intensive nuclear reactor; a new electrical power grid; and an electromagnetic catapult for launching aircraft. The Navy had hoped that those changes would dramatically increase the power available on the ship; free up weight that could be available for other things; and, especially, lead to a smaller crew and a reduction in the total ownership cost of the ship class. The CVNX-2, the carrier that the Navy had hoped to order in 2011, would then have had additional improvements, such as further reductions in crew size as well as improvements to the flight deck and hull in order to increase the number of sorties flown off the carrier in a 24-hour period.

Rather than pursue all of those new technologies for the CVN-21, this option would eliminate the research and development funding that was designated for the CVNX-2 and thereby force the Navy to build a second CVNX-1. Doing so would save almost $900 million in outlays between 2004 and 2013, although most of those savings would come in the latter half of the period.

The Navy argues that it needs a new class of aircraft carrier because the reactor for the Nimitz class does not generate much excess power, making it difficult to incorporate new weapons or combat systems. Thus, pursuing the CVNX-1, which this option does, would solve that problem and improve reliability, survivability, and maintainability. But building a CVNX-1 (or CVN-21) would not clearly yield a substantial advance in capabilities over a second CVNX-1. Navy carriers today are already far more capable in terms of the number of strike sorties they can launch and the number of targets they can hit in a 24-hour period than they were 10 years ago. Furthermore, although additional savings from more reductions in crew size might be possible, they would not be realized for many decades.

**RELATED CBO PUBLICATION:** *Improving the Efficiency of Forward Presence by Aircraft Carriers*, August 1996

## 050-09—Discretionary

# Cancel Production of the V-22 Aircraft

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,451 | 1,870 | 1,791 | 1,722 | 801 | 7,636 | 9,716 |
| Outlays | 388 | 980 | 1,501 | 1,723 | 1,551 | 6,142 | 8,889 |

The V-22 aircraft, which entered production in 1997, is designed to help the Marine Corps perform its amphibious assault mission (seizing a beachhead in hostile territory) and its subsequent operations ashore. The Marine Corps plans to buy a total of 360 of the planes. (The Air Force may eventually buy 50 V-22s for its special-operations forces, and the Navy plans to buy 48 V-22s for combat search-and-rescue missions and for logistics support of its fleet.) The V-22 can transport more than 20 Marines or about 10,000 pounds of their equipment from ship to shore. The plane's tilt-rotor technology enables it to take off and land vertically as a helicopter does and, by tilting its rotor assemblies into a horizontal position, to become a propeller-driven airplane when in forward flight. As a result, the V-22 can fly faster than conventional helicopters. The Marine Corps argues that the plane's increased speed and other design features make it less vulnerable than other aircraft when flying over enemy terrain and enable it to provide over-the-horizon amphibious assault capability—which minimizes the exposure of amphibious ships to coastal fire and increases tactical surprise by obscuring the destination of the attack. In addition, the V-22 is designed to fly longer distances without refueling than conventional helicopters do. Thus, it can fly directly to distant theaters, whereas many helicopters must be transported there on planes or ships.

Despite those advantages, critics of the V-22 have questioned whether the new aircraft will demonstrate enough improved capabilities to justify its higher cost. Each V-22 is expected to cost about $72 million (in 2003 dollars), or significantly more than the Marine Corps's conventional helicopters. A November 2000 report by the Director of Operational Testing and Evaluation in the Office of the Secretary of Defense (OSD) expressed concern about whether the V-22 would actually be able to take off and land quickly enough to have a higher survival rate than that of current helicopters. That report also raised concern about the V-22's low rate of availability (which results when planes break down frequently or take a long time to fix). According to the report, the V-22s that were tested were ready to perform their missions (that is, were mission capable) only 36 percent to 57 percent of the time, in contrast to the Marine Corps's desired rate of 82 percent. By comparison, the Army's Blackhawk had a mission-capable rate of about 80 percent, on average, in the past, and even the aging CH-46 helicopter, which the V-22 is intended to replace, had a rate of 79 percent. The Marine Corps argues that many of the problems leading to the low availability cited in that study have been solved. Nonetheless, if availability proved low, the V-22's cost-effectiveness would be significantly reduced. Despite the concerns raised in the report, the study endorsed continued flight-testing for the V-22, although it recommended that testing be completed before the V-22 was deployed.

The greatest concerns about the V-22 program relate to the plane's safety. Of the 17 V-22s that were bought for developmental flight-testing or allocated to operational flight-testing, three (or 18 percent) have been lost. A fourth V-22 was lost on a routine training flight, not as part of flight-testing. (A tilt-rotor predecessor of the plane also crashed.) The percentage of V-22s lost during testing is much lower than the 50 percent loss rate experienced by the Marine Corps's CH-53 helicopter during its testing and almost equal to the 17 percent loss rate during testing of the Blackhawk and the Army's early-model Apache attack helicopter. However, none of the prototypes of the S-92 (a commercial transport helicopter developed by the Sikorsky Aircraft Corporation) or the SH-60 (a seagoing variant of the Blackhawk) have crashed.

If the Department of Defense (DoD) canceled the program altogether, DoD might instead buy conventional helicopters for the Marine Corps. Several helicopters have been proposed as alternatives to the V-22:

- The CH-53E, which the Marines already use for heavy amphibious lift missions;
- The CH-60, a variant of the Army's Blackhawk helicopter, which the Navy chose instead of the V-22 to replace the aging CH-46s that it uses in transport missions; or
- A military version of the medium-lift S-92, which has a capacity to carry troops and equipment between that of the CH-60 and the CH-53E.

This option assumes that DoD would buy a total of 360 S-92s for the Marine Corps and 48 S-92s for the Navy in place of an equal number of V-22s. (Only 215 of those S-92s would be purchased through 2013, however—163 fewer than the number of V-22s that would have been bought by then under DoD's 2003 plan. The slower acquisition occurs because modifying the S-92 for maritime missions and testing the plane are assumed to take several years.) The S-92 can transport roughly the same number of troops and carry about the same amount of weight externally as the V-22 can. Purchasing S-92s for the Navy's search-and-rescue mission would provide commonality with the Marine Corps's aircraft and could also provide commonality with the Air Force's since the S-92 is a candidate to perform that service's search-and-rescue mission as well. (OSD may also be considering purchasing an improved version of the UH-1, a utility helicopter already in the Marine Corps's helicopter fleet. That plane might be used to augment the capabilities of the V-22 if replacing all of the CH-46s became too expensive. Or OSD might substitute a combination of CH-53Es and UH-1s for the V-22s if the latter continued to experience safety problems.)

Some analyses of alternatives to the V-22 have suggested that more than one helicopter would need to be purchased to replace the lift capability lost from cutting the number of V-22s that DoD had planned to buy. Consequently, under this option, DoD would buy additional helicopters, specifically 80 CH-53s from 2008 through 2013. The Marine Corps would buy CH-53s that incorporated a number of improvements over the CH-53Es in the fleet today. Buying just 10 of the improved CH-53s would add the capacity to transport another 360,000 pounds of equipment or 550 troops. Together with the S-92s, those CH-53s would provide almost as much capability as the planned fleet of V-22s. The option would save nearly $400 million in 2004 and $6.1 billion over five years, the Congressional Budget Office estimates.

Opponents of the V-22 cancellation might point out that conventional helicopters cannot perform amphibious operations as quickly or as safely as the V-22 can. Because the aircraft can fly faster and carry more equipment (or carry it longer distances) than helicopters can, Marine forces with V-22s could build up combat power ashore —especially from long distances—more quickly than forces with helicopters could. As a result, amphibious assaults relying on V-22s could prove less risky. Similarly, slower helicopters could present a target for ground-to-air missiles over longer periods, and some types, including perhaps the S-92s, might have areas vulnerable to small-arms fire that were larger than those of the V-22s.

In addition, unlike the V-22s, the helicopters purchased under this option might not be able to self-deploy (fly from their base directly to a theater of operations rather than be partially disassembled and carried on transport aircraft). They also lack other improvements the Marine Corps hopes to gain with the V-22s, including systems that give pilots better information about potential threats.

This option also assumes that no V-22s are bought for the Air Force, since that service probably would not pursue the V-22 program alone. (Indeed, procurement of V-22s for the Air Force has been delayed while awaiting the outcome of the current test program.) Although the option assumes that the Navy would substitute S-92s for the V-22s it intended to buy, the option does not include a replacement for those Air Force planes. The savings from this option would be lower if such replacements were procured.

## 050-10—Discretionary

# Reduce Purchases of the Air Force's F/A-22 Fighter

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 8 | 1,044 | 3,190 | 3,974 | 8,217 | 18,724 |
| Outlays | 0 | 2 | 264 | 1,275 | 2,673 | 4,214 | 18,355 |

The F/A-22, under development as the Air Force's next premier fighter aircraft, is scheduled to begin replacing the older F-15 fighter soon. But the program has experienced repeated delays and increases in cost during the more than 20 years that the Department of Defense (DoD) has discussed a replacement for the F-15. This option would decrease the planned purchase of F/A-22s by 156 planes, thereby saving a total of $8.2 billion in budget authority through 2008.

The Air Force originally planned to buy more than 800 F/A-22s. After a series of cuts, the 2003 plan would have bought only 295 aircraft—almost enough for three air wings. Press reports indicate that the Administration will buy fewer planes—perhaps 276 through the end of the program. If the Air Force cuts its purchases to that number, it will have to pay $146 million apiece for the F/A-22, the Congressional Budget Office estimates. Although the F/A-22 has a number of improvements in capability over other fighters, its cost makes it the most expensive fighter ever built.

The F/A-22 is the only new tactical fighter program to survive from the Cold War period. (The other two fighters that DoD is planning—the joint service F-35 and the Navy's F/A- 18E/F—entered development after 1990. They are likely to be both less capable and less expensive than the F/A-22, although they may face many of the same threats.) The F/A-22's sophistication and cost, plus concerns about whether it will actually realize promised improvements in capability, have led some analysts to suggest that the F/A-22 is a legacy of the Cold War—a plane designed to fight many sophisticated Soviet fighters rather than the modest regional fighter forces that it is more likely to encounter today. Such critics recommend canceling the program, or at least cutting planned procurement further.

In its report on its fiscal year 2000 defense appropriation bill, the defense subcommittee of the House Committee on Appropriations expressed concerns about the plane's cost and capability. The Senate concurred and the Congress directed DoD to complete testing of the F/A-22 before spending funds on production. The Air Force indicates that it has successfully completed all of the testing ordered by the Congress, and it seems likely to move the program into the next phase of production.

Some proponents of this option might argue that the Air Force could reduce production quantities to a total of 120 F/A-22s, enough to let the service field one air wing of the sophisticated fighters. Such a "silver-bullet" purchase would allow the Air Force to learn lessons about producing aircraft of the F/A-22's technological complexity but might still leave enough planes to perform the missions for which the service needs the F/A-22's degree of stealth and other performance advantages.

One possible disadvantage of this option is that it would make the Air Force's fighter fleet, which is already aging under current plans, even older. However, buying F-15s to make up for the cut in F/A-22s would remedy that problem (although it would reduce the savings from this option). The F-15 is much less capable than the F/A-22, but it is far more capable than the fighters of almost any of the United States' regional adversaries.

**RELATED OPTION:** 050-11

**RELATED CBO PUBLICATION:** *A Look at Tomorrow's Tactical Air Forces*, January 1997

## 050-11—Discretionary

# Slow the Schedule of the F-35 Joint Strike Fighter Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 134 | 1,759 | 2,328 | 2,552 | 6,773 | 18,420 |
| Outlays | 0 | 29 | 388 | 1,080 | 1,531 | 3,028 | 17,006 |

The F-35 Joint Strike Fighter program is one of the military's most ambitious aircraft development programs. A team of several manufacturers led by the Lockheed Martin Aeronautics Company was awarded a contract in 2002 to develop three versions of the aircraft: an inexpensive multirole fighter for the Air Force; a longer-range, stealthy ground-attack plane for the Navy; and a short-takeoff/vertical-landing fighter for the Marine Corps. Together, those planes account for two-thirds of the fighter aircraft that the military expects to buy through 2020 and roughly two-thirds of the spending on new tactical fighters, the Congressional Budget Office estimates. Their procurement costs are expected to total $147 billion in budget authority (in 2003 dollars) through the end of the F-35 program, according to the Administration's estimates.

This option would defer purchase of the first F-35s until 2008—two years later than the Department of Defense (DoD) now plans. A slowdown in development and production would give the program more time to clear development hurdles and would decrease outlays by $3 billion over the next five years. The slowdown would save $17 billion through 2013 because DoD would purchase 412 fewer planes through that year.

The F-35's development could prove very challenging. Variants of the aircraft are intended to perform significantly different missions, although the planes themselves are expected to have much in common. F-35s are also supposed to be more capable than the aircraft they replace but only slightly more expensive, if at all. Addressing those seemingly inconsistent goals at the same time could take longer than the program manager and contractors now envision.

In addition, the program's schedule is tight compared with that of the only other full-fledged development program for a fighter in recent years, the Air Force's F/A-22 air-superiority aircraft. The F-35 became a major defense acquisition program in May 1996; the first formal review took place in 2001, when the program entered the systems development and demonstration phase. The F-35 is scheduled to enter production in 2006, just five years after significant development began and 10 years after the beginning of the program. The F/A-22 program, by contrast, has already been running for about 15 years and may take more time before it jumps its last developmental hurdles. Although the schedule for the F-35 is about 80 percent longer than that for another fighter, the Navy's F/A-18E/F, that program needed only to modify an existing aircraft.

The F-35 program has already experienced delays. The demonstration phase and selection of a contractor team took about a year longer than the program had originally projected. Even longer delays might be associated with the next stage of development since it is much more challenging than the demonstration phase.

Slowing the schedule of the F-35 program would mean that DoD would have to adapt its future plans for tactical fighter fleets. For example, if DoD had to wait longer for F-35s, it might keep the production lines of current-generation aircraft open longer than it now plans. Also, anticipating delays in the F-35 program might result in DoD's modifying current aircraft to make them last longer.

Opponents of slowing the schedule for F-35s could cite a number of concerns. Any up-front savings from length-

ening the program, they might argue, would be offset by higher total costs. In addition, delays would make DoD's fighters (on average already much older than in the past) grow even older before they were replaced. As a result, DoD could have to pay modification costs that it would otherwise avoid and would have fewer fighters available as they underwent age-related repairs.

Conversely, pursuing development at a more measured pace might result in savings. A delay might permit DoD to avoid producing aircraft before the design was complete and to avoid costly retrofits. It also might allow DoD and the services to develop production schedules that were more realistic. Costs can be much higher if contractors build facilities with production capacity in excess of what is needed for the maximum production rate—a risk that can exist with aggressive production schedules.

**RELATED OPTIONS:** 050-10 and 050-12

**RELATED CBO PUBLICATIONS:** *A Look at Tomorrow's Tactical Air Forces*, January 1997, and *The Effects of Aging on the Costs of Operating and Maintaining Military Equipment*, August 2001

## 050-12—Discretionary

# Substitute Unmanned Combat Air Vehicles for Manned Aircraft

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 0 | 0 | 0 | 14 | 14 | 3,587 |
| Outlays | 0 | 0 | 0 | 0 | 4 | 4 | 2,481 |

Unmanned aircraft have performed surveillance and reconnaissance missions during U.S. military operations in Afghanistan. For instance, unmanned Predators, armed with Hellfire missiles, have directed manned fighters to enemy targets and even attacked Taliban targets themselves. The Department of Defense (DoD) has several programs that are slated to develop unmanned combat air vehicles (UCAVs)—armed unmanned aircraft—from scratch. A prototype of the Air Force's UCAV, the X-45, flew earlier this year. Production versions of that aircraft are supposed to become operational around the end of this decade.

This option would cut a manned F-35 (formerly known as the Joint Strike Fighter) for every 1.1 UCAVs deployed, to reflect the ratio of the currently projected payloads of the two aircraft. That substitution would leave the Air Force's total capacity to deliver munitions unchanged. The Air Force is currently scheduled to increase annual production of F-35s from six planes in 2006 to 110 by 2012. For this option, the Congressional Budget Office (CBO) assumed that purchases would be slowed and that peak production of F-35s would equal only 72 planes per year. Thus, this option would replace 114 F-35s with 126 UCAVs over the 2004-2013 period, saving $2.5 billion in outlays through 2013 (although almost no savings would appear during the next five years).

Last year, DoD submitted detailed plans for UCAVs only through 2007, the end point of the 2003 Future Years Defense Program, although the services or program offices that oversee such weapons development possessed tentative schedules beyond that period. Under those plans, the first six procurement-funded UCAVs for the Air Force would be bought in 2006, with eight more to follow in 2007. For the purposes of this option, CBO assumed that 20 UCAVs would be purchased per year beginning in 2008 and continuing beyond 2013 and that DoD would meet its expressed cost goals for UCAVs.[1]

In addition to replacing Air Force F-35s with UCAVs, Navy and Marine Corps F-35s could also be cut to offset purchases of the Navy's UCAV. CBO has not estimated the savings of such an option because the Navy's unmanned aircraft (designated the X-47) is not as far along as the X-45. It will probably not be procured until the early 2010s or later—and thus falls outside the budgetary window of this option. The X-47 will face the additional challenge of operating from aircraft carriers; the Navy may also expect it to perform patrol missions that could require it to have longer ranges or more loiter time than the Air Force version.

UCAVs may have several advantages over manned aircraft. First, they can perform dangerous missions without risking the lives of their pilots. Second, UCAVs are expected to cost less to acquire and operate than their manned counterparts. The X-45 is supposed to cost less than half as much as the Air Force's version of the F-35. Its operating costs might represent an even greater percentage reduction if the UCAVs are kept in storage when they are not needed, which is the current operational concept. (CBO did not estimate operating savings for this option.) Third, improvements in technology to detect,

1. The Office of the Secretary of Defense seems likely to propose changes in the structure of DoD's UCAV programs. If, as press reports indicate may happen, DoD combines the UCAV programs of several of the services into one joint effort (as it did in the restructuring that brought about the F-35 program), both production quantities and development and procurement costs would change, as would the savings and costs of this option.

recognize, and attack targets may have lessened the benefits brought by having a pilot in the cockpit. Indeed, fighter aircraft must fly at such speeds and heights that they depend on the same target information that will be supplied to UCAVs. (However, even the most autonomous UCAVs being designed today will not decide whether to bomb targets but will have human operators who make that decision.) Fourth, UCAVs might be able to loiter in the vicinity of a suspected enemy target until more data about the site becomes available, potentially reducing collateral damage.

UCAVs may also have some disadvantages. Predators operating in Afghanistan did eliminate some of their targets, according to press reports, but those reports also suggest that the unmanned aircraft experienced some failures. Moreover, the success of the more sophisticated UCAV depends on technological advances that are far from certain. One such technology—automatic target recognition—will determine whether the UCAV can find the targets that it is supposed to attack. However, automatic recognition is an objective that has proved elusive. Unmanned aircraft have also experienced more mishaps than expected. If more UCAVs had to be bought to offset higher attrition, the savings from this option would be lower. They would also be lower if UCAVs grew significantly in cost—which could be a greater concern for UCAVs than for manned attack aircraft since the former may incorporate more unproven technologies.

**RELATED OPTION:** 050-11

**RELATED CBO PUBLICATION:** *A Look at Tomorrow's Tactical Air Forces*, January 1997

## 050-13—Discretionary

# Accelerate Replacement of the C-5s' Engines

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Costs (-) or Savings | | | | | | | |
| Budget authority | -556 | 3,376 | 3,176 | 1,211 | -1,070 | 6,137 | 5,709 |
| Outlays | -188 | 635 | 2,332 | 2,446 | 1,106 | 6,332 | 4,802 |

The Department of Defense (DoD) relies on its fleets of C-5 Galaxy and C-17 aircraft for the majority of its strategic airlift (long-range transport) capability. For example, those planes have carried approximately 80 percent of DoD's air cargo during the conflict in Afghanistan. To help remedy a perceived shortfall in airlift capacity, the department recently ordered an extra 60 C-17 aircraft beyond the previous goal of 120. Additionally, the Air Force intends to modernize the C-5 fleet through the Reliability Enhancement and Re-enginning Program (RERP), a key component of which is the replacement of chronically faulty engines with a commercial variant. According to an Air Force study, the RERP could improve the reliability rate of that fleet by as much as 20 percentage points—in effect, increasing the number of C-5s available for missions by up to 20 aircraft.

This option would accelerate the replacement of the C-5s' engines with new, more reliable ones, helping to increase strategic airlift capacity while providing savings by delaying or reducing purchases of C-17s. Depending on how the strategic airlift force was ultimately structured, this option could reduce the need for C-17s by 20 to 40 aircraft, which would translate into savings of $6.3 billion in outlays over the next five years.

DoD has placed a higher priority on purchasing additional C-17s than on modernizing the C-5s. Current plans call for purchasing the additional C-17s by 2007, while full-rate modernization of the C-5s would not begin until 2009 and then proceed at a rate of 12 aircraft per year through 2016. This option would shift the emphasis to the C-5s by speeding up the modernization program, which could be completed in 2012—eight years ahead of the current schedule. Full-scale replacement of the C-5s' engines would begin in 2006, at a rate of 24 per year, double the currently planned pace.

The savings possible under this option depend on the structure that the strategic airlift force takes over the coming decades. In the near term, modernized C-5s and an additional 22 C-17s could provide about the same airlift capacity as the planned addition of 60 C-17s, yielding a savings of 38 C-17s. From a longer-term perspective, those C-5s plus 39 additional C-17s would meet DoD's recently established requirement for the ability to airlift an average of 54.5 million ton-miles of cargo per day and provide a savings of 21 C-17s, although the budgetary savings would be smaller than those shown above.

Proponents of this option would argue that maintaining a diversified fleet of different types of airlift aircraft is preferable to relying disproportionately on a single type: if one suffers from unforeseen design or maintenance problems, the availability of an alternative ensures that airlift operations can continue. Modernizing the C-5s helps maintain that balance with the C-17s. Proponents also would argue that the entire airlift fleet would benefit from the C-5s' improved reliability because the effects of their breaking down at unexpected points in the airlift cycle could ripple through the airlift system, adversely affecting the general flow of air traffic. Additionally, some analysts predict that the cost of the C-5 modernization program will be more than recouped by reduced operation and support costs.

Opponents would argue that an emphasis on modernizing C-5s is a risky proposition, with possibly hidden costs. As of yet, no C-5 aircraft have been modified with new engines, so the modernization costs are still uncertain, and the predicted increase in reliability remains unproved. Additionally, some opponents would warn that unforeseen structural problems, especially for older A-model aircraft, might render the service life of the C-5s too short to be worth the expense of modernization. In

contrast to those risks, opponents would cite the current record of C-17s, with their 85 percent mission-capable rate, as proof of their value. Furthermore, opponents would argue, an accelerated program to modernize the C-5s could be more costly than currently thought if depot facilities needed to be expanded to meet a higher modernization rate. Similarly, that faster pace might require a greater number of aircraft in depots at any given time, temporarily reducing the number available for airlift operations.

Finally, critics of this option would argue that the trade-off between the C-5 and C-17 aircraft is not simply about cargo capacity. The C-17 has capabilities that the C-5 lacks. For example, the C-17 can land and take off on short, austere runways, and it has defensive countermeasures that allow it to operate in hostile situations. However, supporters of this option would counter, an airlift fleet that includes more than 100 C-17s should be sufficient for the relatively unusual occasions when such capabilities are needed.

**RELATED CBO PUBLICATION:** *Moving U.S. Forces: Options for Strategic Mobility*, February 1997

## 050-14—Discretionary

# Reduce Nuclear Delivery Platforms to Achieve the Moscow Treaty's Limits on Operational Nuclear Warheads

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 100 | 360 | 820 | 830 | 470 | 2,580 | 5,500 |
| Outlays | 50 | 270 | 640 | 850 | 630 | 2,440 | 5,070 |

For most of the past 40 years, the Department of Defense (DoD) has maintained a triad of strategic offensive nuclear forces consisting of missiles, submarines, and bombers. Those forces have been subject to the Strategic Arms Reduction Treaty (START) since it took effect in December 1994. That treaty limits the United States and the countries of the former Soviet Union (Russia, Belarus, Kazakhstan, and Ukraine) to 6,000 warheads at the end of a seven-year reduction period that ended in December 2001. The United States' strategic nuclear force currently consists of 1,200 nuclear warheads on 500 Minuteman III missiles, 500 warheads on 50 Peacekeeper missiles, 3,200 warheads on C4 and D5 missiles carried on 18 Trident submarines, and roughly 1,000 warheads (nuclear bombs and cruise missiles) deployed on nearly 200 strategic bombers, for a total of 5,900 warheads.

At the Moscow Summit on May 24, 2002, Presidents Bush and Putin signed the Treaty Between the United States of America and the Russian Federation on Strategic Offensive Reductions (informally known as the Moscow Treaty). Under that treaty, the United States and Russia would reduce their number of operational strategic nuclear warheads to between 1,700 and 2,200, about one-third of the current levels, by 2012. The treaty does not require the actual destruction of a single warhead; nor does it require retirement of delivery platforms—the missiles, submarines, and bombers that carry nuclear warheads. Rather, each country may achieve the reductions mandated in the treaty by storing nuclear weapons in a manner that makes them unavailable for immediate operational use. The Moscow Treaty was submitted to the U.S. Senate for ratification on June 20, 2002, but the Senate has not acted on it.

Before signing the treaty, the Administration had announced its intent to eventually reduce the number of operational nuclear warheads that the United States maintains to levels essentially identical to those later specified in the Treaty. That intent was announced at the conclusion of the Nuclear Posture Review (NPR) in January 2002. That review concluded that strategic forces equipped with between 1,700 and 2,200 operational nuclear warheads would be sufficient to maintain the security of the United States and set an interim goal of reducing the number of operational warheads to 3,800 by 2007. The Administration's 2003-2007 defense plan submitted in early 2002 partially anticipated the results of the NPR. That plan would reduce U.S. nuclear forces by retiring all 50 Peacekeeper missiles, converting four of the oldest Trident submarines to a conventional (nonnuclear) role, and permanently converting all 81 B-1 bombers to a conventional role. The nuclear warheads previously carried on those forces would be stored, resulting in a reduction to about 4,800 operational warheads by 2007.

This option would lower the United States' operational nuclear arsenal by another 1,000 warheads by 2007 to fully attain the NPR's interim goal. Also, the option would remove and store a total of 2,600 nuclear warheads by 2012 to achieve the Moscow Treaty's goal of having no more than 2,200 operational warheads. If those reductions were achieved without retiring any of the missiles, submarines, and bombers that carry the warheads, no budgetary savings would result. In addition to removing nuclear warheads from operational use and storing them, this option would retire 200 Minuteman missiles and two Trident submarines, although those steps would not be required by the treaty.

Compared with the Administration's 2003-2007 plan, this option would save about $100 million in budget authority in 2004, $2.6 billion over the 2004-2008 period, and $5.5 billion through 2013. Overall, the 10-year savings would come from canceling upgrades to the Minuteman missiles and Trident submarines that would be retired under this option (saving $3.2 billion) and from reduced operations costs (saving $2.9 billion). Those savings would be partially offset by the nearly $0.6 billion in costs to retire the delivery platforms and remove the warheads. The Congressional Budget Office's (CBO's) estimates do not include any costs to build additional facilities to store the warheads removed from operational use because, according to DoD, available storage capacity would be sufficient to accommodate all of those warheads.

CBO assumes that, under this option, 550 nuclear warheads would be removed by retiring a wing of 150 single-warhead Minuteman missiles by 2007 and converting 200 Minuteman missiles that currently carry three warheads to a single-warhead configuration. The costs to retire the missiles and remove the 550 warheads would total about $250 million over the 2004-2013 period. However, those costs would be more than offset by the $3.1 billion in savings over 10 years—$1 billion from canceling planned upgrades and $2.1 billion from reduced operations costs. Also, under this option, about 1,200 nuclear warheads would be removed by retiring two Trident submarines by 2007 and deploying fewer warheads on each of the remaining submarines. CBO estimates that the costs to retire the submarines and remove and store the associated nuclear warheads would total another $250 million over the 2004-2013 period. However, those costs would be more than offset by the $3 billion in savings over 10 years—$2.2 billion from not buying the missiles ($1.4 billion) and not overhauling the submarines ($0.8 billion); and $0.8 billion from reduced operations costs. Finally, under this option, 892 nuclear bombs and cruise missiles carrying nuclear warheads would be removed from service by converting the B-2 bombers to a conventional role and deploying fewer cruise missiles on the B-52 bombers. CBO estimates that the costs to remove those nuclear weapons would amount to about $50 million through 2013.

Proponents of this option might argue that with the reduced threat from a major nuclear power, the United States might now decide that it could safely deploy fewer nuclear warheads on fewer weapon systems. Moreover, despite the reductions in delivery platforms, this option would still retain three types of nuclear systems—the nuclear triad of missiles, submarines, and bombers—and thus provide a margin of security in case an adversary developed a new technology that would render a leg of the triad more vulnerable to attack. In addition, some supporters of this option might argue that current U.S. force requirements are driven by an outdated and unnecessarily large target list. Deterrence, they believe, would still be robust with a much smaller arsenal of warheads and fewer delivery platforms.

Critics of the option might argue that the Administration's plans, which to date have involved limited reductions in the number of nuclear delivery platforms, are a prudent hedge against the emergence of unforeseen threats. Moreover, the submarines that this option would retire could be converted for conventional use. Thus, retiring those submarines might eliminate capabilities to conduct conventional warfare that could prove useful in the future.

**RELATED OPTION:** 050-15

**RELATED CBO PUBLICATION:** *Letter to the Honorable Joseph R. Biden Jr. regarding estimated costs and savings from implementing the Moscow Treaty*, September 24, 2002

## 050-15—Discretionary

# Reduce the Trident Submarine Force to 12 and Buy 48 Fewer D5 Missiles

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 110 | 170 | 330 | 220 | 200 | 1,030 | 2,840 |
| Outlays | 60 | 160 | 270 | 270 | 180 | 940 | 2,440 |

Until recently, the Navy deployed a fleet of 18 Trident submarines. Eight of those submarines were based in Bangor, Washington, and the other 10 were stationed in Kings Bay, Georgia. All of the submarines at Kings Bay and two of the submarines at Bangor deployed 24 newer, more-capable D5 missiles that, under the Strategic Arms Reduction Treaty, each carried eight nuclear warheads. The six remaining submarines stationed at Bangor deployed 24 older C4 missiles that carried six nuclear warheads apiece. In all, about 3,200 warheads were deployed on those 18 submarines.

The Navy has begun converting four of the Trident submarines that carried C4 missiles to a conventional (nonnuclear) role. Two of the conversions began in 2003, and the remaining two will start in 2004. The C4 missiles that will be removed from the submarines will be transported to a Department of Defense (DoD) facility for disposal. The warheads removed from those missiles will either be reloaded onto the newer D5 missiles or stored at a DoD facility. The Navy's plan to pursue those conversions was announced in January 2002 after the Nuclear Posture Review (NPR), which concluded that a force of 14 Trident submarines would be sufficient. Under that plan, each of the remaining 14 Trident submarines will be equipped to carry 24 D5 missiles by 2007. According to the Navy, an average of two submarines a year will undergo a major overhaul, during which they will not carry any missiles. The 12 other operationally deployed submarines will carry a total of 288 D5 missiles and about 2,300 warheads (about 192 warheads on each submarine).

The Administration plans on buying a total of 540 D5 missiles—288 for the Trident submarines, 86 that have already been purchased for flight tests (through 2002), and 166 for future flight tests and spares. By the end of 2002, the Navy had purchased 396 missiles; it plans to buy the remaining 144 missiles over the 2003-2013 period. In all, the Congressional Budget Office assumes that the 12 operationally deployed submarines would carry 1,152 warheads, or about 96 warheads on each submarine.

This option would retire two Trident submarines carrying the older C4 missiles when they would otherwise be upgraded to carry the newer D5 missiles (one in 2005 and another one the following year). The option would also cancel the planned purchase of 48 D5 missiles because fewer missiles would be needed to support a 12-submarine force. To keep a similar number of warheads overall, the smaller Trident force would carry 111 warheads on each submarine instead of 96. Compared with the Administration's plan, this option would save about $1 billion in budget authority over the 2004-2008 period and $2.8 billion over 10 years. Specifically, by retiring the two submarines early, the Navy would save about $0.6 billion from reduced operations during the 2004-2013 period, net of the costs to retire the submarines. In addition, retiring the submarines by 2007 would save $2.2 billion in planned upgrades and purchases over that 10-year period. (That figure results because not overhauling the two submarines to accommodate the newer D5 missiles would save about $0.8 billion and not buying the D5 missiles that would be deployed on the overhauled submarines would save about $1.4 billion.)

Purchasing 48 fewer D5s would have several drawbacks, however. The Navy recently extended the service life of Trident submarines from the original 30 years to 44 years. That extension created a mismatch between the life span of the submarines and the life span of their missiles, so the Administration has begun to extend the service life of D5 missiles. That program involves redesigning the

guidance sets and retrofitting every missile with them, requiring additional flight tests to judge the guidance sets' performance. Those flight tests are scheduled to take place over the 2008-2013 period. If production of D5 missiles had ceased by then (as it would under this option) and those flight tests ended up requiring more D5s, reopening production lines could be costly.

Opponents of this option might also argue that loading more warheads on existing missiles would reduce their range and lessen the flexibility of the force, since missiles with fewer warheads can cover more widely dispersed targets. In addition, cutting the number of operationally deployed submarines from 12 to 10 could increase their vulnerability to attack by Russian antisubmarine forces. Nevertheless, some people would consider the capability retained under this option sufficient to deter nuclear war. Although the missiles' range and the submarines' patrol areas would be smaller, they would still exceed the levels planned during the Cold War—when Russia had more antisubmarine forces and the United States intended to deploy the D5 with eight large warheads (W-88s). Moreover, less targeting flexibility might not reduce the force's nuclear deterrent: 1,152 warheads deployed on 288 missiles might not deter an adversary any more than the 1,110 warheads on 240 missiles called for in this option. The end of the Cold War and Russia's atrophying nuclear forces may have weakened the rationale for the United States to be able to increase its forces by adding warheads to the D5 missile.

**RELATED OPTION:** 050-14

**RELATED CBO PUBLICATIONS:** *Letter to the Honorable Joseph R. Biden Jr. regarding estimated costs and savings from implementing the Moscow Treaty*, September 24, 2002, and *Rethinking the Trident Force*, July 1993

## 050-16—Discretionary

# Consolidate Military Personnel Costs in a Single Appropriation

More than 20 percent of the federal government's costs to recruit and retain military personnel fall outside the Department of Defense's (DoD's) military personnel appropriation. DoD pays for many personnel benefits—for example, commissaries, some medical care, DoD schools, and on-base family housing—from other appropriations. The Department of Veterans Affairs (VA) pays some additional benefits, such as ones under the Montgomery GI bill and veterans' disability payments.

Under this option, the DoD-funded personnel-support costs mentioned above would become part of the military personnel appropriation. Some VA programs might also be funded in the defense budget as well. That realignment of funding would have two related goals: to provide more-accurate information about how much money is being allocated to support military personnel and to give DoD managers a greater incentive to use resources wisely. The amount that this option might save is unknown (so no table is shown). But with the total cost of supporting military personnel at about $115 billion per year, the potential savings from better management are substantial. Savings of just 1 percent, for example, would equal about $1 billion annually.

The current distribution of personnel costs among different appropriations makes it difficult for DoD, the Congress, and taxpayers to track the total level of resources devoted to supporting military personnel. Changes in the level of the appropriation for military personnel can be either offset or enhanced by changes in the resources devoted to health care, housing, or education benefits that are funded from other appropriations. The total picture is rarely, if ever, seen—making it hard to analyze total compensation or to make comparisons with civilian compensation.

DoD has some recent experience in consolidating costs into the military personnel appropriation. When DoD adopted accrual funding for the cost of Medicare-eligible retirees' health care in 2003, those funds shifted out of the operation and maintenance accounts and into the military personnel account. This option would expand that concept by incorporating additional personnel support costs.

Advocates of this option would argue that further consolidation would improve the incentives for DoD managers to use military personnel effectively, encouraging them to substitute less costly civilian employees of the department, contractors, or labor-saving technology for military personnel where possible.

Critics of this option would argue that implementation could be difficult. For example, new financial management systems and a new structure for appropriations would be required. Moreover, the responsibilities and the structure of various Congressional subcommittees might need to change. Finally, in order to realize savings, DoD leaders would have to respond to the new incentives by reducing their reliance on military personnel or by increasing efficiency.

**RELATED CBO PUBLICATION:** *Accrual Budgeting for Military Retirees' Health Care*, March 2002

## 050-17—Discretionary

# Target Pay to Meet Military Requirements

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 751 | 1,651 | 2,735 | 3,091 | 3,296 | 11,525 | 30,230 |
| Outlays | 714 | 1,606 | 2,681 | 3,073 | 3,286 | 11,360 | 30,028 |

The cash pay that military members receive includes basic pay, which depends on rank and years of service, as well as bonuses, allowances, and the tax advantage that arises because some allowances are not subject to federal income tax. Basic pay is the most important element of cash pay, averaging 55 percent or more of total cash compensation. The 2001 defense authorization act included provisions to increase basic pay at a greater rate than recent pay growth in the private sector. Those provisions set the annual military pay raise between 2001 and 2006 at 0.5 percentage points above the increase in the employment cost index (ECI) for wages and salaries of private-sector workers. In addition to those general pay increases, the Department of Defense (DoD) requested in the 2002 and 2003 defense authorization acts, and the Congress authorized, changes in the pay table to improve retention of both officers and enlisted personnel in certain pay grades. Those legislative changes have raised the pay for average enlisted personnel by 16 percent between 1999 and 2003, for example, and the pay for senior enlisted personnel by 31 percent (in real terms). Real pay for officers has risen by 13 percent over the same period. Those changes appear to have improved retention, as all of the military services reported strong overall retention in 2002.

In addition to pay raises, another tool that the services have used is selected reenlistment bonuses (SRBs), which are cash incentives that encourage the reenlistment of qualified service members in occupational specialties with high training costs or demonstrated shortfalls in retention. Eligible personnel generally receive half of their bonus when they reenlist and the remainder in annual payments over the course of their additional obligation. Each service regularly adjusts its SRBs to address current retention problems, adding or dropping eligible specialties and raising or lowering bonus levels.

Yet shortages remain among specific occupations. On average, between 1999 and 2002, about 30 percent of occupations for enlisted personnel had shortages, while about 40 percent were overstaffed. To address current occupational shortages of experienced personnel, this option would substitute reenlistment bonuses for part of the planned future pay raises. It would limit annual pay raises to 2 percent in 2004 through 2006 and offer SRBs to service members in those occupations where shortages remained. This option would approximately double the services' spending on initial bonus payments over four years, by adding about $108 million in bonuses annually from 2004 through 2007, and remove current restrictions on the maximum bonus amount that an individual can receive. After 2006, pay raises for all personnel would be in step with the employment cost index. Those changes would save $714 million in outlays in 2004 and more than $11 billion between 2004 and 2008. Service members receiving the bonuses would have higher overall pay than under the current plan between 2004 and 2006. But because bonuses do not compound in the same way as general pay raises, they would have lower overall compensation in 2007 and beyond, unless the bonus program was extended.

Advocates of this option would argue that increasing selected reenlistment bonuses would be more efficient than increasing pay in general because bonuses allow DoD to target military pay to specific occupational skills where there are shortages. General pay increases would lessen shortages in some occupations but would also worsen surpluses in other occupations. In addition, compared with pay increases, bonuses would be easier to adjust from year to year as recruiting and retention goals changed. Furthermore, bonuses would not incur the heavy cost of "tag-alongs," the elements of compensation, such as retirement benefits, that are tied to basic pay.

Supporters of this option would also argue that bonuses could be focused on the years of service in which personnel make career decisions. In addition, they might argue that the current bonus levels are too small to provide meaningful differences in pay among occupations and that larger differences would be a cost-effective tool for improving military readiness.

Some critics of expanding reenlistment bonuses would argue that large pay differences among occupations could violate a long-standing principle of military compensation: that personnel with similar levels of responsibility should receive similar pay. Turning the argument about tag-alongs on its head, critics would also say that increasing bonuses would unfairly deprive service members of the retirement and other benefits that they would receive if that money was part of basic pay throughout their career.

**RELATED OPTION:** 050-20

## 050-18—Discretionary

# Reduce Military Personnel in Overseas Headquarters Positions

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 115 | 237 | 371 | 384 | 397 | 1,503 | 3,711 |
| Outlays | 114 | 236 | 371 | 383 | 396 | 1,501 | 3,705 |

The last fundamental reorganization of military headquarters occurred under the Goldwater-Nichols Act of 1986. That law gave the unified theater commands—such as the European and Pacific Commands—the lead role in planning operations and executing policy and had them report directly to the President. When a crisis develops requiring additional military forces and support, a unified commander calls on the four military services to provide that support. The services' role is to recruit, train, equip, and support unified commanders' forces, while unified commanders exercise geographic command and control.

In practice, however, unified commanders are another management layer over existing overseas service "component" commands such as U.S. Army Europe and the Pacific Fleet. The unified commanders' requests for forces and support are relayed through those component commands to the services' U.S. headquarters. With each service maintaining a separate headquarters component in a region, redundancies exist in many management functions. And in some regions, the only personnel in a particular service branch are those at the component command headquarters. The overseas component command headquarters currently comprise some 6,000 personnel, or 10 percent of all headquarters staff.

This option would reorganize the military's command structure by eliminating the overseas component headquarters. Savings could then come from reducing the number of management personnel by 4,000, which would save $1.5 billion over five years if the personnel reductions produced cuts in end strength. Alternatively, the reorganization might allow for 4,000 additional troops for more critical missions. However, no savings would result from that approach.

According to proponents of this option, eliminating overseas component commands would improve command and control as well as provide personnel savings. It would streamline command, control, and communications by eliminating an entire layer of headquarters between the services and the unified commanders. Yet, assuming that some of the overseas component commands' responsibilities could not be eliminated, it would retain some of those personnel.

The services assert that continued commitments overseas, combined with new requirements at home, have stretched the active-duty military to its limits. Also, the newly created Northern Command and the Department of Defense's emphasis on creating standing joint forces—multiservice units that can deploy anywhere with little notice—may require additional personnel. Instead of simply eliminating the positions for budgetary savings, this option could provide the Secretary of Defense with available personnel without increasing personnel costs.

Some military analysts, however, argue that the overseas component commands provide essential support to the unified commanders: dedicated and responsive support for staging operations and integrating personnel and equipment deployed to a region, freeing the unified commanders to concentrate on the responsibilities of warfighting. Additionally, overseas component commands bolster theater "enablers" such as medical support, engineering, intelligence, fuel handling, and the movement of supplies. Other responsibilities include managing the planning and execution of joint and coalition military exercises and treaty obligations as directed by NATO (the North Atlantic Treaty Organization) and by bilateral agreements, for example. Finally, those commands support legal responsibilities such as contracting, logistics support, and facilities management.

Opponents of restructuring also argue that it is politically and practically too difficult, considering the uncertainties in the world. The reorganization envisioned in this option would be the single largest restructuring since the 1986 Goldwater-Nichols Act, and it could eliminate up to 45 general officer positions overseas. However, others, including senior staff members of the Office of the Secretary of Defense, argue that despite the difficulty, the new threat environment and the need for additional combat troops demand consideration of just such a widespread reorganization.

## 050-19—Discretionary

# Replace Military Personnel in Some Support Positions with Civilian Employees of the Department of Defense

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 201 | 417 | 649 | 894 | 924 | 3,086 | 8,194 |
| Outlays | 191 | 406 | 637 | 882 | 922 | 3,040 | 8,140 |

This option would replace 20,000 of the 1.4 million uniformed military personnel in certain support jobs with civilian employees of the Department of Defense (DoD). An examination of job functions reveals some jobs that one service considers "military essential" but the others do not and some functions that clearly could be open to civilians. Some analysts put the number of military positions that could be converted to civilian jobs as high as 90,000. Successfully converting 20,000 positions—and reducing military end strength by that amount—could save $191 million in outlays in 2004 and $3 billion over five years. Greater savings could be possible if some of those positions were deemed eligible for competition with contract personnel. Some of the savings from this option would occur because civilians, unencumbered by military-specific responsibilities, have more time available to perform their jobs, so fewer could be substituted for military personnel.

Under this option, the replacement of the 20,000 military positions with civilian employees of DoD would be phased in over four years. Also, the savings estimated for this option assume that future military and civilian pay raises are in accordance with statutory provisions.

Although in recent years, many analysts have called on DoD to reduce costs by transferring military positions to civilian ones, only a small percentage of the department's total personnel have been subject to review. In 2002, DoD undertook an inventory of all positions (civilian and military), categorizing them by function and determining whether they were inherently governmental and, if so, whether they had to be filled by military personnel. That inventory could be used to identify many support positions that, although currently occupied by military personnel, could be performed by civilian employees of DoD at lower cost.

For positions in the functional category of Morale, Welfare, and Recreation Services, for example, the Army fills 2 percent of those jobs with military personnel, whereas the Navy fills 13 percent, and the Air Force categorizes 32 percent as military. Removing the military designation on the Air Force positions could open up 1,000 jobs to civilians. In another example, the Army fills 35 percent of the positions in the functional category of Legal Services and Support with military personnel, and the Navy fills 53 percent. However, the Air Force requires 70 percent of those positions to be military personnel. Removing the military designation on some Air Force and Navy positions could open another 500 jobs to civilians.

Opponents of this option would argue that the process of defining, evaluating, and then redesignating personnel positions would be lengthy and cumbersome, with hard-to-define savings. Furthermore, they would point out, comparisons among services can be misleading to some extent, because certain functional areas have service-specific aspects. For example, the Navy claims that it must rely on military personnel on board ships to serve in support positions.

Finally, if civilian employees of DoD were substituted for military personnel without reducing end strength, DoD's total costs would increase, not decrease. However, proponents of transferring military personnel out of nonmilitary tasks argue that even if military end strength was not reduced, "warfighters" would still be freed up to fulfill their primary purpose.

## 050-20—Discretionary

# Increase the Use of Warrant Officers to Attract and Retain Personnel

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 214 | 189 | 159 | 124 | 81 | 767 | 1,318 |
| Outlays | 203 | 190 | 161 | 125 | 83 | 763 | 1,312 |

Warrant officers, who account for only about 1 percent of active-duty military personnel, currently serve as senior technical experts and managers in a wide variety of occupations and, in the Army, as pilots of helicopters and fixed-wing aircraft. In rank, they fall between enlisted personnel and other commissioned officers. Warrant officers—and the closely related limited duty officers in the Navy—tend to have long careers in which they gain considerable expertise.

This option would slowly expand the use of warrant officers as a means of attracting and retaining high-quality, skilled personnel, particularly in occupations with attractive civilian alternatives. To achieve savings, it would offer smaller pay raises to senior enlisted personnel.

Programs designed to help the military meet its personnel needs tend to be more cost-effective the more narrowly focused they are on the people and the decisions that they are intended to affect. Some analysts have pointed out that growing numbers of midcareer and senior enlisted personnel have substantial college training, which current military pay scales may not adequately recognize. The Department of Defense (DoD), in part to address that trend, has increased pay for senior enlisted personnel more rapidly than for other military personnel. For example, between 1999 and 2003, real pay for senior enlisted personnel rose by about 31 percent while real pay for enlisted personnel generally increased by about 16 percent.

Instead of raising the pay of all midcareer and senior enlisted personnel, however, DoD could offer warrant officer positions (with their higher pay) to those people it most wanted to retain or to those who were serving in military occupations with the best-paying civilian alternatives. Under this option, pay raises for senior enlisted personnel from 2004 through 2006 would be 1.25 percentage points below those currently planned by DoD. In 2007 and 2008, pay raises for those senior personnel would be 1.25 percentage points below the increase in the employment cost index. This option would also convert 10,000 positions for enlisted personnel in the top four grades to warrant officer positions. Net savings from those changes would total $763 million from 2004 through 2008. A program that expanded opportunities for warrant officers could be focused on specific occupational areas, such as information technology, where a robust civilian sector can make military compensation noncompetitive. Traditionally, DoD has used enlistment and reenlistment bonuses to fill such positions, although some people might argue that current bonus levels are too small to provide meaningful differences in pay among occupations.

Advocates of this proposal might also point to other advantages. Expanded opportunities for warrant officers might be more attractive to graduates of two-year colleges, who could come in as professionals instead of having to serve a long apprenticeship in the enlisted ranks. Serving as a warrant officer rather than as an enlistee might also appeal to people who would rather remain technical specialists than assume leadership responsibilities. It is possible that the resulting more-experienced workforce could reduce the size of the force that DoD needs.

Critics of this proposal would argue that converting senior enlisted positions to warrant officer positions would create a new set of problems. Currently, there are relatively few warrant officers—only about 15,400 were serving on active duty at the end of 2002. Adding another 10,000 officers to that pool could make the force more top-heavy without a commensurate increase in leadership skills. Some people within the military might object to having a larger group of senior technicians who did not have leadership responsibilities.

**RELATED OPTION:** 050-17

**RELATED CBO PUBLICATION:** *The Warrant Officer Ranks: Adding Flexibility to Military Personnel Management*, February 2002

## 050-21—Discretionary

# Reduce Recruiting Budgets

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 135 | 275 | 462 | 536 | 609 | 2,017 | 6,259 |
| Outlays | 128 | 247 | 421 | 518 | 598 | 1,910 | 6,092 |

This option would reduce spending on recruiting and advertising for active-duty forces to the 2002 level, saving $128 million in outlays in 2004 and about $1.9 billion over five years. After several years of difficulty in reaching recruiting goals, the military services all managed to meet or exceed their targets in 2002. For 2003, the recruiting environment appears to remain favorable. For example, as of November 30, 2002, the Army had about 35,000 recruits in its Delayed Entry Program (DEP) waiting to report for training, as compared with about 19,000 at the same time last year and only 17,000 the year before. The quality of recruits is also high for all of the services, with more than 90 percent of those in the DEP classified as high quality. Over the long term, prospects for recruiting also appear favorable, as the unusual combination of demographic and economic factors that made recruiting so difficult in the past seems unlikely to reappear.

In the latter half of the 1990s, the military services experienced considerable difficulty—and occasionally failed to meet—their recruiting targets. Much of that difficulty, however, can be attributed to the unusually low unemployment rates among teenagers during those years. The unemployment rate for people ages 16 to 19—which had hovered near 20 percent in the early 1990s—fell, and in 1999 dropped below 14 percent for the first time in the history of the All-Volunteer Force. Low unemployment rates translate into better civilian opportunities for the young adults that the military tries to attract, making the recruiting mission more difficult and costly.

The Department of Defense's spending on recruiting and related activities (measured in constant dollars) increased by more than 30 percent between 1980 and 2002; because of the decreasing size of the military, the increase in spending per recruit was far greater. In 2002, the cost per active-duty enlisted recruit was two and a half times what it had been in 1980. The factors that required those increases have, however, abated. The unemployment rate among teenagers is back to about 17 percent, and the size of the young-adult population, which has already increased by 15 percent from its post-baby-boom low in 1994, is projected to grow steadily through 2011. In addition, the military services have recently begun significant recruiting efforts among college students and students who have had some college coursework, which should further increase the pool of high-quality candidates.

The savings from this option would, however, make the recruiting mission more challenging. If the recruiting environment worsened significantly, this option could result either in a need for additional resources for recruiting or in another failure to meet recruiting goals.

## 050-22—Discretionary

# Have the Departments of Defense and Veterans Affairs Purchase Drugs Jointly

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 44 | 114 | 144 | 157 | 173 | 632 | 1,773 |
| Outlays | 38 | 104 | 138 | 154 | 170 | 604 | 1,723 |

In 2002, the Departments of Defense (DoD) and Veterans Affairs (VA) together spent about $4.7 billion on pharmaceuticals. Nationwide, spending on prescription drugs has grown roughly twice as fast in recent years as total national spending on health care. Constraining such cost growth is an important goal for DoD and VA.

This option would consolidate DoD's and VA's purchases of pharmaceutical products, as the Congressional Commission on Servicemembers and Veterans Transition Assistance recommended in 1999. Specifically, it would require the two agencies to organize a joint procurement office and develop a common clinically based formulary, or a list of prescription drugs that both agencies' health plans would agree to provide. Formularies can save money by encouraging providers to substitute generic versions for brand-name drugs or by including only specific preferred brand-name drugs within a therapeutic class. The joint formulary would apply throughout the VA health system, to mail-order pharmacy services, and at military hospitals and clinics. Once in place, it would allow the agencies to enter into more "committed volume" contracts with pharmaceutical manufacturers, which generally lead to lower drug prices. In addition, this option would merge the two agencies' mail-order pharmacy services. Those changes would save DoD and VA a total of $38 million in outlays in 2004 and $604 million through 2008.

In recent years, DoD and VA have attempted to combine some purchases, but that collaboration has been limited, and they continue to maintain separate formularies and procurement offices. VA's National Acquisition Center is responsible for purchasing prescription drugs for most federal agencies except DoD, and it negotiates and maintains the federal supply schedules of prices for those items. The Defense Supply Center Philadelphia (DSCP), an office of the Defense Logistics Agency, negotiates prices for pharmaceutical products and draws up contracts with vendors to buy and deliver those products to military treatment facilities. DSCP also makes plans to deliver those items overseas quickly in the event of a conflict.

Proponents of joint purchasing would argue that DoD and VA need to rein in the rapid growth of prescription drug costs. In addition, those proponents would say, the need for separate procurement offices is not apparent. According to a 1998 report by DoD's Inspector General, only a tiny fraction of the items that the DSCP procures on behalf of military facilities are "militarily unique"; most are common items. VA officials maintain that the National Acquisition Center has already achieved significant savings on many of its pharmaceutical purchases through committed-volume contracts. A recent study by the Institute of Medicine seems to confirm that point: it estimated that VA saved about 15 percent on drug purchases in six therapeutic classes by selecting a preferred drug in each class.

In developing a common formulary, the two agencies would need to adopt procedures by which physicians could prescribe nonformulary drugs to patients who needed them (for example, because they were allergic to the formulary drugs). The design and execution of such an exception process would affect the savings from this option. The stricter the process, the higher would be the cost of documenting and judging a patient's need for a nonformulary drug. A less restrictive process, however, would reduce the government's bargaining power and could reduce the savings from this option.

Critics of consolidation argue that such savings are unachievable. The veterans who obtain health care from VA

make up a very different mix of medical cases than military beneficiaries do—for example, more of them suffer from mental illness, substance abuse, or severe disabilities (such as spinal cord injuries). Therefore, the degree of overlap in prescription drugs dispensed by the two agencies may be limited.

Some observers argue that DoD and VA have already taken important steps to expand their joint procurement. The General Accounting Office estimates that the departments currently save about $170 million per year through joint purchasing contracts. From October 1998 to April 2002, DoD and VA awarded joint contracts for 18 products. Nevertheless, DoD officials contend that they must maintain their own procurement office to ensure that drug supplies will be available quickly in the event of war. Some officials believe that the agencies will achieve the bulk of any possible savings simply by sharing price data with each other so they can negotiate the lowest prices with pharmaceutical manufacturers and suppliers.

Finally, some analysts might argue that this option would not go far enough. Savings could be even larger if DoD implemented a uniform formulary for all three types of pharmacies that its beneficiaries use: pharmacies at military hospitals and clinics, the mail-order service, and retail pharmacies (where beneficiaries receive partial reimbursement through insurance). DoD officials say that as they have tightened the formularies of drugs available at military facilities, beneficiaries have increasingly turned to retail outlets—which often costs DoD more than if the department had purchased the drugs at federal prices and dispensed them itself. (Consequently, the estimate for this option assumes that DoD's insurance claims for pharmacy services would increase.) If DoD could enforce a single formulary at all pharmacy outlets, it would achieve greater savings.

## 050-23—Discretionary

# Introduce a "Cafeteria Plan" for the Health Benefits of Family Members of Active-Duty Military Personnel

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 18 | 76 | 188 | 207 | 216 | 705 | 1,931 |
| Outlays | 14 | 64 | 164 | 199 | 212 | 653 | 1,861 |

Under the Department of Defense's (DoD's) current health care system, many families may be overinsured. That is, given a choice, many would prefer a somewhat less generous health care plan and greater cash compensation. This option would give families that choice by having DoD provide the family members of active-duty personnel with a special cash allowance for their health coverage. The allowance, which would be nontaxable (like the current housing allowance), could be used in one of three ways. First, family members could purchase TRICARE coverage, which would include any of the current options (TRICARE Standard, TRICARE Extra, and TRICARE Prime). Second, they could use some of the money to purchase a new "low option" TRICARE plan and keep the remaining funds. That version of TRICARE would be similar to TRICARE Prime in that it would have many managed care features. However, it would also incorporate a substantial deductible as well as copayments for health care services obtained at either military treatment facilities or from civilian providers. Third, military family members could show proof of employer-provided insurance and apply the allowance toward their share of the premiums, copayments, and deductibles.

This option would save $653 million in outlays over the next five years. That estimate incorporates the cost of the cash allowances. It also accounts for the decrease in demand for health care by people choosing the new low-option plan, because copayments and deductibles would improve the efficiency of health care utilization. The estimate also takes into consideration the fact that there are a few eligible family members of active-duty personnel who are not currently using TRICARE and who thus cost the system nothing but who would be likely to apply for the cash allowance.

Supporters of this option argue that it would offer several advantages. First, families of active-duty personnel would have greater choice about the mix of benefits and cash that they received. Second, those who chose the low-option plan would be more likely to make cost-effective use of medical services because they would face a share of the costs of those services. Third, some health coverage costs would be shifted from DoD to spouses' civilian employers, reducing the department's spending. Finally, because family members would have to commit to an arrangement for their health insurance annually, total utilization would be easier to predict than it is under the current system, which users may join or leave at any time. Consequently, this option would improve resource planning within the military health system and allow DoD to negotiate firmer contracts for pharmaceuticals and civilian medical services. That advantage would exist even if most beneficiaries chose to remain in one of the three traditional TRICARE plans.

Opponents of this option note that people who selected the low-option TRICARE coverage would be taking on additional risks and might face financial difficulties if someone in their family fell seriously ill. However, that level of coverage would be designed to include a reasonable "stop-loss" limit to control the financial consequences of catastrophic illness.

Opponents also point out that families who chose an employer-provided plan might face the complication of having their coverage disrupted if the active-duty spouse experienced a permanent change of station in the middle of the year. DoD would have to develop methods to prorate cash allowances and deductibles for people forced to change their health care plans midyear.

## 050-24—Discretionary

# Create Incentives for Military Families to Save Energy

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 4 | 21 | 42 | 52 | 53 | 173 | 460 |
| Outlays | 3 | 16 | 35 | 48 | 52 | 154 | 437 |

The Department of Defense (DoD) spent about $360 million last year on gas, electricity, and water for the approximately 200,000 family housing units in the United States that it owns. Many of those units are slated for privatization by 2006, but DoD expects to retain about 121,000 units for the foreseeable future. To date, the department's efforts to reduce energy costs in family housing units by promoting conservation have met with limited success. One reason is that service members living in DoD-owned housing do not pay for their utilities and may not even know how much gas, electricity, and water they use. Landlords in the private sector have found that utility use typically declines by about 20 percent when tenants are responsible for their own utility bills.

This option would install utility meters in DoD's housing units, provide cash allowances for utility bills to the families living there, and then charge them for utilities on the basis of actual use. Residents who spent less than their allowance could keep the savings; those who spent more would pay the extra cost out of pocket. The budget for allowances would be set equal to the expected cost of utilities under the new system, or about 80 percent of what DoD now spends. The department would allocate that amount among the different housing units on the basis of their size, energy efficiency, and location. Although DoD would incur the up-front costs of determining allowance amounts, setting up a billing system, and installing meters, this option could save $3 million in outlays in 2004 and a total of $154 million from 2004 through 2008.

Once the program was established, the allowance budget for each year could be set equal to the previous year's actual utility charges plus an adjustment for inflation. If service members were able to cut their utility usage by more than 20 percent, allowances would fall and the savings from this option would increase. If, however, 20 percent overestimates service members' ability to reduce their usage, allowances would be higher and the savings would be less.

The proposed system would operate very similarly to one being implemented by DoD in most privatized units. Energy costs are borne explicitly by the families occupying the units. Extending that system to units owned and operated by DoD should be straightforward. Many of the department's housing units already have a connection where a meter could be installed.

The principal advantage of this option is that it would reduce DoD's costs by giving military families who live on-base the same incentives for conservation that most homeowners and renters have—including military families who live off-base. Because families who conserved aggressively would receive more in allowances than they would be charged for utilities, they would be rewarded. Families who did not economize would face utility bills in excess of their allowances.

Critics of this option might argue that, in the case of some housing units, the allowances did not account for physical characteristics that made energy conservation difficult. People living in such units might find that the allowances did not cover all of their utility costs even after they had made reasonable conservation efforts. To address those concerns, DoD could grant exemptions from the metering requirement, utility allowances, and charges.

**RELATED CBO PUBLICATION:** *Military Family Housing in the United States*, September 1993

## 050-25—Discretionary

# Consolidate and Encourage Efficiencies in Military Exchanges

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 73 | 129 | 186 | 191 | 195 | 774 | 1,828 |
| Outlays | 53 | 109 | 166 | 184 | 192 | 704 | 1,745 |

The Department of Defense (DoD) operates three chains of military exchanges—the Army and Air Force Exchange Service, the Navy Exchange Command, and the Marine Corps exchange system. Those chains, which provide a wide array of retail goods and consumer services at military bases, have combined annual sales of about $10 billion.

This option would consolidate the three systems into a single organization. In addition, it would introduce incentives for more-efficient operations by requiring the combined system to pay all of its operating costs out of its own sales revenue, rather than relying on DoD to provide some services free of charge. Those changes would save about $200 million annually after a three-year phase-in period. (The next option, 050-26, would go one step farther and consolidate the exchanges with DoD's separate network of commissaries.)

Numerous studies sponsored by the Office of the Secretary of Defense have shown that consolidating the exchange systems could lead to significant efficiencies. It would eliminate the costs of duplicative purchasing and personnel departments, warehouse and distribution systems, and management headquarters. Although consolidation would entail some one-time costs, the Congressional Budget Office (CBO) estimates that those costs would be more than offset by one-time savings from the reduction in inventories that consolidation would permit.

DoD provides the exchanges with about $400 million in free services each year, CBO estimates. Those services include maintaining some parts of buildings (such as roofs, windows, and heating and cooling systems), transporting goods overseas, and providing utilities at overseas stores. Under this option, the combined system would reimburse DoD for the cost of such services and would thus have an incentive to economize on their use. Furthermore, the requirement for the system to pay all of its own operating costs would improve the exchanges' visibility in the defense budget.

Today, earnings from the exchanges are used to support the military's morale, welfare, and recreation programs, which contribute to service members' quality of life. If the combined exchange system continued to provide earnings to support those programs, it would do so from earnings that represented receipts in excess of the full cost of operations. To compensate the morale, welfare, and recreation programs for the lower level of support that could result from lower earnings by the system of exchanges, this option assumes that the Congress would appropriate about $50 million annually in additional funds for those programs. That direct funding would increase the Congress's control over spending on morale, welfare, and recreation activities.

One obstacle to implementing this option would be the need to find an acceptable formula for allocating among the individual services the funds for morale, welfare, and recreation activities. The services might be concerned that they would not receive a fair share of the earnings from a combined exchange system or of the additional appropriations for those activities. In addition, they might fear that over a period of years, the Congress would reduce the amount of additional funding appropriated for those activities.

Some critics of consolidation argue that the Navy Exchange Command and the Marine Corps system, with their unique service identities, are better able to meet the needs of their patrons than a larger, DoD-wide system would be. But proponents of consolidation point to the Army and Air Force Exchange Service, which has successfully served two distinct services for many years. People who shop in exchanges say their main concern is the ability of exchanges to offer low prices and a wide selection of goods—a concern that a consolidated system might be able to satisfy more effectively.

**RELATED OPTION:** 050-26

**RELATED CBO PUBLICATION:** *The Costs and Benefits of Retail Activities at Military Bases*, October 1997

## 050-26—Discretionary

# Consolidate the Department of Defense's Retail Activities and Provide a Grocery Allowance to Service Members

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 326 | 410 | 497 | 537 | 579 | 2,350 | 5,471 |
| Outlays | 231 | 342 | 435 | 494 | 542 | 2,044 | 5,081 |

The Department of Defense (DoD) operates four separate retail systems on military bases: a network of grocery stores (commissaries) for all of the services and three chains of general retail stores (exchanges) for the Army and Air Force, the Navy, and the Marine Corps. This option would consolidate those systems into a single retail chain that would operate more efficiently, without any appropriated subsidy. The consolidated system, like the current separate systems, would be responsible for giving military personnel access to low-cost groceries and other retail goods at all DoD installations, including those in isolated or overseas locations.

The current commissary and exchange systems operate under very different funding mechanisms. The commissary system, which is run by the Defense Commissary Agency (DeCA), has annual sales of about $5 billion, but it also receives an appropriation of about $1 billion a year. The three exchange systems (the Army and Air Force Exchange Service, the Navy Exchange Command, and the Marine Corp exchange system) have annual sales totaling about $10 billion. They do not receive direct appropriations; instead, they rely on sales revenue to cover their costs.

One reason that exchanges can operate without an appropriated subsidy is that they charge their customers a higher markup over wholesale prices than commissaries do. Another reason is that the exchange systems are nonappropriated-fund (NAF) entities rather than federal agencies, which enables them to use more flexible and businesslike practices concerning personnel and procurement. DeCA, by contrast, is a federal agency, so its employees are civil service personnel, and it follows standard federal procurement practices. This option assumes that consolidation would eliminate duplicative overhead headquarters functions and that DeCA's civil service employees would be converted to a NAF workforce.

Under this option, the commissary and exchange systems would be consolidated over a five-year period. When that process was complete, DoD's costs would be about $1.1 billion a year lower (in 2004 dollars)—about $900 million from eliminating the subsidy for commissaries and $200 million from eliminating duplicate functions among the exchange systems. This option would return half of that $1.1 billion to active-duty service members through a tax-free grocery allowance of about $500 per year payable to personnel eligible to receive the current cash allowances to cover food costs. The grocery allowance would be phased in to coincide with the consolidation of commissary and exchange stores at each base. The remaining $550 million a year would represent savings for DoD.

Low-cost shopping on bases has long been a benefit of military service. But recent increases in security on bases and changes in the civilian retail industry have made it more difficult and costly for DoD's fragmented retail systems to provide that benefit. Both commissaries and exchanges must now compete with large discount chains that offer low-cost, one-stop shopping for groceries and general merchandise just outside the gates of many military installations.

To break even without appropriated funds, the consolidated system would have to charge about 10 percent more for groceries than commissaries do now. (That estimate is based on the difference between the 20 percent markup that exchanges charge and the 5 percent markup

that commissaries charge and evidence that exchanges pay lower wholesale prices than commissaries do for the same goods.) At the current level of commissary sales, a 10 percent price increase would cost customers an extra $500 million annually.

About $300 million of that price increase would be borne by the military retirees who now shop in commissaries. As a result, this option could face strong opposition from associations of retirees. The average family of a retired service member would pay an additional $150 per year for groceries.

Active-duty members and their families would benefit from consolidation. The average such family would pay about $240 more per year for groceries—but that figure would be more than offset by the grocery allowance that the family would receive under this option. (A military family would have to spend about $5,000 per year on groceries in commissaries before a 10 percent price increase outweighed the benefits of a $500 allowance.) Cash allowances would be particularly attractive to personnel who lived off-base and could shop near their home more conveniently than on-base. Moreover, all military families —active-duty, reserve, and retired—would gain from longer store hours, more convenient one-stop shopping, access to private-label groceries (not currently available in commissaries), and the security of a military shopping benefit that did not depend on the annual appropriation process. Some people might nonetheless oppose the change, as it would disrupt familiar modes of shopping.

DoD could target the $500 in cash payments to service members in a variety of ways. An allowance based solely on pay grade might be the most effective in enhancing retention and rewarding service members for their work. However, some people might argue that an allowance tied to pay grade and family size would be more equitable. If desired, supplemental payments could be made to junior enlisted personnel with large families who might otherwise be eligible for Food Stamps.

**RELATED OPTION:** 050-25

**RELATED CBO PUBLICATION:** *The Costs and Benefits of Retail Activities at Military Bases*, October 1997

## 050-27—Discretionary

# Eliminate the Department of Defense's Elementary and Secondary Schools

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | -20 | -3 | 26 | 49 | 67 | 118 | 754 |
| Outlays | -16 | -6 | 19 | 43 | 63 | 103 | 718 |

The Domestic Dependent Elementary and Secondary Schools (DDESS) system operates schools on several military bases in the United States to educate dependents of military personnel living there. The Department of Defense (DoD) also operates a separate school system for military dependents living overseas.

This option would phase out most of the schools that the DDESS system runs in favor of increased use of local public schools and would consolidate management of any remaining schools into the much larger overseas school system. Those changes would save DoD a total of $300 million in outlays between 2004 and 2008. Savings for the federal government as a whole would be less—about $103 million through 2008—because the Department of Education would have to spend more on Impact Aid, which it provides to local school districts that enroll dependents of federal employees. (These cost estimates assume that funding for Impact Aid would immediately increase so that the average amount paid per student living on federal land would remain at its current level.)

Proponents of this option would argue that the DDESS system takes an uneven and largely arbitrary approach to educating the dependents of active-duty service members. The distribution of its schools is mainly a historical accident, dating to the time when segregated public schools in the South did not adequately serve an integrated military. The great majority of military bases in the United States have no DDESS school. And where such schools do exist, they generally enroll only dependents of active-duty members who live on-base; those living off-base, and dependents of civilian employees, are the responsibility of local school districts. In addition, most bases with DESS facilities offer only elementary and middle schools; high school students living on-base use the public schools. In most of the places where the DDESS system operates schools, accredited public schools are readily available—with the possible exceptions of Guam, Puerto Rico, and West Point, where DoD would continue to run domestic schools under this option.

Closing these schools need not create major disruptions. The roughly 25,000 students who might be affected already change schools frequently, in large part because they move often as their military parent is reassigned. In many locations, the public school district could continue to use DoD's facilities. (DoD already offers support to some local districts by allowing public schools to operate on-base or providing additional limited funding on a per- student basis.) Finally, to ease the transition, DoD's schools would be phased out at a rate of one per district per year rather than all at once. And the local school districts would receive additional one-time funding and would have facilities and equipment transferred to help them absorb their new teaching load.

This option might have several disadvantages, however. First, many parents of DDESS students might be reluctant to see the schools phased out because they believe DoD schools offer higher-quality education than local public schools do. Second, if local school districts did not retain the on-base schools, former DDESS students might face longer commutes. Third, some of the savings to the federal government from this option would be offset by increased costs to local school districts. In the past, those districts have effectively been subsidized by not having to pay any of the costs of educating DDESS students while receiving at least some direct and indirect tax revenues from their parents. This option would eliminate that subsidy.

DoD has undertaken a study of this issue and is due to issue a report next year.

**RELATED OPTION:** 500-01

## 050-28—Discretionary

# Price Military Housing According to Market Rates

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 1,785 | 1,459 | 1,156 | 1,032 | 5,432 | 9,427 |
| Outlays | 0 | 53 | 461 | 823 | 849 | 2,186 | 5,541 |

This option would charge rents for on-base housing. Each military family would receive a cash allowance for housing and would choose among government-owned and -operated, privatized, or private-sector housing. Rents for on-base housing would be set at market-clearing levels (levels at which there would be neither excess vacancies nor waiting lists) and would be based on the size and quality of the units. This option would therefore equalize the value of the housing benefits that the Department of Defense (DoD) provides to families living on- and off-base and to families of different sizes.

About two-thirds of military families receive cash allowances for housing and buy or rent dwellings in the local community. About one-third of military families give up their housing allowance to live in government-owned and -operated housing or to live in privatized housing sponsored by DoD. For those families, the forgone housing allowance can be viewed as the "rent" paid to live in on-base housing. Under the current system, housing allowances provided to military families are based on the costs of rental housing typically occupied by civilians with comparable income, regardless of family size—although in making housing assignments, DoD often provides larger units to larger families. Moreover, the quality of on-base housing has no bearing on the "rent" paid—that is, the forgone allowance.

The current system creates an incentive for military service members (particularly those with large families) to prefer on-base housing or privatized housing over living in the community. For example, a married junior enlisted member with three dependents might be assigned to a three-bedroom townhouse on-base, but the member's forgone housing allowance might equal the cost of a two-bedroom apartment in the community. That incentive inflates the demand for government-owned and privatized housing. In response to that higher demand, DoD is increasing the number of larger units. In addition, the growing number of large military families will boost the demand for ancillary family support services on-base. Convenient access to subsidized on-base services, such as child care and commissaries, also creates a financial incentive to live on-base rather than in the community.

Charging market-based rates for both DoD-owned and privatized units would equalize the value of the housing benefit for all personnel regardless of whether they live on- or off-base. Under this option, for example, that junior enlisted member would either live in a two-bedroom unit (either on-base or off-base) with no out-of-pocket costs or pay to obtain a three-bedroom unit (either on-base or off-base). Because the financial incentive to prefer on-base housing would be removed and the demand for those units would fall, proponents of this approach would argue that fewer aging units would need to be renovated or replaced. On-base (or privatized) housing units would be replaced or renovated if they met one of two criteria: their value to service members (the market-clearing rents they could command) was sufficient to cover both operating costs and amortized capital costs, or their historical nature or importance for military readiness made the units indispensable. Those criteria would limit DoD to renovating or replacing about 25 percent of its existing housing stock, the Congressional Budget Office estimates.

Savings from this option could total more than $2 billion in outlays and more than $5 billion in budget authority from 2004 through 2008. On average, the market rent would tend to equal the housing allowance, so military personnel would not incur net costs. Savings could be less if future decisions about realigning or closing bases required substantial new construction of family housing

units. Savings could be greater if the reduced demand for on-base housing also lessened the demand for ancillary services, such as child care centers or commissaries.

Opponents of this approach argue that it ignores the important nonmonetary aspects of living on-base (fostering unit cohesion, for example). In addition, large families currently living on-base would be worse off than they are now because they would lose subsidized access to larger dwellings. This option also would represent a significant break with military tradition and therefore could have a negative impact on morale.

**RELATED CBO PUBLICATION:** *Military Family Housing in the United States*, September 1993

## 050-29—Discretionary

# Change Depots' Pricing Structure for Repairs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 42 | 88 | 135 | 138 | 142 | 546 | 1,312 |
| Outlays | 31 | 73 | 118 | 133 | 139 | 495 | 1,252 |

Unit commanders can repair many components of weapon systems, such as transmissions and radars, in their own local repair facilities or pay to have the components repaired in centralized maintenance depots. Under current policies, however, the prices that the depots charge units for repairing such components (known as depot-level reparables, or DLRs) exceed the actual cost of making the repairs. Those pricing policies raise total costs to the Department of Defense (DoD) because they discourage commanders from relying on the depots even when doing so would be less costly for DoD as a whole. For example, one avionics sensor used by the Army costs $16,000 to repair at a local facility and $12,000 to repair at a depot. Nevertheless, under the current pricing structure, the depot charges $71,000 to repair the sensor—creating an incentive for unit commanders to use their local facilities even though the actual cost of the repair is less at the depot.

This option would change depots' pricing policies so that depots would charge only the actual cost of repairs. By encouraging unit commanders to choose the most cost-effective source of repair, the new pricing policy could lower the annual cost of repairs by a total of about $500 million over five years.

Currently, the prices that depots charge for repairing DLRs include both the additional transportation, materials, and labor costs that the depots incur in making the repairs and an allocated share of the depots' fixed overhead costs. Under this option, the prices charged for repairing DLRs would cover only those costs that vary with the number of DLRs being repaired in the depot—for instance, transportation, materials, and direct labor costs. Fixed costs that do not vary with the level of workload—including overhead—would be covered through a flat charge paid by customers that would not depend on the level of workload.

That two-part pricing structure, which is similar to the pricing structures used by some telephone and utility companies, has been proposed as a cost-saving initiative by economists at RAND, the Center for Naval Analyses, and elsewhere. The Air Force implemented a two-part pricing system for DLRs on a test basis in 2002. A study by RAND concluded that two-part pricing would reduce the prices that depots charge by more than one-third in many cases. A price reduction of one-third could shift a significant amount of the workload for DLRs now being done in local facilities to depots. That could in turn reduce the department's total cost of repairs because—according to studies by RAND, the Navy, and the Office of the Secretary of Defense (OSD)—maintenance done locally can range from 25 percent more expensive to twice as expensive as repairs done at depots.

Although no set of accounting systems captures the total cost of repairs done in local facilities, OSD currently estimates that total cost to be in the range of $25 billion a year. If a two-part pricing structure shifted just 2 percent of that local workload to depots, $500 million worth of repairs would be shifted each year, and DoD could realize savings of $125 million a year, on average, through 2008.

Shifting some of that work to depots might also improve the quality of maintenance. Because local facilities are not as well equipped for some tasks as depots are, repairs can also take longer or have higher failure rates. In addition, the high prices currently charged by depots for repairs give local maintenance personnel an incentive to scavenge parts from a broken DLR to use in repairing others,

eventually sending the DLR on to a depot with multiple broken parts—increasing labor and repair costs at both local facilities and the depots.

One disadvantage of this option is that developing appropriate prices for the depot facilities could prove difficult. Depot managers, eager to attract work by keeping their prices as low as possible, might try to move costs into the flat charge or direct appropriations that were in fact part of their costs that varied with workload. Alternatively, depot managers might be reluctant to separate repair costs that varied with workload from those that were fixed because doing so would highlight their degree of excess capacity.

Another concern about changing the price of repairs is the problem of predicting behavioral responses. The DLR pricing system that is currently being used was intended to encourage commanders to be more careful in their use of DLRs. Although it has had that desired effect, it has also created an inappropriate incentive to undertake repairs in local facilities. Although the potential benefits of a two-part pricing system are significant, there is a risk that a new system might also have unexpected and unintended consequences.

# 150

# International Affairs

Budget function 150 covers all spending on international programs by various departments and agencies. The category includes spending by the Department of State to conduct foreign policy and exchange programs, funds controlled directly by the President to give other nations economic and military aid, and U.S. contributions to international organizations such as the United Nations, multilateral development banks, and the International Monetary Fund. Function 150 also includes financing for exports through the Export-Import Bank. CBO estimates that discretionary outlays for the function will total more than $25 billion in 2003 after hovering around the $20 billion level throughout the 1990s. Repayments of loans and interest income in the Exchange Stabilization Fund account for the negative balances in mandatory spending for this function.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 20.0 | 21.3 | 20.9 | 33.3 | 20.9 | 20.2 | 18.1 | 18.2 | 19.0 | 41.5 | 23.5 | 24.7 | 25.2 | 25.5 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 19.1 | 19.7 | 19.2 | 21.6 | 20.8 | 20.1 | 18.3 | 19.0 | 18.1 | 19.5 | 21.3 | 22.5 | 26.2 | 25.5 |
| Mandatory | -5.3 | -3.8 | -3.1 | -4.3 | -3.7 | -3.7 | -4.8 | -3.8 | -5.0 | -4.3 | -4.1 | -6.0 | -3.8 | -2.4 |
| Total | 13.8 | 15.9 | 16.1 | 17.2 | 17.1 | 16.4 | 13.5 | 15.2 | 13.1 | 15.2 | 17.2 | 16.5 | 22.4 | 23.1 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 3.4 | -2.7 | 12.6 | -3.5 | -3.3 | -8.8 | 3.5 | -4.6 | 7.8 | 9.1 | 5.7 | 16.4 | -2.7 |

Note: n.a. = not applicable.

## 150-01—Discretionary

# Eliminate the Export-Import Bank, the Overseas Private Investment Corporation, and the Trade and Development Agency

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 586 | 609 | 644 | 684 | 713 | 3,236 | 7,057 |
| Outlays | 72 | 261 | 437 | 541 | 605 | 1,916 | 5,307 |

The Export-Import Bank (Eximbank), the Overseas Private Investment Corporation (OPIC), and the Trade and Development Agency (TDA) promote U.S. exports and overseas investment by providing a range of services to U.S. companies wishing to do business abroad. Eximbank offers subsidized direct loans, guarantees of private loans, and export credit insurance; OPIC provides investment financing and insurance against political risks; and TDA funds feasibility studies, orientation visits, training grants, and other forms of technical assistance. Appropriations in 2003 for Eximbank, OPIC, and TDA are $578 million, $64 million, and $47 million, respectively.

This option would eliminate TDA and the subsidy appropriations for Eximbank and OPIC. The latter two agencies could not conduct any new financing or issue new insurance but would continue to service their existing portfolios. Those changes would save $72 million in outlays in 2004 and $1.9 billion over five years (compared with the 2003 appropriations enacted on February 20, 2003, adjusted for inflation).

Proponents of this option dispute the contribution that those agencies make to the economy. The value of exports supported by the agencies' programs is small—less than 2 percent of total U.S. exports. Moreover, many economists disagree with the claim that promoting exports creates U.S. jobs. They assert that by subsidizing exports, the government distorts business decisions that are best left to occur in free markets. OPIC and Eximbank finance programs that would have trouble raising funds on their own merit. Similarly, those agencies' insurance programs might encourage companies to invest in riskier projects than they would if more of their own funds were at stake.

Opponents of this option argue that the three agencies play an important role in helping U.S. businesses, especially small businesses, understand and penetrate overseas markets. Those agencies level the playing field for U.S. exporters by offsetting the subsidies that foreign governments provide to their exporters, thereby creating U.S. jobs and promoting sales of U.S. goods. By encouraging U.S. investment in areas such as Russia and the states of the former Soviet Union, those agencies may also serve a foreign policy objective.

**RELATED CBO PUBLICATIONS:** *The Domestic Costs of Sanctions on Foreign Commerce*, March 1999, and *The Role of Foreign Aid in Development*, May 1997

## 150-02—Discretionary

# End the United States' Capital Subscriptions to the European Bank for Reconstruction and Development

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 0 | 38 | 39 | 40 | 117 | 329 |
| Outlays | 0 | 0 | 20 | 25 | 30 | 75 | 277 |

The European Bank for Reconstruction and Development (EBRD) supports market-oriented economic reforms by providing loans in the nations of Central and Eastern Europe and the former Soviet Union. Nearly 80 percent of the projects approved in 2000 were in the private sector. At the end of that year, the EBRD had a portfolio of nearly 800 projects with a net value of $11.3 billion.

The United States contributes 10 percent of the capitalization of the EBRD, or $36 million in 2003. The 2003 subscription (the buying of stock) is the sixth installment of an eight-year capitalization agreement with the bank. This option would terminate U.S. subscriptions to the EBRD at the end of the eight-year agreement, saving $75 million in outlays over five years—if the level of U.S. support remains steady. After the U.S. ends its subscriptions, the bank could be privatized.

Proponents of this option say that loans from the United States or public entities to the private sector encourage businesses to make riskier investments than they would otherwise do if their decisions were based purely on market factors. That effect might seem inappropriate for a policy initiative designed to support market-oriented reforms in formerly communist countries. Investments that respond to market conditions, including risk, are more likely to allocate capital in a cost-effective manner and to promote economic growth. Proponents also note that the EBRD is showing a "profit"—that is, its current repayments exceed its current outlays. Thus, the bank is making loans for investments that are potentially viable without subsidies from taxpayers.

Opponents of this option argue that the funds are used to promote investment in a region that only recently made the transition to a market-based economy and that the loans are important to the economic security of those countries. Without institutions such as the EBRD, opponents argue, there would be less private investment and economic growth in the region.

**RELATED CBO PUBLICATION:** *The Role of Foreign Aid in Development*, May 1997

# 270

# Energy

Budget function 270 includes funding for the nondefense programs of the Department of Energy as well as for the Tennessee Valley Authority, rural electrification loans, and the Nuclear Regulatory Commission. The programs supported by this function are intended to increase the supply of energy, encourage energy conservation, provide an emergency supply of energy, and regulate energy production and distribution. CBO estimates that discretionary outlays for function 270 will be about $3 billion in 2003. That amount continues a recent trend of funding levels for federal energy programs that are much lower than the levels of the early and mid-1990s. Negative balances in mandatory spending for function 270 result from repayment of loans, receipts from the sale of electricity produced by federal entities, and charges for the disposal of nuclear waste.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 5.6 | 5.4 | 5.8 | 5.8 | 6.4 | 6.2 | 4.9 | 4.2 | 3.1 | 2.9 | 2.7 | 3.2 | 3.2 | 3.3 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 4.8 | 4.4 | 5.4 | 5.6 | 6.4 | 6.8 | 6.0 | 4.9 | 3.7 | 3.1 | 3.0 | 2.9 | 3.0 | 3.2 |
| Mandatory | -1.4 | -2.0 | -0.9 | -1.2 | -1.2 | -1.8 | -3.1 | -3.4 | -2.4 | -2.2 | -4.0 | -2.9 | -2.5 | -2.4 |
| Total | 3.3 | 2.4 | 4.5 | 4.3 | 5.2 | 4.9 | 2.8 | 1.5 | 1.3 | 0.9 | -1.1 | * | 0.5 | 0.7 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | -7.4 | 22.4 | 3.0 | 15.1 | 5.7 | -11.9 | -17.7 | -24.4 | -15.7 | -5.4 | -2.1 | 2.7 | 6.2 |

Note: * = between zero and $50 million; n.a. = not applicable.

## 270-01—Discretionary

# Eliminate the Department of Energy's Applied Research for Fossil Fuels

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget Authority | 505 | 644 | 659 | 674 | 690 | 3,172 | 6,875 |
| Outlays | 151 | 370 | 549 | 619 | 665 | 2,354 | 5,954 |

The Department of Energy (DOE) currently receives over $600 million in appropriations annually to improve the applied technologies for finding and using fossil fuels (petroleum, coal, and natural gas). Those research programs were put into place when the prices of fossil fuels were controlled and, as a result, incentives for technology development were muted. In a world of partial deregulation and increasingly free energy markets, the value of federal spending for such research and development (R&D) programs is questionable. Eliminating the research programs would save $151 million in federal outlays in 2004 and $2.4 billion over the 2004-2008 period.

Supporters of this option contend that energy markets provide suppliers with sufficient incentives to develop better technologies and bring them to market. They argue that private entities are more attuned to which new technologies have commercial promise than are federal officials. Federal programs have had a long history of funding fossil-fuel technologies that, although interesting technically, had little chance of commercial implementation. As a result, much of the federal spending has not been productive.

People who support eliminating the applied research programs also argue that DOE should concentrate on basic energy research and reduce the department's involvement in applied technology development. They point out that the federal government has a clearer role in developing the basic science for a new energy source because the benefits of such investment are widespread and cannot be captured by individual firms.

Opponents of eliminating the programs argue that they help offset several failures in energy markets and represent a sound investment for the nation. They say, for example, that energy prices do not reflect the environmental damage done by the production and use of fossil fuels. Research that allows coal to be used with less damage to the environment decreases the cost of its use to society. Those research programs could also increase the efficiency of energy use and thereby reduce dependence on foreign oil.

People who oppose this option also point to the continued development of fuel cell technology in these programs. Fuel cells, which have come down in cost, are just a few years away from displacing more conventional energy sources in a wide variety of markets, from cell phone batteries to household electrical use.

**RELATED OPTIONS:** 270-02, 270-03, and 270-04; Revenue Options 25 and 40

**RELATED CBO PUBLICATION:** *Causes and Lessons of the California Electricity Crisis*, September 2001

## 270-02—Discretionary

# Eliminate the Department of Energy's Applied Research for Energy Conservation

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 521 | 665 | 680 | 695 | 711 | 3,272 | 7,082 |
| Outlays | 235 | 482 | 617 | 676 | 698 | 2,708 | 6,449 |

In 2002, the Department of Energy (DOE) received appropriations of $640 million for programs to develop energy conservation technologies. Those efforts include the FreedomCAR Partnership (discussed in option 270-07) for automobile research as well as industrial and residential energy-efficiency research. Federal agencies' involvement in the selection and development of technologies with near-term commercial prospects raises questions about the appropriateness of the current division of labor between the public and private sectors. Eliminating these programs would save $235 million in outlays in 2004 and $2.7 billion over the 2004-2008 period.

People who support halting federal spending for energy conservation research and development (R&D) argue that the federal government should stay out of the development of applied energy technology and concentrate on basic research in the underlying science. Specifically, they note that many projects funded through this research effort are small and discrete enough—and, in many cases, have a clear enough market—to warrant private investment. In such instances, DOE may be crowding out or preempting private-sector firms. In other instances, such programs conduct R&D that the intended recipients are likely to find too expensive or esoteric to implement.

Supporters of this option also note that other federal policies encourage the introduction of some of the technologies. For example, federal law sets minimum efficiency standards for appliances and cars. In addition, the tax code favors investments in conservation technologies. Thus, federal R&D programs may duplicate other support.

People who oppose eliminating the programs argue that federal R&D in energy conservation helps offset several failures in energy markets. Current energy prices, they contend, do not reflect the damage to the environment, including the potential for global warming, from excessive reliance on fossil fuels. In addition, they argue that energy conservation will decrease the social costs of producing and using energy and the nation's dependence on foreign oil. Opponents of eliminating DOE's programs also encourage cost sharing in some industrial grants, which may raise the rate of private R&D in the field.

(Because energy conservation R&D and the FreedomCAR Partnership overlap, the savings from eliminating both programs would be less than the sum of the figures for the two options. In addition to its own energy conservation programs, DOE separately provides grants to state and local agencies for energy conservation. Those grants are discussed in option 270-04.)

**RELATED OPTIONS:** 270-01, 270-03, 270-04, 270-07, and 300-11; Revenue Option 40

**RELATED CBO PUBLICATIONS:** *Causes and Lessons of the California Electricity Crisis*, September 2001; *Electric Utilities: Deregulation and Stranded Costs*, October 1998; and *Should the Federal Government Sell Electricity?* November 1997

## 270-03—Discretionary

# Eliminate the Department of Energy's Applied Research for Solar and Renewable Energy Sources

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 315 | 401 | 411 | 420 | 430 | 1,977 | 4,282 |
| Outlays | 142 | 291 | 373 | 409 | 422 | 1,637 | 3,899 |

In 2002, the Department of Energy (DOE) received appropriations of $386 million to spend on research and development (R&D) for solar and other renewable energy sources. The largest such technology development efforts by far are those for developing alternative liquid fuels from biomass and electricity from photovoltaic cells. Smaller efforts involve electric energy storage and wind energy systems. Eliminating this research would save $142 million in outlays in 2004 and $1.6 billion over the 2004-2008 period.

Supporters of this option argue that the federal government should stay out of the development of applied energy technology and concentrate on basic research in the underlying science. Federally sponsored researchers lack the market incentives and information that help researchers in private companies recognize marketable technologies.

Another criticism applicable to DOE's conservation R&D programs (discussed in option 270-02) is that many of the research projects funded by the renewable energy program are sufficiently small and discrete and have a clear enough market to attract private funding.

Several renewable energy technologies—most notably wind power and photovoltaic cells—are now at the heart of commercial markets. Wind energy, according to industry estimates, currently constitutes a $6 billion market worldwide and has grown rapidly. Similarly, the photovoltaic market is growing at between 20 percent and 25 percent per year. In such cases, it may be time for an orderly withdrawal of federal support. Given the large U.S. venture capital market, continued federal support may be displacing private funding.

Finally, supporters of this option explain that for liquid fuels derived from renewable resources, especially biomass, the federal tax code already provides incentives for developing the technology. Ethanol fuels receive special treatment under the federal highway tax (see Revenue Option 25). Furthermore, federal regulations authorized by many different statutes favor alcohol fuels, which now usually mean those that are corn-based.

By reducing the costs of alternative energy sources, opponents of this option argue, DOE's programs have provided some insurance against permanent increases in the price of oil. One 1999 analysis showed that many of the technologies had indeed met their goals to lower costs, although they were not used because costs for conventional energy sources had fallen by even more. Should energy prices rise over the longer term, however, these new energy sources could gradually come into wider use.

Opponents of eliminating the programs also argue that the energy prices consumers pay fail to incorporate the risks posed by the nation's dependence on fossil fuels. Furthermore, the United States plays the role of international R&D laboratory for less developed countries, which often have much higher energy costs.

**RELATED OPTIONS:** 270-01, 270-02, 270-04, and 270-07; Revenue Options 25 and 40

## 270-04—Discretionary

# Eliminate Grant Programs That Support Energy Conservation

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 224 | 286 | 292 | 299 | 306 | 1,407 | 3,044 |
| Outlays | 101 | 207 | 265 | 291 | 300 | 1,164 | 2,772 |

Weatherization assistance grants supported by the Department of Energy's (DOE's) Office of State and Community Programs help low-income households reduce their energy bills by funding such activities as installing weather stripping, storm windows, and insulation. Institutional conservation grants supported by the office help reduce the use of energy in educational and health care facilities by adding federal funds to private and local public spending to encourage local investment in improvements to buildings. The Office of State and Community Programs also supports the energy conservation programs of states and municipal governments that, for example, establish energy-efficiency standards for buildings and promote public transportation and carpooling.

This option would halt new appropriations for DOE's grant programs that support energy conservation activities by the states. Implementing this option would save $100 million in outlays in 2004 and $1.2 billion over the 2004-2008 period.

People who support this option question whether the programs actually work and whether the conservation actions they call for are not already promoted by other programs or laws, such as the Clean Air Act Amendments of 1990. The DOE programs duplicate a similar block-grant activity, the Low Income Home Energy Assistance Program, administered by the Department of Health and Human Services. Moreover, federal support for reducing the use of gas and coal through conservation grants conflicts with other federal policies that promote the production and use of those fuels.

People who oppose this option claim that eliminating the grant programs could impose hardships on states that wish to continue their energy conservation efforts. Many states still rely heavily on such grants to help low-income households and public institutions. In addition, the energy savings those programs effect could contribute to reducing greenhouse gas emissions.

**RELATED OPTIONS:** 270-01, 270-02, 270-03, and 300-11

**RELATED CBO PUBLICATIONS:** *Causes and Lessons of the California Electricity Crisis*, September 2001; *Electric Utilities: Deregulation and Stranded Costs*, October 1998; and *Should the Federal Government Sell Electricity?* November 1997

## 270-05—Mandatory

# Restructure the Power Marketing Administrations to Charge Higher Rates

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 0 | 160 | 160 | 160 | 160 | 640 | 1,440 |

The three smallest power marketing administrations (PMAs) of the Department of Energy—the Western Area Power Administration, the Southwestern Power Administration, and the Southeastern Power Administration—sell about 1 percent of the nation's electricity. Those PMAs sell power to customers at below-market rates.

The power generated by the PMAs comes largely from hydropower facilities that the Army Corps of Engineers and the Bureau of Reclamation have built and continue to operate. Current law requires that those sales be made at cost—a pricing structure intended to ultimately reimburse taxpayers for all of the costs of current operations and a share of the costs of construction and interest on the portion of total costs that has not been repaid. Interest charges are generally below the government's cost of borrowing. Those lower charges, along with the low cost of generating electricity from hydropower, result in power rates for customers that are significantly below the rates that other utilities charge. Current law also requires that PMAs first offer their power to rural electric cooperatives, municipal utilities, and other publicly owned utilities.

Restructuring would require that those three PMAs sell electricity at market rates to any wholesale buyer. Those higher rates would provide the federal government with about $640 million in added receipts over five years.

Supporters of the restructuring maintain that the rationale for federal power subsidies is weak. The market power of private utilities is checked by federal and state regulation of the power supply; by federal antitrust laws; and, increasingly, by competition from independent producers. In many cases, neighboring communities—some receiving federal power and some not—have similar characteristics. For households in the regions that the three PMAs serve, federal sales of power meet only a small share of their total power needs; therefore, the impact of increased federal rates on households' electricity costs would be modest. In addition, bolstering the case for increasing power rates now is the prospect of significant future costs for the PMAs to perform long-deferred maintenance and upgrades. Finally, selling power at below-market rates encourages the inefficient use of energy.

People who oppose the option believe that restructuring could greatly increase electricity rates for the many small and rural communities served by PMAs. Opponents of restructuring also argue that continuing to provide low-cost federal power is necessary to counter the uncompetitive practices of investor-owned utilities and to bolster the economies of certain regions of the country.

**RELATED OPTIONS:** 270-06; Revenue Options 27, 30, and 31

**RELATED CBO PUBLICATION:** *Should the Federal Government Sell Electricity?* November 1997

## 270-06—Mandatory

# Sell the Southeastern Power Administration and Related Power-Generation Equipment

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 0 | 0 | 1,900 | -112 | -115 | 1,673 | 1,060 |

Note: Excludes discretionary savings for operations.

The Southeastern Power Administration (SEPA) of the Department of Energy sells electricity from hydropower facilities that the Army Corps of Engineers has constructed and operates. SEPA pays private transmission companies to deliver that power to more than 300 wholesale customers: rural cooperatives, municipal utilities, and other publicly owned utilities. Selling federal power assets would be consistent with the policy goal of increasing efficiency in energy markets.

SEPA's power rates are designed to recover for taxpayers all of the costs of current operations, a share of the costs of construction, and a nominal interest charge on the portion of the total costs that has not yet been recovered. The average revenues from SEPA power are about 2.8 cents per kilowatt-hour (kWh), compared with average revenues of 5.0 cents per kWh for utilities in the region.

Selling assets that directly support SEPA's supplying of electricity would provide the federal government with about $1.7 billion in added receipts over five years. That estimate reflects sale proceeds of about $1.9 billion minus a loss of receipts for that period of about $230 million. Over the 2004-2013 period, added receipts would total $1.1 billion. Those figures do not include reduced discretionary outlays of about $75 million annually from ending appropriations to SEPA and the Corps for operations. The estimate of sale proceeds is based on SEPA's most recent audited statement of its assets and liabilities. The Corps's assets that would be transferred include equipment, such as turbines and generators, but not the related dams, reservoirs, or waterfront properties. The sale would also include rights of access to that equipment and to the water flows necessary for power generation, subject to the constraints of competing uses for the water.

Supporters of this option contend that the original reasons for establishing SEPA—marketing low-cost power to promote competition and fostering economic development—are no longer compelling to many people because of the small amount of power that SEPA sells and because of competitive and regulatory constraints on power rates. Also, selling federal facilities does not mean transferring all functions in managing and protecting the water as a resource. The Corps could retain direct responsibility for managing water flows for all uses, including the upkeep of basic physical structures and surrounding properties. Or, as with other nonfederal dams, the terms of the federal licenses to operate the facilities (issued by the Federal Energy Regulatory Commission) could determine the management of water flows for competing purposes.

People opposed to ending federal ownership believe that nonfederal entities lack the proper incentives to perform all of SEPA's functions. Many Corps facilities serve multiple purposes, managing water resources for navigation, flood control, or recreation as well as for power generation. Opponents also argue that selling SEPA could increase power rates. Although sales by SEPA meet only about 1 percent of the total power needs in the 11 states in which it operates, a few rural communities depend heavily on SEPA.

**RELATED OPTIONS:** 270-05; Revenue Options 27, 30, and 31

**RELATED CBO PUBLICATIONS:** *Electric Utilities: Deregulation and Stranded Costs*, October 1998, and *Should the Federal Government Sell Electricity?* November 1997

## 270-07—Discretionary

# Eliminate Federal Funding for the FreedomCAR Partnership

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 122 | 156 | 159 | 162 | 166 | 765 | 1,648 |
| Outlays | 55 | 113 | 145 | 158 | 163 | 634 | 1,503 |

The FreedomCAR Partnership is a joint federal/private research effort that aims to foster the development of energy-efficient vehicles, primarily by promoting research into fuel cell technology. Fuel cells generate electricity by stripping out the electrons from hydrogen fuel. Recycling the electrons back into the remaining fuel mixture and combining it with oxygen produce air and water vapor emissions.

This program replaces the Partnership for a New Generation of Vehicles (PNGV), which focused on hybrid automobiles (cars with diesel and electric motors). Although the FreedomCAR Partnership will emphasize fuel cell vehicles and the infrastructure needed to support them, it will also sponsor research into combustion and emission systems, lightweight materials, and electronic and battery technologies suitable for energy-efficient automobiles. The FreedomCAR Partnership complements a larger effort, announced in the President's State of the Union address to the Congress, to develop hydrogen-based sources of energy for automotive and other uses.

The Department of Energy (DOE) will assume the lead federal role in the FreedomCAR Partnership. Eliminating funding for the program would save $55 million in outlays in 2004 and $634 million over the 2004-2008 period. However, because the FreedomCAR Partnership and DOE's energy conservation and renewable energy programs—discussed in options 270-02 and 270-03, respectively—are related, the savings from eliminating all of those programs would be less than the sum of the figures for the three programs individually.

Supporters of this option point out that the program that preceded FreedomCar, the PNGV, lagged in its efforts to create a production-ready vehicle. Indeed, by early 2003, the only hybrid vehicles available to American consumers were made by Honda and Toyota, two foreign automakers. Hence, the efficacy of yet another domestic research partnership between the public and private sectors in this area is questionable. This option's proponents note as well that domestic automakers have already begun conducting fuel cell research and that competitive pressures on them from their foreign competitors may spur those efforts. In 2002, Honda began leasing a fuel cell-powered vehicle in California, and Toyota made fuel cell vehicles available to government test fleets. Proponents contend, therefore, that economic incentives to undertake such efforts already exist in the private sector and that government financial support would simply represent corporate welfare without inducing greater research.

Proponents also argue that instead of supporting applied research, the federal government could more effectively increase the efficiency of the nation's automotive fleet by raising gasoline taxes, user fees, or both. Such measures would increase the incentives for consumers to purchase energy-efficient automobiles. They might also bring about more productive research, as automakers would have a greater incentive both to conduct research into fuel cell technology and to broaden their research efforts to include other potential sources of automotive fuel efficiency, such as more-sophisticated drive trains and transmissions and lightweight but durable chassis and body materials.

Opponents of this option argue that imperfections in energy markets and environmental considerations make government promotion of energy-efficient technologies desirable, because private-sector incentives to conduct research are less than those of society overall to see such research undertaken. They would argue further that the disparity between private and societal incentives is exa-

cerbated by the fact that, relative to other investment projects competing for private-sector dollars, the possibility of commercializing fuel cell vehicles is far off and fraught with risk. Hence, without government sponsorship, the private sector would underfund research in this area. From the perspective of the option's opponents, funding the FreedomCAR Partnership brings the future viability of reducing energy consumption through fuel cell technology to a level that more closely corresponds to the interests of society overall.

**RELATED OPTIONS:** 270-01, 270-02, and 270-03; Revenue Options 27 and 40

## 270-08—Mandatory

# Reduce the Size of the Strategic Petroleum Reserve

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 367 | 376 | 386 | 395 | 405 | 1,929 | 1,929 |

The Strategic Petroleum Reserve (SPR) is a stock of crude oil, owned by the federal government, that was first authorized in 1975 to help safeguard the nation against the threat of a severe disruption of oil supplies. Consisting of four underground sites along the Gulf of Mexico, the SPR currently holds about 600 million barrels of oil and is about 85 percent full. The Department of Energy (DOE) can sustain a draw from the SPR at a maximum rate of about 4 million barrels per day (or 20 percent of the nation's current petroleum use) for about 90 days. The department has released oil in emergency circumstances only three times: it released more than 17 million barrels during the Persian Gulf War to prop up the U.S. supply, nearly 3 million barrels in fall 2000 to help establish a heating oil reserve for the Northeast in anticipation of a frigid winter, and 500,000 barrels earlier in 2000 to aid a local refinery after a dry-dock accident. The government's net investment in the SPR is about $17 billion for oil and about $4 billion for storage and transportation facilities. At a price of $25 per barrel, for example, that oil is valued at nearly $15 billion.

This option would require DOE to reduce the size and excess capacity of the SPR by closing the smallest storage site, Bayou Choctaw in Louisiana, and selling the site's 71 million barrels of oil over a five-year period (to minimize the impact of the sale on world oil prices). Receipts from the oil sales would be about $400 million in 2004 and would total $1.9 billion over the 2004-2008 period. Appropriations for operating the reserve could be reduced after the site was decommissioned. The option conforms with past Congressional actions: in 1996 and 1997, the Congress directed DOE to sell SPR oil to offset spending on the reserve and other programs. DOE is currently adding to the SPR's holdings in the absence of new appropriations for purchases. Royalties owed to the federal government by private companies are being taken in kind, rather than cash, and diverted to the reserve (about 23 million barrels thus far). And DOE has entered into exchange agreements with oil companies that have borrowed government oil or used SPR facilities, repaying the government with oil (about 10 million barrels). (This option does not include any budgetary savings from not operating the closed site or from avoiding government losses in those swap programs.)

Proponents of this option contend that reducing the SPR is supported by changes in the reserve's benefits and costs since 1975. Structural changes in energy markets and the economy at large have lowered the potential costs of a disruption of oil supplies and consequently the benefits from releasing the oil in a crisis. The Middle East remains an unreliable source of oil because of continuing tensions in the area. However, the increasing diversity of world oil supplies and the growing integration of the economies of oil-producing and oil-consuming nations lessen the risk of a sustained widespread disruption. Moreover, DOE's experience with selling oil during the Persian Gulf War and at other recent times indicates that the process of deciding to release oil and establishing its price can contribute to market uncertainty, diminishing the benefits of a release. The rising costs of maintaining the SPR also strengthen the case for this option: many of the SPR's facilities are aging and have required unanticipated spending for repairs.

Opponents of closing the site and selling the oil stress logistical and pricing concerns. Closing Bayou Choctaw could reduce DOE's flexibility in distributing oil from a drawdown, especially in the Mississippi Valley. Pipelines from that site connect to refineries that would otherwise be costly to supply. And selling SPR oil could adversely affect domestic oil producers, a concern that prompted the Congress to repeal legislation in 1998 requiring oil to be sold. The President has stated the goal of filling the SPR to its current capacity of 700 million barrels.

**RELATED CBO PUBLICATION**: *Rethinking Emergency Energy Policy*, December 1994

## 270-09—Mandatory

# Require the Tennessee Valley Authority to Impose a Transmission Surcharge on Future Electricity Sales

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 0 | 270 | 270 | 270 | 270 | 1,080 | 2,430 |

The Tennessee Valley Authority (TVA) is the largest single producer of electricity in the country and the sole supplier of power to retail utilities, large industrial customers, and federal agencies in large portions of the southeastern United States. The TVA is supposed to set electricity rates on the basis of its costs so that over time, receipts from its sales will be sufficient to pay for routine operations, depreciation of productive assets, and certain other activities. Current rates, however, are not sufficient to pay off the $4.1 billion that the TVA has invested in certain nuclear power plants that have never been completed.

It may be difficult for the TVA to raise funds to recover the costs of those uneconomic investments, for a number of reasons. First, the TVA's market may be opened to competition at some point, raising the pressure to keep rates low. Second, the TVA recently signed at least one contract that protects its customers from being charged after 2007 for the agency's uneconomic investments. Third, the TVA has other liabilities to cover that it has financed through leasebacks and other nontraditional means. Those arrangements have raised concerns about circumventing the $30 billion statutory limit on the agency's debt. If the TVA fails to recoup the costs of investments through increased rates, the burden may fall on taxpayers nationwide.

This option would require the TVA to impose a surcharge on electricity transported over its transmission system, regardless of the source, to recover a portion of its past costs. That transmission surcharge would have customers in the TVA's traditional service area pay for the past costs, even if they switched suppliers. The surcharge would be set to recoup $2.4 billion of the TVA's $4.1 billion investment in uneconomic assets over a period of 10 years. (The option would also redefine the TVA's debt limit to include related liabilities arising from long-term contracts and gradually scale back that limit to $20 billion—or $5 billion below the current level of outstanding debt—to ensure that revenues collected from the surcharge would go toward lowering the agency's debt burden.) Added receipts would total $1.1 billion over the 2004-2008 period.

Supporters of this option would contend that a surcharge on transmission services would lessen the possibility that taxpayers—rather than the TVA's customers—were saddled with the cost of its past uneconomic investments. The surcharge would produce additional receipts for the agency over the next 10 years. It would also protect the TVA's sales base because it would apply to all sales of electricity in its historical service area. Many states have authorized similar tariff surcharges to help local utilities recover the costs of investments that became uneconomic with the introduction of competition at the wholesale level.

Opponents of the option might argue that if charges for past investments made the TVA's rates uncompetitive, the region could suffer. They also might argue that requiring a transmission surcharge would constrain the TVA's ability to formulate efficient plans for paying off uneconomic investments. The most efficient solution, for example, might be for the TVA to write off a portion of the $4.1 billion investment in deferred nuclear assets at taxpayers expense.

**RELATED OPTIONS:** Revenue Options 27, 30, and 31

# 300

# Natural Resources and Environment

Budget function 300 supports programs administered by the Army Corps of Engineers, the Department of Agriculture, the Department of the Interior, the Environmental Protection Agency, and the Department of Commerce's National Oceanic and Atmospheric Administration. Those programs involve water resources, conservation, land management, pollution control, and natural resources. CBO estimates that discretionary outlays for function 300 will total $28 billion in 2003. Since 1990, spending under this function has increased almost every year.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 18.6 | 19.6 | 21.3 | 21.4 | 22.4 | 20.4 | 20.6 | 22.4 | 23.4 | 23.8 | 24.6 | 29.1 | 29.6 | 29.1 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 17.8 | 18.6 | 20.0 | 20.1 | 20.8 | 21.9 | 20.9 | 21.3 | 21.9 | 23.6 | 25.0 | 26.0 | 28.6 | 28.1 |
| Mandatory | -0.7 | * | * | 0.2 | 0.2 | * | 0.6 | -0.1 | 0.4 | 0.3 | 0.1 | -0.3 | 0.8 | 1.0 |
| Total | 17.1 | 18.6 | 20.0 | 20.2 | 21.0 | 21.9 | 21.5 | 21.2 | 22.3 | 24.0 | 25.0 | 25.6 | 29.5 | 29.1 |
| **Memorandum**: Annual Percentage Change in Discretionary Outlays | n.a. | 4.5 | 7.7 | 0.2 | 3.7 | 5.4 | -4.6 | 1.7 | 3.0 | 7.9 | 5.7 | 3.9 | 10.3 | -1.8 |

Note: * = between -$50 million and zero; n.a. = not applicable.

## 300-01—Discretionary

# Increase Net Receipts from National Timber Sales

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 78 | 80 | 83 | 86 | 89 | 416 | 909 |
| Outlays | 76 | 80 | 82 | 85 | 88 | 411 | 899 |

The Forest Service (FS) manages federal timber sales from national forests. The spending necessary to make those sales in some cases exceeds the receipts paid to the government. As a result, questions have arisen about whether those sales should be made.

In 1998, the FS sold roughly 3 billion board feet of public timber. Purchasers may harvest the timber over several years and pay the FS upon harvest. The total 1998 harvest, 3.3 billion board feet, represented a plateau following a decline in volume over previous years. According to the FS's *Forest Management Program Annual Reports*, in recent years, the FS spent more on the timber program than it collected from companies harvesting the timber. In 1998, the expenses for the program reported by the FS exceeded the receipts by about $126 million. (Because of new depreciation procedures associated with road costs, 1998 figures are not directly comparable with those for prior years.) In calculating expenses, the FS excluded receipt-sharing payments to states. With such payments included, expenses exceeded receipts by more than $338 million (or more than 60 percent) in 1998.

The FS does not maintain the data needed to estimate the annual receipts and expenditures associated with each individual timber sale. Therefore, it is hard to determine precisely the possible budgetary savings from phasing out all timber sales in the National Forest System for which expenditures are likely to exceed receipts. To illustrate the potential savings, however, this option estimates the reduction in net outlays in the federal budget from eliminating all future timber sales in five National Forest System regions for which expenditures significantly exceeded receipts in 1997 and 1998.

In those five regions (the Northern, Rocky Mountain, Southwestern, Intermountain, and Alaska regions), cash expenditures exceeded cash receipts by at least 30 percent in 1997 and 1998. Eliminating all future timber sales from those regions would reduce the FS's outlays for 2004 by $76 million and by $411 million for the 2004-2008 period.

Timber sales for which spending exceeds receipts have several potential drawbacks in addition to their federal costs. They may lead to excessive depletion of federal timber resources and the destruction of roadless forests that have recreational value.

Potential advantages of those sales include mitigating forest stewardship costs and bringing stability to communities dependent on federal timber for logging and related jobs. Timber sales also provide access to the land —as a result of road construction—for fire protection and recreational uses.

**RELATED OPTIONS:** 300-03, 300-04, and 300-07; Revenue Option 26

## 300-02—Discretionary

# Eliminate Federal Grants for Water Infrastructure

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,082 | 1,654 | 2,816 | 2,874 | 2,938 | 11,364 | 27,055 |
| Outlays | 54 | 245 | 713 | 1,387 | 2,081 | 4,480 | 18,477 |

The Clean Water Act (CWA) and the Safe Drinking Water Act (SDWA) require municipal wastewater and drinking water systems to meet certain performance standards to protect the quality of the nation's waters and the safety of its drinking water supply. The CWA provides financial assistance so communities can construct wastewater treatment plants that comply with the act's provisions. The 1996 amendments to the SDWA authorized a state revolving loan program for drinking water infrastructure. For 2003, the Congress appropriated about $2.6 billion for the Environmental Protection Agency's (EPA's) programs for wastewater and drinking water infrastructure. Phasing out all of EPA's funding of water facilities over three years would save $54 million in outlays in 2004 and $4.5 billion through 2008.

Title II of the CWA provides for grants to states and municipalities for constructing wastewater treatment facilities. As amended in 1987, the CWA phased out title II grants and authorized a new grant program under title VI to support state revolving funds (SRFs) for water pollution control. Under the new system, states continue to receive federal grants, but now they are responsible for developing and operating their own programs. For each dollar of title VI grant money a state receives, it must contribute 20 cents to its SRF. States use the combined funds to make low-interest loans to communities for building or upgrading municipal wastewater treatment facilities. Although authorization for the SRF program under the CWA has expired, the Congress continues to provide annual appropriations for grants.

As amended in 1996, the SDWA authorizes EPA to make grants to states for capitalizing revolving loan funds for treating drinking water. As with the CWA's wastewater SRF program, states may use those funds to make low-cost financing available to public water systems for constructing facilities to treat drinking water. In 2003, the Congress appropriated $850 million for capitalization grants for drinking water SRFs.

Proponents of eliminating federal grants to water-related SRFs say such grants may encourage inefficient decisions about water treatment by allowing states to lend money at below-market interest rates, which in turn could reduce incentives for local governments to find less costly alternatives for controlling water pollution and treating drinking water. Proponents also argue that federal contributions to wastewater SRFs were originally viewed as a temporary step on the way to full state and local financing and that they may have replaced, rather than supplemented, state and local spending.

Opponents of such cuts argue that the need for investments to replace aging infrastructure, reduce health threats in drinking water (from cryptosporidium, for example), and protect the nation's waters (from sewer overflows, for example) is so large that federal aid should be increased, not reduced. They say that water systems in many small and economically disadvantaged communities will be unable to maintain service quality and comply with the CWA's and SDWA's new and forthcoming requirements without external assistance and that states cannot supply all of the needed funding. They further argue that eliminating the federal grants would mean that even many large systems, which tend to have lower costs because of economies of scale, would have to charge rates that would pose significant hardships for low- and moderate-income households.

**RELATED OPTIONS:** 300-02 and 450-01

**RELATED CBO PUBLICATIONS:** *An Analysis of Future Investment in Water Infrastructure*, October 2002; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

## 300-03—Mandatory

# Reauthorize Holding and Location Fees and Charge Royalties for Hardrock Mining on Federal Lands

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 25 | 25 | 25 | 25 | 25 | 125 | 250 |

The General Mining Law of 1872, which originally supported the policy of encouraging settlement of the American West, governs access to hardrock minerals—including gold, silver, copper, and uranium—on public lands. Unlike producers of fossil fuels and other minerals from public lands, miners do not pay royalties to the government on the value of hardrock minerals that they extract. Instead, under the mining law, holders of more than 10 mining claims on public lands pay an annual holding fee of $100 per claim, and claimholders pay a one-time $25 location fee when recording a claim. However, authorization for the federal government to collect the holding and location fees expires in 2003.

Estimates place the current gross value of the production of hardrock minerals at about $600 million annually (excluding claims with patent applications in process). That sum has diminished greatly in recent years because of patenting activity. (In patenting, miners gain title to public lands by paying a one-time fee of $2.50 or $5.00 an acre.) This option would reauthorize the current holding and location fees. It assumes that such fees would be recorded as offsetting receipts to the Treasury (they are currently counted as offsetting collections to appropriations). The option also includes an 8 percent royalty that the Congress could impose on producers of hardrock minerals from public lands. That royalty would apply to net proceeds (defined here as revenues from sales minus costs for mining, separation, transportation, and other items).

Total budgetary receipts from those actions would be $25 million in 2004 and $125 million over the 2004-2008 period. Of that total, the reauthorization of holding and location fees would account for about $100 million and royalty collections for about $25 million. Those estimates assume that states in which the mining takes place would receive 10 percent of the gross royalty receipts. They also assume that no further patenting of public lands would occur. (In comparison, royalties based on gross proceeds would raise more money. In general, the costs of administering any royalty based on net proceeds could exceed those for a royalty based on gross proceeds.)

People in favor of this option—including many environmental advocates—argue that low holding fees and no royalties make producing minerals on federal lands less costly than on private lands (where the payment of royalties is the rule). That policy, they contend, encourages overdevelopment of public lands, which may cause severe environmental damage. Reforming the law could promote other uses of those lands, such as recreation and wilderness conservation.

Opponents of this option would argue that without free access to public resources, miners—especially small ones—would limit their exploration for hardrock minerals in this country. In addition, they might argue, royalties would diminish the profitability of many mines, leading to scaled-back operations or closure and adverse economic consequences for mining communities in the West. Because many mineral prices are set in world markets, miners would be unable to pass along new royalty costs to consumers.

**RELATED OPTIONS:** 300-01, 300-04, and 300-07; Revenue Options 22 and 23

**RELATED CBO PUBLICATIONS:** *Reforming the Federal Royalty Program for Oil and Gas,* November 2000; *Alternative Proposals for Royalties on Hardrock Minerals*, May 4, 1993; and *Review of the American Mining Congress Study of Changes to the Mining Law of 1872*, April 1992

## 300-04

# Set Grazing Fees for Federal Lands on the Basis of State Formulas

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 5 | 16 | 20 | 22 | 23 | 86 | 159 |

Note: This fee could be classified as a discretionary offsetting collection or a mandatory offsetting receipt, depending on the specific language of the legislation establishing the fee.

The federal government owns and manages just over 630 million acres of public lands, which have many purposes, including providing grazing for privately owned livestock. Cattle owners compensate the government for using the lands by paying grazing fees, but the fees may not give the public a fair return.

The Forest Service and the Bureau of Land Management (BLM) administer grazing on public rangelands in the West. In 2001, ranchers were authorized to use about 16 million animal unit months (AUMs)—a standard measure of forage—for grazing on those lands.

In 1990, the appraised value of public rangelands in six Western states varied between $5 and $10 per AUM. A 1993 study indicated that the Forest Service and BLM spent $4.60 per AUM in that year to manage their rangelands for grazing. The 1993 fee, however, was $1.86 per AUM. Thus, the current fee structure may be well below market rates and also below the federal costs of administering the program. (The current fee is $1.35 per AUM.)

The Public Rangelands Improvement Act of 1978 established the current formula for grazing fees. It uses a 1966 base value of $1.23 per AUM and makes adjustments to account for changes in beef cattle markets and in markets for feed, fuel, and other production inputs. The Congress has considered various proposals to increase grazing fees. The increase in federal receipts resulting from any such proposal depends on the degree to which ranchers reduce their use of AUMs in response to higher fees.

This option would determine grazing fees for federal lands in each state the same way the particular state determines grazing fees on state-owned lands. The government would implement this option over 10 years as existing permits expired. Added receipts in 2004 would be $5 million, and added receipts through 2008 would total $86 million. Those estimates are net of additional payments to states, which would total roughly $29 million in the 2004-2008 period. The estimates do not include any additional appropriations for range improvements that could result from added receipts.

Proponents of this option believe that the low fees subsidize ranching and contribute to overgrazing and deteriorated range conditions. They support the approach of following decisions made at the state level and reject the one-size-fits-all nature of the current federal fee. State grazing fees and the means of calculating them vary widely by state and sometimes even within a state. Supporters of this option also point out that states' interest in the revenue received from both state and federal fees lessens any incentive to manipulate state fees to lower federal fees.

Opponents of this option note that state rangelands may be more valuable than federal lands for grazing purposes. Therefore, some formulas used by states to establish fees may not reflect those differences in quality and conditions of use when applied to federal lands. Opponents could also argue that the administrative costs of using different procedures to set federal grazing fees in each state would be higher than those incurred under the current uniform federal fee structure. (This option does not consider possible differences in administrative costs.)

**RELATED OPTIONS:** 300-01, 300-03, and 300-07

## 300-05

# Recover Costs Associated with the Issuance of Permits by the Army Corps of Engineers

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 10 | 20 | 21 | 21 | 22 | 94 | 217 |

Note: This fee could be classified as a discretionary offsetting collection or a mandatory offsetting receipt, depending on the specific language of the legislation establishing the fee.

The Army Corps of Engineers administers laws pertaining to the regulation of the nation's navigable waters. Section 10 of the Rivers and Harbors Act of 1890 requires the Corps to issue permits for work that would affect navigable waters or materials around those waters. Section 404 of the Clean Water Act requires the Corps to issue permits for dredging or placing fill material in navigable waters. In 2001, the Corps received about 85,000 permit applications. By increasing fees for permits issued under sections 10 and 404, the Corps could recover a portion of its annual regulatory costs. Imposing cost-of-service fees on commercial applicants would generate $10 million in receipts in 2004 and $94 million through 2008.

Section 404 grew to become the core of the nation's effort to protect wetlands. As legally interpreted, the term "navigable" includes waters that would not conventionally seem so, such as wetlands adjacent to navigable waters and perhaps wetlands adjacent to nonnavigable tributaries of traditional navigable waters; the terms "dredge" and "fill" encompass virtually any activity in which dirt is moved. As a result, the Corps has regulatory jurisdiction over many wetlands. (In the wake of a 2001 Supreme Court ruling, the extent of the Corps's jurisdiction over U.S. wetlands will ultimately be determined by federal agencies' interpretations of terms like "adjacent" and "tributary" that withstand the scrutiny of the courts.) Under section 404, the Corps must evaluate each application and grant or deny a permit on the basis of expert opinion and statutory guidelines. The bulk of the permits are quickly approved through outstanding general or regional permits, which grant authority for many low-impact activities. Evaluation of applications not covered by outstanding permits may require the Corps to conduct detailed, lengthy, and costly reviews.

Currently, the fees levied for commercial and private permits are $100 and $10, respectively. Government applicants do not pay a fee. That fee structure has not changed since 1977. Total fee collections fall far short of covering the costs of administering the program, particularly for applications requiring detailed review.

Proponents of higher fees for commercial applicants argue that the party pursuing a permit—not the general taxpaying public—should bear the cost of the permit. Since the permit seeker is advancing a private interest whose benefits accrue to a private party, the cost should be borne by that party. Taxpayers should not have to pay for something that advances the interests of a comparative few.

Permit seekers oppose such fees because they do not want to pay the costs of a process that may ultimately deny them the right to use their land in the way they choose. The goal of the section 404 program, for example, is to advance a public interest by protecting wetlands. Some people argue that because society benefits from wetlands protection, often at the perceived expense of property owners, society should pay. Furthermore, they contend, the regulatory process that property owners must deal with is already onerous, so raising the permit fees would further infringe on property owners' rights.

**RELATED OPTIONS:** 300-06, 300-08, 400-04, and 400-05

**RELATED CBO PUBLICATION:** *Regulatory Takings and Proposals for Change*, December 1998

## 300-06—Discretionary

# Impose Fees on Users of the Inland Waterway System

| | | | | | | Total | |
|---|---|---|---|---|---|---|---|
| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | 2004-2013 |
| Added Receipts | 88 | 175 | 360 | 371 | 381 | 1,376 | 3,456 |

Note: This fee could be classified as a discretionary offsetting collection, a mandatory offsetting receipt, or a tax receipt, depending on the specific language of the legislation establishing the fee.

The Army Corps of Engineers spent about $600 million on the nation's inland waterway system in 2001—about 60 percent for operation and maintenance (O&M) and about 40 percent for new construction. Current law allows up to 50 percent of new inland waterway construction to be funded by revenues from the inland waterway fuel tax, a levy on the fuel consumed by tow boats using most segments of the system.

Imposing user fees that are high enough to fully recover both O&M and construction outlays for inland waterways would generate $88 million in receipts in 2004 and about $1.4 billion over five years. The receipts could be considered tax revenues, offsetting receipts, or offsetting collections, depending on the form of the implementing legislation. They could be raised by increasing fuel taxes, imposing charges for the use of locks, or imposing fees based on the weight of shipments and distance traveled. (The estimates do not take into account any resulting reductions in income tax revenues.)

Advocates of this option contend that imposing higher fees on users of the inland waterway system could improve the efficiency of its use by encouraging shippers to choose the most efficient transportation route. Moreover, user fees would encourage more-efficient use of existing waterways, reducing the need for new construction to alleviate congestion. Further, user fees based on costs send market signals that help identify the additional projects likely to provide the greatest net benefits to society.

But the effects of user fees on efficiency would depend largely on whether the fees were set at the same rate for all segments of a waterway or were based on the cost of each segment. Since costs vary dramatically by segment, systemwide fees would offer weaker incentives for the efficient use of resources.

Opponents of this option argue that user fees might repress economic development in some regions. Fees could be phased in to lessen those effects, but that approach would reduce near-term receipts. Imposing higher user fees would also lower the income of barge operators and shippers in some regions, but those losses would be small in the context of overall regional economies.

**RELATED OPTIONS:** 300-05, 300-08, 400-04, 400-05, and 400-06; Revenue Option 35

**RELATED CBO PUBLICATION:** *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992

## 300-07—Mandatory

# Open the Coastal Plain of the Arctic National Wildlife Refuge to Leasing

| | | | | | | Total | |
|---|---|---|---|---|---|---|---|
| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | 2004-2013 |
| Added Receipts | 0 | 0 | 1,700 | 0 | 400 | 2,100 | 2,150 |

The Arctic National Wildlife Refuge (ANWR) consists of 19 million acres in northeastern Alaska, of which 1.5 million acres are coastal plain. The coastal plain is the yet-to-be-explored onshore area with perhaps the country's most promising oil-production potential. It is also the least disturbed Arctic coastal region—valued for species conservation and used by indigenous people to support their daily lives.

ANWR was established by the Alaska National Interest Lands Conservation Act of 1980. The refuge serves to conserve fish and wildlife habitats, fulfill related international treaty obligations, provide opportunities to continue indigenous lifestyles, and protect water quality. The law prohibits industry activity on ANWR's coastal plain unless specifically authorized by the Congress.

This option would open ANWR's coastal plain to oil and gas production. The federal government would receive proceeds from auctioning oil and gas development rights and (once production begins) royalties. This option, as do some proposals, incorporates the assumption that the federal government receives one-half of the offsetting receipts from those sources and the state of Alaska receives the other half.

For this estimate, the Congressional Budget Office assumed an average price of $22 per barrel (in 2003 dollars) during the 2013-2045 period, on the basis of price projections from the state of Alaska, the Energy Information Administration, and other sources. With oil selling for $22 per barrel (delivered to the West Coast), the Department of the Interior estimates a 50 percent probability that at least 2.5 billion barrels of oil will be produced. Using that mean resource assessment and assuming that lease sales are held in 2006 and 2008, CBO estimates that leasing ANWR will generate receipts of about $4.2 billion over five years (with half of that amount going to Alaska).

Arguments in favor of this option include the national security advantages of reducing dependence on imported oil. Most of ANWR would remain closed to development, and the part of the coastal plain that would be directly affected by oil drilling and production represents less than 1 percent of the refuge. Moreover, technological changes in the industry have improved its ability to safeguard the environment.

An argument against this option is the short-term nature of the still uncertain gain from extracting a nonrenewable resource: it will not provide lasting energy security. The coastal plain is ANWR's most biologically productive area and sustains the biological productivity of the entire refuge. Opponents of leasing in ANWR point out that industrial activity poses a threat to wildlife and the environment despite efforts to mitigate its impact.

**RELATED OPTIONS:** 300-01, 300-03, and 300-04

## 300-08

# Impose a New Harbor Maintenance Fee

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 150 | 229 | 208 | 191 | 172 | 950 | 1,569 |

Notes: These numbers are net of revenues lost from repealing the existing harbor tax.

This fee could be classified as a discretionary offsetting collection or a mandatory offsetting receipt, depending on the specific language of the legislation establishing the fee.

On March 31, 1998, the Supreme Court ruled that the harbor maintenance tax (as it applied to exports) violated the constitutional restriction that "No tax or duty shall be laid on articles exported from any State." The federal government ceased collecting the tax on exports on April 25, 1998, but continued to collect the tax on imports. One way to replace the revenue formerly generated by the harbor maintenance tax is to develop a new system of harbor fees that is constitutional. Under such a system, the commercial users of U.S. ports would pay a fee based on port use rather than a payment based on cargo value. Such a fee would apply to imports, exports, and domestic shipments. Taxes currently levied on imports and domestic shipments would be rescinded. The fees would help support the operation, construction, and maintenance of harbors.

The Army Corps of Engineers now spends about $960 million (in 2000 dollars) annually for costs associated with operating, constructing, and maintaining commercial harbors nationwide. A major part of those activities is maintaining adequate channel depths. Replacing what remains of the harbor maintenance tax with a more comprehensive fee on commercial port users would generate $150 million in receipts in 2004 and $950 million over the 2004-2008 period.

Two arguments can be made for imposing a harbor maintenance fee. First, harbor maintenance activities, such as dredging by the Corps of Engineers, provide a commercial service to identifiable beneficiaries. Modern and well-maintained ports save shippers money by allowing the use of larger vessels and by minimizing inland transport costs. Exporters currently make no payments directly associated with their use of port facilities. Second, imposing a harbor fee would be unlikely to decrease the use of ports because the fee would result in charges on users similar to the ones they recently paid under the rescinded tax.

Whether a new harbor fee would pass constitutional muster is uncertain. Such a fee might be viewed by the Supreme Court as an unconstitutional export tax disguised by another name. A second legal concern with a fee program is whether it would violate international trade agreements, as several international trading partners allege of the harbor maintenance tax. Another drawback of the fee is that after several years, the cash it generated would not keep pace with the revenue that the rescinded tax on exports would have generated: under the existing harbor maintenance tax on imports, tax collections based on the value of the goods shipped are projected to increase more quickly than the fee in this option, which would be tied to the costs of operating, constructing, and maintaining harbors.

**RELATED OPTIONS:** 300-05, 300-06, 400-05, and 400-06

## 300-09—Discretionary

# Terminate Economic Assistance Payments Under the South Pacific Fisheries Treaty

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 14 | 15 | 15 | 15 | 15 | 74 | 157 |
| Outlays | 14 | 15 | 15 | 15 | 15 | 74 | 157 |

The South Pacific Fisheries Treaty is formally known as the Treaty on Fisheries Between the Governments of Certain Pacific Island States and the Government of the United States of America. Signed in April 1987, it lays out terms and conditions under which up to 55 U.S.-flag commercial fishing vessels may use methods involving special nets (referred to as purse seine) to catch tuna in the territorial waters of 16 Pacific Island states, including Kiribati, Micronesia, and Papua New Guinea. Japan, South Korea, and Taiwan have similar treaties providing access to those waters for their tuna fleets.

Associated with the treaty is an agreement on economic assistance paid by the United States to the South Pacific Forum Fisheries Agency—from June 1993 through June 2002, it called for an annual payment of $14 million. In March 2002, the signatories completed negotiations to amend and extend the treaty, agreeing on an annual economic assistance payment of $18 million from June 2003 to June 2012. The amendment has not yet been forwarded to the U.S. Senate for ratification. This option would terminate the U.S. government's payments to the South Pacific Forum Fisheries Agency. Savings would be $14 million in 2004 and would total $74 million over the 2004-2008 period.

The expiring treaty also provided for an annual payment of $4 million by the U.S. tuna industry to cover license fees for up to 55 vessels as well as technical assistance to the Pacific Island parties. (In addition, it called for the industry to cover the cost of a program under which observers could board vessels for scientific, compliance, monitoring, and other purposes.) From June 1993 to June 2000, on average, 40 U.S.-flag vessels had access to tuna in the territorial waters of the South Pacific Island states each year. Thus, industry payments per vessel, excluding the cost of the observer program, averaged nearly $100,000 annually. The treaty extension in this option would lower the maximum number of vessel licenses to 45 and the annual industry payment to $3 million.

People in favor of terminating U.S. economic assistance and not extending the treaty believe that taxpayers are supporting the access of private vessels to the territorial waters of the party states. The U.S. subsidy may in fact be encouraging the overexploitation of fisheries.

People who oppose this option believe that the treaty is a vehicle through which the United States provides financial assistance in keeping with its foreign policy interests to the nations in the South Pacific Forum Fisheries Agency. They argue that it is not a subsidy—the fishing industry's own payments under the treaty are comparable with those made by non-U.S. fleets. Those fleets obtain yearly licenses on a bilateral basis with any Pacific Island state of interest at a cost of 5 percent of the value of their previous year's catch.

## 300-10—Discretionary

# Eliminate Federal Funding of Beach Replenishment Projects

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 96 | 98 | 100 | 103 | 105 | 502 | 1,090 |
| Outlays | 34 | 98 | 100 | 102 | 104 | 438 | 1,030 |

Each year, the Army Corps of Engineers partially funds and conducts several sand replenishment projects to counter beach erosion. That activity raises questions about the federal role in addressing what may be primarily local problems and the ultimate effectiveness of the replenishment efforts, regardless of who pays for them. The operations typically involve dredging sand from offshore locations and pumping it ashore to rebuild eroded areas. Typically, state and local governments share part of the cost. Ceasing federal funding for beach replenishment activities would reduce discretionary outlays by $34 million in 2004 and $438 million over the 2004-2008 period.

Beach replenishment projects have two primary motivations: mitigating damage and enhancing recreation. Beaches act as a barrier to waves and protect coastal property from severe weather. Replenishing eroded beaches helps them maintain that protective function. And because beaches are an important recreational resource in many areas, sand replenishment projects help to ensure that such areas continue to generate economic activity through tourism.

Proponents of halting federal spending for beach replenishment argue that its benefits accrue largely to the states and localities in which the projects occur. Therefore, they reason, state and local governments should bear the projects' entire cost, not the federal government. An argument against any funding, federal or otherwise, of replenishment projects is their ultimate futility. Beach erosion is an irreversible natural process, and replenishment projects serve only to temporarily delay the inevitable natural shifting of beaches. A better long-term solution, proponents argue, would be to accept the fact that beaches will shift over time and to remove the various retention structures that inhibit the natural flow of sand along beaches and sometimes exacerbate erosion.

Opponents of eliminating federal funding argue that beach replenishment not only benefits specific states and localities but also serves the interests of nonresident beachgoers. They further contend that it would be unfair to stop federal funding because municipalities and owners invested in beachfront property with the expectation of continuing federal support. Opponents also argue that in some cases, federal projects—such as those intended to keep coastal inlets open—contribute to beach erosion and that the federal government should bear part of the cost of replenishment in those cases.

**RELATED OPTIONS:** 400-02 and 400-03

## 300-11—Discretionary

# Eliminate the Environmental Protection Agency's Energy-Efficiency Partnerships

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 59 | 60 | 61 | 63 | 65 | 308 | 655 |
| Outlays | 59 | 60 | 61 | 62 | 64 | 306 | 655 |

The Climate Change Technology Initiative (CCTI) is a governmentwide strategy to stabilize emissions of greenhouse gases. It includes several partnership programs of the Environmental Protection Agency (EPA) that are intended to stimulate the adoption of energy-efficient technologies and the use of renewable energy by households and businesses. This option would halt new appropriations for two of EPA's activities that are a part of the CCTI but may contribute few environmental benefits: the Energy Star and Green Lights programs for labeling energy-efficient products and the Climate Wise program of public/private partnerships to encourage businesses to save energy. Ending those appropriations would save $59 million in 2004 and $306 million over the 2004-2008 period.

Energy Star and Green Lights are product-labeling programs meant to encourage businesses to sell products that meet or exceed federal guidelines for energy efficiency and to raise consumers' awareness of energy-efficient products. The types of products that EPA has designated to receive the labels include lighting fixtures, home appliances, office equipment, home construction materials, and new houses. EPA also disseminates information on sellers of the labeled products and offers program participants some technical assistance in implementing changes that increase energy efficiency. The Climate Wise program helps businesses identify actions that may save energy and reduce their production costs—by providing free pollution-prevention and energy-efficiency assessments, for instance. For the three programs, major benefits to participants are in the public recognition and free advertising that they receive for their efforts.

People who advocate eliminating the partnership programs question the actual energy savings they produce and whether any savings that do occur reduce greenhouse gas emissions. For example, putting a government label on products that already meet government standards may produce little gain. Furthermore, encouraging consumers to purchase an electric appliance identified by EPA's partnerships rather than a less-efficient gas appliance could actually increase carbon dioxide emissions because the carbon content of the coal used to produce electricity is so high.

People who oppose eliminating the programs emphasize that saving energy may reduce emissions of greenhouse gases (primarily carbon dioxide) and other toxic or smog-producing elements. They also believe that EPA is addressing market failures because consumers do not see the full public benefits of using energy-saving products. Insufficient consumer interest in energy efficiency may compound industry's reluctance to invest in uncertain new technologies.

**RELATED OPTIONS:** 270-02 and 270-04

# 350

# Agriculture

Budget function 350 covers programs administered by the Department of Agriculture, including activities such as agricultural research and the stabilization of farm incomes through loans, subsidies, and other payments to farmers. CBO estimates that discretionary outlays for function 350 will total more than $5 billion in 2003, and mandatory outlays will total $16 billion.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 2.7 | 3.1 | 4.5 | 4.3 | 4.4 | 4.0 | 4.2 | 4.2 | 4.3 | 4.5 | 4.7 | 5.2 | 5.6 | 5.5 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 2.6 | 2.8 | 4.2 | 4.3 | 4.4 | 4.0 | 4.1 | 4.1 | 4.3 | 4.6 | 4.7 | 5.1 | 5.3 | 5.5 |
| Mandatory | 9.3 | 12.4 | 11.0 | 16.1 | 10.7 | 5.8 | 5.0 | 5.0 | 7.9 | 18.4 | 32.0 | 21.3 | 16.9 | 16.2 |
| Total | 12.0 | 15.2 | 15.2 | 20.4 | 15.0 | 9.8 | 9.2 | 9.0 | 12.2 | 23.0 | 36.6 | 26.4 | 22.2 | 21.7 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 6.6 | 49.2 | 1.9 | 3.1 | -8.5 | 3.1 | -1.5 | 6.3 | 5.5 | 1.9 | 9.7 | 4.0 | 4.2 |

Note: n.a. = not applicable.

## 350-01—Mandatory

# Eliminate the Foreign Market Development Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 24 | 31 | 35 | 35 | 35 | 160 | 335 |
| Outlays | 24 | 31 | 35 | 35 | 35 | 160 | 335 |

The Department of Agriculture (USDA) promotes exports and international activities through the programs of the Foreign Agricultural Service (FAS). In the Foreign Market Development Program, FAS acts as a partner in joint ventures with "cooperators," such as agricultural trade associations and commodity groups, to develop markets for U.S. exports. Eliminating funding for that program would reduce outlays by $24 million in 2004 and $160 million over five years.

The Foreign Market Development Program, also known as the Cooperator Program, typically promotes generic products and basic commodities, such as grains and oilseeds, but it also covers some higher-valued products, such as meat and poultry. The program's effectiveness and the extent to which it replaces private expenditures with public funds are uncertain. Supporters of this option contend that cooperators should bear the full cost of foreign promotions because the cooperators benefit from them directly. They also argue that the program's services duplicate USDA's Market Access Program and other activities.

Eliminating the Cooperator Program, however, could place U.S. exporters at a disadvantage in international markets, because other countries provide support to their exporters. Regarding the issue of duplicative services, some critics of this option note that the Cooperator Program is distinct from other programs in part because it focuses on services to trade organizations and technical assistance. Moreover, some opponents of this option consider the program useful for developing markets that could benefit the overall economy.

**RELATED OPTIONS:** 350-03 and 370-02

## 350-02—Mandatory

# Eliminate the Market Access Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 6 | 101 | 140 | 188 | 200 | 635 | 1,635 |
| Outlays | 6 | 101 | 140 | 188 | 200 | 635 | 1,635 |

The Market Access Program (MAP) assists U.S. exporters of agricultural products. MAP provides funds to partially offset the costs of overseas market building and product promotion conducted by trade associations, commodity groups, and some for-profit firms. Under current law, funding for the program will increase from $125 million in 2004 to $200 million in 2006 and thereafter, the Congressional Budget Office estimates. Eliminating MAP would reduce outlays by $635 million over the next five years.

The program has been used to promote a wide range of products, most of them highly valued, including fruit, tree nuts, vegetables, meat, poultry, eggs, and seafood. About 25 percent of MAP's funding goes to promote brand-name products. To promote such products, cooperatives or small private companies must contribute a minimum of 50 percent of the promotion cost. To promote generic products, trade associations and others must contribute at least 10 percent of the cost.

Some supporters of this option argue that participants should bear the full cost of foreign promotions because they benefit directly from them. (The extent to which the program has developed markets or replaced private expenditures with public funds is uncertain.) In addition, some supporters note the possibility of duplication because the Department of Agriculture provides marketing funds through the Foreign Market Development Program, administered by the Foreign Agricultural Service, and other activities. Many people also object to spending taxpayers' money on advertising brand-name products.

Opponents of this option argue that eliminating MAP could place U.S. exporters at a disadvantage in international markets, because other countries support their exporters. Responding to concerns about duplication, some opponents note that MAP differs from other programs partly because it focuses on foreign retailers and consumer promotions. In addition, some critics of this option maintain that the Market Access Program is useful for developing markets that could benefit the overall economy.

**RELATED OPTIONS:** 350-01 and 370-02

## 350-03—Mandatory

# Reduce the Reimbursement Rate Paid to Private Insurance Companies in the Department of Agriculture's Crop Insurance Program

| | | | | | | Total | |
|---|---|---|---|---|---|---|---|
| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | 2004-2013 |
| Savings | | | | | | | |
| Budget authority | 53 | 53 | 54 | 55 | 56 | 271 | 575 |
| Outlays | 48 | 52 | 54 | 55 | 56 | 265 | 565 |

The Federal Crop Insurance Program protects farmers from losses caused by droughts, floods, pests, and other natural disasters. Insurance policies that farmers buy through the program are sold and serviced by private insurance firms, which receive an administrative cost reimbursement according to the total amount of insurance premiums they handle. Firms also share underwriting risk with the federal government and can gain or lose depending on the value of crop losses relative to the claims made. Overall, the companies typically gain.

The General Accounting Office (GAO) has studied the crop insurance program, particularly the amount paid to the firms that service and sell the insurance policies. In a 1997 study, GAO concluded that the amount the program had paid those firms exceeded the reasonable expenses of selling and servicing the crop insurance policies. Partly on the basis of that information, the Congress cut the reimbursement rate for the benchmark crop insurance plan from 27 percent of premiums to 24.5 percent (with comparable reductions for other plans). This option would further reduce the benchmark rate—to 22.5 percent—saving $48 million in outlays in 2004 and $265 million over the 2004-2008 period.

Proponents of this option believe that lawmakers could cut the reimbursement rate more deeply without substantially affecting the quantity or quality of services provided to farmers. In addition to relying on GAO's analysis, they point to the dramatic expansion in business that followed enactment of the Federal Crop Insurance Reform Act of 1994 and the Agricultural Risk Protection Act of 2000. The crop insurance policies in force for 2002 totaled about $37 billion, which is about three times the level of the early 1990s. Total premiums grew correspondingly, but because of economies of scale, the costs of selling and servicing the policies probably grew by less. Therefore, proponents argue, further cuts to the benchmark reimbursement rate are appropriate. Finally, even if cuts caused firms to curtail some services to farmers, proponents claim that the results would not be significant or irreversible.

Opponents of this option argue that further cuts would impair the ability of the crop insurance industry to sell and service insurance and would threaten farmers' access to insurance. If farmers lacked insurance, opponents contend, lawmakers would be more likely to resort to expensive, special-purpose relief programs when disaster struck, negating any apparent savings from cutting the reimbursement rate. Given the current drought conditions in some areas of the country and the failure last year of the largest insurance company participating in the program, cutting reimbursement rates would further reduce companies' profits, making it harder for them to maintain the services they now provide to farmers.

## 350-04—Mandatory

# Impose New Limits on Farm Program Payments to Producers of Certain Agricultural Commodities

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 156 | 180 | 187 | 180 | 180 | 883 | 1,654 |
| Outlays | 156 | 180 | 187 | 180 | 180 | 883 | 1,654 |

The government supports producers of certain commodities, including wheat, feed grains, cotton, and rice, by giving them cash payments or cash-equivalent benefits.[1] Since 1970, the amount that a producer can collect of some or all of those payments has been subject to a dollar limit. The size of such limits and how they would be applied were subjects of much debate during Congressional consideration of the recently enacted Farm Security and Rural Investment Act.[2] The new law sets limits that are similar to the ones that applied under the previous farm legislation. This option would adopt the tighter limits contained in the Senate-passed version of the farm bill (S. 1731). Savings would total $156 million in 2004 and $883 million over five years.

Producers are entitled to two different types of support payments under current law. First, they can receive fixed payments based on their historical production. Those payments are not affected by market prices. Second, producers may be entitled to additional payments, known as countercyclical payments, that depend on market prices. In addition to those two types of support, producers can receive benefits from the commodity loan program, which essentially guarantees them a minimum price for their crop. Under that program, whenever a shortfall occurs, producers receive cash payments or benefits that amount to forgiveness of a portion of the commodity loan.

Commodity program payments are made to "persons," including individuals, some partnerships, and other legal entities. Individual producers can qualify for payments through up to three different entities—such as three different farms. Thus, individuals are actually limited to receiving about twice the current farm payment limit of $105,000 per year ($40,000 per person for direct payments and $65,000 per person for countercyclical payments). In theory, an additional limit of $75,000 per person applies to commodity loan benefits, but that limit is not effective in most circumstances.

This option would limit total fixed and countercyclical payments to an individual to $75,000 per year, compared with the current effective limit of $210,000 per person. Under this option, payments would go only to individuals and would be denied to other entities in which an individual participated. Finally, this option would impose an actual limit of $150,000 per individual per year on commodity loan program benefits.

Those changes would reduce payments, particularly to large farming operations. Producers of cotton and rice would be affected to a greater degree than producers of other crops because cotton and rice tend to be produced on large farms, and the value of program benefits per acre

1. For a brief description of farm commodity programs, see Geoffrey Becker, *Farm Commodity Programs: A Short Primer*, CRS Report for Congress RS20848 (Congressional Research Service, June 20, 2002).

2. For an explanation of payment limits, see Jasper Womach, *Commodity Program Payment Limits Under the 2002 Farm Bill*, CRS Agriculture Policy and Farm Bill Briefing Book (Congressional Research Service, July 17, 2002). For a more detailed description, see Christopher R. Kelley, *Introduction to Federal Farm Program Payment Limitation and Payment Eligibility Law* (National Center for Agricultural Law Research and Information, University of Arkansas School of Law, June 2002).

for those crops is relatively high.[3] Production of those crops is concentrated in the southern and western parts of the United States.

Limiting farm program benefits has been an issue for many years. An appropriate limit depends on the perceived purpose of farm payments. Some policymakers hold that the purpose of payments should be to keep smaller, family farms in business, particularly those that are struggling financially. Lower payment limits do not necessarily increase payments to small producers, however, but only constrain payments to larger operations. Still, some supporters of this option argue that cutting payments to large operations would slow the rate of loss of small farms by reducing farmers' financial incentives to expand their operations.

Opponents of this option contend that larger payments help U.S. agriculture stay competitive in global markets. Some producer organizations have called for eliminating payment limits altogether. They say that restricting program benefits on the basis of size hurts the larger, more efficient farming operations that are better able to compete internationally.

3. See Food and Agricultural Policy Research Institute, *The House and Senate Farm Bills: A Comparative Study,* FAPRI Policy Working Paper No. 01-02 (Columbia, Missouri: University of Missouri, March 2002).

# 370

# Commerce and Housing Credit

Budget function 370 covers programs administered by the Department of Commerce, the Federal Housing Administration, and the Small Business Administration, among others. They include programs to regulate and promote commerce and provide housing credit and deposit insurance. Also included in this category are outlays for loans and other aid to small businesses and support for the government's efforts to gather and disseminate economic and demographic data. CBO estimates that outlays for function 370 will total about $3 billion in 2003, with virtually all of that spending mandatory. (Spikes in mandatory and later in discretionary spending reflect funding for the decennial census, and the large negative amounts for mandatory spending in the mid-1990s reflect proceeds from the resolution of failed banks and thrifts.)

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 3.9 | 2.8 | 3.4 | 2.5 | 1.4 | 3.1 | 2.2 | 1.4 | 0.4 | 0.8 | 5.1 | 1.4 | 0.6 | * |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 3.8 | 3.4 | 2.6 | 2.1 | 0.9 | 2.9 | 1.7 | 1.6 | 0.5 | 0.5 | 4.5 | 1.5 | 1.0 | * |
| Mandatory | 63.8 | 72.9 | 8.3 | -24.0 | -5.1 | -20.7 | -12.1 | -16.2 | 0.5 | 2.2 | -1.3 | 4.4 | -1.4 | 3.1 |
| Total | 67.6 | 76.3 | 10.9 | -21.9 | -4.2 | -17.8 | -10.5 | -14.6 | 1.0 | 2.6 | 3.2 | 5.9 | -0.4 | 3.1 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | -12.6 | -21.7 | -19.9 | -59.4 | 234.1 | -41.3 | -3.9 | -69.4 | -8.3 | 892.0 | -67.1 | -32.2 | -95.1 |

Note: * = between zero and $50 million; n.a. = not applicable.

## 370-01—Discretionary

# End the Credit Subsidy for the Small Business Administration's Major Business Loan Guarantee Programs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 73 | 75 | 76 | 78 | 80 | 382 | 807 |
| Outlays | 38 | 70 | 72 | 74 | 76 | 330 | 735 |

The Small Business Administration (SBA) operates several loan guarantee programs to increase small businesses' access to capital and credit. Under the Federal Credit Reform Act of 1990, the credit subsidy for those programs is the estimated net present-value cost (over the lives of the loans) of projected defaults minus fees and recoveries, excluding administrative costs. The SBA's largest business credit programs are the general business loan guarantee, or 7(a), program; the certified development company, or 504, program; and the small business investment company (SBIC) equity capital programs. Both the certified development company and SBIC loan programs operate without a federal subsidy. Reducing to zero the subsidy for all of the SBA's other major business loan guarantee programs would lower outlays by $38 million in 2004 and $330 million over the 2004-2008 period.

Under the 7(a) program, the SBA's largest loan program, the federal government can guarantee 85 percent of the principal for business loans up to $150,000 and 75 percent of the principal for larger loans. Small business investment companies in the SBIC program (private investment firms licensed by the SBA) make equity investments and long-term loans to small firms, using their own capital supplemented by SBA-guaranteed debentures.

In 1996, the Congress amended both the Small Business Act and the Small Business Investment Act to reduce subsidy rates and improve the performance of the SBA's business loan programs. One change the Congress made was to increase the fees paid by loan recipients for most business loans. Such fee increases help to reduce program costs because the revenues from the fees cover some of the expenses if a borrower defaults. In 2001, the Congress decreased the fees to their current levels, which are determined by the amount of the loan guarantee. For loans of $150,000 or less, the guarantee fee is 1 percent of the guaranteed portion. For those loans, lenders are permitted to retain 25 percent of the fee. For loans between $150,000 and $700,000, the SBA charges a 2.5 percent guarantee fee. For loans greater than $700,000, it charges a guarantee fee of 3.5 percent.

Since 1996, the Congress has cut the percentage of each loan amount that the government guarantees under the 7(a) program from about 90 percent to the current level of about 75 percent. Reducing the guarantee rates further should induce banks to evaluate loan applications more carefully because the banks will share more responsibility for any losses from defaults. If banks used more care in approving SBA loans, the default rate would decline and the costs to the government decrease accordingly. Adjusting fees (and changing loan guarantee levels) to cover potential default losses could make the SBA's major business loan programs financially sound. As the subsidy rate declined to zero, the Congress would no longer have to appropriate funds to cover the government's expected losses.

Supporters of this option contend that subsidies are not necessary to encourage the private sector to make financing available to small businesses. They also argue that the SBA's assistance serves only a tiny fraction of the nation's small businesses and that most of the programs' borrowers could obtain financing without the SBA's help.

Opponents of this option believe that the SBA's assistance aids small businesses by filling a gap in financing when banks and other private sources do not provide loans for the purposes, in the amounts, or with the terms required by small-business borrowers. Some opponents also argue against increasing program fees or decreasing guarantee rates because such changes would reduce access to credit for small businesses.

**370-02—Discretionary**

# Eliminate the International Trade Administration's Trade Promotion Activities or Charge the Beneficiaries

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 217 | 279 | 288 | 297 | 306 | 1,387 | 3,076 |
| Outlays | 163 | 244 | 278 | 294 | 303 | 1,282 | 2,953 |

The International Trade Administration (ITA) of the Department of Commerce runs a trade development program (which assesses the competitiveness of U.S. industries and promotes exports) and the U.S. and foreign commercial services (which counsel U.S. businesses on exporting). The ITA charges some fees for its services, but those fees do not cover the cost of all such activities.

This option would eliminate the ITA's trade promotion activities or charge the beneficiaries. Those changes would save $163 million in outlays in 2004 and $1.3 billion through 2008.

Proponents of this option argue that trade promotion activities are better left to the firms and industries that stand to benefit from them than to the ITA. Opponents might argue that those activities are subject to some economies of scale; 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 abroad might make sense. In that case, net federal spending could be reduced by charging the beneficiaries of those programs their full costs.

Proponents also note that when beneficiaries do not pay the full costs of services, the ITA's activities effectively subsidize the industries involved. Those implicit subsidies are an inefficient means of helping the industries because they are partially passed on to foreigners in the form of lower prices for U.S. exports. Moreover, they result in the industries' products being sold abroad for less than their cost of production and sales and thus lower U.S. economic well-being.

Opponents of this option counter that fully funding the ITA's trade promotion activities through voluntary charges might not be possible. For example, in many cases, promoting the products of selected firms that were willing to pay for such promotion would be impossible without also encouraging demand for the products of other firms in the same industry. In those circumstances, firms would have an incentive not to purchase the services because they would be likely to receive the benefits whether they paid for them or not. Consequently, if the federal government wanted to charge beneficiaries for the ITA's services, it might have to require that all firms in an industry (or the industry's national trade group) decide together whether to purchase the services. If the firms opted to purchase them, all firms in the industry would be required to pay according to some equitable formula.

**RELATED OPTIONS:** 150-01, 350-01, and 350-02

**RELATED CBO PUBLICATIONS:** *Causes and Consequences of the Trade Deficit: An Overview*, March 2000, and *How the GATT Affects U.S. Antidumping and Countervailing-Duty Policy*, September 1994

## 370-03—Discretionary

# Eliminate the Advanced Technology Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 150 | 192 | 196 | 201 | 206 | 945 | 2,052 |
| Outlays | 24 | 83 | 151 | 183 | 197 | 638 | 1,705 |

The Omnibus Trade and Competitiveness Act of 1988 established the Advanced Technology Program (ATP) within the Commerce Department's National Institute of Standards and Technology. The objective of the ATP is to further the competitiveness of U.S. industry by helping convert discoveries in basic research more quickly into technological advances with commercial potential. The program awards research and development (R&D) grants on the basis of merit to individual companies, independent research institutes, and joint ventures. The ATP's grants are limited to $2 million over a three-year period when awarded to a single firm and require, on average, a matching commitment from private sources. The grants support research in generic technologies that have applications for a broad range of products as well as research that precedes product development. Eliminating the ATP would save $24 million in outlays in 2004 and $638 million over the 2004-2008 period.

The Administration and other supporters of this option argue that private investors are better able than the federal government to decide which research efforts should be funded. They argue that even when the federal government chooses "a winner," it may be displacing private capital. The U.S. venture capital markets are the best developed in the world, supporters say, do an effective job of funding new ideas, and focus on many of the same research areas as the ATP. Furthermore, venture capital funds have grown enormously since the ATP was conceived. In the first three quarters of 2002, venture capital funds invested $16.9 billion, about 65 times the size of the ATP. In addition, according to industry sources, venture capital firms had another $90 billion in reserves committed to them but not yet invested. That size differential suggests that the ATP is funding work that would have been funded by venture capital firms.

Responding to the criticism that the Advanced Technology Program is merely displacing private and venture capital funds, opponents of this option point to a 2001 survey showing that 63 percent of the firms that applied for but did not win an ATP award did not proceed with R&D. Another 17 percent proceeded but on a much smaller scale. Only 5 percent of firms denied ATP funds went ahead with their R&D programs as originally designed. Opponents of this option argue that the survey shows that the ATP's selection process has been refined so as to reduce the overlap between projects that the ATP is likely to fund and those that private sources are likely to finance, even if the general research areas are similar. (That result is a change from an earlier survey by the General Accounting Office, which found that fully half of nonwinners were able to find private sources of funding.) Furthermore, this option's opponents argue, venture capital firms spend only a small fraction of their funds on the very early stages of technology development—the area in which the ATP concentrates its funding.

Critics of this option also note that surveys of the ATP's award recipients indicate that the awards have accelerated the development and commercialization of advanced technology by two years or more in the majority of planned commercial applications. In addition, those surveys show that recipients are more willing to tackle high-risk technology development projects as a result of their grants, presumably increasing both the amount and the breadth of the R&D funded.

**RELATED OPTION:** 370-04

## 370-04—Discretionary

# Eliminate the Manufacturing Extension Partnership and the National Quality Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 91 | 116 | 119 | 123 | 126 | 575 | 1,250 |
| Outlays | 17 | 66 | 98 | 115 | 122 | 418 | 1,073 |

The Manufacturing Extension Partnership (MEP) and the National Quality Program are run by the National Institute of Standards and Technology. MEP consists primarily of a network of manufacturing extension centers that assist small and midsize firms by providing expertise in the latest management practices and manufacturing techniques as well as other knowledge. The nonprofit centers are not owned by the federal government but are partly funded by it. The National Quality Program consists mainly of the Malcolm Baldrige National Quality Award, which is given to firms for achievements in quality. This option would eliminate MEP and the National Quality Program, reducing outlays by $17 million in 2004 and $418 million through 2008.

Supporters of this option could question the need for the government to provide the technical assistance given by MEP. Many professors of business, science, and engineering are also consultants to private industry, and other ties between universities and private firms facilitate the transfer of knowledge. In fact, some of the centers that MEP subsidizes predate the program.

Advocates of eliminating MEP also could question the program's positive effect on productivity. Federal spending for MEP represents a subsidy for the firms that the program helps. In most cases, subsidies allow inefficient firms to remain in business, tying up capital, labor, and other resources that would otherwise be used more productively elsewhere. For 2004, the Administration proposes eliminating the federal contribution to all centers with more than six years' experience—a substantial total reduction—in line with what it argues is the original design of the program.

Opponents of this option point to the economic importance of small and midsize firms, which produce more than half of U.S. output and employ two-thirds of U.S. manufacturing workers. Small firms, they argue, often face limited budgets, a lack of expertise, and other barriers to obtaining the information that MEP provides. Those circumstances and the substantial reliance of larger firms on small and midsize companies for supplies and intermediate goods lead opponents of this option to argue that MEP promotes U.S. productivity and international competitiveness.

In regard to the National Quality Program, proponents of this option could argue that businesses need no government incentives to maintain quality—the threat of lost sales is sufficient. Furthermore, winners of the Baldrige Award often mention it in their advertising, which means they value it. If so, supporters of this option say, they should be willing to pay contest entry fees large enough to eliminate the need for federal funding. Critics of this option counter that the National Quality Program promotes U.S. competitiveness.

**RELATED OPTION:** 370-03

## 370-05—Mandatory Offsetting Receipts

# Charge All Banks and Thrifts Deposit Insurance Premiums

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 1,400 | 1,600 | 900 | 500 | 400 | 4,800 | 6,600 |

Federal deposit insurance protects accounts up to $100,000 in the event of a bank's failure, and the Federal Deposit Insurance Corporation Improvement Act of 1991 authorized the Federal Deposit Insurance Corporation (FDIC) to levy risk-based premiums on banks to cover the cost of that insurance. However, the Deposit Insurance Fund Act of 1996 limited the FDIC's ability to charge those premiums. Currently, deposit insurance premiums are assessed on about 10 percent of all banks and thrift institutions; the remainder pay nothing for deposit insurance even though they pose some risk of loss for the government.

This option would apply to banks and thrifts the FDIC's rate schedule for banks that was in effect before 1996; as a result, the vast majority of institutions that do not pay deposit insurance premiums now would pay a premium of 4 basis points (4 cents per $100 of deposits) per year. (The FDIC's current schedule of insurance premiums ranges from zero to 27 basis points.) That change would increase receipts to the government by $1.4 billion in 2004 and $4.8 billion over five years.

The Deposit Insurance Fund Act stipulated that when the accumulated reserves of a deposit insurance fund exceed 1.25 percent of insured deposits, the FDIC is prohibited from charging premiums of all but the riskiest institutions. The risk classification of a bank or thrift is based on the amount of capital it holds, the quality of its assets, the effectiveness of its management, and other factors. When insurance fund reserves fall below 1.25 percent of insured deposits, the FDIC must raise rates sufficiently to increase the reserve ratio to 1.25 within a year. The Congressional Budget Office projects that, under current law, the accumulated reserves in the Bank Insurance Fund may fall below the 1.25 percent target balance in 2003, largely because of growing deposits in banks that currently pay no premiums.

Proponents of this option argue that there are several rationales for charging all banks and thrifts some deposit insurance premium even when insurance funds' reserves exceed 1.25 percent of insured deposits. First, that target level of reserves bears no relation to expected losses. Second, even institutions in the best risk category pose some risk of failure over time and consequently should pay some premium, just as private insurers impose some premium on even the best risks. Third, recent experience indicates that some failures occur abruptly from risks that cannot be easily quantified or tracked, such as fraud or losses by rogue traders.

A disadvantage of this option is that the 4-basis-point premium, which would be paid by most institutions, is only a crude approximation of the risks they pose. Some institutions would be charged too much and some too little. Ideally, a more accurate risk-based system of premiums, including some charge to the least risky institutions, could be reinstated.

Opponents of this option contend that the current level of reserves provides ample protection to taxpayers. They argue that a strengthened regulatory regime and better risk-management practices make a repeat of the bank and thrift crisis of the 1980s highly unlikely. In addition, banks and thrifts may pass the cost of deposit insurance on to borrowers and depositors. To the extent that depositors undervalue FDIC insurance, banks might be put at a competitive disadvantage in attracting deposits compared with uninsured substitutes such as money market mutual funds.

**RELATED CBO PUBLICATION:** *Raising Federal Deposit Insurance Coverage*, May 2002

# 400

# Transportation

Budget function 400 covers most programs of the Department of Transportation as well as aeronautical research by the National Aeronautics and Space Administration. It supports programs that aid and regulate ground, air, and water transportation, including grants to states for highways and airports and federal subsidies for Amtrak. CBO estimates that total outlays for function 400 will be $67 billion in 2003. Almost all of that amount is classified as discretionary spending. (Funding for most transportation programs is provided by mandatory contract authority.) Spending under function 400 has more than doubled since the early 1990s.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 13.5 | 13.7 | 15.0 | 14.0 | 15.7 | 12.5 | 13.6 | 14.5 | 14.0 | 15.1 | 15.2 | 19.7 | 23.4 | 22.0 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 27.9 | 29.3 | 31.5 | 33.2 | 36.0 | 37.0 | 37.0 | 38.4 | 38.3 | 40.6 | 44.7 | 50.1 | 57.3 | 64.8 |
| Mandatory | 1.6 | 1.8 | 1.9 | 1.8 | 2.1 | 2.3 | 2.5 | 2.4 | 2.1 | 2.0 | 2.1 | 4.3 | 4.6 | 2.4 |
| Total | 29.5 | 31.1 | 33.3 | 35.0 | 38.1 | 39.4 | 39.6 | 40.8 | 40.3 | 42.5 | 46.9 | 54.4 | 61.9 | 67.2 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 5.0 | 7.5 | 5.7 | 8.3 | 2.9 | * | 3.7 | -0.4 | 6.0 | 10.3 | 12.0 | 14.4 | 13.1 |

Note: n.a. = not applicable; * = between -0.05 percent and zero.

## 400-01—Discretionary

# Reduce Federal Subsidies for Amtrak

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 278 | 287 | 296 | 306 | 317 | 1,484 | 3,241 |
| Outlays | 278 | 287 | 296 | 306 | 317 | 1,484 | 3,241 |

When the Congress established the National Railroad Passenger Corporation, commonly known as Amtrak, in 1970, it anticipated providing subsidies for only a limited time until Amtrak could become self-supporting. After more than a quarter century of federal subsidies, in 1997 lawmakers enacted the Amtrak Reform and Accountability Act, which directed Amtrak to take a more business-like approach to operations so that it would not need federal subsidies after December 2002. For several years after that law was enacted, Amtrak reported to the Congress that it was on a "glide path" toward the achievement of operating self-sufficiency by the deadline. In the spring of 2002, however, Amtrak announced that it could not meet the deadline and that the goal of operating self-sufficiency was—and always had been—unrealistic.

By early summer of 2002, Amtrak was rapidly running out of cash to run its operations. In addition to a federal subsidy of $521 million provided through appropriation legislation for fiscal year 2002, Amtrak sought and received a federal loan of $100 million in July. In addition, it received $205 million in supplemental appropriations to get through the rest of the fiscal year.

Under this option, federal subsidies would be reduced by the amount currently needed to support train operations on the routes that lose the most money. According to data from Amtrak's Route Profitability System, the five trains that lost the most money accounted for losses of about $250 million in 2001. Cutting that amount from Amtrak's subsidies each year would save $278 million in 2004 and nearly $1.5 billion through 2008.

Proponents of this option generally favor having the railroad act more like a business. They suggest that Amtrak should cut service on routes that have attracted so few riders that Amtrak incurs large losses on each train it operates and that it should focus on the routes for which demand is greater. If passenger revenues were not sufficient to cover the cost of operating a train but states valued the service, the states could provide additional subsidies to help cover costs. Otherwise, travelers could use buses, airplanes, or cars to reach their destinations.

Opponents of this option generally regard Amtrak as a public service that should be available on a nationwide basis without regard to cost. They contend that passengers on lightly traveled routes have few transportation alternatives and that the railroad is vital to the survival of small communities along those routes. Moreover, they suggest that improving service throughout the system could attract more passengers and make rail transportation more viable economically.

**RELATED OPTIONS:** 400-03, 400-07, and 400-08

**RELATED CBO PUBLICATION:** *A Financial Analysis of H.R. 2329, The High-Speed Rail Investment Act of 2001*

## 400-02—Mandatory

# Eliminate the Essential Air Service Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 91 | 116 | 117 | 118 | 119 | 561 | 1,182 |
| Outlays | 81 | 113 | 115 | 118 | 119 | 547 | 1,168 |

The Essential Air Service (EAS) program was created by the Airline Deregulation Act of 1978 to continue air service to communities that had received federally mandated air service before deregulation. The program provides subsidies to air carriers serving small communities that meet certain criteria. (Subsidies are available for service to communities only if they are 70 miles or more from a large or medium-sized hub airport, except in Alaska and Hawaii.) In 2002, subsidies supported air service to 114 U.S. communities, including 31 in Alaska (for which separate rules apply). The number of passengers served annually has fluctuated in recent years, as has the subsidy per passenger, which has ranged from $6 to $400. The Congress has directed that such subsidies not exceed $200 per passenger unless the community is more than 210 miles from the nearest large or medium-sized hub airport. This option would eliminate the EAS program, saving $547 million in mandatory outlays from 2004 through 2008.

Supporters of this option contend that the EAS subsidies are excessive, providing air transportation at a high cost per passenger. They also maintain that the program was intended to be transitional and that the time has come to phase it out. If states or communities derive benefits from service to small communities, the states or communities could provide the subsidies themselves.

Opponents of this option believe that the subsidy program prevents the isolation of rural communities that would not otherwise receive air service. Because the availability of airline transportation is an important ingredient in the economic development of small communities, without it some towns might lose a sizable portion of their economic base, opponents claim.

**RELATED OPTIONS:** 300-10 and 400-03

## 400-03

# Eliminate Grants to Large and Medium-Sized Hub Airports

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,360 | 1,360 | 1,360 | 1,360 | 1,360 | 6,800 | 13,600 |
| Outlays | 251 | 811 | 1,116 | 1,271 | 1,364 | 4,813 | 12,375 |

Note: Budget authority is mandatory. Outlays are discretionary.

Under the Airport Improvement Program (AIP), the Federal Aviation Administration (FAA) provides grants to airports to expand runways, improve safety and security, and make other capital investments. Over the period from 1982 to 2002, about 40 percent of the AIP's funding went to large and medium-sized hub airports—the 70 or so airports that together account for nearly 90 percent of passenger boardings. This option would eliminate the AIP's funding for those airports but would continue grants to smaller airports at levels consistent with those of 2003—assuming that smaller airports will receive about 60 percent of the $3.2 billion made available in 2003, or about $1.9 billion.

AIP funding is subject to distinctive budgetary treatment. The program's budget authority is provided in authorization acts as contract authority, which is a mandatory form of budget authority. The spending of contract authority is subject to obligation limitations, which are contained in appropriation acts. Therefore, the resulting outlays are categorized as discretionary. Under this option, both budget authority and obligation limitations would be reduced, saving $4.8 billion over the 2004-2008 period.

Supporters of this option assert that larger airports do not need federal funding and that federal grants simply substitute for funds that could be raised from private sources. Because they serve many passengers, those airports generally have been able to finance investments through bond issues and through passenger facility charges and other user fees. Smaller airports may have more difficulty raising funds for capital improvements, although some have been quite successful in tapping the same sources of funding as their larger counterparts. By eliminating grants to larger airports, this option would focus federal spending on airports that appeared to have the fewest alternative sources of funding.

People who oppose this option argue that the controls exerted by the FAA as conditions of receiving aid ensure that the airports will continue to make investment and operating decisions that promote a safe and efficient aviation system.

**RELATED OPTIONS:** 300-10, 400-01, 400-02, 400-07, and 400-08

**RELATED CBO PUBLICATION:** *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992

## 400-04

# Increase Fees for Certificates and Registrations Issued by the Federal Aviation Administration

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 5 | 5 | 5 | 5 | 5 | 25 | 50 |

Note: The fees could be classified as a discretionary offsetting collection or a mandatory offsetting receipt, depending on the specific language of the legislation establishing them.

The Federal Aviation Administration (FAA) runs a large regulatory program to ensure safe air travel. It oversees and regulates the registration of aircraft, licensing of pilots, issuance of medical certificates, and other similar activities. The FAA issues most licenses and certificates free of charge or at prices well below its costs. For example, the current fee to register an aircraft is $5, but the FAA's cost of providing the service is closer to $30. The FAA estimates the cost of issuing a pilot's certificate to be $10 to $15, but the agency does not charge for the certificates. Imposing or raising fees to cover the costs of the FAA's regulatory services could increase receipts by an estimated $25 million over the 2004-2008 period. Added receipts could be somewhat smaller if the FAA needed additional resources to establish and administer the fees.

The Drug Enforcement Assistance Act of 1988 authorizes the FAA to impose several registration fees as long as they do not exceed the agency's costs for providing the services. For general aviation, the law allows fees of up to $25 for aircraft registration and up to $12 for pilots' certificates (plus adjustments for inflation). Setting higher fees would require additional legislation.

As supporters of this option point out, FAA fees based on the cost of services would be comparable with automobile registration fees and operators' licenses and thus would probably be modest, especially when compared with the total cost of owning an airplane. People who oppose this option contend that increasing regulatory fees might burden some aircraft owners and operators. That effect could be mitigated by setting registration fees according to the size or value of the aircraft rather than on the basis of the FAA's cost.

**RELATED OPTIONS:** 300-05, 300-06, 400-05, and 400-06

## 400-05

# Establish Fees Based on Costs for Air Traffic Control Services

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 10,000 | 20,000 |

Note: The fees could be classified as a discretionary offsetting collection or a mandatory offsetting receipt, depending on the specific language of the legislation establishing them.

The Federal Aviation Administration (FAA) operates the air traffic control (ATC) system, which serves commercial air carriers, the military, and smaller users, such as air taxis and operators of private corporate and recreational aircraft. Traffic controllers in airport towers, terminal radar approach control facilities (TRACONs), and air route traffic control centers (ARTCCs) help guide aircraft safely as they taxi to the runway, take off, fly through designated airspace, land, and taxi to the airport gate. Other ATC services include flight service stations that provide weather data and other information useful to small-aircraft operators.

This option would impose fees for ATC services that reflect the FAA's marginal costs of providing the services. The marginal costs of a flight equal the costs of every ATC service (or contact) provided for that flight. For example, a commercial flight from New York to San Francisco entails contacts with two airport towers, two TRACONs, and seven ARTCCs. Under this option, the airline would pay the sum of the marginal costs of those contacts. A 1997 FAA study estimated total marginal costs for all airlines operating in the United States to be about $2 billion a year.

Fees based on marginal costs would affect various types of airline operations differently. Carriers mainly using hub-and-spoke networks would probably face higher fees than those providing nonstop origin-to-destination flights because of differences in the number of contacts with towers, TRACONs, and ARTCCs.

Supporters of this option assert that imposing fees for marginal costs would encourage efficient use of the ATC system. Noncommercial users might reduce their use of ATC services, freeing controllers for other tasks and increasing the system's overall capacity. By analyzing the pattern of revenues from user fees, FAA planners could better decide on the amount and location of additional investments in the ATC system, which would make it more efficient.

Opponents contend that this option would raise the cost of ATC services to users. Such a move could weaken the financial condition of some commercial air carriers. Assuming that the airlines would pass along most of the increase in cost to their customers, the Congressional Budget Office would expect some decrease in demand for aviation services under this option.

**RELATED OPTIONS:** 300-05, 300-06, 300-08, 370-02, 400-04, and 400-06

**RELATED CBO PUBLICATION:** *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992

## 400-06

# Impose a User Fee to Cover the Costs of the Federal Railroad Administration's Rail Safety Activities

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 0 | 45 | 92 | 93 | 95 | 325 | 827 |

Note: This fee could be classified as a discretionary offsetting collection or a mandatory offsetting receipt, depending on the specific language of the legislation establishing the fee.

The function of the Federal Railroad Administration's (FRA's) rail safety activities is to protect railroad employees and the public by ensuring the safe operation of passenger and freight trains. Field safety inspectors are responsible for enforcing federal safety regulations and standards. Other functions include issuing standards, procedures, and regulations; administering post-accident and random drug testing of railroad employees; providing technical training; and managing highway grade-crossing projects.

Railroad safety fees, which had been authorized in the Omnibus Budget Reconciliation Act of 1990, expired in 1995. Before that year, railroads were subject to those fees, which covered the safety enforcement and administrative costs of carrying out the FRA's mandated safety activities. The fees offset a portion of federal spending on safety programs.

This option would impose new user fees to offset the costs of the FRA's rail safety activities—totaling $325 million over five years. People in favor of this option contend that the specific recipients of government services should bear the costs. The user fees would relieve general taxpayers of the burden of supporting the FRA's rail safety activities.

People who oppose this option contend that the general public is the main beneficiary of the FRA's rail safety activities. Opponents also note that, apart from businesses in the pipeline industry, no other freight or transportation businesses pay user fees for federal services that promote safety.

**RELATED OPTIONS:** 300-06, 300-08, 370-02, 400-04, and 400-05

## 400-07

# Eliminate Funding for "High-Priority" Highway Projects

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,778 | 1,778 | 1,778 | 1,778 | 1,778 | 8,890 | 17,780 |
| Outlays | 190 | 653 | 1,078 | 1,338 | 1,477 | 4,736 | 13,044 |

Note: Budget authority is mandatory. Outlays are discretionary.

A portion of the Federal-Aid Highway program is devoted to "high-priority" projects—specific ones designated by the Congress as especially worthy of funding. In authorizing $171 billion in funding for the Federal-Aid Highway program over the 1998-2003 period, the Transportation Equity Act for the 21st Century (TEA-21) designated nearly $9.4 billion for 1,851 high-priority projects. For those projects, in 2002 the Congress provided nearly $1.8 billion in TEA-21 funding. The authorized federal shares of the high-priority projects range from $15,000 to $134 million. This option would eliminate funding for those projects.

The budgetary treatment of the Federal-Aid Highway program is unusual. Budget authority is provided in authorization acts as contract authority, which is a mandatory form of budget authority. The spending of contract authority is subject to obligation limitations, which are contained in appropriation acts. Therefore, the resulting outlays are classified as discretionary. To achieve budgetary savings, this option would require the modification of TEA-21 to cut spending authority by an amount equal to that provided for the high-priority projects. Under this option, both budget authority and obligation limitations would be reduced, saving $190 million in 2004 and $4.7 billion over the 2004-2008 period.

For the bulk of the Federal-Aid Highway program, states set priorities and choose projects within certain broad categories established by the federal government. Supporters of this option contend that Congressional earmarking for high-priority projects subverts the states' processes of establishing priorities for highway spending. If those projects were so important, they argue, the states would have included them in their transportation plans, and they would receive funding under the normal ranking processes. Moreover, annual federal aid to states for highways surged under TEA-21—from about $20 billion in 1997 to $33 billion in 2002—thereby giving states the resources to fund more projects.

Opponents of this option respond that the states' project-ranking models do not necessarily include all of the important factors (or give them sufficient weight) in setting overall priorities. Members of Congress, who are in touch with the needs of their states and districts, may balance the process by designating exceptional projects that merit consideration. Those projects may serve special purposes, such as providing economic aid for depressed regions.

**RELATED OPTIONS:** 400-01, 400-03, and 400-08

## 400-08

# Eliminate Funding for the "New Starts" Transit Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,593 | 1,624 | 1,659 | 1,693 | 1,731 | 8,300 | 17,540 |
| Outlays | 239 | 721 | 1,054 | 1,315 | 1,534 | 4,863 | 13,628 |

Note: Budget authority includes mandatory contract authority specified in law. Outlays are discretionary.

Under the "New Starts" program, the Department of Transportation provides for the construction of new rail and other fixed-guideway systems and extensions of existing systems. For 2002, the Congress provided $1.1 billion for the program. This option would eliminate the New Starts program, although state and local governments could still use federal aid distributed by formula grants for new rail projects. In 2002, the federal government provided $3.5 billion in formula funding for a wide variety of transit projects.

The budgetary treatment of transit funding is complex. A portion of the budget authority for the New Starts program is provided in authorization acts as contract authority, which is a mandatory form of budget authority. The spending of contract authority is subject to obligation limitations, which are contained in appropriation acts. Therefore, the resulting outlays are categorized as discretionary. The remainder of the budget authority is provided in appropriation acts and is considered discretionary. Under this option, discretionary budget authority, contract authority, and obligation limitations would all be reduced, saving $239 million in 2004 and $4.9 billion over the 2004-2008 period.

Supporters of this option argue that new rail transit systems tend to provide less value per dollar spent than bus systems do. Bus systems require much less capital, and they are more flexible in their ability to adjust schedules and routes to meet changing needs. Moreover, supporters contend that letting the federal government dictate how communities should spend federal aid for transit is inappropriate and inefficient because local officials know their needs and priorities better than federal officials do.

Those opposed to this option contend that the suburban sprawl resulting when families and businesses move out of central cities leads to increasing congestion and pollution. Building additional roads will not solve the problem but only leads to greater decentralization and sprawl, they argue. New rail transit systems, in contrast, can help channel future development into corridors where public transportation is available, as companies and residential developers locate where they can attract employees by offering easy and reliable access to the workplace.

**RELATED OPTIONS**: 400-01, 400-03, and 400-07

**RELATED CBO PUBLICATION**: *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992

## 400-09—Discretionary

# Increase Fees for Transportation Security

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 2,611 | 2,709 | 2,815 | 2,930 | 3,048 | 14,113 | 31,372 |

The terrorist attacks of September 11, 2001, led to increased security measures at the nation's transportation facilities. One of the most sweeping changes resulted from the Aviation and Transportation Security Act (Public Law 107-71), which made the federal government, rather than airlines and airports, responsible for screening airline passengers, carry-on luggage, and checked baggage. The new standards for screening have raised costs by requiring a larger number of screeners with higher qualifications (thus necessitating higher compensation).

To help pay for increased security, the law authorized airlines to charge passengers a fee of $2.50 each time they board a plane (capped at $5 for a one-way trip). The law also authorized fees on the airlines themselves. In addition, it authorized funds to reimburse airport operators, service providers, and airlines for additional costs of security enhancements. The Congressional Budget Office expects that the Transportation Security Administration (TSA) will collect about $2.1 billion from the fees in 2004; that amount, however, is less than half of the estimated $4.7 billion increase in costs to the federal government. Under this option, user fees would be raised so that they would fully cover the costs of the added security measures.

For 2003, appropriations for the TSA are about $4.5 billion. Of that amount, CBO estimates that about $2.0 billion will be financed by collections from existing charges imposed on passengers and airlines, including the boarding fee of $2.50 per passenger. Imposing charges that would cover the entire cost of security improvements—for instance, by increasing the boarding fee to $6.25—would boost collections (and thus reduce net discretionary spending) by an estimated $2.6 billion in 2004 and $14.1 billion over the 2004-2008 period. Standard budgetary treatment of such collections would classify them as revenues, but because the Aviation and Transportation Security Act requires that revenues from the existing fees be recorded as offsetting collections (a form of discretionary spending), under this option the additional fees would be treated the same way.

Supporters of this option contend that the primary beneficiaries of the increased transportation security are the users of the system. Security is a cost of airline transportation, in the same way that fuel and labor costs are. Having those costs covered by taxpayers in general—not just users of the aviation system—would provide a subsidy to air transportation.

Opponents of this option argue that the public in general, not just air travelers, benefits from improved airport security. To the extent that enhanced security reduces the risk of terrorist attacks, the entire population is better off. That argument provides a rationale for federal financing of the enhanced transportation security measures without additional collections raised directly from the airline industry or its customers to cover those costs.

# 450

# Community and Regional Development

Budget function 450 includes programs that support the development of physical and financial infrastructure intended to promote viable community economies. It covers certain activities of the Department of Commerce and the Department of Housing and Urban Development. This function also includes spending to help communities and families recover from natural disasters and spending for the rural development activities of the Department of Agriculture, the Bureau of Indian Affairs, and other agencies. CBO estimates that in 2003, discretionary outlays for function 450 will be almost $16 billion. Such spending for community and regional development has roughly doubled from the levels of the early 1990s.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 7.3 | 5.9 | 11.4 | 9.7 | 15.4 | 12.1 | 11.7 | 13.1 | 10.4 | 11.1 | 12.2 | 14.4 | 22.8 | 11.4 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 7.3 | 6.2 | 6.4 | 8.4 | 10.9 | 10.2 | 10.4 | 10.8 | 10.2 | 12.0 | 11.4 | 12.4 | 14.2 | 15.7 |
| Mandatory | 1.2 | 0.6 | 0.4 | 0.7 | -0.3 | 0.5 | 0.3 | 0.3 | -0.4 | -0.1 | -0.8 | -0.5 | -1.2 | 0.1 |
| Total | 8.5 | 6.8 | 6.8 | 9.1 | 10.6 | 10.7 | 10.7 | 11.1 | 9.8 | 11.9 | 10.6 | 11.9 | 13.0 | 15.9 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | -16.0 | 3.9 | 31.9 | 28.8 | -6.2 | 2.3 | 3.3 | -5.3 | 17.3 | -4.6 | 8.8 | 13.9 | 11.1 |

Note: n.a. = not applicable.

## 450-01—Discretionary

# Convert the Rural Community Advancement Program to State Revolving Loan Funds

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 14 | 30 | 48 | 65 | 85 | 242 | 5,003 |
| Outlays | 1 | 5 | 14 | 26 | 42 | 88 | 2,673 |

The Department of Agriculture's Rural Community Advancement Program (RCAP) assists rural communities by providing loans, loan guarantees, and grants for water and waste-disposal projects, community facilities, economic development, and fire protection. Funds are generally allocated among the states on the basis of their rural populations and the number of rural families with income below the poverty level. Within each state's allocation, the department awards funds on a competitive basis to eligible applicants, including state and local agencies, nonprofit organizations, and (in the case of loan guarantees for business and industry) for-profit firms.

The terms of a particular recipient's assistance depend on the purpose of the aid and, in some cases, the economic condition of the recipient's geographic area. For example, aid for water and waste-disposal projects can take the form of loans with interest rates ranging from 4.5 percent to market rates, depending on the area's median household income; areas that are particularly needy may receive grants or a mix of grants and loans.

For 2002, the Congress appropriated roughly $800 million for RCAP's grants and the budgetary cost of its loans and loan guarantees, which is defined under credit reform as the present value of the interest rate subsidies and expected defaults. The Congress could reduce future spending by capitalizing state revolving loan funds for rural development and then ending federal assistance under RCAP. The amount of federal savings would depend on the level and timing of the contribution to capitalize the revolving funds. Under one illustrative option, the federal government would provide steady funding of $807 million annually for five more years to capitalize the funds, then cut off assistance in 2009. That option would yield savings of $2.7 billion from 2004 to 2013. That level of capitalization alone would not support the volume of loans and grants that RCAP now provides. Accordingly, the Congress could allow the revolving funds to use their capital as collateral with which to leverage new funds from the private sector—as the state revolving loan funds established under the Clean Water and Safe Drinking Water Acts have been allowed to do.

Supporters of this option contend that the federal government should not bear continuing responsibility for local development; rather, programs that benefit localities, whether urban or rural, should be funded at the state or local level. They argue that a few more years of federal funding to capitalize the revolving funds will provide a reasonable transition to the desired policy.

Opponents of converting RCAP argue that states might shift their aid from grants to loans and from low-interest to high-interest loans to avoid depleting the revolving funds, which could price the aid out of the reach of needier communities. In addition, precedent suggests that the estimated federal savings might not materialize: the Congress continues to appropriate additional grants to the state funds for wastewater treatment systems, long past the expiration of the original authorization for those grants.

**RELATED OPTION:** 300-02

## 450-02—Discretionary

# Eliminate Region-Specific Development Agencies

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 121 | 123 | 126 | 129 | 132 | 631 | 1,337 |
| Outlays | 21 | 54 | 86 | 106 | 119 | 386 | 1,064 |

The federal government provides annual funding to three regional development agencies: the Appalachian Regional Commission (ARC), the Denali Commission, and the Delta Regional Authority (DRA). The ARC, established in 1965, conducts activities that promote economic growth in the Appalachian counties of 13 states. Modeled after the ARC, the Denali Commission, created in 1998, covers remote areas in Alaska. Similarly, the DRA, established in 2000, covers 240 counties and parishes near the Mississippi River in eight states stretching from southern Illinois to the Louisiana coast. For 2003, the Congress appropriated $71 million for the ARC, $38 million for the Denali Commission, and $10 million for the DRA. Discontinuing federal funding for all three programs would save $21 million in 2004 and $386 million over five years.

The three agencies provide programs designed to, among other things, create jobs, improve rural education and health care, develop utility and other infrastructure, and provide job training. Few studies address the effectiveness of such programs. A 1996 report by the General Accounting Office reviewed the available evidence and found one study showing that ARC-aided counties grew significantly faster, along various socioeconomic measures, than otherwise similar non-ARC counties. However, a strong link could not be made between the activities of the ARC and the counties' growth.

Supporters of this option focus on two main points. First, they contend that the responsibility for supporting local or regional development basically lies with the state and local governments whose citizens will benefit from the development, not with the federal government. Second, they note that all regions of the country have needy areas; thus, they argue that the Appalachian areas, rural Alaska, and the Mississippi Delta have no special claim to federal dollars and should get any federal development aid through national programs, such as those of the Economic Development Administration.

Opponents of this option believe that the federal government has a legitimate role to play in redistributing funds among states to support development in the neediest areas and that cutting federal funding would reduce local progress in education, health care, and job creation. They further contend that the size, physical isolation, and severe poverty of Appalachia and the other regions covered require special attention.

**RELATED OPTION:** 450-08

## 450-03—Discretionary

# Drop Wealthier Communities from the Community Development Block Grant Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 620 | 633 | 646 | 659 | 674 | 3,232 | 6,832 |
| Outlays | 12 | 211 | 476 | 572 | 615 | 1,886 | 5,332 |

The Community Development Block Grant (CDBG) program provides annual grants to cities and urban counties through what is referred to as its entitlement component. The program also allocates funds to states, which in turn distribute them among smaller and more rural communities, called nonentitlement areas, typically through a competitive process.

In general, CDBG funds must be used to aid low- and moderate-income households, eliminate slums and blight, or meet emergency needs. Specific eligible uses include housing rehabilitation, infrastructure improvement, and economic development. Funds from the entitlement component may also be used to repay bonds that are issued by local governments (to acquire public property, for example) and guaranteed by the federal government under the Section 108 program. For 2003, the CDBG program received an appropriation of $4.4 billion, including $3.0 billion for entitlement communities.

Under current law, all urban counties, central cities of metropolitan areas, and cities with a population of 50,000 or more are eligible for the CDBG entitlement program. The program allocates funds according to a formula that includes the following factors: population, the number of residents with income below the poverty level, the number of housing units with more than one person per room, the number of housing units built before 1940, and the extent to which an area's population growth since 1960 is less than the average for all metropolitan cities. The formula neither requires a threshold percentage of residents living in poverty nor excludes communities with high average income. An analysis in the President's budget for 2004 shows that under the current formula, population and other data from the 2000 census will shift funding from poorer to wealthier communities, as measured by average poverty rates.

Federal spending for the program could be reduced by focusing entitlement grants on needier jurisdictions and lowering funding accordingly. Several alternative changes to the current formula could yield similar results; one simple approach, however, would be to exclude communities whose per capita income exceeds the national average by more than a certain percentage. Data suggest that restricting the grants to communities whose per capita income is less than 112 percent of the national average, for example, would save 26 percent of the entitlement funds, in part by cutting the large grants to New York City and Los Angeles. To illustrate the general approach, this option assumes a somewhat smaller cut of 20 percent of entitlement funding, which would save an estimated $12 million in 2004 and $1.9 billion over five years.

Proponents of this option might argue that if the CDBG program can be justified at all (some people contend that using federal funds for local development is generally inappropriate), its primary rationale is redistribution and that redirecting money to wealthier communities serves no pressing interest. Opponents might argue that such a change would reduce efforts to aid low- and moderate-income households in pockets of poverty within those communities, because local governments would not sufficiently reallocate their own funds to offset the lost grants.

**RELATED OPTIONS:** 450-07 and 450-08

## 450-04—Discretionary

# Eliminate the Neighborhood Reinvestment Corporation

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 107 | 109 | 111 | 114 | 116 | 557 | 1,177 |
| Outlays | 107 | 109 | 111 | 114 | 116 | 557 | 1,177 |

The Neighborhood Reinvestment Corporation (NRC) is a public, nonprofit organization charged with revitalizing distressed neighborhoods. The NRC oversees a network of locally initiated and operated groups called NeighborWorks organizations, or NWOs, which engage in a variety of housing, neighborhood revitalization, and community-building activities. The corporation provides technical and financial assistance to begin new NWOs; it also monitors and assists current network members. As of September 2002, the NeighborWorks network had 223 members operating in 2,339 communities nationwide. For 2002, the NRC's appropriation was $105 million.

With its appropriated funds, plus a few million dollars from fees and other sources, the corporation provides grants, conducts training programs and educational forums, and produces publications in support of NWOs. The bulk of the grant money goes to NWOs, which use the funds to purchase, construct, and rehabilitate properties; capitalize their revolving loan funds; develop new programs; and cover their operating costs. NWOs' revolving loan funds make home ownership and home improvement loans to individuals or loans to owners of mixed-use properties who provide long-term rental housing for low- and moderate-income households. In addition, the NRC awards grants to Neighborhood Housing Services of America to provide a secondary market for the loans from NWOs. Eliminating the NRC would save $107 million in 2004 and $557 million over five years.

Supporters of this option assert that the federal government should not fund programs whose benefits are local rather than national. In addition, they argue that the NeighborWorks approach duplicates the efforts of programs of other federal agencies (particularly the Department of Housing and Urban Development, or HUD) that also rehabilitate low-income housing and promote home ownership and community development. Moreover, they note that even within the NeighborWorks approach, the NRC is a redundant funding channel. In 2001, NRC grants accounted for about 17 percent of the NWOs' government funding and roughly 3.4 percent of their total funding. Larger shares came from private lenders, foundations, corporations, and HUD.

Opponents of this option argue that the large number of federal programs to assist local development is evidence of widespread support for a federal role—particularly in areas where state and local governments may lack adequate resources of their own. They further argue that NWOs concentrate on whole neighborhoods rather than individual housing properties and, with their nonhousing activities (such as community organization building, neighborhood cleanup and beautification, and leadership development), provide economic and social benefits that other federal programs do not. Finally, people who oppose this option say that the NRC is valuable because of its flexibility in making grants, which allows it to fund worthwhile efforts that do not fit within the narrow criteria of larger federal grantors, and because of the valuable services it provides to the NWOs, such as training, program evaluation, and technical assistance.

**RELATED OPTION:** 450-07

## 450-05—Mandatory

# Drop Flood Insurance for Certain Repeatedly Flooded Properties

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Outlays | 90 | 194 | 209 | 225 | 242 | 960 | 2,481 |

Data from the National Flood Insurance Program (NFIP) show that a relatively small number of properties subject to repeated flooding account for a large share of the losses incurred by the program. The Federal Emergency Management Agency (FEMA), which administers the NFIP, has focused its attention on properties for which there have been two or more losses of at least $1,000 each in any 10-year period since 1978 (the earliest year for which data are available). The roughly 95,000 properties fitting that definition account for about one-third of all claims, by both number and dollar value, since 1978. Many of those properties no longer have flood insurance: in some cases, the property has been destroyed or relocated; in other cases, the owner dropped the policy —for example, after FEMA, in 1983, limited coverage under the NFIP for basement losses. The NFIP currently insures roughly 45,000 repeatedly flooded properties, representing about 1 percent of all policies in force but accounting for a much larger share of annual flood losses.

The issue of repeatedly flooded properties raises concern in part because they generally are covered at premiums that are well below the actuarial risk of flood losses. FEMA's data show that 95 percent of such properties were built before the development of the flood insurance rate map (FIRM) for their community—which is not surprising, given the flood mitigation requirements imposed on post-FIRM construction. Thus, almost all repeatedly flooded properties are covered under the pre-FIRM premiums that the government explicitly subsidizes. (See the related discussion in option 450-06.) Some properties may incur losses twice in 10 years because of a bad "draw" of storms or other random events—but others have flooded four, five, or even 10 or 20 times since 1978.

One way to reduce federal costs for the flood insurance program would be to deny coverage after the third loss of at least $1,000 in any 10-year period. According to FEMA's data, that option would immediately affect more than 27,000 properties; by the Congressional Budget Office's estimates, it would reduce federal outlays by $90 million in 2004 and $960 million over the 2004-2008 period. Supporters of this option argue that neither taxpayers nor other policyholders should be required to provide an unlimited subsidy for properties known to be at high risk for frequent flood damage. The loss or threat of losing the NFIP's protection could encourage owners of such properties to take appropriate mitigation measures, such as elevating their structures or rebuilding elsewhere.

Opponents of this option argue that it would be unfair to the owners to suddenly withdraw their protection from flood risk—especially owners who have occupied their properties since before the local FIRM was developed and who cannot readily afford relocation or other costly mitigation measures. Some opponents might prefer a more moderate change from the current policy, such as adding a repetitive-loss surcharge to insurance premiums or denying coverage only to policyholders who reject offers of mitigation assistance.

**RELATED OPTION:** 450-06

## 450-06—Mandatory

# Phase Out the Flood Insurance Subsidy on Pre-FIRM Structures Other Than Primary Residences

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 25 | 60 | 106 | 182 | 215 | 588 | 1,702 |

The National Flood Insurance Program (NFIP) charges two different sets of premiums: one for buildings constructed before 1975 or before the completion of a participating community's flood insurance rate map (FIRM)—known as pre-FIRM buildings—and another for post-FIRM buildings. Post-FIRM premiums are intended to be actuarially sound—that is, to cover the costs of all insured losses over the long term—and are based on buildings' elevations relative to the water level expected during a "100-year flood" (the most severe flood thought to have a local probability of at least 1 in 100 each year). In contrast, pre-FIRM rates are heavily subsidized, on average, and do not take elevation into account.

The Federal Emergency Management Agency (FEMA), which administers the flood insurance program, estimates that about 19 percent of all coverage is provided at pre-FIRM rates. Those rates are available only for the first $35,000 of coverage for a single-family or a two- to four-family dwelling and for the first $100,000 of coverage for a larger residential, nonresidential, or small-business building. Various levels of additional coverage are available at actuarially sound rates. The program also offers insurance for buildings' contents; again, policyholders in pre-FIRM buildings pay lower rates for a first tier of coverage. The Congressional Budget Office estimates that, on average, the first-tier prices represent 38 percent of the actuarial value, implying a subsidy rate of 62 percent. The size of the subsidy for any particular building depends heavily on its elevation.

Phasing out the subsidy on all insured structures other than primary residences—second and vacation homes, rental properties, and nonresidential structures—would yield additional receipts of $25 million in 2004 and $588 million over the 2004-2008 period. Those estimates take into account the likelihood that some current policyholders will drop their coverage. Flood insurance is mandatory only for properties in special flood hazard areas that carry mortgages from federally insured lenders, and compliance with the requirement is far from complete. Accordingly, CBO expects that the option would somewhat reduce the participation of both voluntary purchasers and property owners for whom the insurance is mandatory.

Advocates of this option argue that the subsidy has outlived its original justification as a temporary measure to encourage participation among property owners who were not previously aware of the magnitude of the flood risks they faced. Phasing out the subsidies, such advocates maintain, would make policyholders pay more of their fair share for insurance protection and would give them incentives to relocate or take preventive measures. And while some proponents would prefer to phase out the subsidies on primary residences as well, advocates of this particular option argue that it focuses on structures whose owners would face relatively little hardship in paying actuarial rates.

Some opponents of this option primarily object to its inclusion of rental properties, because owners may pass on the increased costs to renters. Others support the subsidy more generally, on the grounds that it would be unfair to charge full actuarial rates to owners of properties built before FEMA documented the extent of local flood hazards. Subsidy supporters would also argue that reduced rates of participation in the program would lead to increased spending on disaster grants and loans and thereby erode some of the projected savings. Finally, they question the accuracy of the maps FEMA uses to estimate the average long-run subsidy, noting that for most pre-FIRM properties (except a relatively few structures that repeatedly flood), premiums now roughly equal the average losses incurred to date.

**RELATED OPTION:** 450-05

## 450-07—Discretionary

# Eliminate the Community Development Financial Institutions Fund

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 65 | 82 | 83 | 85 | 88 | 403 | 874 |
| Outlays | 5 | 35 | 69 | 81 | 84 | 274 | 728 |

The Congress created the Community Development Financial Institutions (CDFI) fund in 1994 to expand the availability of credit, investment capital, and financial services in distressed communities. The fund provides equity investments, grants, loans, and technical assistance to CDFIs, which include community development banks, credit unions, loan funds, venture capital funds, and microenterprise funds. In turn, the CDFIs provide a range of financial services—such as mortgage financing for first-time home buyers, loans and investments for new or expanding small businesses, and credit counseling—in markets that are underserved by traditional institutions. The CDFI fund also provides incentive grants to traditional banks and thrifts to invest in CDFIs and to increase loans and services to distressed communities. In addition, the fund administers the New Markets Tax Credit (NMTC) program begun in 2002 to provide federal tax credits for qualified investments in "community development entities."

For 2002, the Congress appropriated $79 million for the CDFI fund. Eliminating the fund would save $5 million in 2004 and $274 million over five years. The estimated savings take into account the small amount of spending that would still be required by other agencies for oversight of the fund's existing loan portfolio and administration of the NMTC program.

Supporters of this option argue, first, that local development should be funded at the state or local level, not by the federal government, since its benefits are not national in scope. Second, they see the CDFI fund as redundant, given that many other federal programs and agencies support home ownership and local economic development, including the Empowerment Zones/Enterprise Communities Program, housing loan programs of the Rural Housing Service, the Community Development Block Grant program, the Neighborhood Reinvestment Corporation, and the Economic Development Administration. Appropriations for those programs and agencies totaled $6.2 billion in 2002. Third, some proponents argue that assistance to CDFIs is likely to be inefficient, encouraging them to make loans that would not pass market tests for creditworthiness.

Opponents of this option contend that the federal government has a legitimate role in assisting needy communities, some of which lack access to traditional credit sources. By assisting existing CDFIs and stimulating the creation of others, the fund provides an efficient mechanism, they argue, for leveraging private-sector investment with a relatively small federal contribution.

**RELATED OPTIONS:** 450-03, 450-04, and 450-08

## 450-08—Discretionary

# Eliminate Grant Funding for Empowerment Zones

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 61 | 63 | 64 | 65 | 67 | 320 | 673 |
| Outlays | 1 | 21 | 47 | 57 | 61 | 187 | 527 |

The Omnibus Budget Reconciliation Act of 1993 authorized a program under which nine economically distressed communities could be designated as "empowerment zones." To receive the designation, communities had to meet certain eligibility criteria and compete for selection on the basis of their strategic plans for implementing the program, which provides tax incentives—in the form of wage tax credits, accelerated depreciation, and tax-exempt financing—to businesses to encourage them to locate to or expand in the designated areas. When the law was enacted, the Congress made available $100 million in block grants for each urban empowerment zone and $40 million for each rural one to support a broad range of economic and social development activities. (The law also authorized designation of 95 "enterprise communities" that are eligible for grants of $3 million each.)

Since 1993, the Congress has authorized two additional rounds of empowerment zones, increasingly emphasizing tax credits rather than grants. Only zones created in 1998 continue to receive grant funding. In 2002, funding for those zones totaled $60 million. In recent years, the President has requested no funding for grants to empowerment zones.

Eliminating grant funding, while leaving the tax incentives in place, would save $1 million in 2004 and $187 million over five years. Proponents of this option contend that local economic development is an inappropriate use of federal dollars and should be left to state and local governments. They further note that funds for social services and community benefits are available from a number of other government programs, including the Community Development Block Grant program and various regional commissions and authorities. Proponents of eliminating grants also argue that tax breaks and other incentives are a more cost-effective way to stimulate private-sector activity and thereby promote economic revival.

People opposed to the option argue that some evidence shows that communities are carrying out their plans to develop local capacities to assist businesses and encourage private investment. Opponents note that the program could do more to help local entrepreneurs if additional funds were available to assist with business planning and administration. Finally, many communities issued bonds and developed strategic plans expecting that multiyear grant funding would be available.

**RELATED OPTIONS:** 450-02, 450-03, and 450-07

# 500

# Education, Training, Employment, and Social Services

Budget function 500 primarily covers federal spending within the Departments of Education, Labor, and Health and Human Services for programs that directly provide—or assist states and localities in providing—services to individuals. Its activities include making developmental services available to low-income children, helping to fund programs for disadvantaged and other elementary and secondary school students, making grants and loans to postsecondary students, and funding job-training and employment services for people of all ages. CBO estimates that total outlays for function 500 will be $79 billion in 2003. Discretionary outlays represent more than $71 billion of that total. Since 1990, function 500 has experienced increases in discretionary outlays in all but one year.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 30.0 | 33.8 | 36.3 | 38.1 | 40.6 | 39.9 | 36.5 | 42.8 | 46.7 | 46.6 | 44.4 | 61.3 | 71.3 | 71.7 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 27.9 | 30.6 | 34.0 | 36.5 | 37.6 | 38.9 | 38.5 | 39.6 | 42.5 | 45.1 | 48.9 | 54.3 | 62.7 | 71.4 |
| Mandatory | 9.3 | 10.6 | 8.7 | 10.9 | 5.7 | 12.1 | 9.9 | 9.3 | 8.0 | 5.5 | 4.8 | 2.9 | 7.8 | 7.7 |
| Total | 37.2 | 41.2 | 42.7 | 47.4 | 43.3 | 51.0 | 48.3 | 49.0 | 50.5 | 50.6 | 53.8 | 57.1 | 70.5 | 79.1 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 9.8 | 11.2 | 7.2 | 3.0 | 3.6 | -1.2 | 3.1 | 7.3 | 6.1 | 8.5 | 10.9 | 15.6 | 13.9 |

Note: n.a. = not applicable.

## 500-01—Discretionary

# Reduce Funding to School Districts for Impact Aid

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 127 | 129 | 132 | 135 | 138 | 661 | 1,397 |
| Outlays | 119 | 125 | 130 | 134 | 137 | 646 | 1,379 |

The Impact Aid program, authorized under title VIII of the Elementary and Secondary Education Act, provides money to school districts that are affected by activities of the federal government. Most of the program's funds are used to make basic support payments to districts for so-called federally connected students (such as those living on Indian land or military bases). Impact Aid funds are also used to maintain schools owned by the Department of Education and to help pay for school construction in areas where the federal government has acquired a significant portion of the real property tax base, thus depriving the school district of a source of revenue.

In 2003, approximately 1,300 local education agencies will receive basic support payments from the Impact Aid program. For a school district to be eligible for those payments, a minimum of 3 percent—or at least 400—of its students must be associated with activities of the federal government. The amount of a school district's basic support payments is based on a grant formula that considers the district's population of "Type A" and "Type B" students. Type A students include those living on Indian land as well as students living on federal land whose parents are either employed on federal land, are members of the armed forces, or are employees of a foreign government (such as embassy personnel). Type B students include children whose parents are in the military services but who live on private property as well as children who reside in federally subsidized low-rent housing. In addition, aid goes to a few districts in which 10 percent—or at least 1,000—of the students have parents who work but do not live on federal property. Those children are also classified as Type B students.

This option would focus Impact Aid on the school districts that are most affected by federal activities by eliminating support for Type B students. Instead, a school district's basic support payments would be based solely on its enrollment of Type A students. That change would reduce federal outlays by $119 million in 2004 and by $646 million over the 2004-2008 period.

Proponents of this option argue that it is appropriate to restrict Impact Aid payments to cover only those students whose presence puts the greatest burden on school districts. Opponents argue that eliminating payments for other types of children associated with federal activities could significantly affect certain districts—for example, those in which large numbers of military families live off-base but shop at military exchanges, which do not collect state and local sales taxes.

**RELATED OPTION:** 050-27

**500-02—Discretionary**

# Repeal the Safe and Drug-Free Schools and Communities Act

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 480 | 489 | 500 | 510 | 522 | 2,501 | 5,287 |
| Outlays | 246 | 429 | 491 | 509 | 520 | 2,195 | 4,701 |

The Safe and Drug-Free Schools and Communities Act (SDFSCA) funds programs to discourage the use of illegal substances—such as alcohol, cigarettes, and drugs—among young people and to address the related issue of violence in schools. States get SDFSCA funding on the basis of their school-age population and number of poor children. In 2002, that funding totaled $472 million.

States distribute SDFSCA funds to school districts in the form of grants that can be used at the discretion of local administrators. Some 97 percent of the nation's school districts receive those grants. The SDFSCA program stipulates that the money go toward activities that address violence and drug abuse in schools, but it offers little guidance about what constitutes an effective use of those funds. Moreover, little evidence exists about what activities reduce violence and drug abuse among young people.

This option would eliminate payments to states under the SDFSCA. That change would save $246 million in outlays next year and a total of about $2.2 billion over the 2004-2008 period.

Advocates of this option might argue that the activities supported by the SDFSCA do not appear to be effective. A 2001 RAND report concluded that those activities have shown little success in reducing the incidence of violence and drug abuse in schools. Furthermore, although violence and drug abuse in general are pressing societal issues, they are problems that rarely occur on school grounds. Despite the occasional well-publicized incident, studies show that schools are among the safest places in the country, on average, and that drug use occurs infrequently on school property. In addition, rates of violent injury on school grounds have not changed significantly since the SDFSCA was enacted in 1986.

Critics of this option would argue that prevention efforts such as those funded by the SDFSCA may serve a proactive function by raising people's awareness of the problems of drug abuse and violence. If such activities were eliminated, drug use and violence might accelerate and lead to even more costly interventions on the part of school systems and communities.

## 500-03—Mandatory

# Eliminate Interest Subsidies on Loans to Graduate Students

| | | | | | | Total | |
|---|---|---|---|---|---|---|---|
| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | 2004-2013 |
| Outlay Savings | 625 | 950 | 985 | 1,010 | 1,030 | 4,600 | 10,005 |

Federal student loan programs give students and their parents the opportunity to borrow funds to pay for postsecondary education. Those programs offer "subsidized" loans to students who are defined as having financial need and "unsubsidized" loans to students regardless of need. Two programs provide both types of loans: the Federal Family Education Loan Program, in which loans made by private lenders are guaranteed by the federal government; and the William D. Ford Federal Direct Loan Program, in which the government makes loans through schools. Borrowers of federal student loans benefit because the interest rates that they are charged are lower than the rates that most of them could secure from alternative sources. Borrowers of subsidized loans benefit further because the federal government forgives interest on those loans while students are in school and for six months afterward.

This option would reduce federal costs by restricting eligibility for subsidized loans only to undergraduate students. Doing so would lower federal outlays by $625 million in 2004 and by $4.6 billion over the 2004-2008 period.

Restricting subsidized loans only to undergraduate students would direct a larger share of student aid funding to those students than is now the case. Supporters of that shift would argue that the federal government's primary role in higher education is to make such education available to all high school graduates. In their view, graduate students have already achieved the success not available to many high school graduates. Opponents of such a shift in funding would argue that supporting graduate students is an equally important role of the federal government because those students are the ones most likely to make scientific, technological, and other advances that will benefit society as a whole.

Under this option, graduate students who lost access to subsidized loans could take out unsubsidized federal loans of the same amount and still benefit from below-market interest rates. Nevertheless, graduate students often amass large student loan debts because of the number of years of schooling required for their degrees. Without the benefit of interest forgiveness while they were enrolled in school, their debt would be substantially larger when they entered the repayment period, because the interest on the amounts they had borrowed over the years would be added to their loan balance. However, the federal student loan programs have several options for making repayment manageable for students who have high loan balances or difficult financial circumstances.

**RELATED OPTION:** 500-04

## 500-04—Mandatory

# Raise Interest Rates on Federal Student Loans

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 240 | 360 | 515 | 735 | 815 | 2,665 | 7,090 |

Under the Federal Family Education Loan (FFEL) Program and the William D. Ford Federal Direct Loan Program, students have the opportunity to borrow money for postsecondary education—from lenders and from the government, respectively—at below-market interest rates. The rate that students are charged on loans from those programs during the repayment period equals the interest rate that the government pays on 91-day Treasury bills plus 2.3 percentage points (with the total rate not to exceed 8.25 percent). For the 2002-2003 school year, that rate totals 4.06 percent. Beginning in July 2006, students' interest rate will be fixed at 6.8 percent.

Lenders that participate in the FFEL program usually receive a higher interest rate on federal loans than students pay, with the federal government making up the difference. Their rate equals either the student rate or the interest rate on commercial paper issued by financial institutions plus 2.34 percentage points, whichever is higher. Even if their rate is lower than market interest rates, lenders are willing to make Federal Family Education loans because the government guarantees repayment of those loans.

This option would raise students' interest rate on federal loans from both programs by calculating that rate using the formula for lenders in the FFEL program. That change would boost students' interest rate by an average of about 0.15 percentage points before the planned increase in July 2006 and by 0.5 percentage points afterward. Their rate would still be capped at 8.25 percent, however, and the government would continue to make an additional payment to lenders when the lender-rate formula exceeded that cap. This option would reduce federal outlays by $240 million in 2004 and by a total of almost $2.7 billion over five years.

For most students, the higher interest rate would still be lower than the rates available on loans from alternative sources. Furthermore, federally guaranteed student loans have attractive repayment options and cost-reducing incentives not available elsewhere. However, even a small increase in that interest rate would raise the already high costs that many student face for postsecondary education. Thus, it could discourage some students from continuing their education.

**RELATED OPTIONS:** 500-03, 500-05, 500-06, and 500-07

## 500-05—Mandatory

# Increase Up-Front Fees on Unsubsidized Loans to Dependent Students and Their Parents

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 75 | 85 | 50 | 20 | 20 | 250 | 350 |

In the Federal Family Education Loan Program and the William D. Ford Federal Direct Loan Program, the government recoups part of its costs by collecting up-front fees on each loan to students or their parents. Those fees —which are generally 3 percent of the face value of the loan—are charged on subsidized and unsubsidized loans to dependent and independent students as well as on PLUS loans to parents.

This option would raise those fees to 4 percent for unsubsidized loans to dependent students and PLUS loans in both programs. That increase would save the programs a total of $75 million in 2004 and $250 million over the 2004-2008 period.

Supporters of this option argue that even with higher fees, many families would still benefit substantially from federal student loans. Moreover, because the option would affect only unsubsidized loans to dependent students and PLUS loans to parents, it would produce savings without affecting the value of loans to independent students (who generally have fewer financial resources than dependent students do) or the value of subsidized loans to the neediest dependent students.

Critics of this option counter that raising up-front fees would reduce the net proceeds that students received from any given loan. Thus, it would add to the already high education costs that many students face and could cause some of them to forgo or drop out of postsecondary school.

**RELATED OPTIONS:** 500-04 and 500-06

## 500-06—Mandatory

# Restrict Eligibility for Subsidized Student Loans by Including Home Equity in the Determination of Financial Need

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 60 | 90 | 95 | 95 | 95 | 435 | 910 |

The Higher Education Amendments of 1992 eliminated home equity from consideration in determining how much a student's family is expected to contribute for education expenses. That change made it easier for many students to obtain subsidized student loans. The amount a family is expected to contribute depends on its income and assets. Since 1992, the definition of assets has excluded home equity for all families and has excluded all assets for applicants with annual family income below $50,000.

This option would once again include home equity in calculating a family's need for financial aid for postsecondary education, treating home equity as other assets are treated now. In addition, the income threshold under which all assets are excluded would decline from $50,000 per year to its previous level of $15,000. Those changes would mean that fewer students qualified for subsidized loans, and those who did qualify would get smaller loans, on average. Overall, including home equity in loan calculations could reduce outlays by $60 million in 2004 and $435 million during the 2004-2008 period.

Under this option, students who lost access to subsidized loans could take out unsubsidized federal loans to finance their families' greater expected contribution. That approach would cause relatively little difficulty for families' budgets because the interest payments on unsubsidized loans can be postponed while the student is in school. The interest is then simply added to the accumulated loan balance when the student leaves school and begins repayment.

Nonetheless, students who shifted from subsidized to unsubsidized loans (or to larger unsubsidized loans) would leave school with higher loan balances. That addition would make repaying the loans more difficult for some students. And for many families, having to determine the value of their home and other assets would complicate the loan application process. Furthermore, families' larger expected contribution could limit their access to discretionary student aid, including Pell grants.

**RELATED OPTIONS:** 500-04 and 500-05

## 500-07—Mandatory

# Eliminate the Floor on Lenders' Yields from Federally Guaranteed Student Loans

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 340 | 545 | 880 | 1,280 | 1,425 | 4,470 | 12,135 |

Under the Federal Family Education Loan (FFEL) Program, which guarantees loans made by lenders to eligible students, borrowers pay lenders an interest rate (called the student rate) that is determined once a year according to a formula set in law. The interest rate that lenders are supposed to receive is calculated quarterly using another formula. If that rate is greater than the student rate, the federal government pays lenders an additional amount in that quarter. If that rate is less than the student rate, the government does not make any additional payments. In effect, the student rate is a floor below which a lender's return cannot fall.

This option would eliminate the floor on the interest rate that lenders receive. If the calculated lender rate exceeded the student rate, the government would pay lenders as it does now. But if the calculated lender rate was less than the student rate, lenders would be required to rebate the excess to the government. That change would reduce federal outlays for the FFEL program by $340 million next year and by a total of almost $4.5 billion over the 2004-2008 period.

Supporters of this option would argue that the lender-rate formula is designed to approximate a fair market return to lenders. In that view, lenders now earn an above-market return during quarters when the calculated lender rate is below the student rate. Moreover, compared with other ways of lowering lenders' returns, this approach might be preferable to many lenders because it would closely tie their interest income with their interest expenses.

Some opponents of this change contend that the current lender-rate formula underestimates a fair market return. To compensate for that underestimate, lenders rely on occasionally earning more than the calculated rate, as they do when the student-rate floor is in effect. Moreover, the lender-rate formula has been adjusted downward several times in the past decade. Further reductions might induce some lenders to leave the FFEL program.

**RELATED OPTION:** 500-04

## 500-08—Discretionary

# End New Federal Funding for Perkins Loans

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 102 | 104 | 106 | 108 | 111 | 530 | 1,120 |
| Outlays | 10 | 99 | 104 | 106 | 108 | 427 | 1,006 |

The federal government provides student loans through various programs, including the Federal Family Education Loan Program, the William D. Ford Federal Direct Loan Program, and the Federal Perkins Loan Program. The Perkins Loan program is the smallest, with allocations made directly to nearly 1,900 postsecondary schools. Financial aid administrators at those schools determine which eligible students receive Perkins loans. During the 2001-2002 academic year, approximately 710,000 students received such loans.

Funding for Perkins loans—which totaled about $1.4 billion in 2002—comes from an institutional revolving fund that has four sources: payments on previous years' student loans, which schools collect ($1.1 billion in 2002); federal payments for loan cancellations, which are granted when students agree to teach in high-need areas or undertake military or public service ($68 million in 2002); federal contributions from new appropriations ($100 million in 2002); and matching contributions from schools, which must equal at least one-third of a school's federal contribution.

This option would eliminate new appropriations for federal contributions to the Perkins Loan program, thus lowering outlays by a total of $427 million during the 2004-2008 period. The extent to which funding for student loans declined would depend on the responses of postsecondary institutions, some of which might make up part or all of the lost federal money. If schools did not make up any of the lost federal funds but continued to contribute to the program at the level of their previous matching contributions, approximately 60,000 fewer Perkins loans would be made annually.

Supporters of this option would argue that enough low-interest loans are available through the Federal Family Education Loan and direct loan programs to render additional federal capital contributions to the Perkins Loan program unnecessary. Furthermore, although the main goal of federal student aid is to eliminate financial barriers to postsecondary education, the Perkins Loan program may be failing to provide equal access to students with equal financial need. Federal contributions are allocated first on the basis of an institution's 1999 allocation and then on the basis of the financial need of its students. Because campus-based aid such as the Perkins Loan program is tied to specific institutions, students with greater need at poorly funded schools may receive less money than students with less need at well-funded institutions.

Opponents of this option would contend that eliminating new funds for Perkins loans would reduce the total amount of aid available and give schools less discretion in packaging aid to address the special situations of some students. Moreover, nearly half of Perkins loan money goes to students at private nonprofit institutions (compared with about 20 percent of Pell grant aid). Thus, cutting Perkins loans would make that type of school less accessible to financially needy students.

**RELATED OPTION:** 500-09

## 500-09—Discretionary

# Eliminate Administrative Fees Paid to Schools in the Campus-Based Student Aid and Pell Grant Programs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 191 | 195 | 199 | 203 | 208 | 996 | 2,104 |
| Outlays | 22 | 186 | 195 | 199 | 204 | 806 | 1,893 |

In several federal student aid programs, the government pays schools to administer the programs or to distribute the funds, or both. One type of program, campus-based aid, includes the Federal Supplemental Educational Opportunity Grant Program, the Federal Perkins Loan Program, and the Federal Work-Study Program. The government distributes funds for those programs to institutions, which in turn award grants, loans, and jobs to qualified students. Under a statutory formula, institutions are allowed to use up to 5 percent of those program funds for administrative costs. In another program, the Federal Pell Grant Program, schools also distribute federal funds but eligibility is determined by federal law rather than by the institutions. The Higher Education Act provides for a federal payment of $5 per Pell grant to reimburse schools for some of their costs in administering that program.

The government could save about $167 million in budget authority next year if schools were not allowed to use federal funds from the campus-based aid programs to pay administrative costs. It could save another $24 million that year if the $5 payment to schools in the Pell Grant program was eliminated. Together, those changes would save a total of $806 million in outlays over the 2004-2008 period.

Arguments can be made both for eliminating those administrative payments and for retaining them. On the one hand, schools benefit significantly from participating in federal student aid programs even without the payments because the aid makes attendance at those schools more affordable. In 2003, students at those institutions will receive an estimated $15.5 billion in funds under the Pell Grant and campus-based aid programs. On the other hand, institutions do incur costs to administer the programs. Furthermore, if the federal government did not pay those expenses, schools might simply pass along the costs to students in the form of higher tuition or lower institutional student aid.

**RELATED OPTION:** 500-08

**500-10—Discretionary**

# Eliminate the Leveraging Educational Assistance Partnership Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 68 | 69 | 71 | 72 | 74 | 355 | 750 |
| Outlays | 14 | 68 | 70 | 71 | 73 | 296 | 684 |

The Leveraging Educational Assistance Partnership (LEAP) program (formerly the State Student Incentive Grant program) helps states provide financially needy postsecondary students with grant and work-study assistance while they attend academic institutions or vocational schools. States must match federal funds at least dollar for dollar and also meet maintenance-of-effort criteria (minimum funding levels based on funding in previous years). Unless excluded by state law, all public and private nonprofit postsecondary institutions in a state are eligible to participate in the LEAP program.

This option would eliminate the program, reducing federal outlays by $296 million over five years. The extent to which students' financial assistance declined would depend on the responses of the states, some of which would probably make up at least part of the lost federal funds.

Proponents of eliminating the LEAP program argue that it is no longer needed to encourage states to provide more student aid. When the program was first authorized in 1972, only 28 states had student grant programs; now, all 50 states provide such grants. Moreover, states currently fund the program far in excess of the level to which federal matching funds apply.

Opponents of eliminating the LEAP program argue that not all states would increase their student aid appropriations to make up for the lost federal funds, and some might even reduce them. In that case, some of the students who received less aid might not be able to enroll in college or might have to attend a less expensive school.

## 500-11—Discretionary

# Eliminate the Senior Community Service Employment Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 450 | 459 | 468 | 478 | 489 | 2,344 | 4,954 |
| Outlays | 76 | 433 | 460 | 470 | 480 | 1,919 | 4,481 |

The Senior Community Service Employment Program (SCSEP) funds part-time jobs for people age 55 and older who have low income and poor employment prospects. To participate in the program in 2002, a person had to have annual income of less than $11,075—or 125 percent of the federal poverty line for someone living alone. SCSEP grants are awarded to nonprofit organizations, the Forest Service, and state agencies. Those organizations and agencies pay participants to work in part-time community service jobs, up to a maximum of 1,300 hours per year.

In 2002, nearly 100,000 people took part in the SCSEP, working in schools, hospitals, and senior citizen centers and on beautification and conservation projects. Participants are paid the federal or state minimum wage or the local prevailing wage for similar employment, whichever is higher. They are also offered annual physical examinations, training, personal and job-related counseling, and assistance to move into unsubsidized jobs when they complete their projects.

This option would eliminate the SCSEP, saving $76 million in outlays next year and $1.9 billion over the 2004-2008 period (compared with the 2003 appropriations enacted on February 20, 2003, adjusted for inflation).

Advocates of this option maintain that the SCSEP offers few benefits aside from income support and that the work experience gained by participants would generally be more valuable if it was provided to equally disadvantaged young people, who have longer careers over which to benefit from it. In addition, the costs of producing the services now provided by SCSEP participants could be borne by the organizations that benefit from their work; under current law, those organizations usually must bear just 10 percent of such costs. Shifting those costs would ensure that only the services that were most highly valued would be provided.

Opponents of this option note that the SCSEP is the major federal jobs program aimed at low-income older workers. Eliminating it could cause hardship for workers who were 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 the SCSEP, community services might be reduced if nonprofit organizations and states were unwilling or unable to increase their spending to offset the loss of federal funds.

# 550

# Health

Budget function 550 includes federal spending for health care services, disease prevention, consumer and occupational safety, health-related research, and similar activities. The largest component of spending is the federal/state Medicaid program, which funds health services for some low-income women, children, and elderly people as well as people with disabilities. Mandatory outlays for Medicaid increased by more than 10 percent per year in the early 1990s and have risen significantly again in the past few years. CBO estimates that in 2003, the federal government will spend $157 billion on Medicaid and a total of $216 billion on function 550. Discretionary outlays make up only about $43 billion of that total. They have grown every year since 1990.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 16.1 | 18.2 | 19.6 | 20.7 | 22.2 | 22.8 | 23.3 | 25.1 | 26.4 | 30.2 | 33.8 | 38.9 | 45.8 | 44.7 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 14.9 | 16.2 | 18.0 | 19.6 | 20.5 | 22.0 | 22.6 | 23.0 | 24.9 | 26.9 | 30.0 | 33.2 | 39.4 | 43.3 |
| Mandatory | 42.9 | 55.0 | 71.5 | 79.8 | 86.6 | 93.4 | 96.8 | 100.9 | 106.6 | 114.1 | 124.5 | 139.1 | 157.1 | 173.1 |
| Total | 57.7 | 71.2 | 89.5 | 99.4 | 107.1 | 115.4 | 119.4 | 123.8 | 131.4 | 141.1 | 154.5 | 172.3 | 196.5 | 216.4 |
| **Memorandum**: Annual Percentage Change in Discretionary Outlays | n.a. | 8.8 | 11.1 | 9.3 | 4.6 | 7.2 | 2.5 | 1.7 | 8.2 | 8.4 | 11.4 | 10.5 | 18.8 | 9.9 |

Note: n.a. = not applicable.

## 550-01—Mandatory

# Reduce the Enhanced Federal Matching Rates for Certain Administrative Functions in Medicaid

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 970 | 1,180 | 1,520 | 1,620 | 1,740 | 7,030 | 18,000 |

The federal government pays part of the costs that states incur in administering their Medicaid programs. The federal matching rate is 50 percent for most administrative activities but is higher in certain cases. For example, the federal government pays 75 percent of the costs of skilled medical professionals who are employed in Medicaid administration, 75 percent of the costs of utilization review, 90 percent of the costs of developing systems to process claims and manage information, and 75 percent of the costs of operating such systems.

This option would set the federal matching rate for all Medicaid administrative costs at 50 percent. That change would save $970 million in 2004 and $7.0 billion over five years.

Supporters of this option would argue that enhanced matching rates are designed to encourage states to develop and support particular administrative activities that the federal government considers important for the Medicaid program. Once the administrative systems are operational, however, there may be less reason to continue to pay higher rates. Moreover, because states pay about 43 percent of the cost of health care for Medicaid beneficiaries, on average, they have clear incentives to maintain efficient information systems and employ skilled professionals.

Opponents would counter that without higher matching rates, states might decide to cut back on some activities, with adverse consequences for the quality of care and for program management. For example, states might hire fewer nurses to conduct utilization reviews and oversee care in nursing homes, or they might make fewer improvements to their information-management systems. However, if the Congress wanted to support particular administrative functions, it could retain the higher matching rates for those functions while reducing the matching rates for others.

**RELATED OPTIONS:** 550-02 and 550-03

## 550-02—Mandatory

# Restrict the Allocation of Common Administrative Costs to Medicaid

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 280 | 320 | 390 | 390 | 390 | 1,770 | 3,720 |

Public assistance programs have certain administrative tasks that are common to the enrollment process, such as collecting information about a family's income, assets, and demographic characteristics. Before the 1996 welfare reform law, the federal government's three major public assistance programs—Aid to Families with Dependent Children (AFDC), Food Stamps, and Medicaid—all reimbursed states for 50 percent of most types of administrative costs. As a matter of administrative convenience, states usually charged the common administrative costs of those programs to AFDC.

The welfare reform law replaced AFDC and some related programs with the Temporary Assistance for Needy Families (TANF) block-grant program. The block grants that states receive are based on past federal welfare spending, including reimbursements for administrative costs. Thus, insofar as states had previously paid the common administrative costs of public assistance programs from AFDC funds, those amounts are now included in their block grants. Although the welfare reform law was silent about the cost allocation process, the Department of Health and Human Services requires states to charge part of those common administrative costs to Medicaid, even if the costs are already included in the states' TANF block grants.

This option would reduce federal reimbursement for the administrative costs of Medicaid to reflect the share of those costs that is assumed to be covered by the TANF block grant; it would also prohibit states from using TANF funds to pay those costs. (Assuming that states spend all of their TANF block-grant funds in the long run, prohibiting them from using those funds to pay Medicaid administrative costs would increase the savings from this option in the early years, although it would have little effect over a longer period.) The reduction in funding would equal about one-third of the common costs of administering the Medicaid, AFDC, and Food Stamp programs that were charged to AFDC during the base period used for determining the amount of the TANF block grant. (A similar adjustment has already been made in the amount that the federal government pays the states to administer the Food Stamp program.)

The primary advantage of this option would be its savings: federal outlays would decline by $280 million in 2004 and by almost $1.8 billion over the 2004-2008 period. If the policy allowed states to use TANF funds to pay those administrative costs, the savings would be smaller in the short run: $150 million in 2004 and $1.7 billion over five years. In the long run, the savings would be about the same as under this option.

Critics of this option would argue that reducing federal reimbursements could hamper states' outreach activities to enroll more eligible children in Medicaid and the State Children's Health Insurance Program or could prompt states to reduce eligibility or services. As a result, fewer people might be enrolled in those programs.

**RELATED OPTIONS:** 550-01 and 550-03

## 550-03—Mandatory

# Reduce Spending for Medicaid Administration

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 2,150 | 2,560 | 2,980 | 3,410 | 3,880 | 14,980 | 43,580 |

Option 550-02 describes one way to limit federal payments to the states for Medicaid's common administrative costs. An alternative strategy would be to base those payments on matching payments for administrative costs in the period before the Temporary Assistance for Needy Families (TANF) block-grant program was established. Under this option, the federal government would cap the amount per enrollee that it paid the states for Medicaid administration. That cap would grow by 5 percent a year from the base-year amount, which would be the administrative costs per enrollee for which the states claimed matching payments in 1996. Savings from that change would total almost $2.2 billion in 2004 and $15.0 billion over the 2004-2008 period.

Under this approach, states that had allocated Medicaid's common administrative costs to the Aid to Families with Dependent Children program before TANF's creation would not have those costs included in their projected Medicaid administrative costs. But states that had claimed those common costs through the Medicaid program would have them built into their administrative cost base for Medicaid. Limiting federal payments to a 5 percent growth rate would produce large savings because the actual growth rate of administrative costs averaged more than 5 percent a year during the 1996-2002 period and is projected to exceed 5 percent in 2003 and later years.

**RELATED OPTIONS:** 550-01 and 550-02

## 550-04—Mandatory

# Convert Medicaid Payments for Acute Care Services into a Block Grant

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 3,170 | 6,380 | 11,940 | 17,860 | 24,680 | 64,030 | 318,070 |

The Medicaid program funds two broadly different types of health services for low-income people: acute care (including inpatient stays in hospitals, visits to physicians' offices, and prescription drugs) and long-term care (such as nursing home care and home- and community-based services). The program is financed jointly by the states and the federal government, with the government matching state spending at a rate of 50 percent to 83 percent depending on the state's per capita income. (The matching rate averages 57 percent nationwide.) Although the federal match helps states provide health coverage to disadvantaged populations, it may also encourage overspending by subsidizing each additional Medicaid dollar spent. In 2002, the federal share of Medicaid outlays amounted to $80.2 billion for acute care and $43.1 billion for long- term care.

This option would convert the federal share of Medicaid payments for acute care services into a block grant, as 1996 legislation did with welfare programs. (Long-term care would continue to be financed as it is now.) Each state's block grant would equal its 2003 federal Medicaid payment for acute care, indexed to the increase in the medical consumer price index for urban consumers. That change in financing would reduce federal outlays by $3.2 billion in 2004 and by $64.0 billion over the 2004-2008 period because federal Medicaid payments are projected to grow faster than that price index under current law. (Alternatively, block grants could be indexed to changes in a state's Medicaid caseload. In that case, savings would be the same in 2004 but would grow at a slower rate thereafter, totaling $55.6 billion over five years.) In exchange for slower growth in payments, states would be given more flexibility in how they could use the funds to meet the needs of their low-income and uninsured populations.

The Administration has proposed a Medicaid block-grant plan in its 2004 budget request. Its proposal would give states the option of operating under current Medicaid rules or choosing separate block grants for acute care and long-term care. Those grants would include funds for both Medicaid and the State Children's Health Insurance Program and would allow significantly more flexibility in program administration.

Supporters argue that subsidizing acute care with a block grant rather than a federal matching rate would give states more incentive to spend money cost-effectively by requiring them to face the full cost of each additional dollar of health spending. Block grants would also give states more discretion in designing and administering their own programs. For example, some states might choose to offer a less generous benefit package in order to extend coverage to more people. In addition, block grants would end states' incentives to employ funding strategies that are designed mainly to maximize federal assistance.

Opponents counter that converting acute care payments to a block grant would have various drawbacks. First, the block-grant option as described here would reduce the total amount of federal support for Medicaid, which could increase fiscal pressures on states. Second, removing the matching rate could provide an incentive for states to scale back their Medicaid coverage. Unless states were willing to do more themselves or could find ways to provide care more cost-effectively, some people who would benefit under current law might receive less coverage or none at all. Third, distinguishing between acute and long-term care for the purposes of financing could be difficult administratively. For example, hospital patients often receive services that resemble long-term care to facilitate their recovery after an inpatient stay. Fourth, having greater state discretion could widen the gaps that now exist between different states' Medicaid benefits and eligibility requirements.

## 550-05—Mandatory

# Convert Medicaid Disproportionate Share Hospital Payments into a Block Grant

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 680 | 760 | 850 | 930 | 1,000 | 4,220 | 10,480 |

Hospitals that serve a disproportionately large share of low-income patients may receive higher payments from Medicaid than other hospitals do. Under broad federal guidelines, each state determines which hospitals receive so-called disproportionate share hospital (DSH) payments and the size of those payments. During the late 1980s and early 1990s, many states were able to increase the amount of federal Medicaid funding they received relative to the amount they spent on disproportionate share hospitals—in effect raising the federal matching rate above the rate specified in statute for a given state. To accomplish that, states assessed special taxes, accepted donations, or obtained intergovernmental transfers from DSH hospitals; made a DSH payment back to those providers, financed wholly or partly by the tax, donation, or transfer; reported the DSH payment to Medicaid; and subsequently obtained federal matching payments for those funds.

During the 1990s, lawmakers enacted a series of restrictions on Medicaid DSH payments, culminating in fixed ceilings on states' DSH payments that applied through 2002. After 2002, those ceilings are adjusted to keep pace with inflation. Consequently, federal outlays for Medicaid DSH payments, which totaled $8.7 billion in 2002, are projected to rise to $9.5 billion by 2008 under current law.

This option would convert the current Medicaid disproportionate share hospital program into a block grant to the states, as an alternative way to provide federal financial support for health care institutions that serve a large share of poor and uninsured patients. The grant could be reduced below current-law levels and its future growth limited to a slower rate than the rate at which Medicaid DSH payments would increase under current law. In exchange for lower funding, states could be given greater flexibility to use the funds to meet the needs of their low-income and uninsured populations in the most cost-effective ways.

In this illustrative option, the block grant for each state in 2004 would equal the state's Medicaid DSH allotment for 2003 minus 10 percent. In subsequent years, the block grant would be indexed to the increase in the consumer price index for urban consumers minus 1 percentage point. Savings from this option would total $680 million next year and $4.2 billion over the 2004-2008 period.

Supporters of a block grant would argue that the increased latitude provided to states under this option could result in DSH funds' being targeted more appropriately and equitably to facilities and providers that serve low-income populations. For example, states would have greater flexibility to use those funds to support outpatient clinics and other nonhospital providers that treat Medicaid beneficiaries and low-income patients.

Opponents of this option would argue that given the fiscal problems facing many states today, state governments might not increase their contributions to make up for the reduction in federal subsidies. As a result, hospitals (and health care providers in general) could receive less in combined federal and state Medicaid subsidies. Additionally, giving states more flexibility to allocate DSH payments could alter the distribution and amount of assistance among hospitals, possibly causing some large urban hospitals to receive less public funding than they do now. Moreover, states may already have enough flexibility under current rules to allocate DSH payments to achieve the maximum benefit.

**RELATED OPTIONS:** 550-06 and 570-05

## 550-06—Mandatory

# Require All States to Comply with New Rules About Medicaid's Upper Payment Limit by 2004

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 2,770 | 1,940 | 1,170 | 890 | 560 | 7,330 | 7,330 |

Until 2001, federal regulations stated that Medicaid could not pay more for hospital and nursing home services than the Medicare program did. That ceiling, known as the upper payment limit (UPL), applied to aggregate payments for services provided in both private facilities and those operated by local governments. Since Medicaid's payment rates are typically lower than Medicare's, most states had room to increase their Medicaid payments without exceeding the UPL. As a result, many states inflated their payment rates for services provided in local government facilities so as to generate additional federal matching funds and then recovered the inflated portion of those payments from the facilities. The additional federal Medicaid funds could then be used for any purpose. That process effectively increased federal Medicaid payments to states without raising the states' Medicaid expenditures.

To limit states' ability to generate enhanced payments, the Department of Health and Human Services issued regulations in January 2001 that created separate UPLs for private facilities and facilities operated by local governments. Those regulations (as required by the Benefits Improvement and Protection Act of 2000) take full effect at different times for different states. States that have used the enhanced-funding mechanism the longest are allowed a transition period stretching to September 30, 2008, whereas some other states have a transition period lasting until 2005. (States that had only recently sought to enhance their funding are already subject to the new rules.) The extended transition period was designed to give states with the longest history of relying on enhanced payments more time to adjust their budgets to the smaller federal payments that result from the new regulations.

This option would require all states to be in full compliance with the UPL regulations beginning in 2004. That requirement would reduce federal outlays by almost $2.8 billion in 2004 and $7.3 billion over five years.

Supporters of this option argue that eliminating the extended transition period would treat all states the same, which is more equitable than allowing some states to continue, in effect, to obtain a higher federal matching rate than the one specified by statute. Opponents counter that requiring quicker compliance would reduce federal payments to some states at a time when they are already facing severe budgetary difficulties.

**RELATED OPTIONS:** 550-05 and 570-05

## 550-07—Mandatory

# Reform the Process for Listing Drug Patents in the FDA's Orange Book

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 10 | 30 | 80 | 180 | 300 | 590 | 4,410 |

Many top-selling brand-name drugs are protected by multiple patents. Those patents can cover a drug's substance (chemical compound), its use, or its formulation (such as an extended-release dosage), as approved by the Food and Drug Administration (FDA). Such patents are listed in an FDA volume titled *Approved Drug Products with Therapeutic Equivalence Evaluations*, commonly known as the Orange Book. A manufacturer wishing to market a generic version of a brand-name drug must either formally challenge a patent listed in the Orange Book or wait until the patent expires before the FDA can approve its application to produce a generic copy.

Although the FDA publishes patent information in the Orange Book, it makes no judgments about whether the patent submitted by a brand-name manufacturer actually covers the drug in question. As a result, some of the patents currently included in the Orange Book may be inappropriately listed, in that they do not claim the same use, formulation, or drug substance that the FDA approved. (A single drug patent can make several claims.)

This option would require that for each patent listed in the Orange Book, the brand-name manufacturer would identify those claims that met the FDA's listing criteria and specify whether the claim related to the approved substance, use, or formulation of the drug. The FDA would publish that direct mapping of patent claims, by type of claim, in the Orange Book. Manufacturers of generic drugs could petition the Secretary of Health and Human Services to review specific listings on an expedited basis. If the Secretary found that a patent or claim did not appear to cover the approved substance, use, or formulation, the Secretary could request that the brand-name company delist the patent or claim. Under this option, any manufacturer interested in producing a generic copy would also be able to sue that brand-name company over the appropriateness of the patent listing. Those changes would apply to both current and future patent listings.

By helping to ensure that the information in the Orange Book was clear and accurate, this option could speed the marketing of generic drugs in some cases. Generic drugs have much lower prices than their brand-name counterparts; consequently, the Congressional Budget Office estimates that federal direct spending on drugs by Medicaid, the Federal Employees Health Benefits Program, the Department of Defense, and (to a limited extent) Medicare would decline by an average of 1 percent over 10 years. As a result, federal outlays would fall by $590 million over five years and $4.4 billion over 10 years.

The FDA has proposed a rule that would require manufacturers to submit patent information on a claim-by-claim basis, as discussed in this option. That proposed rule would be limited to patents not yet listed in the Orange Book.

Under this option, some brand-name drugs would be likely to experience competition from multiple generic copies earlier than they would under current law. Not only the federal government but also states and private-sector purchasers would benefit from the lower average drug prices associated with earlier marketing of generic drugs.

However, to the extent that brand-name manufacturers' sales declined under this option, they would have less money available and less incentive to invest in developing new drugs. The effect on that incentive would probably be small, however, because any decline in profits would occur toward the end of a drug's market life and would thus be heavily discounted (in present-value terms) when the decision about investing in research and development was made.

**RELATED OPTION:** 550-08

## 550-08—Mandatory

# Eliminate the 30-Month Stay for Late-Listed Patents

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 2 | 7 | 18 | 31 | 46 | 104 | 719 |

The 1984 Drug Price Competition and Patent Term Restoration Act (also known as the Hatch-Waxman Act) created a process whereby manufacturers of generic drugs can challenge patents on brand-name drugs. Many top-selling brand-name drugs are protected by multiple patents, which can cover the substance, use, or formulation of the drug as approved by the Food and Drug Administration (FDA). Such patents, together with the brand-name products that they cover, are published by the FDA (see option 550-07). If a generic manufacturer can successfully demonstrate that a patent is invalid or would not be infringed by its generic copy, it can enter the market before the patent on the brand-name drug expires. Some observers believe that the patent-challenge process established under the Hatch-Waxman Act has encountered unanticipated delays that have lessened competition by slowing the marketing of generic drugs in some cases.

Generic manufacturers apply to the FDA for approval to produce a bioequivalent copy of a brand-name drug by filing an abbreviated new-drug application (ANDA). When doing so, they must inform the FDA and the brand-name manufacturer of any patents that they are challenging. If the brand-name manufacturer does not sue to defend its patent within 45 days of receiving notification, the FDA can approve the generic company's ANDA as soon as the company has successfully demonstrated bioequivalence. If, however, the brand-name manufacturer does sue, the FDA cannot approve the generic company's ANDA for 30 months or until a district court rules in favor of the generic company. That delay is referred to as a 30-month stay. When the brand-name company wins such a suit, the FDA cannot approve the ANDA until the challenged patent has expired. Conversely, when a generic manufacturer that is the first to file an ANDA with a patent challenge obtains FDA approval and is able to enter the market before the challenged patent expires, it may be eligible for 180 days of marketing exclusivity. (That exclusivity period gives generic manufacturers an incentive to take on the litigation costs associated with challenging a patent.)

One event that can slow down the patent-challenge process is to have a new patent issued on a brand-name drug after a generic manufacturer has already filed its ANDA. A report by the Federal Trade Commission (FTC) found several recent cases in which a patent was listed after an ANDA had been filed, resulting in a new 30-month stay. Such patents are latecomers to the patent-challenge process and can prolong litigation.

Under this option, patents listed for a brand-name drug after an ANDA had already been filed would no longer be entitled to a 30-month stay. Instead, if a generic applicant challenged the late-listed patent, the brand-name manufacturer would be required to sue within 45 days and obtain a preliminary injunction to place a stay on FDA approval. If no preliminary injunction was granted by the court, the late-listed patent would not hold up the FDA's final approval of the challenger's ANDA. Further, if the brand-name manufacturer did not sue within 45 days of being notified of the challenge to its late-listed patent, it would lose the right to sue the challenger in the future for infringement of the patent.

Together, those changes would help bring some generic drugs to market more quickly, thus reducing the average price of certain drugs. The Congressional Budget Office estimates that federal direct spending on drugs by Medicaid, the Federal Employees Health Benefits Program, the Department of Defense, and (to a limited extent) Medicare would decline, saving $104 million over the 2004-

2008 period. Nongovernment purchasers would also benefit from the lower average cost of drugs that experienced earlier competition from generic copies.

The FDA has proposed a rule that would allow only one 30-month stay per ANDA. That rule, which has not taken effect, is somewhat less comprehensive than this option. Whereas this option would require legislative action, the proposed rule would rely on the FDA's reinterpretation of the Hatch-Waxman Act.

Besides 30-month stays on late-listed patents, another mechanism that can delay the marketing of a generic drug is an agreement to that effect reached by the brand-name and generic manufacturers before a court ruling. Moreover, in that case, subsequent generic applicants may be unable to obtain FDA approval while the agreement is in effect (because of interactions with the 180-day marketing exclusivity). Requiring that such agreements be reported to the FTC could help reduce their frequency and facilitate earlier marketing of some generic drugs. However, that requirement would produce relatively small savings in the federal government's drug spending, in part because the FTC has already increased its oversight of such agreements.

To the extent that sales of brand-name drugs declined under this option, both the incentive to invest in the development of new drugs and the profits available for reinvestment would be lessened.

**RELATED OPTION:** 550-07

## 550-09—Discretionary

# Reduce Subsidies for Health Professions Education

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 195 | 200 | 200 | 205 | 210 | 1,010 | 2,140 |
| Outlays | 70 | 150 | 185 | 200 | 205 | 810 | 1,910 |

In 2002, lawmakers provided $180 million to the Public Health Service to subsidize institutions that educate physicians and other health professionals. Those subsidies primarily take the form of grants and contracts to schools and hospitals. Several programs provide federal grants to medical schools, teaching hospitals, and other training centers to develop, expand, or improve graduate medical education in primary care specialties and related health fields and to encourage health professionals to practice in underserved areas.

This option would eliminate those grants and subsidies, saving $70 million in outlays next year and $810 million over the 2004-2008 period.

Supporters of this option argue that even without those subsidies, market forces provide strong incentives for people to seek training and jobs in the health professions, so federal subsidies are unnecessary. Over the past several decades, the number of physicians—one of the health professions targeted by the subsidies—has increased rapidly. In 2000, for example, the United States had 288 physicians in all fields for every 100,000 people, compared with just 142 in 1960.

Critics counter that market incentives may not be strong enough by themselves to achieve desired levels of health professionals. For instance, third-party reimbursement rates for primary care may not encourage enough physicians to enter those specialties and may not provide sufficient financial inducements to increase access to care in underserved areas.

**RELATED OPTIONS:** 570-01, 570-02, 570-03, and 570-04

## 550-10—Mandatory

# Finance the Food Safety Inspection Service Through User Fees

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 350 | 720 | 750 | 780 | 800 | 3,400 | 7,900 |

The Food Safety and Inspection Service (FSIS), an agency in the Department of Agriculture, regulates the safety and proper labeling of most domestic and imported meat and poultry sold for human consumption in the United States. It also ensures the safety of certain egg products. The FSIS employs about 10,000 inspectors, one or more of whom must be present at all times when a meat or poultry slaughtering plant is operating. In addition, inspectors monitor processing plants daily for adherence to federal standards (for sanitary conditions, ingredient levels, and packaging) and sample and test processed meat and poultry products. Recently, the FSIS has also been charged with protecting the nation's meat and poultry products from bioterrorism. The agency gets most of its funding through annual appropriations—which totaled $731 million in 2002—but the meat packing industry pays for FSIS inspectors (through user fees) when its plants are operating on holiday or overtime hours.

This option would finance all federal meat and poultry inspection activities (in addition to those that occur on holiday or overtime shifts) through user fees paid by meat and poultry slaughtering and processing firms. That change would reduce federal outlays by $350 million in 2004 and by a total of $3.4 billion over five years.

Proponents of this option argue that users of government services should pay for those services. Federal inspections benefit both producers and consumers of meat and poultry products because they prevent diseased animals from being sold as food. But the meat and poultry industries benefit in other ways as well: for example, they can advertise their products as having been inspected by the Department of Agriculture, which may enhance the quality of those products in the eyes of consumers.

Opponents of this option maintain that the current system of public financing is appropriate because the public at large benefits from meat and poultry inspections, since the inspections may prevent the transmission of infectious diseases from those animals to other food or water sources. Moreover, if the packing industry was required to pay user fees, consumers would probably face higher prices for meat and poultry products.

## 550-11—Discretionary and Mandatory

# Adopt a Voucher Plan for the Federal Employees Health Benefits Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings[a] | | | | | | | |
| Discretionary[b] | 400 | 900 | 1,300 | 1,700 | 2,200 | 6,500 | 25,000 |
| Mandatory | 300 | 800 | 1,200 | 1,600 | 2,100 | 6,000 | 24,500 |

a. Estimates do not include any savings realized by the U.S. Postal Service.

b. Savings measured from the 2003 funding level adjusted for premium increases and changes in employment.

The Federal Employees Health Benefits (FEHB) program provides health insurance coverage for more than 4 million federal employees and annuitants, as well as for their 4.6 million dependents and survivors, at an expected cost to the government of almost $18.5 billion in 2003. The cost-sharing structure of the FEHB program encourages federal employees to switch from high-cost to lower-cost plans to blunt the effects of rising premiums; cost sharing also intensifies competitive pressures on all participating plans to hold down premiums. The federal government's share of premiums for employees and annuitants (including for family coverage) is 72 percent of the average weighted premium of all plans. (The employer's costs are higher for the U.S. Postal Service under that agency's collective bargaining agreement.) Policyholders are required to pay at least 25 percent of the premium of any particular plan. (Since October 1, 2000, employees' premiums have come out of pretax income, consistent with the practice for workers in the private sector.)

This option would reduce federal expenditures by offering a flat voucher for health insurance that would cover the first $2,800 of premiums for individual employees and retirees or $6,300 for family coverage. Those amounts, which are based on the government's average expected contribution for nonpostal employees in 2003, would increase annually at the rate of inflation rather than at the average weighted rate of change for premiums in the FEHB program. Indexing premiums to inflation rather than to the growth of premiums would produce budgetary savings because the Congressional Budget Office expects FEHB premiums to grow more than twice as fast as inflation under current law. Savings in discretionary spending (from lower payments for current employees and their dependents) would be $400 million in 2004 and a total of $6.5 billion over five years. Savings in mandatory spending (from reduced payments for retirees) would be $300 million in 2004 and $6.0 billion over five years.

Supporters of this option contend that it would strengthen price competition among health plans in the FEHB program because nearly all current enrollees would be faced with paying the full amount of premiums above the level of the voucher. In addition, removing the requirement that enrollees pay at least 25 percent of their premiums should increase price competition among low-cost plans to attract participants. In the lowest-cost plans, the government voucher would cover almost the entire premium.

Opponents of this option point out that participants would pay an ever-increasing share of their premiums—possibly more than 40 percent by 2008—if premiums rose as expected. The added cost to enrollees could exceed $1,300 per worker in 2008 and more in later years. Currently, large private-sector companies' health plans provide better benefits for employees—although not for retirees—which makes it harder for the government to attract high-quality workers. In addition, opponents note that for current federal retirees and long-time workers, this option would cut benefits that have already been earned. Finally, the option could strengthen existing incentives for plans to structure benefits to disproportionately attract people with lower-than-average health care costs. That "adverse selection" could destabilize other health care plans.

**RELATED OPTION:** 550-12

**RELATED CBO PUBLICATION:** *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998

## 550-12—Mandatory

# Base Retirees' Health Benefits on Length of Federal Service

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings[a] | | | | | | | |
| Budget authority | 80 | 170 | 270 | 380 | 510 | 1,410 | 6,390 |
| Outlays | 80 | 170 | 270 | 380 | 510 | 1,410 | 6,390 |

a. Estimates do not include any savings realized by the U.S. Postal Service.

Federal retirees are generally eligible to continue receiving benefits from the Federal Employees Health Benefits (FEHB) program if they have participated in the program during their last five years of service and are eligible to receive an immediate annuity. About 78 percent of those new retirees elect to receive health benefits. For retirees over age 65, the FEHB program's benefits are coordinated with those of Medicare; the program pays amounts not covered by Medicare (but no more than what it would have paid in the absence of Medicare). Participants and the government share the cost of premiums. The government's share for annuitants and employees is 72 percent of the weighted average premium of all participating plans (up to a cap of 75 percent of the total premium). In 2003, the government expects to pay $6.6 billion in premiums for 1.4 million nonpostal annuitants plus their dependents and survivors.

This option would reduce health benefits for retirees with relatively short federal careers, although it would preserve their right to participate in the FEHB program. For new retirees only, the government's share of premiums would be cut by 2 percentage points for every year of service less than 30. For example, for a retiree with 20 years of service, the government's contribution would fall from 70 percent to 50 percent of the average premium. (On average, the government pays a lower share of premiums for annuitants than employees because annuitants tend to enroll in more expensive plans.) In 2002, about 60 percent of the roughly 87,000 new retirees who continued in the FEHB program had less than 30 years of service. The average new retiree affected by this option would pay 40 percent of the premium rather than 28 percent, an annual increase of $700 in 2004. The estimated savings to the government in mandatory spending would total $80 million in 2004 and $1.4 billion over five years. (Those estimates exclude savings realized by the Postal Service.)

Proponents of this option contend that it would make the government's mix of compensation fairer and more efficient by improving the link between length of service and deferred compensation. It would also help bring federal benefits closer to those of private firms. Federal retirees' health benefits are significantly greater than those offered by most large private firms, which have been aggressively paring and, in some cases (about 20 percent), eliminating retirees' health benefits for new hires in recent years. A survey of medium and large U.S. employers found that just over 40 percent provide medical benefits to retirees. Moreover, of those companies still offering such benefits, most have tightened eligibility rules for new hires (typically requiring 10 or more years of service), implemented service-related contributions for future retirees, and capped contributions for new hires, according to a 2001 survey by Watson Wyatt, a benefits consulting firm.

Opponents of this option assert that it would mean a substantial cut in promised benefits, the effects of which would be felt most strongly by the roughly 25 percent of new retirees with less than 20 years of service. The option could also encourage some employees with short federal careers to delay retirement, whereas others might accelerate retirement plans to avoid the new rules.

**RELATED OPTION:** 550-11

**RELATED CBO PUBLICATION:** *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998

# 570

# Medicare

Budget function 570 comprises spending for Medicare, the federal health insurance program for elderly and eligible disabled people. Medicare consists of two parts, each tied to a trust fund. Hospital Insurance (Part A) reimburses health care providers for inpatient care that beneficiaries receive in hospitals as well as for care at skilled nursing facilities, some home health care, and hospice services. Supplementary Medical Insurance (Part B) pays for physicians' services, outpatient services at hospitals, home health care, and other services. CBO estimates that Medicare outlays (net of premiums paid by beneficiaries) will total $248 billion in 2003. That amount includes discretionary outlays of almost $4 billion, which are for the administrative expenses of operating the Medicare program. Mandatory outlays for Medicare have more than doubled since 1990.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 2.4 | 2.6 | 2.9 | 2.8 | 3.0 | 3.0 | 2.9 | 2.6 | 2.7 | 2.8 | 3.0 | 3.3 | 3.8 | 3.6 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 2.3 | 2.4 | 2.8 | 2.7 | 2.9 | 3.0 | 3.0 | 2.6 | 2.6 | 2.8 | 3.0 | 3.3 | 3.2 | 3.8 |
| Mandatory | 95.8 | 102.0 | 116.2 | 127.9 | 141.8 | 156.9 | 171.3 | 187.4 | 190.2 | 187.7 | 194.1 | 214.1 | 227.7 | 244.6 |
| Total | 98.1 | 104.5 | 119.0 | 130.6 | 144.7 | 159.9 | 174.2 | 190.0 | 192.8 | 190.4 | 197.1 | 217.4 | 230.9 | 248.4 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 6.3 | 16.4 | -6.9 | 10.0 | 2.0 | -0.6 | -12.8 | 0.5 | 6.3 | 8.9 | 10.8 | -5.0 | 16.3 |

Note: n.a. = not applicable.

## 570-01—Mandatory

# Reduce Medicare's Payments for the Indirect Costs of Patient Care That Are Related to Hospitals' Teaching Programs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 2,600 | 3,000 | 3,200 | 3,500 | 3,700 | 16,000 | 38,500 |

The Social Security Amendments of 1983 established the prospective payment system (PPS) under which Medicare pays hospitals for inpatient services provided to its beneficiaries. The program pays higher rates to hospitals with teaching programs to cover their higher costs of caring for Medicare patients. In 2003, the additional percentage that those hospitals receive averages about 5.5 percent for each increase of 0.1 in a hospital's ratio of full-time residents to its number of beds.

The additional payments to teaching hospitals are designed to compensate them for indirect teaching costs—such as the greater number of tests and procedures that residents are thought to prescribe—and to cover higher operating costs from factors not otherwise accounted for in setting the PPS rates. Such factors might include a greater number of severely ill patients, an inner-city location, and a more costly mix of staffing and facilities, all of which are associated with hospitals that have large teaching programs.

The Medicare Payment Advisory Commission has estimated that a 2.7 percent adjustment to Medicare's payments would more closely match the increase in operating costs associated with teaching. This option would lower the teaching adjustment accordingly, saving $2.6 billion in 2004 and $16 billion over five years.

Supporters of this option contend that it would better align payments with the actual costs that teaching institutions incur. Furthermore, proponents maintain, since the training that medical residents receive will significantly increase their future income, and since hospitals benefit from using residents' labor, it is reasonable for some or all of a hospital's indirect training costs to be borne by both residents and the hospital. (Residents already bear some of those costs in the form of stipends that are lower than the value of their services to a hospital.)

Critics of this option argue that a lower teaching adjustment would probably lead to smaller residency programs. In addition, if teaching hospitals now use some of their payments to fund activities such as charity care, this option could reduce access to medical services for people without health insurance.

**RELATED OPTIONS:** 550-09, 570-02, 570-03, and 570-04

**RELATED CBO PUBLICATION:** *Medicare and Graduate Medical Education*, September 1995

## 570-02—Mandatory

# Reduce Medicare's Direct Payments for Medical Education

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 800 | 1,000 | 1,000 | 1,000 | 1,000 | 4,800 | 10,500 |

Medicare's prospective payment system does not include payments to hospitals for the direct costs they incur in providing graduate medical education (GME)—namely, residents' salaries and fringe benefits, teaching costs, and institutional overhead. Instead, Medicare makes those payments separately on the basis of its share of a hospital's 1984 cost per resident, indexed for increases in the level of consumer prices. Medicare's direct GME payments, which about one-fifth of U.S. hospitals receive, totaled $2.4 billion in 2002.

Under this option, hospitals' direct GME payments would be based on 120 percent of the national average salary paid to residents in 1987, updated annually for changes in the consumer price index for all urban consumers. In effect, this option would reduce teaching and overhead payments for residents but continue to pay their salaries and fringe benefits. The option would also maintain the current-law practice of reducing payments for residents who have gone beyond their initial residency period. The savings from this option would total about $800 million in 2004 and $4.8 billion over the 2004-2008 period. 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. (Although the Congress recently took action to lessen some of the variation among hospitals in payments per resident, considerable differences remain.)

Advocates of this option argue that an overall reduction in the level of federal subsidies for medical education might be warranted because market incentives appear to be sufficient to encourage a continuing flow of new physicians. Moreover, since hospitals use resident physicians to care for patients, and since residency training helps young physicians earn higher incomes in the future, both hospitals and residents might reasonably contribute more to those training costs than they do now. Residents would contribute more to those costs if hospitals responded to the change in reimbursement by cutting residents' salaries or fringe benefits.

Opponents of this change note that if hospitals lowered residents' salaries or benefits, the costs of longer residencies—in terms of forgone practice income—could exert greater influence on young physicians' decisions about pursuing a specialty. More residents might choose to begin primary care practice rather than specialize further. That outcome could be negative for the individual resident (although the Council on Graduate Medical Education and other groups believe that a relative increase in the number of primary care practitioners would be desirable for society). Finally, decreasing GME reimbursement could force some hospitals to reduce the resources they commit to training, possibly jeopardizing the quality of their medical education programs.

**RELATED OPTIONS:** 550-09, 570-01, 570-03, and 570-04

**RELATED CBO PUBLICATION:** *Medicare and Graduate Medical Education*, September 1995

## 570-03—Mandatory

# Eliminate Additional Capital-Related Payments for Hospitals with Residency Programs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 200 | 200 | 200 | 200 | 200 | 1,000 | 2,500 |

Under the prospective payment system for inpatient hospital services, Medicare pays hospitals an amount for each patient discharged that is intended to compensate hospitals for capital-related costs. Currently, hospitals with teaching programs receive additional capital-related payments that are based on "teaching intensity," measured as the ratio of their residents to their average daily number of inpatients. An increase of 0.1 in that ratio raises a hospital's capital-related payment by 2.9 percent.

This option would eliminate those extra capital-related payments to teaching hospitals. Doing so would save the Medicare program about $200 million next year and $1.0 billion over the 2004-2008 period.

Proponents of this option argue that paying teaching hospitals more than nonteaching hospitals for otherwise similar patients may discourage efficient decisionmaking by hospitals. In addition, Medicare's payment adjustments for teaching intensity may distort the market for residency training by artificially increasing the value (or decreasing the cost) of residents to hospitals. If residents' training raises the costs of patient care for a hospital, supporters of this option argue, the hospital should bear those costs in order to encourage an efficient amount of training. Hospitals are likely to shift such costs to residents in the form of lower stipends or greater workloads. Residents will engage in such training if they perceive that their future productivity, as reflected in their future income, will be great enough to outweigh those costs.

Critics charge that eliminating the special capital-related payments would reduce revenues to teaching hospitals at a time when they already face pressure to cut costs in order to remain competitive. Teaching hospitals would probably have to reduce some services as a result, which could mean conducting less medical research or providing fewer services to people without health insurance.

**RELATED OPTIONS:** 550-09, 570-01, 570-02, and 570-04

**RELATED CBO PUBLICATION:** *Medicare and Graduate Medical Education*, September 1995

## 570-04—Mandatory

# Convert Medicare Payments for Graduate Medical Education into a Block Grant and Slow Their Growth

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 400 | 700 | 900 | 1,200 | 1,600 | 4,800 | 18,400 |

Three types of Medicare payments to teaching hospitals are tied to the size or intensity of a hospital's residency program: direct graduate medical education (GME) payments (option 570-02); the indirect medical education adjustment for inpatient operating costs (option 570-01); and the indirect medical education adjustment for inpatient capital-related costs (option 570-03). Teaching hospitals now receive GME payments for participants in Medicare+Choice health plans in addition to their traditional payments for fee-for-service Medicare patients. Several variables determine the total amount of GME payments to a hospital, including the number and diagnoses of Medicare patients discharged and numerical factors used annually to update payments for inpatient operating costs and capital-related costs. Because of changes in those variables over time, the Congressional Budget Office expects GME payments to grow at an average rate of 6 percent a year between 2004 and 2013 under current law.

This option would replace the current payments with a consolidated block grant to fund the special activities of teaching hospitals. Under the present system, a hospital receives GME payments on the basis of formulas set forth in regulations, and Medicare's total GME spending is the resulting sum of what it owes each hospital. This option assumes that the switch to a block-grant program would occur in 2004 and that the amount of the grant would be based on spending in 2002, with increases for the overall rate of inflation. Compared with projected spending under current law, this option would reduce federal outlays by $400 million in 2004 and by $4.8 billion over the 2004-2008 period.

Advocates of establishing a block grant for the three types of GME payments argue that it would allow lawmakers to better monitor and adjust GME funding. In addition, Medicare would no longer pay different rates to hospitals for inpatient services merely because of differences in the size or presence of residency programs.

Opponents argue that because this option would reduce total payments to teaching hospitals below the amounts expected under current law, such hospitals would, on average, receive less revenue than they would otherwise. In response, teaching hospitals might reduce the amount or quality of some of their services, including medical research and care for people without health insurance.

**RELATED OPTIONS:** 550-09, 570-01, 570-02, and 570-03

**RELATED CBO PUBLICATION:** *Medicare and Graduate Medical Education*, September 1995

## 570-05—Mandatory

# Convert Medicare Disproportionate Share Hospital Payments into a Block Grant

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 730 | 1,120 | 1,460 | 1,810 | 2,190 | 7,320 | 25,030 |

Hospitals that serve a disproportionately large share of low-income patients can receive higher payment rates under Medicare than other hospitals do. The Medicare disproportionate share hospital (DSH) adjustment was introduced in 1986 to account for what were assumed to be the higher costs of treating Medicare patients in such hospitals. Recently, however, the DSH adjustment has been seen mainly as a means to protect access to care for low-income populations by providing financial support to hospitals that serve a large number of low-income patients. Annual outlays for Medicare DSH payments rose rapidly between 1989 and 1997, reaching $4.5 billion. Restrictions established by the Balanced Budget Act of 1997 caused those outlays to decline for a few years, but they resumed growing in 2000. Last year, Medicare DSH payments totaled $5.2 billion.

This option would convert DSH payments into a block grant to states. In 2004, each state's grant would be 10 percent less than the estimated sum of Medicare DSH payments made to hospitals in that state in 2003. In subsequent years, the block grant would be indexed to the change in the consumer price index for urban consumers minus 1 percentage point. In return for the lower payments, states would gain more flexibility in how DSH funds were used. Those changes would decrease Medicare outlays by $730 million in 2004 and by $7.3 billion over five years. (The estimated savings include the fact that lower Medicare DSH payments would reduce payment updates to plans participating in Medicare+Choice.)

Supporters of this option argue that the added flexibility provided to states under this option could result in DSH funds' being targeted more appropriately and equitably to facilities and providers that serve low-income populations. For example, rather than going solely to hospitals, such funds might also be used to support outpatient clinics that treat low-income patients.

Critics of this option argue that state governments might not increase their subsidies to make up for the reduction in federal payments. As a result, hospitals as a whole could receive less in combined federal and state funding. Additionally, allowing states to allocate DSH payments could change the distribution of assistance among hospitals, possibly causing some large urban hospitals to receive less public funding than they do now.

**RELATED OPTION:** 550-05

## 570-06—Mandatory

# Expand Global Payments for Hospitals' and Physicians' Services Provided During an Inpatient Stay

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 100 | 100 | 100 | 100 | 100 | 500 | 1,500 |

Under Medicare's prospective payment system (PPS), hospitals receive payments for the operating and capital costs of providing inpatient services to Medicare beneficiaries. Those payments are determined on a per-case basis: payment rates vary with the patient's diagnosis—which Medicare classifies using a system of diagnosis-related groups (DRGs)—and with the characteristics of the hospital. Those rates take into account reasonable variations in the treatment of patients within a given DRG and offer hospitals an incentive to reduce the cost of treatment. PPS payments do not cover all services rendered to patients during their hospital stay. In particular, Medicare pays separately for physicians' services provided on an inpatient basis.

This option would give hospitals the choice to receive a single global payment for high-cost, high-volume inpatient procedures—a change that has been explored by the Centers for Medicare and Medicaid Services. That payment would be lower than the separate payments now made for hospitals' operating costs and physicians' services, thus saving Medicare $100 million in 2004 and $500 million over the 2004-2008 period. The global payment would cover such procedures as heart bypass surgery, cataract surgery, coronary angioplasty, heart valve replacement, and joint replacement.

Advocates of this option note that during a demonstration project in the 1990s in which Medicare made global payments to seven hospitals for heart bypass surgery, Medicare outlays for those hospitals were about 10 percent lower, on average, than they would have been otherwise. In that demonstration, discounted payment rates were established through negotiations with participating hospitals in conjunction with teams of physicians. Supporters argue that global payments give both hospitals and physicians an incentive to reduce operating costs while maintaining a satisfactory standard of care. Hospitals could offset the declines in their Medicare payments by improving efficiency (with resultant cost savings) or by increasing their volume of patients (using new marketing efforts).

Opponents argue that this option would not be widely applicable because only a handful of hospitals perform a significant number of such high-cost, high-volume inpatient procedures.

## 570-07—Mandatory

# Further Reduce the Medicare Prospective Payment System Update Factor for Hospitals' Inpatient Operating Costs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 900 | 2,000 | 3,200 | 4,500 | 6,000 | 16,600 | 75,700 |

Under Medicare's prospective payment system (PPS), payments for hospitals' operating costs for inpatient services provided to Medicare beneficiaries are determined on a per-case basis, according to preset rates that vary with the patient's diagnosis and the characteristics of the hospital. Payment rates are adjusted each year using an update factor that is determined in part by the projected rise in the hospital market-basket index (MBI), which reflects increases in hospital costs. Changes in the MBI also affect payments for Medicare+Choice plans, because those payments are calculated taking into account Medicare's payments to hospitals.

Under current law, the hospital update factor for 2003 is the change in the MBI minus 0.55 percentage points. After 2003, the update factor reverts to the full change in the MBI.

This option would reduce the Medicare PPS update factor to the annual change in the MBI minus 1.1 percentage points. That rate would take effect in 2004 and continue through at least 2013. Savings from that reduction would total $900 million next year and $16.6 billion over five years (including savings from reduced payments to Medicare+Choice plans).

Supporters of this option argue that further reductions in the update factor are justifiable because hospitals' profit margins on Medicare inpatient services are relatively high. In 2002, when the update factor was also the change in the MBI minus 0.55 percentage points, hospitals were expected to have an average profit margin of about 11 percent on Medicare inpatient services. Furthermore, when the update factor has been lower in the past, hospitals have been able to maintain fairly high inpatient profit margins by achieving greater efficiencies. In 1999, for example, when the update factor was the change in the MBI minus 1.9 percentage points, those profit margins averaged about 12 percent.

Critics of this option note that Medicare inpatient profit margins are overstated because Medicare's payment systems have given hospitals an incentive to allocate too much of their overhead and ancillary costs to outpatient services. Thus, hospitals' profit margins on Medicare outpatient services are understated. (In 2002, those margins were expected to average about -16 percent.) Opponents of this option argue that hospitals' overall Medicare profit margins, which were expected to average about 4 percent in 2002, indicate that Medicare's total payments to hospitals for all services are reasonable. Therefore, critics argue, Medicare's payments for inpatient services should not be reduced without carefully evaluating the adequacy of payments for hospital outpatient services as well. Finally, critics say, even with inpatient margins overstated, about one-third of hospitals have negative profit margins on Medicare inpatient services; further reductions in the update factor could cause considerable hardship for those hospitals.

## 570-08—Mandatory

# Further Reduce Medicare's Payments for Hospitals' Inpatient Capital-Related Costs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 500 | 600 | 600 | 700 | 700 | 3,100 | 6,900 |

In 1992, Medicare switched its method of paying hospitals for the capital-related costs of inpatient services from cost-based reimbursement to a prospective payment system. Under that system, hospitals receive a predetermined amount for each Medicare patient to cover capital-related costs, which include depreciation, interest, taxes, insurance, and similar expenses for buildings and equipment. The prospective system for capital-related costs applies to about 5,000 hospitals that are also paid under Medicare's prospective payment system for operating costs. In both systems, a hospital's prospective rate is adjusted for its mix of patients and other characteristics.

Analyses by the Centers for Medicare and Medicaid Services (CMS) suggest that the prospective rates for capital payments set in 1992 were too high. Those rates were based on 1989 data projected to 1992, but in actuality, capital costs grew more slowly than expected between 1989 and 1992. Moreover, the level of capital costs per case in 1989 that was used to set rates was probably higher than would be optimal in an efficient market because of incentives created by the Medicare payments. Factors such as changes in capital prices, the mix of patients treated by hospitals, and the "intensity" of hospital services contributed to the overestimate, which the Medicare Payment Advisory Commission and CMS estimated at between 15 percent and 28 percent, with an average of about 22 percent. Consequently, the Balanced Budget Act of 1997 reduced the federal rate by 17.8 percent for capital payments made to hospitals for patient discharges occurring in 1998 through 2002. (A small part of that reduction, 2.1 percentage points, was restored beginning this year.)

This option would further reduce the prospective payment rate for hospitals' capital-related costs by 5 percentage points—bringing the total reduction to about 22 percent from the initial level. That change would lower Medicare outlays by $500 million in 2004 and $3.1 billion over the 2004-2008 period.

Proponents of lower payments note that Medicare's payments for capital costs are a small share (less than 5 percent) of hospitals' total revenues. Most hospitals would probably be able to adjust to the reductions by lowering their capital costs or partially covering those costs with other sources of revenue.

Opponents of this option argue that hospitals in poor financial condition could have difficulty absorbing the reductions. As a result, the quality of the care they offer could decline, and they might provide fewer services to people without health insurance.

## 570-09—Mandatory

# Increase the Number of Postacute Care Discharges Treated as Hospital Transfers Under Medicare

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 300 | 400 | 400 | 400 | 500 | 2,000 | 4,800 |

Medicare's prospective payment system (PPS) pays hospitals for inpatient treatment of Medicare beneficiaries on the basis of the patient's diagnosis. The PPS amounts were developed using data on costs for an average length of stay in a hospital for each diagnostic grouping. Over time, the average length of stay has decreased, particularly for patients in certain diagnosis-related groups (DRGs) who are frequently discharged to postacute care settings, such as home health agencies and skilled nursing facilities. (In turn, Medicare's payments to postacute care providers have increased.)

Medicare reduces its payment to an admitting hospital if a patient is transferred from that acute care hospital to another for related care. The final discharging hospital receives full payment, whereas the admitting hospital receives a per diem payment not to exceed the full amount. Beginning in 1998, Medicare applied a similar policy to hospitals that discharge certain patients to postacute care settings. Specifically, hospitals receive reduced payments for patients in 10 DRGs who are transferred to a postacute care setting if their stay in the admitting hospital is shorter than the average length of stay for that DRG. Researchers evaluating the impact of that change found that it lowered Medicare payments in 2001 by about $400 million.

This option would extend the postacute transfer policy to a further 13 DRGs with the next-highest rates of discharge to postacute care facilities. Doing so would reduce Medicare outlays by $300 million in 2004 and $2.0 billion over five years.

Supporters of this option argue that extending the postacute transfer policy would not only save money for Medicare but also give hospitals greater incentive to ensure that patients were fully ready to be discharged before transferring them to a postacute care setting.

Critics of this option, including many hospitals, contend that the transfer policy (even in today's limited form) undermines one of the original incentives in the prospective payment system—to reduce hospital costs by discharging patients as soon as is practicable. Moreover, they argue, the policy creates an administrative burden for hospitals, which must verify discharge destinations, and may diminish the quality of care for some patients by encouraging hospitals to delay postacute care placements following hospital discharges.

## 570-10—Mandatory

# Reduce Medicare Payments for Currently Covered Prescription Drugs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 450 | 700 | 710 | 790 | 920 | 3,580 | 10,890 |

Supplementary Medical Insurance (Part B of Medicare) paid providers about $5.5 billion in 2001 for certain outpatient drugs. Prescription drugs are covered by Part B when they must be administered under a physician's supervision, as is the case with many drugs requiring injection or infusion. Medicare also pays for drugs that must be delivered by durable medical equipment covered under the program. In addition, some oral chemotherapy and antinausea drugs for cancer patients, immunosuppressive drugs for recipients of organ transplants, and vaccines and certain drugs related to end-stage renal disease are covered.

Medicare's payments for covered prescription drugs delivered at home and in physicians' offices have varied over time. Since 1998, those payments have been set at 95 percent of a drug's average wholesale price (AWP), which is a published list price established by the manufacturer. As a list price, however, the AWP is not the actual price that providers pay for drugs. Pegging Medicare's payment to the AWP has meant that providers and suppliers could profit from dispensing or administering Medicare-covered drugs.

This option would limit Medicare's reimbursements for most prescription drugs by reducing the allowed charge from 95 percent to 85 percent of the AWP and by limiting increases in that allowed charge to changes in the rate of inflation (as measured by the consumer price index for all urban consumers, excluding food and energy). As a result, net outlays for Medicare Part B would decline by $450 million next year and by a total of $3.6 billion between 2004 and 2008.

Proponents of this option point to recent evidence suggesting that acquisition costs for many Medicare Part B drugs are about one-fourth less than Medicare's reimbursement rate, on average. A 2001 report by the Inspector General of the Department of Health and Human Services examined pricing of the top 24 drugs that constitute 80 percent of Part B drug spending. The report concluded that if Medicare's reimbursement rates had been set at those drugs' acquisition costs, spending on the drugs would have been reduced by 25 percent, or $761 million. An attempt by the Centers for Medicare and Medicaid Services (CMS) to use market forces to gauge acquisition costs yielded similar results. CMS included several nebulizer drugs in a competitive-bidding demonstration project covering durable medical equipment and related supplies in Texas. On the basis of preliminary data, CMS reported that the reimbursement amounts set for those drugs using competitive bids were about 26 percent below the typical Part B reimbursement rate.

Opponents of this option argue that it would encourage manufacturers to introduce new drugs at elevated AWPs in order to restore profit margins for physicians and other suppliers. Physicians would prescribe newly introduced drugs more quickly as a result. Therefore, the option's effectiveness in limiting the growth of Part B spending would gradually erode as new drugs replaced older ones in the mix of covered drugs. (Another approach for approximating the acquisition costs of Medicare Part B drugs would be to require manufacturers to report their average sales price for a drug, including discounts and rebates. The reimbursement rate could be based on that reported transaction price.)

Critics of this option also claim that the profit margins physicians now get when they dispense drugs to Medicare patients subsidize their administrative costs. Savings would be reduced and patient care might suffer if patients were diverted from physicians' offices to hospital outpatient settings, where Medicare payment rates are higher. (The estimate of savings from this option accounts for that possibility.)

**RELATED OPTION:** 570-11

## 570-11—Mandatory

# Require Competitive Bidding for High-Volume Items of Durable Medical Equipment

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 0 | 20 | 60 | 110 | 160 | 360 | 1,480 |

Medicare paid about $5.3 billion for supplies of durable medical equipment (DME), orthotics, and prosthetics last year, the Congressional Budget Office estimates. Suppliers of DME are paid according to a fee schedule that reflects their historical charges to Medicare rather than current market prices. Both the General Accounting Office and the Inspector General of the Department of Health and Human Services (HHS) have determined that Medicare's payments for many of those items far exceed the prices that other insurers pay or the prices charged in retail stores.

The Balanced Budget Act of 1997 authorized HHS to conduct several competitive-bidding demonstrations for durable medical equipment. Two such demonstrations have taken place: first in Polk County, Florida, and more recently in San Antonio, Texas. Bidders competed on the basis of price and quality for several categories of medical supplies. (Some of those categories differed in the two demonstrations, but oxygen supplies and hospital beds were included in both cases.) Only a limited number of bidders were selected as Medicare suppliers for each product, and other suppliers were generally not permitted to provide those products to fee-for-service Medicare beneficiaries in the area. Savings from the Florida competition averaged 17 percent across all product categories and were as high as 30 percent for hospital beds. Based on the bids it received in San Antonio, HHS set payment rates that averaged about 20 percent less than Medicare's current fee schedule for the items covered by that demonstration.

Under this option, Medicare would use competitive bidding to buy high-volume DME supplies in all areas of the country that have large numbers of suppliers. Savings would probably be lower in some competitive-bidding areas than those seen in the demonstrations. Even so, using that approach to purchase just two high-volume DME items—oxygen supplies and hospital beds—would reduce Medicare outlays by about $20 million in 2005 and a total of $360 million through 2008. (Savings would not begin until 2005 because of the time needed to implement the competitive-bidding system.) HHS would incur additional administrative costs for implementation, which are not included in CBO's estimate —but those added costs would most likely represent only a small percentage of the savings shown here.

Supporters of competitive bidding note that Medicare beneficiaries pay 20 percent coinsurance on DME items, so lower prices for those items would reduce their out-of-pocket costs. In addition, beneficiaries pay about 25 percent of Medicare's costs for DME items through their monthly Medicare premiums, so the savings for Medicare would be accompanied by a proportional decrease in those premium payments.

Critics of competitive bidding raise several concerns. One is that beneficiaries could find it more difficult to obtain DME items that were competitively bid. Beneficiaries' access to suppliers has been a major consideration in determining the number of winning bidders in the HHS demonstrations. In addition, beneficiaries who were receiving durable medical equipment at the start of each demonstration were allowed to continue using the same supplier even if it was not one of the winning bidders. Initial evaluations in both Florida and Texas found that no significant access problems arose (and that lesser problems were resolved).

Another concern is that fewer suppliers of oxygen and hospital beds would be participating in Medicare under this option than under current law. In cases in which

Medicare represented a large share of the total market for those supplies, over time this option could reduce the extent of competition among suppliers or at least give HHS a large role in determining which suppliers were viable. Competitive bidding could also create financial hardship for suppliers that were not selected in the bidding process if Medicare was a major source of their revenue.

## 570-12—Mandatory

# Increase Medicare's Premium for Supplementary Medical Insurance to 30 Percent of Benefit Costs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 3,520 | 5,380 | 6,050 | 6,610 | 7,130 | 28,680 | 75,370 |

Medicare offers insurance coverage for physicians' services and hospital outpatient services through its Supplementary Medical Insurance (SMI) program, or Part B of Medicare. SMI benefits are partially funded from monthly premiums paid by enrollees, with the remainder funded from general federal revenues. Although the SMI premium was initially intended to cover 50 percent of the cost of benefits, that share declined between 1975 and 1983, reaching less than 25 percent. The 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 rose faster than that. Premiums are now set to cover about 25 percent of average SMI benefits for an aged enrollee.

This option would raise the SMI premium to cover 30 percent of the cost of Part B benefits, beginning in 2004. That increase would save $3.5 billion in 2004 and $28.7 billion over five years and would raise the 2004 premium for enrollees to $78.10 per month instead of $65.10. The estimated savings shown here assume a continuation of the current hold-harmless provisions, which ensure that no Medicare enrollee's monthly Social Security benefit will fall because the dollar amount of the Social Security COLA is smaller than the dollar increase in the SMI premium. (SMI premiums are deducted from Social Security checks for most enrollees.)

Advocates of higher premiums argue that unlike proposals such as boosting cost-sharing requirements, which could substantially raise out-of-pocket costs for SMI enrollees who become seriously ill, this option would affect enrollees broadly and raise their costs only a little. Moreover, the option need not affect enrollees with income below 120 percent of the federal poverty line and few assets because they are eligible to have Medicaid pay their Medicare premiums (although not everyone who is eligible for Medicaid applies for benefits).

Critics of this option argue that low-income enrollees who are not eligible for Medicaid could find the higher premiums burdensome. A few might drop SMI 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 those Medicare enrollees who also receive Medicaid benefits.

**RELATED OPTION:** 570-13

## 570-13—Mandatory

# Tie Medicare's Premium for Supplementary Medical Insurance to Enrollees' Income

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 1,310 | 2,030 | 2,460 | 2,920 | 3,360 | 12,080 | 38,800 |

Instead of increasing the basic premium for Supplementary Medical Insurance (SMI) to 30 percent of benefit costs for all enrollees (option 570-12), this option would collect relatively more from higher-income enrollees. For example, individuals with modified adjusted gross income of less than $50,000 and couples with income below $75,000 would continue to pay the current premium, set at 25 percent of SMI costs per aged enrollee. But premiums would rise progressively for higher-income enrollees, reaching 50 percent of costs for individuals with income of more than $100,000 and for couples with income exceeding $150,000. Those premiums might have to be collected through the income tax system, so that rates could be aligned with income, rather than deducted from Social Security checks, as they are now for most enrollees.

If this option took effect on January 1, 2004, savings would total $1.3 billion in 2004 and $12.1 billion over the 2004-2008 period. Those estimates assume that the current hold-harmless provisions would continue only for people subject to the basic 25 percent premium. (The hold-harmless provisions ensure that no Medicare enrollee's Social Security check will decline because the dollar increase in the SMI premium exceeds the dollar amount of the Social Security cost-of-living adjustment.)

Proponents of this option argue that it would affect only a small fraction of SMI enrollees. Roughly 84 percent of enrollees would still pay the basic 25 percent premium, only 4 percent would pay the maximum premium, and 12 percent would pay an amount in between.

Opponents of this option counter that enrollees subject to the income-related premiums could pay substantially more than they do today. For example, the maximum premium for 2004 would be $126.60 per month instead of the $65.10 projected under current law. That increase might lead some enrollees to drop out of the SMI program. Enrollees with retiree health plans that do not require Medicare enrollment (mainly retired government employees) would be most likely to drop SMI coverage. Some healthy enrollees who have no other source of health insurance might do so as well, if they were not averse to the risk that they could incur large health care costs.

**RELATED OPTION:** 570-12

## 570-14—Mandatory

# Index Medicare's Deductible for Supplementary Medical Insurance Services

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 100 | 200 | 300 | 400 | 600 | 1,600 | 8,300 |

The Supplementary Medical Insurance (SMI) program has a number of cost-sharing requirements for enrollees, including an annual deductible (the amount that enrollees must pay for services before the government shares responsibility). That deductible is now $100 a year.

This option would increase the SMI deductible each year, beginning in 2004, for the annual growth in total spending per enrollee for SMI services. That change would save the program $100 million in 2004 and $1.6 billion over five years.

Supporters of an increase point out that the SMI deductible has been raised only three times since Medicare began in 1966, when it was set at $50. Then, the deductible equaled roughly 45 percent of average annual per capita charges under the SMI program, whereas by 2000 it equaled just 3 percent. Moreover, supporters say, raising the deductible would give enrollees a greater economic incentive to use medical care prudently. Even with the increase, enrollees would not pay significantly more out of pocket. In 2004, the deductible would be $104, so no enrollee's out-of-pocket costs would rise by more than $4 in that year.

Critics of a higher deductible argue that over time, the additional out-of-pocket costs under this option might discourage some low-income enrollees who are not eligible for Medicaid from seeking needed care. In addition, states' costs would rise because their Medicaid programs pay the deductibles for Medicare enrollees who also receive benefits under Medicaid.

## 570-15—Mandatory

# Simplify and Limit Medicare's Cost-Sharing Requirements

| | | | | | | Total | |
|---|---|---|---|---|---|---|---|
| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | 2004-2013 |
| Outlay Savings | 970 | 1,480 | 2,290 | 2,730 | 3,130 | 10,610 | 36,580 |

In Medicare's fee-for-service sector, cost-sharing requirements vary significantly by the type of service provided. For example, Medicare beneficiaries who are hospitalized must pay a Part A deductible of more than $800 per spell of illness and can be subject to increasing levels of coinsurance for very long hospital stays. For outpatient services covered under Part B of Medicare, the deductible has remained $100 a year since 1991. Beyond that deductible, beneficiaries pay 20 percent of the allowable cost of most Part B services. Certain Medicare services, such as home health visits or clinical laboratory tests, require no cost sharing. As a result of those variations, beneficiaries may not consider relative costs accurately when choosing among alternative treatments. Moreover, if Medicare patients experience high medical costs, they can face unlimited cost-sharing expenses, since the program does not cap those expenses.

Medicare could simplify and limit cost-sharing requirements in its fee-for-service sector while also reducing federal costs. This option would replace the current complicated mix of cost sharing with a single combined deductible (covering all services in Parts A and B of Medicare), a uniform coinsurance rate of 20 percent for amounts above that deductible, and a cap on each beneficiary's total cost-sharing liabilities. If the option took effect on January 1, 2004, federal savings would total $970 million in 2004 and $10.6 billion over five years. The combined deductible would be $600 in 2004, and the cap on total cost sharing would be $3,400. In later years, those amounts would grow at the same rate as per capita Medicare benefits.

Those estimates assume that the new Medicare cost-sharing rules would be mandatory. In contrast, some recent Congressional proposals to revise fee-for-service Medicare would allow beneficiaries to decide whether they wanted to enroll under new cost-sharing requirements. If participation was voluntary rather than mandatory, savings from this option would fall significantly and could even turn into costs—particularly if the only participants were people who would pay less in cost sharing under the new rules than under current law.

Supporters of this option argue that it would have several advantages besides reducing federal spending for Medicare. First, the option would cap beneficiaries' out-of-pocket expenses, which could particularly help people who have serious illnesses or require hospitalization. Second, it would increase the incentives for enrollees to use medical services prudently. By design, deductibles and coinsurance are mechanisms for exposing beneficiaries to some of the financial consequences of their choices about the use of health services. This option's combined deductible would be higher than the deductible under Part B (the vast majority of Medicare enrollees do not need to pay the Part A deductible in a given year); thus, people without supplemental coverage or with a medigap plan that did not cover the deductible would face the full cost for a larger proportion of the services they used. Moreover, the uniform coinsurance rate of 20 percent on all services would encourage enrollees without supplemental coverage to consider relative costs when choosing among various treatments. Third, the resulting reductions in costs for Medicare's Part B program would translate into lower premiums for enrollees.

Although this option is consistent with steps that some private insurers and employers are taking to control the growth of health spending, opponents would argue that, in general, it would increase Medicare's cost-sharing requirements for most enrollees. Cost-sharing expenses would fall substantially for about 8 percent of enrollees, stay the same for nearly 16 percent, and rise modestly for the other 77 percent. However, most Medicare beneficiaries would be insulated from those direct effects be-

cause they have supplemental coverage; instead, some would see the effects in the form of higher premiums for supplemental policies. In addition, the option would make beneficiaries responsible for paying coinsurance on certain services—such as home health care—that are not now subject to cost sharing, which would increase administrative costs for some types of health care providers.

**RELATED OPTIONS:** 570-16 and 570-17

## 570-16—Mandatory

# Restrict Medigap Coverage of Medicare's Cost Sharing

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 1,860 | 2,830 | 3,030 | 3,220 | 3,440 | 14,390 | 36,510 |

Cost-sharing requirements in Medicare's fee-for-service sector can be substantial, so most beneficiaries seek some form of supplemental insurance coverage. In particular, about 30 percent of fee-for-service enrollees buy individual private insurance (or medigap) policies that are designed to cover all or most of the cost sharing that Medicare requires. On average, medigap policyholders use at least 25 percent more services than Medicare beneficiaries who have no supplemental coverage and about 10 percent more services than beneficiaries who have supplemental coverage from their former employer (which tends to reduce but not eliminate their cost-sharing liabilities). However, it is taxpayers (through Medicare)—not medigap insurers or policyholders—who pay most of the cost of those additional services.

Federal costs for Medicare could be reduced if medigap plans were restructured so that policyholders faced some cost sharing for Medicare services while still having their out-of-pocket costs limited. This option would bar medigap policies from paying any of the first $600 of an enrollee's cost-sharing liabilities for calendar year 2004 and would limit coverage to 50 percent of the next $2,800 in Medicare cost sharing. (All further cost sharing would be covered, so enrollees could not pay more than $2,000 in cost sharing that year.) If those dollar limits were indexed to growth in the average value of Medicare's costs for later years, savings would total almost $1.9 billion in 2004 and $14.4 billion over five years. Those estimates assume that all current and future medigap policies are required to meet the new standards; savings would be much lower if—as in some recent proposals—the new medigap design was optional.

Proponents of this option argue that most Medicare enrollees who have medigap policies would be better off financially as a result. Because insurers that offer medigap plans must compete against each other for business, they would most likely reduce premiums to reflect the lower costs of providing the new policies. Indeed, most medigap policyholders would have smaller annual expenses under this option because their medigap premiums would decline by more than their cost-sharing liabilities would increase. (Part of the reason is that premiums for medigap policies are generally somewhat higher than the average cost-sharing liabilities that the policies cover, because of the administrative and other costs that medigap insurers incur, but the primary reason is that most of those liabilities are generated by a relatively small number of policyholders.) Greater exposure to Medicare's cost sharing could even lead some medigap policyholders to forgo treatments that would yield them few or no net health benefits. Indirectly, the decline in Medicare's costs would also cause that program's monthly premiums (which cover about 25 percent of costs for Part B of Medicare) to fall, so other Medicare beneficiaries would also be better off.

This option could have several drawbacks, however. Medigap policyholders would face more uncertainty about their out-of-pocket costs. For that reason, some policyholders might object to being barred from purchasing first-dollar coverage, even if they would be better off financially in most years under this option. (Most medigap policyholders buy optional coverage of the $100 Part B deductible; new high-deductible medigap policies have attracted only limited enrollment despite their substantially lower premiums.) Moreover, in any given year, about a quarter of medigap policyholders would incur higher total costs under this option than they would under the current system, and those with expensive chronic conditions might be worse off year after year. Finally, the decline in use of services by medigap policyholders (which would generate the federal savings under this option) might adversely affect their health in some cases.

**RELATED OPTIONS:** 570-15 and 570-17

## 570-17—Mandatory

# Combine Medicare Cost-Sharing Changes with Medigap Restrictions

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 2,980 | 4,530 | 5,540 | 6,190 | 6,820 | 26,070 | 75,530 |

The savings from simplifying and limiting Medicare's cost-sharing requirements (option 570-15) could be greatly increased by restricting medigap coverage at the same time (option 570-16). In fact, savings from carrying out both changes together would be greater than the sum of savings from either one alone.

Under this option, medigap plans would be prohibited from covering any of the $600 combined deductible for Medicare in 2004 (described in option 570-15) and could not cover more than 50 percent of remaining cost-sharing requirements, up to a limit of $3,400 a year on out-of-pocket spending. Such a medigap policy would correspond to the one described in option 570-16, with coverage limited to 50 percent of the next $2,800 in Medicare cost sharing (thus capping out-of-pocket expenses at $2,000 in 2004). If those various dollar limits were indexed to growth in per capita benefits paid by Medicare, this option would save almost $3.0 billion next year and $26.1 billion over the 2004-2008 period.

Those estimates assume that participation in Medicare's new cost-sharing requirements would be mandatory and that all medigap policies would be required to follow the new standards. That approach differs from some recent Congressional proposals, in which beneficiaries could decide whether they wanted to enroll in a new cost-sharing system. With voluntary participation, savings would be lower—or could even become costs—if the only enrollees in the new program were people who would pay less in cost sharing than they would under current law.

This option would appreciably strengthen incentives for more prudent use of medical services by raising the initial threshold of health costs that most Medicare beneficiaries faced and by prohibiting medigap plans from covering that deductible or more than half of Medicare's additional cost-sharing requirements. As a result, the five-year savings from this option would be $1.1 billion larger than the sum of savings achieved from options 570-15 and 570-16.

Despite the new catastrophic cap, which would protect Medicare enrollees against very large out-of-pocket expenses, some enrollees would object to this option or any other policy that denied them access to first-dollar supplemental coverage.

**RELATED OPTIONS:** 570-15 and 570-16

## 570-18—Mandatory

# Collect Deductible and Coinsurance Amounts for Clinical Laboratory Services Under Medicare

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 670 | 1,040 | 1,120 | 1,200 | 1,290 | 5,330 | 13,440 |

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. For most other services provided under Medicare's Supplementary Medical Insurance (SMI) program, beneficiaries are subject to both a $100 deductible and a coinsurance rate of 20 percent.

This option would impose the SMI program's usual deductible and coinsurance requirements on laboratory services, beginning on January 1, 2004. That change would yield appreciable federal savings: $670 million in 2004 and $5.3 billion over five years.

Supporters of this option argue that besides reducing Medicare's costs, this change would make cost-sharing requirements under the SMI program more uniform and therefore easier to understand. Moreover, enrollees might be less likely to undergo laboratory tests with little expected benefit if they paid part of the costs themselves.

Critics of this option counter that enrollees' use of laboratory services would probably not be substantially affected because decisions about what tests are appropriate are generally left to physicians, whose judgments do not appear to depend on enrollees' cost-sharing liabilities. Thus, only a small part of the expected savings from this option would stem from more prudent use of laboratory services; the rest would reflect the transfer to enrollees of costs now borne by Medicare. Moreover, the billing costs of some providers, such as independent laboratories, would be higher under this option because those providers 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.) In addition, states' Medicaid costs would increase for Medicare enrollees who also receive Medicaid benefits.

## 570-19—Mandatory

# Reduce Medicare Payments for Home Health Care

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 280 | 790 | 1,400 | 2,160 | 2,560 | 7,200 | 25,420 |

Last year, Medicare paid about $10 billion for home health care services—including intermittent skilled nursing care as well as physical therapy and speech therapy—for beneficiaries who were deemed to be homebound. Medicare spending on home health services grew rapidly in the mid-1990s, when agencies were reimbursed separately for each home health visit, but fell sharply after new payment systems were implemented under the Balanced Budget Act of 1997. Since 2001, home health agencies have generally been paid a fixed amount for providing all covered services for a 60-day period (known as a home health "episode"). The payments are adjusted prospectively on the basis of factors related to each beneficiary's expected need for care; in 2001, payments ranged from $1,114 to $5,947 per episode. Under current law, payments per episode are generally indexed to annual changes in input costs.

Although the per-episode payment rates for 2003 were cut by about 7 percent because of statutory reductions in payment limits, an analysis by the General Accounting Office (GAO) suggests that those payments will exceed home health agencies' estimated costs by an average of 25 percent. (GAO found that payments outstrip average costs in 75 of Medicare's 80 payment categories for home health care, with the extent of the difference ranging from a few percent to as much as 72 percent for the most common payment categories.) The disparity between home health payments and agencies' costs primarily reflects the fact that the per-episode payment amounts were based on the number of visits made under the previous payment system, but the number of visits per episode has fallen by about one-third under the current payment system.

This option would freeze the base payment for each home health episode at its 2003 level ($2,159) through 2007 to gradually narrow the gap between payments and costs. In addition, the option assumes that adjustments would be made among the 80 home health payment categories to bring payments more closely into line with costs in each case. Those changes would reduce Medicare outlays by $280 million in 2004 and by $7.2 billion over the 2004-2008 period. (The estimates of savings assume that cuts in average payment levels will be partially offset by an increase in the share of patients assigned to higher-payment categories, a practice called "up-coding." The estimates also take into account other responses that reduce the effect of those cuts on total spending.)

Advocates of this option argue that if average per-episode costs for home health agencies grew at the rate of inflation, this reduction would still leave average payments at least 10 percent above agencies' average costs for 2007 and beyond. That difference would provide a margin for agencies whose costs were slightly higher than average or that experienced faster cost growth.

Opponents of this option argue that it could reduce access to home health services for Medicare beneficiaries. If Medicare payments were moved closer to the average costs of home health agencies, agencies with substantially higher costs would eventually have to reduce their operating expenses or cease participating in the program. If the remaining agencies did not have enough capacity to serve all of the Medicare beneficiaries requiring home health care—or could not do so at costs that were at or below the revised payment rates—some beneficiaries would have difficulty receiving home health services. Lower payment rates could also lead some of those agencies to reduce the level or quality of services they provided to beneficiaries during a 60-day episode (although such concerns arise under any system of fixed prospective payments).

**RELATED OPTION:** 570-20

## 570-20—Mandatory

# Impose a Copayment Requirement on Home Health Episodes Covered by Medicare

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 1,000 | 1,600 | 1,800 | 2,000 | 2,300 | 8,700 | 24,900 |

Medicare's spending for home health care dropped during the late 1990s. But the Congressional Budget Office projects that use of home health services and the resulting costs will grow rapidly over the coming decade. One reason for the unrestrained growth is that Medicare beneficiaries are not required to pay any of the cost of home health services covered by the program.

This option would charge beneficiaries a copayment amounting to 10 percent of the total cost of each home health episode (60-day period of services) covered by Medicare, beginning on January 1, 2004. That change would yield net federal savings of $1 billion in 2004 and $8.7 billion over five years.

By shifting part of the cost of each home health episode to beneficiaries, this option would reduce the use of home health services—at least among the less than 10 percent of enrollees in fee-for-service Medicare who do not have supplementary coverage for their cost-sharing expenses. However, it would also increase the risk of very large out-of-pocket costs for those enrollees. Little or no drop in use would be expected among the more than 90 percent of enrollees who have Medicaid, medigap, or employment-based supplementary coverage. Thus, the 31 percent of enrollees with private medigap policies would be likely to face higher premiums, and the costs of the Medicaid program would rise on behalf of the 17 percent of Medicare enrollees who also receive Medicaid benefits.

**RELATED OPTION:** 570-19

# 600

# Income Security

Budget function 600 covers federal income-security programs that provide cash or in-kind benefits to individuals. Some of those benefits (such as food stamps, Supplemental Security Income, Temporary Assistance for Needy Families, and the earned income tax credit) are means-tested, whereas others (such as unemployment compensation and Civil Service Retirement and Disability payments) do not depend on a person's income or assets. CBO estimates that in 2003, federal outlays for function 600 will total nearly $328 billion, including about $50 billion in discretionary outlays. In the early 1990s, discretionary spending for function 600 grew significantly; since then, annual growth has generally been slower.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 18.9 | 29.6 | 30.4 | 32.0 | 33.1 | 27.5 | 27.8 | 22.7 | 29.8 | 32.8 | 31.6 | 39.7 | 42.7 | 43.2 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 23.5 | 25.8 | 28.2 | 31.4 | 35.7 | 39.2 | 38.0 | 39.4 | 40.9 | 40.0 | 41.4 | 44.0 | 48.0 | 50.4 |
| Mandatory | 125.1 | 146.7 | 171.3 | 178.6 | 181.4 | 184.5 | 191.7 | 195.5 | 196.8 | 202.4 | 212.1 | 225.6 | 264.5 | 277.2 |
| Total | 148.7 | 172.4 | 199.5 | 209.9 | 217.1 | 223.7 | 229.7 | 235.0 | 237.7 | 242.4 | 253.6 | 269.6 | 312.5 | 327.6 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 9.5 | 9.6 | 11.1 | 14.0 | 9.7 | -3.1 | 3.8 | 3.7 | -2.3 | 3.7 | 6.1 | 9.2 | 4.9 |

Note: n.a. = not applicable.

## 600-01—Discretionary

# Increase Payments by Tenants in Federally Assisted Housing

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 394 | 810 | 1,250 | 1,714 | 2,203 | 6,371 | 18,382 |
| Outlays | 173 | 627 | 1,056 | 1,509 | 1,988 | 5,354 | 17,217 |

Most lower-income tenants who receive federal rental assistance are aided through various Section 8 programs or the public housing program, all of which are administered by the Department of Housing and Urban Development (HUD). Those programs usually pay the difference between 30 percent of a household's income (after certain adjustments) and a local payment standard. In 2002, the average federal expenditure per assisted household for all of HUD's rental housing programs combined was roughly $6,200, the Congressional Budget Office estimates. That amount included both housing subsidies and fees paid to administering agencies.

This option would increase tenants' rent contributions over a five-year period from 30 percent to 35 percent of their adjusted income. Savings in outlays would total $173 million in 2004 and almost $5.4 billion over five years, including $4.0 billion for Section 8 programs and $1.3 billion for public housing. (The estimates shown here assume that lawmakers will provide budget authority to extend the life of all commitments for housing aid that are due to expire during the 2004-2013 period.)

Supporters of this option might argue that to blunt the impact of the change on assisted tenants, state governments—which currently contribute no funds to the federal rental assistance programs—could be encouraged to make up some or all of the decreased federal support. One rationale for directly involving states is that housing assistance programs generate substantial local benefits, such as improved quality of the housing stock. Moreover, since eligibility for housing aid is determined by each area's median income, tying states' contributions to renters' incomes (assuming that every state increased its contribution) would ensure that lower-income states would pay less per assisted family than higher-income states would.

Opponents of this option could argue that not all states would make up the reduction in federal assistance. As a result, housing costs could increase for some current recipients of aid, who generally have very low income. This option could also cause some relatively high-income renters in assisted-housing projects to move out, because paying an additional 5 percent of their income for such housing could be more expensive than renting an unassisted unit. As those tenants were replaced by new ones with lower income, the concentration of families with very low income in assisted-housing projects would increase and the savings from this option would decline (in some situations, the cost of the public housing program could rise).

**RELATED OPTION:** 600-02

## 600-02—Discretionary

# Reduce Rent Subsidies for Certain One-Person Households

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 54 | 108 | 160 | 212 | 263 | 797 | 2,860 |
| Outlays | 24 | 79 | 133 | 186 | 238 | 659 | 2,616 |

In general, recipients of federal housing assistance either live in assisted-housing projects or rent units of their own choosing in the private market. Support for that second type of assistance comes in the form of Section 8 vouchers, which generally reduce the amount that recipients spend for housing to 30 percent of their income. Specifically, Section 8 programs pay the difference between 30 percent of a tenant's income (after certain adjustments) and a payment standard determined by local rental levels.

The payment standard and the amount of the federal subsidy both vary according to the type of unit in which the tenant lives. Generally, one-person households may live in apartments with up to one bedroom, whereas larger households may reside in bigger units.

This option would link the rent subsidy for a newly assisted one-person household (or for a currently assisted person who moves to another unit) to the cost of an efficiency apartment rather than a one-bedroom apartment. That change would save $24 million in federal outlays next year and $659 million over the 2004-2008 period.

Advocates of this option would argue that an efficiency unit provides adequate space for someone living alone. Opponents would counter that renters in some areas might have difficulty finding suitable housing under the new rule and, as a result, might have to spend more than 30 percent of their income for available units.

**RELATED OPTION:** 600-01

## 600-03—Mandatory

# Eliminate Small Food Stamp Benefits

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 90 | 90 | 90 | 90 | 95 | 455 | 950 |

Under the Food Stamp program, applicants must meet eligibility requirements to receive a monthly benefit. Among other conditions, they must have income at or below 130 percent of the federal poverty line and have countable assets of less than $2,000. Countable assets exclude certain items, such as the value of a house and the value of a car up to a set limit.

Once eligibility for the program has been determined, the value of the benefit is calculated. A household is expected to contribute 30 percent of its net income (gross income minus deductions for personal expenses) for food expenditures. The Department of Agriculture has determined the monthly cost of a "Thrifty Food Plan" for a given household size. A household's food stamp benefit equals the amount by which the monthly cost of the Thrifty Food Plan exceeds 30 percent of the household's net monthly income. For one- and two-person households, a minimum benefit exists: if the calculated benefit is less than $10, the food stamp benefit is set at $10.

This option would eliminate food stamp benefits for households whose calculated benefit is less than $10 a month. Savings from that change would total $90 million in 2004 and $455 million over the 2004-2008 period.

Proponents of this option argue that it would concentrate food stamp benefits on recipients with the greatest calculated need because the people who would lose benefits are those who have the highest expected contribution to their monthly food costs. Critics argue that eliminating benefits for households eligible for less than $10 a month might discourage those households from reapplying for the program if their financial situation changed. That discouraging effect could lessen the extent to which the program achieved its goal of aiding low-income households.

## 600-04—Mandatory

# Target the Subsidy for Certain Meals in Child Nutrition Programs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 85 | 555 | 655 | 670 | 680 | 2,650 | 6,125 |

The School Lunch Program and the School Breakfast Program provide funds to participating schools to subsidize lunches and breakfasts for children. Participating schools must offer free meals to children with family income below 130 percent of the federal poverty line, reduced-price meals to children with family income between 130 percent and 185 percent of the poverty line, and full-price meals to children with family income above 185 percent of the poverty line. Most schools that participate in the lunch program also participate in the breakfast program.

The subsidy rate per meal does not vary with the cost that the school incurs in providing the lunch or breakfast—it depends solely on the family income of the student receiving the meal. For the 2002-2003 school year, the federal subsidies amount to $2.14 per lunch and $1.17 per breakfast for students receiving free meals, $1.74 per lunch and $0.87 per breakfast for reduced-price meals, and $0.20 per lunch and $0.22 per breakfast for full-price meals. (Schools with large numbers of participating students can get an additional subsidy.) The school sets the prices it charges students for reduced-price and full-price meals, although the reduced-price meal cannot cost more than 40 cents.

This option would eliminate the breakfast and lunch subsidy for full-price meals for students with family income above 350 percent of the poverty line, beginning in July 2004. At the same time, it would increase the subsidy for reduced-price meals by $0.20 for both breakfast and lunch. Those changes would yield net savings of $85 million in 2004 and more than $2.6 billion over five years.

Supporters of this option argue that there is no clear justification for subsidizing meals for children who are not from low-income families. Opponents argue that if a school has been using funds from the full-price subsidy to offset the cost of administering its breakfast and lunch programs, it might decide to raise meal prices for students from higher-income families or drop out of the program. The latter outcome would mean that students who were eligible for free or reduced-price meals would no longer receive them.

## 600-05—Mandatory

# Reduce the $20 Exclusion for Unearned Income Under the Supplemental Security Income Program

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 90 | 135 | 125 | 115 | 130 | 595 | 1,260 |

The federal Supplemental Security Income (SSI) program provides monthly cash payments—based on uniform, nationwide eligibility rules—to low-income elderly and disabled people. In addition, many states provide supplemental payments. Because SSI is a means-tested program, recipients' outside income reduces their SSI benefits, subject to certain exclusions. For unearned income (most of which consists of Social Security benefits), $20 a month is excluded; SSI benefits are reduced dollar for dollar for unearned income above that amount. The program allows a larger exclusion for earned income (such as wages) to encourage SSI recipients to work.

This option would reduce the exclusion for unearned income from $20 a month to $15. That reduction would save $90 million in 2004 and $595 million over five years.

Advocates of this option argue that a program designed to ensure a minimum standard of living for its recipients need not provide a higher standard for people who happen to have unearned income. But opponents point out that reducing the monthly exclusion by $5 would decrease by as much as $60 a year the income of the roughly 2.3 million low-income people (approximately 35 percent of all federal SSI recipients) who would otherwise benefit from the exclusion in 2004. Even with the full $20 exclusion, the income of many SSI recipients is below the poverty line.

**RELATED OPTION:** 600-06

## 600-06—Mandatory

# Create a Sliding Scale for Children's SSI Benefits Based on the Number of Recipients in a Family

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 0 | 70 | 135 | 130 | 150 | 485 | 1,345 |

The federal Supplemental Security Income (SSI) program makes cash payments—based on uniform, nationwide eligibility rules—to elderly and disabled people with low income. In addition, many states provide supplemental payments to SSI recipients. In 2002, children received approximately $5.3 billion, or almost one-sixth, of federal SSI benefits.

Unlike other means-tested benefits, the SSI payment for an additional child does not decline as the number of SSI recipients in a family increases. In 2003, a family with one child qualifying for SSI benefits could receive up to $552 a month, or $6,624 a year, if the family's income (excluding SSI benefits) was under the cap for the maximum benefit. If the family had additional eligible children, it could receive another $552 a month for each one. (A child's benefit is based only on the presence of a severe disability and the family's income and resources, not on the nature of the qualifying disability or on participation by other family members in the SSI program.)

This option would create a sliding scale for SSI disability benefits so that a family would get smaller benefits per child as its number of children receiving SSI increased. The sliding scale used in this option was recommended by the National Commission on Childhood Disability in 1995. It would keep the maximum benefit for one child the same as in current law but reduce benefits for additional recipient children in the same family. If that sliding scale was in place in 2003, the first child in a family qualifying for the maximum benefit would continue to receive $552 a month, but the second child would get $333, and the third would receive $291. Benefits would continue to decrease for additional children. As with current SSI benefits, the sliding scale would be adjusted each year to reflect changes in the consumer price index.

This option assumes that the change would not be carried out until 2005 because the Social Security Administration does not maintain data on multiple SSI recipients in a family, so implementing the sliding scale would require significant effort on the agency's part. Savings from this option would total $70 million in 2005 and $485 million between 2005 and 2008.

Proponents of a sliding scale argue that the reductions in benefits it would produce reflect economies of scale that generally affect the cost of living for families with more than one child. Moreover, the high medical costs that disabled children often incur, which would not be subject to economies of scale, would continue to be covered because SSI participants are generally eligible for Medicaid.

Opponents of this option could argue that children with disabilities sometimes have unique needs that may not be covered by Medicaid, including modifications to their housing and specialized equipment. With lower SSI benefits, some families might be unable to meet such needs.

**RELATED OPTION:** 600-05

## 600-07—Mandatory

# Reduce the Federal Matching Rate for Administrative and Training Costs in the Foster Care and Adoption Assistance Programs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 125 | 155 | 160 | 160 | 165 | 765 | 1,615 |

The Foster Care and Adoption Assistance programs provide benefits and services to eligible low-income children and families. The federal government pays 50 percent of most administrative costs for the programs, including costs for child placement services; state and local governments pay the remaining share. However, the federal government pays higher matching rates for certain activities to induce local administrators to undertake more of them. For example, the federal government pays 75 percent of the costs of training administrators and prospective foster and adoptive parents.

This option would reduce the matching rates for all administrative and training expenses in the Foster Care and Adoption Assistance programs to 50 percent, thus eliminating special rates for specific activities. That change would decrease federal outlays by $125 million in 2004 and by $765 million over five years.

Proponents of this option could argue that because the higher matching rate for training and related expenses has been in place for many years, it is unclear whether states require that rate to provide those services. Reducing the matching rate to 50 percent would shed some light on states' willingness to pay a larger share of those costs, as well as bring the matching rate in line with that for administrative expenses.

Critics argue that states might respond to this option by reducing their administrative efforts, which could raise program costs and offset some of the federal savings. Specifically, states might make less of an effort to eliminate waste and abuse in payments to providers. Or they might provide less training for administrators and parents or reduce the payments and other services that the programs offer. Such reductions could be especially likely because many states are facing budget shortfalls.

Under the Unfunded Mandates Reform Act of 1995, cuts in federal funding for some entitlement grant programs —including Foster Care and Adoption Assistance—are considered mandates on state governments if the states lack authority to amend their programmatic or financial responsibilities to offset the loss of funding. Because some states may not have sufficient flexibility within the Foster Care and Adoption Assistance programs to make such changes, this option could constitute an unfunded federal mandate under the law.

## 600-08—Mandatory

# Limit Some Cost-of-Living Adjustments for Federal Retirees

| | | | | | | Total | |
|---|---|---|---|---|---|---|---|
| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | 2004-2008 | 2004-2013 |
| Outlay Savings | 200 | 490 | 790 | 1,120 | 1,470 | 4,070 | 17,550 |

Annuitants under the Civil Service Retirement System (CSRS) receive annual cost-of-living adjustments (COLAs) that offer 100 percent protection against inflation. Annuitants under the newer Federal Employees Retirement System (FERS) receive full protection only when the annual rate of inflation is less than 2 percent. If inflation in a year is between 2 percent and 3 percent, FERS annuitants receive COLAs of 2 percent. If inflation is over 3 percent, their COLA is the increase in inflation minus 1 percentage point.

This option illustrates one way among many to limit COLAs for federal retirees. It would restrict COLAs for CSRS annuitants to half a percentage point below inflation. Moreover, when inflation was less than 3 percent, FERS retirees would receive a COLA that was 1 percentage point below inflation. (Those two reductions would produce roughly comparable cuts in total retirement benefits for the two types of annuitants because FERS enrollees are also covered by Social Security.) The option would save $200 million in direct spending for civilian pensions in 2004 and $4.1 billion during the 2004-2008 period. Over five years, the average CSRS retiree would lose $1,900. (The Congress could also consider limiting COLAs only for the FERS plan, which is more generous when Social Security and Thrift Savings Plan benefits are factored in.)

Advocates of this option contend that federal pension plans offer greater protection through COLAs than most private pension plans do. COLAs are becoming less prevalent in the private sector. According to a 1999 survey, fewer than 10 percent of private-sector retirement plans offered annuitants any automatic protection against inflation.

Opponents of this option argue that cutting any retirement benefit hurts both retirees and the government's ability to recruit a high-quality workforce. Further, when workers accept employment with the federal government, they count on the benefits promised. Federal workers may be accepting salaries below private-sector rates for comparable jobs in exchange for better retirement provisions. (In essence, workers pay for their more-generous retirement benefits by accepting lower wages during their working years.) This option would hurt those retirees—CSRS annuitants—who are most dependent on their pensions. It would also renege on an understanding that workers covered under CSRS who passed up the chance to switch to FERS would retain their full protection against inflation. Finally, opponents note that federal retirees' protection against inflation has already been restricted to some extent. The General Accounting Office calculated that delays and reductions in COLAs between 1985 and 1994 effectively reduced the adjustments to about 80 percent of inflation.

**RELATED OPTIONS:** 600-09 and 600-10

**RELATED CBO PUBLICATIONS:** *Measuring Differences Between Federal and Private Pay*, November 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; and *Comparing Federal Salaries with Those in the Private Sector*, July 1997

## 600-09—Mandatory

# Modify the Formula Used to Set Federal Pensions

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Outlay Savings | 70 | 130 | 185 | 235 | 295 | 915 | 3,485 |

The government's major retirement plans for civilian employees, the Federal Employees Retirement System (FERS) and the Civil Service Retirement System (CSRS), provide initial benefits that are based on average salary during an employee's three consecutive highest-earning years. In 2002, outlays for benefits under the two programs totaled $48.9 billion.

This option would use a four-year average to compute benefits for people who retire under FERS and CSRS after September 30, 2003. As a result, initial pensions would be about 1.5 percent to 2 percent smaller for most new civilian retirees, saving the federal government $70 million in 2004 and a total of $915 million over five years.

Proponents contend that this option would align federal practices more closely with those in the private sector, which commonly uses five-year averages to calculate an employee's base pension. The change in formula would encourage some federal employees to work longer in order to boost their pensions to reflect the higher salaries they receive with more years on the job. That incentive could help the government keep experienced people, but it could hinder efforts to decrease the size of the federal workforce and promote the hiring of entry-level workers.

Opponents argue that by cutting benefits, this option would reduce the attractiveness of the government's civilian compensation package. In previous legislative sessions, the Congress took several actions to improve that compensation package, including rolling back required contributions by federal employees to their retirement plans.

Under this option, FERS benefits (which include Social Security and the Thrift Savings Plan) would remain more generous than those offered by large private firms, but CSRS benefits (which do not include Social Security and the Thrift Savings Plan) would fall below those received by many retirees from the private sector. The average new CSRS retiree would lose $620 in 2004 and $3,200 over five years, whereas the average new FERS retiree would lose $190 in 2004 and just $1,000 over five years because of the smaller defined benefit under that system.

**RELATED OPTIONS**: 600-08 and 600-10

**RELATED CBO PUBLICATIONS:** *Measuring Differences Between Federal and Private Pay*, November 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; and *Comparing Federal Salaries with Those in the Private Sector*, July 1997

## 600-10—Discretionary

# Restructure the Government's Matching Contributions to the Thrift Savings Plan

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 375 | 400 | 430 | 460 | 495 | 2,160 | 5,250 |
| Outlays | 375 | 400 | 430 | 460 | 495 | 2,160 | 5,250 |

Most federal workers covered by the Federal Employees Retirement System (FERS) can direct up to 13 percent of their salary to the Thrift Savings Plan (TSP), which is similar to a 401(k) plan. (That limit will increase over the next several years.) At the same time, federal agencies automatically contribute an amount equal to 1 percent of salaries for their FERS employees to the TSP. In addition, they match the first 3 percent of workers' voluntary contributions to the TSP dollar for dollar and the next 2 percent at 50 cents on the dollar. Employees can contribute another 8 percent of pay but get no matching contribution. Thus, although federal workers can save up to 13 percent of their earnings in the TSP, they can receive the maximum government match by contributing just 5 percent of their earnings.

This option would restructure the TSP contribution schedule so that the government made the full 5 percent match only when employees contributed 10 percent. Specifically, the government would match voluntary contributions ranging from 1 percent to 6 percent of earnings at the rate of 50 cents per dollar (for a maximum 3 percent match) and contributions ranging from 7 percent to 10 percent at 25 cents per dollar (for a maximum 1 percent match). The government would continue to automatically contribute an amount equal to 1 percent of employees' earnings. That restructuring would save $375 million in 2004 and $2.2 billion over the 2004-2008 period.

Supporters of this option contend that changing the government's matching schedule would bring federal practices more in line with those of defined-contribution plans in the private sector, which usually provide lower matches and no automatic contributions. According to the Bureau of Labor Statistics, the most prevalent practice among medium and large private firms is to match employees' contributions up to 6 percent of pay at 50 cents on the dollar. Some federal employees, especially those currently contributing 5 percent of their earnings, would have an incentive to contribute more to the TSP and, as a result, would have more savings available when they retired. Furthermore, restructuring matching contributions might reduce the disparity between the government's two major retirement systems. Benefits under FERS—which include Social Security and the TSP—are currently higher and cost the government more than benefits under the older Civil Service Retirement System for most participants.

Opponents argue that this option would have several drawbacks. First, a lower government match on smaller contributions could reduce the retirement resources of some employees by weakening their incentive to contribute. Second, the government might achieve its savings at the expense of those employees who are least likely to contribute a higher percentage of their earnings to the TSP—namely, young workers and others with relatively low pay. Third, changing the TSP could be considered unfair because many people accepted employment with the government or switched from the Civil Service Retirement System to FERS assuming that TSP benefits would remain the same.

**RELATED OPTIONS:** 600-08 and 600-09

**RELATED CBO PUBLICATIONS:** *Measuring Differences Between Federal and Private Pay*, November 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; and *Comparing Federal Salaries with Those in the Private Sector*, July 1997

# 700

# Veterans Benefits and Services

Budget function 700 covers programs that offer benefits to military veterans. Those programs, most of which are run by the Department of Veterans Affairs, provide health care, disability compensation, pensions, life insurance, education and training, and guaranteed loans. CBO estimates that total outlays for function 700 will be about $55 billion in 2003, including discretionary outlays of just over $24 billion. Since 1990, discretionary outlays for veterans benefits and services have increased almost every year.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 13.0 | 14.1 | 15.3 | 16.2 | 17.2 | 17.6 | 17.8 | 18.9 | 18.9 | 19.3 | 20.9 | 22.5 | 24.0 | 24.1 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 13.0 | 13.8 | 15.1 | 15.8 | 16.7 | 17.4 | 17.6 | 18.6 | 18.5 | 19.4 | 20.8 | 22.4 | 24.1 | 24.2 |
| Mandatory | 16.1 | 17.5 | 19.0 | 19.8 | 20.9 | 20.5 | 19.4 | 20.7 | 23.3 | 23.8 | 26.3 | 22.6 | 26.9 | 30.9 |
| Total | 29.1 | 31.3 | 34.1 | 35.7 | 37.6 | 37.9 | 37.0 | 39.3 | 41.8 | 43.2 | 47.1 | 45.0 | 51.0 | 55.1 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 5.9 | 9.8 | 4.7 | 5.7 | 4.3 | 1.0 | 5.7 | -0.6 | 4.7 | 7.1 | 7.9 | 7.6 | 0.5 |

Note: n.a. = not applicable.

## 700-01—Mandatory

# Narrow the Eligibility for Veterans' Disability Compensation to Include Only Veterans with High-Rated Disabilities

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 75 | 146 | 210 | 254 | 294 | 979 | 3,446 |
| Outlays | 73 | 140 | 209 | 250 | 281 | 953 | 3,395 |

Approximately 2.4 million veterans who have service-connected disabilities receive disability compensation benefits from the Department of Veterans Affairs (VA). The amount of compensation is based on a rating of an individual's impairment that is intended to reflect the resulting reduction, on average, in earnings capacity. Veterans' disability ratings range from zero to 100 percent (the most severe). Veterans who are unable to maintain gainful employment and who have ratings of at least 60 percent are eligible to be paid at the 100 percent rate. Veterans who have disabilities rated 30 percent or higher and who have dependent spouses, children, or parents are paid special allowances because of their dependents.

Each year, about 45,000 more veterans with disability ratings below 30 percent begin receiving compensation of $70 to $200 per month. This option would, for all future cases, narrow the eligibility for compensation to include only veterans with disability ratings equal to 30 percent or greater. That change would reduce federal outlays by $953 million over the 2004-2008 period.

By not awarding new compensation to veterans with disability ratings below 30 percent, VA could concentrate spending on the most impaired veterans. Furthermore, the need for compensating the least impaired veterans may be lessening. Performance in civilian jobs depends less now on physical labor than it did when the disability ratings were originally determined, and improved reconstructive techniques are now available. So physical impairments rated below 30 percent may not substantively reduce veterans' earnings. Examples of low-rated impairments include conditions such as mild arthritis, moderately flat feet, or amputation of part of a finger—conditions that would not preclude working in many occupations today.

However, veterans compensation could be viewed as career or lifetime indemnity payments that the federal government owes to people who were disabled to any degree while serving in the armed forces. Moreover, some disabled veterans might find it difficult to increase their working hours or otherwise make up for the loss of expected compensation payments.

**RELATED OPTIONS:** 700-02 and 700-05

## 700-02—Mandatory

# Narrow the Eligibility for Veterans' Disability Compensation to Veterans Whose Disabilities Are Related to Their Military Duties

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 20 | 63 | 97 | 120 | 157 | 456 | 1,670 |
| Outlays | 18 | 62 | 97 | 118 | 154 | 449 | 1,645 |

Veterans are eligible for disability compensation if they either receive or aggravate disabilities (excluding those resulting from willful misconduct) while in active-duty service. Veterans need not be performing military duties when those disabilities are incurred or made worse for the Department of Veterans Affairs (VA) to consider them service-connected; for example, disabilities incurred while military personnel are on leave qualify. The federal government also gives dependency and indemnity compensation awards to survivors when compensable disabilities cause or are related to a veteran's death.

According to data collected by VA, about 290,000 veterans received a total of approximately $970 million in compensation payments in 2002 for disabilities that, according to the General Accounting Office, are generally neither caused nor aggravated by military service. Those diseases (excluding diabetes mellitus, which VA has since determined to be service-connected for certain veterans) are:

- Osteoarthritis,
- Chronic obstructive pulmonary disease (including chronic bronchitis and pulmonary emphysema),
- Arteriosclerotic heart disease,
- Crohn's disease,
- Hemorrhoids,
- Uterine fibroids, and
- Multiple sclerosis.

Ending new compensation benefits for veterans with only those seven diseases would save $18 million in outlays in 2004 and $449 million over the 2004-2008 period. Eliminating new compensation benefits for veterans whose compensable disabilities are also unrelated to military service would create significantly larger savings.

Opponents of this option could hold the view that veterans' compensation benefits are payments that the federal government owes to veterans who became disabled in any way during their service in the armed forces.

**RELATED OPTIONS:** 700-01 and 700-05

## 700-03—Mandatory

# Increase Beneficiaries' Cost Sharing for Care at Nursing Facilities Operated by the Department of Veterans Affairs

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 214 | 221 | 229 | 236 | 241 | 1,141 | 2,476 |
| Outlays | 214 | 221 | 229 | 236 | 241 | 1,141 | 2,476 |

Veterans may receive long-term care in nursing homes operated by the Department of Veterans Affairs (VA), depending on the availability of resources. That care is rationed primarily on the basis of the nature of a disability and income. Under certain conditions, a veteran may receive care at VA's expense in state-operated or privately run nursing facilities.

VA can charge copayments to veterans with no compensable service-connected disabilities and high enough income when they receive more than 21 days of care in VA-run nursing homes. In 2003, VA may collect up to $50 million from providing such extended-care services, including nursing home care, the Congressional Budget Office estimates. VA can spend those collections, which are outside of the appropriation process. According to the General Accounting Office, state-operated nursing facilities for veterans and community long-term care facilities that treat veterans charge copayments that offset a larger share of their operating expenses than VA does. Those facilities recover as much as 43 percent through copayments. (Estate-recovery programs are another way that they offset costs.)

This option would authorize VA to revise its cost-sharing policies to recover more of the costs of providing care in VA nursing facilities. The department would be required to collect a minimum of 10 percent of its operating costs, but it could determine what type of copayments to charge and who would pay them. For example, it could apply the copayment to a broader category of veterans or require veterans who make copayments to pay more. Recovering 10 percent of VA's operating costs would save $214 million in 2004 and about $1.1 billion over five years. Achieving those savings would require depositing the receipts in the Treasury rather than allowing VA to spend them.

Proponents of this option would argue that veterans in VA nursing facilities are getting a far more generous benefit than similar veterans in non-VA facilities. Recovering more of the expense at VA facilities would make that benefit more equitable among veterans and different sites of care.

Opponents of this option would argue that beneficiaries in nursing facilities might be less able to make copayments than beneficiaries receiving other types of care. They would also argue that a policy allowing VA to charge veterans with service-connected disabilities would be inconsistent with the standard reflected by other medical benefits that those veterans received. In implementing this option, VA could continue to exempt those veterans, but it would have to charge high-income veterans without service-connected disabilities even more to achieve the 10 percent recovery level.

**RELATED OPTION:** 700-04

## 700-04—Discretionary

# Establish a Realignment and Closure Commission for Department of Veterans Affairs Facilities

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Costs (-) or Savings | | | | | | | |
| Budget authority | 0 | -98 | -24 | -112 | 43 | -191 | 3,393 |
| Outlays | 0 | -15 | -35 | -54 | -53 | -157 | 1,642 |

As many as one-third of the hospitals run by the Department of Veterans Affairs (VA) are in areas where there is a limited demand for their services or where other VA clinics and hospitals provide an alternative source of care. Those hospitals remain open, however, because political consensus is lacking to close or realign excess facilities. This option would establish a process for VA similar to the base realignment and closure process that has been used successfully to close nonessential facilities of the Department of Defense (DoD).

The Veterans Health Administration is reassessing its needs for facilities through the Capital Asset Realignment for Enhanced Services (CARES) program. That program examines who uses and who is projected to use VA facilities, defines market areas for serving those populations, and seeks to ensure an adequate supply and proper location of services to meet projected demand. The program's mandate includes considering closing or merging facilities where there is excess capacity or redundancy.

Largely insulated from local political pressure, a realignment and closure commission for VA would facilitate the work of the CARES program by helping to develop the consensus needed to close hospitals and clinics with low demand and merge facilities that are located close together. The commission would also serve as arbiter among interest groups and would help clarify VA's role and priorities in serving patients.

As with DoD's process, this option would entail costs in the early years in order to conduct assessments and close facilities; however, over a 10-year period, it would yield net savings of $1.6 billion in outlays.

Proponents of this option would assert that the current distribution of VA facilities is wasteful and inefficient, costing much more than is necessary to meet the demand of a few veterans for the convenience of having a VA facility nearby. The extension in recent years of health benefits to veterans who are neither disabled nor poor has created a surge in demand for VA's health care that does not reflect a growth in the size or needs of the department's core target groups—veterans disabled because of their military service and very poor veterans. The needs of those core groups might be served with a much smaller VA system, perhaps supplemented by a modest program to help pay for care from private providers when travel to a VA facility was burdensome for patients.

Opponents of this option would argue that an aggressive realignment and closure program would substantially reduce benefits for many veterans, particularly those who lived near facilities that closed. Moreover, opponents would point out, although VA will reimburse travel costs in many circumstances, the time and energy required to seek care at a distant facility is beyond many needy veterans.

**RELATED OPTION:** 700-03

## 700-05—Mandatory

# Reduce Veterans' Disability Compensation to Account for Social Security Disability Insurance Payments

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 1,175 | 1,221 | 1,255 | 1,292 | 1,331 | 6,273 | 13,645 |
| Outlays | 1,175 | 1,221 | 1,255 | 1,292 | 1,331 | 6,273 | 13,645 |

Approximately 2.4 million veterans—about 1.6 million of whom are under age 65—receive compensation from the Department of Veterans Affairs (VA) for disabilities associated with their military service. The amount of compensation is based on a rating of an impairment's average effect on a person's earning ability. Additional allowances are paid to veterans whose disabilities are rated 30 percent or higher and who have dependent spouses, children, or parents.

Veterans with disabilities may also qualify for cash payments from other sources, including workers' compensation, means-tested programs such as Supplemental Security Income; private disability insurance; and, for veterans under 65, Social Security's Disability Insurance (DI) program. An estimated 110,000 veterans who receive disability compensation from VA also receive DI payments from the Social Security Administration. When Social Security beneficiaries are eligible for disability benefits from multiple sources, ceilings usually limit their combined disability benefits from public sources to 80 percent of their average earnings before they were disabled. Those DI payments—after any reduction, if applicable—are adjusted periodically for changes in the cost of living and the average wage level nationwide. Veterans' compensation payments for disabilities, however, are not included and do not apply toward the limit. Neither do means-tested benefits and certain benefits based on public employment.

This option would limit veterans' disability compensation for individuals receiving both it and DI payments. Under the option, disability compensation would be reduced by the amount of the DI benefit. Applying that change to both current and future recipients of veterans' compensation would affect an estimated 110,000 recipients in 2004, saving more than $1 billion that year and an estimated $6 billion over the 2004-2008 period. Applying that change only to veterans who were newly awarded compensation payments or DI payments would affect an estimated 2,200 recipients in 2004, saving $23 million in outlays that year and an estimated $615 million over the 2004-2008 period.

This option would eliminate duplicate payment of public compensation for a single disability. However, opponents could view this option as subjecting veterans' disability benefits to a form of income testing (they are currently considered an entitlement). Moreover, to the extent that this option applied to current recipients of DI benefits, some disabled veterans would see their income drop.

**RELATED OPTIONS:** 700-01 and 700-02

# 800

# General Government

Budget function 800 covers the central management and policy responsibilities of both the legislative and executive branches of the federal government. Among the agencies it funds are the General Services Administration and the Internal Revenue Service. CBO estimates that in 2003, total outlays for function 800 will be $17 billion—most of which is discretionary spending.

**Federal Spending, Fiscal Years 1990-2003 (In billions of dollars)**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | Estimate 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority (Discretionary) | 11.5 | 12.2 | 11.3 | 11.6 | 12.1 | 11.9 | 11.5 | 11.8 | 12.0 | 13.5 | 12.2 | 14.5 | 15.6 | 14.6 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary | 9.0 | 10.4 | 11.0 | 11.5 | 11.7 | 12.4 | 11.7 | 12.0 | 11.9 | 12.3 | 12.2 | 13.0 | 14.6 | 14.6 |
| Mandatory | 1.6 | 1.4 | 2.0 | 1.5 | -0.3 | 1.6 | 0.2 | 0.8 | 3.7 | 3.3 | 1.0 | 1.6 | 2.7 | 2.5 |
| Total | 10.6 | 11.7 | 13.0 | 13.1 | 11.3 | 14.0 | 12.0 | 12.8 | 15.6 | 15.6 | 13.3 | 14.6 | 17.4 | 17.1 |
| **Memorandum**: | | | | | | | | | | | | | | |
| Annual Percentage Change in Discretionary Outlays | n.a. | 15.3 | 6.3 | 4.8 | 1.0 | 6.1 | -5.2 | 2.5 | -0.8 | 2.8 | -0.1 | 6.0 | 12.9 | -0.4 |

Note: n.a. = not applicable.

## 800-01—Discretionary

# Eliminate General Fiscal Assistance to the District of Columbia

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 61 | 62 | 64 | 65 | 66 | 318 | 672 |
| Outlays | 61 | 62 | 64 | 65 | 66 | 318 | 672 |

Under the National Capital Revitalization and Self-Government Improvement Act of 1997 (the Revitalization Act), the federal government assumed responsibility for providing certain services to the District of Columbia in exchange for eliminating the annual payment of general assistance to the District. Specifically, the federal government agreed to fund the operations of the District's criminal justice, court, and correctional systems. It also assumed responsibility for paying off more than $5 billion in unfunded liabilities that the city owed to several pension plans, increased the federal share of the city's Medicaid payments, and provided special borrowing authority to the District.

For 1998, the Revitalization Act included slightly more than $200 million in assistance for the District that was not related to the obligations specifically assumed by the federal government. Such funding increased to $232 million in 1999 and then plummeted to $28 million in 2000; it then rose slightly, to $59 million in 2001 and $60 million in 2002. The 2002 amount included funds for tuition assistance to city residents, emergency planning, and security costs (plus $200 million in one-time supplemental appropriations for activities related to September 11). Eliminating that general fiscal assistance to the District would save $61 million in 2004 and $318 million over the 2004-2008 period.

Supporters of this option contend that the federal government already relieved the District of Columbia government of the cost of a substantial, and increasing, portion of its budget—criminal justice, Medicaid, and pensions. The proposed trade-off for assuming responsibility for those functions was ending other assistance, including the annual federal payment. Eliminating general assistance would be consistent with that policy.

Opponents of this option argue that the need for funding assistance continues. The Constitution gives the Congress responsibility for overseeing the District of Columbia (which the Congress has largely delegated to the city government), and the city still has major problems with its public schools, roadways, and other essential services. Moreover, the Congress prevents the District of Columbia from imposing commuter taxes, as many other cities do. Such taxes are levied on nonresidents who work in a city and benefit from its services. Two of three dollars earned in the District of Columbia are earned by nonresidents. Finally, opponents argue that continued assistance is justified because more than 40 percent of city property, including property owned by the federal government or foreign nations, is exempt from local taxes.

## 800-02—Mandatory

# Require the Internal Revenue Service to Deposit Fees from Installment Agreements in the Treasury as Miscellaneous Receipts

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 83 | 84 | 85 | 86 | 87 | 425 | 875 |
| Outlays | 83 | 84 | 85 | 86 | 87 | 425 | 875 |

The 1996 appropriation act for the Department of the Treasury, the Postal Service, the Executive Office of the President, and certain independent agencies authorized the Internal Revenue Service (IRS) to establish new fees and increase existing ones. Under that law, the IRS can retain and spend receipts collected from those fees, up to an annual limit of $119 million. The IRS has used that authority mainly to charge taxpayers a fee for entering into payment plans with the agency. In 2001, the IRS collected $80 million in fee receipts. Last year, however, it collected only $72 million in fees. The IRS attributes the smaller amount in 2002 to various one-time events, including the terrorist attacks of September 11, the tax rebate, and improvements in its information system.

Requiring the IRS to deposit those receipts in the Treasury would eliminate the agency's ability to spend them. That change would reduce the IRS's direct spending by $83 million in 2004 and $425 million over the 2004-2008 period (assuming that removing the spending authority did not substantially reduce the amount that the IRS collected each year in such fees).

Supporters of this option assert that processing payment plans with taxpayers is an administrative function directly related to the IRS's mission—getting citizens to pay the taxes they owe—and thus is a function for which the agency already receives annual appropriations. (For 2003, the IRS received a total of $8.89 billion in direct appropriations, not counting transfers.) Moreover, the IRS does not directly use the receipts it collects from fees on installment agreements to fund the processing of those agreements. Proponents also contend that the agency's spending authority could create an incentive for the IRS to unnecessarily encourage taxpayers to pay their taxes in installments. Similarly, it could encourage the agency to seek new and unnecessary fees.

Opponents of this option argue that allowing the IRS to generate and use fee receipts helps ensure that the federal government's main revenue collector has sufficient funding to fulfill its mission. Some critics would argue that even an annual decrease of roughly $80 million in funding could negatively affect revenue collection. In addition, eliminating the spending authority could reduce the IRS's incentive to allow installment payments or its ability to provide for them, thus hurting taxpayers who would benefit from such arrangements.

## 800-03—Discretionary

# Eliminate Federal Antidrug Advertising

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 183 | 187 | 191 | 195 | 199 | 955 | 2,016 |
| Outlays | 55 | 148 | 187 | 191 | 195 | 776 | 1,817 |

Funds provided to the Office of National Drug Control Policy (ONDCP) can be used to test advertising, purchase media time, and evaluate the effects of national antidrug media campaigns. The agency is required to solicit donations from nonfederal sources to pay part of its costs.

For 2002, the appropriation act for the Treasury Department, the Postal Service, the Executive Office of the President, and certain independent agencies provided $180 million for the antidrug media program. Eliminating that program would save $55 million in outlays in 2004 and $776 million over the 2004-2008 period.

Proponents of this option argue that there is no solid empirical evidence that media campaigns are effective in either preventing or reducing the use of illegal drugs. Some analysts claim that media spots do not reduce drug use by minors as effectively as treatment or interdiction do. Furthermore, since nonprofit organizations, such as the Partnership for a Drug-Free America, already conduct educational programs about the dangers of drug use, ONDCP's campaign may duplicate private or local efforts.

Opponents of this option argue that educating young people about the hazards of illegal drug use is a national responsibility. Some point to the "Just Say No" campaign begun by former First Lady Nancy Reagan in the 1980s as an example of the successful use of the national media to raise young people's awareness of the dangers of drugs. They also argue that the cost of drug abuse to the country is so high that it is worthwhile to maintain a program that reduces drug use even slightly.

# 920

# Allowances

The President's budget and the Congressional budget resolution sometimes include amounts in function 920 to reflect proposals that are not clearly specified or that would affect multiple budget functions. Since the Congress actually appropriates money for specific purposes, there are no budget authority or outlay totals for function 920 in historical data. In this volume, function 920 includes options that cut across programs and agencies and would affect multiple budget functions.

## 920-01—Mandatory

# Charge Federal Employees Commercial Rates for Parking

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 140 | 140 | 140 | 150 | 150 | 720 | 1,540 |

The federal government owns or leases more than 200,000 parking spaces, which it allocates to its employees—in most cases at no charge. Requiring federal government employees to pay commercial rates for their parking could yield receipts of $140 million in 2004 and $720 million over five years.

Federal workers in the largest metropolitan areas would bear most of the new charges. Those in the Washington, D.C., area would pay about 75 percent of the total charge. (Federal employees in less commercially developed areas, where charging for parking is uncommon, would not face new parking fees.) Employees who continued to use federally owned or managed parking would, on average, pay about $130 per month; employees who currently use free or heavily subsidized parking could choose alternative means of transportation, such as public transit or carpooling, to avoid the charge.

Supporters of this option favor charging commercial rates for parking because it would encourage federal employees to use public transportation or to carpool. That shift would reduce the flow of cars into urban areas, cutting down on energy consumption, air pollution, and congestion. In addition, commercial pricing would indicate the demand for parking by federal workers more accurately, enabling the government to allocate spaces to those who valued them the most. Moreover, if commercial rates reduced the demand for spaces sufficiently, the government might be able to put the unused spaces to new, higher-valued uses. Finally, some supporters argue that the federal government should not provide a valuable commodity, such as parking, free to workers who could afford to pay for it.

Opponents of this option argue that by charging for parking, the government would unfairly penalize workers in urban areas who have difficulty obtaining access to alternative transportation or who drive to work for valid personal reasons. Charging for parking would also reduce federal employees' total compensation. In addition, opponents note that many private-sector employers provide free parking. Some people have also argued that charging commercial rates would merely redistribute the existing parking spaces without reducing the number of people who drive to work. According to that view, the spaces would simply be allocated by willingness to pay rather than by rank, seniority, or other factors.

RELATED CBO PUBLICATION: *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998

## 920-02—Discretionary

# Raise the Threshold for Coverage Under the Davis-Bacon Act

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 130 | 135 | 140 | 140 | 145 | 690 | 1,465 |
| Outlays | 50 | 125 | 170 | 195 | 210 | 750 | 1,900 |

Since 1935, the Davis-Bacon Act has required that "prevailing wages" be paid on all federally funded or federally assisted construction projects with contracts of $2,000 or more. The Department of Labor measures prevailing wages in an area according to the specific wages and benefits earned by at least 50 percent of workers in a particular type of job or the average of the wages and benefits paid to workers in that type of job. Those procedures, as well as the classifications of workers who receive prevailing wages, favor union wage rates in some cases.

In recent years, several bills have been introduced in the Congress that would raise the threshold for determining which projects are covered by the Davis-Bacon Act. This option would increase the threshold from $2,000 to $1 million. That change would save $50 million in discretionary outlays in 2004 and $750 million over the 2004-2008 period—provided that federal agencies' appropriations were lowered to reflect the anticipated reduction in costs. (The higher threshold would also save $1 million in mandatory spending in 2004 and $10 million over the five-year period.) In addition, it would reduce firms' and the government's administrative burden by restricting coverage to the largest contracts.

Supporters of this option argue that the threshold has remained the same for more than 65 years and that raising it would allow the federal government to spend less on construction. Moreover, this option could potentially increase the opportunities for employment that federal projects would offer to less-skilled workers.

Opponents of such a change note that it would lower the earnings of some construction workers. In addition, opponents argue that raising the threshold could jeopardize the quality of federally funded or federally assisted construction projects. They contend that since firms are required to pay at least the locally prevailing wage, firms are more likely to hire able workers, resulting in fewer defects in the finished projects and more timely completion.

## 920-03—Mandatory

# Impose a Fee on the Investment Portfolios of Government-Sponsored Enterprises

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Receipts | 1,480 | 1,554 | 1,631 | 1,713 | 1,798 | 8,175 | 18,610 |

Government-sponsored enterprises (GSEs) are private financial institutions chartered by the federal government to promote the flow of credit to targeted uses, primarily housing and agriculture. GSEs achieve their public purpose by raising funds in the capital markets on the strength of an implied federal guarantee and lending or otherwise conveying monies to retail lenders. Investors infer a federal guarantee of GSE obligations from provisions in the GSEs' charters, such as those that exempt the enterprises from state and local income taxes, render GSE securities eligible to serve as collateral for federal and other public deposits, and authorize the Secretary of the Treasury to purchase debt securities issued by the enterprises. The implicit federal guarantee—for which the federal government now collects no fee—lowers the cost of borrowing for the GSEs and conveys a subsidy that gives them a competitive advantage in financial markets.

Four GSEs—Fannie Mae, Freddie Mac, Farmer Mac, and the Federal Home Loan Banks—have used their privileged borrowing to acquire and hold large portfolios of securities. Those investments consist mostly of mortgage-backed securities but also include other asset-backed securities, corporate bonds, and mortgage revenue bonds. At the end of 2002, the investment portfolios of those four enterprises totaled $2 trillion, or 75 percent of their combined assets. The GSEs earn profits from the difference in yields on their investments and on their subsidized debt issues. Those profits, which owe much to the federal guarantee, accrue to shareholders and other GSE stakeholders.

This option would impose a fee of 10 basis points (10 cents per $100 of investments) on GSEs' investment portfolios. That change would provide the federal government with nearly $1.5 billion in added receipts in 2004 and $8.2 billion over five years. Those proceeds from the fee would equal about one-third of the federal subsidy estimated to be retained by equity investors and other stakeholders of the housing GSEs.

Proponents of imposing the fee could argue that doing so would promote competition in financial markets and recover some of the federal subsidy retained by the GSEs without reducing their capacity to achieve their public mission. For example, the fee would not restrict the housing GSEs' authority to guarantee mortgage-backed securities or prevent them from purchasing those securities, nor would it hamper the ability of the Home Loan Banks to make advances to members.

Opponents of this option might argue that the GSEs either do not receive a government subsidy or that they pass all of it through to targeted borrowers and, hence, should not be subject to a fee.

**RELATED CBO PUBLICATIONS:** *Letter to the Honorable Paul S. Sarbanes regarding the new-business assumption in the risk-based capital rule for Fannie Mae and Freddie Mac*, January 3, 2003; *Federal Subsidies and the Housing GSEs*, May 2001; *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*, May 1996; *The Federal Home Loan Banks in the Housing Finance System*, July 1993; and *Controlling the Risks of Government-Sponsored Enterprises*, April 1991

## 920-04—Discretionary

# Eliminate Cargo Preference

| (Millions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Savings | | | | | | | |
| Budget authority | 288 | 370 | 456 | 464 | 473 | 2,051 | 4,548 |
| Outlays | 243 | 347 | 434 | 458 | 469 | 1,950 | 4,431 |

The Cargo Preference Act of 1904 and other laws require that U.S.-flag vessels be used to carry certain government-owned or government-financed cargo that is shipped internationally. Eliminating that "cargo preference" would lower federal transportation costs by allowing the government to ship its cargo at the lowest available rates—saving $243 million in outlays in 2004 and nearly $2 billion over five years.

Two federal agencies—the Department of Defense (DoD) and the Department of Agriculture (USDA)—account for about 90 percent (by weight) of the government shipments subject to cargo preference laws. The preference applies to nearly all of DoD's freight and three-quarters of USDA's shipments of food aid, as well as shipments associated with programs of the Agency for International Development and the Export-Import Bank. Roughly 66 percent of the savings from eliminating cargo preference would come from defense discretionary spending, with the other 34 percent from nondefense discretionary spending.

Supporters of this option contend that cargo preference represents a subsidy of private vessels by taxpayers, which helps a handful of carriers preserve their market share and market power. Proponents also point out that DoD officials question the national security importance of the cargo preferences. DoD has invested in a fleet of its own specifically for transporting military equipment. It also contracts with foreign-flag ships when needed. In addition, this option's advocates argue that the U.S. government is at a competitive disadvantage in selling surplus agricultural commodities abroad because it must pay higher costs to transport them.

Opponents of this option argue that cargo preference promotes the economic viability of the nation's maritime industry. That industry has suffered from foreign competition in recent decades. Under federal law, U.S. mariners must crew U.S. vessels, and in general, U.S. shipyards must build them. Because U.S.-flag ships face higher labor costs and greater regulatory responsibilities than foreign-flag ships, they generally charge higher rates. Without guaranteed business from cargo preference, opponents contend, many U.S.-flag vessels engaged in international trade would leave the fleet. They would do so either by reflagging in a foreign country to save money or by decommissioning if they could not operate competitively. This option's opponents also argue that cargo preference helps bolster national security by ensuring that U.S.-flag vessels and U.S. crews are available during wartime. Finally, eliminating cargo preference could cause U.S. ship operators and shipbuilders to default on loans guaranteed by the government. (The possibility of such defaults is not reflected in the estimated savings from this option.)

CHAPTER

# 3

# Options That Affect Revenues

## Revenue Option 1

# Combine the Personal Exemption and the Standard Deduction

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | | | | | | | |
| Taxpayer only | 11.4 | 27.2 | 24.0 | 21.4 | 20.3 | 104.3 | 233.7 |
| Taxpayer and spouse | 15.7 | 37.5 | 33.1 | 29.7 | 28.3 | 144.3 | 328.7 |

Source: Joint Committee on Taxation.

To compute their taxable income under current law, taxpayers subtract personal exemptions and either the standard deduction or itemized deductions from their adjusted gross income (AGI). The law allows personal exemptions for the taxpayer, his or her spouse, and any dependents. In 2002, each personal exemption that a taxpayer claimed reduced AGI by $3,000. High-income taxpayers are treated differently, however; for them, the value of personal exemptions phases out above certain income thresholds.

Taxpayers may further reduce their AGI by claiming either the standard deduction or certain itemized deductions. In 2002, the standard deduction was $4,700 for single taxpayers and $7,850 for married taxpayers filing jointly. Itemized deductions are specific expenses that taxpayers are allowed to subtract from their income; they include contributions to charities, home mortgage interest, state and local income and property taxes, and certain medical expenses. Again, above certain income thresholds, the law reduces the value of itemized deductions for high-income taxpayers. In 1999, roughly two-thirds of tax returns (86 million) claimed the standard deduction, and the remaining 40 million claimed itemized deductions.

This option would combine the personal exemption for the primary taxpayer with the standard deduction to yield a higher standard deduction. A corollary option would add the personal exemption for the taxpayer's spouse to that combination to provide a higher standard deduction for married couples filing a joint return. Combining the primary personal exemption with the standard deduction would increase revenues by $104.3 billion over the 2004-2008 period; if the spousal exemption was included, revenues would increase by $144.3 billion over the five-year span.

Under this option, the tax liability of some people would rise, but most taxpayers' liability would be unaffected. Taxpayers who currently claim the standard deduction would see no change in their taxes. However, taxpayers who currently itemize but have itemized deductions that are less than the value of the combined personal exemption and standard deduction would choose to claim the combined standard deduction; as a result, their taxable income would rise by the amount that their itemized deductions exceeded the current standard deduction. Taxpayers who itemize and have itemized deductions above the combined value of the personal exemption and standard deduction would still choose to itemize, but they would see their taxable income increase by the amount of the personal exemption. High-income taxpayers who could not claim personal exemptions because of their income level would see no change in their tax liability.

By eliminating the primary personal exemption, the option would shift 9 million taxpayers from claiming itemized deductions to claiming the standard deduction; eliminating the personal exemption for a spouse would move an additional 5 million. Those taxpayers would no longer have to keep detailed records to justify their itemized deductions, which would lessen the complexity of the tax system. Proponents of this alternative might also argue that it would increase economic efficiency, since taxpayers who no longer itemized would not receive tax-favored treatment that lowered the after-tax price of selected goods, such as mortgage-financed, owner-occupied housing.

Opponents of this option would argue that the activities reflected in itemized deductions serve important purposes and should continue to be favorably treated under tax law. Some of those deductions are designed to encourage activities with social benefits, such as charitable giving, and a reduction in tax incentives for those activities, say opponents, would lead to less of them. Other itemized deductions, such as those for health expenses, casualty losses, and employee business expenses, are allowed because they lower a taxpayer's disposable income; deducting them more accurately measures a person's ability to pay income tax. Eliminating the tax reductions associated with those expenses for taxpayers who no longer itemize would create a less equitable tax system.

## Revenue Option 2

# Eliminate the Deductibility of Interest on Home-Equity Debt

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 2.4 | 5.7 |

Source: Joint Committee on Taxation.

The amount of mortgage interest that can be deducted from adjusted gross income is limited to the interest on up to $1 million of acquisition indebtedness and $100,000 of home-equity debt. (The limits do not apply to mortgages taken out before October 14, 1987.) As defined in the tax code, acquisition indebtedness is a mortgage that is used to buy, build, or substantially improve a primary residence or a second home. Home-equity debt is all other debt that is mortgaged against such homes. Eliminating the deductibility of interest on home-equity debt would raise $0.4 billion in revenues in 2004 and a total of $2.4 billion from 2004 through 2008.

Home-equity debt can arise either from taking out a home-equity loan or from refinancing an existing mortgage with a larger one. If a homeowner takes out a home-equity loan for more than he or she spends on home improvements at that time, the Internal Revenue Service (IRS) considers the excess loan to be home-equity debt. Similarly, if a homeowner refinances at a higher loan amount than the outstanding balance on his or her original loan, and spends less than the increase on home improvements, the IRS considers the excess to be home-equity debt.

Home-equity loans and refinancing have become common, but the IRS would not classify all of that borrowing as home-equity debt. In the late 1990s, 13 percent of homeowners had home-equity loans and 16 percent of homeowners with mortgages had cashed out some of their equity when they refinanced. Most loans and cash-outs were well below the $100,000 limit; only about one-fourth of either type was for $25,000 or more. Both types of borrowing are commonly used to pay for home improvements—and to that extent qualify as acquisition indebtedness—but they are also used to pay off other debts, to invest in businesses or real estate, and to finance household spending for automobiles, medical expenses, education, and vacations.

In general, taxpayers may not deduct from adjusted gross income so-called personal interest—that is, interest on credit card debt, car loans, and personal loans. An exception is made for home mortgages because of the public benefits that are believed to result from home ownership—for example, greater involvement in the community and better home maintenance. Allowing a deduction for interest on home-equity debt results in certain homeowners being able to circumvent the ban on deducting personal interest. Homeowners who itemize and who have sufficient equity in their homes can take out a home-equity loan to pay off credit card debt, buy a car, or cover other personal expenses. Renters and homeowners who do not have sufficient equity or do not itemize cannot circumvent the personal interest ban. That differential treatment is not only inequitable but also encourages greater indebtedness on the part of taxpayers who are allowed to skirt the restriction on deducting personal interest. Ending the deductibility of interest on home-equity debt would still leave substantial tax incentives to encourage home ownership. Such inducements include the continued deductibility of debt to buy, build, or improve a home; the absence of taxation on the value of the housing services that owners provide to themselves; and the exclusion from taxation of most capital gains realized on home sales.

The option has several drawbacks, however, that argue against its adoption. One is that it would subject many more homeowners to complex recordkeeping and tax-filing requirements. Today, only the relatively few owners who borrow more than $100,000 of home-equity debt must keep track of the proportion whose interest is deductible. But under this option, most owners who took

out home-equity loans or cashed out some of their equity when they refinanced would have to make those calculations.

A related drawback would be the cost of enforcing the option. Currently, the IRS enforces the $100,000 limit on home-equity debt primarily through audits, very few of which are conducted for that purpose. Few taxpayers violate the limit, so noncompliance is not a major problem. But under this option, enforcement would become more important because many more homeowners would be subject to a ban on deducting interest from home-equity debt. Furthermore, enforcement on a larger scale would require lenders to report more information than they do now and homeowners to provide documentation of their home-improvement expenses. (However, any substantial increase in enforcement by the IRS would bring in additional revenues beyond the estimates above, which were based on current levels of enforcement.)

Also of potential concern is that this option would treat owners who moved more favorably than owners who stayed put. Movers can borrow against their homes for other purposes by taking out a larger mortgage than they need to pay off the old mortgage and finance any increase in the price of the new home. The IRS considers all of that debt to be acquisition debt as long as the new mortgage is smaller than the price of the new home. Thus, an owner who did not move would gradually pay down his or her mortgage and not be able to deduct interest on borrowing to buy, say, a new car. But an owner who moved to a similarly priced house would be able to take out a mortgage equal to the debt on the old house plus the cost of the car. The mover could then use the extra money from the loan to pay for the car and deduct all of the interest payments.

Favoring owners who move not only seems inequitable but also encourages owners to relocate and therefore probably lessens their interest in becoming involved in their communities. In that way, the option undermines one of the primary purposes of allowing the mortgage interest deduction. The option also encourages homeowners to take out larger mortgages when they move than they otherwise would, which increases their chances of losing their home in the future.

## Revenue Option 3

# Eliminate Deferred Taxation of Like-Kind Exchanges

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.2 | 1.2 | 1.2 | 1.3 | 1.3 | 5.2 | 12.6 |

Source: Joint Committee on Taxation.

The tax code requires people who sell or exchange capital assets to report any capital gain or loss as part of their taxable income. An exception is exchanges of certain similar assets, mainly real estate. The law recognizes no gain or loss if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" that is to be held for the same reasons. In those exchanges, people carry over to the new property any gain that has accrued on the old asset, and they do not pay tax on that gain until the new property is sold. Like-kind real estate assets are broadly defined as any properties located in the United States.

In some exchanges, two owners swap like-kind property, but in many instances, a single owner sells one property to a second party and purchases a replacement property from a third. For those transactions to qualify as like-kind exchanges, the proceeds from the sale of the original property must be held outside the seller's control—for example, by a qualified intermediary—and used to purchase the replacement property. In addition, the like-kind replacement property must be identified within 45 days of the sale and purchased within 180 days.

By deferring taxation, the tax code treats capital gains from like-kind exchanges more favorably than gains that are made in trading many other assets. Any gain realized from selling one stock to purchase another, for example, or from selling a share in one partnership to purchase a share in another is taxable in the year of the exchange. Gains from trades of bonds, mortgages, and other debt instruments are similarly taxed. This option would eliminate the deferral for like-kind exchanges, making the tax system more equitable. That change would raise $0.2 billion in revenues in 2004 and a total of $5.2 billion from 2004 to 2008.

An argument that is sometimes used to justify the current treatment of like-kind exchanges is that the new property is a continuation of the same investment as the previous one and no tax should be levied until the owner leaves that line of investing. Also, it is argued, when owners simply swap property, without cash changing hands, no money becomes available for paying the tax. Furthermore, allowing like-kind exchanges helps property owners respond more easily to changing conditions in their lives or in property markets. But, as proponents of this option contend, those justifications apply as well to many exchanges of stocks, bonds, and partnership shares and therefore do not support treating real estate and certain other exchanges differently from exchanges of assets such as stocks and bonds.

One reason for either continuing the current treatment of like-kind exchanges or phasing it out slowly is that many investors purchased property with the understanding that they would be able to exchange it for other property without paying capital gains taxes. Changing the tax treatment abruptly would impose hardships on some investors and could depress property prices. Another reason for continuing the current treatment is that like-kind exchanges are not the only such transactions on which gains taxes are deferred: the tax code permits deferral on swaps of corporate equities in business mergers as well as on exchanges involving property that is condemned, destroyed, or stolen—known as involuntary conversions. As that term suggests, however, such transactions differ from like-kind exchanges by being largely beyond the property owner's control.

In the past, the Congress has considered limiting the amount of the gain that owners can defer under like-kind exchanges of real property. Proposals have also been made to defer gains only on exchanges of properties that are related or similar in service or use. Although that stricter standard already applies to gains on certain involuntary conversions, applying it on a broader scale would present problems in administration because of the extensive effort required to determine whether assets are similar in service or use.

**RELATED OPTIONS:** Revenue Options 4 and 43

## Revenue Option 4

# Limit Deductions for Charitable Gifts of Appreciated Property to the Gifts' Tax Basis

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.4 | 1.9 | 2.0 | 2.0 | 2.1 | 8.4 | 19.6 |

Source: Joint Committee on Taxation.

Under current law, taxpayers who itemize deductions may deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of their adjusted gross income in any year. Through that deduction, the federal government provides a significant incentive to support philanthropic activities. In addition to donating cash, taxpayers may contribute assets such as stocks or works of art. Taxpayers who contribute property that has appreciated in value receive special treatment under the tax code. As a general rule, if the taxpayer has held the property for more than 12 months, he or she may deduct its fair market value at the time of the gift—regardless of its original price.

This option would limit the deduction for appreciated property to its tax basis—the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. That change would increase revenues by about $0.4 billion in 2004 and more than $8.4 billion over five years.

The existing provision allows taxpayers to deduct the entire value of assets that they contribute to charities even though they have paid no tax on gains from the assets' appreciation. That arrangement treats the donation of appreciated assets more advantageously than other types of donations—for example, cash—and expands the preferential treatment of capital gains in the tax code (see Revenue Option 3). The current provision also encourages people to donate appreciated assets to eligible charities during their lifetime rather than leave them to their heirs at death.

**RELATED OPTION:** Revenue Option 3

**RELATED CBO PUBLICATION:** *Effects of Allowing Nonitemizers to Deduct Charitable Contributions*, December 2002

## Revenue Option 5

# Eliminate the Earned Income Tax Credit for People Who Have No Children

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | * | 0.7 | 0.7 | 0.8 | 0.8 | 3.0 | 6.9 |

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

Policymakers added the earned income tax credit (EITC) to the tax code in 1975 to supplement the wages of low-income families. Originally, the law applied only to families with one or more children. However, in 1994, the program was expanded to include a small credit for low-income individuals with no children. This option would eliminate the childless EITC, lessening the tax code's complexity and raising $3 billion in revenues over the 2004-2008 period.

For 2004, the tax credit is scheduled to phase in at a rate of 7.65 percent—the payroll tax rate for employees—over the first $5,110 of income, yielding a maximum credit of $391. (As an example, a qualifying individual with earnings of $2,000 would receive a credit of $153.) It then phases out at the same rate for earnings above specified thresholds—$7,150 for married couples filing jointly and $6,150 for all others. The phaseout range for the childless EITC begins at less than half the income threshold for families with children, which limits the number of people who are eligible for the credit. In 1999, 3.2 million taxpayers received credits averaging $200. Fewer than 400,000 people received the full credit. About 1.2 million recipients had income within the phase-in range, and roughly 1.6 million were in the phaseout range.

Proponents of this option might point out that in addition to raising revenues, it would eliminate a program that provided little benefit but posed a substantial administrative burden. The paperwork for the EITC is complicated, and almost every person eligible for the childless credit would not have to file a tax return if he or she were not claiming the credit.

Opponents of the option might contend that the credit, though small, provides some assistance to low-income workers. Eliminating the program would reduce government assistance to society's most financially needy individuals.

## Revenue Option 6

# Include Social Security Benefits in Calculating the Phaseout of the Earned Income Tax Credit

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues[a] | * | 0.2 | 0.2 | 0.2 | 0.2 | 0.8 | 1.6 |

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

a. Includes outlay savings.

Under current law, the earned income tax credit (EITC) phases out as the larger of earned income or adjusted gross income (AGI) exceeds a certain threshold. However, AGI excludes most income from government transfer programs such as Social Security, and as a result, low-income families that receive sizable transfers can claim the EITC with the same total income that will reduce or deny the credit to otherwise comparable families whose income is fully included in their AGI. The tax code already requires some Social Security benefits to be counted: for single taxpayers with income above $25,000 and joint filers with income above $32,000, AGI includes up to 85 percent of any Social Security benefits. This option would require taxpayers to include all Social Security benefits in a modified AGI that would be used for phasing out the EITC. That change would increase federal revenues and decrease outlays for the credit by $800 million over the 2004-2008 period.

One argument in support of this option is that it would make the EITC fairer. Counting all Social Security benefits in the calculation for phasing out the credit would give the same EITC to both low-income taxpayers who receive Social Security and claim the credit and otherwise comparable taxpayers whose income derives entirely from sources that are fully included in their AGI. In addition, because the Internal Revenue Service (IRS) already receives information on taxpayers' Social Security benefits, the administration of this option would require only minor procedural changes.

But the modified AGI would still exclude some transfer income; hence, this option would not resolve the problem that families with the same total income receive different credits. The IRS does not currently collect information on most forms of taxpayers' transfer income other than Social Security. As a result, requiring taxpayers to count all such income would substantially expand the information reported to the IRS and markedly increase taxpayers' "costs" of compliance (for example, time spent filling out forms). Furthermore, because most transfer income that is not included in AGI is from means-tested programs (which tie benefit eligibility to a test of need based on income and assets), counting all transfers in phasing out the EITC would offset, at least in part, the goal of providing support to low-income recipients. Even so, excluding transfers from the income measure used to phase out the credit would treat otherwise similar taxpayers differently.

Another consideration is that counting Social Security benefits for the EITC phaseout would increase the costs of compliance for Social Security recipients who claim the credit and would further complicate the already complex form such taxpayers must complete. Those outcomes would run counter to recent efforts to simplify procedures for claiming the earned income tax credit.

## Revenue Option 7

# Substitute a Tax Credit for the Exclusion of Interest Income on State and Local Debt

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.3 | 0.6 | 0.9 | 1.3 | 1.6 | 4.7 | 14.5 |

Source: Joint Committee on Taxation.

The tax code allows owners of state and local bonds to exclude the interest they earn on those bonds from their gross income and thus from income tax. As a result, state and local governments pay lower interest rates on such bonds than would be paid on bonds of comparable risk whose interest was taxable. The revenues that the federal government forgoes exceed $26 billion per year and effectively pay a portion of the costs that state and local governments incur when they borrow.

This option would replace the exclusion of interest income on new issues of state and local debt with a tax credit that, unlike most credits, would be included in adjusted gross income. Under the option, the bondholder would receive a taxable interest payment from the state or local government that issued the bond plus a federal tax credit that would provide the bondholder with an after-tax return comparable with that provided by a tax-exempt bond. The option would retain existing restrictions that now apply to the issuance of tax-exempt bonds. It would raise $0.3 billion in 2004 and $4.7 billion over the 2004- 2008 period.

Switching to a tax credit rather than excluding interest paid on state and local debt from the gross income of bond purchasers would have several effects. It could reduce state and local governments' borrowing costs by a percentage similar to the reduction that the exclusion provides but with a smaller loss of federal revenues. The loss would be smaller because switching to a credit would eliminate gains for bondholders in higher marginal tax brackets that exceed the investment return necessary to induce them to buy the bonds. In addition, the size of the tax credit could be varied to allow the Congress to adjust the size of the federal subsidy—on the basis of the perceived benefit to the public—for different categories of state and local borrowing. Nevertheless, substituting a tax credit for the exclusion would keep the federal subsidy akin to an entitlement.

Another effect of switching to a tax credit is that it might raise the interest rate on state and local government borrowing. For example, it would lower the bonds' after-tax returns for people with higher marginal tax rates and thus lead them to buy fewer bonds. If that drop in demand for bonds was not offset by increased demand from other investors, state and local borrowing costs would be reduced by a smaller percentage than they currently are, and interest rates on state and local debt would rise. Paying higher rates for borrowing could lead state and local governments in turn to reduce investments in capital facilities.

## Revenue Option 8

# Restrict the Tax Exclusion for Qualified Parking to Locations from Which Employees Commute in Vans and Carpools

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.7 | 0.8 | 0.8 | 0.8 | 0.8 | 3.9 | 7.9 |

Source: Joint Committee on Taxation.

The tax code allows employees to exclude from their taxable income the value of certain expenses for transportation that are paid by their employers. Those expenses include transportation in a van or other commuter highway vehicle, transit passes, and so-called qualified parking. (Qualified parking can be parking at or near an employer's place of business as well as parking provided at or near a place from which the employee commutes to work in a commuter highway vehicle or carpool.) The law limits the monthly amount that can be excluded from an employee's income to $100 for commuter highway vehicles and transit passes and $185 for qualified parking. In effect, the tax exclusion provides an incentive from the federal government (in the form of lower taxes) to use those means of transportation.

Under this option, employees would be able to exclude only their costs for parking at sites from which they continue on to work in a commuter highway vehicle or carpool and not their costs for parking at or near their job. The option would increase revenues by $0.7 billion in 2004 and $3.9 billion over the 2004-2008 period.

By raising the cost of commuting by private vehicle, this option could lead workers to drive less and thereby reduce air pollution and traffic congestion. Those outcomes might be more efficient than the current situation in which drivers do not bear the full cost of the pollution and congestion that they cause and so may drive more than is efficient. The incentive that the tax exclusion provides for parking at work exacerbates that problem by further encouraging workers to drive. Moreover, because the incentive for parking exceeds the incentive for mass transit, workers who would otherwise be indifferent to which of the two modes of transportation they used will choose to commute by car.

Some drivers would continue to drive to work even without the exclusion. For people who lack good alternatives to driving, eliminating it would be costly. Furthermore, the current incentive for mass transit may already offer an economically appropriate inducement for commuters to use public transportation rather than to drive. Finally, taxing the value of parking would increase the reporting required of employers and complicate the completion of tax returns for many workers.

**RELATED OPTIONS:** Revenue Options 36, 37, 38, and 39

## Revenue Option 9

# Include Employer-Paid Life Insurance in Taxable Income

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | | | | | | | |
| Individual income tax | 1.2 | 1.7 | 1.7 | 1.7 | 1.8 | 8.1 | 18.0 |
| Payroll tax | 0.6 | 0.9 | 1.0 | 1.0 | 1.1 | 4.6 | 10.3 |

Source: Joint Committee on Taxation.

Tax law excludes from taxable income the premiums that employers pay for employees' group term life insurance, but it limits that exclusion to the cost of premiums for the first $50,000 of insurance. (The exclusion is not available to self-employed people.) Of the fringe benefits that offer a tax advantage to their recipients, employer-paid life insurance is the third most expensive in terms of lost revenues (after health insurance and pensions). If premiums for employer-paid life insurance were included in employees' taxable income, individual income tax revenues would rise by $8.1 billion from 2004 through 2008, and payroll tax revenues would increase by $4.6 billion.

Excluding life insurance premiums from taxation has ramifications for both efficiency and equity. Like the tax exclusions for other employment-based fringe benefits, the exclusion for life insurance creates an incentive that induces people to purchase more life insurance than they would if they had to pay the full cost of it themselves. Furthermore, excluding premiums from taxation allows workers whose employers purchase life insurance for them to pay less tax than workers who have the same total compensation but must purchase insurance on their own. Those factors, which some people might view as arguments in support of this option, are reinforced by the relative ease with which it could be implemented. The value of employer-paid life insurance, unlike the value of some other fringe benefits, can be accurately measured and allocated. Employers could report the premiums they paid for each employee on the employee's W-2 form and compute withholding in the same way as for wages. Indeed, employers already withhold taxes on the life insurance premiums they pay that fund death benefits above the $50,000 limit.

Yet a tax incentive to purchase life insurance might be called for in certain circumstances. One such case might be if people bought too little life insurance because they systematically underestimated the potential financial hardship for their families that their death might bring. Whether, in fact, people purchase too little insurance for that reason is unclear. Moreover, even if too little life insurance was purchased, a more efficient way of encouraging people to buy it might be to extend the favorable tax treatment to all purchasers and avoid favoring only people with insurance provided by employers.

**RELATED OPTION:** Revenue Option 10

## Revenue Option 10

# Include Investment Income from Life Insurance and Annuities in Taxable Income

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 11.2 | 22.6 | 23.2 | 23.8 | 24.4 | 105.2 | 236.7 |

Source: Joint Committee on Taxation.

Life insurance policies and annuities often combine features of both insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which a person pays a single premium, or a series of premiums, and the company provides a series of fixed or variable payments to that person at some future time, usually during retirement.) The investment income from the money paid into life insurance policies and annuities, sometimes called inside buildup, is not taxed until it is paid out to the policyholder. If it is left to the policyholder's estate or used to pay for life insurance (in the case, for example, of whole-life policies), it can escape taxation entirely. The tax treatment of inside buildup is similar to the taxation of capital gains.

Under this option, life insurance companies would inform policyholders annually—just as mutual funds do now—of the investment income realized on their account, and people would include those amounts in their taxable income. As a result, disbursements from life insurance policies and benefits from annuities would no longer be taxable when they were paid. Making such investment income taxable as it was realized would raise $11.2 billion in 2004 and a total of $105.2 billion from 2004 through 2008; in addition, its tax treatment would then match that of income from a bank account, taxable bond, or mutual fund. Tax on the investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be deferred until benefits were paid.

By taxing the investment income from life insurance policies, this option would eliminate a tax incentive to purchase life insurance, which may or may not be useful. Encouraging such purchases would be desirable if people systematically underestimated the financial hardship that their death would impose on spouses and families. Such shortsightedness could cause them to buy too little life insurance or, similarly, too little annuity insurance to protect themselves against outliving their assets. However, there is little evidence of such shortsightedness.

A drawback of using tax-deferred savings as an incentive to purchase life insurance is that it provides no inducement to purchase term life insurance (because term insurance has no savings component). Under the assumption that some incentive to purchase insurance would, indeed, be useful, an alternative approach might be to encourage the purchase of life insurance directly, by giving people a tax credit for their insurance premiums or by allowing them to take a partial deduction. Annuities already receive favorable tax treatment through special provisions for pensions and retirement savings.

**RELATED OPTION:** Revenue Option 9

## Revenue Option 11

# Raise the Age Limit from 14 to 18 for Taxing Investment Income Under the Kiddie Tax

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | * | 0.1 | 0.1 | 0.1 | 0.1 | 0.4 | 0.7 |

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

Investment income that is received by a dependent child under age 14 and that exceeds specified limits is taxed at the parents' marginal rate (the rate of tax on the last dollar earned). In 2001, the applicable limit on such income was $1,500. The provision—often referred to as the kiddie tax—is intended to restrict parents' ability to reduce the income tax on their investment income by transferring ownership of income-producing assets to their young children. It does not, however, preclude parents from cutting their tax bill by giving such assets to children older than 13. Under current law, income from assets in the name of a child over age 13 is taxed at the child's rate, which is generally 10 percent or 15 percent, rather than at the parents' rate, which can be as high as 37.6 percent in 2004. As an example, the difference in rates on $10,000 in annual income from assets can cut the family's tax bill from $3,760 to $1,000, or by more than 70 percent.

This option would raise the age limit—from 14 to 18—below which a child's income from investments is taxed at the parents' rates. The option would increase income tax revenues by $400 million over the 2004-2008 period.

Extending the kiddie tax to the income of older children would help prevent parents from sheltering assets to reduce the taxes they have to pay. But the assets of older children may be their own. A teenager may have earned and saved a substantial amount of money or may have received sizable gifts. In that case, it is reasonable to tax the income from those assets at the child's rate rather than the parents'. Indeed, imposing the parents' higher rate could discourage teenagers from saving their earnings or gifts.

## Revenue Option 12

# Include in Adjusted Gross Income All Income Earned Abroad by U.S. Citizens

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.7 | 3.0 | 3.2 | 3.4 | 3.6 | 13.9 | 34.4 |

Source: Joint Committee on Taxation.

U.S. citizens who live abroad are required to file a tax return but may exclude from taxation some of the income they earn there—in 2002, up to $80,000 for single filers and as much as $160,000 for qualifying married couples. That exclusion, along with one for foreign housing and the usual personal exemptions and deductions, means that Americans residing abroad and earning close to $100,000 may not incur any U.S. tax liability, even if they pay no taxes to the country in which they reside. U.S. citizens with foreign-earned income above the exclusion amount also receive credits for taxes they pay to foreign governments, which may eliminate tax liability on that income under the U.S. tax system.

This option would retain the credit for taxes paid to foreign governments but include in adjusted gross income all income earned abroad by U.S. citizens residing there. Thus, under the option, Americans living in foreign countries that have tax rates higher than those in the United States would generally not owe U.S. tax on their earned income, whereas those living in relatively low-tax countries could have some U.S. tax liability. The option would increase revenues by $0.7 billion in 2004 and $13.9 billion over the 2004-2008 period.

Proponents and opponents of this option part company on issues of equity and efficiency. Proponents argue that U.S. citizens should pay U.S. taxes under this country's tax system because they still receive the benefits of citizenship, even as foreign residents. They also maintain that U.S. citizens with similar income should incur similar tax liabilities, regardless of where they live, and note the unfair advantage gained by individuals who have moved to low-tax foreign countries to escape U.S. taxation while retaining their American citizenship. In contrast, opponents note that U.S. citizens who live in other countries do not receive the same volume of government services that U.S. residents receive. They also argue that the exclusion of foreign-earned income makes it easier for U.S. multinational firms to find American employees who are willing to work and live abroad.

## Revenue Option 13

# Expand the Medicare Payroll Tax to Include All State and Local Government Employees

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.9 | 1.1 | 1.1 | 1.0 | 0.9 | 5.0 | 8.0 |

Source: Congressional Budget Office.

Certain groups of employees of state and local governments are not covered by Medicare on the basis of that employment and thus do not pay the Medicare payroll tax. (All federal employees have been covered since 1983, as required by the Tax Equity and Fiscal Responsibility Act of 1982.) The Consolidated Omnibus Budget Reconciliation Act of 1985 mandated that state and local employees who began work after March 31, 1986, pay Medicare payroll taxes, but it did not make coverage mandatory for people hired before that date. The Omnibus Budget Reconciliation Act of 1990 expanded Medicare tax coverage to include all state and local government employees who were not covered by a state or local retirement plan.

Making all state and local government employees who are not now covered under Medicare subject to the payroll tax would raise $0.9 billion in revenues in 2004 and a total of $5.0 billion from 2004 through 2008. The annual gain in receipts would decline gradually as employees who were hired before April 1986 left the payrolls of state and local governments.

Only one out of 10 state and local employees is not covered by Medicare through their employment, but most of those workers will still receive Medicare benefits when they retire because under current law, many of them will qualify for benefits on the basis of other employment in covered jobs or through their spouse's employment. As a result, requiring all state and local employees to pay Medicare payroll taxes could be justified on grounds of fairness. The program's broader coverage would lessen the inequity of the high levels of benefits received by those employees in relation to the payroll taxes they paid. Of course, expanding Medicare coverage to include more state and local employees would increase the federal government's liability for future benefits under the program.

## Revenue Option 14

# Calculate Taxable Wages in the Same Way for Both Self-Employed People and Employees

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | | | | | | | |
| On-budget | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 1.4 | 3.1 |
| Off-budget | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 1.0 | 2.2 |

Source: Congressional Budget Office.

Social Security and Medicare levies come in two forms: the Federal Insurance Contribution Act (FICA) tax paid on wages and the Self-Employment Contribution Act (SECA) tax paid on income from self-employment. Under FICA, employees and employers each pay a Social Security tax of 6.2 percent on wages up to a taxable maximum ($87,000 in 2003) and a Medicare tax of 1.45 percent on all wages. Until 1983, the SECA rate was lower than the combined employer and employee rate under FICA. As part of the Social Security Amendments of 1983, the Congress increased the effective SECA rates starting in 1984. The conference committee said that the law was "designed to achieve parity between employees and the self-employed" beginning in 1990.

Despite the Congress's stated intent, the current method for calculating SECA taxes allows a self-employed taxpayer to pay less tax than a worker with the same nominal income who is not self-employed. For example, an employee who earns $50,000 and his or her employer each pay $3,825 in FICA taxes, so that employee's total compensation is $53,825 (the employer's share is considered compensation), and the total FICA tax is $7,650. But if that worker's self-employed sibling also earned total compensation of $53,825, he or she would pay only $7,605 in SECA taxes, or $45 less than the employee sibling would pay. The difference arises because the self-employed sibling will have a calculated taxable income base that is lower than that of the employee sibling. Under current law, the income base on which self-employed people calculate their tax equals total compensation less 7.65 percent. Thus, the self-employed sibling pays taxes on $49,707, but the employee sibling pays taxes on $50,000.

Among people with earnings above Social Security's taxable maximum, workers who are self-employed pay the same amount of Social Security tax that employees pay, but they pay less Medicare tax. For example, an employee earning $100,000 and his or her employer each pay $5,394 in Social Security taxes and $1,450 in Medicare taxes, so that employee's total compensation is $106,844 and the total FICA tax is $13,688. That person's self-employed sibling—with the same total compensation—pays the same maximum Social Security tax but only $2,861 in Medicare taxes, or $39 less. (The self-employed person pays Medicare taxes on $96,824, whereas the employee pays Medicare taxes on $100,000.) High-income, self-employed taxpayers may pay as much as 6.3 percent less in Medicare taxes under SECA than employees with similar total compensation pay under FICA. That difference has existed since 1991, when the Congress first set the taxable maximum for Medicare higher than the taxable maximum for Social Security. Eliminating the difference would require a slight change in Schedule SE (the income tax form for reporting self-employment income), but it would directly affect only a relatively small percentage of self-employed taxpayers—those with income above the taxable maximum.

Changing the formula for calculating SECA taxes would increase on-budget revenues by $1.4 billion from 2004 to 2008. Off-budget SECA revenues, which are credited in the Social Security trust funds, would increase by $1.0 billion.

## Revenue Option 15

# Subject All Earnings to the Social Security Payroll Tax

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 66.0 | 91.8 | 97.2 | 103.4 | 109.9 | 468.4 | 1,128.4 |

Source: Congressional Budget Office.

Social Security—which is composed of the Old-Age, Survivors, and Disability Insurance (OASDI) programs—is financed by a payroll tax on employees, employers, and self-employed people. The receipts from that tax go to trust funds (essentially accounting mechanisms that the government uses to track receipts and spending for programs with specific taxes or other revenues earmarked for their use). Only earnings up to a specified maximum amount are taxed, although that amount automatically increases each year. (In 2003, the maximum amount of earnings taxed under Social Security is $87,000.) This option would make all earnings subject to the payroll tax, generating $66 billion in receipts in 2004 and a total of about $468 billion from 2004 through 2008. Some of those revenues, however, would be offset by the additional retirement benefits that Social Security would pay to people with income above the current law's maximum taxable amount.

When Social Security began in 1937, about 92 percent of the earnings from jobs covered by the program were below the maximum taxable amount. That percentage gradually declined over time because the maximum rose only occasionally, when the Congress enacted specific increases to it. In the 1977 amendments to the Social Security Act, the Congress raised the percentage of covered earnings subject to the tax to 90 percent by 1982 and also provided for an automatic increase in the ceiling each year thereafter equal to the growth in average wages. Despite that indexing, the fraction of taxable earnings has slipped over the past decade as a result of faster-than-average growth in the earnings of the highest-paid workers. In 2000, approximately 85 percent of earnings from employment covered by OASDI fell below the maximum.

Subjecting all earnings to the payroll tax, proponents of this option argue, would have several positive effects—for example, it would improve the balances of the OASDI trust funds. Proponents also contend that the option would increase the progressivity of the payroll tax. Because people who have income above the ceiling do not pay the tax on all of their earnings, they pay a lower share of their total income in payroll taxes than do people whose total earnings fall below the maximum. Making all earnings taxable would raise payroll taxes for high-income earners, making the tax more progressive. Although that change could also entitle people with earnings above the old maximum to higher Social Security payments when they retired, the additional benefits would be small relative to the additional taxes those earners would have to pay. An alternative option would maintain a cap on earnings subject to tax but raise it substantially above its current level of $87,000. Doing so would generate less additional revenue and increase the progressivity of the tax system by less than would a complete removal of the cap.

Opponents of this option could argue that improving the solvency of the trust funds on paper would not necessarily improve the economy's ability to pay future benefits, since the trust funds are only accounting mechanisms. Removing the earnings cap could also weaken the link between the taxes that workers pay into the system and the benefits that they receive, an important aspect of the Social Security system since its inception. Additionally, this option would reduce the rewards from working for people whose earnings are above the maximum now, because those earnings would become subject to the payroll tax. As a result, such workers would have an incentive to work less or to take more compensation in the form of fringe benefits that would not be subject to payroll taxes.

**RELATED CBO PUBLICATION:** *Social Security: A Primer*, September 2001—see pp. 42-43 for a more detailed discussion of trust funds.

## Revenue Option 16

# Eliminate the Source Rules Exception for Inventory Sales

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 1.8 | 4.2 | 4.5 | 4.8 | 5.2 | 20.5 | 52.5 |

Source: Joint Committee on Taxation.

U.S. multinational corporations generally pay U.S. tax on their worldwide income, including the income they earn from operations of their branches or subsidiaries in other nations. Foreign nations also tax the income from those operations, and the U.S. tax code allows multinational firms to take a limited credit for that foreign income tax. The credit is applied against what the firms would have owed in U.S. taxes on that income, but it cannot exceed what they would have owed if the income had been earned in the United States. If a corporation pays more foreign tax on its foreign income than it would have paid on otherwise identical domestic income, it accrues what the tax code calls excess foreign tax credits.

In contrast to income generated by operations abroad, the income corporations earn from products that are sold abroad but produced domestically results almost entirely from value created or added in the United States. Hence, the income that U.S. firms receive from exports typically is not taxed by foreign nations. But the tax code's "title passage" rule specifies that the source of a gain on the sale of a firm's inventory is the place to which the legal title to the inventory "passes." If a firm exports its inventory abroad, the title passage rule allocates the income from those sales in a way that, in effect, sources half of it to the jurisdiction in which the sale takes place and half to the place of manufacture. In practice, that means that if the firm's inventory is manufactured in the United States and sold abroad, half the income from the sale is still treated as though it were foreign in source—even though the firm may have no branch or subsidiary located in the place of sale and the foreign jurisdiction does not tax it.

The upshot of this rule is that a firm can classify more of its income from exports as foreign in source than could be justified solely on the basis of where the underlying economic activity occurred. A multinational firm with excess foreign tax credits can then use those credits to offset U.S. taxes on that foreign income. As a result, about half of the export income received by companies with such credits is effectively exempted from U.S. tax, and the income allocation rules essentially give U.S. multinational corporations an incentive to produce goods domestically for sale by their overseas subsidiaries.

This option would replace the title passage rule with one that apportioned income for the purpose of taxation on the basis of where a firm's economic activity actually occurred. The change would increase revenues by $1.8 billion in 2004 and $20.5 billion over the 2004-2008 period.

Export incentives, such as those embodied in the title passage rule, do not boost overall levels of domestic investment and employment, nor do they affect the trade balance. They increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. But the U.S. dollar appreciates as a consequence, making foreign goods cheaper and thereby reducing profits, investment, and employment for U.S. firms that compete with imports. Export incentives, therefore, distort the allocation of resources so that the prices of the goods they affect no longer reflect the goods' production costs (either domestically or abroad).

Foreign tax credits granted under U.S. tax law were intended to prevent business income from being taxed both domestically and abroad. But the title passage rule allows export income that is not usually subject to foreign tax to be exempted from U.S. taxes as well—which means that the income escapes business taxation altogether. Hence, allowing multinational corporations to use for-

eign tax credits to offset the U.S. taxes they would otherwise owe on export income may be an inappropriate use of such credits.

Opponents of eliminating the title passage rule base their position on a perceived need to provide U.S. corporations with an advantage over foreign corporations that operate in the same markets. However, corporations without excess foreign tax credits receive no advantage. Thus, the rule gives U.S. multinational exporters a competitive advantage over U.S. exporters that conduct all of their business operations domestically (and it gives U.S. multinational exporters that have excess foreign tax credits an advantage over those that do not).

**RELATED CBO PUBLICATION:** *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

## Revenue Option 17

# Make Foreign Subnational Taxes Deductible Rather than Creditable

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 2.6 | 6.0 | 6.3 | 6.6 | 6.9 | 28.4 | 67.4 |

Source: Joint Committee on Taxation.

Under current law, U.S.-owned corporations deduct state and local income taxes from their taxable income. However, they receive tax credits—a more favorable tax treatment in this instance than deductions—for income taxes that they pay to foreign governments, including foreign subnational governments such as foreign states, cities, and provinces. This option would treat income tax payments to foreign subnational governments the way payments to domestic state and local governments are treated. That change would increase tax revenues by $2.6 billion in 2004 and $28.4 billion over the 2004-2008 period.

Specifically, this option would continue to allow corporations to receive a credit for foreign taxes provided that those taxes exceeded a fixed percentage of either their foreign-source income or their foreign income taxes. That percentage would be set to reflect the overall ratio of state and local to federal income taxes within the United States. Taxes for which credits were denied would be deducted from a corporation's foreign-source gross income to yield its foreign-source taxable income. The option could be structured to either defer to or override existing tax treaties between the United States and foreign governments that call for other kinds of tax treatment.

Proponents of this option would probably argue that its main benefit would be to level the playing field between domestic and foreign investment. The option would accomplish that by reducing the slight incentive that U.S.-based multinational corporations now have to invest more abroad than at home, particularly in countries where the overall level of foreign income tax on a foreign investment is lower than the combined U.S. federal, state, and local taxes on a domestic investment. In turn, equalizing the tax treatment of foreign and domestic investment would allocate capital more efficiently worldwide.

In some respects, however, removing the creditability of income taxes paid to foreign subnational governments would have drawbacks. The option would make U.S. corporations operating in a foreign country less competitive with other foreign companies operating there and would probably lead some firms to repatriate less income from prior overseas investments to avoid paying the additional U.S. tax. Furthermore, if foreign countries implemented similar rules for taxing income that their corporations earned in the United States, those firms might curtail their U.S. investments, and the amount of capital flowing into the United States might decline.

**RELATED CBO PUBLICATION:** *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

## Revenue Option 18

# Set the Corporate Tax Rate at 35 Percent for All Corporations

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 2.4 | 3.7 | 3.7 | 3.4 | 3.0 | 16.2 | 32.1 |

Source: Joint Committee on Taxation.

Under current law, so-called C corporations pay taxes on their income under a progressive schedule of four explicit marginal tax rates: 15 percent, 25 percent, 34 percent, and 35 percent. (The marginal rate is the percentage of an extra dollar of taxable income that a corporation must pay in taxes.) This option would tax all corporate taxable income at the single statutory rate of 35 percent, raising $2.4 billion in revenues in 2004 and a total of $16.2 billion from 2004 through 2008. (Of note is that replacing the current rate structure with the maximum rate would make debt financing more favorable than equity financing for those firms that are subject to a higher rate. As a result, this option might have some repercussions on how firms raise capital.)

Under the progressive structure, corporate taxable income below $50,000 is currently taxed at the 15 percent rate. Taxable income from $50,000 to $75,000 is taxed at 25 percent, and income from $75,000 to $10 million is subject to a 34 percent rate. Corporations pay the top tax rate of 35 percent on taxable income in excess of $10 million. But additional taxes are added to the explicit rates, which reduces the progressivity of the tax structure. As a result, firms with taxable income of $18.3 million or more pay an average tax of 35 percent and receive no benefit from the progressive rate structure.

The progressive rate schedule for the corporate income tax was designed to encourage entrepreneurship and to provide some tax relief to businesses with small and moderate levels of profit. Of the approximately 1 million corporations that have positive corporate tax liabilities each year, only a few thousand do not benefit from the schedule's reduced rates. Yet those few thousand firms earn approximately 80 percent of all corporate taxable income.

People who might favor this option would argue that corporations other than small and medium-sized firms receive favorable treatment under the progressive rate structure. For example, the structure allows large corporations to shelter income or control the timing of income and expenses to reduce their taxable income for certain years. With the exception of owners of personal services corporations (such as physicians, attorneys, and consultants), whose firms are taxed at a flat rate of 35 percent, individuals can also benefit by sheltering income in the form of retained earnings in a small corporation.

Another argument against a progressive rate structure is that it favors firms that may have relatively low profits because they are inefficient. Except in the case of new or small firms, low profits may imply a low return on capital investment.

The earnings of C corporations are taxed twice, first at the corporate level and then at the individual level, if earnings are distributed to shareholders as dividends. Proponents of a progressive rate structure argue that it lessens the effect of that "double taxation." Corporations may be able to avoid double taxation by operating either as an S corporation or as a limited liability corporation (LLC). Owners of such enterprises pay tax on total business income but at the rates of the individual income tax. However, the top individual rate is now above the corporate tax rate, making it relatively less advantageous for businesses that retain earnings to choose the S corporate form or that of an LLC.

## Revenue Option 19

# Repeal the "Lower of Cost or Market" Inventory Valuation Method

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.2 | 0.6 | 0.6 | 0.6 | 0.3 | 2.3 | 2.9 |

Source: Joint Committee on Taxation.

The lower of cost or market (LCM) method of inventory valuation provides favorable tax treatment to firms that use the first-in, first-out approach to identifying inventory. Under the LCM method, firms are allowed to deduct from their taxable income unrealized year-end losses on items in their inventory that have declined in value. (The losses are unrealized because the items have not actually been sold.) For items that have increased in value, they are permitted to defer taxes on unrealized gains until the year in which the items are sold. Similarly, under the subnormal goods method of valuing inventory, firms may deduct inventory losses that arise from damaged or imperfect goods (or from similar causes), even if those goods may be sold and income realized in later years.

This option would repeal the LCM and subnormal goods methods of inventory valuation over a three-year period and require all firms to value their inventories at cost. (Under the cost valuation method, firms must include in taxable income both the gains and losses from any changes in the value of inventory when the goods are sold.) The option would increase revenues by $0.2 billion in 2004 and a total of $2.3 billion from 2004 through 2008.

Inventory valuation is an integral component of determining a firm's taxable profits, which in accounting terms are the difference between its receipts and the cost of the goods that it has sold. Under the accrual method of accounting, which firms typically use, the cost of goods sold is calculated by adding the value of the inventory at the beginning of the year to the cost of goods purchased or produced during the year and then subtracting from that total the value of the inventory at the end of the year. Firms may use either the LCM method or the cost method to value their inventory.

Under the LCM method, the market value of each item in a firm's inventory is compared with its cost; the lower of the two values must be used for that item. The value of a firm's inventory will be lower under the LCM method than under the cost method if the market value of any inventory item is below its cost. But the reverse is not true: inventory items that have appreciated in value over the year are still valued at their original cost. Using the resulting lower value for a firm's year-end inventory increases the cost of goods sold for a firm and lowers its taxable profits. In contrast, under the cost method of inventory valuation, gains and losses from changes in the value of inventory are included in taxable income only when the goods are sold.

Opponents of repealing the LCM method of inventory valuation argue that for firms that incur inventory losses without gains to offset them, the method provides a "cushion" during economic downturns or periods of uncertainty created by shifts in markets. A taxpayer with inventories that have dropped in value has incurred an economic loss. If that loss is deferred (not accounted for) until the inventory is subsequently sold, the taxpayer may be viewed as being overtaxed.

For firms that experience both inventory gains and losses, the LCM method provides favorable tax treatment. The asymmetric treatment of the gains and losses—firms can recognize losses without counting comparable gains—gives the LCM method a tax advantage over the cost method of accounting. As a result, a firm may claim a deduction for certain inventory losses even if the value of its entire inventory has increased. The LCM method has two other features that may offer unwarranted advantages to taxpayers that use it. First, once a firm has reduced the value of its inventory, current law does not require it to record an increase if market values subsequently rise. Second, market values under the LCM method are based on the replacement cost of inventory items, not on their resale value. Thus, the method allows a firm to reduce the value of inventory items if their replacement cost has declined—even though the firm may still be able to sell the inventory at a profit.

## Revenue Option 20

# Reduce Tax Credits for Rehabilitating Buildings, and Repeal the Credit for Nonhistoric Structures

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 1.0 | 2.4 |

Source: Joint Committee on Taxation.

The Congress has enacted tax credits for rehabilitating buildings to induce people to preserve historic structures, prompt businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit is 10 percent of expenditures on commercial buildings built before 1936 and 20 percent of expenditures on commercial and residential buildings that the Department of the Interior has certified as historic structures because of their architectural significance. This option would reduce the credit for historic structures to 15 percent and repeal the credit for nonhistoric structures, which would increase revenues by $0.2 billion in 2004 and by about $1.0 billion over the 2004-2008 period. Repealing both credits would raise about $2.5 billion over the same period.

Proponents and opponents of this option could mount several arguments to support their positions. On the one hand, proponents might say that the credits favor commercial structures over most rental housing and may therefore distort the allocation of capital. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining additional housing and commercial buildings. On the other hand, the option's opponents might contend that the credit may have social benefits when it encourages people to rehabilitate historically noteworthy buildings. The government could promote that objective at a lower cost, however, by permitting a credit only for renovating certified historic buildings and by lowering the credit's rate. Some surveys indicate that a credit of 15 percent would be sufficient to cover the extra costs involved in undertaking rehabilitation that satisfied regulatory standards for historic preservation.

## Revenue Option 21

# Tax Large Credit Unions Like Other Thrift Institutions

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.6 | 1.0 | 1.1 | 1.1 | 1.2 | 5.0 | 12.0 |

Source: Joint Committee on Taxation.

Credit unions are nonprofit institutions that provide their members with financial services—for example, they accept deposits and make loans. Originally, they were designed to be cooperatives whose members shared a common bond—in most cases, the same employer or the same occupation. Partly as a consequence of that distinction, federal income tax law treats credit unions more favorably than competing thrift institutions, such as savings and loans and mutual savings banks, by exempting their retained earnings from taxation. (Retained earnings are the portion of net income that credit unions reserve rather than pay out in dividends to members.) This option would tax the retained earnings of large credit unions —those with more than $10 million in assets—similarly to the way retained earnings of other thrift institutions are taxed, but it would permit small credit unions (less than $10 million in assets) to retain their tax-exempt status. The option would raise $0.6 billion in revenues in 2004 and a total of $5.0 billion from 2004 through 2008.

Initially, the retained earnings of credit unions, savings and loans, and mutual savings banks were all tax-exempt. In 1951, however, the Congress eliminated the exemptions for savings and loans and mutual savings banks on the grounds that they were similar to profit-seeking corporations. Since that time, large credit unions have come to resemble other thrifts. Beginning in 1982, credit union regulators have allowed a credit union to extend its services (subject to some restrictions) to members of organizations other than the one for which it was founded. In addition, most credit unions allow members and their families to participate even after a member has left the sponsoring organization.

The result of that relaxation of restrictions is that membership in credit unions has grown from about 5 million in 1950 to about 70 million today. Large credit unions, like taxable thrifts, now serve the general public and provide many of the services offered by savings and loans and mutual savings banks. A significant number of credit unions offer mortgages and car loans, access to automatic tellers, credit cards, individual retirement accounts, and discount brokerage services. They also resemble thrift institutions in that they retain earnings.

Proponents of taxing the retained earnings of large credit unions similarly to the way earnings of other large thrift institutions are taxed might argue for it on the basis of efficiency. Similar tax treatment of like institutions promotes competition and the provision of services at the lowest cost. Proponents might also raise the issue of equity: other thrift institutions contend that credit unions use their retained earnings to finance expansion.

Small credit unions are more like nonprofit organizations than like their larger counterparts, which supports the argument that their retained earnings should be tax-exempt, as those of nonprofit organizations are. Like those nonprofits, most small credit unions have members with a single common bond or association. And in some cases, their organizations are rudimentary: volunteers from the membership may manage and staff the credit union, and the level of services may not be comparable with what other thrifts offer. Allowing small credit unions to retain their tax exemption for retained earnings would affect 8 percent of all assets in the credit union industry and about two-thirds of all credit unions. However, a difficulty encountered in taxing the assets of large credit unions but allowing the assets of small ones to remain tax-exempt is that the $10 million cutoff in asset size could be viewed as arbitrary.

## Revenue Option 22

# Repeal the Expensing of Exploration and Development Costs for Extractive Industries

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 2.9 | 3.9 | 3.0 | 2.1 | 1.2 | 13.1 | 15.7 |

Source: Joint Committee on Taxation.

Through various tax incentives, the current tax system treats extractive industries (producers of oil, gas, and minerals) more favorably than most other industries (see Revenue Option 23). One incentive designed to encourage exploration and development of certain types of oil, gas, and hard minerals allows producers of those commodities to "expense" some of their exploration and development costs (deduct them from their taxable income when they are incurred) rather than capitalize them (deduct them over time as the resulting income is generated). Eliminating the expensing of those costs would raise $2.9 billion in revenues in 2004 and a total of $13.1 billion from 2004 through 2008. (The option incorporates the assumption that firms could still expense some of their costs, specifically those from unproductive wells and mines.)

Immediately deducting costs contrasts with the tax treatment that other industries face, in which costs are deducted more slowly, according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs related to property to be either deducted when the property is sold or recovered over several years as depreciation. (In both cases, the deducting of costs is postponed.) However, so-called intangible costs (for example, maintenance of working capital) related to drilling and development and costs for mine development and exploration are exempt from those rules. Thus, the expensing of such costs provides an incentive for extractive industries that other industries do not have. (See Revenue Options 25 and 26 for other exceptions.)

Costs for exploration and development that extractive firms can expense include costs for excavating mines, drilling wells, and prospecting for hard minerals—but not for oil and gas. Although current law allows independent oil and gas producers and noncorporate mineral producers to fully expense their costs, it limits expensing to 70 percent of costs for "integrated" oil and gas producers (companies involved in substantial retailing or refining activities) and corporate mineral producers. Firms subject to the 70 percent limit must deduct the remaining 30 percent of their costs over 60 months.

The rationale for expensing the costs of exploration and development has shifted from its original focus. When the incentive was put in place, the argument was that such costs were ordinary operating expenses. Today, advocates of continuing the incentive justify it on the grounds that oil and gas are "strategic minerals," essential to national energy security. But expensing works in several ways to distort the allocation of resources. First, it causes resources to be allocated to drilling and mining that might be used more productively elsewhere in the economy. Second, although the incentive might make the United States less dependent on imported oil in the short run, it encourages producers to extract more now—perhaps at the cost of extracting less in the future and having to rely more on foreign production. Third, expensing may result in production being allocated inefficiently within these extractive industries. Inefficiency may occur because the magnitude of the incentive varies depending on factors that are not systematically related to economic productivity—such as the difference between the immediate deduction and the true useful life of the capital—as well as on whether the producer must pay the alternative minimum tax (in which case expensing is limited).

**RELATED OPTIONS:** 300-03; Revenue Options 23, 24, 25, and 26

**RELATED CBO PUBLICATION:** *Reforming the Federal Royalty Program for Oil and Gas*, November 2000

## Revenue Option 23

# Repeal Percentage Depletion for Extractive Industries

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.9 | 2.3 |

Source: Joint Committee on Taxation.

The current tax system in various ways favors extractive industries (producers of oil, gas, and minerals) over most other industries. One way is by allowing producers to deduct immediately, rather than over time, the costs they incur for exploration and development (see Revenue Option 22). Another is by allowing some firms to use the "percentage depletion" method to recover their costs rather than the standard "cost depletion" method. This option would repeal percentage depletion, raising $0.1 billion in revenues in 2004 and about $0.9 billion over the 2004-2008 period.

The percentage depletion method of cost recovery is a tax incentive provided to certain types of extractive companies—independent producers, owners of royalties, and "nonintegrated" firms (companies that are not involved in substantial retailing or refining activities). The tax code allows those firms to deduct from their taxable income a certain percentage of a property's gross income in each taxable year, regardless of the property's actual capitalized costs (that is, the deduction that should occur over time). In contrast, other industries (and, since 1975, integrated oil companies as well) use the cost depletion method. Under that approach, the costs that a firm recovers cannot exceed its expenses for acquiring and developing the property; under percentage depletion, they may. Thus, the percentage depletion method treats certain types of extractive companies more favorably than others. Unlike the expensing of exploration and development costs, however, percentage depletion applies only to a small portion of total oil, gas, and minerals production because it excludes the large integrated producers.

Current law typically allows nonintegrated oil and gas companies to deduct 15 percent of their gross income from producing oil and gas, up to a ceiling of the income from 1,000 barrels per day. But the Omnibus Budget Reconciliation Act of 1990 made percentage depletion even more generous for nonintegrated companies that are considered "marginal" producers (those with very low total production or production entirely made up of heavy oil). The deduction for marginal properties can be up to 25 percent of gross income if the price of oil drops low enough. Producers of hard minerals may also use percentage depletion, but the statutory deduction percentages vary from 5 percent to 22 percent, depending on the type of mineral. Tax law limits the amount of percentage depletion to 100 percent of the net income from a property with oil and gas and 50 percent of the net income from a property with hard minerals.

Percentage depletion has been justified on the grounds that oil and gas are "strategic minerals," essential to national energy security. But that method of recovering costs distorts the allocation of resources by encouraging more production in the oil and gas industry than among other types of firms. And, like expensing, percentage depletion can cause extractive businesses to allocate their resources inefficiently—for example, by developing existing properties rather than exploring for and acquiring new ones.

**RELATED OPTIONS:** 300-03; Revenue Options 22 and 24

**RELATED CBO PUBLICATION:** *Reforming the Federal Royalty Program for Oil and Gas*, November 2000

## Revenue Option 24

# Repeal the Tax Credit for Enhanced Oil Recovery Costs, and Eliminate the Expensing of Tertiary Injectants

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.5 | 0.7 | 0.6 | 0.6 | 0.6 | 3.0 | 5.8 |

Source: Joint Committee on Taxation.

Oil producers currently receive a tax credit of 15 percent against their costs for recovering domestic oil by a qualified "enhanced oil recovery" (EOR) method. Qualifying methods are those that allow producers to recover oil that is too viscous to be extracted by conventional methods. The costs of labor, materials, equipment, repairs, and development as well as so-called intangible costs related to drilling qualify for the credit, which phases out when oil prices rise above $28 per barrel (adjusted for inflation).

The tax code also provides another incentive related to viscous oil. It allows producers to "expense" the costs of tertiary injectants—the fluids, gases, and other chemicals that are injected into oil or gas reservoirs to extract highly viscous oil. Producers may deduct the full cost of those chemical injectants in the year in which they are used to extract oil. The expenditures for injectants also qualify for the EOR credit; however, the credit must be subtracted from the deduction if both are claimed for the same expenditure. Eliminating both the EOR credit and the expensing of tertiary injectants would increase revenues by $0.5 billion in 2004 and $3.0 billion over the 2004-2008 period.

The Congress enacted the EOR credit as part of the Omnibus Budget Reconciliation Act of 1990. It was designed to increase the domestic supply of oil and reduce the demand for imported oil, particularly from producers in the Persian Gulf and other politically unstable areas. Legislators enacted the expensing of tertiary injectants in 1980 for similar reasons. However, without the tax incentives provided by the credit and expensing, the use of tertiary injectants to extract oil would not be economical, and enhanced oil recovery would not be an economically viable extraction approach (because it is more expensive than recovering oil by conventional methods).

Advocates of retaining both provisions say they provide several benefits: they lower the cost of producing oil by unconventional, more-expensive methods and enable producers to increase the extractable portion of a reservoir's oil beyond the normal one-third to one-half. Increased domestic production lessens short-term dependence on foreign oil, but it also depletes domestic resources, encouraging long-term dependence on imports. Indeed, opponents of the tax incentives argue that these provisions are unlikely to reverse either the long-term slide that has occurred in domestic production or the nation's growing dependence on imports. They also contend that the United States is now less vulnerable to disruptions in supply because it stockpiles oil in the Strategic Petroleum Reserve and world oil markets have become increasingly competitive.

**RELATED OPTIONS:** 270-08; Revenue Options 22, 23, and 26

**RELATED CBO PUBLICATION:** *Climate Change and the Federal Budget*, August 1998

## Revenue Option 25

# Repeal the Partial Exemption from Motor Fuel Excise Taxes Now Given to Alcohol Fuels

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.8 | 0.8 | 0.9 | 0.9 | 1.0 | 4.4 | 9.8 |

Source: Joint Committee on Taxation.

The tax code imposes excise taxes on motor fuels, but it partially exempts from those levies fuels that are blends of gasoline and alcohol (and that as a result have a higher oxygen content than gasoline alone). Repealing that partial exemption would raise $0.8 billion in revenues in 2004 and $4.4 billion over the 2004-2008 period. Those estimates incorporate the assumption that the Congress would also repeal the alcohol fuels credit, which producers may claim instead of the partial excise tax exemption. In almost all cases, however, the credit is less valuable than the exemption and is rarely used.

The tax incentive that the exemption represents applies only to blends that use alcohol fuels produced from nonfossil, or renewable, sources. One such fuel is ethanol, which is made primarily from corn and sugar. When used as a fuel, ethanol is eligible for a nonrefundable reduction in the excise tax—through the credit or the exemption—of up to 53 cents per gallon. The magnitude of the reduction depends on the percentage of alcohol in the fuel. For example, the exemption for gasohol, which is 90 percent gasoline and 10 percent ethanol, is 5.2 cents per gallon from the excise tax on gasoline of 18.3 cents per gallon. (The exemption goes to the firm that blends the ethanol with the gasoline.) It was first enacted in the 1970s and was scheduled to expire at the end of fiscal year 1999. But the Transportation Equity Act of 1998 extended it while gradually lowering the maximum amount. Thus, the exemption drops to 5.2 cents per gallon for 2003 to 2004 and 5.1 cents per gallon for 2005 to 2007. The entire exemption for gasohol is now scheduled to expire at the end of fiscal year 2007.

The tax inducement had several main purposes when it was first enacted. One was to reduce the demand for imported oil, thereby lessening U.S. dependence on foreign sources. Another was to provide an additional market for U.S. agricultural products by encouraging firms to produce ethanol domestically. Judging by sales of the motor fuel blends, the tax incentive appears to have successfully encouraged energy producers to substitute ethanol for gasoline.

Today, as the incentive's supporters argue, the major justification for it is that using oxygenated fuels in motor vehicles generally produces less carbon monoxide pollution than using gasoline does. Those proponents might also point to the effect that repealing the incentive could have on federal outlays for price support loans for grains. Without the tax inducement to produce corn for ethanol, the price of corn might fall, which could lead the government to step in to help farmers. But any increase in outlays for price support loans, which is not included in the budget estimates for this option, would probably be much smaller than the projected boost in revenues from repealing the tax incentive.

Regulations now in place under the Clean Air Act Amendments of 1990, which mandate the minimum oxygen content of gasoline in areas with poor air quality, raise questions about the continued need for the incentive. Further contributing to those questions are actions by the Environmental Protection Agency, which support the use of ethanol to meet the standards for oxygen content by restricting the use in gasoline of MTBE (an alcohol fuel derived from fossil fuel sources). Another argument for repealing the exemption is that ethanol is more costly to produce than gasoline. The partial exemption might be economically inefficient if the added cost outweighed the value of the reduction in air pollution.

**RELATED OPTIONS:** 270-01, 270-03, and 270-07; Revenue Options 22 and 35

**RELATED CBO PUBLICATION:** *Reducing Gasoline Consumption: Three Policy Options*, November 2002

## Revenue Option 26

# Capitalize the Costs of Producing Timber

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 2.4 | 4.6 |

Source: Joint Committee on Taxation.

The current tax system allows timber producers to deduct from their taxable income, or "expense," most of the costs of maintaining a stand of timber when those costs are incurred. (Such expenses include disease and pest control, brush clearing, and indirect carrying costs such as interest on loans and property taxes.) That tax treatment contrasts with the uniform capitalization rules that apply to such costs in most other industries. (See Revenue Options 22 and 24 for other exceptions to the rules.) Established under the Tax Reform Act of 1986 (TRA-86), the uniform capitalization rules require that production costs be deducted only when goods or services are sold. When businesses are allowed to expense those costs (deduct them immediately), the effective tax rate on a producer's investment in them is zero. Thus, timber producers pay no tax on any income they use to cover those costs, and the tax code in effect favors timber production by deferring taxes that producers otherwise would owe on their income. (Under certain circumstances, however, the tax code limits losses from passive business activities, which may greatly curtail the deferral granted to noncorporate producers of timber.)

This option would capitalize costs incurred after December 31, 1999, for producing timber. It would raise $0.4 billion in revenues in 2004 and a total of $2.4 billion from 2004 through 2008 by accelerating tax payments from timber producers.

Various rationales have been offered for expensing the costs of timber production. The original justification was a general perception that such costs were for maintenance and thus deductible as ordinary costs of a trade or business. When TRA-86 established uniform capitalization rules for other industries, one reason given for exempting timber production was that applying the rules to that industry might have been unduly burdensome. But the exemption comes with an economic price. Allowing timber producers to expense their production costs distorts investing in two ways: more private land is devoted to timber production than might otherwise have been the case, and trees are allowed to grow longer before they are cut (because producers do not have to harvest them quickly to finance their costs). Those outcomes could be considered beneficial if timber growing offered spillover benefits to society that market prices did not take into account. Otherwise, the tax-favored treatment would lead to inefficiency in both the use of land and the rate of harvesting.

Whether timber production offers important spillover benefits is unclear. Standing timber provides some benefits by deterring soil erosion and absorbing carbon dioxide (a gas linked to global warming)—but producing and disposing of wood and paper products contribute to pollution.

In the short run, capitalizing the costs of timber production might lower the price of domestic timber because producers would have an incentive to harvest trees earlier. In the longer run, however, it would raise prices and lower the value of the land used to grow timber. Another effect of capitalizing costs is that lease payments to private landowners by timber growers would probably decline, causing some land that historically has been devoted to growing timber to be used in other ways.

**RELATED OPTIONS:** 300-01; Revenue Options 22 and 24

## Revenue Option 27

# Tax the Income Earned by Public Electric Power Utilities

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.5 | 0.7 | 0.7 | 0.7 | 0.8 | 3.4 | 7.6 |

Source: Joint Committee on Taxation.

The income that local governments earn from any public utility, including electric power facilities, is exempt from federal income tax. In contrast, the income of investor-owned utilities is taxable. Taxing the income of public facilities for generating, transmitting, and distributing electricity similarly to the income of investor-owned facilities would raise $0.5 billion in revenues in 2004 and a total of $3.4 billion from 2004 through 2008.

In the past, electricity was provided by local monopolies, in part to take advantage of cost-saving economies of scale. Some of those utilities were public facilities, which developed for a variety of reasons. For example, public facilities offered a feasible alternative in geographic areas where low population density caused the cost of power per customer to be high and private producers were reluctant to enter a market in which the potential for profit appeared inadequate. Public utilities also developed in areas where citizens, worrying that a private provider might exploit its position as a monopoly, wanted to ensure that electricity would be available to all residential consumers at a reasonable cost.

But times and circumstances change. States are in varying stages of deregulating electric power generation, in part because improved technologies have lessened the importance of economies of scale and in part because electric service is almost universal in this country, even in areas of low population density. And the competition that the industry's restructuring brings, say advocates of this option, will protect consumers from monopolistic pricing by private firms.

Proponents of this option would contend that economic and technological changes, combined with the fact that approximately 75 percent of electric power is already provided by the private sector, cast doubt on the benefits society receives from public-sector involvement in this market. Even less clear are the benefits that federal taxpayers receive from treating the earnings of public providers of electricity more favorably than the earnings of private providers. Proponents might also argue that taxing publicly owned electric power facilities will spur competition, result in consumption of an economically efficient amount of public power, and preserve the corporate tax base.

One argument for exempting public power's income from taxation has been that it is a way to keep the price of power low and thus reduce the power costs of lower-income people. But treating public utilities' income more favorably than other utilities' is an inefficient way of accomplishing that. The federal government helps lower-income groups more directly with programs such as the Low Income Home Energy Assistance Program of grants to the states.

Taxing the income of public electric utilities might adversely affect consumers in some communities who rely on that source for their power. The tax would cause the price of publicly provided electricity to rise, and public utilities that found themselves uncompetitive might have to shut down some facilities that were inefficient. If those facilities were being financed with debt that had not yet been retired, state and local taxpayers could be left with significant costs. Further complicating a change such as the one described in this option are the numerous legal and practical issues that would have to be resolved if the federal government taxed income earned from what might be termed business enterprises of state and local governments.

**RELATED OPTIONS:** 270-05, 270-06, and 270-09; Revenue Options 30 and 31

## Revenue Option 28

# Tighten Rules on Interest Deductions for Corporate-Owned Life Insurance

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.2 | 0.5 | 0.5 | 0.6 | 0.6 | 2.4 | 5.8 |

Source: Joint Committee on Taxation.

Corporations purchase life insurance policies in part to protect their firms against financial loss in case one or more of their important employees or owners dies. Purchases of life insurance that builds up a cash value provide a tax advantage if corporations pay the premiums on the policies indirectly (by increasing debt or other liabilities) and then deduct the interest they pay on that debt from their taxable income. The Internal Revenue Service will not allow corporations to deduct that interest if it can link a firm's increases in debt or other liabilities directly to its purchase of cash-value insurance. Establishing a direct connection is difficult, however, because firms increase their liabilities for many purposes.

This option would disallow a proportion of a firm's total deductions for interest equal to the proportion of its total assets invested in cash-value life insurance policies. The option would not apply to insurance on the life of owners who had an interest of 20 percent or more in the firm. It would raise an estimated $0.2 billion in revenues in 2004 and $2.4 billion over the 2004-2008 period.

The tax code's asymmetrical treatment of the investment income that a corporation receives from life insurance policies and its costs in relation to those policies is the source of the tax advantage. First, tax law exempts the investment income (termed the "inside buildup") of a life insurance policy from corporate income tax. Second, it permits a corporation to deduct from its taxable income the interest on debt that is indirectly used to finance that investment. Such an approach opens the door to tax arbitrage (broadly, gaining advantage from asymmetrical treatment of gains and losses in the tax code) because corporations can generate interest deductions that they can then use to shelter other, taxable income. Individual taxpayers may not avail themselves of that advantage because the tax code does not allow them to deduct those interest payments.

Over the past several years, corporations have been restricted from using life insurance policies to shelter income. After 1996, they could no longer deduct the interest on loans from an insurance company that used the cash-value policy as collateral. (An exception was made, however, for insurance on certain key employees.) In 1997, the Congress and the President enacted a law that disallowed a proportion of a corporation's interest deductions, but the law applied only to firms that purchased cash-value insurance on the lives of people who were not employees or owners. This option would further prohibit such deductions except for purchases of insurance on the lives of people who own at least 20 percent of a firm. (This kind of disallowance has been used in other contexts as well. In 1986, a proportion of interest deductions was disallowed for financial institutions that purchase debt issued by state and local governments whose interest is tax-exempt.)

Opponents of this option argue that a firm may have legitimate business reasons to purchase life insurance policies on its employees and owners as well as other business reasons to issue debt, and that the firm may not be linking the two decisions to create a tax shelter. Proponents of the option argue, however, that firms in most cases intend to use the policies and debt to shelter income from taxation.

## Revenue Option 29

# Repeal Tax-Free Conversions of Large C Corporations to S Corporations

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.5 | 1.0 |

Source: Joint Committee on Taxation.

For tax purposes, the predominant forms of business enterprise are C corporations, S corporations, partnerships, and sole proprietorships. Under current law, a C corporation may reduce taxes on some of its income by electing to be treated as an S corporation or by converting to a partnership. The income of C corporations faces a two-tiered corporate tax; that is, it is generally taxed twice—once when it is earned by the corporation and again when it is distributed to stockholders. Income received by S corporations and partnerships, in contrast, is taxed only once, at the individual income tax rates of the firms' owners.

Over time, the distinction between S corporations and partnerships has blurred. Nevertheless, a C corporation that elects to change its tax filing status to that of an S corporation is treated more favorably than a C corporation that converts to a partnership. Converting to an S corporation is tax-free in many circumstances. Converting to a partnership is taxable; it requires the corporation to "recognize" (include in its taxable income) any built-in gain on its assets and requires shareholders to recognize any such gain in their corporate stock. Under section 1374 of the Internal Revenue Code, if a C corporation converts to an S corporation, the appreciation of the firm's assets while it was a C corporation is not subject to the corporate-level tax—unless the assets are sold within 10 years of the conversion. Thus, current law allows a C corporation to avoid the two-tiered corporate tax by converting tax-free to an S corporation.

This option would repeal tax-free conversions for corporations with a value of more than $5 million at the time of conversion. Thus, when a C corporation with a value of over $5 million converted to an S corporation, the corporation and its shareholders would immediately recognize the gain in their appreciated assets. This option would increase income tax revenues by $0.1 billion in 2004 and $0.5 billion over the 2004-2008 period.

Proponents of this option might argue that repealing tax-free conversions by C corporations would treat economically similar conversions—from two-tiered corporate tax systems to single-tiered systems—in the same way. That equalization would, in turn, make tax considerations less important in decisions about the legal form that a firm might take. However, people who think S corporations more closely resemble corporations than they do partnerships might consider it beneficial to preserve the current differential tax treatment. According to that viewpoint, current law merely allows a corporation to change its filing status from that of a C corporation to that of an S corporation, providing it meets the legal requirements, without having to pay tax for choosing a different corporate form.

## Revenue Option 30

# Tax the Income of Cooperatively Owned Electric and Telephone Utilities

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.5 | 0.8 |

Source: Joint Committee on Taxation.

Electric and telephone cooperatives, which are owned by their customers, are effectively or explicitly exempt from the corporate income tax. They pay no tax on the portion of their income that they are required to distribute as dividends to their members, and they pay no tax on earnings from other sources, as long as at least 85 percent of their income comes from members for providing their primary service (electricity or telephone). Moreover, some forms of outside income—including rental income from telephone poles that are leased to cable or telephone companies and income from the Yellow Pages, cable TV, and Internet access—are not even counted toward the remaining 15 percent.

Eliminating those exemptions, which essentially treat electric and telephone cooperatives more favorably than privately owned electric and telephone utilities, and taxing the co-ops as ordinary for-profit corporations would raise $0.1 billion in 2004 and $0.5 billion over the 2004-2008 period. In addition to exempting the co-ops' income from the corporate income tax, current law does not levy taxes on their distributions of dividends to members—whether as cash or as payments in kind in the form of household utility services. Eliminating that exemption could generate additional revenues.

The tax breaks given to co-ops, along with the low-interest loan program available through the Rural Utilities Service, were created to encourage the wiring of rural areas for service. But now that most of the nation has telephone service, and the use of cell phones is widespread, there is little justification for the co-ops' tax-favored status. As for electricity, most of the United States is already connected to the nationwide electricity grid, and the cost to distributors of providing electricity is probably the same for rural and urban customers. Moreover, the income of all electric cooperatives is exempted from taxation—even that of generation co-operatives, which do not need the favorable treatment (because generating electricity does not cost more in rural areas). Finally, the market for electricity has been partially deregulated in the past few years. Continuing to provide this tax exemption in a more competitive environment gives cooperatives an advantage over utilities that are investor owned and that pay corporate income taxes.

Arguing against this option are its potential consequences for the co-ops' customers. If the tax exemption was withdrawn and cooperatively owned electric and telephone utilities had to pay the same corporate income tax that other suppliers of electricity pay, rates might increase for the cooperatives' customers. Ending the exemption would also raise issues related to equity. Subjecting electric and telephone co-ops to taxes that most other co-ops do not pay would treat some kinds of firms more favorably than other, similar operations.

**RELATED OPTIONS:** 270-05, 270-06, and 270-09; Revenue Options 27 and 31

**RELATED CBO PUBLICATIONS:** *Electric Utilities: Deregulation and Stranded Costs*, October 1998; and *Should the Federal Government Sell Electricity?* November 1997

## Revenue Option 31

# Eliminate the Exemption of Interest Income on Debt Issued by State and Locally Owned Electric Utilities for New Generating or Transmitting Facilities

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | * | 0.1 | 0.1 | 0.2 | 0.2 | 0.6 | 2.3 |

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

State and locally owned utilities, as well as a small number of investor-owned utilities, issue tax-exempt bonds to finance the generation and transmission of electricity. Because the interest that utilities pay on those bonds is not taxed, investors are willing to accept a lower yield than they would otherwise require to purchase those securities. By allowing some utilities to finance new generating and transmitting facilities through tax-exempt bonds, the tax code treats those utilities more favorably than some others—for example, most cooperatively or investor-owned utilities that must issue taxable debt, on which investors require a higher rate of interest. This option would eliminate the exemption and tax the interest earned on bonds used by state and locally owned utilities to finance new generating or transmitting facilities. The option would raise about $0.6 billion over the 2004-2008 period.

State and locally owned utilities also use tax-exempt bonds to finance the distribution and retailing of electricity. This option does not apply to bonds for those purposes, although eliminating those tax exemptions could generate additional revenues. The option also does not apply to outstanding bonds that were used to finance existing generating and transmitting facilities.

The market for electricity is becoming increasingly competitive. Many states have already deregulated the generation sector of the electricity industry, allowing customers to choose their electricity supplier. More states are expected to deregulate in the future. Utilities that have access to tax-exempt financing have a lower cost of capital than do other providers of electricity. By using that lower-cost capital to cut prices to their customers, such utilities not only encourage consumers to use more electricity than they would otherwise have used but also gain an advantage over other utilities in competing for customers. Utilities that had access to lower-cost capital and did not use it to cut prices would probably use it to subsidize other public services or support inefficient techniques for producing electricity.

Opponents of eliminating the tax exemption argue that if it ended and state and locally owned utilities paid the same interest rate to attract capital for generation and transmission that other electricity suppliers pay, the rates charged for electricity by publicly owned utilities might rise. In addition, some people argue that the low cost of capital is necessary to finance universal service or affordable electricity rates for some disadvantaged groups.

**RELATED OPTIONS:** 270-05, 270-06, and 270-09; Revenue Options 27 and 30

**RELATED CBO PUBLICATION:** *Causes and Lessons of the California Electricity Crisis*, September 2001

## Revenue Option 32

# Apply the Limited Depreciation Schedule to All Business-Use Sport Utility Vehicles and Automobiles

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.2 | 0.3 | 0.3 | 0.2 | * | 1.0 | 1.3 |

Source: Joint Committee on Taxation.

Note: * = less than $50 million.

Taxpayers are generally allowed to recover the cost of depreciable business property under the tax code's modified accelerated cost recovery system. They may also, under certain circumstances, expense rather than depreciate the first $25,000 of the cost of depreciable property —that is, deduct it from taxable income in the year in which the property is placed in service, rather than over time, in scheduled increments. In addition, current law provides a temporary 30 percent expensing allowance for most depreciable equipment that is acquired after September 10, 2001, and before September 11, 2004.

But the cost recovery for vehicles with a loaded gross vehicle weight (GVW) under 6,000 pounds is generally subject to scheduled limits on those deductions. For tax year 2002, the depreciation limits were $3,060 in the first tax year (or $7,660, if the temporary 30 percent depreciation allowance applied); $4,900 in the second year; $2,950 in the third year; and $1,775 in each additional year. (Those amounts are indexed for inflation as measured by the consumer price index for automobiles.) As a result of those limits, the cost of acquiring a business-use automobile does not usually qualify for the full tax-favored treatment of expensing and accelerated depreciation.

However, the depreciation limits do not apply to vehicles with a loaded GVW of more than 6,000 pounds—a category that includes most sport utility vehicles (SUVs) and light trucks—whose cost can therefore be written off at a much faster rate. With that differential treatment, the tax code provides an incentive for business car buyers to purchase SUVs or other such heavy vehicles (that is, with a loaded GVW of more than 6,000 pounds) when they might otherwise have purchased smaller automobiles.

This option would apply the limited depreciation schedule to all business-use SUVs and automobiles regardless of weight but would not change the tax treatment of other types of vehicles with a loaded GVW of more than 6,000 pounds. The option would raise $0.2 billion in revenues in 2004 and $1.0 billion over the 2004-2008 period.

Proponents of this option argue that SUVs are rarely needed for business use and that the option would increase economic efficiency by eliminating the tax incentive for businesses and self-employed individuals to purchase them instead of smaller vehicles. Because heavy SUVs tend to emit more pollutants and have lower gas mileage than lighter vehicles, this option would also reduce pollution and the consumption of fossil fuels.

Opponents of this option would argue that the differential tax treatment accorded to heavy SUVs used for business was appropriate in some cases (because the operations of some firms require that type of vehicle). Other opponents might also point out that this option does not eliminate the incentive for businesses and self-employed individuals to purchase other vehicles with loaded GVWs exceeding 6,000 pounds, even though a smaller, less-polluting vehicle might be an acceptable alternative in those cases as well.

## Revenue Option 33

# Increase the Excise Tax on Cigarettes by 50 Cents per Pack

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 6.6 | 6.5 | 6.5 | 6.6 | 6.6 | 32.8 | 65.5 |

Source: Joint Committee on Taxation.

Taxes on certain goods and services can influence consumers' choices, leading people to purchase less of the taxed items than they might have otherwise. That taxation generally leads to a less efficient allocation of society's resources—unless some of the costs associated with the taxed items are not reflected in their price.

Tobacco is one such product that creates "external costs" to society that are not covered in its pretax price—for example, higher costs for health insurance to cover the medical expenses linked to smoking and the effects of cigarette smoke on the health of nonsmokers. But taxes increase prices and can result in consumers' paying the full cost (including the external costs) of smoking. Increased taxes have also been shown to reduce the consumption of tobacco. Researchers estimate that each 10 percent increase in cigarette prices is likely to lead to a decline in cigarette consumption of 2.5 percent to 5 percent, with probably a larger decline for teenagers.

Tobacco is taxed by both the federal government and the states. Currently, the federal cigarette excise tax is 39 cents per pack; other tobacco products are subject to similar levies. In recent years, state excise taxes have increased from an average of 42 cents per pack in 2000 to an average of about 54 cents per pack in 2002. In addition, settlements reached between state attorneys general and major tobacco manufacturers require payments of fees equal to an excise tax of about 50 cents per pack. Federal tobacco taxes raised about $7.4 billion in fiscal year 2001, or about 0.4 percent of total federal revenues.

This option would increase the federal excise tax on cigarettes by 50 cents per pack. It would generate $6.6 billion in added revenues in 2004 and a total of $32.8 billion from 2004 to 2008.

No consensus exists about the magnitude of the external costs of smoking, which makes it difficult to judge the efficiency of tobacco taxes. Some economists estimate that the external costs of smoking are significantly less than the taxes and settlement fees now levied on tobacco. Other analysts think that the external costs are greater and that taxes should be boosted even more. Technical issues cloud the debate; for example, the effect of secondhand smoke on people's health is uncertain. Much of the controversy centers on varying theories about what to include in figuring external costs—such as whether to consider tobacco's effects on the health of smokers' families or the savings in spending on health care and pensions that result from smokers' shorter lives. Nevertheless, an increase in excise taxes on cigarettes may be desirable, regardless of the size of the external costs, if consumers underestimate the harm done by smoking or the addictive power of nicotine. Teenagers in particular may not be prepared to evaluate the long-term effects of beginning to smoke, although all groups know that smoking has health risks.

Arguing against taxes on tobacco is their regressivity; that is, such taxes take up a greater percentage of the earnings of low-income families than of middle- and upper-income families. That imbalance occurs because lower-income people are more likely than other income groups to smoke and because expenditures on cigarettes by people who smoke do not rise appreciably with income.

**RELATED CBO PUBLICATIONS:** *The Proposed Tobacco Settlement: Issues from a Federal Perspective*, April 1998; and *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990. (The proposal discussed in the former publication does not reflect the final settlement.)

## Revenue Option 34

# Increase All Alcoholic Beverage Taxes to $16 per Proof Gallon

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 3.9 | 4.8 | 4.9 | 5.0 | 5.1 | 23.7 | 50.3 |

Source: Joint Committee on Taxation.

In terms of the federal excise tax per ounce of ethyl alcohol, current law treats alcoholic beverages in different ways. Levies remain much lower on beer and wine than on distilled spirits, and they are figured on different liquid measures. Distilled spirits are measured in proof gallons, a standard measure of a liquid's alcohol content; the current rate of $13.50 per proof gallon results in a tax of about 21 cents per ounce of alcohol. Beer, however, is measured by the barrel, and the current rate of $18 per barrel leads to a tax of about 10 cents per ounce of alcohol (assuming an alcohol content for beer of 4.5 percent). The current levy on wine is $1.07 per gallon and results in a tax of about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent). In fiscal year 2001, federal excise taxes on distilled spirits, beer, and wine brought in approximately $8 billion in revenues.

This option would standardize the base on which the federal excise tax is levied and use the proof gallon as the measure for all alcoholic beverages. It would also increase the tax to $16 per proof gallon, raising about $4 billion in 2004 and a total of almost $24 billion between 2004 and 2008. A tax of $16 per proof gallon comes to about 25 cents per ounce of ethyl alcohol. It would boost 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.

The consumption of alcohol creates costs to society that are not reflected in the pretax price of alcoholic beverages. Examples of those "external costs" include costs related to health care that are covered by the public, losses in productivity that are borne by others besides the alcohol consumer, and the loss of lives and property in alcohol-related accidents and crimes. Calculating such costs raises both practical and theoretical difficulties; however, a study reported by the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998.

Increasing the price of alcoholic beverages through a hike in excise taxes would reduce the external costs of alcohol use and lead alcohol consumers to pay a larger share of the costs of such consumption. Studies consistently show that higher prices lead to less consumption and less abuse of alcohol, even among heavy drinkers. Moreover, boosting excise taxes to reduce consumption may be desirable, regardless of the effect on external costs, if consumers are unaware of or underestimate either the harm that their drinking does to them and others or the extent of the addictive qualities of alcohol.

Yet taxes on alcoholic beverages have their downside as well. They are regressive when compared with annual family income; that is, such taxes take up a greater percentage of income for low-income families than for middle- and upper-income families. In addition, taxes on alcohol fall not only on problem drinkers but also on drinkers who impose no costs on society and are thus unduly penalized. Another consideration is that taxes may reduce consumption by some light drinkers whose intake of alcohol might produce beneficial health effects.

**RELATED CBO PUBLICATION:** *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990

## Revenue Option 35

# Increase Excise Taxes on Motor Fuel by 12 Cents per Gallon

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 15.3 | 15.4 | 15.6 | 16.1 | 16.6 | 79.0 | 170.6 |

Source: Joint Committee on Taxation.

Federal taxes on motor fuel, which are used to finance highway construction and maintenance, are currently 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel. This option would raise those taxes by 12 cents per gallon, increasing revenues by about $15 billion in 2004 and$79 billion over the 2004-2008 period. The total federal tax on gasoline under the option would be 30.4 cents per gallon.

Imposing new or higher taxes on petroleum could have several beneficial effects. For example, making petroleum more expensive could encourage conservation and reduce pollution. Higher prices might encourage people to drive less or to purchase more-fuel-efficient cars and trucks. Less consumption of motor fuel would also lower carbon dioxide emissions and could therefore help moderate human impacts on the global climate. A further benefit is that the tax would offset, though imperfectly, the costs of pollution and road congestion that automobile use engenders.

Increasing tax rates on motor fuels raises some issues of fairness, however. Higher rates would impose an added burden on the trucking industry and a disproportionate cost on rural households; yet the costs associated with vehicle emissions and congestion are greatest in densely populated areas, primarily the Northeast and coastal California. In addition, some researchers argue that taxes on gasoline and other petroleum products are regressive —that is, they take up a greater percentage of the income of lower-income families than of middle- and upper-income families. Other researchers find that the effects are proportionate.

**RELATED OPTIONS:** 270-07; Revenue Options 25 and 39

**RELATED CBO PUBLICATIONS:** *Reducing Gasoline Consumption: Three Policy Options*, November 2002; and *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, August 1990

## Revenue Option 36

# Impose a Tax on Sulfur Dioxide Emissions

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.4 | 0.6 | 0.6 | 0.5 | 0.5 | 2.6 | 4.8 |

Source: Joint Committee on Taxation.

Under the Clean Air Act, the Environmental Protection Agency (EPA) sets national standards for ambient air quality that are designed to protect the public's health and welfare. EPA defines acceptable levels for six "criteria" air pollutants: sulfur dioxide ($SO_2$), nitrogen oxides ($NO_x$), ozone, particulate matter, carbon monoxide (CO), and lead. Along with emissions from natural sources, emissions of air pollutants from stationary sources (such as industrial facilities and commercial operations) and mobile sources (automobiles, trains, and airplanes) contribute to the ambient levels of those criteria pollutants.

Sulfur dioxide belongs to the family of sulfur oxide gases formed during the burning of fuel that contains sulfur (mainly coal and oil) and during metal smelting and other industrial processes. Exposure to high concentrations of $SO_2$ may promote respiratory illnesses or aggravate cardiovascular disease. In addition, $SO_2$ and $NO_x$ emissions are considered the main cause of acid rain, which the EPA believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings.

The Clean Air Act Amendments of 1990 adopted a program to control acid rain that introduced a market-based system of emission allowances to reduce $SO_2$ emissions. An emission allowance is a limited authorization to emit a ton of $SO_2$. EPA allots tradable allowances to affected electric utilities on the basis of the utilities' past fuel use and statutory limits on emissions. Once the allowances are allotted, the act requires that annual $SO_2$ emissions not exceed the number of allowances held by each utility plant. Firms may trade allowances, bank them for future use, or purchase them through periodic auctions held by EPA. Firms with relatively low costs for abating pollution have an economic incentive to reduce their emissions and sell surplus allowances to firms that have relatively high abatement costs.

This option would tax emissions of $SO_2$ from stationary sources that are not already covered under the acid rain program. The rate of the tax would be based on the average cost of an additional reduction in $SO_2$ emissions by those sources. That approach would result in a tax of $200 per ton of $SO_2$ and would raise about $2.6 billion in revenues over the 2004-2008 period. Thus, the tax would both encourage further reductions in pollution and provide significant revenues. Major sources of pollutants currently pay user fees to cover the costs of a program providing operating permits (stating which air pollutants a source is allowed to emit) under the 1990 amendments to the Clean Air Act. Basing the tax described in this option on the terms granted in the permits would minimize the Internal Revenue Service's costs of administration.

In general, taxes on emissions can help reduce pollution in a cost-effective (least-cost) manner. The tax described in this option would lead to cost-effective reductions in $SO_2$ emissions by encouraging firms with abatement costs that are less than the tax to reduce their emissions and, at the same time, allowing firms with abatement costs that exceed the tax to continue emitting pollutants and pay the levy.

Opponents of this kind of tax, however, might argue that it would impose a large burden on affected firms. Firms covered under this option would not only pay a tax on their emissions of $SO_2$ but in most cases would also incur some costs for abatement (such as the cost of scrubbers and other equipment to reduce emitted pollutants). In contrast, regulatory approaches that mandated reductions in emissions would not require firms to pay that kind of levy on their allowed emissions.

**RELATED OPTIONS**: Revenue Options 37 and 39

**RELATED CBO PUBLICATIONS:** *An Evaluation of Cap-and-Trade Programs for Reducing U.S. Carbon Emissions*, June 2001; and *Factors Affecting the Relative Success of EPA's $NO_x$ Cap-and-Trade Program*, June 1998

## Revenue Option 37

# Impose a Tax on Nitrogen Oxide Emissions

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 3.3 | 4.7 | 4.5 | 4.3 | 4.2 | 21.0 | 40.7 |

Source: Joint Committee on Taxation.

Nitrogen oxides ($NO_x$) usually enter the air as the result of high-temperature combustion processes such as those found in automobiles and power plants. Emissions of $NO_x$ play an important role in the atmospheric reactions that generate ground-level ozone (smog) and acid rain. Moreover, the Environmental Protection Agency (EPA) believes that $NO_x$ can irritate the lungs and lower a person's resistance to respiratory infections such as influenza. Nitrogen oxides and pollutants formed from them can be transported over long distances, so problems associated with $NO_x$ are not confined to areas where they are emitted.

The Clean Air Act requires states to implement programs to reduce ground-level ozone. Because of the transportability of $NO_x$ and ozone, the act requires upwind states to establish programs that will help downwind states meet statutory standards. In 1998, EPA promulgated the Ozone Transport Rule (commonly referred to as the $NO_x$ Sip call), which required 22 eastern states and the District of Columbia to revise their programs to reduce $NO_x$ emissions beyond the levels previously mandated under the Clean Air Act. (The rule was subsequently revised to cover all or part of 21 states.) The rule did not mandate specific methods but instead gave each affected state a target for $NO_x$ emissions. In addition, EPA established a $NO_x$ budget trading program in which large electricity-generating units and industrial boilers may participate—provided that the state in which they are located approves. Sources of emissions covered under that program would be issued a specific number of allowances that would entitle them to emit a limited amount of $NO_x$ each year. Firms would be required to hold an allowance for each ton of $NO_x$ that they emitted and would be free to buy and sell allowances.

Another way to help control $NO_x$ would be to tax emissions from stationary sources in states not covered by the $NO_x$ Sip call. Such a tax would apply to industrial facilities and commercial operations, including electricity-generating units and industrial boilers as well as other sources; it could provide significant revenues and encourage further reductions in pollution below the level that current regulations require. Controlling $NO_x$ from stationary sources costs between $500 and $10,000 per ton of emissions abated. Imposing a tax of $1,500 per ton of $NO_x$ emissions would encourage stationary sources that could reduce emissions at a cost below that amount to do so. Facilities with abatement costs that were higher than the tax could continue to pollute and pay the levy. A tax of $1,500 per ton would raise over $3.3 billion in revenues in 2004 and $21.0 billion over the 2004-2008 period.

Proponents of taxing pollution argue that such taxes discourage activities that impose costs on society and could help reduce air pollution in a cost-effective (least-cost) manner. Opponents of that kind of tax, however, might argue that it would impose a large burden on affected firms. Firms covered under this option would not only pay a tax on their emissions of $NO_x$ but in most cases would also incur some costs for abatement (such as the cost of scrubbers and other equipment to reduce emitted pollutants). In contrast, regulatory approaches that simply mandated reductions in emissions would not require firms to pay a tax on the emissions.

**RELATED OPTIONS:** Revenue Options 36 and 39

**RELATED CBO PUBLICATION:** *Factors Affecting the Relative Success of EPA's $NO_x$ Cap-and-Trade Program*, June 1998

## Revenue Option 38

# Subject Vehicles with a Gross Vehicle Weight of Between 6,000 and 10,000 Pounds to the Gas Guzzler Tax

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 | 2.9 | 6.1 |

Source: Joint Committee on Taxation.

Under the Energy Tax Act of 1978, most automobiles whose fuel economy fails to meet a certain level are subject to the gas guzzler tax. For example, the manufacturer of an automobile belonging to a "model type" whose adjusted miles per gallon (mpg) rate is under 22.5 pays a tax for each of those vehicles that it sells. (The adjusted mpg rate is a combined fuel economy measure that is calculated by assuming 55 percent city and 45 percent highway driving.) The lower the gas mileage of the model type, the higher the tax that is paid. The maximum tax is $7,700 per vehicle with gas mileage of less than 12.5 mpg.

In fact, few vehicles are subject to the gas guzzler tax. Currently, the tax does not apply to vehicles that are rated at more than 6,000 pounds unloaded gross vehicle weight (GVW). In practice, it also does not apply to minivans, trucks, or sport utility vehicles (SUVs), a group collectively known as light trucks. One reason for that group's exclusion is that the tax code exempts "non-passenger vehicles"—as defined by the Department of Transportation (DOT)—from the tax. DOT's definition includes pickup trucks; vans; and most minivans, SUVs, and station wagons. Another reason is that the tax is imposed on the basis of the gas mileage of the model type to which the vehicle belongs. Model types are defined by the Environmental Protection Agency; each category comprises different vehicles that have one or more construction features in common. Hence, a vehicle with gas mileage of 15 mpg may not be subject to the gas guzzler tax because it is a member of a model-type category that has an average fuel economy of more than 22.5 mpg.

This option would extend the gas guzzler tax to light trucks by increasing the tax's weight limit to 10,000 pounds unloaded GVW, repealing the exemption for so-called nonpassenger vehicles, and calculating the tax per vehicle instead of on the basis of model type. The option would increase revenues by about $0.5 billion in 2004 and $2.9 billion over the 2004-2008 period.

Proponents of this option could argue that not applying the gas guzzler tax to light trucks creates an incentive for people to buy those large vehicles instead of smaller, more energy-efficient ones. (In 1978, light trucks made up about 27 percent of retail sales of motor vehicles; in 2000, their share of the market was 50 percent.) Vehicles with low gas mileage generate more pollution than do vehicles with higher mileage, so taxing less-efficient vehicles could reduce pollution. The tax was intended to encourage the manufacture and sale of energy-efficient vehicles and the reduction of pollution, but it has been less effective than it might have been (because certain vehicles have been exempt).

Opponents of the option might point out that many light trucks are used for purely commercial purposes and that this option would impose a burden on businesses that had economic reasons for purchasing larger vehicles. Opponents would also maintain that many light trucks carry more passengers than automobiles do, so pollution per passenger mile may be lower for those vehicles than for automobiles. Some observers would also argue that the gas guzzler tax should not be extended and that, in fact, the tax on passenger cars should be repealed and replaced with either a tax on the pollution that cars and light trucks emit or a tax placed directly on energy use (such as a gasoline tax). Those critics would say that such taxes would be more efficient than the current gas guzzler tax or a gas guzzler tax extended to light trucks.

## Revenue Option 39

# Impose a One-Time Tax on Emissions of New Automobiles and Light Trucks

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 2.5 | 3.7 | 3.8 | 3.8 | 3.8 | 17.6 | 37.4 |

Source: Joint Committee on Taxation.

The Clean Air Act Amendments of 1990 strengthened the provisions of the earlier law that sought to reduce emissions from mobile sources of pollution. The amendments raised the tailpipe standards for cars, buses, and trucks; they expanded inspection and maintenance programs to include more regions with pollution problems and promote more stringent testing; and they introduced several regulations to reduce air pollution from mobile sources, including regulations for selling improved gasoline formulations in some polluted cities to reduce levels of pollutants. In addition, the amendments tightened emission standards for vehicles to encourage the development of even cleaner cars and fuels.

Despite progress to date in controlling air pollution from motor vehicles, mobile sources continue to significantly affect the nation's air quality. Nationwide, highway motor vehicles on average account for over one-quarter of all emissions of volatile organic compounds (VOCs), over one-third of nitrogen oxide ($NO_x$) emissions, and more than half of carbon monoxide emissions. VOCs and $NO_x$ contribute to atmospheric reactions that generate ground-level ozone, which remains a pervasive pollution problem for many areas of the United States. Nitrogen oxides also contribute to the formation of acid rain, which the Environmental Protection Agency (EPA) believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings. Carbon monoxide reduces the ability of a person's blood to deliver oxygen to vital tissues, affecting primarily the cardiovascular and nervous systems.

Taxing emissions of those pollutants from mobile sources could help reduce them by providing an additional incentive for consumers to purchase more-fuel-efficient cars and trucks. One option would be to impose a one-time tax on new automobiles and light trucks. The tax could be based on the grams of VOCs (measured in grams of hydrocarbons), $NO_x$, and carbon monoxide that a vehicle emitted per mile as estimated by the emissions tests that EPA requires for every new vehicle. The tax could be administered similarly to the current excise tax on luxury vehicles: the auto dealer would collect the tax from the vehicle's purchaser on behalf of the Internal Revenue Service.

Such a tax, which would average $300 for each new passenger car and light truck sold, could raise about $2.5 billion in revenues in 2004 and a total of $17.6 billion from 2004 through 2008. A disadvantage of the option, however, is that it would leave out older cars and trucks, which account for a larger share of emissions from mobile sources than do new vehicles. A further drawback is that a one-time emissions tax would raise the prices of new vehicles and might therefore induce people to delay purchasing them.

**RELATED OPTIONS:** Revenue Options 35, 36, and 37

## Revenue Option 40

# Eliminate Tax Credits for Producing Unconventional Fuels and for Generating Electricity from Renewable Energy Sources

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.4 | 0.7 | 0.7 | 0.8 | 0.4 | 3.0 | 3.9 |

Source: Joint Committee on Taxation.

Under current law, firms that produce unconventional fuels or generate electricity from certain renewable forms of energy can claim a credit against their income taxes. Section 29 of the Internal Revenue Code offers credits to businesses that produce natural gas from coal seams (known as coalbed methane), oil from shale and tar sands, gas from geopressured brine and Devonian shale, energy from biomass (including landfill methane), and synthetic fuels from coal. Section 45 of the code offers credits to producers of electricity from wind, closed-loop biomass (including landfill methane), and poultry waste.

The tax credits may prompt some businesses to reduce the price of energy from those sources or may lead to larger profits for manufacturers. Lower prices—or larger profits—in turn may lead to greater reliance on unconventional forms of energy. But that outcome has seldom been achieved. Only coalbed methane, landfill methane, and wind power have been commercially viable sources of energy. Eliminating the credits would increase revenues by $0.4 billion in 2004 and $3.0 billion over the 2004-2008 period.

The credits were initially enacted to promote energy security and efficiency (by encouraging consumers to use alternatives to imported petroleum as well as energy that would otherwise be lost) and to foster a cleaner environment (by encouraging the use of nonpolluting sources of energy). But proponents of eliminating the credits point out that the energy sources that benefit from them contribute very little to meeting the nation's energy requirements. Moreover, the limited success that markets for coalbed methane, landfill methane, and wind power have had is attributable less to the credits than to such factors as technological advances, rising natural gas prices, other federal programs (such as the Environmental Protection Agency's New Source Performance Standards), and subsidies from the states. Indeed, critics claim that far from benefiting the environment, the production of energy from some of the eligible sources causes environmental problems. (For example, wind rotors may endanger migratory birds, and coalbed methane production may harm groundwater.) In addition, the credits may reduce economic efficiency by encouraging the use of relatively expensive fuels. Finally, proponents of eliminating the credits believe that the goal of promoting a cleaner environment would be more efficiently achieved by imposing taxes on pollutants that reflect the damage they cause.

Advocates of retaining the tax credits argue that they remain an important part of the national policy to promote development of new sources of energy. Moreover, they believe that the credits help curb wasteful and polluting practices. For example, capturing landfill methane as a fuel rather than venting it into the air reduces odors and other hazards associated with emissions of landfill gas. And encouraging the use of poultry waste as fuel may help reduce the negative consequences—such as water pollution and unpleasant odors—of traditional means of its disposal. To the extent that the tax credits encourage the use of renewable sources of energy, they may also help moderate human impacts on the global climate.

**RELATED OPTIONS:** 270-01, 270-03, and 270-07

## Revenue Option 41

# Reinstate the Superfund Taxes

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | 0.9 | 1.3 | 1.4 | 1.5 | 1.6 | 6.7 | 15.3 |

Source: Joint Committee on Taxation.

Since 1981, the Superfund program of the Environmental Protection Agency (EPA) has been charged with cleaning up the nation's most hazardous waste sites. Most Superfund cleanups are paid for by the parties that are held liable for contamination of individual sites. In many cases, however, the liable parties cannot be identified, no longer exist, or are unwilling or unable to undertake the job. In such cases, EPA pays for the cleanup and, where possible, tries to recover the costs through subsequent enforcement actions.

Money to pay for those EPA-led cleanups and other program costs comes from an annual appropriation. Traditionally, the Congress has designated two sources of funds in the appropriation: the general fund and balances in the Superfund trust fund (formally, the Hazardous Substance Superfund). Revenues credited to the trust fund have come primarily from taxes on petroleum and various industrial chemicals and from a corporate environmental income tax. However, authorization for the taxes expired in December 1995, and the fund's balance has declined every year since 1997.

The Congress has slowed the decline by relying more on the general fund as a source of the program's appropriated money. (Before 1999, the maximum contribution from the general fund was $250 million; in 2000, it was $700 million; in 2001, $634 million; and in 2002, $635 million.) Still, the available balance in the trust fund at the end of 2002 was expected to be just $427 million, or about one-third of the program's 2002 appropriation of $1.3 billion. Thus, future funding for the Superfund program will come almost entirely from the general fund unless the trust fund gets a new or renewed source of revenues. One option would be to reinstate the previous taxes; doing so would yield revenues of $0.9 billion in 2004 and $6.7 billion over the 2004-2008 period.

Proponents of reauthorizing the taxes argue that they are consistent with the "polluter-pays" principle. Specifically, proponents maintain that petroleum products and various chemical feedstocks and derivatives are common sources of contamination at Superfund sites and thus it is fair that producers and users of such substances, as well as corporations more broadly, foot much of the bill for the cleanup program. Some advocates of renewed taxation also argue that EPA needs a stable source of funding for Superfund, for two reasons: to maintain multiyear cleanup efforts at the largest sites and to continue to provide a credible threat that the agency will clean up sites and pursue cost recovery from liable parties who do not undertake cleanups themselves.

Some people who oppose reinstating the taxes argue that the Superfund program should not be given dedicated funding until the Congress reforms the program's liability system and clarifies its future mission. Other opponents criticize the taxes themselves. They point to a 1995 analysis by the Brookings Institution and Resources for the Future, which found that the costs to administer and comply with the taxes were high, compared with the relatively small amounts collected. Also, they argue that the polluter-pays principle may be relevant to Superfund's liability system but has no bearing on the question of who should pay for the cleanup of sites whose liable parties are recalcitrant or insolvent. Finally, opponents of reinstating the taxes argue that Superfund spending has always been subject to annual appropriations and thus dedicated taxes are no guarantee of stable funding.

## Revenue Option 42

# Consolidate Child-Related Tax Provisions

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Revenues | -0.4 | -2.4 | -6.6 | -11.2 | -15.1 | -35.7 | -151.9 |

Source: Joint Committee on Taxation.

The tax code currently contains several provisions—specifically, the child credit and the exemption for dependents—that benefit taxpayers with children. However, those provisions have different structures and rules for eligibility. The child credit equals $600 per child in 2003 and is refundable; the refundable portion—the amount that exceeds tax liability and is paid to the taxpayer—is limited to an amount equal to 10 percent of earnings above $10,500. The credit phases out by $50 for every $1,000 of adjusted gross income over certain thresholds: $110,000 for married couples filing jointly, $75,000 for single taxpayers and heads of household, and $55,000 for married couples filing separately. Under the dependent exemption, a taxpayer may exclude (deduct) $3,050 from his or her taxable income for each child. The value of the exemption rises with the taxpayer's marginal tax rate (the rate on the last dollar of income), so upper-income families receive greater tax savings from the deductions than their lower-income counterparts do.

This option would replace the two provisions with a single consolidated credit of $1,000 per child beginning in 2004. The consolidated child credit would retain a refundable portion, which would be determined in the same way as the refundable part of the current child credit. However, unlike the current credit, there would be no phaseout, and the amount of the credit would be indexed for inflation. For the purposes of the credit, a child would be defined as either a son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or descendant of such individuals; as an adopted child; or as a foster child. The child would have to be under age 19 (or age 24, if he or she was a student) and live for more than half the tax year with the taxpayer (or taxpayers) claiming the credit. (Students would be exempted from the residence requirement.)

The specific elements of this option are illustrative and could be modified to alter its effect. As described, the option would reduce federal revenues by $0.4 billion in 2004 and $35.7 billion over the 2004-2008 period.

Proponents of this option might point out that consolidating the provisions into a single credit would substantially reduce complexity in this area of the tax code, as would the elimination of any phaseout. Opponents, however, might express concern that some middle-income taxpayers with children would see their taxes rise. They might also argue that the dependent exemption has been part of the tax code for a long time and many taxpayers may count on the money it represents when they make their financial plans.

**RELATED OPTION:** Revenue Option 1

## Revenue Option 43

# Replace Multiple Tax Rates on Long-Term Capital Gains with a Deduction of 45 Percent

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Revenues | 2.6 | -4.4 | -0.8 | 0.2 | 0.2 | -2.2 | 0 |

Source: Joint Committee on Taxation.

When a taxpayer sells an asset whose value has increased since it was purchased, he or she realizes a capital gain, which is subject to taxation. The gains realized on assets that are held for more than a year are taxed at lower rates than the rates that apply to ordinary income. Which capital gains tax rate applies to a gain depends on the type of asset sold, how long it was held, when it was purchased, and the taxpayer's other income—a level of complexity that requires numerous calculations by taxpayers to figure their tax. To simplify that process, this option would allow taxpayers to deduct 45 percent of their net long-term capital gains realizations from their taxable income—whether or not they itemized their other deductions. Taxpayers subject to the alternative minimum tax (AMT) would treat 30 percent of the deduction as preference income to adjust for the lower rate structure of that tax. (Revenue Option 44 discusses the AMT.) Although the five-year total for the effects of this option shows a loss of revenues of $2.2 billion, the option would be approximately revenue neutral from 2004 to 2013 (under the assumption that the change would be enacted at the end of 2003 and become effective January 1, 2004).

The variety of long-term capital gains tax rates in current law presents a substantial challenge to taxpayers who attempt to calculate their tax liability. For example, in 2002, a taxpayer who was in an individual income tax bracket of 27 percent or above and who sold stock owned for more than a year would generally pay tax of 20 percent on the realized gain. But if that stock had been an original issue of certain start-up businesses and had been held for more than five years, the tax rate on the gain would be effectively 14 percent. If that stock had not been an original issue but had been purchased in 2001 or later, and if it was held for more than five years, the tax rate, as now scheduled, would be 18 percent. Furthermore, the taxpayer could face a 25 percent tax rate on some long-term gains from real estate and a 28 percent rate on gains from the sale of gold, works of art, or other collectibles. Taxpayers in the 10 percent or 15 percent brackets of the individual income tax face lower rates on gains until they realize enough to push their income past the 15 percent bracket. Taxpayers who are subject to the AMT face different rates on gains from the sale of collectibles and from original stock issues of certain start-up businesses.

Taxpayers with long-term gains are required to go through many calculations to determine their tax. On their 2002 returns, taxpayers with gains from the sale of general corporate stock, for example, have to complete 22 lines at the end of Schedule D, Form 1040. Taxpayers with gains from collectibles, start-up businesses, or depreciable real estate are sent to a 37-line worksheet.

This option would reduce the number of lines that a taxpayer faced at the end of Schedule D to two or three, as was required between 1942 and 1986, when the tax code excluded gains from adjusted gross income. The deduction under this option would be calculated like that exclusion but would not understate the income of taxpayers with gains in determining eligibility for tax credits and other options intended for lower-income taxpayers.

Under the option, a taxpayer's actual rate on capital gains would be 55 percent of his or her rate on ordinary income. In 2004, for example, someone in the 26 percent bracket for ordinary income would face a rate on gains of 14.3 percent, whereas someone in the 37.6 percent bracket would face a rate on gains of 20.7 percent.

Switching to a uniform percentage deduction for long-term capital gains, however, would overturn several provisions of the tax code that were designed to improve efficiency or equity or to promote economic growth. As a result, careful consideration is warranted in weighing the benefits of those provisions against the benefits of simplification.

A reduction of 2 percentage points in the gains tax rate on assets held more than five years was enacted partly to reduce the pressure on businesses—which has been strong in recent years—to meet quarterly earnings targets and produce short-run increases in the value of their stock in order to attract investors. Excessively focusing on short-run results can deter businesses from undertaking more-productive actions that may take several years to reach fruition. However, much current short-term trading is done by institutions, many of which are exempt from individual capital gains taxes. Furthermore, long-term investors are not a necessary component of a firm's planning for the long term. A string of investors who all hold a stock for short intervals can provide a market to maintain the value of the firm's shares if the firm's long-term plans are plausible.

When the tax rate on gains held more than five years was lowered, an argument that was offered in support of the action was that gains resulting from inflation, which should not be taxed as income, grow over time. That argument is typically false, however, because it ignores the advantage that the tax code provides of deferring taxes on gains until an asset is sold. When deferral is accounted for, the effective tax rate on capital gains is still boosted by inflation, but the amount of that increase typically declines the longer an asset is held. Thus, if the lower statutory rate for gains (relative to ordinary income) was meant solely to account for inflation, that differential should decline the longer an asset is held.

The current lower tax rate on capital gains realized from initial public offerings (IPOs) held at least five years was designed to encourage new enterprises that might develop new products and methods to benefit the entire economy. But evidence is lacking about how big those benefits actually are; moreover, the costs from excess business formation—such as increased business failures—must be considered as well. Another question involves the size of the differential tax rate. When the differential was created in 1993, it reduced the rate on gains from IPOs to half of the rate paid on other gains. But when the rates on other gains were reduced in 1997, that differential was eroded. Now, the top rate of 14 percent on gains from IPOs may not be enough lower than the 20 percent and 18 percent rates on most other gains to justify the extra complexity that special IPO rates create.

Gains on gold, works of art, and other collectibles are currently taxed at a higher rate (28 percent) than are gains on most other assets. Supporters of maintaining those higher rates justify their position by the lack of broader benefits—in terms of innovation, new products, and higher productivity—that society receives from those assets. But other observers argue that public benefits arise from the preservation of works of art. In any event, so few gains fall into this category that the economic efficiency resulting from having just the right tax rate for these assets may be less than the administrative costs of maintaining a separate rate.

Certain gains from the sale of real estate are taxed at ordinary income tax rates up to a maximum of 25 percent (which is above the 20 percent rate levied on gains from most other assets). The higher rate could be justified on the grounds that such gains arise when tax deductions for depreciation turn out to have been excessive, a circumstance that becomes evident when the structures are sold for more than their depreciated tax value. During the time that such property is being used to generate profits and rent—which are taxed at ordinary income tax rates—the owners are taking deductions for the depreciation of the property's value that reduce their (ordinary income) taxes. Logic suggests that gains resulting from excess depreciation deductions also be taxed at those rates; that rationale is followed in taxing—at ordinary income tax rates—the gains from all excess depreciation on sales of equipment and the portion of excess depreciation on real estate that results when depreciation for tax purposes is faster (because in some instances the tax code permits accelerated depreciation) than the conventional straight-line method. However, the remaining fraction of the gains that owners derive from excess depreciation deductions on real estate is taxed at rates that are capped at 25 percent. This option would treat all excess depreciation deductions—including that fraction—as ordinary income

(and tax them at ordinary rates) on the basis of the above rationale and the goal of administrative simplicity. Arguments against taxing those gains at a higher rate than the rate imposed on some other gains could be based on the additional costs of administering a multirate system and the burden imposed on investors who have been taxed at gains rates since 1942.

Current tax law also includes different capital gains tax rates for people with different levels of total income. Those rates reflect part of the progressive rate structure on ordinary income, but as separate rates, they add to the complexity of calculating overall tax liability. Under the option presented here, the progressive rates applicable to ordinary income would apply to capital gains as well.

The benefits to be derived from multiple tax rates for capital gains may not be large, but the benefits resulting from simpler tax calculations may be no larger. The tax code's current complexity affects only the roughly one out of six taxpayers who report capital gains. Furthermore, roughly three-fourths of those with gains can avoid the most extended worksheets. Other taxpayers with substantial capital gains typically use professional tax-return preparers or computer software, both of which mitigate the burden of filling out the current forms—although they impose added costs for filing. Finally, some of the current complexity could be eliminated by simply taxing all gains at the same rate, without turning to a deduction.

**RELATED OPTION:** Revenue Option 3

**RELATED CBO PUBLICATIONS:** *Capital Gains Taxes and Federal Revenues*, October 2002; and *Indexing Capital Gains*, August 1990

## Revenue Option 44

# Provide Relief from the Individual Alternative Minimum Tax

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Revenues | | | | | | | |
| Index exemption amounts and brackets for inflation after 2004 | 0 | -4.0 | -13.6 | -22.0 | -31.5 | -71.1 | -288.8 |
| Allow some preferences | -5.0 | -17.6 | -33.3 | -49.9 | -65.0 | -170.8 | -533.8 |
| Repeal the AMT | -7.4 | -23.4 | -39.5 | -57.3 | -73.5 | -201.1 | -611.1 |

Source: Joint Committee on Taxation.

Under current law, the individual alternative minimum tax (AMT), as its name implies, is an alternate method of computing federal income tax liability. A minimum tax was initially enacted in 1969 amid concerns that taxpayers with substantial income were able to aggressively use tax preferences to reduce their tax liability to very low levels—in some cases, to zero. The present form of the AMT was largely enacted as part of the Tax Reform Act of 1986; it has since been modified several times, most recently by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

To compute AMT liability, a taxpayer must add back several items to taxable income that are not regularly included in it, such as the deduction for state and local taxes, personal exemptions, and the standard deduction. AMT adjustments also include preferences that are generally used only by taxpayers with complex financial circumstances—such as the preferences for certain intangible costs of drilling for oil and gas. Those adjustments are replaced with an AMT exemption—$33,750 for single taxpayers and $45,000 for married taxpayers filing a joint return— that phases out at higher levels of income. The exemption is subtracted from income, yielding a taxpayer's alternative minimum taxable income (AMTI). AMTI is taxed at two rates: 26 percent on the first $175,000 and 28 percent on the remainder. Taxpayers must pay the higher of their AMT liability or their liability under the individual income tax. Additionally, they may not take certain tax credits if the credit would make their individual income tax liability lower than their AMT liability.

Unlike the schedule of brackets and exemptions for the individual income tax, the AMT brackets and exemptions are not indexed for inflation. As a result, growth in nominal income subjects more and more taxpayers to the alternative tax. For a given level of nominal income, individual income tax liability will decline over time as the value of personal exemptions and the standard deduction increases with inflation; in addition, the size of the lower tax brackets increases, so more income is taxed at lower rates. However, because AMT liability remains unchanged by inflation, with time it will exceed individual income tax liability over a larger and larger portion of the income range.

Before passage of EGTRRA, the number of taxpayers subject to the AMT was projected to grow rapidly from 1.5 million in 2001 to 16 million in 2010. But EGTRRA lowered individual income tax rates with little change in the AMT and so increased to 32 million the projected number of taxpayers who will be subject to it in 2010. The law provided some relief from the AMT by increasing the size of its exemption but only through 2004.

Taxpayers who are subject to the AMT, or are close to being affected by it, have to calculate their taxes twice. As the number of those taxpayers rises sharply, the overall complexity of the tax system will increase. Many of those taxpayers will be in the AMT's ranks not because they are sheltering high income but rather because they have large numbers of dependents or high state and local taxes.

The AMT could be modified in several ways to provide some relief from its burdens. One option would be to make permanent the relief provided by EGTRRA and index the exemption amounts and brackets for inflation after 2004. Under that option, 21 million taxpayers would be moved off the AMT in 2010 (the peak year), and revenues for the 2004-2008 period would fall by $71 billion. Another option would be to allow AMT-affected taxpayers to take the standard deduction, personal exemptions, and the deduction for state and local taxes—which would reduce the tax's rolls by 29 million in 2010 and lower revenues by $171 billion over the five-year period. A third option would be to eliminate the AMT altogether. That approach would move 32 million taxpayers off the tax in 2010 at a revenue cost of $201 billion over five years.

The primary benefit of these alternatives would be simplification—each one would simplify the tax system by reducing the number of taxpayers subject to the AMT. The first two options would provide relief to taxpayers with simple returns but maintain the goal of preventing high-income taxpayers from using tax shelters to avoid income taxes. The third option would reduce complexity the most. Proponents of AMT relief would also argue that many preferences that are not allowed by the AMT, such as personal exemptions and state and local taxes, represent differences in taxpayers' ability to pay taxes and consequently, equity calls for allowing those items to be subtracted from taxable income.

Opponents of these options might argue against them on several counts. Because the options would reduce taxes, they would be costly, and the cost would rise as the amount of AMT relief increased. Equity could be at issue as well, given that higher-income taxpayers would receive most of the options' tax relief. Approaches other than complete elimination of the AMT would leave in place some of the complexity of the current system; however, complete elimination would also result in cases in which high-income taxpayers had little or no tax liability.

A further consideration is that relief from the AMT would change the marginal tax rate (the tax rate on the last dollar of income) faced by taxpayers who are currently subject to the tax and might thus alter their incentives to work and save. Some taxpayers would see their marginal rates increase under these options, and others would see them decrease; on balance, though, more taxpayers would see marginal rate decreases. AMT relief might further affect incentives to work by reducing some taxpayers' tax burdens—lower tax liability would allow those individuals to achieve the same level of after-tax income with less income before taxes. How AMT relief on balance would affect incentives to work and save is not clear; it would depend on taxpayers' relative sensitivity to those incentives.

## Revenue Option 45

# Immediately Eliminate the Personal Exemption Phaseout and the Limit on Itemized Deductions

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Revenues | -5.5 | -10.8 | -8.1 | -5.6 | -4.3 | -34.3 | -90.8 |

Source: Joint Committee on Taxation.

Under current law, taxpayers subtract personal exemptions and either the standard deduction or itemized deductions from their adjusted gross income (AGI) to compute their taxable income. The value of both personal exemptions and itemized deductions is reduced for high-income taxpayers by gradually phasing them out above specified income thresholds. The provisions for the two phaseouts were enacted temporarily as part of the Omnibus Budget Reconciliation Act of 1990 and made permanent by the Omnibus Budget Reconciliation Act of 1993. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), both provisions are scheduled to phase out gradually over the next several years. In 2006 and 2007, their impact will be reduced by one-third; in 2008 and 2009, it will be reduced by two-thirds; and in 2010, the provisions will be repealed. Since EGTRRA remains in effect only until the end of 2010, the phaseouts will return, in their pre-EGTRRA form, in 2011.

This option would accelerate to 2004 the planned repeal of the phaseouts and make the repeal permanent. Immediate repeal would cost $5.5 billion in revenues in 2004 and $34.3 billion over the 2004-2008 period.

The personal exemption phaseout, often referred to as "PEP," reduces the value of personal exemptions by 2 percent for each $2,500 of AGI above an income threshold. In 2002, that threshold was $137,300 for single filers and $206,000 for married couples filing a joint return. Thus, single taxpayers with AGI of $162,300 ($25,000 above the threshold) would lose 20 percent of the value of their personal exemption. In 2002, the value of personal exemptions was completely phased out for single filers with AGI above $259,800 and joint filers with AGI above $328,500.

The limit on itemized deductions, often referred to as "Pease," reduces them by 3 percent of the amount of AGI above an income threshold—which was $137,300 for all taxpayers in 2002. Thus, a taxpayer with $237,300 in AGI would have his or her itemized deductions reduced by $3,000, or 3 percent of the $100,000 in AGI above the threshold. Under current law, itemized deductions cannot be reduced by more than 80 percent.

Repealing Pease and PEP would make the tax system less complex. Both provisions require numerous calculations by taxpayers to determine whether the provision applies to them and, if it does, to figure the impact of the phaseouts on their taxable income. Proponents of this option would argue that repeal would increase economic efficiency by lowering marginal tax rates (the tax rate applied to the last dollar of income). Currently, both provisions increase marginal tax rates over the portion of the income range that they affect and may thus reduce incentives to work and save.

Opponents of this option might object to it largely on equity grounds. Because the tax system is progressive (rates rise with a taxpayer's income), higher-income taxpayers get a bigger tax reduction from exemptions and deductions than do taxpayers in lower tax brackets. The Pease and PEP provisions reverse that effect and increase the tax system's progressivity.

## Revenue Option 46

# Advance the Marriage Penalty Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Revenues | -16.7 | -17.3 | -9.7 | -6.9 | -3.2 | -53.8 | -227.1 |

Source: Joint Committee on Taxation.

Many married couples who file a joint return have higher tax liabilities than they would if they were allowed to file as individuals or as heads of household (single taxpayers with dependents). At the same time, many other married couples pay lower taxes than they would if they filed as single taxpayers. Whether a couple incurs a marriage "penalty" or receives a marriage "bonus" depends on the spouses' relative income: penalties generally occur when spouses have similar income, and bonuses occur when only one spouse works or when spouses have substantially different earnings. Penalties tend to be larger for couples with dependents who would qualify them to file as heads of household if they were not married.

In 1999, just over 40 percent of married couples incurred marriage penalties averaging $1,480, and about 50 percent received marriage bonuses averaging $1,600. Overall, bonuses totaled $43 billion, or about $10 billion more than total penalties. High-income couples were more likely to incur penalties and less likely to receive bonuses than were couples with lower income. About 70 percent of both penalties and bonuses affected couples with income above $50,000.

Four provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were designed to lessen the effects of the marriage penalty. Only one of those measures was fully implemented in 2001; the others phase in over varying periods and at different times from 2002 through 2009. All of the measures expire on December 31, 2010, leaving in place the same tax structure for married and unmarried taxpayers that existed before 2001. This option would fully implement those four provisions, effective in 2004, and make them permanent, at a cost of $16.7 billion for 2004 and $53.8 billion for the 2004-2008 period. A summary of the provisions follows.

- EGTRRA established an individual income tax bracket of 10 percent, effective from July 31, 2001, through December 31, 2010. For a married couple filing a joint return, that bracket is twice the size of the corresponding bracket for unmarried individuals filing a single return. The bracket's upper dollar limits are fixed through 2007; they increase for single and joint filers by $1,000 and $2,000, respectively, in 2008 and are indexed to inflation for all taxpayers in 2009 and 2010.

- From 2005 through 2009, the law gradually increases the standard deduction for married couples filing jointly from approximately 166 percent to 200 percent of the deduction for single taxpayers. Under that implementation schedule, the standard deduction for married couples filing jointly would be twice that for single filers in 2009 and 2010.

- Between 2005 and 2009, EGTRRA widens the 15 percent individual income tax bracket for married couples filing jointly to twice that for a single filer. The current upper dollar limit on that bracket for joint filers is about 166 percent of that for single taxpayers.

- Finally, for married couples filing jointly, EGTRRA increased by $1,000 the beginning and ending phaseout limits for income on which the earned income tax credit (EITC) applies in each of tax years 2002, 2005, and 2008. After 2008, those limits are indexed for inflation. Before EGTRRA, the phaseout limits for single and joint filers were identical.

Many analysts have observed that marriage penalties affect couples' decisions about whether to marry and how

much to work. Reducing marriage penalties would lessen the tax code's disincentives to marry and, if the changes in EGTRRA were made permanent, simplify families' financial planning. In addition, because this option would lower the marginal tax rate (the rate that applies to a taxpayer's last dollar of income) for many couples, it would help reduce the adverse impact of taxes on labor supply. Research has shown that how much the secondary earners in couples work—that is, the spouses with the lower of the two incomes—is particularly sensitive to tax rates. (An analysis published by the Congressional Budget Office in 1997, using simulations and the pre-EGTRRA tax code, indicated that higher tax rates for lower-earning spouses could prompt them to work from 4 percent to 7 percent less than they might have if they could have filed individually.)

Opponents of the option would argue that it would not only reduce marriage penalties but also increase marriage bonuses. The latter outcome would effectively penalize unmarried taxpayers relative to their married counterparts.

**Revenue Option 47** (Revised March 12, 2003)

# Freeze Tax Rates and Brackets at the 2002 or 2004 Level Under EGTRRA, and Index the Brackets' Upper Limits for Inflation

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | | | | | | | |
| Freeze rates and brackets at 2002 level and index for inflation | 10.8 | 13.3 | 24.4 | 29.0 | 30.0 | 107.5 | -0.5 |
| Freeze rates and brackets at 2004 level and index for inflation | -0.5 | -1.4 | 10.9 | 15.9 | 17.6 | 42.5 | -143.0 |

Source: Joint Committee on Taxation.

Before 2001, the federal individual income tax contained five brackets, under which income was taxed at 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a 10 percent bracket beginning in 2001; other provisions lower the top four tax rates in stages, beginning in 2006 and later, to 25 percent, 28 percent, 33 percent, and 35 percent. (The 15 percent rate was not changed.) All but the lowest bracket are indexed for inflation throughout the 2004-2013 period, and indexing of the 10 percent bracket will begin in 2009. As with all provisions of EGTRRA, the tax rates revert to their pre-2001 levels after the law expires on December 31, 2010.

This option would freeze the tax-bracket changes established by EGTRRA at either their 2002 or 2004 levels. For 2002, the brackets include the new 10 percent bracket and rates for the higher levels—27 percent, 30 percent, 35 percent, and 38.6 percent—that are each 1 percentage point lower than the rates in effect before 2001. The rates for 2004 are the same except that the top four rates are each reduced by an additional percentage point. Both alternatives would index all brackets for inflation beginning in 2004.

Freezing the brackets at their 2002 levels would increase revenues by $10.8 billion in 2004 and $107.5 billion over the 2004-2008 period. Moving permanently to the 2004 brackets would decrease revenues by $0.5 billion in 2004 and $143 billion over the 2004-2008 period.

Proponents of freezing EGTRRA's cuts in tax rates assert that the slowdown in the economy and the accompanying drop in revenues make it desirable for higher-income taxpayers to forgo the law's scheduled rate reductions in the interest of balancing the budget. All taxpayers saw their rates fall in 2001, and these options would maintain those cuts. However, they would also deny additional cuts on the grounds that future rate reductions under EGTRRA would affect only the top four brackets, which apply to the 32 percent of taxpayers with the highest income. Making the rate cuts permanent, say proponents of the option, would also simplify planning for the future. The scheduled expiration of EGTRRA's provisions after 2010 creates uncertainty about whether the Congress will change the law over the next few years. Some of that uncertainty could be mitigated by freezing tax brackets at specified levels.

Opponents of freezing tax rates above the levels scheduled for 2006 argue that lower tax rates will generate more-rapid economic growth as taxpayers decide to work and invest more. High marginal tax rates (the rate that applies to a taxpayer's last dollar of income) discourage work and investment and thus constrain both the level of economic activity and the revenues collected on that activity. Lower tax rates, goes this argument, will encourage economic growth, which can help provide for future needs.

**Revenue Option 48** (Revised March 12, 2003)

# Extend or Freeze the Estate and Gift Tax Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001

| (Billions of dollars) | 2004 | 2005 | 2006 | 2007 | 2008 | Total 2004-2008 | Total 2004-2013 |
|---|---|---|---|---|---|---|---|
| Added Revenues | | | | | | | |
| Option 1 | 0 | 0 | 0 | 4.8 | 5.8 | 10.6 | 10.0 |
| Option 2 | 0 | -7.2 | -7.6 | -4.0 | -3.9 | -22.7 | -77.1 |
| Option 3 | -5.5 | -31.2 | -34.6 | -31.6 | -34.1 | -137.0 | -360.8 |
| Option 4 | -0.5 | -0.8 | -1.0 | -1.3 | -1.7 | -5.3 | -161.7 |

Source: Joint Committee on Taxation.

When a person dies, an estate tax is imposed on the value of assets that are transferred at death, and a gift tax is paid on the value of taxable gifts made during the decedent's lifetime. Only the amount of the estate that exceeds an exemption amount ($1 million in 2003 and increasing thereafter until 2011) is subject to the estate tax. Likewise, only taxable gifts that exceed the lifetime exemption amount ($1 million in 2002 and thereafter) are subject to the gift tax. Gifts and bequests between spouses and charitable bequests are exempt from taxation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phases out and ultimately repeals estate taxes. (It does the same for generation-skipping transfer taxes, which are designed to prevent estates from escaping some estate taxation by the transferring of assets —through gifts during life or through bequests—to individuals more than one generation younger than the transferer.) In addition, EGTRRA retains but reduces the gift tax.

The phaseout of the taxes primarily takes the form of increases in the amount of the estate that is exempt from taxation and reductions in the estate and gift taxes' top marginal rates. EGTRRA set the amount of the exemption under the estate tax at $1 million for 2002, with scheduled increases to $1.5 million for 2004, $2 million for 2006, and $3.5 million for 2009. The law also reduced the top marginal rate paid under the tax in 2002 to 50 percent; it provides for additional declines of 1 percentage point annually through 2007. At that point, the maximum rate stabilizes at 45 percent from 2007 through 2009. In 2002, the amount of the gift tax exemption rose permanently to $1 million.

In 2010, the law repeals estate and generation-skipping transfer taxes, and the top rate on taxable gifts falls to equal the top rate in the individual income tax, currently legislated to be 35 percent. All of EGTRRA's provisions expire on December 31, 2010. As a result, the estate and gift tax returns to its unified pre-EGTRRA form, with a top marginal rate for 2011 of 55 percent. In addition, the amount of an estate and of taxable gifts that is exempt from taxation drops to $1 million.

EGTRRA also phases out (between 2002 and 2005) the credit for state death taxes that is allowable under current law. The credit is scheduled to be repealed in 2005; EGTRRA replaces it with a deduction for death taxes paid to any state or the District of Columbia.

EGTRRA has substantially reduced the number of estates subject to the estate tax relative to the number affected under earlier law. For example, before EGTRRA, about 30,400 estates would have been subject to the tax in 2005, compared with about 16,700 expected now. Similarly, under prior law, about 38,100 estates would have been subject to the tax in 2010, compared with zero under EGTRRA. EGTRRA has also made estate planning significantly more complicated: people now face not only the traditional uncertainty about when they will die and what the ultimate size of their estate will be but also the complexity of legislated phaseouts, repeal, and ultimate reinstatement of the estate and gift tax. The transfer of

wealth to heirs during one's life through the strategic use of gifts (called inter vivos gifting), which is also a significant part of many taxpayers' estate plans, has also become more complicated under EGTRRA.

Several options could be designed to modify the scheduled phaseouts and eventual repeal of the estate tax (and generation-skipping transfer taxes). They range from freezing EGTRRA's provisions as they stand in particular years (Options 1 and 2) to accelerating the repeal of estate taxes (Options 3 and 4).

- Option 1 would retain the estate and gift taxes but permanently freeze the exemption and top rate at their levels in 2005—for an estate exemption level of $1.5 million, a taxable gift exemption of $1 million, and a top marginal rate of 47 percent. In 2005 as well, the state death tax credit would be fully phased out and treated as a deduction. This option would increase revenues by $10.6 billion over the 2004-2008 period. Under it, receipts would rise in 2007 and several subsequent years but would drop after 2011, when EGTRRA's provisions would have expired. Approximately 18,800 estates would be required to pay some federal estate tax in 2009 under this option, compared with approximately 12,300 under EGTRRA.

- Option 2 would retain the estate and gift taxes but permanently set the exemption at $3.5 million and the top tax rate at 50 percent, starting in 2004. The state death tax credit would be fully phased out in 2004, and state death tax payments would be treated as a deduction. Under this option, approximately 4,600 estates would be required to file federal estate and gift tax returns in 2005, compared with approximately 15,700 under EGTRRA. The option would decrease revenues by $22.7 billion over the 2004-2008 period.

- Option 3 would permanently repeal the estate tax in 2004. It would retain the gift tax, with an exemption of $1 million, and set the top gift tax rate to equal the top individual income tax rate. As is the case under EGTRRA, the option would allow each estate to increase, or "step up," the basis of the assets being transferred by as much as $1.3 million. That element of the option affects the calculation of capital gains (or losses)—and any applicable taxes—when the assets are eventually sold. A capital gain or loss on an asset is measured by the amount of the proceeds received from its sale minus the taxpayer's basis in the property. A taxpayer's basis generally represents his or her investment in an asset. "Carryover basis" on inherited property means that the basis of an asset in the hands of the heir is the same as it was in the hands of the decedent. "Stepped-up basis," for estate tax purposes, means that the basis of the property passing from a decedent's estate is generally the fair market value on the date of the decedent's death or on the alternate valuation date, as specified by law. This option would also increase by $3 million the basis of property that could be transferred to a surviving spouse. It would reduce revenues by $137.0 billion over the period from 2004 through 2008.

- Option 4 would make the repeal of EGTRRA's estate tax provisions permanent in 2010 and permanently freeze the gift tax provisions as EGTRRA specifies for 2010. This option would reduce revenues by $161.7 billion over the 2004-2013 period.

Advocates of these options might argue that they would simplify estate planning by providing more certainty about future estate and gift tax law. Another potential benefit would be the options' exemption of smaller estates from the filing of estate tax returns, which would reduce the filing burden of those taxpayers. Under the options, smaller estates would also be more likely to avoid incurring estate tax liability, which would reduce the potential for small businesses to have to liquidate to pay estate taxes.

Yet some observers criticize the first two options, which would retain the estate and gift taxes, as having the potential to hurt small businesses. They point out that under the options, federal estate tax returns would still have to be filed for some estates and some estates would still incur estate tax liability. Other critics of these options would oppose the permanent increase in the exemption, preferring that it return to $1 million in 2011.

Opponents of the options for repealing the estate tax support the progressivity of estate and gift taxes and believe

that they reduce the concentration of wealth in the United States. Some critics might also contend that repealing the estate tax would reduce charitable giving because it would eliminate the tax deduction for charitable bequests and thus an incentive that encourages individuals to make bequests. They also point out that, first, the negative impact of the estate tax on small estates and closely held businesses (for example, family-owned firms) could be largely avoided by increasing the amount of the estate that was exempt from taxation; and second, even before EGTRRA, very few businesses were forced to liquidate to pay estate taxes. Critics note as well that the repeal options do not eliminate the filing burden because many estates will still need to file returns and pay estate tax under state law.

Both proponents and opponents of the estate and gift taxes make a variety of claims about the taxes' effect on savings, capital accumulation, and economic growth. However, research in those areas is inconclusive.

CHAPTER

# 4

# Slowing the Long-Term Growth of Social Security and Medicare

Without changes to federal programs for the elderly, the aging of the baby-boom generation will cause a substantial deterioration in the fiscal position of the United States government. The demographics are inexorable: the number of people age 65 and older will nearly double by 2030, while the number of adults under age 65 will grow by only about 15 percent. In addition to those demographic factors, the costs per enrollee in federal health programs are likely to grow much faster than inflation.

As a result, the amount that the federal government spends on its major retirement and health programs is projected to consume a substantial portion of what the government now spends on the entire federal budget. Beyond 2030, those pressures will intensify as longevity continues to increase and health costs continue to grow, so simply weathering the demographic surge of the baby-boom generation will not be enough to restore the federal government's fiscal posture to its recent norms. To accommodate such growth in spending, either taxes would need to rise dramatically, spending on other federal programs would have to be cut severely, or federal borrowing would soar.

In recent years, the Congressional Budget Office has made a number of long-range projections of spending. Those estimates are highly uncertain and very sensitive to even small changes in demographic and economic assumptions. Seventy-five-year projections prepared for this report merge CBO's assumptions for its current budget baseline for the next 10 years with the long-range demographic and economic assumptions of the Social Security and Medicare trustees. Like CBO's previous estimates, the 75-year projections reflect spending under current policies for the largest federal entitlement programs —Social Security, Medicare, and Medicaid. The projection for Social Security reflects growth in both the number of recipients and wages (the latter being the basis on which individual benefits are calculated). The projections for Medicare and Medicaid also reflect a growing number of recipients as well as higher costs for medical care. For those projections, the rise in health care costs per recipient is assumed to slow to a growth rate of 1 percentage point faster than gross domestic product per capita. While seemingly large, that rate is less than it has been in recent decades.

According to CBO's new long-range projections, which assume the current rules for benefits, outlays for Social Security, Medicare, and Medicaid will grow as a share of GDP by more than two-thirds by 2030, rising from 8 percent of GDP today to 14 percent. By 2050, outlays for the three programs could equal 17 percent of GDP and by 2075, 21 percent—exceeding the average shares of GDP absorbed by all federal spending and revenues over the post-World War II period.[1]

1. For the purpose of the analysis presented in this chapter, the projected shortfall of dedicated taxes to finance Social Security and Medicare is ignored.

This chapter examines options for slowing the growth of Social Security and Medicare.[2] Compared with the spending trajectory under current law, the options would lessen the risk of unsustainable deficits and thus enhance the economic prospects of future generations. Of course, reducing the growth of Social Security benefits means lower future benefits than those currently scheduled under the law. However, the alternative of doing nothing could also mean lower benefits, given that the trustees for the two programs project that the Treasury Department's authority to spend for them will be curtailed abruptly—in 2030 for the Hospital Insurance part of Medicare and in 2041 for Social Security—as the programs' respective trust fund balances would fall to zero in those years. (As accounting devices, the trust funds reflect spending authority, and their balances allow the Treasury to make disbursements for the programs, but they do not provide the resources to make benefit payments.) Moreover, that scenario does not reflect the potential strain on overall budgetary resources that is likely to occur when the revenues that the Treasury receives for the two programs fall below their spending—which is projected to occur as early as 2010—and the possibility that having to constrain all other government activities will cause policymakers to curb Social Security and Medicare spending much earlier than the dates projected for the depletion of the trust funds. That gap between the programs' spending and revenues grows wider with time.

Any option to relieve the long-term fiscal pressures requires either substantially constraining the growth of benefits or raising the burden on future taxpayers. There is no free lunch in addressing the looming strains that Social Security and Medicare could create. Economic growth that is greater than what is currently projected could help mitigate the problem but by itself is unlikely to render a solution. Greater economic growth could result in higher incomes and thus higher tax receipts. But because expenditures for these two programs are driven in large measure by earnings in the economy (Social Security benefits are derived from an individual's wage history, and much of Medicare spending is composed of labor costs), a larger economy will also result in higher spending for the programs. A significant advantage of a larger economy comes from the timing of the higher potential receipts vis-à-vis the higher expenditures. The higher tax receipts would be collected while people were working, whereas a substantial portion of the higher expenditures would arise later, during their retirement years. That timing advantage may help, but given the magnitude of the projected fiscal pressures, it is unlikely by itself to be sufficient to close the gap.

The advantage of acting sooner rather than later is illustrated by one of the options for Social Security discussed in the ensuing pages. Under the Social Security trustees' latest projections, in 2041 the system will lack 34 percent of the resources that it needs to fully cover its benefit commitments. If the rise in the level of initial benefits was constrained by roughly 1 percent each year starting with people who retire in 2029, the system would still lack 29 percent of the resources needed in 2041. If that restraint started 10 years sooner (that is, with those retiring in 2019), the gap in resources would be 26 percent. If it started in 2009, the gap would be only 14 percent, and if it started in 2004, the gap would shrink to 10 percent.[3] Thus, the sooner action is taken, the less likely will be the need for an abrupt increase in taxes or a cut in the benefits of *all* recipients, not just a constraint on the incremental rise in initial benefits of new retirees.

## Social Security

In 2002, the federal government spent over $450 billion to provide Social Security benefits to more than 46 million retired or disabled workers, their dependents, and survivors. According to CBO's projections, under the current structure of benefits, spending will exceed the tax

2. This chapter summarizes the situation for Medicaid; specific short-range options for that program appear in Chapter 2 on pages 128 to 133.

3. For the alternatives that would begin to constrain the rise in initial benefits before 2029, CBO assumed that the normal retirement age for Social Security benefits would not increase beyond age 66—thereby keeping the alternatives from resulting in a decline in the real value of benefits from one cohort to the next. Under current law, the normal retirement age is scheduled to rise gradually from age 66 to age 67 beginning with people who become eligible in 2017.

revenues earmarked for Social Security beginning in 2017. By 2030, total spending (in 2002 dollars) will reach about $1.2 trillion for 85 million beneficiaries. On average, beneficiaries will receive about $14,000 per year in 2030, compared with about $10,000 in 2002.

Three broad approaches for slowing the growth in spending for Social Security have received considerable attention. First, policymakers could alter the formula used to calculate benefits for newly eligible Social Security beneficiaries to constrain the increase in initial benefits from one cohort to the next. Second, they could increase the age at which workers became eligible for full benefits, referred to as the "normal retirement age," which also would constrain the increase in initial benefits. Third, they could reduce the cost-of-living adjustments that beneficiaries received once they were on the rolls. Specific options to illustrate both the strengths and the weaknesses of those approaches are presented below, along with estimates of the savings they could bring.

In general, workers are eligible for retirement benefits if they are at least age 62 and have had sufficient earnings on which they paid Social Security taxes in at least 10 years. Workers whose employment has been limited because of a physical or mental disability can become eligible at an earlier age with a shorter employment history. Various rules apply to family members of retired, disabled, or deceased workers.

If policymakers decide to slow the growth in Social Security benefits, equity and efficiency argue for enacting those changes long before they take effect. People view entitlement programs for the elderly and the disabled as long-term commitments between the government and the citizenry, and they may have based their behavior on current provisions. Deciding soon on any future changes in such programs and making gradual changes in spending and tax policies would give people more time to plan and adjust. The Congress set such a precedent when it amended the Social Security system in 1983. When policymakers raised the age at which retired workers could receive full benefits, the first workers affected by that change were then only 45 years old. By announcing the change so far in advance, the government gave them the opportunity to take that new policy into account when planning for retirement.

## Background on Social Security

Social Security is, by far, the federal government's largest income redistribution program, playing a critical role in supporting the standard of living of its beneficiaries. The Social Security system has two parts. The Old-Age and Survivors Insurance (OASI) program is the part of the system that provides benefits to retired workers, members of their families, and their survivors. The other part, Disability Insurance (DI), funds benefits for disabled workers younger than the normal retirement age and their dependents. OASI is by far the larger program: last year it accounted for about 85 percent of the spending for the two parts combined (referred to as OASDI). Benefits for both parts are financed primarily from payroll taxes paid by workers and employers on earnings covered by the OASDI program. The combined tax rate for 2003 is 12.4 percent of covered earnings—up to $87,000 annually.[4]

In confronting the impending imbalance between benefits and the revenues designated to pay for them, the Congress will need to decide what the Social Security system should attempt to accomplish and what legislative changes will be needed to ensure that the system achieves those goals for the baby boomers and subsequent generations. The current design of the Social Security system represents a trade-off between ensuring a sufficient level of benefits for the poorest beneficiaries and distributing benefits so that workers who have paid more taxes for Social Security receive more in benefits. The progressive benefit structure of the program reflects the attempt to balance those two objectives. Retired workers with a history of low wages receive benefits that replace a higher percentage of their preretirement earnings than do other

4. For a fuller discussion of how Social Security works and how changes to the program might affect the nation's ability to deal with its impending demographic shifts, see Congressional Budget Office, *Social Security: A Primer* (September 2001).

retired workers. Nonetheless, workers who earned higher wages receive a higher level of monthly benefits.[5]

## Approaches and Illustrative Options for Slowing the Growth of Social Security

To reduce the projected growth in spending for Social Security, legislation is needed to curtail the commitments made under current law. All of the approaches examined below have been proposed in recent years. The specific options shown here do not exactly replicate those approaches; they are designed more to show their generic forms. The estimates of savings are intended to indicate relative magnitudes of change.

***Constrain the Increase in Initial Benefits***. The most straightforward method of reducing the growth in Social Security spending is to slow the rates at which initial benefits rise from one cohort to the next. The effect of that approach would be to reduce the size of initial benefits going to each new group of eligible beneficiaries. The benefits awarded to them would still rise in nominal terms but only enough to keep up with inflation. That approach would not alter the benefits of those already on the rolls prior to its implementation.

Procedures under current law base the benefits of retired (and disabled) workers on their past earnings, expressed as an average level of earnings over their working lifetime —their average indexed monthly earnings (AIME). From that average, a formula calculates workers' primary insurance amount (PIA). The Social Security Administration then adjusts the PIA for a number of factors, such as reductions for early retirement, credits for later retirement, and increases for inflation.

The Social Security Administration bases workers' AIME on wages in employment covered by the Social Security program (up to the taxable maximum), with some adjustments. Earnings on which retired workers and their employers paid Social Security taxes are indexed to compensate for past inflation and real (inflation-adjusted) growth of wages. To convert the AIME to the PIA, the Social Security Administration applies a progressive formula in which the PIA replaces a higher proportion of preretirement earnings for people with low average earnings than it does for those with higher earnings.[6] The thresholds used in that formula are indexed to average annual earnings for the labor force as a whole. As a result of that feature, benefits for future recipients are designed to grow in real terms.

In general, workers will receive lower monthly benefits if they retire earlier than the normal retirement age. For example, workers who retire at age 62 in 2003 will receive a permanent 23 percent reduction. The size of that reduction is intended to be actuarially fair: the present value of the reduced monthly benefits that average workers could expect at age 62 is roughly equivalent to the present value of the full monthly benefits they could expect by delaying initial benefits until the normal retirement age (for example, 65 years and 8 months for workers age 62 in 2003). Similarly, workers who delay collecting benefits beyond the normal retirement age receive a credit to compensate them for the reduction in the length of time that they will receive benefits.[7]

Workers who had average earnings throughout their career and retired at age 65 in 2002 were eligible for an annual benefit of about $13,500, which replaced 40 percent of their previous annual earnings. Under current law, workers with average earnings who retire at age 65 in the future will receive benefits that will replace a smaller percentage of their past earnings. The scheduled increase in

5. Even though the formula for calculating monthly benefits is progressive (in that it favors retired workers with low lifetime earnings), some people have questioned whether the overall benefit structure of the Social Security program is progressive. They point out that men with low lifetime earnings have shorter life spans, on average, than other men. Other people, however, observe that Social Security also provides benefits to the survivors of deceased workers and to disabled workers—features that contribute to the program's progressivity.

6. The following formula is used for workers who reach age 62 in 2003: PIA equals 90 percent of the first $606 of the AIME, plus 32 percent of the AIME between $606 and $3,653, plus 15 percent of the AIME over $3,653.

7. Starting with beneficiaries born in 1943, each year delayed beyond the normal retirement age will add 8 percent to their benefits. The delayed retirement credit for workers reaching the normal retirement age in 2003 is 6.5 percent.

the normal retirement age, discussed below, will produce most of the decline in the replacement rate.

Even with that decline, the real value of initial benefits will rise in the future as a result of the wage-indexing adjustments made in the calculation of benefits. An option that has received considerable attention would change the way benefits are calculated so that the real value of initial benefits would no longer rise. That option, which would link the growth in initial benefits to a price index, rather than to a wage index, would ensure that the purchasing power of future benefits was maintained, but it would no longer pass along gains in purchasing power that resulted from the growth of productivity in the economy. As a result, as long as average real wages continued to rise, the average replacement rate would fall for beneficiaries. Real benefits, however, would not decline.[8]

If such an option was implemented in 2009, each cohort of newly retired and disabled workers thereafter would receive benefits that were lower than what they would have received under the current rules. The difference would increase over time—cohort by cohort—with its size determined by how much real wages grew. If the growth of real wages was about 1.1 percent per year, for example, the projected impact on future benefits would be quite large. For example, workers becoming eligible for benefits in 2030 would receive nearly 20 percent less than they would under the current rules, and workers becoming eligible in 2075 would receive about 50 percent less. The value of the average benefits for each cohort would be similar to that for recent beneficiaries, but those benefits would replace a much smaller percentage of earnings. CBO estimates that adoption of this option would cut Social Security outlays in 2075 by about 40 percent from what they would be if benefits remained as currently prescribed.[9]

8. To prevent real benefits from declining under this option, the normal retirement age was assumed not to increase beyond age 66.

9. The estimates for Social Security spending in this chapter are based on CBO's long-term simulation model (CBOLT). The version of the model used here is based on a methodology and assumptions about key economic and demographic factors similar to those used by the Social Security Administration's Office of the Chief Actuary.

***Raise the Retirement Age***. Under current law, the age at which workers become eligible for full retirement benefits (or the normal retirement age) is 65 years and 8 months for people reaching age 62 this year and will gradually increase to 67. For workers born before 1938, the normal retirement age was 65. That eligibility age increases in two-month increments for workers thereafter, reaching 66 for workers born in 1943. It remains at 66 for workers born from 1944 through 1954. It then begins to rise again, in two-month increments, until it reaches 67 for workers born in 1960 or later. Workers can still receive benefits at age 62, but with a larger reduction for taking them early (that is, prior to their normal retirement age).

Some Members of Congress and others have recommended that the shift toward the normal retirement age of 67 be accelerated and that the age be extended further thereafter. Proponents point out that people age 65 today are projected to live significantly longer than was the case in the early days of the Social Security system, that life expectancy is projected to continue to increase, and that that otherwise favorable development will raise the cost of the program.

Under the specific option illustrated here, the transition to the normal retirement age of 67 would be accelerated, followed by further increases so that the normal retirement age would keep up with assumed future increases in life expectancy (*see Table 4-1*). The normal retirement age of workers born in 1949 would be 67. Thereafter, the retirement age would increase by two months a year until it reached 70 for workers born in 1967. After that, it would increase by one month every other year. As under current law, workers would still be able to begin receiving reduced benefits at age 62, but the amounts of the reductions would be larger. This option would produce substantial savings in relation to projected spending levels under current law: by 2075, the savings would be about 20 percent.

As with the option to constrain the rise in initial benefits, raising the normal retirement age to keep up with future increases in life expectancy would shift the nature of the government's commitment somewhat. Debate about the level of Social Security benefits tends to focus on how much beneficiaries will receive each month rather than

**Table 4-1.**

## Increase in the Normal Retirement Age Under Current Law and an Illustrative Option

| Year of Birth | Year in Which Age 62 Would Be Reached | Year in Which Age 65 Would Be Reached | Normal Retirement Age | Reduction for Retirement (Percentage of PIA) | |
|---|---|---|---|---|---|
| | | | | At Age 62 | At Age 65 |
| | | **Current Law** | | | |
| 1943 | 2005 | 2008 | 66 | 25.00 | 6.67 |
| 1960 | 2022 | 2025 | 67 | 30.00 | 13.33 |
| | | **Illustrative Option**[a] | | | |
| 1943 | 2005 | 2008 | 66 | 25.00 | 6.67 |
| 1949 | 2011 | 2014 | 67 | 30.00 | 13.33 |
| 1955 | 2017 | 2020 | 68 | 35.00 | 20.00 |
| 1961 | 2023 | 2026 | 69 | 40.00 | 25.00 |
| 1967 | 2029 | 2032 | 70 | 45.00 | 30.00 |
| 1991 | 2053 | 2056 | 71 | 50.00 | 35.00 |

Source: Congressional Budget Office based on information provided by the Social Security Administration, Office of the Actuary.

Note: PIA = primary insurance amount.

a. Under this option, the normal retirement age of workers who turned 62 in 2011 would be 67. After 2011, the retirement age would increase by two months a year until it reached 70 in 2029, and then it would increase by one month every two years.

on how much they will receive over their lifetime. But because of increasing longevity, a commitment to provide retired workers with a certain amount of monthly benefits at age 62 in, say, 2030, is actually more costly than that same commitment made to today's recipients. Linking the normal retirement age with future increases in life expectancy is one way of dealing with that source of the program's rising costs.

For most purposes, this approach to constraining the growth in benefits is equivalent to cutting replacement rates. However, the benefits of workers who qualify for Disability Insurance would not be reduced. Consequently, older workers nearing retirement would have a somewhat stronger incentive to apply for DI benefits in order to receive a higher monthly amount. For instance, under current law, workers retiring at age 62 in 2029 would receive 70 percent of their PIA; yet if they qualified for DI benefits, they would receive 100 percent. Under this illustrative option for increasing the normal retirement age, workers retiring at 62 in 2029 would receive only 55 percent of their PIA but would still receive 100 percent if they qualified for DI benefits. (To avoid increasing the incentive to apply for DI benefits, policymakers could narrow that difference—for example, by setting the benefits for workers who qualified for Disability Insurance at the level they would have received upon retiring at age 65.)

***Reduce the Cost-of-Living Adjustment***. Each year, the Social Security Administration adjusts monthly benefits by the increase in the consumer price index (CPI). For example, the 1.4 percent cost-of-living adjustment (COLA) effective for December 2002 was based on the increase in the CPI for urban wage earners and clerical workers (CPI-W) between the third quarter of 2001 and the third quarter of 2002. The basic level of benefits is raised by the percentage increase in the CPI-W beginning when workers become eligible for them, which for retired workers is age 62.

One way of reducing the growth in Social Security benefits is to reduce the automatic COLA. Some policymakers suggest that the law be changed to provide a COLA equal to the increase in the CPI minus a specified number of percentage points. To illustrate that approach, CBO estimated the effect of determining the COLA on the basis of the increase in the CPI minus 1 percentage point for December 2003 and thereafter. Doing so would reduce outlays by about 10 percent in 2075; most of that reduction (in percentage terms) would be achieved by 2030.

Unlike constraining the increase in initial benefits and raising the retirement age, this option of reducing the cost-of-living adjustment could be used to reduce the growth in the benefits of current beneficiaries and workers who will soon be eligible for Social Security. The estimated impact on monthly benefits for those first two options would progressively increase from one cohort to the next—either because of real wage growth or increased longevity. Thus, the baby-boom generation would incur a relatively small portion of the reductions in benefits. However, trimming the COLA would be one way of having the baby-boom generation and future generations share more evenly in the reductions.

Moreover, many economists believe that the CPI may overstate increases in the cost of living, but they disagree about the size of the overstatement. Devising a "true" cost-of-living index is problematic, and collecting and compiling data for such an index are difficult. For those reasons, economists have had trouble reaching a strong consensus on the issue. In 1996, the Advisory Commission to Study the Consumer Price Index (known as the Boskin Commission) concluded that the CPI probably overstated the change in the cost of living by between 0.8 percentage points and 1.6 percentage points a year.[10] Since the commission's report was issued, the Bureau of Labor Statistics has made several changes to the way that it calculates the CPI and has thereby eliminated some of the problems with the index. But some thorny issues remain, including how to measure the cost of living for Social Security beneficiaries, whose purchasing patterns may differ from those of other consumers.

To the extent that the CPI still overstates increases in the cost of living for Social Security recipients, policymakers could reduce the COLA by a corresponding amount without making benefits any lower in real terms than they were when the recipients became eligible for the program. In contrast to an equivalent across-the-board constraint on the increase in initial benefits (or an equivalent increase in the normal retirement age), reducing the COLA generally would most affect the oldest beneficiaries and those who initially became eligible for Social Security on the basis of disability. Alternatively, lawmakers might choose to reduce the COLA of only those beneficiaries whose benefits or income was above specified levels, but doing so would reduce the savings. (Some beneficiaries with low income and few assets would receive Supplemental Security Income [SSI] benefits, which would offset some or all of the reduction in their Social Security benefits; the increased spending for SSI would help those beneficiaries, but it would also directly reduce the budgetary savings from this option by a small amount.)

The impact of even a relatively small reduction in the COLA would be quite large for older Social Security recipients in the future because their benefits would reflect the cumulative effects of a series of smaller adjustments tied to the cost of living. For example, if benefits were adjusted by 1 percentage point less than the increase in the CPI every year, beneficiaries at age 75 would incur a 12 percent reduction in benefits compared with what they would have received under current law; at age 85, they would get a 20 percent reduction; and at age 95, they would get a 28 percent reduction.

### Conclusions About Social Security

Reducing the growth in spending for Social Security would require cutbacks in the commitments that the law currently prescribes. Constraining the rise in initial benefits, gradually increasing the normal retirement age, or reducing the cost-of-living adjustment could all produce substantial savings and still preserve the basic benefit structure of the Social Security system. Each of the options would also improve the outlook for the program's finances (*see Box 4-1*).

10. Advisory Commission to Study the Consumer Price Index, *Toward a More Accurate Measure of the Cost of Living: Final Report to the Senate Finance Committee* (December 1996).

**Box 4-1.**

## Impacts of Illustrative Options on Social Security's Finances

When considering questions about the financial status of the Social Security program in isolation, analysts often use three measures. One looks at the relationship between the program's costs and income in any given year, as measured by the projected gap between the two, expressed as a percentage of payroll subject to the Social Security tax, focusing on the first year in which projected annual costs exceed projected revenues (other than interest). Another measure is the first year in which the combined Social Security trust funds are projected not to have an amount credited to them that is sufficient to pay that year's benefits. A third measure summarizes the expected adequacy of trust fund balances over a specific projection period. The 75-year actuarial deficit is the difference between annual costs and income, expressed as a percentage of taxable payroll, summarized over the period. The table below provides the Congressional Budget Office's estimates of those yardsticks under the current rules for calculating benefits and under each of the three options for Social Security that are presented in this chapter.

By any of those yardsticks, the Social Security program's long-term financial outlook is not good. In 2017, projected outlays for Social Security will begin to exceed the tax revenues earmarked for the program. Once that happens, the federal government will need to draw on other resources to fund Social Security, even though the program's combined trust funds will continue to be credited with interest on the balances. The trust funds themselves are projected to be depleted in 2041. The 75-year projected actuarial deficit in the trust funds is nearly 2 percent of taxable payroll—meaning that the present value of the projected financial obligations of the program over that period substantially exceeds the present value of the resources projected to be available to the program under current law. According to the program's actuaries, an immediate, permanent 15 percent increase in the payroll tax or an equivalent reduction in benefits would be needed to eliminate that deficit.

Each of the three illustrative options discussed in this chapter would improve the program's outlook, but only the option of constraining the increase in initial benefits would reduce the growth in costs by enough to ultimately close the gap between costs and income, prevent the trust funds from being depleted, and eliminate the 75-year actuarial deficit. The options of raising the normal retirement age and reducing the cost-of-living adjustment would delay the date at which the trust funds were depleted and would substantially reduce the actuarial deficit, but additional steps—to slow the growth in benefits or to increase resources earmarked for the program—would be required to bring the program's finances into balance.

| | Current Law Base Case | Constrain the Increase in Initial Benefits | Raise the Retirement Age | Reduce the COLA |
|---|---|---|---|---|
| Cost/Income Gap (Percentage of taxable payroll) | | | | |
| 2002 | 1.83 | 1.83 | 1.83 | 1.83 |
| 2030 | -4.02 | -2.30 | -2.60 | -2.46 |
| 2050 | -4.64 | -0.89 | -2.02 | -2.79 |
| 2075 | -6.37 | 0.46 | -2.54 | -4.28 |
| First Year in Which Costs Exceed Noninterest Revenues | 2017 | 2019 | 2019 | 2020 |
| First Year in Which Combined OASDI Trust Funds Are Depleted | 2041 | n.a.[a] | 2064 | 2063 |
| 75-Year Actuarial Deficit of the Combined OASDI Trust Funds (Percentage of taxable payroll) | -1.89 | 0.28 | -0.39 | -0.58 |

Source: Congressional Budget Office.

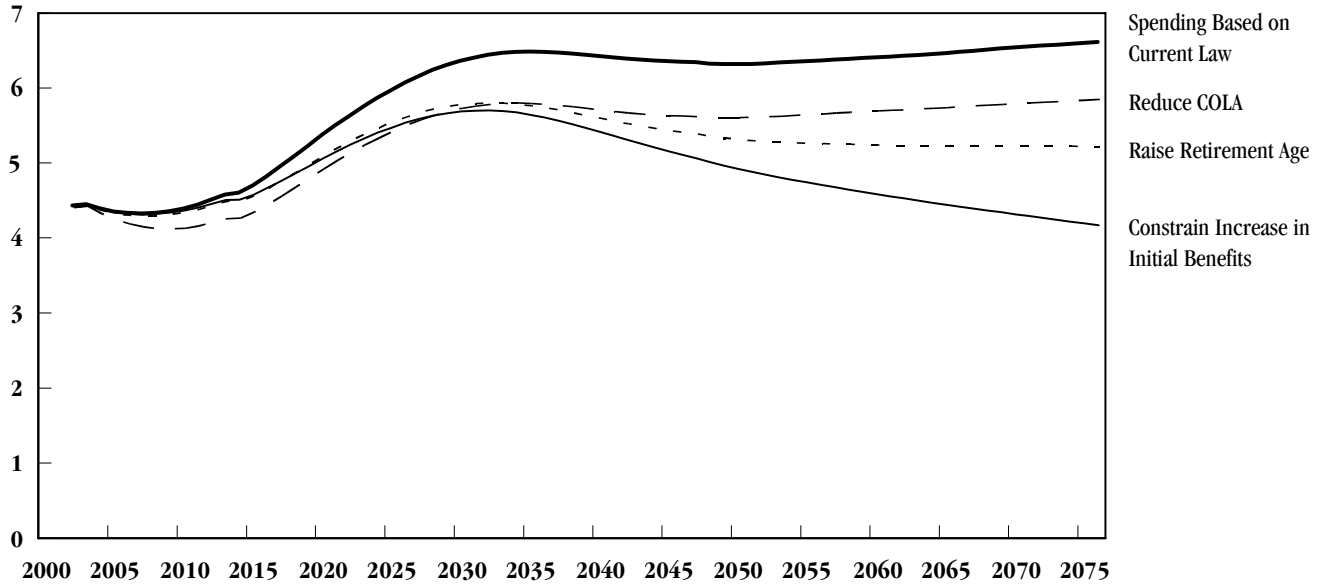
Note: COLA = cost-of-living adjustment; OASDI = Old-Age and Survivors Insurance and Disability Insurance programs.

a. Not applicable because under this option, the trust funds would not be depleted within the 75-year projection period.

**Figure 4-1.**

## Federal Spending Under Illustrative Options for Slowing the Growth in Social Security

(Percentage of GDP)




Source: Congressional Budget Office.

Note: See the text of this chapter for descriptions of the illustrative options.

The option to constrain the rise in initial benefits by linking their growth to a price index rather than to a wage index would achieve the largest savings because once it was fully implemented, the nominal growth in Social Security benefits would no longer respond to the general growth in real wages in the economy. Thus, by 2075 projected spending for Social Security benefits as a share of GDP would be 4.2 percent of GDP (slightly below its current share) instead of rising to 6.6 percent, as projected under current law (*see Figure 4-1 and Table 4-2*). Neither of the other illustrative options would reduce the growth in benefits by enough to prevent outlays for the program from becoming a significantly larger share of national income once the baby-boom generation retired. The option for increasing the normal retirement age would cut projected spending in 2075 by about 1.4 per cent of GDP. Reducing the COLA would cut projected spending by about 0.7 percent of GDP.

Considering Social Security, Medicare, and Medicaid together, CBO projects that, under current policies, the costs for the programs will increase from about 8 percent

**Table 4-2.**

## Effects of Illustrative Options for Reducing Growth in Spending for Social Security

(Percentage of GDP)

| | 2002 | 2030 | 2050 | 2075 |
|---|---|---|---|---|
| Current-Law Base Case | 4.4 | 6.3 | 6.3 | 6.6 |
| **Effects of Illustrative Options** | | | | |
| Constrain the Increase in Initial Benefits | n.a. | -0.7 | -1.4 | -2.4 |
| Raise the Retirement Age | n.a. | -0.5 | -1.0 | -1.4 |
| Reduce the COLA | n.a. | -0.6 | -0.7 | -0.7 |

Source: Congressional Budget Office.

Notes: n.a. = not applicable; COLA = cost-of-living adjustment.

See the text of this chapter for descriptions of the illustrative options.

The effects of each illustrative option are considered in isolation; if joined together, the options would interact in ways that would reduce the combined savings.

this year to 21 percent by 2075. Even though constraining the increase in initial benefits in the Social Security program by linking their growth to a price index—the illustrative option producing the largest savings—would solve that program's long-term fiscal problem, it would eliminate only about one-fifth of the projected increase in spending for the three programs combined. The other illustrative options would each make a notably smaller contribution toward slowing the growth in spending for all three programs. Additional savings could be achieved by combining the options, but doing so would further reduce the income of Social Security recipients.

## Medicare

After changes in the reimbursement of providers were imposed under the Balanced Budget Act of 1997, per capita Medicare spending remained stable between 1997 and 1998, and it actually fell by nearly 2 percent in 1999. In 2000, it grew by only 2 percent. But that slowdown in spending was short-lived. The growth in per capita spending resumed higher levels in 2001.

CBO expects that growth to continue at high levels in the future, causing Medicare spending to increase from 2 percent of GDP today to about 9 percent in 2075. That long-term projection is based on demographic forecasts similar to those used by the Social Security Administration's actuary; and it assumes that spending growth per beneficiary from 2028 through 2075 will decline to 1 percentage point above the growth in per capita GDP —which is similar to the intermediate assumption made by the trustees of the Medicare trust funds. That projected rate of growth is considerably lower than the historical rate of growth for Medicare.[11] Although CBO's projection is intended to reflect the path of spending under current law, it is based on the assumption that the private sector will act to constrain health care costs and that, in the long run, Medicare spending will have the same per capita growth rate as private health care.

The same demographic trends contributing to growth in Social Security spending will drive long-term growth in Medicare spending. The Medicare population will expand rapidly as baby boomers retire and as longevity continues to extend. Increases in the cost of the program per person will add to Medicare's long-term cost growth.

Medicare's payment schemes under its fee-for-service program, which covers approximately 88 percent of enrollees, create incentives for health care providers to increase the volume of services that they furnish. For each service (or bundle of services) from providers, Medicare makes a payment, so providers that are successful in increasing their volume of services increase their revenues. The program has limited ability to control through the payment system the total number of services furnished; instead, it generally can only set the amount of payment per service. That problem, driven by the volume of transactions, is most serious in physician services, although it also exists for durable medical equipment and laboratory services and other types of providers as well.[12]

Two broad approaches might be used to reduce federal spending on Medicare in the future:

- Reducing the number of people who are eligible for benefits and
- Lowering Medicare's costs per eligible person.

Reducing the number of people who are eligible for benefits is a matter of determining which individuals would be affected and when to implement the change. Lowering Medicare's costs per person could be achieved in several ways. One would be to shift more expenses to enrollees by raising premiums or boosting cost sharing. Another way would limit what Medicare contributes toward health care expenses. A defined contribution could

11. For example, from 1970 to 2000 Medicare spending per beneficiary grew at an annual rate of about 3 percentage points above the annual growth in per capita GDP. Per capita spending on health care historically has risen faster than per capita GDP as a result of the introduction of new technology and muted concern by consumers about its cost because of insurance coverage.

12. The Congress and the President have enacted legislation directed at controlling the volume of physician services (and thus the total payments to physicians) through a mechanism called the sustainable growth rate. That mechanism adjusts the payment rate per service to reflect the overall volume of services that has been furnished in the past, relative to a target. If the volume of services exceeds the target, payment rates will be reduced; conversely, if the volume of services comes below the target, payment rates will be raised.

strengthen consumers' and providers' incentives to seek efficient modes of care. Depending on the level of the benefit and the responses of consumers, providers, and health plans, such an approach could but would not necessarily increase the costs borne by beneficiaries. A related approach would be to stimulate private health plans to compete through premiums to a greater extent than they do under current policies. Under competition, enrollees could have the incentive to join the health plans that provided benefits at the lowest cost while maintaining acceptable quality. Another possibility for lowering Medicare's costs per eligible person would be reducing payments to providers.

All of the approaches discussed in this chapter would lower total spending below the level to which it would rise under current policies, but most of the approaches would not change the rate of growth over time. For example, reducing the number of people eligible for Medicare would decrease spending by the amount that those people would have cost the program each year, but the rate of increase in spending for the remaining Medicare population would still be driven by the same factors as before—population growth and per capita increases in spending. However, some approaches, such as introducing more competition, would have the potential to slow growth if they changed incentives for health plans, providers, and enrollees to encourage them to use less—or less expensive—health care.

As in the Medicare program, federal expenditures for Medicaid will grow significantly after the baby boomers reach retirement age. Medicaid is a federal/state program that, like Medicare, provides health coverage to a target population that includes Medicare enrollees who are poor or have medical costs that consume much of their income. Certain Medicare beneficiaries who are very poor or who spend a significant portion of their income on medical care qualify for full Medicaid coverage, which provides not only payments for Medicare premiums and cost sharing but also services not covered by Medicare, such as prescription drugs and long-term care. Other poor Medicare beneficiaries with somewhat higher income have more limited Medicaid benefits, consisting of payments to cover Medicare premiums and cost sharing or the premiums only.

This chapter does not provide options to constrain Medicaid spending, but several options for the program appear in Chapter 2. Because many opportunities for cost cutting lie with the states, which have primary management responsibility for Medicaid and considerable discretion in tailoring their Medicaid plans, federal policies for reducing Medicaid spending are limited primarily to reducing the federal contribution to the program and restricting the coverage options available to the states. Both are approaches that have encountered strong resistance from state governments. Another option would convert to a block grant supplemental payments to hospitals that serve large numbers of the poor and uninsured.[13]

Over the past decade, many states have expanded eligibility for Medicaid and benefits far beyond federally mandated levels. In a climate of cost reduction, states could reduce rates for payments to providers, cut back on eligibility standards, trim enrollment through decreased outreach, and reduce the scope of benefits provided under the program. States could also increase cost sharing for Medicaid beneficiaries, but only to a modest extent because of federal limits. In any case, given the income levels of Medicaid beneficiaries, the potential savings from increasing cost sharing are modest at best. (*See Box 4-2.*)

## Background on Medicare

Medicare provides federal health insurance for 40 million people who are aged or disabled or who have end-stage renal disease. Part A of Medicare, or Hospital Insurance (HI), covers inpatient services provided by hospitals as well as skilled nursing, home health, and hospice care. Part B, or Supplementary Medical Insurance (SMI), covers services provided by physicians, limited-licence practitioners (such as chiropractors and podiatrists), hospitals' outpatient departments, home health agencies, and suppliers of medical equipment.

Everyone who is eligible for Social Security benefits on the basis of age or disability is ultimately eligible for Medicare as well. For early retirees, eligibility for Medicare is delayed until age 65. Similarly, after they become eligible for Social Security, disabled enrollees must wait two years to become eligible for Medicare. In addition,

13. See option 550-05.

**Box 4-2.**

## Medicaid and Long-Term Care

As with the Medicare program, federal expenditures for Medicaid are projected to grow significantly as the baby boomers begin reaching age 65 in 2011, but the most significant growth for the Medicaid program will probably materialize around 2030—when baby boomers begin to join the ranks of the "oldest old" (those age 85 or older) and many of them begin to need long-term care services.[1] The potentially large future demand for long-term care services poses a major challenge for federal policymakers and for the economy. Spending from all sources for nursing home and home-based services for seniors is expected to exceed $120 billion in 2002 (see the table). Increasing costs are driven by both the growing number of senior citizens and higher costs for care. By 2040, spending on long-term care is projected to reach $346 billion (in 2000 dollars), or 1.5 percent of gross domestic product (GDP), up from 1.2 percent of GDP in 2002.

### The Use of Long-Term Care Services by the Elderly

Long-term care comprises a variety of medical and social services for elderly and disabled people whose disabilities prevent them from living independently. Formal long-term care services may be provided in the home or community or in institutions for those who can no longer remain in their homes. Not all people who could use such services receive them, however, because formal services are costly and may be less desirable than informal help from family and friends. Indeed, the most important sources of assistance for disabled elderly people who remain in the community are live-in caregivers and networks of family helpers.

1. While a significant number of people under age 65 are disabled and consume long-term care services, the bulk of such care goes to the elderly.

**Long-Term Care Expenditures for the Elderly, by Source of Payment, 2002 (In billions of dollars)**

| | Institutional Care | Home Care | All Long-Term Care |
|---|---|---|---|
| Third-Party Payers | | | |
| Medicaid | 34.8 | 7.0 | 41.9 |
| Medicare | 13.5 | 15.2 | 28.7 |
| Private insurance | 2.5 | 3.7 | 6.2 |
| Out-of-Pocket Payments | 33.5 | 5.7 | 39.2 |
| Other | 1.2 | 3.6 | 4.8 |
| **Total** | **85.5** | **35.2** | **120.8** |

Source: Congressional Budget Office based on data from the national health accounts, the Medicare Current Beneficiary Survey, the Medical Expenditure Panel Survey, and the Centers for Medicare and Medicaid Services and from the long-term care financing model prepared by the Lewin Group for the Assistant Secretary for Planning and Evaluation of the Department of Health and Human Services.

Despite recent rapid growth in spending for long-term care, most services are still provided informally and are not, therefore, represented in the data on expenditures.

In 1999, about 6.6 million seniors (or about 19 percent of the elderly population) required assistance because of physical or cognitive impairments. Of that number, 1.7 million were in nursing homes, and 1 million were severely disabled but still living in the community, although they probably would have qualified for admission to a nursing home. The remainder were less severely disabled but still potential users of long-term care services.

## Box 4-2.
## Continued

Over the next 30 years or so, the elderly population will double, a level of growth that is also foreseen for the "oldest old" population, which of course is made up of people who are more likely to have disabilities that make them depend on others for assistance. In 2030, the number of seniors who are disabled is projected to be more than 12 million. Although the prevalence of disability among the elderly appears to be on the decline, the large increase in the number of people age 85 or older will more than offset that favorable trend. Those estimates are quite speculative, however, because of the uncertainty that surrounds future rates of disability and longevity among the elderly.

Another uncertainty affecting the future demand for formal long-term care services is whether or not informal caregivers will continue to provide as much care as they do now.

### Financing Long-Term Care for the Elderly

The future growth of spending on long-term care for the elderly has major significance for the federal budget as well as the overall economy. Medicare and Medicaid, the two largest public financing programs, paid for more than half of nursing home and home care expenditures for the elderly in 2002. Medicare pays primarily for medical treatment for acute health problems but has become a de facto provider of long-term care through its coverage of home health care and services in skilled nursing facilities. Although that coverage was originally intended to meet the short-term needs, Medicare's home health benefit is increasingly important for chronic care patients. During the latter part of the 1990s, Medicare spending for home health care fell in response to several factors, including changes in the reimbursement methodology and a crackdown on fraud and abuse, but such spending resumed its steady growth in 2000.

The federal government is the principal payer of formal long-term care services for the elderly. That financing role steadily expanded in the 1990s as a result, in part, of a rapid rise in Medicare spending for skilled nursing facilities and home health services. In 2002, the federal government accounted for about 45 percent of all spending on nursing home and home care for the elderly and about 75 percent of the public expenditures for those services.

By contrast, the role of private insurance in financing long-term care is small, though growing; in 2002 it accounted for about 5 percent of all spending on nursing home and home care for the elderly.[2] Less than 10 percent of seniors have private long-term care insurance, but employers, including the federal government, are increasingly facilitating such coverage as an employee benefit. However, employees typically must pay the total premium. Without a major expansion of the market for private long-term care insurance, the federal government's responsibility for financing long-term care is likely to continue to grow. Yet the use of such services would probably rise significantly if a large percentage of the population had long-term insurance—especially if those policies covered in-home services.

2. Payments by private insurance may be underreported because most insurers reimburse policyholders for costs that they have already incurred and paid, rather than paying providers of services directly. As a result, those payments by insurers may be reported as out-of-pocket spending rather than as spending by private insurance.

people who are 65 or older and not eligible for Social Security benefits may enroll in Medicare by paying premiums. In total, 96 percent of the U.S. population age 65 or older is enrolled in Part A; 92 percent is enrolled in Part B.

Hospital Insurance benefits are financed primarily from current workers' payroll taxes. Supplementary Medical Insurance is financed from two sources: 25 percent comes from enrollees who pay premiums, and 75 percent comes from general revenues.

Medicare requires enrollees to pay part of the cost of most covered services through various arrangements and to various degrees. Inpatient hospital stays, for example, require patients to first pay a deductible ($840 per benefit period in 2003) and then pay additional daily copayments if they have more than 60 days of care. Part B services require a $100 deductible per year. For physician and other medical services, patients generally pay 20 percent of the Medicare-approved amount after they meet the deductible. Some services require no cost sharing, namely, laboratory, home health, and selected preventive services.

The federal government and state governments incur additional health care costs for the Medicare population through Medicaid. Because of the overlap in coverage between Medicare and Medicaid, efforts to control Medicare spending generally will affect Medicaid spending; the magnitude and direction of the effect, however, will depend on the specifics of each proposal. For example, increasing Medicare's cost-sharing requirements would raise Medicaid spending, but lowering Medicare's payments to providers would lower Medicaid spending.

Other governmental and private entities also incur health care costs for Medicare enrollees. Government benefits programs, available through the Federal Employees Health Benefits program and the Departments of Defense and Veterans Affairs, for example, provide health care coverage or services to eligible enrollees.[14] Approximately 33 percent of Medicare enrollees have supplemental coverage provided by a former employer or union. Another 23 percent of Medicare enrollees pay for individual supplemental insurance, or medigap. Such supplemental coverage typically pays for much of Medicare's cost sharing and occasionally for some items that Medicare does not cover, such as prescription drugs.

As described, most Medicare enrollees receive their care through a fee-for-service system. But 12 percent receive their care through private health plans (usually HMOs [health maintenance organizations]) that agree to take on the insurance risk for all Medicare benefits in exchange for a predetermined monthly payment. Operating under the Medicare+Choice (M+C) program, all plans receive payments that are based in part on historical costs in the fee-for-service sector, but they are guaranteed a minimum (floor) payment. If a plan's cost of providing Medicare benefits is less than the capitated payment it receives, it must return all of the excess to enrollees by covering additional benefits or by providing a rebate (which is limited to the amount of the Part B premium). M+C plans have typically offered enrollees lower cost sharing than that required under the fee-for-service system and often have enhanced the benefit package to include services that Medicare does not cover.

## Approaches and Illustrative Options for Slowing the Growth of Medicare Spending

Two broad approaches could slow the growth in federal spending for Medicare: reducing the number of people who are eligible for benefits or reducing the costs per enrollee. Within those two approaches, the illustrative options discussed in this chapter could be combined to generate even more savings.

All of the options involve difficult choices and political challenges. Reducing the number of people who are eligible or reducing the government's costs per enrollee by increasing the share of costs paid by enrollees would shift costs from the Medicare program to those people who

14. Under the Department of Defense's TRICARE for Life program, created in 2000, eligible people age 65 or older receive generous coverage of cost-sharing amounts within the Medicare program, as well as coverage of prescription drugs. Because that supplemental coverage insulates enrollees from having to pay for any of the costs of services, Medicare spending for this population tends to be relatively high.

had lost their coverage or to enrollees (or to the government programs or insurance companies that paid the cost sharing for them). Reducing costs through competition offers the potential for savings through greater efficiency, though beneficiaries who do not wish to join private health plans might face higher premiums than those to which they have been accustomed.

The timing of changes to the program is important from both a budgetary and a policy perspective. The longer legislators postpone changes designed to slow spending, the lower the impact that those changes will have on total spending over time. As with changes to Social Security, equity and efficiency argue for announcing any changes long before they take effect so that people have more time to plan and adjust to the changes.

***Reduce the Number of Enrollees by Raising the Age of Eligibility***. The number of people who are eligible for Medicare could be reduced by gradually raising the age of eligibility, as two options presented here show. The first would gradually increase the age of eligibility for Medicare from 65 to 67 by 2026, to be consistent with currently scheduled increases in the normal retirement age for Social Security benefits. Although the gradual increase has already begun in the Social Security program, this option assumes that the increase in the age of eligibility for Medicare would not start until 2015, to allow people who are currently nearing retirement the time to plan and adjust. Beginning in 2015, the eligibility age would increase by two months every year until it reached 67 in 2026, where it would remain in future years.

The second option assumes that the eligibility age would increase by two months every year beginning in 2015 until it reached 70 in 2044, where it would remain. This option is analogous to the one that would raise the normal retirement age for Social Security (described earlier in this chapter), but it would be phased in more slowly and would not raise the eligibility age above 70.

According to CBO's estimates, the first option, once it was fully in place, would reduce Medicare's enrollment by about 7 percent and net spending by about 3 percent a year, compared with what they would be under current policies. Spending is projected to fall by less than enrollment is because people who are 65 or 66 are typically the least costly enrollees. By 2075, the reduction in net spending for Medicare would be about 0.3 percent of GDP. The second option, once it was fully in place, would reduce Medicare's enrollment by about 17 percent and net spending by about 9 percent a year. By 2075, the reduction in net spending for Medicare would be about 0.7 percent of GDP.

The reduced spending for Medicare would be partially offset by increased spending under Medicaid and the Federal Employees Health Benefits program—both of which would have to pick up part of the health care costs of their beneficiaries whose eligibility for Medicare had been delayed.[15] However, spending would be reduced for the military's TRICARE for Life program, because eligibility for that program is limited to people who are enrolled in Medicare. The effects of raising the Medicare eligibility age on federal spending for these three programs through 2075 are not estimated here. However, to provide an indication of the likely effects, CBO estimates that raising the Medicare eligibility age to 67 or to 70 by 2013 would result in an increase in the combined spending for those three programs equal to about 13 percent to 14 percent of the savings for Medicare.

Although raising the age of eligibility would reduce Medicare spending, it would do little to reduce total health care costs for those eligible for Medicare under current law. Further, it would lengthen the period of time during which those opting for early retirement under Social Security (at age 62) might have difficulty getting insurance coverage. That disadvantage could be lessened by coupling this approach with an option under which early retirees could buy Medicare coverage by paying an actuarially fair premium. Such coverage would be costly, however, and designing it so that it was budget neutral would be difficult because of the need to account for the fact that the people who participated would be expected

15. Raising the eligibility age would also increase state spending for Medicaid because about 17 percent of Medicare enrollees receive Medicaid benefits as well.

to have a greater demand for medical care than those who did not participate.[16]

Increasing Medicare's eligibility age would shift costs that are now paid by Medicare to enrollees and to employers. The higher costs to employers might reduce the number of them who offered health benefits to retirees, thereby accelerating a current trend. Another effect might be to increase the number of applications for disability from the affected population, which would reduce the savings that Medicare would otherwise realize; that effect is not estimated here.

***Decrease Medicare's Costs per Person by Raising Monthly Premiums***. One way to decrease Medicare's costs per person would be to increase enrollees' premiums (see options 570-12 and 570-13 in Chapter 2). Premiums paid by Medicare's SMI enrollees now cover about 25 percent of the average benefits paid through that program, although the premiums were intended to cover 50 percent of the costs for SMI when Medicare was first established. Increasing collections from all enrollees to cover that percentage would reduce net Medicare spending by about 12 percent, or 1.0 percent of GDP, in 2075.

If premiums were higher for all enrollees, the increase could impose a financial hardship on lower-income enrollees who were not eligible for Medicaid. In addition, it would raise Medicaid's costs for Medicare enrollees who were also receiving Medicaid benefits, since Medicaid pays the Medicare premiums for those people. The resulting increases in federal spending for Medicaid would offset the net savings for Medicare by less than 0.1 percent of GDP. Another likely consequence would be lower participation in Part B by people with alternative coverage, including coverage through federal programs like the Federal Employees Health Benefits program, and thus higher costs in those programs. Such costs are not estimated here.

One alternative would vary the amounts that Medicare collected from enrollees on the basis of their financial resources (necessitating a process for determining enrollees' income). For example, premiums could be higher for enrollees with the highest income and the same as they are under current law for all other enrollees. Under the option presented here, individuals with an adjusted gross income of less than $50,000 (in 2003 dollars) would pay the Part B premiums now prescribed by law. For higher-income people, premiums would rise, reaching a maximum of twice the current premiums for individuals with an adjusted gross income of more than $100,000.[17] Those thresholds would be adjusted over time to hold the proportions of beneficiaries constant. This alternative would reduce net Medicare spending by about 0.1 percent of GDP by 2075. A result would be higher implicit marginal tax rates for Medicare enrollees due to phasing out the subsidy for higher-income enrollees.

The premiums that Medicare enrollees now pay average about 2 percent of their income and are projected to rise to nearly 6 percent on average by 2075. If premiums rose to cover 50 percent of SMI costs, Medicare premiums on average would amount to about 12 percent of enrollees' income by 2075. Under the option in which premiums would be higher only for the wealthiest individuals, premiums on average would be about 7 percent of enrollees' income by 2075. Those costs for enrollees could be reduced only if the growth in health care costs slowed to a greater extent than the projections assume.

Increasing premiums would reduce net federal spending for Medicare but only by shifting more costs to enrollees or their secondary payers. It would do little or nothing to lower beneficiaries' use of health care.

***Decrease Medicare's Costs per Enrollee by Raising Cost Sharing for Services***. Another way to increase the portion of costs that enrollees pay would be to raise cost sharing for services (see options 570-14, 570-15, 570-16,

16. Because of that anticipated "adverse selection," the Clinton Administration's proposal to allow people ages 62 to 64 to buy into Medicare called for a two-part premium. Before age 65, enrollees would have paid premiums that reflected the average expected cost of benefits if everyone ages 62 to 64 had participated in the buy-in. At age 65 and thereafter, participants would have paid a surcharge (in addition to the regular Medicare premiums) to account for the government's extra costs resulting from adverse selection in the buy-in program.

17. The adjusted gross income thresholds for couples would be $75,000 and $150,000 (in 2003 dollars).

570-17, 570-18, and 570-20 in Chapter 2). Raising cost sharing would both lower Medicare spending directly and make enrollees more sensitive to the costs of health services and thus more judicious in seeking those services. Increased cost sharing (as well as higher premiums for enrollees) has become more prevalent in the design of private-sector plans over the past several years, as insurers try to limit premium increases for purchasers. Studies have found that higher cost sharing generally reduces the use of services with little effect on health outcomes, with the notable exception of patients with low income and certain health conditions.[18]

Cost sharing could increase in a number of ways to support a variety of policy goals. For example, increases could be targeted toward services that are used relatively frequently at enrollees' election, such as doctor's visits. Or greater cost sharing could be more broadly applied, such as through higher deductibles, regardless of the type of services used. Copayments—fixed dollar payments per service—have the advantage of giving Medicare enrollees a predictable amount of cost sharing, while coinsurance —a fixed percentage of a bill—sends a clearer price signal about the relative costliness of providers (to the extent that fees are permitted to vary). Private-sector plans are experimenting with ways to simultaneously raise cost sharing and send clearer price signals about the costs of different health care providers.[19]

Although, in principle, cost-sharing requirements can encourage enrollees to be more prudent consumers of health care, that effect is likely to be weak in the Medicare program because so many people have supplemental coverage that pays for cost sharing. Consequently, they would not directly experience the higher costs. The result would be primarily a shift in costs rather than a reduction in the use of services. To be effective at deterring the use of services, such a policy would need to be combined with rules that limited supplemental coverage.

Medicaid pays cost sharing for most Medicare enrollees who are also eligible for Medicaid, although states may require enrollees to pay nominal cost-sharing amounts. Thus, increases in cost sharing for Medicaid enrollees would only shift costs to the states rather than reduce total spending.

Medigap plans typically cover most of Medicare's cost sharing. If Medicare increased cost sharing and medigap plans could pick up the additional amounts, enrollees would pay for the increases in higher medigap premiums rather than through higher out-of-pocket spending when they were deciding whether or not to use health services. For that reason, medigap supplemental coverage would dampen the savings from higher cost sharing.

Other types of supplemental Medicare coverage pose a similar constraint on the effectiveness of increasing cost sharing. Medicare HMOs and employer-based plans typically have lower cost-sharing requirements than Medicare has. However, both types of supplemental coverage have increased cost sharing in recent years.[20]

Short of increasing Medicare's cost sharing requirements, changes to medigap alone that would expose enrollees to at least some of Medicare's existing cost sharing would generate savings. Enrollees would likely lower their use of some discretionary services if they had to pay more for them. Even greater savings would be realized by prohibiting all private supplemental insurers from paying for Medicare cost sharing.

18. Robert H. Brook and others, "Does Free Care Improve Adults' Health?" *The New England Journal of Medicine*, vol. 309, no. 23 (December 8, 1983), pp. 1426-1434; W. Manning and others, "Health Insurance and the Demand for Medicaid Care: Evidence from a Randomized Experiment," *American Economic Review*, vol. 77, no. 3 (June 1987), pp. 251-277.

19. James C. Robinson, "Renewed Emphasis on Consumer Cost Sharing in Health Insurance Benefit Design," *Health Affairs* (March 20, 2002), pp. W139-W154, Web issue available at www.healthaffairs.org.

20. For a discussion of the increase in cost sharing in employer-based plans, see The Henry J. Kaiser Family Foundation and Hewitt Associates, *The Current State of Retiree Health Benefits* (December 2002). For information on the trend toward increased cost sharing in HMOs, see Marsha Gold and Lori Achman, "Trends in Premiums, Cost-Sharing, and Benefits in Medicare+Choice Health Plans, 1999-2001" (issue brief prepared for The Commonwealth Fund, April 2001), available at www.cmwf.org.

***Introduce Greater Competition***. Restructuring the Medicare market to introduce greater competition could reduce costs per enrollee. The option presented here would set up a system in which plans would compete for enrollees on the basis of premiums and other attributes such as quality of care and customer service. The system would include private plans such as HMOs and preferred provider organizations as well as providers in Medicare's traditional fee-for-service sector. But Medicare's payments would be determined through competitive market forces rather than through administered pricing. Furthermore, unlike arrangements under the current M+C payment system, Medicare would capture some of the savings if private plans provided Medicare benefits more efficiently than the fee-for-service sector did.

In 1999, the Bipartisan Commission on the Future of Medicare developed a proposal for reform based on competition, but the proposal did not receive enough votes among the commission's members for it to be presented as a formal recommendation to the President and the Congress. Subsequently, some members of the commission introduced a bill, S. 357, based on the commission's proposal. Other proposals for reforming Medicare through competition (which differ in important ways from S. 357) include the Clinton Administration's proposal, a proposal passed by the House in 2002 (H.R. 4954), and a bill introduced in the Senate in 2001 (S. 358).

In the option presented here, all participating plans would be required to offer a standard benefit package. Medicare would make a contribution toward the premiums of each plan up to a maximum amount, called the reference premium, or benchmark. Plans' premiums and perhaps the benchmark as well would be determined through competitive bidding. Beneficiaries would be required to pay premiums above the benchmark and would receive rebates for enrolling in less expensive plans. Plans would be permitted to offer supplemental benefits for which beneficiaries would pay an additional premium.

Such a competitive bidding system could reduce Medicare's costs by altering the incentives facing both beneficiaries and plans. Requiring beneficiaries to pay higher premiums for enrolling in more expensive plans would encourage them to be more cost-conscious in their selection. Competitive forces would therefore encourage plans to keep premiums low.

But whether or not a restructured market produced significant savings for Medicare would depend on how it was designed and on how beneficiaries and plans responded. A key design decision would be how to set the benchmark. One approach would be to base the benchmark on the bids submitted by plans, with the bids from all plans treated on an equal basis. For example, the benchmark could be set to equal the minimum or average bid in a market area or the national average bid, which would include the average cost in the fee-for-service sector.

A second approach would be to set the benchmark to equal the average cost in that sector. This approach would give special status to the fee-for-service sector and would guarantee that beneficiaries in that sector would never pay higher premiums than the Part B premiums—even if the care in that sector was the most expensive option available. The approach would therefore have less potential for reducing Medicare spending.

A third approach would be to set the benchmark independently of the actual costs of health plans, initially on the basis of a budgetary target, and then to update it by a predetermined amount (for example, the annual growth in per capita GDP). Medicare could be certain of controlling its spending under this approach because the financial risks posed by the growth in health care costs would shift to plans—and ultimately to beneficiaries through premiums. However, if health care costs grew faster than the annual update in the defined contribution, beneficiaries could face very large increases in their premiums. This approach is analogous to the defined-contribution approach that some employers are considering.

The effects of a competitive bidding system on Medicare spending would also depend on whether private plans could provide Medicare benefits more efficiently than the fee-for-service sector could and on whether those differences in efficiency were revealed through plans' bids. There is evidence that HMOs provide care at a lower total cost than do other types of plans because those organizations use hospital services and other expensive

resources less. However, in recent years, in response to a backlash from consumers, some plans have eased their restrictions on care, and providers have gained greater leverage with HMOs in their contract negotiations. Those circumstances suggest that the cost advantages enjoyed in the past by HMOs have diminished, at least temporarily.

Beneficiaries' preferences—and particularly their willingness to switch plans in response to differences in premiums—would also play an important role in determining whether a competitive bidding system significantly reduced Medicare spending. Plans would be more likely to bid aggressively if doing so enabled them to capture a substantial share of the market. The limited evidence on the price responsiveness of Medicare beneficiaries suggests that they respond much less to differences in premiums than people under 65 do, but additional research on the topic is needed to draw definitive conclusions.

Implementing a competitive bidding system would pose many challenges. First, the payment system would have to include an effective mechanism to compensate for the fact that some plans would be likely to attract enrollees who were healthier than average, while others would be likely to attract enrollees with below-average health. An effective risk adjustor would pay plans fairly for the people they enrolled and would minimize the chance that plans would try to compete on their ability to attract enrollees who were "good risks."[21] Another challenge would be educating beneficiaries about the new system and about the costs and quality of the available health plans. In addition, it would be necessary to determine whether and how benchmarks should reflect geographic variations in Medicare's costs, which reflect differences in utilization as well as prices and other factors. Finally, a method for setting the government's contributions in geographic areas with few competing plans would be needed.

21. Medicare will implement a new risk adjustor for managed care plans that will incorporate information on the health status of enrollees derived from their previous encounters with the health care system. Although the new risk adjustor is expected to be a significant improvement over the current one, whether or not it will be adequate is unknown.

All in all, the effect of a competitive bidding system on Medicare spending is highly uncertain because of questions about how plans and beneficiaries would respond. Presumably, a properly designed competitive system would lead to greater efficiency and reduced spending. However, there is insufficient evidence to predict with confidence the magnitude of any reduction in spending. For example, it is not known how the bids of private plans would compare with average spending in the fee-for-service sector and whether vigorous competition would emerge in many geographic areas. Moreover, there is great uncertainty about whether, after being fully implemented, a competitive system would reduce the level of Medicare spending per enrollee and whether the long-term growth of spending per enrollee would be reduced as well.

If the competitive system reduced Medicare spending per enrollee by 5 percent but did not change the growth in spending per enrollee, in 2075 net spending on Medicare would be reduced by about 0.4 percent of GDP. However, if the competitive system initially reduced spending by 5 percent and also reduced the growth in spending per enrollee from the projected 5.4 percent a year to, say, 5.0 percent a year, in 2075 net Medicare spending would be reduced by about 2.0 percent of GDP—illustrating the power of compounding over a long period even when a policy option reduces the growth in spending by only a modest amount. The proportion of the savings that would come from lower payments to plans versus higher premiums paid by beneficiaries would depend on the design of the competitive system and the willingness of beneficiaries to switch plans in response to differences in premiums.

***Reduce per Capita Spending Using Other Strategies***. Other approaches for reducing Medicare spending that affect aspects of the current fee-for-service program include reducing payments to providers and introducing coverage of disease or case management—programs that coordinate care among providers, ensure that patients comply with their treatment regimens, and encourage health care providers to adhere to evidence-based guidelines.

*Reduce Provider Payments*. Over Medicare's history, the Congress often has changed payments to health care

providers to slow the growth in per capita spending—often lowering the increase, or update, to the annual payment rate that would have otherwise applied (see options 570-07, 570-08, and 570-19 in Chapter 2). That sort of strategy might be effective in generating savings in the short run but would do little to address the underlying sources of spending growth. Further, such changes would tend not to be sustainable, since formulas for updates are based on increases in providers' costs. If payments did not keep pace with overall cost increases, reducing provider payments could restrict Medicare enrollees' access to health care: because Medicare limits the amount that providers may charge enrollees over and above the program's payment rate, if the total amount that providers were allowed to charge was below their marginal cost of providing services, they could restrict Medicare patients' access to care.

*Introduce Disease Management and Case Management*. Proponents of disease management and case management claim that adding those benefits to Medicare will improve the quality of care that enrollees receive and lower federal costs at the same time. Because Medicare's expenditures are concentrated among a small number of high-cost enrollees (for whom expenditures often persist over time), savings could come from preventing the use of expensive services by better coordinating existing resources or using preventive care. For example, a disease management program for patients with diabetes could ensure that enrollees received recommended foot and eye exams annually. By detecting problems earlier, such steps could prevent more-expensive treatments, such as hospitalization or surgery.

But whether or not disease management or case management can improve health outcomes, much less produce long-term savings, is not yet known.[22] The industry has developed programs that claim to improve the quality of care and to reduce costs, but the limited number of studies available and the methodological issues that they present raise questions about those claims. Even if disease management and case management programs were found to save money, determining how the programs applied within Medicare would still be necessary.

22. Statement of Dan L. Crippen, Director, Congressional Budget Office, *Disease Management in Medicare: Data Analysis and Benefit Design Issues*, before the Senate Special Committee on Aging, September 19, 2002.

**Table 4-3.**

## Effects of Several Illustrative Options for Reducing Growth of Net Medicare Spending

(Percentage of GDP)

| | 2002 | 2030 | 2050 | 2075 |
|---|---|---|---|---|
| Projected Gross Medicare Spending Under Current Policies | 2.4 | 4.7 | 6.5 | 9.2 |
| Less: SMI Premiums | 0.2 | 0.6 | 0.7 | 1.0 |
| Projected Net Medicare Spending Under Current Policies | 2.1 | 4.2 | 5.8 | 8.2 |
| **Effects of Illustrative Options** | | | | |
| Raise the Eligibility Age | | | | |
| To 67 | n.a. | -0.2 | -0.2 | -0.3 |
| To 70 | n.a. | -0.2 | -0.6 | -0.7 |
| Increase SMI Premiums | | | | |
| Collect 50 percent of SMI costs from enrollees | n.a. | -0.6 | -0.7 | -1.0 |
| Increase SMI premiums for upper-income beneficiaries[a] | n.a. | -0.1 | -0.1 | -0.1 |

Source: Congressional Budget Office

Notes: n.a. = not applicable; SMI = Supplementary Medical Insurance (Part B of Medicare).

The effects of each illustrative option are considered in isolation; if joined together, the options would interact in ways that would reduce the combined savings.

a. For this option, CBO assumed that individuals with an adjusted gross income (AGI) of less than $50,000 and couples with an AGI of less than $75,000 would pay the Part B premiums as prescribed under current law. Higher-income people would pay progressively higher premiums. The maximum (which would be paid by individuals with an AGI of more than $100,000 and couples with an AGI of more than $150,000) would be twice the premiums that exist under current law.

Income is expressed in 2003 dollars. CBO assumed that the income thresholds would grow at the same rate as the AGI among the Medicare population (that is, the proportions of the beneficiaries in each group would remain constant).

## Conclusions About Medicare

Some of the options described in this chapter would have greater potential for reducing the growth in Medicare spending than would others. However, none of the options for which CBO developed long-range estimates would reduce the growth in spending by enough to prevent Medicare outlays from consuming a significantly higher share of GDP once the baby-boom generation retired. Among the options for which long-range estimates were presented, doubling the Part B premiums would achieve the largest savings, reducing net Medicare spending by 1.0 percent of GDP by 2075. However, net Medicare spending would still increase significantly under that option—from 2.1 percent of GDP today to 7.2 percent in 2075 (*see Table 4-3*). Increasing the eligibility age for Medicare to 70 would achieve smaller savings, reducing projected net Medicare spending in 2075 by 0.7 percent of GDP. Making inroads that would be significant enough to change the long-term outlook for Medicare could require a combination of approaches.

APPENDIX

# Contributors to This Volume

All divisions of the Congressional Budget Office (CBO) contributed to this report, which was coordinated by Arlene Holen. The Budget Analysis Division, under the supervision of Robert Sunshine and Peter Fontaine, prepared the spending estimates that appear throughout the volume. The staff of the Joint Committee on Taxation prepared most of the revenue estimates. Many people at CBO helped prepare the report:

## Chapter 1

Written by Sandy Davis of the Projections Unit in the Budget Analysis Division with the assistance of Robert Dennis of the Macroeconomic Analysis Division, Arlene Holen, and Roberton Williams of the Tax Analysis Division (TAD).

## Chapter 2

Coordinated by Eric J. Labs of the National Security Division, R. Mark Musell of the Microeconomic and Financial Studies Division, and Bruce Vavrichek of the Health and Human Resources Division (HHR). The following analysts contributed options or budget estimates:

*National Defense, International Affairs, and Veterans' Benefits*

Adebayo Adedeji
David Arthur
Russell Beland
Kent Christensen
Deborah Clay-Mendez
Richard Farmer
J. Michael Gilmore
Raymond Hall
Sarah Jennings
Gregory Kiley
Eric J. Labs
Carla Tighe Murray
David Newman
Sam Papenfuss
Michelle Patterson
Allison Percy
Lane Pierrot
Paul Rehmus
Matthew Schmit
Zachary Selden
Adam Talaber
Jo Ann Vines
Joseph Whitehill
Melissa Zimmerman

*Natural Resources, Commerce, Justice, and Related Areas*

Bruce Arnold
Perry Beider
Charles Capone
Megan Carroll
Kim Cawley
Lisa Driskill
Cary Elliott
Richard Farmer
Andrew Goett
Patrice Gordon
Mark Grabowicz
Kathleen Gramp
Mark Hadley
Roger Hitchner
Greg Hitz
David Hull
Ken Johnson
James Langley
Cecil McPherson
Susanne Mehlman
Julie Middleton
Rachel Milberg
R. Mark Musell
Nathan Musick
Matthew Pickford
Elizabeth Pinkston
Deborah Reis
Judith Ruud
Ralph Smith
Jean Talarico
Natalie Tawil
David Torregrosa
Lanette Walker
Philip Webre
Joseph Whitehill

*Education, Health, Income Security, and Related Areas*

Alexis Ahlstrom
Nabeel Alsalam
James Baumgardner
Shawn Bishop
Kate Bloniarz
Thomas Bradley
Niall Brennan
Michael Carson
Chad Chirico
Julia Christensen
Anna Cook
Paul Cullinan
Sheila Dacey
Jeanne De Sa
Philip Ellis
Kathleen FitzGerald
Carol Frost
Geoffrey Gerhardt
Stuart Hagen
Deborah Kalcevic
Samuel Kina
Steven M. Lieberman
Lyle Nelson
Robert Nguyen
Margaret Nowak
Sam Papenfuss
Michelle Patterson
Eric Rollins
Kathy Ruffing
Christi Hawley Sadoti
Rachel Schmidt
Ralph Smith
Shinobu Suzuki
Christopher Topoleski
David Torregrosa
Bruce Vavrichek
Daniel Wilmoth
Donna Wong

## Chapter 3

Coordinated by Pamela Greene of TAD with contributions from the following analysts:

Perry Beider
Mark Booth
Paul Burnham
Terry Dinan
Barbara Edwards
Richard Farmer
Patrice Gordon
Pamela Greene
Ed Harris
Carolyn Lynch
Lauren Marks
Robert McClelland
Larry Ozanne
Kurt Seibert
Andrew Shaw
David Weiner
Roberton Williams
Thomas Woodward
Dennis Zimmerman

## Chapter 4

Written by David Koitz, Lyle Nelson, and Ralph Smith, all of HHR.

## Editing and Production

Christine Bogusz, Leah Mazade, John Skeen, and Christian Spoor edited the report, and Kathryn Winstead prepared it for publication. Annette Kalicki prepared the electronic versions for CBO's Web site, with assistance from Martina Wojak-Piotrow. Karina Braszo designed the cover on the basis of a concept from Barry Anderson.