2005-2006

A JOINT PROJECT OF

THE COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

AND

THE UNIVERSITY OF AKRON

The Committee for a Responsible Federal Budget is a bipartisan, non-profit organization committed to educating the public about issues that have significant fiscal policy impact. Members of the Committee include many of the past Directors of the Budget Committees, the Congressional Budget Office, the Office of Management and Budget and the Federal Reserve Board.

The Committee for a Responsible Federal Budget launched the ***Exercise in Hard Choices***sm in 1983. The Committee updates the *Exercise* regularly to reflect changes in the national fiscal policy debate. Nearly 2,000 groups and more than 15,000 people have participated in *Exercises* over the years.

The Committee has a joint project with **The University of Akron** to provide alternative methods of delivering the *Exercise.* Video-teleconferencing and web-based versions of the *Exercise* are now available that allow individuals and groups to participate from remote locations either synchronously or asynchronously.

COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

EXERCISE IN HARD CHOICES

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Exercise in Hard Choices

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INTRODUCTION

Why the *Exercise in Hard Choices* and why now? The federal budget represents our collective expectations of our national government and our plan for how we will pay for them. Currently, what we want and what we are willing to pay for are at odds—leading to deficits and accumulating debt for the foreseeable future. Debt is not free: it merely passes on the financial burden to the future generations of taxpayers. Unless we can decide how to reconcile our wants with our wallets, we put our children's future and standards of living at risk.

The 2005-2006 *Exercise* reflects a difficult time in U.S. budget history. The wars in Iraq and Afghanistan, the global war against terror, uncertain economic growth, and commitments made decades ago to aging workers put seemingly inexorable upward pressure on federal outlays and little room in the budget for everything else voters expect from the federal government. Both major political parties want to provide tax relief, at least for the middle class. The surpluses achieved and projected in 2001 are but a memory, replaced by red ink throughout most or all of the coming decade.

The baby boom generation, those born between 1946 and 1964 who make up about 27 percent of today's U.S. population, will begin to retire within a few years. Their benefits will lead to the "graying" of the budget, driving outlays for Social Security and Medicare high enough to force political leaders eventually to confront limited and very unattractive choices:

- Raise total federal taxes to record levels of 25-30 percent above post-WW II averages;
- Significantly scale back retirement security and health care assistance for the elderly;
- Weaken the social safety net that protects the most vulnerable populations;
- Make fundamental changes in the role of the federal government and eliminate whole large functions such as education, transportation, housing, public assistance, etc., from the federal budget; or
- Run deficits so large as to threaten the nation's economy.

Ending deficits, running surpluses, and reducing debt held by the public today could help to alleviate future problems by reducing interest costs and freeing up resources for programmatic spending that otherwise would go to interest payments.

Reforming programs designed to meet the needs of older people sooner rather than later would spread the costs and give people more time to plan and adjust to new rules before they retire.

The *Exercise* serves as a guide to the policy issues we face. It focuses on six major spending categories in the budget: national security; income security; general government; Social Security; Medicare; and Medicaid and the State Children's Health Insurance Program (SCHIP). (See Figure 1). It provides options to change revenues. (See Figure 2). The choices available to you are representative of ones that have actually been put on the table—some in more detailed form than others. Among the *Exercise* options are incremental proposals that would impose relatively small modifications on existing programs as well as proposals that would significantly alter programs' current structure. Options were selected to give you a reasonable and realistic range. Only those that would have substantial budgetary impact (at least $500 million a year to round up to $1 billion) are included—your time is limited! That being said, the budget numbers get so big that it is easy to lose perspective. It may help to keep in mind:

$1 Billion Equals:

- Earnings of 38,700 median earners in 2002;
- 50,000 Ford Tauruses;
- Income tax bills for 108,000 average taxpayers in 2000;
- 200 million Extra Value Meals;
- Compensation for 11,800 federal employees—enough to staff the Department of Housing and Urban Development or the National Science Foundation, Nuclear Regulatory Commission, Peace Corps, Securities and Exchange Commission, and the Small Business Administration combined;
- Annual benefits for 100,000 average Social Security beneficiaries in 2003; or
- Sufficient funding for all rural development programs, the Federal Housing Administration (FHA) loan programs, or energy conservation programs.

Suffice it to say, $1 billion is a lot of money.

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It will take you three hours to complete the *Exercise*. You may feel that is not enough time. You will complain that you need more information. In those respects you will be just like the members of Congress. Ideally, you will complete the Exercise as part of a group of people from diverse backgrounds, with each group producing just one budget.

The group process will help you to understand the collective decision-making process that makes it so hard for the President and the Congress to reach agreements on public policy change and sometimes produces gridlock. Any member of Congress could balance the budget if she or he did not have to worry about at least 218 votes in the House, 51 votes in the Senate and a presidential signature.

You can get more information about the budget, the economy, and the long-term fiscal policy challenges on the internet at sites for the Congressional Budget Office (CBO), the General Accounting Office (GAO), the Office of Management and Budget (OMB), the U.S. House of Representatives and the U.S. Senate Committees on the Budget. All are official U.S. government sites. (See **Links** for a list of web sites).

FIGURE 1. COMPOSITION OF SPENDING IN FY 2004: $2.3 TRILLION

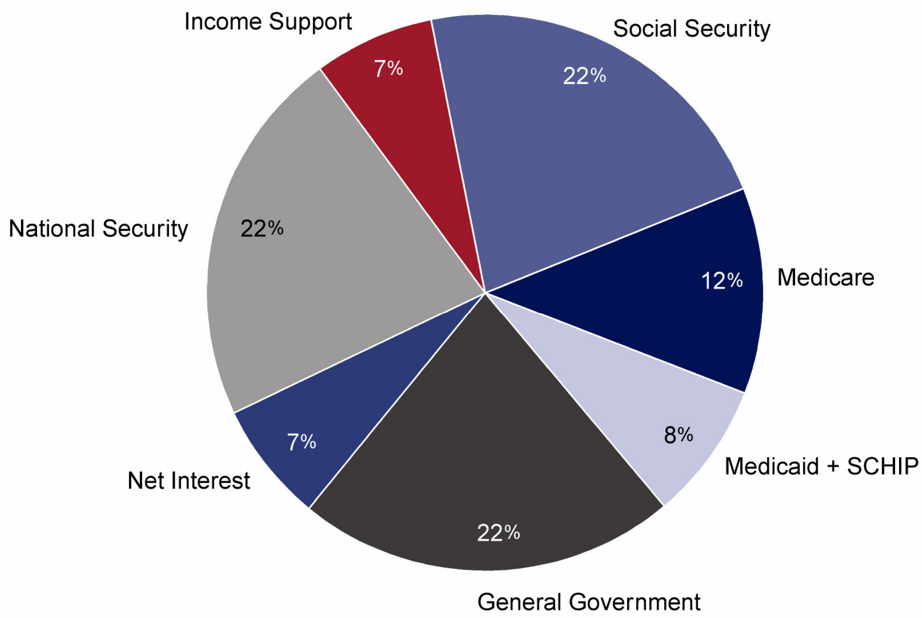
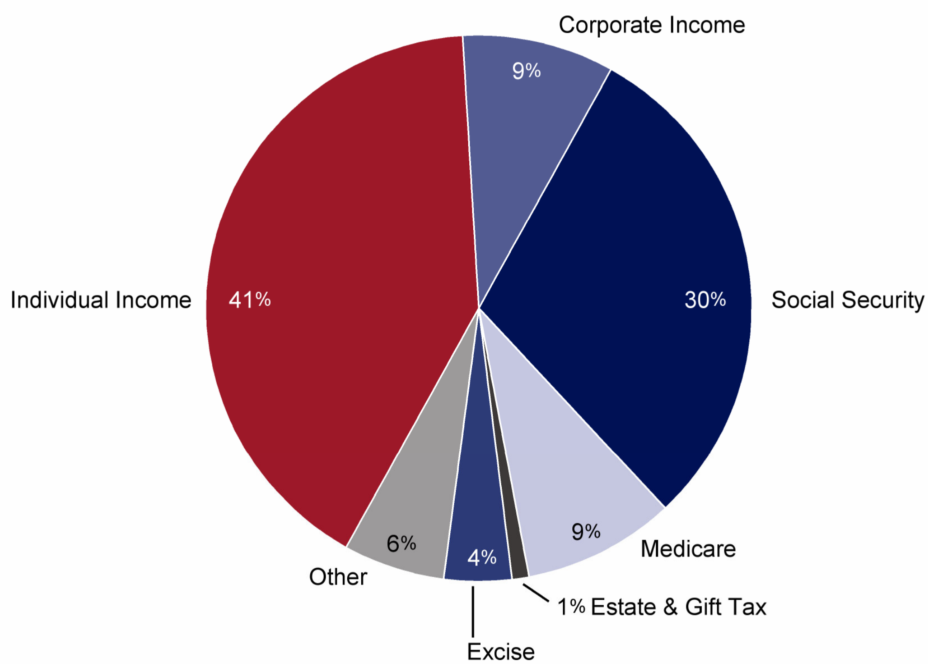


FIGURE 2. COMPOSITION OF RECEIPTS IN FY 2004: $1.9 TRILLION



BUDGET BASICS

The budget is the key instrument in national policymaking. It is through the budget that the Nation chooses what areas it wishes to leave to private choice and what services it wants to provide through government. When enacted the budget expresses the decisions of the Nation's elected representatives as to which government services should be provided at the federal rather than the State or local level; though what programs and instruments; and at what level of activity and cost.

President's Commission on Budget Concepts, 1967

OVERVIEW

Each year the President and the Congress establish the budget of the United States government for the upcoming year. That annual process produces a financial plan that indicates where the government will obtain resources and how it will spend them. The process is a highly political and difficult exercise.

At its core, the budget debate seeks to define what role the federal government should play in our lives. It is where economics and politics intersect. If the federal government engages in an activity it does so to serve a national purpose or objective. Otherwise, that function would be left to individuals and families, private enterprise, or State or local governments. Lengthy analysis cannot determine the "right" size or role for government. Consequently there are many viewpoints on what constitutes its appropriate scope. It is up to the political process to resolve differences and shape the budget. Along the way, it affects the lives of virtually everyone living in the United States and, since U.S. fiscal policy can affect the world's economy, it has global implications as well.

Beyond the political dimension, there are economic considerations. Budget policies represent decisions to use economic resources to achieve national objectives. To further those goals, the budget reallocates resources among specific segments of the population—young and old, rich and poor, urban and rural dwellers, employers and employees. The dollars that the federal government spends come primarily from taxes. A large portion of the money the government spends come from borrowing, but borrowing is, after all, deferred taxation. The manner in which the government obtains and allocates financial resources influences individual decisions to work, save, and invest.

Perspectives diverge as to when government activity becomes harmful to overall well being. Do deficits matter to the economy, and if so when? Although most economists would argue that we should balance the budget over the business cycle—that is, run surpluses in times of economic expansion and deficits during economic recessions, most would also agree that a balanced budget itself is not the highest priority but sends signals about the nation's economic strength and political resolve.

Budget decisions require hard choices. In a country as big and as diverse as the United States, there are conflicting views on just about all aspects of the budget. Some would like the federal government to do more: others would prefer that it do less. The stakes are large and the issues are complex. As a result the annual budget process seldom runs smoothly.

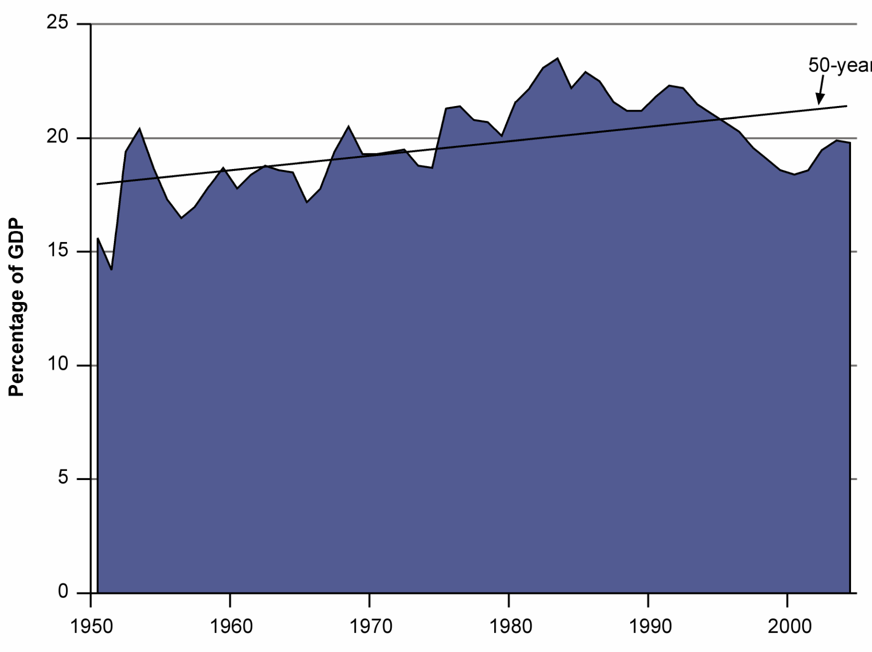
In ***fiscal year*** **(FY)** 2004, the federal government spent $2.3 trillion and collected $1.9 trillion in revenues. (A fiscal year runs from October 1 to September 30.) Spending exceeded revenues and the deficit was $412 billion in 2004.

Although we most frequently think about the budget in terms of decisions to tax and spend, that perspective is too narrow. Effectively, federal budgeting represents a three-part process: 1) Determining that economic resources should be allocated to achieve a specific purpose; 2) Deciding that the objective should be pursued through the federal government as opposed to state or local government or through the private sector; and 3) Finding the most effective route—that is via direct spending, tax policy, or regulation, by which to direct those resources.

In 2004, the federal government spent almost 20 percent of ***gross domestic product*** **(GDP)**. (GDP is a measure of the value of goods and services produced in the country each year.) That level of spending is consistent with the average for the last 50 years, although spending has generally trended upward. (See Figure 3).

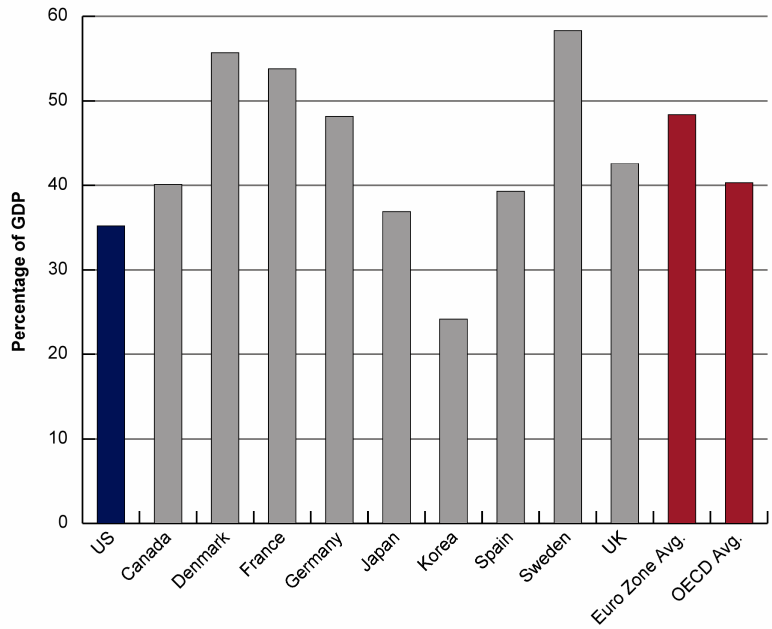
Compared to other developed countries, public expenditures (including state and local spending for comparability) in the U.S. rank at the lower end of the range. (See Figure 4). That reflects differences in kind, as well as scope. For example, there are few government-owned industries in the U.S. whereas many other governments own part or all of the basic industries and utilities. In addition, many other countries have national health care systems and pay for most or all of higher education. Other countries generally achieve lower deficits or have surpluses more frequently. (See Figure 5).

FIGURE 3. FEDERAL SPENDING 1950-2004 AS A % OF GDP



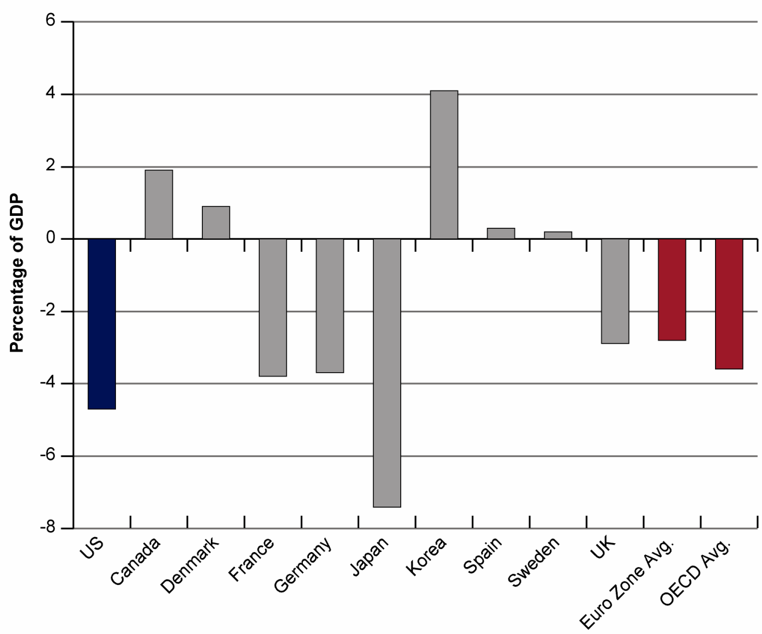
Sources: OMB Historical Tables (February 2004) and CBO, *The Budget and Economic Outlook: An Update* (September 2004).

FIGURE 4. PUBLIC RECEIPTS AND EXPENDITURES IN 2004 AS A % OF GDP



Source: Organization for Economic Development and Cooperation, 2004.

FIGURE 5. PUBLIC FINANCIAL BALANCES IN 2004 AS A % OF GDP



Source: Organization for Economic Development and Cooperation, 2004.

MEASURING THE SIZE OF THE BUDGET, DEFICITS AND DEBT

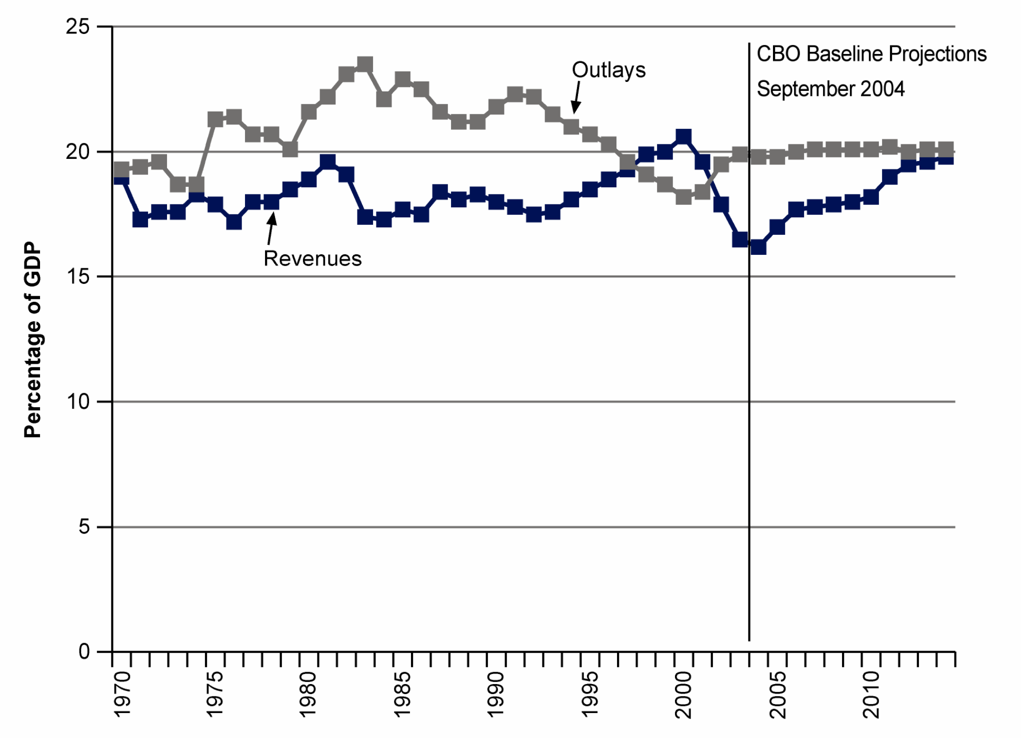
The simplest measure of the budget's status compares total federal revenues with total expenditures.

- The budget is said to be in **balance** when *receipts* (taxes, fees, and other revenues) equal *outlays* (spending or expenditures).
- When revenues exceed spending, the budget runs a **surplus**. That has occurred in only five of the last 40 years (in 1969 and from 1998-2001).
- **Deficits** result when spending is greater than revenues.

There is no "right" level for taxes or spending but it is fair to say that citizens demand more from the federal government than they are willing to pay in taxes. Since 1960, the receipts have averaged 18.2 percent of GDP, while outlays, on average, were 20.3 percent of GDP. (See Figure 6). As a result, deficits have averaged 2.1 percent of GDP. (See Figure 7).

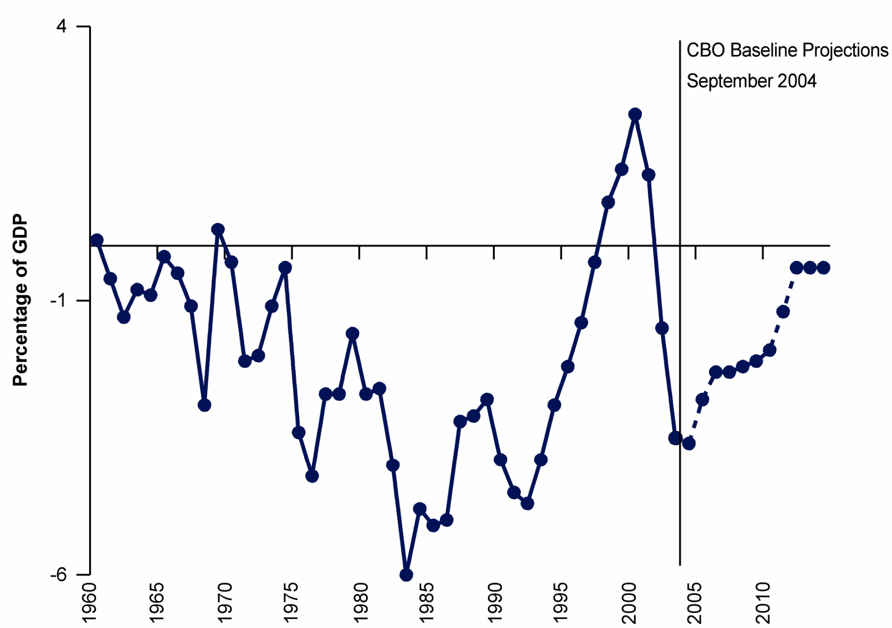
The government finances deficits by borrowing from the public. (See Figure 8). The federal **debt** represents accumulated borrowing. Publicly-held debt increases when the government runs deficits and decreases when the budget is in surplus. The debt does not include long-term commitments to pay Social Security or Medicare benefits, which are promises, not legal liabilities.

FIGURE 6. RECEIPTS AND OUTLAYS AS A % OF GDP



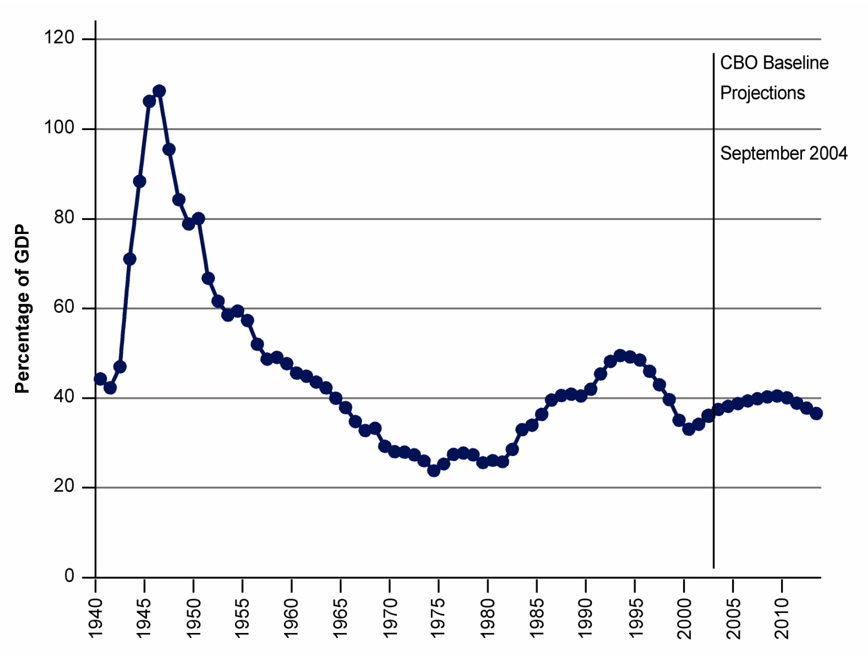
Sources: OMB Historical Tables (February 2004) and CBO, *The Budget and Economic Outlook: An Update* (September 2004).

FIGURE 7. FEDERAL SURPLUSES AND DEFICITS AS A PERCENT OF GDP



Sources: OMB Historical Tables (February 2004) and CBO, *The Budget and Economic Outlook: An Update* (September 2004).

FIGURE 8. FEDERAL DEBT HELD BY THE PUBLIC AS A PERCENT OF GDP



Sources: OMB Historical Tables (February 2004) and CBO, *The Budget and Economic Outlook: An Update* (September 2004).

THE BUDGET BASELINE

The Congressional Budget Office (CBO) is a non-partisan organization created by the Congress to provide budget and economic analyses. Each January, CBO issues its preliminary budget projections for the upcoming fiscal year and the succeeding nine years. Those projections are called the **baseline.** (See Table 1)**.** The baseline serves as a policy-neutral benchmark against which the Congress can measure the budgetary impact of legislative actions. The baseline is generally updated in March and in August to reflect changes in policy as well as its underlying economic and technical assumptions.

The Office of Management and Budget (OMB) also publishes budget projections. OMB is part of the Executive Office of the President. It oversees the formulation of the President's budget and manages budget-related activity once resources are available. However, OMB works for the President and aligns its projections and analyses to support the President's policies. Therefore, the *Exercise* reflects CBO's projections, which are more neutral.

The CBO baseline has distinct limitations. It is not CBO's forecast of the future. Instead, in a somewhat mechanical manner, the baseline projects budgetary levels based upon current laws and incorporating updated economic assumptions, recent information about eligible beneficiaries, and federal agencies' latest experience with the pace of program spending. The baseline does not attempt to predict future actions on the part of lawmakers. It assumes, for example, that tax provisions will expire when they are scheduled to expire in law even though there is a good chance that policy makers will extend them. It does not try to anticipate wars, other major calamities, or even the regular-as-clockwork decennial census. It assumes that the economy performs according to historical trends. Thus the baseline does not represent the most likely budgetary outcomes and, because it relies on so many assumptions, it incorporates a great deal of uncertainty.

CBO's September 2004 outlook for the budget shows deficits for the next 10 years. CBO is required to base its projections on current funding levels and existing laws and to follow certain rules and assumptions, some of which are questionable. Among those are two critical assumptions: that $115 billion in supplemental funding to support operations in Iraq, Afghanistan and the global war on terror will continue on an inflation-adjusted basis each year through 2014; and that all tax cuts that are scheduled to expire between now and 2014 will indeed expire. The first assumption adds $1.4 trillion (including the cost of additional interest expenses, or debt service) to the deficit over the next 10 years. The second assumption reduces the 10-year deficit projection by $1.2 trillion (including debt service).

Despite its shortcomings, CBO's baseline, whether adjusted for anomalies as is the case in the *Exercise* baseline or—as has occasionally happened—formally rejected during the congressional process for a more favorable OMB baseline, serves as a neutral benchmark that cannot be entirely ignored. The baseline measures how much impact a set of policy proposals is likely to have on projected deficits and thus informs the debate.

To establish its starting point, the *Exercise* baseline does not extend the supplemental funding provided for Iraq, Afghanistan and the global war on terror beyond FY 2004. (See Table 2). Those funds are clearly extraordinary and not part of the overall "pot" of funds available to fund ongoing operations of government. Including them, particularly once operations begin to wind down, would overstate deficits and understate the difficulty of budget choices. As a result of the adjustment, deficits total $1.4 trillion less under the *Exercise* baseline than CBO's baseline.

TABLE 1. CBO'S BASELINE BUDGET PROJECTIONS, AUGUST 2004

	2004[a]	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-2009	2005-2014
In billions of dollars													
Receipts	1,880	2,094	2,279	2,406	2,531	2,673	2,821	3,077	3,308	3,471	3,648	11,983	28,308
Outlays	2,292	2,442	2,577	2,714	2,849	2,985	3,119	3,276	3,378	3,547	3,713	13,568	30,601
Deficits	-412	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-1,584	-2,294
Debt held by the public	4,334	4,694	5,009	5,329	5,660	5,984	6,295	6,506	6,588	6,675	6,753	n.a.	n.a.
As a percentage of GDP													
Receipts	16.3	17.0	17.7	17.8	17.9	18.0	18.2	19.0	19.5	19.7	19.8	17.7	18.6
Outlays	19.8	19.8	20.0	20.1	20.1	20.1	20.1	20.2	20.0	20.1	20.1	20.0	20.1
Deficits	-3.6	-2.8	-2.3	-2.3	-2.2	-2.1	-1.9	-1.2	-0.4	-0.4	-0.4	-2.3	-1.5
Debt held by the public	37.5	38.2	38.8	39.4	39.9	40.3	40.5	40.1	38.9	37.8	36.6	n.a.	n.a.

SOURCE: Congressional Budget Office, September 2004.
[a] Actual amount for revenues, outlays, and deficit amounts in FY 2004 reported by the Treasury in October 2004.

TABLE 2. DEFICITS (-) OR SURPLUSES (+) UNDER THE EXERCISE BASELINE

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-2009	2005-2014
CBO Baseline Deficits(-) / Surpluses (+)	-412	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-1,584	-2,294
Adjustment	0	39	96	121	135	146	156	168	178	191	203	536	1,433
Exercise Baseline Deficits (-)/ Surpluses (+)	-412	-310	-202	-187	-183	-166	-142	-32	108	115	138	-1,048	-861

UNCERTAINTY IN BUDGET PROJECTIONS

CBO's baseline projections are just that—projections. They are based upon economic and technical assumptions about the way the economy and the budget will behave in the future given past trends, current laws and policies, and rules that govern baseline calculations. Budget analysts, including those at CBO, are not surprised when actual budget results differ from the baseline projections.

In January 2001, after the budget recorded surpluses for three straight years, CBO's baseline projected $5.6 trillion in surpluses over the 2002-2011 period. CBO now projects $3.0 trillion in deficits over the same period (including actual amounts for 2002 through 2004)—an erosion of $8.6 trillion in the budget's bottom line. According to CBO's January 2001 projections, for 2001 through 2004 alone, surpluses would accumulate to $1.35 trillion. Instead, the budget ended up with $819 billion in deficits—a difference of $2.2 trillion.

What happened? Recession, terrorist attack, war, and other unforeseen events were partial causes. Policy makers' decision that other priorities were more important than balancing the budget certainly played a role. According to CBO, changes in economic and technical assumptions were responsible for just under half of the difference while changes in policy accounted for the balance. About 30 percent of the change came from tax cuts enacted in 2001, 2002, and 2003, and another 22 percent from decisions to increase spending for defense and non-defense programs.

ECONOMIC ASSUMPTIONS

The CBO's baseline projections are built on a set of economic assumptions that reflect trends in the economy. (See Table 3). Deviations from those economic assumptions are a principal reason why actual budget outcomes differ from CBO projections. CBO estimates, for example, that if interest rates are 1 percent higher each year than its baseline assumes (and nothing else changes), the deficit would be $11 billion higher than the baseline in the first year, $213 billion higher over five years, and $592 billion higher over the 10-year budget horizon. Or, if the economy grows 0.1 percent more slowly than assumed, the deficit would increase by $1 billion in the first year, $51 billion over the first five years, and $236 billion over 10 years.

TABLE 3. CBO'S ECONOMIC PROJECTIONS FOR CALENDAR YEARS 2004-2014

	Actual	Forecast		Projected Annual Average	
	2003	2004	2005	2006-2009	2010-2014
Nominal GDP					
In billions of dollars	11,004	11,753	12,464	15,016[a]	18,628[b]
As a percentage change	4.9	6.8	6.1	4.8	4.4
Real GDP (Percentage change)	3.0	4.5	4.1	3.0	2.6
GDP Price Index (Percentage change)	1.8	2.2	1.8	1.7	1.8
Consumer Price Index (Percentage change)	2.3	2.6	2.0	2.2	2.2
Unemployment Rate (Percent)	6.0	5.6	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.0	1.3	2.6	4.5	4.6
Ten-Year Treasury Note Rate (Percent)	4.0	4.6	5.4	5.5	5.5
Tax Bases (Percentage of GDP)					
Corporate book profits	7.9	8.9	11.7	10.0	9.1
Wages and salaries	46.4	45.7	45.8	46.1	46.1
Tax Bases (Billions of dollars)					
Corporate book profits	874	1,045	1,455	1,411[a]	1,710[b]
Wages and salaries	5,104	5,370	5,703	6,924[a]	8,592[b]

Sources: Congressional Budget Office (September 2004); Based on data from Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year. Year-by-year economic projections for calendar and fiscal years 2004 through 2014 appear in Appendix C.

a. Level in 2009.

b. Level in 2014.

c. The consumer price index for all urban consumers.

THE COMPOSITION OF THE BUDGET

The composition of the budget changes over time as policies and priorities change. One way to illustrate changes is to focus on process-related categories:

Discretionary spending refers to programs that Congress and the President fund each year through appropriation bills. Without annual appropriations, discretionary programs—unless designated as "essential government programs"—do not have the financial resources they need to operate and may shut down until funds are enacted.

Mandatory spending consists of entitlement programs, net interest and other expenditures for which funding is permanently authorized in law. No action is needed to grant funding for these activities.

The Congress and President must pass a law to fund discretionary programs. Funding for mandatory programs is on "auto pilot"—it continues unless policy makers pass a law to change or end it. Some activities are mandatory because the government is contractually obligated to make payments (e.g., interest on the date and payments to satisfy insurance claims). Other activities are classified as mandatory because policy makers decided that some payments—such as Social Security and Medicare and Medicaid benefits—should be protected from annual political contests. Those programs are known as "**entitlements**"—beneficiaries are entitled to payments as long they meet eligibility requirements.

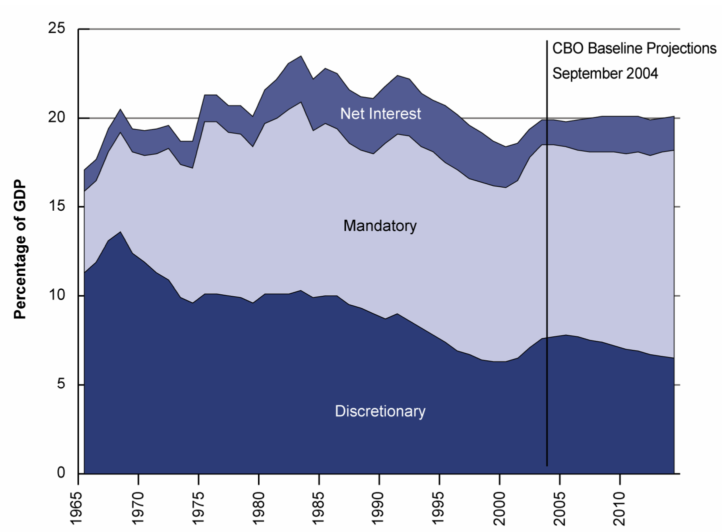
Funding for mandatory programs only becomes an issue when lawmakers want to change it. Discretionary programs however compete for funding each year. That difference is intentional and has important implications for the budget. Discretionary programs have borne the brunt of deficit reduction efforts while spending for mandatory programs continues to grow as a share of the budget. In the 1960s, over two-thirds of federal spending was discretionary. Today, the discretionary share is less than 40 percent. Social Security and the growth in health care entitlements are largely the cause of that shift. (See figure 9).

Over time, the budget has grown bigger. In constant (inflation-adjusted) dollars, today it is almost three times bigger than it was during the 1960s. Allocations for programs and activities have changed, too, as national priorities have shifted. (See Figure 10). In the 1960s, defense spending represented almost one-half of the federal budget. Today, its share is less than one-fifth, although that amount has been growing since 2001. Medicare, which began in 1965, now equals almost 12 percent of total spending. Social Security has grown from 13 percent of the budget in 1960 to over 22 percent.

The Composition of Receipts

Federal receipts consist of income, payroll and excise taxes, customs duties, and other receipts. Individual income taxes make up the largest share of the total, followed by social insurance or payroll taxes that are designated for Social Security and other retirement programs, Medicare, and unemployment insurance. (See Figure 11). Over time, the composition of receipts has changed. Since the 1960s individual income taxes have provided about 45 percent of total receipts. The share of social insurance and retirement receipts has more than doubled while shares of corporate income and excise taxes have declined.

Figure 9. Federal Spending by Category



Sources: OMB Historical Tables (February 2004) and CBO, *The Budget and Economic Outlook: An Update* (September 2004).

Figure 10. Slices of the Federal Budget (Billions of FY 2000 Constant Dollars)

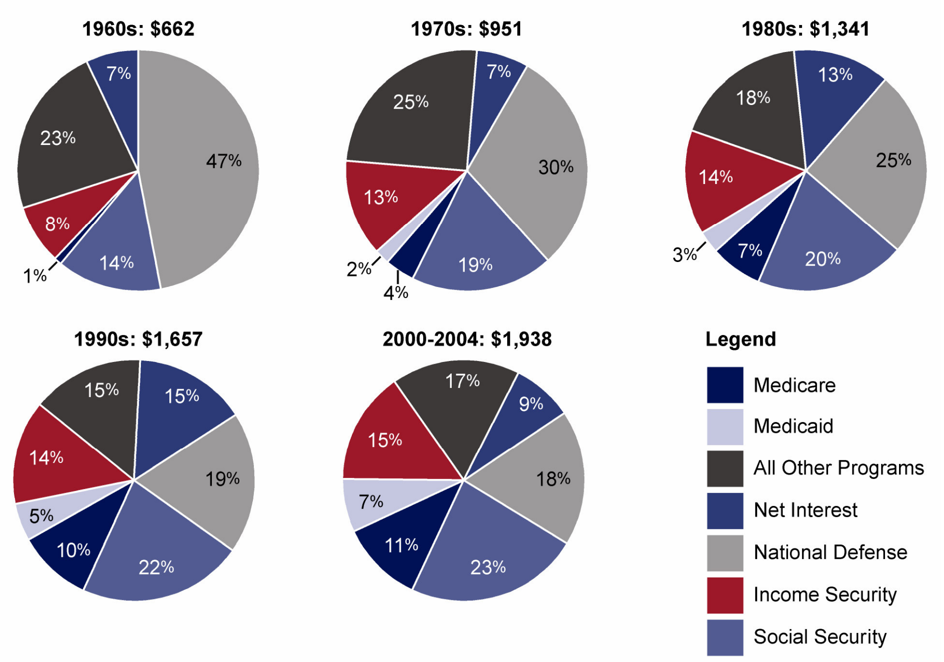
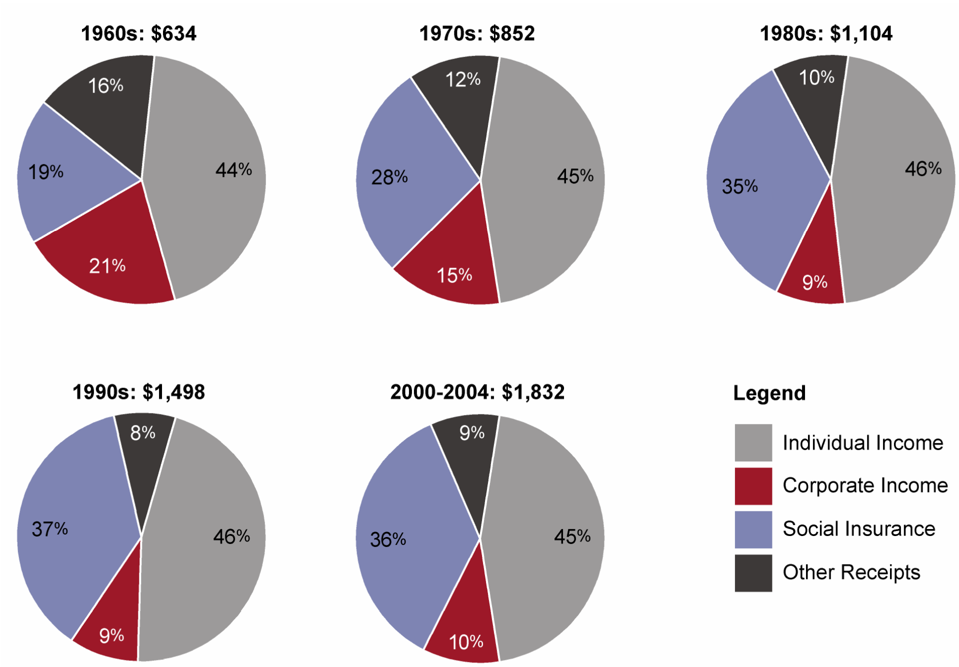


Figure 11. Federal Receipts by Source (Billions of FY 2000 Constant Dollars)

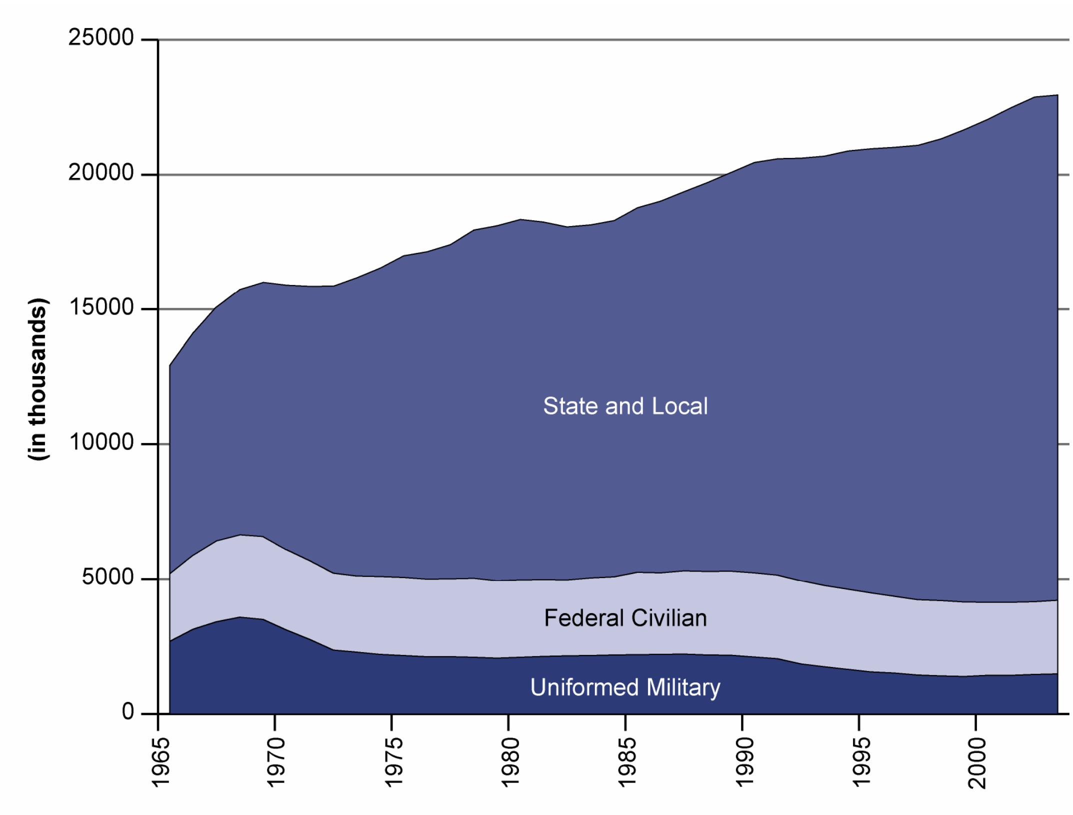


FEDERAL EMPLOYMENT

There is a tendency to equate government expenditure with federal "bureaucrats." In fact, outside of defense, expenditures are mostly for payments to individuals—Social Security, and federal pensions, and to institutions such as hospitals and universities or to state and local governments that deliver services such as health care and education to individuals or operate federal programs such as food stamps. The federal government spends a little over $160 billion, or about 7 percent of the total budget, for the compensation of civilian employees.

Figure 12 illustrates that the size of the federal workforce varies with defense policy. Employment increased during the Vietnam War and the Reagan defense build-up and declined at the end of the Cold War. Another up-tick is just beginning as the war against terror and increased military commitments in Afghanistan and Iraq continue. Relative to the U.S. population, the number of federal civilian employees has steadily declined. In 1965, there were 13 executive branch employees per 1,000 people in U.S. population. In 2003, there were about nine per 1,000.

FIGURE 12. GOVERNMENT EMPLOYMENT: FEDERAL, STATE AND LOCAL



Source: OMB Historical Tables (February 2004).

THE BUDGET PROCESS

The annual budget process consists of two phases:

During the **executive budget process**, the President, working through OMB, develops budget proposals for the federal government. Agencies formulate their budget requests and transmit them to the OMB. The executive process culminates when the President sends the budget to the Congress. It is due no later than the first Monday in February.

During the **congressional budget process**, the Congress votes on a budget resolution. The congressional budget resolution is not law—it does not go to the President for signature. It represents an agreement between the House and the Senate on budget parameters, including total spending, revenues, deficits, and debt. It also serves as a plan to allocate resources among activities, or functions, of government. (See Table 4). Action on the budget resolution is followed by legislation that does go to the President for signature or veto. There are 13 separate appropriation bills and, in some years, to satisfy budget targets, changes to laws governing taxes and entitlement programs are packaged together into a reconciliation bill. Reconciliation legislation is considered under special procedures that facilitate its passage. That is particularly important in the Senate, where a filibuster can prevent a bill from coming up for a vote.

When everything goes smoothly, all budget-related legislation is signed into law by October 1, the start of the fiscal year. Frequently, however, lawmakers have to enact a stop-gap measure known as a "continuing resolution" to keep programs running until they reach final agreement on year-long appropriations.

FISCAL GOALS

The annual budget debate either explicitly or implicitly addresses many significant policy issues including: the size for government; fiscal goals; short-term priorities; and long-term challenges.

Many budget analysts believe that setting fiscal goals, such as balancing the budget, provides a necessary framework for decision making. When elected officials talk of "ending big government" they generally are not relying on a precise definition or setting a target spending level as a percentage of GDP. Instead, they are referring more generically to how much the federal government intrudes into private lives and finances.

The size of the federal government has averaged 20 percent of GDP over the last 50 years. Over the next 50 years it could grow to 25 percent, 30 percent, or more if current policies do not change. Because Americans are likely to resist the tax increases implied by such growth, and deficits of 10 percent or more of GDP would threaten the economy, policy makers are likely to act. They are not likely to set an explicit target for the size of government. However, that measurement can provide a useful indicator of how much of the economy is devoted to federal activity.

The establishment of an explicit fiscal goal (i.e., a balanced budget) sets boundaries on budget-making. Otherwise the political rewards from cutting taxes and increasing spending lead to the fiscally irresponsible outcome of widening deficits. Some observers believe that such goals may interfere with the accomplishment of important policy objectives such as lowering taxation or providing critical benefits. Others view fiscal constraints as a means to an end—that is, a way to force concessions to achieve a common objective that has beneficial implications for the overall economy.

TABLE 4. MAJOR FUNCTIONS IN THE BUDGET

Function		Description and Examples of Major Activities	2003 Outlays ($ in billions)
050	National defense	Department of Defense military operations, atomic energy defense activities, and other defense-related activities	405
150	International affairs	Department of State consular and diplomatic activities, international development and humanitarian assistance, and international security assistance	21
250	General science, space and technology	General science and basic research, space flight and research (NASA)	21
270	Energy	Energy supply and conservation, emergency preparedness, information, policy and regulation	-1
300	Natural resources and environment	Water resources (Corps of Engineers), conservation and land management, pollution control, recreational (National Park Service) and other resources (United States Geological Survey)	29
350	Agriculture	Farm income stabilization (crop insurance, subsidies, and disaster relief), and agricultural research and services	23
370	Commerce and housing credit	Mortgage credit (Federal Housing Administration, Government National Mortgage Association), postal services, and federal deposit insurance	-2
400	Transportation	Ground transportation (highways and mass transit), air transportation (Federal Aviation Administration), and water transportation	67
450	Community and regional development	Community development (block grants and loans), regional development (Appalachian Regional Commission, Tennessee Valley Administration), disaster relief and insurance	19
500	Education, training, employment and social services	Elementary, secondary and vocational assistance, higher education assistance (student loans, Pell grants), Library of Congress, Smithsonian Institution, training and employment services (welfare to work grants), labor law and statistics (Bureau of Labor Statistics), social service block grants, and Americorps	83
550	Health	National Institutes of Health, food safety and inspection, occupational health and safety, health care services (public health, Indian Health Service, Center for Disease Control), Medicaid, state children's health insurance program, federal employees' and retirees' health benefits	219
570	Medicare	Hospital insurance, supplemental medical insurance, and program administration	249
600	Income security	General retirement and disability insurance (non-Social Security), federal employee retirement and disability, unemployment compensation, housing assistance, food and nutritional assistance (food stamps and Women, Infant Children food program), supplemental security income (SSI), temporary assistance for needy families, foster care and adoption assistance, refundable portion of child tax credit, and earned income tax credit	334
650	Social security	Old-age and survivors insurance and disability insurance, and program administration	475
700	Veterans benefits and services	Veterans compensation, pensions, and insurance, education benefits, hospital and medical services, and housing programs	57
750	Administration of Justice	Federal law enforcement activities (Federal Bureau of Investigation, U.S. Marshals, Secret Service, Alcohol, Tobacco and Firearms Administration, Drug Enforcement Administration), federal litigative and judicial activities (U.S. Attorneys), border security and immigration, and crime assistance activities	35
800	General government	Legislative activities (congressional operations), executive operations (White House and Executive Office of the President), Treasury operations, central personnel operations (Office of Personnel Management), and management of government property (General Services Administration)	23
900	Net interest	Interest on Treasury debt instruments, interest received by trust funds, and other interest and investment income	153
950	Undistributed offsetting receipts	Rents and royalties on the Outer Continental Shelf, federal asset sales	-54

Note: In some functions, programs collect offsetting fees (e.g., insurance premiums) that more than offset spending and result in negative outlays for the function.

THE LONG-TERM CHALLENGE

As difficult as they are, immediate budget pressures pale in comparison to the longer-term challenge. In 2008, the first wave of the Baby Boomers will turn 62 and become eligible for early retirement benefits provided by Social Security. Shortly thereafter, they will become eligible for full Social Security and Medicare benefits. The impact of the demographic change will not be limited to the budget. As the baby boomers age, the size of the older population will increase relative to the rest of the population. (See Figure 13). Retirees stop producing economic resources and begin withdrawing resources in the form of savings and retirement benefits. That puts added pressure on remaining workers, who have to produce enough to satisfy their own needs as well as the needs of retirees.

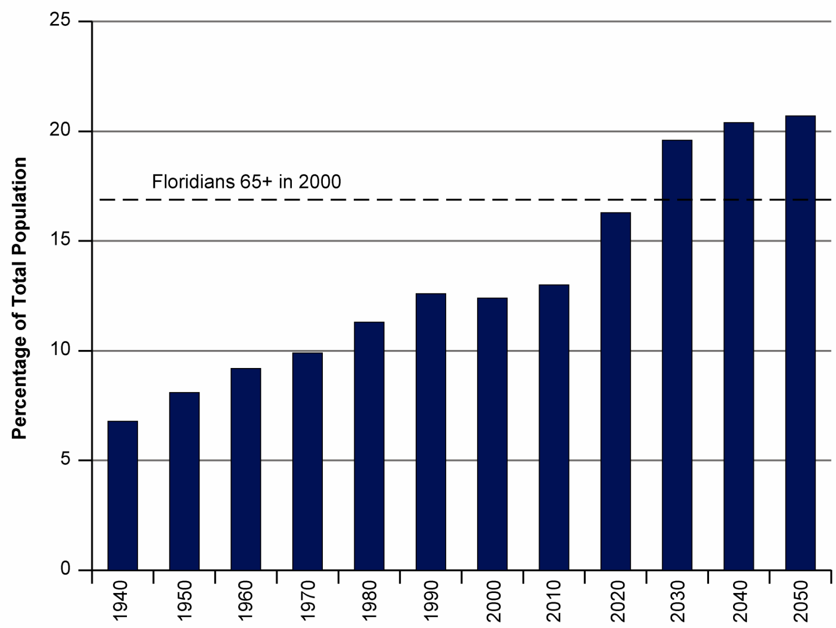
Over the long term, if current policies do not change, the combination of an aging population and rising health care costs will result in growing deficits and accumulating debt. The General Accountability Office (GAO) projects that if baseline budget policies are extended, federal debt held by the public would increase from just shy of 40 percent of GDP today to 96 percent in 2040. That level of borrowing would approach levels reached during World War II. Unlike the 1940s, the current projections of growing debt would not be temporary. The growing level of deficits debt would increasingly deprive the economy of resources needed to grow and lower future standards of living.

The issues can seem, simultaneously, simple and complicated. If Social Security, Medicare, and Medicaid did not exist, individuals would have to rely on themselves, their families, and informal networks as they age. They would have to accumulate savings during their working lives and would likely suffer significant reductions of their living standards once retired. That might encourage a higher private savings rate. However, many people would lack the foresight or the income to save enough to sustain them throughout their older years. Even the most disciplined savers would have difficulty facing medical costs without insurance. Social Security, Medicare, and Medicaid help to address the income and health care needs of retirees by diffusing financial burdens across generations and diversifying risks. Since the 1940s, public policy has used the taxation of active workers to pay retirees' benefits. That policy of intergenerational transfers has created long-term commitments that elected lawmakers will not tamper with lightly.

Unless future tax increases and cuts to other government programs offset the growth in age-driven costs, deficits and debt will grow to unsustainable levels. Growth is the surest way to reduce the burden on the overall economy of the coming demographic shift. However, it is unrealistic to believe that economic growth alone will be strong enough to resolve fiscal challenges over the longer term. Policy makers eventually will have to make adjustments to revenues, spending, or both. The sooner they act, the less jarring the changes will have to be.

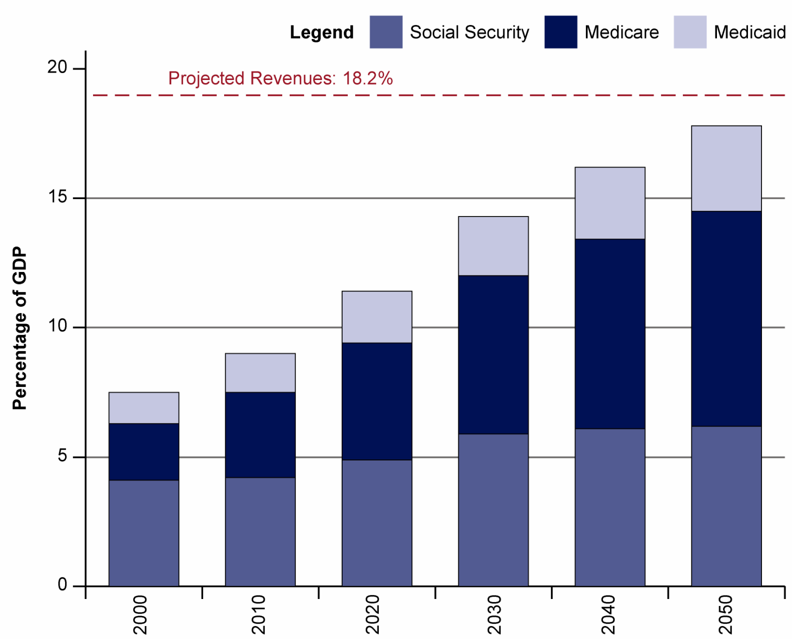
There are several ways to measure the severity of the challenge—impending insolvency of the Social Security and Medicare trust funds, escalating deficits and debt, or gaps between the streams of future benefits and future receipts designated to pay for them. All of those yardsticks indicate that the long-term fiscal problem is big and is growing bigger every year.

Figure 13. U.S. Population Age 65 and Older



Source: Bureau of the Census, March 2004.

Figure 14. Long-Term Budget Outlook



Source: CBO, *The Long-Term Budget Outlook,* Scenario 2 (December 2003).

Gene Steuerle and Adam Carasso of the Urban Institute help explain the growing gap between benefits and dedicated receipts. Each generation is getting more out of the system than they put in (including interest), but the payback is getting progressively smaller. Steuerle and Carasso estimate that:

- A two-earner couple who reached age 65 in 1970 (one with average wages and one with low wages) received \$6.67 in benefits from Social Security and Medicare for every \$1.00 in payroll taxes paid.[1] They will receive \$2.28 back for every \$1.00 paid in if they reach age 65 in 2000 and \$2.09 back if they turn 65 in 2030.

- In contrast, a couple comprising a high-wage earner and an average wage earner reaching age 65 in 1970 received \$4.86 in benefits for every \$1.00 paid in payroll taxes. They will receive \$1.63 back in benefits for every \$1.00 paid in if they turn 65 in 2000 and \$1.49 if they reach 65 in 2030.

Intergenerational transfers work well when there is steady growth in the population and economy. However, within the next decade the retirement of large numbers of post-World War II baby boomers, improvements in life expectancy, and rapid growth in health care costs will combine to put increasing pressure on the system of intergenerational financing.

Policy makers know about the looming problems, but they lack the political will and popular support to respond. The solution—lower current consumption to increase future consumption (i.e., saving)—appeals to few. The threat is gradual and seems far off. The public and their elected representatives delay making the necessary modifications. Delay, however, only makes potential changes more difficult and provides less time for adjustments.

[1] *Eugene Steuerle and Adam Carasso,* Lifetime Social Security and Medicare Benefits*, Urban Institute, 2002.*

The Long-Term Revenue Outlook

Over the coming decades, CBO and GAO assume that revenues will grow with the economy while spending on behalf of older people will outpace GDP growth. However, there is no consensus about whether lawmakers will allow the 2001 and 2003 tax cuts to expire as scheduled in 2010 or whether they will extend them, so CBO and GAO provide a range of scenarios that provide very different budget outlooks depending on the "jump off" point for revenues. The budget outlook is more optimistic if the simulations assume that the tax cuts expire and more pessimistic if they assume permanent extension at lower revenue levels.

CBO's baseline projections go out 10 years. That baseline assumes that the tax cuts will expire as scheduled by the end of 2010. The current budget debate, however, only looks at the next five years. That allows policy makers to ignore the impact their policy decisions will have on revenues in 2011 and beyond. Critics of the truncated budget window charge that it hides the longer-term cost of new decisions to cut taxes (or extend old tax cuts). Supporters of the five-year outlook argue that longer projections will be wrong. Both arguments are right. Nevertheless, revenue levels are a very important variable in efforts to address the long-term challenge. Experience indicates that revenues do not stay above 18.5 to 19 percent of GDP for long—the average since 1960 is 18.2 percent of GDP. Eventual solutions are unlikely to incorporate changes solely to promised benefits and other programs. They are likely to include increases in revenues as well.

Social Security

Social Security provides retirement benefits and disability and survivors' insurance. Almost 62 percent of payments go to retired workers, another 5 percent goes to spouses and children of retirees, 15 percent goes to disabled workers and their dependents, and the balance is paid to the survivors of deceased workers. Those benefits provide important protections, particularly for low- and middle-income earners.

Without them, poverty rates would soar particularly among older Americans.

Workers' benefits are based on wages earned in covered employment. Payroll taxes are levied against wages. Thus, benefits are tied indirectly to contributions, but cumulative benefits are not limited to the amounts actually contributed (plus interest earnings). A career low-wage worker who retires at age 65 in 2004 can expect annual benefits equal to 56 percent of wages earned prior to retirement, adjusted to reflect overall wage growth.[2] This benefit-to-pre-retirement earnings ratio is called the *replacement rate*. The replacement rate declines gradually to 42 percent for average earners and to 30 percent for those whose benefits are based on earnings at the taxable ceiling ($90,000 in 2005). In other words, low-income workers receive benefits representing a much higher proportion of their earnings than average- and high-income workers receive.[3]

About 88 percent of current payroll taxes pay for current benefits. That is why Social Security is called a "pay-as-you-go" system. If the working population grew as rapidly as the retired population, that could continue to work well. However, the ratio of workers to retirees has declined dramatically. As recently as 1965, it was 4:1. Today it is 3.3:1. By 2040, it will be 2:1. The declining ratio is due to the combined impacts of the baby boom generation's pending retirement, longer life spans, and a slower-growing labor force. Some argue that the burden on future workers is unfair and unsupportable. Others say that the economy will be much larger and that the growth in benefits will be affordable. In any event, they continue, it is too late to change the rules. Retirees expect these benefits and—with relatively modest changes to the system—they can continue to receive them without unduly burdening younger generations.

According to the 2004 actuarial report issued by Social Security's trustees, an immediate and permanent payroll tax increase of almost 2 percent, an immediate and permanent benefit reduction of nearly 13 percent, or a transfer of $3.7 trillion would assure solvency of the Social Security trust fund—that is, there would be sufficient resources dedicated to the program to pay benefits for the next 75 years. Those solutions do not take into account what impact they might have on the rest of the federal government—that is, that dedication of additional resources to Social Security could "crowd out" or leave no room for other federal priorities.

One way or another, active workers will be called on to support older people. Even private retirement and savings accounts represent claims against future economic resources. That is why it is important to encourage economic growth. A larger future economy will accommodate more easily the demographic shift.

KEY FACTS ABOUT SOCIAL SECURITY

Program Features

- *Beneficiaries:* 47 million at the end of 2003, of which 63 percent were retired workers, 7 percent were their spouses, 14 percent were survivors, and 16 percent were disabled workers and their dependents.

- *Retirement age*: Eligible for early retirement benefits begins at age 62. Workers born before 1938 may begin to receive full benefits at age 65. The normal retirement ages rises in two-month increments, reaching age 66 for those born in 1943. It stays at age 66 for workers born in 1943-1954. It again rises gradually for those born in 1955-1960, reaching age 67 for those born in 1960 or thereafter.

- *Payroll tax rates*: Workers and employers contribute 6.2 percent each (a combined total of 12.4 percent) in payroll taxes on

[2] *A "low-wage" earner earned about $15,750 in 2004. An "average-wage" earner earned $35,000.*

[3] *That replacement rate advantage is offset somewhat by the shorter life expectancies of low-wage earners relative to higher-wage earners. However, disability and survivor benefits are likely to be more important to low-wage earners.*

covered earnings up to $90,000 in 2005. The limit changes annually based on inflation.

- *Benefits*: Benefits are based on lifetime earning in employment covered by Social Security, adjusted for inflation and the real growth in wages. Social Security replaces a higher proportion of pre-retirement income for lower wage earners than for high-wage earners. The formula is indexed for the growth in average earnings, which allows real growth in the benefits of future retirees.

- *Taxation of benefits*: Benefits are subject to taxation depending on the adjusted gross income of recipients. Single taxpayers with incomes over $25,000 and taxpayers filing jointly with incomes over $32,000 pay income taxes on up to 50 percent of their benefits. Beginning in 1993, legislation extended the taxation of benefits so that single taxpayers with incomes over $34,000 and taxpayers filing jointly with incomes over $44,000 pay income taxes on up to 85 percent of their benefits. That resulting additional tax or income is dedicated to the Medicare Hospital Insurance Trust Fund.

Program Financing[4]

- *Social Security benefits rise* from 4.3 percent of GDP in 2004 to 6.5 percent in 2040 while non-interest income remains at 4.9 percent of GDP over that period.

- *Program cash flow deficits* (program costs exceed payroll tax income) begin in 2018.

- *Operational deficits* (program costs exceed income, including interest transfers from the general fund) expected to begin in 2028.

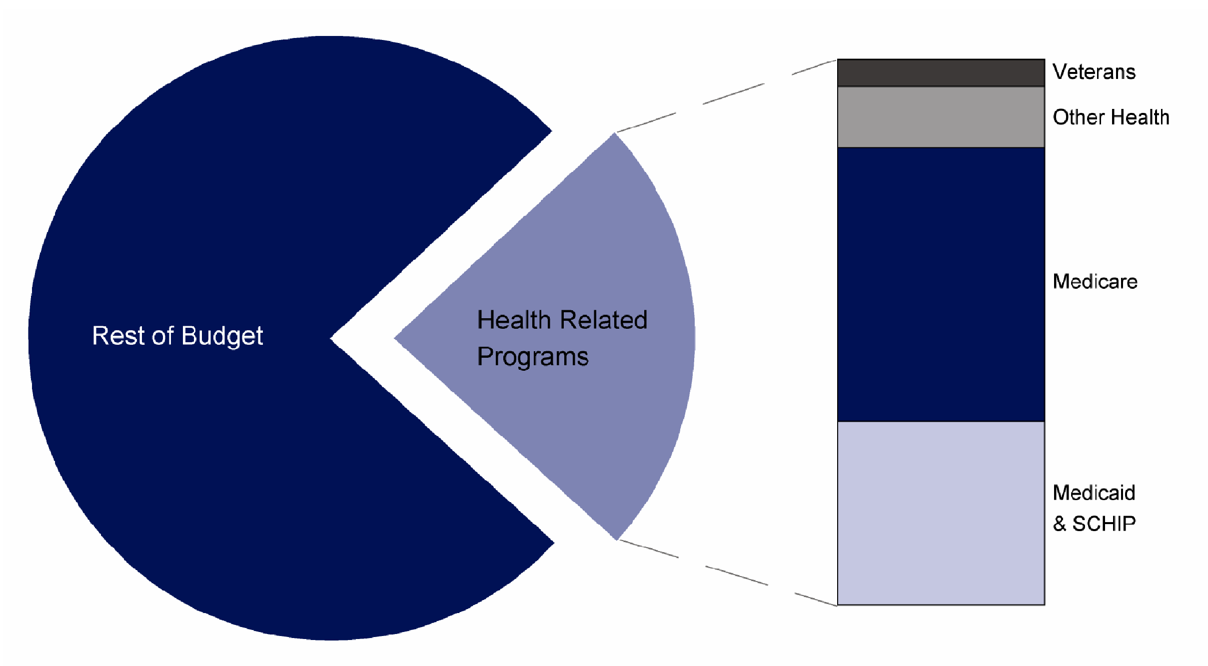
- *Social Security trust fund exhausted* in 2042.

- *The projected actuarial deficit* is 1.89 percent of payroll, meaning that payroll taxes would have to rise immediately by 1.89 percent to 14.29 percent to keep Social Security solvent for the next 75 years. Alternatively, benefits could be cut immediately by 13 percent, general fund transfers of $3.7 trillion (in present value) could be made, or benefits could be cut 27 percent in 2042 (rising to 32 percent in 2078) once the trust fund is depleted.

- *The ratio of covered workers to Social Security beneficiaries* declines from 3.3 to 1 in 2005 to 2.0 to 1 in 2040 and to 1.9 to 1 in 2075.

[4] All projections from The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 23, 2004.

FIGURE 15. HEALTH-RELATED SPENDING IN THE BUDGET, 2004



HEALTH CARE AND THE BUDGET

Federal spending for heath care (including Medicare) covers almost one-third of the nation's health care bills and more than one-fourth of the population. All together, federal, state, and local governments pay for about 46 percent of the nation's health expenditures.

Federal spending for health-related programs, like health care costs in general, is growing faster than the GDP, revenues, and the rest of the budget. Nearly one out of every four dollars spent by the federal government is related to health care. (See Figure 15). That is up from about one out of every five dollars a decade ago. In addition to direct spending, the federal government subsidizes health care through the tax code. Allowing individuals to exclude employer contributions for health insurance and medical care from taxable income is the largest single tax benefit provided under current law. Other tax provisions such as the deductibility of medical expenses and charitable contributions to health care institutions also support the health care system.

Despite federal and state efforts, an estimated 45 million people (including 8 million children) lack health insurance for at least part of any year. Many people do not qualify for Medicare, Medicaid, or SCHIP (State Children's Health Insurance Program)—including single, low-income childless adults and lower-wage workers who do not receive employer-sponsored health insurance coverage. Nearly one-fifth of children in poverty are uninsured, even though they are eligible for public coverage. About 28 percent of younger adults (ages 18 to 34) are uninsured. They represent 42 percent of the uninsured population. While most people lacking health insurance had lower incomes, nearly one-third of the uninsured had family incomes of $50,000 or more and nearly 46 percent worked full-time. Those figures indicate how complicated the issue of lack of health insurance coverage is.

MEDICARE

Medicare is the third largest category of expenditure in the budget (behind Social Security and defense) and growing fast. (See Figure 16). In 2024, actuarial projections show Medicare surpassing Social Security to become the largest federal program. All retirees over 65 years of age are eligible for Medicare. Those who are eligible for Social Security or Railroad Retirement benefits or have paid Hospital Insurance payroll taxes (or who are spouses of eligible workers) are automatically eligible. Others may buy into the program by paying premiums.

There are two parts to the Medicare program. **Hospital Insurance (HI)** or ***Medicare Part A*** is funded through a 2.9 percent payroll tax. **Supplemental Medical Insurance (SMI)** includes ***Part B*****,** which covers doctors' bills, home health care, outpatient services, and medical supplies and equipment, and ***Part D***, the new prescription drug benefit program. Those programs are voluntary. Social Security beneficiaries pay monthly premiums ($78.20 in 2005) through deductions from their benefit checks. Those who do not receive Social Security (generally retired state and local government employees) pay premiums directly to the government.

Medicare was enacted in 1965. At the time the growth in employment-based health insurance had bypassed retirees. The new federal program was touted as a social contract with senior citizens, guaranteeing them the same health care coverage enjoyed by workers. Because Medicare's architects worried more about convincing physicians and hospitals to participate in the program than they did about costs, they set fairly generous fee schedules. Over time the lawmakers enhanced benefits for a politically active constituency while attempting to control costs by tightening payments to health care providers.

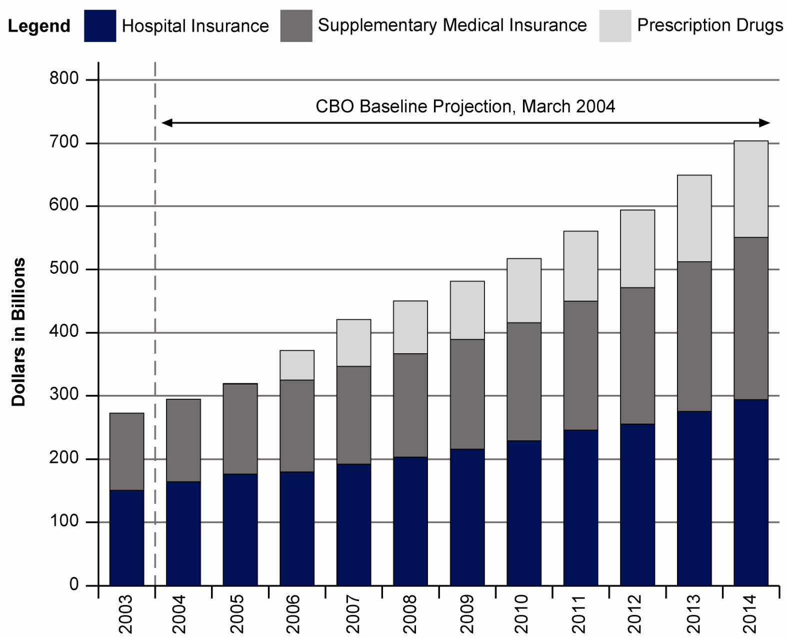
Despite increases, payroll taxes and beneficiaries' premiums cover a smaller and smaller share of Medicare's bills. In 1970, HI taxes and premiums paid for 85 percent of Medicare benefits. In 2003, that share had declined to 65 percent. By 2040, the Medicare actuary projects that only 29 percent of Medicare's costs will be covered by payroll taxes and premiums.

Medicare was never designed to be self-supporting. Initially beneficiaries were supposed to share Medicare SMI costs equally with the federal government. As costs rose, lawmakers did not force beneficiary premiums to keep up. As a result, premiums paid by beneficiaries now cover about 25 percent of Part B costs while general tax revenues make up the rest. In 2003, those general revenues represented almost 9 percent of total income tax revenues. Unless current policies change, in 2040, transfers of general revenues to the SMI will exceed one-third of income tax collections.

Although Medicare costs are growing 2 to 3 percent a year faster than the overall economy, its benefits have failed to keep up with changes in medicine. Even though its costs are rising faster than dedicated revenues, its gaps in coverage provoke criticism. It provides only limited nursing home care. It does not cover long-term care. A new prescription drug benefit was enacted in 2004, but will not be fully implemented until 2006. It is too early to tell how effective and affordable it will be.

Despite the coverage gaps and growing out-of-pocket costs for many beneficiaries and tight provider payment rates, the Medicare Trustees project there will be cash flow deficits in the HI program beginning in 2004. According to the 2004 report of the Medicare trustees, the payroll tax rate (2.9 percent of wages) would have to more than double to assure sufficient resources for that program over the next 75 years. By law, SMI will have sufficient resources because general revenues will assure adequate resources. But if SMI expenditures grow from a little over 1 percent of GDP to over 5 percent in 2040 and if total Medicare expenditures triple over the same period as projected by the actuary, it will put severe strains on the rest of the budget.

FIGURE 16. MEDICARE BENEFITS 2003-2014



Source: CBO, March 2004.

KEY FACTS ABOUT MEDICARE

Program Features

- *Beneficiaries*: 42 million individuals were covered by Medicare Part A—Hospital Insurance (HI) and/or Medicare Part B—Supplemental Medical Insurance (SMI) in 2004. (41 had HI and 39 had SMI.)

- *Eligibility*: Individuals and their spouses age 65 and older who paid HI taxes are automatically eligible. Those who are not automatically eligible may buy into Medicare by paying premiums. Individuals receiving Social Security disability benefits are eligible for HI after a 24-month waiting period. Federal employees hired before January 1, 1983 and State and local employees hired after March 31, 1986 pay HI taxes and are eligible for Medicare at age 65. SMI is voluntary. Beneficiaries must pay premiums ($58.70 per month in 2003) equal to 25 percent of SMI costs. The remaining 75 percent is financed through general tax revenues.

- *Payroll tax rates*: Workers and their employers each contribute 1.45 percent in payroll taxes. Since 1994, payroll taxes are paid on all covered earnings (no ceiling).

- *Benefits*: HI covers inpatient hospital stays, up to 100 days in skilled nursing facilities, and some home health and hospice care. SMI covers physician services, laboratory services, durable medical equipment, outpatient service, and other medical needs. The new Part D prescription drug program will subsidize voluntary enrollment in drug benefit plans beginning in 2006. HI and SMI reimburse health care providers for the services they provide according to a schedule of payments (fee-for-service). Medicare+Choice uses managed care plans to offering a range of inpatient hospital and ambulatory benefits. Managed care (group) plans provide coverage in exchange for a per capita payment (partially risk-adjusted to reflect health status). Only 13 percent of beneficiaries are enrolled in group plans, and enrollment in those plans is declining.

- *Premiums, co-insurance, and deductibles*: Beneficiaries are liable for premiums, deductibles, and co-insurance totaling almost 23 percent of Medicare's overall costs. Most beneficiaries have other coverage (Medigap, coverage from former employers) to help reduce their out-of-pocket payments. Medicaid pays for the out-of-pocket costs (including SMI premiums) of eligible, low-income Medicare beneficiaries.

- *Average per beneficiary spending* is projected to rise from $7,500 in 2004 to $14,100 in 2014.

Program Financing [5]

- *Total Medicare spending is projected to rise* from 2.7 percent of GDP in 2004 to 8.4 percent in 2040 and 13.8 percent in 2078.

- *The Hospital Insurance Trust Fund* began to run cash deficits in 2004 when payroll tax income fell short of expenditures. The HI trust fund will be exhausted in 2019. By 2078, tax income will cover 25 percent of projected costs.

- *The SMI program is not self-financing*. General revenues make up the difference between premium income and expenditures. SMI expenditures will rise from 1.17 percent of GDP in 2004 to 2.96 percent in 2040.

[5] *Projections from The 2004 Annual Report of the Trustees of the Federal Hospital Insurance and Federal Supplemental Medical Insurance Trust Funds, March 23, 2004.*

- *Spending for the new prescription drug program (Part D)* will grow to nearly 1 percent of GDP in 2014 to 2.1 percent of GDP in 2040, and to 3.4 percent by 2080.

- *The projected actuarial deficit* is 3.1 percent of taxable payroll for HI.

MEDICAID AND STATE CHILDREN'S HEALTH INSURANCE PROGRAM (SCHIP)

Medicaid is a ***means-tested*** program: beneficiaries of any age must have incomes and assets below levels specified in statute and regulations in order to qualify for any benefits at all. Medicaid spends about 42 percent of its budget on long-term care. It covers over one-third of the nation's long-term care costs and pays nearly half of the annual costs of nursing homes. Only 9 percent of Medicaid beneficiaries are elderly, but they account for 27 percent of total program spending. (Children, who make up 50 percent of Medicaid beneficiaries, account for only 18 percent of expenditures.) Combined expenditures for Medicare and elderly assistance under Medicaid total more than any other federal program except Social Security.

States administer the Medicaid program. Although they must provide coverage for certain categorically-eligible populations (e.g., children under 19 in families with incomes under the poverty level—$18,000 for a family of four; pregnant women with family incomes up to 133 percent of poverty; low-income Medicare beneficiaries), they can expand coverage to more people and provide broader benefits. The federal government matches state Medicaid spending according to state per capita income. The federal match ranges from 50 percent to 77 percent.

The State Children's Health Insurance Program (SCHIP) provides grants to states to expand health insurance coverage of poor or near-poor children (ages 18 or younger) who do not qualify for Medicaid. States can use these grants to expand Medicaid eligibility for children whose families have incomes up to 200 percent of the poverty level ($37,600 for a family of four in 2003) or to create separate children's health insurance programs. Together, Medicaid and SCHIP provided coverage for over 22 percent of children in 2002.

Medicaid spending grew 13 percent last year and is expected to rise by another 10 percent this year. Given large budget shortfalls, Medicaid places substantial pressure on state budgets. To control costs, governors would like greater flexibility to determine Medicaid eligibility and benefits. In addition, they seek protection from downside risks (e.g., economic downturns, potential medical disasters). Many would like to transfer responsibility for Medicaid's elderly population to the federal government.

HEALTH INSURANCE COVERAGE

In the United States, 63 percent of the population is covered through employment-based, private health insurance (See Figure 17). Another 25 percent is covered through government-sponsored insurance, principally Medicare (13 percent) and Medicaid (11 percent).

Estimates of the number of people who are uninsured vary depending on how they are counted, but the most commonly cited statistic is 14 percent of the total population, or around 43 million people.[6] Virtually all people over the age of 65 have health insurance from Medicare. Medicaid and SCHIP are helping to reduce the lack of insurance coverage among children by providing coverage for those from low-income families.

The linkage between health insurance and employment strongly affects the number and composition of the uninsured. Not surprisingly, the number of uninsured grows when the economy is weak. In addition, insurance status varies depending on employment-related factors such as income, level of education, and size of employing firm.

Young adults age 18 to 24 (who lose coverage under their parents' policies and do not obtain their own) are most likely to lack insurance. In general, they are healthy but they are often in transition and not settled in jobs that offer health benefits. Even if they can buy group insurance, their premiums probably would be higher than necessary to cover the cost of their own care. They almost certainly would subsidize higher-cost populations if they bought insurance. One can make a case that this group's decision to forego insurance is very rational—until they get into an accident or suffer a serious illness. Unfortunately, accidents and illness do not affect some virtual average across the group—they affect individuals. But it may be hard to persuade young people that they are the individuals likely to be affected and that insurance may be a good investment.

Despite Medicaid and SCHIP, more than one out of five poor children does not have insurance.

Poor adults are twice as likely as poor children to be uninsured.

For most people, being uninsured is a temporary state. CBO reports that 44 percent of uninsured spells last four months or less and that 70 percent last less than a year. People reporting poor health status do not seem to experience longer spells without insurance than those reporting good or excellent health. But poor health can keep people from working and contribute to a lack of insurance when it is most needed.

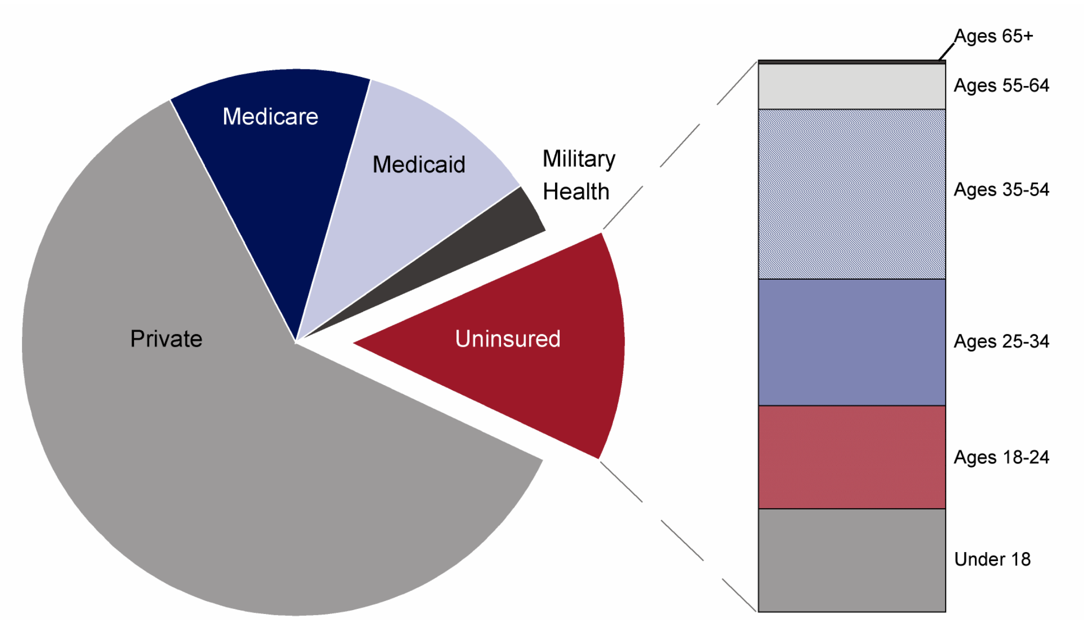
[6] *CBO and other researchers believe that the estimates of 41 to 43 million uninsured (14 percent of the population) overstates the number of people who lack insurance for the full year. CBO estimates that the number of people who are without insurance is between 21 to 31 million.*

Policymakers are concerned about the number of people without insurance for a number of reasons:

- People without insurance may not have access to adequate health care services.
- That in turn could contribute to more serious illnesses and the higher cost of treatment must be paid from public or private resources. Insurance diffuses financial risk.
- The distribution of health care costs among individuals, employers, and government shifts with the number of insured. Lower numbers of people with insurance mean fewer folks voluntarily sharing costs. That makes the problem more difficult to solve.
- Adverse selection occurs when people obtain insurance in anticipation of need. That means that they only enroll when they know they are likely to require costly surgery or switch to a plan that includes dental care only when their children need orthodontic treatment.
- Adverse selection and/or services rendered to uninsured populations produce cost shifting, force those who regularly carry insurance to pay higher premiums, and require taxpayers to pay higher taxes to pick up the tab for "uncompensated care."

Similarly, large medical malpractice settlement awards, large numbers of chronically empty hospital beds, unnecessary tests and treatments, etc., act as surcharges to the system, driving up costs that must be born by those who pay their own way, those who regularly purchase insurance—and ultimately and inevitably by taxpayers when nobody else is there to pay the bill.

FIGURE 17. HEALTH INSURANCE COVERAGE, 2003



Source: U.S. Census Bureau, *Income, Poverty and Health Insurance Coverage in the United States: 2003,* August 2004.

INSTRUCTIONS

1) BACKGROUND PREPARATION

You will be able to participate more fully in the *Exercise* if you familiarize yourself with these materials in advance and make preliminary decisions about which policy options come closest to your preferences. Reading the background materials will also be useful in helping you to understand the larger budget issues. During the *Exercise* session you will express your views and will likely have to defend your positions. You will be a stronger discussant if you don't have to spend time reading and have already formed preliminary interpretations of the issues and options.

You will either be using a paper or electronic Scorecard. (The Scorecard is located at the back of this booklet.) The Scorecard helps you to keep track of your decisions and asses your progress.

The Scorecard begins with federal deficits or surpluses as projected by the *Exercise* baseline. **Spending options** that increase spending and therefore the deficit are shown as positive amounts; options that decrease spending and therefore the deficit are show as negative numbers.

For **revenue options**, the Scorecard begins with projections of baseline revenues. Options that increase revenues (and reduce deficits) are positive: options to cut taxes (and increase deficits) are shown as negatives.

2) WORKING WITH YOUR GROUP

Diverse Groups – To the extent possible, your group should be made up of people with diverse viewpoints about the role of government and public policies to reflect the mix of opinions in Congress.

Pick a Chair – The Chair is responsible for keeping the discussion moving.

Pick a Recorder – The Recorder is responsible for tracking all decisions.

Decide how you will make choices – Majority wins? By consensus? How will you break a tie?

3) MAKE BUDGET DECISIONS

Set a goal to establish overall parameters. If you meet your goal you will earn a bonus—lower interest costs.

For each budget option decision, the *Exercise* provides summary information, including:

- baseline revenue levels for 2005-2010,
- the baseline level for 2014 as a percent of GDP, and
- a pie chart of the category in 2004.

Then the *Exercise* presents a number of options and shows how much each option would affect the budget. Options are based on proposals that have been presented in the President's budget, House and Senate budget resolutions and other sources.

The Exercise baseline is the default option. If you want to stay with current policy, you would select the baseline option.

You make decisions in the following categories:

I. Spending

- National Security
- Income Support
- General Government
- Social Security
- Medicare
- Medicaid and State Children's Health Insurance Program (SCHIP)

II. Measures to expand health insurance

III. Revenues

4) TRACK YOUR PROGRESS

The Scorecard tracks budgetary impacts in 2009 and 2014 in billions of dollars and for 2014 and 2040 in percent of GDP. The *Exercise* extends spending and revenue levels under your budget in 2014 as a constant share of GDP *except for Social Security and health care programs* (Medicare, Medicaid and SCHIP, and measures to expand health insurance coverage). To provide you with an indication of how your budget would fare over the long term, the scorecard provides estimates of the long-term impact (as a percent of GDP) of Social Security and health care programs.

5) SUM UP

After you've finished making decisions, take a moment to review what you've done and to compare it with baseline projections. Did you meet or exceed your goal? How much of your budget total was due to changes in spending? To revenues? Are you comfortable with the results? If given more time, would you go back and revise some of your decisions? Would you vote for a policy maker who advocated your budget? You may be asked to share and compare your results with other groups.

Remember:

The *Exercise* reflects baseline projections published by CBO in September 2004, adjusted to remove annual repetition in 2005 through 2014 of $115 billion in new, emergency, supplemental appropriations that were provided in 2004 to support operations in Iraq, Afghanistan and the global war on terror. The amounts corresponding to each option show its impact on the baseline projections of spending and revenues.

When you consider **spending (outlay)** options, you will consider each option's impact on the total spending**. Spending increases are shown as positive numbers and would make the deficits worse. Spending cuts are shown as negative numbers and would reduce deficits.**

When you consider **revenue** options, you will consider each option's impact on total revenues. **Options to cut taxes (negative amounts) reduce revenues but increase deficits. Tax increases are shown as positive numbers because they increase revenues, but they reduce deficits.**

Each section includes fiscal policy impacts for each option in the current year, the upcoming year, and over five years. You will also see the impact of each option expressed as a percentage of GDP in 2014. CBO projects 2014 GDP will be $18.4 trillion. Most options, therefore, will be a very small percentage of GDP.

SET A BUDGET GOAL

WHERE TO BEGIN

To begin the *Exercise*, choose a budget goal to establish a framework for your decision-making. Your choice will determine how much the government has to borrow and how much it will pay in net interest costs. (Interest savings are approximate. Actual savings depend on the package of individual policy changes selected and the timing of resulting costs or savings.)

When is the budget balanced?

In this *Exercise* "balancing the budget" means balancing the **unified** or total budget—that is, total receipts equal total spending. Within the budget, a few activities, principally Social Security, are designated as **off-budget** while the rest of government is **on-budget** and is sometimes referred to as the **operating budget**.

- Off-budget status for Social Security is intended to protect the Social Security program. When the Congress considers its annual budget resolution, it ignores Social Security's taxes and spending. That reduces the incentive to trade-off Social Security (by raising its payroll taxes or cutting its benefits) against other objectives. Policy makers can make changes to Social Security, but such changes are supposed to improve the long-term financial stability of the program, not be used to cover the costs of non-Social Security objectives.
- **Saving the Social Security surplus** is shorthand for running unified budget surpluses equal to or greater than the Social Security surplus. Other ways to characterize the same objective is to achieve **on-budget balance** or to balance the non**-Social Security budget**.

What happens to budget surpluses?

When the budget runs surpluses, the Treasury can pay down the publicly-held debt. When the stock of debt goes down, the government lowers its interest costs, demands fewer resources from the economy and leaves more for other purposes, including private investment activity that can help increase economic growth. Budget surpluses, whether generated by Social Security or other government operations, are beneficial to the economy and to the budget. They are akin to government savings. Reducing the federal government's outstanding debt now strengthens its ability to address future demands.

EXERCISE BASELINE
ESTIMATED DEFICITS (-) OR SURPLUSES (+) IN BILLIONS OF DOLLARS

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
Budget Deficits (-)/ Surpluses (+)	-310	-202	-187	-183	-166	-142	0.7%
On-budget	-482	-395	-398	-411	-409	-398	-0.8%
Off-budget	173	193	211	228	242	256	1.6%

OPTIONS AND IMPLICATIONS

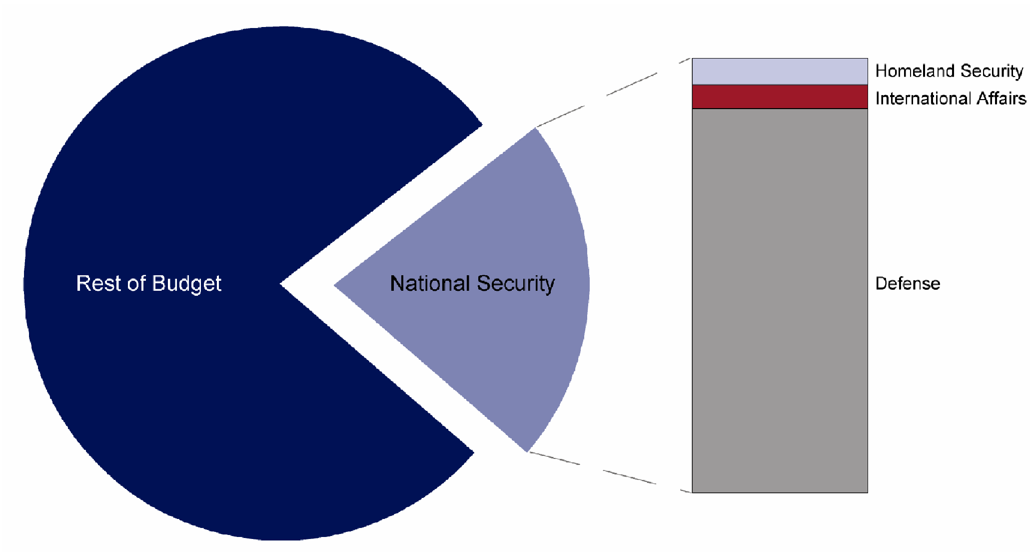
	2005	2006	2009	2014	Percent of GDP in 2014
Policy Options Projected unified deficits in billions of dollars					
1. *Exercise* baseline	-310	-202	-166	138	0.7%
2. Cut the deficit in half in 5 years; balance in 10 years	-371	-329	-207	0	0.5%
3. Balance unified budget in 2009	-331	-249	0	138	0.7%
4. Cut on-budget deficit in half in 5 years; balance the non-Social Security budget in 10 years	-323	-233	38	288	1.6%
5. Balance the non-Social Security budget in 5 years	-282	-151	242	288	1.6%

Note: Budget deficits are shown as negative amounts (-); budget surpluses are shown as positive amounts.

Option	Arguments In *Favor*	Arguments *Opposed*
OPTION 1. *Exercise* baseline. This option would avoid setting any deficit reduction target. It assumes no change in projected deficits and eventual surpluses over the next 10 years.	Fiscal rules prevent a full debate over policies. Policies, not rules, should drive the numbers. Rules are inflexible and can adversely affect programs when lawmakers try to live within constraints. Gimmicks multiply when policy makers try to make the numbers fit.	Without a consensus goal there will be too many competing priorities and no budget constraints. The most likely outcome is bigger deficits and more debt because everyone will get at least some of what they want.
OPTION 2. Cut the deficit in half in five years (FY 2009), balance the unified budget in 10 years, but with no goal after 2014, deficits return as Social Security, Medicare and Medicaid grow over the longer term. This was the goal of both presidential candidates in 2004. This option would limit the deficit in 2009 to $207 billion. Annual deficits under this option would exceed the *Exercise* baseline deficits each year over the next 10 years.	This is the most politically realistic option in the near term. It was the only goal identified during the recent presidential campaign. If the goal is set too high, policy makers will be forced to ignore it or find creative ways around it. That will create greater public cynicism and diminish the credibility of the budget process. Beyond 2009, this goal is fairly aggressive. Its deficits are larger than those contained in the baseline only because the baseline allows the tax cuts to expire. If those tax cuts are extended, this goal would impose fiscal restraint.	A goal that sets the bar lower serves little purpose. It would allow a $41 billion bigger deficit in 2009 than projected by the baseline. Lawmakers could achieve better budget results, run smaller deficits and accumulate less debt if they just stay home and leave current funding levels and policies the way they are. It is always easier for elected officials to put off the "pain" to sometime in the future. That saddles future Congresses and presidents with the problem and allows current policy makers to avoid being held accountable for making progress on budget issues.

Option	Arguments In *Favor*	Arguments *Opposed*
OPTION 3. – Balance the unified budget in 2009 and balance the budget over the business cycle thereafter. This option would impose fiscal restraint in the next five years, then follow the baseline surplus path. This option would reduce the debt by $474 billion over 10 years. As a long-term objective, it would balance the budget over the business cycle, allowing the budget to serve as a fiscal stabilizer during fluctuations in the economy.	For 2009, this sets an understandable—and therefore enforceable—goal. It recognizes reality—lawmakers will not maintain surpluses, but will work to keep the budget balanced if they have to. Voters will easily be able to judge whether or not policy makers achieve the goal. Beyond 2009 this option would allow the budget to act as a counterweight to economic conditions. It would allow deficits when the economy is in recession so that federal spending offsets the effects of the downturn. But the budget would run surpluses in times of growth and begin to reduce debt to help prepare for the baby boomers' retirement.	This goal would not require the government to run surpluses and pay down the debt before the baby boomers retire. As a result, future interest costs will be higher than they would be with a more aggressive goal. This objective does little to address the looming cost of the baby boomers' retirement. Requiring budget balance over the business cycle makes it very hard to maintain fiscal discipline. If deficits are OK during recessions, lawmakers will find it harder to put the controls back on once the economy recovers.
OPTION 4. – Cut the on-budget deficit in half in five years (FY 2009), balance the non-Social Security budget in 10 years, then run surpluses or deficits equal to Social Security's. This option would achieve a small surplus in the unified budget in 2009 and a surplus equal to the Social Security surplus in 2014. This option would reduce the debt by $334 billion over five years and $1.1 trillion over 10 years. It would run surpluses equal to Social Security surpluses through 2028, when the surpluses are projected to disappear, then run deficits equal to Social Security deficits.	This goal is rigorous without being completely unrealistic. For 2009, it would require $204 billion in revenue increases (8 percent of baseline receipts), spending reductions (7 percent of outlays) or a combination of the two. It won't be easy but it would put the budget on the right path toward long-term fiscal responsibility. Lawmakers can always raise taxes or cut programs to accommodate any new priorities.	This goal is only modestly more aggressive over the next five years than Goal B (a surplus of $38 billion in 2009), yet harder to explain than either Goal B or Goal D. The ultimate objective (balance the non-Social Security budget) is admirable, but too distant to be influential. Experience shows that easy to remember numbers (like 0) or simple concepts (balance the budget) have the most political potency. In 2028, Social Security is projected to begin running deficits. This target would lose its effectiveness after that point.
OPTION 5. – Balance the non-Social Security budget in five years (FY 2009), keep it balanced through 2028, then balance the unified budget once Social Security begins to run deficits. This is the most aggressive option. It would achieve a unified budget surplus equal to the Social Security surplus—$242 billion—in 2009. By 2015, the debt would be over $2 trillion lower than levels projected under the baseline.	This is the most fiscally responsible and most aggressive choice. It would force policy makers to pay down the publicly-held debt at a rapid rate, which is the best preparation for the looming cost of the baby boomers' retirement. If new priorities arise, lawmakers can always raise taxes or cut spending to pay for them. By requiring the budget to be balanced once Social Security runs deficits this option would maintain fiscal discipline over the long-term.	This goal is not sustainable. It would require $408 billion in changes in 2009 relative to the baseline—the equivalent of 2.75 percent of GDP. Once unified budget surpluses were achieved beginning in 2008, lawmakers would be looking at substantial surpluses ($1.7 trillion for 2008-2014). They would not be able to resist cutting taxes again (as they did in 2001) or increasing spending.

CHOICE 1: NATIONAL SECURITY



National security represents over one-fifth of the total budget. It includes three major activities:

- **National Defense** This is the largest activity. It includes funding for: the Department of Defense (DOD); intelligence activities; atomic energy defense activities conducted by the Department of Energy; and other defense-related programs.

- **International Affairs** This provides funds for: foreign aid (international development; humanitarian and security assistance programs); diplomatic and consular services (the State Department); foreign information and exchange programs; and international financing programs.

- **Homeland Security** This comprises border and transportation security (38 percent of homeland security spending); protection of critical infrastructure and other key assets (32 percent); emergency preparedness and response (14 percent); domestic counter-terrorism—law enforcement (9 percent); defense against catastrophic threats—chemical, biological, and nuclear attacks (6 percent); and intelligence and warning (1 percent).[7]

[7] *Homeland Security is not a separate budget function, making it difficult to track spending accurately. Funding for homeland security is scattered across every budget function, over 200 appropriation accounts, and many agencies other than the Department of Homeland Security (DHS). The* Exercise *treats Homeland Security as separate function, which may lead to double counting in the* Exercise *results. However, the benefit of considering Homeland Security as a separate category outweighs that technical accounting problem.*

ISSUES

Few would argue that national security is not an essential function of the federal government. However, there is disagreement about how the United States can best address the types of threats we are most likely to face around the world. Some analysts believe that as the only remaining superpower, the United States' strength serves as the best deterrent against future attacks. Others believe that the U.S. has too frequently become engaged in conflicts that have little to do with our national interests. Still others believe that we are using our military to address problems that should be handled through diplomacy.

Policy makers strive to balance the need to defend U.S. interests against the costs of providing that defense. Since 2001, policymakers have directed more resources into activities related to national security at home as well as abroad. Between 2001 and 2004, nominal spending for defense grew by 50 percent, largely due to wars in Afghanistan and Iraq and the global war against terror. Those operations will continue to need funding but there are conflicting views about when and how much to budget for them.

As the largest element of national security, the DOD budget has the most impact on the overall budget. In the near term, national security policy focuses on financing military and reconstruction activities in Iraq and Afghanistan and providing resources to safeguard people and critical infrastructure at home. The current planning base for the Pentagon is inflation-adjusted funding plus $10 billion a year. That is just the base and does not include costs related to Iraq, Afghanistan, and the global war on terror. DOD planners oppose any cuts, arguing that defense budget is tight and already assumes greater efficiency, reduction of wasteful spending, and limited priorities. Other analysts disagree: some believe that the defense budget should be cut while others believe it should be increased.

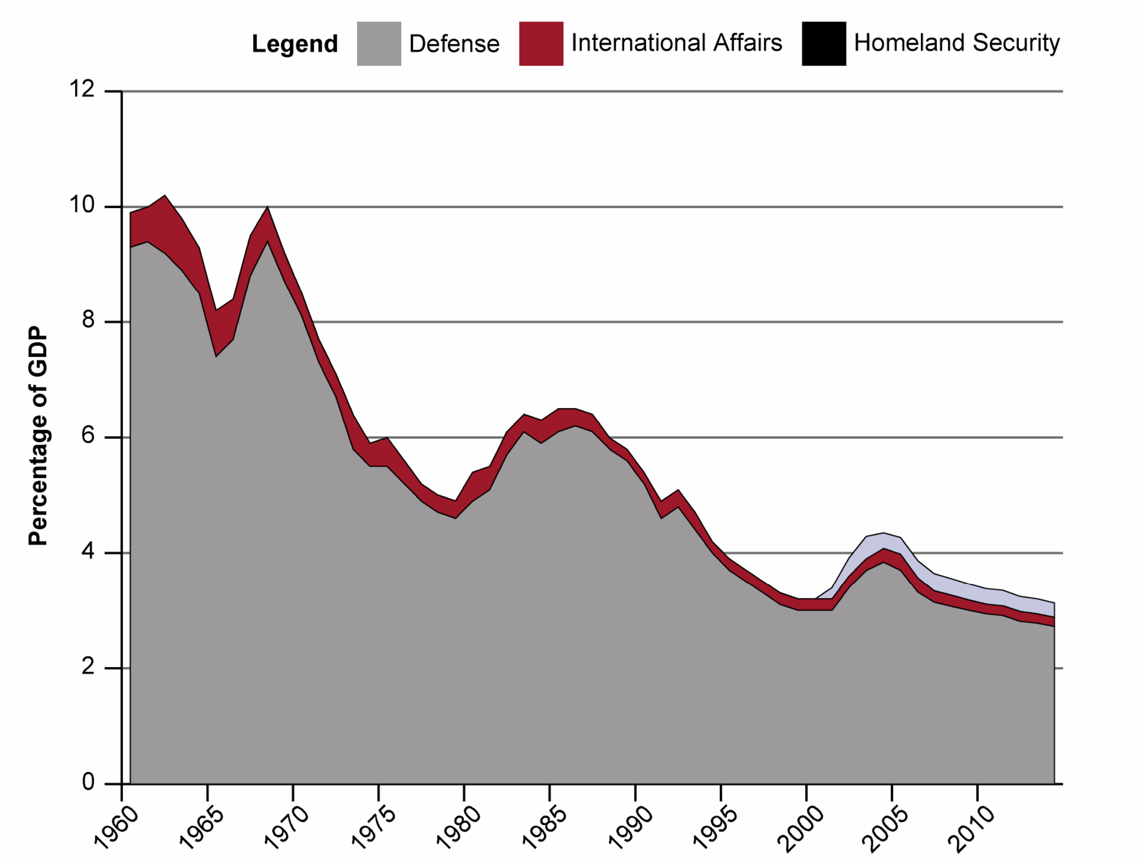
Over the long term, the challenge is to define potential threats and determine how best to meet them. Since the end of the Cold War, the Pentagon has been transforming its weapons systems and force structure to adjust to new global conditions. The planning scenario is in flux—shifting from the need to prepare for major armed conflicts and wars to more frequent peacekeeping and stabilization missions. That has significant resource implications. Some lawmakers support aggressive spending for defense and homeland security. They would invest heavily in new weapons systems and the personnel to operate them. Others believe that the Pentagon's budget can be constrained by prioritizing defense spending and convincing other nations to accept a greater share of the burden of maintaining international stability.

International affairs and homeland security complement the defense department. Some experts believe that a stronger emphasis on diplomacy, multilateral burden-sharing, and strategic and humanitarian foreign assistance would increase national security. Others don't view diplomacy as an effective alternative to a strong military. Homeland security activities increase public safety and domestic law enforcement but may overlap the responsibilities of state and local governments. As a result, homeland security is a somewhat elastic and—because it is highly appealing to voters—growing category. Like spending for defense, spending for international affairs and homeland security has ballooned in the last several years, raising questions about whether they should continue to grow while other areas of the budget are cut back.

NATIONAL SECURITY ESTIMATED SPENDING (BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
National Defense	455	428	424	436	446	456	2.7%
International Affairs	34	32	28	27	27	27	0.2%
Homeland Security	36	38	40	41	41	42	0.3%
Total	**525**	**499**	**492**	**503**	**514**	**526**	**3.1%**

HISTORICAL SPENDING FOR NATIONAL SECURITY (PERCENTAGE OF GDP)



OPTIONS

NATIONAL SECURITY OPTIONS (BILLIONS OF DOLLARS)

	2005	2006	2009	2014	Percent of GDP in 2014
Exercise baseline spending level [a]	525	499	514	578	3.1%
Policy Options – Choose 1 (Projected changes to baseline **spending** levels)					
1. *Exercise* baseline	0	0	0	0	0.0%
2. Scale back national security	-9	-42	-178	-282	-1.5%
3. Freeze at the 2004 level	-1	-10	-43	-109	-0.6%
4. Emphasize homeland security and international affairs	0	1	26	52	0.3%
5. Current policy	0	6	44	62	0.3%
6. Maintain at 4.5 percent of GDP	25	78	150	246	1.3%
Current Issues – Optional Choice					
7. Add new funds for Iraq, Afghanistan and the global war on terror	19	41	37	24	0.0%

[a] The *Exercise* baseline adjusts the CBO baseline by removing the extension of new supplemental funds after 2004.

You may choose among six policy options including the baseline option. In addition, you may decide to add new funding for operations in Iraq and Afghanistan (option 8).

1. *Exercise* Baseline.
The *Exercise* baseline maintains spending at its current level after adjusting for inflation. By 2009, spending for defense would decline to 3 percent of GDP, from almost 4 percent today, while funding for international affairs and homeland security would decline about 14 percent as a share of GDP. Although the baseline provides increases in funding to keep pace with inflation, it does not assume any new funding for operations in Iraq and Afghanistan after 2004. The funding already provided for those activities through 2004 will phase out over several years. As it does, overall spending for the category falls.

2. Scale Back National Security.
Spending could be scaled back dramatically if the U.S. would refrain from intervening in conflicts that do not affect our national interests and stop supporting activities that should be paid for by the private sector or by state and local governments. Over five years, this option would cut defense and international affairs spending in half and homeland security spending by 25 percent. Instead of planning to fight one and a half regional conflicts at one time, this option would assume one conflict, plus a cushion. This option would cut 5 of 10 active Army divisions, 6 of 12 Navy carrier battle groups, 2 of 3 Marine divisions and 1 of 14 Air Force tactical fighter divisions. In addition, the option would terminate U.S. financial support for the United Nations and other multi-lateral organizations, eliminate foreign military financing and other trade assistance programs, and end funding for educational and cultural exchanges. The option would end federal assistance to state and local first responders and terminate the Transportation Security Administration (TSA).

3. Freeze at 2004 Level.
The freeze option would keep defense, international affairs and homeland security resources at their current dollar level (not including new funding for operations in Iraq and Afghanistan). In five years, that would result in savings of $43 billion relative to the baseline level. By 2014, defense spending would be $100 billion lower than baseline or about 2.2 percent of GDP, and international affairs and homeland security would be 0.3 percent of GDP. To achieve the projected saving in defense would require aggressive cost cutting, not only through reduced procurements and cancellations of weapons systems, but also by reining in increase in pay and benefit for uniformed personnel.

4. Emphasize Homeland Security and International Affairs.
An emphasis on international affairs and homeland security would provide more modest growth in defense spending than options 5 or 6 propose. In 2014, total spending for national security would equal 3.5 percent of GDP, including a defense share of 2.8 percent. Defense spending would grow by 2 percent after adjusting for inflation, requiring savings beyond those anticipated under the current defense budget. In 2014, spending for international affairs would be 75 percent greater than in 2005 and funding for homeland security would more than double.

5. Current Policy.
The current policy funding level represents the Administration's request for defense, international affairs, and homeland security. Under this option, spending for national security activities would decrease to 3.5 percent of GDP by 2014, with a defense share of 3.1 percent. Funding for international affairs and homeland security would keep pace with economic growth, each remaining at about 0.2 percent of GDP.

6. Maintain at 4.5 percent GDP.
Maintain spending at 4.5 percent of GDP, its current level (excluding the cost of supplemental appropriations for Iraq and Afghanistan), with defense at 4 percent and 0.5 percent for international affairs and homeland security. That level would fund defense in between the 6 percent of GDP achieved during the Reagan build-up and the 3 percent level that existed prior to the 2001 terrorist attacks. At that level, DOD would have sufficient resources to prepare for global emergencies and longer-term threats if it increased efficiencies and eliminated wasteful spending. Under this option, spending for international affairs and homeland security would keep pace with the growth in the economy and maintain their share of GDP.

7. Add new funds for Iraq, Afghanistan and the global war on terror.
You also need to decide whether to budget for anticipated costs of future operations in Iraq, Afghanistan, and the global war on terrorism.

The option to add new funding for Iraq, Afghanistan and the global war on terrorism assumes $56 billion in additional funds in 2005, declining to about $23 billion a year. The option would build the likely costs of those activities into the budget instead of using supplemental appropriations as funds are required.

Up to now, DOD has used existing inventories of equipment, arms, and supplies, and moves funds from one account or another as needed. Then congressional lawmakers are asked to enact supplemental appropriations to replenish donating accounts and restock inventories.

The Administration argues that costs cannot be accurately predicted in advance and that the current approach provides more flexibility. Lawmakers typically are reluctant to provide discretionary funds upfront—they would like to know how those funds will be used—something DOD says it cannot do. In addition, upfront budgeting could force competition with other national security funding needs.

However, the supplemental appropriation route can disrupt military operations if policy makers don't enact funds on time. In addition, supplemental appropriations make it difficult to budget. Although upfront budgeting would probably not eliminate supplementals altogether, it would reduce the potential element of "surprise" and promote greater transparency and honesty during budget deliberations.

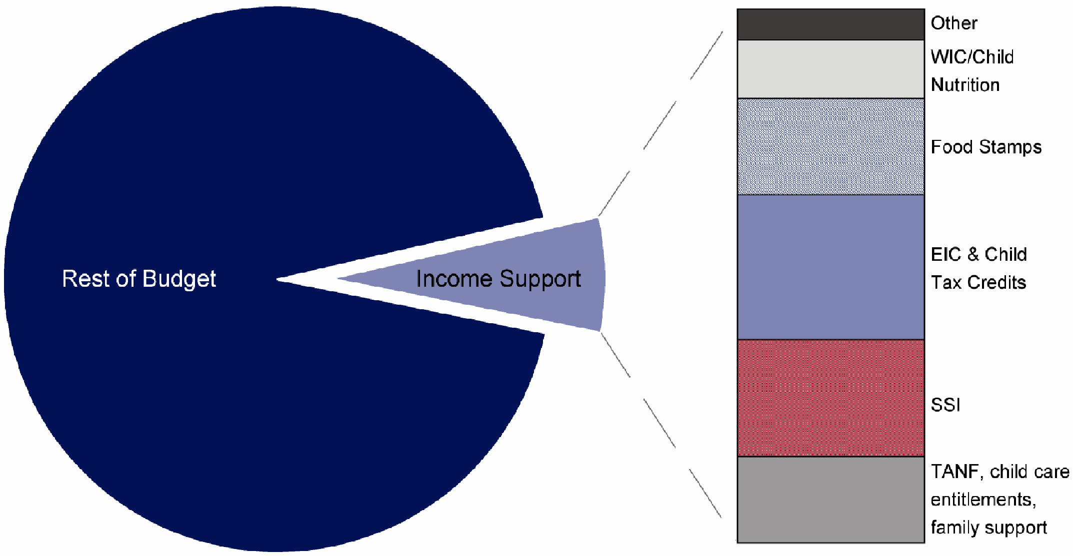
PROS & CONS

Arguments Favoring *More* Resources for National Security	Arguments Favoring *Fewer* Resources for National Security
Meet threats to U.S. security. The U.S. is the largest and most powerful country in the world. We have vital interests around the globe and have to be prepared to defend them. The world is unpredictable. New threats are emerging that require more mobile and responsive capabilities. We should be willing to commit a small percentage of our national economic resources (4 percent of GDP) to meet those challenges.	**U.S. can limit defense spending.** The US devotes far more of its economic resources to defense than any other developed nation. We can secure our own interests without spending as much on defense as we did during the Reagan defense build up in the 1980s ($400 billion a year in constant dollars). We have global responsibilities but other nations should share in the burden of international peacekeeping and conflict resolution.
Invest in weapons systems to save lives. Weapons systems acquired during the Reagan years are reaching the end of their useful lives and must be replaced. Adequate resources are required to develop and deploy new advanced technology systems that provide the military with better capabilities and tactical advantages. Investing in weapons systems will save lives by reducing the need to put troops in battle.	**Invest only in most useful weapons systems.** Defense planners should set priorities for the development and acquisition of expensive new weapons systems. We do not have to pursue all of the projects on the drawing board and not all units need to have the most advanced equipment. We should invest only in those systems most useful in the kinds of conflicts in which we are most likely to be come involved.
No savings achieved by cutting new weapons systems. Cutting new weapons systems is not an easy way to cut defense spending. Because of the length of time it takes to develop and deploy new weapons systems, reducing or terminating new weapons systems would achieve only small savings over the next 5 years. For example, canceling the V-22 aircraft and the DDX surface warship and reducing the purchase of F/A 22 aircraft and substituting less sophisticated systems would only save $17 billion over the next 5 years. While cheaper systems could be substituted, they would not provide the technological advantages of the new systems.	**Upgrades to existing weapons systems cost less.** Many new weapons systems were designed to meet Cold War requirements and are often unreliable and ill-suited to today's needs. The military could purchase upgrades to existing systems for less money. For example, the Marine Corp could purchase CH-53s and S-92 helicopters instead of the V-22s, which cost $72 million each and suffer more downtime. The Navy could buy 40 new frigates for the cost of 16 DDXs. New F-15s lack the stealth and other advanced capabilities but are superior to any of the fighters that regional adversaries possess.
Cutting defense means cutting personnel. With peacekeeping missions more likely, personnel costs will increase. Yet many proposals to cut defense would have to cut personnel. There are only 1.5 million active duty uniformed personnel today—down from 2.2 million at the end of the Cold War. Cutting more places too much of a burden on too small a share of the population.	**U.S. should not be a global police force.** A smaller, leaner military is an appropriate goal. There is no need to put more people in uniform than we have too. We can rely on the reserves and the National Guard to augment troop strength when it is necessary. Besides, we should resist the pressure to serve as a global police force. Other nations should share that burden.
Military personnel must be adequately compensated. Efforts to save money by reducing compensation and benefits are counterproductive. The military needs qualified, skilled personnel to operate and maintain today's systems. It takes attractive pay and benefits and support to recruit, train, and retain high caliber military personnel. These individuals are called upon to engage in dangerous duty. For that, they should be adequately compensated and supported.	**Cutting compensation to personnel equals savings.** Military personnel enjoy better pay and benefits than most civilian and private-sector employees in comparable positions. Uniformed personnel received a 3.5 percent pay increase while their civilian federal counterparts only received a 2.7 adjustment. Each 0.1 percent cost $45 million in the first year alone. In addition, military personnel enjoy better health insurance coverage, including no co-pays or deductibles, than other employees. Realigning health benefits with civilian federal coverage would save $2 billion a year.

Arguments Favoring *More* Resources for National Security	Arguments Favoring *Fewer* Resources for National Security
Apply savings to unmet needs not deficit reduction. It is easy to argue that the defense department should eliminate waste, fraud and abuse. Undoubtedly in a budget that exceeds $400 billion there are opportunities to improve efficiency and accountability. But there are also unmet needs. If the Pentagon was allowed to use savings from improving its operations for departmental priorities, it would have a better incentive to make changes than if the savings go to deficit reduction.	**Reduce funding to encourage efficient operations.** Pentagon officials have indicated that DOD could save 5 percent of its budget—or $20 billion—by becoming more efficient and eliminating waste. The Pentagon should be expected to budget honestly and operate efficiently. The only way to get the waste out of the budget is to reduce funding levels. That will force managers to operate within the given constraints.
International support advances U.S. interests abroad. International assistance programs are relatively inexpensive ways of advancing U.S. interests abroad. Total spending for international affairs is only 1 percent of the budget. Foreign aid can be used strategically to win friends and reduce the likelihood of having to use military force to advance our national interest. Humanitarian assistance (e.g., fighting HIV/AIDS in Africa, relief efforts for natural disaster and assistance for refugees) demonstrates our role as a responsible global nation and fulfills a moral imperative to help those who need it.	**International aid may not advance U.S. interests.** Funding for many domestic programs is essentially frozen. Funding for international programs should not take place at the expense of needs at home. It is not certain that such funding improves our image abroad. Foreign aid can end up supporting corrupt and ineffective governments—never reaching the intended beneficiaries. It would be better to leave humanitarian assistance efforts to non-governmental organizations that have a much better track record of getting things done.
Trade assistance helps U.S. economy. Trade assistance helps U.S. firms compete abroad, which helps the economy at home.	**Cutting trade assistance aids other programs.** Trade promotion programs help large corporations who don't need taxpayer-subsidies. If those activities were terminated, the savings could be devoted to humanitarian and strategic aid programs.
9/11 justifies federal assistance to homeland security. The events of 9/11 demonstrate why homeland security has become a top priority. The kinds of threats posed to our nation's infrastructure and population exceed our current level of preparedness and capability to respond. As first responders, state and local authorities need new personnel, training and equipment. We need additional protection for our borders, ports, and transportation facilities. Additional investments are required to improve domestic intelligence gathering, to safeguard sensitive public and private facilities, and to assess potential threats. Broad federal assistance is well-justified.	**Target security assistance to most vulnerable areas.** The federal government should assist state and local governments with homeland security needs. Although every state has potential targets, not all parts of the country are at equal risk. By targeting assistance to the most vulnerable localities, efforts will be more effective and less costly. Unless the federal government is tight-fisted and controls spending carefully, homeland security will become a new form of revenue sharing—tantamount to a blanket mist spread everywhere that fails to provide focused attention where it is most needed.

Note: The greater the proposed increase or decrease in resources, the more valid the arguments.

CHOICE 2: INCOME SUPPORT



The income support category comprises programs that form the safety net for low-income children and families. The programs are **means-tested.** Means tested programs are limited to beneficiaries whose family incomes do not exceed specified levels. [8]

Federal funds for family support programs (including **Temporary Assistance to Needy Families (TANF)**, and child care block grants), foster care and adoption assistance, and the special supplemental nutritional assistance program for **women, infants, and children (WIC)** are provided to beneficiaries through the states.

Other payments, including **Supplemental Security Income (SSI)**, food stamps, and refundable portions of the earned income and child tax credits, are provided directly to individuals who meet eligibility requirements.

The federal government and the states share responsibility for the largest low-income benefit programs. Welfare reform legislation enacted in 1996 replaced the individual entitlement to cash benefits provided by **Aid to Families with Dependent Children (AFDC)** with TANF block grants administered by the states. The 1996 reforms changed the focus of federal policy from income maintenance to providing

[8] *Low income families may also qualify for Medicaid, subsidized housing assistance, and educational assistance for post-secondary education (e.g., Pell grants). Eligibility for those programs is not linked to cash welfare benefits. Other assistance benefiting low-income families is provided through social service block grant and children and family service programs. Options affecting those programs are presented under the Health and All Other Government sections of the* Exercise.

support for families to encourage and enable them to move from receiving cash assistance into employment. In 2001 (latest figures available) more TANF funding went to child care and work-related activities than to cash assistance.

The TANF block grant provides states with over $16.5 billion in fixed funding. States spend another $11 billion in maintenance of effort (MOE) funds. Federal funding represents about half of total state spending for public assistance. Federal law determines the amount of federal funding available to each state, sets broad eligibility criteria, and establishes state financial, administrative and performance requirements. States design a mix of programs and services to meet their needs, establish eligibility rules, and set and administer sanctions on TANF recipients who do not fulfill work-related requirements.

Families may receive cash assistance for no more than 60 months, although states may set their own policies and either lower lifetime limits or allow recipients to receive cash assistance for more than the federal limit.

ISSUES

Welfare legislation expired in 2002. Since then programs have been operating on a series of short-term extensions. Several years have elapsed since reforms were enacted in 1996. The challenge now is to understand better the successes and limitations of the new approach.

The TANF block grants provide states with a stable source of funding and allow them more flexibility in how they used resources. However, the value of block grant funding erodes over time because it is not inflation-adjusted. While the economy was growing caseloads fell, allowing states to build up reserves. Then the economy entered a recession.

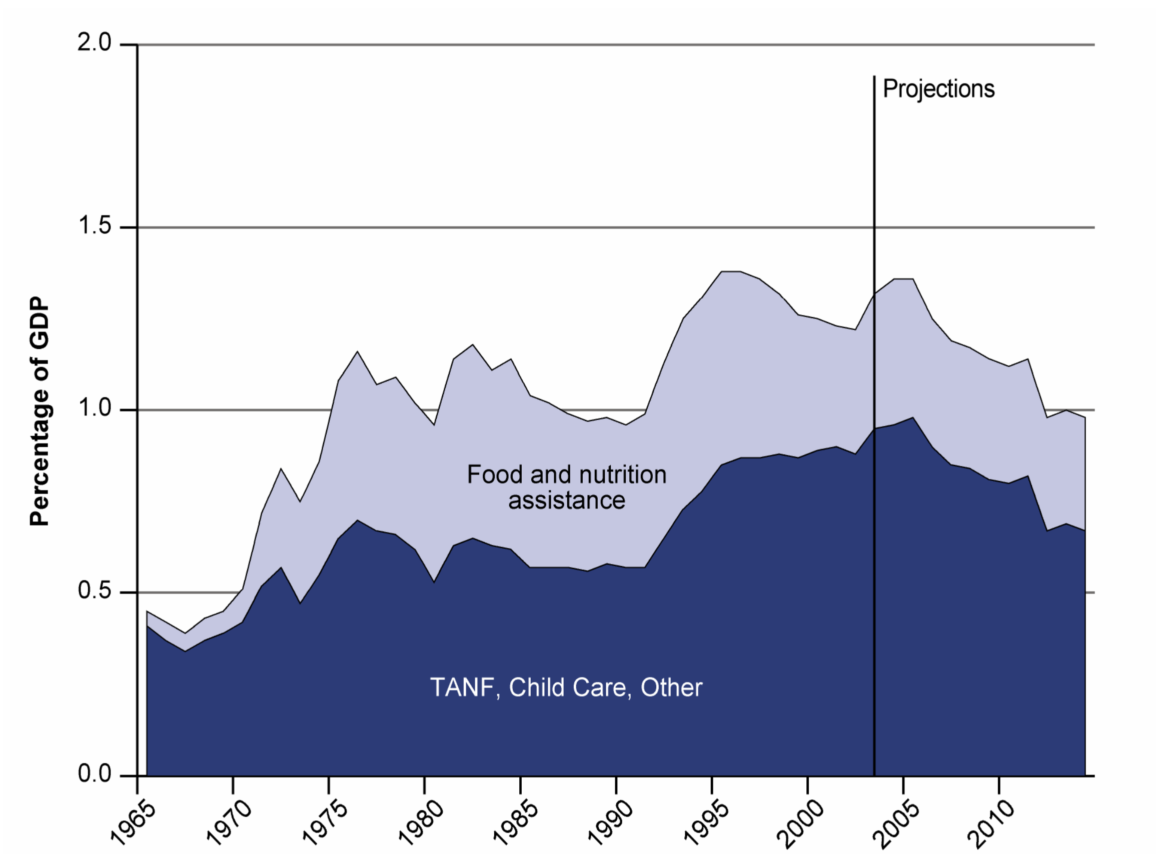
Between 2000 and 2003, the number of people living below the official poverty level rose by 4.3 million. Nevertheless, the number of cash assistance caseloads continued to fall, continuing a trend started in 1997. Overall TANF spending increased as states used up reserves, but some analysts have questioned how states have been dealing with funding constraints and what impact their actions have had on low-income families. Are sufficient funds available to help low-income families join the economic mainstream or are they falling through the social safety net?

INCOME SUPPORT ESTIMATED SPENDING (BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
TANF & family support	25	26	26	25	25	25	0.1%
SSI	39	37	35	40	42	43	0.3%
Food & nutrition	47	46	46	47	49	50	0.3%
EIC & child tax credit[a]	46	43	42	41	41	41	0.2%
Foster care and other	11	12	12	13	13	13	*
Total	**167**	**163**	**161**	**166**	**169**	**174**	**1.0%**

[a]Outlays only. Tax expenditures for the Exercise are projected to be $5 billion in 2005. For the child credit, the projected tax expenditure is $30 billion.

HISTORICAL SPENDING FOR INCOME SECURITY (PERCENTAGE OF GDP)



OPTIONS

INCOME SUPPORT OPTIONS (BILLIONS OF DOLLARS)

	2005	2006	2009	2014	Percent of GDP in 2014
Exercise baseline spending level	167	163	169	180	1.0%
Policy Options (Projected changes to baseline **spending** levels)					
1. *Exercise* baseline	0	0	0	0	0.0%
2. Devolve welfare programs to the states	-5	-10	-25	-26	-0.1%
3. Target subsidies and reduce costs	-2	-2	-2	-3	*
4. Increase federal funding	15	16	19	23	0.1%

** = Less than 0.05 percent.*

You may choose among the following four options.

1. *Exercise* Baseline.
The CBO baseline assumes that current policies continue without change. Funding would be frozen for the TANF and childcare entitlement block grants. Funding for other programs increases with inflation. Under this option, spending for income support would fall gradually from about 1.4 percent of GDP in 2004 to 1 percent of GDP in 2014. In addition to the $33 billion included in the baseline for the refundable earned income credit (EIC), low-wage earners also receive about $5 billion in tax relief. (Many low-wage earners have little or no income tax liability, but do pay payroll taxes of 7.65 percent of wages. If their EIC exceeds their income tax liabilities, those workers receive a check for the balance of their credits.)

2. Devolve Welfare Programs to the States.
Devolving welfare programs to the states would phase-out funding over five years for TANF, child care grants, and other family support programs. States would gradually assume full responsibility for low-income assistance. States would have to make up for the loss of federal funds with their own revenues but would be completely freed from federal regulations, restrictions, and interference in determining how to address the needs of their low-income population. Under this option, federal income support assistance provided through SSI and the earned income credit (EIC) would continue unchanged.

3. Target Subsidies and Reduce Costs.
By targeting subsidies and reducing other costs the federal government could achieve modest savings with relatively small impact on low-income beneficiaries. This option would eliminate school breakfast and lunch subsidies for children with family incomes above 350 percent of the federal poverty line (about $66,500 for a family of four); eliminate food stamp benefits of less than $10 per month; cut the monthly exclusion for unearned income when calculating SSI benefits from $20 to $15; create a sliding scale for SSI child benefits so the per child benefit would get smaller for each additional child; and reduce the matching rate the federal government pays to states for administrative costs under the foster care and adoption assistance program from 75 percent to 50 percent.

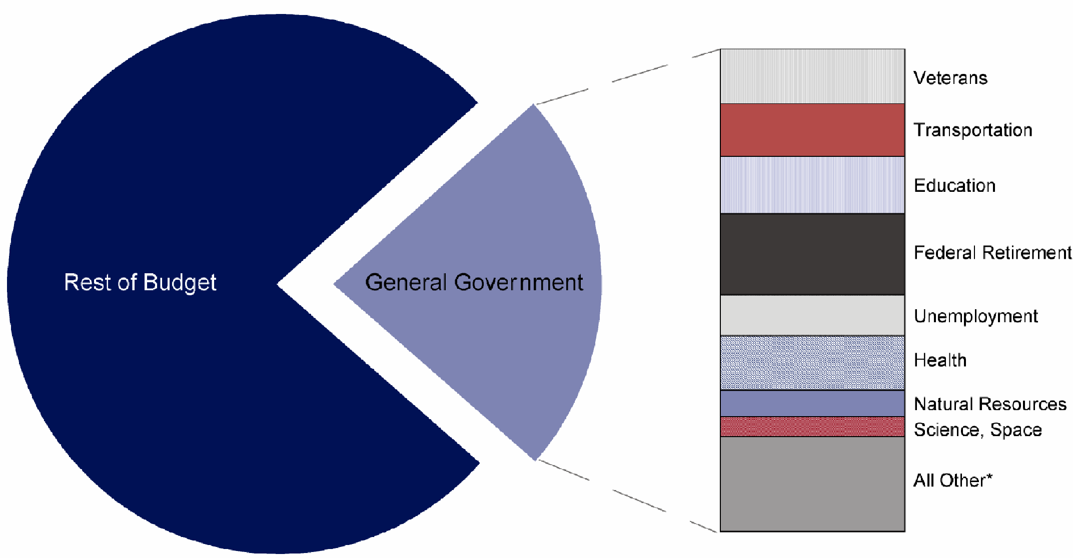
4. Increase Federal Funding.
Increasing federal funding for income support programs would restore the value of the TANF and child care entitlement block grants lost through inflation since 1996 and adjust the grants for future inflation. In addition, this option would expand the EIC, a refundable tax credit that offsets the tax liabilities of low-income earners. Those measures would be consistent with efforts to move from welfare to work. The increased funds for TANF and child

care entitlement funds would enable states to provide education, training, child care, transportation, transitional Medicaid, and other services to former cash benefit recipients, thereby helping to assure that they become and stay self-sufficient. The EIC expansion could be structured to provide more benefits to lowest-wage workers and workers with large families, or to increase the income range over which the credit is phased out. Those changes would increase the incentive to work for low-wage earners by raising their after-tax income.

PROS & CONS

Arguments Favoring *More* Resources for Income Support	Arguments Favoring *Fewer* Resources for Income Support
Federal income support programs are essential elements of the social safety net. It is a fundamental responsibility of the federal government to look out for the welfare of its citizens.	The responsibility for low-income support should rest primarily with states. The framers of the Constitution only intended the federal government to assume the responsibility for general welfare of all citizens, not the welfare of individuals.
Not all states have the resources to address the needs of low-income families and children. The effects of economic downturns can overwhelm the finances of even larger, wealthier states. Federal assistance is necessary to counteract the economic slowdowns which can have ripple effects across regions.	The federal government only has greater financial capacity because it can redistribute resources from one state to another. While some states are helped, others are hurt by federal grant programs. Why should the citizens of one region make up for problems in another?
Federal income support programs help to even out conditions between the states for low income families and children. Being poor in one state should not result in vastly different circumstances than in another state. Absent federal assistance, there would be a "race to the bottom" for welfare benefits. States would have an incentive to make their benefits as low as possible or else they could encourage low-income people to migrate into their states in order to qualify for better assistance than they currently receive.	Recognizing that one size does not fit all, the 1996 welfare reforms granted states more flexibility in the design and administration of income support programs. Rather than sending tax dollars to Washington, DC and then pleading to get them back, states and localities would be better off if they were in charge of their own programs and did not have to deal with federal bureaucrats. Inevitably federal resources will not be managed as carefully as state resources.
Federal policies recognize the need for state and local flexibility. TANF and child care block grants strike a happy medium between lots of "pots" of funds representing federal priorities and leaving all the responsibility and decision-making to the states.	States are happy to get block grants—some would even like "super" block grants that would combine other low-income programs (e.g. housing and Medicaid) with the TANF and child care grants. But when the federal government acts as tax collector while state and local politicians control how funds are spent, voters have a harder time seeing the relationship between federal taxes and benefits/services.
The TANF and child care funds have been instrumental in encouraging states to change the focus of their welfare efforts from subsistence and dependency on cash benefits to self-sufficiency and entry into the economic mainstream. Additional funding will promote a more secure foothold for former cash benefit recipients, which will produce broad economic and social benefits over the longer term. The EIC is one of the best ways to reward work and offset payroll taxes, which impose a heavier burden on low-wage earners than high-wage workers.	The TANF block grant was a big step in the right direction, but most policy innovation comes from the states in the first place. Because state economies differ, federal timetables and performance standards may be unrealistic for some states and too lenient for others. If, however, the states assume greater financial responsibility, taxpayers would know who to hold accountable, and the use of taxpayer resources would be allocated according to state priorities and needs.

CHOICE 3: GENERAL GOVERNMENT



* Agriculture, Energy, Commerce, Community Development, Labor, Social Services, Justice, General Government, and Housing Programs

This section of the *Exercise* groups several budget activities together under "General Government" because individually they represent a small share of the budget. Specific options to increase or reduce spending in any one group generally amount to well below $100 million a year. That does not mean that changes are not worth considering—$100 million is not an insignificant amount! It does, however, mean that although the choices are as difficult and time-consuming as the ones presented for larger programs, the bottom-line impact is relatively small. That is why the appropriations process often bogs down, and the Congress often has to resort to a massive catch-all bill to keep the government running for another year.

The general government category includes many of the most visible federal activities that comprise 23 percent of the federal government's annual spending (less than 4 percent of GDP). Nearly 70 percent is classified as discretionary. Policy makers set funding levels during the annual appropriations process. Major activities in the general government category include:

Education – elementary, secondary and higher education programs, the Corporation for Public Broadcasting, the Smithsonian Institution;

Transportation – highway and mass transit programs, the Federal Aviation Administration, AMTRAK, and the Federal Maritime Administration;

Health Research, Disease Prevention and Public Health Programs – the National Institutes of Health (NIH), the Food and Drug Administration (FDA), the Indian Health Service, the Public Health Service, Substance Abuse and Mental Health Services, and the Centers for Disease Control and Prevention;

Income Security – Federal retirement and disability programs (other than Social Security) for federal employees, railroad workers, and other workers, the Pension Benefit Guarantee Corporation (PBGC), unemployment benefits, and subsidized housing programs;

Veterans Programs – Veterans can qualify for health care, disability and pension benefits, and education assistance;

Natural Resources and Environment, Energy, and General Science, Space and Technology Programs – National Parks Service, the United States Geological Survey, National Weather Service, National Science Foundation, the Nuclear Regulatory Agency, Fish and Wildlife Service, Environmental Protection Agency, and Corps of Engineers;

Agriculture – federal crop insurance and Commodity Credit Corporation, the food safety and inspection service, the National Forest Service;

Labor and Social Service – Occupational Safety and Health Administration, Bureau of Labor Statistics, service block grants;

Commerce and Housing Credit – Census Bureau, Bureau of Economic Affairs, the Government National Mortgage Association (GNMA), the Federal Housing Administration (FHA), federal banking agencies (e.g., Federal Deposit Insurance Corporation, National Credit Union Administration), the Federal Communications Commission, Securities and Exchange Commission, and the Small Business Administration;

Justice – federal law enforcement and judicial activities, federal prisons, and the Federal Elections Commission;

General Government – the White House, the Congress, Office of Personnel Management, General Service Administration, the Treasury, and the Internal Revenue Service

ISSUES

Most efforts to cut spending affect programs in this category of the *Exercise*. The other areas of the budget—defense, Social Security, Medicare and Medicaid, and income support—tend to get taken "off the table" when it comes time to balance the budget. The programs and activities in this area are all that is left. Many of the programs have strong constituencies and are politically popular. Others are too small to make much of a difference to the budget's bottom line. But, to update an old saying, "A billion here, a billion there and pretty soon you are talking real money."

For perspective, listed below are the annual costs for:

- The U.S. Congress and congressional organizations (including CBO, the General Accountability Office, and the Library of Congress): $3.2 billion;
- The White House and the Executive Office of the President: $0.6 billion;
- The Supreme Court: less than $0.1 billion ($9.4 billion if all federal judicial and litigative activities are tallied up).

Budget proposals often include measures like spending freezes (at the last enacted level). Such approaches essentially impose ceilings on spending and produce savings relative to the baseline by removing the adjustment for inflation. They also force someone else (i.e., the appropriations committees) to make the tough decisions. Across-the-board options do not have identical impacts on programs. Some programs may have room to absorb a cut, while others have little flexibility. Policy and management analysts would argue that it would be preferable to eliminate whole programs and to preserve adequate funding for remaining ones than to risk crippling high priority efforts. Agencies can be granted flexibility in how they implement across-the-board cuts, but don't assume that agency administrators will be any more willing to make difficult decisions than are elected officials.

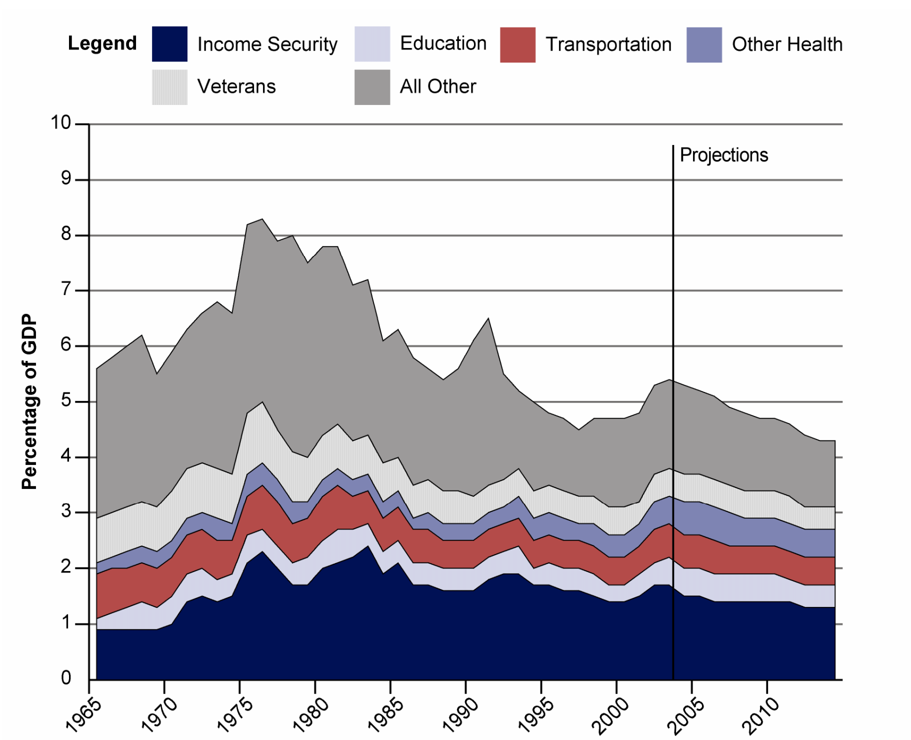
Once the budget reached balance in 1998, policy makers were unable to maintain tight control over many programs in the general government category. Tight caps on discretionary spending first imposed in 1990, then subsequently renewed, lost their potency. Non-defense discretionary spending grew 5 percent in 1999, 8 percent in 2000 and 7 percent in 2001 as lawmakers allocated hefty increases to education programs, public health and other research efforts, transportation, and other priorities. That growth was easier to afford when the budget was in surplus and then seemed necessary in the immediate aftermath of the terrorist attacks. The question is whether such spending growth can be sustained now that deficits have re-emerged.

ESTIMATED GENERAL GOVERNMENT PROGRAM SPENDING (BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
General science, space and technology	23	23	24	24	24	25	0.1%
Energy	1	1	1	1	1	1	0.0%
Natural resources and environment	32	34	35	36	37	38	0.2%
Agriculture	19	21	22	23	25	25	0.1%
Commerce and housing credit	4	4	3	1	0	0	0.0%
Transportation	62	65	67	68	69	70	0.4%
Community and regional development	15	14	13	13	13	13	0.1%
Education	64	66	67	68	70	71	0.4%
Training, employment and social services	26	26	26	26	27	27	0.2%
Health	61	63	65	67	69	71	0.4%
Federal retirement, disability and other income security	179	184	191	199	206	213	1.3%
Veterans benefits	67	67	66	70	71	73	0.4%
Administration of Justice	29	30	30	31	31	32	0.2%
General government	21	20	21	21	22	22	0.1%
Offsetting receipts	-64	-71	-74	-78	-75	-78	-0.5%
Total	**535**	**546**	**556**	**570**	**590**	**603**	**3.6%**

** = Less than 0.05 percent.*

HISTORICAL SPENDING FOR GENERAL GOVERNMENT PROGRAMS (PERCENTAGE OF GDP)



OPTIONS

GENERAL GOVERNMENT OPTIONS
(BILLIONS OF DOLLARS)

	2005	2006	2009	2014	Percent of GDP in 2014
Exercise baseline spending level	536	546	591	662	3.6%
Policy Options (Projected changes to baseline spending levels)					
1. *Exercise* Baseline	0	0	0	0	0.0%
Across the Board Options					
2. Across-the-board increase	20	35	74	161	0.4%
3. Across-the-board freeze	-7	-15	-41	-91	-0.5%
Options to Increase Spending					
4. Increase grants for elementary and secondary education	3	7	10	11	0.1%
5. Increase funding for IDEA	0	2	9	14	0.1%
6. Increase Pell grants	5	8	18	27	0.1%
7. Increase spending for highways, mass transit and other surface transportation	1	2	5	1	*
8. Double grants for clean air, clean water and alternative energy	2	3	5	6	*
Options to Reduce Spending					
9. Freeze elementary and secondary education funding	0	-1	-2	-6	*
10. Freeze higher education funding	0	0	-1	-3	*
11. Reform the student loan program	-1	-2	-4	-4	*
12. Freeze transportation spending	-1	-2	-6	-14	-0.1%
13. Increase fees for airport security screening	-3	-3	-3	-4	*
14. Charge for air traffic control services	-2	-2	-2	-2	*
15. End funds for Department of Energy applied research programs	-1	-1	-2	-2	*
16. End CDBGs	0	-5	-5	-6	*
17. Offset veterans' disability for Social Security disability payments	-1	-1	-1	-2	*
18. Cut COLAs for federal retirees	0	0	-1	-4	*
19. Cut federal travel by 10%	-1	-1	-1	-1	*
20. Adjust federal pay for CPI instead of ECI	-1	-3	-8	-19	-0.1%

**= Less than 0.05 percent.*

OPTIONS

You may choose to increase spending, cut spending, or a combination of the two.

If you choose the across-the-board increase or overall freeze, you are done. Lawmakers use across-the-board options (freezes, mostly, not increases) when they want or need to set limits but don't have the time or the votes to make the hard decisions about specific programs. The individual options listed will give you an idea of the type of policy changes that will be required to live within that frozen level.

Alternatively, you can choose from options to increase spending, decrease spending, or both. This gives you the ability to increase the funding of programs you favor while simultaneously decreasing the funding of other programs.

1. *Exercise* Baseline. The baseline would sustain funding for all activities at the same level as provided in 2004, adjusted annually for inflation.

Across-the-Board Options

2. Across-the-Board Increase. This option would provide about 1 percent more than the inflation-adjusted baseline funding level, adding $8 billion in 2005 and $65 billion in 2014. The increase would allow spending to grow by one-half of the growth rate between 2002 and 2004.

3. Across-the-Board Freeze. This option would limit spending for general government activities to the overall nominal dollar amount provided in 2004. By 2014, the freeze would save $91 billion, a 15 percent reduction from the projected baseline level. Spending increases in one area would have to be offset with decreases in other areas. This option would force agencies to absorb the added costs of pay raises and inflation.

Options to Increase Spending

4. Increase Grants for Elementary and Secondary Education. This option would increase funding to local school districts to the level authorized in the No Child Left Behind Act (NCLB). Grants are designed to help school districts meet minimum standards for school performance and show measurable improvement in learning levels.

5. Increase IDEA Funding. This option would raise federal support for the Individuals with Disabilities Education Act (IDEA) to the levels contained in the House-passed education reauthorization bill. IDEA funding is designed to help schools integrate special needs children into regular classrooms.

6. Increase Pell Grants. This option would increase the maximum Pell grant award from $4,050 to $5,800 in 2005. In 2011, the maximum grant would be $11,600. Pell grants are need-based and provide financial assistance to low-income students enrolled in post-secondary education.

7. Increase Spending for Highways, Mass Transit and Other Surface Transportation. Federal assistance for surface transportation consists primarily of highway spending, the costs of which are largely offset by motor fuel taxes. Both the House- and Senate-passed reauthorization bills would increase spending above baseline levels. This option would split the difference in spending levels in each bill, adding $17 billion over the next 5 years and $34 billion over the next 10 years. The last highway bill, passed when tax collections were robust, set up a mechanism to tie spending with receipts and to keep those receipts from being used for other purposes. Now that excise tax receipts are down and spending needs are up, the highway and surface transportation reauthorization bill seeks to keep funding flowing and offset costs with general revenues and higher deficits.

8. Double Grant Funds for Clean Air, Clean Water, and Alternative Energy. This option would provide states and tribes with more resources to protect and preserve the environment by fighting pollution, reducing lead exposure, cleaning up bodies of water, and treating and storing waste in ecologically safe ways. In addition, this option would double resources to develop new energy technologies and improve existing ones.

Options to Reduce Spending

9. Freeze Elementary and Secondary Education Funding. The federal government provides grants that aid local schools. Impact aid is designed to compensate for the presence of federal facilities, which can reduce the property tax base. Other grants are designed to promote a variety of federal objectives—e.g., academic performance, drug use prevention, and safe schools. This option would maintain spending at the 2004 level of $38 billion. That would be a significant change from the trend over the last several years. Funding for those programs has grown by nearly 14 percent a year since 2000. This option would stop that growth. Savings would grow to $6 billion a year in 2014.

10. Freeze on Higher Education Funding. The federal government provides financial assistance to post-secondary institutions including campus-based financial aids and direct and guaranteed loans that help 8.5 million students. This option would freeze the spending level. Spending for those programs has grown rapidly in recent years, more than doubling since 2000. Assistance could be targeted towards students with the greatest financial need or could be channeled into more loans, which cost the government less than grants.

11. Reform the Student Loan Program Students and their families can borrow at subsidized rates directly from the federal government or from participating lenders. Low-income students receive an interest subsidy—they do not have to pay interest on loans while they are in school. Higher income students accrue interest charges while they are in school. Those costs are added to loan balances. This option would make a number of changes to the loan program, including: eliminating the interest subsidy for graduate students; raising the interest rate by 0.15 percent on new loans originated through 2006 and 0.5 percent thereafter; eliminating the floor on lender yields, which keeps their loan rates high when market interest rates fall; and ending fees the federal government pays to schools for administering campus-based aid programs.

12. Freeze Transportation Spending. By freezing spending for highways and other surface transportation projects, savings would grow from $1 billion in the first year to $14 billion 10 years from now. The federal government spends almost $40 billion a year on ground transportation, with highways funded largely from annual excise taxes on motor fuels and other user fees. A freeze on spending would allow excess receipts to be used for deficit reduction instead of more construction. However, a freeze could slow completion of projects already underway or delay the start of new projects.

13. Increase the Fees Charged for Airport Security Screenings. This option would raise the cost airline passengers pay from $2.50 per boarding to $6.25 per boarding for security screening. The higher fee would recover the full costs of security screenings of passengers and their baggage.

14. Charge for Air Traffic Control Services. The Federal Aviation Administration could recover some of the costs of providing air traffic control services by imposing fees based upon air carriers' use of services.

15. End Funds for Department of Energy Applied Research Programs. The federal government funds research and development efforts to improve the applied technologies related to solar and renewable energy, energy conservation, and fossil fuels. This option would transfer responsibility for those activities to private suppliers who benefit from the development of commercially feasible processes.

16. End Community Development Block Grants (CDBGs). CDBGs are allocated by formula to states, urban counties, and large cities to support local development activities. The grants are intended to leverage community investment and development. If CDBGs are eliminated, state and local governments would have to use local funds or forgo the development activity. This option would save about $5 billion per year.

17. Offset Veterans' Disability for Social Security Disability Payments. This option would reduce payments to 110,000 of the disabled veterans who are also collecting Social Security disability benefits. That would eliminate duplicate payments for the same disability but would subject veterans' disability to a form of means-testing.

18. Cut COLAs for Federal Retirees. Savings of up to $4 billion a year in 2014 could be achieved by reducing the **cost-of-living adjustments** (COLAs) for federal retirees. Annuitants under the discontinued Civil Service Retirement System (CSRS) receive full COLAs. Newer retirees under Federal Employee Retirement System (employees hired in 1983 and afterwards) receive a full COLA if inflation is less than 2 percent; a COLA of 2 percent if inflation is between 2 and 3 percent; and if inflation is higher than 3 percent their COLA is inflation minus 1 percent. This option would apply the same formula to CSRS retirees so all civilian retirees would receive the same COLA.

19. Cut Federal Travel by 10%. The federal government spends about $10 billion a year for employee travel costs. The Department of Defense accounts for about half of that amount.

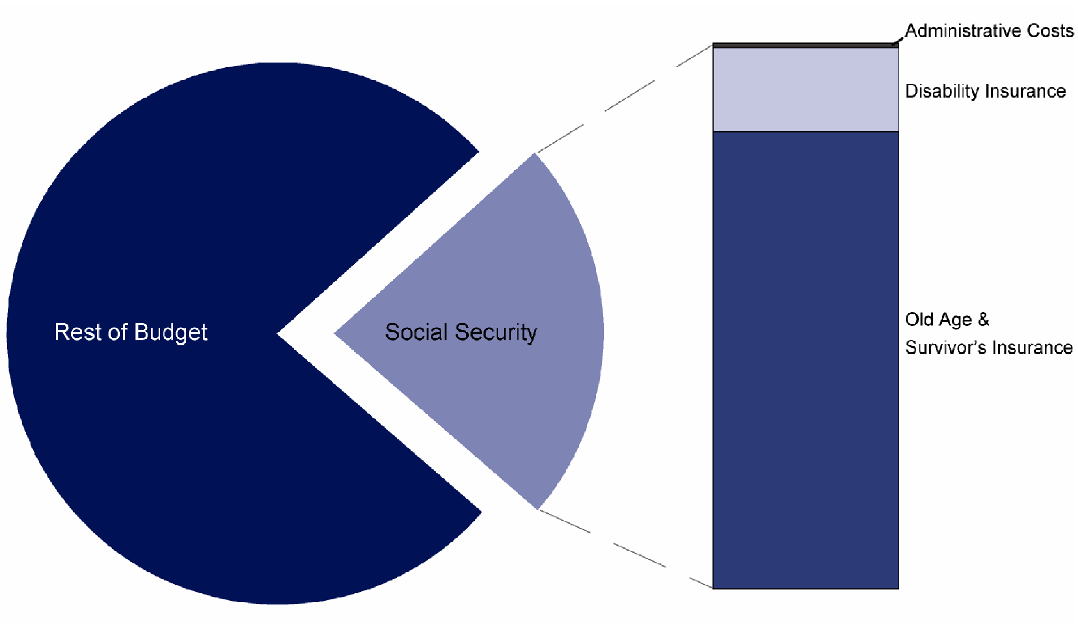
20. Adjust Federal Pay for CPI Instead of ECI. Civilian workers receive annual pay increases that are pegged to **the employment cost index** (ECI), which measures wage and salary costs. That linkage is designed to keep federal pay rates from falling further behind private compensation. This option would instead provide pay raises pegged to the **consumer price index** (CPI), adjusting pay for the effects of inflation, but not other factors affecting the labor market. Savings would grow significantly from $1 billion in the first year to $14 billion in 10 years.

PROS & CONS

Arguments In Favor of *Increasing* Spending for General Government	Arguments In Favor of *Limiting* Spending for General Government
Programs benefit general taxpayers. These programs are the ones that are most likely to benefit or be available to general taxpayers. National parks, housing assistance, the Centers for Disease Control, the National Weather Service, NASA, the IRS, federal disaster assistance, and the Small Business Administration are but a few of the necessary activities that should continue to serve the public.	**Increased spending leads to "pork" projects.** Controlling general government spending is the only way to restrain politicians, who use "bringing home the bacon" to justify re-election. For every worthy program there are others of dubious benefit or questionable effectiveness. One watchdog group[9] tallied up $23 billion in "pork" for 2004—earmarked projects that were not competitively awarded, requested by the President, not discussed during a congressional hearing, etc.
Cuts to these programs are more costly than savings. Spending for general governmental activities is not the source of serious fiscal problems. Together these programs represent between one-fourth and one-fifth of the budget. A relatively small amount of federal funds can "leverage" needed resources for economic development, arts and cultural activities, and other services. Because grants and payments to communities and individuals are visible and popular and funds for back-office operations are not, cuts could deprive federal agencies of resources to oversee and manage their operations effectively. That outcome could be more costly than any savings achieved.	**Low priority programs are funded after goal is met.** High priority programs can be retained and even increased if policy makers are forced to eliminate lower priorities. Needs change over time, but federal programs seem to find new reasons to exist long after their original goals have been met. Two examples: the Small Business Administration (SBA) was created following World War II to facilitate the transformation back to a peacetime economy; and the federal government continues to subsidize rural utilities even though the original goal of making electricity and phone service available to rural communities has long been accomplished.

[9] *Citizens Against Government Waste, http://www.cagw.org*

CHOICE 4: SOCIAL SECURITY



Social Security is the largest activity in the budget. Its benefit payments represent one-fifth of federal spending, and its payroll taxes provide 30 percent of total revenues. Its coverage is nearly universal. More than 46 million people currently receive cash benefits.[10]

- **Old Age and Survivors Insurance (OASI)** provides retirement income to workers, their spouses and children, and the survivors of deceased workers. Retired workers make up 69 percent of all beneficiaries.

- **Disability Insurance (DI)** provides cash benefits to workers and their families who become disabled and unable to work. Disabled workers are 12 percent of beneficiaries.

Social Security represents a long-term, intergenerational commitment. Its importance to the financial security of older Americans is undeniable. In 2001, 91 percent of all people ages 65 and older received Social Security cash benefits. That represents a significant increase compared to 1962, when only 69 percent of that population received benefits. The program provides over 38 percent of the aggregate income of all older people. One-third of Social Security's beneficiaries depend on it for 90 percent or more of their annual income.

At present, Social Security has a positive impact on the budget. Social Security payroll taxes exceed benefit payments. That situation won't

[10] About 4 million state and local government workers do not participate in Social Security and are covered by their own retirement plans.

continue forever. As baby boomers retire and retirees live longer, they will draw benefits at a faster rate than workers will contribute. That spells financial trouble for the program and increasing stress on the rest of the budget.

Under current law, there is no "crisis" until the trust fund is depleted (in 2042 according to 2004 projections). However, the status of the trust fund is a misleading measure of the program's financial health. Within five years, the size of Social Security's cash surpluses will begin to decline as benefit payments grow faster than income. In 2018, those surpluses will turn into deficits.[11] After 2018, interest income (paid from general revenues or public borrowing) and balances in the trust fund (which will also have to come from general revenues or borrowing) will be used to cover the annual cash shortfalls. In 2042, trust fund balances will be exhausted. If policies are not changed before then, benefits will have to be cut by 27 percent or payroll taxes will have to jump from 12.4 to 16.9 percent.

The budgetary pressure will be felt much earlier than 2042, however. Between now and then Social Security benefits payments will grow by an estimated 2 percent of GDP. That growth will draw resources away from the rest of the budget and the economy. Spending for other programs must decline, taxes must go up, Treasury borrowing from the public must increase, or some combination of the three must occur. Despite warnings from Social Security's trustees, CBO, and the General Accounting Office of long-term financial imbalance, policy makers still find it difficult to address the long-term problem. That inaction is troublesome because it will take long lead times to introduce reforms—that is unless lawmakers are willing to impose sudden benefit reductions or tax increases to achieve a more immediate fix.

[11] *Long-term actuarial projections are from The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 23, 2004, under an intermediate set of assumptions.*

ISSUES

When Social Security was created the country was in the midst of the Great Depression. One-fourth of workers were unemployed, and although a few were covered by private pensions, by 1935 most of those plans were bankrupt. Older workers couldn't leave the workforce if they wanted to—fewer than 7 percent had pensions and three-fourths of older people were wholly or - or partially dependent - dependent on children, other relatives or friends, or public and private social agencies.

Today, over half of all workers work for employers that sponsor retirement plans and 42 percent participate in those plans. About 68 percent report that they have saved for retirement, but 56 percent of all workers and one-third of workers ages 55 and older report total savings and investments (excluding home equity) of less than $50,000—far short of what most of them will need to sustain them through many years of retirement. Although recent surveys show that current workers expect to retire later than current retirees did, only 7 percent of all workers believe that individuals should assume a greater share of responsibility for their retirement. More than half think government and employers should pay more.[12]

The question of who is responsible for retirement incomes is at the center of the debate over the future of Social Security. Social Security redistributes income from workers to retirees and from higher- to lower-income earners. It has substantially improved standards of living for older people. The problem is that Social Security places greater and greater burdens on each generation of new workers as the ratio of workers to retirees falls. It was 4 to 1 in 1965. Today it is 3.3 to 1. In 2040, it will be 2 to 1.

If there is still a popular consensus in favor of Social Security as we currently know it, then

[12] *Ruth Helman and Variny Paladino,* Will Americans Ever Become Savers? The 14th Retirement Confidence Survey,*" Issue Brief No. 268, Employment Benefit Research Institute, April 2004.*

preserving the program is a matter of finding an acceptable balance between adjustments to benefits and revenues to restore long-term financial solvency.

If that consensus is weakening, the options are more complicated. That is because Social Security is largely a **pay-as-you-go** system. The taxes that each generation of workers pays taxes into the system finance the benefits of retired workers. At present all but 12 percent of payroll tax collections are used to pay benefits; the rest is credited to the trust fund. Transition to a new structure of financing and benefits would make very explicit the cost of promised benefits that have accumulated over the years. Currently those costs are not recognized—or funded—in the budget because they are not considered to be legal obligations and they occur outside of the five or 10-year budget planning window. In order to change to a new system, policy makers will have to address the cost of future benefits—whether through borrowing or through proposals to reduce benefits or increase taxes. Those measures would be over and above those required to address shortfalls in the program as it is currently structured.

Individual Accounts

Proposals to replace traditional Social Security benefits with individual or personal accounts appear to be gaining support, especially among younger workers. That approach would largely replace Social Security's *defined benefit* structure with one that can be characterized as defined contribution. Traditional Social Security benefits are based on a formula reflecting lifetime earnings, wage growth, and other factors. Individual accounts would provide annuities—or payouts of amounts accumulated from contributions and investment earnings that are calculated to last over the beneficiary's remaining lifetime. Individual account options vary, but many would not be truly private in the sense that they would insulate individuals from investment risk by providing federal guarantees that eventual benefits under the new system will be close to or better than what workers would receive under the traditional program.

Establishing individual accounts, however, faces a major hurdle. It would force upfront acknowledgement of the costs of continuing to pay benefits to current retirees and workers who would remain in the traditional system. If the contributions of current workers are redirected to individual accounts, there will not be sufficient revenues to sustain the benefits received by current retirees from Social Security. Deficits and debt would rise unless the transition costs are offset by cuts in benefits, cuts to other programs, or increased revenues. Shifting from pay-as-you go to a pre-funded system essentially means that the costs of two generations of workers have to be financed at the same time. Once the conversion is completed, however, payment for the traditional program will diminish and budgetary costs could fall substantially (depending on how the accounts are structured).

Proposals to increase system resources or cut benefits

Note that keeping the pay-as-you-go structure does not eliminate the cost of unfunded promises. They do, however, escape having to acknowledge them until the imbalances between the system's costs and income surface.

Any proposal to increase the level of resources dedicated to Social Security or to cut the program's benefits will improve the system's finances relative to current law. If, however, new resources or savings achieved from benefit reductions are redirected into higher benefits or individual accounts, Social Security's finances may be improved without a corresponding improvement in overall federal finances.

Individual changes affect generations of workers differently. Options to cut benefits have a greater impact on older workers and retirees. Options to raise payroll taxes affect younger workers the most. Some options use financing from the general fund (non-payroll tax resources). Those funds would come from other sources of federal revenue or from public borrowing. Most proposals seek to protect from benefit reductions both lifetime low-wage earners and workers (and dependents) who are receiving disability benefits. It is important to remember that proposals to cut benefits may result in *slower growth* in benefits rather than outright reductions. That is because retirement benefits reflect the growth in real wages over a work life. Thus, under current law, each cohort of new retirees receives higher benefits (on average) than earlier retirees.

KEY POLICY LEVERS FOR REFORM

Efforts to strengthen Social Security's finances or to replace it with a new framework have a limited number of levers with which to work. They include:

Covered employment - Most jobs are now covered by Social Security, and payroll taxes are collected from the earnings of most employees. (Self-employed individuals are also covered by and must pay payroll taxes.) About 4 million state and local employees, however, are not covered by Social Security. Although it would be difficult to move all of those workers to Social Security, some analysts have proposed that new state and local hires be shifted to Social Security. (Federal workers who were hired after 1983 were shifted to Social Security.) That would effectively broaden the payroll tax base and increase revenues. Eventually it will increase benefit costs but that would be many years before newly eligible participants begin to draw benefits.

Indexes - Social Security uses indexes to incorporate changes in prices and wages over long time periods. The **consumer price index (CPI)** is used to calculate annual cost-of-living adjustments, which maintains benefits at an inflation-adjusted level. Initial benefit levels are based upon lifetime earnings adjusted for average wage growth. That incorporates real economic growth into initial benefits. Many economists believe that the CPI over-estimates inflation because it does not account for changes in consumption over time. They recommend a "chained" CPI instead.

Maximum contributions and benefit base - Social Security payroll taxes are collected up to a maximum amount of earnings, which is increased each year by the rate of the average growth in wages. In 2005, that limit is $90,000. Earnings above that limit are not subject to the Social Security payroll tax. By contrast, Medicare hospital taxes are collected on the full amount of wage earnings. Only 6 percent of workers have earnings above the taxable maximum. Those earnings represent about 15 percent of total covered earnings. Because higher wages have grown faster than average earnings, that percentage has risen over time. In 1980, it was 10 percent. Some reformers would increase the maximum contributions base to cover a greater share of payroll and broaden the taxable base. That would increase payroll taxes for higher income earners, but they would eventually receive higher benefits because the maximum is also used to calculate workers' benefit levels.

Payroll taxes - Social Security taxes equal 12.4 percent of covered earnings split equally between employees and employers. Self-employed individuals pay the full 12.4 percent by themselves. Most economists believe that the employer contribution is a form of compensation, since it comes out of the wages employers otherwise would pay. Thus, employees bear the full burden of payroll taxes. Increasing the payroll tax rate would affect all earners regardless of wage level, but the tax is regressive—it is more burdensome for low-income earners than for higher-income employees.

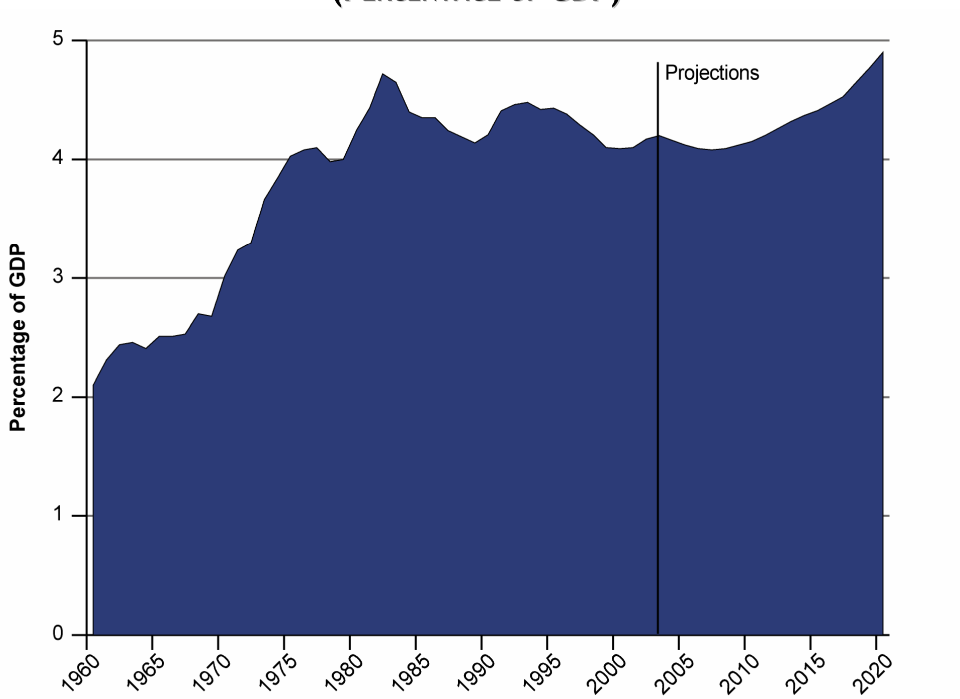
Retirement age - Between 1940 and 2003, life expectancy at age 65 increased by more than 4 years for men and 5 years for women. Under the Social Security intermediate actuarial assumptions, life expectancy is expected to increase about 4 more years for men and women over the next 75 years. In 1983, for workers born in 1938 and later, policymakers increased the **normal retirement age (NRA)**—the eligibility age for full retirement benefits—from 65 to 67. The change meant that the NRA increase did not start for 20 years. In 2003, it began to rise two months per year. In 2009, it will reach 66 and stay there through 2020 (for workers born in 1943-1954). Then it rises again at the rate of two months per year, reaching 67 for those born in 1960 and thereafter. Eliminating the hiatus at age 66 or increasing the retirement age (e.g., to 70) would reduce the costs of Social Security. Some argue, however, that change would disproportionately affect lower-wage earners, whose jobs are more physically demanding and who tend to be in poorer health.

Rates of return - By law, Social Security trust fund assets are invested in special investment securities issued by the U.S. Treasury. Those certificates pay interest to the trust fund at rates comparable to publicly-traded Treasury securities. Privately-issued equity and debt instruments yield higher rates of return. Although higher rates of return would increase resources available to provide retirement benefits, many economists, believe the higher rates of return reflect additional risk. Thus, on a risk-adjusted basis, the investment in private equities would not provide greater returns than investment in Treasury securities. (Social Security actuarial projections assume that the long-term real rate of return for private equities will be 3.5 to 4 percent higher than the yield for Treasury bonds.)

SOCIAL SECURITY ESTIMATED SPENDING (BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
Administrative Costs	4	4	5	5	5	5	*
DI	84	88	94	101	108	115	0.8%
OASI	433	450	469	490	515	544	3.8%
Total	**521**	**543**	**568**	**596**	**628**	**664**	**4.6%**

HISTORICAL SPENDING FOR SOCIAL SECURITY (PERCENTAGE OF GDP)



OPTIONS

SOCIAL SECURITY OPTIONS
(BILLIONS OF DOLLARS)

	2005	2006	2009	2014	Percent of GDP in 2014
Exercise baseline spending level	521	543	628	843	4.6%
Policy Options (Projected changes to spending (net of receipts))					
1. *Exercise* baseline	0	0	0	0	0.0%
2. Incremental Changes	-1	-2	-5	-19	-0.1%
3. Sustainable Social Security	-26	-30	-40	-58	-0.3%
4. Personal Savings Accounts	0	61	79	66	0.4%
5. President's Commission Plan 2	0	0	129	206	1.1%

In addition to the current law baseline, the *Exercise* presents four options: two that would retain the current framework while strengthening its financial condition and two that would create individual accounts while reducing traditional Social Security benefits.

To the extent that such information is available, the *Exercise* presents indicators of the potential impact of proposed reforms from three points of view:

Social Security solvency
If a proposal identifies sufficient resources to pay Social Security benefits over the 75- to 100-year actuarial period, it is said to achieve solvency, even if some of those resources are transfers from the general fund and thus squeeze resources available for other uses or increase borrowing. Solvency is a limited measure of the state of Social Security's finances and ignores implications for the rest of the budget.

Unified budget totals (deficits or surpluses)
If a proposal improves cash flows across the budget, then it would reduce the deficit as well as improve Social Security's solvency. However, proposals to divert general revenues to Social Security would improve its solvency at the expense of the rest of government. Unified budget totals are typically estimated for relatively short time periods—5 to 10 years—and thus will not capture impacts of many reform options that unfold over many decades. Unified budget measures will include changes in the government's interest costs, which can improve or worsen the overall budget picture. Expressing changes in terms of percentages of GDP uses the size of the economy as a constant to gauge the magnitude of differences.

Individual benefits and payroll taxes
There are two benchmarks for determining whether individuals would be better or worse off under proposed reforms relative to current law. The "scheduled benefits" benchmark assumes that benefits will be provided without regard to the exhaustion of the Social Security trust fund in 2042. The "trust fund financed" benchmark assumes that beginning in 2042, benefits have to be reduced each year to stay within the resources available. The benefit reduction would begin at 27 percent in 2042 and rise each year, reaching 32 percent in 2078. How individuals fare under Social Security reform can depend on which benchmark is assumed and frequently varies depending on individual characteristics (lifetime earnings, marital status, gender, etc.).

Note - None of the options have much impact on the short-term budget outlook, but their impact on the long-term outlook varies considerably.

OPTION 1: *EXERCISE* BASELINE

The baseline would leave Social Security unchanged for the foreseeable future. This option would maintain "traditional" Social Security benefits without changes. Benefits are linked to contributions. Upon retirement, lower-wage earners receive a higher replacement of income than do high-wage earners, but high-wage earners receive larger benefits.

Financing - Payroll taxes total 12.4% of covered earnings up to $90,000 in 2005. Workers pay 6.2% paid directly and employers pay 6.2% percent on behalf of workers. The self-employed pay 12.4%.

Financial Indicators - CBO projects that Social Security cash surpluses (payroll tax and other non-interest revenues in excess of benefits) will continue until 2019. In 2040 CBO estimates Social Security spending will be 6.1 percent of GDP, compared to 4.2 percent today. The Social Security Actuary estimates that the 75-year actuarial deficit is 1.92 percent. That is, adding 1.92 percent to the payroll tax (raising it to 14.32 percent) would balance the system through 2072. According to the actuary, general fund transfers to the Social Security trust fund will reach $4.9 trillion on a present discounted value basis as Treasury securities held by the trust fund are redeemed and if additional resources are provided to maintain benefits at their scheduled levels beyond 2042 (the projected date of trust fund depletion.)

OPTION 1: EXERCISE BASELINE

Arguments In *Favor*	Arguments *Opposed*
Benefit increases can be easily accommodated. The projected increase in Social Security benefits under current law is only about 2 percent of GDP and can be easily accommodated within a growing economy—just as the country was able to afford a growth in Social Security spending from less than 1 percent of GDP in the 1950s to over 4 percent today	**National saving will spur economic growth.** The aging of the population will strain the overall economy not just the federal budget. Reforms to Social Security could help increase national saving, which is essential to investment and long-term growth. Raising the economy's rate of growth will make the demographic change easier to bear for everyone.
Social Security benefits reduced poverty. Why mess with success? Social Security benefits have successfully reduced the rate of poverty among older Americans **Unfair to take away promised benefits.** Individual savings rates are too low to be able to sustain standards of living in retirement. Many aging workers may be counting on Social Security—it would be unfair to take promised benefits away now.	***Status quo* will unfairly burden younger workers.** For the last 20 years, the burden on workers has remained relatively constant at around 30 beneficiaries per 100 workers. However, the number of beneficiaries will grow steadily over the next 30 years, reaching nearly 50 in 2040. Addressing long-term shortfalls with increases in the payroll tax rates will place very heavy burdens on low-wage earners who can barely make ends meet. Maintaining the *status quo* will place a growing burden on younger generations of workers.

OPTION 2: INCREMENTAL CHANGES

This option would maintain "traditional" Social Security benefits with two modest adjustments: it would switch to chained CPI to calculate COLA increases; and it would gradually expand the taxable contributions and earning base to cover 90 percent of covered payroll in 2036 (instead of the current 85 percent).

Financing - Benefit reductions through use of chained CPI to reduce annual COLAs by about 0.22 percent. If that index had been used in 2004, it would have reduced the average monthly benefits of retired and disabled workers by only $2. Revenue increase from subjecting a larger percentage of earnings to taxation. This provision would affect high-wage earners. Only about 6 percent of covered workers have earning in excess of the current taxable maximum.

Financial indicators - Analysis by the Social Security actuary estimates that this option would extend cash surpluses by two years and the life of the trust fund by 13 years. It would reduce the 75-year actuarial deficit from 1.92 percent to 0.97 percent of payroll, and lower transfers from the general fund to the Social Security trust fund from $4.9 trillion to $3.1 trillion in present value terms. Those transfers represent amounts needed to redeem assets held by the trust fund and an additional amount required to maintain benefits at their scheduled levels (instead of reducing them after 2042 to the level of resources available under current law).

OPTION 2: INCREMENTAL CHANGES

Arguments In *Favor*	Arguments *Opposed*
Trust fund will be extended for future decisions. This option would extend the Social Security trust fund until 2055—another 13 years—with only modest changes. That would give future policy makers and voters plenty of time to decide what additional changes, if any, should be made.	**Short-term solution.** This option does not provide a long-term solution. By imposing minimal changes, this option enables current generations (including baby boomers) to escape from making significant contributions to fixing the system.
Small increase in payroll tax – 75 year solvency. According to the Actuary, a 2.44 percent increase in the payroll tax in 2038 would assure solvency throughout the 75-year period. Even if no other changes are enacted before then, that would not be a substantial increase.	**Solution gets more difficult each year.** Each passing year makes finding a solution more difficult. While the expansion of contributions generates higher revenues, eventually, it increases costs because future benefits will reflect the higher covered earnings.

Note: This option was proposed by Robert M. Ball, Commissioner of Social Security 1962-1973.

OPTION 3: MODIFIED SOCIAL SECURITY

This option would maintain the current structure of Social Security but institute a number of changes to benefits and contributions to stabilize the program financially. It would largely attain long-term financial stability by reducing benefits and increasing taxes for higher-wage earners. It would not affect the benefits of current retirees or of workers age 55 and older in 2004.

Financing - Benefit reductions include: 1) gradually increasing the maximum taxable earnings and contribution base to cover 87 percent of covered payroll in 2063; 2) reducing benefits for new, higher-income retirees in 2012 and later; 3) adding a 3 percent longevity surtax for workers who have earnings above the taxable maximum and increasing it annually by .055 percent after 2023 (the higher base would not be reflected in eventual benefits); 4) after 2023, reducing benefits for all new retirees and increasing payroll taxes by 0.255 percent for all workers who do not have earnings above the taxable maximum; and 5) covering all new state and local government workers hired after 2008. Savings would be offset by increasing benefits for low-wage earners who retire in 2012 and later so that those who work for 20 years would receive benefits of at least 60 percent of the poverty threshold. The enhancement would increase with years of work so that someone who retires in 2012 after 35 years would receive benefits at least equal to 100 percent of the poverty level. The proposal would also increase benefits for surviving spouses.

Financial indicators - Analysis by the Social Security Actuary estimates that this option would indefinitely extend the life of the trust fund. It would replace the 75-year actuarial deficit of 1.92 percent of payroll with a 0.9 percent surplus and reduce amounts transferred from the general fund to the Social Security trust fund by $4 trillion in present value terms (from $4.9 trillion to $0.9 trillion).

OPTION 3: MODIFIED SOCIAL SECURITY

Arguments In *Favor*	Arguments *Opposed*
Retains existing Social Security structure. This option would retain a successful and popular program while fixing recognized weaknesses in its safety net features. It would also avoid increasing the burden on other parts of the budget.	**Sustained by raising payroll taxes.** This option achieves sustainability largely by raising taxes, principally on higher income workers. By the end of the 75-year actuarial period, the contribution rate—12.4 percent of payroll currently—would be 25 percent higher.
Arguments In *Favor*	**Arguments *Opposed***
Appropriately distributes responsibility and protects. The approach properly assigns responsibility to those who can best afford it—higher income workers who have enjoyed the greatest improvements in their standards of living and in longevity—while protecting more vulnerable populations, e.g., lifetime low-wage earners and surviving spouses.	**Characteristic of a welfare program**. By making the program more redistributive (from higher- to lower-income workers) the option would erode the earned benefit characteristic of the system and make it more into a welfare program. If Social Security is to become a social safety net, then it would be better to do it explicitly, instead of trying to disguise it as a public pension program that provides earned benefits.

Note: This option was proposed by economists Peter A. Diamond and Peter R. Orszag, Saving Social Security: A Balanced Approach, 2004.

OPTION 4: PERSONAL SECURITY ACCOUNTS

This option adds individual accounts, called "personal security accounts" (PSAs), to traditional Social Security for workers who are below the age of 55. Workers would contribute 3% of the first $10,000 in covered earnings and 2% of earnings over that amount up to the taxable wage ceiling, or about 2.3 percent of the 12.4 percent total. Social Security would administer the accounts although workers could transfer larger accounts (balances greater than $7,500) to private investment managers. Upon retirement the account balances would be disbursed as annuities. Balances would belong to workers (or their estates).

Financing - Benefit reductions include: 1) accelerating the increase in the normal retirement age to 67 for workers born in 1949 and after; 2) switching to the chained CPI to calculate annual COLAs; 3) reducing benefits for higher-income earners; and reducing benefits for increases in longevity.

Revenue increases include: 1) stepping up the taxable maximum contributions base to include 87 percent covered earnings (reaching $133,000 in 2008); 2) redirecting amounts currently credited to the Medicare Hospital Insurance trust fund that derive from the taxation of benefits of high income Social Security beneficiaries; and 3) adding a new general fund transfer that would climb gradually to 0.6 percent of taxable payroll in 2063.

Savings would be offset by: 1) creation of a minimum benefit equal to the poverty level and subsequently indexed by wage growth; and 2) an increase in benefits for surviving spouses.

Financial indicators - CBO estimates that relative to current law, this option would increase deficits through 2023 but would have a positive impact on projections afterwards. CBO estimates that by 2040 this option would reduce projected budget shortfalls by 1 percent of GDP. The Social Security Actuary estimates that the proposal would replace the 75-year actuarial deficit of 1.92 percent of payroll with a 0.14 percent surplus and reduce amounts transferred from the general fund to the Social Security trust fund by $2.5 trillion in present value terms (from $4.9 trillion to $2.4 trillion).

OPTION 4: PERSONAL SECURITY ACCOUNTS

Arguments In *Favor*	Arguments *Opposed*
Gives workers a stake in economic rewards. Retains a base Social Security program, but allows workers individual accounts. That will give workers a greater stake in the private economy and allow them to share more fully in the accompanying economic rewards.	**Investment opportunities will not be significant.** This proposal would provide modest opportunities for individual investment. PSAs will be insignificant for low-income workers. Higher income workers don't need them because they already have IRAs, 401(k), etc.
Beneficiaries would fare better. Assuming that current law benefits will have to be reduced, beneficiaries would fare better under this option. Average lifetime benefits for low-wage earners would be 35 percent higher; middle- and lifetime benefits for high-wage earners would be 3-4 percent higher on average.	**Stress to the budget for the next 20 years.** The option would eventually improve the budget outlook, but it would increase budget deficits for the next 20 years, and the general fund transfers would increase stress on the rest of the budget. It would harm Medicare by diverting revenues that currently fund the Hospital Insurance program.

Note: This option was proposed by Congressmen Jim Kolbe (R-Arizona) and Charlie Stenholm (D-Texas) in the 108th Congress, 2004.

OPTION 5: PRESIDENT'S COMMISSION PLAN 2

This option would create voluntary personal accounts without increasing payroll taxes or drastically reducing traditional benefits. Workers would contribute 4 percent of their 12.4 percent payroll taxes to the accounts, up to a maximum of $1,000/year. Eligibility for traditional benefits would be reduced, but workers are highly likely to receive a higher benefit from combining individual accounts and the remaining traditional benefit than they would if they don't participate. Thus universal participation is projected. Account balances would be distributed as annuities. Before retirement, balances would belong to workers (or their estates). The plan would raise benefits of disabled workers, low-wage earners and surviving spouses.

Financing - Benefit reductions – switch to price-indexing from wage-indexing to establish initial, traditional benefits.

Revenue increases – authorize general fund transfers to the Social Security trust as needed to pay benefits, putting upward pressure on income taxes or increase borrowing.

Savings would be partially offset by enhancing benefits for low-wage workers with at least 20 years of work and for low- to middle-income surviving spouses.

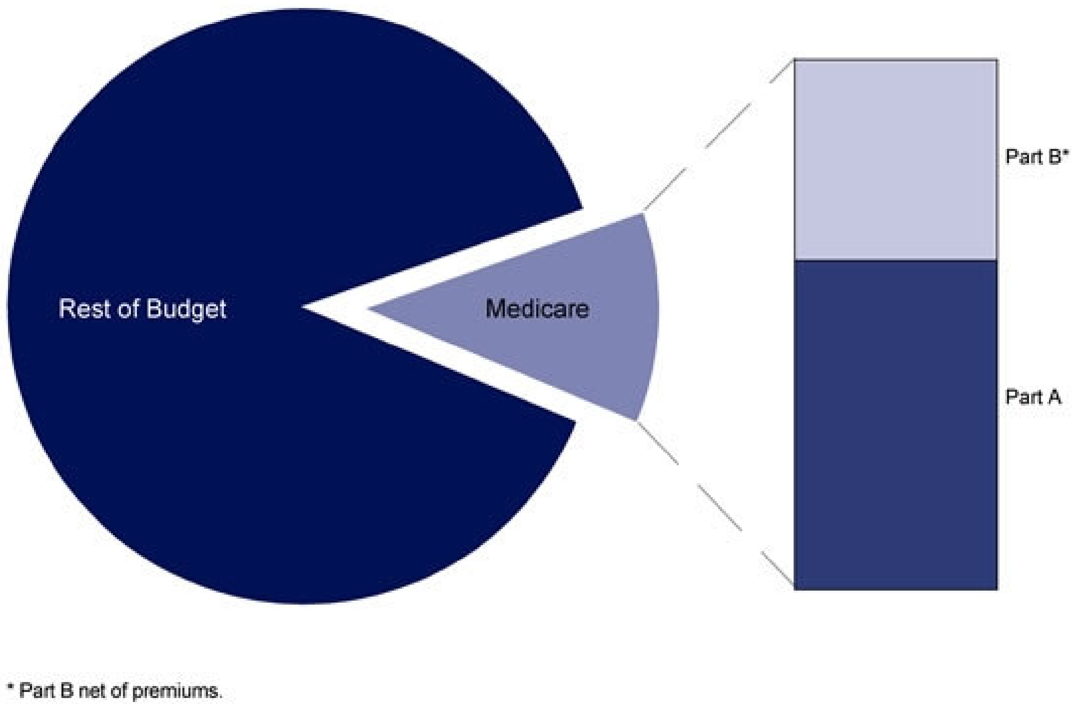
Financial indicators - CBO estimates that this option would increase budget deficits by an increasing percentage of GDP, reaching 1.5 percent in 2024. Then the negative impact would decline until 2040 to 2050, when the proposal's impact on the budget would turn positive. Based upon analysis by the Social Security Actuary, this option would: change the 75-year actuarial deficit of 1.92 percent of payroll to a 0.1 percent surplus; and lower transfers from the general fund to the Social Security trust fund from $4.9 trillion to $3.0 trillion in present value terms. Those transfers represent amounts needed to redeem assets held by the trust fund and additional amounts required to maintain benefits at their scheduled levels (instead of reducing them after 2042 to the level of resources available under current law).

OPTION 5: PRESIDENT'S COMMISSION PLAN 2

Arguments In *Favor*	Arguments *Opposed*
Retains basic program with individual accounts. Retains a base Social Security program, but allows workers individual accounts. That will give workers a greater stake in the private economy and allow them to share more fully in the accompanying economic rewards.	**No structural resolution and imposes budget stress.** This proposal would provide modest opportunities for individual investment. PSAs will be insignificant for low-income workers. Higher income workers don't need them because they already have IRAs, 401(k), etc.
Workers have a stake in private economy. Option would give workers a greater stake in the private economy and allow them to share more fully in the accompanying economic rewards. It would offer the same benefits as Personal Security Accounts (PSAs) but without all the explicit tax increases and only modest reductions to traditional benefits.	**Benefits would be reduced.** Combined benefits from the personal accounts and traditional Social Security would average 10-20 percent lower than scheduled or reduced benefits under current law for middle- and high-earners. Low earners would break even relative to reduced benefits, but would receive 10 percent less relative to scheduled benefits.

Note: This option was one of three recommended models in the final report of the President's Commission on Strengthening Social Security (CSSS) that was issued in December 2001.

CHOICE 5: MEDICARE



The Medicare program provides health insurance to people ages 65 and older and individuals of who are disabled or who have end-stage renal disease. It is not means-tested: eligibility is not restricted on the basis of income. Anyone who is eligible for Social Security disability or retirement benefits is also eligible for Medicare. Medicare consists of:

- **Hospital Insurance (HI)**, also known as Part A, which covers inpatient hospital, skilled nursing, home health, and hospice care; and
- **Supplemental Medical Insurance (SMI)**, including Part B, which covers physician services, outpatient care, home health services, and medical equipment, and Part D, which will begin in 2006 and will provide coverage for prescription drugs. (Transitional prescription drug assistance is available until the full program starts.) SMI is voluntary. Beneficiaries must pay monthly premiums in order to participate. Medicaid, the federal government's means-tested health insurance program, pays SMI premiums for eligible low-income people.

Medicare is financed through a variety of sources.

- The HI program is financed through: payroll taxes of 2.9 percent (1.45 percent paid directly by workers and 1.45 percent by their employers); interest earnings on accumulated trust fund balances; and income taxes collected on some Social Security benefits. Currently, tax revenues cover about 98 percent of HI costs. Actuarial estimates project that share will drop to 81 percent in 2019 and 26 percent at the end of the 75-year projection period.

- Initially SMI Part B costs were equally shared by beneficiaries and other taxpayers. Now Part B premiums cover about 25 percent of SMI costs while transfers from the Treasury general fund (general revenues) cover the difference. Beginning in 2007, Part B premiums will reflect beneficiaries' incomes. Individuals with annual incomes below $80,000 will continue to pay 25 percent of costs. By 2011, individuals with income over $200,000 will pay 80 percent of costs, with those with incomes between $80,000 and $200,000 will contribute 35 to 65 percent of costs.

- Part D prescription drug benefits will require beneficiary premiums averaging 25.5 percent of expected costs. General revenues make up most of the remaining premium costs. Medicare will provide additional subsidies to help low-income beneficiaries participate in the program. Over the next 75 years, the cost of Part D subsidies is projected to exceed $8 trillion in today's dollars (or 70 percent of 2004 GDP).

- CBO estimates that payroll taxes and beneficiaries' premiums covered 35 percent of Medicare costs in 2004 and that general revenues covered the remainder. By 2014, that share will fall to 54 percent. In 2040, according to the Medicare trustees, payroll taxes and premiums will cover only 31 percent of projected costs.

ISSUES

The challenge is to find a way to modernize Medicare and facilitate better coordination of care while keeping the program affordable as the number of beneficiaries grows and the cost of health care increases.

The growth in Medicare costs poses serious issues for the federal budget. Medicare costs are rising faster than premiums and other dedicated receipts, making the program increasingly dependent on general revenues. According to the latest actuarial projections (which assume that the rate of growth in spending somehow will slow down), Medicare spending will exceed Social Security in 2024. After 2019, authorized resources will be insufficient to pay for Part A hospital insurance benefits. (General revenues fill the gap between Part B premiums and costs, so there is never a technical shortfall in financing.)

Yet despite the substantial and growing level of federal resources committed to the program, Medicare pays for only about half of the health care costs of older people. Gaps in coverage expose beneficiaries to large out-of-pocket costs for co-pays, premiums, deductibles, and other uncovered expenses. Many Medicare beneficiaries carry Medigap insurance. Medicaid covers out-of-pocket costs for low-income seniors.

Medicare is the primary source of health insurance for older people. Other insurers are supplementary. Options to improve Medicare's finances are not politically popular because they would limit individual choices and restrict access to care. Options to expand benefits (the new prescription drug benefit) are very popular. As a result, when forced to address Medicare's financing problems, policy makers tend to resort to tightening payments to health care providers rather than undertaking measures that directly affect beneficiaries. That approach can reduce beneficiaries' access to care as providers limit the number of Medicare patients served.

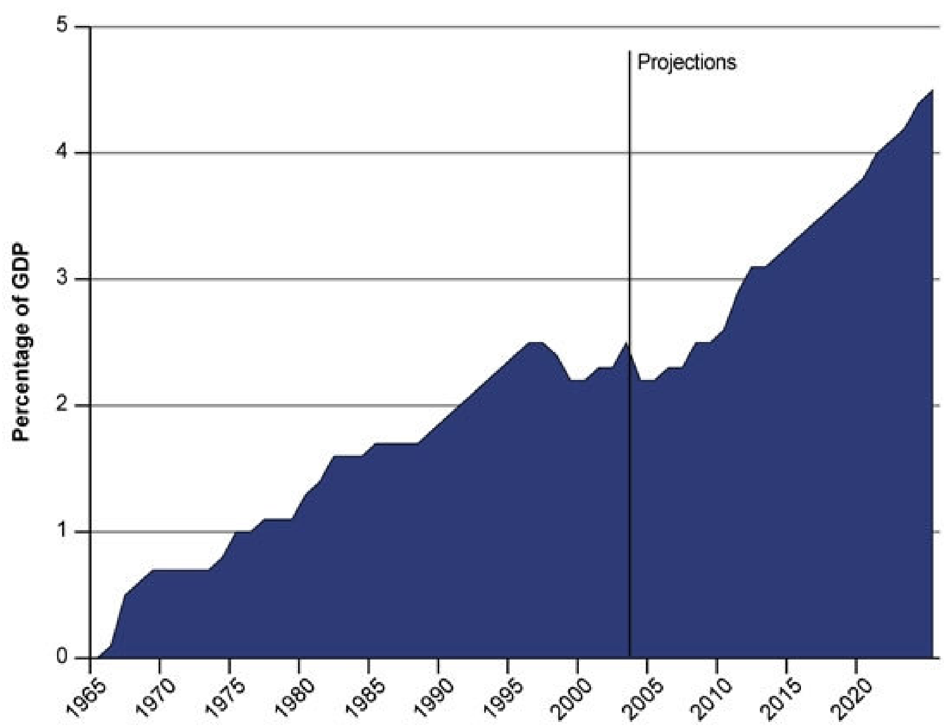
Some health policy analysts believe that allowing private insurers to compete with the federal fee-for-service program would help to contain costs. (Private insurers would receive per enrollee payments to provide a comprehensive benefit package delivered through a network of participating providers.) Under the fee-for-service approach, Medicare reimburses providers for their services. The higher the volume of services, the more providers collect in reimbursements. But managed care options have proved to be unpopular among beneficiaries and only 13 percent are enrolled in group plans. Another option is to make beneficiaries bear more of the costs of their care to encourage more careful consumption of health care services. However, that raises equity concerns. Most beneficiaries have supplemental coverage that helps to insulate them from out-of-pocket costs, while many others would not be able to afford higher premiums or out-of-pocket costs.

MEDICARE ESTIMATED SPENDING
BILLIONS OF DOLLARS

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
Administrative Costs	4	4	4	4	5	5	*
Hospital Insurance benefits	178	180	192	203	216	229	1.6%
Part B (SMI) benefits	143	145	154	163	174	187	1.4%
Prescription Drugs	1	47	75	84	92	101	0.8%
Other (net premiums and other offsetting collections)	-34	-53	-62	-67	-72	-79	-0.6%
Total	**290**	**323**	**363**	**388**	**415**	**443**	**3.2%**

** = Less than 0.05%.*

HISTORICAL SPENDING FOR MEDICARE
(PERCENTAGE OF GDP)



OPTIONS

MEDICARE OPTIONS
(BILLIONS OF DOLLARS)

	2005	2006	2009	Total: 2005-2009	Percent of GDP in 2014
CBO baseline spending level	290	323	443	1,933	3.2%
Policy Options—Projected changes to baseline spending levels					
1. *Exercise* baseline	0	0	0	0	-0.0%
Incremental Options					
2. Reduce PPS for hospital inpatient care	-1	-2	-6	-17	-0.1%
3. Replace formula-driven payments with block grants for graduate medical education	-1	-1	-2	-6	*
4. Reduce payments for prescription drugs	0	-1	-1	-4	*
5. Restrict Medigap coverage of cost sharing	-2	-3	-3	-14	-0.1%
6. Raise the eligibility age	0	0	0	0	-0.0%
*Structural Reforms***					
7. Defined contribution	0	0	-1	-1	-0.3%
8. Defined benefit	0	0	0	0	-0.1%
9. Medicare expansion	0	0	0	0	0.3%

* *Less than 0.05 percent.*
** *Estimates of structural reforms are illustrative.*

PROS & CONS

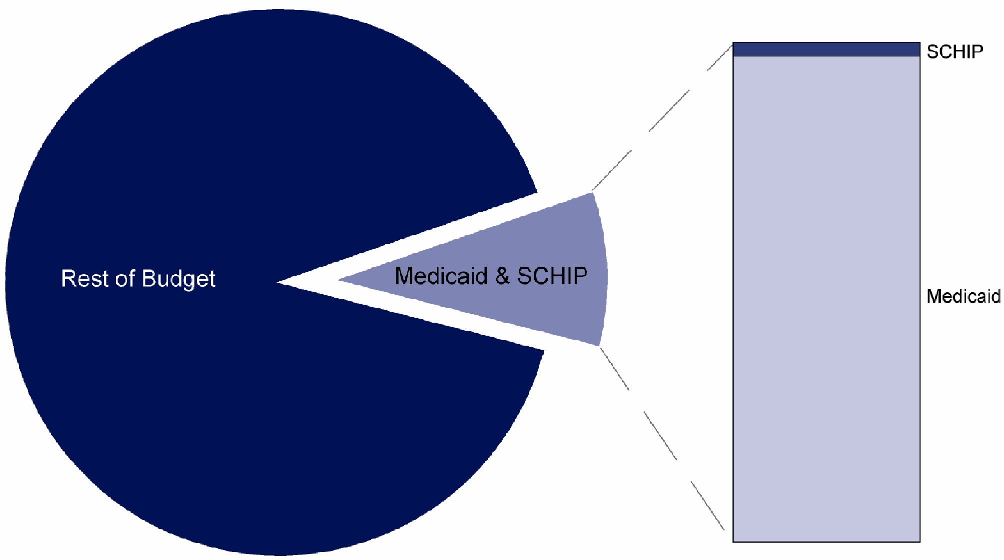
The *Exercise* provides a range of options for Medicare reform. You may select a combination of incremental changes or one of the structural reform options. The latter are not detailed legislative proposals. Instead they are designed to illustrate alternative approaches to changing Medicare.

Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
1. *Exercise* baseline. The baseline option continues Medicare as currently structured. Spending would increase from $290 billion in 2005 to nearly $600 billion in 2014. By 2040, CBO estimates that if the growth in Medicare spending takes an intermediate path, it would reach 7.3 percent of GDP in 2040, compared with 2.5 percent today.	The baseline is the least disruptive option. Changes to Medicare could have unforeseen consequences and adversely affect the availability of health care services, particularly if undertaken without reforming the overall health care system.	The current Medicare system is clearly unsustainable. It is costly, has failed to keep up with changes in health care, and to keep costs down, relies heavily on restraining payments to providers, which may limit the number of Medicare patients they treat.
Incremental Reforms		
2. Reduce the Medicare prospective payment system update factor for hospital inpatient operating costs. Medicare's payments to hospitals for inpatient treatment are based upon the patient's diagnosis and the hospital's characteristics. The annual increase in payment rates is based, in part, on the projected inflation using the hospital market basket index. Increases are projected to be 3.2 percent over the next 10 years. This option would reduce the update factor to the annual change in the index minus 1.1 percent. Savings would compound each year. In five years, payments to hospitals for inpatient care would be approximately 4 percent lower than without the change. In 2014 payments would be 9 percent lower.	Hospitals earn healthy profit margins on Medicare inpatient services and thus can absorb lower payments. In 2002, when the update factor was the index minus 0.55 percent, the profit margin was 11 percent. In 1999, the update factor was the index less 1.9 percent and profits were 12 percent.	The high profit margins for inpatient care are due to the allocation of costs between inpatient and outpatient care. Overall profit margins for hospitals are only around 4 percent in 2002. About a third of hospitals have negative profit margins. Thus reductions in hospital payment rates could cause severe stress for some institutions and have a negative impact on the quality of care available to beneficiaries.

Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
3. Provide block grants for graduate medical education (GME). Medicare provides three types of payments to teaching hospitals to subsidize the costs. The payments compensate teaching hospitals for higher direct costs (residents' compensation, teaching costs, and overhead), indirect costs (additional tests and procedures), and additional capital costs. This option would instead use a block grant based upon total GME spending indexed for inflation. This would simplify the determination of each hospital's payment and eliminate differences reimbursement rates.	Providing a single block grant would reduce the administrative costs that teaching hospitals incur keeping track of the data required to determine their eligibility for funds under the three current programs. Consolidation of the payments to teaching hospitals would make it easier for policy makers to monitor funding and evaluate its effectiveness.	Teaching hospitals provide treatment to more complicated cases, conduct medical research, and are a source of innovation. Cutting funding could undercut those efforts or could force teaching hospitals to provide less care for the uninsured.
4. Reduce Medicare payments for currently covered prescription drugs. Medicare SMI pays providers for certain outpatient prescription drugs when administered under a physician's supervisions (e.g., injections or infusions, some oral chemotherapy, immunosuppressive drugs for recipients of organ transplants, and certain drugs related to end-stage renal disease). Payments are set at 95 percent of average wholesale price, which is an estimated 25 percent higher than the acquisition price paid by providers. This option would reduce the payment to 85 percent of the wholesale price and limit the growth to CPI instead of the growth in manufacturer's list prices. Note: this option would not affect the new prescription drug benefit.	There is evidence that the acquisition cost of Medicare-covered drugs is 25-26 percent below the SMI payment rates. Providers and suppliers that administer or dispense those drugs are making large profits at the taxpayer's expense.	The drug companies and providers will find a way around the reduced payment rates. Manufacturers will introduce new drugs at higher list prices to restore profit margins and encourage use of their products. Furthermore, reducing payments to physicians could induce them to reduce treatment for Medicare patients, diverting them to hospital or outpatient facilities where Medicare payment rates are higher.
5. Restrict Medigap coverage. Most beneficiaries obtain supplemental Medigap coverage to protect them from Medicare co-pays and deductibles. Some have "first-dollar coverage" so they do not have any out-of-pocket costs. People with Medigap policies use 25 percent more Medicare services than individuals without supplemental coverage, increasing costs for taxpayers. This option would bar Medigap policies from paying the first $600 of an individual's cost-sharing requirements and limit coverage to half of the next $2,800, leaving enrollees with a maximum of $2,000 in out-of-pocket costs. Restrictions would be indexed.	If beneficiaries have to pay more out-of-pocket they are likely to be more careful in the use of services and forego treatments that yield little or no benefit. That will reduce overall Medicare costs. While this option would expose beneficiaries to costs, it is designed to protect them from large cost-sharing requirements. This option could reduce beneficiaries' total costs since premiums for Medigap policies should fall.	Beneficiaries will be at risk for limited but unpredictable out-of-pocket costs. Those costs could be significant for some individuals and could cause them to forego necessary care. About one-fourth of Medigap policyholders would face higher costs under this option than under the current system. Individuals with chronic conditions would have to pay more every year.
6. Raise the Medicare eligibility age. Beginning in 2015, this option would gradually raise the eligibility age by 2 months per year to reach 70 in 2044. Alternatively this option could be modified by raising the eligibility age to 67 (between 2015 and 2026) instead of 70. That would make the increase in eligibility age consistent with the scheduled increase in Social Security's full retirement age.	An increase in eligibility age is reasonable given lengthening life expectancies. (In 2015, life expectancy at age 65 will be four years longer for men and three years longer for women than it was in 1965.) To allow people to prepare, the change would not begin until 2015.	Raising the eligibility age most affects people who have engaged in physically-demanding labor. They are least likely to be able to continue working longer, but would have few other options. The cost of private insurance, if they could obtain it, would likely be very high.

Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
Structural Reforms (Estimates assume that structural reforms are gradually phased-in beginning in 2008 after the Medicare prescription drug program is implemented.)		
7. Defined contribution. This option would convert Medicare from a largely a fee-for-service system that pays providers for the procedures and care they provide to a system that provides each beneficiary with a voucher to buy health insurance from approved plans. The rate of growth in benefits costs would gradually slow so that in 2014 Medicare costs would increase to accommodate the increase in beneficiaries and the rate of inflation (4.9 percent compared to the baseline's 8.4 percent). Individuals would choose among competing insurers, but all plans would have to offer a minimum standard package of benefits. Beneficiaries could pay more if they wanted to, or keep the savings if premiums for their selected plans cost less than their vouchers. The amount of an individual voucher would be risk-adjusted (vary according to the beneficiary's age, health status, income etc.) and would reflect local health care market conditions. Traditional Medicare would continue but would have to compete with privately-offered plans.	This proposal is like the system covering federal employees and members of Congress. It would allow individuals to choose the plan that suits them best while limiting how much the federal government pays towards the premiums. Participating health plans will compete for enrollment based upon benefits (beyond the minimum requirements), price, service, and convenience. Traditional Medicare would continue to be available, but would have to compete for enrollees. Federal costs would be more predictable and controllable instead of open-ended.	Although vouchers would be risk-adjusted, it would be hard to ensure that the calculation was done properly. Inevitably, this system would allow plans to tailor benefits to healthier beneficiaries, leaving those with greater medical needs with fewer options. The traditional Medicare option would tend to attract sicker, more costly enrollees and would not be able to offer coverage comparable to other plans. The limit on federal payments could end up shortchanging beneficiaries in order to meet budget targets. That would shift risk to providers and patients and could have disastrous consequences for people needing health care..
8. Defined benefit with premium support. This approach would provide a comprehensive standard package of health care benefits attractive enough to satisfy most consumers. The federal government would provide a subsidy to each beneficiary that could be used to purchase coverage from insurers offering the standard plan. Cost savings are assumed to result from competition among plan providers, better coordination of patient care, and streamlined administrative procedures. The amount of the federal per capita payment would be set at the low-middle range of bids submitted by competing health plans that want to participate. Higher-income beneficiaries would pay a surcharge and could buy more expensive plans. But the federal subsidy payment would be sufficient to allow lower income people to purchase the standard plan. Participating insurers compete on the basis of service and convenience, not by benefit package or price. The payment to each plan would be risk-adjusted to reflect the characteristics of their enrollment and local market conditions. Plans would be regulated by the federal government. Traditional Medicare would remain available for existing beneficiaries only.	This option would combine private market efficiency with necessary federal oversight. Competition between private plans would hold costs down. The standardized benefit package would assure that the basis of competition is better service and convenience, not the ability to attract healthier enrollees. That would assure that all beneficiaries would have choice of plans without facing the possibility of inadequate coverage or drastically different costs.	Beneficiaries would have choices only if they were willing to pay more than the amount provided by the federal contribution. Traditional Medicare would be phased-out for newly-eligible beneficiaries, potentially limiting their choice of plans without the assurance that they would have access to favored providers. This option would not offer consumers much choice—high deductible plans, for example. Because it would require a fairly comprehensive benefit package, potential cost savings would be limited.
9. Medicare expansion. This proposal would maintain the current structure of Medicare, but would broaden coverage to include more preventive services and long-term care. It would raise payroll taxes and add general revenue financing to cover increased costs. It would support continued research to identify effective practices and eliminate unnecessary or ineffective procedures. This option could be expanded to cover long-term care, which would at least double its eventual costs.	This option retains the near-universal coverage for vulnerable populations while addressing the coverage and out-of-pocket costs. It would reduce administrative costs by eliminating the need to keep track of multiple cost-sharing requirements and by imposing greater federal oversight and monitoring.	If Medicare is currently unaffordable, an expanded version would be even less financially viable. It would only make it harder to control costs if coverage and benefits are expanded. Medicare costs would grow even larger and, as a result, Medicare's financing would become more and more unstable.

CHOICE 6: MEDICAID AND THE STATE CHILDREN'S HEALTH INSURANCE PROGRAM



Medicaid and the **State Children's Health Insurance Program (SCHIP)** provide health insurance coverage to low-income beneficiaries: children and their parents, elderly and disabled individuals and certain other adults (e.g., low-income pregnant women). Both programs are administered by the states. Although the federal government sets broad criteria, such as minimum eligibility and benefits, the states exercise broad discretion over the programs.

- **Medicaid** is an entitlement program—federal spending rises and falls as the number of beneficiaries and the cost of health care changes. It provides health insurance coverage for 53 million people, targeted to pregnant women and children from families with incomes up to 133 percent of the federal poverty level[13], the "medically-needy" (individuals whose incomes are above the eligibility levels but who face high health care costs), and those needing long-term care if they meet income and asset tests. States can expand coverage beyond mandated populations. The program

[13] *In 2004, the federal poverty level is about $19,100 for a family of four. States are required to cover pregnant women and children under age six with family incomes up to 133 percent of poverty and children under age 19 in families with incomes below the poverty level.*

covers one-fourth of the nation's children and is the largest purchaser of long-term care services. Medicaid pays for about one-third of all births and covers Medicare premiums, co-pays, and deductible for over 5 million elderly and disabled individuals. Costs are shared with the states, which cover about 43 percent of costs. The federal government's contribution varies depending on state per capita income and ranges from 50 to 77 percent of state costs.

- **SCHIP** is a block grant that covers children from families that do not qualify for Medicaid. States' shares of the total are determined by formula. Each state can use SCHIP funds to cover more people under Medicaid or to develop other insurance programs for children. Most states assist families with incomes up to 200 percent of poverty, but they may—and many do—set higher limits. SCHIP covers 4 million children (compared with the 27 million under Medicaid). The federal block grant is capped at about $5 billion a year and does not change as the number of beneficiaries changes or as health care costs grow.

Issues

Medicaid presents lawmakers at the federal, state and local level with significant financial challenges. Medicaid and SCHIP are key elements of the social safety net. They provide access to health care for the most vulnerable segments of the population—low-income children and pregnant women, and disabled and elderly individuals. That safety net is under pressure because of the high rate of growth in health care costs. Medicaid spending grew 12 to 14 percent a year between 2000 and 2002 and another 9 percent in 2003.[14] While CBO projects that Medicaid growth will moderate to an average of 8 percent a year over the next 10 years, spending will still outpace the estimated growth in beneficiaries (1 percent per year) and annual inflation of 2 percent.

Medicaid and SCHIP are federal-state partnerships. That means that changes at the federal level can aggravate budget problems for states and localities and that state policy changes can cause federal spending to grow. The shared financial responsibility creates strong incentives to shift costs from one level of government to the other. Without restructuring, uncoordinated efforts at either level of government to contain costs can end up reducing health insurance coverage among the low-income population. That may ultimately increase the amount of "uncompensated care" that will further strain health care service providers and shift costs to private insurers.

Medicaid is the second largest item in state budgets after elementary and secondary education. It is straining state and local finances, prompting state officials to urge federal policy makers to provide fiscal relief and greater administrative flexibility. At the federal level, Medicaid's cost growth also raises serious concerns. As long as the program remains an open-ended entitlement directed by state policies, the federal government has limited control over program costs.

As with Medicare, Medicaid will continue to exert pressure on the budget over the long term. Its spending is expected to rise dramatically from today's 1.5 percent of GDP to 2.8 percent in 2040 (using CBO's intermediate assumptions).

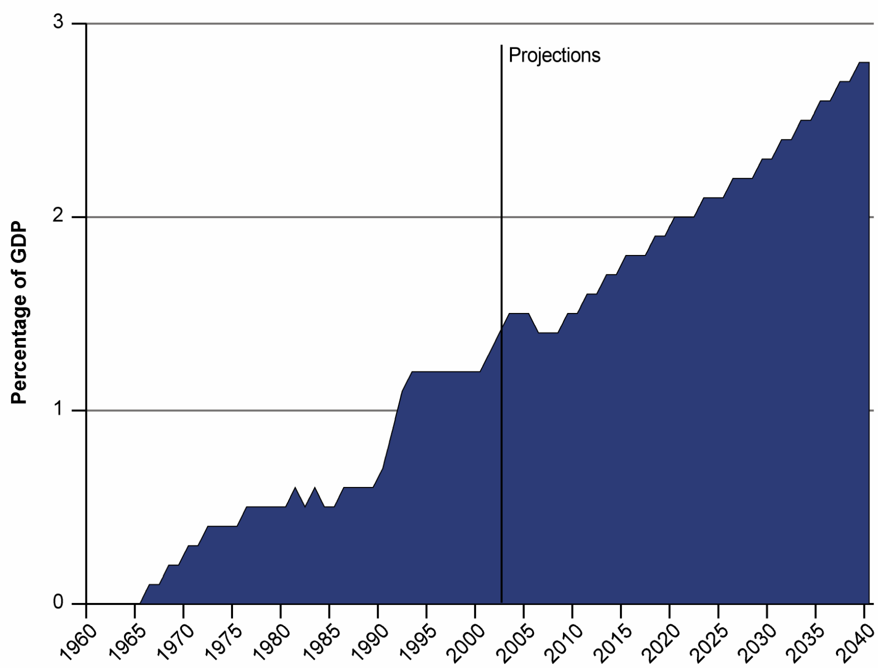
[14] *Medicaid enrollment increases when the economy is weak and more people qualify for assistance. Caseloads drop when people are able to find jobs and their incomes increase.*

MEDICAID AND SCHIP ESTIMATED SPENDING
(BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
Medicaid	182	189	201	219	238	258	2.0%
SCHIP	5	5	5	5	5	5	*
Total	**187**	**194**	**206**	**224**	**243**	**264**	**2.0%**

* Less than 0.05 percent.

HISTORICAL SPENDING FOR MEDICAID AND SCHIP
(PERCENTAGE OF GDP)



OPTIONS

SPENDING IN BILLIONS OF DOLLARS

	2005	2006	2009	2014	Percent of GDP in 2014
Exercise baseline spending level	187	194	243	367	2.0%
Policy Options (Projected changes to baseline spending levels)					
1. *Exercise* baseline	0	0	0	0	0.0
Incremental Measures					
2. Reduce federal match for high income states	-5	-5	-7	-11	-0.1%
3. Convert DSH payments to block grants	-1	-1	-1	-1	*
4. Reduce federal payments for state administrative costs	-2	-3	-4	-7	0.0%
Structural Reform Options					
5. Medicaid block grants	-7	-13	-36	-97	-0.5%
6. Reallocate federal-state responsibilities	27	27	40	78	0.4%

- Less that 0.05 percent.

PROS & CONS

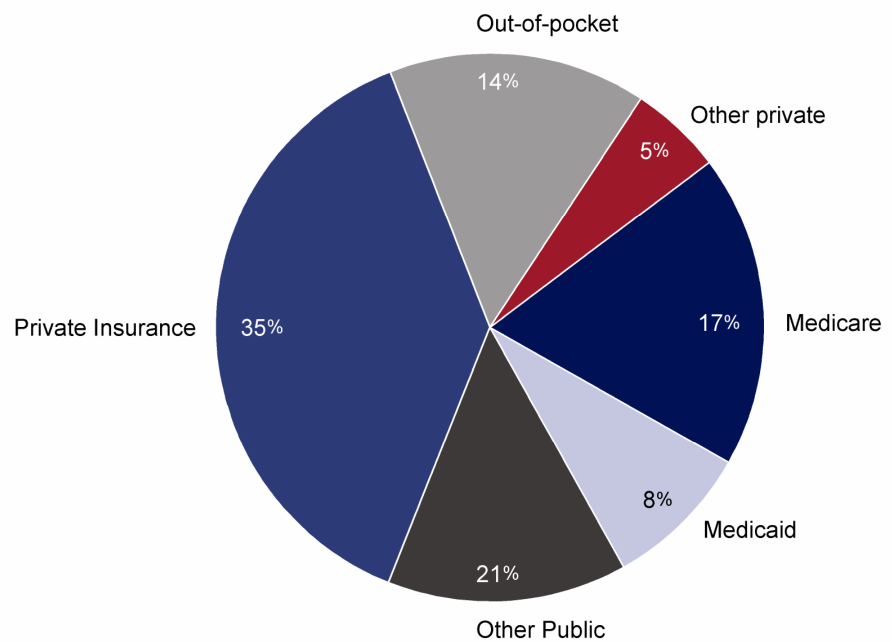
In this section of the Exercise you may consider incremental or structural changes to Medicaid.

Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
1. *Exercise* Baseline. This option assumes funding at the currently authorized level for Medicaid and SCHIP and continues funding for discretionary health programs at the level enacted for 2004, adjusted annually for inflation. This option would provide over $250 billion in spending in 2005, growing to $454 billion in 2014.	Current policy represents the best course until we reach a consensus about the larger issues of how to expand health insurance coverage and control the growth in health care costs. Health care financing is complex. Changes to one area could be disruptive in others, unintentionally raising costs or restricting access to care. Too much tinkering with Medicaid and SCHIP could adversely affect the most vulnerable populations.	The current policy is not sustainable. Medicaid costs are growing at over 8 percent a year, with the fastest growth in long-term care. If we don't fix Medicaid before the boomers become eligible for long-term care, costs will explode. Additionally: 19 percent of poor children are uninsured; and costs are increasing to the point where states are freezing SCHIP and cutting back optional coverage in Medicaid.

Incremental Measures		
2. Reduce the Federal match for high-income states. The federal share of a state's Medicaid cost varies depending on state per capita income and ranges from a floor of 50 percent to a ceiling of 77 percent. This option would drop the floor to 45 percent, lowering the matching share for the highest-income states. Thirteen states are currently at the floor rate of 50 percent: California, Colorado, Connecticut, Delaware, Illinois, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, New York, Virginia, and Washington.	The floor unnecessarily protects the most well-off states. Reducing it to 45 percent would better reflect differences in state per capita income. If savings are needed, it makes more sense to lower federal payments to more affluent states, which are more likely to offer expanded benefit packages, are more likely to have the budgetary capability to absorb funding decreases.	Because high-income states are likely to have higher costs of living, making up for cuts in federal funds is not any easier for them. The cost of health care services is greater than in low-income states. Federal cuts could result in less access to care for low-income people, who already have a difficult time surviving in places where it costs more to live.
3. Convert disproportionate share hospital (DSH) payments to block grants. The federal government provides higher payments to hospitals that serve large numbers of low-income payments. DSH payments total over $8 billion. Although they must conform to federal guidelines, states determine which hospitals are eligible for the DSH payments and how much they receive. DSH payments are capped but are annually adjusted for inflation. This option would cut DSH payments by 10 percent in the initial year and adjust them to the consumer price index minus 1 percent in subsequent years.	States could use block grants to provide cost-effective care instead of relying on more rigid DSH payments, which can only be used to reimburse hospitals that serve large numbers of low-income patients. States could, for example, use the funds for outpatient clinics and other care providers in non-hospital settings.	Large, public hospitals are likely to lose funds under this option. That could damage an already fragile health care system in many low-income areas. Besides, states already have enough flexibility under the current DSH system to accommodate efficient, non-hospital care providers.
4. Reduce federal payments for state administrative costs. The federal government shares the costs of administering Medicaid, Temporary Assistance for Needy Families (TANF), and food stamps with the states. The programs have some administrative procedures in common (e.g., gathering financial and demographic information from applicants). Before TANF was enacted, states generally charged the cost of those common tasks to Aid to Families with Dependent Children (AFDC). Although those common charges are now embedded in TANF allocations, states are required to charge a portion of those costs to Medicaid—essentially paying states twice for the same expenses. This option would impose a per capita cap on federal contributions for state administrative costs based upon what states spent in 1996 (before TANF), less any common costs allocated to AFDC, and adjusted by a growth rate of 5 percent a year. This option produces large savings because eliminating the common costs lowers the base amount and grows it at a slower rate than the 7-8 percent included in the baseline.	This option would eliminate what are arguably double payments for the same expenses (common costs included in TANF grants and charged to Medicaid) and provide an incentive for states to become more cost-efficient and productive in their administration of Medicaid.	Cutting administrative expenses could deprive states of the resources required to administer Medicaid effectively—for example, medical professionals to review the delivery and utilization of services, resources to upgrade management information systems, etc.

Structural Reform Options		
5. Medicaid Block Grants Block grants would replace the open-ended individual entitlement. States would choose whether to accept block grants or remain with the current structure. States would have to stay in the block grant program for at least five years and maintain their contributions at least at the same level as when they entered the program. The proposal would allow states greater flexibility in how they provide health insurance. For example, as long as they guaranteed a minimum standard package for those who are currently entitled to Medicaid, states could combine Medicaid and SCHIP, broaden coverage to a wider population, and modify their benefit packages without federal approval. The federal contribution would be based upon current state spending, adjusted annually for the medical consumer price index. That would produce savings over 10 years for the federal government because CBO estimates that Medicaid will grow faster than the index. State budgets would be better off if state officials could manage health insurance programs more efficiently than under the current array of programs and requirements. They would, however, be at risk financially if they could not exert enough control over costs to stay within federal allotments.	Block grants would provide a stable, inflation-adjusted level of funding for the states. The loss of the individual entitlement would not be a problem because all currently eligible populations would be protected. The combination of Medicaid and SCHIP funding would make it easier for the states to design more seamless programs to cover a range of populations. Currently they have to ask Washington for waivers to regulations to provide services in ways not anticipated by the Medicaid statutes. In addition, states could better coordinate access to Medicaid with its income support programs, making it less confusing to beneficiaries trying to navigate available programs and benefits.	Block grants are a backdoor way to cut federal funding. Although initial funding would be at or above the current law level, the federal government would save over time as medical costs rise faster than the inflation-adjusted block grants. Without the individual entitlement provided by Medicaid, people who are currently eligible for assistance could lose coverage if states run short on funding. States would be fully exposed to adverse economic conditions and forced to cut benefits at times when expanded assistance is needed. In addition, there would be more political risk because federal policy makers could find it easier to cut block grants than to cut entitlements.
6. Reallocate federal-state responsibilities. The amount of discretion exercised by states leaves the federal government with few means to control Medicaid costs. This option would separate federal and state responsibilities for covering different Medicaid populations. The federal government would assume full responsibility for low-income aged, blind, and disabled people, and the states would assume full responsibility for low-income families and other adults. This option would discontinue payments to the states on behalf of children and adults and terminate SCHIP block grants, but the states would save more than they would lose if they no longer have to pay for aged, blind, and disabled beneficiaries who have higher health care needs. (Those beneficiaries are only one-fourth of the current Medicaid population but account for 72 percent of the cost of acute and long-term care services.) States would be able to use their savings to broaden coverage to uninsured residents, to improve coordination with income support programs, or for other purposes. Although the federal government would pick up higher-cost populations, it would be able to integrate better its health care coverage with coverage provided through Medicare. That should streamline administration and reduce gaps in coverage.	The federal government, through Medicare, Social Security and Supplemental Security Income (SSI), is already responsible for the needs of people who are older, blind, or disabled. The federal government could assume full responsibility for health care coverage for the low-income aged, blind, and disabled people who are currently eligible for Medicaid and Medicare coverage. That would simplify the design and administration of health insurance programs for those populations. Now, whenever there is an effort to improve Medicare policy, makers must factor in potential effects on the Medicaid (or "dual-eligible") population. This option would allow states to focus on low-income children and families, populations that they are experienced with serving. The savings realized by the states would provide welcome fiscal relief and could be allocated according to individual state priorities.	If the federal government assumes full responsibility for the aged, blind, and disabled population currently covered by Medicaid, it would pick up the most costly beneficiaries and relieve the states of any financial responsibility for those populations. Over the longer term as the baby boomers retire and become eligible for long-term care, states would receive a substantial "windfall" because they won't have to pick up a share of those costs. If the federal government pays for benefits provided under Medicaid (especially long-term care assistance) for some people, there could be pressure to provide those benefits to all, which would increase federal costs dramatically. If the states assumed full financial responsibility for low-income children and families, the federal government would lose its ability to assure that those individuals have adequate access to health care services.

CHOICE 7: HEALTH INSURANCE COVERAGE



Note: Katherine Levit, Cynthia Smith, Cathy Cowan, Art Sensenig, Aaron Catin, and the Health Accounts Team, "Health Spending Rebound Continues in 2002," *Health Affairs,* Vo. 23, Number 1, January/February 2004.

There are three ways to obtain health insurance coverage in the United States: employment-based plans; public programs like Medicare, Medicaid, and State Children's Health Insurance Program (SCHIP); and direct purchase by individuals. The largest source of coverage is employment-based plans, which cover 60 percent of the population. Government-sponsored insurance covers another 26 percent. Individuals who purchase coverage directly represent another 9 percent. [15]

Although most people are covered through private, employer-sponsored coverage, the federal government provides them with an important subsidy. The tax code allows individual taxpayers to exclude from their taxable incomes amounts employers contribute for insurance and medical care. That tax expenditure is the largest single tax benefit provided under current law. The favorable tax treatment of employer-sponsored health insurance reduces the cost of health insurance

[15] *Percentages add to more than 100 percent because some people have more than one source of coverage. Estimates of health insurance coverage and the number of uninsured from* Income, Poverty and Health Insurance Coverage in the United States: 2003*, U.S. Census Bureau, August 2004.*

coverage for employees. It also allows employers to provide tax-free compensation to workers and gives employers an incentive to sponsor coverage. That same tax advantage is not available to workers whose employers do not sponsor health insurance plans. The self-employed, who have to pay for insurance on their own, only receive half the tax benefit of employees who are covered through their jobs. Other tax provisions allow deduction of medical expenses once taxpayer spending reaches a specific threshold.

ESTIMATED TAX EXPENDITURES
(BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
Exclusion of employment-based benefits	113	121	130	140	150	n.a.	n.a.
Deductibility of medical expenses	8	8	9	10	11	n.a.	n.a.

"n.a." = not available

ISSUES

Nearly 16 percent of the population does not have any type of health insurance coverage. Lack of coverage prevents people from obtaining care on a timely basis and shifts the cost of the care they do obtain to private insurers and public budgets. Proposals to expand health insurance include extending coverage under existing federal programs like Medicare and Medicaid, providing additional tax incentives to encourage private insurance, and converting to a government-financed, or single-payer, system.

Health insurance diffuses risks and shares costs. From an individual's perspective, there are only two ways to keep health costs low: stay healthy and avoid paying for someone else's care; and if care is required, spread its costs over as wide a population as possible. From societal point of view, health care financing is more complex. A stable system depends on everyone paying a share whether they are currently ill or not. If only those who need health care were willing to buy coverage, they would not be able to afford it. Most Americans believe that everyone should have access to health care, regardless of their ability to pay for it. They also believe that everyone should, to the extent they are able, contribute to the cost of the nation's health care.

Policy makers face the challenge of controlling costs while preserving individual choice and maintaining the quality of care. To keep the system affordable, the use of the health care system has to be limited to medically-necessary and cost-effective care. To preserve individual choice, consumers must be able to make informed decisions. Efforts to expand health insurance coverage have implications for overall health care costs and the array of available choices. Any changes could produce winners (better access to health care for the currently uninsured and lower costs from reduction in "uncompensated care"–the costs incurred treating the uninsured that are shifted to private insurers) and losers (reductions in individual coverage, and higher costs paid for in the form of premiums, taxes or higher deficits).

The *Exercise* shows the impact of proposals to expand health insurance on both the federal and national health expenditures. Expand health insurance coverage would affect both: national health care costs because people with insurance are more likely to use services; and the federal budget because more spending or greater tax incentives will affect projected deficits. Some proposals would appear more costly because they would bring a greater percentage of costs into the federal budget, while offsetting reductions in private costs would be less visible.

OPTIONS

DEFICIT IMPACT IN BILLIONS OF DOLLARS

	2005	2006	2009	2014	Percent of GDP in 2014
Policy Options Projected impact on the deficit					
1. *Exercise* baseline	0	0	0	0	0.0%
2. Expand Medicaid Eligibility	20	33	55	88	0.5%
3. Tax Credits instead of Tax Exclusion	114	121	140	175	0.9%
4. Pay or Play	66	74	101	168	0.9%
5. Fully-Tax Financed System	46	47	41	19	0.1%

The following proposals are representative of major approaches to expand health insurance coverage. To provide consistent estimates across the plans, all budget effects, national health spending projections, and reductions in the uninsured are based on the work of John Sheils and Randall Haught.[16] In addition to the brief descriptions below, the following pages contain more information on each approach.

Note: increases in federal costs are greater than the increases in national health spending. That is because under each proposal costs that are currently paid for with private funds and are off-budget would be shifted to public (tax) financing. As a result, the budget costs reflect more than the cost of newly-covered individuals.

1. Exercise Baseline. Aside from tax expenditures under existing law to encourage private health insurance coverage, the baseline does not include any direct spending to expand coverage.

2. Expanding Medicaid Eligibility. Would expand coverage to individuals and families whose incomes are currently too high to qualify for Medicaid benefits. People with incomes up to 150 percent of the poverty level, or $28,650 for a family of four, would automatically be covered. (Medicaid currently covers pregnant women and children in families with incomes up to 133 percent of the poverty level.) Those with incomes between 150 and 300 percent of the poverty level ($28,650 to $57,300 for a family of four) could buy into Medicaid by paying premiums that would increase with income. In addition, the option would provide refundable tax credits to small businesses that employ fewer than 50 low-income workers. Participation would be voluntary. This option would expand coverage to about **29 percent** of the uninsured.

3. Tax Credits Instead of Tax Exclusion. Converting the tax exclusion to refundable tax credits would provide people with tax credits for health insurance premiums and out-of-pocket spending but would include employer contributions for health insurance in taxable income. Currently, employer-paid health benefits are not included in employees' taxable incomes and are not subject to payroll taxes. This proposal would provide a refundable tax credit that would give a larger credit to lower-income people. Credits would only be provided for health insurance plans that provided a minimum level of benefits. To help states expand coverage, the proposal would also convert Medicaid to a block grant, adding $6 billion to the current funding level plus any unclaimed tax credits. Health insurance coverage would remain voluntary. An estimated

[16] *John Sheils and Randall Haught,* Cost and Coverage Analysis of Ten Proposals to Expand Health Insurance Coverage, *http://esresearch.org/covering_america.php, October 2003. The* Exercise *adjusts the estimates to reflect more recent projections of health spending and assumed implementation in 2005 instead of 2002.*

64 percent of the uninsured would obtain coverage.

4. Pay or Play. A "pay or play" plan would require employers either to provide employees with health insurance coverage or to pay a payroll tax to cover their employees under a new public program, which would replace Medicaid/SCHIP. Workers would be required to accept employer coverage or would be covered through the new public program. Non-workers would be required to have insurance and could enroll in the public program. The new public program would allow participating individuals a choice of private plans meeting a minimum national standard. An estimated **88 percent** of the uninsured would obtain coverage.

5. Fully Tax-Financed System. A fully tax-financed system would provide federal grants to states to cover their residents. The grants would be financed with payroll taxes totaling 9.4 percent—employers would contribute 7 percent of payroll and workers would contribute 2.4 percent of before-tax pay. Medicaid/SCHIP funding for acute care services would be discontinued and those services would be covered under the new program. States would be required to contribute state funding equal to 90 percent of their spending for Medicaid/SCHIP and low-income Medicare beneficiaries. With the combined federal-state funds, states could create a single-payer system (state-run plan) or create insurance pools that offer a choice of private plans. All plans would have to offer a minimum package of standard benefits. An estimated **96 percent** of the uninsured would be covered under this approach.

COMPARISON OF PROPOSALS TO EXPAND HEALTH INSURANCE COVERAGE

	Option 2. Medicaid Expansion	Option 3. Tax Credits	Option 4. Pay or Play	Option 5. Fully Tax-Financed
Change in the number of uninsured (millions)	-12.0	-26.9	-36.7	-40.3
Percentage reduction in uninsured	-29%	-64%	-88%	-98%
Amount of federal funding				
First year: new federal grants, subsidies and tax credits ($ billions)	20	114	66	591
10th year: new federal grants and tax credits ($ billions)	88	175	168	953
10th year: new federal cost (percent of GDP)	0.3%	0.9%	0.9%	5.2%
Change in national health spending				
First year: change in national health spending ($ billions)	28	25	62	33
10th year: change in national health spending ($ billions)	57	-134	102	-163
10th year: change in national health spending (percent of GDP)	0.3%	-0.9%	0.6%	-0.9%

Source: CRFB based on estimates by John Sheils and Randall Haught, October 2003.

PROS & CONS

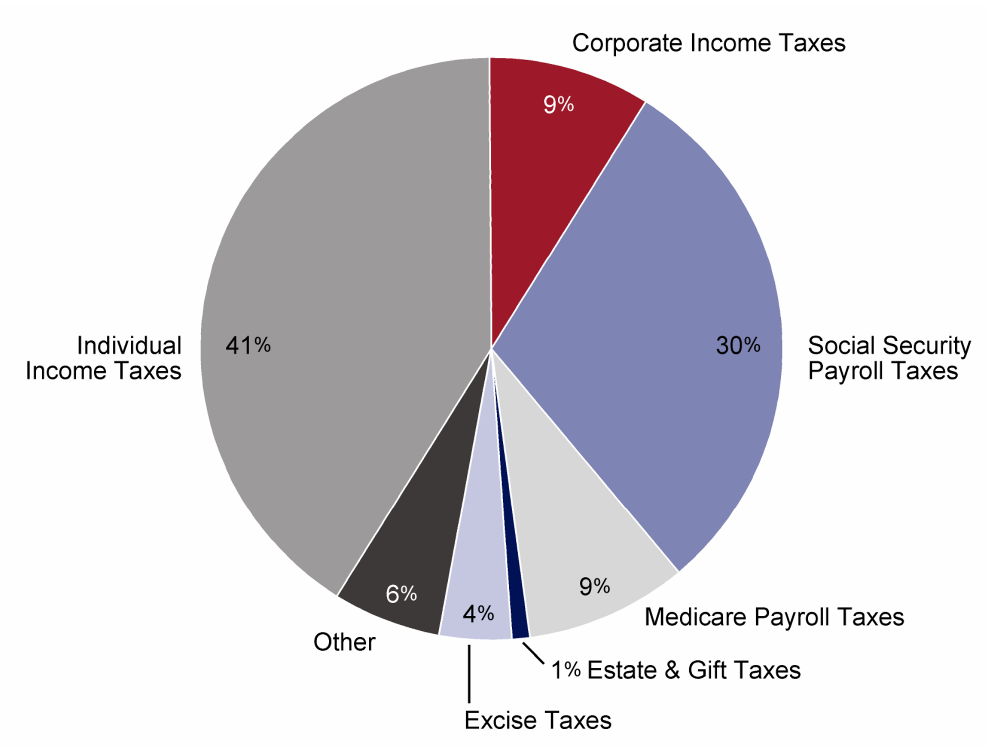
Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
2: MEDICAID EXPANSION. This option would use existing approaches to achieve a modest expansion in health insurance coverage. The Medicaid/SCHIP expansion would help those who do not have access to employment-based coverage. The tax credits would help employers that want to offer benefits but can't afford the current cost of small group coverage. ▪ The plan would raise the income cut-off levels for Medicaid and SCHIP so that families with incomes below 150 percent of the poverty level would be eligible for Medicaid, and families with incomes between 150 and 300 percent of the poverty level could buy into the Medicaid/SCHIP program with income-related premiums. Roughly two-thirds of the uninsured would be eligible for coverage—about 24 million people would be eligible for free coverage; another 45 million could purchase coverage. ▪ Medicaid/SCHIP would continue to operate as state-administered programs. The federal government would match the additional costs that states would incur as a result of higher enrollments. ▪ Under the plan, firms who employ fewer than 50 people would receive tax credits. The amount of health insurance costs subsidized through the credits would vary by size of firm and average salary. Very small firms (fewer than 10 workers with an average salary of less than $10,000) would receive a credit of 50 percent of costs. A firm with 45 workers with average salaries of less than $10,000 would receive a credit worth 6.3 percent of premiums; while a firm with fewer than 10 workers, with an average wage/salary of $25,000-$30,000, would receive a 12.5 percent subsidy. An estimated 13 million people would be eligible for the tax credit; almost 7 million would obtain coverage, but an estimated 6 million of those are already covered under employer-sponsored plans.	**Targets those lacking health insurance -** This proposal would target the income categories that are most likely to lack health insurance—low and lower-middle income workers and families with annual incomes below $50,000. **Voluntary Plan -** The plan would be voluntary and does not impose any new mandates on employers or consumers. **Those most in need of insurance will be covered -** The 29 percent of the uninsured that would be covered would most likely be those most in need of assistance—those with high health costs who face expensive options in the individual insurance market; small employers with lower-wage workers; non-custodial, low-income adults; working poor families and children.	**Duplicates available coverage -** This option would largely duplicate coverage that is already available. Almost 70 million people would be eligible for coverage under the plan, but only an estimated 19.4 million would enroll because the others have other coverage. **Workers would shift to Medicaid and SCHIP -** Some employers would drop their health plans and shift their workers to Medicaid and SCHIP. The plan would also add to the fiscal burdens of states, further reducing their budgetary flexibility. **Makes insurance more affordable -** The problem faced by small employers can be solved at less cost to the taxpayer by pooling arrangements that would spread costs over many employers and make insurance more affordable.
OPTION 3: TAX CREDITS. This plan would eliminate the favorable tax treatment for employer payments for health insurance and replace it with refundable tax credits for health insurance premiums and out-of-pocket health spending. The proposal seeks to remove the incentive to maximize the amount of health expenses covered by insurance, which many economists believe leads to more comprehensive coverage that insulates consumers from costs and drives up spending. ▪ The plan would provide a refundable tax credit to individuals that would vary by income: taxpayers	**Tax credit for health insurance -** By making it taxable, this option would put employment-based health insurance on a comparable level to cash income. It would remove the appearance that health insurance is something the employer provides for "free." Employers and employees would no longer	**Deductible and other costs expensive -** This minimum benefit package would include 20 percent coinsurance and high deductibles ($1,000 per individual and $2,000 per family). That would appeal to consumers because it would appear to be less expensive. However, even with the

Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
would receive a credit of 25 percent of costs amounting to up to 5 percent of income; a 40 percent credit for costs between 5 and 15 percent; and 60 percent of costs over 15 percent of income. The maximum credit would be $5,000 per individual or $12,000 per family. Costs would include health insurance premiums, whether paid by employers or contributed by employees, and out-of-pocket expenses. ▪ Lower-income workers (income under $20,000) could opt for a $1,000 per adult, $500 per child, or $2,500 per family maximum credit. ▪ The credit would only be available for health plans meeting a standard minimum benefit level. ▪ The income tax and payroll tax exclusion for employer-paid health benefits and health spending from flexible spending accounts would be eliminated, as would the health expense deduction. ▪ Insurance market rules would prevent discrimination on the basis of health status. ▪ Medicaid would be converted into a state block grant. The federal government would increase its contribution by $6 billion plus the value of unclaimed tax credits. That would allow states to expand coverage to people who do not have access to employment-based coverage.	favor better health insurance plans over wages and salaries. **Slows overall cost growth -** The plan would make people more cost conscious and exercise more care over their use of health care services, thus slowing the overall cost growth. **Voluntary health plan -** The plan would be voluntary. Employers would not have to pay for coverage, but they would have to facilitate coverage—e.g., handle the administration of plan enrollment, premium payments, etc.	tax credit, individuals could find themselves without the resources to meet the deductibles and out-of-pocket costs **Select policies on price not needs -** Higher apparent costs could discourage people from seeking necessary care or to select policies solely based on price, not on what best suits their needs. That would put more pressure on lower-wage and salary earners than those with higher incomes who do not have to worry about other competing claims on their incomes.
OPTION 4: PAY OR PLAY. This option would mandate that employers contribute towards the cost of their employees' health insurance either through plans they sponsor or through the payment of a payroll tax that would support coverage under a new public program administered by the states. Employees would either have to accept enrollment in their employer-sponsored plans or enroll in the public program. ▪ Employers who "play," or provide health insurance, would have to offer minimum standard benefit package and cover 85 percent of the cost of workers' coverage (and 75 percent of the cost of covering dependents). ▪ Employers who don't provide health insurance would pay a 7.7 percent payroll tax. The payroll tax would support coverage offered through an insurance pool offering a choice of private health plans. Each plan would provide a standard minimum benefit package established by a national board. ▪ Employees who are enrolled in the public program would pay a 3.3 percent payroll tax. Low-income workers would receive premium subsidies: those with incomes below the poverty level would receive a 100	**Ensures contribution by employers to employee coverage -** This option would assure that all employers contribute towards employee coverage. Currently, firms that don't offer health benefits shift costs to firms that do. That is because insurance costs reflect the cost of "uncompensated care"—the costs associated with health care provided to the uninsured. **Employer incentives for cost-efficiency -** The proposal provides incentives for employers to be cost-efficient in their health plan offerings. They realize tax savings if they can provide coverage at less cost than	**Continues health insurance mandates on employers -** This option further distorts the health insurance and labor markets by imposing mandates on employers instead of individuals. There is no reason other than historical accident that health insurance is largely employment-based.[17] **Increase employment costs -** Imposing an employer mandate will adversely affect job creation by increasing employment costs. Firms that currently don't provide coverage largely can't afford to because they have low profit

[17] *The link between employment and health insurance was created during World War II when wage and price controls prevented firms from raising wages and salaries to attract and retain employees. They began offering health benefits instead. Since then, health insurance has become a customary component of compensation. Employment-related coverage has expanded to cover about 60 percent of the population.*

Option	Arguments In Favor of Each Option	Arguments Opposed to Each Option
percent subsidy and no cost sharing. The subsidy would phase-out between 100 and 200 percent of the poverty level. Employees could choose better benefit packages if they were willing to pay additional premiums (with after-tax dollars).	they would have to pay in payroll taxes.	margins.
OPTION 5: A FULLY TAX-FINANCED SYSTEM. This option would finance health insurance through federal taxes on payroll. The payroll tax receipts would be allocated back to states to cover their residents, either through a single-payer framework or through the creation of insurance pools offering a choice of private health plans. This plan would shift health insurance costs onto the federal budget that are currently not classified as federal. Those amounts would be offset by reductions in private financing. Overall, national health spending would be roughly 1 percent lower as a percentage of GDP than baseline projections. ▪ The total payroll tax would be 9.4 percent: 7 percent paid by employers and 2.4 percent paid by employees. The tax rate would be set to produce 95 percent of the cost of health benefits provided under the plan. Workers' payments would be excluded from taxable income. Firms employing low-wage workers would pay 2 percent less. ▪ States would design plans that would meet minimum federal standards, including guaranteed coverage of 98 percent of the state's legal residents, and would be penalized if they did not meet them. ▪ States would be expected to maintain a level of financial support of at least 90 percent of amounts currently spent for Medicaid/SCHIP. The federal government would provide block grants to states to cover the cost of services now provided to children under Medicaid/SCHIP that would not be covered in the new benefit package. ▪ Federal payments for Medicaid/SCHIP acute care would end. The federal government would pay the difference between the cost of state coverage and state contributions. If the difference between a state's contributions and expected costs is greater than 20 percent, the federal government would share the savings or additional costs and would pay 80 percent of costs that exceed 50 percent of state contributions. Federal funding would be annually appropriated, but the growth in funding would at least be equal to the five-year growth rate in per capita Medicare spending. ▪ Individuals would pay no additional premium for the basic plan. People could obtain better coverage and lower out-of-pocket costs, but would have to pay more for it.	**Eliminates employment and health insurance link -** This option would sever the link between employment and health insurance coverage. It would eliminate "job lock" (because benefits are not portable), cost shifting between employers, and many problems facing small employers (e.g., high cost of plan administration, small risk pools). **Fix many insurance market problems -** The plan would fix many problems associated with the current insurance markets: adverse risk selection or "cherry picking" to eliminate likely high-cost enrollees; and reduce administrative costs.	**Increase size of federal government -** This option would greatly expand the size and scope of the federal government. It would grant politicians vast control over people's health care and inevitably will interfere with individual choices and the quality of care. **Cost containment may lead to reduced quality care -** Cost containment comes from controlling the standard benefit package. If political pressures favored better benefits, public costs would increase. If public budgetary pressures prevailed, people could face erosion in their health benefits and, unless they could afford it, reduced access to good quality care.

CHOICE 8: REVENUES



ESTIMATED RECEIPTS
(BILLIONS OF DOLLARS)

	2005	2006	2007	2008	2009	2010	Percent of GDP in 2014
Individual income taxes	923	1,031	1,110	1,183	1,273	1,376	10.6%
Corporate income taxes	227	249	251	255	258	261	1.5%
Social insurance taxes	792	836	877	916	958	1,001	6.4%
Excise taxes	74	76	77	79	82	83	0.5%
Estate and gift taxes	22	26	24	26	26	19	0.3%
Customs duties	22	24	25	27	28	30	0.2%
Miscellaneous receipts	34	37	42	46	49	51	0.3%
Total	**2,094**	**2,279**	**2,406**	**2,531**	**2,673**	**2,821**	**19.8%**

Over the last 40 years, the federal government has collected revenues averaging 18.2 percent of GDP. Individual income taxes provide the largest share of the total, followed closely by social insurance taxes, for Social Security and Medicare. Generally, tax receipts vary with the overall economy. Revenues rise when the economy expands and personal and corporate income grow. Revenues fall when the economy slows down. Because of lags, adjustments in behavior, and tax laws, government receipts can change more rapidly or slowly than GDP.

In FY 2000, the budget recorded a record surplus of $236 billion, or 2.4 percent of GDP. That year, revenues exceeded $2 trillion and totaled approximately 20.9 percent of GDP—both record high levels. For FY 2004, revenues were $1.9 trillion, or 16.2 percent of GDP. That put revenues at their lowest level of GDP since 1951. The decline in the stock market that began in 2000, the 2001 recession, and tax cuts enacted in 2001, 2002 and 2003 all contributed to the drop in revenues. According to CBO's estimates, FY 2004 revenues will be almost $640 billion below the level it projected in January 2001. CBO estimates that about 58 percent of the shortfall stems from changes in economic and technical factors. Approximately 42 percent of the change can be attributed to tax cuts.

There are two major issues in today's budget debate: 1) whether to raise or lower taxes; and 2) whether to overhaul the entire tax system. The *Exercise* does not address the second option. Fundamental tax reform—the way in which the federal government taxes—is a separate topic from deciding how much aggregate revenue the government raises. Any tax system—whether a national sales tax, a consumption-based income tax, a flat tax, or a broader-based progressive income tax—can be designed to raise a targeted level of aggregate revenue. While a different system could radically alter the distribution of the tax burden and change incentives to work, save, and invest, it should be considered on its merits—not as a way to raise or lower the federal government's aggregate receipts.

Under current laws, CBO projects that revenues will rise gradually over the next 10 years, from their current level of 16 percent of GDP to 20 percent in 2014. However, those projections assume that the 2001-2004 tax cuts expire as scheduled. If they are extended, federal revenues would be 1.5 percentage points of GDP smaller than the baseline projects for 2014—or 18.5 percent of GDP.

Major Elements in the Revenue Debate

Sharp differences of opinion characterize the debate over revenues. Some proponents of raising taxes are being pragmatic—deficit reduction cannot be successfully accomplished solely through cutting spending. Revenue proposals, however, also reveal divergent views about the size of government and who should pay for it. At the core of the debate is the question of whether overall economic well-being is enhanced or restrained by federal activities. Those who believe in a smaller role for the federal government would limit receipts as a way to constrain government spending. Those who believe in a larger role for government would raise receipts to pay for it. In addition, there are conflicting views on ways to raise taxes. Different forms of taxation affect population subgroups differently.

The 2001 and 2003 Tax Cuts

In January 2001, CBO's baseline projected budget surpluses totaling more than $5.6 trillion between 2002 and 2011. In May 2001, the Congress and President enacted the **Economic Growth and Tax Relief Reconciliation Act of 2001** (known as "**EGTRRA**"), which phased in significant tax cuts. EGTRRA was projected to cost an estimated $1.3 trillion over the 2002-2011 period (not including the interest savings foregone if the resources had been used instead to pay down the publicly-held debt). The economic outlook subsequently deteriorated rather significantly: the stock market fell; the economy entered a recession; and the events of September 2001, followed by military action in Afghanistan and Iraq, contributed to a far less robust economy. In 2003, lawmakers enacted the **Jobs and Growth Tax Relief**

Reconciliation Act (**JGTRRA**). That law intended to stimulate the economy by accelerating the phase-in of some of the EGTRRA tax reductions and by cutting rates individuals pay on dividend income and capital gains.[18] JGTRRA's 10-year cost was estimated at $271 billion (excluding debt service).

In October 2004, **The Working Families Tax Relief Act of 2004** extended the major components of the temporary tax relief enacted in JGTRRA, including the $1,000 child tax credit, marriage penalty relief, and the new 10 percent rate bracket.

The President has proposed to make the 2001 and 2003 tax cuts permanent. If the tax cuts are extended, most of the budgetary impact would not occur until 2011 and later because the CBO baseline assumes that the tax cuts will expire as scheduled by December 2010 or earlier. If the cuts are repealed, the revenue gains from reversing the cuts would occur before 2011 and be temporary because the baseline assumes that they expire in December 2010, if not before.

MAJOR PROVISIONS OF EGTRRA AND JGTRRA

Changes in the areas highlighted below account for almost 95 percent of the revenue reductions resulting from EGTRRA. As the table below shows, the changes were originally scheduled to phase-in at different rates. All of the changes were scheduled to expire (revert to their pre-existing levels) by the beginning of calendar year 2011.

Individual Income Tax Rate Reductions - EGTRRA phased in reductions in individual tax rates between 2001 and 2006. JGTRRA accelerated the phase-in of some of those provisions (see table 5).

Expanded Child Tax Credits - EGTRRA expanded the refundable child tax credit, from $600 per child in tax years 2001-2004, to $700 in 2005-2008, to $900 in 2009, and to $1,000 per child in 2010 and later. JGTRRA increased the credit to $1,000 for 2003 and 2004 only. The credit would have reverted back to the original phase-in schedule after December 31, 2004. However, in October 2004 the $1,000 credit was extended through 2009. Eligibility for these tax credits begins to phase out for single tax payers (heads of households) with incomes above $75,000 and for joint filers with incomes above $110,000.

Marriage "Penalty" Relief - Many married couples who file jointly face higher taxes than they would if they could file as individuals or heads of households. (More couples receive a marriage "bonus.")[19] Between 2005 and 2009, EGTRRA increased the standard deduction for married couples from 166 percent of that of a single filer to 200 percent. It expanded the 15 percent tax bracket for joint returns between 2005 and 2007 so that the upper limit on income taxed at the 15 percent rate on joint returns would equal 200 percent of the limit for single filers. The 2001 changes also phased in a $3,000 increase for joint returns in the earnings limitation that determines eligibility for the earned income tax credit. Previously, the same earnings limitations applied to single and married individuals. JGTRRA accelerated the phase-in in the standard deduction and the 15 percent bracket provisions to 200 percent for 2003 and 2004. The provisions would have reverted back to the EGTRRA phase-in schedule in 2005. However, in October 2004 the marriage penalty relief was extended through 2008.

Elimination of Estate Taxes - Estate taxes are taxes charged to the estate of a person who has died, before any of that person's estate has

[18] *A smaller tax cut bill was enacted in 2002—the Job Creation and Worker Assistance Act. It contained special depreciation-expensing allowances for specific property and tax benefits for New York City (intended to help spur economic recovery in areas affected by the September 2001attack). CBO estimated that the legislation would cost $262 billion over 10 years (2004-2013).*

[19] *CBO estimated that in 1999 60 percent of married couples received a marriage bonus averaging $1,600 while 40 percent faced a marriage penalty averaging $1,480. Higher income couples were more likely that lower income couples to receive penalties than bonuses. Approximately 70 percent of penalties and bonuses affected couples with incomes of $50,000 or more.*

been transferred to others. Prior to 2001, estates in excess of $1 million were taxed at a maximum rate of 50 percent. EGTRRA gradually increased the exemption to $3.5 million and lowered the rate to 45 percent in 2009, before eliminating the estate tax completely in 2010. (Estate taxes are scheduled to return to their pre-2001 level in 2011.)

Expanded Education IRAs and other education-related changes - IRAs, or Individual Retirement Accounts, allow qualified wage earners to invest income that will grow tax-deferred, meaning they won't pay taxes on the earnings until they take the funds out of their accounts when they are retired, earn less income, and are likely to pay taxes at a lower rate. For many, the contribution itself is tax-deductible. Education IRAs allow parents and guardians to make nondeductible contributions to an education fund for children under the age of 18. These funds can be withdrawn tax free when they are needed to pay education and certain other costs. EGTRRA increased the annual contribution limit to educational IRAs from $500 to $2,000. Tax filers are eligible to deduct contributions if their incomes fall below specific limits. For married couples who file jointly, EGTRRA raised the phase-out range to be twice the phase-out range that applies to single filers. The 2001 act also included a number of other provisions related to education, such as permanently extending the exclusion of employer assistance for undergraduate and graduate coursework and increasing the deduction for qualified higher education expenses in 2002-2005.

Lower tax rates on dividends and capital gains - While money in a bank earns interest, money invested in stocks can earn dividends, and growth in the value of financial and physical assets (i.e., land and real estate) over a qualifying time-period is termed capital gains. Previously, dividends were taxed at the same marginal rates as ordinary income (15 to 35 percent) and capital gains were taxed at 8, 10, and 20 percent. JGTRRA cut the tax rate for individuals on capital gains and dividends for qualifying investments to 5 and 15 percent through 2007 (0 and 15 percent in 2008).

TABLE 5. 2001 AND 2003 CHANGES TO INDIVIDUAL INCOME TAX RATES

PRIOR LAW		2001 EGTRRA		2003 JGTRRA
Rate	Income range over which rate applies: Tax Year 2001	Rate	Income range over which rate applies: Tax Year 2006	Changes to EGTRRA
n.a.	n.a.	10%	$0-$6,000 single filers ($7,000 in 2008) $0-$12,000 joint returns ($14,000 in 2008)	$0-$7,000 in 2003-2004 single filers. Reverts to schedule in 2005. (In October 2004, increase extended through 2010.) $0-$14,000 in 2003-2004 joint returns. Reverts to schedule in 2005. (In October 2004, increase extended through 2010.)
15%	$0- $27,050 single filers $0- $45,200 joint returns	15%	$6,000-$30,950 single filers $12,000-$57,850 joint returns	n.a.
28%	$27,050-$65,500 single filers $45,200-$109,250 joint returns	27% in 2001-2003 26% in 2004-2005 25% in 2006 and later	$30,950-74,950 single filers $57,850-$124,900 joint returns	25% in 2003 and later
31%	$65,500-$136,750 single filers $109,250-$166,500 joint returns	30% in 2001-2003 29% in 2004-2005 28% in 2006 and later	$74,950-$156,300 single filers $124,900-$190,300 joint returns	28% in 2003 and later
36%	$136,750-$297,350 single filers $166,500-$297,350 joint returns	35% in 2001-2003 34% in 2004-2005 33% in 2006 and later	$156,300-$339,850 single filers $190,300-$339,850 joint returns	33% in 2003 and later
39.6%	Over $297,350 single filers and joint returns	38.6% in 2001-2003 37.6% in 2004-2005 35% in 2006 and later	Over $330,850 single filers and joint returns	35% in 2003 and later

SOURCE: Joint Committee on Taxation

ALTERNATIVE MINIMUM TAX (AMT)

The **alternative minimum tax (AMT)** provision was enacted in 1969 to prevent high-income taxpayers from using tax preferences to reduce substantially or eliminate their income tax liabilities. The provision has been modified several times, most recently in October 2004. The AMT requires a separate calculation of taxes due. Taxpayers must pay whatever is higher: tax liability under the AMT or taxes due under the regular individual income tax. Under the AMT, normal deductions such as the personal exemptions and state and local taxes as well as preferences used by taxpayers with more complex finances (e.g., oil and gas drilling costs) are added back to adjusted gross income and replaced by an AMT exemption. Filers subject to the AMT are taxed at the rate of 26 percent on the first $175,000 of income and 28 percent on remaining amounts.

EGTRRA and JGTRRA increased the AMT exemptions to their current levels of $40,250 for single filers and $58,000 for joint returns. Those increases were scheduled to expire December 31, 2004, but were extended for an additional year. Unless the increases are extended again, the exemptions will fall to $33,750 for singles and $40,250 for married couples for the 2006 tax year.

Because the AMT exemptions and income brackets are not adjusted for inflation and those related to the regular income tax are, the number of taxpayers subject to the AMT is growing. Many of the new AMT taxpayers are people with large numbers of dependents and high state and local taxes—not members of the high-income group that the AMT was originally designed to address. The rate reductions enacted through EGTRRA and JGTRRA have increased the number of taxpayers affected by the AMT. As a result, CBO estimates that about 32 million filers will be subject to the AMT in 2010, about twice the number the agency projected before the 2001 and 2003 tax cuts. Currently about 2 million filers are subject to the AMT.

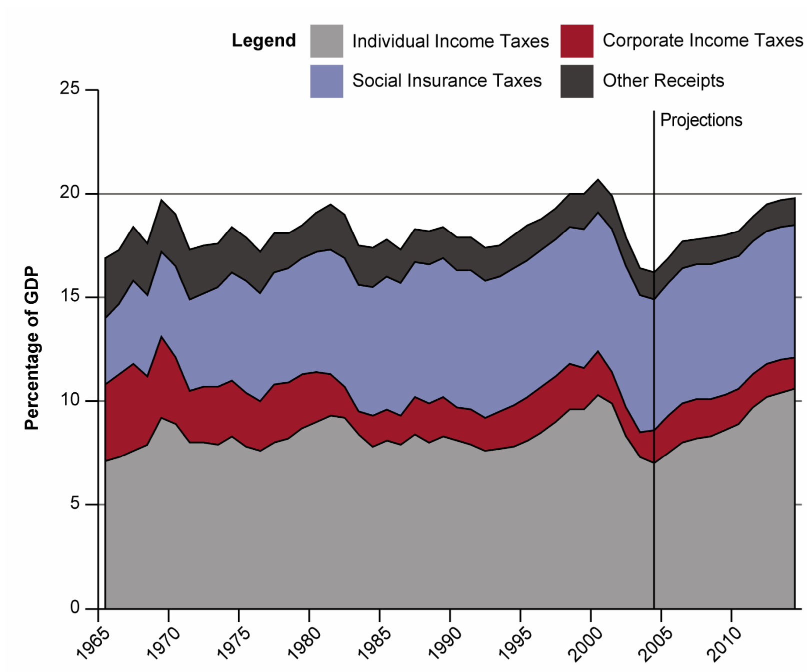
Closing Corporate Loopholes

Corporate and business income taxes have declined as a share of GDP, falling from an average of almost 4 percent in the 1960s to about 2 percent since the 1980s. Some economists argue that taxing income at the corporate level distorts economic decision making. They believe that it would be better to tax income once it is distributed to individuals in the form of dividends and wages. Others argue that corporations should pay their fair share of the tax burden. They warn that eliminating corporate and business income taxes entirely would provide a way for the wealthy to defer taxes indefinitely if resources are left in the business.

Many profitable corporations and businesses are able to reduce substantially their tax liability because of numerous provisions (known as "tax expenditures") in the tax code allowing reductions or deferrals of taxable income. Those tax expenditures are designed to encourage various activities or to benefit specific industries. For example, the tax code allows employers to deduct contributions to employee pensions and the cost of health insurance. Without those provisions, few employers would be willing to provide those benefits. Other tax expenditures encourage various activities that include research and development, exploration and development of oil and gas resources, investment in cleaner technologies, and formation and operation of small businesses.

Proposals to "close corporate loopholes" seek to limit the use (some would say abuse) of tax provisions and to end the favorable treatment of business activities that are viewed as contrary to the public interest. The potential revenue gain from eliminating each individual provision, however, tends to be relatively small. The largest tax expenditures—such as the deductibility of mortgage interest and the exclusion of employer-paid health from income—benefit individuals, not corporations.

Federal Revenues



CHANGE IN BASELINE REVENUES LEVELS (BILLIONS OF DOLLARS)

		2005	2006	2009	2014	Percent of GDP in 2014
Exercise baseline receipts level [a]		2,094	2,279	2,673	3,471	19.8%
Choose One	1. *Exercise* Baseline	0	0	0	0	0.0%
	Options to cut taxes					
	2. Make the 2001-2003 tax cuts permanent	0	-7	-24	-285	-1.6%
	3. Make the 2001-2003 tax cuts permanent and fix the AMT	0	-18	-69	-364	-2.1%
	4. Fix the AMT only	0	-7	-46	-33	-0.2%
	5. One-year AMT fix	0	-9	0	0	0.0%
	Options to increase income taxes					
	6. Repeal rate cuts for the top two brackets	29	42	45	0	0.0%
	7. Temporary 5% surtax for individual taxpayers	0	73	63	0	0.0%
	8. 10 % surtax for individual taxpayers	0	147	125	192	1.0%
Choose Any or All	9. Increase corporate income taxes to a uniform 35%	2	4	3	3	0.0%
	10. Close some corporate loopholes	3	6	7	8	0.1%
	Options to increase other taxes					
	11. Increase cigarette taxes	7	7	7	7	0.0%
	12. Increase taxes on alcoholic beverages	4	5	5	5	0.0%

[a] The *Exercise* baseline for receipts is the same as the CBO baseline.

OPTIONS

You have the option to keep revenues at the baseline (current law) level, to cut taxes by making the tax cuts enacted in 2001 and 2003 permanent or by fixing the AMT, or to increase income or other taxes.

Remember that the CBO baseline assumes that tax cuts expire as scheduled. Income tax rates and other provisions revert to their pre-EGTRRA levels in 2011. A proposal to repeal cuts earlier will only provide short-term revenue increases. Conversely, a proposal to make the tax cuts permanent will have little effect on revenues over the next five years but will result in large revenue reductions during the following five years (see the impact of options expressed as percentage of GDP).

You may choose one option of Options 1-8. In addition, you may choose any or all of Options 9-12.

PROS & CONS

Option	Arguments In *Favor* of Each Option	Arguments *Opposed* to Each Option
1. *Exercise* Baseline. The baseline assumes a continuation of current law. Tax provisions, notably those enacted in 2001 that reduced individual income tax rates, added a new 10 percent bracket, expanded child tax credits, provided marriage penalty relief, reduced estate and gift taxes, and reduced capital gains and dividend tax rates paid by individuals, would continue to phase-in and expire as currently scheduled in law. In addition to the various tax cuts enacted in 2001 and 2003 (and extended in 2004), the baseline assumes that other unrelated tax provisions will change or expire as scheduled between now and 2014. Those provisions include a range of credits and deductions related to education, pensions, business investment, and trade-related activities.	This option would stabilize tax policy, thus avoiding another round of changes that create uncertainty and confusion. If policy makers are serious about fundamental tax reform, they should stop tinkering with the existing system. Each time a tax bill passes, it is loaded up with all sort of special breaks that move the system further away from the commonly espoused goals of simplicity and fairness and create another class of potential opponents of tax reform. With the recent extension of marriage penalty relief, the child tax credit and the 10 percent bracket, there is no real need to do anything now.	The *status quo* doesn't satisfy any policy objective. *Revenues are too low*: budget projections have changed since policy makers embraced tax cuts. Deficits are bad for the economy and are squeezing resources for other urgent needs. *Revenues are too high:* as the economy grows and once the cuts expire in 2011, revenues will climb above their historical level of 18.2 percent. Moreover, the scheduled phase-in for cuts, followed by their repeal in 2011, creates uncertainty, complicates individual and business planning efforts, and therefore stymies savings and investment. As a result, the economic impact of lower taxes is diluted.
	Options to Cut Taxes	
2. Make the EGTRRA and JGTRRA tax cuts permanent. This option, proposed by the President in his 2005 budget, would extend and make permanent many of the tax cuts enacted in 2001 and 2003. Those provisions would begin to expire before January 2005 and all would expire at the end of 2010. The option would: ▪ Permanently extend the 10 percent bracket, marriage penalty and child care tax credit provisions; ▪ Permanently extend the reductions in marginal tax rates for individuals; ▪ Permanently extend the 15 percent 0 percent rate structure for capital gains and dividend income; ▪ Permanently repeal the estate and generation-skipping taxes; ▪ Increase expensing provisions for certain business property, modify IRA and pension provisions, and other provisions.	Making permanent the 2001 and 2003 tax cuts permanent would: ▪ Provide tax relief to individuals and families who are still struggling; ▪ Provide a stable tax structure that individuals and businesses can count on; ▪ Constrain the level of resources available to around 18 percent of GDP—their historic average share of the total economy—and help limit the size of government; ▪ Leave a greater share of resources in the private sector to promote economic growth. Tight resources pressure on policy makers to address budget problems. Allowing the tax cuts to expire or repealing them earlier will lessen that pressure to address structural imbalances between federal resources and federal obligations.	The proposed change would deprive the government of resources at the time when it will begin to need them the most: ▪ Leading-edge baby boomers will turn 65 in 2011. Demographic pressures will get worse thereafter; ▪ Extending the tax cuts will reduce revenues in 2014 by 1.6% of GDP—the same amount that Medicare, Medicaid, and Social Security are projected to grow. ▪ The proposal would largely benefit higher-income tax payers because they are the ones who reaped the largest reductions in their tax bills. ▪ "Starving" government does not appear to be working. That wishful thinking leads to deficits and more debt. Historically policymakers have been unable to exercise restraint. If the economy grows faster than currently projected, lawmakers can always reduce taxes in the future. But if they act now to preserve tax cuts, it will be more difficult to reverse that action.

Option	Arguments In *Favor* of Each Option	Arguments *Opposed* to Each Option
3. Make the EGTRRA and JGTRRA tax cuts permanent and fix the AMT. This option would make the individual tax cuts permanent (see Option 2, above) and would also modify the alternative minimum tax (AMT) provision. It would extend AMT exemptions, adjust applicable income brackets for the marginal rate cuts, index brackets to inflation, and allow deductions for dependents and personal credits. That would prevent the number of taxpayers subject to the AMT from growing solely because of the reduction in marginal rates, inflation, or because they have lots of dependents.	EGTRRA and JGTRRA were designed to provide tax relief for taxpayers but because lawmakers did not make corresponding changes to the AMT, many taxpayers are not benefiting. Middle-income earners who live in states with high taxes or who have a large number of dependents are being caught by the AMT though the AMT was not designed to reach them. This option would reduce the number affected by the AMT by 88 percent in 2010, 98 percent of whom would have incomes less than $100,000. Same arguments as above for Option 2 in favor of extending the tax cuts.	Fixing the AMT on top of the tax cut extension would be extremely costly. Those two changes should be put on hold until policy makers can consider a comprehensive overhaul of the tax system. The Tax Policy Center estimates that by 2008, the AMT will raise more revenue than the regular income tax. Given short-term deficits and the long-term fiscal imbalance, policymakers should first determine the level of revenue necessary to fund overall needs, then adjust tax rates, tax brackets, and the AMT provisions accordingly. Same arguments as above for Option 2 against extending the tax cuts.
4. Fix the AMT only. This provision would modify the AMT by indexing it to inflation but would not extend the individual tax cuts.	Same arguments given above for Option 3 in favor of fixing the AMT. This option would provide AMT relief, but leave aside the issue of extending the tax cuts.	Same arguments given above for Option 3 against fixing the AMT.
5. Fix the AMT for one-year only. This option would provide AMT relief through the end of calendar year 2006.	This option would provide temporary relief from the AMT. Analysts from the Tax Policy Center estimate that the temporary extension would cut the number of taxpayers affected by AMT from 13 million to 4 million in 2005. A similar benefit could be expected if another one-year fix is enacted for 2006.	Temporary extension only puts a band-aid on a huge problem. As repeated one-year fixes demonstrate, a temporary fix would be a budget gimmick. It would allow policy makers to continue to duck the issue in the short-term. But because they are likely to enact another "temporary" fix for 2007, this option provides a misleadingly optimistic projection of future revenues and artificially low deficits.
Options to Increase Taxes		
6. Repeal the reduction in marginal income tax rate for the top two brackets, only This option would restore the top two marginal tax rates to their pre-EGTRRA levels. The top rate, now 36 percent, would return to its pre-2001 level of 39.6 percent. The next highest marginal rate, now 33 percent, would revert to 36 percent. The option would mostly affect taxpayers with adjusted gross income above $200,000, or about the top 2 percent of all taxpayers.	This option would return the top two marginal tax rates to the levels in effect during the 1990s. As a result, those in the top tier of the income scale would pay at the same rates that they paid before the 2001 tax cut. Those taxpayers are enjoying the largest gains in income and don't really need a tax cut.	This option would penalize those who have been successful, often after investing significant time and resources and taking risks in order to get where they are. Those with the highest incomes already pay a disproportionate share of income taxes. This option would be counterproductive. Tax increases act as a disincentive to work and take risks and divert resources that otherwise could be invested in ways that would create jobs and promote economic growth.
7. Impose a temporary five-year 5 percent surtax. This option would add a five percent surtax to the tax bills of all individual taxpayers. (For example, a tax bill of	This option would spread the cost of the war across all current taxpayers instead of sending the bill to future generations. Although raising taxes is never popular, voters are more	It is a bad idea to establish a dedicated tax for national security purposes. Providing adequate funding for operations related to Iraq, Afghanistan and the global war on terror should be a

Option	Arguments In *Favor* of Each Option	Arguments *Opposed* to Each Option
$1,000 would increase to $1,050.) The proceeds of the surtax would help to offset the costs of the wars in Afghanistan and Iraq and the global war on terror. Any proceeds not required for those national security purposes could be used for deficit reduction.	likely to support paying for the war than an unspecified tax increase. The surtax could be eliminated or extended depending on how events unfold.	top priority and have first claim on resources. It would set a bad precedent to use emergencies or priorities as an excuse to increase taxes. That will allow the budget to get more bloated. Instead, policy makers should eliminate low priority programs.
8. Impose a 10 percent deficit surtax. This option would add a 10 percent surtax to individual tax bills that would stay in place until the budget is balanced. The surtax would be clearly identified on tax forms as the deficit surtax.	Like Option 6, this proposal would require current taxpayers to pay more so that future generations will pay less. The proceeds for this surtax would be earmarked for deficit reduction, however not any specific program. It would remind voters of the fiscal imbalance and pressure elected officials to balance the budget.	This option would require new accounting mechanisms to keep track of the surtax proceeds and to devote them to deficit reduction. The surtax proceed will be indistinguishable from other revenues, allowing policy makers to find a way to circumvent the intent while appearing to be fiscally responsible. In the end, this option would be a tax increase.
9. Increase corporate income tax rates to a uniform 35 percent. Corporate taxable income is currently taxed as follows: 15 percent (under $50,000); 25 percent ($50,000-$75,000); 34 percent ($75,000 to $10 million); and 35 percent on income that exceeds $10 million. This proposal would tax all corporate taxable income at the single rate of 35 percent	Corporations have become adept at minimizing their tax liabilities through the use of numerous tax preferences and the ability to shift the timing of when they recognize income and expenses. As a result, corporate income taxes have declined as a share of the overall tax burden has fallen. Lawyers, physicians, consultants, and other owners of personal service corporations, are taxed at a flat rate of 35 percent. Thus, this option would help to level the playing field between types of corporations (e.g., personal service/non-personal service; high-profit/low profit) and would reduce the incentives to engage in accounting and other measures that reduce their tax rates.	Taxing income at the corporate level creates distortions between equity- and debt-financed businesses. Interest payments are deductible at the corporate level. But profits are taxed twice if they are distributed in the form of dividends—once at the corporate level and again at the individual level. The tax rate on dividends has been lowered partially to address the double taxation problem. Raising the corporate rate would reverse that progress. Although the top marginal rate is 35 percent, the largest corporations already pay an average rate of 35 percent. This proposal would mostly affect small and mid-size corporations that are currently taxed at lower marginal rates.
10. Close corporate loopholes. This option would reduce tax benefits currently enjoyed by a variety of businesses. It would: ▪ Tax large credit unions (more than $10 million in assets) like other thrift institutions—credit unions do not pay taxes on retained earnings (earnings that are not distributed to members as dividends). ▪ Require oil, gas, and mineral producers to capitalize (deduct costs over time as revenue is earned) exploration costs instead of being allowed to expense them	Businesses often complain about the complexity of the tax system, but then do as much as they can to gain favorable treatment for themselves. The overall rate could be lowered if all the special provisions granted to well-connected industries did not exist. This option would repeal some of the loopholes that benefit a small number of corporate taxpayers. ▪ Large credit unions are indistinguishable from savings and loan and other thrift institutions and should be taxed in the same manner.	Without so-called loopholes, many businesses would be less viable. Loss of those enterprises would cost the economy more than the revenue loss from the tax provisions. The notion that underlies the negative view of "loopholes" is that the beneficiaries are somehow short-changing the government by taking or keeping funds that they are not entitled to. In fact, the revenues belong to them because they earned them. It is the government that is taking resources away from the rightful owners. Therefore businesses are fully justified in taking advantage of whatever provisions they

Option	Arguments In *Favor* of Each Option	Arguments *Opposed* to Each Option
(deduct them from taxable income) when they are incurred; ▪ Require corporations to deduct foreign taxes from taxable income instead of providing tax credits, which reduce tax liability. That would treat foreign tax payments the same way that state and local taxes are treated. ▪ Tighten rules that govern leasing arrangements between entities that do not pay taxes (state and local government and non-profits) and those that do that allow taxpayers to reduce their tax liability.	▪ Allowing corporations that are operating abroad a tax credit for foreign tax payments subsidizes their foreign activities. If they conducted the same activities at home, income earned would be taxed. ▪ Some leasing arrangements between public or non-profit institutions and private entities exploit the tax-exempt status granted to those organizations for the benefit of private, profit-making institutions.	can that will reduce their tax liability. Corporate income should not be taxed anyway. Income should be taxed when it is received by stockholders and business owners. They are the ultimate beneficiaries. Loopholes would be unnecessary under that simplified and more logical tax structure.
11. Increase cigarette excise taxes by 50¢ a pack. This option would raise the federal excise tax on cigarettes from 39¢ a pack to 89¢. The federal tax would be in addition to state excise taxes, which averaged 42¢ in 2002. (Payments to states under the settlement with tobacco companies would not be affected.)	Researchers estimate that each 10 percent increase in cigarette prices will lead to a decline in smoking of 2.5 to 5 percent, even more for price-sensitive teenagers. Because of tobacco's effects on the health of smokers and non-smokers alike, discouraging and deterring smoking is in the public interest.	Cigarette taxes are regressive. Lower-income people are more likely to smoke, and excise taxes burden them more than they affect people with middle- and higher-incomes. Excise taxes unfairly penalize people who smoke. Cigarettes and tobacco products are legal. If politicians don't want people to smoke, they should ban tobacco products outright instead of using tobacco to raise revenues.
12. Increase alcohol beverage taxes by $16 per proof gallon. This option would raise the federal tax on alcohol to about 25¢ per ounce of alcohol. That would boost the tax on a 750 ml bottle of distilled liquor from $2.14 to $2.54, on a six-pack of beer from 33¢ to 81¢, and on a 750 ml bottle of wine from 21¢ to 70¢.	Alcohol consumption creates costs to society in the form of lost productivity and alcohol-related accidents and crimes. It also increases the health care costs of people who drink. Increasing the price of alcohol will help to reduce consumption and abuse, even among heavy drinkers.	Increasing taxes on alcohol is also regressive because it makes lower-income people pay a larger percentage of their income than higher-income drinkers. It affects people whether or not they are problem drinkers or impose other costs on society. It hurts brewers, distillers and wineries that employ workers and add to economic activity.

LINKS

GOVERNMENT BUDGET-RELATED WEB SITES

Center for Medicare and Medicaid Services	www.cms.hhs.gov
Congressional Budget Office	www.cbo.gov
General Accountability Office	www.gao.gov
House Budget Committee	www.house.gov/budget/
Joint Tax Committee	www.house.gov/jct/
Office of Management and Budget	www.omb.gov
Senate Budget Committee	www.senate.gov/~budget/
Social Security Administration	www.ssa.gov
U.S. Treasury Office of Tax Policy	www.ustreas.gov/offices/tax-policy/index.html

NON-GOVERNMENTAL ORGANIZATIONS

American Enterprise Institute	www.aei.org
The Brookings Institution	www.brookings.edu
CATO Institute	www.cato.org
Center on Budget and Policy Priorities	www.cbpp.org
Citizens Against Government Waste	www.cagw.org
Citizens for Tax Justice	www.cjt.org
Committee for Economic Development	www.ced.og
Committee for a Responsible Federal Budget	www.crfb.org
Concord Coalition	www.concordcoalition.org
New America Foundation	www.newamerica.net
The Heritage Foundation	www.heritage.org
Tax Foundation	www.taxfoundation.org
Tax Policy Center	www.taxpolicycenter.org
The Urban Institute	www.urban.org

Exercise in Hard Choices Scorecard

Note: "" means less than $0.5 billion or 0.05%.*

Enter number that corresponds to chosen goal.

Goal

I Fiscal Framework: determines debt service changes

1 *Exercise* Baseline: No change to current policy
2 Goal A: Cut the deficit in half by 2009; balance the unified budget in 2014 and after
3 Goal B: Balance the unified budget in 2009, save any surpluses, and balance the budget over the business cycle
4 Goal C: Cut the non-Social Security budget in half in 2009; balance the non-Social Security budget in 2014; run surpluses/deficits equal to Social Security surpluses/deficits.
5 Goal D: Balance the non-Social Security budget in 2009-2028; then balance the unified budget

	Impact of Options				Decisions			
	$ in billions		% of GDP		$ in billions		% of GDP	
	2009	2014	2014	2040	2009	2014	2014	2040
Spending								
II National Security: Baseline Budget								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
2 Scale back national security	-178	-282	-1.5%	-1.5%				
3 Freeze at the 2004 level	-43	-109	-0.6%	-0.6%				
4 Emphasize homeland security & international affairs	26	52	0.3%	0.3%				
5 Current policy	44	62	0.3%	0.3%				
6 Maintain at 4.5% of GDP	150	246	1.3%	1.3%				
and/or								
7 Add funds for Iraq, Afghanistan & global war on terror	37	24	0.0%	0.0%				
III Income Support								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
2 Devolve welfare programs to the states	-25	-26	0.1%	0.1%				
3 Target subsidies and reduce costs	-2	-3	*	*				
4 Increase federal funding	19	23	0.1%	0.1%				
IV General Government								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
Across-the-Board Options								
2 Across-the-board increase	74	161	0.9%	0.9%				
3 Across-the-board freeze	-41	-91	-0.5%	-0.5%				
Options to Increase Spending								
4 Increase grants for elementary and secondary education	10	11	0.1%	0.1%				
5 Increase IDEA funding	9	14	0.1%	0.1%				
6 Increase Pell Grants	18	27	0.1%	0.1%				
7 Increase highways & other surface transportation	5	1	*	*				
8 Double grants for clean air & water & alternative energy	5	6	*	*				
Options to Cut Spending								
9 Freeze elementary and secondary education funding	-2	-6	*	*				
10 Freeze higher education funding	-1	-3	*	*				
11 Reform the student loan program	-4	-4	*	*				
12 Freeze transportation spending	-6	-14	-0.1%	-0.1%				
13 Increase fees for airport security screenings	-3	-4	*	*				
14 Charge for air traffic control services	-2	-2	*	*				
15 End funds for some Dept. of Energy applied research	-2	-2	*	*				
16 End Community Development Block Grants	-5	-6	*	*				
17 Offset veterans' disability benefits	-1	-2	*	*				
18 Cut COLAs for federal retirees	-1	-4	*	*				
19 Cut federal travel by 10%	-1	-1	*	*				
20 Adjust federal pay for CPI instead of ECI	-8	-19	-0.1%	-0.1%				
1. Subtotal: Changes on this page (II + III + IV)								Line 1

	Impact of Options				Decisions			
	$ in billions		% of GDP		$ in billions		% of GDP	
	2009	2014	2014	2040	2009	2014	2014	2040
V Social Security								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
2 Incremental Changes	-5	-19	-0.1%	-1.3%				
3 Modified Social Security	-40	-58	-0.3%	-1.9%				
4 Personal Security Accounts	79	66	0.4%	-0.9%				
5 President's Commission Plan 2	129	206	1.1%	2.7%				
VI Medicare								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
2 Reduce PPS for hospital inpatient care	-6	-17	-0.1%	-0.2%				
3 Block grants for medical education	-2	-4	*	*				
4 Reduce payments for prescription drugs	-1	-2	*	*				
5 Restrict media coverage of cost sharing	-3	-5	*	*				
6 Raise the eligibility age	0	0	0.0%	-0.4%				
7 Defined Contribution	-1	-55	-0.3%	-2.7%				
8 Defined Benefit w/ Premium Support	0	-26	-0.1%	-1.0%				
9 Medicare Expansion	0	52	0.3%	1.0%				
VII Medicaid and SCHIP								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
2 Reduce floor on federal matching share	-7	-11	-0.1%	-0.1%				
3 Reduce disproportionate hospital share funds	-1	-1	*	*				
4 Reduce funding for Medicaid admin costs	-4	-7	0.0%	0.1%				
5 Medicaid Block Grant	-36	-97	-0.5%	-0.9%				
6 Reallocate federal-state roles	40	78	0.4%	0.8%				
VIII Health Insurance Expansion								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
2 Expand Medicaid eligibility	1	88	0.5%	0.9%				
3 Tax Credits instead of tax exclusion	2	175	0.9%	1.9%				
4 Pay or Play	101	168	0.9%	1.8%				
5 Fully Tax-Financed	741	953	5.2%	7.7%				
Subtotal: Changes for decisions IV + V+ VI + VII + VIII								
Plus: Changes from page 1 (Line 1)								
2. Equals: Your Total Changes to Spending								Line 2
IX Revenues								
1 *Exercise* Baseline	0	0	0.0%	0.0%				
Options to Cut Taxes								
2 Make EGTRRA and JGTRRA tax cuts permanent	-24	-285	-1.6%	-1.6%				
3 Make EGTRRA and JGTRRA tax cuts permanent and fix the AMT	-69	-364	-2.1%	-2.1%				
4 Permanent AMT fix (without extending tax cuts)	-46	-33	-0.2%	-0.2%				
5 One-year AMT fix	0	0	0.0%	0.0%				
Options to Increase Income Taxes								
6 Repeal rate cuts for top two brackets	45	0	0.0%	0.0%				
7 Temporary 5% surtax	63	0	0.0%	0.0%				
8 10% deficit reduction surtax	125	192	1.0%	1.0%				
9 Increase corporate income tax rate to uniform 35%	3	3	*	*				
10 Close some corporate tax loopholes	7	8	0.1%	0.1%				
Other Options to Increase Revenues								
11 Raise cigarette taxes	7	7	*	*				
12 Raise taxes on alcoholic beverages	5	5	*	*				
3. Your Changes to Revenues (Decision IX)								Line 3

Tally up the Results: Your Budget

	$ in billions		% of GDP		
	2009	2014	2014	2040	
Calculate your projected Deficits (-) or Surpluses (+)					
Beginning Baseline Deficits (Baseline revenues less baseline spending)	**-166**	**138**	**-0.6%**	**-9.9%**	Line 4
Enter your changes to Spending (Line 2 from page 2)					Line 5
Multiply your changes to Spending by -1 (Line 5 times -1)					Line 6
Enter your changes to Revenues (Line 3 from page 2)					Line 7
Your Changes to Projected Deficits/Surpluses due to your policy decisions : ***Add*** lines 6 and 7. (Note: positive amounts mean *smaller* deficits; negative amounts mean *larger* deficits.)					Line 8
Debt Service calculations:					
Multiply: Your policy changes (Line 8) by:	0.25	0.50	0.50	0.60	
Equals: Debt service bonus (+) or penalty (-)					Line 9
Your Total Changes to Projected Deficits/Surpluses: ***Add*** lines 8 and 9					Line 10
Projected Deficits/Surpluses under your budget (***Add*** lines 4 and 10**)**					Line 11

	$ in billions		% of GDP	
Did you meet or exceed your goal?	2009	2014	2009	2014
Compare your results to target deficits(-) or surpluses (+) for your Goal (Decision I--see below)				
1 *Exercise* Baseline	-166	138	-0.6%	-9.9%
2 Goal A	-207	0	0.0%	-12.4%
3 Goal B	0	138	0.0%	0.0%
4 Goal C	38	288	1.6%	-1.5%
5 Goal D	242	288	1.6%	0.0%