CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

CBO

Reducing the Deficit: Spending and Revenue Options

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MARCH 2011

Report Documentation Page

Form Approved
OMB No. 0704-0188

Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.

1. REPORT DATE **MAR 2011**	2. REPORT TYPE	3. DATES COVERED **00-00-2011 to 00-00-2011**
4. TITLE AND SUBTITLE **Reducing the Deficit: Spending and Revenue Options**		5a. CONTRACT NUMBER
		5b. GRANT NUMBER
		5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S)		5d. PROJECT NUMBER
		5e. TASK NUMBER
		5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) **Congressional Budget Office,Ford House Office Building, 4th Floor ,Second and D Streets, SW ,Washington,DC,20515-6925**		8. PERFORMING ORGANIZATION REPORT NUMBER
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)		10. SPONSOR/MONITOR'S ACRONYM(S)
		11. SPONSOR/MONITOR'S REPORT NUMBER(S)
12. DISTRIBUTION/AVAILABILITY STATEMENT **Approved for public release; distribution unlimited**		
13. SUPPLEMENTARY NOTES		
14. ABSTRACT		
15. SUBJECT TERMS		

16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT **unclassified**	b. ABSTRACT **unclassified**	c. THIS PAGE **unclassified**	**Same as Report (SAR)**	**256**	

Standard Form 298 (Rev. 8-98)
Prescribed by ANSI Std Z39-18

Pub. No. 4212

CBO

Reducing the Deficit: Spending and Revenue Options

March 2011

The Congress of the United States ■ Congressional Budget Office

Notes

Unless otherwise indicated, all years referred to in this report are federal fiscal years, which run from October 1 to September 30.

The numbers in the text and tables are in nominal (current year) dollars. Those numbers may not add up to totals because of rounding.

The baseline budget projections discussed in this report are those published in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011).

The estimates for the various options shown in this volume may differ from any subsequent cost estimates for legislative proposals that resemble the options presented here.

On the cover: A U.S. Navy F/A-18F Super Hornet aircraft near Joint Base Pearl Harbor–Hickam, Hawaii, July 2010, photo by Technical Sergeant Jacob N. Bailey, U.S. Air Force; other photos, copyright as indicated on the cover.

Preface

The Congressional Budget Office (CBO) regularly issues a compendium of budget options to help inform federal lawmakers about the implications of possible policy choices. This volume—one of several reports that CBO produces regularly for the House and Senate Committees on the Budget—presents more than 100 options for altering federal spending and revenues. Nearly all of the options would reduce federal budget deficits. From 1983 to 1997, the reports in this series were titled *Reducing the Deficit: Spending and Revenue Options.* In 2000, at a time of budget surpluses, the title was changed to *Budget Options.* This volume returns to the earlier title because the budgetary context has shifted dramatically since 2000.

The report begins with an introductory chapter that describes the current budgetary picture and the uses and limitations of this volume. Chapters 2 and 3 present options that would reduce mandatory and discretionary spending, respectively. Chapter 4 contains options that would increase revenues from various kinds of taxes and fees.

The options discussed in this report stem from a variety of sources, including legislative proposals, various Administrations' budget proposals, Congressional staff, other government entities, and private groups. The options are intended to reflect a range of possibilities rather than to provide a ranking of priorities or a comprehensive list. The inclusion or exclusion of a particular policy change does not represent an endorsement or rejection by CBO. In keeping with CBO's mandate to provide objective, impartial analysis, this report makes no recommendations.

Some previous reports in this series grouped spending options according to budget function (the 20 programmatic categories into which the government's activities are frequently divided). This volume, however, groups spending options according to whether the funds are generally controlled through authorizing legislation (mandatory spending) or through the annual appropriation process (discretionary spending). An index listing the options by budget function appears in Appendix C.

This volume is the result of work by more than 130 people at CBO; those contributors are listed in Appendix E. The staff of the Joint Committee on Taxation prepared most of the revenue estimates. The report is available on CBO's Web site (www.cbo.gov).

Douglas W. Elmendorf

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Director

March 2011

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CHAPTER

1

Introduction

The choices facing the 112th Congress come at a time when the federal government's debt has increased dramatically in the past few years and when large annual budget deficits are projected to continue indefinitely under current laws or policies. If current laws remain unchanged, deficits will total $7 trillion over the next 10 years, the Congressional Budget Office (CBO) projects; if certain policies that are scheduled to expire under current law are extended instead, deficits may be much larger. Beyond the coming decade, the aging of the U.S. population and rising health care costs will put increasing pressure on the budget. If federal debt continues to expand faster than the economy—as it has since 2007—the growth of people's income will slow, the share of federal spending devoted to paying interest on the debt will rise more quickly, and the risk of a fiscal crisis will increase.

This report presents 105 illustrative options that would reduce projected budget deficits. As in past reports, the options cover an array of policy areas—from defense to energy to entitlement programs to provisions of the tax code. The budgetary effects shown for most options span the 10 years from 2012 to 2021 (the period covered by CBO's January 2011 baseline budget projections), although many options would have longer-term effects as well.

The options in this volume come from legislative proposals, various Administrations' budget proposals, Congressional staff, other government entities, and private groups, among others. The options are intended to reflect a range of possibilities, not a ranking of priorities. The contents of this volume do not represent an endorsement or a rejection by CBO of any particular option, and the report does not recommend specific changes or provide an exhaustive list of policy alternatives. It also does not offer any comprehensive budget plans—although many of the options could be combined into broader plans.

This volume focuses to a greater extent than its recent predecessors did on options that would reduce the deficit—especially on changes that would have a relatively large budgetary impact. However, Appendix A contains six options that would increase rather than decrease the deficit; they are included here because of Congressional interest in them. In particular, some of the choices that lawmakers will face in the next few years involve tax provisions and mandatory spending programs that are scheduled to expire soon, and continuing those policies would have budgetary costs. Appendix B lists additional options that were presented in the most recent previous version of this report (issued in August 2009) but that were not updated for this volume.

The Current Context for Making Decisions About the Budget

The amount of federal debt held by the public has nearly doubled in the past three years.[1] At the end of fiscal year 2007, debt held by the public totaled $5 trillion. That amount was equal to 36 percent of the nation's annual economic output, or gross domestic product (GDP)—close to the average ratio of debt to GDP over the past 40 years, 37 percent. Since 2007, financial turmoil and a severe drop in economic activity, combined with various policies implemented in response to those conditions, have sharply reduced federal revenues and increased spending. Those changes added to the imbalance between revenues and spending that had existed before the recession, causing annual budget deficits to surge. As a result, debt held by the public grew to more than $9 trillion by the end of fiscal year 2010—equaling

1. Debt held by the public consists primarily of securities that the Treasury issues to raise cash to fund the operations and pay off the maturing liabilities of the federal government that tax revenues are insufficient to cover. Such debt is held by investors outside the federal government and by the Federal Reserve System.

Figure 1-1.

Federal Debt Held by the Public Under CBO's Baseline or with a Continuation of Certain Policies, Compared with Past Debt

(Percentage of gross domestic product)

Source: Congressional Budget Office (as of January 2011).

Note: The projection with the continuation of certain policies is based on several assumptions: first, that provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) that originally were enacted in 2001, 2003, or 2009, or that modified estate and gift taxation do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare's payment rates for physicians are held constant at their 2011 level.

62 percent of GDP, the highest percentage since shortly after World War II (see Figure 1-1).

Under current law, the imbalance between spending and revenues will persist in the future, CBO estimates, even as the economy recovers and expands (see Figure 1-2). That imbalance is projected to worsen in coming decades as health care costs continue to rise and as more members of the baby-boom generation become eligible for certain federal benefits. Under current law, those factors will cause debt to keep growing relative to the size of the economy.

Projected Budget Deficits

In CBO's current-law baseline, the deficit is projected to equal 9.8 percent of GDP in 2011, shrink to 4.3 percent of GDP by 2013 (after certain tax provisions are scheduled to expire and the economy has recovered further from the recession), and then range between 2.9 percent and 3.4 percent of GDP through 2021—a little above the average of 2.8 percent seen over the past 40 years (see Table 1-1).[2] Those deficits would push total debt held by the public to 77 percent of GDP by 2021.

CBO's baseline projections are predicated on the assumption that many policies now in place will be allowed to expire over the next decade, as scheduled under current law. If, instead, those policies were extended, budget deficits would be much larger than in the baseline. As an example, if many provisions of the 2010 tax act were extended rather than being allowed to expire on December 31, 2012,[3] and if the alternative minimum tax (AMT) was indexed for inflation, annual revenues would average about 18 percent of GDP through 2021 (equal to their 40-year average), rather than about 20 percent as shown in CBO's baseline. If, in addition, Medicare's

2. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011).

3. This statement applies to most of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) that originally were enacted in 2001, 2003, or 2009 or that modified estate and gift taxation.

Figure 1-2.

Total Revenues and Outlays, 1971 to 2021

(Percentage of gross domestic product)

Source: Congressional Budget Office (as of January 2011).

payment rates for physicians' services were held constant, rather than dropping next year as scheduled under current law, deficits from 2012 through 2021 would average about 6 percent of GDP—compared with 3.6 percent in the baseline—and the deficit in 2021 would equal 6.6 percent of GDP (see Figure 1-3). Annual deficits would total nearly $12 trillion over the 2012–2021 period, rather than $7 trillion, and debt held by the public would be 20 percentage points higher in 2021, reaching 97 percent of GDP (see Figure 1-1).

Over the longer term, the continued aging of the population and growth in health care costs will almost certainly push up federal spending significantly relative to GDP under current law. Without changes in law, CBO projects, spending on Social Security and the government's major mandatory health care programs (Medicare, Medicaid, the Children's Health Insurance Program, and health insurance subsidies to be provided through insurance exchanges) will increase from roughly 10 percent of GDP today to about 16 percent 25 years from now. If revenues remain near their past levels relative to GDP, that increase in spending will lead to rapidly growing budget deficits and mounting federal debt.

In June 2010, CBO issued long-term budget projections under two scenarios reflecting different assumptions about future policies for revenues and spending.[4] The extended-baseline scenario was based on the assumption that, by and large, current law would continue without change—including the assumption that tax cuts enacted in 2001 and 2003 would expire as scheduled. Under those assumptions, revenues were projected to climb to 23 percent of GDP by 2035. Even with those higher revenues, federal debt held by the public was projected to rise from 62 percent of GDP at the end of 2010 to about 80 percent by 2035.

CBO has not yet updated its long-term projections to reflect enactment of the 2010 tax act and other recent changes. But the 10-year baseline that the agency issued in January 2011, which does reflect those changes, shows larger budget deficits and accumulated debt over the next decade than the June 2010 projections did. Debt is now projected to equal 76 percent of GDP at the end of 2020 under current law, compared with the June 2010 projection of 66 percent.

CBO also prepared long-term budget projections last year under an alternative fiscal scenario. Whereas the extended-baseline scenario was predicated on current law, the alternative fiscal scenario incorporated several changes to current law that were widely expected to occur or that would modify some provisions of law that might be difficult to sustain for a long period. Those changes included

4. See Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010, revised August 2010).

Table 1-1.

CBO's Baseline Budget Projections

	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
							In Billions of Dollars							
Revenues														
Individual income taxes	899	998	1,128	1,516	1,671	1,829	1,967	2,105	2,231	2,365	2,509	2,662	8,110	19,983
Social insurance taxes	865	819	943	1,029	1,092	1,148	1,204	1,256	1,309	1,364	1,424	1,484	5,416	12,253
Corporate income taxes	191	201	279	343	428	398	370	413	417	420	420	437	1,817	3,923
Other revenues	207	211	205	203	251	276	292	301	318	340	359	380	1,227	2,925
Total Revenues	**2,162**	**2,228**	**2,555**	**3,090**	**3,442**	**3,651**	**3,832**	**4,075**	**4,275**	**4,489**	**4,712**	**4,963**	**16,570**	**39,084**
On-budget	1,530	1,662	1,887	2,358	2,673	2,840	2,977	3,178	3,336	3,508	3,687	3,893	12,735	30,338
Off-budget	632	566	668	732	769	811	855	897	938	981	1,025	1,069	3,835	8,745
Outlays														
Mandatory spending	1,910	2,108	2,038	2,106	2,203	2,346	2,538	2,647	2,757	2,964	3,138	3,333	11,230	26,070
Discretionary spending	1,349	1,375	1,352	1,364	1,378	1,397	1,426	1,453	1,482	1,524	1,562	1,600	6,917	14,538
Net interest	197	225	264	325	394	459	527	592	646	697	751	792	1,969	5,447
Total Outlays	**3,456**	**3,708**	**3,655**	**3,794**	**3,975**	**4,202**	**4,491**	**4,691**	**4,885**	**5,185**	**5,451**	**5,726**	**20,117**	**46,055**
On-budget	2,901	3,210	3,073	3,150	3,294	3,481	3,730	3,884	4,029	4,276	4,485	4,702	16,727	38,103
Off-budget	555	498	581	644	682	721	761	807	856	909	966	1,024	3,390	7,952
Deficit (-) or Surplus	**-1,294**	**-1,480**	**-1,100**	**-704**	**-533**	**-551**	**-659**	**-617**	**-610**	**-696**	**-739**	**-763**	**-3,547**	**-6,971**
On-budget	-1,371	-1,548	-1,186	-792	-621	-641	-752	-706	-693	-768	-798	-808	-3,992	-7,765
Off-budget	77	68	86	88	87	90	94	90	82	73	59	45	445	794
Debt Held by the Public	9,018	10,430	11,598	12,386	12,996	13,625	14,358	15,064	15,767	16,557	17,392	18,253	n.a.	n.a.
Memorandum:														
Gross Domestic Product	14,513	15,034	15,693	16,400	17,258	18,195	19,141	20,033	20,935	21,856	22,817	23,810	86,686	196,138
							As a Percentage of Gross Domestic Product							
Revenues														
Individual income taxes	6.2	6.6	7.2	9.2	9.7	10.1	10.3	10.5	10.7	10.8	11.0	11.2	9.4	10.2
Social insurance taxes	6.0	5.4	6.0	6.3	6.3	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2	6.2
Corporate income taxes	1.3	1.3	1.8	2.1	2.5	2.2	1.9	2.1	2.0	1.9	1.8	1.8	2.1	2.0
Other revenues	1.4	1.4	1.3	1.2	1.5	1.5	1.5	1.5	1.5	1.6	1.6	1.6	1.4	1.5
Total Revenues	**14.9**	**14.8**	**16.3**	**18.8**	**19.9**	**20.1**	**20.0**	**20.3**	**20.4**	**20.5**	**20.7**	**20.8**	**19.1**	**19.9**
On-budget	10.5	11.1	12.0	14.4	15.5	15.6	15.6	15.9	15.9	16.0	16.2	16.4	14.7	15.5
Off-budget	4.4	3.8	4.3	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.4	4.5
Outlays														
Mandatory spending	13.2	14.0	13.0	12.8	12.8	12.9	13.3	13.2	13.2	13.6	13.8	14.0	13.0	13.3
Discretionary spending	9.3	9.1	8.6	8.3	8.0	7.7	7.4	7.3	7.1	7.0	6.8	6.7	8.0	7.4
Net interest	1.4	1.5	1.7	2.0	2.3	2.5	2.8	3.0	3.1	3.2	3.3	3.3	2.3	2.8
Total Outlays	**23.8**	**24.7**	**23.3**	**23.1**	**23.0**	**23.1**	**23.5**	**23.4**	**23.3**	**23.7**	**23.9**	**24.0**	**23.2**	**23.5**
On-budget	20.0	21.4	19.6	19.2	19.1	19.1	19.5	19.4	19.2	19.6	19.7	19.7	19.3	19.4
Off-budget	3.8	3.3	3.7	3.9	4.0	4.0	4.0	4.0	4.1	4.2	4.2	4.3	3.9	4.1
Deficit (-) or Surplus	**-8.9**	**-9.8**	**-7.0**	**-4.3**	**-3.1**	**-3.0**	**-3.4**	**-3.1**	**-2.9**	**-3.2**	**-3.2**	**-3.2**	**-4.1**	**-3.6**
On-budget	-9.4	-10.3	-7.6	-4.8	-3.6	-3.5	-3.9	-3.5	-3.3	-3.5	-3.5	-3.4	-4.6	-4.0
Off-budget	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.2	0.5	0.4
Debt Held by the Public	62.1	69.4	73.9	75.5	75.3	74.9	75.0	75.2	75.3	75.8	76.2	76.7	n.a.	n.a.

Source: Congressional Budget Office (as of January 2011).

Note: n.a. = not applicable.

Figure 1-3.

Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies

Source: Congressional Budget Office (as of January 2011).

Note: GDP = gross domestic product.

a. The projection with the continuation of certain policies is based on several assumptions: first, that provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) that originally were enacted in 2001, 2003, or 2009, or that modified estate and gift taxation do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare's payment rates for physicians are held constant at their 2011 level.

an extension of the 2001 and 2003 tax cuts (except for rate reductions that applied to high-income taxpayers), broad relief from the AMT, growth in discretionary spending that matched the rate of growth in GDP, and increases in Medicare's payment rates for physicians, among others. Under that scenario, U.S. debt was projected to rise to unprecedented levels by 2025—exceeding its past peak of about 110 percent of GDP—and continue growing to 185 percent by 2035. If that alternative fiscal scenario was updated to reflect the current 10-year outlook, the debt projections would be even worse.

The Fiscal Gap

To prevent federal debt from becoming unsupportable, lawmakers will have to restrain the growth of spending substantially, raise revenues significantly above their historical share of GDP, or pursue some combination of those two approaches. How much would policies have to change to avoid unsustainable increases in federal debt?

A useful answer comes from looking at the so-called fiscal gap, which measures the immediate change in spending or revenues that would be necessary to keep debt at the same percentage of GDP at the end of a given period as at the beginning of the period.

Last year, CBO estimated that the fiscal gap for the 2010–2034 period would be 1.2 percent of GDP under the extended-baseline scenario or 4.8 percent under the alternative fiscal scenario. In other words, relative to the projections of the alternative fiscal scenario, an immediate and permanent cut in spending or increase in revenues equal to 4.8 percent of GDP—equivalent to almost $700 billion today—would be needed to create a sustainable fiscal path for the next quarter century. If that change came entirely from revenues, it would amount to roughly a one-quarter increase in revenues relative to the amount projected for 2020 and later years. If the change came entirely from spending, it would represent a cut of roughly one-fifth in all spending (except interest payments on federal debt) from the amount projected for 2020 or a cut of one-sixth from the amount of such spending projected for 2035. Because of legislative actions taken since last summer, when those estimates were made, fiscal gaps based on the current 10-year budget outlook would be larger.

Effects of Waiting to Address the Budgetary Imbalance

Lawmakers must decide not only how to reduce budget deficits but also how quickly to act.[5] That decision involves difficult trade-offs.

Implementing deficit reduction policies more slowly would lead to higher government debt, which would have several negative consequences:

- **Reducing the amount of U.S. savings devoted to investment in productive capital.** Increased government borrowing would crowd out private investment in productive capital, because the portion of private savings used to buy Treasury securities would not be available to fund such investment. The resulting decrease in the nation's capital stock would lead to lower output and incomes in the long run than would otherwise be the case and would make future generations worse off. That crowding-out phenomenon is slow but inexorable: In any given year, the incremental effect on output is small, but the effects add up over time and can become substantial.

- **Requiring greater federal spending on interest payments.** With more resources devoted to servicing the debt, larger changes in revenues and noninterest spending would be needed to make fiscal policy sustainable. If those changes took the form of bigger cuts to spending programs, they would be harder for people to adjust to than smaller cuts would be. If the changes took the form of bigger increases in marginal tax rates (the rates that would apply to an additional dollar of a taxpayer's income), they would create larger disincentives to work and save, which would reduce incomes more than smaller tax-rate increases would.

- **Giving policymakers less flexibility to deal with unexpected problems.** If federal debt had been bigger in 2008 than it was, the government would have had less flexibility to respond to the turmoil in financial markets and the slumping economy by using government funds to stimulate economic activity and stabilize the financial sector, while still continuing to fund other federal commitments. Similarly, larger debt would give the government less flexibility to raise spending in response to international events such as wars or humanitarian crises.

- **Increasing the likelihood of a fiscal crisis.** If federal debt continued to grow relative to the nation's output and income, investors would require the government to pay higher interest rates on its securities to compensate for the risk that they might not be repaid or that the value of the securities might be eroded by inflation. Interest rates might rise only gradually to reflect such growing uncertainty—but other countries' experiences suggest that a loss of investors' confidence can occur abruptly and might well come during an economic downturn. To resolve the resulting fiscal crisis, lawmakers would need to make fiscal policy choices that would be much more drastic and painful than if policies had been adjusted sooner.[6]

5. In a previous analysis, CBO examined the effects of different choices about when to put the nation's fiscal policy on a sustainable course by stabilizing the ratio of debt to GDP. See Congressional Budget Office, *Economic Impacts of Waiting to Resolve the Long-Term Budget Imbalance*, Issue Brief (December 2010).

6. See Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis*, Issue Brief (July 2010).

At the same time, implementing major budgetary changes gradually would have some advantages:

- **Minimizing the drag of spending cuts or tax increases on the economic expansion.** In times when the economy has substantial unemployment, as well as unused factories, offices, and equipment, running a deficit usually increases output and employment compared with what would occur under a balanced budget.[7] For example, during a recession, tax revenues automatically decline and government spending on certain benefits automatically increases relative to what would happen otherwise, thus widening deficits. Those "automatic stabilizers" help reduce the severity of a recession by offsetting some of the decline in people's disposable income and thus supporting demand for goods and services. Similarly, during and immediately after a recession, fiscal stimulus measures financed with deficits—such as the spending increases and tax cuts in the American Recovery and Reinvestment Act of 2009 (Public Law 111-5)—usually keep output and employment higher than they would be otherwise.[8]

- **Possibly helping older generations.** A delay in putting the budget on a sustainable path would postpone the increases in taxes or the cuts in benefit payments and government services that people would face. With certain policies, the gains to older generations from such a delay would outweigh some of the resulting drawbacks—such as greater reductions in future incomes and larger ultimate changes to taxes and spending—because the effect of those drawbacks would be muted for people who have completed all or part of their working life. Whether the gains from waiting would outweigh the other drawbacks of higher debt for older generations is unclear.

- **Providing time to adjust.** Giving people, businesses, and state and local governments time to plan for changes would make the changes less disruptive. For example, if lawmakers chose to scale back benefit programs or modify tax preferences in the individual income tax, households would benefit from having time to alter their behavior. Similarly, if lawmakers changed corporate taxes or cut back on government contracts with private firms, the affected companies would benefit from advance notice. And if lawmakers reduced federal grants to state and local governments, those governments would prefer to have a chance to adjust their own spending and revenue plans.

Although there are trade-offs in choosing the timing of policy changes to reduce future deficits, such trade-offs do not apply to the timing of decisions about those changes. Rather, there are important benefits and few apparent costs to deciding soon what policy actions will be taken to resolve the long-term budgetary imbalance. Enacting policy changes soon, even if they are to be implemented later, would probably boost economic activity by providing more certainty about the nature and size of the changes and more assurance that the nation's fiscal policy will be put on a sustainable path. Deciding on changes soon would also give lawmakers more flexibility in determining the timing of the changes while still limiting further increases in federal debt and the negative consequences that would flow from those increases.

Examples of Plans to Reduce the Deficit

Putting fiscal policy on a sustainable course will require difficult decisions. Different types of spending cuts and tax increases would impose direct costs on different people and businesses; those policy changes could also affect the size of the economy. For instance, some choices about spending could influence investment, which would affect overall economic growth, and other spending options would involve transferring resources from one group to another. Likewise, some changes to the tax system (such as raising marginal tax rates) would tend to reduce economic growth, whereas other changes (such as broadening the base for a given tax) might not.

In recent months, a number of groups and individuals have released plans focused on reducing the deficit.[9] The plans reflect widely varying priorities, with some emphasizing spending cuts and others emphasizing tax increases. As an example, members of the bipartisan

7. See Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011* (January 2010).

8. See Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from October 2010 Through December 2010* (February 2011).

9. For a summary of the provisions of some of those plans, see Committee for a Responsible Federal Budget, "Summary Table of Fiscal Plans," http://crfb.org/sites/default/files/CRFB_Summary_Table_of_Fiscal_Plans.pdf. Also see the "You Fix the Budget" discussion at *Economix* blog, *New York Times*, http://economix.blogs.nytimes.com/tag/you-fix-the-budget/.

National Commission on Fiscal Responsibility and Reform, created by the President, recently proposed a plan to balance the budget excluding interest payments by 2015 and to make meaningful improvements to the long-term fiscal outlook.[10] The plan would reduce the costs of federal health care programs by altering the degree of cost sharing required of beneficiaries, changing malpractice laws, and limiting federal costs for prescription drugs. It would also decrease spending on Social Security, agriculture programs, and military and civil service retirement; reduce defense and nondefense discretionary spending; and increase revenues, mainly by eliminating various tax preferences (such as special exclusions, exemptions, and deductions) and thus broadening the tax base. The plan was endorsed by 11 of the commission's 18 members. (If it had received the support of 14 members, its recommendations would have been formally issued and, according to some Congressional leaders, would have been brought up for a vote in the Congress.)

The Options in This Report

The budget options presented in this volume do not constitute a comprehensive plan but rather a set of discrete policy actions that illustrate ways in which lawmakers could decrease federal spending or increase revenues. The options are grouped according to three major budget categories:

- **Mandatory Spending.** Also known as direct spending, mandatory spending accounts for more than half of federal outlays (see Figure 1-4). The category includes spending for entitlement programs and certain other payments to people, businesses, nonprofit institutions, and state and local governments. The Congress generally determines spending for mandatory programs by setting eligibility rules, benefit formulas, and other parameters in authorizing legislation rather than by appropriating specific amounts each year. The largest mandatory programs are Social Security, Medicare, and Medicaid, which together accounted for 74 percent of mandatory spending in 2010 and are projected to account for 81 percent by 2021, under current law.

- **Discretionary Spending.** Nearly 40 percent of federal outlays stem from budget authority provided in annual appropriation acts, which is referred to as discretionary funding.[11] In 2010, roughly half of discretionary spending went for defense, and the other half paid for a wide range of federal activities, including law enforcement, homeland security, transportation, national parks, disaster relief, scientific research, and foreign aid. In CBO's baseline, discretionary spending is assumed to grow at the rate of inflation and thus is projected to decline as a share of the budget over the next decade, falling to 28 percent of total spending by 2021.

- **Revenues.** Federal revenues come from taxes on individual and corporate income, payroll taxes for social insurance programs (such as Social Security and unemployment compensation), excise taxes, estate and gift taxes, remittances from the Federal Reserve System, customs duties, and miscellaneous fees and fines. The two largest sources are individual income taxes and social insurance taxes, which together produce more than 80 percent of the government's revenues (see Figure 4-1 on page 130).

Chapters 2 and 3 contain options to reduce mandatory and discretionary spending, respectively. Chapter 4 presents options to increase revenues. Each chapter begins with an introduction that describes overall budgetary trends in that category and some of the broad policy issues to consider when choosing among the options. Each option includes a brief discussion that provides background information about the issue, describes the policy change envisioned in the option, and summarizes arguments for and against the change. As appropriate, citations are given to related options and relevant CBO publications.

For options that deal with mandatory spending, CBO estimated budgetary effects relative to the spending projected to occur under current law. For most options that

10. The commission was created by executive order in February 2010 and included three House Republicans, three House Democrats, three Senate Republicans, three Senate Democrats, and six members appointed by the President. Its final report was published on December 1, 2010. See National Commission on Fiscal Responsibility and Reform, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform* (December 2010).

11. In this report, spending generally refers to outlays, which are the disbursement of federal government funds. Funding (in the form of budget authority or obligation limitations) refers to the authority provided by law to incur financial obligations, which ultimately result in outlays.

Figure 1-4.

Breakdown of Federal Spending in 2010

Source: Congressional Budget Office.

involve discretionary spending, the effects of the changes were calculated relative to 2011 appropriation levels, as adjusted for inflation in later years.[12] For options involving discretionary spending for defense procurement, budgetary effects were measured relative to the Department of Defense's (DoD's) projections of the costs of its plans for the coming 5 years.[13] (Consequently, the estimates for those options cover only the next 5 years, whereas estimates for the other options cover the next 10 years.)

12. Because full-year appropriations had not been enacted for 2011 when this report was prepared, the estimates for discretionary spending options (other than those affecting defense procurement) were based on the annualized value of the funding provided in the Continuing Appropriations and Surface Transportation Extensions Act, 2011 (Public Law 111-322), the continuing resolution that ran through March 4, 2011.

13. For the 2012–2015 period, those costs come from DoD's 2011 Future Years Defense Program (FYDP), which was issued in April 2010. For 2016, CBO constructed an extension of the FYDP starting with DoD's cost estimates for 2015 and projecting the costs of DoD's longer-term plans, which are available for all of the procurement programs analyzed. For further discussion of CBO's extension of the FYDP, see Congressional Budget Office, *Long-Term Implications of the 2011 Future Years Defense Program* (February 2011).

Budgetary effects for most of the revenue options were estimated by the staff of the Joint Committee on Taxation (JCT).

Some options that involve collecting fees raise the question of whether the proceeds from those fees should be classified as revenues (governmental receipts) or as offsets to spending (offsetting receipts or offsetting collections). In classifying new fees for this volume, CBO generally followed the guidance of the 1967 President's Commission on Budget Concepts, which indicates that receipts from a fee imposed pursuant to the federal government's sovereign power should generally be recorded in the budget as revenues. (Sometimes, however, the Congress has legislated the budgetary classification of fees, requiring that they be recorded as offsets to spending when they would otherwise have been recorded as revenues.)

Caveats About This Report

Because the options in this volume are intended to help lawmakers review individual programs or tax provisions, they do not include large-scale budget initiatives, such as eliminating entire departments or agencies. Many of the

options could be combined to provide the building blocks for broader changes. In some cases, however, combining various spending or revenue options would produce different budgetary effects than the sums of the estimates shown here. The reason is that some options would overlap or would interact with one another in ways that would change their budgetary impact. Also, certain options would be mutually exclusive.

The estimates shown in this volume could differ from any later cost estimates by CBO or revenue estimates by JCT for legislative proposals that resemble these options. One reason is that the proposals on which those later estimates would be based might not precisely match the options presented here. Another reason is that the baseline budget projections against which such proposals would ultimately be measured might have been updated and thus would differ from the projections used for this report.

The estimated budgetary effects of options do not reflect the extent to which a policy change would affect interest payments on federal debt. Interest savings may be included as part of a comprehensive budget plan (such as the Congressional budget resolution), but CBO does not make such calculations for individual pieces of legislation or for options of the type discussed here.

CBO's analyses also do not attempt to quantify the impact of options on states' spending or revenues. However, some of the estimates in this volume depend on projections of states' responses to federal policy changes, which can be difficult to predict and can vary over time with the fiscal conditions of states and other factors.

Some options that would affect other levels of government or the private sector might involve federal mandates. The Unfunded Mandates Reform Act of 1995 defines mandates as including enforceable duties imposed on state, local, or tribal governments or the private sector, as well as certain types of provisions affecting large entitlement programs that provide funds to states. That law requires CBO to estimate the costs of any mandates that would be imposed by new legislation that the Congress is considering. The discussions of the options in this volume, however, do not address the costs of potential mandates.

CHAPTER

2

Mandatory Spending Options

Mandatory spending—which totaled about $1.9 trillion in 2010, or 55 percent of federal outlays—consists of all spending (other than interest on federal debt) that is not subject to annual appropriations. The Congress generally determines spending levels for mandatory programs by setting the programs' parameters, such as eligibility rules and benefit formulas, rather than by appropriating specific amounts each year. Mandatory spending also includes offsetting receipts, which consist of fees and other charges that are recorded as negative budget authority and outlays.[1]

Nearly all mandatory outlays occur through social insurance programs (programs in which most eligible people participate and to which they contribute at least part of the funding) or through means-tested programs (which link eligibility to people's income). The largest mandatory programs are Social Security and Medicare (see Figure 2-1). Together, they accounted for 60 percent of mandatory outlays in 2010—or about one-third of all federal spending—shares that are expected to grow appreciably in coming years. Medicaid and other health programs accounted for about 15 percent of mandatory spending last year, and unemployment compensation, boosted by high unemployment and extended benefits, accounted for about 8 percent.

The remaining mandatory spending goes to various income security programs—including the Supplemental Nutrition Assistance Program (SNAP), child nutrition programs, Temporary Assistance for Needy Families, and certain refundable tax credits—as well as to retirement benefits for civilian and military employees of the federal government, veterans' benefits, deposit insurance (net of premiums that banks pay for such insurance), student loans, and support for agriculture.[2] In the past few years, mandatory spending has also included outlays for the Troubled Asset Relief Program (TARP) and subsidies for Fannie Mae and Freddie Mac (two institutions that facilitate the flow of funding for home loans nationwide).

Trends in Mandatory Spending

Relative to the size of the economy, mandatory spending peaked in 2009 at 14.9 percent of gross domestic product (GDP), before dropping last year to 13.2 percent of GDP (see Figure 2-2). Much of the decline in spending in 2010 resulted from unusually large negative outlays recorded for the TARP and deposit insurance, as well as from a drop in payments to Fannie Mae and Freddie Mac. Taken together, all other mandatory spending grew in 2010.

If no new laws are enacted that affect mandatory programs, outlays for such programs will rise to 14.0 percent of GDP in 2011, the Congressional Budget Office (CBO) estimates.[3] Mandatory spending is then projected to decline to around 13.0 percent of GDP from 2012 to 2018, as the economy grows and spending on income security programs such as unemployment compensation decreases. Thereafter, mandatory outlays are projected to increase steadily relative to GDP under current law—reaching 14.0 percent again in 2021—because of the aging of the population, rising health care costs, and

1. Offsetting receipts differ from revenues in that revenues are collected through the exercise of the government's sovereign powers (for example, levying income taxes), whereas offsetting receipts are generally collected from other government accounts or from members of the public through businesslike transactions (for example, collecting premiums for Medicare or rental payments and royalties for the extraction of oil and gas on public lands). Throughout the introduction to this chapter, spending for Medicare is reported net of offsetting receipts.

2. Tax credits reduce a taxpayer's overall tax liability (the amount owed); if a refundable credit exceeds that liability, the excess may be refunded to the taxpayer, in which case it is recorded in the budget as an outlay.

3. The baseline budget projections discussed in this report are from Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011).

Figure 2-1.

Breakdown of Mandatory Spending in 2010

Source: Congressional Budget Office.

Notes: Other health programs include the Children's Health Insurance Program, some public health initiatives, and certain health programs for military retirees.

Other mandatory spending includes outlays for federal civilian and military retirement, refundable tax credits, certain veterans' benefits, the Supplemental Nutrition Assistance Program (formerly called Food Stamps), and a variety of other programs.

other factors. By comparison, mandatory spending averaged 11.2 percent of GDP over the past 10 years and 9.9 percent over the past 40 years.[4]

Those projections for total mandatory spending mask diverging trends for different components of such spending. CBO projects that spending for Social Security, Medicare, Medicaid, and other health care programs will grow from 9.9 percent of GDP in 2010 to 12.0 percent by 2021, driven largely by rapid growth in health care costs. At the same time, outlays for income security programs (such as unemployment compensation, SNAP, and certain refundable tax credits) will decline relative to GDP, from 3.0 percent in 2010 to 1.3 percent by 2021. That projected decline reflects an expected economic expansion, which will reduce the number of people eligible for many income security programs, and scheduled changes to tax provisions, which will reduce the refundability of some tax credits. The remaining portion of mandatory spending is projected to increase from 0.2 percent of GDP in 2010 to 0.7 percent by 2021.

Assumptions Underlying Projections of Mandatory Spending

In creating its baseline budget projections, CBO generally assumes that existing laws will remain unchanged. That assumption applies to most, but not all, mandatory programs. Following long-standing Congressional procedures, CBO assumes that most mandatory programs that are scheduled to expire in the coming decade under current law will be extended instead. In particular, all such programs that predate the Balanced Budget Act of 1997 and that have outlays in the current year greater than $50 million are presumed to continue under CBO's baseline; for programs established after 1997, continuation is

4. For a more detailed discussion of the components of mandatory spending and CBO's projections for them, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, Chapter 3.

Figure 2-2.

Mandatory Spending, 1971 to 2021

(Percentage of gross domestic product)

Source: Congressional Budget Office (as of January 2011).

Note: Data include offsetting receipts (funds collected by government agencies from other government accounts or from the public in businesslike or market-oriented transactions that are recorded as offsets to outlays).

assessed on a program-by-program basis in consultation with the House and Senate Budget Committees. The assumption that expiring programs will continue has little effect on CBO's projection of total mandatory spending for 2011. However, that assumption raises projected mandatory outlays by $118 billion (or about 3 percent) in 2021 and by a total of about $1.0 trillion between 2012 and 2021.

CBO's baseline also incorporates the assumption that Medicare spending will be constrained beginning next year by the sustainable growth rate mechanism, which controls the fees paid for physicians' services. Under current law, those fees will be reduced by about 28 percent in January 2012 and by additional amounts in subsequent years, CBO projects. If, however, future legislation overrides the scheduled reductions—as has happened every year since 2003—spending for Medicare may be greater than the amounts projected in the baseline. For example, if payment rates for physicians stayed at their 2011 dollar levels through 2021, Medicare outlays over the next decade (net of premiums paid by enrollees) would exceed the current baseline projections by about $250 billion (or 3 percent). If payment rates were raised over time, the impact on Medicare outlays would be even greater.[5]

Some of the options for Medicare presented in this chapter might be implemented under current law and could be the means by which the growth of Medicare spending is limited to the amounts projected in the baseline. The reason is that the Patient Protection and Affordable Care Act (Public Law 111-148) created the Independent Payment Advisory Board (IPAB) and made it responsible for restraining the growth rate of Medicare spending per enrollee.[6] If the growth of such spending is projected to exceed specified targets, the IPAB will be required to submit proposals to reduce it, and the Secretary of Health and Human Services must implement those proposals unless the Congress acts to change them or otherwise alter the IPAB process. The board is not allowed to make recommendations that would ration care, raise premiums, increase cost sharing, restrict benefits, or modify eligibility, leaving reductions in payments to health care

5. For additional information on Medicare's payments to physicians, see Congressional Budget Office, *Factors Underlying the Growth in Medicare's Spending for Physicians' Services*, Background Paper (June 2007).

6. For more details about the IPAB and its mandate, see David Newman and Christopher M. Davis, *The Independent Payment Advisory Board*, Report for Congress R41511 (Congressional Research Service, November 30, 2010).

providers as its major potential source of savings. CBO's baseline projections incorporate an estimate that the IPAB process will reduce outlays for Medicare by a total of $14 billion between 2017 and 2021.

Another assumption underlying CBO's projections involves the role of trust funds. Payments for Social Security and Medicare are made from dedicated trust funds within the federal budget: Social Security's Old-Age and Survivors Insurance (OASI) Trust Fund and Disability Insurance (DI) Trust Fund, and Medicare's Hospital Insurance (HI) Trust Fund and Supplementary Medical Insurance (SMI) Trust Fund.[7] Revenues from specific payroll taxes go into the OASI, DI, and HI trust funds; those funds also receive some receipts from other sources specified in law. The SMI trust fund receives revenues from general government funds, premiums paid by enrollees, and other sources. CBO expects that under current law, receipts for the OASI, DI, and HI trust funds will not be sufficient at some points in the future to pay currently prescribed benefits. Specifically, CBO projects that under current law, the OASI trust fund will be exhausted in 2042, the DI trust fund in 2017, and the HI trust fund in 2021.[8] (Because the SMI trust fund can draw on general revenues without limit, its receipts will not fall short of benefit payments.)

If a program's trust fund is exhausted and the receipts coming into the fund during a given year are not sufficient to pay the full benefits scheduled under law that year, the program will not have the legal authority to pay full benefits. In that case, benefits will have to be reduced to bring outlays in line with receipts. Nonetheless, following long-standing Congressional procedures, CBO's baseline incorporates the assumption that beneficiaries will receive the full payments or services to which they are entitled under Social Security and Medicare in coming years.

Trust funds are essentially accounting mechanisms. Any cash generated when annual receipts exceed annual spending is not retained by a trust fund. Rather, the money is turned over to the Treasury, which gives the trust fund government bonds in exchange and uses the cash to finance the government's ongoing activities. Because trust funds are part of the government, transactions between them and the Treasury are intragovernmental and have no net impact on the overall budget or on federal borrowing from the public. The resources used to redeem a trust fund's government bonds—and thus pay for benefits—in some future year will have to be generated from taxes, other government income, or government borrowing in that year. As a result, although trust funds have important legal meaning, they have little meaning for the overall federal budget or the economy.

Sources of Growth in Mandatory Programs

A number of factors—such as changes in eligible populations, increases in health care costs, developments in the economy, and actions by state governments—influence growth in federal mandatory spending. The importance of specific factors varies among programs.

Demographic Changes

Many mandatory programs provide benefits to specific populations, with eligibility a function of such criteria as age, income, and family status. People who meet those eligibility rules are typically entitled to benefits.[9] For such programs, an important factor in CBO's baseline is the effect of demographic changes on the size of the population enrolled or participating in the program. For example, CBO's projections of Medicare spending incorporate the impact of the aging of the baby-boom generation, whose oldest members are now reaching the age of eligibility for Medicare. CBO estimates that the number of enrollees in Medicare will grow from 45 million in 2010 to almost 60 million by 2021.

7. The HI trust fund pays for care in hospitals and other institutions under Part A of Medicare; the SMI trust fund pays for care by physicians and other providers under Part B of Medicare and for prescription drugs under Part D of Medicare. In addition, both trust funds are used to pay benefits for people who join private Medicare Advantage plans under Part C of Medicare.

8. The DI trust fund has been close to exhaustion before. The 1994 annual report of the Social Security Board of Trustees projected that it would be exhausted in 1995. That outcome was prevented by legislation that redirected revenue from the OASI trust fund to the DI trust fund. CBO projects that if legislation to shift resources from the OASI trust fund to the DI trust fund was enacted again, the combined OASDI trust funds would be exhausted in 2039.

9. Some mandatory programs are capped or are provided in the form of grants to states. In such cases, although a program's funding is mandatory, there is not a specific individual entitlement to benefits or services.

Similar demographic pressures will affect outlays for Social Security, the largest federal spending program. Those outlays rose by 3.4 percent in 2010, primarily because both the retirement (OASI) and disability (DI) components of the program saw increases in the number of people enrolled. Over the 2011–2021 period, as more baby boomers become eligible for OASI benefits, the number of people collecting those benefits will grow by about 3 percent per year, CBO estimates—from 44 million in 2010 to 59 million by 2021. In addition, average OASI benefits will rise over time, both because benefits for people who are already collecting them are subject to annual cost-of-living adjustments (COLAs) to keep pace with inflation and because initial benefits are based on individual earnings, which tend to grow with time. For all of those reasons, OASI outlays are projected to increase by about 6 percent a year in the coming decade (see Table 2-1).

The number of people receiving DI benefits jumped by almost 5 percent in 2010, to nearly 10 million. Higher-than-average increases in enrollment are expected to persist through 2012, largely because the high unemployment rate means that many disabled people will continue to face meager job prospects. After 2013, however, the annual growth rate of enrollment is projected to average 1.2 percent, as a strengthening economy leads fewer people to seek disability benefits and as more people qualify for benefits under OASI.

Growth in Health Care Spending per Person

In the case of health care programs, although demographics are a significant element of CBO's projections, expected growth in health spending per person is also important. Enrollment in Medicare is projected to increase by about one-third between 2010 and 2021, and spending per Medicare beneficiary is expected to rise by about one-half over that period. Some of the latter rise stems from overall inflation, and some results from growth in spending per beneficiary over and above inflation. Altogether, CBO projects that spending for the Medicare program will roughly double between 2011 and 2021 in dollar terms and will increase from 3.6 percent of GDP to 4.3 percent of GDP. Growth in health care spending per person will also boost spending on Medicaid and other mandatory federal health programs in the coming decade.

Over the longer run, rising health care spending per person will continue to drive up federal health spending under current law. For the past several decades, the rate of growth of health care spending per person (adjusted for the effect of changes in the age composition of the population) has exceeded the growth of per capita GDP—a phenomenon referred to as "excess cost growth." Between 1985 and 2008, for example, excess cost growth averaged 1.5 percentage points a year for Medicare, 1.2 percentage points for Medicaid, and 1.9 percentage points for other national health spending.[10] CBO expects rates of excess cost growth to slow somewhat over time. Even so, it projects that spending for Medicare and Medicaid combined will climb from 5.5 percent of GDP today to 11 percent of GDP by 2035, with slightly more than half of that increase resulting from excess cost growth and slightly less than half from the aging of the population.

Economic Changes

Overall economic trends also influence CBO's estimates of mandatory spending. Growth in productivity and GDP, changes in prices and wages, and other economic factors affect both the number of people who participate in mandatory programs and the cost of providing the benefits specified in current law. Therefore, CBO's baseline budget projections depend on the agency's economic projections. For example, a forecast of lower inflation would tend to restrain projections of mandatory spending, because of smaller COLAs for some programs and because of slower growth in input prices for other programs.

The recent economic downturn had a significant impact on several mandatory programs. A decline in consumer prices precluded COLAs for Social Security benefits in 2010 and 2011, so Social Security outlays were lower than they would have been otherwise. CBO expects Social Security COLAs to resume in 2012. Outlays for the Supplemental Nutrition Assistance Program doubled between 2007 and 2010, to $70 billion, as enrollment leapt from about 26 million people to 40 million. CBO estimates that spending for SNAP will increase by another 10 percent in 2011, to $77 billion, as the enrolled population continues to swell. SNAP enrollment is expected to decline in later years as the economy improves, falling back to roughly 31 million people by 2021 in CBO's baseline projections. Likewise, outlays

10. For additional discussion of excess cost growth, see Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010, revised August 2010), Chapter 2.

Table 2-1.

CBO's Baseline Projections of Mandatory Outlays

(Billions of dollars)

	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
Social Security	701	727	761	799	842	889	940	997	1,059	1,126	1,196	1,267	4,231	9,876
Health Programs														
Medicare[a]	520	572	566	610	645	679	738	771	806	885	949	1,021	3,238	7,670
Medicaid	273	274	264	278	329	371	416	447	474	508	544	587	1,659	4,219
Other[b]	17	24	27	27	52	78	101	118	126	137	144	155	286	966
Subtotal	810	870	858	915	1,027	1,128	1,256	1,337	1,407	1,529	1,636	1,764	5,183	12,856
Income Security Programs														
SNAP	70	77	80	80	71	69	68	67	65	64	64	63	368	691
Unemployment compensation	159	129	87	64	61	58	53	52	54	56	58	60	324	604
Supplemental Security Income	47	53	46	52	53	54	60	57	53	60	62	69	265	566
Earned income and child tax credits	77	77	77	77	46	46	45	45	46	46	46	46	290	520
Other[c]	84	73	54	55	54	55	56	58	59	61	62	64	274	578
Subtotal	438	409	343	327	285	282	284	279	278	287	292	302	1,521	2,958
Federal Civilian and Military Retirement	139	146	141	149	154	158	168	168	169	180	185	192	770	1,665
Veterans' Programs[d]	58	78	64	70	72	74	81	78	75	82	84	87	360	765
Other Programs[e]	-52	68	82	68	54	55	58	55	53	63	62	60	316	608
Offsetting Receipts[f]	-184	-191	-211	-222	-230	-240	-249	-267	-285	-302	-317	-338	-1,151	-2,659
Total Mandatory Spending	**1,910**	**2,108**	**2,038**	**2,106**	**2,203**	**2,346**	**2,538**	**2,647**	**2,757**	**2,964**	**3,138**	**3,333**	**11,230**	**26,070**
Memorandum:														
Spending for Medicare Net of Offsetting Receipts	446	492	477	517	549	578	633	653	679	746	797	855	2,755	6,485

Source: Congressional Budget Office (as of January 2011).

Notes: Spending for the benefit programs shown above generally excludes administrative costs, which are discretionary.

SNAP = Supplemental Nutrition Assistance Program.

a. Excludes offsetting receipts (premiums paid by Medicare enrollees and certain payments by states).

b. Includes health insurance subsidies, exchanges, and related spending under the Patient Protection and Affordable Care Act (Public Law 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152); the Department of Defense's Medicare-Eligible Retiree Health Care Fund; and the Children's Health Insurance Program.

c. Includes Temporary Assistance for Needy Families and various programs that involve payments to states for child support enforcement and family support; child nutrition programs; foster care programs; and the Making Work Pay and other tax credits.

d. Includes veterans' compensation, pensions, and life insurance programs, as well as education subsidies for veterans.

e. Includes the Troubled Asset Relief Program, Fannie Mae, Freddie Mac, deposit insurance, higher education programs, and agriculture programs.

f. Includes Medicare premiums, amounts paid by states from savings on Medicaid prescription drug costs, the federal share of federal employees' retirement contributions, and other funds collected by government agencies from other government accounts or from the public in businesslike or market-oriented transactions that are recorded as offsets to outlays.

for unemployment compensation quadrupled between 2008 and 2010, reaching $159 billion, because of high unemployment rates and legislation that enhanced benefits. CBO projects that outlays for unemployment compensation will return to prerecession levels as the economy improves, falling to $60 billion (roughly the 2007 level) in 2021.

Actions by States

Among mandatory programs, both Medicaid and the Children's Health Insurance Program (CHIP) are funded jointly by the federal government and the states. Federal funding matches a portion of state spending, within established rules (although total federal funds for CHIP are capped). Thus, federal spending on those programs is partly determined by states' behavior, and the growth rate of spending (particularly for Medicaid) will depend on states' decisions about eligibility criteria, the types of services that the programs will cover, and the prices that states will pay for those covered services.

Approaches to Reducing Mandatory Spending

Because mandatory programs account for the majority of federal spending—and their share is expected to continue to rise—reducing the budget deficit significantly in both the short and long terms would be very difficult without restraining the growth of mandatory spending. Annual appropriations do not determine the amount of mandatory spending, so policymakers must look to different approaches to control such spending. Examples of possible approaches include modifying the automatic indexation of benefits, the populations entitled to benefits, or the federal government's share of spending.

Changing the Automatic Indexation of Benefits

Many mandatory programs use some form of indexing for inflation to determine annual changes in benefits. Therefore, the choice of an index or inflation adjustor can have a significant impact on a program's spending. Using a different measure of inflation or adjusting benefits by less than the full measured change in prices each year can generate savings that, because of the impact of compounding, will tend to grow over time.

Changing the Populations Entitled to Benefits

Mandatory programs that provide benefits to specific populations grow or contract with the size of the populations served. For example, people may enroll in income support programs during periods of economic dislocation and then leave once their situation improves. Consequently, in a downturn affecting the overall economy, the federal government may be faced with additional mandatory spending at the same time that revenues are lower. (Such changes in government spending and revenues are known as "automatic stabilizers" because they occur independent of any legislative action and tend to stabilize economic activity.) As another example, more people will enroll in mandatory programs over the next decade because the aging of the population will make a larger share of Americans eligible for Social Security, Medicare, and other programs that focus on older people. Moreover, increasing life expectancy means that many Americans will receive benefits from those programs for more years than people would have in the past. Policymakers could seek to mitigate the growth of mandatory spending by altering the criteria that determine eligibility for income support programs or by increasing the eligibility age for certain benefits.

Changing the Federal Government's Share of Spending

Federal spending on mandatory programs can be lowered by reducing the federal government's share of the programs' spending and increasing the shares borne by state governments, program participants, and others. For example, in Medicaid and other programs that involve state matching funds, the federal commitment could be reduced, thus shifting costs to the states and encouraging states to trim spending on those programs. In health care programs such as Medicare, premiums or cost sharing could be increased, thus shifting costs to beneficiaries and encouraging them to restrain their use of services. Requiring people to pay more for a service would decrease federal costs and might lower the overall cost of providing that service if people responded by using less of it.

Mandatory Spending Options in This Chapter

The options that follow encompass a broad range of mandatory spending programs. Although the options are grouped by program, some of the options for different programs are conceptually similar, in line with the approaches to reducing spending discussed above. For instance, two options address the effects of applying different inflation factors to the benefit formulas for certain programs. Other options would alter the balance of

spending between the government and program participants or between the federal government and the states.

Of the 32 options in this chapter, 15 deal with spending for health care programs. Another 7 would make changes to Social Security or other retirement programs. The remaining options focus on Fannie Mae, Freddie Mac, and programs that deal with education, energy, or agriculture. The budgetary impact of each option is estimated independently, without consideration for potential interactions with other options. The table accompanying an option shows the option's estimated budgetary effects in each of the next 10 years, as well as 5- and 10-year totals. Those effects are measured relative to the spending that CBO projects would occur under current law, as shown in the agency's January 2011 baseline.

In addition to the options in this chapter, three more options—which would increase rather than decrease mandatory spending—are discussed in Appendix A. Those options relate to provisions of Medicaid, Medicare, and Social Security. They are included in this volume because CBO frequently receives requests for estimates of their budgetary effects.

Mandatory Spending—Option 1 **Function 050**

Introduce Minimum Out-of-Pocket Requirements Under TRICARE For Life

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays												
Department of Defense	0	-2,100	-3,000	-3,300	-3,500	-3,700	-4,000	-4,300	-4,600	-5,000	-11,900	-33,500
Medicare	0	-600	-900	-900	-1,000	-1,100	-1,100	-1,200	-1,300	-1,400	-3,400	-9,500
Total	0	-2,700	-3,900	-4,200	-4,500	-4,800	-5,100	-5,500	-5,900	-6,400	-15,300	-43,000

TRICARE For Life (TFL) was introduced in 2002 as a supplement to Medicare for military retirees and their family members who are eligible for Medicare. The program pays nearly all medical costs for acute care not covered by Medicare and requires few out-of-pocket fees. Because the Department of Defense (DoD) is a passive payer in the program—it neither manages care nor provides incentives for the cost-conscious use of services—it has virtually no means of controlling the program's costs. In contrast, most public and private programs that pay for health care either manage the care or require people receiving care to pay deductibles or copayments to a specified threshold. In 2010, DoD spent about $8.4 billion on Medicare-eligible beneficiaries (in addition to amounts spent for those individuals by Medicare).

This option would introduce minimum out-of-pocket requirements for TFL beneficiaries. For calendar year 2013, TFL would not cover any of the first $550 of an enrollee's cost-sharing payments under Medicare and would cover only 50 percent of the next $4,950 in such payments. (Because all further cost sharing would be covered by TFL, enrollees would not be obliged to pay more than $3,025 in cost sharing in that year.) Those dollar limits would be indexed to growth in average Medicare costs for later years. Currently, military treatment facilities charge very small or no copayments for hospital services to TFL beneficiaries. To reduce beneficiaries' incentive to switch to those facilities and avoid the out-of-pocket costs of using civilian facilities, this option would require TFL beneficiaries seeking care from military treatment facilities to make payments that would be roughly comparable to the charges they would face at civilian facilities.

This option would reduce spending for Medicare as well as for TFL because higher out-of-pocket costs would lead beneficiaries to use somewhat fewer medical services. Altogether, this option would reduce the federal spending devoted to TFL beneficiaries by about $15 billion through 2016 and by about $43 billion through 2021. Approximately 30 percent of those savings would come from a reduced demand for medical services; the rest represents a shift of spending from the government to military retirees and their families.

An advantage of this option is that greater cost sharing would increase TFL beneficiaries' awareness of the cost of health care and promote a corresponding restraint in their use of medical services. Research has generally shown that introducing modest cost sharing can reduce medical expenditures without causing measurable increases in adverse health outcomes for most people.

Among its disadvantages, this option could discourage some patients (particularly low-income patients) from seeking preventive medical care or from managing their chronic conditions under close medical supervision, which might negatively affect their health.

RELATED OPTIONS: Discretionary Spending, Options 3 and 5

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011; and *The Effects of Proposals to Increase Cost Sharing in TRICARE,* June 2009

Mandatory Spending—Option 2 **Function 270**

Transfer the Tennessee Valley Authority's Electric Utility Functions and Associated Assets and Liabilities

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	5	20	-100	-500	-500	-500	-500	-500	-500	-500	-1,075	-3,575

In 1933, the Tennessee Valley Authority (TVA) was established as a federal agency to control flooding, improve navigation, and develop the hydroelectric resources of the Tennessee River for the benefit of a seven-state region in the southeastern United States. Since then, TVA has developed an extensive network of transmission facilities and nuclear- and fossil-fuel-powered electricity-generating plants. As one of the largest electric utilities in the nation, TVA accounted for 5 percent of national electricity generation in 2010. To maintain sufficient capacity, TVA anticipates that it will need to make large capital expenditures in the next decade and beyond. TVA funds its investments primarily by issuing debt, and it services those debt obligations from revenues earned through electricity sales to customers over several decades.

This option would transfer most of TVA's electric utility functions and associated assets and liabilities to a nonfederal owner and operator—a private firm, for example, or to an entity owned by its distributors. That entity could be similar to the newly formed Seven States Power Corporation, a nonprofit electricity generation and transmission cooperative in the Tennessee Valley. The hydropower assets and liabilities would be retained by the government because they serve several other purposes, such as flood control and recreation. This option assumes that the transfer of TVA's electric utility functions and associated assets and liabilities would be completed by the end of 2013. Such a transfer could be accomplished in different ways: TVA's assets and liabilities could be conveyed free of charge, for example, or they could be sold in a competitive auction to a nonfederal entity. Proceeds from such an auction would depend on the terms and conditions of the sale. As a result, potential proceeds are not included in this estimate.

Even in the absence of auction proceeds, the Congressional Budget Office estimates that implementing this option will reduce net outlays by about $1 billion over the 2012–2016 period and by nearly $4 billion over the 2012–2021 period. Those savings reflect the estimated net outlays that TVA otherwise would have incurred to build new electric power facilities over the next 10 years. CBO's estimate assumes that the current $30 billion ceiling on TVA's borrowing would be maintained; if that ceiling was raised, the budgetary savings from this option would probably be greater over the 2012–2021 period.

The 10-year budgetary impact of such a capital transfer does not fully capture its long-term impact on the government. For example, although the government would avoid new capital outlays, it would also forgo a stream of future income that would accrue from those outlays. That income would not fully compensate for the upfront capital costs, however, because of the implicit subsidies conveyed to ratepayers in the region. By law, TVA's rates are set to recover its costs and maintain an operating reserve. But the capital charge included in those rates is artificially low because, unlike private utilities, TVA does not have to provide a return to equity holders—in this case, the taxpayers, who are exposed to the risk of having to make up for future revenue shortfalls. In addition, TVA's borrowing costs are relatively low because its status as a federal agency leads many creditors to assume that TVA's obligations would be paid off in the event of default, even though existing law explicitly states that TVA's debts are not guaranteed by the federal government.

One rationale for this option is that transferring ownership could give state regulatory agencies and TVA's customers more control over future costs. TVA is exempt from most state regulatory review because of its status as a federal agency. Its operations are sheltered from competition, moreover, because federal law requires customers in its service area to purchase virtually all of their electricity from TVA. Increased competition, proponents would argue, could produce greater efficiency and improve cost control. In addition, many would argue that the genera-

tion and transmission of electricity are fundamentally private-sector activities. A final rationale is that it would eliminate the implicit subsidies that the government now provides to the region's ratepayers.

An argument against this option is that TVA's contribution to the economic development of its seven-state region could be diminished if TVA was under nonfederal ownership. For example, a new owner might reduce expenditures on efforts to attract new businesses to the communities in TVA's service area. Furthermore, a reduction in public subsidies would probably cause an increase in electricity prices. Finally, regulatory and other constraints on the new owner and operator of TVA's system could limit the potential benefits of a transfer.

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

Mandatory Spending—Option 3 **Function 270**

Reduce the Size of the Strategic Petroleum Reserve

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	-700	-1,300	-1,400	-1,400	-1,400	-700	0	0	0	0	-6,200	-6,900

The Strategic Petroleum Reserve (SPR) is a stock of crude oil that the government owns and stores at four underground sites along the Gulf of Mexico. The SPR, which can hold about 727 million barrels of oil, was established in 1975 to help insulate the United States against a severe disruption in oil supplies. With a final shipment of about half a million barrels, the SPR was filled to capacity in December 2009. The Department of Energy (DOE) is authorized to expand the SPR's capacity to 1 billion barrels. DOE can draw oil from the reserve at a maximum sustained rate of 4.4 million barrels per day (or about 44 percent of average daily U.S. oil imports and about 22 percent of average daily U.S. petroleum consumption) for about 90 days; after that, the maximum draw rate is less.

This option would reduce the SPR's holdings by about 10 percent during the 2012–2016 period and then maintain a reserve of 650 million barrels. In the Congressional Budget Office's estimation, selling the excess holdings—about 75 million barrels of oil—would generate $700 million in 2012 and roughly $6 billion over five years, net of estimated decommissioning costs. That estimate assumes that DOE will receive slightly more than $90 per barrel, consistent with CBO's January 2011 economic projection. The estimate does not include savings from forgoing expansion of the SPR.

Oil has seldom been withdrawn from the SPR. In 1996, DOE sold 28 million barrels at the direction of lawmakers in order to reduce the federal budget deficit. DOE also sold a combined 5 million barrels in test sales in 1985 and 1990. Since 1996, DOE has released—to respond to temporary supply disruptions or to exchange one grade of crude oil for another—a total of about 68 million barrels to private firms through negotiated exchange agreements under which the companies have later replaced the oil, with interest. Only twice has oil been sold from the SPR in response to an emergency, and each of those sales involved only a small fraction of the reserve's holdings. Citing the risk of economically threatening disruptions in supply, DOE sold about 17 million barrels during the 1991 Gulf War and about 11 million barrels after Hurricane Katrina in 2005.

Most arguments in favor of this option concern changes over time in the benefits and costs associated with the reserve. The increasing diversity of world oil supplies and growing integration of the economies of oil-producing and oil-consuming nations have probably lessened the risk of a sustained, widespread disruption. Large structural shifts in energy markets and in the U.S. economy since 1975 have moderated the likely costs of a disruption in oil supplies and, thus, the benefits that might accrue from releasing oil in a crisis. In addition, the government's ability to smooth oil prices by selling oil from the SPR at times of increasing world oil prices, or by purchasing oil for the SPR when world oil prices are declining, may be limited because SPR sales or purchases would represent only a very small fraction of world oil consumption. Moreover, the cost of maintaining SPR facilities has escalated as those facilities have aged. Finally, analysis of past sales and withdrawals from the SPR suggests that a 10 percent reduction in its holdings probably would not compromise its ability to address the types of problems that have triggered past releases.

Several arguments can be made against this option. If the capacity of the SPR is not expanded and U.S. demand for oil continues to grow, the SPR will eventually be unable to hold the equivalent of 90 days' worth of net oil imports in reserves of oil or petroleum products. (The United States and other nations have made a commitment to the International Energy Agency to hold reserves in at least that amount.) In 2010, the SPR held the equivalent of about 79 days' worth of net oil imports. Estimates in the Energy Information Agency's (EIA's) *Annual Energy Outlook 2011* suggest that the SPR will hold, at capacity, between 65 and 105 days' worth of net oil imports in 2021, depending on future crude oil prices and associated demand. The EIA's central projection of future oil demand implies an 82-day supply in the SPR

in 2021. Also arguing against the option are several factors—instability in the supply of oil from the Persian Gulf and other regions; expected growth in U.S. reliance on oil imports, particularly from the Middle East; and the possibility of terrorist attacks on the oil system—that suggest that the benefit of maintaining the SPR to guard against supply disruptions may be increasing.

RELATED CBO PUBLICATIONS: *The Economic Effects of Recent Increases in Energy Prices,* July 2006; and *Rethinking Emergency Energy Policy,* December 1994

Mandatory Spending—Option 4 **Function 300**

Prohibit New Enrollment in the Conservation Stewardship Program

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-35	-255	-479	-706	-899	-1,185	-1,411	-1,634	-1,860	-2,087	-2,374	-10,549

The Conservation Stewardship Program (CSP) gives agricultural producers financial and technical help with conserving and improving soil, water, air, energy, and plant and animal life on agricultural lands. Under the CSP, producers enter into five-year contracts (in some cases, those contracts may be extended for an additional five years) with the Department of Agriculture (USDA) to undertake various conservation measures—such as enhancing wildlife habitats or renovating windbreaks—in exchange for annual payments. For every acre enrolled in the CSP, a producer receives compensation for carrying out and maintaining new conservation activities and for improving, maintaining, and managing existing conservation practices. Current law limits new enrollment in the CSP to 12.769 million acres per year, at an average cost of $18 per acre.

This option would prohibit new enrollments in the Conservation Stewardship Program beginning in 2012. Land currently enrolled in the CSP would be eligible to continue to receive payments until the contract expired. By the Congressional Budget Office's estimates, this change would reduce spending by about $2 billion over 5 years and by almost $11 billion over 10 years.

One argument for phasing out the CSP is that some provisions of the program limit its effectiveness. For example, paying producers for conservation practices they have already adopted does not enhance the nation's conservation efforts. The criteria used by USDA to determine whether improvements in existing conservation practices have been made are not clear, and the absence of such objective measurements could result in higher payments than necessary to encourage adoption of new conservation measures.

An argument in favor of continuing the CSP is that it may be a way to support agriculture that provides more environmental benefits than traditional crop-based subsidies do. Conservation practices often impose significant up-front costs, and those expenditures can reduce the net economic output of agricultural land; CSP payments help offset those costs.

RELATED OPTION: Mandatory Spending, Option 5

Mandatory Spending—Option 5 **Function 300**

Limit Enrollment in the Conservation Reserve Program

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-300	-800	-800	-1,100	-1,000	-1,100	-1,000	-1,200	-1,200	-3,000	-8,600

The Department of Agriculture's Conservation Reserve Program (CRP) is intended to promote soil conservation, improve water quality, and protect wildlife habitat by removing land from active agricultural production. Landowners sign contracts with the Department of Agriculture to keep land out of production—usually for 10 to 15 years; in exchange, the department provides annual payments and cost-sharing grants to establish appropriate conservation practices on land enrolled in the program. Acreage may be added to the CRP through general enrollments, which are held periodically for larger tracts of land, or through continuous enrollments, which are available at any time during the year for smaller tracts of land. An example of an effective type of acreage for those purposes is conservation buffers—narrow strips of land that are maintained in permanent vegetation and are designed to intercept pollutants, reduce erosion, and provide other environmental benefits. Acreage is accepted into the CRP on the basis of an evaluation of the costs and potential environmental benefits of a landowner's plan for the land. Under current law, total enrollment is capped at 32 million acres, and about 31 million acres are enrolled. The Department of Agriculture spends about $2.4 billion per year on the CRP.

Prohibiting new general enrollments (including reenrollments), beginning in 2012, would reduce spending by $3 billion over the 2012–2016 period, the Congressional Budget Office estimates, and by about $9 billion over the 2012–2021 period. Under this approach, the amount of land enrolled in the CRP would drop significantly, to 11.9 million acres by 2021.

Although there is widespread agreement about the need to take some environmentally sensitive land out of production, an advantage of scaling back the CRP is that the land could become available for other uses that would provide greater environmental benefits. Another advantage of limiting the program could be that retiring less cropland in a given area might enhance economic activity (for example, by increasing the demand for seed, fertilizer, and other farm supplies), thus helping rural communities. Also, reducing CRP enrollment could free more land to produce crops and biomass needed for renewable energy products.

A disadvantage of scaling back the CRP could be that the Department of Agriculture's existing plan to accept only the most environmentally sensitive land in future enrollments might turn out to be a cost-effective way to protect fragile lands. Studies have indicated that the CRP yields high returns—in enhanced wildlife habitat, improved water quality, and reduced soil erosion—for every dollar it spends.

RELATED OPTION: Mandatory Spending, Option 4

Mandatory Spending—Option 6 **Function 350**

Reduce the Premium Subsidy in the Crop Insurance Program

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-0.4	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-5.3	-11.8

The Federal Crop Insurance Program protects farmers from losses caused by drought, floods, pest infestation, other natural disasters, and low market prices. Farmers can choose various amounts and types of insurance protection—for example, they can insure against losses caused by poor crop yields, low crop prices, or both. Premium rates for federal crop insurance are set by the Department of Agriculture (USDA) so that the premium equals the expected payment to farmers for crop losses. The federal government pays about 60 percent and farmers pay about 40 percent of the total premium. Insurance policies purchased through the program are sold and serviced by private insurance companies, which receive a federal reimbursement for their administrative costs. Those businesses also share in insurance gains and losses through reinsurance agreements with the federal government.

This option would reduce the federal government's subsidy to 50 percent of the crop insurance premium. The Congressional Budget Office estimates that under current law, federal spending for crop insurance will total $35 billion over the 2012–2016 period; reducing the crop insurance premium subsidy would save more than $5 billion over the same period and almost $12 billion over the 2012–2021 period, CBO estimates.

An argument in favor of this option is that lawmakers could probably cut the premium subsidy without substantially affecting the level of participation in the program, partly because of linkages between crop insurance and other assistance programs offered by USDA and partly because private lenders increasingly view insurance as a way for farmers to ensure that they can repay their loans. Those producers who did reduce their crop insurance coverage or dropped out of the program would continue to receive substantial crop and income support from other federal farm programs.

An argument against this option is that federal funding for the program has already been reduced by about 5 percent through changes in the 2008 farm bill and by an additional estimated 5 percent through changes in the reinsurance agreements with private companies in 2010. Further cuts, some argue, would threaten farmers' access to insurance. If participation in the crop insurance program declines significantly, opponents say, lawmakers would be more likely to resort to special-purpose relief programs when disaster strikes, reducing the savings from cutting the premium subsidy. (Such ad hoc disaster assistance programs for farmers have cost an average of about $700 million annually over the past five years.)

Mandatory Spending—Option 7 **Function 350**

Reduce by 20 Percentage Points the Share of a Farmer's Base Acreage Eligible for USDA Payments

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-1.0	-1.0	-1.0	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-4.1	-9.5

The Department of Agriculture's (USDA's) direct and countercyclical payments to agricultural producers for certain commodities (cotton, feed grains, oilseeds, peanuts, wheat, and rice) are expected to cost $51 billion over the next 10 years. Beginning with the 2012 crop (harvested in fiscal year 2013), those payments will be calculated, in part, on 85 percent of a producer's base acreage, which in general is determined by the average number of acres planted with each eligible crop between 1998 and 2001.

This option would reduce the portion of a producer's base acreage eligible for direct or countercyclical payments by 20 percentage points. The option would reduce spending for farm programs by $4 billion over the 2012–2016 period and by about $10 billion over the 2012–2021 period, the Congressional Budget Office estimates.

The primary advantage of reducing the portion of a producer's base acreage that is eligible for payments is that the reduction would affect all participants in the program in proportion to their expected payments instead of disproportionately affecting the producers of any particular commodity.

One disadvantage of this option is that producers would receive less income from the government. Another is that other USDA payments, such as marketing loan benefits, essentially guarantee minimum prices for certain crops and therefore tend to send more market-distorting signals to producers than direct and countercyclical payments do. Consequently, some would argue that changing other USDA payments would be a better approach because it could generate greater reductions in market distortions.

Mandatory Spending—Option 8 **Function 370**

Lower the Loan Limits on Mortgages Guaranteed by Fannie Mae and Freddie Mac

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-400	-300	-300	-300	-400	-400	-400	-500	-500	-1,300	-3,500

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are government-sponsored enterprises (GSEs) that were federally chartered to help ensure a stable supply of financing for residential mortgages, including those for low- and moderate-income borrowers. Over the past 40 years, Fannie Mae and Freddie Mac have carried out that mission in two main ways: by issuing and guaranteeing mortgage-backed securities (MBSs) and by buying mortgages and MBSs to hold in their portfolios. Under current law, the entities are temporarily able to purchase and guarantee mortgages in amounts up to $729,750 in areas with high housing costs, although that limit will fall to $625,500 after September 30, 2011. The limit outside of high-cost areas currently is $417,000, and regulators can raise that limit if house prices rise. The two GSEs provided credit guarantees for over 60 percent of home mortgages originated in 2010, and they also purchased and retained mortgages.

In September 2008, the federal government took control of Fannie Mae and Freddie Mac in a conservatorship process after falling housing prices and rising mortgage delinquencies threatened the GSEs' solvency, impairing their ability to ensure a steady supply of financing to the secondary mortgage market. With that shift in control, the Congressional Budget Office concluded that the institutions had effectively become government entities whose operations should be reflected in the federal budget.

This option would set a maximum loan limit of $417,000 nationally beginning in 2013 and freeze that limit going forward. The option would retain the scheduled reduction—to $625,500 starting October 1, 2011—in the loan limit for high-cost areas; thus, no savings would be realized in 2012. Lower loan limits would reduce federal subsidies for the GSEs by roughly $1 billion over the 2012–2016 period and by almost $4 billion from 2012 to 2021. For consistency, similar changes could be made to the Federal Housing Administration's (FHA's) loan limits. Lower limits for FHA loans would affect discretionary spending subject to appropriations, but the effects of such changes are not included in these estimates.

The major advantages of this option are that it could provide a transition path from conservatorship and restore a role for the private sector in the secondary mortgage market while reducing taxpayers' exposure to the risk of defaults. Current loan limits, which are high compared with the median price of about $170,000 for an existing single-family residence in 2010, leave little scope for a private secondary market, which had been significant before the financial crisis. The option would also lower subsidies to affluent borrowers, for whom home ownership is already subsidized through the tax code. Another advantage of the option is that it would probably reduce the amount of capital allocated to housing and shift it toward other investments that would be more productive.

One disadvantage of this option is that housing markets remain fragile and any reduction of federal support might further weaken those markets. The effects would be greatest in high-cost areas, although some of the negative effects might be mitigated through increased reliance on FHA loans. Another disadvantage is that mortgage markets might become more prone to disruptions in the

supply of credit during periods of acute financial stress. Reducing the subsidies would also mean that some borrowers would pay more for mortgages; in particular, once markets stabilized, borrowers seeking mortgages in amounts between $417,000 and $625,500 would pay interest rates that would probably be about a quarter of a percentage point higher than under current law.

RELATED OPTION: Mandatory Spending, Option 9

RELATED CBO PUBLICATIONS: *Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market,* December 2010; Letter to the Honorable Barney Frank about the budgetary impact of Fannie Mae and Freddie Mac, September 16, 2010; and *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac,* Background Paper, January 2010

Mandatory Spending—Option 9 **Function 370**

Increase Guarantee Fees Charged by Fannie Mae and Freddie Mac

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	-1.2	-2.5	-2.5	-2.5	-2.5	-2.7	-3.0	-3.1	-3.2	-3.3	-11.2	-26.5

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are government-sponsored enterprises (GSEs) that were federally chartered to help ensure a stable supply of financing for residential mortgages, including those for low- and moderate-income borrowers. Over the past 40 years, Fannie Mae and Freddie Mac have carried out that mission in two main ways: by issuing and guaranteeing mortgage-backed securities (MBSs) and by buying mortgages and MBSs to hold in their portfolios. The two GSEs provided credit guarantees for more than 60 percent of home mortgages originated in 2010, and they also purchased and retained mortgages.

In September 2008, the federal government took control of Fannie Mae and Freddie Mac in a conservatorship process after falling housing prices and rising mortgage delinquencies threatened the GSEs' solvency, impairing their ability to ensure a steady supply of financing to the secondary mortgage market. With that shift in control, the Congressional Budget Office concluded that the institutions had effectively become government entities whose operations should be reflected in the federal budget.

This option would require Fannie Mae and Freddie Mac to raise the average guarantee fee they assess on loans in the MBSs they issue by 5 basis points (100 basis points are equivalent to 1 percentage point) and to raise the effective guarantee fee on loans acquired for their portfolios by the same amount. Those increases, constituting roughly a 20 percent rise in fees, would reduce federal costs for the GSEs by $11 billion over the 2012–2016 period and by about $27 billion from 2012 to 2021.

The main advantage of raising guarantee fees would be to reduce the projected costs of conservatorship. CBO estimates that the mortgage guarantees the GSEs issue over the 2012–2021 period will cost the federal government nearly $50 billion on a fair-value basis with fees at their current levels. (That amount reflects the estimated federal subsidies inherent in the guarantees at the time they are made—that is, the up-front payment that a private entity in an orderly market would require to assume the federal responsibility for the GSEs' obligations.) Increased fees on the guarantees would reduce those costs. The higher fees would probably flow through to borrowers in the form of higher mortgage rates; however, rates on 30-year fixed-rate mortgage loans eligible for purchase by Fannie Mae and Freddie Mac are relatively low, about 5 percent, in early 2011. This option would provide the GSEs with flexibility in setting fees for particular borrowers, so the potential would exist to minimize the adverse effects of the higher fees on low- and moderate-income borrowers. Coordination with the GSEs' regulator, the Federal Housing Finance Agency, would be necessary to ensure that the increase in average fee income represented an increase in the rates charged to borrowers with particular risk characteristics and not a shift toward lending to riskier borrowers, who already pay higher-than-average rates. Another advantage of this option is that it would help address the current underpricing of risk, which could shift the allocation of capital too far toward housing and away from more productive activities.

The main disadvantage of raising guarantee fees would be the consequent increase in the cost of borrowing, which could somewhat reduce demand for housing. Another drawback would be more limited refinancing opportunities, which might constrain spending by consumers. Both of those concerns would be particularly salient as long as housing markets and the economy remain weak.

RELATED OPTION: Mandatory Spending, Option 8

RELATED CBO PUBLICATIONS: *Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market*, December 2010; Letter to the Honorable Barney Frank about the budgetary impact of Fannie Mae and Freddie Mac, September 16, 2010; and *CBO's Budgetary Treatment of Fannie Mae and Freddie Mac,* Background Paper, January 2010

Mandatory Spending—Option 10 **Function 500**

Eliminate Subsidized Loans to Graduate Students

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	-0.7	-1.7	-2.0	-2.0	-1.9	-1.9	-2.0	-2.0	-2.1	-2.1	-8.3	-18.4

The federal government operates programs to help students and their parents pay for postsecondary education. Subsidized Stafford loans help students with demonstrated financial need pay for their education, and unsubsidized Stafford loans are available, without regard to need, to any student. (The labels "subsidized" and "unsubsidized" refer to the terms of the loans, not to whether the federal government incurs subsidy costs for the program.) Borrowers of both subsidized and unsubsidized loans benefit from interest rates that are not generally available to those without a demonstrated credit history or collateral and from deferment of repayment until six months after a student leaves school. Students with subsidized loans benefit further because the government also forgives interest on those loans while the students are enrolled and for six months after they leave school. Also, most loan programs offer flexible repayment plans that allow for extended repayment periods or that cap required monthly payments at an amount intended to be manageable, based on income and family size.

This option would end, in 2012, the practice of making new subsidized loans to graduate students, on the presumption that those students would generally take out unsubsidized loans instead. The option would reduce federal outlays by more than $8 billion from 2012 to 2016 and by about $18 billion from 2012 to 2021. (The Federal Credit Reform Act of 1990 requires that the federal budget record all costs and collections associated with a new loan in the year in which the loan is disbursed.)

An argument for this option is that graduate students who lose access to subsidized loans would be able to take out unsubsidized federal loans for the same amount and still benefit from few or no requirements with respect to credit history or collateral and from repayment options that take into account borrowers' financial circumstances. Another argument in favor of this option is that it would help focus federal student aid on the area that some people believe is the federal government's primary responsibility—making a college education available to all high school graduates. According to that rationale, graduate students have already received the benefit of higher education.

An argument against this option is that graduate students often amass large amounts of debt because of the number of years of schooling required to complete advanced degrees. Without the benefit of interest forgiveness while they are enrolled in school, that debt would be substantially larger when they entered the repayment period because the cumulative interest on the money borrowed over the years would be added to loan balances. Also, opponents of this option might argue that federal support for graduate students is no less important than support for undergraduates because graduate students are most likely to effect scientific, technological, and other advances that will benefit the nation as a whole.

RELATED OPTIONS: Mandatory Spending, Option 11; Discretionary Spending, Option 28; and Revenues, Option 15

Mandatory Spending—Option 11 **Function 500**

Change the Interest Rate Structure for Student Loans

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	2.1	3.0	0.9	-2.0	-4.9	-8.0	-10.0	-10.7	-11.0	-11.4	-0.9	-52.0

The federal government operates several loan programs to help students and their parents pay for postsecondary education. The terms and eligibility for loans made under those programs vary widely. Subsidized loans feature interest forgiveness while students are enrolled and for six months after they leave school, but those loans are available only to those with demonstrated financial need. Unsubsidized loans, without interest forgiveness, are available to any student regardless of need. PLUS loans are available to parents of dependent students and to graduate and professional students; their terms are similar to those of unsubsidized loans, except that interest rates are higher. Regardless of the type of loan, borrowers benefit from few or no requirements with respect to credit history or collateral and from repayment options that take into account the borrowers' financial circumstances.

Currently, the interest rate on all new unsubsidized and subsidized loans to nonundergraduate students is 6.8 percent. On all new PLUS loans, the interest rate is 7.9 percent. For the 2011–2012 academic year, the interest rate on new subsidized loans to undergraduate students will be 3.4 percent, but for all subsequent years, that rate will be 6.8 percent because of the expiration of a provision in the College Cost Reduction and Access Act of 2007.

This option would change the structure of interest rates on federal student and parent loans to resemble those on fixed-rate mortgage loans. In particular, the interest rate on new loans would depend on conditions in financial markets at the time of origination but remain fixed for the life of the loan. Under this option, the interest rate on all new federal student and parent loans would be set to the interest rate on 10-year Treasury notes at the beginning of the academic year in which the loan is originated plus 3 percentage points. This option would reduce federal outlays by $900 million from 2012 to 2016 and by $52 billion from 2012 to 2021, the Congressional Budget Office estimates. (The Federal Credit Reform Act of 1990 requires that the federal budget record all costs and collections associated with a new loan in the year in which the loan is disbursed.)

The large jump in savings between the first and second halves of the 10-year estimating window reflects CBO's projections of a steady increase in Treasury interest rates over the first few years of the 2012–2021 period. Initially, interest rates on certain student loans under this option would be lower than under current policies, generating some costs for the government. As interest rates rise, however, the rates on student loans under this option would grow to be higher than under current policies, generating large savings.

A rationale for this option is that it would focus the loan programs' role on providing access to financing for all students at an interest rate not generally available to borrowers who have neither a demonstrated credit history nor collateral. (The Federal Pell Grant Program would continue to provide tuition relief to students with the greatest financial need.) In addition, the interest rate on student and parent loans would adjust to conditions in financial markets at the time a loan was originated, making the government subsidy equally valuable in relatively high and relatively low interest rate environments. However, borrowers would continue to benefit from predictable monthly payments because of the fixed interest rate over the life of a loan.

An argument against this option is that, given CBO's projections of the interest rates on 10-year Treasury notes from 2012 to 2021, the option would raise the expected average interest rate on student and parent loans. Consequently, for most loans, the interest accrued and monthly payments when borrowers left school would be greater than under current policies. The anticipation of higher debt payments might limit the fields of study students would consider and the types of jobs they would seek. Also, borrowers who were in school during times of tight financial markets would pay higher interest rates than borrowers who were in school during other times.

RELATED OPTIONS: Mandatory Spending, Option 10; Discretionary Spending, Option 28; and Revenues, Option 15

Mandatory Spending—Option 12 **Function 550**

Add a "Public Plan" to the Health Insurance Exchanges

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	0	0	-0.9	-2.4	-2.4	-3.4	-4.0	-4.8	-4.6	-4.2	-5.8	-26.7
Change in Revenues	0	0	2.3	3.5	5.8	7.9	9.5	10.4	10.7	11.2	11.6	61.2
Net Effect on the Deficit	0	0	-3.2	-5.9	-8.3	-11.3	-13.5	-15.2	-15.3	-15.3	-17.4	-88.0

Starting in 2014, health insurance exchanges will be established through which individuals and families may purchase private coverage. In general, people who are not offered coverage through their employer and purchase coverage through an exchange will be eligible for federal subsidies on a sliding scale if their income is between 138 percent and 400 percent of the federal poverty level. The amount of the subsidies will be based in part on the premium of the second cheapest plan offered through the exchange in an enrollee's area of residence. Small employers will have the option to allow their workers to buy coverage through the exchanges, and beginning in 2017, states may grant large employers that choice as well. In those cases, the affected workers will not receive exchange subsidies, but the costs of their coverage will be excluded from income and payroll taxation, just as the costs of other employment-based health coverage are currently excluded.

Under this option, the Secretary of Health and Human Services would establish and administer a public health insurance plan that would be offered alongside private plans through the exchanges beginning in 2014. The public plan would have to charge premiums that fully covered its costs for benefit payments and administrative expenses. The plan's payment rates for physicians and other practitioners would be set to exceed Medicare's rates in 2010 by 5 percent and would rise annually through 2014 and beyond to reflect estimated increases in physicians' costs; those payment rates would not be subject to the future reductions required by Medicare's sustainable growth rate formula. The public plan would pay hospitals and other providers the same amounts that would be paid under Medicare, on average, and would establish payment rates for prescription drugs through negotiation. Health care providers would not be required to participate in the public plan in order to participate in Medicare.

In the Congressional Budget Office's estimation, the public plan's premiums would be 5 percent to 7 percent lower, on average, than the premiums of private plans offered in the health insurance exchanges. The differences between the premiums of the public plan and the average premiums of private plans would vary across the country, largely because of geographic differences in the plans' relative payment rates for providers. Those differences in average premiums would also reflect differences in the other factors that affect all health insurance premiums, including administrative costs, the degree of benefit management applied to control spending, and the characteristics of the enrollees (the effects of which would be partly offset by the risk-adjustment mechanism that will be used in the exchanges).

This option, CBO and the staff of the Joint Committee on Taxation estimate, would reduce federal budget deficits by about $88 billion over the 2012–2021 period. That reduction is the combination of an almost $27 billion reduction in outlays (mostly from a reduction in exchange subsidies) and a $61 billion increase in tax revenues (mostly from changes in employment-based insurance coverage). Those estimates include effects on other outlays and revenues related to insurance coverage (such as Medicaid outlays and penalties on employers and uninsured individuals).

Overall, exchange subsidies would be reduced by $35 billion over the 2014–2021 period. (Although the exchange subsidies for premiums are structured as refundable tax credits, most of the resulting costs are classified as outlays because the payments will usually exceed their recipients' total income tax liability.) That decline in subsidies is the net effect of several influences. By CBO's estimates, the public plan's premium in many parts of the country would be lower than the second-lowest premium among private plans; the introduction of the public plan in those places would therefore reduce federal subsidies that are

tied to that benchmark. The existence of a public plan with substantial enrollment would also, CBO expects, place additional competitive pressure on private plans operating in the exchanges to lower their premiums to some degree, thereby producing a further reduction in federal subsidies. Partly offsetting those two sources of federal savings would be higher enrollment in exchange plans, which would increase subsidy payments.

The increase in tax revenues under this option results primarily from changes in employment-based coverage, which is offset in part by an increase in costs for providing tax credits to small employers. Two developments would result in a greater share of employees' compensation taking the form of taxable wages and salaries (rather than nontaxable health benefits), thereby resulting in higher revenues. First, because the public plan would make the exchanges more attractive to individual purchasers, some employers would forgo offering coverage altogether, thus reducing their spending on employment-based health insurance and increasing the share of compensation devoted to taxable wages and salaries. Second, the availability of a relatively inexpensive public plan would also lead some employers to purchase lower-cost coverage for their employees through the exchanges. The resulting reduction in spending on employment-based coverage would further increase the share of total compensation devoted to taxable wages and salaries. Those budgetary effects would be partly offset by the reduction in revenues that would occur as more small employers took advantage of the tax credits that will be available when purchasing coverage through the exchanges.

Enrollment in the public plan would be affected by several considerations, including its relative premium and the number and types of providers that decided to participate in it. On the basis of all relevant factors, CBO estimated that, on average, about 13 million people—about one-third of the estimated 38 million that would obtain coverage through the insurance exchanges—would enroll in the public plan in the 2017–2021 period. Of that number, on average, about 25 million people would purchase coverage individually, and about 13 million people would obtain employment-based coverage through the exchanges. (Given all of the factors at work, however, those estimates are subject to an unusually high degree of uncertainty.)

Compared with projections of health insurance coverage under current law for the 2017–2021 period, under this option, about one and a half million more people would obtain individually purchased coverage, CBO estimates, and about one and a half million fewer would have employment-based coverage. The option would have minimal effects on the number of people with other sources of coverage and the number of people who would be uninsured.

Supporters of this option might point to the federal savings that would result. In addition, because the public plan would be one of the lowest-cost plans in many areas, the option would help reduce premiums for some individuals, families, and employers who purchase insurance through the exchanges but do not receive exchange subsidies. Another argument for this option is that a public plan would increase the competitive pressure on private plans, leading them to reduce their premiums.

Opponents might be concerned that the public plan's payment rates would be substantially lower than rates for private plans in many parts of the country, which could lead some providers who participated in the public plan to reduce the quality of care they furnished. Although providers' participation in the public plan would be voluntary, opponents might anticipate that enrollment in the plan could be sufficiently large that providers would face substantial pressure to participate.

Another concern is that the federal government would have to finance the public plan's losses if the plan attracted high-cost enrollees and was unable to collect enough in premiums to cover its costs. (The public plan would be required to build up a contingency fund.) More generally, opponents might object to a greater federal role in providing health insurance.

RELATED OPTIONS: Revenues, Options 30 and 32

RELATED CBO PUBLICATION: Letter to the Honorable Fortney Pete Stark about CBO's analysis of a proposal to offer a public plan through the new health insurance exchanges, July 22, 2010

Mandatory Spending—Option 13 **Function 550**

Limit Medical Malpractice Torts

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Mandatory Outlays[a]	-100	-600	-1,900	-3,600	-5,400	-6,400	-7,000	-7,600	-8,200	-8,700	-11,600	-49,500
Change in Revenues[b]	0	200	600	1,100	1,600	1,800	1,800	1,900	1,900	2,000	3,500	12,900
Net Effect on the Deficit	-100	-800	-2,500	-4,700	-7,000	-8,200	-8,800	-9,500	-10,100	-10,700	-15,100	-62,400
Change in Discretionary Spending												
Budget authority	*	*	-100	-100	-200	-200	-200	-200	-300	-300	-400	-1,600
Outlays	*	*	-100	-100	-200	-200	-200	-200	-300	-300	-400	-1,600

Note: * = between zero and -$50 million.

a. Estimates include potential savings by the U.S. Postal Service, whose spending is classified as off-budget.

b. Estimates include the effects on Social Security payroll tax receipts, which are classified as off-budget.

Individuals may pursue civil claims against physicians, hospitals, and other health care providers for alleged torts, which are breaches of duty that result in personal injury. That system of tort law has twin objectives: deterring negligent behavior on the part of providers and compensating claimants for losses they incur (including lost wages, medical expenses, and pain and suffering) as the result of an injury caused by negligence. Malpractice claims are generally pursued through the state courts, and states have established various rules by which those claims are adjudicated. Nearly all health care providers obtain malpractice insurance to protect against the risk of having to pay a very large malpractice claim. The cost of that insurance results in higher medical costs because, in order to pay for the premiums, providers charge their patients higher fees. Furthermore, research suggests that placing limits on malpractice torts will reduce the quantity of prescribed health care services by a small amount.

This option would impose certain nationwide curbs on medical malpractice torts. Many states have enacted some or all of these limits, whereas others have very few restrictions on malpractice claims. The tort limits include caps on noneconomic damages (also known as pain and suffering) and on punitive damages; a shortened statute of limitations; restrictions on the use of joint-and-several liability; and changes to rules regarding collateral sources of income.[1] The specific components of medical malpractice tort reform under this option are as follows:

- A cap of $250,000 on awards for noneconomic damages;
- A cap on awards for punitive damages of $500,000 or two times the value of awards for economic damages, whichever is greater;
- A statute of limitations of one year from the date of discovery of the injury for adults, and three years for children;
- A fair-share rule (replacing the rule of joint-and-several liability) under which a defendant in a lawsuit would be liable only for the percentage of the final award that was equal to that defendant's share of responsibility for the injury; and
- Permission to introduce evidence of income from collateral sources (such as life insurance payouts and health insurance) at trial.

Malpractice tort limits would reduce total health care spending in two ways. First, by reducing the average size of malpractice awards, tort limits would reduce the cost

1. Under the joint-and-several liability rule, all of the defendants in a lawsuit are individually responsible for the entire amount of the award. An example of a collateral source of income is the amount paid by a plaintiff's health insurer to cover health care services provided to a patient as a result of an injury resulting from malpractice.

of malpractice insurance premiums. That reduced cost of malpractice insurance paid by providers would flow through to health plans and patients in the form of lower prices for health care services. Second, as noted above, tort limits would also reduce utilization of health care services by a small amount as practitioners prescribed somewhat fewer services when faced with less pressure from potential malpractice claims. In the estimation of the Congressional Budget Office, the combined effect of those two factors would be a reduction of about 0.5 percent of total health care spending. For this option, CBO assumed that a change enacted in October 2011 would have an impact that increased over time, achieving its full effect after four years, as providers gradually changed their practice patterns. In terms of federal health care spending, the percentage decline in spending for Medicare is estimated to be larger than the decline in spending for other federal health programs or for national health spending. That estimate is based on empirical evidence showing that the impact of tort reform on the use of health care services is greater for Medicare than for the rest of the health care system.

By reducing spending on health care in the private sector, this option would also affect federal revenues. Much private-sector health care is provided through employment-based insurance that represents nontaxable compensation. Because premiums paid by employers for health insurance are excluded from employees' taxable income, reducing such premiums would, on average, increase the share of employees' compensation that was taxable and thereby increase federal tax revenues by an estimated $13 billion over the next 10 years.

This option would reduce mandatory spending for Medicare, Medicaid, the Children's Health Insurance Program, subsidies for coverage purchased through health insurance exchanges, and the Federal Employees Health Benefits program by a total of roughly $50 billion from 2012 to 2021. Discretionary savings would amount to $400 million over the 2012–2016 period and $1.6 billion over the 2012–2021 period, if the amounts appropriated for federal agencies were reduced accordingly.

An argument in favor of this option is that it would reduce spending for health care services. Another rationale is that, by reducing premiums for medical malpractice insurance, the option could help alleviate shortages of certain types of physicians in some areas of the country. For example, annual malpractice premiums for obstetricians exceed $100,000 in some areas. Such high premiums may deter some obstetricians from practicing in those areas or from practicing at all.

An argument against this option is that tort limits could prevent those who have suffered substantial harm as a result of medical negligence from obtaining full compensation for their injuries. In addition, reducing the amount of money that could be collected in the case of a medical injury might cause providers to exercise less caution, resulting in an increase in the number of medical injuries attributable to negligence.

The evidence is mixed on whether tort limits have an adverse effect on health outcomes. Some researchers who have observed a reduction in the use of health care services as the risk of litigation falls have also found that reducing that risk produces a small increase in the mortality rate. Another study found that reform of joint-and-several liability had positive impacts on health but caps on noneconomic damages had negative impacts. Other studies have concluded that tort limits have no effect on mortality or other measures of health.

RELATED CBO PUBLICATIONS: Letter to the Honorable Bruce L. Braley responding to questions on the effects of tort reform, December 29, 2009; Letter to the Honorable John D. Rockefeller IV providing additional information on the effects of tort reform, December 10, 2009; Letter to the Honorable Orrin G. Hatch about CBO's analysis of the effects of proposals to limit costs related to medical malpractice ("tort reform"), October 9, 2009; and *Key Issues in Analyzing Major Health Insurance Proposals,* December 2008

Mandatory Spending—Option 14 **Function 550**

Adopt a Voucher Plan and Slow the Growth of Federal Contributions for the Federal Employees Health Benefits Program

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Mandatory Outlays[a]	0	-300	-1,100	-1,700	-2,400	-2,800	-3,900	-5,100	-6,400	-7,800	-5,500	-31,500
Change in Revenues	0	0	-10	-10	-10	-10	-20	-20	-30	-40	-30	-150
Net Effect on the Deficit	0	-300	-1,090	-1,690	-2,390	-2,790	-3,880	-5,080	-6,370	-7,760	-5,470	-31,350
Change in Discretionary Spending												
Budget authority	0	-500	-1,700	-2,400	-3,000	-4,100	-5,500	-6,800	-8,200	-9,700	-7,600	-41,900
Outlays	0	-500	-1,700	-2,400	-3,000	-4,100	-5,500	-6,800	-8,200	-9,700	-7,600	-41,900

a. Estimates include potential savings by the U.S. Postal Service, whose spending is classified as off-budget.

The Federal Employees Health Benefits (FEHB) program provides health insurance coverage to approximately 4 million federal workers and annuitants as well as to approximately 4 million of their dependents and survivors. In 2011, those benefits are expected to cost the government almost $41 billion (including amounts paid by the U.S. Postal Service). Policyholders are required to pay 25 percent of the premium for the lowest-cost plans available and generally a larger share for higher-cost plans; the federal government pays the remainder of the premium. Retired enrollees pay the same premiums that active employees pay, and the federal government typically shares in the cost of the premiums to the same extent for both groups. That premium-sharing structure provides some incentive for federal employees to switch from higher-premium to lower-premium plans, although the incentive is less than it would be if employees realized the full savings from choosing a less expensive plan. The premium-sharing structure also imposes some competitive pressure on plans to hold down premiums.

This option would offer a voucher for the FEHB program that would cover roughly the first $5,000 of an individual premium or the first $11,000 of a family premium beginning on January 1, 2013. Those amounts, which are based on the Congressional Budget Office's estimate of the government's average expected contribution in 2012, would increase annually at the rate of inflation as measured by the consumer price index for all urban consumers, rather than at the average weighted rate of change in FEHB premiums. According to CBO's estimates, indexing vouchers to inflation rather than to the growth of premiums would produce budgetary savings because FEHB premiums are predicted to grow significantly faster than inflation. (The expected cost growth in FEHB premiums is similar to expected growth in other private insurance premiums.)

This option would reduce discretionary spending by federal agencies (because of lower payments for FEHB premiums for current employees and their dependents) by an estimated $8 billion over the 2012–2016 period and by $42 billion over the 2012–2021 period, under the assumption that appropriations reflect the reduced costs. The option would also reduce mandatory on- and off-budget spending because of lower payments from the Treasury and the U.S. Postal Service for FEHB premiums for retirees. Estimated savings from those reductions would be roughly $6 billion over the 2012–2016 period and about $32 billion over the 2012–2021 period.

In addition, CBO anticipates, the option would cause some FEHB participants to leave the program and enroll in health insurance exchanges starting in 2014.[1] As a result, health exchange subsidy costs would increase by $100 million over the 2012–2016 period and $500 million over the 2012–2021 period, and revenues would fall by about $30 million over the 2012–2016 period and about $150 million over the 2012–2021 period. Also, some FEHB annuitants could leave the program and

1. In general, individuals with an offer of insurance coverage from an employer are not eligible for exchange subsidies. However, an affordability exemption exists for individuals who face an employee contribution for health insurance that exceeds a specified percentage of their income. As a result, the increase in the enrollee premium contribution under this option would boost the number of federal employees eligible for exchange subsidies through the affordability exemption.

enroll in Medicare Part D (the prescription drug benefit) to obtain drug coverage that they had previously had through the FEHB program. As a result, Medicare spending would increase by an estimated $100 million over the 2012–2016 period and $500 million over the 2012–2021 period. Overall, the option would reduce mandatory spending, on net, by an estimated $6 billion over 5 years and almost $32 billion over 10 years.

Under this option, employees who selected plans that cost more than the voucher amount would pay the full additional cost of the plan. Therefore, this option would increase the incentive to choose lower-premium plans and would strengthen price competition among health care plans participating in the FEHB program. In particular, because enrollees would pay nothing for plans that cost as much as the value of the voucher, insurers would have a greater incentive to offer lower-premium plans whose cost approached or matched that value.

This option could have several drawbacks. First, because the federal contribution would grow more slowly over time than premiums, the option would reduce benefits. Participants would eventually pay more for their health insurance coverage; the FEHB enrollee premium contribution would increase by more than $2,000, on average, by 2021, CBO estimates. Some employees and annuitants who would be covered under current law might decide to forgo coverage altogether. For the most part, large private-sector companies currently provide health care benefits for their employees that are comparable to benefits that the government provides; under this option, government benefits could be less attractive than private-sector benefits, making it harder for the government to attract highly qualified workers. Finally, this option would cut benefits that many current federal retirees and federal employees looking ahead to retirement may believe they have already earned.

RELATED CBO PUBLICATIONS: *Characteristics and Pay of Federal Civilian Employees,* March 2007; *The President's Proposal to Accrue Retirement Costs for Federal Employees,* June 2002; and *Comparing Federal Employee Benefits with Those in the Private Sector,* August 1998

Mandatory Spending—Option 15 **Function 550**

Convert the Federal Share of Medicaid's Payments for Long-Term Care Services into a Block Grant

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays												
Index the grant to changes in the ECI	-3.8	-10.8	-15.2	-19.3	-24.3	-29.3	-35.3	-42.1	-49.5	-57.9	-73.3	-287.4
Index the grant to changes in the ECI and in the Medicaid aged, blind, and disabled populations	-1.9	-5.1	-8.1	-11.0	-14.8	-18.6	-23.3	-28.5	-34.3	-40.9	-41.0	-186.6

Note: ECI = employment cost index.

The Medicaid program funds coverage for two different types of health care: acute care (including inpatient hospital stays, visits to physicians' offices, and prescription drugs) and long-term care (services such as nursing home care and home- and community-based services). The program is financed jointly by the states and the federal government, with the federal government's share equal to a percentage determined by a formula defined in law. The formula assigns a higher federal reimbursement rate to states that have lower income per capita (and vice versa). Currently, that share—referred to as the federal medical assistance percentage (FMAP)—is approximately 57 percent, on average across the states.

The Congressional Budget Office estimates the federal share of Medicaid outlays in 2011 to be $155 billion for acute care and $71 billion for long-term care, excluding the enhanced federal matching funds established in the American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5) and extended under subsequent legislation.

This option would convert the federal share of Medicaid payments for long-term care services, as well as a portion of the federal share of Medicaid administrative costs, into a block grant to each state, as previous legislation did with funding for welfare programs. Starting in 2012, a state's block grant for each fiscal year would apply to long-term care services for all of its Medicaid beneficiaries, but acute care would continue to receive funding as it does under current law. This option includes two alternatives for structuring the block grants, differentiated by how they would adjust the amount of the block grant annually. Specifically, a state's block grant would equal its 2010 federal Medicaid payment for long-term care services (excluding the enhanced matching provided in ARRA) indexed annually to one of the following factors:

- **The employment cost index.** Indexing each state's block grant to annual increases in the employment cost index (ECI)—which reflects changes in labor costs such as benefits, wages, and salaries—would reduce federal outlays by $73 billion from 2012 to 2016 and by $287 billion from 2012 to 2021. That would represent a 25 percent reduction in estimated federal spending on long-term care over the 2012–2021 period relative to current law. This alternative would generate savings because federal payments for Medicaid are projected under current law to grow faster than the cost of labor as a result of both rising costs per beneficiary and an increasing number of beneficiaries.

- **The ECI and changes in the number of aged, blind, and disabled people enrolled in Medicaid.** If block grants were indexed to the ECI and also to changes in the size of the Medicaid aged, blind, and disabled populations, savings would be somewhat lower than those generated by the first alternative because the Medicaid aged, blind, and disabled populations are expected to increase over the next 10 years. Under this approach, savings would total $41 billion for the 2012–2016 period and $187 billion for the 2012–2021 period. That would represent a 16 percent reduction in estimated long-term care spending by the federal government during that decade relative to current law.

CBO's estimates represent weighted averages of possible savings because changes in these index factors and changes in federal spending on long-term care under current law are both uncertain. If the adjustment was based on the ECI alone, states that had faster growth in their aged, blind, and disabled populations would need to make larger reductions in the long-term care benefits they provide to each Medicaid beneficiary or undertake larger increases in their own spending to compensate for the gap in federal funding. At the same time, states with slower growth in their aged, blind, and disabled populations would be in a better position to manage the long-term care benefits they provide or reduce the amount of money they allocate to long-term care services. If the adjustment also took into consideration changes in the size of states' populations of aged, blind, and disabled Medicaid enrollees, then states' financial circumstances would not be affected by the growth of those groups. That alternative would not produce as high a level of savings, however.

A rationale for this option is that a block grant would provide greater predictability in federal spending for long-term care services, which represents a large portion of total Medicaid spending. Furthermore, it would eliminate the federal subsidy for each additional dollar that states spend on long-term care services, thereby providing a greater incentive for states to find more cost-effective ways to care for individuals who need long-term care. Another rationale is that, if the block grant policy was coupled with reductions in federal program requirements, states would have greater flexibility to design and administer long-term care benefits in ways that might better serve their populations. With greater freedom to tailor their own programs, states could modify program eligibility and the benefits provided, including the types and settings of services offered. An additional rationale for this option is that converting the federal contribution to a block grant would reduce states' ability to obtain more federal assistance than intended under the law. For example, in the past, some states have inflated Medicaid payments to institutional facilities and then required those facilities to pay special state taxes. That strategy boosted states' federal matching funds without a corresponding increase in their net costs for the program. Over the past 10 years, the Congress and the Department of Health and Human Services have acted to rein in that practice.

An argument against this option is that converting long-term care payments into a block grant would shift some of the burden of Medicaid's growing costs to the states. Depending on the extent of flexibility provided in the legislation that would create the block grant, states could drop optional Medicaid services. Ending federal matching payments for long-term care services would eliminate the existing incentive for states to spend more on long-term care, possibly reducing the options available to people in need of those services. Another argument against the option is that distinguishing between long-term care and acute care could be difficult administratively, especially in cases where individuals receive both types of care. For example, hospital patients who receive acute care services often require additional post-acute services after they are released; those services may be provided in the same venues in which long-term care services are delivered and by the same providers. Thus, rules would need to be established to define when long-term care services would be covered by the block grant and when such services would be covered by the acute care part of the Medicaid program. A further argument against this option is that greater discretion for the states in how they structure their Medicaid programs creates the potential for increased disparity from one state to another in eligibility criteria and benefit packages.

Mandatory Spending—Option 16 **Function 550**

Reduce the Floor on Federal Matching Rates for Medicaid Services

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	-13.0	-14.0	-15.0	-16.0	-17.0	-18.0	-20.0	-21.0	-23.0	-25.0	-75.0	-181.0

The federal government pays a share of the costs that states incur for providing health care services through the Medicaid program. For most medical services that Medicaid covers, the percentage of costs paid by the federal government is determined by the federal medical assistance percentage (FMAP). The FMAP is based on a formula that assigns a higher federal reimbursement rate to states that have lower income per capita, and vice versa. (Per capita income serves as a proxy for a state's financial resources.) By law, a state's FMAP rate can be no less than 50 percent and no more than 83 percent. On average, the federal matching rate is 57 percent, and states pay the remaining 43 percent of the cost of services. Beginning in 2009 and continuing through the third quarter of 2011, the American Recovery and Reinvestment Act of 2009 (Public Law 111-5) specified that the federal government pay a larger share of Medicaid costs, averaging between about 65 percent and 68 percent, depending on the year.

Starting in 2014, the federal government will pay a different matching rate, specified in law, for the cost of services incurred by enrollees made newly eligible for Medicaid under the Patient Protection and Affordable Care Act (PPACA, P.L. 111-148), as amended by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152). The matching rates for those enrollees will vary from 90 percent to 100 percent, depending on the year, and are not affected by the FMAP rate formula. Also starting in 2014, for certain childless adults that some states made eligible for Medicaid prior to the passage of PPACA, the federal government will pay a specified percentage of the difference between the states' FMAP rates (as determined by the aforementioned formula) and the rates paid on behalf of those made newly eligible under PPACA.

Although matching rates are set through formulas specified in statute, states generally determine the amount of Medicaid's spending because they pay health care providers and then submit claims to the federal government for reimbursement at the appropriate FMAP rate. Medicaid spending is therefore driven by the choices that states make regarding payment rates for providers, the coverage of optional benefits, and the eligibility thresholds for the program.

This option would lower the 50 percent floor on federal matching rates to 45 percent starting in 2012 for all Medicaid-covered services that are reimbursed at the FMAP rate; the option would not affect the matching rates for newly eligible enrollees under PPACA. The affected states would be those with high per capita income relative to the national average that, in the absence of the floor, would have FMAP rates lower than 50 percent. Lowering the floor to 45 percent would reduce FMAP rates for 14 states such that the new rates would range from 45.0 percent to 49.6 percent. Federal matching rates would not change for the remaining 37 states and the District of Columbia.

If the federal government reduced the share of Medicaid that it reimbursed, states would be faced with a choice. At one extreme, they could substitute additional state spending for all of the lost federal funding and thereby maintain their Medicaid programs' payment rates, covered services, and enrollment levels. At the other extreme, they could provide no additional state funding and reduce the size of their Medicaid programs. For this estimate, the Congressional Budget Office assumed that states would increase their contributions to make up for some of the reduced federal funding, but not by enough to prevent a decline in the size of their Medicaid programs.

This option would reduce federal outlays by $75 billion during the 2012–2016 period, CBO estimates, and by $181 billion from 2012 through 2021.

A rationale for lowering the floor on the federal matching rate is to decrease federal spending for the Medicaid program by reducing payments to states that have the greatest financial resources available to fund their programs. The FMAP formula is designed to provide a larger federal contribution for states that have lower income per capita

and a smaller federal contribution for states that have higher income per capita. However, the floor of 50 percent provides a number of states with FMAP rates above the rates they would be assigned in the absence of such a floor. Lowering the current floor would require states that have higher income per capita to pay a greater share of the cost of Medicaid services for their populations.

An argument against the option is that it would concentrate significant reductions in federal spending among a fairly small number of states. The 14 states affected by the option would generally have several mechanisms for reducing expenditures in their Medicaid programs: They could cut their payment rates to providers; they could reduce the kinds and amounts of medical benefits they provide; or they could cover fewer people by reducing outreach efforts that encourage enrollment or by increasing administrative requirements for enrollment. States that faced significant reductions in their FMAP rates would probably respond by using a combination of those cost-cutting approaches.

Mandatory Spending—Option 17 **Function 570**

Consolidate and Reduce Federal Payments for Graduate Medical Education Costs at Teaching Hospitals

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-5.2	-5.8	-6.4	-7.2	-7.8	-8.3	-8.9	-9.5	-10.3	-24.6	-69.4

Under Medicare's prospective payment system for inpatient medical services, hospitals with teaching programs receive additional funds for costs related to graduate medical education (GME). One component of that additional funding, direct graduate medical education (DGME), covers a portion of a teaching hospital's costs for compensation of physicians serving as medical residents and for institutional overhead. DGME payments are based on a hospital's 1984 costs per resident (indexed for changes in consumer prices), the number of residents, and Medicare's share of total inpatient days at that hospital. The other component, indirect medical education (IME), is intended to cover teaching-related costs that are not attributable either to residents' compensation or to other direct costs of running a residency program. Examples of IME costs are the added demands placed on staff as a result of teaching activities and the greater number of tests and procedures ordered by residents as part of the learning and teaching process. Teaching hospitals also tend to treat a larger proportion of severely ill patients, which raises costs. Under current law, for every increase of 0.1 in the ratio of full-time residents to the number of beds, the IME adjustment provides teaching hospitals with about 5.5 percent more in payments. However, the Medicare Payment Advisory Commission (MedPAC) has consistently found that the IME calculation overstates the effect of teaching status on incurred costs. In its most recent (March 2010) report to the Congress on Medicare's payment policy, MedPAC estimates that an IME adjustment of about 2 percent more closely reflects the indirect costs that teaching hospitals actually incur.

Teaching hospitals also receive GME payments from both the federal government and the states through the Medicaid program. The Congressional Budget Office estimates that total mandatory federal spending for hospital-based GME in 2010 was about $10 billion—$9.5 billion through Medicare and $500 million through Medicaid.

This option would consolidate all mandatory federal spending for GME into a grant program for teaching hospitals. Total funds available for distribution would be based on the 2011 aggregate payments for DGME and Medicaid GME plus the 2011 aggregate payments for IME reduced to reflect a 2.2 percent IME adjustment. Total funding for the grant program would grow with inflation as measured by the consumer price index for all urban consumers minus 1 percentage point per year. Payments would be apportioned according to the number of residents at a hospital and the portion of the hospital's inpatient days accounted for by Medicare and Medicaid patients.

In CBO's estimation, this option would save approximately $25 billion over the 2012–2016 period and roughly $69 billion over the 2012–2021 period. By 2021, the annual savings would represent about 60 percent of federal spending for GME projected under current law.

If the discretionary funds for graduate medical training currently provided by the Health Resources and Services Administration of the Department of Health and Human Services were also included in the mandatory grant pool, total available funding would rise by an estimated $300 million in 2013. If that component of the funding was also automatically indexed to inflation (instead of remaining subject to annual appropriations), the option would decrease mandatory spending by about $66 billion over the 2012–2021 period.

An argument for reducing the subsidy for GME is that federal payments under current law exceed hospitals' actual teaching costs. As MedPAC's analysis suggests, a smaller subsidy would create savings for the federal budget without unduly affecting hospitals' teaching activities. A smaller subsidy would also remove an incentive for hospitals to have a greater number of residents than may be necessary. If hospitals responded to the reduction in the

subsidy by lowering residents' compensation, residents would bear more of the cost of their medical training, which might deter some people from entering the medical profession. However, medical training enables individuals to earn a significantly higher income in the future, and market incentives appear to be sufficient to encourage people to become physicians.

An argument against this option is that reducing the federal subsidy for GME could lead some teaching hospitals to train fewer residents or devote less time and fewer resources to beneficial educational activities. Also, to the extent that some teaching hospitals use a portion of their additional payments to fund care for uninsured individuals, decreasing those payments could reduce the number of patients that hospitals treat or lower the quality of care that those hospitals provide. Another argument against the option is that states could lose some discretion to direct Medicaid GME payments to hospitals because the federal government would be administering the grant program. Finally, even if payments were initially equal to hospitals' costs, the payments would grow more slowly than inflation and thus might not keep pace with increases in costs.

Mandatory Spending—Option 18 **Function 570**

Raise the Age of Eligibility for Medicare to 67

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays												
Medicare	0	0	-3.5	-7.4	-11.6	-16.0	-20.8	-27.4	-34.0	-41.7	-22.5	-162.4
Other	0	0	0.3	1.3	2.7	3.7	5.1	6.6	8.0	9.9	4.3	37.6
Total	0	0	-3.2	-6.1	-8.9	-12.3	-15.7	-20.8	-26.0	-31.8	-18.2	-124.8

The usual age of eligibility for Medicare benefits is 65, although certain people qualify for coverage earlier. (Medicare is available to persons under age 65 who have been eligible for disability benefits under Social Security for at least 24 months and to those with end-stage renal disease or amyotrophic lateral sclerosis.) Because of increases in life expectancy, the average length of time that people are covered by Medicare has risen significantly since the program began in 1965. That trend, which increases the program's costs, is expected to continue.

This option would raise the age of eligibility for Medicare by two months every year beginning with people who were born in 1949 (who will turn 65 in 2014) until the eligibility age reached 67 for people born in 1960 (who will turn 67 in 2027). Thereafter, the eligibility age would remain at 67. Those increases are similar to those already under way for Social Security's full retirement age (FRA)—that is, the age at which workers become eligible for full retirement benefits—except that scheduled increases in the FRA include a 12-year period during which the FRA remains at 66. (Unlike Medicare, with its single eligibility age, Social Security allows workers to receive a reduced retirement benefit as early as age 62. The vast majority of the eligible population chooses to claim Social Security benefits before reaching the FRA.) The eligibility age for Medicare would remain below Social Security's FRA until 2020, when both would be age 66 for people born in 1954; from that point on, the two would be identical.

By the Congressional Budget Office's estimates, this option would reduce federal spending by about $18 billion over the 2012–2016 period and by roughly $125 billion over the 2012–2021 period. Those estimates primarily reflect a reduction in federal spending on Medicare and a slight reduction in outlays for Social Security retirement benefits. Those reductions would be partially offset by an increase in federal spending on Medicaid and an increase in federal subsidies to purchase health insurance through the new insurance exchanges that are scheduled to be established in 2014.

The option would reduce outlays for Social Security retirement benefits by inducing some people to delay their application for such benefits (some people apply for Social Security benefits at the same time they apply for Medicare) and by encouraging some people to delay retirement to maintain their employment-based health insurance coverage until they became eligible for Medicare. The option could also affect the number of people who apply for disability benefits; those effects are expected to be quite small and are not included in this estimate.

The increase in Medicare's eligibility age would boost federal spending on Medicaid in two ways. First, some of the people who were no longer receiving Medicare benefits would have income below 138 percent of the federal poverty level and would therefore sign up for and receive Medicaid benefits instead. (Under current law, that income threshold applies only to people under age 65, but for this option CBO assumed that that age limit would increase in tandem with the Medicare eligibility age.) Second, people over 65 who would have been enrolled in both Medicare and Medicaid (those for whom Medicaid pays Medicare's premiums and cost sharing, and covers certain services not covered by Medicare) would instead have Medicaid as their primary source of coverage until they reached the new Medicare eligibility age.

Subsidies for insurance coverage purchased in the new health insurance exchanges would also increase under this option because some of the people whose eligibility for

Medicare was delayed would receive those subsidies instead.

Federal revenues under this option would decrease by a small amount over the 2012–2021 period; however, those effects are not included in this estimate. That decline in revenues would occur primarily because some employees and retirees whose eligibility for Medicare was delayed would accept coverage through their employer instead. (Active workers who are eligible for Medicare have the option of accepting or rejecting coverage from their employer; for those who accept such coverage, Medicare is the secondary payer.) Most of the resulting increase in employers' spending on health insurance would lead to reductions in taxable wages for active workers or would reduce employers' taxable profits; the remainder would probably be passed along to enrollees in the form of higher premiums. In addition, employers that provided retiree coverage to former workers before they became eligible for Medicare would incur higher costs to the extent that they provided such coverage over a longer period. Although the option could induce some employers to reduce or eliminate such retiree coverage, no changes of that sort are incorporated in this estimate. Federal revenues also would be reduced because a small portion of the subsidies provided through the health insurance exchanges are tax expenditures rather than outlays. CBO did not estimate any increase in tax revenues resulting from workers who delay retirement because total employment in the economy was assumed to remain unchanged; that assumption is consistent with CBO's standard approach to cost estimates.

By 2035, Medicare's spending under this option is estimated to be about 7 percent below what it would be in the absence of this policy change—5.5 percent of gross domestic product rather than 5.9 percent. On the basis of estimates for the 2012–2021 period, CBO anticipates that about one-quarter of those Medicare savings would be offset by the increases in federal spending described above.

A rationale for this option is that it would raise the eligibility age for Medicare to accompany increases in life expectancy. The option would restrain the growth of spending for Medicare. In addition, a higher age threshold for Medicare eligibility would reinforce the incentive to delay retirement created by increases in Social Security's FRA.

An argument against this option is that it would shift costs that are now paid by Medicare to individuals and to employers that offer health insurance to their retirees. States' spending on Medicaid would also be higher.

RELATED OPTION: Revenues, Option 31

RELATED CBO PUBLICATION: *The Long-Term Budget Outlook,* June 2010

Mandatory Spending—Option 19 **Function 570**

Impose Cost Sharing for the First 20 Days of a Stay in a Skilled Nursing Facility Under Medicare

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-1.5	-2.1	-2.2	-2.3	-2.4	-2.5	-2.6	-2.8	-2.9	-8.1	-21.3

For enrollees who have been hospitalized and need continuing skilled nursing care or rehabilitation services on a daily basis, Medicare currently covers up to 100 days of care in a skilled nursing facility (SNF) for each episode of care. There is no deductible for SNF care and no copayment for the first 20 days of each stay. A daily copayment is required for days 21 through 100; that copayment is set at 12.5 percent of the hospital inpatient deductible and is projected to be about $148 in 2013. A substantial share of Medicare SNF stays are shorter than 20 days and therefore do not require any copayment. The Congressional Budget Office projects that total Medicare spending for SNF services will rise from about $30 billion in 2012 to $60 billion in 2021.

Beginning in 2013, this option would impose a copayment for each of the first 20 days of care in a skilled nursing facility equal to 5 percent of the inpatient deductible; that copayment is projected to be about $59 per day in 2013. The maximum additional liability for each SNF stay would thus equal the inpatient deductible, which CBO projects will be $1,184 in 2013. Imposing that copayment would reduce federal outlays by about $8 billion over the 2012–2016 period and by $21 billion over the 2012–2021 period.

The effect of this option on the use of SNF services and on beneficiaries' out-of-pocket payments would depend on whether participants had supplemental coverage. Most individual medigap policies include full coverage of current SNF copayments, so most beneficiaries with such policies would be insulated from the direct impact of the higher copayments—but they would face higher medigap premiums to reflect the average cost of covering those payments. Employers' spending on supplemental coverage for their retirees would also probably increase, and those costs could be passed on to enrollees in the form of higher premiums. This option would not directly affect Medicare beneficiaries who receive full Medicaid benefits or those considered qualified Medicare beneficiaries because Medicaid would be responsible for the additional copayments under this option. The savings shown in this option are net of the additional federal Medicaid spending that would occur as a result.

An argument in favor of this option is that it would discourage some use of Medicare-covered SNF services that may have limited value. For those beneficiaries who would incur higher out-of-pocket costs under this option, the absence of cost sharing under current law for the first 20 days of SNF care encourages additional use of those services, some of which may not be clinically necessary.

One argument against this option is that the added copayment could lead some beneficiaries to forgo services that would help avoid further complications from surgery or improve their health in other ways. Some beneficiaries would probably choose instead to receive similar services through other benefits in Medicare, such as the home health care benefit, that currently have no cost sharing and would not have any cost sharing under this option. In addition, expenditures for states would rise as a result of the increase in copayments that Medicaid would cover.

Mandatory Spending—Option 20 **Function 570**

Require a Copayment for Home Health Episodes Covered by Medicare

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-2.6	-3.6	-3.8	-4.1	-4.4	-4.7	-5.2	-5.7	-6.1	-14.0	-40.1

The Congressional Budget Office projects that the use of home health services, and the resulting costs to the Medicare program, will grow rapidly over the next 10 years, rising from about $23 billion in 2012 to $52 billion in 2021. One reason for the high level of spending is that Medicare beneficiaries are not required to pay any of the costs of home health services covered by the program.

This option would charge Medicare beneficiaries a copayment amounting to 10 percent of the total cost of each home health episode—a 60-day period of services—starting on January 1, 2013. That change would yield net federal savings of $14 billion over the 2012–2016 period and $40 billion over the 2012–2021 period. For Medicare beneficiaries who use home health services, the average increase in Medicare copayments in 2013 would be about $600.

An argument in favor of this option is that it would directly offset a portion of Medicare's home health outlays and encourage some beneficiaries to use those services in a cost-conscious manner. The use of services would also decrease, most likely among the approximately 10 percent of beneficiaries with fee-for-service Medicare only—that is, beneficiaries who do not have supplemental insurance, such as medigap or "wrap-around" retiree coverage, and who are not enrolled in Medicaid or a health maintenance organization.

An argument against this option is that it would increase the risk of significant out-of-pocket costs for the 10 percent of Medicare enrollees who have fee-for-service coverage only—a population that tends to have lower income than do beneficiaries with private supplemental insurance. As a result, implementing the option could cause some of those individuals to forgo beneficial care. Among the majority of enrollees who have supplemental insurance, little or no drop in use would be expected because their supplemental policies would presumably be expanded to cover the home health copayment proposed in this option. For that reason, the approximately 25 percent of enrollees with individually purchased medigap policies would probably face higher premiums, and the costs of employment-based supplemental policies could also rise. Finally, this option would result in increased spending by Medicaid for home health care for individuals who have both Medicare and Medicaid coverage; the federal share of higher Medicaid outlays is included in the estimated change in outlays.

Mandatory Spending—Option 21 **Function 570**

Reduce Medicare Costs by Changing the Cost-Sharing Structures for Medicare and Medigap Insurance

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays												
Establish uniform cost sharing only	0	-2.7	-3.6	-3.3	-3.2	-3.4	-3.8	-4.0	-4.1	-4.1	-12.8	-32.2
Restrict medigap plans only	0	-3.7	-5.1	-5.4	-5.7	-6.0	-6.3	-6.7	-7.1	-7.5	-19.9	-53.4
Establish uniform cost sharing and restrict medigap plans	0	-6.9	-9.4	-9.3	-9.7	-10.1	-10.9	-11.6	-12.1	-12.6	-35.2	-92.5

In Medicare's traditional fee-for-service program—that is, services covered under Part A (primarily hospital and post-acute care) and Part B (physicians' and other outpatient services)—enrollees' cost sharing varies significantly depending on the type of service provided. For example, enrollees must pay a Part A deductible, which the Congressional Budget Office estimates will be $1,184 in 2013, for each "spell of illness" or injury for which they are hospitalized; in addition, enrollees are subject to substantial daily copayments for extended hospital and skilled nursing care. Meanwhile, the annual deductible for outpatient services covered under Medicare's Part B is estimated to be $163 in 2013. Beyond that deductible, enrollees generally pay 20 percent of allowable costs for most Part B services, but cost sharing is higher for some outpatient hospital care. At the same time, certain services that are covered by Medicare, such as home health visits and laboratory tests, require no cost sharing at all. As a result of those variations, enrollees lack consistent incentives to weigh relative costs when choosing among options for treatment. Moreover, if Medicare patients incur extremely high medical costs, they may face a significant amount of cost sharing because the program does not place a limit on those expenses.

Because the cost-sharing requirements in Medicare's fee-for-service program can be substantial, about 90 percent of enrollees obtain supplemental coverage. About 15 percent of fee-for-service enrollees have Medicaid coverage as well, and about 40 percent also have coverage through an employer. About another 30 percent of fee-for-service enrollees buy medigap policies—individual insurance policies that are designed to cover most or all of Medicare's cost-sharing requirements. Studies have found that medigap policyholders use about 25 percent more services than Medicare enrollees who have no supplemental coverage and about 10 percent more services than enrollees who have supplemental coverage from a former employer (which tends to reduce, but not eliminate, their cost-sharing liabilities). Those differences probably arise in part because of the incentive effects of cost sharing and in part because of differences in health status and attitudes toward health care. Because Medicare enrollees with supplemental coverage are liable for only a portion of the costs of those additional services, it is taxpayers (through Medicare) and not supplemental insurers or the policyholders themselves who bear most of the resulting costs. Federal costs for Medicare could be reduced if medigap plans were restructured so that policyholders faced some cost sharing for Medicare services but still had a limit on their out-of-pocket costs.

This option presents three alternatives to reduce Medicare costs by modifying the cost sharing that Medicare beneficiaries face. The first alternative would replace Medicare's current mix of cost-sharing requirements with a single combined annual deductible of $550 covering all Part A and Part B services, a uniform coinsurance rate of 20 percent for amounts above that deductible (including inpatient expenses), and an annual cap of $5,500 on each enrollee's total cost-sharing liabilities. If this option took effect on January 1, 2013, and the various thresholds were indexed to growth in per capita costs for the Medicare program in later years, federal outlays would be reduced by about $13 billion over the 2012–2016 period and by about $32 billion over the 2012–2021 period.

The second alternative would bar medigap policies from paying any of the first $550 of an enrollee's cost-sharing liabilities for calendar year 2013 and would limit coverage

to 50 percent of the next $4,950 in Medicare cost sharing. (All further cost sharing would be covered by the medigap policy, so enrollees in such policies would not pay more than about $3,025 in cost sharing in that year.) If this option took effect on January 1, 2013, and the various thresholds were indexed as specified in the first alternative, federal outlays would be reduced by about $20 billion over the 2012–2016 period and by roughly $53 billion over the 2012–2021 period.

The third alternative combines the restructuring parameters for the first two. Therefore, medigap plans would be prohibited from covering any of the new $550 combined deductible—which would apply to both Part A and Part B of Medicare's fee-for-service program. Under this combined option, the level of beneficiary spending at which the medigap policy's cap on out-of-pocket costs was reached would be equal to the level at which the Medicare program's cap was reached. For spending between the deductible and the cap on the out-of-pocket expenditures, medigap policyholders would face a uniform coinsurance rate of 10 percent for all services; Medicare beneficiaries without other types of supplemental coverage would face a uniform coinsurance rate of 20 percent for all services. If this option took effect on January 1, 2013, and the various thresholds were indexed to growth in per capita costs for the Medicare program in later years, federal outlays would be reduced by about $35 billion over the 2012–2016 period and by roughly $93 billion over the 2012–2021 period. Those savings do not equal the sum of the savings that would result from the first two alternatives because of the interactions between their effects.

An argument in favor of this option is that it would appreciably strengthen incentives for more prudent use of medical services—both by raising the initial threshold of health care costs that most Medicare beneficiaries face and by ensuring that more enrollees pay at least a portion of all subsequent costs up to the out-of-pocket limit. Because medigap plans would be barred from paying the first $550 of an enrollee's cost-sharing liabilities (under the second and third alternatives), the costs borne by medigap plans would decrease, and therefore so would the premiums that the medigap plans charge. Another argument in support of this option is that it would provide greater protection against catastrophic costs. Capping enrollees' out-of-pocket expenses would especially help people who develop serious illnesses, require extended care, or undergo repeated hospitalizations but lack supplemental coverage for their cost sharing.

An argument against the option is that it would boost cost-sharing liabilities for most Medicare enrollees. Another argument against the option (specifically, under the second and third alternatives) is that the restructuring of medigap coverage would mean that people would not be able to purchase policies with the low levels of cost sharing for which they have revealed a preference in the past. Even with the new cap on out-of-pocket expenses, some enrollees would object to any policy that denied them access to full supplemental coverage for their cost sharing. Furthermore, in any given year, some enrollees would see their combined payments for premiums and cost sharing rise.

Mandatory Spending—Option 22 **Function 570**

Increase the Basic Premium for Medicare Part B to 35 Percent of the Program's Costs

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-3.5	-8.3	-13.6	-19.5	-26.4	-29.4	-31.0	-33.5	-36.2	-39.8	-71.3	-241.2

Medicare Part B allows beneficiaries to obtain coverage for physicians' and other outpatient services by paying a monthly premium. When the program began in 1966, the premium was intended to finance 50 percent of Part B costs per aged enrollee, with the remainder funded by general revenues. Subsequent legislation, however, reduced that share, and premium collections fell to less than 25 percent of program spending. The Balanced Budget Act of 1997 permanently set the Part B premium at about 25 percent of Part B spending per aged enrollee. General revenues still fund the remainder of Part B spending. (These calculations are based on costs for enrollees age 65 and older and do not include costs for people who qualify for Medicare before age 65 because of a disability.)

The basic monthly Part B premium increased from $96.40 in 2009 to $110.50 in 2010. However, the majority of beneficiaries who enrolled prior to 2010 were not affected by that increase, because there was no cost-of-living adjustment (COLA) to Social Security benefits for 2010 and a "hold-harmless" provision protects beneficiaries from a drop in their monthly net Social Security payment if an increase in the Part B premium exceeds the Social Security COLA. Since January 2007, higher-income enrollees have faced greater premiums for Part B than other enrollees have, but the basic premium of 25 percent still applies to about 95 percent of enrollees. The Patient Protection and Affordable Care Act (Public Law 111-148) froze, through 2019, the thresholds at which income-related premiums begin—at the 2010 levels of $85,000 for single beneficiaries and $170,000 for couples. Thus, the share of enrollees that will be subject to income-related premiums will increase over time owing to growth in beneficiaries' incomes.

This option would gradually raise the basic Part B premium from 25 percent to 35 percent of the program's costs for enrollees ages 65 and older over a five-year period, beginning in 2012. The premium share would increase by 2 percentage points per year through 2016 and then remain at 35 percent, preserving the thresholds at which income-related premiums begin as specified in current law. Also, the hold-harmless provision would be preserved; that provision would apply to more enrollees in 2012 because of the initial increase in premiums under this option. This option, the Congressional Budget Office projects, would result in estimated savings of about $71 billion over the 2012–2016 period and about $241 billion over the 2012–2021 period.

One rationale for this option is that it would ease the budgetary pressures posed by rising costs in the Part B program, which will climb faster as members of the baby-boom generation reach age 65. Even under this option, the public subsidy for most Part B enrollees—65 percent when fully phased in—would be greater than the 50 percent that was intended at the program's outset. Also, because Medicaid pays the premiums for certain low-income Part B enrollees with limited assets, about 18 percent of Medicare beneficiaries would be unaffected.

An argument against this option is that it would reduce disposable income for many Part B enrollees. Also, higher premiums might lead to a decline in Part B enrollment; if such an effect materialized, however, it would most likely be small because the subsidy would remain quite large. In addition, expenditures by states would rise because states would pay higher premiums for people eligible for coverage through both Medicare and Medicaid.

Mandatory Spending—Option 23 **Function 570**

Reduce Medicare's Payment Rates Across the Board in High-Spending Areas

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	-1.1	-2.2	-3.4	-4.9	-6.2	-6.4	-7.0	-7.5	-8.0	-11.6	-47.6

In some parts of the country, Medicare's spending per beneficiary is unusually high, a circumstance that appears to be attributable, at least in part, to differences in local patterns and professional norms of medical practice, and not just to higher local prices for "inputs" (goods and services used in the production of services, such as professional labor, office space, and so forth) or to unusually sick populations. Researchers have questioned whether the additional services provided in such high-spending areas produce improvements in patients' health that are commensurate with their cost.

In parts of the country where per-beneficiary spending is unusually high, after accounting for differences in prices and beneficiaries' health status, this option would apply across-the-board reductions to Medicare payment rates for services covered under Parts A and B (the fee-for-service parts of the program). The first step in determining those reductions would be to define the geographic areas to be used for measuring and comparing spending per beneficiary; the size of such areas has a substantial effect on the amount of change in mandatory spending that the option would produce. For this option, each metropolitan statistical area (MSA) designated by the Office of Management and Budget would constitute an area. Then, in each state, all nonmetropolitan regions—all parts of the state not included in an MSA—would constitute a single additional area.

Payment rates in the fee-for-service program would depend on each area's "relative spending"—defined as the spending per beneficiary in that area, adjusted to reflect the price of inputs and the health status of beneficiaries in that area, divided by the average spending per beneficiary nationwide. (Adjustments for health status would be based on Medicare's hierarchical condition categories, which are currently used to adjust payment rates for Medicare Advantage plans.) Fee-for-service payment rates under this option would be reduced in areas where relative spending exceeded 1.1—that is, where adjusted spending was at least 10 percent higher than the national average; reductions would equal one-half of the difference between the region's relative spending and the threshold of 1.1. For example, a region with relative spending of 1.2—that is, adjusted spending 20 percent above the national average—would have Medicare payment rates reduced by 5 percent, or 1.2 minus 1.1, divided by 2.

The reduction in payment rates in high-spending areas would be phased in over five years and capped at 20 percent. It would apply to all payments—including those to hospitals, physicians, and providers of post-acute care—made on the basis of a fee schedule. Moreover, the reduction in fee-for-service payment rates would indirectly reduce Medicare's payments to private Medicare Advantage plans by reducing the benchmark payment rates for those plans. If implemented, this option would reduce Medicare spending by an estimated $12 billion over 5 years and by almost $48 billion over 10 years.

An argument in favor of this option is that it would bring about more equity among regions in Medicare's spending. The option also might encourage initiatives in high-spending areas to reduce the utilization of health care resources, especially services thought to have only marginal benefits for patients, and would encourage providers to deliver services more efficiently. Reductions in Medicare's Part B expenditures would also lower beneficiaries' premiums and out-of-pocket payments.

An argument against this option is that it would not target specific medical providers or specific types of services. In high-spending areas, all medical providers would face reductions in payment rates, regardless of whether their practice patterns contributed to the area's unusually high level of spending. Thus, payments for all services, regardless of a service's value to a patient, would be reduced. Medicare beneficiaries might face difficulties in obtaining certain medical services if providers became less willing to offer them. In addition, by reducing the revenue of providers, this option might limit their ability to deliver high-quality care.

RELATED CBO PUBLICATION: *Geographic Variation in Health Care Spending,* February 2008

Mandatory Spending—Option 24 **Function 570**

Eliminate the Critical Access Hospital, Medicare-Dependent Hospital, and Sole Community Hospital Programs in Medicare

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-3.8	-4.1	-4.5	-5.0	-5.6	-6.3	-7.0	-7.8	-8.6	-9.5	-23.0	-62.2

Hospitals designated as critical access hospitals (CAHs), Medicare-dependent hospitals (MDHs), and sole community hospitals (SCHs) are exempt from the Inpatient Prospective Payment System (IPPS) through which Medicare pays for services provided by most acute care hospitals. Eligibility for the CAH, MDH, and SCH designations is based on several factors, including size and location. Most of the hospitals exempt from the IPPS are small, rural facilities. Some of those hospitals receive payments equal to 101 percent of the costs of providing care, while others receive payments based on a blend of IPPS rates and their costs. Hospitals benefiting from the special adjustments for CAHs, MDHs, and SCHs are paid about 25 percent more, on average, for inpatient and outpatient services than the payments that would otherwise apply. Currently, one-third of hospitals benefit from those designations and account for about 10 percent of total Medicare spending for hospital inpatient services.

This option would eliminate the CAH, MDH, and SCH programs and end the higher Medicare payments made to those facilities. Instead, payment to those hospitals, as with other hospitals paid through the IPPS, would be determined prospectively on the basis of the following: patients' diagnoses and the severity of their illness or injury; geographic variations in hospital "input" costs (for example, for professional labor or medical supplies); and certain other hospital- and patient-specific factors, such as the hospital's teaching status and Medicaid caseload. By eliminating the CAH, MDH, and SCH programs and the higher payments to hospitals participating in those programs, this option would reduce federal outlays by $23 billion over the 2012–2016 period and by approximately $62 billion over the 2012–2021 period.

An argument in favor of eliminating the CAH, MDH, and SCH programs is that doing so would move Medicare toward a payment structure that compensates all hospitals in a consistent manner. Smaller rural hospitals would no longer be able to participate in programs that compensated them at relatively higher rates. Additionally, this option might improve efficiency in the health care system. IPPS payments are intended to encourage efficiency by compensating hospitals for the costs that reasonably efficient providers would incur in furnishing high-quality care (including adjustments for local input costs). By placing CAHs, MDHs, and SCHs under the IPPS, those hospitals would face greater incentives to provide efficient care.

A potential drawback of this option is that the special payments currently made to the CAHs, MDHs, and SCHs may offset the higher costs of operating smaller facilities in rural areas. If those hospitals are not able to reduce their costs under the IPPS, the increased financial pressure resulting from the elimination of special payments to CAHs, MDHs, and SCHs might force some of those hospitals to convert to outpatient facilities or even to close. To the extent that occurred, patients who reside in those areas might have difficulty getting access to care.

Mandatory Spending—Option 25 **Function 570**

Require Manufacturers to Pay a Minimum Rebate on Drugs Covered Under Medicare Part D for Low-Income Beneficiaries

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	*	-4.0	-10.0	-12.0	-12.0	-13.0	-14.0	-14.0	-15.0	-18.0	-38.0	-112.0

Note: * = between zero and $500 million.

Medicare's voluntary outpatient drug benefit, known as Part D, is delivered by private drug plans; federal subsidies for that coverage, net of the premiums that enrollees pay, totaled $52 billion in 2010. (Those subsidies include payments to stand-alone prescription drug plans and prescription drug plans associated with Medicare Advantage plans, but they exclude subsidies provided to employers for prescription drug coverage provided by their retiree health plans.) One way that those drug plans limit the cost of the Part D benefit is by negotiating rebates from the manufacturers of brand-name drugs in return for favorable coverage of those drugs, such as lower copayments for preferred drugs. That strategy is most likely to be effective for "single-source" drugs that are not available in generic form but face competition from other brand-name drugs to treat the same medical condition. The Congressional Budget Office estimates that in 2008, rebates under Part D averaged about 14 percent of gross spending on all brand-name drugs and a slightly higher percentage of spending on single-source brand-name drugs.

Prior to the establishment of Part D in 2006, Medicare beneficiaries who were also eligible for full benefits under Medicaid—known as "dual eligibles"—received drug coverage through Medicaid. Drug manufacturers are required to pay a significant rebate on their sales to Medicaid enrollees. In 2010, the minimum rebate in the Medicaid program was increased from 15.1 percent to 23.1 percent of the average manufacturer price (AMP)—that is, the price that manufacturers receive for sales to retail pharmacies; additional rebates are required if a drug's price rises faster than general inflation. When Part D was established, dual eligibles were enrolled automatically in a low-income-subsidy (LIS) program, which typically covers the premiums and most of the cost sharing required under the basic Part D benefit. Overall, LIS beneficiaries account for about 40 percent of Part D enrollees and about 56 percent of Part D spending; most, but not all, LIS recipients are dual eligibles. Currently, the prices and rebates for drugs used by LIS enrollees are established in the same way as those for other Part D enrollees—that is, through negotiations between Part D plans and drug makers.

This option would require manufacturers of brand-name drugs to pay the federal government a rebate on drugs purchased by enrollees in the LIS program, starting in 2013. The program would reflect the current rebate system for Medicaid: Manufacturers would be responsible for a total rebate of at least 23.1 percent of the AMP, plus an additional rebate for price increases that exceeded the rate of inflation since the drug's introduction.[1] The difference between that amount and the amount of discounts and rebates that manufacturers already provide to Part D drug plans (as defined below) would be paid to the federal government. If the average Part D rebate for a given drug already exceeded the sum of 23.1 percent of the AMP plus the inflation-based rebate, however, no rebate would be paid to the federal government for that drug.

Manufacturers would be required to participate in the new Part D rebate program in order for their drugs to be covered by Parts B and D of Medicare, by Medicaid, and by the Veterans Health Administration. To reduce the amount of rebates owed to the federal government, rebates provided to Part D plans would have to apply to all drug purchases by all Part D enrollees. Therefore, if manufacturers set different rebate levels for different subgroups of beneficiaries, only the lowest rebate provided would be subtracted when determining the amount owed to the federal government on purchases by LIS

1. Unlike the current Medicaid rebate, this option would not have a "best price" feature. That provision in Medicaid requires manufacturers to pay a rebate that exceeds 23.1 percent of the AMP if the difference between the AMP and the best price obtained by a private purchaser (net of certain private rebates) is larger than 23.1 percent of the AMP.

beneficiaries. In particular, under this option, the 50 percent discount on brand-name drugs that manufacturers now have to provide for certain drug purchases would not reduce the rebate owed to the federal government on purchases by LIS beneficiaries because that 50 percent discount applies only to a subgroup of drug purchases (those made by beneficiaries who are not enrolled in the LIS program for drugs purchased within a specified range of spending).

Under this option, manufacturers would continue to have an incentive to provide rebates to drug plans in exchange for preferred coverage of brand-name drugs, but that incentive would be smaller than under current law because the federal rebate would make the additional sales that would result from preferred coverage less profitable. The rebates obtained by drug plans for purchases by Part D enrollees would therefore be reduced, CBO expects. Moreover, drug makers would be expected to set higher "launch" prices for new drugs to limit the impact of the new rebate, particularly for new drugs that do not have close substitutes. Higher launch prices in response to a minimum rebate requirement in Part D would have varying effects on other drug purchasers. Employment-based health insurance plans would probably negotiate for larger rebates to offset the higher launch prices, but state Medicaid programs would pay a higher price for new drugs. Even after accounting for such offsets, CBO estimates that this option will generate savings to the federal government—about $38 billion over the 2012–2016 period and about $112 billion over the 2012–2021 period.

The main advantage of this option is that Medicare would pay less for drugs used by LIS beneficiaries in Part D. Advocates of this option might argue that manufacturers previously paid a rebate to Medicaid for drugs purchased by the dual-eligible population (who constitute the majority of LIS beneficiaries) before those beneficiaries were reassigned to the Part D benefit, so there is a recent precedent for requiring such rebates for that population.

A disadvantage of the option is that the net reduction in the prices paid for drugs under Part D might reduce the amount of funds that manufacturers invest in research and development of new products. Relative to current law, the option would not significantly reduce the incentive to develop "breakthrough" drugs because those drugs could be launched at prices that were high enough to largely offset the rebate. However, the new rebate would apply to LIS beneficiaries who are not dual eligibles, so the magnitude of the total required rebates would be larger than when dual eligibles received their drug coverage from Medicaid; consequently, the adverse impact on manufacturers' incentives would probably be larger than it was prior to the creation of Part D.

RELATED CBO PUBLICATIONS: Letter to the Honorable Paul Ryan about the effect of the March health legislation on prescription drug prices, November 4, 2010; and *Effects of Using Generic Drugs on Medicare's Prescription Drug Spending*, September 2010

Mandatory Spending—Option 26 **Function 600**

Base Cost-of-Living Adjustments for Federal Civilian and Military Pensions and Veterans' Benefits on an Alternative Measure of Inflation

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-300	-800	-1,300	-1,700	-2,200	-2,600	-3,000	-3,600	-4,000	-4,500	-6,300	-24,000

In 2010, the federal government paid $69 billion in pension benefits to 2.5 million civilian retirees and their survivors, as well as $51 billion to 2.2 million military retirees and their survivors. The government also paid $43 billion in compensation to 3.5 million disabled veterans and their survivors and $4 billion in pension benefits to about 500,000 veterans and their survivors. All of those benefits are linked to the CPI-W (the consumer price index for urban wage earners and clerical workers), but the extent of inflation protection varies from one program to the next, as does the age at which benefits are payable.

Pensions paid under the Civil Service Retirement System (CSRS) are subject to annual cost-of-living adjustments (COLAs) that provide complete protection against increases in the CPI-W. Pensions paid under the newer Federal Employees Retirement System (FERS) are fully protected only when that increase is less than 2 percent per year. If the percentage increase in the CPI-W is between 2 percent and 3 percent, FERS annuitants receive a COLA of 2 percent; if the increase exceeds 3 percent, the COLA is the percentage increase in the CPI-W minus 1 percentage point. Unless they retire on disability, FERS annuitants receive COLAs only at ages 62 and above, whereas all CSRS annuitants receive COLAs. CSRS and FERS participants generally can begin to receive pension benefits at age 60 with 20 years of service or at age 62 with 5 years of service. Participants with 30 years of service are eligible to receive benefits even if they retire before the age of 60.

Pensions for military personnel hired before August 1, 1986, garner COLAs that provide complete protection against increases in the CPI-W. People who entered service after that date have a choice: They may elect to stay under the old system and receive a full COLA, or they can accept a $30,000 bonus after 15 years of service and receive reduced annual COLAs that equal the percentage increase in the CPI-W less 1 percentage point. Those who choose the latter arrangement receive an increase in their pension at age 62, restoring the annuity to what it would have been had the full COLA been paid. After age 62, retirees again receive the reduced COLA (but from a higher base because of the increase at age 62). Most military personnel have declined the 15-year bonus and retained eligibility for the full COLA. Active-duty military personnel are eligible to receive pension benefits after completing 20 years of service, regardless of age; reservists are not eligible for retirement annuities until they reach age 60; and personnel with fewer than 20 years of service generally are not eligible for any benefits unless they retire on disability.

Full COLAs are attached to veterans' disability compensation and pensions. Disability compensation is paid to veterans with certified disabilities, in amounts that depend on the severity of the disability. Veterans also are eligible for means-tested pensions.

This option would replace the CPI-W with the chained CPI-U (the chained consumer price index for all urban consumers) as the index by which federal civilian, military, and veterans' benefits are adjusted for inflation. The Congressional Budget Office estimates that, on average, the chained CPI-U will grow 0.25 percentage points per year more slowly than the CPI-W over the next 10 years. Under this option, annual COLAs would equal the increase in the chained CPI-U for CSRS annuitants, military retirees, and veterans. Comparable adjustments would be made for FERS annuitants when the increase in the chained CPI-U was less than 2 percent a year. FERS annuitants would receive a COLA of 2 percent when the increase in the chained CPI-U was between 2 percent and 3 percent and a COLA 1 percentage point below the increase in the chained CPI-U when that increase exceeded 3 percent. Military retirees who chose the $30,000 bonus under the new system would receive a reduced COLA equal to the percentage growth in the chained CPI-U minus 1 percentage point.

The chained CPI-U is initially published as a preliminary value and then revised over the following two years. As a result, implementing this option would require the use of preliminary data. CBO discussed the details of the approach in a Web-only technical appendix released with its February 2010 issue brief, *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code*.

CBO estimates that those changes would decrease mandatory outlays by about $6 billion between 2012 and 2016 and by $24 billion from 2012 through 2021. On average, a CSRS annuitant would receive about $3,900 less over 10 years than under current law; a FERS annuitant would receive about $1,000 less. The average military retiree would receive roughly $3,000 less over 10 years relative to current law, veterans' disability compensation would be about $1,500 less, and veterans' pensions would be about $1,200 less. (Using the chained CPI-U for all federal benefit programs that are indexed for inflation, including Social Security, would reduce outlays by about $36 billion through 2016 and by about $145 billion through 2021.)

A rationale for this option is that the CPI-W overstates increases in the cost of living, so using the chained CPI-U would reduce federal outlays while still ensuring that benefits do not fall relative to the cost of living after a recipient becomes eligible for those benefits. The CPI-W measures inflation on the basis of price changes for a fixed basket of goods that is periodically updated. The chained CPI-U provides a more accurate measure of changes in the cost of living by more quickly capturing the extent to which households adjust their consumption when relative prices change. Another argument in favor of this option is that federal pension plans would still offer more protection against inflation than most private pension plans do. According to a 2001 survey, fewer than 15 percent of private-sector plans gave annuitants formal annual COLAs, and another 25 percent made ad hoc cost-of-living adjustments.

An argument against reducing the COLA is that the prices faced by annuitants could rise faster than the prices faced by the population at large. In particular, annuitants are likely to spend more than younger people do for medical care, the price of which generally grows faster than the prices of many other goods and services. An experimental price index for goods and services purchased by the elderly (the CPI-E) grew an average of 0.27 percentage points per year faster than the CPI-W from 1982 to 2010. Thus, the benefits received by retirees may decline over time in real terms under current law, and using the chained CPI-U would accentuate that decline. CSRS annuitants would be particularly affected because they are most dependent on their pensions: CSRS annuitants typically receive larger pensions than FERS annuitants do, but CSRS annuitants did not receive the matching contributions to their Thrift Savings Plan accounts for which FERS annuitants were eligible. Moreover, CSRS annuitants may have declined to switch to FERS because they believed that they would always have the protection against inflation offered by the current COLA rules. Also, because military personnel can retire earlier and receive immediate pensions after just 20 years of service, their lower COLAs would have larger effects over longer periods. Finally, because current and prospective employees would be expected to analyze retirement benefits when comparing alternative wage and benefit packages, reducing federal retirement benefits could hamper the government's ability to recruit and retain a highly qualified workforce.

RELATED OPTIONS: Mandatory Spending, Option 27; and Revenues, Option 3

RELATED CBO PUBLICATIONS: *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code,* Issue Brief, February 2010; *Assessing Pay and Benefits for Military Personnel,* Issue Brief, August 2007; *Characteristics and Pay of Federal Civilian Employees,* March 2007; *Comparing the Pay of Federal and Nonfederal Law Enforcement Officers,* August 2005; *Measuring Differences Between Federal and Private Pay,* November 2002; and *The President's Proposal to Accrue Retirement Costs for Federal Employees,* June 2002

Mandatory Spending—Option 27 **Function 650**

Base Social Security Cost-of-Living Adjustments on an Alternative Measure of Inflation

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-1.4	-3.3	-5.3	-7.5	-9.8	-12.1	-14.5	-16.9	-19.3	-21.9	-27.3	-112.0

As specified by law, the Social Security Administration increases recipients' monthly benefits in most years. For example, the 5.8 percent cost-of-living adjustment (COLA) that went into effect in January 2009 was based on the increase in the consumer price index for urban wage earners and clerical workers (CPI-W) between the third quarters of 2007 and 2008. That index is calculated by the Bureau of Labor Statistics, or BLS. Although declines in overall consumer prices between the third quarters of 2008 and 2010 meant no COLAs were provided in 2010 or 2011, the Congressional Budget Office projects that there will be one in 2012.

The CPI-W, however, tends to overstate inflation because it does not fully account for changes in patterns of spending. This option would set the COLA equal to the growth in the chained consumer price index for all urban consumers (chained CPI-U). The chained CPI-U is an alternative measure of inflation, also calculated by BLS, that more fully incorporates the effects of changes in patterns of spending. CBO estimates that, on average, the chained CPI-U is likely to grow 0.25 percentage points per year more slowly than the CPI-W over the next 10 years. Using the chained CPI-U to set Social Security COLAs would reduce federal outlays by about $27 billion over five years and by $112 billion through 2021, CBO estimates. By 2050, such action would have reduced Social Security outlays by 3 percent—from 5.9 percent to 5.7 percent of gross domestic product.

Some other policy changes that would reduce Social Security outlays—by constraining the increase in initial benefits, for example, or by raising the full retirement age (Mandatory Spending—Options 28 and 30, respectively)—would affect future beneficiaries only. This option, by contrast, would reduce benefits to current beneficiaries so that current and future generations would bear the reductions more equally.

The chained CPI-U is initially published as a preliminary value and then revised over the following two years. As a result, implementing this option would require the use of preliminary data. CBO discussed the details of the approach in a Web-only technical appendix released with its February 2010 issue brief, *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code*.

A rationale for this option is that the CPI-W overstates increases in the cost of living. Specifically, the CPI-W measures inflation on the basis of price changes for a fixed basket of goods and services that is periodically updated, whereas the chained CPI-U more quickly captures the extent to which households adjust their consumption when relative prices change. (Technically, the chained CPI-U avoids the so-called "substitution bias" that arises from the use of a fixed basket of goods in computing the CPI-W. Some analysts also conclude that neither the CPI-W nor the chained CPI-U fully accounts for increases in the quality of existing products or the value of new products.) Therefore, using the chained CPI-U would reduce federal outlays but ensure that, after adjusting for overall inflation, benefits remain at the same level as they are when a recipient becomes eligible for benefits.

An argument against reducing the COLA is that the prices faced by Social Security beneficiaries could rise faster than prices faced by the population at large. For example, beneficiaries are likely to spend more than younger people do for medical care, the price of which generally outpaces the prices of many other goods and services. BLS computes an experimental consumer price index for the elderly (the CPI-E) that aims to track inflation for the population ages 62 and older. From December 1982 through December 2010, the CPI-E grew faster than the CPI-W by an average of 0.27 percentage points per year. Another potential drawback of this option is that a reduction in the COLA would generally have larger effects on the oldest beneficiaries and on those who initially became eligible for Social Security on the basis of

a disability. For example, if benefits were adjusted every year by 0.25 percentage points less than the increase in the CPI-W, beneficiaries would face a reduction in retirement benefits at age 75 of about 3 percent compared with what they would receive under current law; at age 95, they would face a reduction of about 8 percent. To protect vulnerable populations, lawmakers might choose to reduce the COLA only for beneficiaries whose income or benefits were greater than specified amounts. Doing so, however, would reduce the budgetary savings from the option.

RELATED OPTIONS: Mandatory Spending, Option 26; and Revenues, Option 3

RELATED CBO PUBLICATIONS: *Social Security Policy Options,* July 2010; and *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code,* Issue Brief, February 2010

Mandatory Spending—Option 28 **Function 650**

Link Initial Social Security Benefits to Average Prices Instead of Average Earnings

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays												
Implement pure price indexing	-100	-600	-1,800	-3,800	-6,800	-11,000	-16,600	-23,300	-31,500	-41,100	-13,100	-136,600
Implement progressive price indexing	-100	-400	-1,200	-2,400	-4,200	-6,700	-10,200	-14,400	-19,600	-25,400	-8,300	-84,600

Social Security benefits for retired and disabled workers are based on those individuals' average earnings over a lifetime. The Social Security Administration uses a statutory formula to compute a worker's initial benefit, and through a process known as wage indexing, the benefit formula changes each year to account for economywide growth of wages. Average initial benefits for Social Security recipients therefore tend to grow at the same rate as do average wages, and such benefits replace a roughly constant portion of wages. (After people become eligible for benefits, their monthly benefits also are adjusted annually to account for increases in the cost of living.)

One way to constrain the growth of Social Security benefits would be to change the initial benefit computation so that the real (inflation-adjusted) value of average initial benefits did not rise over time. That approach, often called "price indexing," would allow increases in real wages to result in higher real Social Security payroll taxes but not in higher real benefits. Specifically, beginning with participants who became eligible for benefits in 2012, this option would link the growth of initial benefits to the growth of prices (as measured by changes in the consumer price index) rather than to the growth of average wages. (The calculation of average indexed monthly earnings, a key step in the statutory formula for determining Social Security benefits, would continue to involve wage indexing. However, the benefit would be multiplied by the ratio of a price index to an average wage index—where the indexes are set to be equal in 2011.)

Switching to indexing initial benefits on the basis of prices rather than wages—a "pure price-indexing" approach—would reduce federal outlays by about $13 billion over five years and by almost $137 billion over the next decade. By 2050, scheduled Social Security outlays would be reduced by 29 percent relative to what would occur under current law—from 5.9 percent to 4.2 percent of gross domestic product.

Under pure price indexing, the reduction in payments relative to those that are scheduled to be paid under current law would be larger for each successive cohort of beneficiaries; the extent of the reduction would be determined by the growth of real wages. For example, if real wages grew by 1.3 percent annually (approximately the rate used in the Congressional Budget Office's long-term Social Security projections), workers who were first eligible for benefits in 2012 would receive about 1.3 percent less than they would have received under the current rules; those becoming eligible in 2013 would receive 2.6 percent less; and so on. In reality, however, the incremental reduction would vary from year to year, depending on actual growth in real earnings. If real earnings shrank during a period—that is, if average wages grew more slowly than prices—then benefits would grow faster than they would under current law. Those eligible for benefits in 2030, CBO estimates, would experience a reduction in benefits of about 25 percent relative to benefits scheduled under current law, and the reduction would grow to more than 40 percent by 2050.

An alternative approach, called "progressive price indexing," would retain the current formula for workers who had lower earnings and would reduce the growth of initial benefits only for workers who had higher earnings. Currently, the formula for calculating initial Social Security benefits is structured so that workers who have higher earnings receive higher benefits, but the benefits paid to workers with lower earnings replace a larger share of their

earnings. Under the specifications for progressive price indexing in this option, initial benefits for the 30 percent of workers with the lowest lifetime earnings would increase with average wages, as they are currently slated to do, whereas initial benefits for higher-income workers would increase more slowly, at a rate that depended on their position in the distribution of earnings. For example, for workers whose earnings put them at the 31st percentile of the distribution, benefits would rise only slightly more slowly than wages, whereas for the highest earners, benefits would rise with prices—as they would under pure price indexing. Thus, under progressive price indexing, the initial benefits for most workers would increase more quickly than prices but more slowly than average wages. As a result, the benefit formula would gradually become flatter, and after about 60 years, everyone in the top 70 percent of earners would receive the same monthly benefit. A partially flat benefit formula would represent a significant change from Social Security's traditional structure, under which workers who pay higher taxes receive higher benefits.

Progressive price indexing would reduce scheduled Social Security outlays less than would pure price indexing, and beneficiaries with lower earnings would not be affected. Real annual average benefits would still increase for all but the highest-earning beneficiaries. Benefits would replace a smaller portion of affected workers' earnings than they do today but a larger portion than they would under pure price indexing.

A switch to progressive price indexing would reduce federal outlays by more than $8 billion over 5 years and by about $85 billion over 10 years. By 2050, outlays for Social Security would be reduced by 18 percent, or from 5.9 percent to 4.8 percent of gross domestic product.

Under both approaches, the reductions in benefits relative to current law would be greatest for beneficiaries in the distant future. Those beneficiaries, however, would have had higher real earnings during their working years and thus a greater ability to save for retirement.

An advantage of both approaches in this option is that, although they would reduce outlays for Social Security compared with those scheduled to be paid under current law, average inflation-adjusted benefits in the program would not decline over time. If the pure price-indexing approach was followed, future beneficiaries would generally receive the same real monthly benefit paid to current beneficiaries, and they would, as average longevity increased, receive a larger total lifetime benefit.

A disadvantage of both approaches is that because benefits would no longer be linked to wages, affected beneficiaries would no longer share in overall economic growth. As a result, benefits would replace a smaller portion of workers' earnings than they do today. Another disadvantage is that relative to currently scheduled benefits, reductions would be largest during periods of high wage growth. Finally, the options would continue to reduce the rate of growth of scheduled benefits beyond what is needed to bring Social Security outlays in line with revenues.

RELATED CBO PUBLICATIONS: *Social Security Policy Options,* July 2010; Letter to the Honorable Paul Ryan concerning CBO's analysis of the Roadmap for America's Future Act of 2010, January 27, 2010; "Long-Term Analysis of S. 2427, the Sustainable Solvency First for Social Security Act of 2006," attachment to a letter to the Honorable Robert F. Bennett, April 5, 2006; and "Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," attachment to a letter to the Honorable Larry E. Craig, July 21, 2004

Mandatory Spending—Option 29 **Function 650**

Raise the Earliest Eligibility Age for Social Security

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	-1,700	-3,900	-6,300	-8,900	-11,900	-15,000	-18,400	-22,400	-26,000	-29,400	-32,700	-143,900

Although the full retirement age for Social Security beneficiaries is now 66 and will rise to 67 for people born in 1960 and later, eligible workers may choose to receive benefits at age 62. About 40 percent do so, and nearly all claim benefits by 66. The age at which people claim benefits affects the amount they receive monthly and the duration of their benefits. People who claim benefits before the full retirement age receive less each month, but typically they receive benefits for a longer period; conversely, people who wait to claim benefits until they are older (up to age 70) receive higher monthly payments but for fewer years. The adjustment for the age of claiming benefits is currently actuarially fair, on average, so a person's total lifetime benefits have an approximately equal value regardless of the age at which he or she begins to collect them.

This option would increase the earliest age of eligibility by two months per year, beginning with people born in 1950 (who turn 62 in 2012); by 2025, the age would be 64 for people born in 1961 and later. The result is that federal outlays would be reduced by about $33 billion over five years and by nearly $144 billion through 2021.

Because this option would have little effect on lifetime benefits for the average beneficiary, its main budgetary effect would be a shift in the timing of outlays, which would be slightly lower than under current law from 2012 to about 2035 and would be slightly higher thereafter. There are three complicating factors, however. First, a higher earliest eligibility age would induce some people to work longer, increasing the size of the workforce and boosting federal revenues from income and payroll taxes. Second, the additional work would result in higher future Social Security benefits, although the increase in benefits would be smaller than the increase in revenues. The 10-year estimates for this option do not include those two effects. Third, changing the earliest eligibility age would have a small effect on the number of people who applied and qualified for Social Security disability insurance as well as on the timing of applications for disability benefits. The estimates take that effect into account; however, it does not significantly change the projected savings.

An argument in favor of the option is that the older population is becoming healthier and able to work longer and therefore many people do not need benefits at as early an age as workers did in the past. The change also would increase annual benefits for some beneficiaries, reducing poverty among older people. Under current law, the penalty for claiming benefits early is increasing as the full retirement age rises. For example, people born before 1938 who claimed benefits at age 62 received 80 percent of the full benefit (the amount that they would have received had they waited until the full retirement age). That fraction is decreasing under current law, to 70 percent for people born after 1959 who claim benefits at 62. If the earliest age of eligibility was 64, all retirees would receive at least 80 percent of their full monthly benefit.

An argument against the option is that it would increase financial hardship for some people who do not qualify for Social Security disability benefits and would have to wait until age 64 to claim retirement benefits. In addition, forcing people with lower-than-average life expectancies to delay claiming benefits would reduce their lifetime benefits. For example, someone who died at 68 would collect benefits for four years rather than six. And because people with lower earnings tend to have shorter life expectancies, they would be more likely to be harmed by the change.

RELATED OPTION: Mandatory Spending, Option 30

RELATED CBO PUBLICATION: *Social Security Policy Options,* July 2010

Mandatory Spending—Option 30 **Function 650**

Raise the Full Retirement Age in Social Security

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Outlays	-100	-600	-1,600	-3,200	-6,700	-11,200	-16,200	-21,600	-27,300	-31,400	-12,200	-119,900

The age at which workers become eligible for full retirement benefits—the full retirement age, also called the normal retirement age—depends on their year of birth. For workers born before 1938, that age was 65. The age of eligibility increased in two-month increments until it reached 66 for workers born in 1943. For workers born between 1944 and 1954, the age holds at 66, but it increases again in two-month increments until reaching 67 for workers born in 1960 or later. Workers who turn 62 in 2022 or later will be subject to a full retirement age of 67. Workers will continue to be able to receive benefits at age 62, but at that age, the amount of benefits is smaller than the amount they would receive by waiting until the full retirement age to claim benefits.

Under this option, the full retirement age would increase by two-month increments for 6 years, rising to 66 years and 2 months for workers born in 1950 (who turn 62 in 2012) and reaching 67 for workers who were born in 1955 or later (who turn 62 in 2017 or later). Thereafter, it would continue to increase by two months per year until reaching 70 for workers born in 1973 (who turn 62 in 2035). As under current law, workers could still choose to begin receiving reduced benefits at 62, but the reductions would be larger. The benefits of workers who qualify for disability insurance would not be reduced under this approach.

This approach to constraining growth is equivalent in its effects on benefits to reducing earnings-replacement rates. (Mandatory Spending—Option 28 offers an alternative method of reducing those rates.) Depending on the age at which a worker claims benefits, a one-year increase in the full retirement age is equivalent to a reduction in a retired worker's monthly benefit of between 5 percent and 8 percent. Because many workers retire at the full retirement age, increasing that age is likely to result in beneficiaries' making claims later than they would if a policy with identical benefits at each age was implemented through adjustments in the benefit formula. For the same reason, this option also would probably lead workers to remain employed longer, which would increase the size of the workforce and boost federal revenues from income and payroll taxes. Moreover, the additional work would result in higher future Social Security benefits, although the increase in benefits would be smaller than the increase in revenues. The 10-year estimates for this option do not include those two effects.

This option would shrink federal outlays by about $12 billion over 5 years and by nearly $120 billion over 10 years. By 2050, the option would reduce Social Security outlays relative to what would occur under current law by 12 percent—from 5.9 percent to 5.2 percent of gross domestic product.

A rationale for this option is that people who turn 65 today will, on average, collect Social Security benefits for significantly longer than retirees did in the past and the average life span in the United States is expected to continue to lengthen. In 1940, life expectancy at age 65 was 11.9 years for men and 13.4 years for women. The Social Security trustees estimate that life expectancy has risen by more than 5 years for 65-year-olds, to 17.3 years for men and 19.7 years for women, and that those figures will increase to 19.0 years and 21.1 years by 2035. Therefore, a commitment to provide retired workers with a certain monthly benefit beginning at age 65 in 2035 is significantly more costly than is that same commitment made to today's recipients.

An argument against this option is that it would reduce resources provided to older people, relative to those that are scheduled to be provided under current law. In addition, it would create a somewhat stronger incentive for older workers nearing retirement to apply for disability benefits. Under current law, workers who retire at age 62 in 2035 will receive 70 percent of their primary insurance amount (the benefit they would have received if they had claimed benefits at their full retirement age); if they qualify for disability benefits, however, they will receive 100 percent of that amount. Under this option, workers who retired at 62 in 2035 would receive only 55 percent of their primary insurance amount; they would still

receive 100 percent if they qualified for disability benefits. The estimates of the budgetary effects of this option account for the effect on the Social Security Disability Insurance program. To eliminate that added incentive to apply for disability benefits, policymakers could narrow the difference by also reducing scheduled disability payments—for example, by setting the benefits for disabled workers at the amount they would have received upon retiring at age 65.

RELATED OPTION: Mandatory Spending, Option 29

RELATED CBO PUBLICATIONS: *Social Security Policy Options,* July 2010; and Jae Song and Joyce Manchester, *Have People Delayed Claiming Retirement Benefits? Responses to Changes in Social Security Rules,* Working Paper 2008-04, May 2008

Mandatory Spending—Option 31 **Function 650**

Lengthen by Three Years the Computation Period for Social Security Benefits

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-100	-400	-1,000	-1,900	-3,100	-4,800	-6,700	-8,800	-11,100	-13,500	-6,500	-51,400

As required by law, the Social Security Administration calculates retirement benefits on the basis of a worker's wage history, using the worker's average indexed monthly earnings, or AIME. The current formula computes the AIME on the basis of a worker's earnings in his or her 35 years of highest earnings that are subject to Social Security taxes. If a worker has worked for fewer than 35 years, the average includes years with zero earnings.

This option would gradually lengthen the AIME computation period to 38 years for people who turn 62 in 2014 and beyond. The extended averaging period would generally reduce benefits by requiring that additional years of lower earnings be factored into the benefit computation. The option would not change the number of years used to compute AIMEs for disabled workers; only retirement benefits would be affected.

The option would have the largest effect on people who worked for fewer than 38 years, because they would have additional years with no earnings included in the calculation of their benefits. However, the option would reduce benefits even for workers who worked 38 years or more, because those people would almost always have had lower average earnings in the additional computation years than they would have had in the 35 years of their highest earnings.

Lengthening the period by three years would reduce federal outlays by almost $7 billion through 2016 and by roughly $51 billion through 2021. By 2050, Social Security outlays would be reduced by 2 percent—from 5.9 percent to 5.8 percent of gross domestic product.

An argument in support of expanding the computation period considers increased life expectancy: Because people now live longer, lengthening the period would encourage them to remain in the labor force longer and extend the amount of time they pay into the Social Security system, boosting federal revenues from income and payroll taxes. Additional work would also result in higher future Social Security benefits. The 10-year estimates for this option do not include those two effects.

Extending the computation period also would reduce the advantage currently enjoyed by workers who postpone entering the labor force—for instance, while they pursue advanced education. People with more education generally earn more than their counterparts who enter the labor force sooner; because many years of low or no earnings can now be ignored in calculating the AIME, the former group experiences little or no loss of benefits for any additional years spent not working and thus not paying Social Security taxes.

An argument against this option is that some beneficiaries retire early because of circumstances they do not control, such as poor health or job loss, and this option could adversely affect those recipients who were not able to continue working for 38 years. Other disproportionately affected workers would be parents who interrupted a career to raise children or workers who experienced long stretches of unemployment. On average, the benefit reduction would be larger for women than for men, because women tend to spend more years out of the workforce.

RELATED CBO PUBLICATION: *Social Security Policy Options,* July 2010

Mandatory Spending—Option 32 **Function 650**

Apply the Social Security Benefit Formula to Individual Years of Earnings

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	-0.3	-1.2	-2.5	-4.2	-6.4	-8.9	-11.7	-14.6	-17.8	-20.9	-14.6	-88.5

A two-step process is used to calculate Social Security benefits. First, a worker's average indexed monthly earnings, or AIME, is computed. For a retired worker, the AIME is calculated on the basis of the highest 35 years of earnings on which Social Security taxes were paid, with earnings included up to the taxable maximum, which in 2011 is $106,800. Earnings before age 60 are adjusted by growth in the average wage index (AWI), which is the average of all earnings in the U.S. economy; earnings after age 59 enter the computations as actual amounts. (As a result, for someone born in 1925 or later, earning $10,000 in 1974 had the same effect on benefits as earning $20,000 in 1984 because the AWI doubled over the course of that period.) Second, a progressive benefit formula is applied to the AIME to arrive at the primary insurance amount (PIA), the sum that is payable each month to a worker who begins receiving Social Security retirement benefits at the full retirement age, currently 66. For workers who turn 66 in 2011, the PIA formula is 90 percent of the first $680 of the AIME, plus 32 percent of the AIME between $680 and $4,100, plus 15 percent of the AIME above $4,100.

Under the PIA formula, benefits replace a larger share of average career earnings for people with lower earnings than they do for people with higher earnings. For example, the benefit for someone with very low earnings is 90 percent of that person's AIME, but the benefit for someone with earnings above the taxable maximum for 35 years is about 28 percent of the AIME.

This option would essentially reverse the order of the computation: A progressive benefit formula would be applied to each year of indexed earnings, and the PIA would be equal to the average of the annual PIAs. As under current law, this option's benefit formula is progressive, although it would apply that progressivity to annual earnings rather than to lifetime earnings. The change would reduce federal outlays by about $15 billion over five years and by almost $89 billion through 2021. By 2050, Social Security outlays would be reduced by 5 percent—from 5.9 percent to 5.6 percent of gross domestic product.

Under this option, almost all workers' PIAs would be lower than they are under current law, but the reduction would be steeper for people whose earnings varied more from year to year, including people who were out of the workforce for many years. There would be no change in benefits for a worker whose earnings were equal to (or a constant proportion of) the AWI in every year of work. But benefits would fall substantially for someone with high earnings in some years and no earnings in others. For example, compare the case of a "steady earner" who has earnings equal to the AWI for 35 years or more with the case of a "short-career worker" who earns the same average wage when working but works for only 10 years. Even though that worker has average earnings during 10 years of employment, his or her lifetime earnings are quite low because of the 25 years of zero earnings. Under current law, the progressive benefit formula is applied to that low level of lifetime earnings (as measured by the AIME), and the short-career worker's Social Security benefit will replace almost 80 percent of his or her average lifetime earnings. Under this option, the benefit formula would be applied to the worker's average earnings while working, and the progressive benefit formula would replace just 45 percent of those earnings. Thus, this option would have no effect on the steady earner, but it would reduce the benefits of the short-career worker by more than 40 percent.

A rationale for this option is that it would encourage some people to work longer, which would increase the size of the workforce and boost federal revenues from income and payroll taxes. Also, the additional work would result in higher future Social Security benefits. The 10-year estimates for this option do not include those two effects.

When weighing the decision to retire, people may consider how the timing of retirement will affect Social

Security benefits. Under current law, one additional year of work by someone who had worked for fewer than 35 years would in most cases increase annual benefits by 32 percent or 15 percent of the year's earnings divided by 35, because most workers have an AIME that is in the 32 percent or 15 percent bracket of the PIA formula. Under this option, the worker's benefit would increase by a larger amount, because at least part of the earnings in that additional year would fall in the 90 percent bracket. Consider a worker who worked 34 years at average wages. Under current law, a 35th year of work would increase annual benefits by about $375, but under this option it would increase benefits by about $525.

An argument against this option is that a worker's ability to save for retirement depends on lifetime earnings, not annual earnings. People with more volatile earnings histories, who would experience the largest reductions in benefits, tend to have low lifetime earnings. Benefits would decline by about 15 percent, on average, for beneficiaries in the lowest quintile—or fifth—of lifetime household earnings. In contrast, benefits would fall by about 8 percent for people in the second-lowest earnings quintile and by 5 percent for groups with higher lifetime household earnings.

RELATED CBO PUBLICATION: *Social Security Policy Options,* July 2010

CHAPTER

3

Discretionary Spending Options

Discretionary spending—the part of federal spending that lawmakers control through annual appropriation acts—totaled more than $1.3 trillion in 2010, or nearly 40 percent of federal outlays. Just over half of that discretionary spending ($689 billion) went to defense programs, mainly for operation and maintenance, military personnel, and procurement (see Table 3-1). The rest ($660 billion in 2010) paid for an array of nondefense activities. Some fees and other charges that are triggered by appropriation action are classified in the budget as offsetting collections and are credited against discretionary spending.

Seven broad budget categories (called "budget functions") accounted for more than 75 percent of the spending for nondefense discretionary activities last year. The largest of those functions is the category covering education, training, employment, and social services; it is followed in size by the functions for transportation, income security programs (mostly housing), and health-related research and public health.[1] Functions with smaller amounts of discretionary spending include administration of justice (for law enforcement activities), veterans' benefits and services (mostly for health care), and international affairs (see Figure 3-1).

The discretionary budget authority provided in appropriation acts translates into outlays when the money is spent. Some appropriations (such as for employees' salaries) are spent quickly, but others (such as for major construction projects) are disbursed over several years. Thus,

1. For some major transportation programs, budget authority (the authority provided by law to incur financial obligations) is considered mandatory, but the outlays resulting from that authority are discretionary. The reason is that such programs receive budget authority through authorizing legislation, but annual appropriation acts limit how much of that budget authority the Department of Transportation can obligate. Those obligation limitations are treated as a measure of discretionary budgetary resources, and the resulting outlays are classified as discretionary.

Table 3-1.

Discretionary Spending in 2010

(Billions of dollars)

	2010 Outlays
Defense[a]	
Operation and maintenance	275
Military personnel	151
Procurement	134
Other[b]	129
Subtotal	689
Nondefense[c]	
Education, training, employment, and social services	134
Transportation	90
Income security	71
Health	65
Administration of justice	52
Veterans' benefits and services	51
International affairs	46
Other[d]	151
Subtotal	660
Total	**1,349**

Source: Congressional Budget Office.

a. Includes spending for overseas contingency operations such as the wars in Afghanistan and Iraq.

b. Includes spending for research, development, test, and evaluation; military construction; and family housing. Also includes spending on certain defense-related activities by government entities other than the Department of Defense (such as the Departments of Energy, Transportation, and Justice).

c. Includes spending for certain ground and air transportation programs governed by obligation limitations set in appropriation acts.

d. Includes spending for general science, space, and technology; energy; natural resources and environment; agriculture; commerce and housing credit; community and regional development; administrative activities for Medicare and Social Security; and general government.

Figure 3-1.

Breakdown of Defense and Nondefense Discretionary Spending in 2010

Source: Congressional Budget Office.

Notes: Other defense spending includes outlays for research, development, test, and evaluation; military construction; and family housing; as well as spending on some defense-related activities by government entities other than the Department of Defense.

Other nondefense discretionary spending includes outlays for general science, space, and technology; energy; natural resources and environment; agriculture; commerce and housing credit; community and regional development; Medicare and Social Security (for administrative activities); and general government.

Nondefense discretionary spending for health excludes care provided by the Veterans Health Administration. Outlays for that care are included under veterans' benefits and services.

Figure 3-2.

Discretionary Spending, 1971 to 2021

(Percentage of gross domestic product)

Source: Congressional Budget Office (as of January 2011).

in any given year, discretionary outlays include spending both from new budget authority and from budget authority provided in previous appropriations.

Trends in Discretionary Spending

Relative to the size of the economy, total discretionary outlays have been rising for much of the past decade, following a long period of decline. Such outlays equaled about 10 percent of gross domestic product (GDP) during much of the 1970s and 1980s, then gradually fell to 6.2 percent of GDP in 1999 (see Figure 3-2). Thereafter, discretionary outlays began increasing relative to GDP—reaching 7.0 percent in 2002 and 7.9 percent by 2008—partly because of actions taken in response to the terrorist attacks of September 11, 2011, and subsequent military operations in Afghanistan and Iraq. In the past few years, discretionary spending has been boosted by funding provided in the American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5) and by policy responses to the recent turmoil in financial markets. Discretionary outlays rose to 8.8 percent of GDP in 2009 and to 9.3 percent last year—the highest share of GDP since 1988.

When this report was prepared, discretionary budget authority for 2011 had been provided only through early March, at a rate that would total $1,255 billion for the entire fiscal year: $710 billion for defense and $545 billion for nondefense activities. Those amounts are about the same as the discretionary budget authority provided last year. Because of funding from previous appropriations, however, the Congressional Budget Office (CBO) projects that discretionary outlays will increase this year, to $1,375 billion from $1,349 billion in 2010. That increase is concentrated in defense spending, which is projected to rise by $23 billion (from $689 billion last year to $712 billion this year), while nondefense outlays are expected to inch up by $3 billion (from $660 billion to $663 billion).

CBO's baseline budget projections depict a path for discretionary spending over the next 10 years as directed by section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985.[2] That law stated that current appropriations should be assumed to continue in later years, with adjustments to keep pace with projected inflation. The measures of inflation that CBO uses for its baseline are the ones specified in that law: the employment cost index for wages and salaries (applied to spending for federal personnel) and the GDP price index (for other spending). One exception to the approach of extrapolating current appropriations was made after the enactment of ARRA in early 2009. By agreement among

2. Although the law's provisions expired at the end of September 2006, CBO continues to follow them in preparing its baseline for discretionary spending. The baseline projections discussed in this report were published in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011).

CBO and the House and Senate Committees on the Budget, the additional funding provided by ARRA was not assumed to continue in later years in CBO's baseline projections; instead, subsequent baseline projections were based on non-ARRA appropriations.

CBO's current baseline for 2011 to 2021 represents an extrapolation of the annualized rate of discretionary funding provided through early March of this year in the Continuing Appropriations and Surface Transportation Extensions Act, 2011 (P.L. 111-322). As a share of the economy, total discretionary outlays are projected to decrease to 9.1 percent of GDP in 2011 (from 9.3 percent last year) as spending stemming from the provisions of ARRA wanes. Other than outlays resulting from ARRA, discretionary spending would equal the same share of GDP in 2011 that it did last year: 8.6 percent. In the coming decade, if discretionary funding grew at the rate of inflation—the assumption used in CBO's baseline—outlays would reach $1.6 trillion by 2021. Because the economy is expected to grow at a faster rate than inflation, however, discretionary outlays would decline as a share of GDP, from 9.1 percent in 2011 to 6.7 percent in 2021.

Of the total discretionary spending projected for 2021 under CBO's baseline, nondefense outlays would amount to $731 billion, or about 3.1 percent of GDP—the lowest share in more than four decades—and defense outlays would amount to $869 billion, or about 3.6 percent of GDP. That projection incorporates the assumption that funding for overseas contingency operations (such as the wars in Afghanistan and Iraq) will continue at the 2011 level in future years, with adjustments for inflation. Under an alternative scenario for defense, in which the number of military personnel deployed for such operations would decline from an average of about 180,000 in 2011 to 45,000 by 2015, outlays for defense would amount to $716 billion in 2021, or 3.0 percent of GDP.[3] That scenario would leave defense spending in 2021 at roughly the same share of GDP experienced during the 1999–2001 period—the lowest percentage of GDP since the beginning of World War II.

Another approach to projecting defense spending is to estimate the cost of the plans described in the annual Future Years Defense Program (FYDP) prepared by the Department of Defense (DoD). The 2011 FYDP—which was released in April 2010 and was the most recent plan available when this report was prepared—outlines DoD's intended funding requests for the 2011–2015 period, based on the Administration's plans for personnel levels, procurement and maintenance of weapon systems, operational intensity, and so forth. (CBO used related DoD planning documents to project a funding level for 2016.) Unlike CBO's baseline, the 2011 FYDP does not include funding for overseas contingency operations. CBO's own estimate of the cost of plans in the FYDP is roughly $41 billion greater per year, on average, than the comparable amounts in CBO's baseline.[4]

Approaches to Reducing Discretionary Spending

Because the Congress sets funding for discretionary programs each year, cutting spending through the regular appropriation process can ensure only short-term savings. An approach that has been used in the past to try to ensure longer-term savings is to set overall limits on discretionary spending for future years. Statutory caps on discretionary spending were imposed in 1990, and extended in 1993 and 1997, before expiring in 2002. The caps were enforced through the threat of automatic across-the-board spending cuts, a process known as sequestration. Many observers agree that as long as a consensus remained to rein in budget deficits, the spending caps helped curb the growth of discretionary spending. Such spending increased at an average rate of only 1.6 percent a year during the 1990s. When budget deficits gave way to surpluses late in the decade, however, the caps were overridden in the appropriation process and later allowed to expire. Since 2001, discretionary spending has increased at an average annual rate of 8.2 percent.

Whether lawmakers opt to reduce spending annually or on a multiyear basis, they could choose blunt, across-the-board mechanisms, or they could prioritize spending decisions and make choices about where limited resources should be directed. Such choices would involve difficult trade-offs.

3. Ibid., pp. 21–22.

4. For a comparison of projections of DoD's costs and CBO's baseline, see Congressional Budget Office, *Long-Term Implications of the 2011 Future Years Defense Program* (February 2011), Appendix A.

Assessing large and sustained reductions in defense spending would involve weighing their effects on military capabilities. Cuts could be targeted toward personnel levels, pay rates, and benefits; training and supplies; day-to-day operating and administrative costs; procurement, operation, and maintenance of existing weapon systems; and research and development related to more-advanced weapon systems. Such reductions in funding could require changes in broad strategic objectives—such as the number of simultaneous conflicts in which the military could engage and their intensity, duration, and overlap—or changes in how the nation seeks to achieve those broad objectives. Trade-offs could involve, for example, the choice between fielding a smaller force with more-capable weapon systems and maintaining the current number of units but forgoing some of the upgrades to their weapon systems. A smaller force might not be able to handle as many conflicts at the same time, but it could be structured to maximize its flexibility to engage a variety of opponents with different capabilities or in different parts of the world. Conversely, a larger force would be better able to sustain longer-term counterinsurgency or peacekeeping operations.

Similarly, cuts in nondefense discretionary spending could affect a broad range of activities, and decisions about particular programs have impacts that would need to be weighed against the effects of alternative decisions. Many programs—especially in the areas of education and transportation—involve financing from federal, state, and local governments. Reducing federal support for such activities would force other levels of government to make decisions about decreasing the scope of the activities, increasing their own funding, or some combination of the two.

Lowering pay rates for federal civilian employees would hamper efforts to recruit and retain workers (particularly in some occupations), which would reduce the overall skill level of the federal workforce over time. Having fewer federal workers would probably lower the levels of service that federal agencies provide to the public, unless cuts in the agencies' workforces were accompanied by actions to enhance productivity. Charging users—such as drivers on highways, air travelers, users of waterways, and so forth—for services they receive from federal programs could allow service levels to be maintained while government spending was reduced. Of course, such charges would impose added burdens on users, compared with current arrangements.

Federal income support payments and education grants to low-income households could be reduced or provided to smaller sets of households, which would mean less assistance for people who may value those benefits highly. A variety of federal activities could simply be curtailed—ranging from research by the National Institutes of Health to export promotion by the Department of Commerce—so the value of those activities would need to be carefully assessed.

Whatever approaches lawmakers choose, making frequent large changes to funding for discretionary programs would probably disrupt the effective administration of those programs and the planning of the people, businesses, and governments that the programs affect. The programs would be more effective if lawmakers viewed significant changes in discretionary funding as part of a longer-term plan spanning several years.

Discretionary Spending Options in This Chapter

Two of the options in this chapter (Options 1 and 14) present possible alternatives for freezing or reducing total discretionary spending. The other 36 options cover a broad array of defense and nondefense discretionary programs. Most options are accompanied by a table showing their projected budgetary impact in each of the next 10 years (2012 to 2021), as well as 5- and 10-year totals. Except for options related to defense procurement programs, the budgetary effects were calculated relative to CBO's baseline projections—that is, annualized appropriation levels for 2011, adjusted for projected inflation in later years.

The budgetary effects of options that involve defense spending for procurement were measured relative to DoD's 2011 Future Years Defense Program. CBO determined that it would be more informative to estimate the effects of procurement options relative to DoD's published plan because CBO's baseline for defense procurement is not based on detailed plans for weapon systems. Because the 2011 FYDP extends for only five years, however, the tables in the procurement options show just five years of costs or savings. The text of each procurement option discusses the effect of the option on DoD's long-term acquisition plans.

Discretionary Spending—Option 1 **Function 050**

Reduce the Growth in Appropriations for the Department of Defense

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Reduce Growth by 1 Percentage Point Annually												
Change in Spending												
Budget authority	-5.3	-10.7	-16.2	-22.0	-28.0	-34.3	-40.9	-47.8	-54.9	-62.2	-82.2	-322.3
Outlays	-3.3	-7.9	-13.1	-18.6	-24.4	-30.5	-36.9	-43.5	-50.4	-57.5	-67.3	-286.1
Freeze Funding at 2011 Level												
Change in Spending												
Budget authority	-8.7	-19.6	-31.4	-43.7	-57.3	-73.0	-89.4	-106.1	-122.7	-139.4	-160.7	-691.3
Outlays	-5.5	-14.3	-25.0	-36.6	-49.4	-63.9	-79.5	-95.8	-112.1	-128.6	-130.8	-610.7
Reduce Funding by 1 Percent Annually												
Change in Spending												
Budget authority	-13.9	-30.0	-47.1	-64.4	-83.1	-103.8	-125.2	-146.8	-168.2	-189.8	-238.5	-972.3
Outlays	-8.8	-22.1	-37.7	-54.3	-72.1	-91.5	-112.1	-133.2	-154.4	-175.7	-195.0	-861.9

The Department of Defense (DoD) receives just over 50 percent of all discretionary appropriations. It would be difficult, therefore, to achieve a significant reduction in discretionary spending if DoD appropriations were excluded from consideration. The breadth of DoD's portfolio provides many options for absorbing budget cuts of various magnitudes: It employs nearly 1.5 million military personnel and 785,000 civilians; operates nearly 500,000 buildings and facilities on approximately 5,000 installations; manages 87 major defense acquisition programs; and spends about $200 billion annually to develop and acquire weapons and equipment.

This option includes three alternative paths for reducing the growth in DoD's appropriations (excluding appropriations related to operations in Iraq and Afghanistan) relative to the amounts in the baseline budget projections of the Congressional Budget Office:

- Limit the rate of growth in defense appropriations beginning in 2012 to an average of 1.4 percent a year—1 percentage point less than the rate of growth in CBO's baseline—and thereby reduce outlays by about $286 billion (or 5 percent) over the 2012–2021 period.
- Freeze defense appropriations at the annualized level for 2011 under the continuing resolution that was in effect in February 2011, thus reducing outlays by about $611 billion (or 10 percent) over the 2012–2021 period.
- Reduce defense appropriations by 1 percent annually from the 2011 level, thereby decreasing outlays by an estimated $862 billion (or 15 percent) over the next 10 years. Under that alternative, DoD's appropriations would return to their 2007 funding level—in nominal terms—by 2021. If those reductions were distributed proportionally, a decrease of 400,000 active-duty personnel (about 25 percent of active and reserve personnel) could be required.

Funding for DoD's regular activities (excluding appropriations for overseas contingency operations) has increased by approximately 75 percent over the past 10 years, or by about 40 percent adjusted for inflation. Thus, DoD would have more buying power than it had a decade ago even if its regular budget was reduced substantially relative to the amounts in CBO's baseline. If regular defense appropriations had grown at the rate of inflation since 2001 and continued to do so through 2021, budget authority in 2021 would total $465 billion, $200 billion less than the amount in the baseline. Even if those

appropriations were reduced by 1 percent per year from the current level (as described in the third alternative), funding would still be $10 billion more in 2021 than it would have been if appropriations had grown with inflation since 2001.

An argument for reducing defense spending is that doing so could reduce the deficit and promote economic growth by redirecting resources from soldiers and weapons to more-productive uses. Furthermore, U.S. defense expenditures are almost as large as the combined defense expenditures of all other nations. Proponents of this option might contend, therefore, that the United States could still field a relatively robust military force on a smaller budget. Moreover, many beneficiaries of U.S. defense spending, such as allied nations in Europe, have economies large enough to pay for more of their own defense.

An argument against cutting the growth in DoD's appropriations is that the nation needs to maintain or increase defense spending to counter the increasingly sophisticated threats posed by current and potential adversaries. Weapon systems and facilities are aging, and the costs of replacing them with more-capable systems have grown. Further, the armed forces require sufficient military personnel to defend the nation's interests abroad without overburdening service members with too-frequent deployments. In addition, the costs of military compensation, particularly health care costs, have been growing rapidly and will probably continue to do so. By CBO's estimates, the multiyear plans that DoD had in place in 2010 would involve costs that are almost $600 billion more than CBO's baseline projections over the 2012–2021 period.

RELATED CBO PUBLICATION: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011

Discretionary Spending—Option 2 **Function 050**

Cap Increases in Military Basic Pay

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-280	-700	-1,130	-1,580	-2,090	-2,160	-2,240	-2,340	-2,450	-2,530	-5,780	-17,500
Outlays	-270	-680	-1,100	-1,550	-2,060	-2,150	-2,230	-2,330	-2,430	-2,520	-5,660	-17,320

Between 2001 and 2009, per capita spending on three major components of cash compensation for active military personnel rose by 37 percent in inflation-adjusted dollars. Those components are basic pay and the basic allowances for housing and subsistence, of which basic pay is the largest element, averaging more than 70 percent of the total. Lawmakers typically use the percentage increase in the employment cost index (ECI) for private-sector workers' wages and salaries as a benchmark for setting the annual increase in basic pay. In the 1990s, the military pay raise was generally set equal to the increase in the ECI or 0.5 percentage points below that amount. Over the past decade, in each calendar year from 2001 through 2010, lawmakers approved pay raises—including across-the-board increases and, on occasion, amounts targeted toward certain seniority levels—that exceeded the ECI by 0.5 percentage points for the average service member. Those pay increases boosted outlays not only in the years in which they took effect but also in subsequent years as the raises compounded.

Another element of cash compensation is the selective reenlistment bonus (SRB), an incentive typically offered to qualified enlisted personnel working in occupational specialties that have high training costs or demonstrated shortfalls in retention. Each service branch regularly adjusts its SRBs to address current retention problems, adding or dropping eligible specialties and raising or lowering bonuses. In addition, the Army pays a location-specific SRB to all eligible soldiers who reenlist while they are deployed to certain locations, such as Afghanistan, Iraq, or Kuwait. Depending on the service branch, eligible personnel either receive the bonuses in a lump sum when they reenlist or receive half at reenlistment and the remainder in annual installments over the course of the additional obligation.

This option would cap the basic pay increase over a four-year period: Specifically, from 2012 through 2015, basic pay raises would be set at a rate 0.5 percentage points below the increase in the ECI. Implementing this option would require new legislation to override current law, which stipulates that annual pay raises match the increase in the ECI. Although the prospect of lower basic pay raises would probably adversely affect retention, the effect is likely to be small. To alleviate any effect on retention during those four years, the service branches could increase bonuses for enlistment and reenlistment, step up recruiting efforts, or offer other benefits to service members. In estimating the budgetary impact of this option, the Congressional Budget Office assumed that the service branches would be able to keep overall retention constant through 2015 by boosting their spending on reenlistment bonuses while removing current restrictions on the maximum size of each bonus award.

If implemented, the option would generate net savings of about $6 billion between 2012 and 2016 and $17 billion over the 2012–2021 period. Included in those figures are added costs for bonuses totaling about $920 million between 2012 and 2015 to offset the effects on retention of the lower pay raises for service members who had enlisted or previously reenlisted during the earlier period when pay was rising at the ECI rate or faster. Service members eligible for the additional bonuses between 2012 and 2015 would receive higher overall pay than would be the case had pay kept pace with the ECI. After the four-year transition period, people would base their reenlistment decisions on a level of pay that was lower than would otherwise have prevailed. Although the lower pay could adversely affect recruiting and retention levels in future years, based on the success of DoD's personnel management over the past several years—and the decline in the number of personnel deployed to Iraq and Afghanistan—CBO anticipates that DoD would be able to attain the desired levels in 2016 and beyond without continuing to pay the additional bonuses.

The rationale for this option is that, although DoD must offer a competitive compensation package to attract and retain the military personnel it needs, the annual increase in the ECI is not an appropriate benchmark for setting pay raises over the long run. The comparison group for the ECI includes a broad sample of civilian workers who, on average, are older than military personnel and more likely to have college degrees. Those workers have historically received larger pay increases than the younger workers who more closely match the demographic profile of military personnel. According to CBO's analysis, median cash compensation for military personnel—including the tax-free cash allowances for food and housing—exceeds the salaries of most civilians who have comparable education and work experience.

Another advantage of this option is that, by using SRBs to direct compensation to service members who are at a career decision point, as well as to specific occupational categories that are experiencing shortages, this option could maintain retention goals at a lower cost than the current plan that uses across-the-board pay raises to achieve retention (and other) goals. General pay increases would alleviate shortages in some occupations but would worsen surpluses in others. Also, unlike pay increases, bonuses would be more easily adjusted from year to year to match recruiting and retention goals. Finally, bonuses would avoid the added cost of elements of compensation, such as retirement benefits, that are tied to basic pay.

An argument against this option is that expansion of reenlistment bonuses at the expense of across-the-board increases in basic pay would amplify pay differences that exist among occupations and thus counter the military tradition of paying similar amounts to personnel with similar levels of responsibility. Capping basic pay would also reduce other benefits—including retirement annuities—that service members would receive throughout their career. Another argument is that the risks service members may be exposed to when overseas contingency operations are under way justify the across-the-board pay increases specified in current law.

RELATED CBO PUBLICATIONS: Statement of Carla Tighe Murray, Analyst, Congressional Budget Office, before the Subcommittee on Personnel, Senate Committee on Armed Services, *Evaluating Military Compensation,* April 28, 2010; *Evaluating Military Compensation,* June 2007; and *Recruiting, Retention, and Future Levels of Military Personnel,* October 2006

Discretionary Spending—Option 3 **Function 050**

Increase Medical Cost Sharing for Military Retirees Who Are Not Yet Eligible for Medicare

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Discretionary Spending												
Budget authority	-900	-1,800	-2,500	-2,700	-3,000	-3,200	-3,500	-3,800	-4,000	-4,300	-10,900	-29,700
Outlays	-700	-1,500	-2,300	-2,600	-2,900	-3,100	-3,300	-3,600	-3,900	-4,200	-10,000	-28,100
Change in Mandatory Outlays[a]	10	20	40	40	40	50	50	60	60	70	150	440

a. The Congressional Budget Office estimates that the actual increase in mandatory spending from implementing this option would be about $600 million over the 2012–2021 period. However, CBO's January 2011 baseline reflects an assumption that there is some probability that the Department of Defense—without any Congressional action—will increase fees and copayments; therefore, some of the potential mandatory costs from implementing this option are already incorporated in the baseline projections. If the Congress enacted legislation mandating the policies discussed in this option, the mandatory cost relative to CBO's baseline would be as shown in the table.

In the mid-1990s, the Department of Defense (DoD) created the TRICARE program to reform its system for providing health care for members of the military and their dependents, as well as for eligible military retirees and their families. About 15 percent of enlisted service members and approximately 50 percent of officers remain in the military for an entire career and therefore qualify for health care benefits as retirees. Because most military personnel enter the armed forces between the ages of 18 and 22 and are able to retire after serving 20 years, they become eligible for retiree health care benefits at a relatively young age (as early as age 38) and retain some form of eligibility for the remainder of their lives.

TRICARE offers participants three different alternatives for obtaining health care coverage: a plan that operates like a health maintenance organization (HMO), called TRICARE Prime; a plan that operates as a preferred-provider network, called TRICARE Extra; and a traditional fee-for-service plan, called TRICARE Standard. Military retirees who are not yet eligible for Medicare (generally those ages 38 to 64) may enroll in TRICARE Prime by paying an annual enrollment fee of $230 (for single coverage) or $460 (for family coverage). In addition, those Prime enrollees make a $12 copayment for each outpatient visit to a civilian physician or other civilian health care provider. (Visits to military providers are free.) Retirees who do not choose to enroll in TRICARE Prime may receive benefits under TRICARE Extra or Standard without paying an enrollment fee. Participants in those plans must pay an annual deductible of $150 (for single coverage) or $300 (for family coverage) before typical cost-sharing rates apply. TRICARE enrollment fees, copayments, and deductibles have not changed since 1995.

Military retirees enrolled in TRICARE Prime incur smaller costs than they would owe under typical civilian plans for which they might be eligible (through their current employers, for example). DoD has estimated that, in 2009, a typical military retiree and his or her family who enrolled in the Prime plan incurred about $860 in annual out-of-pocket costs (that is, TRICARE copayments and the enrollment fee). By contrast, again according to DoD's estimates, a similar retiree with family coverage who enrolled in an HMO through a civilian employment-based plan typically paid $5,200 in premiums (not including the share paid by his or her employer) and copayments. TRICARE Prime beneficiaries also use the system more than do comparable civilian beneficiaries: DoD estimates that Prime enrollees use services at rates that are higher by 77 percent for inpatient services and 55 percent for outpatient services than the rates for civilian HMO enrollees.[1]

This option would raise the enrollment fees, copayments, and deductibles for younger military retirees—those younger than 65—who wished to use TRICARE. Beneficiaries with single coverage could enroll in TRICARE Prime by paying a $550 annual fee, and those with family coverage could enroll for $1,100 annually. The family

1. Department of Defense, *Evaluation of the TRICARE Program: FY2010 Report to Congress* (February 28, 2010).

enrollment fee of $1,100 per year is approximately equivalent to the $460 fee first instituted in 1995, after adjusting for the nationwide growth in health care spending per capita. Under this option, each medical visit to a Prime provider in the civilian network would entail a copayment of $30, which, again, is approximately equivalent to the amount that was established in 1995. Copayments for mental health visits and inpatient care would also be adjusted accordingly. Single retirees (or their surviving spouse) who used TRICARE Standard or Extra would face an annual deductible of $350; the annual deductible for families would be $700. Those increases would also be consistent with the nationwide growth in per capita health care spending. In addition—and for the first time—users of TRICARE Standard or Extra would be required to enroll and pay a $50 annual fee for single coverage or a $100 annual fee for family coverage. All of those new or increased fees, copayments, and deductibles would be indexed in the future to reflect the nationwide growth in per capita spending for health care.

The Congressional Budget Office estimates that if TRICARE fees, copayments, and deductibles were modified according to this option, discretionary outlays for DoD's TRICARE program would be reduced, on net, by about $28 billion over the 2012–2021 period, assuming that appropriations would be reduced accordingly. But the option could cause some eligible retirees to switch to other federal programs, such as Medicaid (if the individual has low income), the Federal Employees Health Benefits (FEHB) program (if the person is employed as a civilian by the federal government), or programs of the Veterans Health Administration. This option would increase mandatory spending for Medicaid and for FEHB annuitants by about $440 million over the same period. (Total additional costs would be greater, but some have already been incorporated in the baseline. See the note to the above table.) The estimates do not include the reduction in individual income and payroll tax revenues that might result from a shift of some labor compensation from a taxable to a nontaxable form.

One rationale for this option is that TRICARE coverage and space-available care at military treatment facilities were originally considered a supplement or a safety net to ensure the availability of health care for military retirees and their dependents, not as a replacement for benefits offered by postservice civilian employers. The migration of retirees from civilian to TRICARE coverage is one factor behind the rapid increase in TRICARE spending since 1999, which may mean that fewer resources are available for DoD to purchase and maintain weapon systems and other equipment or for other defense priorities. This option would begin to curtail the growth in health care costs, freeing those resources for other important uses.

An argument against changing access to TRICARE coverage for military retirees and their dependents is that those retirees made decisions about continuing their period of active-duty service with the understanding that they would receive medical care free or at a very low cost after retiring from the military. Significant limitations on TRICARE coverage for military retirees and their dependents would impose a financial cost on many of those beneficiaries and could adversely affect military retention. Another potential disadvantage of this option is that the health of users who remained in TRICARE might suffer if they were discouraged from seeking health care or treating their illnesses in a timely manner because of higher copayments. However, their health might not be affected significantly if the higher copayments fostered more disciplined use of medical resources and only discouraged the use of low-value health care.

RELATED OPTIONS: Discretionary Spending, Option 5; and Mandatory Spending, Option 1

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program*, February 2011; *The Effects of Proposals to Increase Cost Sharing in TRICARE*, June 2009; and *Growth in Medical Spending by the Department of Defense*, Issue Brief, September 2003

Discretionary Spending—Option 4 **Function 050**

Limit the TRICARE Benefit for Military Retirees and Their Dependents

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Discretionary Spending												
Budget authority	-3,000	-6,800	-10,100	-10,800	-11,500	-12,200	-13,000	-13,700	-14,600	-15,400	-42,200	-111,100
Outlays	-2,300	-5,800	-9,100	-10,300	-11,100	-11,800	-12,500	-13,300	-14,100	-14,900	-38,600	-105,200
Change in Mandatory Outlays[a]	100	200	400	400	400	500	500	600	600	600	1,500	4,300

a. The Congressional Budget Office estimates that the actual increase in mandatory spending from implementing this option would be about $4.5 billion over the 2012–2021 period. However, CBO's January 2011 baseline reflects an assumption that there is some probability that the Department of Defense—without any Congressional action—will increase fees and copayments; therefore, some of the potential mandatory costs from implementing this option are already incorporated in the baseline projections. If the Congress enacted legislation mandating the higher cost sharing discussed in this option, the mandatory cost in comparison with CBO's baseline would be as shown in the table.

The Department of Defense (DoD) provides medical care to military beneficiaries through the TRICARE program, which combines access to military hospitals and clinics with coverage for services received from civilian health care providers. Currently, military retirees and their dependents who are not yet eligible for Medicare represent about 40 percent of the TRICARE-eligible population. Those beneficiaries may use one of three plans: TRICARE Standard (a fee-for-service plan allowing free choice of providers but subject to coinsurance and deductibles), TRICARE Extra (a preferred provider plan offering lower coinsurance when using network providers), or TRICARE Prime (a managed care plan with lower out-of-pocket costs but a small annual enrollment fee).[1] About three-quarters of all retired military beneficiaries not yet eligible for Medicare have access to employer-sponsored insurance through civilian employment.[2] Because the out-of-pocket cost of TRICARE coverage has grown much more slowly since 1995 than the corresponding costs under insurance provided by most civilian employers, many of those beneficiaries have dropped their employer-sponsored coverage in favor of full-time reliance on TRICARE. In 1999, 55 percent of military retirees and their dependents had signed up for other health insurance, but by 2009 that figure had dropped to 29 percent. TRICARE spending more than doubled in real terms over that same 10-year period.

This option would preclude military retirees and their dependents from enrolling in TRICARE Prime, which is the TRICARE option with the lowest out-of-pocket cost.[3] Military retirees and their dependents could enroll in TRICARE Standard or Extra during the annual open enrollment period or when a life event occurred (for example, a change in marital status, birth of a child, or change in employment status). Enrollees would pay a monthly enrollment fee that would be set at 28 percent of the cost of providing benefits for that group, to be updated annually based on the average cost the group incurred in the previous year. In addition, the catastrophic cap (maximum out-of-pocket expenses) for military retirees and their dependents would be raised from the current $3,000 per family to $7,500 per family, the level at which it was set before January 2002. That catastrophic cap would increase in future years, with changes

1. While beneficiaries must enroll (and pay the enrollment fee) to use TRICARE Prime, enrollment is not required for beneficiaries choosing TRICARE Standard or Extra. Beneficiaries over age 65 or otherwise eligible for Medicare may be covered by TRICARE For Life, a plan designed to wrap around the Medicare program. See Mandatory Spending—Option 1.

2. When beneficiaries have other health insurance, TRICARE currently acts as second payer to the other insurance plan. Whether a bill is handled under TRICARE Extra or Standard depends on whether or not the provider is a part of one of the regional TRICARE provider networks.

3. Active-duty personnel would continue to be enrolled automatically in TRICARE Prime, and Prime enrollment would remain available for dependents of active-duty personnel. The enrollment fee and most cost sharing would continue to be waived for active-duty service members and their dependents.

indexed to nationwide growth in per capita health care spending.

Military retirees and their dependents would still have the option of seeking care at no cost on a space-available basis at military treatment facilities. However, such patients are considered lower priority than active-duty service members and their dependents, and as a result, they might have difficulty obtaining such space-available care. For that reason, military retirees and their dependents would have an incentive to obtain other coverage rather than rely on military treatment facilities as their main source of medical care.

Those changes in TRICARE coverage options for military retirees and their families would bring the value of TRICARE coverage closer to that of health plans available through civilian employment. The Congressional Budget Office anticipates that among this group of beneficiaries, the share relying entirely on TRICARE would drop by half, from 71 percent to 35 percent. In addition, for those who did not enroll and pay an annual premium, TRICARE would no longer act as secondary payer to civilian health insurance, thereby reducing federal outlays for the 29 percent of beneficiaries who currently have civilian health insurance (and who presumably would continue that coverage). For those who do enroll in TRICARE, the higher cost sharing under TRICARE Standard or Extra (as compared with TRICARE Prime) would reduce the use of health care services by many beneficiaries. However, some retirees and their dependents might turn to other federal programs for which they may be eligible rather than to private civilian options. As a result, CBO anticipates that some additional costs would be incurred by the Veterans Health Administration, the Medicaid program, and the Federal Employees Health Benefits plan.

CBO estimates that this change would reduce discretionary outlays by $39 billion over the 2012–2016 period and by $105 billion over the 2012–2021 period.

CBO projects that approximately 35 percent of military retirees and their dependents would sign up for TRICARE under the new rules outlined in this option and that increases in cost sharing would also result in a decrease in DoD's per capita spending on that group of beneficiaries. CBO estimates that the change would increase mandatory spending for the Medicaid program and for health benefits for annuitants by $4 billion over the 2012–2021 period. (Total costs would be greater, but some have already been incorporated in the baseline. See the note to the above table.) The estimates do not include the reduction in the individual income and payroll tax revenues that might result from a shift of some labor compensation from a taxable to a nontaxable form.

One rationale for this option is that TRICARE coverage and space-available care at military treatment facilities were originally considered a supplement or a safety net to ensure the availability of health care for military retirees and their dependents, not as a replacement for benefits offered by postservice civilian employers. The rapid increase in TRICARE spending since 1999 can be traced in part to a migration of retirees from civilian to TRICARE coverage. In an era of fiscal constraint, rapidly rising health care costs may result in fewer resources available for DoD to purchase and maintain weapon systems and other equipment or to use for other defense budget priorities. This option would begin to curtail the growth in health care costs, freeing those resources for other important uses.

An argument against changing access to TRICARE coverage for military retirees and their dependents is that those retirees made decisions about continuing their period of active-duty service with the understanding that they would receive free or very low-cost medical care after retiring from the military. Significant limitations on TRICARE coverage for military retirees and their dependents would impose a financial cost on many of those beneficiaries and could adversely affect military retention.

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program*, February 2011; *The Effects of Proposals to Increase Cost Sharing in TRICARE*, June 2009; and *Growth in Medical Spending by the Department of Defense*, Issue Brief, September 2003

Discretionary Spending—Option 5 **Function 050**

Increase Cost Sharing for Pharmaceuticals Under TRICARE

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Discretionary Spending												
Budget authority	-600	-1,000	-1,100	-1,100	-1,200	-1,300	-1,500	-1,600	-1,700	-1,900	-5,000	-13,000
Outlays	-500	-900	-1,000	-1,100	-1,200	-1,300	-1,400	-1,600	-1,700	-1,800	-4,700	-12,500
Change in Mandatory Outlays[a]	-500	-900	-1,000	-1,100	-1,300	-1,400	-1,500	-1,700	-1,900	-2,000	-4,800	-13,300

a. The Congressional Budget Office estimates that the actual savings in mandatory spending from implementing this option would be about $20 billion over the 2012–2021 period. However, CBO's January 2011 baseline reflects an assumption that there is some probability that the Department of Defense—without any Congressional action—will increase copayments for prescription drugs; therefore, some of the potential savings from implementing this option are already incorporated in the baseline projections. If the Congress enacted legislation mandating the higher cost sharing discussed in this option, the savings relative to CBO's baseline would be as shown in the table.

The TRICARE program provides health care for the military's uniformed personnel and retirees and for their dependents and survivors. In total, more than 9 million people are eligible to use TRICARE's integrated system of military health care facilities and regional networks of civilian providers under contract to the Department of Defense (DoD). Beneficiaries may take their prescriptions to military pharmacies, which fill prescriptions written by any qualified provider, whether military or civilian, in or outside of TRICARE's network. Beneficiaries who prefer not to use military pharmacies may take prescriptions to retail pharmacies in the TRICARE network or use TRICARE's mail-order pharmacy. In 2009, DoD spent more than $8 billion on outpatient pharmacy benefits.

Cost sharing for pharmaceuticals—in the form of a copayment for each prescription filled—varies not only by the type of drug but also by where the prescription is filled. Beneficiaries pay nothing for prescriptions filled at military pharmacies, although those facilities tend to be located on military bases and may be less convenient than a retail pharmacy for some beneficiaries. Military pharmacies carry only generic drugs and brand-name drugs in the TRICARE formulary (the list of drugs that the plan covers). Beneficiaries who fill their prescriptions at retail pharmacies pay $3 for a 30-day supply of generic drugs, $9 for the same supply of brand-name drugs in the TRICARE formulary, and $22 if the drug is not listed in the formulary. Alternatively, they may order a 90-day supply by mail; copayments for mail-order prescriptions are also $3, $9, or $22 for generic, formulary, or nonformulary drugs, respectively, but the beneficiary receives a 90-day supply for that copayment, compared with a 30-day supply from retail pharmacies. Finally, beneficiaries who choose to fill prescriptions at retail pharmacies that are not part of the TRICARE network must meet a deductible (which varies by military rank) and bear greater cost sharing than beneficiaries who choose other alternatives.

This option would raise the copayments for pharmaceuticals under the TRICARE plan. Active-duty service members would continue to receive their prescriptions at no cost from those pharmacies, but all other beneficiaries would pay $3 for generics and $9 for brand-name pharmaceuticals on the TRICARE formulary when purchasing the drugs from military pharmacies. Prescriptions filled at participating network retailers would cost the beneficiaries $15, $25, or $45 for a 30-day supply of generic, formulary, or nonformulary pharmaceuticals, respectively. Prescriptions filled by mail order would cost $9, $27, or $45 for a 90-day supply of generic, formulary, or nonformulary pharmaceuticals, respectively.

The Congressional Budget Office estimates that this option would save about $10 billion over the period from 2012 to 2016 and about $26 billion over the next 10 years, relative to CBO's baseline projections. (Total savings would be greater, but some are already incorporated in the baseline. See the note to the above table.) About half of the savings would be attributed to pharmacy spending by beneficiaries eligible for Medicare and would be classified as mandatory. The other half of the savings would be subject to annual appropriation acts. DoD's outlays would be reduced, in part, because the

increased cost-sharing payments would directly offset some of the government's cost for the pharmaceuticals. In addition, the higher copayments would induce some people who otherwise would have used the TRICARE program to rely instead on a civilian pharmacy benefit—one available through their spouse's employment, for example.

A rationale for this option is that larger copayments would foster more disciplined use of medical resources and discourage low-value treatments. In an era of fiscal constraint, rapidly rising health care costs may result in fewer resources available for DoD to purchase and maintain weapon systems and other equipment. This option would begin to curtail the growth in health care costs, freeing those resources for other defense priorities.

An argument against this option is that the larger copayments might impose a financial strain on some beneficiaries, who might terminate their use of the TRICARE pharmacy benefit and risk harming their health. The health of people who continue to use the TRICARE benefit, moreover, might suffer if they are discouraged from treating their illnesses with pharmaceuticals in a timely manner or from completing a drug treatment regimen in the face of higher copayments.

RELATED OPTIONS: Discretionary Spending, Option 3; and Mandatory Spending, Option 1

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program*, February 2011; *The Effects of Proposals to Increase Cost Sharing in TRICARE*, June 2009; and *Growth in Medical Spending by the Department of Defense*, Issue Brief, September 2003

Discretionary Spending—Option 6 **Function 050**

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

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	0	-200	-500	-900	-1,200	-1,200	-1,200	-1,300	-1,300	-1,300	-2,800	-9,100
Outlays	0	-100	-400	-700	-1,000	-1,200	-1,200	-1,200	-1,300	-1,300	-2,200	-8,400

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

The existing commissary and exchange systems operate under very different funding mechanisms. The commissary system, which is run by the Defense Commissary Agency (DeCA), has yearly sales of about $6 billion, but it also receives an annual appropriation of about $1.3 billion. The three exchange systems have annual sales that total about $12 billion. They receive no direct appropriations; instead, they rely on sales revenue to cover most of their costs. A relatively small portion of their costs, such as expenses for transporting merchandise overseas, is paid from appropriations elsewhere in the defense budget.

The exchanges can operate without an appropriated subsidy because they charge customers a higher markup over wholesale prices than commissaries do. Also, because the exchange systems are nonappropriated-fund (NAF) entities—that is, they rely mostly on funds generated from sales to finance their operations instead of appropriations from the federal government—they have more flexibility in business practices for personnel and procurement. By contrast, DeCA's employees are civil service personnel, and it must follow standard federal procurement practices. This option is based on the assumption that consolidating the four retail systems would eliminate duplicative administrative functions and that DeCA's civil service employees would be converted to the NAF workforce.

Under this option, the commissary and exchange systems would be consolidated over a five-year period. At the end of that period, the budget authority required to operate the combined system would be lower by almost $2 billion per year. This option would return about a third of that amount to active-duty service members through a tax-free grocery allowance to each of the roughly 1.4 million active-duty service members. The grocery allowance would be phased in to coincide with the consolidation of commissary and exchange stores at each base. The net annual savings in budget authority by 2016 would be a little over $1 billion. Outlay savings to DoD over the next decade would total about $8 billion.

To operate within budget and without appropriated funds, the consolidated system would have to charge about 7 percent more for groceries and other merchandise. At the current volume of sales at the commissaries and exchanges, a 7 percent increase in prices would cost military personnel—active-duty, reserve, and retired—and their families an additional $1.4 billion annually.

Active-duty members and their families would pay about $400 more per year, on average, but that amount would be offset by the new grocery allowance. Cash allowances would be particularly attractive to personnel who lived off base and could shop more conveniently near home or online. All military families would benefit from longer store hours, one-stop shopping, access to private-label groceries (which are not currently sold in commissaries), and the greater certainty inherent in a military shopping benefit that did not depend on the annual appropriation process. Another advantage is that the $400 average grocery allowance could be targeted toward specific pay

grades or groups, with larger allowances given to enhance retention or to benefit junior enlisted members with large families, for example.

DoD's retail system would benefit as well. Commissaries and exchanges must now compete with online retailers and the large discount chains that have opened discount grocery and general merchandise stores just outside the gates of many military installations. Recent tightening of base security procedures and changes in the civilian retail industry have made it more difficult and costly for DoD's fragmented retail systems to provide those services. This option would allow a consolidated system staffed by NAF employees to better compete with civilian alternatives.

One argument against consolidation is that about $750 million of the price increases would be borne by the military retirees who shop in commissaries and exchanges but who, under the option, would not receive grocery allowances. The average family of a retired service member would pay about $325 more per year for groceries.

RELATED CBO PUBLICATIONS: Statement of Carla Tighe Murray, Analyst, Congressional Budget Office, before the Subcommittee on Personnel, Senate Committee on Armed Services, *Evaluating Military Compensation*, April 28, 2010; and *Evaluating Military Compensation*, June 2007

Discretionary Spending—Option 7 **Function 050**

Replace the Joint Strike Fighter Program with F-16s and F/A-18s

(Billions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-8.5	-10.0	-7.1	-6.1	-4.4	-36.1
Outlays	-1.9	-4.9	-7.1	-7.0	-6.0	-26.9

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The F-35 Joint Strike Fighter (JSF) program is the military's largest aircraft development program. The program's objective is to design and produce three versions of the stealthy aircraft: a conventional takeoff version for the Air Force; a carrier-based version for the Navy; and a short takeoff vertical landing (STOVL) version for the Marine Corps. The Departments of the Navy and the Air Force placed orders for 101 F-35s from 2007 through 2011 and anticipate purchasing 2,342 more from 2012 through 2035. The Department of Defense (DoD) has estimated that, including the cost to complete development, the remaining cost for those purchases will amount to about $260 billion. (All three versions of the aircraft are still in the developmental stage and will not enter operational service for several years.)

Under this option, DoD would cancel the F-35 program and instead purchase the most advanced versions of fighter aircraft already in production: the Lockheed Martin F-16 for the Air Force, and the Boeing F/A-18 for the Navy and Marine Corps. If those aircraft were purchased at the rates planned for the F-35, the option would decrease outlays by about $27 billion over the next five years. Over the longer term, the option would save $48 billion through 2021 and $78 billion if the entire planned fleet of F-35s—not all of which would be purchased within the 10-year budget window—was replaced with F-16s and F/A-18s.

The Congressional Budget Office's estimate of savings under this option is based on information from DoD's latest available Selected Acquisition Report. Since that report was prepared, DoD has announced that the JSF program has experienced substantial cost increases and schedule delays. CBO lacked sufficient details about those changes to produce a revised estimate of the savings that could be realized under this option. Savings from canceling the F-35 program would probably be significantly greater than CBO's estimate for the entire production run (now likely to include purchases beyond 2035, if production quantities remain unchanged). How much the potential savings over the next 5 or 10 years will change depends on the degree to which purchases are postponed to accommodate delays in development and increases in cost.

An argument in favor of this option is that—if equipped with upgraded modern radar, precision weapons, and digital communications—new F-16s and F/A-18s would be sufficiently advanced to meet the threats that the nation is likely to face in the foreseeable future. The extreme sophistication of the F-35 and the additional technical challenge of building three distinct types of aircraft with a common airframe and engine have resulted in significant cost growth and schedule delays. Although the F-35 program was recently restructured and further changes have been announced, additional cost growth and schedule delays remain a possibility. The cost of upgrading the other aircraft also could escalate, but their lesser technical challenges relative to the F-35 would make comparable cost growth unlikely. Because the Air Force and the Navy project that planned production rates for the F-35 would be insufficient to meet inventory goals as older aircraft needed to be retired, schedule delays for that aircraft could be particularly problematic.

A disadvantage of this option is that F-16 and F/A-18 aircraft lack the stealth design features that would help the F-35 evade enemy radar and hence operate more safely in the presence of enemy air defenses. The services would maintain some stealth capability, however, with the B-2 bomber and F-22 fighters already in the force. Any greater need for stealth capabilities that might arise in the future could be addressed with new, highly stealthy unmanned fighters and long-range bombers that the services plan to develop. Another potential disadvantage of

this option is that substituting F/A-18s for the F-35B—the Marine Corps' STOVL version of the F-35—would remove that service's capability to operate fixed-wing fighters from the amphibious assault ships in naval expeditionary strike groups, a capability currently provided by the AV-8B Harrier. Those strike groups would be left to rely on armed helicopters (which lack the range, speed, payload, and survivability of the F-35) or on other forces, such as aircraft from aircraft carrier strike groups.

RELATED OPTION: Discretionary Spending, Option 8

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program*, February 2011; *Strategies for Maintaining the Navy's and Marine Corps' Inventories of Fighter Aircraft*, May 2010; and *Alternatives for Modernizing U.S. Fighter Forces*, May 2009

Discretionary Spending—Option 8 **Function 050**

Cancel the Navy and Marine Corps' Joint Strike Fighters and Replace Those Aircraft with F/A-18E/Fs

(Billions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-3.7	-5.4	-2.1	-1.7	-1.6	-14.5
Outlays	-0.9	-2.6	-3.5	-2.8	-2.2	-12.0

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The Department of the Navy currently plans to purchase 680 Joint Strike Fighters (JSFs) in two variants: the F-35B short takeoff vertical landing (STOVL) aircraft for the Marine Corps and the F-35C carrier-based aircraft for the Navy. (The Air Force is purchasing F-35As, which are conventional land-based fighters.) The department has already placed orders for 53 F-35s through 2011 and anticipates purchasing 627 more F-35s from 2012 through 2026. The department has estimated that, including costs to complete development, the remaining cost for those purchases will amount to $82 billion. The F-35B and F-35C are still in the developmental stage and will not enter service for several years.

Under this option, the Department of the Navy would cancel its plans for further development and fielding of the F-35B and F-35C and instead purchase additional F/A-18E/F fighters currently in production. If those aircraft were purchased at the same rates planned for the department's F-35s, the option would decrease outlays by $12 billion over the next five years and save nearly $18 billion through 2021. The projected savings take into account increased costs for the 660 F-35As the Air Force plans to purchase from 2012 through 2021. (Because the option would affect the JSF program as a whole—resulting in reduced annual production rates and fewer total aircraft being purchased—the Air Force's costs for the F-35A would increase accordingly.) Including the higher estimated costs for the Air Force's F-35As in years after 2021 reduces the projected long-term net savings under this option to $6 billion.

The Congressional Budget Office's estimate of savings under this option is based on data from the latest available Selected Acquisition Report. Since that report was prepared, the Department of Defense has announced that the JSF program has experienced substantial cost growth and schedule delays. CBO lacked sufficient details about those developments to produce a revised estimate of the savings that could be realized under this option. Savings from canceling the program would probably be significantly greater than CBO's estimate for the entire JSF production run (now likely to include purchases beyond 2026 for the Navy and Marine Corps, if production quantities remain unchanged). How much the potential savings over the next 5 or 10 years would change depends on how purchase schedules change—specifically, to what extent purchases are postponed to accommodate schedule delays and cost increases.

An argument for this option is that because of the F/A-18E/F's relatively new design, that aircraft is capable of meeting likely threats in the foreseeable future. In addition, the costs of producing the F/A-18E/F are well understood. Moreover, further delays in the production of F-35s could pose significant difficulties because the Navy is already projecting that production rates will not be sufficient to match the retirement rate of F/A-18A/B/C/D fighters, which are approaching the end of their structural service life. A middle course—augmenting F-35B/C production with enough F/A-18E/F purchases to maintain inventory—would require higher than planned near-term funding to support the simultaneous production of both aircraft.

An argument against this option is that even though the F/A-18E/F was designed to incorporate stealth features that the smaller F/A-18C/D does not have, it is still far less stealthy than the F-35. Consequently, canceling the F-35 could limit naval aviation operations early in a conflict before enemy air defenses have been suppressed. That shortcoming could be mitigated if the Navy's efforts to develop stealthy unmanned combat aircraft are successful. Another disadvantage of the option is that

substituting F/A-18s for the STOVL F-35B would mean that the Marine Corps could no longer operate fixed-wing fighters from the amphibious assault ships in naval expeditionary strike groups or from locations ashore that cannot accommodate conventional fighters—capabilities that are currently offered by the AV-8B Harrier. In the absence of support by carrier- or land-based aircraft, the strike groups would have to rely on armed helicopters that do not have the same range, speed, payload, and survivability as the F-35.

RELATED OPTION: Discretionary Spending, Option 7

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program*, February 2011; *Strategies for Maintaining the Navy's and Marine Corps' Inventories of Fighter Aircraft*, May 2010; and *Alternatives for Modernizing U.S. Fighter Forces*, May 2009

Discretionary Spending—Option 9 **Function 050**

Cut the Number of Aircraft Carriers to 10 and the Number of Navy Air Wings to 9

(Millions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-10	-250	-330	-470	-750	-1,810
Outlays	0	-30	-100	-180	-310	-620

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The Administration's 2011 budget called for maintaining a fleet of 11 aircraft carriers and 10 active-duty naval air wings. For the 2013–2015 period, the number of carriers will temporarily fall to 10 as a result of the three-year gap between the decommissioning of the USS *Enterprise* in early 2013 and the commissioning of its replacement, the USS *Gerald R. Ford,* in late 2015. (The number of active air wings is one less than the number of carriers because, at any particular time, one of the Navy's carriers is usually undergoing a major overhaul.) Aircraft carriers are also accompanied by a mix of surface combatants (usually cruisers and destroyers) and submarines to defend against aircraft, ships, and submarines that might threaten the carrier. The Navy calls such a force a carrier strike group.

This option would permanently reduce the carrier force to 10 and the number of air wings to 9. It would do so primarily by retiring a Nimitz class carrier, the USS *George Washington,* in 2016, when it is scheduled to undergo various maintenance activities and have its nuclear reactors refueled, an expensive and time-consuming process. Those changes would save the refueling and overhaul costs that the Navy expects to incur between 2012 and 2017 (the Navy begins purchasing long-lead items several years before the refueling is scheduled), as well as the operating costs associated with the ship between 2017 and 2021 and thereafter. Overall, this option would save about $620 million in outlays over the 2012–2016 period and about $7 billion over the 2012–2021 period.

The savings in this option reflect the assumption that the Navy would permanently reduce the size of its force by 5,600 sailors after the *George Washington* is decommissioned in 2016. Those savings would be partially offset, however, by the cost of decommissioning a Nimitz class nuclear-powered aircraft carrier, which involves removing the two nuclear reactor plants from the ship and placing them at a permanent storage site, as well as dismantling the ship. Decommissioning a Nimitz class carrier would eventually cost a total of about $2 billion, although only about $1 billion would be spent through 2021.

Under this option, the other ships associated with a carrier strike group would be retained and deployed to support other Navy missions, so no additional savings related to other types of ships would be realized from the decommissioning. In addition, although the administrative structure of the retired air wing would be eliminated, the aircraft would be retained to reduce the shortfall between the Navy's goals and the number of planes in its inventory. About 8 percent of the savings from this option would come from smaller accrual payments to the military retirement and health care trust funds as a result of the reduction in Navy personnel associated with removing the ship from the fleet. Although those accrual payments are intragovernmental transfers that would not represent current savings to the federal government, they are shown in the budget as savings to the Department of the Navy and represent long-term savings to the federal government as a whole.

The rationale for this option is that the Navy could carry out its mission with fewer aircraft carriers. Recent experience suggests that the Navy mobilizes 5 to 7 carriers to fight a major war, and the 10 carriers remaining in the fleet under this option would still provide a force of at least 5 or 6 carriers within 90 days to fight such a war. In addition, although the Navy would lose some ability to provide a carrier presence overseas, 10 carriers would be enough to provide full-time coverage in the western Pacific and the Arabian Sea, as well as coverage in the Mediterranean Sea for two or three months of the year. Some analysts have argued that because the Mediterranean region is more secure than it was during the Cold War, it no longer requires the continuous or nearly continuous presence of an aircraft carrier. Should the need for a carrier arise in the Mediterranean, the one in

the Arabian Sea could be sent there quickly via the Suez Canal, or a carrier could depart from Norfolk and arrive near Europe within 35 days.

An argument against this option is that having one less aircraft carrier increases the operational risk the Navy is taking because that carrier could be valuable in the event of a major conflict—in part because it has the flexibility to operate anywhere in the world without the permission of another country. Further, the U.S. military's European, Central (Middle East), and Pacific Commands each have goals for full-time carrier presence in their respective regions. Under current crewing and operating practices, 15 carriers would be needed to achieve that presence, and having one less carrier would move even farther away from that goal. In addition, the two wars since 1990 in the Mediterranean area (Bosnia and Kosovo) that involved the support of carrier strike groups, and the political unrest in that area, may indicate that having a carrier presence there would be particularly valuable.

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011; and *An Analysis of the Navy's Fiscal Year 2011 Shipbuilding Plan,* May 2010

Discretionary Spending—Option 10 **Function 050**

Cancel the Expeditionary Fighting Vehicle

(Millions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-160	-520	-580	-590	-640	-2,490
Outlays	-60	-160	-350	-480	-540	-1,590

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The Marine Corps' expeditionary fighting vehicle (EFV) is a tracked armored vehicle that can travel at high speed through the water from a ship to land. The Marine Corps regards the EFV as essential for the conduct of amphibious warfare in the future, particularly for its concept of operational maneuver from the sea, in which troops deploy from ships and move directly to their intended objective far inland without pausing to build up additional forces on the beach. In a major amphibious assault from the sea, six brigades of Marines would deploy from amphibious ships to attack the enemy position. Four of those brigades would be equipped with EFVs, and the other two brigades would deploy from aircraft. According to the Marine Corps, the EFV represents a significant improvement over the existing amphibious assault vehicles (AAVs). The EFV is more survivable and can deploy with higher speed and from much greater distances than the AAVs. In particular, the EFV is intended to deploy from amphibious ships that are 25 nautical miles from the shore compared with only a few miles for the AAV. The higher speed and range provide the Marines with more flexibility as to where and when they land, making it more difficult for the enemy to defend against the assault.

The Marine Corps plans to begin procuring the EFV in 2012. Annual procurement costs would range from about $500 million to $1 billion between 2013 and 2025, when the program would end. The entire program would involve 574 EFVs at a total procurement cost of about $12 billion. The Marine Corps has already spent about $3 billion to develop the vehicle.

This option would cancel the program but provide a stream of research and development funds—and, eventually, procurement funds—that would enable the Marine Corps to come up with an alternative to the EFV. This option does not specify which alternative the Marine Corps would pursue in lieu of the EFV but simply reserves research, development, and procurement funding for an alternative. Such an alternative could involve a different tracked amphibious vehicle that "swims" ashore but is better suited for ground combat, for example, or a new ground combat vehicle that is ferried to shore by a high-speed, ship-to-shore connector craft. Savings over the 2012–2016 period would total about $2 billion. Savings over a longer period would depend on which alternative system emerged from research and development.

An argument for this option is that when the EFV was first conceived as a replacement for the AAV two decades ago, the prospective combat environment was very different. At that time it was thought that the proliferation of antiship cruise missiles would compel naval forces to operate 25 nautical miles from the shore; an amphibious vehicle would therefore need high speed and greater range to deploy from its ship. However, many supporters of this option observe that over the past 20 years the shore-based threats to naval forces have grown more diversified, sophisticated, and numerous; as a result, naval forces in the future may have to operate much farther than 25 nautical miles from an enemy shore to be able to protect themselves from antiship threats. In addition, new enemy tactics and threats have emerged from the insurgency campaigns in Iraq and Afghanistan that make the EFV particularly vulnerable during operations on land. To achieve high speed in getting ashore, the EFV is designed with a flat bottom. Once ashore, however, that flat-bottom design, as well as other features of the EFV—its flat sides, low ground clearance, light armor, small interior space, and many hydraulic pressure lines throughout the inside—make the vehicle particularly vulnerable to tactics that employ improvised explosive devices (IEDs), mines, and antiarmor weapons. In short, optimizing the vehicle to get to shore quickly makes it much more vulnerable in a fight once it has reached land. Supporters of this option also argue that if the objective is to use the EFV's range to land in places that are not heavily

defended, speed may be less important than the ability to engage in effective ground combat once the force has landed. In addition, the growing cost of the program could make it difficult for the Marine Corps to buy other needed ground equipment.

An argument against this option is that the major criticisms of the EFV's capabilities are overstated and that canceling the EFV is tantamount to abandoning the concept of major amphibious warfare. Under that argument, what is needed is an amphibious vehicle with the capability to get to shore quickly and then immediately move out and fight. Canceling the EFV now would at best mean relying on the aging AAV for years to come. Redesigning the EFV to make it less vulnerable to IEDs or mines would mean forgoing the flat bottom of the vehicle needed to achieve the high speed from the ship to shore. A better solution to the vehicle's vulnerabilities, supporters of the EFV argue, would be to use more blast-resistant material in constructing the vehicle and to employ bolt-on armor when needed. Furthermore, the threat of IEDs and mines would be mitigated by the range of the EFV, which makes it difficult for the enemy to predict where the vehicle would land and therefore where to place IEDs and mines.

RELATED CBO PUBLICATION: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011

Discretionary Spending—Option 11 **Function 050**

Delay Fielding of the Army's Ground Combat Vehicle

(Millions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-1,600	-1,900	-1,100	-1,100	-300	-6,000
Outlays	-600	-1,400	-1,400	-1,000	-700	-5,100

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The Ground Combat Vehicle (GCV) program is the Army's latest attempt to design and field a new combat vehicle. Its previous attempt, the manned vehicle program that was part of the Army's larger Future Combat Systems program was canceled in the spring of 2009. Army officials have stated that the service needs a vehicle large enough to carry and protect a full squad of nine infantry soldiers at one time. In order to meet its goal of fielding units equipped with GCVs beginning in 2017, the Army would require appropriations totaling more than $10 billion through 2016: $8.6 billion for development—that is, to design, test, and evaluate the vehicle— plus almost $2 billion to procure the items needed to begin production. After 2016, the Army could need as much as $3 billion in funding annually to purchase 200 vehicles each year.

This option would delay the initial fielding of the GCV until 2025. From 2012 through 2021, funds currently planned for developing the GCV would be reduced to roughly $600 million per year, thereby decreasing the need for appropriations by more than $2 billion. Under this option, no procurement funding for the GCV would be provided between 2012 and 2021, which would reduce the need for appropriations by an additional $14 billion. Some of the savings would be used to develop and purchase upgrades for Bradley Fighting Vehicles because they will remain in the Army's inventory through at least 2025, whether or not this option is implemented. Consequently, the total reduction in appropriations associated with this option would be roughly $7 billion through 2021, mostly between 2012 and 2016. In total, this option would lower outlays by about $5 billion through 2016 and by almost $6 billion over the 2012–2021 period.

An argument in favor of this option is that it would give the Department of Defense and the Congress time to evaluate the need for the proposed GCV and to consider alternative vehicles, as some defense experts have suggested. Under the Army's plan, GCVs would replace only about 25 percent of the armored vehicles that the service uses to transport soldiers on the battlefield. The Army would still rely on older vehicles that are based on the chassis of the M113 armed personnel carrier and on Bradley Fighting Vehicles to provide the bulk of its armored combat vehicles. The Army has already invested $27 billion between 2004 and 2010 to upgrade existing Abrams tanks and Bradley Fighting Vehicles and to purchase new Stryker vehicles, and continuing upgrades would still be required even if the Army proceeded with the GCV program.

An argument against this option is that if the Army eventually purchased some form of the GCV—because that vehicle would better meet the demands of current and future operations—delaying those purchases would push the costs out further into the future and perhaps increase the total costs over the very long run. It would also delay the fielding of a combat vehicle with greater capabilities than those currently available. For instance, the Bradley Fighting Vehicle cannot carry its own crew and a full infantry squad at the same time. Keeping a squad together, which the GCV would allow, would facilitate tactical planning while the force was moving. That capability would allow a squad to better synchronize its actions when it left the vehicle. In addition, the greater protection afforded by the GCV—especially against improvised explosive devices—would enhance the safety of soldiers who conduct the types of close operations among civilian populations that are becoming increasingly common. This option could increase the total cost of the program by adding eight extra years of research and development before achieving those goals.

A further argument against this option is that the Army has not fielded a new combat vehicle since the early 1990s. Delaying the fielding of the GCV would mean

that an even larger portion of the Army would continue to use systems originally developed in the 1980s or earlier (although those systems have been updated several times since then). Some of those armored vehicles, notably the Abrams tank, are not fuel-efficient and require intensive maintenance. Improving the data processing and connectivity of those older systems would require that newer components be integrated into older frames, which can be a difficult process (although the exact costs are not easily estimated and are not included in the above estimate). Finally, retaining old systems might eventually cause the Army to lose its technological edge and compromise the service's dominance on the battlefield.

RELATED CBO PUBLICATIONS: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011; and *An Analysis of the Army's Transformation Programs and Possible Alternatives,* June 2009

Discretionary Spending—Option 12 **Function 050**

Terminate the Medium Extended Air Defense System Program

(Millions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-730	-630	-610	-740	-1,630	-4,340
Outlays	-250	-500	-550	-570	-970	-2,840

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The Medium Extended Air Defense System (MEADS) is an air and missile defense system under joint development by the United States, Germany, and Italy. It is intended to provide low- and medium-altitude defense against attack by short-range ballistic missiles, cruise missiles, unmanned aerial vehicles, and other airborne weapons. The program includes two types of radar, as well as command-and-control systems, missile launchers, and an interceptor missile. MEADS is slated to replace and improve on the capabilities of the Patriot system, which is approaching the end of scheduled production of its interceptor missiles. As a result of delays in the development of the MEADS interceptor, production of the Patriot Advanced Capability-3 (PAC-3) interceptor was extended into 2011, two years beyond its planned end date.

This option would terminate MEADS development. In place of the new system, the option would continue production of Patriot interceptors and initiate an engineering effort to maintain and improve the Patriot system. To estimate the savings from canceling MEADS, the Congressional Budget Office has relied on plans described in the December 2009 Selected Acquisition Report for MEADS, which calls for procurement of about 1,000 interceptors and 16 complete fire units over the next 10 years. CBO estimates that canceling MEADS would save about $4 billion in outlays over the next five years and $13 billion over a decade. The 10-year savings would come from discontinuing research and development for the MEADS system (about $3 billion) and ending the procurement of MEADS equipment (almost $11 billion). In this option, the 5- and 10-year savings would be partially offset by continuing to improve and procure Patriot systems, including ground equipment; CBO has assumed that nearly $400 million per year would be spent on that effort, sufficient to procure 40 interceptors per year and provide $100 million per year for engineering support and upgrades. CBO estimates that the net savings for this option would be about $3 billion over the next five years and nearly $10 billion over a decade. In a February 2011 fact sheet, the Department of Defense (DoD) indicated that it may end participation in MEADS development after 2013 and not procure any operational MEADS systems; under those circumstances, CBO's estimates of savings would change. CBO's estimates do not include any costs associated with canceling the contract.

An argument in favor of this option is that the program has experienced technical difficulties, and development of the MEADS interceptor has exceeded DoD's thresholds for both cost growth and schedule delay. In addition, some critics of the program argue that MEADS may not provide effective protection. *Defense Daily,* for example, on August 27, 2010, cited an internal Army memo that advocates "harvesting MEADS technologies and improving the Patriot program it was designed to replace," on the basis of concerns that MEADS technical requirements do not address current and emerging threats.

An argument against this option is that the capability improvements intended for MEADS may be valuable for addressing the ballistic and cruise missile threats that U.S. forces may face in the future. In its 2009 report, *Ballistic and Cruise Missile Threat*, DoD's National Air and Space Intelligence Center concluded that "ballistic and cruise missiles present a significant threat to U.S. and Allied forces" that "continues to increase with the proliferation of missile technology." Also, because MEADS involves international collaboration, canceling the program would require negotiations with the program partners, which might prove diplomatically sensitive.

RELATED CBO PUBLICATION: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011

Discretionary Spending—Option 13 **Function 050**

Terminate the Precision Tracking Space System Program

(Millions of dollars)	2012	2013	2014	2015	2016	Total, 2012–2016
Change in Spending						
Budget authority	-120	-180	-350	-480	-450	-1,580
Outlays	-60	-140	-250	-380	-440	-1,270

Note: Estimates of savings displayed in the table are based on the fiscal year 2011 Future Years Defense Program and CBO's extension of that program.

The Precision Tracking Space System (PTSS), currently being designed by the Missile Defense Agency (MDA), is intended to be a constellation of low-Earth-orbit satellites that track enemy ballistic missiles and distinguish enemy warheads from decoys (a process known as discrimination). The newest in a set of evolving concepts for missile defense that relies on satellite-based infrared tracking, the program supersedes the Space Tracking and Surveillance System (STSS) program. The design of PTSS will draw on knowledge gained from two STSS demonstration satellites, which were launched in September 2009 and are gathering data that will be used to assess the performance of onboard sensors. Existing plans call for one or more PTSS prototypes to be fielded initially, followed shortly by an operational constellation of 6 to 12 satellites.

This option would terminate the PTSS program. To estimate the savings from ending the program, the Congressional Budget Office assumed that the operational constellation would consist of 9 satellites, with the first to be launched in about 2019. Estimated savings would be about $1 billion over the next five years and about $7.5 billion over a decade. The 10-year savings would be realized by not starting research and development for the new satellites (about $2.5 billion) and by not buying, launching, and operating them (almost $5 billion). CBO's estimates do not include any savings that might arise from not building and launching replacement satellites after the initial constellation reached the end of its design life. (Construction of replacement satellites would begin within the next decade if the design life of the PTSS satellite was less than seven years.)

An argument in favor of this option is that the feasibility of operating infrared sensors in space for the purposes of discrimination has not yet been established. Another argument is that the constellation might not provide enough added value to justify the cost because programs that MDA and the Air Force plan to operate simultaneously with the PTSS also would provide some ability to track and discriminate enemy warheads. MDA has recently developed and fielded deployable surface-based radars for missile defense, including the Sea-Based X-Band (SBX) and the AN/TPY-2 radar systems, and has upgraded several early-warning radars to enhance the nation's ability to track ballistic missiles. MDA's plans to deploy surface-based radar close to Iran and North Korea will provide tracking and discrimination information much earlier in the flight of ballistic missiles from those countries than have previous approaches. MDA has also begun research into using infrared sensors onboard unmanned aerial vehicles to track ballistic missiles. In addition, the Air Force is improving its missile-warning capability with the Space-Based Infrared System (SBIRS)-High constellation—satellites in highly elliptical orbits are currently in operation, and the first launch of a SBIRS-High GEO (geosynchronous) satellite is planned for 2011. The sensors on those satellites will also be able to track ballistic missiles early in their flight.

An argument against this option is that the data being gathered from the STSS demonstration satellites might show that space-based infrared sensors would be effective and valuable for tracking and discriminating warheads launched on enemy ballistic missiles. Reliance on a combination of ground-based radars and airborne infrared systems would probably not match the broad geographic coverage offered by a full constellation of PTSS satellites and thus would reduce the nation's ability to track ballistic missiles through all phases of flight for some missile trajectories. The PTSS may also have greater capability to track missile salvos—multiple missiles launched nearly simultaneously—than those other systems.

RELATED CBO PUBLICATION: *Long-Term Implications of the 2011 Future Years Defense Program,* February 2011

Discretionary Spending—Option 14 **Multiple Functions**

Reduce Growth in Appropriations for Agencies Other Than the Department of Defense

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Reduce Growth by 1 Percentage Point Annually												
Change in Spending												
Budget authority	-6.2	-12.6	-19.2	-26.0	-33.0	-40.4	-48.0	-56.0	-64.2	-72.8	-97.0	-378.4
Outlays	-3.4	-8.6	-14.7	-21.1	-27.8	-34.9	-42.2	-49.9	-57.9	-66.2	-75.6	-326.7
Freeze Funding at 2011 Level												
Change in Spending												
Budget authority	-7.5	-19.4	-33.0	-46.7	-62.0	-79.5	-97.6	-116.2	-134.6	-153.4	-168.6	-749.9
Outlays	-4.1	-12.7	-24.3	-37.0	-51.1	-67.1	-84.2	-102.2	-120.3	-139.0	-129.2	-642.0
Reduce Funding by 1 Percent Annually												
Change in Spending												
Budget authority	-13.8	-31.8	-51.5	-71.3	-92.5	-116.0	-139.9	-164.4	-188.5	-213.1	-260.9	-1,082.8
Outlays	-7.5	-21.3	-38.5	-57.1	-77.1	-99.0	-122.0	-145.7	-169.6	-194.0	-201.5	-931.8

The budgets of 14 cabinet-level agencies (excluding the Department of Defense [DoD]); 21 large independent agencies; and more than 80 commissions, boards, foundations, and other federal entities account for almost 50 percent of all discretionary resources.[1] The Departments of Health and Human Services, Education, Transportation, Veterans Affairs, and Homeland Security received just over half of those funds in 2010.

Aside from DoD and Postal Service personnel, the federal government spent approximately $175 billion in 2010 on about 1.3 million civilian employees, the large majority of whom were paid with discretionary appropriations. The federal government also makes about $250 billion in discretionary grants to state and local governments. The variety of programs that federal agencies administer provide a wide range of options for absorbing budget cuts of various magnitudes. Those cuts could be targeted toward selected agencies, leaving most federal programs unaffected, or they could be distributed more evenly among many of them, avoiding the need to drastically reduce or eliminate any particular program.

This option includes three broad alternatives for reducing the growth in discretionary funding for nonmilitary departments and agencies—that is, excluding appropriations for DoD—relative to the baseline budget projections of the Congressional Budget Office:[2]

- Limit the rate of growth in non-DoD discretionary resources to an average of 1.2 percent a year, beginning in 2012; that rate of growth is 1 percentage point less than the rate of growth in CBO's baseline and would reduce outlays by just over $325 billion (or 5 percent) over the 2012–2021 period.

1. Discretionary resources include budget authority and limitations on the availability of mandatory budget authority (called obligation limitations) that are provided in appropriation acts.

2. This option considers changes in discretionary funding for all agencies other than the Department of Defense. Thus, the option includes funding for agencies that receive some appropriations that are classified under national defense (budget function 050)—for example, certain activities of the Departments of Energy, Homeland Security, and Transportation—as well as most other budget functions.

- Freeze those discretionary resources at the annualized level for 2011 under the continuing resolution that was in effect in February 2011, thereby reducing outlays by $642 billion (or 10 percent) over the 2012–2021 period.

- Reduce those resources by 1 percent each year from the 2011 level, thus decreasing outlays by about $932 billion (or 15 percent) over the same period. Under that alternative, non-DoD discretionary resources would be reduced to their 2008 funding level—in nominal terms—by 2021. Appropriations in 2021 would be reduced by $213 billion (or 27 percent) compared with the baseline amount. That reduction is roughly equivalent to the total discretionary resources projected under CBO's baseline assumptions for the Departments of Health and Human Services, Veterans Affairs, and Agriculture.

Over the past 10 years, discretionary funding (other than for DoD) has increased by about 60 percent, or by more than 30 percent after adjusting for inflation. Thus, federal agencies would have more buying power than they had a decade ago even if their budgets were reduced substantially relative to the amounts in CBO's baseline. If those discretionary resources had grown at the rate of inflation since 2001 and continued to do so through 2021, they would total $592 billion in 2021—$185 billion less than the baseline amount. If those resources were reduced by 1 percent annually from the current level (as described in the third alternative), budget authority in 2021 would be $27 billion less than it would have been if funding had grown with inflation since 2001.

One rationale for reducing discretionary spending is that it has been growing faster than inflation and the size of the economy, thereby diverting ever more resources from the private sector, restraining economic growth, and contributing to the increase in federal deficits and debt. Discretionary outlays for programs other than DoD's averaged 3.7 percent of gross domestic product (GDP) in the 1990s and climbed to 4.7 percent of GDP in 2010; those outlays would decline to between 2.4 percent and 2.9 percent of GDP in 2021 under the alternatives in this option. Furthermore, some observers believe that many programs spend money ineffectively and that there is little relationship between expenditures and results; thus, reductions could be made with little negative impact on individuals or on the economy.

An argument against cutting non-DoD discretionary funding is that it supports important programs such as education, infrastructure, housing, and law enforcement, among others. Providing those services to a growing population could be difficult if spending declined to historically low levels as a percentage of GDP, as it would under the alternatives in this option. In the current budget environment, state and local governments would have difficulty compensating for reductions in federal expenditures. Implementation could be challenging as well; discretionary appropriations, which are comparable in amount with DoD's appropriations, are widely distributed among more than 100 agencies. Implementing well-targeted cuts in those appropriations would therefore be much more challenging than making such cuts in DoD's spending.

Discretionary Spending—Option 15 **Function 270**

Eliminate the Department of Energy's Grants to States for Energy Conservation and Weatherization

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	-253	-257	-261	-266	-271	-277	-283	-288	-294	-300	-1,308	-2,750
Outlays	-73	-138	-193	-239	-264	-269	-274	-280	-285	-291	-907	-2,306

The Weatherization and Intergovernmental Program, which is administered by the Department of Energy (DOE), provides grants that help fund state and local government programs for energy conservation and the weatherization of buildings. Some grants provide low-income households with insulation, storm windows, and weather stripping. Institutional grants help reduce energy use at educational, municipal, and health care facilities and fund local efforts to encourage private investment in building improvements. Other grants support efforts by state and municipal governments to establish energy-efficiency standards for new and remodeled buildings and to promote energy-saving practices such as car-pooling and the use of public transportation. In 2010, DOE received regular appropriations of about $230 million to provide grants to states and municipalities for energy conservation and building weatherization. The American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5) provided an additional $8.1 billion.

This option would eliminate new funding for the grants that DOE provides to state and local governments through its Weatherization and Intergovernmental Program. Ending that funding would save about $900 million over the next five years and more than $2 billion over the 2012–2021 period.

One rationale for eliminating new funding for the grants is that the funding provided in 2009 should be sufficient to cover several years' worth of weatherization activity; the appropriation provided by ARRA was roughly eight times the normal amount of funding provided in an average year for weatherization activities across all federal programs. Another rationale is that other federal programs—such as the Low Income Home Energy Assistance Program, which is administered by the Department of Health and Human Services, and DOE's own Building Energy Codes Program—are doing similar work. Moreover, direct federal funding may encourage state and local governments to reduce their own support for energy conservation and weatherization and to redirect that support to other uses. In the extreme, if federal funding simply substituted dollar-for-dollar for what a state or local government otherwise would have spent, then that federal spending would have no net effect on energy conservation.

One argument against such a policy change is that many states rely heavily on federal grants to improve the energy efficiency of low-income housing and public institutions. Eliminating DOE's energy conservation and weatherization grants could make it harder for states to continue to promote such efforts. A second argument is that the grants support policies the federal government should consider a priority—specifically, those designed to reduce emissions of greenhouse gases and other air pollutants from natural gas and electric power generation. Eliminating the DOE grant program could result in fewer resources being allocated for such purposes. Finally, weatherization and energy conservation limit the effects that higher energy prices have on public and household budgets. Ending DOE's grants would have a particularly adverse impact on the programs' beneficiaries—primarily low-income households (who devote a larger-than-average share of their income to energy bills) and public institutions—especially if energy prices were to rise over time.

Discretionary Spending—Option 16 **Function 270**

Reduce Department of Energy Funding for Energy Technology Development

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Reduce Funding for Fossil Energy Research, Development, and Demonstration												
Change in Spending												
Budget authority	-110	-223	-340	-346	-352	-360	-367	-375	-382	-390	-1,371	-3,245
Outlays	-22	-75	-158	-233	-287	-319	-339	-351	-358	-366	-775	-2,508
Reduce Funding for Nuclear Energy Research, Development, and Demonstration												
Change in Spending												
Budget authority	-125	-255	-389	-396	-403	-412	-421	-430	-440	-449	-1,568	-3,720
Outlays	-75	-188	-318	-376	-398	-408	-417	-426	-435	-444	-1,355	-3,485
Reduce Funding for Energy Efficiency and Renewable Energy Research, Development, and Demonstration												
Change in Spending												
Budget authority	-245	-498	-759	-773	-788	-805	-823	-841	-859	-877	-3,063	-7,268
Outlays	-71	-205	-374	-496	-578	-653	-721	-773	-807	-829	-1,724	-5,507
Total, All of the Above Programs												
Change in Spending												
Budget authority	-480	-975	-1,488	-1,515	-1,543	-1,577	-1,612	-1,645	-1,681	-1,716	-6,001	-14,232
Outlays	-168	-468	-850	-1,105	-1,263	-1,380	-1,477	-1,550	-1,600	-1,639	-3,854	-11,500

Since 1978, the Department of Energy (DOE) has spent more than $45 billion to develop new technologies in the areas of fossil fuels, nuclear power, and energy efficiency and renewable energy (EERE). Currently, a variety of DOE programs support research and development (R&D) of those energy technologies and their commercial demonstration. Spending for such efforts peaked in the 1980s and declined during the following 20 years, but funding began to increase again in 2006. Many lawmakers have questioned the value of those technology development programs and have considered whether DOE should cut back on programs to develop near-term energy technologies and concentrate instead on basic research in those fields.

This option would reduce spending for technology development in the fossil, nuclear, and EERE R&D programs to 25 percent of their 2011 levels. The Congressional Budget Office estimates that, in total, those reductions would reduce discretionary outlays by about $4 billion over the 2012–2016 period and by about $11 billion over 10 years. The specific activities that would be eliminated in those programs are those that focus on the later stages of technology development, the demonstration of commercial feasibility, and the deployment of new technologies. (This option would not affect funds for technical assistance and financial assistance, such as weatherization services for low-income families. See Discretionary Spending—Option 15.)

An argument for this option is that some of DOE's activities are better undertaken by the private sector, which has an advantage in the development, demonstration, and deployment of new energy technologies. Generally, the direct feedback that the markets provide to private investors has proved more cost-effective than the judgment of government managers in selecting which technologies will be successful in the market. The limits on the government's ability to foster new energy technologies are illustrated by DOE's Partnership for a New Generation of Vehicles (PNGV). The original goal of PNGV research was a production-ready vehicle powered by a hybrid (diesel and electric) motor for U.S. automakers. Foreign car manufacturers, pursuing similar technologies

in a small-sized car, were ultimately the first to supply—and subsequently dominate—the U.S. market for small hybrid cars. Similarly, in the area of fossil energy development, DOE has long sought to introduce new energy technologies through expensive technology demonstration plants that have often failed to deliver commercially useful knowledge. Accordingly, proponents of this option would scale back DOE's efforts to support applied research and the commercialization of new technologies and shift resources to favor DOE's support of basic and early applied research, which is less likely to be undertaken by the private sector.

Another argument for this option is that federal agencies have too many conflicting policy goals to implement a program of investments efficiently, as would be required for large technology demonstration projects. The Government Accountability Office (GAO) has long been critical of DOE's project management, pointing to inadequate oversight of contractors and to projects that failed to meet expectations for costs or schedules. Despite DOE's attempts at reform, GAO concluded in 2007 that DOE's performance had not improved substantially because new management processes had not been applied consistently.

Other arguments focus on the merits of specific programs. Regarding R&D related to nuclear energy in particular, some observers question the wisdom of pursuing new technologies as long as electric utilities—the intended recipients—are not building new nuclear plants. Since many state policymakers moved to deregulate the electricity-generation market in the 1990s, investors have generally shied away from building capital-intensive generating facilities, preferring to rely on less expensive natural gas facilities instead. Recent developments suggest that the natural gas required to power those new generators will remain cheap and plentiful for the foreseeable future, casting further doubt on the financial viability of nuclear-powered generators.

In the EERE area, which includes energy conservation as well as solar, wind, and other renewable energy sources, the federal government provides support through other means. Many of the technologies whose development is supported by the EERE programs also receive the tax credit for renewable electricity production or conservation-related tax credits. Furthermore, several of the EERE industries enjoy high rates of growth. Given the tax preferences and the high level of market penetration, some analysts argue that it may be time to begin withdrawing federal commitments for further technology development in those areas.

An argument against this option is that federal support may be needed because the prices businesses and consumers pay for energy do not compensate for the potentially large long-run costs of climate change. Reducing emissions of greenhouse gases would diminish those costs, but because those costs are not reflected in current energy prices, producers and consumers have little incentive to manufacture or purchase products that reduce energy consumption or produce energy with minimal greenhouse gas emissions. Thus, some observers argue that DOE's energy technology development programs fill a gap left by the market by providing the resources and incentives necessary to develop new technologies to produce and conserve energy.

In addition, most analysts agree that investors in many sectors, not just energy, do not receive all the benefits of investment in R&D because others also benefit from the knowledge gained. That result suggests a possible need for federal support to ensure that adequate R&D takes place. Because society gains even if the original investor does not capture all the benefits, it is argued, the federal government should invest in R&D to compensate for the gap between all the benefits that accrue to society and those that the original investors receive.

Finally, some analysts assert that DOE's technology development programs are a worthwhile activity on their own merits. Panels convened by the National Academy of Sciences have estimated that some of DOE's technology development programs, especially in the area of energy efficiency, have provided substantial benefits that exceed their costs.

Discretionary Spending—Option 17 **Function 300**

Eliminate Federal Grants for Wastewater and Drinking Water Infrastructure

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	-1,490	-2,260	-3,840	-3,900	-3,970	-4,050	-4,130	-4,210	-4,300	-4,380	-15,460	-36,530
Outlays	-60	-420	-1,100	-2,010	-2,810	-3,330	-3,610	-3,770	-3,890	-3,990	-6,400	-24,990

To protect the quality of the nation's waters and the safety of its drinking water, the Environmental Protection Agency (EPA) administers provisions of the Clean Water Act of 1972 (CWA) and the Safe Drinking Water Act of 1974 (SDWA). Both laws authorize the federal government to provide grants that capitalize state revolving funds (SRFs). SRFs, in turn, offer financial assistance—market-rate and subsidized loans, loan or bond guarantees, and bond purchases, for example—to communities building or replacing wastewater and drinking water systems to meet or maintain federal standards. For 2010, EPA received an appropriation of about $3.6 billion for such grants, including $2.1 million for clean-water SRFs, $1.3 billion for drinking water SRFs, and $200 million for grants to specific communities and locales. This option would phase out EPA's grants to SRFs over three years, reducing federal outlays by $6 billion through 2016 and by $25 billion over 10 years.

In 1987, amendments to the CWA phased out a program of direct construction grants for wastewater treatment facilities and replaced it with SRFs. States match federal contributions to the SRFs at a rate of 20 cents on the dollar and operate them within broad limits, defining eligible projects, choosing the terms of assistance, and setting priorities. In 2009, 78 percent of the loans—23 percent of total funding from clean-water SRFs—went to communities with populations under 10,000. Authorization for the SRF program under the CWA has expired, but the Congress continues to provide annual appropriations for grants, allocating them to states according to the shares specified in the 1987 amendments.

Amendments to the SDWA in 1996 authorized EPA to make grants to capitalize SRFs for drinking water systems. Although generally modeled on the wastewater program, the SDWA program allocates funding using a formula based on the results of EPA's quadrennial "Drinking Water Infrastructure Needs Survey." States must establish a priority-setting system that focuses on reducing the greatest health risks and achieving compliance with SDWA standards, taking into account the financial needs of local water systems.

One justification for this option is that the grants could encourage inefficient decisions about water infrastructure because they allow states to lend money at below-market interest rates, which in turn reduces incentives for local governments to find the least costly ways to control water pollution and provide safe drinking water. Another rationale is that responsibility for water systems properly lies with state and local governments. Federal contributions to wastewater SRFs originally were viewed as a temporary step on the way to full state and local financing. Moreover, those contributions may not increase total investment in water systems if they merely replace funding that state and local sources would have provided otherwise.

An argument against such cuts is that the need to replace aging infrastructure, improve the safety of the drinking water, and protect the nation's waters is so great that federal aid should be increased, not reduced. In particular, given the budgetary pressures on states, water systems in many small or economically disadvantaged communities could not maintain the quality of their service and

comply with the CWA's and the SDWA's new and forthcoming requirements without federal funding. Another argument against this option is that eliminating the federal grants would force even large systems, which tend to have lower costs because of economies of scale, to charge rates that would pose significant hardships for low- and moderate-income households.

RELATED CBO PUBLICATIONS: *Trends in Public Spending on Transportation and Water Infrastructure, 1956 to 2004*, August 2007; Letter to the Honorable Don Young and the Honorable James L. Oberstar regarding future spending on water infrastructure, January 31, 2003; and *Future Investment in Drinking Water and Wastewater Infrastructure*, November 2002

Discretionary Spending—Option 18 **Function 300**

Increase Fees for Use of the Inland Waterway System

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-109	-228	-355	-483	-494	-506	-518	-531	-544	-558	-1,669	-4,326
Outlays	-109	-228	-355	-483	-494	-506	-518	-531	-544	-558	-1,669	-4,326

Note: Fees collected under this option could be recorded in the budget as offsetting collections (discretionary), offsetting receipts (usually mandatory), or revenues, depending on the legislative language used for their establishment.

The Army Corps of Engineers spent about $900 million in 2010 on the nation's system of inland waterways. About 30 percent of those expenditures were devoted to the construction of new navigation channels, locks, and other infrastructure, and about 70 percent paid for the operation and maintenance of existing infrastructure. Current law allows up to half of the Corps' new construction on inland waterways to be funded with revenues from a tax on fuel consumed by towboats (which use most segments of the system); the remaining costs of construction and expenditures for operation and maintenance are financed through appropriations not tied to the revenue source.

This option would set fees high enough to cover all the costs of constructing, operating, and maintaining inland waterways. Those fees could take the form of higher fuel taxes, charges for the use of locks, or assessments based on the weight of transported goods and the distance those goods travel. If implemented, the option would boost collections (and thus reduce net spending) by $2 billion over five years and by $4 billion through 2021.

The principal rationale for this option is that it would increase economic efficiency. Imposing fees on the basis of the actual cost associated with keeping the inland waterway system open would encourage firms that arrange for goods to be shipped—producers or logistics specialists—to choose the most efficient routes and modes of transportation (which in some cases might involve transport by rail or highway or by another water route). In addition, more efficient use of existing waterways could alleviate congestion and perhaps curtail the demand for new construction. Any congestion that remained when fees covered costs would serve as a useful signal of market demand, giving the Corps better information about which additional construction projects would be likely to provide the greatest net benefits.

The effects of such fees on efficiency would depend largely on whether they were set at the same rate for all segments of a waterway or were based on each segment's operating costs. Because costs vary substantially from one segment to another, systemwide fees would offer weaker incentives for the efficient use of resources.

An argument against this option is that higher fees might slow economic development in some regions that depend on waterway commerce. Although the increase could be phased in to ameliorate those effects, doing so would reduce revenues in the near term. Imposing higher fees also would reduce the income of barge operators and shippers in some areas, although those losses would be small in the context of overall regional economies.

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

Discretionary Spending—Option 19 **Function 370**

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

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	-335	-343	-352	-362	-373	-385	-399	-412	-425	-438	-1,765	-3,824
Outlays	-285	-332	-347	-357	-367	-380	-393	-406	-419	-432	-1,688	-3,718

The Manufacturing and Services unit of the International Trade Administration (ITA) in the Department of Commerce strives to enhance the competitiveness of U.S. industries and to increase exports. ITA also operates the U.S. Commercial Service, which is the trade promotion arm of the agency. The service counsels domestic businesses on issues related to exports and engages in trade advocacy for U.S. companies. It charges fees for those services, but the fees do not cover the costs of all activities.

This option encompasses two alternatives: eliminating ITA's trade promotion activities or charging the beneficiaries for those services. Either change would save about $2 billion through 2016 and almost $4 billion over the 2012–2021 period.

The principal rationale for eliminating ITA's trade promotion activities is that such business activities are usually better left to the companies and industries that are likely to benefit rather than to a government agency. In addition, having the government engage in such activities (without charging the beneficiaries for their full cost) is an expensive means of helping U.S. businesses because the benefits are partially passed on to consumers and firms abroad in the form of lower prices for U.S. exports. Hence, the cost to taxpayers is likely to be larger than the benefit to U.S. businesses. Furthermore, in its 2008 evaluation using the Program Assessment Rating Tool, the Office of Management and Budget concluded that businesses can obtain services similar to those offered by ITA from state, local, and private-sector entities.

An argument against eliminating ITA's trade promotion activities is that they may be subject to some economies of scale, so having one entity (the federal government) counsel exporters about foreign legal and other requirements, disseminate information about foreign markets, and promote U.S. products abroad might make sense.

An alternative way to reduce net federal spending but continue ITA's activities would be to charge the beneficiaries for their full costs. Fully funding ITA's trade promotion activities through voluntary charges, however, could prove difficult. In many cases, it would be impossible to promote the products of selected businesses that were willing to pay for such promotion without also promoting the products of other companies in the same industry. In those circumstances, there would be little incentive for companies to purchase ITA's services because they would probably accrue benefits regardless of whether they paid for them. Consequently, if the federal government wanted to charge beneficiaries for ITA's services, it might have to require that all companies in an industry (or the industry's national trade group) decide collectively whether to buy the services. If an industry chose to purchase the services, all of the companies in the industry would be required to pay according to some equitable formula.

RELATED CBO PUBLICATIONS: *The Decline in the U.S. Current-Account Balance Since 1991,* Issue Brief, August 2004; and *Causes and Consequences of the Trade Deficit: An Overview,* March 2000

Discretionary Spending—Option 20 **Function 400**

Limit Highway Funding to Expected Highway Revenues

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	-9.3	-9.3	-9.4	-9.6	-9.9	-10.6	-11.4	-12.1	-12.9	-13.6	-47.5	-108.1
Outlays	-2.3	-6.2	-7.6	-8.1	-8.7	-9.2	-9.8	-10.6	-11.2	-11.9	-32.9	-85.6

Note: Outlays for the highway program are controlled by limitations on obligations set in appropriation acts rather than by contract authority (a mandatory form of budget authority) set in authorizing law. This option assumes that the contract authority is reduced to equal the obligation limitations presented here.

The Federal-Aid Highways Program provides grants to states for highway and other surface transportation projects. The last reauthorization for the highway program—the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (Public Law 109-59)—expired in 2009 and has been temporarily extended several times since then. Highway funding is provided as contract authority, a type of mandatory budget authority. However, most spending from the program is controlled by annual limitations on obligations set in appropriation acts.

Historically, most of the funding for highway programs has come from the Highway Trust Fund, which has two accounts. In 2010, the fund's highway account spent $32.0 billion and was credited with $30.2 billion in revenues. The fund also includes a mass transit account. Revenues credited to both accounts are generated by the federal taxes on gasoline and diesel fuels, as well as other federal taxes related to highway transportation. Since 2001, outlays from the highway account have been outpacing revenues credited to it by an average of about $2.8 billion per year. Because of that gap, the Congress has supplemented revenues dedicated to the trust fund with three separate transfers totaling $29.7 billion from the Treasury's general fund. In addition, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) appropriated $27.5 billion for highway programs from the general fund. About half of that amount—$14.2 billion—was spent in 2009 and 2010; the Congressional Budget Office estimates that the remaining amount will be spent over the next several years.

This option would reduce federal funding for the highway system, starting in fiscal year 2012, by lowering the obligation limitation for the Federal-Aid Highways Program to the amount of projected revenues going to the highway account of the Highway Trust Fund. The federal taxes that directly fund the Highway Trust Fund would not change. CBO estimates that this option would reduce resources provided for the highway program by almost $48 billion from 2012 through 2016 and by about $108 billion over 10 years. Outlays would decrease by about $33 billion over the 2012–2016 period and $86 billion over the 2012–2021 period, CBO estimates.

A key rationale for this option is that federal funding for highways should come from highway users, not general taxpayers: first, because it is fairer if those who benefit from government spending pay for those benefits; and second, because resources are allocated most efficiently when beneficiaries pay and will therefore consider those user costs when determining their behavior. In that view, if the Congress believes that higher levels of federal support for highways are appropriate, it should increase the taxes that are credited to the Highway Trust Fund.

Another rationale for this option is that shifting more responsibility for highway construction and maintenance costs to the states not only would give the states stronger incentives to focus on projects with the greatest net benefits but also could reduce the substitution of federal spending for spending by state and local governments. (The Government Accountability Office reported in 2004 that the existence of federal highway grants has encouraged state and local governments to reduce their own spending on highways and to allocate those funds for other uses.) Supporters of this option might also contend that the revenues credited to the highway account of the trust fund are sufficient to fund an appropriate share of all highway projects with true interstate significance—

and those are the projects that should be the primary responsibility of the federal government.

An argument against this option is that the government should spend more on roads and bridges to offset the effects of aging and increased traffic. Federal support for the road network as a whole is appropriate, moreover, because even local roads support interstate commerce and strengthen the national economy—for example, by allowing Internet retailers to operate with large economies of scale. Another argument against this option is that the use of general taxpayer funds to supplement trust fund revenues from highway users is appropriate because money from the Highway Trust Fund is spent on nonhighway projects and purposes, such as public transit, sidewalks, bike paths, recreational trails, scenic beautification, and preservation of historic transportation structures.

RELATED CBO PUBLICATIONS: *Spending and Funding for Highways,* Issue Brief, January 2011; *Using Pricing to Reduce Traffic Congestion,* March 2009; *Issues and Options in Infrastructure Investment,* May 2008; and Statement of Donald B. Marron, Acting Director, Congressional Budget Office, before the Subcommittee on Highways, Transit, and Pipelines, House Committee on Transportation and Infrastructure, *CBO's Projections of Revenues for the Highway Trust Fund,* April 4, 2006

Discretionary Spending—Option 21 **Function 400**

Eliminate Grants to Large and Medium-Sized Hub Airports

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	-1,070	-1,090	-1,100	-1,120	-1,140	-1,170	-1,190	-1,220	-1,240	-1,270	-5,520	-11,610
Outlays	-200	-660	-900	-1,020	-1,110	-1,140	-1,160	-1,180	-1,210	-1,230	-3,890	-9,810

Note: Outlays for the grants to large and medium-sized airports are controlled by limitations on obligations set in annual appropriation acts rather than by contract authority (a mandatory form of budget authority) set in authorizing law. This option assumes that the contract authority is reduced to equal the obligation limitations presented here.

Under the Airport Improvement Program (AIP), the Federal Aviation Administration (FAA) provides grants to airports to expand runways, improve safety and security, and make other capital investments. In 2010, about 30 percent of that money went to airports that are classified, on the basis of the number of passenger boardings, as large and medium-sized. Those airports—currently, there are 65, although the number fluctuates from year to year—account for nearly 90 percent of passenger boardings.

This option would eliminate the AIP's grants to large and medium-sized airports but would continue to provide grants to smaller airports in amounts that match funding in 2010. That year, smaller airports received $2.4 billion, more than two-thirds of the $3.5 billion available under the program. Retaining only that portion of the program would reduce federal outlays by about $4 billion through 2016 and by almost $10 billion over the 2012–2021 period.

The AIP, like some other transportation programs, is treated in an unusual way in the budget. The program's budget authority is provided in authorization acts as contract authority, a mandatory form of budget authority. But because the spending of contract authority is subject to obligation limitations contained in appropriation acts, the resulting outlays are categorized as discretionary.

The main rationale for this option is that federal grants simply substitute for funds that larger airports could raise from private sources. Because those airports serve many passengers, they generally have been able to finance investments through bond issues as well as passenger facility charges and other fees. Smaller airports may have more difficulty raising funds for capital improvements, although some have been successful in tapping the same sources of funding as their larger counterparts. By eliminating grants to larger airports, this option would focus federal spending on airports that appear to have the fewest alternative sources of funding.

One argument against ending federal grants to large and medium-sized airports is that those airports currently lack the flexibility to substitute private sources of funding for reduced federal grants because of provisions of federal law that limit the amount that airports can charge passengers to finance capital projects.

Another argument against ending such grants is that they allow the FAA to retain greater control over how those airports spend their funds by imposing conditions for aid.

RELATED CBO PUBLICATIONS: *Financing Small Commercial-Service Airports: Federal Policies and Options,* April 1999; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments,* June 1998

Discretionary Spending—Option 22 **Function 400**

Increase Fees for Aviation Security

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-1.9	-1.9	-2.0	-2.0	-2.1	-2.1	-2.1	-2.2	-2.2	-2.3	-9.9	-20.8
Outlays	-1.9	-1.9	-2.0	-2.0	-2.1	-2.1	-2.1	-2.2	-2.2	-2.3	-9.9	-20.8

Note: Fees collected under this option could be recorded in the budget as offsetting collections (discretionary), offsetting receipts (usually mandatory), or revenues, depending on the legislative language used for their establishment.

The attacks of September 11, 2001, led to sweeping changes to increase security in the nation's transportation systems. One major change occurred when the Aviation and Transportation Security Act of 2001 made the federal government, rather than airlines and airports, responsible for screening passengers, carry-on luggage, and checked baggage. Implementing the new standards required the hiring of screeners who were more highly qualified and trained, necessitating increased compensation and raising overall security costs.

To help pay for increased security, the law directed airlines to charge passengers a fee, remitted to the government, of $2.50 for a one-way trip with no stops and $5.00 for a trip with one or more stops. The 2001 law also authorized the government to impose fees on the airlines themselves and to reimburse airlines, airport operators, and service providers for the costs of security enhancements. In 2010, the Transportation Security Administration collected $2.1 billion from the fees on passengers and airlines—less than half of the $5.5 billion federal aviation security budget that year.

This option would increase fees to cover a greater portion of the federal government's costs for aviation security. Passengers would pay a flat fee of $5 per one-way trip because travelers typically pass through security screening only once per one-way trip. Implementing the option would boost collections (and thus reduce net spending) by about $10 billion through 2016 and by almost $21 billion over the 2012–2021 period. Under standard budgetary treatment, the collections would be classified as revenues, but because the Aviation and Transportation Security Act requires that revenues from the existing fees be recorded as offsets to federal spending, the budgetary impact of this option is presented that way.

The arguments for and against this option rest on the principle that the beneficiaries of a service should pay for it. The differences lie in who is seen as benefiting from such measures. A justification for the option is that the primary beneficiaries of transportation security enhancements are the users of the system. Security is viewed as a basic cost of airline transportation in the same way that fuel and labor costs are. The current situation, in which those costs are covered partly by taxpayers in general and partly by users of the aviation system, provides a subsidy to air transportation.

Conversely, an argument against higher fees is that the public in general—not just air travelers—benefits from improved airport security. To the extent that greater security reduces the risk of terrorist attacks, the entire population is better off. That reasoning suggests that the federal government should fund at least part of the enhanced transportation security measures without collecting additional funds directly from the airline industry or its customers.

Discretionary Spending—Option 23 **Function 400**

Eliminate Intercity Rail Subsidies

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-4.1	-4.2	-4.2	-4.3	-4.4	-4.5	-4.6	-4.7	-4.8	-4.9	-21.2	-44.7
Outlays	-1.6	-1.8	-2.0	-2.3	-2.8	-3.3	-3.6	-3.9	-4.2	-4.4	-10.5	-29.9

Including funds appropriated in the American Recovery and Reinvestment Act (ARRA, Public Law 111-5), the Congress appropriated more than $14 billion to subsidize intercity passenger rail services in 2009 and 2010. About $4 billion has been allocated for the National Railroad Passenger Corporation—or Amtrak—and about $10 billion is available both to Amtrak and to state and local governments to fund high-speed and intercity regional rail service. In 1970, when the Congress established Amtrak, it anticipated subsidizing the railroad only for a short time, until it became self-supporting. Over the past 40 years, however, the federal subsidy to Amtrak has amounted to approximately $40 billion cumulatively.

This option would eliminate federal subsidies not only for Amtrak but also for high-speed and other intercity rail service, yielding savings of $11 billion over the next 5 years and $30 billion over 10 years. (Not included in those estimates are potential savings that could be obtained by rescinding unobligated funds provided in ARRA. The savings would depend on the amount of funds still unobligated when the legislation was enacted, but could be on the order of $1 billion to $2 billion.)

An argument in favor of this option is that intercity passenger rail service should be provided only if it is a self-supporting commercial service. It is also argued that current federal spending represents just a small down payment on a much larger expenditure that would be necessary to build a large high-speed rail system—such as one that would meet the Administration's goal of making high-speed rail available to 80 percent of Americans—and that the total costs of the system would exceed its benefits, both of which are highly uncertain.

With respect to Amtrak, a rationale for this option is that eliminating its federal subsidy would encourage its managers to cut unprofitable services and routes and focus instead on those that are profitable and in high demand. One example of an unprofitable service that could be cut is sleeper-class service. The Inspector General of the Department of Transportation estimates that eliminating sleeper service would save Amtrak $75 million to $158 million annually, net of lost revenues from customers who would no longer travel by train if sleeper service was discontinued. Large savings could also accrue from eliminating unprofitable routes. According to Amtrak's Performance Tracking System, the five most unprofitable routes account for combined annual losses of roughly $260 million, although some of that amount represents allocated overhead costs that would continue to be incurred if the lines were eliminated.

An argument against eliminating support for intercity passenger rail is that the amount of such support needs to be analyzed in the context of the budgetary and social costs of travel by highways and air—namely, that highway and air travel are subsidized even though they involve higher safety risks and greater emissions of greenhouse gases. Also, eliminating federal support could require Amtrak to greatly reduce its route network. Some opponents of this option regard rail service as a public service that should be widely available. They maintain that passengers on lightly traveled routes have few transportation alternatives and that Amtrak is vital to the survival of small communities along those routes. Continuing federal support could help Amtrak and other passenger rail carriers improve service, attract more passengers, and make rail transportation more viable economically.

RELATED CBO PUBLICATIONS: *Effects of Gasoline Prices on Driving Behavior and Vehicle Markets*, January 2008; *The Past and Future of U.S. Passenger Rail Service*, September 2003; and *A Financial Analysis of H.R. 2329, the High-Speed Rail Investment Act of 2001*, September 2001

Discretionary Spending—Option 24 **Function 400**

Eliminate the Transit Starts Programs

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-2,020	-2,050	-2,090	-2,120	-2,160	-2,200	2,250	-2,290	-2,340	-2,380	-10,440	-21,900
Outlays	-240	-790	-1,210	-1,530	-1,800	-2,010	-2,130	-2,170	-2,210	-2,260	-5,570	-16,350

Under the New Starts program, the Department of Transportation funds the construction or expansion of rail and other fixed-guideway systems—mass transit systems that use exclusive or controlled rights of way. A related program, Small Starts, makes discretionary grants to public transportation capital projects that cost less than $250 million and require less than $75 million in federal funding. For 2010, the Congress appropriated a total of $2 billion for both programs, of which $200 million was designated for Small Starts.

This option would eliminate both the New Starts and the Small Starts programs. The Congressional Budget Office estimates that this option would save about $6 billion over 5 years and $16 billion over 10 years.

One rationale for ending the programs is that the federal government should not be funding rail transit systems because their benefits are primarily local. A second rationale is that if the federal government is to support local public transit, there is no reason to focus on new rail transit systems, which tend to provide less value per dollar spent than bus systems do. Bus systems require much less capital and offer more flexibility in the adjustment of schedules and routes to meet changing demands. Even without New Starts, state and local governments could use federal aid distributed by formula grants (noncompetitive awards based on a formula) for new rail projects if they determined, on the basis of local circumstances, that those projects would make the best use of the funds. In 2010, for example, the federal government provided $8.4 billion in formula funding for transit projects, of which about $4.1 billion was allocated in broad "urbanized area" grants for existing and new systems, and $1.6 billion was designated for the maintenance and improvement of existing fixed-guideway systems. The remaining $2.7 billion was distributed among a variety of smaller grant programs.

One argument against this option is that the New Starts program seeks to identify the most promising rail transit projects from a long list of candidates. Many supporters of rail transit systems contend that rail transit will become increasingly valuable as gasoline prices continue their long-term upward trend. They also assert that building new roads does not alleviate urban congestion or pollution but leads only to greater decentralization and sprawl. New rail transit systems, by contrast, could help channel future commercial and residential development into corridors where public transportation is available, offering people convenient, affordable, and reliable transportation.

RELATED CBO PUBLICATION: *Issues and Options in Infrastructure Investment*, May 2008

Discretionary Spending—Option 25 **Function 450**

Create State Revolving Funds to Finance Rural Water and Waste Disposal

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-7	-16	-25	-35	-45	-607	-620	-632	-645	-657	-128	-3,289
Outlays	-1	-4	-9	-16	-24	-88	-258	-407	-490	-558	-54	-1,855

The Department of Agriculture assists rural communities through a program that provides loans, loan guarantees, and grants for water and waste-disposal projects. It also offers grants for solid-waste management, emergency community water assistance, and technical assistance. For fiscal year 2010, $551 million was appropriated for the program to fund its grants and cover the cost of its loans and loan guarantees. (The cost of loans is defined under the Federal Credit Reform Act of 1990 as the present value of interest rate subsidies and expected defaults.)

The program's funds generally are allocated to each state on the basis of its rural population and the number of rural families with income below the poverty level. The Department of Agriculture distributes the funds allocated to each state on the basis of competitive proposals from eligible state and local agencies, recognized Native American tribes, and nonprofit organizations. The terms of assistance generally depend on the median household income in a grant recipient's area. Thus, the interest rates on direct loans for water and waste-disposal projects range from 60 percent to 100 percent of the market yields on municipal bonds covering similar numbers of years. Areas that are particularly needy may apply for grants or for combinations of grants and loans.

This option would reduce federal spending by providing an initial infusion of capital for state revolving funds devoted to rural water and waste disposal and then ending federal assistance. The revolving funds would be modeled on those established under amendments to the Clean Water Act in 1987 and under amendments to the Safe Drinking Water Act in 1996. The federal savings would depend on the amount and timing of the contributions to the revolving funds. Specifically, under this option, the federal government would provide $550 million annually for five years and then end assistance beginning in 2017. The option would save $54 million over five years and about $2 billion through 2021. (The details of the option are illustrative; the same basic approach could be implemented with different capitalization amounts or periods, yielding different savings.) The capitalization of the state revolving funds would not by itself allow states to offer the same amount of assistance currently provided by the federal grants and loans, but the Congress could allow the revolving funds to use their capital as collateral to leverage private-sector financing.

The rationale for this option is that the federal government should not bear indefinite responsibility for local development; programs that benefit communities, whether urban or rural, should be funded by state or local governments. The rationale for the specific approach in this option is that it is reasonable to provide funding for a few years to capitalize revolving funds before they become self-sustaining.

One argument against this option is that states might change their aid formulas (substituting loans for grants or high-interest loans for low-interest loans) to avoid depleting the funds and to recoup the costs of leveraged financing. That action could price the aid out of reach of needier communities.

Discretionary Spending—Option 26 **Function 450**

Drop Wealthier Communities from the Community Development Block Grant Program

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Spending												
Budget authority	-565	-574	-583	-593	-603	-616	-628	-641	-654	-666	-2,918	-6,123
Outlays	-5	-150	-445	-550	-570	-585	-600	-615	-625	-640	-1,720	-4,785

The Community Development Block Grant (CDBG) program provides annual grants to communities to aid low- and moderate-income households, eliminate municipal blight, meet emergency needs, rehabilitate housing, improve infrastructure, and promote economic development. Under one component of the program, which is administered by the Department of Housing and Urban Development (HUD), grants go directly to cities and urban counties, referred to as entitlement communities. (Other CDBG funds are allocated to states, which typically distribute them through a competitive process to smaller, more rural communities known as nonentitlement areas.) Funds from the entitlement component also may be used to repay bonds issued by local governments and guaranteed by the federal government under the Section 108 Loan Guarantee Program (established along with the CDBG program by the Housing and Community Development Act of 1974). For 2010, $4.0 billion was appropriated for the CDBG program, of which $2.8 billion was designated for entitlement communities.

Under current law, the CDBG entitlement program is open to all urban counties, principal cities of metropolitan areas, and cities with a population of at least 50,000. The program allocates funds according to a formula based on a community's population, the number of residents in poverty, the number of housing units with more than one person per room, the number of housing units built before 1940, and the extent to which population growth since 1960 is below the average for all metropolitan cities. The formula does not require a certain community poverty rate, nor does it exclude communities with high average income. In an analysis conducted in 2003, HUD showed that when population data and other information were updated using results from the 2000 census, funding provided on the basis of the formula shifted from poorer to wealthier communities, as measured by average poverty rates.

This option would reduce funding for CDBG entitlement grants and direct the remaining funding to needier communities. The option could be implemented in a variety of ways, but one approach would be to exclude communities with per capita income that exceeded the national average by more than a specified percentage—for example, the communities with per capita income greater than 105 percent of the national average, which accounted for 23.4 percent of the entitlement funds in 2010. The option presented here illustrates the general approach without specifying a particular form of implementation: It would cut funding for the entitlement grants by 20 percent, saving about $2 billion over 5 years and about $5 billion over 10 years.

One argument in favor of this option, or of a more substantial reduction, is that it is not appropriate to use federal funds for local development. An alternative argument is that even if the program is viewed as meeting national needs that some local governments cannot address adequately, that rationale does not justify redirecting money to wealthier communities.

The main argument against this option is that dropping wealthier communities from the CDBG program could reduce efforts to aid low-income households within those communities unless local governments reallocated their own funds to offset the lost grants.

Discretionary Spending—Option 27 **Function 500**

Eliminate Certain Grant Programs for Elementary and Secondary Education

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-1,600	-1,600	-1,600	-1,600	-1,700	-1,700	-1,700	-1,800	-1,800	-1,800	-8,100	-16,900
Outlays	-30	-900	-1,400	-1,600	-1,600	-1,700	-1,700	-1,700	-1,800	-1,800	-5,530	-14,230

The Department of Education distributes funding for more than 50 discretionary grant programs to state and local educational agencies. Eleven of those programs address the physical, emotional, and social well-being of students both inside and outside the school environment. Those grants are allocated to state and local educational agencies on the basis of a formula or are competitively awarded to local educational agencies and nonprofit entities. Funding for those grant programs totaled $1.5 billion in 2010. The largest grant program in this group is the 21st Century Community Learning Centers program, which accounted for $1.2 billion of the $1.5 billion in funding in 2010. That program awards grants to states according to a formula based on the number of poor students in the state. States then award competitive grants to local educational agencies or community-based organizations to establish or expand centers that offer educational services and opportunities outside normal classroom hours.

This option would eliminate those 11 grant programs. The Congressional Budget Office estimates that doing so would reduce federal outlays by about $6 billion through 2016 and by $14 billion through 2021.

An argument in favor of this option is that an evaluation of the 21st Century Community Learning Centers program found that those centers were not attaining their stated goals. That evaluation, funded by the Department of Education, concluded that programs funded by those grants had no significant impact on the academic achievement, parental involvement, or homework completion of participating students relative to similar students not participating in the program.[1] More broadly, some people argue that educating children is primarily a responsibility of state and local governments, that the federal government's involvement should be minimal, and that grant programs such as the ones this option would eliminate go beyond an appropriate role for the federal government.

An argument against this option is that federal funding is necessary to augment state and local efforts to educate children growing up in poor families; for those families, federal resources help compensate for a lack of resources in their home environment. Opponents of this option may also point to research that has shown that increasing the social, physical, and emotional health of students helps them become higher achievers. Particularly relevant to the 21st Century Community Learning Centers program is a body of research (compiled by the Harvard Family Research Project) that found that children who participate in well-implemented, high-quality after-school programs make larger cognitive gains while they are enrolled and exhibit better educational outcomes after leaving the program than do children who receive no such intervention.[2]

1. Susanne James-Burdumy and others, *When Schools Stay Open Late: The National Evaluation of the 21st Century Community Learning Centers Program: Final Report* (report submitted by Mathematica Policy Research, Inc., to the Department of Education, Institute of Education Sciences, April 2005).

2. Heather B. Weiss and others, *The Federal Role in Out-of-School Learning: After-School, Summer Learning, and Family Involvement as Critical Learning Supports* (research review paper submitted by the Harvard Family Research Project to the Center on Education Policy project, Rethinking the Federal Role in Elementary and Secondary Education, February 2009).

Discretionary Spending—Option 28 **Function 500**

Restrict Pell Grants to the Neediest Students

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Discretionary Spending												
Budget authority	-400	-400	-500	-700	-700	-800	-900	-1,000	-1,000	-1,100	-2,700	-7,500
Outlays	-100	-400	-500	-600	-700	-800	-900	-900	-1,000	-1,000	-2,300	-6,900
Change in Mandatory Outlays	-40	-200	-200	-300	-400	-600	-700	-800	-900	-1,000	-1,140	-5,140

The Pell Grant program is the single largest source of federal grant aid to low-income students for postsecondary undergraduate education. For the 2010–2011 academic year, the program is estimated to provide almost $37 billion in aid to about 8.9 million students. A student's Pell Grant eligibility is chiefly determined on the basis of Expected Family Contribution (EFC), a federal calculation of his or her family's ability to pay for postsecondary education. The EFC is based on factors such as the student's income and assets and, for dependent students (in general, unmarried undergraduate students under the age of 24), the parents' income and assets, as well as the number of other dependent children in the family attending postsecondary schools. Generally, families with high EFCs have less financial need than those with low EFCs and are able to contribute more to their child's education.

Since 2008, funding for the Pell Grant program has had both a discretionary and a mandatory component. Mandatory funding supports automatic increases to the maximum award set in each fiscal year's appropriation act. The automatic increase for the 2010–2011 award year is $690, which, when added to the maximum award of $4,860 set in the appropriation act, results in a total maximum award of $5,550.

Under current law, students with an EFC exceeding 95 percent of the total maximum Pell grant award ($5,273 for academic year 2010–2011) are ineligible for a grant. This option would make students with an EFC exceeding $2,500 ineligible for a Pell grant. Assuming that, under current law, the maximum discretionary award level specified in appropriation acts would remain at $4,860 in future years, the Congressional Budget Office estimates that this option would yield discretionary savings of $2 billion through 2016 and $7 billion through 2021, along with accompanying mandatory savings of about $1 billion through 2016 and $5 billion through 2021.

A rationale in favor of this option is that it would focus federal aid on those students with the greatest need. Furthermore, students who lose eligibility under the option would probably still be able to afford a public two-year college according to federal needs analysis. Tuition and fees at public two-year colleges for the 2008–2009 academic year averaged about $2,140, which is still below the EFC of students who would lose eligibility under this option. Those students may also be eligible for $3,500 or more in federal student loans that are interest-free while students are enrolled.

An argument against the option is that among Pell grant recipients with an EFC above $2,500, significant educational expenses are not covered by their EFC or by federal, state, institutional, or other aid. For example, 70 percent of those students had expenses that were not covered by those sources. Denying Pell grants to those students would further increase the financial burden of obtaining an undergraduate education and might cause some to choose less postsecondary education or to forgo it altogether. The amount of postsecondary education received is an important determinant of future wages. In 2009, for example, the median wage for men ages 16 to 64 with bachelor's degrees was 72 percent more than the median wage for men with only high school diplomas or GEDs.

RELATED OPTIONS: Mandatory Spending, Options 10 and 11; and Revenues, Option 15

RELATED CBO PUBLICATIONS: *Changes in the Distribution of Workers' Hourly Wages Between 1979 and 2009*, February 2011; and *Costs and Policy Options for Federal Student Loan Programs,* March 2010

Discretionary Spending—Option 29 **Function 500**

Eliminate Funding for National Community Service Programs

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-1,150	-1,160	-1,180	-1,180	-1,180	-1,200	-1,230	-1,250	-1,280	-1,310	-5,850	-12,120
Outlays	-270	-780	-940	-1,020	-1,050	-1,090	-1,130	-1,160	-1,180	-1,320	-4,060	-9,940

National community service programs provide financial assistance to students and other volunteers who aid their communities in the areas of education, public safety, the environment, and health care, among others. In fiscal year 2010, appropriations for national service programs totaled about $1.1 billion, which supported the following initiatives: the AmeriCorps Grants Program, the AmeriCorps National Civilian Community Corps (NCCC) program, the AmeriCorps Volunteers in Service to America (VISTA) program, Learn and Serve America, the National Senior Service Corps, and the National Service Trust. In addition, AmeriCorps receives supplemental funding from state and local governments and from private sources for service projects that, in many cases, build on existing federal, state, and local programs. Participants in the AmeriCorps Grants Program, NCCC, and VISTA may receive an educational allowance, a stipend for living expenses, and access to health insurance and child care subsidies. Learn and Serve America participants generally do not receive such stipends or awards.

This option would eliminate federal funding for national service programs, reducing outlays by $4 billion through 2016 and by $10 billion over the coming 10 years. (Those estimates account for the administrative costs associated with terminating the programs.)

An argument in favor of this option is that funding community service programs by local governments might be more efficient than funding them at the federal level because the benefits of community service accrue locally rather than nationally. From that standpoint, decisions about such programs—the types of service projects to undertake and the amount of funding to provide, for instance—would be made more efficiently by the community that receives the benefits. Another rationale for eliminating student-focused national service programs is that a goal of federal aid to students is to provide low-income people with access to postsecondary education. Because participation in those programs is not based on family income or assets, funds do not necessarily go to the poorest students.

An argument against implementing this option is that the programs provide opportunities for participants of all socioeconomic backgrounds to engage in public service. In addition, relative to other approaches, the programs may offer a cost-effective way of providing community services because of the low budgetary cost per hour of service provided.

RELATED OPTION: Discretionary Spending, Option 30

Discretionary Spending—Option 30 **Function 500**

Eliminate the Senior Community Service Employment Program

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-834	-847	-861	-876	-891	-909	-928	-946	-965	-984	-4,309	-9,041
Outlays	-142	-811	-841	-859	-874	-889	-907	-926	-944	-963	-3,527	-8,156

The Senior Community Service Employment Program (SCSEP) funds part-time jobs for low-income people age 55 or older who have poor prospects for other employment. Participation in the program in 2010 was limited to people whose annual income was below 125 percent of the federal poverty level (for someone living alone, $13,500). SCSEP grants are competitively awarded to nonprofit organizations and state agencies that hire SCSEP participants to work in part-time community service jobs. In 2010, $825 million was appropriated for the program. That appropriation included $225 million to fund a one-time expansion for the 2009–2010 and 2010–2011 program years ($66 million and $159 million, respectively).

Participants in the program are paid the federal or state minimum wage or the prevailing local wage for similar employment, whichever is higher. They are offered annual physical examinations as well as training, counseling, and assistance with moving into unsubsidized jobs when they complete their projects. The Department of Labor estimates that SCSEP had about 99,000 participants in 2009 working in schools, hospitals, and senior citizens' centers and on beautification and conservation projects.

This option would eliminate the SCSEP, reducing federal outlays by about $4 billion through 2016 and by about $8 billion over the 2012–2021 period.

An argument in support of this option is that the cost of subsidizing program participants' wages and the other benefits they receive for their services could be borne by the organizations that gain from their work; under current law, those organizations usually bear just 10 percent of such costs. Shifting the full cost of the services to the organizations would increase the likelihood that only the most highly valued services would be provided.

An argument against this option is that eliminating SCSEP, which is a major federal jobs program for low-income older workers, could cause serious hardship for some people. Although, in general, older workers are less likely than younger workers to be unemployed, if they are without a job it can take longer for them to find work, particularly during periods of high unemployment.

RELATED OPTION: Discretionary Spending, Option 29

Discretionary Spending—Option 31 **Function 500**

Reduce Funding for the Arts and Humanities

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-477	-487	-498	-509	-521	-536	-550	-565	-580	-595	-2,492	-5,318
Outlays	-349	-439	-478	-497	-510	-524	-538	-553	-568	-583	-2,273	-5,039

In 2010, combined federal funding for several arts and humanities programs that received federal subsidies was just over $1.8 billion. Recipients of the subsidies included the Smithsonian Institution ($761 million), the Corporation for Public Broadcasting ($506 million), the National Endowment for the Humanities ($168 million), the National Endowment for the Arts ($168 million), the National Gallery of Art ($167 million), and the John F. Kennedy Center for the Performing Arts ($40 million).

This option would cut support for those programs by 25 percent and hold future appropriations constant at those nominal amounts. Federal outlays would be reduced by about $2 billion between 2012 and 2016 and by $5 billion over the 2012–2021 period.

One argument in favor of this option is that such programs may not provide social benefits that equal or exceed their costs. Another argument is that certain practices—such as charging admission at museums—could be more widely used to help mitigate the effects of a reduction in federal funding and that funding could be obtained from other sources.

An argument against such a policy change is that a decline in federal support would reduce activities that preserve and advance the nation's culture and that introduce the arts and humanities to people who might not otherwise have access to them. The effect on the arts and humanities nationwide would depend in large part on the extent to which other sources of funding—such as state and local governments, individual or corporate donors, and foundations—boosted their contributions. But alternative sources might not fully offset a drop in federal funding; most state and local governments, for example, are themselves facing tight budgetary constraints. Subsidized projects and organizations in rural or low-income areas might find it especially difficult to garner increased private backing or sponsorship.

Discretionary Spending—Option 32 **Function 550**

Finance the Food Safety and Inspection Service Through Fees

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-1.0	-1.0	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3	-1.3	-1.3	-5.3	-11.6
Outlays	-1.0	-1.0	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3	-1.3	-1.3	-5.3	-11.6

Note: Fees collected under this option could be recorded in the budget as offsetting collections (discretionary), offsetting receipts (usually mandatory), or revenues, depending on the specific legislative language used for their establishment.

The Food Safety and Inspection Service (FSIS), an agency within the Department of Agriculture (USDA), provides mandatory and continuous inspection services involving meat, poultry, and processed egg products. The scope of those services is explicitly defined by the statutes that give FSIS its inspection authority. Meat inspection is restricted to species defined as amenable species, such as cattle, sheep, and swine; catfish were added to that list in the 2008 farm bill (Public Law 110-246). Poultry and processed egg products subject to inspection are also explicitly specified. In addition, FSIS runs a voluntary inspection service for animals not listed in the statutes for producers who wish to sell their products in interstate commerce. Those services are provided on a fee-for-service basis and are paid by the producers.

FSIS employs about 8,000 full-time in-plant inspectors and other front-line inspectors who are responsible for the mandatory inspection of the nation's commercial supply of meat, poultry, and processed egg products. Meat and poultry are inspected before they enter or exit the slaughterhouse and before they are transferred to a processing facility. Egg processing plants are subject to continuous inspection whenever the plant is in operation. Inspectors are also responsible for monitoring adherence to regulations that govern areas such as sanitary conditions, recordkeeping, packaging, and ingredient lists. The majority of those services are funded through annual appropriations, with the exception of the voluntary inspection services noted above and inspections performed during holidays or overtime shifts, which are funded by user fees. In 2010, FSIS appropriations totaled approximately $1 billion.

This option would finance all mandatory federal inspections of meat, poultry, and processed egg products with fees paid by the processing facilities. The Congressional Budget Office estimates that this option would increase collections by about $5 billion over 5 years and by $12 billion over 10 years.

An argument in favor of this option is that users of government services should pay for them. Federal inspections benefit producers and consumers of meat, poultry, and egg products because they prevent diseased animals and adulterated egg products from being sold for human consumption.[1] The meat and poultry industries also benefit in other ways. For example, they can advertise that their products have passed USDA inspection, which some consumers consider to be an important affirmation of the safety of the products they purchase.

An argument against this option is that the federal government should protect the public at large through inspections that ensure the safety of the nation's food supply; it should therefore be the responsibility of the taxpayers to pay for those inspections. Another argument against this option is that the fees imposed on food producers would probably be passed along to consumers in the form of higher prices for meat, poultry, and egg products.

1. Under federal laws that govern inspection of the nation's food supply, the term "adulterated" applies to meat, poultry, and egg products that are found to contain poisonous substances, pesticides, or chemicals, for example, or are determined to have been prepared under unsanitary conditions.

RELATED OPTION: Discretionary Spending, Option 38

Discretionary Spending—Option 33 **Function 550**

Reduce or Constrain Funding for the National Institutes of Health

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Restrict Funding Growth to 1 Percent												
Change in Spending												
Budget authority	-60	-280	-370	-620	-940	-1,340	-1,780	-2,200	-2,630	-3,060	-2,270	-13,280
Outlays	-20	-110	-260	-400	-640	-960	-1,350	-1,770	-2,190	-2,610	-1,430	-10,310
Reduce 2012 Funding Level and Allow Growth at Rate of Inflation												
Change in Spending												
Budget authority	-3,930	-4,000	-4,050	-4,120	-4,200	-4,300	-4,390	-4,490	-4,590	-4,680	-20,300	-42,750
Outlays	-1,020	-3,160	-3,800	-3,980	-4,080	-4,170	-4,260	-4,350	-4,450	-4,540	-16,040	-37,810

The budget of the National Institutes of Health (NIH) has grown significantly over the past 15 years, primarily because of the large increases in NIH's appropriations (or budget authority) during the 1998–2003 period, when funding nearly doubled. In addition, NIH received $10 billion in supplemental funding provided in the American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5). In 2010, over half of all nondefense discretionary spending for health research and development went to NIH.

This option presents two alternatives that would reduce NIH's appropriations relative to the amounts in the baseline budget projections of the Congressional Budget Office. One alternative would restrict the rate of growth in appropriations to 1 percent per year. That alternative would reduce projected appropriations by about $2 billion over 5 years and by about $13 billion over 10 years, thereby reducing federal outlays by about $1 billion and about $10 billion, respectively. The other alternative would reduce NIH's fiscal year 2012 appropriation to the amount provided in 2003, the last year in which NIH had a large increase in its appropriation; after that, funding would grow at the rate of inflation assumed in CBO's baseline projections. Such a one-time cut of about 13 percent would reduce projected appropriations by about $20 billion over 5 years and about $43 billion over 10 years, thus cutting federal outlays by about $16 billion and $38 billion, respectively.

An argument in support of this option is that such reductions would encourage increased efficiencies throughout NIH and more careful focus on priorities that will provide the greatest benefits. NIH has 27 institutes and centers that fund research across a wide array of health-related topics. In addition, it supports more than 300,000 scientists and research personnel affiliated with more than 3,100 organizations worldwide. Furthermore, spending by NIH nearly tripled from 1997 to 2010. With such a broad range of personnel and activities and a large increase in funding, inefficiencies and duplicative or wasteful efforts are likely. In a 2009 report (GAO-09-687), the Government Accountability Office "found gaps in NIH's ability to monitor key aspects of its extramural funding process." Thus, some costs could probably be reduced or eliminated without harming high-priority research.

An argument against this option is that more than 80 percent of NIH's funding supports extramural research activities (research that is not conducted by NIH staff or on the main NIH campus) that are critical to improving the nation's health care, which accounts for a large and growing share of the economy. Reducing NIH's funding would probably result in decreased support for extramural research. Because NIH is a major source of funding for academic biomedical research, deep cuts to its budget could disrupt funding for programs already under way. Furthermore, while having more focused priorities is beneficial, it is difficult to know in advance which projects will yield the most useful results. As a result, large cuts to the NIH budget could discourage innovation in agency-supported medical technologies that have the potential to improve people's health.

Discretionary Spending—Option 34 **Function 600**

Increase Payments by Tenants in Federally Assisted Housing

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-580	-1,180	-1,810	-2,470	-3,170	-3,260	-3,350	-3,450	-3,540	-3,630	-9,210	-26,440
Outlays	-420	-1,020	-1,640	-2,290	-2,980	-3,230	-3,320	-3,420	-3,510	-3,610	-8,350	-25,440

Most low-income tenants who qualify for federal rental assistance receive aid through the Housing Choice Voucher Program (sometimes called Section 8), the Public Housing Program, or project-based assistance programs (which designate privately owned, government-subsidized units for low-income tenants). Funded by the Department of Housing and Urban Development (HUD), those programs usually require that tenants pay 30 percent of their gross monthly household income (after certain adjustments) for rent; the federal government subsidizes the difference between that amount and the maximum allowable rent. In 2010, the Congressional Budget Office estimates, the average combined federal expenditure for all of HUD's rental housing assistance programs was roughly $7,500 per household. That amount includes the housing subsidies and fees paid to the agencies that administer the programs.

This option would gradually increase tenants' rental contributions from 30 percent of adjusted gross family income to 35 percent over the 2012–2016 period. Provided that federal appropriations were reduced accordingly, those higher rent contributions would reduce outlays by a total of about $8 billion over 5 years: about $4 billion for the Housing Choice Voucher Program, almost $2 billion for the Public Housing Program, and about $2 billion for project-based assistance programs. Savings would total about $25 billion over 10 years.

An argument in support of this option is that, on average, renters not currently receiving vouchers or rent subsidies—"unassisted" renters—whose income is comparable with that of assisted renters spend roughly 40 percent of their income on rent. Even if the contribution requirement for subsidized renters increased to 35 percent of family income, that contribution would still be below the amount that unassisted renters currently spend on rent. Furthermore, households that received assistance would continue to benefit from paying a fixed percentage of their income toward housing, whereas unassisted renters with similar family income could confront increases in housing costs relative to their income.

An argument against implementing this option is that housing costs for most renters who currently receive assistance would rise, and even a modest increase in rent could be difficult to manage for households with very low income. In addition, by increasing the proportion of income that tenants are required to pay in rent, the option would reduce some participants' incentive to increase their income by working more.

Discretionary Spending—Option 35 **Function 700**

End Enrollment in VA Medical Care for Veterans in Priority Groups 7 and 8

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Discretionary Spending												
Budget authority	-5.6	-5.9	-5.9	-6.1	-6.2	-6.4	-6.6	-6.8	-7.0	-7.2	-29.7	-63.7
Outlays	-5.0	-5.8	-5.9	-6.0	-6.2	-6.3	-6.5	-6.7	-6.9	-7.1	-28.9	-62.4
Change in Mandatory Outlays	2.8	3.0	3.1	3.2	3.3	3.4	3.5	3.7	3.8	3.9	15.4	33.7

Note: Discretionary savings accrue to the Department of Veterans Affairs; increases in mandatory outlays are projected for the Medicare and Medicaid programs and for federal subsidies to participate in health insurance exchanges.

Veterans who seek medical care from the Department of Veterans Affairs (VA) are enrolled in one of eight priority-care groups that are defined on the basis of income, disability status, and other factors. Veterans in priority group 8 do not have service-connected disabilities, and their annual income or net worth exceeds both VA's means-testing thresholds and VA's geographic income thresholds, which are updated annually. Veterans enrolled in priority group 7 have no service-connected disabilities, and their income is above the VA's means-testing threshold but below the VA's geographic index. About 2.3 million veterans who are currently enrolled in the VA health care system have been assigned to priority groups 7 and 8; not all of those veterans seek medical care from VA in any given year.

Although veterans in those groups pay no annual enrollment fees, they make copayments for their care; if they have private health insurance, VA bills those insurance plans for reimbursement. Copayments and private-plan billings cover about 18 percent of the cost of those veterans' care. In 2009, VA incurred $4.4 billion in net costs for those patients, or about 11 percent of the department's total appropriations for medical care (excluding the medical care collections fund, in which amounts collected or recovered from first- or third-party payers are deposited and used for medical services for veterans). When the priority system was established in law in 1996, the Secretary of the Department of Veterans Affairs was given the authority to decide which priority groups VA could serve each year. By 2003, VA could no longer adequately serve all enrollees, prompting the department to cut off new enrollment of veterans in priority group 8. Veterans who were already enrolled were allowed to remain in the program. VA eased that restriction in 2009 to allow some additional enrollment of priority group 8 veterans.

This option would close enrollment for priority groups 7 and 8 and cancel the enrollment of all veterans currently in those two groups. Such action would curtail VA's health care spending for veterans who do not have service-related medical needs and who are not poor. To be eligible for VA medical services under this option, a veteran would have to qualify for a higher priority group by demonstrating a service-connected disability, by documenting income and assets that were below the means-testing thresholds, or by qualifying under other criteria (such as exposure to Agent Orange, status as a Purple Heart recipient or a former prisoner of war, eligibility for Medicaid, or catastrophic non-service-connected disability).

Disenrolling all priority groups 7 and 8 veterans would reduce discretionary outlays on net by almost $30 billion between 2012 and 2016 and by about $62 billion between 2012 and 2021. Those estimates reflect the assumption that appropriations would be reduced accordingly. However, because this option would result in greater use of other government health care programs, implementing the option would increase mandatory spending for Medicare and Medicaid and for federal subsidies provided through health insurance exchanges by about $15 billion between 2012 and 2016 and by $34 billion between 2012 and 2021.

An advantage of this option is that it would refocus VA's attention and services on its traditional group of patients—those with the greatest needs or fewest financial resources. Higher-income veterans without service-connected disabilities gained access to the VA system only in the mid-1990s, when the federal budget was under less

strain and experiencing less demand for services by higher-priority veterans. In 2007, 90 percent of enrollees in priority groups 7 and 8 had other health care coverage, most notably Medicare and private health insurance. As a result, the vast majority of the veterans who would lose VA coverage under this option would have continued access to other sources of coverage, and veterans without other health insurance options could be eligible to obtain coverage through health insurance exchanges in future years.

A disadvantage of the option is that veterans enrolled in priority groups 7 and 8 who have come to rely on VA for at least part of their medical care might find their health care disrupted by the change in enrollment rules. Some of those veterans—particularly those whose income was just above the income thresholds—might have difficulty identifying other sources of care. In addition, because of the relatively low out-of-pocket cost to veterans for VA health care, veterans switching to alternative sources of care might pay more than they would have paid at VA.

RELATED CBO PUBLICATIONS: *Potential Costs of Veterans' Health Care*, October 2010; Statement of Allison Percy, Analyst, Congressional Budget Office, before the Subcommittee on Military Construction, Veterans Affairs, and Related Agencies, House Committee on Appropriations, *Future Medical Spending by the Department of Veterans Affairs*, February 15, 2007; and "Potential Growth Plans for Medical Spending by the Department of Veterans Affairs," attachment to a letter to the Honorable Larry E. Craig, July 14, 2006

Discretionary Spending—Option 36 **Function 750**

Reduce Funding for Certain Department of Justice Grants

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	-834	-847	-861	-876	-891	-909	-928	-946	-965	-985	-4,309	-9,042
Outlays	-154	-401	-589	-738	-865	-880	-896	-914	-932	-951	-2,747	-7,320

The Department of Justice (DOJ) carries out law enforcement activities directly, but it also has five grant programs that assist nonprofit community organizations and state and local law enforcement agencies, each of which is funded in a separate account in the federal budget. The programs are as follows: State and Local Law Enforcement Assistance, Justice Assistance, Juvenile Justice, Community Oriented Policing Services (COPS), and Violence Against Women.

Funding for those programs totaled about $2.5 billion annually over the 2006–2008 period; nearly $7 billion in 2009, including $4.0 billion provided in the American Recovery and Reinvestment Act of 2009 (Public Law 111-5); and $3.3 billion in 2010. In its baseline projection, the Congressional Budget Office estimates that spending will be $4.2 billion in 2011 if full-year funding is equal to the appropriation for the first several months annualized. This option would reduce financial assistance from the five grant programs by 25 percent relative to CBO's baseline projection for the next 5 years, reducing spending by almost $3 billion between 2012 and 2016 and by about $7 billion over 10 years.

Grant recipients currently use these funds for an array of activities, including the purchase of body armor and other equipment for law enforcement officers and the improvement of DNA analysis and other forensic activities conducted by state and local police agencies. Other supported activities include substance abuse treatment programs for prisoners; funding for Boys and Girls Clubs; research, development, and evaluation of state justice programs; and the collection and analysis of statistics and information on the judiciary. For some grants, recipients must contribute funds toward the total cost of the program. Under this option, those activities would be scaled back or funded in other ways.

An argument in favor of the option is that the five grant programs address law enforcement issues that are primarily local, and therefore funding at the local level would lead to a more efficient allocation of resources. Another argument is that resources provided by these programs in the past may have been used inefficiently and that future financial assistance could be scaled back substantially with few consequences for the nation's law enforcement capabilities. For example, the Government Accountability Office has reported that grants awarded through the COPS program made only a modest contribution to declines in crime in the 1990s.

An argument against the option is that given the financial constraints facing state and local governments, it would be difficult for them to compensate for the loss of federal funds. The problems the grant programs address have national elements, and state and local governments might neglect such problems because of the scarcity of resources. Therefore, some people argue, such federal assistance helps make many communities safer.

Discretionary Spending—Option 37 **Multiple Functions**

Reduce the Across-the-Board Adjustment for Federal Civilian Employees' Pay

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Budget authority	0	-780	-1,840	-2,960	-4,130	-5,370	-6,690	-8,110	-9,620	-11,210	-9,710	-50,710
Outlays	0	-740	-1,800	-2,920	-4,090	-5,320	-6,640	-8,050	-9,560	-11,140	-9,550	-50,260

Under the Federal Employees Pay Comparability Act of 1990 (FEPCA), most federal civilian employees receive an annual adjustment to their pay each January. As specified by that law, the size of the adjustment is set at the annual rate of increase of the employment cost index (ECI) for wages and salaries minus one-half of a percentage point.[1] The across-the-board increase as spelled out under FEPCA, however, does not always occur. For example, the President can limit the size of the increase if he determines that a national emergency exists or that serious economic conditions call for such action. (Similarly, the Congress can authorize an adjustment that differs from the one sought by the President.) Legislation forgoing across-the-board adjustments for 2011 and 2012 was recently enacted in the Continuing Appropriations and Surface Transportation Extensions Act, 2011 (Public Law 111-322).

Under this option, the annual across-the-board adjustment that would be expected to occur under FEPCA would be reduced by 0.5 percentage points each year from 2013 through 2021. Under such a scenario, federal civilian salaries (as well as benefits directly tied to salaries) would not be affected in 2011 and 2012 because the annual pay adjustment has already been canceled for those years. Assuming that appropriations were reduced by a commensurate amount, federal outlays would be reduced by almost $10 billion over 5 years and by $50 billion over 10 years.

One rationale for this option is that compensation costs for federal civilian employees make up roughly 15 percent of federal discretionary spending, and therefore any significant reduction in that category of spending would require that personnel costs be constrained. In addition, it would signal that the federal government and its workers were sharing in the sacrifices that many beneficiaries of federal programs may be asked to make in the name of deficit reduction. Similarly, it would demonstrate that federal workers have not been shielded from the impacts of the economic downturn, which has resulted in large numbers of workers in the private sector either losing their job or having their wages remain flat or decline.

An argument against this option is that it would make it more difficult for the federal government to recruit qualified employees. That effect might be pronounced for federal agencies that require workers with advanced degrees and professional skills. Recent research suggests that although federal workers with less education are paid more than private-sector workers with comparable characteristics, federal workers with professional and advanced degrees are paid less than comparable workers in the private sector. Thus, lower across-the-board increases in federal pay might bring federal and private pay closer to parity for less educated workers but at the same time widen the gap between federal employees and private-sector employees working in jobs that require high levels of education. For federal employees who are eligible to retire but have not done so, such action could also reduce their incentive to continue working. If a significant number of those workers decided to retire as a result of smaller increases in pay, increased retirement costs could offset some of the payroll savings produced by the policy change.

1. The law specifies that the increase should be calculated by measuring the annual growth in the ECI in the third quarter that ended 15 months earlier. For example, in 2010 the law set the adjustment at the rate of increase between the ECI in the third quarter of 2007 and the third quarter of 2008, minus 0.5 percentage points. The law also sought to reduce the disparity between the salaries of federal workers and private-sector workers in similar occupations and locations by granting locality adjustments designed to reduce the gap to no more than 5 percent within nine years. However, those locality adjustments have not been fully implemented.

Discretionary Spending—Option 38 **Multiple Functions**

Impose Fees to Cover the Cost of Government Regulation and Charge for Services Provided to the Private Sector

(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Spending												
Increase fees for permits issued by the Army Corps of Engineers	-23	-50	-53	-55	-57	-59	-61	-63	-65	-68	-238	-554
Authorize maintenance and location fees for hardrock mining on federal lands	-54	-53	-53	-53	-53	-52	-52	-52	-52	-51	-266	-525
Use state formulas to set grazing fees for federal lands	-3	-5	-8	-11	-14	-17	-20	-24	-27	-31	-41	-160
Impose fees on users of the St. Lawrence Seaway	-17	-35	-35	-36	-36	-37	-38	-39	-40	-41	-159	-354
Impose fees that recover the costs of pesticide and new-chemical registration	-50	-51	-80	-83	-89	-89	-92	-92	-95	-95	-353	-816
Charge fees to offset the cost of federal rail safety activities	-91	-185	-188	-191	-194	-198	-203	-206	-211	-215	-849	-1,882
Charge transactions fees to fund the Commodity Futures Trading Commission	-173	-177	-183	-188	-194	-201	-209	-217	-224	-232	-915	-1,998
Increase registration fees for the Federal Aviation Administration	-46	-47	-49	-50	-52	-54	-55	-57	-59	-61	-244	-530
Collect new fees for the Food and Drug Administration	-71	-74	-77	-79	-82	-86	-88	-92	-95	-99	-383	-843

Note: Fees collected under this option could be recorded in the budget as offsetting collections (discretionary), offsetting receipts (usually mandatory), or revenues, depending on the specific legislative language used in establishing the fees.

Federal law imposes a variety of regulations on private individuals and businesses to ensure the health and safety of the public and to facilitate commerce. The federal government also provides the private sector with a wide array of services and allows the use of public assets that have economic value, such as navigable waterways and grazing land. This volume includes a number of budget options that would raise substantial amounts of income over five years by imposing fees on users of certain services or otherwise charging for those services. For example, Discretionary Spending—Option 22, would increase the fees that cover the cost of aviation security by about $10 billion over five years; and Discretionary Spending—Option 32 would support the regulatory functions performed by the Food Safety and Inspection Service by expanding collections, which would raise $5 billion from 2012 through 2016. A number of other fees or taxes that raise smaller amounts could be imposed either to cover the cost to the government of administering regulations or to ensure that the government is compensated for the value of services currently provided to the private sector. Those fees could be applied across a wide array of federal agencies and through a variety of programs.

This option encompasses an illustrative group of relatively small fees and taxes that could be implemented independently. However, if all were put in place, they could increase income to the government by $3 billion from 2012 through 2016 and by $8 billion over the 2012–2021 period. Each of the fees in that group appeared as an individual option in CBO's *Budget Options: Volume 2* (August 2009).

Depending on the way the legislation was written, the fees included in this option could be recorded as revenues or as collections that would then be subtracted from either discretionary or mandatory spending. Several of the specific fees listed in this option would normally be classified as revenues, consistent with the guidance provided by the 1967 President's Commission on Budget Concepts. That guidance indicates that receipts from a fee that is imposed under the federal government's sovereign power to assess charges for governmental activities should generally be recorded as revenues. If that treatment were to apply to any of these specific fee options, the amounts shown in the table would be recorded as revenues and adjusted downward to account for their effect of shrinking the tax base for income and payroll taxes and, thus, of reducing revenues from those sources. However, the Congress has sometimes legislated the budgetary classification of fees, specifying that they be recorded as offsets to spending when they otherwise would have been recorded as revenues.

A rationale for user charges is that private businesses should cover all of their costs of doing business, including the costs of ensuring the safety of their activities and products—for example, the Federal Railroad Administration's costs for rail safety activities, and the Environmental Protection Agency's costs to register pesticides and new chemicals. In addition, the private sector should compensate the government for the market value of services it benefits from, such as the dredging of the inland waterway system, and for using or acquiring resources on public lands, such as grasslands for grazing and mineral deposits. In that view, it is unfair to taxpayers and a net drain on the productivity of the economy for businesses to provide products or services that cannot be priced high enough to cover those costs.

An argument against setting fees to cover the cost of regulation and recover the value of public services and resources is that some of the products and services provided by private businesses are beneficial to people not involved in producing or consuming those products and services; thus, it is both fair and efficient for taxpayers to subsidize the provision of those benefits. For example, by lowering the cost of rail transportation, taxpayers' support for rail safety activities reduces highway congestion and emissions of greenhouse gases; support for the registration of new chemicals reduces the use of older chemicals that may be more damaging to public health and to the environment; and not charging tolls on the portion of the St. Lawrence Seaway that is controlled by the United States supports the economies of port communities on the Great Lakes.

RELATED OPTION: Discretionary Spending, Option 32

CHAPTER

4

Revenue Options

In 2010, the federal government collected roughly $2.2 trillion in revenues. Individual income taxes were the largest source, accounting for nearly 42 percent of total revenues. Social insurance taxes (primarily payroll taxes collected to support Social Security and Medicare) provided another 40 percent. About 9 percent of revenues last year came from corporate income taxes, with other receipts—from excise taxes, estate and gift taxes, earnings of the Federal Reserve System, customs duties, and miscellaneous fees and fines—making up the remaining 10 percent (see Figure 4-1).

Trends in Revenues

Relative to the size of the economy, federal revenues are currently at their lowest level in 60 years. In both 2009 and 2010, revenues equaled 14.9 percent of gross domestic product (GDP). By comparison, they averaged about 18 percent of GDP between 1971 and 2010, peaking at 20.6 percent of GDP in 2000 (see Figure 4-2).

The variation in total revenues as a percentage of GDP over time has resulted primarily from ups and downs in individual income tax receipts and, to a lesser extent, from swings in corporate income tax receipts. Revenues from individual income taxes, which have averaged about 8 percent of GDP since 1971, have ranged from a high of 10.2 percent (in 2000) to a low of 6.2 percent (in 2010). The volatility of those revenues stems from two factors. First, a substantial share of the base for individual income taxes is nonwage income (such as capital gains realizations and noncorporate business income), which varies widely over the business cycle.[1] Second, legislative changes often produce significant shifts in individual income taxes. Receipts from corporate income taxes are also quite volatile over the business cycle. They have changed especially dramatically in the past few years—from 2.7 percent of GDP in 2007, the largest share in almost 30 years, to 1.0 percent of GDP in 2009, the smallest share since the 1930s. Because corporate income tax receipts have averaged only 2 percent of GDP over the past 40 years, however, their swings generally have a much smaller impact on total revenues than do the ups and downs in individual income tax receipts.

Social insurance taxes, by contrast, have been a fairly stable source of federal revenues over the years. Receipts from those taxes increased as a percentage of GDP during the 1970s and 1980s as tax rates, the number of people required to pay those taxes, and the share of wages subject to the taxes grew. For the past two decades, however, legislation has not had a substantial effect on social insurance taxes, and the primary base for those taxes—wages and salaries—has varied less as a share of GDP than have other sources of income.

Revenues from other taxes and fees declined relative to the size of the economy over the 1971–2010 period. The main reason is that receipts from excise taxes—which are levied on such goods and services as gasoline, alcohol, tobacco, and air travel—have steadily dwindled as a share of GDP over time, largely because most of those taxes are levied on the quantity rather than the value of goods, and rates have generally not kept up with inflation.

Looking ahead, revenues are projected to grow at a slower pace than GDP this year and then at a much faster rate. The Congressional Budget Office (CBO) estimates that if current laws remain unchanged, revenues will increase by 3 percent in 2011, to more than $2.2 trillion (see Table 4-1). As a share of GDP, however, they will fall slightly, to 14.8 percent. Thereafter, revenues are projected to rise rapidly under current law, reaching 19.9 percent of GDP by 2014. About three-quarters of

1. The business cycle refers to fluctuations in overall business activity, which are typically accompanied by swings in the unemployment rate, interest rates, and corporate profits.

Figure 4-1.

Breakdown of Revenues in 2010

Source: Congressional Budget Office.

Note: Other sources of revenues include excise taxes, estate and gift taxes, earnings of the Federal Reserve System, customs duties, and miscellaneous fees and fines.

that increase stems from the effects of scheduled changes to the tax code, including the following:

- A one-year reduction in the payroll tax and a two-year extension of provisions designed to limit the reach of the alternative minimum tax (AMT) are due to expire at the end of calendar year 2011.

- Other provisions of the 2010 tax act (the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312) are set to expire at the end of 2012. They include extensions of significant tax provisions that were originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5).

- New tax provisions are scheduled to take effect over the next three years. They include most of the revenue provisions in the major 2010 health care legislation (the Patient Protection and Affordable Care Act of 2010, P.L. 111-148; and the Health Care and Education Reconciliation Act of 2010, P.L. 111-152).

The rest of the projected increase in revenues as a percentage of GDP through 2014 is largely attributable to the effects of improvement in the economy. CBO expects that as the economy continues to recover from the recession, wages and salaries, capital gains realizations, and other taxable income will grow more rapidly than GDP.

Under the current-law assumptions of CBO's baseline projections, revenues will keep outpacing GDP for the remainder of the 10-year projection period. By 2021, total revenues are projected to rise to 20.8 percent of GDP, just surpassing their 2000 peak.

Considerations in Setting Tax Policy

The primary aim of a tax system is to raise enough revenues to pay for government spending. Taxes vary, however, in their effects on individuals and on the economy as a whole. When choosing among tax policies,

Figure 4-2.

Total Revenues, 1971 to 2021

(Percentage of gross domestic product)

Source: Congressional Budget Office (as of January 2011).

economists often evaluate the performance of a tax according to three criteria:

- Efficiency—the impact of the tax on economic activity;
- Equity—the fairness of a tax with respect to who bears its burden; and
- Simplicity—the costs of complying with and collecting the tax.

Because those criteria can conflict with each other, lawmakers often face difficult choices when setting tax policy.

Other considerations may also come into play. Many observers view the tax system as a means of achieving social policy goals—for example, by targeting tax hikes or tax preferences toward certain groups or activities. As a result, the current U.S. tax system contains many provisions whose main goal is to encourage certain types of desired behavior, such as buying health insurance, saving for retirement, or owning a home. Those goals can sometimes clash with the objective of raising revenues in an efficient, equitable, and simple manner.

The Effect of Taxes on Economic Activity

Taxes influence the economy by causing people to alter their behavior, which generally results in a less efficient allocation of resources. People can respond to taxes in several ways: by changing the timing of their activities (such as accelerating bonus payments or asset sales into a certain year if they think tax rates on earnings or capital gains will rise in future years); by adjusting the form of their activities (such as substituting tax-preferred fringe benefits for cash wages if the tax rate on wages goes up); or by changing more-fundamental aspects of their behavior (such as choosing to work or save less if tax rates on earnings or capital income rise).[2]

Those behavioral changes occur because taxes raise the price of taxed activities and thereby lower the relative prices of other things. In particular, the individual income tax and payroll taxes reduce the returns from working (after-tax wages), which increases the return from other activities relative to working. Those taxes also reduce the returns from saving (the after-tax rate of return), which lowers the price of spending now relative to saving to spend in the future.

One measure of the effect of taxes on the returns from working and saving is the marginal tax rate—the tax paid per dollar of extra earnings or extra income from saving.

2. For more details, see the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on Finance, *Trends in Federal Tax Revenues and Rates* (December 2, 2010).

Table 4-1.

CBO's Baseline Projections of Revenues

(Billions of dollars)

	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
Individual Income Taxes	899	998	1,128	1,516	1,671	1,829	1,967	2,105	2,231	2,365	2,509	2,662	8,110	19,983
Social Insurance Taxes	865	819	943	1,029	1,092	1,148	1,204	1,256	1,309	1,364	1,424	1,484	5,416	12,253
Corporate Income Taxes	191	201	279	343	428	398	370	413	417	420	420	437	1,817	3,923
Other Revenues														
Excise taxes	67	73	80	86	95	100	102	106	110	113	116	120	463	1,028
Estate and gift taxes	19	11	12	14	42	48	53	57	61	65	69	73	168	492
Federal Reserve earnings	76	80	63	51	39	36	37	33	38	44	50	54	225	445
Customs duties	25	29	31	33	36	40	44	49	52	56	60	64	185	467
Miscellaneous fees and fines	20	18	19	20	39	51	55	55	57	62	64	69	184	493
Subtotal	207	211	205	203	251	276	292	301	318	340	359	380	1,227	2,925
Total Revenues	**2,162**	**2,228**	**2,555**	**3,090**	**3,442**	**3,651**	**3,832**	**4,075**	**4,275**	**4,489**	**4,712**	**4,963**	**16,570**	**39,084**
On-budget	1,530	1,662	1,887	2,358	2,673	2,840	2,977	3,178	3,336	3,508	3,687	3,893	12,735	30,338
Off-budget[a]	632	566	668	732	769	811	855	897	938	981	1,025	1,069	3,835	8,745

Source: Congressional Budget Office (as of January 2011).

a. Receipts from Social Security payroll taxes.

For individuals, the marginal tax rate that applied to the top income tax bracket was 91 percent in the late 1950s and early 1960s and 70 percent as recently as 1980.[3] Today, the top statutory marginal tax rate for most types of income (other than capital gains and dividends) is 35 percent; with the expiration of the 2001 and 2003 tax cuts, that rate is scheduled to rise to 39.6 percent in 2013. Most taxpayers are not in the highest rate brackets, however. For a representative family of four with median income, the marginal tax rate on earnings (counting both income and payroll taxes) was about 20 percent from 1955 to 1975. That marginal rate climbed over the following 10 years because of rising payroll tax rates and inflation-driven increases in nominal income, which pushed median-income families into higher tax brackets. Following a reduction in income tax rates in 1986, the marginal tax rate for a representative family has remained at about 30 percent.

3. Different rate schedules have applied to some types of income at different points in time. Since 1955, the maximum rate for long-term capital gains has been lower than the maximum rate for ordinary income. Other sources of income have been subject to alternative rate schedules for shorter periods. For example, between 1971 and 1986, a lower maximum tax rate applied to earned income.

Changes in marginal tax rates have two different types of effects on people. On the one hand, the lower those tax rates are, the greater the share of the returns from additional work or saving that people can keep, thus encouraging them to work and save more. On the other hand, because lower marginal tax rates increase after-tax income, they make it easier for people to attain their consumption goals with a given amount of work or saving, thus possibly causing people to work and save less. On balance, the evidence suggests that reducing tax rates boosts work and saving relative to what would occur otherwise, if budget deficits remain the same. But without other changes to taxes or spending, reducing tax rates from current levels would generally decrease revenues and increase deficits; higher deficits, even with lower tax rates, can reduce economic activity over the longer term.

Changes in marginal tax rates can also affect businesses—by encouraging them to alter the size and location of investments or to engage in tax-avoidance activities (such as shifting income from high-tax countries to low-tax countries solely to reduce the amount of tax they owe worldwide). Many observers have expressed concern that the U.S. corporate income tax hampers competitiveness because its top statutory rate (35 percent) is one of the highest among countries in the Organisation for

Figure 4-3.

Cumulative Budgetary Effect of Major Income Tax Expenditures, 2010 to 2014

Source: Joint Committee on Taxation.

Economic Co-operation and Development.[4] Those statutory rates, however, do not reflect differences among various countries' tax bases and rate structures and thus do not indicate the actual tax rates that multinational companies face.[5]

Some features of the tax code affect the economy by subsidizing certain types of activities. Those subsidies often take the form of special exclusions, exemptions, or deductions from gross income; preferential tax rates; special tax credits that offset tax liabilities (the amount people owe); or deferrals of tax liabilities. Such subsidies are referred to as "tax expenditures," and their costs to the federal government are measured in terms of forgone revenues, which total hundreds of billions of dollars each year.[6] According to estimates by the staff of the Joint Committee on Taxation, the three largest tax expenditures in income tax law are the ones that provide preferential treatment for employment-based health insurance, retirement savings, and home ownership (see Figure 4-3). Each of those tax expenditures may help achieve certain societal goals: a healthier population, adequate financial resources for retirement, and stable communities of homeowners. But uncapped tax expenditures may also encourage overconsumption of the favored good or subsidize activity that would have taken place without the tax incentives. For example, those three income tax expenditures may prompt people to consume more health services than are necessary, reallocate existing savings from accounts that are not tax-preferred to retirement accounts, and acquire mortgages and purchase homes beyond their needs.

The Tax Burden and Who Bears It

Households generally bear the economic cost, or burden, of the taxes that they pay themselves, such as individual income taxes and employees' share of payroll taxes. But

4. See Organisation for Economic Co-operation and Development, "OECD Tax Database: Corporate and Capital Income Taxes," www.oecd.org/ctp/taxdatabase.

5. See Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons* (November 2005).

6. The Congressional Budget and Impoundment Control Act of 1974 requires that a list of tax expenditures be included in the federal budget, and each year the Administration publishes estimates of those expenditures (prepared by the Treasury's Office of Tax Analysis) for provisions that affect individual and corporate income taxes. The Congress's Joint Committee on Taxation also publishes estimates of individual and corporate income tax expenditures each year, most recently in *Estimates of Federal Tax Expenditures for Fiscal Years 2010–2014,* JCS-3-10 (December 15, 2010). Neither the committee nor the Treasury issues estimates of tax expenditures for social insurance or other federal taxes.

households also bear the burden of the taxes paid by businesses. In the judgment of CBO and most economists, the employers' share of payroll taxes is passed on to employees in the form of lower wages. In addition, households bear the burden of corporate income taxes, although the extent to which they do so as owners of capital, as workers, or as consumers is not clear.

One measure of the tax burden on households is the average tax rate—that is, taxes paid as a share of income. Federal taxes are progressive, meaning that average tax rates generally rise with income. In 2007, households in the bottom one-fifth (quintile) of the income distribution (those with an average income of $18,400, under a broad definition of income) paid about 4 percent of their income in federal taxes; those in the middle quintile, with an average income of $64,500, paid 14 percent; and those in the highest quintile, with an average income of $264,700, paid 25 percent. Average tax rates continued to rise within the highest quintile. Households in the top 1 percent of the income distribution faced an average tax rate of about 30 percent.[7]

Much of the progressivity of the federal tax system derives from the largest source of revenues, the individual income tax, for which average tax rates rise with income. The next largest source of revenues, social insurance taxes, has average tax rates that vary little across most income groups—although the average rate is lower for higher-income households, because earnings above a certain threshold are not subject to the Social Security payroll tax and because earnings are a smaller portion of total income for that group. The average social insurance tax rate is higher than the average individual income tax rate for all income quintiles except the highest one (see Figure 4-4). The impact of corporate taxes on households also rises with household income—with the largest effect by far on the top quintile (under the assumption that the corporate tax reduces after-tax returns on capital). By contrast, the average excise tax rate falls as income rises.

Between 1979 and 2007, the average rate for all federal taxes combined declined for every income group. The average individual income tax rate also dropped over that period, with the lowest quintile seeing the greatest decrease. (The decline in average tax rates is based on a comparison of rates for different income groups at different points in time; it does not reflect the experiences of particular households, which may move up or down the income scale over the years.)

Another way to describe the distribution of the tax burden is to compare different groups' shares of before-tax income with their shares of taxes paid. The share of taxes paid by the top quintile grew sharply between 1979 and 2007, almost entirely because of an increase in that group's share of before-tax income. In 2007, households in the highest quintile earned 55 percent of the nation's before-tax income and paid almost 70 percent of federal taxes. For all other quintiles, the share of federal taxes was less than the share of income.

Collection Costs and Complexity

Collection costs include both the costs that the government incurs in administering the tax code and the costs that the public incurs in complying with it. In 2005, the Department of the Treasury estimated those costs at nearly $150 billion a year, including the cost of operating the Internal Revenue Service (IRS), taxpayers' out-of-pocket expenses on such items as paid tax preparers and software, and the value of the time that taxpayers spend on tax preparation (from learning about tax law to gathering records of income and expenses to completing and submitting their returns).[8]

Collection costs reflect the complexity of the tax system. Complexity is also a factor underlying the "tax gap"—the difference between the amounts of tax that people owe under the tax code and the amounts they actually pay. The IRS estimated that the net tax gap (after accounting for recoveries from its enforcement activities) totaled $290 billion in tax year 2001, equivalent to a net noncompliance rate of 14 percent.[9]

The complexity of the tax system partly results from tax expenditures that are designed to affect behavior by taxing some endeavors more or less than others. Those tax expenditures include tax exemptions for some activities, deductions for various preferred items, and credits for undertaking certain actions. As a consequence,

7. See Congressional Budget Office, *Average Federal Tax Rates in 2007* (June 2010).

8. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (November 2005).

9. Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (August 2007).

Figure 4-4.

Average Federal Tax Rates, by Income Quintile and Tax Source, 2007

(Percent)

Source: Congressional Budget Office.

Note: For information about the calculation of average tax rates, the ranking of households by fifths (quintiles) of the income distribution, and the allocation of taxes for this figure, see the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on Finance, *Trends in Federal Tax Revenues and Rates* (December 2, 2010).

many of the same aspects of the tax system that reduce economic efficiency also increase complexity.

Complexity also arises from efforts to achieve certain equity goals. Provisions that phase out various tax credits and deductions at higher income levels are designed to target benefits toward people with the greatest need, but they make taxes more difficult to calculate. Similarly, refundable tax credits—such as the earned income tax credit and the child tax credit—provide cash assistance to low-income workers with children, but their eligibility rules are often difficult to administer. In addition, the alternative minimum tax is intended to limit the use of tax preferences by higher-income taxpayers, but it requires people to recalculate their tax liability in an entirely different way and then pay the larger of the regular tax or the AMT.

Approaches to Increasing Revenues

Although revenues are projected to reach historically high levels as a percentage of GDP by 2021, there are various reasons why lawmakers may want to consider options that would raise revenues. First, those anticipated levels may not be reached. CBO's projections of revenue growth assume that current laws remain unchanged. If, instead, a number of expiring tax provisions that have been extended in the past were made permanent—including the income tax provisions enacted in EGTRRA, JGTRRA, and ARRA and recently extended by the 2010 tax act; relief from the AMT; and temporary changes to estate and gift taxes—revenues would rise more slowly than in CBO's projections: to about 19 percent of GDP by 2021 rather than about 21 percent. Second, lawmakers may not want to cut spending enough to put fiscal policy on a sustainable path without increasing revenues as well.

Lawmakers could raise revenues by modifying existing taxes—either by increasing tax rates or by expanding tax bases (the measures on which assessments of tax liabilities are made). Alternatively, they could impose new taxes on income, consumption, or particular activities. All of those approaches would have consequences not only for the amount of revenue collected but also for economic activity, tax burdens, and the complexity of the tax system.

An advantage of raising tax rates is that such a change would be simpler to implement than many of the alternative approaches to boosting revenues. Unlike other types of changes, an increase in rates generally does not require new reporting requirements, additional instructions, and

more tax forms. However, as explained above, raising marginal tax rates would cause people and businesses to change their behavior in ways that affect economic activity. Raising rates would also have implications for the progressivity of the tax system, although those implications would depend on the types of taxes and taxpayers affected.

Other approaches to raising revenues would expand the base of existing taxes—for example, by increasing the types of income, the number of goods, or the number of people subject to those taxes. One comprehensive strategy that has received much attention lately would expand the tax base by eliminating or curtailing tax expenditures, often as part of a plan that would change the structure of the tax system as well as increase revenues. For instance, the National Commission on Fiscal Responsibility and Reform, which was established by the President, recently issued a report that called for eliminating or cutting tax expenditures—with some of the savings devoted to *reducing* tax rates.[10] One argument for eliminating tax expenditures is that doing so would not only raise substantial revenues but could also improve economic efficiency and simplify the tax code. At the same time, however, eliminating tax expenditures might raise concerns about fairness and other policy goals that those tax preferences were designed to achieve.

Like altering current taxes, imposing a new tax—perhaps on people's and business's consumption rather than on their income—might also require trade-offs between various policy goals. An argument in favor of creating a consumption tax rather than increasing income tax rates is that it would raise revenues without discouraging saving. A consumption tax would also prompt concerns about fairness, however, because lower-income people—who consume a greater share of their income than wealthier people do—would pay a larger percentage of their annual income in consumption taxes than other people would.

Another approach to raising revenues is to improve the collection of taxes that are owed, but not paid, under current law. Efforts to reduce the tax gap, however, may require additional reporting by taxpayers and businesses, thus raising their costs of complying with the tax system. Increasing funding for IRS enforcement can also narrow the tax gap, but the revenue gains are highly uncertain.

Revenue Options in This Chapter

This chapter presents 35 separate options to increase revenues. They are grouped in a number of broad categories according to the part of the tax system they would target:

- Individual income tax rates,
- The individual income tax base,
- Individual income tax credits,
- The Social Security tax base,
- Corporate income tax rates,
- Taxation of income from businesses and other entities,
- Taxation of income from worldwide business activity,
- Consumption and excise taxes,
- Health care provisions, and
- Other taxes and fees.

If combined, the options might interact with one another in ways that could alter their revenue effects as well as their impact on households and the economy.

Each option is accompanied by a table showing its estimated budgetary effects over each of the next 10 years, as well as 5- and 10-year totals. Nearly all of the estimates were prepared by the staff of the Joint Committee on Taxation. For simplicity in presentation, some of the changes in revenues shown in the tables represent the net effects of an option on revenues and outlays combined. For example, options that would directly or indirectly affect refundable tax credits would generally cause a change in outlays because those credits are usually paid as tax refunds when their amounts exceed people's income tax liabilities. Options that would expand the base for Social Security taxes would also affect outlays: Because those options would require some or all workers to contribute more to the Social Security system, higher benefits would have to be paid out when the affected workers retired or became disabled.

10. National Commission on Fiscal Responsibility and Reform, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform* (December 2010).

Although most of the spending options in this report would take effect on October 1, 2011 (the beginning of the next fiscal year), many of the revenue options would take effect on January 1, 2012 (the beginning of the next tax year). Some revenue options would have later effective dates. For example, an option to create a value-added tax would take effect somewhat later to give the IRS enough time to implement the new tax. Other options—such as changes to the child tax credit or the education tax credits—would not take effect until the tax cuts extended in the 2010 tax act expire (currently scheduled for the end of 2012).

In addition to the 35 options presented in this chapter, three more options—which would reduce revenues rather than raise them—are discussed in Appendix A. Those options relate to tax provisions that are scheduled to expire in the next few years.

Revenues—Option 1

Increase Individual Income Tax Rates

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues												
Raise all tax rates on ordinary income by 1 percentage point	18.6	40.3	47.8	49.7	51.5	52.8	53.8	54.5	55.2	56.1	207.9	480.4
Raise all ordinary tax rates and AMT rates by 1 percentage point	36.9	57.0	61.6	65.5	69.6	73.5	77.8	82.2	86.7	91.5	290.6	702.4
Raise all ordinary tax rates, AMT rates, and dividend and capital gains rates by 1 percentage point	37.3	59.0	61.1	66.9	71.0	75.0	79.3	83.8	88.3	93.2	295.3	715.0
Raise the top ordinary tax rate by 1 percentage point	2.8	5.3	6.5	7.4	8.4	9.2	9.9	10.6	11.4	12.3	30.4	83.9
Raise the top two ordinary tax rates by 1 percentage point	3.5	7.3	9.2	10.3	11.5	12.5	13.6	14.6	15.7	16.8	41.8	115.0
Raise the top three ordinary tax rates by 1 percentage point	3.9	9.1	11.5	12.8	14.1	15.2	16.4	17.5	18.7	19.9	51.4	139.1

Source: Joint Committee on Taxation.

Notes: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

AMT = alternative minimum tax.

Under current law, ordinary taxable income earned by most individuals through 2012 will be taxed at the following six statutory rates: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. (Income from long-term capital gains, which is taxed under a separate schedule, is excluded from ordinary income. For tax years 2011 and 2012 only, dividends are also excluded from ordinary income because they are subject to a separate rate schedule for those years.) After 2012, those rates are scheduled to revert to the rates that were in effect before 2001: 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. The lower rates were originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and were scheduled to expire at the end of 2010. They were extended for two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312).

Under the tax code, different tax rates apply at different levels of ordinary taxable income. (Taxable income generally is gross income minus allowable adjustments, exemptions, and deductions.) Tax brackets—the income ranges to which the different rates apply—vary depending on whether a taxpayer files singly or jointly. (See the table on page 140 for a list of the six tax brackets for both single and joint filers and the corresponding statutory tax rates.) In 2011, for example, a person filing singly with taxable income of $40,000 would pay a tax rate of 10 percent on the first $8,500 of taxable income, 15 percent on the next $26,000, and 25 percent on the remaining $5,500 of taxable income. The starting points for those income ranges are indexed to increase with inflation each year. Taxpayers who are subject to the alternative minimum tax (AMT) face statutory rates of 26 percent and 28 percent. (Federal tax liability is computed differently under the AMT than it is under the regular income tax because the former allows a more limited set of exemptions, deductions, and tax credits; taxpayers pay the higher of their regular tax or the AMT.)

Income from long-term capital gains is taxed under a separate rate schedule, with a maximum statutory rate of 15 percent; that rate will remain in effect through 2012 and then rise to 20 percent in ensuing years. Income from dividends is currently subject to the same rate schedule

Starting Points for Tax Brackets (2011 dollars)		Statutory Tax Rate on Ordinary Taxable Income (Percent)	
Single Filers	Joint Filers	2011–2012	After 2012
0	0	10	15
8,500	17,000	15	15
34,500	69,000	25	28
83,600	139,350	28	31
174,400	212,300	33	36
379,150	379,150	35	39.6

that applies to long-term capital gains; however, after 2012, dividends will be taxed as ordinary income.[1]

This option includes four alternative approaches for increasing statutory rates under the individual income tax. Those approaches are as follows:

- Raise all tax rates on ordinary income (income subject to the regular rate schedule) by 1 percentage point. Consistent with current law, this option would not apply to dividends earned in 2012.
- Raise all ordinary tax rates and AMT rates by 1 percentage point.
- Raise all ordinary tax rates, AMT rates, and the separate rates on dividends and capital gains by 1 percentage point.
- Raise the top tax rate, the top two tax rates, or the top three tax rates on ordinary income by 1 percentage point.

Raising all statutory tax rates on ordinary income by 1 percentage point would increase revenues by a total of $208 billion from 2012 through 2016 and by $480 billion from 2012 through 2021. If this alternative was implemented, for example, the top rate of 35 percent that is scheduled to be in effect in 2012 under current law would increase to 36 percent; and the top rate of 39.6 percent that is scheduled to be in effect starting in 2013 would increase to 40.6 percent. Rates for the AMT would remain the same as they are under current law. Thus, the impact on revenues of raising all ordinary tax rates would diminish over time relative to the size of the economy because, under current law, a greater share of taxpayers would become subject to the AMT and therefore would not be affected by the increase in regular rates.

Raising AMT rates along with all of the regular tax rates by 1 percentage point would increase revenues by $291 billion from 2012 through 2016 and by $702 billion over the 2012–2021 period. Unlike the first approach, this alternative would impose higher rates on all ordinary taxable income, regardless of whether those rates were applied according to the regular or AMT schedule. Consequently, the amount of additional revenues would not be greatly affected by the growing number of taxpayers subject to the AMT because those taxpayers would face higher statutory tax rates, too.

If, in addition to raising the ordinary and AMT rates, lawmakers boosted the separate tax rates on capital gains and dividends by 1 percentage point, federal revenues would increase by a total of $295 billion over the next five years and by $715 billion over the 2012–2021 period.

Alternatively, lawmakers could target specific individual income tax rates. For example, *boosting only the top statutory rate on ordinary income by 1 percentage point* would raise revenues by $30 billion from 2012 through 2016 and by $84 billion over the 10-year period. Because most people who are subject to the top rate in the ordinary schedule are not subject to the alternative minimum tax, the AMT would not significantly limit the effect of that increase in regular tax rates. Raising the rates for the top two or three brackets would generate more revenues.

As a way to boost revenues, an increase in tax rates would offer some administrative advantages over other types of tax increases because it would require only relatively minor changes to the current tax system. Rate hikes also would have drawbacks, however. Higher tax rates would

1. After 2012, income from dividends and capital gains, along with other investment income received by higher-income taxpayers, will be subject to an additional tax of 3.8 percent as a result of the Health Care and Education Reconciliation Act of 2010 (Public Law 111–152).

reduce people's incentive to work and save. In addition, they would encourage taxpayers to shift income from taxable to nontaxable forms and to increase spending on tax-deductible items, such as home mortgage interest. In those ways, higher tax rates would cause economic resources to be allocated less efficiently than they might be otherwise.

The estimates shown here reflect the assumption that taxpayers would respond to higher rates by shifting income from taxable to nontaxable or tax-deferred forms. (Such a shift might involve substituting tax-exempt bonds for other investments or opting for more tax-free fringe benefits instead of cash compensation.) However, the estimates do not incorporate potential changes in how much people would work or save in response to higher statutory tax rates. Such changes are difficult to predict and would depend in part on whether the federal government used the added tax revenues to reduce deficits or to finance increases in spending or cuts in other taxes.

RELATED OPTIONS: Revenues, Option 2; and Revenues, Options A-1 and A-2

RELATED CBO PUBLICATIONS: Statements of Douglas W. Elmendorf, Director, before the Senate Committee on Finance, *Trends in Federal Tax Revenues and Rates,* December 2, 2010; and the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices,* September 28, 2010; "Average Federal Taxes by Income Group," Web document, June 2010; *The Individual Alternative Minimum Tax,* Issue Brief, January 2010; *Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates,* Issue Brief, December 2005; and *How CBO Analyzed the Macroeconomic Effects of the President's Budget,* July 2003

Revenues—Option 2

Raise Tax Rates on Capital Gains

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	0.4	2.0	-0.3	3.7	4.3	4.9	6.0	7.2	9.1	11.4	10.1	48.5

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

When individuals sell an asset for more than the purchase price, they generally realize a capital gain that is subject to taxation. Most taxable capital gains are realized from the sale of corporate stocks, other financial assets, real estate, and unincorporated businesses. Long-term capital gains—those realized on assets held for more than a year—are taxed at various rates, most of them below the rates applied to other types of income (typically referred to as ordinary income). The tax rate depends on the year in which the taxpayer realizes the gain, the type of asset, how long the asset has been held, and the taxpayer's other income.

For example, in 2013, under current law, a taxpayer who is in the 28 percent tax bracket, or higher, for ordinary income and who sells corporate stock owned for more than a year will pay a basic tax rate of 20 percent on the realized gain.[1] For taxpayers in the 15 percent tax bracket, the comparable basic rate is 10 percent. If the stock has been held for more than five years, special tax rates apply—generally, 18 percent for higher-income taxpayers and 8 percent for taxpayers in the lowest tax bracket.

The tax rate on gains realized from many other assets is the same as that for corporate stock. However, special tax treatment is allowed under certain circumstances:

- Lower rates apply to gains on the sale of stock of certain small businesses that are held for more than five years, and gains from the sale of such stock can be deferred if other small-business stock is purchased.
- Under certain circumstances, taxpayers (including corporations) can defer paying taxes on gains from the sale of assets held for "productive use or investment" (rental cars or real estate, for instance), if they purchase a similar—"like-kind"—property.
- When real estate is sold, the capital gain is measured as the difference between the sale price and the adjusted basis, which is the purchase price less deductions for depreciation that were previously claimed. (Generally, taxpayers cannot claim deductions for depreciation on owner-occupied housing.) The portion of the gain that is equal to the deductions for depreciation is taxed at ordinary rates up to a maximum rate of 25 percent. (The remaining gains are taxed in the same manner as corporate stocks.)
- Profits from the sale of livestock are taxed as capital gains, even though such income—usually earned in the course of operating a business—is similar to other types of ordinary income earned by businesses.

Beginning in 2013, this option would raise the basic tax rates on realized gains by 2 percentage points—from 20 percent to 22 percent for people in the 28 percent tax bracket or higher and from 10 percent to 12 percent for those in the 15 percent bracket. The special rates for assets held for more than five years, including those for small-business stock, would be repealed. Gains realized after the sale of an asset that was held for productive use or investment could no longer be deferred when the taxpayer purchased a like-kind asset; similarly, no deferral would be allowed when an investor purchased equity in a small business after selling stock in another small firm. The recapture of depreciation from real estate gains would be taxed as ordinary income, without any ceilings on the tax rates. Finally, profits from the sale of livestock also would be treated as ordinary income and taxed as such. If implemented, the changes outlined in this option would raise revenues by a total of $10 billion from 2012 through 2016 and by $49 billion from 2012 through 2021.

1. The effective tax rate on capital gains would be increased by 3.8 percentage points for higher-income taxpayers subject to the "unearned income" surtax, which was enacted in the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152). The surtax takes effect in 2013.

An advantage of disallowing special tax treatment for certain types of assets is that it could improve economic efficiency by encouraging investors to focus more on economic factors than on the tax advantages associated with different types of investments. When tax rates are lower on assets held for at least five years, taxpayers may hold on to those assets longer just to lower their tax liability—even though it might make sense to sell sooner, given economic conditions. Another example is that current law allows taxpayers to defer gains when switching from one real estate investment to another, thus encouraging investment in land and buildings rather than in stocks and other financial assets where deferral is not allowed. In addition, recapturing depreciation deductions as ordinary income would reduce the tax advantage accorded to people in the highest tax brackets who invest in real estate. Simplification of the tax system is another argument for eliminating the special treatment of various assets; with fewer exceptions, most people would find it easier to compute capital gains taxes.

Increasing the basic tax rates on capital gains from corporate stock and most other assets—rather than on ordinary income—also could encourage people to base investment decisions on economic factors rather than on tax advantages. For example, the tax code will encourage businesses to retain profits rather than paying them out as dividends after 2012, when dividends will once again be taxed as ordinary income. By raising the rates on capital gains, the option would reduce that incentive to retain profits. Furthermore, by reducing the difference between the tax rates on ordinary income and those on realized capital gains, people would have less incentive to engage in tax planning to characterize compensation and profit as a capital gain.

Raising the rates at which capital gains were taxed also could have a negative effect on economic efficiency, however, even if those rates were applied uniformly. Raising rates would discourage some people from selling assets when doing so makes sense for economic reasons. Instead, people would hold on to the assets longer to defer the tax—or they might avoid taxes altogether by passing the asset on to their heirs when they die. (The resulting decline in the sales of assets would also reduce the amount of revenue that could potentially be collected from the higher capital gains tax rates.)

Another disadvantage of the option is that lower rates on certain types of capital gains may reduce barriers to investment. Capital gains from the sale of a stock often occur because a corporation reinvested profits—which were already taxed under the corporate income tax—in the business. A lower tax rate on such gains would mitigate that double taxation of profits, which discourages equity investment in the corporate sector. Yet another reason for taxing some forms of capital gains at lower rates is that investors may view certain investments—such as starting a new business or investing in a new technology—as too risky and thus undervalue their benefits for the economy. A drawback of recapturing the depreciation deductions on real estate is that some depreciation probably occurred, reducing the value of the property since the time of purchase. Finally, denying deferral on like-kind exchanges would increase the tax burden on people who rent out property in their own community but must sell it when they have to move to another community.

RELATED OPTION: Revenues, Option 1

Revenues—Option 3

Use an Alternative Measure of Inflation to Index Some Parameters of the Tax Code

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	0.7	1.6	3.1	5.2	6.8	7.8	9.8	11.0	12.3	13.7	17.3	71.8

Source: Joint Committee on Taxation. [The estimates presented in the table were revised by JCT on June 10, 2011.]

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Several parameters of the tax code change every year with the price of goods and services, as measured by the consumer price index for all urban consumers (CPI-U). Among the tax parameters that change are the amounts of personal and dependent exemptions; the size of the standard deductions; the income thresholds that divide the rate brackets for the individual income tax; the amount of annual gifts exempt from the gift tax; and the thresholds and phaseout boundaries for the earned income tax credit, the child tax credit, and several other credits. Indexing is intended to keep those amounts relatively stable in real (inflation-adjusted) terms.

Indexing is accomplished by adjusting each parameter from its value in a base year by the percentage change in the CPI-U between that base year and the most recent year for which information is available. The period used for the calculation is not a calendar year but the 12 months that elapse from September to August. The value of the CPI-U in August becomes available in September, which allows enough time to index the tax parameters and prepare the necessary forms for the coming year. Adjustments in parameters of the tax code are calculated as follows: In the base year of 1987, for example, the standard deduction for a single tax filer was $3,000. Between 1987 and 2010, the CPI-U increased by 93.9 percent; correspondingly, the standard deduction (rounded to the lowest $50 increment) increased to $5,800 for 2011.

The standard CPI-U, however, overstates changes in the cost of living by not fully accounting for the extent to which households substitute one product for another when the relative prices of products change. The Bureau of Labor Statistics created the chained CPI-U to explicitly address that "substitution bias" in the standard CPI-U. Whereas the standard CPI-U uses a basket of products reflecting consumption patterns that are as much as two years old, the chained CPI-U incorporates adjustments that people make in the types of products they buy from one month to the next. Although the chained CPI-U corrects for the substitution bias in the standard CPI-U, neither the chained nor the standard CPI-U perfectly captures changes in the cost of living because neither fully accounts for increases in the quality of existing products or the value of new products.

This option would use the chained CPI-U instead of the standard CPI-U to adjust various parameters of the tax code. The Congressional Budget Office estimates that the chained CPI-U is likely to grow at an average annual rate that is 0.25 percentage points less than the standard CPI-U over the next decade. Therefore, using the chained CPI-U to index tax parameters would increase the amount of income subject to taxation and result in higher tax revenues. Furthermore, the effects of instituting such a policy would grow over time. The net revenue increase would be about $700 million in 2012 but would reach $14 billion in 2021. Net additional revenues would total $17 billion over the 2012–2016 period and would sum to $72 billion from 2012 through 2021.

An argument in favor of using the chained CPI-U to index tax parameters is that this approach would more accurately adjust people's tax liability to reflect changes in the cost of living than the standard CPI-U. The chained CPI-U provides a better measure of changes in the cost of living by more quickly capturing the extent to which households adjust their consumption in response to changes in relative prices.

An argument against implementing this option is that only an initial estimate of the chained CPI-U is available on a monthly basis; a final and more accurate estimate is delayed because it is more complicated and time-consuming to compute the chained CPI-U than it is to compute the standard index. (The Congressional Budget

Office discussed the details of this approach in a Web-only technical appendix released with its February 2010 issue brief *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code*.) At the start of every year, all of the initial estimates for the prior year are revised, and one year later those interim estimates are further revised and made final. Because of those delays, the initial and interim estimates of the chained CPI-U, which typically contain errors, would need to be used to index the parameters in the tax code. Since the chained CPI-U was first published in 2002, however, the changes between the initial and final values have been relatively small. If the adjustment for each year was based on the index value from an earlier base year, those small errors would not accumulate beyond the current year. Furthermore, because the initial and interim estimates of the chained CPI-U have been closer to the final version of the chained CPI-U than the existing CPI-U has been, those estimates still reflect the basic improvement attributable to the chained CPI-U.

RELATED OPTIONS: Mandatory Spending, Options 26 and 27

RELATED CBO PUBLICATION: *Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code,* Issue Brief, February 2010

Revenues—Option 4

Gradually Eliminate the Mortgage Interest Deduction

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	0	0	0.7	4.5	8.4	14.3	23.3	35.7	52.6	75.1	13.6	214.6

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

The tax code treats investments in owner-occupied housing more favorably than it does other investments. For example, the owner of a rental house can deduct various expenses, such as mortgage interest, property taxes, depreciation, and maintenance, but has to pay taxes on the rental income—net of those expenses—and on any capital gain when the house is sold. In contrast, homeowners can deduct mortgage interest and property taxes from their income when they compute their income tax liability, even though they do not have to pay tax on the net rental value of their home. (Other housing-related expenses cannot be deducted from homeowners' income.) Homeowners also can exclude from taxation capital gains of up to $250,000 ($500,000 for joint filers) when they sell their primary residence.

Current law limits the total amount of mortgage debt that can be included in the calculation of an interest deduction to $1.1 million: $1 million for debt that a homeowner incurs to buy, build, or improve a first or second home; and as much as $100,000 in other debt (such as a home-equity loan) for which the owner uses the home as security, regardless of the purpose of that loan.

Beginning in 2013, with the expiration of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312), the total value of certain itemized deductions—including the mortgage interest deduction—will be reduced if the taxpayer's adjusted gross income is above a specified threshold.[1]

1. In 2009—the last year that the provision to reduce itemized deductions was in effect—itemized deductions began to be reduced when adjusted gross income was greater than $166,800. As was the case before 2010, the income thresholds will be adjusted for inflation when that provision is reinstated in 2013. The Congressional Budget Office estimates that in 2013 that threshold will be about $174,500.

This option would phase out the mortgage interest deduction, beginning in 2014. By that time, the Congressional Budget Office forecasts, foreclosures will have subsided, construction will have returned to normal levels, and housing prices will have begun to recover. The option would reduce the maximum mortgage eligible for the interest deduction from $1.1 million in 2013 to zero in 2024 in annual increments of $100,000. That change would boost revenues by only $14 billion from 2012 through 2016 but by $215 billion through 2021 and by increasing amounts relative to the size of the economy through 2024.

One argument in favor of the option is that it would improve the allocation of resources in the economy. The current deduction encourages home buyers who can itemize deductions to buy houses when they might otherwise rent or, especially, to buy bigger houses than they would buy if all investments were taxed equally. As a result, it is argued, homeowners invest too much in their houses and too little elsewhere. Reducing the maximum amount of mortgage debt on which interest could be deducted—and then eliminating that deduction entirely—should make many people more willing to invest in stocks, bonds, savings accounts, or their own businesses rather than in housing. Between 1950 and 2009, about 36 percent of net private domestic investment went into owner-occupied housing. That share is large enough that a reduction in investment in owner-occupied housing could eventually boost the amount of capital available to other sectors of the economy and increase total economic output.

Another argument in favor of this option is that eliminating the mortgage interest deduction would curtail the tax advantage for homeowners who borrow against their homes to buy other goods or to fund tax-favored retirement savings accounts, such as 401(k) plans and individual retirement accounts. Allowing homeowners to deduct interest for loans used to finance other consumption

distorts their choices between saving and consuming and probably reduces national saving. The deduction also favors owners over renters, who cannot deduct interest on normal consumer loans (such as automobile loans or credit card debt). Furthermore, allowing homeowners to deduct interest on mortgage loans at the same time that they contribute to tax-favored savings plans enables homeowners to take advantage of tax savings on both transactions. It thus provides an incentive for people to pay down mortgage debt more slowly and contribute more to retirement accounts than they would if mortgage interest was not deductible. Such transactions reduce federal tax revenues without increasing net saving because the higher retirement contributions are offset by larger amounts of outstanding mortgage debt.

A drawback of eliminating the deductibility of mortgage interest is that it could delay the recovery of home values, home construction, and home mortgage lending from their currently depressed levels. Even though the option would not take effect until 2014 and would be implemented gradually over a 10-year period, housing markets might begin to feel the effects sooner, as buyers anticipated the reduction—and eventual elimination—of the mortgage interest deduction. That would create new hardships, in addition to those already plaguing the housing market, for people who own homes (particularly those currently "under water" because they owe more on their mortgage than the house is worth), home builders, and lenders.

Another drawback is that this option might adversely affect individuals and their communities by reducing the rate of home ownership, particularly among younger and less wealthy people who must borrow in order to buy. Owning a home has been found to increase people's involvement in their community and local government. Moreover, it motivates people to better maintain their property, which benefits their neighbors as well as themselves. Even though such actions benefit communities, individuals typically do not consider those benefits when deciding whether to rent or own a home. Subsidies to encourage home ownership might offset that omission.

Although some incentive to become a homeowner may benefit communities, the mortgage interest deduction may be ineffective in that capacity. Despite the favorable tax treatment that mortgage interest receives in the United States, the rate of home ownership here is similar to that in Australia, Canada, and the United Kingdom, and none of those countries currently offers a tax deduction for mortgage interest. The effect of the deduction on people's decisions about whether to buy a house may be small because lower-income people—who face the greatest challenges in their efforts to become homeowners—get the least benefit from the deduction. There are two reasons for that disparity. First, lower-income people may not have sufficient deductions to make itemizing worthwhile. Second, the value of an itemized deduction is greater for people in higher income tax brackets and with larger mortgages.

RELATED OPTION: Revenues, Option 6

RELATED CBO PUBLICATION: *Taxing Capital Income: Effective Rates and Approaches to Reform,* October 2005

Revenues—Option 5

Limit or Eliminate the Deduction for State and Local Taxes

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues												
End the current itemized deduction	11.3	55.9	88.7	92.7	96.5	99.6	101.7	103.6	105.0	107.1	345.1	862.2
Cap the deduction at 2 percent of adjusted gross income	7.8	39.8	66.1	68.4	70.9	72.8	74.1	76.2	76.2	78.0	253.0	629.3

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

In determining their taxable income, taxpayers may choose the standard deduction when they file their tax returns or they may itemize and deduct certain expenses (including state and local taxes on income, real estate, and personal property) from their adjusted gross income (AGI). Under the American Jobs Creation Act of 2004, taxpayers who itemized were allowed to deduct state and local sales taxes, which previously had not been deductible, instead of state and local income taxes. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, referred to in this report as the 2010 tax act) extended that provision through 2011. Beginning in 2013, with the expiration of the 2010 tax act, the total value of certain itemized deductions—including the deduction for state and local taxes—will be reduced if the taxpayer's AGI is above a specified threshold.[1]

This option would change the deductibility of state and local tax payments, either by eliminating the deduction or by restricting it to an amount equal to or less than 2 percent of AGI. Eliminating the deduction would increase federal revenues by $345 billion from 2012 through 2016 and by $862 billion from 2012 through 2021. Capping the deduction at 2 percent of AGI would increase revenues by $253 billion over five years and by $629 billion over 10 years.

1. In 2009—the last year that the provision to reduce itemized deductions was in effect—itemized deductions began to be reduced when adjusted gross income was greater than $166,800. As was the case before 2010, the income thresholds will be adjusted for inflation when that provision is reinstated in 2013. The Congressional Budget Office estimates that in 2013 that threshold will be about $174,500.

Those revenue estimates reflect the assumption that the alternative minimum tax (AMT) would continue to operate as it does under current law. (Federal tax liability is computed differently under the AMT than it is under the regular income tax because the former allows a more limited set of exemptions, deductions, and tax credits; taxpayers pay the higher of their regular tax or the AMT.) Because the deduction for state and local taxes is the largest item that must be added back into income under the AMT, assumptions regarding the AMT have a substantial effect on the revenue estimates for this option. Under current law, the number of taxpayers who pay the AMT will grow each year because the exemption amounts and brackets for the AMT are not indexed for inflation. As the scope of the AMT expands, fewer people will benefit from the deduction for state and local taxes. However, policymakers have routinely changed the requirements to limit the number of taxpayers affected by the AMT. If legislation that limited AMT liability was already in place, more taxpayers would benefit from the deduction for state and local taxes—and eliminating that deduction would result in a larger revenue gain than would be the case under current law.

The deduction for state and local taxes is effectively a federal subsidy to state and local governments. As such, it indirectly finances spending by those governments at the expense of other uses of federal revenues. Either variation of this option would substantially reduce the incentive that the current subsidy provides for state and local government spending, although some research indicates that total state and local spending is not sensitive to that incentive.

An argument in favor of curtailing the deduction is that the federal government should not subsidize state and local governments through the tax deduction because state and local taxes are largely paid in return for services provided to the public. If that is the case, such taxes are analogous to spending on other types of consumption, which are nondeductible. Another argument is that the deduction largely benefits wealthier localities, where many taxpayers itemize, are in the upper income tax brackets, and enjoy more abundant state and local government services. Because the value of an additional dollar of itemized deductions increases with the marginal tax rate (the rate on the last dollar of income), the deductions are worth more to taxpayers in higher income tax brackets than they are to those in lower income brackets. Additionally, the deductibility of taxes could deter states and localities from financing services with nondeductible fees, which could be more efficient.

An argument against eliminating or restricting the current deduction involves the equity of the tax system. A person who must pay relatively high state and local taxes has less money with which to pay federal taxes than does someone with the same total income and smaller state and local tax bills. The validity of that argument, however, depends at least in part on whether people who pay higher state and local taxes also benefit more from goods and services provided by states and localities.

RELATED OPTION: Revenues, Option 6

RELATED CBO PUBLICATION: *The Deductibility of State and Local Taxes,* February 2008

Revenues—Option 6

Curtail the Deduction for Charitable Giving

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	3.7	18.7	20.0	21.3	22.5	23.8	25.1	26.5	28.0	29.4	86.2	219.0

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Current law allows taxpayers who itemize to deduct the value of their contributions to qualifying charitable organizations. By lowering the after-tax cost of donating to charities, the deduction provides an added incentive to donate. In 2008 (the most recent year for which data are available), taxpayers claimed $173 billion in charitable contributions on 39 million tax returns.

The deduction is restricted in two ways. First, charitable contributions may not exceed 50 percent of a taxpayer's adjusted gross income (AGI) in any one year. Second, beginning in 2013, with the expiration of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312), the total value of certain itemized deductions—including the deduction for charitable donations—will be reduced if the taxpayer's AGI is above a specified threshold.[1]

This option would further curtail the deduction for charitable donations while preserving a tax incentive for donating. Only contributions in excess of 2 percent of AGI would be deductible for a taxpayer who itemizes. That amount would still be subject to the additional reduction described above for higher-income taxpayers in 2013 and later. Limiting the deduction to contributions in excess of 2 percent of AGI would match the treatment that now applies to unreimbursed employee expenses, such as job-related travel costs and union dues. Such a policy change would increase revenues by $86 billion from 2012 through 2016 and by $219 billion from 2012 through 2021.

An argument in favor of this option is that, even without a deduction, a significant share of charitable donations would probably still be made. Therefore, allowing taxpayers to deduct contributions is economically inefficient because it results in a large loss of federal revenue for a very small increase in charitable giving. For taxpayers who contribute more than 2 percent of their AGI to charity, this option would maintain the current incentive to donate but at much less cost to the federal government. People who make large donations often are more responsive to that tax incentive than people who make small contributions. Moreover, smaller contributions are apt to be a source of abuse among taxpayers because donations that are under $250 do not require the same degree of documentation as those that are larger.

A potential disadvantage of this option is that total charitable giving would decline, albeit by only a small amount. People who contribute less than 2 percent of their AGI would no longer have a tax incentive to donate, and many of them could reduce their contributions. Although larger donors would still have an incentive to give, they would have slightly lower after-tax income because of the smaller deduction and thus might reduce their contributions as well (although by a lesser percentage than smaller donors). Another effect of creating the 2 percent floor is that it would encourage taxpayers who had planned to make gifts over several years to combine donations into a single tax year to qualify for the deduction.

1. In 2009—the last year that the provision to reduce itemized deductions was in effect—itemized deductions began to be reduced when adjusted gross income was greater than $166,800. As was the case before 2010, the income thresholds will be adjusted for inflation when that provision is reinstated in 2013. The Congressional Budget Office estimates that in 2013 that threshold will be about $174,500.

RELATED OPTION: Revenues, Option 7

RELATED CBO PUBLICATIONS: *The Estate Tax and Charitable Giving,* July 2004; and *Effects of Allowing Nonitemizers to Deduct Charitable Contributions,* December 2002

Revenues—Option 7

Limit the Tax Benefit of Itemized Deductions to 15 Percent

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	23.4	77.6	112.0	119.6	127.5	134.7	140.6	145.3	148.7	151.5	460.1	1,180.8

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

When preparing their returns, taxpayers may choose the standard deduction or they may itemize and deduct certain expenses (including state and local taxes, mortgage interest, charitable contributions, and some medical expenses) to determine their taxable income. Taxpayers benefit from itemizing when their itemized deductions exceed the amount of the standard deduction. For some types of expenses (such as medical expenses), only the amount that exceeds a given percentage of the taxpayer's adjusted gross income may be deducted. Beginning in 2013, with the expiration of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312), the total value of certain itemized deductions will be reduced if the taxpayer's adjusted gross income is above a specified threshold.[1]

As with any deduction, the benefit of itemizing increases with a taxpayer's marginal tax rate (the rate that applies to the last dollar of income). For instance, $10,000 in deductions reduces tax liability by $1,500 for someone in the 15 percent tax bracket but by $2,800 for someone in the 28 percent tax bracket.

This option would limit the extent to which taxes can be reduced by itemizing to 15 percent of the deductions' value, thus increasing revenues by $460 billion from 2012 through 2016 and by $1,181 billion over 10 years. It would raise taxes for people in marginal tax brackets above 15 percent who itemize deductions. Most taxpayers, however, do not itemize deductions. Among the 36 percent who do, about 75 percent receive a tax benefit from itemizing that is worth more than 15 percent of their deductions. Thus, the option would affect about one out of four taxpayers.

An argument in favor of the option is that the current rules for itemizing deductions lead to too much spending on tax-favored activities because they effectively reduce the after-tax price of such activities. For example, the deduction for mortgage interest may cause homeowners to invest too much in their houses and too little elsewhere. From that perspective, reducing the benefit derived from itemizing deductions would lessen the incentive to spend money on deductible activities. That could improve the allocation of society's resources in cases in which the current subsidy has led to too much spending on those activities. But some deductions are intended to subsidize activities that have widespread benefits to the public, such as the work of charitable organizations; under certain circumstances, curtailing those deductions could worsen the allocation of resources.

Another argument in favor of the option concerns equity. The current system provides a greater tax reduction per dollar of deductible expense to higher-income taxpayers than to those with lower income. By weakening the link between deductible expenses and a household's marginal tax bracket, the option would subsidize those expenses more equitably among households with different incomes. Weakening that link could also reduce the extent to which resources are misallocated. For a given amount of subsidies, a system of uniform subsidies generally distorts taxpayer behavior less than does a system in which subsidies are large for some households and small for others.

However, in cases in which higher-income taxpayers are more sensitive than lower-income taxpayers to the after-tax price of a subsidized activity that has widespread benefits to society, eliminating the link between deductions and a household's marginal tax bracket could

1. In 2009—the last year that the provision to reduce itemized deductions was in effect—itemized deductions began to be reduced when adjusted gross income was greater than $166,800. As was the case before 2010, the income thresholds will be adjusted for inflation when that provision is reinstated in 2013. The Congressional Budget Office estimates that in 2013 that threshold will be about $174,500.

worsen economic efficiency by reducing the amount of resources those taxpayers allocate to such activities.

An argument against the option is that some deductions are intended to yield a measure of taxable income that more accurately reflects a person's ability to pay taxes. For example, taxpayers with large medical expenses or casualty and theft losses may have fewer resources than taxpayers with similar income and smaller expenses. Under this option, taxpayers subject to the limitation would not have those expenses fully subtracted from their taxable income.

Limiting the tax benefit of itemized deductions would alter relative tax burdens. Reducing the benefit from itemized deductions would raise average tax rates more for upper-income taxpayers than for those with lower incomes. It would also raise average tax rates more for people who incurred large deductible expenses than for those with smaller expenses.

RELATED OPTIONS: Revenues, Options 4, 5, and 6

Revenues—Option 8

Include Employer-Paid Premiums for Income Replacement Insurance in Employees' Taxable Income

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0	0.1	0.2	0.2	0.3	0.4	0.6	0.7	0.9	1.1	0.8	4.4
Change in Revenues	13.0	28.9	29.8	31.5	32.6	33.8	35.0	36.0	37.2	38.0	135.8	315.9
Net Effect on the Deficit	-13.0	-28.8	-29.7	-31.3	-32.3	-33.4	-34.5	-35.3	-36.3	-36.9	-135.0	-311.5

Sources: Joint Committee on Taxation and Congressional Budget Office.

Notes: To the extent that the option would affect refundable tax credits, the revenue estimates include effects on outlays.

To the extent that the option would affect Social Security payroll taxes, a portion of the revenues is off-budget. The outlays are associated with payments of Social Security benefits and are classified as off-budget.

Benefits that replace income for the unemployed, injured, or disabled are currently subject to different tax treatments. Whereas unemployment benefits are fully taxable, benefits paid under workers' compensation programs (for work-related injuries or illnesses) are tax-exempt. Disability benefits (for non-work-related injuries) may be taxable, depending on who paid the premiums for the disability insurance. If the employer paid the premiums, the benefits are taxable (although the recipient's tax liability can be offset partly by special income tax credits for elderly or disabled people). If the employee paid the premiums out of after-tax income, the benefits are not taxed.

This option would eliminate existing taxes on income replacement benefits but would include in employees' taxable income the value of several taxes, premiums, and other contributions paid by employers. Specifically, all of the following would be subject to the individual income tax and the payroll taxes for Social Security and Medicare: the taxes that employers pay under the Federal Unemployment Tax Act and to various state unemployment programs; 60 percent of premiums that employers pay for workers' compensation (excluding the 40 percent that covers medical expenses); and the portion of insurance premiums or contributions to pension plans that employers pay to fund disability benefits. Together, those changes would increase revenues by $136 billion from 2012 through 2016 and by $316 billion over the 2012–2021 period. Over the long term, the gain in revenues would result almost entirely from adding workers' compensation premiums to taxable income. Including those various items in employees' taxable income, and thus in the wage base from which Social Security benefits are calculated, also would increase federal spending for Social Security. On net, the option would reduce federal budget deficits by $135 billion from 2012 through 2016 and by $312 billion from 2012 through 2021.

An advantage of this option is that it would treat different kinds of income replacement insurance similarly and thereby eliminate the somewhat arbitrary discrepancies that currently exist. For example, people who are unable to work because of an injury would not be taxed differently on the basis of whether their injury was related to a previous job. In addition, the option would spread the tax burden among all workers covered by such insurance rather than placing the burden solely on those who need the benefits, as is presently the case with unemployment insurance and employer-paid disability insurance.

A disadvantage of this option is that it would not eliminate all disparities in the way income replacement benefits are treated. For example, the income replacement portion of adjudicated awards and out-of-court settlements for injuries not related to work and not covered by insurance would remain entirely exempt from taxation. Also, recipients of the supplemental unemployment benefits that the government sometimes provides during economic downturns would receive those benefits tax-free, even though no amount corresponding to an employer's contribution had ever been included in the recipients' taxable income.

Another disadvantage of the option is that it would initially exempt from taxation the benefits received by people whose premiums were not taxed, providing particularly large benefits to that cohort relative to earlier

or subsequent cohorts. Transition rules could be devised to limit or prevent such gains, but those rules would probably be complicated and difficult to implement.

The option would reduce nearly every worker's take-home pay but by a relatively small amount—less than one-half of one percent, on average. For some workers, that reduction in after-tax income would be somewhat mitigated because any unemployment benefit or employer-financed disability insurance, received at some future date, would no longer be taxable.

RELATED OPTION: Revenues, Option 30

Revenues—Option 9

Include Investment Income from Life Insurance and Annuities in Taxable Income

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	12.5	25.3	25.8	26.3	26.9	27.4	28.0	28.5	29.1	29.7	116.8	259.5

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Certain types of life insurance policies and annuities combine features of insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which, in exchange for premiums, the company agrees to make fixed or variable payments to a person at a future time, usually during retirement.) Portions of the premiums paid for certain types of insurance policies, such as whole-life polices, and for annuities are invested and earn interest, dividends, and other types of investment income. (A whole-life policy is a contract with an insurance company that provides life insurance coverage throughout the policyholder's lifetime—not just for a specified period, as is the case with term life insurance.) That investment income, sometimes called inside buildup, is generally not included in taxable income until it is paid out to the policyholder as a return of cash value or as a recurring payment. If the inside buildup is used to reduce premiums in later years (as occurs with whole-life policies) or is paid out because of the death of the insured, it can escape taxation under the income tax.

Under this option, life insurance companies would inform policyholders annually of the investment income their accounts have realized, just as mutual funds do now, and policyholders would include those amounts in their taxable income for that year. In turn, the cash value from life insurance policies and recurring payments from annuities would not be taxed when they were paid out. That approach would make the tax treatment of investment income from life insurance and annuities match the treatment of income from bank accounts, taxable bonds, or mutual funds. (Taxes on investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be deferred until benefits were paid.) Such changes in tax treatment would increase revenues by $117 billion from 2012 through 2016 and by $260 billion from 2012 through 2021. Those revenue gains would diminish over time, however, relative to the size of the economy, because taxes paid on the inside buildup would mean that future payouts were tax-exempt.

By taxing the investment income from life insurance and annuities as it was realized, this option would eliminate a tax incentive to purchase such insurance products. Whether that outcome would be a benefit or a drawback depends on whether the current incentive is considered beneficial. Encouraging the purchase of life insurance is useful if people buy too little because they underestimate the financial hardship that their death will impose on their families. Encouraging the purchase of annuities is helpful if people tend to underestimate their retirement spending or life span and thus buy too little annuity insurance to protect against outliving their assets. However, scant evidence exists about how successful the current tax treatment is in encouraging people to obtain adequate amounts of insurance.

If providing an incentive to purchase life insurance is indeed considered a useful part of the tax system, an alternative approach would be to encourage such purchases directly by giving people a tax credit for their life insurance premiums or by allowing them to deduct part of those premiums from their taxable income. Either alternative would encourage people to purchase term insurance as well as whole-life policies. (Term insurance, which accounts for a large proportion of all life insurance policies, earns no inside buildup and so does not benefit from the same favorable tax treatment. Term insurance provides coverage for a specified period and pays benefits only if the policyholder dies during the term. Otherwise, the policy expires without value.)

A disadvantage of taxing inside buildup is that the people who would be affected would not have access to the buildup to pay the tax. People who had accumulated considerable savings from contributions to whole-life

policies or annuities could owe substantial amounts of taxes relative to the cash income from which they would have to pay the taxes. (That is one reason inside buildup is currently taxed in a manner that is similar to the treatment of capital gains, in that the gains are not taxed until the investor sells the asset.)

RELATED OPTIONS: Revenues, Options 11 and 12

Revenues—Option 10

Tax Carried Interest as Ordinary Income

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	2.2	2.2	1.9	1.7	1.7	2.2	2.5	2.4	2.3	2.3	9.7	21.4

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Investment funds—such as private equity, real estate, and hedge funds—are typically organized as partnerships with one or more general partners managing the fund. The general partners determine investment strategy; solicit capital contributions; acquire, manage, and sell assets; arrange loans; and provide administrative support for all of those activities. Such partnerships also typically include limited partners, who contribute capital to the partnership but do not participate in the fund's management. General partners can invest their own financial capital in the partnership, but such investments usually represent a small share of the total funds invested.

General partners typically receive two types of compensation for managing a fund: a fee tied to some percentage of the fund's assets under management; and a profit share, or "carried interest," tied to some percentage of the profits generated by the fund. A common compensation agreement gives general partners a 2 percent fee and 20 percent in carried interest. The fee, less the fund's expenses, is taxed as ordinary income (and thus is subject to regular income tax rates). In contrast, the carried interest that general partners receive is taxed in the same way as the investment income passed through to the limited partners. For example, if that investment income consists solely of capital gains, the carried interest is taxed only when those gains are realized and at the lower capital gains rate. Until 2013, the general partners' share of dividends is also taxed at the lower rate.

This option would treat the carried interest that partners receive for performing investment management services as ordinary income. Income those partners received as a return on their own capital contribution would not be affected. The change would produce $10 billion in revenues from 2012 through 2016 and $21 billion from 2012 through 2021.

Arguments in favor of this option reflect the view that carried interest should be considered performance-based compensation for management services rather than a return on the financial capital invested by the general partner. In accordance with that viewpoint, the option would eliminate two notable differences in the way carried interest and comparable forms of income are currently taxed. First, taxing carried interest as ordinary income would make its treatment consistent with that applied to many other forms of performance-based compensation, such as bonuses and most stock options. Second, the option would equalize the tax treatment of income that partners receive for performing investment management services and the treatment of income earned by corporate executives who do similar work. (The managers of publicly traded mutual funds, for example, also invest in a variety of assets. And the executives of many corporations direct investment, arrange financing, purchase other companies, or spin off components of their enterprises.)

Arguments against the option reflect the view that at least a portion of carried interest represents a return on the financial capital invested by the general partner. From that perspective, carried interest is the equivalent of an interest-free nonrecourse loan from the limited partners to the general partner. That loan is equal to the agreed-upon share of the partnership's assets (commonly 20 percent), with the requirement that the loan proceeds be reinvested in the fund. (A borrower is not personally liable for a nonrecourse loan beyond the pledged collateral, which in this case would be the general partner's claim on future profits.) When the partnership sells its assets, it is argued, any gain realized or loss incurred by the general partner on his or her share (after the loan was paid back) could be legitimately viewed as a capital gain or loss.

Furthermore, this option would treat the income of partners who provide investment management services differently from that earned by entrepreneurs who start a new business, contribute both labor services and capital, and then sell the business. Profits from such sales generally are

taxed as capital gains, even though some of those profits represent a direct return on specific labor services provided by the owners.

Another argument against such a policy change is that, if at least a portion of carried interest is presumed to be a return on the general partner's investment, it would reduce the incentive for general partners to undertake risky investments that can lead to innovation, new products, and more-efficient markets and businesses. It is not clear, however, to what extent a lower rate on capital gains contributes to such outcomes, or even whether promoting risky investment offers more economic advantages than disadvantages.

An alternative option, which presupposes that carried interest is neither entirely a return on capital nor entirely labor compensation, would explicitly recognize carried interest as an interest-free nonrecourse loan from the limited partners to the general partner. Under current tax rules, the implicit interest on that (nominally interest-free) loan would be determined by the interest rate on federal securities with the same duration and would be taxed as ordinary income. At the time the partnership sold its assets, any gains realized or losses incurred by the general partner (after the loan was repaid) would be treated as a capital gain or loss. The general partner would typically pay more in taxes than is assessed under current law but less than would be assessed if all carried interest was treated as ordinary income.

An advantage of the alternative option is that it would apply full taxation to at least some performance-based compensation without changing the underlying economics of the partnership arrangement. However, the approach is complex, which could make it particularly difficult to implement.

RELATED CBO PUBLICATION: Statement of Peter R. Orszag, Director, Congressional Budget Office, before the House Committee on Ways and Means, *The Taxation of Carried Interest,* September 6, 2007

Revenues—Option 11

Tax Social Security and Railroad Retirement Benefits in the Same Way That Distributions from Defined-Benefit Pensions Are Taxed

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	16.1	36.8	42.2	43.7	45.2	46.9	48.8	50.7	52.8	55.0	184.0	438.4

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Under current law, less than 30 percent of the benefits paid by the Social Security and Railroad Retirement programs is subject to the federal income tax. Recipients with income below a specified threshold pay no taxes on those benefits. Most recipients fall in that category, which constitutes the first tier of a three-tiered tax structure. If the sum of their adjusted gross income, their nontaxable interest income, and one-half of their Social Security and Tier I Railroad Retirement benefits exceeds $25,000 (for single taxpayers) or $32,000 (for couples filing jointly), up to 50 percent of the benefits are taxed. Above a higher threshold—$34,000 for single filers and $44,000 for joint filers—as much as 85 percent of the benefits are taxed.

By contrast, distributions from defined-benefit plans are taxable except for the portion that represents the recovery of an employee's "basis"—that is, his or her after-tax contributions to the plan. In the year that distributions begin, the recipient determines the percentage of each year's payment that is considered to be the nontaxable recovery of previous after-tax contributions, based on the cumulative amount of those contributions and projections of his or her life expectancy. Once the recipient has recovered his or her entire basis tax-free, all subsequent pension distributions are fully taxed. (Distributions from traditional defined-contribution plans and from individual retirement accounts, to the extent that they are funded by after-tax contributions, are also taxed on amounts exceeding the basis.)[1]

1. Distributions from Roth plans, which allow after-tax contributions only, are entirely tax-exempt—a more favorable treatment than the tax-free recovery of basis only. If Social Security benefits were treated like distributions from Roth plans, half the benefits would be exempt from taxation, reflecting the share financed by employees' contributions, which are after-tax (or, in the case of the self-employed, the share of their contributions that is not deducted from their taxable income).

This option would treat the Social Security and Railroad Retirement programs in the same way that defined-benefit pensions are treated by defining a basis and taxing only those benefits that exceed that amount. For employed individuals, the basis would be the payroll taxes they paid out of after-tax income to support those programs (but not the equal amount that employers paid on their workers' behalf). For self-employed people, the basis would be the portion (50 percent) of their self-employment taxes that is not deductible from their taxable income. Revenues would increase by $184 billion from 2012 through 2016 and by $438 billion from 2012 through 2021.

An argument in favor of this option concerns equity. Taxing benefits from the Social Security and Railroad Retirement programs in the same way as those from defined-benefit pensions would make the tax system more equitable in at least two ways. First, it would eliminate the preferential treatment given to Social Security benefits but not to pension benefits—a preference that is minimal for higher-income taxpayers but much larger for low- and middle-income taxpayers. Second, it would treat elderly and nonelderly taxpayers with comparable income the same way. For people who pay taxes on Social Security benefits under current law, the option could also simplify the preparation of tax returns because the Social Security Administration—which would have information on their lifetime contributions and life expectancy—could compute the taxable amount of benefits and provide that information to beneficiaries each year.

This option also has drawbacks. A greater number of elderly people would have to file tax returns than do so now. People with incomes below $44,000, including some who depend solely on Social Security or Railroad Retirement for their support, would have their taxes

increased by the greatest percentage. In addition, raising taxes on Social Security and Railroad Retirement benefits would be equivalent to reducing those benefits and could be construed by some retirees—as well as people nearing retirement—as violating the implicit promises of those programs, especially because the option would provide no opportunity for them to adjust their saving or retirement strategies to mitigate the impact. Finally, calculating the percentage of each recipient's benefits that would be excluded from taxation would impose an additional burden on the Social Security Administration.

RELATED OPTIONS: Revenues, Options 9 and 12

RELATED CBO PUBLICATION: *Social Security Policy Options,* July 2010

Revenues—Option 12

Reduce Limits on Contributions to Retirement Plans

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	1.5	2.6	3.1	3.9	4.7	5.0	5.6	6.1	6.3	7.1	15.8	45.9

Source: Joint Committee on Taxation.

Note: To the extent that the options would affect refundable tax credits, the estimates include effects on outlays.

Current law allows taxpayers to make contributions to certain types of tax-preferred retirement plans up to a limit that varies depending on the type of plan and the age of the taxpayer. The most common such vehicles are 401(k) plans, which are sponsored by employers, and individual retirement accounts (IRAs), which are maintained by the participants themselves.

Individuals under the age of 50 may contribute up to $16,500 to 401(k) and similar employment-based plans in 2011; participants ages 50 and above are also allowed to make "catch-up" contributions of up to $5,500, enabling them to make as much as $22,000 in total contributions in 2011. In general, those limits apply to contributions to all types of employment-based plans combined. However, contributions to 457(b) plans, available primarily to employees of state and local governments, are subject to a separate limit. As a result, employees who are enrolled in both 401(k) and 457(b) plans can contribute the maximum amount to both plans, thereby allowing some people to make tax-preferred contributions of as much as $44,000 in a single year.

In 2011, IRA contribution limits are $5,000 for those under age 50 and $6,000 for those ages 50 and above. The limits on deductible amounts are phased out above certain income thresholds if either the taxpayer or the taxpayer's spouse is covered by an employment-based plan. Contribution limits for all types of plans are indexed for inflation but increase only in $500 increments.

This option would reduce contribution limits, regardless of a taxpayer's age, to $14,850 for 401(k)–type plans and $4,500 for IRAs. Furthermore, it would suspend the indexing of those limits for five years. Finally, it would require all contributions to employment-based plans—including 457(b) plans—to be subject to a single combined limit. If implemented, the option would increase revenues by $16 billion from 2012 through 2016 and by $46 billion from 2012 through 2021.

One argument in favor of this option centers on fairness. The tax savings associated with these retirement plans—particularly the employment-based plans that do not have income restrictions—increase with the participant's income tax rate and the amount of his or her contribution. Thus, a worker in the 15 percent tax bracket defers taxes of 15 cents on each dollar contributed to a 401(k) plan, while an employee in the 35 percent tax bracket defers taxes of 35 cents. That larger tax benefit per dollar saved is enhanced for higher-income taxpayers because they tend to save more. Consequently, the taxpayers who would be most affected by the option are primarily higher-income individuals. The limits on 401(k) contributions affect few taxpayers—only 5 percent of participants in 2003—but of those affected, 64 percent had income in excess of $160,000 that year. The option also would level the playing field between those who currently benefit from higher contribution limits (people ages 50 and over and employees of state and local governments) and those subject to lower limits.

In addition to enhancing fairness, the option would improve economic efficiency. A goal of tax-preferred retirement plans is to increase private saving (although at the cost of some public saving). However, the higher-income individuals who are constrained by the current limits on contributions are most likely to be those who can fund the tax-preferred accounts out of existing savings without responding to the intended incentive to actually save more. Thus, the option would increase public saving—by reducing the deficit—at the cost of very little private saving.

The main argument against this option is that it would reduce the retirement saving of a significant number of people, particularly those who find it difficult to save because of income constraints or family responsibilities.

Although only 5 percent of workers with income under $80,000 in 2003 contributed to IRAs, more than 40 percent of those people contributed the maximum amount permitted. Those workers generally have relatively little in accumulated savings and are more likely to respond to the incentive to save than are people in higher-income groups. Eliminating the catch-up contribution limits would adversely affect those ages 50 and over who might have failed to save enough for a comfortable retirement while raising their families. The amount they could contribute to tax-preferred retirement accounts would be cut at precisely the time when reduced family obligations and impending retirement make them more likely to respond to tax incentives to save more.

RELATED OPTIONS: Revenues, Options 9 and 11

CBO PUBLICATION: *Utilization of Tax Incentives for Retirement Saving: Update to 2003,* Background Paper, March 2007

Revenues—Option 13

Replace the Tax Exclusion for Interest Income on State and Local Bonds with a Direct Subsidy for the Issuer

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	0.4	2.9	6.0	9.0	12.2	15.5	19.0	22.5	25.9	29.3	30.5	142.7

Source: Joint Committee on Taxation.

Note: These estimates represent the change in the overall budget balance that results from the sum of changes to revenues and outlays.

The federal tax code offers several types of tax preferences for bonds issued by state and local governments. First, interest income from governmental bonds—those that state and local governments issue to finance their own activities—can be excluded from a bondholder's adjusted gross income (AGI). As a result, the interest earned on those bonds is exempt from the federal income tax. Second, the interest earned on qualified private activity bonds—which states and localities can issue to finance certain types of socially beneficial projects undertaken by private entities, such as the construction of hospitals and schools—can also be excluded from a bondholder's AGI. (In some cases, however, that income may be subject to the alternative minimum tax.)[1] As a result of those tax preferences, borrowers pay less interest than they would on comparable bonds with taxable interest. The revenue forgone by the federal government effectively pays part of the borrowing costs of state and local governments and of those private entities whose bonds qualify for a tax preference.

For governmental and qualified private activity bonds issued in 2012 and afterward, this option would replace the exclusion for interest income with a subsidy paid directly to the issuers of the bonds. Under the option, borrowers would make taxable interest payments to bondholders; in turn, state and local issuers of those bonds would receive a subsidy payment directly from the federal government equal to 15 percent of the interest paid on the bonds. (States and localities that issued qualified private activity bonds would pass the subsidy payment on to the corresponding borrower in the private sector.) The option would retain restrictions that apply to governmental bonds, such as those on arbitrage earnings. In addition, it would not alter any of the limits—such as volume caps—currently imposed on the issuance of qualified private activity bonds. If implemented, such a policy change would increase federal revenues by more than it would increase federal outlays, for a net saving of $31 billion from 2012 through 2016 and of $143 billion from 2012 through 2021.

Making subsidy payments to borrowers for the bond interest they pay could have several advantages. First, switching from a tax exclusion to a subsidy payment for bond interest would be a more cost-effective way of providing a subsidy to borrowers. Only a portion of the federal revenue currently forgone through a tax exclusion on bond interest income actually lowers financing costs; in contrast, borrowers would receive all of the benefits of direct subsidy payments for bond interest. The tax exclusion on interest income is less cost-effective because some of the federal revenue forgone through the tax exclusion goes to bondholders in higher tax brackets. They receive gains that exceed the investment return necessary to clear the market for such bonds—that is, to attract enough buyers so that the demand for bonds matches the amount supplied. (In order to attract sufficient buyers in lower tax brackets to sell all of the bonds, issuers have to offer higher yields than are necessary to attract at least some of the buyers in higher tax brackets.)

Second, the amount of the federal subsidy for borrowing would be explicit and unaffected by other federal policy decisions. Currently, for example, the savings in financing costs that are realized by issuing governmental or qualified private activity bonds are largely determined indirectly by other features of the federal tax code (such as bond buyers' tax brackets, which are an important determinant of the demand for such debt).

1. Tax liability under the alternative minimum tax, or AMT, is computed differently than it is under the regular income tax because the former allows a more limited set of exemptions, deductions, and tax credits; taxpayers pay the higher of their regular tax or the AMT.

Third, making subsidy payments to the issuers of bonds could improve federal budgeting practices. The subsidies provided under current law are not readily visible in the budget; in contrast, under this option, the federal government would know the exact amount of financing subsidies it was providing in a given fiscal year. As a result, policymakers would be able to accurately assess the cost of the subsidies in comparison with the cost of other types of assistance to state and local governments and other spending more generally.

A disadvantage of the option is that it could raise borrowing costs for issuers of tax-preferred debt and thereby deter some investment that might have national benefits or place greater burdens on already strained state and local budgets. A subsidy payment rate of 15 percent is at the lower end of the range of estimated annual reductions in interest payments attributable to the exclusion of bondholders' income from federal taxes. Thus, state and local governments and some private entities would probably have to pay more to borrow, which in turn could cause them to reduce their spending on capital projects, such as schools and roads, and on existing programs (because general tax revenues are often used both to pay principal and interest on debt and to fund ongoing government operations). Borrowing costs could rise even further if lenders became fearful that transforming the subsidy from a tax exclusion to a more visible expenditure program would lead to further reductions (and potentially elimination) of the subsidy in the future and, as a consequence, charged higher rates of interest.

However, the option could increase or decrease demand for tax-preferred debt, and it is therefore unclear whether borrowing costs would fall or rise. On the one hand, offering a taxable—and thus higher—yield on bonds issued by state and local governments would make that debt attractive to new types of bond buyers (such as managers of pension funds and foreign investors, who generally do not pay U.S. taxes). The demand created by those purchasers could lower borrowing costs. On the other hand, the demand for tax-preferred bonds could fall as a result of converting the tax exclusion on interest income into a direct subsidy payment. That is because the option would reduce the after-tax returns on such bonds for people who are in higher tax brackets (although the yield would be higher, they would pay taxes on all of the interest income they received) and, as a result, could lead them to buy fewer of those bonds.

If a 15 percent credit were to result in higher borrowing costs that deterred investments considered desirable by the federal government, the amount of the subsidy payment could be increased, either overall—say, from 15 percent to 20 percent or 25 percent—or in a way that depended upon the purpose for which a bond was issued. However, increasing the subsidy rate would yield less savings for the federal government.

Revenues—Option 14

Modify or Eliminate the Child Tax Credit

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues												
Eliminate the refundable portion of the child tax credit	0	0.4	3.3	3.4	3.4	3.4	3.4	3.3	3.3	3.2	10.5	27.1
Eliminate the child tax credit	0	3.1	15.3	15.1	14.9	14.7	14.2	13.7	13.2	12.6	48.4	116.7

Source: Joint Committee on Taxation.

Note: These estimates represent the change in the overall budget balance that results from the sum of changes to revenues and outlays.

The child tax credit, first enacted in the Taxpayer Relief Act of 1997, allows taxpayers to claim a credit against their federal income tax liability for each eligible child. To qualify, the child must be 16 or younger at the close of the tax year, and the taxpayer must be able to claim the child as a dependent. The credit phases out for single filers whose adjusted gross income is more than $75,000 and for joint filers whose income is above $110,000. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and other laws increased the credit from $500 to $1,000 per child. Most recently, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, referred to in this report as the 2010 tax act) extended the $1,000 per child credit through 2012. Starting in 2013, however, the credit amount will return to its pre–EGTRRA amount of $500 per child.

The child tax credit is partially refundable, which means that families whose income tax liability (before the credit is applied) is less than the total amount of the credit may receive all or at least a portion of the credit as a payment. Before 2001, only taxpayers with three or more children were eligible for a refundable child tax credit, and the refund was limited to the amount by which their Social Security taxes exceeded the earned income tax credit, or EITC. (The earned income tax credit is a fully refundable credit designed to supplement the wages of low-income families.) EGTRRA made the credit refundable for taxpayers with one or two children and also introduced a new formula for computing the refund. Under the new formula, the refund could not exceed 15 percent of the taxpayer's earned income above an established threshold. That threshold was initially set at $10,000 in 2001 and indexed for inflation; but it has been temporarily reduced to $3,000 by legislation several times over the past few years. Although smaller families must use the newer method to calculate the refundable credit, taxpayers with three or more children can choose the method that yields the larger refund. Beginning in 2013, with the expiration of the 2010 tax act, the criteria for receiving refunds will revert to those in effect before 2001: Only taxpayers with three or more children will be eligible for a refund, which in turn, will be limited to the amount that taxpayers' Social Security taxes exceed their EITC.

Starting in 2013, the first variant of this option would eliminate the portion of the child tax credit that is refundable. The second variant would eliminate the child tax credit altogether. The first approach would reduce the deficit by $11 billion from 2012 through 2016 and by $27 billion over the 10-year projection period; the second would reduce the deficit by $48 billion from 2012 through 2016 and by $117 billion from 2012 through 2021.

One argument for curtailing or eliminating the child tax credit is that other features of the individual income tax—such as the standard deduction for heads of households, personal exemptions, the dependent care tax credit, and the EITC—already provide significant tax preferences to families with children. (For example, a typical single parent with two children is projected to receive up to nearly $5,300 from the EITC in 2013.)

Moreover, the credit does not benefit many of the poorest families because they have no income tax liability—when the credit reverts to its pre–EGTRRA form in 2013, only a handful of taxpayers with three or more children will be eligible for a refundable credit. (Even under the

provisions of law that will be in place in 2012—specifically, as outlined by the 2010 tax act—a household's earnings will have to exceed a minimum threshold to be eligible for the refundable credit.) Another argument for the option is that having children represents a family's decision about how to spend its income—a choice that could be considered analogous to other decisions about spending.

Either alternative would also simplify the tax code. The phaseout of the child tax credit at higher income levels requires taxpayers to complete a separate worksheet and perform additional computations. The computation of the refundable portion of the credit for families with three or more children is particularly complex. If policymakers believe that some families do not receive sufficient assistance through the tax system, then a simpler way to provide benefits would be through expansions of the other child-related tax benefits.

An argument against reducing or eliminating the child tax credit is that the other preferences in the tax code may not fully compensate families for the extra costs of raising children. And eliminating the portion of the tax credit that is refundable, in particular, would limit compensation to those families least able to bear those additional costs. Raising children is an investment that may benefit all of society when those children become productive adults. With additional resources, parents could invest more in child rearing and benefit society as a whole. Those social benefits could take many forms, such as a better educated and more productive workforce, a healthier population, or a more civically engaged electorate.

Revenues—Option 15

Eliminate Certain Tax Preferences for Education Expenses

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	0	1.3	6.2	6.1	6.0	5.9	5.8	5.6	5.5	5.3	19.6	47.7

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Federal support for higher education takes many forms, including grants, subsidized loans, and tax preferences. Since the enactment of the Taxpayer Relief Act of 1997, however, assistance provided through the tax system has increased and expanded to families higher up the income distribution.

In addition to several tax-advantaged accounts that allow families to save for their child's postsecondary education, taxpayers can also benefit from several education-related credits and deductions. One of those allows taxpayers to deduct up to $4,000 from their taxable income for qualifying tuition and fees, whether they itemize deductions or not. That deduction, which expired at the end of 2009, was reinstated by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312). It is currently scheduled to expire at the end of 2011. Another tax preference, the American Opportunity Tax Credit (AOTC), covers up to $2,500 in educational expenses (100 percent of the first $2,000 and then 25 percent of the next $2,000) and is available for up to four years of postsecondary education. Up to 40 percent of the credit (or $1,000) is refundable for lower-income families. That credit is scheduled to expire at the end of 2012.

Three other tax preferences will be in effect through the end of the 10-year projection period under current law:

- The Hope tax credit was replaced by the American Opportunity Tax Credit in 2009 but will be reinstated in 2013 when the AOTC is scheduled to expire. In 2008, the last year it was available, the Hope credit was equal to 100 percent of the first $1,200 of qualifying tuition and fees and 50 percent of the next $1,200 for a maximum credit of $1,800 per year. As was the case before the Hope credit expired, the parameters used to calculate the credit amount will be indexed for inflation when the credit is reinstated. On the basis of that adjustment, the Congressional Budget Office estimates that the maximum credit in 2013 will be $1,950. The Hope credit is nonrefundable (that is, the credit amount may not exceed the filer's income tax liability). It can be claimed only for expenses incurred in the first two years of a postsecondary degree or certificate program, and the student must be enrolled at least half-time during that period. In 2008, the Hope tax credit began to phase out for joint filers when their modified adjusted gross income (MAGI) exceeded $96,000 and for single filers when their MAGI exceeded $48,000.[1] As with the parameters used to calculate the credit amount, the income thresholds for the Hope tax credit are also adjusted for inflation. CBO estimates those thresholds will be $104,000 for joint filers and $52,000 for single filers when the Hope tax credit is reinstated in 2013.

- The nonrefundable Lifetime Learning tax credit provides up to $2,000 for qualifying tuition and fees. (The credit equals 20 percent of each dollar of qualifying expenses up to a maximum of $10,000.) Only one Lifetime Learning credit may be claimed per tax return per year, but the expenses of more than one family member (a taxpayer, spouse, or dependent) may be included in the calculation. In 2011, the Lifetime Learning tax credit begins to phase out for joint filers whose MAGI is more than $102,000 and for single filers whose MAGI exceeds $51,000. As with the Hope tax credit, those income thresholds are also adjusted for inflation. Unlike the Hope credit, the Lifetime Learning credit can be used after the first two years of postsecondary education and by students who attend school less than half-time. Taxpayers may not, however, claim both credits for the same student in the same year.

1. Several foreign income and foreign housing exclusions are added to adjusted gross income (AGI) to calculate the modified AGI measure used to determine eligibility for education-related tax credits.

- A tax deduction of up to $2,500 per year for interest payments on student loans may be taken by itemizers and nonitemizers alike. In 2011, the interest deduction for student loans begins to phase out for joint filers with MAGI above $120,000 and for single filers with MAGI above $60,000. Although the maximum deduction is not indexed for inflation, the income thresholds for the phaseout ranges are adjusted for inflation.

This option would eliminate the Hope tax credit and the Lifetime Learning tax credit beginning in 2013. The option would also gradually eliminate the deductibility of interest expenses for student loans. Because students borrowed money with the expectation that a portion of the interest would be deductible over the life of the loan, the interest deduction for student loans would be phased out in annual increments of $250 over a 10-year period. If implemented, this option would raise revenues by $20 billion from 2012 through 2016 and by $48 billion over the 2012–2021 period.

An argument in favor of the option is that the current tax benefits are not targeted to those who need assistance the most. Many low-income families do not have sufficient income tax liability to claim all—or in some cases, any—of the education-related tax benefits. However, the cost of higher education may impose a greater burden on those families as a proportion of their income. Further, some research indicates that lower-income individuals and families may be more sensitive to the cost of higher education than those with higher income and thus more likely to enroll in higher education programs if tuition and fees are subsidized.

A second rationale in favor of the option concerns the administration of education benefits through the income tax system. Education benefits administered through the tax system are poorly timed because families must pay tuition and fees before they can claim the benefits on their tax returns. In contrast, federal spending programs such as the Pell Grant program are designed to provide assistance when the money is needed—at the time of enrollment. Further, providing education assistance through various credits and deductions, each with slightly different eligibility rules and benefit amounts, makes it difficult for families to determine which tax preferences provide the most assistance. As a result, some families may not choose the most advantageous educational benefits for their particular economic circumstances.

A drawback of this policy option is that some households would not receive as much assistance for educational expenses unless federal outlays for education assistance were expanded. The option would increase the financial burden on families with postsecondary students—particularly middle-income families who do not qualify for current federal spending programs. Another drawback is that despite the current system's complexity—which creates overlapping tax benefits—some families may find it easier to claim benefits on their tax returns (on which they already provide information about their family structure and income) than to fill out additional forms for assistance through other federal programs.

RELATED OPTIONS: Mandatory Spending, Options 10 and 11; and Discretionary Spending, Option 28

RELATED CBO PUBLICATIONS: *Costs and Policy Options for Federal Student Loan Programs,* March 2010; and *Private and Public Contributions to Financing College Education,* January 2004

Revenues—Option 16

Increase the Maximum Taxable Earnings for the Social Security Payroll Tax

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0.1	0.2	0.4	0.5	0.8	1.1	1.4	1.8	2.2	2.7	2.0	11.1
Change in Revenues	8.7	40.0	40.8	44.3	48.3	50.6	53.4	57.4	60.8	63.5	182.1	467.8
Net Effect on the Deficit	-8.6	-39.8	-40.4	-43.8	-47.5	-49.6	-52.0	-55.7	-58.6	-60.8	-180.1	-456.7

Sources: Joint Committee on Taxation and Congressional Budget Office.

Notes: To the extent that the option would affect refundable tax credits, the revenue estimates include effects on outlays.

Most of the revenues are off-budget. To the extent that the option would affect individual income tax revenues, a portion is on-budget. The outlays are associated with payments of Social Security benefits and are classified as off-budget.

Social Security—which consists of Old-Age, Survivors, and Disability Insurance (OASDI)—is financed by payroll taxes on employers, employees, and the self-employed. Only earnings up to a maximum, which is $106,800 in 2011, are subject to the tax. That maximum usually increases each year by the growth rate of average wages in the economy.[1]

When payroll taxes for Social Security were first collected in 1937, about 92 percent of earnings from jobs covered by the program were below the maximum taxable amount. During most of the program's history, the maximum was increased only periodically, so the percentage varied greatly. It fell to 74 percent in 1965 and, by 1977, was 87 percent. Amendments to the Social Security Act in 1977 boosted the amount of covered taxable earnings, which reached 91 percent in 1983. That law also indexed the taxable maximum to match annual growth in average wages. Despite those changes, the percentage of taxable earnings has slipped in the past decade because earnings for the highest-paid workers have grown faster than the average. Thus, in 2009, about 83 percent of earnings from employment covered by OASDI fell below the maximum taxable amount.

1. The Social Security Act specifies that the taxable maximum rises only in those years in which benefits increase to reflect changes in the consumer price index for urban wage earners and clerical workers (often referred to as a cost-of-living adjustment or COLA). Because there was no COLA in 2010 or 2011, the taxable maximum has remained at its 2009 level. The Congressional Budget Office projects that there will be COLAs beginning in 2012 and continuing throughout the budget period, causing the taxable maximum to once again increase annually.

This option would increase the share of total earnings subject to the Social Security payroll tax to 90 percent by raising the maximum taxable amount to $170,000 in 2012. (After being increased, the maximum would continue to be indexed as it is now.) Implementing such a policy change would increase revenues by $182 billion from 2012 through 2016 and by $468 billion over the 2012–2021 period. (The estimates include the reduction in individual income tax revenues that would result from a shift of some labor compensation from a taxable to a nontaxable form.)

Because Social Security's retirement benefits are tied to the amount of income on which taxes are paid, however, some of the increase in revenues from this option would be offset by the additional retirement benefits paid to people with income above the current maximum taxable amount. On net, the option would reduce federal budget deficits by $180 billion over the 5-year period and by $457 billion over the 10-year period.

Enacting this option would enhance the long-term viability of the Social Security program, which, according to the Congressional Budget Office's projections, will not have sufficient income to finance the benefits that are due to beneficiaries under current law. CBO projects that, in combination, the two Social Security trust funds will be exhausted in the late 2030s. Under this option, exhaustion of the combined trust funds would be delayed until after 2050.

In addition to improving Social Security's long-term financial outlook, this option would make the payroll tax less regressive. People whose income is above the ceiling

now pay a smaller percentage of their total income in payroll taxes than do people whose total earnings are below the maximum. Making more earnings taxable would increase payroll taxes for those high-income earners. (Although that change also could lead to higher benefit payments for people with earnings above the current maximum, the additional benefits would be modest relative to the additional taxes those earners would pay.)

An argument against this option is that raising the earnings cap would weaken the link between the taxes that workers pay into the system and the benefits they receive (because the addition to benefits would be modest relative to the increase in taxes). That link has been an important aspect of Social Security since its inception. Another drawback is that people whose earnings fall between the existing and proposed taxable limits would earn less after taxes for each additional hour worked, which would reduce the incentive to work and encourage taxpayers to substitute tax-exempt fringe benefits for taxable wages. People whose earnings are well above the proposed limit would not see any reduction in the return on their additional work, but they would have less income after taxes, which would encourage more work.

RELATED OPTION: Revenues, Option 17

RELATED CBO PUBLICATIONS: *Social Security Policy Options,* July 2010; *The Long-Term Budget Outlook,* June 2010; and *CBO's Long-Term Projections for Social Security: 2009 Update,* August 2009

Revenues—Option 17

Expand Social Security Coverage to Include Newly Hired State and Local Government Employees

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	1.0	2.8	4.7	6.6	8.6	10.5	12.5	14.4	16.5	18.5	23.7	96.0

Source: Joint Committee on Taxation.

Note: Most of the revenues are off-budget. To the extent that the option would affect individual income tax revenues, a portion is on-budget.

Unlike nearly all private-sector workers and federal employees, some workers employed by state and local governments—about 25 percent—are not covered by Social Security. Under federal law, state and local governments can opt to enroll their employees in the Social Security program or they can opt out if they provide a separate retirement plan for those workers instead. State and local governments may also have their employees participate in Social Security and be part of a separate retirement plan. In contrast, all federal employees hired after December 31, 1983, are covered by Social Security and pay the associated payroll taxes. Furthermore, all state and local government employees hired after March 31, 1986, and all federal government employees are covered by Medicare and pay taxes for Hospital Insurance (Medicare Part A).

Under this option, Social Security coverage would be expanded to include all state and local government employees hired after December 31, 2011. Consequently, all newly hired state and local government employees would pay the Social Security payroll tax, which funds the Old-Age, Survivors, and Disability Insurance programs. In 2012 and thereafter, that tax will be 12.4 percent of earnings, half of which is deducted from employees' paychecks and half of which is paid by employers. (As a result of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 [Public Law 111-312], the share of the Social Security tax that employees pay was reduced from 6.2 percent of covered earnings to 4.2 percent for 2011 only.) If implemented, this option would increase revenues by $24 billion from 2012 through 2016 and by a total of $96 billion over the 2012–2021 period. (The estimates include the reduction in individual income tax revenues that would result from a shift of some labor compensation from a taxable to a nontaxable form.)

Paying the Social Security payroll tax for 10 years generally qualifies workers (and their dependents) to receive Social Security retirement benefits; other work requirements must be met for employees to qualify for disability benefits or, in the event of their death, for their dependents to qualify for survivors' benefits. Although extending such coverage to all newly hired state and local employees would eventually increase the number of Social Security beneficiaries, that increase would have little impact on the federal government's spending for Social Security in the short term. Over the 2012–2021 period, outlays would increase only by a small amount because most people who would be hired by state and local governments over that period would not begin receiving Social Security benefits for many years. (The estimates do not include any effects on outlays.)

In the long term, the additional benefit payments for the expanded pool of beneficiaries would be only about half the size of the additional revenues. That is largely because most of the newly hired workers would receive Social Security benefits anyway under current law for one of two possible reasons: They may have held other covered jobs in the past, or they were covered by a spouse's employment. As a result, this option would slightly enhance the long-term viability of the Social Security program, which faces the prospect that income from Social Security payroll taxes will not be sufficient to finance the benefits that are due to beneficiaries under current law.

Another rationale for the option concerns fairness. Social Security benefits are intended to replace only a percentage of a worker's pre-retirement earnings. That percentage (referred to as the replacement rate) is higher for workers with low career earnings than for workers with higher earnings. But the standard formula for calculating Social Security benefits does not distinguish between

people whose career earnings are low and those who just appear to have low career earnings because they spent a portion of their career working in jobs that were not covered by Social Security. To make the replacement rate more comparable for workers with similar earnings histories, current law reduces the standard benefits for retired government employees who have worked a substantial portion of their career in employment that is not covered by Social Security. However, that adjustment is imperfect and can affect various public employees differently: specifically, it can result in higher replacement rates for some public employees who were not covered by Social Security throughout their career and in lower replacement rates for other public employees. This option would eliminate the inequities of the current system.

Implementing this option would also provide better retirement and disability benefits for many workers who move between government jobs and other types of employment. By facilitating job mobility, the option would enable some workers—who would otherwise stay in state and local jobs solely to maintain their public-employee retirement benefits—to move to jobs in which they could be more productive. Many state and local employees are reluctant to leave their jobs because pensions are structured to reward people who spend their entire careers in the same pension system. If their government service was covered by Social Security, there would be fewer disincentives to moving because they would remain in the Social Security system. State and local governments, however, might respond to greater turnover by reducing their investment in workers—by cutting training programs, for example—causing the productivity of state and local employees to decline.

An argument against such a policy change is that it might place an added burden on some state and local governments, which already face significant budgetary challenges. State and local pension plans are generally designed to be prefunded so that participants' contributions can be invested to pay future benefits. As long as the plans are fully funded, transferring new employees to the Social Security system would not cause any problems. However, many plans are underfunded and depend on the contributions from new participants to make up the shortfall. Under this option, the affected state and local governments would probably restructure their plans in one of two ways. First, they might exclude newly hired state and local employees from participation—thereby forgoing a possible source of new funding—which would place an additional burden on those governments. Second, they might choose to supplement the Social Security coverage for new employees, but costs to state and local governments would have to increase to provide an equivalently valued benefit package that included Social Security. Total costs would be higher because the cost per dollar of Social Security benefits for state and local government employees would probably exceed the cost per dollar for pensions provided by state and local governments. Social Security costs would be greater because that program initially paid benefits to recipients who had not contributed much to the system and because Social Security redistributes benefits to workers with low career earnings. Delaying implementation of the option for a few years would provide state and local governments time to restructure their pension plans. Nevertheless, costs to the affected state and local governments would probably rise.

RELATED OPTION: Revenues, Option 16

RELATED CBO PUBLICATIONS: *Social Security Policy Options,* July 2010; *The Long-Term Budget Outlook,* June 2010; and *CBO's Long-Term Projections for Social Security: 2009 Update,* August 2009

Revenues—Option 18

Increase Corporate Income Tax Rates by 1 Percentage Point

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	5.9	9.5	10.1	10.6	10.7	10.5	10.6	10.5	10.8	11.5	46.8	100.6

Source: Joint Committee on Taxation.

Most corporations subject to the corporate income tax calculate their tax liability according to a progressive rate schedule. The first $50,000 of corporate taxable income is taxed at a rate of 15 percent; income of $50,000 to $75,000 is taxed at a 25 percent rate; income of $75,000 to $10 million is taxed at a 34 percent rate; and income above $10 million is generally taxed at a rate of 35 percent.[1]

Although most corporate income falls in the 35 percent tax bracket, the average tax rate on corporate income (corporate taxes divided by corporate income) is lower than 35 percent because of allowable deductions, exclusions, tax credits, and the lower tax rates that apply to the first $10 million of income. For example, corporations can deduct business expenses, including interest paid to holders of the firm's bonds, from gross income to compute taxable income. (Dividends paid to shareholders, however, are not deductible.) Most income earned by the foreign subsidiaries of U.S. corporations is not subject to U.S. taxation until it is repatriated in the form of dividends paid to the parent corporation. To prevent income earned abroad from being subject to both foreign and U.S. taxation, the tax code gives U.S. corporations a credit that reduces their U.S. tax liability on that income by the amount of income and withholding taxes they have paid to foreign governments. The foreign tax credit is subject to limits that are designed to ensure that the amount of credits taken does not exceed the amount of U.S. tax that otherwise would have been due.

1. Under current law, surtaxes are imposed on some amounts of corporate income. Income between $100,000 and $335,000 is subject to a surtax of 5 percent, and an additional 3 percent tax is levied on income between $15 million and $18.3 million. Those surtaxes effectively phase out the benefit of the three lower tax rates for corporations with income above certain amounts. As a result, a company that reports more than $18.3 million in taxable income effectively faces a statutory rate equal to 35 percent of its total corporate taxable income.

This option would increase all corporate income tax rates by 1 percentage point. For example, the corporate income tax rate would increase to 36 percent for taxable income above $10 million. The option would increase revenues by $47 billion from 2012 through 2016 and by $101 billion over the 2012–2021 period.

The major argument in favor of the option is its simplicity. As a way to raise revenue, increasing corporate income tax rates would be easier to implement than most other types of business tax increases because it would require only minor changes to the current tax collection system.

The option would also increase the progressivity of the tax system to the extent that the corporate income tax is largely borne by owners of capital, who tend to have higher incomes than other taxpayers. But the extent to which the financial burden of the tax ultimately falls on the owners of corporations, owners of all capital assets, or workers is unclear. The United States is an open economy, in which many firms engage in international trade. Because labor tends to be less mobile than capital in open economies, some of the corporate income tax burden might be passed back to workers through reductions in their compensation over a number of years—making an increase in corporate tax rates somewhat less progressive.

An argument against the option is that it would further reduce economic efficiency. The current corporate income tax system already distorts firms' choices about how to structure the business (for example, whether to operate as a C corporation, an S corporation, a partnership, or a sole proprietorship) and whether to finance investment by issuing debt or by issuing equity. Increasing corporate income tax rates would make it even more advantageous for firms to expend resources to qualify as an S corporation solely as a way to reduce their tax liabilities. That is because net income from C corporations—those subject to the corporate income tax—is first taxed at the business level and then again at the individual level

after it is distributed to shareholders or investors. By contrast, income from S corporations—which can have no more than 100 owners and are subject to other restrictions—is generally free from taxation at the business level but is taxed under the individual income tax, even if the income is reinvested in the firm. Raising corporate tax rates would also encourage companies to increase their reliance on debt-financing because interest payments, unlike dividend payments to shareholders, can be deducted. Carrying more debt might increase some companies' risk of default. Moreover, the option could cause businesses to decrease the amounts they invest, hindering the growth of the economy. An alternative to this option that would reduce such incentives would be to lower the tax rate while broadening the tax base.

Another concern raised about the option is that it would increase the tax rate that corporations—those based in the United States and those based in foreign countries—face when they earn income in the United States. Such an increase would cause the top marginal tax rate (that applied to the last dollar of income) in the United States to be higher than the top marginal tax rates that most other countries have adopted. That would be of concern if it were to discourage investment in the United States. Those statutory rates, however, do not reflect the differences in various countries' tax bases and rate structures and therefore do not represent the true average tax rates that multinational firms face. Other factors, such as the skill level of a country's workforce and its capital stock, also affect corporations' decisions about where to incorporate and invest.

RELATED OPTION: Revenues, Option 19

RELATED CBO PUBLICATIONS: Jennifer C. Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis,* Working Paper 2010-03, May 2010; William C. Randolph, *International Burdens of the Corporate Income Tax,* Working Paper 2006-09, August 2006; and *Corporate Income Tax Rates: International Comparisons,* November 2005

Revenues—Option 19

Set the Corporate Income Tax Rate at 35 Percent for All Corporations

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	1.5	2.8	2.7	2.6	2.5	2.5	2.5	2.5	2.5	2.4	12.1	24.4

Source: Joint Committee on Taxation.

Most corporations subject to the corporate income tax calculate their tax liability according to a progressive rate schedule. That tax is assessed at the following rates: 15 percent for the first $50,000 of taxable income; 25 percent for income from $50,000 to $75,000; 34 percent for income from $75,000 to $10 million; and 35 percent for income above $10 million.

This option would set a single statutory rate of 35 percent for all corporate taxable income, increasing revenues by $12 billion from 2012 through 2016 and by $24 billion from 2012 through 2021.

Under current law, surtaxes are imposed on some amounts of corporate income. Income between $100,000 and $335,000 is subject to a surtax of 5 percent (increasing the tax rate on income in that range from 34 percent to 39 percent), and an additional 3 percent tax is levied on income between $15 million and $18.3 million (increasing the tax rate on income in that range from 35 percent to 38 percent). Those taxes effectively phase out the benefit of the three lower tax rates for corporations with income above certain amounts. As a result, a company that reports more than $18.3 million in taxable income effectively faces a statutory tax rate equal to 35 percent of its total corporate taxable income.[1] Because the surtaxes would also be eliminated, this option would not alter the taxes those businesses pay, nor would it affect businesses that operate as S corporations or as limited liability companies. (Owners of those enterprises do not pay corporate taxes but instead pay taxes on their total business income under the individual income tax.)

A primary benefit of the progressive rate schedule for the corporate income tax is that it lessens the "double taxation" of profits earned by small and medium-sized companies. Double taxation occurs when the government taxes the earnings of C corporations once at the corporate level and again at the individual level when those earnings are distributed to households. Of the 500,000 to 1 million corporations that typically owe corporate income taxes each year, all but a few thousand pay only the lower rates that apply to lower amounts of income. (Because the companies that benefit earn only about 10 percent to 15 percent of all taxable corporate income, however, the reduced rates have a limited effect on tax revenues.)

One argument for creating a flat corporate income tax is that many of the companies that benefit from the current rate structure are not small or medium-sized. Under current law, large corporations can reduce their taxable income for certain years by sheltering some of it or by controlling when they earn income and incur expenses. Another argument is that the current rate structure creates opportunities for individuals to shelter income in closely held corporations (that is, corporations whose shares are held by one individual or a closely knit group of shareholders and whose shares are not publicly traded). People avoid paying individual income taxes on that income if the corporation retains the earnings—which may be taxed at the lower corporate rates—rather than paying them out as dividends. (That benefit does not apply to owners of personal-services corporations—such as physicians, attorneys, and consultants—whose companies are already taxed at a flat rate of 35 percent.)

1. Although most corporate income falls in the 35 percent tax bracket, the average tax rate on corporate income (corporate taxes divided by corporate income) is lower than 35 percent, chiefly because of allowable deductions, exclusions, and tax credits.

An argument against this option is that it would reduce the amount the affected companies would invest and distort the way in which those businesses finance their remaining investments. Investment capital would be more costly for businesses affected by the higher tax rates. Consequently, instead of issuing as much stock, those companies would either increase their use of debt financing (because the interest is tax-deductible) or decrease the amounts they invest. Carrying more debt would increase some companies' risk of default.

RELATED OPTION: Revenues, Option 18

Revenues—Option 20

Repeal the "LIFO" and "Lower of Cost or Market" Inventory Accounting Methods

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	9.2	16.5	17.3	17.8	11.2	5.9	4.6	4.8	5.0	5.2	72.0	97.5

Source: Joint Committee on Taxation.

To compute its taxable income, a business must first deduct from its receipts the cost of purchasing or producing the goods it sold during the year. Determining those costs requires that the business identify and attach a value to its inventory. Most companies calculate the cost of the goods they sell in a year using the accrual method of accounting, adding the value of the inventory at the beginning of the year to the cost of goods purchased or produced during the year and then subtracting from that total the value of the inventory at the end of the year.

The tax code allows firms to choose among several approaches for identifying and determining the value of the goods included in their inventory. For itemizing and valuing goods in stock, firms can use the "specific identification" method. That approach, however, requires a very detailed physical accounting in which each item in inventory is matched to its actual cost. An alternative approach—"last in, first out" (LIFO)—also allows firms to value their inventory at cost but, in addition, permits them to assume that the last goods added to inventory were the first ones sold. Under that assumption, the cost of those more recently produced goods should approximate current market value (that is, the cost of replacing the inventory).

Yet another alternative approach—"first in, first out" (FIFO)—is based on the assumption that the first goods sold from a business's inventory have been in that inventory the longest. Like firms that adopt the LIFO method, firms using the FIFO approach can also value their goods at cost. But firms that use the FIFO approach have still another choice—the "lower of cost or market" (LCM) method. Instead of assessing their existing inventory at cost, they can assess that inventory on the basis of its market value and then choose whichever valuation is lower. In addition, if a business's goods cannot be sold at market prices because they are damaged or flawed, firms that use the FIFO approach can qualify for the "subnormal goods" method of inventory valuation.

This option would eliminate the LIFO method of identifying inventory, as well as the LCM and subnormal-goods methods of inventory valuation. Businesses would be required to use the specific-identification or FIFO methods to account for goods in their inventory and to set the value of that inventory on the basis of cost. Those changes—which would be phased in over a period of four years—would increase revenues by $72 billion from 2012 through 2016 and by a total of $98 billion over the 2012–2021 period.

The main rationale for this option is to align the tax accounting rules with how businesses probably sell their goods. Under many circumstances, firms probably prefer to sell their oldest inventory first—among other reasons, to minimize the risk that the product becomes obsolete or damaged during storage. Under those circumstances, allowing firms to use alternative methods to identify and to value their inventories for tax purposes allows them to reduce their tax liabilities without any change in their economic behavior.

An argument for eliminating the LIFO method is that it allows companies to defer taxes on real (inflation-adjusted) gains when the prices of their goods are rising relative to general prices. Firms that use LIFO can assume that the goods that are sold are from newer—and costlier—inventory when, in fact, the items may have been in inventory for some time and were produced when costs were lower. By deducting those higher costs as the price of production, firms are able to defer taxes on the amount by which the value of their goods has appreciated, until those goods are sold.

An argument against disallowing the LIFO accounting method is that such a policy change could also result in the taxation of income that arises from inflation. The gains that would be taxed if the LIFO method was terminated could be attributable to inflation and, therefore, would not represent real changes in a firm's resources and

its ability to pay taxes. However, other elements of the corporate income tax do not correct for inflation and therefore gains attributable to inflation are taxed.

An argument for eliminating the LCM method of inventory valuation under FIFO is that, when prices are falling, it provides a tax advantage for goods that have not been sold. The LCM method allows a business to compare the market value of each item in its inventory with the item's cost and then set the lower of the two as the item's value. The year-end inventory will have a lower total value under LCM than under the cost method if the market value of any item in the inventory is less than its cost. Using the LCM method when prices are falling allows the firm to claim a larger deduction for the costs of goods sold, causing the firm's taxable income to fall as a result. In effect, that method allows a firm to deduct from its taxable income the losses it incurred from the decline in the value of its inventory. (That deduction is allowed even though the firm has not sold the goods.) A firm, however, is not required to recognize gains in the value of its inventory when prices are rising, which means that gains and losses are taxed differently. Similarly, firms that use the subnormal goods method of inventory valuation can immediately deduct the loss, even if the company later sells the good at a profit.

Revenues—Option 21

End the Expensing of Exploration and Development Costs for Extractive Industries

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	1.3	1.8	1.7	1.5	1.3	1.1	0.6	0.3	0.2	0.2	7.6	10.0

Source: Joint Committee on Taxation.

Current tax law treats the extractive industries that produce oil, natural gas, and minerals more favorably than it does most other industries. One incentive designed to encourage exploration for and development of oil, gas, and hard minerals allows producers to "expense" rather than capitalize some of their costs. Expensing allows companies to fully deduct the costs of exploration and development from taxable income as they are incurred rather than waiting to deduct those costs over time as the income they produce is generated.

Other industries, by contrast, must deduct costs more slowly, according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs related to property either to be deducted when the property is sold or to be depreciated over several years. In either case, the businesses involved must postpone the deduction of those costs from their taxable income. Intangible costs (such as maintaining a working-capital fund) that are related to drilling and development and the costs for mine development and exploration are exempt from those rules. The ability to expense such costs gives extractive industries a tax advantage that other industries do not have.

The costs that companies can expense include those incurred for excavating mines, drilling wells, and prospecting for hard minerals. The rules do not apply across the board to producers of oil and natural gas, however. Although current law allows independent oil and gas producers and noncorporate mineral producers to fully expense their costs, that practice is limited to 70 percent of costs for "integrated" oil and gas producers (companies with substantial retailing or refining activity) and for corporate mineral producers. Those companies must deduct the remaining 30 percent of their costs over 60 months.

This option would replace the expensing of exploration and development costs for oil, gas, and minerals with the standard capitalization rules set in the Tax Reform Act of 1986, increasing revenues by $8 billion from 2012 through 2016 and by a total of $10 billion over the 2012–2021 period. (Those amounts reflect the assumption that businesses could still expense some of their costs, including those associated with unproductive wells and mines.)

An argument in favor of this option is that expensing distorts the allocation of society's resources in several ways. First, it encourages the use of resources for drilling and mining that might be employed more productively elsewhere in the economy. Second, it could influence the way resources are allocated within the extractive industries. A company could decide what to produce not on the basis of factors related to economic productivity but on the basis of the size of the advantage that expensing provides (for example, the difference between the immediate deduction and the deduction over time, which reflects the true useful life of the capital involved). Such decisions also could rest on whether the producer must pay the alternative minimum tax, under which expensing is limited. Third, expensing encourages producers to extract more resources in a shorter time. That, in the short run, could make the United States less dependent on imported oil; but, in the long run, it could deplete the nation's store of oil for extraction and cause greater reliance on foreign producers.

An argument against such a policy change is that exploration and development costs should be expensed because they are ordinary operating expenses. Supporters of expensing also argue that the tax advantage is necessary to encourage producers to continue exploring and developing the strategic resources that are essential to the nation's energy security.

RELATED CBO PUBLICATION: *Reforming the Federal Royalty Program for Oil and Gas,* November 2000

Revenues—Option 22

Extend the Period for Depreciating the Cost of Certain Investments

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	0	5.2	16.8	26.4	30.4	34.1	36.2	33.9	30.3	28.1	78.8	241.4

Source: Joint Committee on Taxation.

When calculating their taxable income, companies can deduct the expenses they incurred when producing goods or services for sale, including depreciation (the drop in the value of a productive asset over time). The tax code sets the number of years over which the value of different types of investments can be deducted from taxable income.

This option would extend the lifetime of equipment and certain structures placed into service after December 31, 2012, for purposes of tax depreciation. Specifically, where the tax code currently stipulates a lifetime of 3, 5, 7, 10, 15, or 20 years, this option would raise the lifetime to 4, 8, 11, 20, 30, or 39 years, respectively.[1] Those changes would increase revenues by a total of $79 billion from 2012 through 2016 and by $241 billion over the 2012–2021 period.

An argument in favor of this option is that the current rates of tax depreciation overstate the decline in the economic value of assets because they do not accurately reflect the rate of inflation that is likely to occur over the asset's lifetime. Because rates of depreciation are set by the tax code and depreciation deductions are not indexed for inflation, the real (inflation-adjusted) value of the depreciation allowed by tax law depends on the rate of inflation.

Most rates of depreciation in the tax code today were set in the Tax Reform Act of 1986 and would approximate economic depreciation (the decline in an asset's economic value, including the impact of inflation over time) if the average rate of inflation had been 5 percent during that 25-year period. The Congressional Budget Office estimates, however, that inflation over the next decade will average about 2 percent annually. That difference of about 3 percentage points means businesses can deduct larger amounts of depreciation from taxable income—and thus have a lower tax liability—than they could if the deduction accurately measured economic depreciation.

Another argument in favor of this option is that it would equalize effective tax rates—the total amount of tax liability divided by income—on the income from different types of investment. Equipment and structures are two of the main types of tangible capital for which businesses take depreciation deductions, and the effective tax rates are currently quite different. Deductions for equipment generally contribute more to the understatement of taxable income than do deductions for structures; equipment has a shorter service life (the time over which depreciation deductions can be taken), so changes in inflation have a greater effect on deductions for equipment. Since 1986, policymakers have extended the useful lifetime of some kinds of structures for calculating depreciation.

In contrast, recent legislation allows firms to accelerate depreciation deductions for equipment. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) allows firms to expense—that is, immediately deduct from taxable income—100 percent of the costs of investment in equipment made between September 8, 2010, and December 31, 2011. For equipment acquired between January 1, 2012, and December 31, 2012, firms will be able to immediately deduct 50 percent of the cost. After 2012, current tax law will revert to the typical rules, which allow no expensing (except in limited cases) and generally require firms to deduct their equipment investment over a number of years.

Under the law currently in effect for 2013, if inflation remained at 2 percent and the real discount rate (which adjusts for the change in the value of a dollar over time) for businesses was 5 percent, the average effective tax

1. Most structures—including residential and office buildings—have a lifetime that is greater than 20 years and thus would be unaffected by this option. However, some structures—such as electric power plants and barns—have a shorter lifetime under current law; the option would extend the lifetime of those structures as well.

rates on income from corporate investment would be 25 percent for equipment and 30 percent for structures. In contrast, under this option, those rates would be 33 percent for equipment and 32 percent for structures. That near parity would mitigate the incentive that exists in the tax code for companies to invest more in equipment and less in structures than they might if investment decisions were based on economic returns. Such an incentive distorts choices between investing in equipment and investing in structures, thus reducing economic efficiency.

Those average tax rates would differ if inflation was different, however. If the rate of inflation was a percentage point lower, the average effective tax rate under this option would be 30 percent for equipment and 31 percent for structures. Conversely, if inflation was a percentage point higher, the rates for equipment and structures would be 35 percent and 33 percent, respectively. Therefore, if inflation differed from CBO's expectations, new distortions between investment in equipment and structures would emerge over the long run.

An argument against this option is that low tax rates on capital may encourage investment. From that perspective, the current tax treatment could be equalized by easing taxation on all forms of capital rather than by raising the effective tax rate on a type of capital that is now favored. In addition, under this option, there would continue to be substantial variation in the effective tax rates for equipment with different service lives.

RELATED CBO PUBLICATIONS: *Computing Effective Tax Rates on Capital Income,* Background Paper, December 2006; and *Taxing Capital Income: Effective Rates and Approaches to Reform,* October 2005

Revenues—Option 23

Repeal the Deduction for Domestic Production Activities

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	5.3	14.3	15.2	15.9	16.7	17.5	18.3	19.1	19.9	20.9	67.4	163.1

Source: Joint Committee on Taxation.

The American Jobs Creation Act of 2004 allows businesses to deduct from their taxable income a percentage of what they earn from qualified domestic production activities. Set at 3 percent for tax years 2005 and 2006, the deduction rose to 6 percent for tax years 2007 through 2009 and to 9 percent for tax year 2010 and thereafter. The Emergency Economic Stabilization Act of 2008 reduced the deduction rate for oil-related qualified production activities to 6 percent for tax years after 2009.

Various activities qualify for the deduction:

- Lease, rental, sale, exchange, or other disposal of tangible personal property, computer software, or sound recordings, if they are manufactured, produced, grown, or extracted in whole or significant part in the United States;
- Production of films (other than those that are sexually explicit);
- Production of electricity, natural gas, or potable water;
- Construction or renovation; and
- Performance of engineering or architectural services.

The list of qualified activities specifically excludes the sale of food or beverages prepared at retail establishments; the transmission or distribution of electricity, natural gas, or potable water; and many activities that would otherwise qualify except that the proceeds come from sales to a related business.

The deduction for domestic production activities was created in part to replace the tax code's extraterritorial income exclusion—which allowed businesses to exclude income from certain types of transactions that generate receipts from trade with foreign countries. According to the World Trade Organization, that exclusion violated its agreements by subsidizing exports. The deduction was intended to reduce the taxes on income from domestic production without violating the organization's rules.

This option would repeal the deduction for domestic production activities. Doing so would increase revenues by $67 billion from 2012 through 2016 and by $163 billion from 2012 through 2021.

One argument in favor of this option is that it would reduce economic distortions. Although the deduction is targeted toward investments in domestic production activities, it does not apply to all domestic production. Whether a business activity qualifies for the deduction is unrelated to the economic merits of the activity. Thus, the deduction gives businesses an incentive to invest in a particular set of domestic production activities and to forgo other, perhaps more economically beneficial, investments in domestic production activities that do not qualify.

In addition, to comply with the law, businesses must satisfy a complex and evolving set of statutory and regulatory rules for allocating gross receipts and business expenses to the qualified activities. Companies that want to take full advantage of the deduction may incur large tax-planning costs (for example, fees to tax advisers). Moreover, the complexity of the rules can cause conflict between businesses and the Internal Revenue Service regarding which activities qualify under the provision.

An argument against implementing this option is that simply repealing the deduction for domestic production activities would increase the cost of domestic business investment and could reduce the amount of such investment. Alternatively, the deduction could be replaced with a revenue-neutral reduction in the top corporate tax rate

(a cut that would reduce revenues by the same amount that eliminating the deduction would increase them). That alternative would end the current distortions between activities that qualify for the deduction and those that do not. It also would reduce the extent to which the corporate tax favors noncorporate investments over investments in the corporate sector and foreign activities over domestic business activities.

Revenues—Option 24

Eliminate the Source-Rules Exception for Exports

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	2.1	4.1	4.5	4.9	5.3	5.7	6.1	6.5	7.0	7.5	20.9	53.7

Source: Joint Committee on Taxation.

To prevent the income that U.S. corporations earn abroad from being subject to both foreign and U.S. taxation, the federal government provides a credit that reduces those companies' domestic tax liability by the amount of income and withholding taxes they have paid to foreign governments. Under the rules governing that foreign tax credit, it cannot exceed the amount of U.S. tax those businesses otherwise would have owed, nor can it be used to reduce taxes on the income they earned in the United States. If a corporation pays more foreign tax on its foreign income than it otherwise would have paid on identical domestic income, it accrues what is known as excess foreign tax credits under the U.S. tax code.

Unlike income from overseas operations, income from goods that are produced domestically but sold abroad results almost entirely from the value created or added in the United States. Hence, the income that U.S. corporations receive from exports typically is not taxed by foreign nations. But, according to the tax code, if a firm produces its goods within the United States and then sells its inventory abroad as exports, only half of the income is allocated to the United States; the other half is governed by the U.S. tax code's "title passage rule" and allocated to the jurisdiction in which the sale took place. (The title passage rule specifies that, when a firm's inventory is sold, the income from that sale is treated as earned in the country in which the sale occurred—and is subject to that country's tax laws.) In practice, if the company's inventory is produced in the United States and sold elsewhere, half of the income from those sales is treated as originating abroad, even if the company has no branch or subsidiary located in the place of sale and the foreign jurisdiction does not tax the income.

The result is that a business can classify more of its income from exports as foreign than could be justified solely on the basis of where the underlying economic activity occurred. A multinational corporation can then use any excess foreign tax credits to offset U.S. taxes on that income. About half of the export income that companies with such excess credits receive is effectively exempted from U.S. taxation, and the income allocation rules give those companies an incentive to produce goods domestically for sale by their overseas subsidiaries.

This option would eliminate the title passage rule and require taxpayers to allocate income for the purpose of taxation on the basis of where the economic activity actually occurs. That change would increase revenues by $21 billion from 2012 through 2016 and by $54 billion over the 2012–2021 period.

One rationale in favor of the option is that export incentives, such as those embodied in the title passage rule, do not boost domestic investment and employment overall or affect the trade balance. They do increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. However, the value of the U.S. dollar is boosted as a result, making foreign goods cheaper and thereby reducing profits, investment, and employment for U.S. companies whose products compete with imported goods. Thus, export incentives distort the allocation of resources by misaligning the prices of goods relative to their production costs, regardless of where the goods are produced.

This option also would end a feature of U.S. tax law that allows businesses to avoid taxes on certain types of income earned abroad. Foreign tax credits were intended to prevent the income of U.S. businesses from being taxed twice. But the title passage rule allows domestic export income that is not usually subject to foreign taxes to be exempted from U.S. taxes as well, so the income escapes corporate taxation altogether.

An argument against this option is that the title passage rule gives U.S. corporations an advantage over foreign companies operating in the same markets. (However, enterprises that lack excess foreign tax credits—such as some U.S. multinationals and U.S. exporters that carry

out all of their production domestically—receive no such advantage.) Some opponents of this option also argue that allocating income under the title passage rule is less complicated than doing so under the normal rules for income allocation.

RELATED OPTIONS: Revenues, Options 25 and 26

RELATED CBO PUBLICATIONS: William C. Randolph, *International Burdens of the Corporate Income Tax,* CBO Working Paper 2006-09, August 2006; *Corporate Income Tax Rates: International Comparisons,* November 2005; and *Causes and Consequences of the Trade Deficit: An Overview,* CBO Memorandum, March 2000

Revenues—Option 25

Tax the Worldwide Income of U.S. Corporations As It Is Earned

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	4.7	10.8	11.1	11.4	11.7	12.1	12.5	12.9	13.3	13.7	49.7	114.2

Source: Joint Committee on Taxation.

The income that U.S. businesses earn at home and abroad is taxed by the federal government and may also be subject to taxation in the country in which it is earned. To prevent such double taxation, U.S. companies are allowed to claim a foreign tax credit, which reduces their domestic tax liability by the amount of any income and withholding taxes they pay to foreign governments. The foreign tax credit is subject to limits that are designed to ensure that the amount of credits taken does not exceed the amount of U.S. tax that otherwise would have been due. Those limits also are intended to prevent corporations from using foreign tax credits as a way to reduce taxes on income earned in the United States. For computing those limits, the overhead expenses (such as interest costs) that a U.S. parent company incurs for its operations must be allocated between domestic and foreign activities. Most of the income that foreign subsidiaries of U.S. corporations earn is not subject to U.S. taxation until it is repatriated in the form of dividends that those subsidiaries pay to the parent corporation.

Under this option, all income earned by the foreign subsidiaries of U.S. companies would be subject to U.S. taxes as it was earned, regardless of when it was repatriated. To prevent double taxation, foreign tax credits would still be allowed. For determining the limit on those credits, however, the U.S. parent corporation's overhead expenses would no longer be allocated between domestic and foreign activities because all income would be treated identically and taxed concurrently. Together, those changes would increase revenues by $50 billion from 2012 through 2016 and by $114 billion over the 2012–2021 period.

An argument in favor of this option is that by not taxing income until it is repatriated as dividends, the current system reduces the cost of foreign investment relative to that of domestic investment. This option would eliminate that bias and thus increase domestic investment, which in turn would make U.S. workers more productive and boost their earnings.

Other arguments focus on how such a policy change would simplify the tax system. Eliminating the rules for allocating overhead expenses and the provisions that distinguish between "active" foreign income (which is not taxed until it is repatriated) and "passive" foreign income (which is generally taxed as it is earned) would make international tax rules less complex. In addition, the costs of tax planning also would decline for U.S. multinational corporations, which would no longer need to plan the repatriation of dividends from their foreign subsidiaries. Finally, enforcing tax rules would be less costly because U.S. companies would not be able to reduce their worldwide taxes by treating U.S. income as foreign income.

An argument against this approach is that it would put U.S. multinational corporations at a competitive disadvantage: Whereas the cost of foreign investments would increase for U.S. multinationals, similar investment costs for foreign multinationals would remain the same. Such a competitive disadvantage, it is argued, would shift market share and production toward businesses controlled by foreign multinationals. Those concerns could be addressed by reducing U.S. corporate tax rates if such a policy change was implemented.

RELATED OPTIONS: Revenues, Options 18, 19, 24, and 26

RELATED CBO PUBLICATION: *Corporate Income Tax Rates: International Comparisons,* November 2005

Revenues—Option 26

Exempt Active Foreign Dividends from U.S. Taxation and Change the Tax Treatment of Overhead Expenses

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	3.3	6.5	6.9	7.3	7.7	8.1	8.5	8.9	9.3	9.7	31.7	76.2

Source: Joint Committee on Taxation.

The federal government taxes the income that U.S. businesses earn both at home and abroad. Most of the income that U.S. corporations earn from their foreign subsidiaries' business activities is not subject to taxation in the United States until it is repatriated in the form of dividends that the subsidiaries pay to their parent company. Other forms of foreign income, such as royalties, interest, and "passive" income—that is, income derived from business assets by investors with little or no personal participation in the business—are subject to U.S. tax as that income is earned.

To prevent income earned abroad from being subject to both foreign and U.S. taxation, the tax code gives U.S. corporations a credit that reduces their domestic tax liability by the amount of income and withholding taxes they have paid to foreign governments. The foreign tax credit is subject to limits that are designed to ensure that the value of the credits taken does not exceed the amount of U.S. tax that otherwise would have been due. Those limits also are intended to prevent corporations from using foreign tax credits as a way to reduce taxes on income earned in the United States. For computing those credit limits, the overhead expenses (such as interest costs) that a U.S. parent company incurs for its operations must be allocated between domestic and foreign activities. (When computing taxable income, however, firms can deduct total overhead expenses, regardless of the source.)

This option would exempt from U.S. taxation "active" dividends—those that U.S. corporations earn from the business operations of their foreign subsidiaries or foreign branches. All other foreign income (including royalties, interest, and income from passive activities) would be taxed in the current manner—as it is earned. Foreign tax credits would be allowed so that companies could offset any foreign income taxes or withholding taxes paid on foreign income that was still subject to U.S. taxation. Overhead costs, such as interest expenses, of a U.S. parent company would be allocated between the company's U.S. and foreign activities, as is the case under current law for purposes of computing the foreign tax credit. In a departure from current law, however, overhead expenses allocated to foreign income would no longer be deductible from U.S. income. Those changes would increase revenues by a total of $32 billion from 2012 through 2016 and by $76 billion over the 2012–2021 period. The revenue lost by exempting active dividends from U.S. taxation would be more than offset by increases in taxes on other sources of income. Specifically, taxes on U.S. income would rise because overhead expenses allocated to exempt foreign income could no longer be deducted from U.S. income. In addition, companies that paid high foreign income taxes could no longer use the foreign tax credits associated with repatriated dividends to shield other low-tax foreign income, such as royalties and export income, from U.S. taxes.

An argument in favor of this option is that such a change would reduce the complexity of the tax system. Current rules allow U.S. multinational corporations to reduce their worldwide taxes by carefully planning how and when to repatriate dividend income from their foreign subsidiaries. Researchers have estimated the total costs of such planning to be more than $1 billion per year. This option would eliminate those planning costs. It is also argued that this option would allow foreign tax-credit rules to be simplified because many of those rules would no longer apply to active dividend income.

An argument against such a policy change is that it would have the same effect as the current tax system, causing U.S. corporations to favor foreign investment over U.S. investment and thus reducing the amount of capital available for production in the United States.

RELATED OPTIONS: Revenues, Options 24 and 25

RELATED CBO PUBLICATION: *Corporate Income Tax Rates: International Comparisons*, November 2005

Revenues—Option 27

Impose a 5 Percent Value-Added Tax

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues												
Broad base	0	180	240	260	270	290	300	310	320	330	950	2,500
Narrow base	0	100	140	140	150	160	160	170	180	190	530	1,390

Source: Congressional Budget Office.

A value-added tax (VAT) is a type of consumption tax that is collected at each stage of a commodity's production and distribution. Although a VAT is typically administered by taxing the total value of a business's sales of a particular product or service, the business can claim a credit for the taxes it paid on the "inputs"—such as materials and equipment—it used to make the product or provide the service.

More than 140 countries—including all members of the Organisation for Economic Co-operation and Development (OECD), except for the United States—have adopted VATs. However, the tax bases and rate structures differ greatly among countries. Most European countries have implemented VATs that have a narrow tax base, with certain categories of goods and services—such as food, education, and health care—either exempted from the tax or taxed at lower rates than other goods and services. In Australia and New Zealand, the VAT has a much broader tax base, with exemptions generally limited only to those goods and services for which it is difficult to determine a value. As of January 1, 2010, the average VAT rate for OECD countries was 18 percent, ranging from 5 percent in Japan to 25.5 percent in Iceland. All OECD countries that impose a VAT also collect revenues from taxes on income and profits.

This option would impose a 5 percent VAT in one of two ways. The first alternative would apply the VAT to a broad base that would include most goods and services. Because their value is difficult to measure, certain items—such as financial intermediation services, existing housing services, primary and secondary education, and other services provided by government agencies and nonprofit organizations for a nominal or no fee—would be excluded from the base. (Existing housing services encompass the monetary rents paid by tenants and rents imputed to owners who reside in their own homes.) Although existing housing services would be excluded under this alternative, the broad base would include all future consumption of housing services by taxing the purchase of new residential housing. The broad base would also exclude government-reimbursed expenditures for health care (primarily costs paid by Medicare and Medicaid).

The option would become effective on January 1, 2013—a year later than most of the revenue options presented in this volume—to provide the Internal Revenue Service sufficient time to set up and administer a VAT. The first approach would increase revenues by $950 billion from 2012 through 2016 and by $2.5 trillion over the 2012–2021 period. (Because a VAT reduces the tax base of income and payroll taxes, the imposition of a VAT would lead to reductions in revenues from those sources. The estimates shown here reflect those reductions.)

Under the second alternative, the 5 percent VAT would apply to a narrower base. In addition to those items excluded under the broad base, the narrow base would exclude purchases of new residential housing, food purchased for home consumption, health care, postsecondary education, and all other financial services. This approach would increase revenues by $530 billion from 2012 through 2016 and by $1.4 trillion over the 2012–2021 period.

One argument in favor of imposing a VAT, as an alternative to increasing income tax rates, is that such action would raise revenues without discouraging saving and investment. Through tax credits, deductions, and exclusions, the individual income tax provides incentives that encourage saving, but those types of provisions—each with their own eligibility rules and income phaseouts—make the tax system more complicated. By taxing

consumption only, a VAT would exempt saving in a simpler, more direct fashion.

A drawback of the option is that it would require the federal government to establish a new system to monitor and collect the tax. As with any new tax, a VAT would impose additional administrative costs on the federal government and additional compliance costs on businesses. Because such costs are typically higher for smaller businesses, many countries, including the United Kingdom, exempt some small businesses from the VAT. A study conducted by the Government Accountability Office (GAO) in 2008 showed that all of the countries evaluated—Australia, Canada, France, New Zealand, and the United Kingdom—devoted significant resources to addressing and enforcing compliance. However, the GAO study also found that a VAT might be less expensive to administer than an income tax. For example, the tax administration agency in the United Kingdom estimated administrative costs for the VAT to be 0.55 percent of revenue collected, whereas the cost of administering the income tax was 1.27 percent.

Another argument against imposing a VAT is that it might increase the prices consumers have to pay for goods and services relative to the after-tax price sellers would otherwise receive for providing those goods and services. Therefore, adopting a VAT would cause an initial jump in the overall consumer price index because that index is computed on a tax-inclusive basis. The increase in the price level, however, would not necessarily lead to further inflation. If the Federal Reserve adjusted the money supply in a way that maintained current-dollar income, little inflation, beyond the initial price jump, would occur. (If there was an initial increase in the price level, federal spending for mandatory programs with benefits that are affected by inflation, such as Social Security, could increase; parameters of the tax system that are indexed to inflation could also be affected. However, the estimates shown here correspond to the standard estimating convention of holding macroeconomic aggregates—such as gross domestic product and the overall price level—unchanged.)

Yet another drawback of imposing a VAT is that the tax is regressive when its burden is measured on an annual basis. In any given year, lower-income families—who consume a greater share of their income than higher-income families—would pay a larger share of their annual income in consumption taxes than other families. A VAT appears to be less regressive when its burden is measured over a longer period.

The choice between the two alternatives—a broad base and a narrow base—presents certain trade-offs. A VAT could be made less regressive by adopting a narrow base and thus granting tax preferences for the goods and services that command a relatively larger proportion of budgets for low-income individuals and families. Those preferences, however, would substantially increase the costs of enforcement and compliance, and they would reduce revenues. In addition, a narrow-based VAT with exemptions would distort economic decisions to a greater degree than would a VAT with a broader base.

Policymakers could offset some of the regressive impact of a VAT by allowing additional exemptions or refundable credits under the federal income tax for individuals and families with lower income. That approach could be specifically targeted to lower- and middle-income families, but such provisions could add to the complexity of the individual income tax.

RELATED CBO PUBLICATIONS: *The Economic Effects of Comprehensive Tax Reform,* July 1997; and *Effects of Adopting a Value-Added Tax,* February 1992

Revenues—Option 28

Increase Excise Taxes on Motor Fuels by 25 Cents

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	20.9	29.4	29.7	30.0	30.2	30.2	30.2	30.2	30.1	30.0	140.2	291.0

Source: Joint Committee on Taxation.

Revenues from federal excise taxes on motor fuels are credited to the Highway Trust Fund to pay for highway construction and maintenance as well as for investment in mass transit. Those taxes currently are set at 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel produced. (State and local excise taxes bring total average tax rates nationwide to about 48 cents per gallon of gasoline and 54 cents per gallon of diesel fuel.)

This option would increase federal excise taxes on gasoline and diesel fuel by 25 cents per gallon, to 43.4 cents per gallon of gasoline and 49.4 cents per gallon of diesel fuel. That change would increase federal revenues by $140 billion from 2012 through 2016 and by a total of $291 billion over 10 years. (Because excise taxes reduce the tax base for income and payroll taxes, higher excise taxes would lead to reductions in revenues from those sources. The estimates shown here reflect those reductions.)

A rationale for increasing excise taxes on motor fuels is that the rates currently in effect are not sufficient to fully fund the federal government's spending on highways. In addition, economic efficiency is promoted when users of highway infrastructure are charged according to the marginal (or incremental) costs of their use, including the "external costs" that are imposed on society. Because the current fuel taxes do not cover all of those marginal costs, higher fuel taxes could more accurately reflect the external costs created by the consumption of motor fuel. Some of those costs—including the costs of pollution, climate change, and dependence on foreign oil—are directly associated with the amount of motor fuel consumed. But the larger fraction of those costs is related to the number of miles that vehicles travel, usage that results in road congestion, noise, pavement damage, and accidents.

If the cost of fuel was higher, people would drive less or purchase vehicles that used fuel more efficiently, thus reducing some of the external costs. (In contrast, paying for highways and mass transit through general revenues provides no incentive for the efficient use of those systems.) Various studies suggest that, in the absence of a tax on motor fuels or the number of vehicle miles traveled, the external costs of motor fuels amount to at least $1 per gallon, indicating that for drivers to cover the costs they impose on society, excise tax rates on motor fuels would have to be substantially higher than the current rates. Under this option, tax rates on motor fuels would more closely reflect those external costs. In addition, this option would have relatively low collection costs.

An argument against this option is that it could be more economically efficient to base a tax on the number of miles that vehicles travel. (Such a usage fee could be assessed on its own or in conjunction with taxes on motor fuels.) For example, imposing tolls or implementing congestion pricing (charging fees for driving at specific times in given areas) could be better ways to alleviate congestion. Similarly, a levy on the number of miles driven could be structured to correspond more closely to the costs of repairing damaged pavement than could a tax on motor fuels. However, creating the systems necessary to administer a tax on the number of vehicle miles traveled would be more complex than increasing the existing excise taxes on fuels.

Other arguments against raising taxes on motor fuels involve issues of fairness. Such taxes impose a proportionately larger burden, as a share of income, on middle- and lower-income households (particularly those not well-served by public transit) than they do on upper-income households. Similarly, those taxes impose a disproportionate burden on rural households because

the benefits of reducing vehicle emissions and congestion are greatest in densely populated, mostly urban, areas. Finally, to the extent that the trucking industry passed the higher cost of fuel on to consumers—in the form of higher prices for transported retail goods, for instance—those higher prices would further increase the relative burden on low-income and rural households.

RELATED CBO PUBLICATIONS: *Spending and Funding for Highways,* Issue Brief, January 2011; *Using Pricing to Reduce Traffic Congestion,* March 2009; *Effects of Gasoline Prices on Driving Behavior and Vehicle Markets,* January 2008; and *The Economic Costs of Fuel Economy Standards Versus a Gasoline Tax,* December 2003

Revenues—Option 29

Increase All Taxes on Alcoholic Beverages to $16 per Proof Gallon

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	4.8	5.8	5.9	6.0	6.0	6.1	6.2	6.3	6.4	6.4	28.5	59.9

Source: Joint Committee on Taxation.

In 2009, the federal government collected $9.6 billion in revenue from excise taxes on distilled spirits, beer, and wine. The different alcoholic beverages are taxed at different rates. Specifically, the alcohol content of beer and wine is taxed at a much lower rate than the alcohol content of distilled spirits because the taxes are determined on the basis of different liquid measures. Distilled spirits are measured in proof gallons (a standard unit for measuring the alcohol content of a liquid). The current excise tax levied on those spirits, $13.50 per proof gallon, translates to about 21 cents per ounce of alcohol. Beer, by contrast, is measured by the barrel, and the current tax rate of $18 per barrel translates to about 10 cents per ounce of alcohol (under the assumption that the average alcohol content of beer is 4.5 percent). The current levy on wine is $1.07 per gallon, or about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent).

This option would standardize the base on which the federal excise tax is levied by using the proof gallon as the measure for all alcoholic beverages. The tax would be raised to $16 per proof gallon, thus increasing revenues by about $29 billion over the 2012–2016 period and by $60 billion over the 2012–2021 period. (Because excise taxes reduce producers' and consumers' income, higher excise taxes would lead to reductions in revenues from income and payroll taxes. The estimates shown here reflect those reductions.)

A tax of $16 per proof gallon would equal about 25 cents per ounce of alcohol. Under this option, the federal excise tax on a 750-milliliter bottle (commonly referred to as a fifth) of distilled spirits would rise from about $2.14 to $2.54. The tax on a six-pack of beer would jump from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of wine would increase by a similar amount, from about 21 cents to 70 cents.

Experts agree that the consumption of alcohol creates costs for society that are not reflected in the pretax price of alcoholic beverages. Examples of those "external costs" include spending on health care that is related to alcohol consumption and covered by the public, losses in productivity stemming from alcohol consumption that are borne by others besides the consumer, and the loss of lives and property that results from alcohol-related accidents and crime. Calculating such costs is difficult. However, a study conducted for the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998—an amount far greater than the revenues currently derived from taxes on alcoholic beverages.[1] When adjusted for inflation, current excise tax rates on alcohol are far lower than historical levels. In the 1950s, excise taxes accounted for nearly half of the pretax price of alcohol; they now account for between 10 percent and 20 percent of the pretax price.

One argument in favor of raising excise taxes on alcoholic beverages is that they would reduce alcohol use—and thus the external costs of that use—and make consumers of alcoholic beverages pay a larger share of such costs. Research has consistently shown that higher prices lead to less alcohol consumption, even among heavy drinkers.

Moreover, raising excise taxes to reduce consumption might be desirable, regardless of the effect on external costs, if lawmakers believed that consumers underestimated the harm they do to themselves by drinking. Heavy drinking is known to cause organ damage and cognitive impairment; and the links between highway accidents and drinking, which are especially strong among the young, are well-documented. Substantial evidence also indicates that the use of alcohol from an early age can lead to heavy consumption later in life. When deciding how much to drink, people—particularly young people—may not adequately consider such long-term risks to their health.

1. See National Institute on Alcohol Abuse and Alcoholism, *Updating Estimates of The Economic Costs of Alcohol Abuse in The United States: Estimates, Update Methods, and Data* (December 2000).

An increase in taxes on alcoholic beverages would have disadvantages as well. It would make a tax that is already regressive—one that takes up a greater percentage of income for low-income families than for middle- and upper-income families—even more so. In addition, it would affect not only problem drinkers but also drinkers who imposed no costs on society and who thus would be unduly penalized. Furthermore, higher taxes would reduce consumption by some moderate drinkers whose intake of alcohol is believed to have health benefits. (Moderate alcohol consumption, particularly of wine, has been linked to lower incidence of heart disease, obesity, and stroke and to increases in life expectancy in middle age.) Finally, with regard to the argument that some drinkers underestimate the personal costs of alcohol consumption, some opponents of raising taxes on alcohol argue that the government should not try to modify consumers' private behavior.

Revenues—Option 30

Accelerate and Modify the Excise Tax on High-Cost Health Care Coverage

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	0	0	32.4	30.6	37.1	44.3	39.3	42.4	41.3	42.1	100.1	309.5

Sources: Joint Committee on Taxation and Congressional Budget Office.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

Although employer-paid premiums for health insurance are part of many employees' total compensation, those premiums are generally exempt from individual income taxes and payroll taxes. Employees at firms offering "cafeteria plans"—plans that allow employees to choose between taxable cash wages and nontaxable fringe benefits—can pay their share of premiums for employment-based health insurance with pretax earnings. In addition, contributions to certain other types of employee accounts, which can be used to pay for many health care costs not covered by insurance, may be exempt from income and payroll taxes. Those include employers' contributions to health reimbursement accounts (HRAs), employees' contributions to flexible spending accounts (FSAs), and employers' and employees' contributions to health savings accounts (HSAs).

Starting in 2018, an excise tax will be imposed on employment-based health care coverage if the total value of that coverage—including employers' and employees' contributions for health insurance and contributions made through HRAs, FSAs, or HSAs for other health care costs—exceeds a certain threshold. The tax will be equal to 40 percent of the difference between that total value and the threshold. In 2018, the annual threshold will be $27,500 for family coverage and $10,200 for individual coverage (which could be adjusted upward to reflect faster-than-expected growth in health care costs between 2010 and 2018). In 2019, the thresholds will change in accordance with the rate of growth in the consumer price index for all urban consumers (CPI-U) plus 1 percentage point. In 2020 and subsequent years, the thresholds will be indexed solely on the basis of the CPI-U. Higher thresholds will apply to retirees between the ages of 55 and 64 and to workers engaged in certain high-risk professions. Employees participating in union-sponsored plans will be subject only to the family thresholds. Finally, in determining the amount of the tax, employers will be allowed to adjust the cost of health insurance coverage if the distribution of their workforce by age and gender differs from that of a national risk pool.

Under this option, implementation of the excise tax would be accelerated and the thresholds would be lowered. In 2014, the 40 percent excise tax would apply to qualifying contributions that together exceeded $21,000 a year for family coverage and $8,200 for individual coverage. Beginning in 2015, the thresholds—which are based on the 80th percentile for health insurance premiums paid by or through employers—would be indexed for inflation using the CPI-U. Similar to the provisions of current law, the thresholds would be 10 percent higher for retirees ages 55 to 64 and for workers in designated high-risk professions; however, the other adjustments provided under current law would be eliminated. The option would increase revenues from income and payroll taxes by a total of $100 billion over the 2012–2016 period and by $310 billion over the 2012–2021 period.

As is the case under current law, the modified excise tax would increase revenues in two ways. First, for employment-based plans that remained above the thresholds, it would generate additional excise tax revenues. Second, many individuals and employers would probably respond to the presence of the excise tax by shifting to lower-cost insurance plans—plans with premiums below the tax threshold—to avoid paying the excise tax. As a result, total payments of health insurance premiums for those individuals would be less than they would have been in the absence of the tax. Because total compensation paid by employers would not be affected over the long term, lower expenditures for health insurance would mean higher taxable wages for employees and, consequently, higher revenues from income and payroll taxes.[1]

1. The increase in Social Security payments that would result from including more employers' contributions for health care coverage in employees' taxable income—and thus in the wage base from which Social Security benefits are calculated—is not included in the estimates.

An argument in support of this option is that it could dampen health care spending and thus restrain the growth of health care costs. Many analysts maintain that the tax preference for employment-based health insurance distorts the markets for health insurance and health care. That tax preference provides incentives for health insurance plans to cover routine expenses as well as large, unexpected costs because routine charges are subsidized (through the tax exclusion) only if they are paid for through an insurance plan (or other type of tax-favored health plan, such as an FSA). Under this option, more employees and their employers would have an incentive to buy less-expensive health insurance and to reduce contributions to FSAs and other tax-favored plans for health care spending—which could reduce upward pressure on costs for health care and encourage greater use of cost-effective types of care. Those incentives would also grow under current law but would be greater under this option because the tax would start sooner and would apply to a larger share of employment-based plans. Another argument for this option is that it would simplify the computation of the excise tax by eliminating adjustments for the age and gender of a firm's workforce.

An argument against this option is that it would probably increase the financial burden on people with substantial health problems. Employers might seek to avoid the tax by shifting to plans that have lower premiums and higher cost-sharing requirements, which would increase out-of-pocket costs for those workers, and the dependents of those workers, who use more services. In some cases, those higher cost-sharing requirements might lead enrollees to forgo care that would be beneficial to their health. Another argument against this option is that more firms would be subject to the tax simply because they had less-healthy workers or because they operated in an area with above-average costs for health care. In addition, by eliminating the adjustment for age, the option would make some firms liable for the tax if they had an older-than-average workforce.

RELATED OPTIONS: Mandatory Spending, Option 12; and Revenues, Options 8 and 32

Revenues—Option 31

Increase the Payroll Tax Rate for Medicare Hospital Insurance by 1 Percentage Point

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Revenues	48.6	53.1	58.6	61.4	64.2	66.9	70.0	73.1	76.0	79.0	285.9	650.8

Source: Joint Committee on Taxation.

Note: To the extent that the option would affect refundable tax credits, the estimates include effects on outlays.

The primary source of financing for Hospital Insurance (HI) benefits provided under Medicare Part A is the HI payroll tax. The HI tax is currently 2.9 percent of earnings, half of which is deducted from employees' paychecks and half of which is paid by employers. Self-employed individuals pay 2.9 percent of their net income in HI taxes. Unlike the payroll tax for Social Security, which applies to earnings up to an annual maximum ($106,800 in 2011), the HI tax is levied on total earnings.

Under the Patient Protection and Affordable Care Act of 2010 (Public Law 111-148), the portion of the HI tax that employees pay will increase by 0.9 percent of earnings in excess of $200,000, beginning in 2013. For a married couple filing an income tax return jointly, the surtax will apply to the couple's combined earnings above $250,000.

In recent years, expenditures for the HI program have grown at a much faster pace than revenues derived from the payroll tax. The Congressional Budget Office estimates that, in fiscal year 2011 and in most years thereafter, expenditures for HI will exceed the program's total income (including interest credited to the trust fund), which will necessitate that balances in the HI trust fund be drawn down. CBO projects that the balances will fall sharply during the 10-year budget period and will be exhausted in 2021.

This option would replace the 0.9 percent surtax on high-income taxpayers with a 1.0 percentage point increase in the total HI tax on all earnings. The HI tax rate for both employers and employees would increase by 0.5 percentage points to 1.95 percent, resulting in a combined rate of 3.9 percent. The rate paid by self-employed people would also rise to 3.9 percent. For taxpayers with income above $200,000 ($250,000 for married couples filing jointly), the portion of the HI tax that employees pay on income in excess of the surtax threshold would effectively be reduced from 2.35 percent to 1.95 percent; the portion that employers pay would increase from 1.45 percent to 1.95 percent.

If implemented, the option would increase revenues by $286 billion over the 2012–2016 period and by $651 billion over the 2012–2021 period. (The estimates include the reduction in individual income tax revenues that would result from a shift of some labor compensation from a taxable to a nontaxable form.)

The main argument for the option is that the HI payroll tax is currently not sufficient to cover the costs of the program, as indicated by the prospective insolvency of the HI trust fund. Increasing that tax would boost the revenues that flowed to the HI trust fund to a substantial degree and keep the fund solvent for a longer period. A commonly used measure of the long-term financial status of Medicare Part A is the actuarial balance—that is, the present value of revenues (primarily from payroll taxes) plus the current trust fund balance minus the present value of outlays for the program and the desired trust fund outlays (one year's worth) at the end of a specified period.[1] CBO projects that the actuarial imbalance for the HI trust fund over the next 75 years is 2.4 percent of taxable payroll, which is the difference between projected income— 4.2 percent of taxable payroll—and projected costs—6.5 percent of taxable payroll. Eliminating a gap of that size would require, as an example, either an immediate increase in the HI payroll tax rate, from its current 2.9 percent to 5.3 percent, or an immediate cut of about one-third in spending on Part A. By raising the HI tax by

1. Present value is a single number that expresses a flow of current and future income, or payments, in terms of an equivalent lump sum received or paid today. Here, it is calculated over 75 years using a long-term 3 percent real (inflation-adjusted) discount rate.

1 percentage point for most people (and by 0.1 percentage point for higher-income individuals), the option would delay the exhaustion of the HI trust fund by several decades but would not entirely eliminate the long-term gap between projected income and projected costs.

Another argument in favor of the option concerns tax administration. An increase in the overall payroll tax would be simpler to administer than the surtax that will go into effect in 2013. Another advantage of the option is that it would eliminate the marriage penalties that will result after the new surtax goes into effect. Under the surtax, two single people can each earn up to $200,000—for a combined total of $400,000—without becoming subject to the higher tax rate in 2013. However, if they were to marry, the two workers would be subject to the surtax on their combined earnings in excess of $250,000. Because the HI payroll tax is based on individual earnings, increasing the HI tax rate—instead of imposing the surtax—would eliminate that penalty.

The option would have several drawbacks. When the surtax goes into effect in 2013, it will encourage taxpayers with income above the thresholds to reduce the hours they work or to shift their compensation away from taxable earnings to nontaxable forms of compensation. Increasing the HI tax rate, as called for under the option, would extend those disincentives to all workers. When employees reduce the hours they work or change the composition of their earnings, economic resources are allocated less efficiently than would be the case in the absence of the higher tax rate.

Another drawback of the option is that an increase in the HI payroll tax rate, combined with the elimination of the surtax, would be relatively more burdensome for low- and middle-income workers than for higher-income earners. First, low- and middle-income workers and their employers would face larger rate increases relative to current law than would higher-income earners (whose rates have just increased as a result of the health care legislation) and their employers. Second, taxable wages make up a smaller proportion of income for higher-income earners than for low- and middle-income workers. Although all workers would pay the same percentage of earnings in HI taxes, higher-income households would pay a smaller percentage of their total income because those households derive a greater share of income from sources other than wages (such as capital income and rental income), which are not subject to the HI payroll tax.

RELATED OPTION: Mandatory Spending, Option 18

Revenues—Option 32

Repeal the Individual Health Insurance Mandate

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Net Effect on the Deficit	0	0	-16.0	-25.0	-33.0	-36.0	-39.0	-41.0	-43.0	-49.0	-74.0	-282.0

Sources: Joint Committee on Taxation and Congressional Budget Office.

Note: These estimates represent the change in the overall budget balance that results from the sum of changes to revenues and outlays.

Two laws enacted in March 2010—the Patient Protection and Affordable Care Act (Public Law 111-148) and the Health Care and Education Reconciliation Act (P.L. 111-152)—require that nearly every resident of the United States have health insurance coverage by January 1, 2014. People who do not comply with the mandate may be charged a penalty that is the greater of a flat dollar amount or a percentage of their income. The penalty will be assessed through the individual income tax. The flat amount per uninsured adult will start at $95 in 2014 but rise to $695 by 2016 and be adjusted for inflation after that. The percentage of income—which applies to income that exceeds the threshold for mandatory filing of an income tax return (projected to be about $10,000 for a single filer and about $18,000 for a married couple in 2014)—will start at 1.0 percent but rise to 2.5 percent in 2016. Exemptions from the penalties are provided for several categories of people, including those with taxable income below the filing threshold, unauthorized immigrants, members of certain religious groups, and those who obtain a hardship waiver.

Overall, the Congressional Budget Office and the staff of the Joint Committee on Taxation (JCT) project that the federal government will collect $27 billion in penalty payments from uninsured people through 2021. The existence of the mandate and its associated penalties will also affect the federal budget by encouraging people to obtain federally subsidized insurance coverage through Medicaid, newly created health insurance exchanges, or an employment-based plan (which would be subsidized indirectly because almost no premiums for that coverage are treated as taxable compensation). Moreover, in a competitive labor market, the existence of the mandate will encourage employers to offer coverage to their workers, thus reducing penalty payments from larger businesses that do not offer insurance and increasing payments of tax credits to certain small businesses that provide coverage.

The option would eliminate the requirement that individuals obtain health insurance, while maintaining other provisions of the new health care legislation. The loss of revenues from eliminating the individual mandate penalties would increase the deficit; but the estimated savings from reduced subsidies are greater—yielding net savings of about $282 billion over the 2012–2021 period. Most savings (about $149 billion) would come from lower Medicaid enrollment. On balance, federal subsidies for the purchase of insurance through the exchanges would be about $69 billion lower. Primarily because reductions in employer coverage would result in more taxable compensation for employees, the removal of the mandate would increase tax revenues by about $80 billion. The remainder of the budgetary effect would come from a modest increase (about $8 billion) in employer penalties and a modest reduction (about $3 billion) in tax credits for small businesses.

CBO and JCT estimate that repealing the mandate would substantially reduce the number of people with health insurance coverage. Under current law, about 23 million nonelderly residents are projected to be uninsured in 2021. If this option was implemented, about 39 million people would be uninsured that year. The increase in the number of people without insurance would stem from the following changes: About 4 million fewer people would have employment-based coverage; about 6 million fewer people would obtain coverage in the individual market (including individual policies purchased in the newly established exchanges or directly from insurers in the nongroup market); and about 6 million fewer people would have coverage under Medicaid or the Children's Health Insurance Program.

In the absence of the mandate, CBO estimates, health insurance premiums for individually purchased coverage would be higher than they are projected to be under current law. Insurers would still be required to provide coverage to any applicant, could not vary premiums to

reflect enrollees' health status or limit coverage of preexisting medical conditions, and could adjust premiums on the basis of age only to a limited degree. Relative to current law, the elimination of the mandate would tend to reduce insurance coverage among healthier people more than it would reduce coverage among less healthy people. However, those "adverse selection" effects would be mitigated somewhat by other factors—including the new subsidies for insurance purchased through the exchanges (which may make health insurance less costly) and the annual open enrollment periods in the individual market (which may make it difficult for people to wait until they become ill in order to obtain coverage). Moreover, because the subsidies will limit the share of income that enrollees have to pay for coverage, the impact on payments by subsidized enrollees would be minimal if overall premiums rose because of adverse selection. CBO estimates that such adverse selection would increase premiums for policies in the individual market, whether purchased through the insurance exchanges or not, by 15 percent to 20 percent, relative to current law.

Many proponents of this option argue that the decision to obtain health insurance is a private matter and that the government should not force people to acquire coverage. (Some advocates also argue that the mandate is unconstitutional, but CBO is not in a position to assess that argument.) Another argument in the option's favor is that the mandate and its associated penalty would make some people worse off—either because they would have to obtain more health insurance than they otherwise would have chosen to purchase on their own or because they would have to pay a penalty instead. Another concern is that using the Internal Revenue Service to enforce the mandate will increase the complexity of the tax system and interfere with efforts to fairly administer that system. In addition, the mandate necessitates new reporting requirements that will increase the costs of complying with the tax code for both individuals and their insurers.

Many opponents of the option point to the reductions in coverage and increases in premiums that are likely to occur and argue that it is appropriate for the government to require people to have health insurance in order to prevent those outcomes. Another argument is that imposing a penalty on people who do not obtain coverage could improve economic efficiency. In particular, by increasing the private costs of being uninsured, the mandate—to the extent that it encourages people to obtain coverage—may reduce the social costs of caring for the uninsured. In many cases, uninsured people pay much less than the costs of the care they receive, resulting in lower payments to providers or higher costs for others. In the absence of a mandate, those social costs would probably increase relative to what would occur under current law.

RELATED OPTIONS: Mandatory Spending, Option 12; and Revenues, Option 30

RELATED CBO PUBLICATIONS: David Auerbach and others, *Will Health Insurance Mandates Increase Coverage? Synthesizing Perspectives from the Literature in Health Economics, Tax Compliance, and Behavioral Economics,* Working Paper 2010-05, August 2010; "Effects of Eliminating the Individual Mandate to Obtain Health Insurance," Web document, June 2010; *Key Issues in Analyzing Major Health Insurance Proposals,* December 2008

Revenues—Option 33

Impose a Fee on Large Financial Institutions

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	4.1	6.4	6.7	6.9	7.2	7.4	7.7	7.9	8.2	8.4	31.3	70.9

Source: Joint Committee on Taxation.

During the financial crisis that occurred between 2007 and 2009, concern about the impact of the failure of large financial institutions on the financial markets and on the broader economy prompted federal action. The government provided substantial assistance to major financial institutions through the Troubled Asset Relief Program, the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC). That action effectively protected many uninsured creditors of large financial institutions from losses but at great potential cost to taxpayers. It also reinforced investors' perceptions that large financial firms are "too big to fail"—that is, so important to the financial system that their creditors are likely be protected by the federal government in case of large losses.

Banks and other large financial institutions benefit from a federal financial safety net, but they do not bear the full cost of that protection. The vast majority of the funds that financial institutions lend is obtained from creditors, which for commercial banks include insured and uninsured depositors, and purchasers of bank commercial paper (short-term debt obligations) and other bank debt (such as bonds). Deposits (saving and checking accounts and certificates of deposit) are one of the most important sources of funding for small and medium-sized banks and are insured against losses (generally up to $250,000 per account) by the FDIC. Banks pay a premium for FDIC insurance and also are obligated to make up for losses that exceed the reserves of the FDIC. Large financial institutions, including big banks, are much more likely than smaller banks to obtain financing from sources other than insured deposits. They also are more likely to be perceived as too big to fail. Those implicit federal guarantees, which large financial institutions do not pay for under current law, give them a cost advantage over smaller banks in the form of lower borrowing costs.[1]

This option would assess an annual fee on banks, thrifts, brokers, security dealers, and U.S. holding companies that control such entities. The fee would apply only to firms with consolidated assets of more than $50 billion. (Consolidated assets include all assets controlled by the financial institution's parent company and all of its subsidiaries.) The option would impose a fee at an annual rate of 0.15 percent on the firm's total liabilities as reported in their financial statements, excluding deposits insured by the FDIC (for banks) and certain reserves required by insurance policies (for insurance companies). If implemented, such a policy change would generate $31 billion in revenue from 2012 through 2016 and $71 billion from 2012 through 2021. (Such fees would reduce the tax base of income and payroll taxes, leading to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.)

At 0.15 percent, the fee would probably not be so high as to cause financial institutions to significantly change their financial structure or activities. The fee could affect to some extent institutions' tendency to take various risks, but the net direction of that effect is uncertain. On the one hand, the fee could reduce the profitability of larger institutions, which might create an incentive for them to take greater risks in pursuit of higher returns to offset their higher costs. On the other hand, the fee would provide an incentive for larger financial institutions to reduce their dependence on liabilities subject to the fee. To the extent that institutions increased their reliance on equity and did not change their investment strategies, the risk of future losses would be reduced. The amount of the fee could vary with the amount of risk an institution undertakes, but it might be difficult to measure those risk factors precisely.

1. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Public Law 111-203), the government is required to recover the cost of resolving the failure of a large financial institution by charging an assessment on other large financial institutions in future years.

The fee also might affect the market concentration of the financial industry. Banks would have an incentive to keep assets below the $50 billion threshold, which could reduce the number of large institutions. The fee also would improve the relative competitive position of small and medium-sized banks.

The main advantage of this option is that it would help compensate taxpayers for the cost of providing large institutions with a financial safety net. It would also create a more level playing field for large and small financial institutions, by charging the largest institutions for the greater government protection they receive. By applying the fee to noninsured liabilities, the option would allocate costs from government rescue actions more evenly across the sources of funding.

The option would also have several disadvantages. The fee might be borne by unintended groups: Large financial institutions could pass much of the cost to their customers, employees, and investors, but the precise incidence among those groups is uncertain. In addition, unless the fee was risked-based, stronger financial institutions that pay lower interest rates on their debt would face a proportionally greater increase in funding costs than would weaker financial institutions. Furthermore, more-stringent regulations such as those in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and those in the international Basel III agreement could better protect taxpayers from the risks of large-bank failures than would be the case under previous rules. If so, those regulations would reduce the need to charge large banks a fee to offset the potential costs of being "too big to fail."

RELATED CBO PUBLICATIONS: *Report on the Troubled Asset Relief Program—November 2010,* November 2010; *The Budgetary Impact and Subsidy Costs of the Federal Reserve's Actions During the Financial Crisis,* May 2010; and Letter to the Honorable Charles E. Grassley providing information on the president's proposal for a financial crisis responsibility fee, March 4, 2010

Revenues—Option 34

Reinstate the Superfund Taxes

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	1.4	1.9	2.0	2.0	2.0	2.1	2.1	2.1	2.1	2.2	9.1	19.4

Source: Joint Committee on Taxation.

The Superfund program and its associated trust fund were established in 1981 to clean up the nation's worst hazardous waste sites. By statute, the cost of cleanup is to be borne by the parties responsible for the contamination, but the Environmental Protection Agency (EPA), which administers the program, pays for the cleanup when liable parties cannot be identified, no longer exist, or are unwilling or unable to undertake the job.

EPA-led cleanups and other Superfund activities are funded by an annual appropriation, which lawmakers designate as having two sources: One portion comes from the general fund of the Treasury, and the other portion is drawn from balances in the program's trust fund. In 2010, the total appropriation was $1.3 billion, and net outlays were $1.0 billion.

Originally, revenues designated for the trust fund were derived mainly from taxes on petroleum and various industrial chemicals and from a corporate environmental income tax. However, authorization for those taxes expired in December 1995. The trust fund continues to receive some money from liable parties who pay interest and penalties and reimburse EPA for its cleanup costs; but the program is now financed largely from the general fund.

This option would reinstate the taxes that expired at the end of 1995: the Superfund excise tax of 9.7 cents per barrel of crude oil or refined oil product, an excise tax of $0.22 to $4.87 per ton on various chemicals, and a corporate income tax of 0.12 percent on corporations' modified alternative minimum taxable income above $2 million. (The latter is computed by disallowing certain tax preferences allowed under the regular corporate income tax and by making other adjustments, both positive and negative, to the firm's taxable income.) Together, those taxes would yield revenues of $9 billion between 2012 and 2016 and $19 billion from 2012 through 2021. (Because excise taxes reduce the tax base of income and payroll taxes, additional excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.)

An argument in favor of the option is that reauthorizing the dedicated taxes to finance the Superfund program, rather than continuing to rely on general funds, is more consistent with the principle that entities that contribute to pollution should pay to clean up the resulting problems. Because petroleum products and various chemical feedstocks and derivatives are common sources of contamination at Superfund sites, and because hazardous chemicals are used by many medium-sized and large corporations, having producers and users of those substances—as well as corporations more broadly—pay much of the cleanup bill would be fairer than having all taxpayers bear those costs. A second rationale is that having a stable source of funding would help maintain EPA's long-term efforts at the worst sites and continue to give responsible parties reason for concern that EPA will conduct its own cleanups and seek to recover the costs from them if they do not undertake the work themselves.

An argument against the option is that taxing all companies in an industry or all corporations above a particular size, regardless of those companies' past or current waste-disposal practices, would not provide incentives for companies to handle waste carefully or, in fact, to avoid creating it in the first place. Instead, companies would be subject to the tax without regard to their role in creating future hazardous waste sites. The tax would distort economic decisions, thus hampering rather than promoting efficiency. Another argument against the option is that it could unfairly tax current stakeholders of a business (its customers, employees, and investors) who were not responsible for and did not benefit from earlier polluting activities.

A third argument against the option is that some research indicates that the administrative and compliance costs of such levies are out of proportion with the relatively small amounts of revenue they raise. Also, because Superfund spending (including spending from the trust fund) has always been subject to annual appropriations, dedicated taxes would provide no guarantee of stable funding.

Revenues—Option 35

Impose a Price on Emissions of Greenhouse Gases

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues	88.2	93.4	99.4	105.3	112.2	119.5	127.2	135.7	144.4	153.6	498.5	1,178.9

Source: Congressional Budget Office.

The accumulation of greenhouse gases in the atmosphere—particularly carbon dioxide (CO_2) released as a result of deforestation and the use of fossil fuels—could create costly changes in regional climates throughout the world. The damage could include water shortages, the loss of land in coastal areas because of rising sea levels, acidification of the world's oceans, and the extinction of various species. Concern about such damage has led policymakers and analysts to consider policies designed to reduce emissions of those gases.

Greenhouse gas emissions could be reduced by requiring emitters of large amounts to pay a price to emit those gases. Such a policy could be instituted as a tax on emissions or as part of a cap-and-trade system. In either case, the cost of producing and consuming goods and services would increase in proportion to the amount of greenhouse gases emitted as a result of that production and consumption. Ultimately, those costs would be passed on to consumers in the form of higher prices. Those higher prices, in turn, would create incentives throughout the U.S. economy to reduce emissions of greenhouse gases.

This option would establish a cap-and-trade program governing emissions of greenhouse gases in the United States. Emissions would be measured in CO_2 equivalents (CO_2e)—that is, the amount of carbon dioxide that would cause an equivalent amount of warming. Under such a program, a decreasing number of allowances—which would convey the right to emit 1 metric ton of CO_2e apiece—would be sold at open auction, beginning in 2012 and ending in 2050. According to estimates by the Congressional Budget Office, emissions from the sectors that were subject to the cap-and-trade policy would fall by roughly 20 percent from their projected amounts in 2025 and by 50 percent from their projected amounts in 2050. Firms would be allowed to shift their use of allowances from one year to another by "banking" unused allowances or by "borrowing" allowances from future allocations for current use. However, firms would not be allowed to comply with the cap by submitting "offset credits," which reflect reductions in emissions from sectors that otherwise would not be subject to the cap.

If implemented, this option would raise revenues by close to $500 billion from 2012 through 2016 and by $1.2 trillion from 2012 through 2021. (Because it would reduce the tax base of income and payroll taxes, the option would lead to reductions in revenue from those sources. The estimates shown here reflect those reductions.)

Those revenue estimates are based on an estimated allowance price in 2012 of $20 that would increase at an annual rate of 5.6 percent. Such a price would motivate firms and households to undertake reductions that cost up to $20 per metric ton of CO_2e to achieve in the initial year of the policy. The reductions would be economically justified if those costs were less than the long-term benefits of each ton of emissions that was reduced. An interagency federal analysis published in 2010 estimated the value of the benefit (that is, the damage that would be avoided) from reducing baseline emissions—those that would have occurred in the absence of any policy limiting emissions—by 1 metric ton. According to that study, the value of that benefit would range from an estimated $5 to $40 per metric ton in 2012.[1]

An argument that is made in favor of a cap-and-trade program such as the one described here is that an initial allowance price of $20 would be justified by the benefits resulting from the program. In addition to the direct benefits from reducing the damage associated with climate

1. That estimate is expressed in present-value terms, which indicates the value today of an amount of money in the future, given a set rate of return. For more information on the benefit range, see Department of Energy, *Technical Support Document: Social Cost of Carbon for Regulatory Impact Analysis Under Executive Order 12866* (February 2010), www.epa.gov/oms/climate/regulations/scc-tsd.pdf.

change, such a program would generate "co-benefits." Co-benefits would occur when measures taken to reduce emissions—such as generating electricity from natural gas rather than from coal—reduced other pollutants not explicitly limited by the cap, thereby reducing the harmful effects associated with those emissions. The magnitude of those co-benefits is uncertain and depends on which standards were already in place to limit such pollutants. However, in terms of the benefits to human health, a literature survey published in 2010 indicates that the reductions in other pollutants that would occur as a by-product of limiting CO_2 emissions could be as large as, or larger than, the direct benefits of reducing CO_2 emissions.[2]

Another argument in favor of the option is that setting an economywide price on emissions of greenhouse gases would impose a smaller cost on the economy than the alternative approach of achieving the same reductions through various provisions in the existing Clean Air Act (CAA). Setting an economywide price on greenhouse gas emissions would lower the cost of reducing emissions by allowing market forces to determine where, how, and—to some extent—when such reductions could be achieved. In contrast, standards issued under the CAA (for example, specifying an emissions rate for a plant or an energy efficiency standard for a given product) would offer less flexibility and, as a result, would achieve emission reductions at a higher cost. Finally, an economywide tax or cap-and-trade program would provide a potential source of revenue for the federal government, an option that would not be available under the existing CAA. The government could use some of those revenues to accomplish various goals such as reducing taxes, offsetting the costs of the cap-and-trade program for certain groups or industries that are put at a competitive disadvantage by the program, or reducing the federal deficit.

An argument that is made against policies that limit emissions is that any attempt to curtail U.S. emissions in the near term would burden the economy by raising prices for emissions-intensive goods and services while yielding benefits of an uncertain magnitude. In addition, most of those benefits might occur outside the United States, particularly in developing countries. It is also argued that reductions in domestic emissions could be offset by increases in emissions overseas if carbon-intensive industries relocated to countries that did not impose restrictions on emissions. Another argument against the option is that the budgetary savings from a cap-and-trade program would be diminished if the revenues were used to fund generous subsidies to industries and households affected by the program. Moreover, averting the risk of future damage caused by climate change would depend on collective global efforts to cut emissions. Most analysts agree that if other countries with high levels of emissions do not cut those pollutants over the same period that the United States does and by roughly the same percentage, efforts in this country would produce small climate-related benefits.

2. See G.F. Nemet, T. Holloway, and P. Meier, *Environment Research Letters,* vol. 5, "Implications of Incorporating Air-Quality Co-Benefits into Climate Change Policymaking" (January-March 2010).

RELATED CBO PUBLICATIONS: *Evaluating Limits on Participation and Transactions in Markets for Emissions Allowances,* December 2010; *Managing Allowance Prices in a Cap-and-Trade Program,* November 2010; *How Policies to Reduce Greenhouse Gas Emissions Could Affect Employment,* Issue Brief, May 2010; *The Costs of Reducing Greenhouse-Gas Emissions,* Issue Brief, November 2009; *The Economic Effects of Legislation to Reduce Greenhouse-Gas Emissions,* September 2009; *Potential Impacts of Climate Change in the United States,* May 2009; Cost estimate for S. 1733, Clean Energy Jobs and American Power Act, December 16, 2009; and Cost estimate for H.R. 2454, American Clean Energy and Security Act of 2009, June 5, 2009, with an amendment June 26, 2009

APPENDIX

A

Options That Would Increase the Deficit

Unlike the other options in this volume, the six options in this appendix would add to federal budget deficits. The first three would make changes to mandatory programs; they are included because the Congressional Budget Office frequently receives requests for estimates of their budgetary effects. The other three options involve tax provisions that are scheduled to expire in the next few years; they are included because of the high level of public interest in those provisions.

Mandatory Spending—Option A-1 **Function 550**

Extend the Requirement for States to Provide Transitional Medical Assistance

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	200	1,100	1,200	200	0	0	0	0	0	0	2,700	2,700

Current law allows certain Medicaid beneficiaries who would otherwise lose eligibility because of increased earnings to retain their Medicaid coverage for a limited period of time following their increase in income. Beneficiaries who qualify for that extension of coverage—known as transitional medical assistance (TMA)—are usually former recipients of funds from the Temporary Assistance for Needy Families program, which provides time-limited cash assistance, child care, and training opportunities to low-income families with dependent children. Through TMA, parents and children in eligible families qualify for at least 6 months and up to 12 months of Medicaid coverage if their family income rises above the eligibility threshold for families but is still below 185 percent of the federal poverty level. This mandatory eligibility category, which has been extended several times, is currently authorized through December 31, 2012.[1]

This option would extend the TMA eligibility category through the end of 2013. Beginning in January 2014, the population currently eligible for TMA will have access to subsidized health care coverage under the Patient Protection and Affordable Care Act (Public Law 111-148) as modified by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152). The Congressional Budget Office estimates that this option would increase federal spending by about $3 billion through 2015, with no effect on federal spending after that.

A rationale for extending TMA through 2013 is that it would provide low-income working families with health insurance when their income rose above levels that would otherwise make them ineligible for Medicaid. In the absence of TMA in 2013, Medicaid coverage will be lost when family incomes rise because of increased earnings from work. Individuals from low-income working families often have jobs that do not offer employer-sponsored health insurance, and they may feel unable to afford health insurance when their employer does offer it. Therefore, the loss of Medicaid coverage provides a disincentive for low-income families to pursue increased earnings through additional hours of work or higher-paying jobs.

An argument against this option is that some people who would qualify for TMA would be eligible for employer-sponsored insurance, and TMA would serve as a disincentive for them to enroll in available private coverage. CBO estimates that about 22 percent of adults and 17 percent of children whose family income is below 185 percent of the federal poverty level are covered by employer-sponsored insurance. Although coverage rates are lower than for higher-income groups—in part because of the availability of Medicaid—employer-sponsored insurance would be available for some potential TMA enrollees.

1. States have some discretion in determining which groups their Medicaid programs will cover; however, to be eligible to receive federal funds, states are required to provide Medicaid coverage to certain groups commonly referred to as mandatory eligibility categories.

Mandatory Spending—Option A-2 **Function 570**

Permanently Extend Cost-Sharing Assistance for Qualifying Individuals Under Medicaid

											Total	
(Millions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	500	780	900	1,030	1,180	1,360	1,560	1,760	1,970	2,190	4,390	13,230

Under Medicare Savings Programs (MSPs), state Medicaid agencies provide cost-sharing assistance for certain low-income Medicare beneficiaries who qualify for various levels of assistance on the basis of their income. To be considered for the Qualifying Individual (QI) program—one of the MSPs—an individual must have income between 120 percent and 135 percent of the federal poverty level and meet certain requirements related to the assets he or she owns. Qualifying individuals receive assistance only for premiums for Part B of Medicare (which pays for physicians' and other outpatient services). Other MSPs, such as the Qualified Medicare Beneficiary program and the Specified Low-Income Medicare Beneficiary program, apply to people whose income is below 100 percent and 120 percent of the federal poverty level, respectively. Those programs cover some or all of the costs of Medicare premiums, deductibles, and coinsurance. In calendar year 2010, about 450,000 people were enrolled in the QI program, at an estimated gross cost to the federal government of $570 million (Part B premiums paid by other Medicare beneficiaries offset about 25 percent of that amount).

Unlike other MSPs, the QI program does not have permanent funding and is subject to an annual funding cap. Assistance was established by the Balanced Budget Act of 1997 and initially funded through the end of 2002; policymakers have extended funding several times. Under the latest extension, enacted in the Medicare and Medicaid Extenders Act of 2010 (Public Law 111-309), the funding is set to expire on December 31, 2011. Although administered by the states through Medicaid, the QI program is funded by the Medicare Supplementary Medical Insurance Trust Fund, and consequently the states are not required to provide matching funds. Another aspect of the QI program is its annual funding cap, which is set at roughly $1 billion in calendar year 2011; once that cap is reached, no additional enrollment is permitted. The cap, however, has traditionally been set at a level that allows states to cover all eligible individuals who are expected to enroll. A new funding cap has been set with each extension of the provision.

This option would permanently fund the QI program and eliminate the annual funding cap. The Congressional Budget Office estimates that this option would increase spending for Medicare by $4 billion over the 2012–2016 period and by $13 billion during the 2012–2021 period.

An argument in support of this option is that it would ensure that qualifying individuals would receive coverage for their Medicare Part B premiums to the same extent as people covered by other MSPs. In addition, enrollment in an MSP triggers automatic enrollment in the Low-Income Subsidy (LIS) of Medicare Part D (the prescription drug program). By making the QI program permanent, these individuals would have continuity of coverage in the LIS rather than being required to reapply annually (the budgetary effect of that change is included in the estimates shown here).

An argument against this option is that the existing limits on both the duration of the QI provision and the amount of its available funding force policymakers to periodically consider whether the funding for QIs is the best use of scarce resources.

Mandatory Spending—Option A-3 **Function 650**

Increase Social Security Benefits for Workers Who Have Low Earnings Over a Long Working Lifetime

											Total	
(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012–2016	2012–2021
Change in Outlays	0.6	2.5	5.5	9.2	13.5	18.3	23.5	29.0	34.9	40.9	31.2	177.8

Social Security benefits generally are calculated on the basis of a worker's average wages over the course of his or her career. Under the standard formula, retired people who have had low lifetime earnings receive the same benefits regardless of whether they were out of the workforce for some period (perhaps because they were raising children) or they consistently received low earnings over the course of a career. Recognizing that retirees who had consistently low annual earnings are more likely to be in financial need than are people who worked intermittently but for high annual earnings, policymakers established a second formula in 1972, the "special minimum benefit," to give participants the higher of the standard benefit or the special minimum benefit. Unlike the standard formula, in which average benefits grow with average wages, the special minimum formula is indexed to prices. Because wages generally grow faster than prices, the gap between the two formulas is continually shrinking. Each year, fewer people gain from the special minimum benefit, and those who do, gain less. The special minimum benefit is projected to provide no advantage to those who become eligible in 2013 and later.

This option would replace the special minimum benefit with an increase in the standard benefit for workers who have both low lifetime average earnings and at least 20 years of covered earnings. Specifically, it would raise the standard benefit for qualified workers by a specified percentage that would depend on the number of years with earnings above a threshold—currently about $4,500—and a worker's average indexed monthly earnings (AIME). The largest benefit increase would be 40 percent for someone with 35 or more years in the workforce and an AIME below that of someone who had worked full time and earned the minimum wage for 30 years. The benefit increase would be smaller for people with fewer years of work or higher AIMEs, and there would be no increase for people whose AIME exceeded that of a worker with 35 years of earnings above the threshold or who earned, on average, an amount equal to or greater than the average wage index (the average amount of total earnings in the United States in a year). The provision would apply to workers who become eligible to claim benefits in 2012 and later.

This option would increase federal outlays by $31 billion over 5 years and by $178 billion over 10 years, reflecting both higher benefit payments and some offsetting savings in the federal share of the Supplemental Security Income and Medicaid programs. By 2050, the option would increase Social Security outlays by 8 percent—from 5.9 percent to 6.4 percent of gross domestic product.

Although this option would help workers the special minimum benefit also was designed to assist—those with a history of consistently low annual earnings—a drawback is that it would not distinguish between workers who had low annual earnings because they earned low hourly wages and those who had higher hourly wages but worked for only part of the year.

RELATED CBO PUBLICATION: *Social Security Policy Options,* July 2010

Revenues—Option A-1

Permanently Extend the Individual Income Tax Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Extend Individual Income Tax Provisions of EGTRRA												
Change in Revenues												
Statutory rate changes	0	-37.1	-57.0	-62.2	-67.7	-72.5	-77.3	-81.7	-86.3	-91.2	-224.0	-633.0
10 percent bracket	0	-31.9	-46.0	-46.2	-46.3	-46.2	-46.1	-46.4	-46.5	-46.2	-170.4	-401.6
Expanded child tax credit	0	-7.0	-35.3	-36.0	-36.7	-37.2	-37.7	-38.1	-38.4	-38.8	-115.0	-305.4
Marriage penalty relief	0	-5.1	-12.3	-12.1	-12.1	-11.9	-11.7	-11.5	-11.4	-11.4	-41.6	-99.6
Limits on personal exemptions and itemized deductions	0	-5.9	-12.6	-14.1	-15.4	-16.6	-17.8	-18.9	-20.1	-21.4	-48.0	-142.8
Extend Individual Income Tax Provisions of JGTRRA												
Change in Revenues												
Dividends and capital gains rates	-1.6	-13.0	-11.7	-30.0	-31.7	-33.6	-35.4	-36.9	-38.2	-39.9	-88.0	-271.9
Extend Certain Individual Income Tax Provisions of ARRA												
Change in Revenues												
American Opportunity Tax Credit	0	-0.9	-4.4	-4.4	-4.6	-4.9	-4.9	-5.3	-5.4	-5.6	-14.3	-40.4
Expanded child tax credit	0	0	-10.2	-10.2	-10.1	-10.0	-10.0	-9.9	-9.8	-9.8	-30.5	-79.9
Expanded EITC	0	*	-1.7	-1.7	-1.7	-1.7	-1.7	-1.8	-1.8	-1.9	-5.1	-14.0
AMT relief	-8.9	-108.1	-96.8	-107.0	-118.7	-131.3	-145.5	-162.0	-179.0	-196.6	-439.5	-1,253.9
Extend All of the Above Provisions												
Change in Revenues	-10.5	-209.0	-288.0	-323.9	-345.0	-365.9	-388.1	-412.5	-436.9	-462.8	-1,176.4	-3,242.5

Source: Joint Committee on Taxation.

Notes: EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; ARRA = American Recovery and Reinvestment Act of 2009; EITC = earned income tax credit; AMT = alternative minimum tax; * = between -$50 million and zero.

These estimates represent the change in the overall budget balance resulting from the sum of changes to revenues and outlays.

[The estimate of the change in revenues in 2021 from expanding the child tax credit was corrected as of March 30, 2011.]

Several laws enacted since 2001 have substantially altered the individual income tax system. The Economic Growth and Tax Relief Reconciliation Act of 2001(EGTRRA) reduced statutory tax rates, created a 10 percent tax bracket, increased the value of the child tax credit, provided tax relief to married couples filing joint returns, prevented more taxpayers from becoming subject to the alternative minimum tax (AMT), and made many smaller changes to the tax code. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) accelerated the phasing in of some provisions of EGTRRA, extended others through 2010, and made some permanent. It also reduced the tax rate on income from capital gains and certain dividends. The American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5) provided further tax relief by expanding the child and earned income tax credits and creating a new partially refundable education tax credit, among other

provisions. Most of the changes instituted by those laws were originally slated to expire after 2010 but were subsequently extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312, referred to in this report as the 2010 tax act).

This option would make permanent the provisions of EGTRRA, JGTRRA, and ARRA that were extended through 2012 by the 2010 tax act. Additionally, the AMT exemption levels in effect in 2011would be indexed for inflation beginning in 2012 (see the discussion in Revenues—Option A-2). Together, those changes would increase the deficit by $1.2 trillion from 2012 through 2016 and by $3.2 trillion from 2012 through 2021.

Extending the provisions of the 2010 tax act would affect the economy in several ways. Over the first several years, while the economy is operating below its potential, extension would increase households' after-tax income and demand for goods and services, thus encouraging stronger economic activity. Lower marginal tax rates (which apply to a taxpayer's last dollar of income) would also encourage economic growth over a longer period. Unlike lower average tax rates (the amount of tax paid as a share of total income), which can encourage people to work and save less, lower marginal tax rates can encourage people to work and save more. The net economic impact of lower tax rates, however, would depend on how the rate reductions were financed. Financing tax cuts through higher budget deficits, for example, would reduce national saving, which would impair economic growth over the long term and could eventually offset any positive economic effects resulting from lower tax rates.

Lower tax rates can also help the economy by encouraging people to make decisions based on the economic benefit rather than the tax benefit, resulting in a more efficient use of economic resources and, thus, leaving people better off. Higher marginal tax rates can, for example, encourage people to shift income from taxable to nontaxable forms (which could be accomplished by substituting tax-exempt bonds for other investments or tax-free fringe benefits for cash compensation). Higher rates also can motivate people to spend more on tax-deductible items, such as home mortgage interest.

Extending the lower tax rates on capital gains and dividends could also contribute to greater efficiency in the economy in other ways. For example, corporate profits are taxed once through the corporate income tax and again when they are paid out as dividends or reinvested in the business and later realized as capital gains. Reducing the extent of that double taxation would reduce the bias that now exists in the tax code against equity investments in corporations, lessening distortions in investment decisions. As with other types of income, the net effects of lower tax rates on efficiency would depend on how the lower rates on capital gains and dividends were financed.

Permanently extending the individual income tax provisions in the 2010 tax act would have mixed effects on the complexity of the tax system. Although some provisions, such as relief from the AMT, would simplify the tax code for some taxpayers, other provisions, such as expanding tax-favored accounts for education savings, would complicate the tax code.

In addition to the effects that a particular tax policy might have on economic efficiency and the complexity of the tax code, another key consideration is how the policy would affect the tax burden of people at different income levels. Although the various provisions of the 2010 tax act have varying effects, the act's individual income tax provisions as a whole reduce income taxes by a larger percentage of after-tax income for higher-income households than for lower-income households. And although the tax reductions relative to income would be greater for higher-income households, extending the act's provisions would not significantly alter the share of income taxes paid by different households at various income levels.

An alternative approach would limit the extension of the provisions that reduced tax rates to taxpayers with income below certain thresholds. Taxpayers with income above those thresholds would see their top statutory rates rise and would face increases in the tax rate on income from dividends and capital gains, as scheduled under current law. Those taxpayers would still see reductions in their taxes, however, because the portion of their income that fell into the lower tax brackets would benefit from the rate reductions set by EGTRRA for those brackets. That alternative approach would increase the deficit by less than would fully extending all of the tax changes. At the same time, it would also shrink any economic effects

from extending the law. The improvements in incentives to work and save would be lessened, as would the negative economic effects from reduced national saving. Compared with full extension of the 2010 tax act, partial extension would provide high-income taxpayers with smaller tax cuts.

RELATED OPTIONS: Revenues, Options 1 and 2; and Revenues, Option A-2

RELATED CBO PUBLICATIONS: Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices*, September 28, 2010; and *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, January 2010

Revenues—Option A-2

Provide Relief from the Individual Alternative Minimum Tax

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues												
Make the 2011 exemption amounts permanent and index the AMT for inflation	-9.0	-92.8	-39.5	-45.4	-53.1	-61.8	-73.1	-86.7	-102.2	-119.4	-239.8	-683.0
Eliminate the AMT	-12.4	-126.3	-49.5	-55.9	-64.1	-73.5	-85.3	-99.4	-115.1	-132.8	-308.2	-814.3

Source: Joint Committee on Taxation.

Note: AMT = alternative minimum tax.

For the past four decades, the federal individual income tax has consisted of two parallel tax systems: the regular tax and an alternative minimum tax (AMT). Tax liability is computed differently for the AMT than for the regular income tax because the AMT allows a more limited set of exemptions, deductions, and tax credits than are allowed under the regular income tax. Taxpayers pay the higher of their regular tax or the AMT.

When they calculate their liability under the AMT, taxpayers cannot claim some items that are deductible from income under the standard income tax, such as personal exemptions, the standard deduction, or (if they itemize deductions) state and local taxes. Also disallowed under the AMT are some tax preferences that apply only to taxpayers with complex financial situations, such as the deduction for some intangible costs associated with drilling for oil and gas. Under the AMT, all of those adjustments are replaced with a single exemption that phases out at higher incomes. Taxpayers subtract the exemption from their income to determine their taxable income, which is taxed at 26 percent for the first $175,000 and at 28 percent for the remainder.

Unlike the tax brackets and exemptions for the individual income tax, those for the AMT are not indexed for inflation. Thus, if a taxpayer's nominal income grows at the rate of inflation, that taxpayer's liability under the regular income tax will grow at the same rate as his or her income over time as the values of the standard deduction, personal exemptions, and the beginning and endpoints of the tax brackets also rise with inflation. Because the parameters of the AMT are not indexed, that taxpayer's liability under the AMT will grow faster than his or her income. As a result, more taxpayers will be subject to the alternative tax as their nominal income grows with inflation.

In recent years, lawmakers have enacted temporary measures to stem the growth in the number of people subject to the tax. The AMT exemptions were temporarily increased by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Several times since then, the higher exemption amounts have been extended for a year or two and increased, most recently by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, referred to in this report as the 2010 tax act). Before 2001, the exemptions were $33,750 for single filers and $45,000 for joint filers. The 2010 tax act raised them to $48,450 and $74,450 for 2011. Under current law, the exemptions will revert to their pre–EGTRRA amounts in 2012.

This option encompasses two approaches that would provide permanent relief from the AMT. The first approach would limit the effects of the tax by making the exemption amounts for 2011 permanent and indexing those amounts, along with the AMT brackets, for inflation after 2011. This approach would reduce revenues by $240 billion from 2012 through 2016 and by $683 billion over the 10-year period. If this approach was adopted, 5 million taxpayers would pay the AMT in 2012—rather than the 33 million who would be subject to the tax under current law.

The second approach would simply eliminate the AMT. Eliminating the alternative tax would reduce revenues by $308 billion from 2012 through 2016 and by $814 billion over 10 years. All 33 million taxpayers who would have been subject to the AMT in 2012 would, instead,

pay the regular income tax. (The revenue estimates for both approaches are based on the assumption that other provisions of current law would remain in effect, including those specifying that most of the tax reductions enacted since 2001 would expire at the end of 2012. If the lower tax rates and other expiring provisions were extended, the AMT would apply to more people and more income, and the revenue loss from the two AMT alternatives would be considerably higher. Similarly, other changes to the regular income tax could change the impact of AMT relief.)

One rationale for this option is that the AMT, if left unchanged, will apply to more and more taxpayers—an estimated 45 million by 2021. That was not the original purpose of the tax, which was first enacted in 1969 to address concerns that a small number of wealthy taxpayers were using provisions of the regular tax code to greatly reduce their tax liability—in some cases, to zero. Because the values of the standard deduction and personal exemption under the regular tax system will rise with inflation while the AMT exemption amounts remain constant after 2011, the AMT will increasingly affect taxpayers who do not itemize their deductions, effectively limiting the value of the standard deduction and personal exemption under the regular income tax. And among taxpayers who itemize, many will become subject to the AMT not because they shelter income but because they have large families (and can currently make use of the personal exemptions), incur high medical expenses, or reside in areas with high state and local taxes (medical expenses and state and local taxes are deductible for purposes of the regular income tax but not for the AMT).

Another benefit of either approach described in this option would be simplification. Taxpayers who are now or who might be subject to the AMT must calculate their tax liability twice. As that group expands, an increasing number of people will confront more complex calculations when preparing their tax returns and making tax plans. This option would simplify the tax system by making fewer taxpayers subject to the AMT.

An argument against this option is that without the AMT, more taxpayers would be eligible for certain deductions, exclusions, and credits available under the ordinary income tax, which could worsen the allocation of resources in the economy. For example, by disallowing the deduction on second homes and certain other mortgage debt, the AMT encourages taxpayers to invest in other assets rather than in additional housing; and by disallowing the deduction for state and local taxes, the AMT limits subsidies to certain state and local governments and treats otherwise similar taxpayers in different locations more comparably. (If those limits were considered desirable, however, they could be incorporated into the regular income tax even if the AMT was modified or eliminated.)

This option would raise issues of fairness because it would primarily benefit higher-income taxpayers. The option would also have economic effects. Relief from the AMT would alter the marginal tax rate that applies to taxpayers who currently are subject to the alternative tax. (The marginal tax rate applies to a taxpayer's last dollar of income.) Some taxpayers would see their marginal rates increase, but more would see their marginal rates decline, which would encourage them to work and save more. AMT relief would also reduce some people's tax liability, allowing them to achieve the same amount of after-tax income with less income before taxes, and might diminish their incentive to work. On balance, it is not clear how the changes in this option would influence incentives to work and save; the overall effect would depend on taxpayers' responsiveness to those incentives.

RELATED OPTIONS: Revenues, Options 1 and 2; and Revenues, Option A-1

RELATED CBO PUBLICATIONS: *The Individual Alternative Minimum Tax*, Issue Brief, January 2010; and Statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, before the Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance, *The Individual Alternative Minimum Tax,* May 23, 2005

Revenues—Option A-3

Modify Estate and Gift Taxes

(Billions of dollars)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012–2016	Total 2012–2021
Change in Revenues												
Alternative 1	-0.7	-4.8	-30.8	-36.9	-41.3	-45.1	-48.2	-51.3	-54.5	-57.9	-114.6	-371.4
Alternative 2	-0.3	-0.7	-22.1	-26.6	-28.7	-31.1	-33.5	-35.9	-38.5	-41.2	-78.4	-258.1
Alternative 3	-2.6	-8.5	-47.4	-56.5	-61.7	-66.3	-70.3	-74.3	-78.4	-82.8	-176.9	-549.0

Source: Joint Committee on Taxation.

When someone dies, a federal estate tax is imposed on the value of assets that are transferred at his or her death. In addition, a gift tax is assessed on the value of taxable gifts that were made during that person's lifetime. Currently, only the portion of an estate that exceeds $5 million is subject to the estate tax, and that amount is taxed at a rate of 35 percent. Likewise, only taxable gifts that exceed the effective lifetime exemption amount, now $5 million, are subject to the gift tax, and they are also taxed at a rate of 35 percent. The two exemptions are not cumulative, however: The effective exemption amount under the estate tax is reduced by any exemption used under the gift tax. Gifts and bequests between spouses and bequests to charities are not subject to taxation. The executor of an estate can deduct the total amount of taxes paid to a state after the property owner's death. Besides the estate and gift taxes, a generation-skipping transfer (GST) tax applies at the tax rate of 35 percent on transfers to an heir who is more than one generation younger than the decedent, such as a grandchild.

Current provisions of the estate and gift tax—which went into effect with the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312)—expire after 2012. In 2013, estates and gifts will be subject to the tax laws that were in effect before the enactment of the Economic Growth and Tax Relief Act of 2001 (EGTRRA). Estates and gifts will still be subject to a unified tax, but with a graduated rate schedule (topping at a marginal tax rate of 55 percent) and a combined effective exemption amount of $1 million. A 5 percent surcharge will apply to wealth transfers between $10 million and $17 million, and instead of deducting from the value of the estate the amount of estate and inheritance taxes owed at the state level, the estate will be able to claim a credit for those taxes (but only up to a certain amount). In addition to the estate and gift taxes, a GST tax will apply at the highest estate tax rate (55 percent in 2013) on transfers to an heir who is more than one generation younger than the decedent.

Certain provisions of the individual income tax, particularly taxes on capital gains realizations, also affect the tax treatment of estates. Under the tax code, a capital gain or loss is measured as the difference between the cost of purchasing the asset (its basis) and the value of the asset when the gain is realized. Basis comes into play when inherited assets are eventually sold and capital gains (or losses)—and any applicable taxes—are calculated. Currently, basis is generally measured as an asset's fair market value on the date of the property owner's death or on an alternative valuation date, as specified by law. This method is often referred to as stepped-up basis. An alternative treatment is carry-over basis, in which the inherited asset retains the same basis it had prior to the date of death.

This option encompasses three methods of modifying the estate, gift, and GST taxes, beginning in 2013. The first two alternatives would retain those taxes but set the exemption amounts, tax rates, and other parameters at either their 2012 or 2009 levels (with the exemption indexed for inflation); the third alternative would permanently repeal the estate tax and the GST tax in the same manner that EGTRRA did for 2010.

- Alternative 1 would permanently extend the unified estate and gift tax law that is currently in place for 2012. Under this alternative, the estate tax and gift tax exemption amounts would be $5 million (with the effective exemption indexed for inflation from 2011 onward), and the tax rate would be 35 percent. This alternative would allow a deduction for inheritance and estate taxes paid to state governments, rather than a credit. In addition, stepped-up basis would continue

to apply to assets transferred from a decedent. Those changes would reduce revenues by $115 billion from 2012 through 2016 and by $371 billion over 10 years. About 5,000 estates would pay some federal estate tax in 2021 under this alternative, compared with about 90,000 under current law.

- Alternative 2 would permanently adopt 2009 estate tax law as specified in EGTRRA, starting in 2013, but would also index the effective exemption amounts for inflation. Under this alternative, the effective estate tax exemption would be $3.5 million with an adjustment for inflation since 2009, and the tax would be assessed at a rate of 45 percent. The gift tax exemption amount would be $1 million (also with an adjustment for inflation since 2009) with a top tax rate of 45 percent. As under Alternative 1, estates would be allowed a deduction for state inheritance and estate taxes, rather than a credit, and stepped-up basis would continue to apply to assets transferred from a decedent. Those changes would reduce revenues by $78 billion over five years and by $258 billion over 10 years. About 9,800 estates would pay some federal estate tax in 2021 under this alternative.

- Alternative 3 would implement certain provisions in effect in 2010 under EGTRRA, permanently repealing the estate and GST taxes starting in 2013 and taxing cumulative gifts in excess of $1 million at a rate of 35 percent. In addition, this alternative would permanently put in place the modified carryover basis that EGTRRA specified in 2010 for transferred assets. Under pure carryover basis, the basis of assets in the hands of an heir is generally the same as it was for the decedent. Under modified carryover basis, selected assets have their basis stepped up by up to $1.3 million and by an additional $3.0 million for assets left to a surviving spouse. The basis of any assets that do not receive that stepped-up treatment is generally measured as the price that the decedent originally paid for the asset. Together, those changes would reduce revenues by $177 billion from 2012 through 2016 and by $549 billion over 10 years. No estate would pay federal estate taxes in 2021.

One argument in favor of such changes is that each alternative would exempt smaller estates—or, in the case of Alternative 3, all estates—from filing estate tax returns, which would reduce both the taxes and the filing burden for some taxpayers and their heirs. Smaller estates would be less likely to incur estate tax liability, which could reduce the slight possibility of the heirs having to liquidate a small business to pay estate taxes after the owner's death. Increasing the exemption levels, rather than repealing the estate tax entirely, would still largely exempt small estates and closely held businesses (such as family-owned enterprises) from the tax. Another argument is that the estate tax represents a form of double taxation: During their lifetime, people pay taxes on their income, a portion of which they save; but when they bequeath those savings to their heirs, it is taxed again under the estate tax. Those bequests, however, often include unrealized capital gains that were never taxed under the individual income tax during the decedent's lifetime.

One argument that is made against reducing or repealing estate and gift taxes is that the progressive nature of those taxes lessens the concentration of wealth in the United States. Another concern is that charitable giving could decline because taxpayers would no longer have a deduction for leaving bequests to charities. Yet another consideration is that repealing the federal estate tax would not completely eliminate the filing burden because the executors of many estates would still have to file returns and pay taxes at the state level.

Analysts hold a variety of views about how estate and gift taxes affect saving, the accumulation of capital, and economic growth. Research in those areas is inconclusive. To the extent that inherited wealth is seen as a windfall to the recipient, taxing it may have less of an effect on work, saving, and capital accumulation than do taxes on income.

RELATED CBO PUBLICATIONS: *Federal Estate and Gift Taxes,* Issue Brief, December 2009; *Effects of the Federal Estate Tax on Farms and Small Businesses,* July 2005; and *The Estate Tax and Charitable Giving,* July 2004

APPENDIX

B

Deficit Reduction Options with Smaller Budgetary Effects

In compiling this volume, the Congressional Budget Office (CBO) focused mainly on options that would, in its estimation, reduce the deficit by at least several billion dollars over five years. CBO recognizes that some spending and revenue options with effects below that threshold are also of interest to policymakers. This appendix lists a selection of such options that were presented in the previous version of this report—*Budget Options, Volume 2* (August 2009)—and that could be implemented in future years essentially as described in that report.

In this list, the options affecting mandatory and discretionary spending are grouped by budget function, with their potential savings estimated in the following ranges: less than $500 million over five years, between $500 million and $1 billion over five years, or more than $1 billion over five years.[1] Those savings may differ from the amounts shown in the 2009 report. The potential budgetary impacts of the options affecting revenues are not shown.

1. Budget functions are the 20 general-subject categories into which budgetary resources are grouped so that all budget authority and outlays can be presented according to the national interests being addressed. There are 17 broad budget functions, including national defense, international affairs, energy, agriculture, health, income security, and general government. Three other functions—net interest, allowances, and undistributed offsetting receipts—are included to complete the budget.

Table B-1.

Selected Options That Appeared in CBO's August 2009 Budget Options Report

Option Title	Budget Function—2009 Option Number	Savings Over Five Years: Less Than $500 Million	Between $500 Million and $1 Billion	Between $1 Billion and $5 Billion
Mandatory Spending Options				
Modify the Assessment Base and Increase the Federal Insurance Premium for Private Pension Plans	600-1			✕
Modify the Formula Used to Set Federal Pensions	600-2		✕	
Target the Subsidy for Certain Meals in Child Nutrition Programs	600-6			✕
Eliminate the Exclusion for Unearned Income Under the Supplemental Security Income Program	600-7			✕
Create a Sliding Scale for Children's Supplemental Security Income Benefits Based on the Number of Recipients in a Family	600-8		✕	
Remove the Ceiling on the Collection of Overpayments from the Supplemental Security Income Program	600-9		✕	
Reduce the Spousal Benefit in Social Security from 50 Percent to 33 Percent	650-5			✕
Eliminate the Social Security Lump-Sum Death Benefit	650-6		✕	
Require Children Under Age 18 to Attend School Full Time as a Condition of Eligibility for Social Security Benefits	650-7		✕	
Eliminate Social Security Benefits for Children of Early Retirees	650-8			✕
Require State and Local Pension Plans to Share Data with the Social Security Administration	650-9		✕	
Require the IRS to Deposit Fees for Its Services in the Treasury as Miscellaneous Receipts	800-2			✕
Discretionary Spending Options				
Ease Restrictions on Contracting for Depot Maintenance	050-22		✕	
Eliminate National Science Foundation Spending on Elementary and Secondary Education	250-1	✕		
Reduce Funding for Research and Development Programs in the Science and Technology Directorate of the Department of Homeland Security	250-3	✕		

Continued

Table B-1. **Continued**

Selected Options That Appeared in CBO's August 2009 Budget Options Report

Option Title	Budget Function—2009 Option Number	Savings Over Five Years: Less Than $500 Million	Between $500 Million and $1 Billion	Between $1 Billion and $5 Billion
Discretionary Spending Options (Continued)				
Eliminate Federal Funding for Beach Replenishment Projects	300-2	✕		
Reduce Funding for Timber Sales That Lose Money	300-4	✕		
Eliminate the Energy Star Program	300-10	✕		
Eliminate the Environmental Protection Agency's Science to Achieve Results Grant Program	300-11	✕		
Eliminate the National Park Service's Local Funding for Heritage Area Grants and Statutory Aid	300-15	✕		
Eliminate the Hollings Manufacturing Extension Partnership and the Baldridge National Quality Program	370-2		✕	
Eliminate the Essential Air Service Program	400-5		✕	
Eliminate NeighborWorks America	450-2			✕
Eliminate the Community Development Financial Institutions Fund	450-3		✕	
Eliminate Regional Development Agencies	450-5	✕		
Restrict First-Responder Grants to High-Risk Communities	450-6	✕		
Eliminate Administrative Fees Paid to Schools in the Campus-Based Student Aid and Pell Grant Programs	500-8		✕	
Eliminate the Leveraging Educational Assistance Partnership Program	500-9	✕		
Reduce Rent Subsidies for Certain One-Person Households	600-5		✕	
Eliminate the Legal Services Corporation	750-2			✕
Eliminate the National Youth Anti-Drug Media Campaign	800-4	✕		
Raise the Threshold for Coverage Under the Davis-Bacon Act	920-1	✕		
Reduce Benefits Under the Federal Employees' Compensation Act	920-2	✕		

Continued

Table B-1. **Continued**

Selected Options That Appeared in CBO's August 2009 Budget Options Report

Option Title	2009 Option Number
Revenue Options	
Include Social Security Benefits in Calculating the Phase-Out of the EITC	24
Tax the Income Earned by Public Electric Utilities	34
Disallow Tax-Free Conversions of Large C Corporations to S Corporations	35
Cap Nonprofit Organizations' Outstanding Stock of Tax-Exempt Bonds	39
Tax Qualified Sponsorship Payments to Postsecondary Sports Programs	43
Require Self-Employed People and Employees to Pay the Same Amounts in Payroll Taxes	46
Increase Federal Employees' Contributions to Pension Plans	47
Impose a Tax on Emissions of Sulfur Dioxide	55
Charge for Examinations of State-Chartered Banks	61

Source: Congressional Budget Office, *Budget Options, Volume 2* (August 2009).

Note: The options listed here had budgetary effects below the threshold generally used for the present report. The effects that would be estimated for these options now might differ from the amounts estimated in 2009.

APPENDIX

C

Options by Budget Function

Function 050: National Defense

Mandatory Spending, Option 1	Introduce Minimum Out-of-Pocket Requirements Under TRICARE For Life	19
Discretionary Spending, Option 1	Reduce the Growth in Appropriations for the Department of Defense	74
Discretionary Spending, Option 2	Cap Increases in Military Basic Pay	76
Discretionary Spending, Option 3	Increase Medical Cost Sharing for Military Retirees Who Are Not Yet Eligible for Medicare	78
Discretionary Spending, Option 4	Limit the TRICARE Benefit for Military Retirees and Their Dependents	80
Discretionary Spending, Option 5	Increase Cost Sharing for Pharmaceuticals Under TRICARE	82
Discretionary Spending, Option 6	Consolidate the Department of Defense's Retail Activities and Provide a Grocery Allowance to Service Members	84
Discretionary Spending, Option 7	Replace the Joint Strike Fighter Program with F-16s and F/A-18s	86
Discretionary Spending, Option 8	Cancel the Navy and Marine Corps' Joint Strike Fighters and Replace Those Aircraft with F/A-18E/Fs	88
Discretionary Spending, Option 9	Cut the Number of Aircraft Carriers to 10 and the Number of Navy Air Wings to 9	90
Discretionary Spending, Option 10	Cancel the Expeditionary Fighting Vehicle	92
Discretionary Spending, Option 11	Delay Fielding of the Army's Ground Combat Vehicle	94
Discretionary Spending, Option 12	Terminate the Medium Extended Air Defense System Program	96
Discretionary Spending, Option 13	Terminate the Precision Tracking Space System Program	97

Function 270: Energy

Mandatory Spending, Option 2	Transfer the Tennessee Valley Authority's Electric Utility Functions and Associated Assets and Liabilities	20
Mandatory Spending, Option 3	Reduce the Size of the Strategic Petroleum Reserve	22

Function 270: Energy (Continued)

Discretionary Spending, Option 15	Eliminate the Department of Energy's Grants to States for Energy Conservation and Weatherization	100
Discretionary Spending, Option 16	Reduce Department of Energy Funding for Energy Technology Development	101

Function 300: National Resources and Environment

Mandatory Spending, Option 4	Prohibit New Enrollment in the Conservation Stewardship Program	24
Mandatory Spending, Option 5	Limit Enrollment in the Conservation Reserve Program	25
Discretionary Spending, Option 17	Eliminate Federal Grants for Wastewater and Drinking Water Infrastructure	103
Discretionary Spending, Option 18	Increase Fees for Use of the Inland Waterway System	105

Function 350: Agriculture

Mandatory Spending, Option 6	Reduce the Premium Subsidy in the Crop Insurance Program	26
Mandatory Spending, Option 7	Reduce by 20 Percentage Points the Share of a Farmer's Base Acreage Eligible for USDA Payments	27

Function 370: Commerce and Housing Credit

Mandatory Spending, Option 8	Lower the Loan Limits on Mortgages Guaranteed by Fannie Mae and Freddie Mac	28
Mandatory Spending, Option 9	Increase Guarantee Fees Charged by Fannie Mae and Freddie Mac	30
Discretionary Spending, Option 19	Eliminate the International Trade Administration's Trade Promotion Activities or Charge the Beneficiaries	106

Function 400: Transportation

Discretionary Spending, Option 20	Limit Highway Funding to Expected Highway Revenues	107
Discretionary Spending, Option 21	Eliminate Grants to Large and Medium-Sized Hub Airports	109
Discretionary Spending, Option 22	Increase Fees for Aviation Security	110
Discretionary Spending, Option 23	Eliminate Intercity Rail Subsidies	111
Discretionary Spending, Option 24	Eliminate the Transit Starts Programs	112

Function 450: Community and Regional Development

Discretionary Spending, Option 25	Create State Revolving Funds to Finance Rural Water and Waste Disposal	113
Discretionary Spending, Option 26	Drop Wealthier Communities from the Community Development Block Grant Program	114

Function 500: Education, Training, Employment, and Social Services

Mandatory Spending, Option 10	Eliminate Subsidized Loans to Graduate Students	31
Mandatory Spending, Option 11	Change the Interest Rate Structure for Student Loans	32
Discretionary Spending, Option 27	Eliminate Certain Grant Programs for Elementary and Secondary Education	115
Discretionary Spending, Option 28	Restrict Pell Grants to the Neediest Students	116
Discretionary Spending, Option 29	Eliminate Funding for National Community Service Programs	117
Discretionary Spending, Option 30	Eliminate the Senior Community Service Employment Program	118
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APPENDIX

E

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