BUDGET OPTIONS FOR FISCAL YEAR 1977:

A REPORT TO THE SENATE AND HOUSE COMMITTEES ON THE BUDGET

**As Required Annually
By The Congressional Budget Act of 1974,
P.L. 93–344**

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NOTES

Dollars are expressed in current terms unless otherwise indicated.

Numbers may not add to totals because of rounding.

Budget numbers for fiscal year 1975 and before are actual. Unless otherwise noted, those for fiscal year 1976 and the transition quarter are estimates based on the 1976 Second Concurrent Resolution on the Budget (H. Con. Res. 466). Those for fiscal years 1977 through 1981 were projected from the fiscal year 1976 base established by the second concurrent resolution. These projections are detailed in *Five-Year Budget Projections: Fiscal Years 1977-81* and *Staff Working Paper for the Five-Year Budget Projections Fiscal Years 1977-81*. Unless otherwise noted, path B economic assumptions were used. The short-run economic forecast presented in Part I, Chapter 2 is more optimistic than the path B economic assumptions.

Where pertinent, summary tax expenditure numbers have been included in the text and tables dealing with individual program areas. A discussion of the caveats that apply to the use and interpretation of these numbers is provided in Part II, Chapter 3.

The U.S. Bureau of Economic Analysis recently revised its national income and products accounts data. Since the relationship between revenue and various underlying economic variables derived from forecasting equations is based on such data, the revenue and, hence, revenue loss--i.e., tax expenditure--estimates for future years may also be revised. The revisions have not been completed yet, but it is expected that the net changes that occur will be small. Regardless of size, the direction and pattern of changes over time will not differ from those based on the unrevised data presented in this report.

PREFACE

This report was prepared by the Congressional Budget Office for the Committees on the Budget pursuant to Section 202(f) of the Congressional Budget Act of 1974 (Public Law 93-344) which states:

> (1) On or before April 1 of each year, the Director shall submit to the Committees on the Budget of the House of Representatives and the Senate a report, for the fiscal year commencing on October 1 of that year, with respect to fiscal policy, including (A) alternative levels of total revenues, total new budget authority, and total outlays (including related surpluses and deficits), and (B) the levels of tax expenditures under existing law, taking into account projected economic factors and any changes in such levels based on proposals in the budget submitted by the President for such fiscal year. Such report shall also include a discussion of national budget priorities, including alternative ways of allocating budget authority and budget outlays for such fiscal year among major programs or functional categories, taking into account how such alternative allocations will meet major national needs and affect balanced growth and development of the United States.

The report is but one of many pieces of information that the Committees on the Budget will have before them as they formulate the First Concurrent Resolution on the Budget for Fiscal Year 1977. It is divided into three parts; a Summary, Part I, which deals with the economy and the important budget issues for fiscal year 1977 and Part II, which examines in more detail major budget options and their long-term impact. Supporting documentation and special studies relating to the materials presented in this report have also been prepared for the use of the Committees.

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

Alice M. Rivlin
Director

SUMMARY

Under the new budget process the Congress is scheduled to complete action by May 15, 1976, on a First Concurrent Resolution on the Budget for Fiscal Year 1977 (which begins on October 1, 1976). The resolution must specify target levels for:

- Spending (both outlays and budget authority) by major functions of the federal government,
- Revenues,
- The size of the deficit or surplus and the consequent change in the national debt.

Making these decisions involves judgments about what is likely to happen to the economy and how inflation and unemployment will be affected by alternative budget policies. It also involves judgments about national priorities--about the relative importance of various federal activities and the appropriate balance of public and private spending.

Continuation of Past Trends Not Inevitable

The past two decades have seen the following changes in the federal budget:

- Total federal spending has grown slightly faster than the economy as a whole.
- The proportion of federal spending devoted to defense has declined (from 56 percent in 1956 to 25 percent in 1976).
- The proportion devoted to payments to individuals, such as social security benefits, has increased (from 19 percent of federal spending in 1956 to 44 percent in 1976).
- The number of federal grants to state and local governments has increased, as has the proportion of federal spending devoted to such grants (from 3 percent in 1956 to 12 percent of federal spending in 1976, not counting grants for payments to individuals).

- The proportion of federal revenue derived from payroll taxes has increased (from 12 percent in 1956 to 31 percent in 1976), while the proportion from excise and corporate income taxes has declined.

Action on the fiscal year 1977 budget could either continue or begin to reverse these trends.

To provide a baseline to which Congress can compare alternative policies, including the President's budget proposals, the Congressional Budget Office (CBO) has developed a set of current policy budget estimates, indicating what the budget would be like if current revenue and spending policies were continued and costs were adjusted to allow for inflation and changes in the population entitled to federal benefits. Under a current policy budget, federal spending would be $419 billion to $425 billion in fiscal year 1977 with an accompanying deficit of $55 billion to $65 billion. Spending would rise to $560 billion to $564 billion by fiscal year 1981, but revenues would rise more rapidly than expenditures, especially if the economy makes a strong recovery from the recession. If current policies were continued, total federal spending would grow less rapidly than the economy as a whole, especially if recovery were strong, and the proportions of the budget devoted to defense, payments to individuals, and grants to state and local governments would not change significantly.

The President's Budget

The President's budget request for fiscal year 1977 would halt or reverse some past trends in the federal budget by cutting the overall rate of spending increase, by giving higher priority to defense spending, by holding down increases in payments to individuals, and by consolidating grants to state and local governments and moderating the growth in such grants.

The President's budget request for fiscal year 1977 proposes outlays of $394 billion, a 5.5 percent increase over fiscal year 1976--a sharp reduction from past rates of increases--and $25 billion to $31 billion below CBO estimates of a current policy budget. About $18 billion of that difference lies in smaller human resources programs. Another $5 billion comes from proposed reductions in federal pay scales below comparability as defined by current law. About $6 billion reflects differences in estimates of offsetting receipts arising from asset sales and offshore leasing.

Cost-saving proposals in the human resources area include consolidation of grants for health, child nutrition, social services, and education at levels below current policy estimates for fiscal year 1977, reduction of some benefits under social security and medicare, and phasing out of temporary employment programs. Savings in other program areas contemplate a combination of tight funding; reductions in existing budget authority (rescissions and deferrals); program terminations; construction slowdowns; and both administrative and legislative changes to reduce program costs.

In defense, the President proposes both reductions in pay below current policy levels and major increases in some nonpay items, especially procurement. Because pay shows up in outlays right away while other items often have delayed effects, the President's proposed outlays for defense in fiscal year 1977 are \$2.3 billion below current policy estimates, although budget authority is \$3.9 billion above current policy levels. The President also requests a substantial increase in funding for energy research and development programs and the establishment of an off-budget Energy Independence Authority with lending authority that would ultimately reach \$100 billion.

On the revenue side, the President proposes extending 1975 tax cuts and reducing individual and corporate income taxes by an additional \$10 billion; this would be partially offset by increases in social security and unemployment insurance payroll taxes for a net reduction of approximately \$5 billion in federal receipts in fiscal year 1977. The Administration's proposed deficit totals \$43 billion, \$12 billion to \$22 billion below current policy budget estimates.

Economic Outlook

There is general agreement that 1976 is likely to be a year of continuing and fairly substantial recovery. Demand in the private sector is expected to gain momentum due to an increase in consumer and business confidence, growth in housing, and a resurgence of demand for new cars. A forecast based on a current policy budget leads to the following projections for 1976 and 1977:

Percent Change in GNP (1972 dollars)

1974:IV to 1975:IV (actual)	+2.5
1975:IV to 1976:IV (projected)	+5.5 to +7.0
1976:IV to 1977:IV (projected)	+5.0 to +6.5

Percent Change in General Price Index (GNP deflator)

1974:IV to 1975:IV (actual)	+6.5
1975:IV to 1976:IV (projected)	+5.0 to +6.5
1976:IV to 1977:IV (projected)	+4.7 to +6.2

Unemployment Rate (percent)

1975:IV (actual)	8.5
1976:IV (projected)	7.0 to 7.5
1977:IV (projected)	6.4 to 6.9

NOTE: 1974:IV refers to the fourth quarter of 1974, seasonally adjusted, and similarly for other years.

The projected rates of growth of constant-dollar GNP are high mainly because the economy is climbing out of an unusually deep recession and is not expected to encounter serious impediments to growth during the next two years. Even so, the gap between actual output and potential output at 4 percent unemployment will remain wide. The projections of the unemployment rate represent a clear improvement over the worst of recent experience, but remain quite high in relation to historical norms. The same is true for inflation rates; once established, inflation has a strong self-perpetuating bias and--at least under standard policy approaches--will probably recede only gradually.

As always, it is possible that the economy will not actually follow the projected path. Crop failures here or abroad, a major strike, or a rapid rise in short-term interest rates are among the possible developments which could worsen the outlook for inflation and unemployment, unexpected increases in private spending or exports could cause the economy to grow faster than projected.

Fiscal Policy Choices

Fiscal policy issues in choosing a 1977 budget differ from those facing the Congress a year ago. At that time, the leading issue was turning the economy around from a severe recession. This year, the central fiscal policy issue is striking a balance between the stimulus the economy must have if it is to continue its recovery and the restraint needed to avoid rekindling high rates of inflation.

Barring unforeseen shocks to the economy, one fiscal strategy--by no means the only one--that would meet this objective is a budget based on current policy. Slight departures from current policy in either direction would probably not alter the outlook for growth or inflation significantly.

The budget proposed by the Administration is on balance more restrictive than a current policy budget; it would reduce the deficit to $43 billion instead of $55 billion to $65 billion implied by current policy. The Administration's budget would put GNP an estimated 1.5 percentage points lower by the fourth quarter of 1977 than would a current policy budget. Hence, unemployment by the fourth quarter of 1977 might be as much as 0.6 percentage points higher than under current policy. Under pessimistic assumptions about private demand, this might mean a halt to the decline in unemployment by 1977.

With respect to inflation, the pay ceiling incorporated in the Administration's spending proposals would reduce the cost of government services and hence improve the inflation outlook. On the other hand, increases in tax rates for social security and unemployment insurance would raise labor costs at least in the short-run and therefore tend to increase prices. On balance, the Administration's budget would probably have little short-run effect on inflation. After two or three years, inflation might be about 0.3 percentage points lower per year under the Administration budget than under the current policy budget.

Alternatively, Congress could choose to pursue a policy even more expansionary than current policy. A $10 billion spending increase, for example, increasing the deficit by about $6 billion after new tax revenues were netted out, would decrease unemployment by 0.3 percentage points by the fourth quarter of 1977, although at a cost of 0.2 additional percentage points of inflation by 1980.

Major Spending Decisions for Fiscal Year 1977

Changes in the size and character of federal spending in fiscal year 1977 will be dominated by the answers to questions in five major areas.

1. National Security

   To what extent do potential threats to national security, especially the apparent buildup of Soviet military capability in recent years, justify expanding and modernizing U.S. general purpose forces and increasing spending on strategic weapons? What should be done to hold down defense manpower costs which now absorb more than half the defense budget?

Under current policy, outlays for national defense in fiscal year 1977 would be $103.4 billion. This figure includes the effects of a 12 percent military and civilian pay increase under provisions in current law.

- The President proposes to begin a buildup of U.S. military capabilities in fiscal year 1977. The first step in this buildup requires additional shipbuilding to maintain the Navy near its current level of 500 ships rather than letting it decline slowly as it would under current policy funding; new equipment and construction required to continue the expansion of the Army from 13 divisions to 16; and aircraft procurement to increase the USAF tactical air forces from 22 wings to 26 and to continue modernization; and increasing strategic capabilities by initiating procurement of the B-1 bomber. Because such buildups necessarily take place slowly, the additional outlays in fiscal year 1977 would be only $0.6 billion. The President also proposes a 4.7 percent increase in military and civilian pay instead of the 12 percent current policy increase. This restraint on pay increases would more than offset the increase in procurement so the total proposed defense outlays of $101.1 billion would actually be $2.3 billion below current policy.

- An alternative that would cut defense costs in the long run as well as in fiscal year 1977 could involve accepting the President's pay proposals but holding procurement at levels that would allow the Navy to decline slowly toward 400 ships, the Army to remain at 13 divisions and the tactical air forces to consist of 22 USAF and 10 USN wings, while deferring modernization of the manned bomber force. This would reduce the fiscal year 1977 defense outlays to $98.3 billion, $5.1 billion below current policy and $2.8 billion below the President's proposals.

- A more rapid buildup than proposed by the President would, of course, involve higher spending. The cost in fiscal year 1977 outlays would be $106.1 billion, $2.7 billion over current policy, should the Navy be rebuilt toward 600 ships, with nuclear propulsion for the new major surface vessels, as has been proposed; the Army built up to 16 fully equipped active divisions and tactical air to 26 USAF and 13 USN wings; strategic forces augmented by the B-1; R&D increased; and the military pay cap left off. (If the military pay cap were kept on, the total would remain $1.2 billion below current policy.) As in the case of the President's program, however, the real growth in costs would come in later years: By fiscal year 1981, outlays under this high option would be $22.2 billion above current policy.

An important decision is the extent of nuclear propulsion for Navy surface ships. Nuclear ships cost more to build. A decision to make all new major escort vessels nuclear would cost about $1 billion 1976 dollars per year more than to build a mix of nuclear and conventional ships.

2. Unemployment

With unemployment rates high, albeit declining, how much should the federal government spend for job-creating programs such as accelerated public works, public service employment and countercyclical revenue sharing? What should be done to extend or alter unemployment compensation?

Because of the recent recession, current policy includes a number of programs designed to go beyond the effects of pure fiscal stimulus in reducing unemployment. These include various job-creating programs--primarily public service employment-- for which fiscal year 1977 current policy outlays would be $4.4 billion.

- The President proposes to phase this down to $2.1 billion in fiscal year 1977, on the grounds that stimulation of the private economy is preferable to provision of public jobs and that the economy is improving rapidly.

- Unemployment will remain very high in any case, however, and Congress is faced with a variety of proposals involving spending above current policy levels. These include substantial increases in public service employment, accelerated public works programs, and antirecession grants to state and local governments.

The major question with respect to unemployment compensation is whether to continue two special benefit programs, federal supplemental benefits (FSB) and special unemployment assistance (SUA) or whether to adopt some other, more permanent, measures. To maintain current policy levels, the estimate for unemployment compensation in fiscal year 1977 is $19.2 billion, but that figure was based on an earlier estimate of the unemployment rate. A reduction of 0.6 percentage points in the unemployment rate could reduce the current policy unemployment compensation estimate by $1 billion to $2 billion.

- The President has proposed allowing expiration of the FSB program which has extended the period of coverage for those whose regular coverage has run out; and replacing SUA which has extended coverage to those not covered under regular programs with increased regular coverage. The savings from these proposals, as compared to current policy, would be about $1 billion in fiscal year 1977.

3. Health

With health care prices rising more rapidly than other prices, what steps should be taken to hold down the cost--to the government and to the patient--of health care? Should the federal government begin moving toward a more comprehensive national health insurance option?

- The President's budget proposes a series of measures to cut federal spending for health some $3.3 billion below current policy levels. These include replacing medicaid and other health programs with block grants to states for health and reducing medicare benefits except for those with very high expenses.

- Alternatively, Congress might choose to expand federal health insurance protection for those most affected by increasing health care costs--low-income groups and persons with "catastrophically" high medical bills. Such a program, if funded for the second half of fiscal year 1977, would add about $5 billion to current policy health spending.

- In addition, a number of legislative proposals have been introduced to provide more comprehensive national health insurance. While these would be unlikely to have significant costs in fiscal year 1977, they could have a major impact on the federal budget over the next few years.

4. Aid to State and Local Governments

To what extent should federal assistance be used to augment the fiscal capacities of state and local governments? To what extent should categorical grants be consolidated or changed to reduce the amount of control the federal government exercises over these funds?

Under current policy, federal aid to state and local governments would reach $67.8 billion in fiscal year 1977. The expiration of the general revenue sharing program, the President's block grant proposals and widespread concern over the effect of the recession on state and local governments make decisions on the appropriate level and degree of control of federal aid inescapable.

- The President's budget proposes grant outlays of $60.5 billion, 13 percent below the current policy level. The President's legislative initiatives include renewal of the general revenue sharing program at $6.5 billion in 1977, and consolidation of a large number of categorical grant programs into separate block grants for health, education, child nutrition, and highways. The block grants would provide recipient governments with more control over the use of federal grant monies, but the proposed funding in most cases represents decreases from current policy levels.

- If the Congress wanted to increase the level of assistance provided to state and local governments while reducing federal control, general revenue sharing could be extended and expanded in 1977 and an "antirecession" grant program could be enacted to partially compensate these governments for the revenues lost due to high levels of unemployment. A partial or total federal takeover of programs--such as medicaid and welfare--that now are supported by grants-in-aid, also would provide fiscal relief for states and localities. Further, increased funding of categorical grants would increase levels of assistance, but it would also increase federal control.

- Federal aid to state and local government could be reduced by gradually phasing out general revenue sharing or by keeping down the growth in categorical grant programs such as medicaid, welfare and nutrition. Alternatively, federal aid could be maintained, but federal control increased by gradually substituting categorical and block grants for general revenue sharing.

5. Federal Civilian Pay

What changes, if any, should be made in the method of computing federal civilian pay?

The general schedule (GS) system is the most important of the federal pay systems, directly affecting three-quarters of civilian pay and indirectly affecting military pay. Under current policy GS pay would be adjusted in October, 1976, to achieve "comparability" with private sector wages. CBO estimates that a 12 percent increase would be needed to maintain current policy; this would include a catch-up factor resulting from the 5 percent cap imposed on pay last year. Current policy outlays for GS pay would thus be $30.1 billion in fiscal year 1977.

- The President has proposed a much more modest adjustment, which would average 4.7 percent, with a minimum of 3 percent for the lower grades and a cap of 5 percent at the top. This proposal is predicated primarily on adoption of those recommendations of the President's Panel on Federal Compensation (the Rockefeller Panel) that can be implemented administratively. The President's proposed average adjustment of 4.7 percent would raise GS and related civilian pay by $1.3 billion in fiscal year 1977 over fiscal year 1976 levels; and would cost about $1.9 billion less than current policy. Counting military pay, the President's proposal would cost about $4 billion less than current policy.

- Alternatives that might increase GS pay include a system of collective bargaining, which would have no budgetary impact in fiscal year 1977, but could increase outlays in fiscal year 1981 by as much as $7 billion. A system of indexation, which would provide automatic cost-of-living increases based on changes in one or more independent economic indicators, would probably raise costs for fiscal year 1977 by about $1.2 billion over current policy levels (including military pay, the increase would be $2.2 billion).

- If Congress chose to lower increases in GS pay, it could adopt the President's budget request, or place a two-year moratorium on pay raises. This would result in no additional costs beyond the payroll base for fiscal year 1977, and would cut $3.2 billion from current policy costs (counting military pay, the decrease would be $5.9 billion).

Major Revenue Decisions for Fiscal Year 1977

Two major tax decisions seem likely to affect the level of revenues for fiscal year 1977.

1. Social Security Payroll Tax

   Should the payroll tax be raised or other measures taken to replenish reserves in the social security trust funds? Or should action be delayed?

Recently, due to the rapid rise in benefit levels and the impact of the recession on receipts, the trust funds have been paying out more than has been coming in so reserves accumulated in past years have been tapped. Under current law, payments in fiscal year 1977 would exceed receipts by $3.5 billion to $5.0 billion. Projections indicate reserves will fall from about $45 billion in fiscal year

1976 to about $30 billion by the end of fiscal year 1981, but probably begin building up again later in the 1980s. Much more substantial deficits are expected to occur in the longer run (after about the year 2015) when the retired population will be large relative to the working population.

- The President has proposed an increase in the payroll tax rate of 0.6 percent (on employers and employees combined) to be effective January 1, 1977. This would increase receipts by $3.5 billion in 1977, eliminate the annual deficit, raise reserves to about $73 billion by 1981, and contribute to reduction of the longer run deficit.

- An alternative is to delay action--on the grounds that none is actually needed this year and that a tax increase might impair economic recovery--or choose a solution other than a payroll tax increase.

- Other options include raising the wage base to which the social security tax applies, either a temporary or a permanent appropriation of general revenues to the trust funds, or provision of standby borrowing authority.

2. The Personal and Corporate Income Taxes

Should the tax reductions enacted in 1975 be allowed to expire on June 30, 1976? Should they be extended? Should further cuts be enacted?

Current policy estimates of revenues for fiscal year 1977 assume that the 1975 individual and corporate income tax reductions will simply be extended.

- The President proposes extension with some modifications, plus a further $10 billion net reduction in individual and corporate income taxes. The President would not extend the earned income credit that goes to low-income workers. Dropping the credit would reduce their incomes about $1.5 billion in fiscal year 1977.

- Whether the Congress accepts the President's proposal of a further $10 billion reduction depends both on desired spending levels and on what is regarded as the appropriate level of deficit. If Congress accepted the desirability of a $10 billion reduction, however, a wide variety of options would be available in addition to the President's. Personal or corporate taxes can be reduced by various means (rate changes, exemptions, deductions, or credits) for people anywhere on the scale of income.

The CBO Report

This report, required by law, is designed to provide assistance to the two Budget Committees as they consider possible 1977 budget alternatives for total spending, revenues, and the size of the deficit. Part I of the report provides more detail on possible future trends of the federal budget under current policies, the economic outlook for the next two years, and estimates of the effect of alternative budget deficits on the economy. It also provides more detail on the major spending and taxing decisions that Congress must make this year. Part II of the report contains analyses of the five-year budget implications of possible spending and taxing options and some illustrative five-year federal budgets.

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PART I

FEDERAL BUDGET CHOICES FOR FISCAL YEAR 1977

PART I-1: THE FEDERAL BUDGET: PAST AND FUTURE

Introduction

The federal budget provides a focal point for national debate about what the federal government should do, how it should do it, and how the burden of paying for federal activities should be shared. Decisions on the federal budget are inevitably complicated and difficult. They reflect compromises among many philosophies and interest groups, as well as the consequences of such decisions made many years ago.

Every budget embodies implicit answers to three important questions about federal policy:

1. How much should the federal government spend and for what?

   Congress must weigh competing claims on federal resources and decide how much to spend for defense, health, housing, energy, and the other varied functions of the federal government. The sum of these decisions determines how much of the nation's total resources will be devoted to federal activities, as opposed to private or state and local government activities.

2. How much revenue should be raised and how?

   The mix of taxes used to raise federal revenue determines how the burden of paying for government services will be shared among individuals and corporations. Moreover, federal taxes, like federal spending, may be used to encourage or discourage private activities.

3. How big will the deficit or surplus be?

   The difference between the revenues and expenditures of the federal government, and the composition of both, influence economic activity and employment in the whole economy and affect the rate of inflation as well.

The New Budget Process

Until recently Congress took action on the budget in a piecemeal fashion. Spending measures were acted on one at a time; tax measures were treated separately. This process offered no opportunity to put the two sides of the budget together--to consider whether the resulting deficit or surplus was appropriate to the needs of the economy, or whether the spending and taxing priorities reflected in specific bills were in accord with Congress' general view of the nation's best interests. With enactment of the Congressional Budget Act of 1974, however, Congress acquired a new procedure for budget decision making that gave it a mechanism for looking at the budget as a whole, weighing priorities, and explicitly addressing questions of fiscal policy.

Under the new process the Budget Committees are responsible, early in the legislative year, for weighing evidence about the economic situation and considering competing demands on the federal government. On the basis of reports submitted by other committees of the Congress, advice from individuals and groups, and the President's budget request, the Budget Committees formulate a first concurrent resolution on the budget. Once passed, the resolution embodies Congress' judgments about the proper size of the budget for the coming fiscal year; the best allocation of spending by functional categories; the desirable level of revenues; and the surplus or deficit appropriate for the economic situation.

This report, required by the 1974 act, is designed to assist the Budget Committees and the Congress as a whole as they make these decisions, by setting forth some of the major options and choices. In keeping with the mission of the Congressional Budget Office (CBO) to provide nonpartisan, objective analytical support for the new budget process, the report contains no recommendations.

The Importance of Looking Ahead

In any one year much of the budget is "locked in" before the Congress begins to act on it. Some spending commitments have the force of law: for example, payments on prior-year contracts for major construction programs, and checks to social security beneficiaries in the amounts to which they are entitled under the law. Moreover, many other programs have been in operation for a long time and would be difficult to change rapidly. For example, a school district that has been receiving a federal grant for many years would be hard put to adjust to its abrupt termination, and the Congress is understandably reluctant to impose such an adjustment.

Hence, dramatic changes in the size or composition of the budget are unlikely in a single year. Changes must take place at the margin. But these marginal changes, in their turn, often continue to have a significant impact well into the future. A decision to begin procurement of a major weapons system, to redefine eligibility for pensions or other benefits, or to eliminate a specific tax may have profound implications for future budgets. Making major changes in the scope and direction of the budget requires considering both the immediate and the long-range consequences of individual taxing and spending decisions. For this reason this report tries, to the extent feasible, to put the budget options for fiscal year 1977 into the context of choices about the direction of federal activities over the fiscal year 1977 to 1981 period.

Plan of the Report. Part I of the report deals with key decisions for fiscal year 1977. The remainder of this first chapter deals with recent budget history and what is likely to happen to the budget over the next five years if no changes are made in federal policy. Chapter 2 discusses the economic context within which this year's budget decisions must be made and the effect of alternative budgets on the economy; Chapter 3 gives a brief overview of the President's proposed budget for fiscal year 1977, then discusses key decisions--big ticket items--that will affect the size and composition of federal spending and revenue in fiscal year 1977 and beyond.

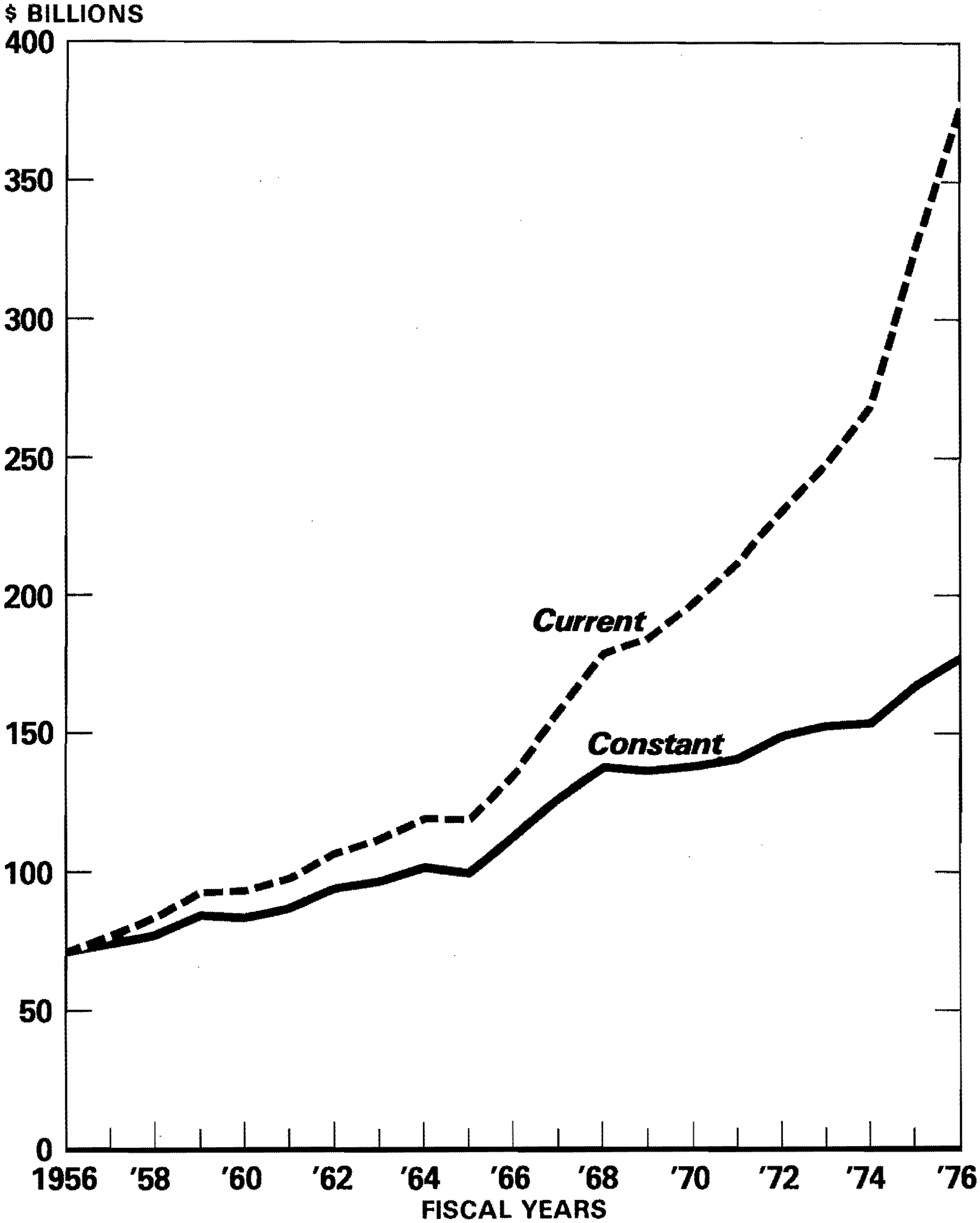
Part II contains more detailed analysis of program areas and five-year budget options within each one. Sections on national security, international affairs, income assistance, health, housing, veterans, unemployment, education, grants to other governments, energy, transportation, agriculture, natural resources and science, general government, federal compensation, and postal services are followed by a section that pulls functional options together into some illustrative five-year total budgets and a final section on "tax expenditures."

Trends in the Federal Budget

Increases in Total Spending. Over the past two decades federal government spending more than quintupled, rising from $70 billion in fiscal year 1956 to $375 billion in 1976. Much of this increase simply reflects inflation. Adjusted for price increases federal spending approximately doubled in this period (see following chart).

At the same time, of course, the economy has been growing; but federal spending has more than kept pace with the total growth of national output. From about 17 percent of gross national product (GNP) in fiscal year 1956, federal spending rose to 19 percent in fiscal year 1966, and to 24 percent in fiscal year 1976. This last figure is misleading, however, because the current recession has both lowered the GNP and temporarily increased federal spending for unemployment compensation. If recession-related expenditures are removed and federal spending is compared with an estimate of GNP at full employment, the federal share has only grown moderately in the last two decades, rising from 17 to 20 percent. State and local government spending, some of it financed by federal grants, has risen more dramatically over this period.

Federal Outlays in Current and Constant Dollars, 1956 - 76



Notes: 1956 GNP deflator used.
1976 outlay total reflects the Second Concurrent Resolution on the Budget for 1976.

BUDGET OUTLAYS BY FEDERAL, STATE, AND LOCAL GOVERNMENTS, DOLLAR AMOUNT AND PERCENTAGE OF GNP, BY SELECTED MEASURES, FISCAL YEARS 1956, 1966, AND 1976

Measure	Actual 1956	Actual 1966	Estimated 1976
UNIFIED FEDERAL BUDGET OUTLAYS			
Billions of dollars	70. 5	134. 7	374. 9
Percent of GNP [a]	17. 2	18. 6	23. 5
FEDERAL OUTLAYS AT FULL EMPLOYMENT [b]			
Billions of dollars	69. 8	132. 3	356. 3
Percent of full employment GNP	16. 9	18. 5	19. 6
STATE AND LOCAL GOVERNMENT OUTLAYS			
Percent of GNP [a]	8. 3	11. 0	14. 9
Percent of full employment GNP [c]	8. 3	11. 1	13. 1

[a] The 1972 benchmark revisions of the National Income Accounts of the U.S.A. are used throughout. Fiscal year 1976 GNP figures are CBO estimates.

[b] Full employment GNP for fiscal years 1956 and 1966 are Data Resources Inc. estimates. The fiscal year 1976 figure is a CBO estimate.

[c] The total public-sector percentage of GNP cannot be obtained by adding the federal and state and local percentages since the latter two include federal grants in aid.

Shifts in Priorities

As the following chart reveals, the most striking shift in the composition of federal spending over the last 20 years has been the relative decline in the importance of defense spending and the relative increase in payments to individuals--for social security, unemployment compensation, veterans' benefits, medicare and medicaid, housing assistance, federal employees' retirement benefits, and other purposes.

From 56 percent of total federal outlays in fiscal year 1956, defense expenditures have declined to 41 percent in fiscal year 1966 and to 25 percent in fiscal year 1976. Over the same period, payments to individuals have grown from 19 percent of total outlays in 1956 to 25 percent in fiscal year 1966 and to 44 percent in fiscal year 1976. Almost two-thirds (64 percent) of this increase in payments to individuals is accounted for by programs designed to assist the aged and disabled, such as social security, medicare, and federal employees retirement benefits.

Federal aid to state and local governments--exclusive of those grant programs that involve benefit payments to individuals--has also grown over the past 20 years; accounting for 3 percent of federal budget expenditures in fiscal year 1956, its proportion doubled by fiscal year 1966, and doubled again to 12 percent in fiscal year 1976.

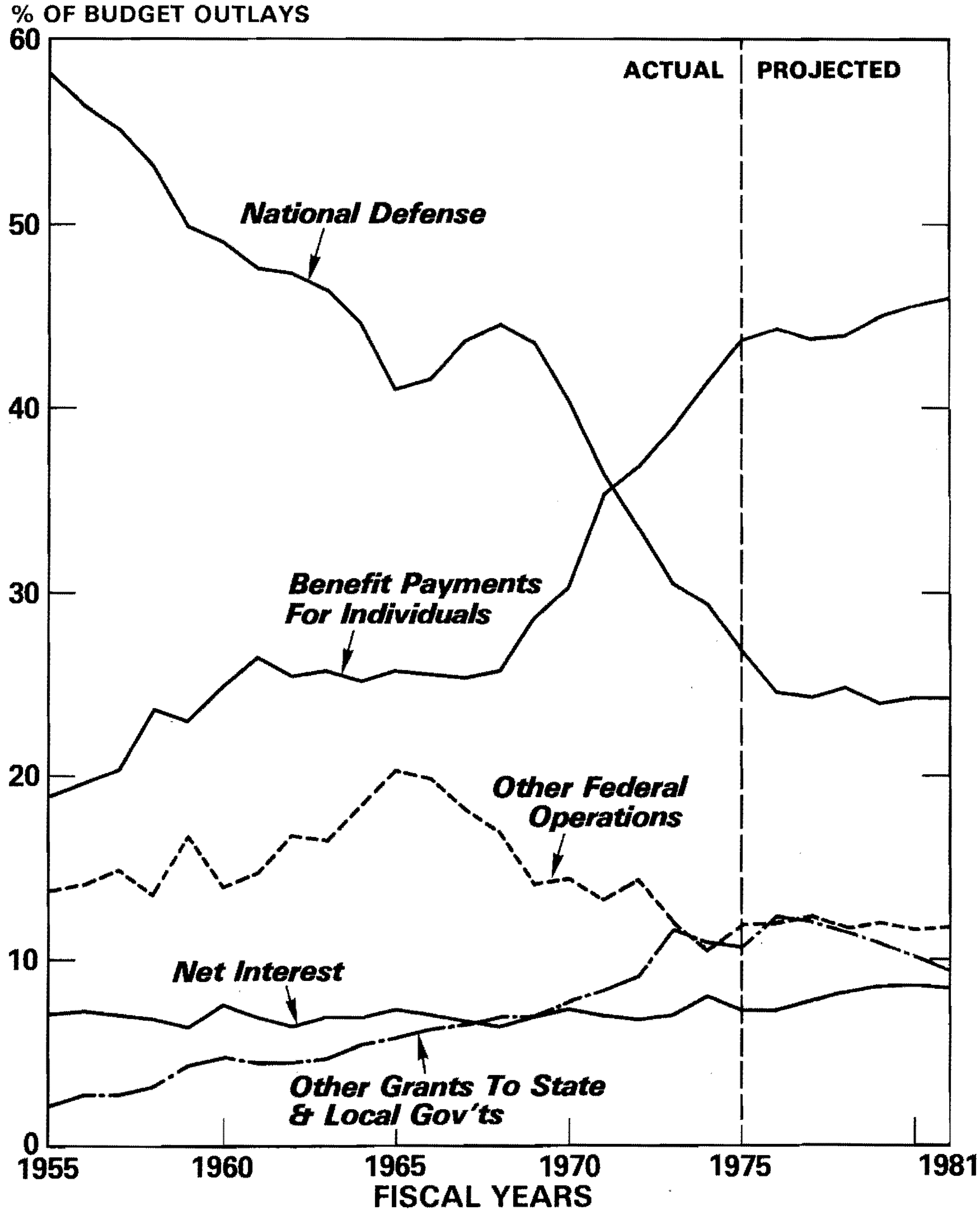
Revenues

Federal revenues have quadrupled during the past 20 years, and the reliance of the government on various sources of revenue has shifted markedly (see following charts). Excise taxes and corporate income taxes have declined substantially as a proportion of total receipts since fiscal year 1956. Meanwhile, social insurance taxes have risen steadily, from 12 percent of federal receipts in fiscal year 1956, to 20 percent in fiscal year 1966, to 31 percent in fiscal year 1976. While receipts from individual income taxes tend to grow faster than those from other taxes as national income increases, this tendency has been offset by periodic income tax cuts--in 1965, 1969, 1971, and 1975--so that individual income taxes in fiscal year 1976 account for about the same percentage of total receipts (44 percent) as they did 20 years ago (43 percent).

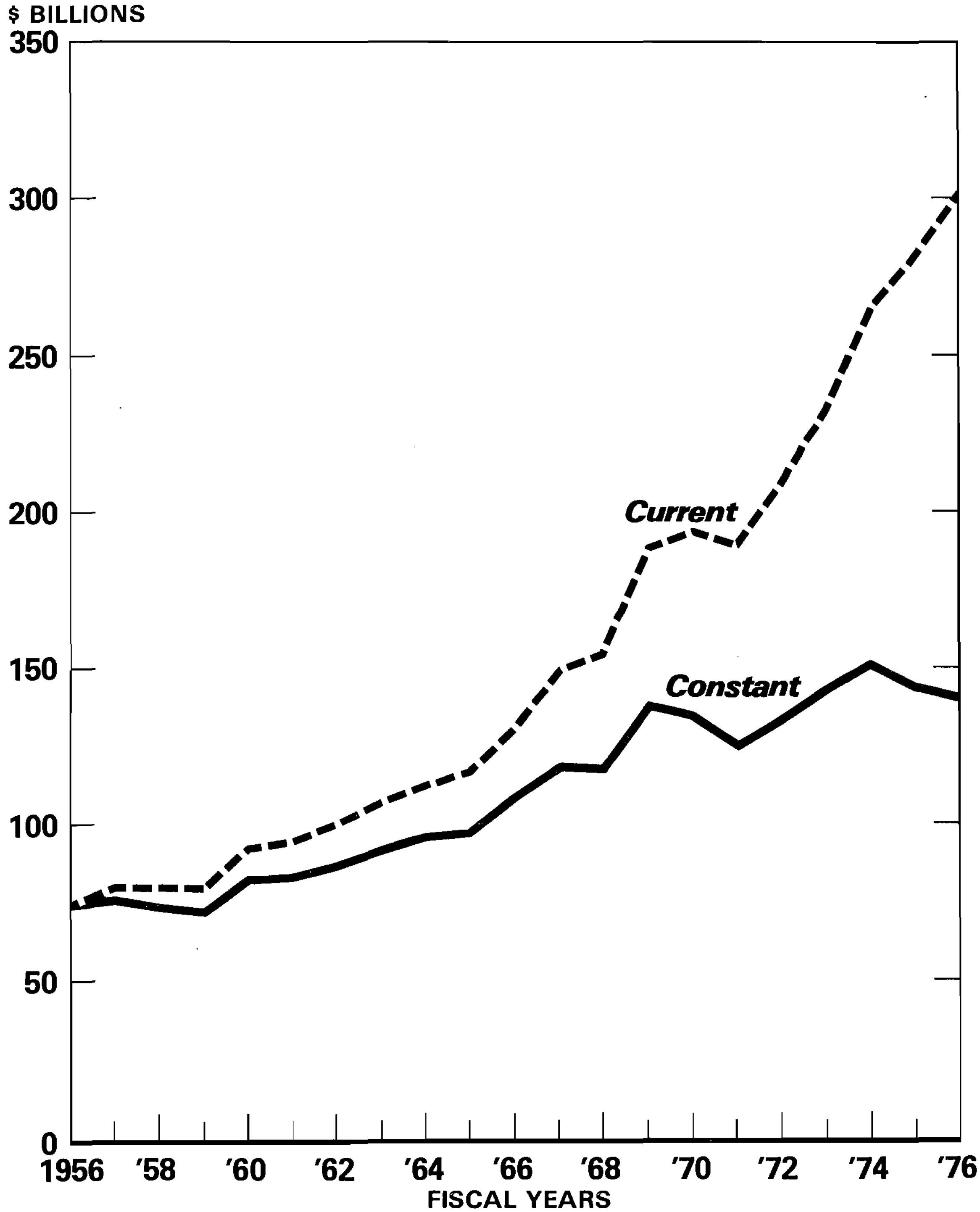
Deficits

The federal budget has been in deficit in 16 out of the last 20 years, but the deficit for fiscal year 1976 set a record of about $74 billion. Even when converted to constant dollars or expressed

Composition of Federal Spending
(Path B Assumptions)

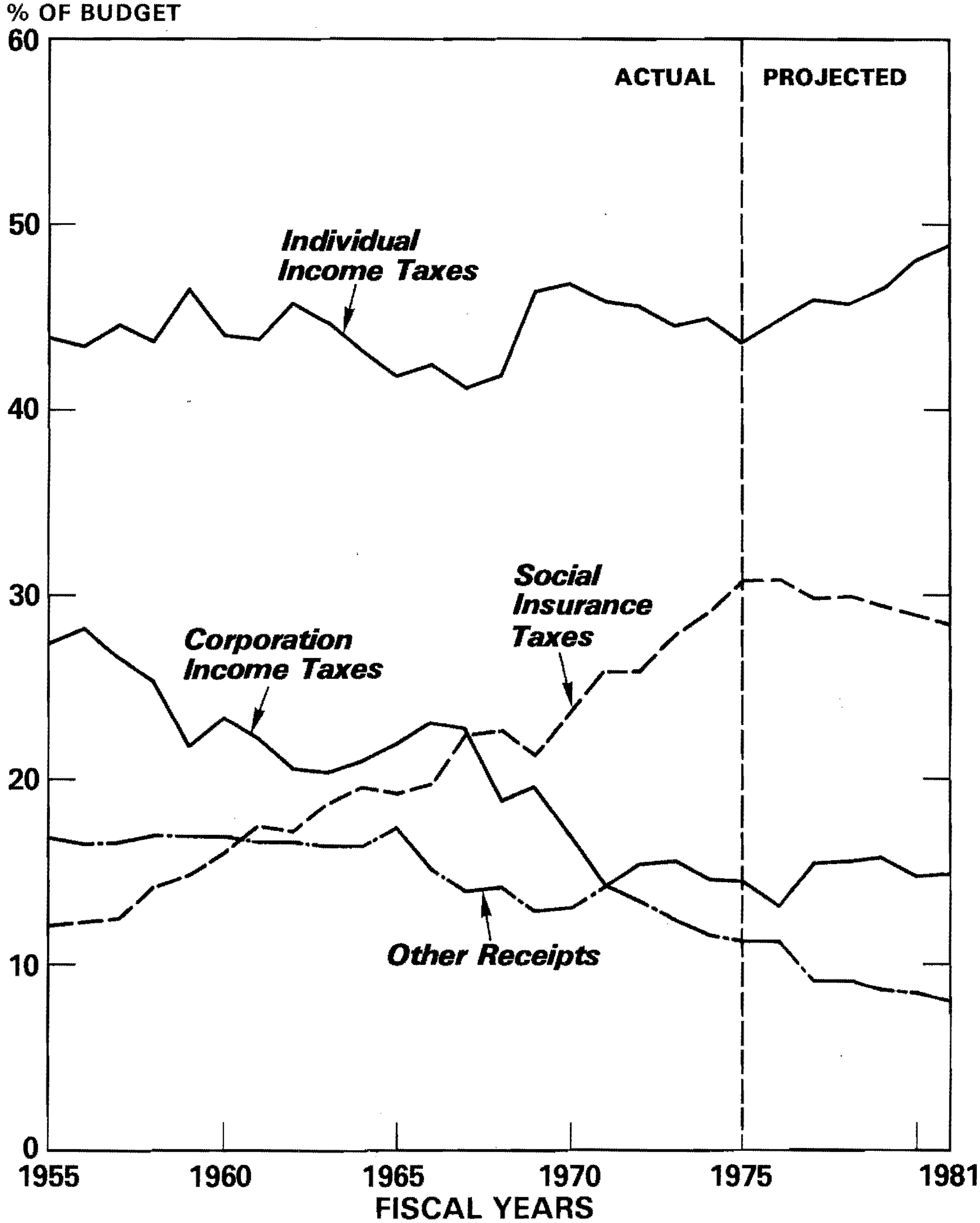


Federal Budget Receipts in Current and Constant Dollars, 1956 - 76



Notes: 1956 GNP deflator used.
1976 receipts total reflects the Second Concurrent Resolution on the Budget for 1976.

Receipts By Source as a Percentage of Total Receipts
(Path B Assumptions)



as a percentage of total federal spending, the current deficit looms large in comparison to previous ones (see following table).

In contrast to the past, however, this year's deficit is almost entirely the result of recession. If the economy had been operating at full capability (conventionally defined as 4 percent unemployment), federal receipts for 1976 would be about $55 billion higher, expenditures would be about $19 billion lower (a drop accounted for mostly by lower unemployment compensation), and the deficit would be only an estimated $800 million instead of the current estimate of $74 billion.

Because of these continued deficits, the total federal debt has more than doubled over the past 20 years; rising from about $272 billion in fiscal year 1956 to approximately $623 billion in fiscal year 1976. At the same time, because the economy has been growing at an even faster rate, the debt as a percent of GNP has steadily declined from 66 percent in fiscal year 1956 to 39 percent in fiscal year 1976.

In sum, over the past 20 years these major trends have characterized the federal budget: (1) total spending has grown slightly faster than the economy as a whole; (2) defense spending has declined as a proportion of the total, while payments to individuals and grants to state and local governments have risen significantly; (3) payroll taxes have become relatively more important while, correspondingly, corporate and excise taxes have declined as sources of revenue; and (4) deficits have been the rule rather than the exception. Whether these trends continue or are changed depends on Congressional budget policy.

Future of the Budget with No Change in Policy

Even without any alteration in legislation or budget policy, individual budget figures can shift substantially from one year to the next. Medicare payments may rise because more elderly people claim benefits and costs of medical care rise; or income tax collections may be lower because fewer people are employed. Hence, in order to have a baseline from which to consider budget proposals--including the President's--one must ask: What would happen to the budget if existing spending and taxing policies were unchanged and no new ones were undertaken?

As required by the Congressional Budget Act, CBO has recently issued a projection of federal revenues and spending for each fiscal year from 1977 through 1981 on the assumption that policies in

THE FEDERAL SURPLUS OR DEFICIT AND TOTAL DEBT BY VARIOUS MEASURES FOR FISCAL YEARS 1956 THROUGH 1976

Fiscal year	Billions of dollars				Percentages	
	Surplus(+) or deficit(−) (current dollars)	Surplus(+) or deficit(−) (1976 constant dollars)	Surplus(+) or deficit(−) at full employment current dollars	Total federal debt in current dollars	Surplus(+) or deficit(−) as percent of total Federal outlays	Total federal debt as a percent of GNP
1956	+4.1	+8.7	+5.1	272.8	+5.8	66.4
1957	+3.2	+6.5	+6.1	272.4	+4.2	62.9
1958	−2.9	−5.7	+6.5	279.7	−3.6	63.3
1959	−12.9	−25.1	+5.0	287.8	−14.0	61.1
1960	+0.3	+0.6	+12.0	290.9	+0.3	58.4
1961	−3.4	−6.4	+13.7	292.9	−3.5	57.5
1962	−7.1	−13.2	+11.1	303.3	−6.7	55.6
1963	−4.8	−8.8	+10.4	310.8	−4.3	53.9
1964	−5.9	−10.7	+9.9	316.8	−5.0	51.4
1965	−1.6	−2.9	+6.3	323.2	−1.4	49.1
1966	−3.8	−6.6	−1.0	329.5	−2.8	45.6
1967	−8.7	−14.7	−8.3	341.3	−5.5	44.1
1968	−25.2	−41.2	−13.0	369.8	−14.1	44.5
1969	+3.2	+5.0	+5.1	367.1	+1.8	40.6
1970	−2.8	−4.2	+11.8	382.6	−1.5	39.8
1971	−23.0	−32.5	+4.1	409.5	−10.9	40.2
1972	−23.2	−31.6	−3.6	437.3	−10.0	39.3
1973	−14.3	−18.8	−6.6	468.4	−5.8	37.8
1974	−3.5	−4.2	+9.2	486.2	−1.3	35.8
1975	−43.6	−47.6	−5.3	544.1	−13.4	37.8
1976	−74.1	−74.1	−0.8	622.6	−19.8	39.3

Notes: Fiscal year 1976 estimates are derived from the fiscal year 1976 second concurrent resolution. Federal outlays and GNP at full employment (4 percent unemployment) are CBO estimates. GNP for fiscal year 1976 is a CBO estimate. All other figures are from the *Budget of the United States Government: 1977*.

effect in fiscal year 1976, as embodied in the second concurrent resolution, are continued.[1]

Making such projections requires specific definitions of what constitutes continuation of current policies. In the case of receipts, the assumptions were simple and straightforward: present tax provisions will remain in force.[2] Spending programs called for three classes of assumptions. First, except where programs were clearly temporary in nature--study commissions, for example--current programs were assumed to operate through fiscal year 1981 where there was a history of past renewals. General revenue sharing and several temporary employment assistance programs were assumed to be renewed. Second, except for programs for which the present law fixes ceilings, it was assumed that spending would be increased enough to offset inflation. Finally, it was assumed that open-ended claims on the federal Treasury, such as those that result from interest on the public debt and social security payments, would respond to assumed economic and population changes in essentially the same way as they have done in the past.

Because the outlays required to sustain services at current levels and the revenues collected depend on economic conditions, assumptions had to be made about those conditions through fiscal year 1981. In view of the uncertainty of the outlook, two alternative sets of assumptions were used. The first, called path A, assumed a strong recovery from the current recession, with the unemployment rate falling to 4.5 percent in 1980 and 1981. The second, labeled path B, assumed a less vigorous recovery and an unemployment rate of just below 6 percent by 1981. Under path A, the inflation rate would remain at historically high levels of 6 to 7 percent, while under path B it would average about 1 percentage point lower.

It is important to understand that all of the budget projections provided here simply show what the federal budget would look like if current policies were maintained and if the economy somehow--as a result of foreign demand, monetary policy, an investment boom or some other developments--achieved path A or path B. These projections do not necessarily represent the budgetary policy that would be required to achieve either path under particular assumptions about the rest of the economy. The question of how the budget affects the economy is dealt with in the next chapter.

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1. Congressional Budget Office, Five-Year Budget Projections: Fiscal Years 1977-1981, January 1976.

2. The Tax Reduction Act of 1975 (adopted in March) and the Revenue Adjustment Act of 1975 (adopted in December), which extended most provisions of the original tax cut for six months, were assumed to be in force through fiscal year 1981.

Spending. Federal spending is projected to rise from $375 billion in fiscal year 1976 to $560 billion under path A and $563 billion under path B by 1981 if current policies are continued. These estimates represent an increase of 50 percent, or an average annual increase of 8 percent. However, under both paths, the whole economy will grow at an even faster rate. Thus, federal expenditures are projected to decline from 24 percent of GNP in fiscal year 1976 to 21 percent in fiscal year 1981 under path B. Assuming the faster path A, recovery from the recession would mean that by fiscal year 1981 federal expenditures would be only 19 percent of GNP.

Composition. If current policies were continued, the share of the federal budget allocated to national defense would remain at its present level of between 24 and 25 percent of the budget through fiscal year 1981 (see following table). Benefit payments to individuals, such as veterans' benefits and social security, would rise only slightly, from 44 to 46 percent of the budget. Finally, the percentage of federal expenditures for grants to state and local governments would decline slightly, from the current 11 percent to 9 percent in fiscal year 1981.

Revenues. Receipts are projected to rise somewhat more rapidly than expenditures, largely because inflation and growth in real income are expected to push individuals into higher income brackets. Some changes can be expected in the proportion of total revenues that will be collected from various types of taxation (see following table).

Specifically, the share of revenues derived from personal income tax collections would increase, from about 44 percent in fiscal year 1976 to between 50 and 51 percent in fiscal year 1981. Second, the share derived from corporate profits taxes would rise slightly, to 14 or 15 percent by fiscal year 1981, after declining from 19 to 13 percent over the last eight fiscal years. Finally, the relative growth in collections from payroll taxes would cease, with the share raised through this source declining from 31 percent to between 27 and 29 percent over the next five fiscal years.

Surpluses or Deficits. The faster the economy grows--and the more rapid the inflation rate--the faster the budget would shift from a deficit to a surplus condition. If the economy follows the more optimistic trend of path A, the federal budget will achieve a surplus in fiscal year 1979. Under the economic assumptions of path B, on the other hand, deficits would continue through fiscal year 1981, although they would decrease in size.

In short, projections of the federal budget for the next five years indicate that nothing in current budget policy makes continuation of past budget trends inevitable. Indeed, if no new policies are

FEDERAL BUDGET OUTLAYS FISCAL YEAR 1975 AND ESTIMATED OUTLAYS FISCAL YEARS 1976–81 UNDER PATH A AND PATH B ECONOMIC ASSUMPTIONS

[Billions of dollars, fiscal years]

Source	1975 actual	1976 estimate	Transition quarter estimate	Projections 1977	1978	1979	1980	1981
	Path A Economic Assumptions							
Path A—6 percent real GNP growth:								
National defense	86. 6	91. 9	24. 8	103. 4	115. 0	119. 6	130. 8	141. 3
Benefit payments for individuals	141. 4	165. 5	43. 7	180. 5	192. 9	213. 3	235. 5	261. 0
Grants to state and local governments	34. 7	45. 7	13. 1	49. 6	51. 6	51. 9	51. 6	52. 6
Net interest	23. 3	26. 9	7. 9	32. 1	34. 9	35. 4	36. 5	37. 5
Other federal operations	38. 6	44. 9	12. 2	53. 6	54. 9	60. 2	64. 3	68. 0
Total budget outlays	**324. 6**	**374. 9**	**101. 7**	**419. 4**	**449. 2**	**480. 4**	**518. 7**	**560. 4**
	Path B Economic Assumptions							
Path B—5 percent real GNP growth:								
National defense	86. 6	91. 9	24. 8	103. 4	114. 5	118. 0	127. 2	135. 6
Benefit payments for individuals	141. 1	165. 5	43. 7	184. 8	203. 3	221. 5	239. 6	258. 0
Grants to state and local governments	34. 7	45. 7	13. 1	50. 5	52. 9	53. 4	52. 6	52. 1
Net interest	23. 3	26. 9	7. 9	33. 2	39. 4	43. 9	48. 3	51. 6
Other federal operations	38. 6	44. 9	12. 2	52. 6	54. 4	58. 7	61. 7	66. 1
Total budget outlays	**324. 6**	**374. 9**	**101. 7**	**424. 5**	**464. 3**	**495. 5**	**529. 4**	**563. 5**

NOTE.—These projections are consistent with budget classifications used in the Presidential budget documents for 1976, and differ slightly from those in the 1977 Presidential budget documents.

FEDERAL BUDGET RECEIPTS FISCAL YEAR 1975 AND ESTIMATED RECEIPTS FISCAL YEARS 1976–81 UNDER PATH A AND PATH B ECONOMIC ASSUMPTIONS—Continued

[Billions of dollars, fiscal years]

Source	1975 actual	1976 estimate	Transition quarter	1977	1978	1979	1980	1981
	Path A Economic Assumptions							
Individual income taxes	122.4	135.0	38.7	175.5	206	241	282	330
Corporate profits tax	40.6	39.5	11.3	59.0	71	81	88	95
Social insurance taxes and contributions	86.4	92.6	26.5	113.0	130	144	160	178
Excise taxes	16.6	16.9	4.8	17.6	19	20	22	22
Estate and gift taxes	4.6	4.6	1.3	5.5	6	7	8	9
Customs duties	3.7	4.3	1.2	4.7	6	6	7	7
Miscellaneous receipts	6.7	7.9	2.2	8.0	8	9	11	11
Total	**281.0**	**300.8**	**86.0**	**383.3**	**445**	**509**	**577**	**652**
	Path B Economic Assumptions							
Individual income taxes	122.4	135.0	38.7	159.8	186	212	242	273
Corporate profits taxes	40.6	39.5	11.3	54.5	59	67	72	78
Social insurance taxes and contributions	86.4	92.6	26.5	110.2	121	133	144	159
Excise taxes	16.6	16.9	4.8	17.5	18	18	18	19
Estate and gift taxes	4.6	4.6	1.3	5.4	6	6	7	7
Customs duties	3.7	4.3	1.2	4.6	5	5	5	5
Miscellaneous receipts	6.7	7.9	2.2	8.0	8	8	9	9
Total	**281.0**	**300.8**	**86.0**	**360.0**	**401**	**448**	**497**	**550**

NOTE.—See text for definition of the current-services receipts concept.

adopted, federal spending will decline as a proportion of total national spending, especially if the economy grows rapidly; the past shift in relative importance from corporate to payroll taxes would cease; and the relative shift of spending priorities from national defense to benefit payments for individuals would not continue.

The projections also illustrate the substantial impact that the economy has on the budget. Inflation and economic growth affect both revenues and expenditures, and the outlook for balancing the budget is much more favorable if recovery from the recession is rapid.

The economy affects the budget; and the budget also affects the economy. In general, increasing the size of the federal deficit through tax cuts or new spending programs tends to stimulate economic activity and reduce unemployment, but at some cost in terms of inflation. Moving toward surplus tends to reduce inflationary pressures, but at some cost in terms of employment. One of the important aspects of the new budget process is that it gives Congress an opportunity to examine both sides of the budget at once and vote on a fiscal policy appropriate to the economic situation anticipated in the budget year.

Fiscal policy issues in choosing a 1977 budget differ from those facing the Congress a year ago. Then the leading issue was turning the economy around from a severe recession to recovery. Thanks to the 1975 tax cuts which Congress enacted and to natural forces in the economy--mainly the slowing down of massive inventory liquidation by business--the economy did indeed begin a fairly strong recovery. At the same time inflation receded from the double-digit rates of 1974. This year, a central fiscal-policy issue is striking a balance between the stimulus the economy must have if it is to maintain its recovery and the restraint necessary to avoid rekindling high rates of inflation.

This chapter begins with a discussion of the state of the economy in early 1976 and the outlook for 1976 and 1977 if current budget policies are continued. It then analyzes the impact of several alternative policies, including Administration tax and spending proposals, a more expansionary fiscal strategy, and two alternative monetary policies.

The Economic Outlook

The American economy had a bad year in 1975, but the last part of the year showed a marked improvement over the first. After a sharp downswing early in the year, there was a rapid rebound during the third quarter, followed by a moderate expansion during the last quarter. Inflation fell from its double-digit rate in 1974 to a 6.8 percent annual rate by the last quarter of 1975. Unemployment dropped to 8.3 percent in December, down from its peak of 8.9 percent in May. By February, 1976, it had fallen further to 7.6 percent. The following chart illustrates recent trends in consumer prices and unemployment.

Much of this improvement was foreseen when the First Concurrent Resolution on the Budget for fiscal year 1976 was formulated. The reduction in output that resulted from the massive inventory liquidation in the first half of 1975 was expected to come to an end. And

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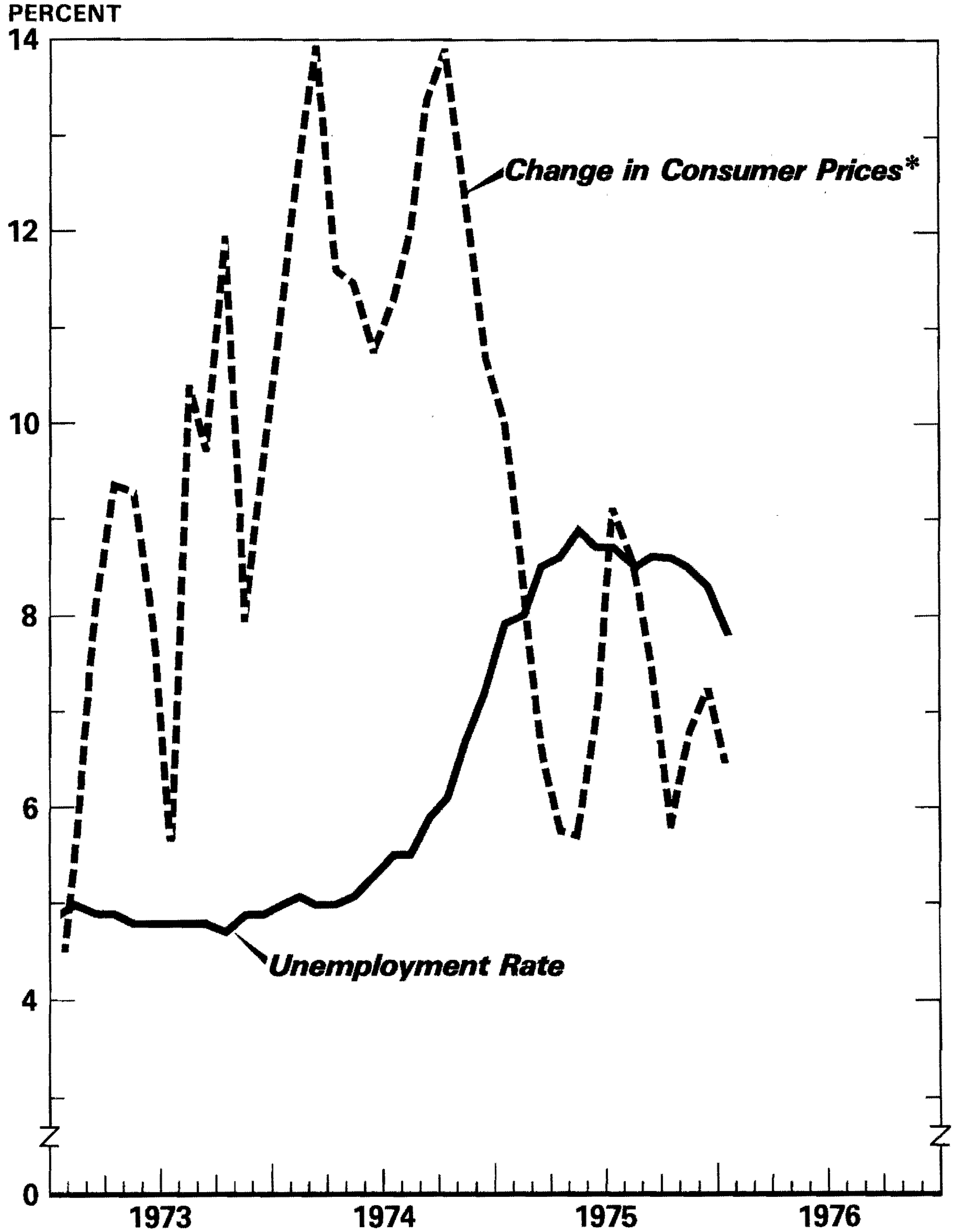
Unemployment and Inflation



*Change from three months earlier, at an annual rate.

the 1975 tax cuts, which restored consumer real incomes and aided the housing and investment sectors, provided the anticipated impetus to private demand.

Furthermore, 1975 was a fortunate year in that inflationary shocks like those of 1973 and 1974 were absent. Food price increases averaged 6.5 percent over the year, and gasoline and other energy prices also rose at a much more moderate rate than in 1973 and 1974. Complete decontrol of oil prices, which would have boosted the inflation rate and slowed recovery significantly, was avoided by extensions of the existing system of controls and, at the end of the year, by the compromise energy bill.

Recovery was also aided by the course of short-term interest rates. Concern that rising interest rates might retard the recovery seemed to be validated during the summer of 1975. But lagging business loans led to a decline in short-term rates late in the year, in spite of a slow rate of growth in the money supply. Low short-term rates put thrift institutions--the chief suppliers of home mortgages--in a better position to compete for household savings and thus to help promote an upturn in housing starts.

The projections for 1976 and 1977, presented in the following table, show continuing growth in output, a slight deceleration of inflation, and moderate reductions in unemployment. Three principal assumptions underlie this forecast:

- A current policy budget that extends existing tax laws and spending programs (including allowances for inflation to maintain real spending levels) but assumes no cutbacks or new initiatives or substantial changes in government efficiency.[3]

- A rise in short-term interest rates of nearly 2 percentage points during 1976 and 1977 with little change in long-term rates.

- The absence of any new upsurge in food or fuel prices.

The projected rates of growth of constant-dollar GNP are high, mainly because the economy is climbing out of an unusually deep recession and is not expected to encounter serious bottlenecks to

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3. On the outlay side, what is assumed is an average of the two current policy budgets (path A and path B) described earlier in this report. During fiscal year 1977 assumed outlays total $422 billion on a unified budget basis. The projections make use of national income rather than unified budget concepts, and on this basis outlays total $429 billion.

ECONOMIC PROJECTIONS, 1976 AND 1977

Economic Indicators	Actual, 1975:IV	Projected Range		Projected Growth Rate (percent)	
		1976:IV	1977:IV	1975:IV to 1976:IV	1976:IV to 1977:IV
GNP, billions of current dollars	1, 573	1,755 to 1,775	1,955 to 1,975	+11.5 to +12.8	+10.7 to +12.0
GNP, billions of 1972 dollars	1, 216	1,285 to 1,300	1,355 to 1,375	+5.5 to +7.0	+5.0 to +6.5
General Price Index (GNP deflator, 1972=100)	129	135 to 138	142 to 146	+5.0 to +6.5	+4.7 to +6.2
Consumer Price Index (1967=100)	166	174 to 177	183 to 188	+5.0 to +6.5	+4.7 to +6.2
Unemployment Rate	8. 5	7.0 to 7.5	6.4 to 6.9		

growth during the next two years. Even so, the gap between actual output and potential output at 4 percent unemployment will remain wide, as the following chart shows. The projections of the unemployment rate represent a clear improvement over the worst of recent experience but remain quite high in relation to historical norms. The same is true of inflation rates; once established, inflation has a strong self-perpetuating bias and--at least under standard policy approaches--will probably recede only gradually.

As always, there are dangers that the economy will not actually follow the projected path. Crop failures here or abroad, a major strike, a rapid rise in short-term interest rates--all contrary to the assumptions made here--would change the outlook for inflation and unemployment. In addition, the forecast rests on judgments about a number of critical aspects of economic behavior, among them the rate of household saving, the vigor of investment, the relation of monetary growth to interest rates, and the persistence of inflation. A brief review of these judgments will aid understanding of the projections.

Consumption and Saving. The household saving rate is unusually high by historical standards. Saving was 7.9 percent of personal disposable income in the last quarter of 1975 compared with a 7 percent average for the 1969-73 period. The direct effect of a decline of 1 percentage point in the saving rate adds about two-thirds of a percentage point to real GNP, and the indirect multiplier effects make the full impact even larger. Our projections assume such a decline by late 1977.

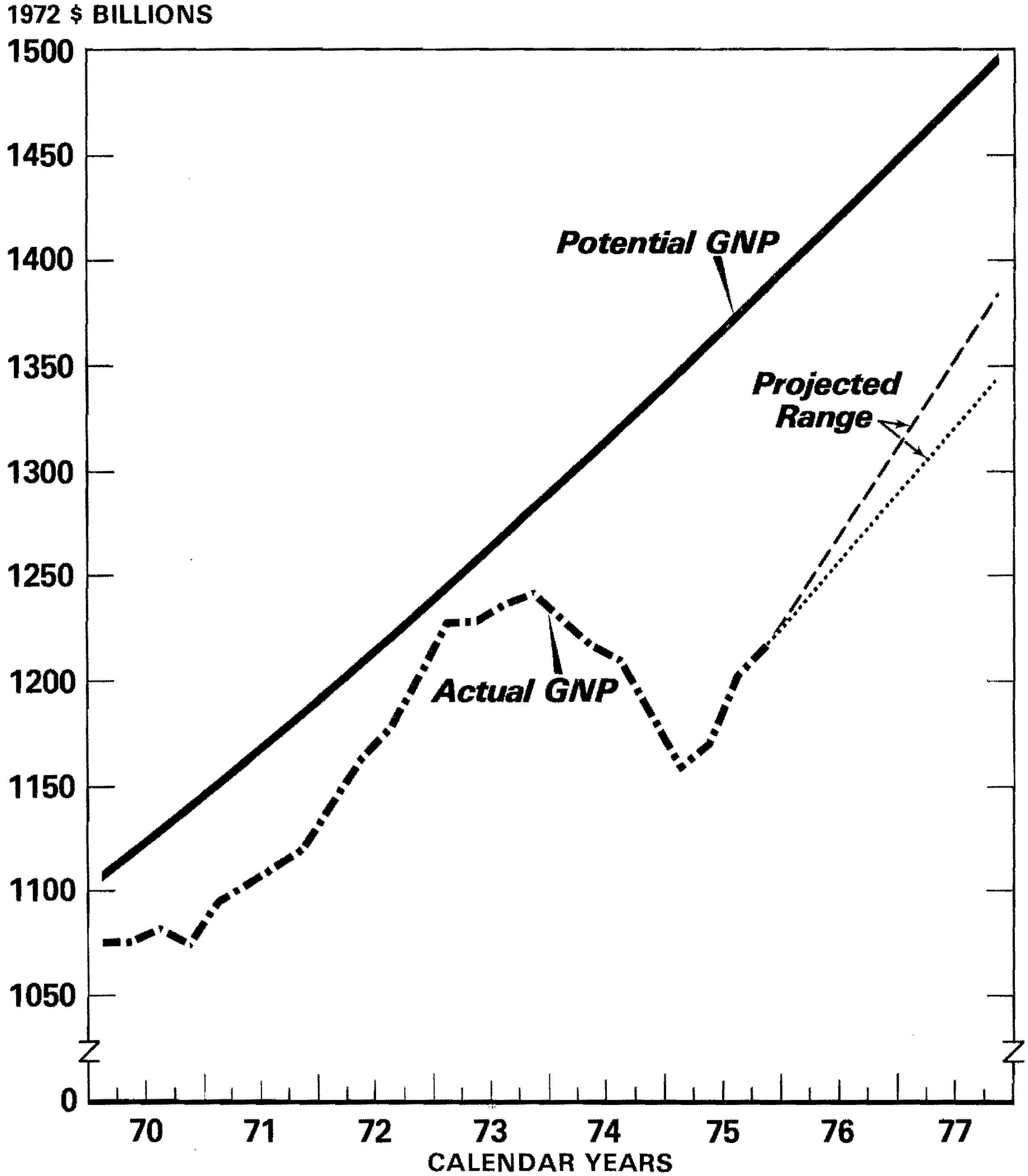
The saving rate is influenced by a number of factors. Uncertainty about inflation is one of the more important: If consumers worry less about the prospect of a new inflationary outburst and become more confident that real income will grow, the saving rate is likely to come down. Rising common-stock prices and strengthening labor markets are also likely to stimulate consumer spending. All of these contribute to the projected decline in the saving rate in the CBO forecast. New inflationary shocks or a downturn in stock prices could change this picture.

A decline in the household saving rate is likely to be reflected in rising auto sales. Car sales recovered from their recession lows in 1975, and appear to be rising further in early 1976.

Private Investment. Since the low point of the recession, housing investment has shown a substantial upward movement; but business spending on plant and equipment has yet to turn up decisively. The vigor of fixed investment in 1976 and 1977 will be a critical determinant of the strength of the recovery.

Actual and Potential GNP

(Billions of 1972 dollars, seasonally adjusted annual rate)



Notes: Potential GNP was converted from 1958 dollars and projected to 1977 by CBO. Growth in potential GNP is estimated at 4 percent per year through 1975 and 3.75 percent thereafter; the lower growth rate takes account of low levels of capital investment in 1975 and 1976. Potential GNP is associated with an unemployment rate of 4 percent.

In the current climate of low short-term interest rates, which encourage savings flows into thrift institutions, recovery of single-family housing would be expected to continue. Multifamily housing, however, is not responsive to short-term rates and savings flows, and remains very depressed. Overbuilding in some areas, continued high long-term interest rates, and losses lending institutions have taken on loans to real estate projects, are among the causes. Infusion of funds from the Government National Mortgage Association (GNMA) may channel funds to this sector of the housing market.

If short-term interest rates rise as anticipated during 1976 and 1977, smaller inflows of savings into thrift institutions are likely to slow the rate of recovery of new housing production. Growth in housing investment is projected at a very low rate by 1977, contributing to the slight slowdown of overall growth forecast for 1977.

Fixed investment in plant and equipment dropped 18 percent during the recession in real terms, the worst decline since the 1930s. Recovery in investment spending apparently started in the fourth quarter of 1975, following some revival in advance orders for capital goods. While the latest surveys of business plans indicate little reason to expect an increase in capital spending in real terms for 1976, businesses are very likely to revise their spending plans upward as the year progresses. Production, productivity, profits, and capacity utilization should all continue to increase, and all of these factors will be conducive to increases in capital spending. If, contrary to the assumption underlying the forecast, long-term interest rates should rise, then the recovery in fixed investment would be slower.

The severe inventory adjustment that caused output to drop so dramatically in early 1975 seems to have been completed, with ratios of inventory to sales restored to more normal levels. Inventory growth should move from the near-zero level of the last quarter of 1975, to a positive rate of around 1 percent of GNP, as firms add to inventories in line with sales increases. This shift will provide some stimulus to GNP, mainly in 1976; inventory investment is projected to level off some time in 1977.

State and Local Spending and Exports. State and local spending has shown little growth in real terms in the last two years, as a result of recession, inflation, and the debt problems of New York and other governments. Faced with the need to improve their cash positions, state and local governments are projected to hold to this modest rate of growth. They are already running a substantial full-employment surplus, according to calculations by the Council of Economic Advisers, and will exert some restraint on the economy in the next two years or so.

Net exports were a source of strength to the economy in 1975. Gross exports were strong, particularly of agricultural commodities and to Organization of Petroleum Exporting Countries (OPEC), while the recession limited U.S. imports of oil and other products. Recovery in the United States will spur imports in 1976 and 1977; but at the same time the recovery generally forecast for Europe and Japan is projected to keep exports growing close to the rate for imports.

Monetary Growth and Interest Rates. Some of the models used in developing this forecast imply that monetary growth rates above the ranges announced in February by the chairman of the Federal Reserve Board might be necessary to hold short-term interest rates down to the gradually rising pattern assumed in the forecast. But these models are based on historical relationships in the financial area that have proved unreliable during the present recovery. Falling short-term interest rates have coincided with low rates of expansion in the money supply, contrary to historical patterns; if this shift in the relation continues, the interest-rate pattern in the forecast might require only modest increases in the stock of money.

The forecast assumes that a gradually rising pattern of short-term interest rates is consistent with monetary growth near the upper end of the Federal Open Market Committee's ranges.[4] This assumption rests on the judgment that at least some of the recent change in the relationship reflects a long-term downtrend in the demand for demand deposits, due to increasing possibilities for telephone transfers between savings and checking accounts and other institutional changes. Undoubtedly, however, some of the shift is of a short-term character, related to the lagging upturn in business loans or shifting seasonal forces in financial markets. The more important these temporary changes are, the more likely is a return to past relationships and the higher the monetary growth required to restrain rapid increases in interest rates in 1976 and 1977.

Whatever the relation of the money supply and interest rates, the importance of interest rate levels in promoting or retarding recovery is beyond question. Low interest rates would promote rapid recovery but might require larger and larger injections of money that might eventually lead to more inflation. Rapid rises in interest rates would eventually restrain inflation but might choke off recovery in the process. The gradually rising pattern of interest rates assumed in this forecast is thought to be consistent with both some reduction of inflation and a continuing recovery.

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4. These ranges are 4.5 to 7.5 percent annual growth in M_1 (demand deposits and currency); and 7.5 to 10.5 percent in M_2 (M_1 plus time deposits other than large certificates of deposit).

The Strength of Inflationary Forces. The rate of general inflation is projected to continue at 5 to 6.5 percent in 1976 and a shade less in 1977. While these rates are much lower than the peaks of 1973 and 1974, they are still high by historical standards. The projection prompts the question of why, with so much slack remaining in the economy, the inflation rate shows so little tendency to recede.

The probable answer is that, in the absence of sudden shocks such as the changes in food and fuel prices of 1973-74, a given rate of inflation tends to persist over a long time. Wage settlements involve catching up with past price changes and are influenced by expectations based on recently experienced inflation; as a result, broad measures of labor cost are expected to continue rising at an annual rate of 7 to 9 percent, down only a little from 1975. First-year collective bargaining settlements in some industries may be much higher than 9 percent, as some unions that did not have full cost-of-living adjustments attempt to regain lost ground; but these settlements will not involve a large proportion of the labor force.

Prices tend to reflect wage trends, after adjustment for productivity changes. In many sectors of the economy, moreoever, prices have their own built-in momentum as long-term sales contracts are adjusted to take account of recent and anticipated trends in costs.

What the projections are saying about prices, then, is that in the absence of new inflationary shocks the legacy of recent inflation will gradually work itself off, and prices will slowly return toward their historical rates of increase. Whether they return all the way or remain permanently at somewhat higher rates is not a matter that will be settled in 1976 and 1977. The long-run outcome for inflation depends critically on the policies followed when the economy is closer to its potential output than it is likely to be during the next two years.

The Federal Deficit. The deficit is affected not only by deliberate fiscal actions but also, and very significantly, by changes in output and prices. Recovery of output will raise incomes and hence tax revenues, and will also lower unemployment and hence outlays for income support. In both these ways, recovery lowers the deficit and recession increases it. All but about $1 billion of the $74 billion deficit estimated for fiscal 1976, in fact, is attributable to the low output and high unemployment associated with the recession.

The rate of inflation also affects the deficit; the more rapid the inflation, the higher both outlays and receipts. Overall, however, receipts are the more sensitive of the two, so that an increase in the inflation rate tends to reduce the federal deficit.

During 1976 and 1977, the net outcome of these forces will be to reduce the deficit. If a current policy budget were adopted, outlays would be about $422 billion (on a unified basis) and revenues in the range of $357 to $367 billion. The deficit for fiscal year 1977 would then fall in the range of $55 billion to $65 billion--substantially below the $74 billion likely for fiscal year 1976.

Policy Alternatives

When the Congress adopts a federal budget, it provides some degree of stimulus or restraint to the economy thereby influencing the growth of output and income, the inflation rate, and the amount of unemployment. Budget decisions, furthermore, have impacts on the economy not just at the time they are enacted but well into the future. The general view of economists is that in a period of high unemployment, lower taxes or higher spending will increase production and jobs fairly promptly. Eventually, however, the consequence will be an intensification of the inflation rate and a weakening of the production and employment impacts. In contrast, lower spending or higher taxes at a time of economic slack will eventually moderate inflation, but only at the cost of prolonging a period of unsatisfactory production and employment.

This view is not unanimously held: Some economists have recently emphasized the role of psychological factors in determining the inflation rate. For example, large federal deficits are said to undermine public confidence and to lead firms and households to expect higher inflation; these expectations and changes in sentiment are then translated into pressures for wages and price increases, higher personal saving, and reductions in business investment. This view, however, remains a hypothesis; there is to date no direct evidence to support it.

Even under the usual view of how fiscal policy affects the economy, the implied tradeoff between jobs and inflation--more precisely between jobs now and inflation later--may not be inevitable. In the current environment estimates of the amount and duration of improvement in production and jobs that can be traded off against inflation are subject to considerable doubt. They are based on experience in periods during which both the unemployment rate and the inflation rate generally were much lower than they have been recently.

Much discussion at present centers on the possibility of special measures that could stimulate employment with relatively minor price effects, or reduce inflation without cutting back jobs. These approaches include special subsidies to reduce prices while providing fiscal stimulus, steps to make markets more competitive, direct job-creation programs, and reforms that would increase incentives to work. For the most part, these approaches have not been tested on any substantial scale; they are experimental rather than proven, and most of them are not analyzed in this report.

This chapter analyzes a number of standard fiscal and monetary alternatives to the assumptions in the basic projections. The expected consequences of these alternative policies for GNP, inflation, unemployment, and the deficit are shown in the following table. The first line in the table summarizes conditions expected if a current policy budget is adopted--that is, if current tax laws and spending programs are extended, as described in the preceding section of this report. The remainder of the table shows additions to, or subtractions from, these baseline projections that would result from alternative policies.

The first set of options examined is the President's budget proposals for fiscal year 1977. Compared to a current policy budget, the President is recommending a reduction in spending (largely cuts in transfer payments to persons and grants to state and local governments), a reduction in personal and corporate income taxes, and an increase in social security and unemployment taxes. These can be viewed as separable fiscal options, and they are shown separately.

Each part of the Administration budget, if enacted, would have a fairly sizable impact on real output growth by the end of 1977. The spending cut, which amounts to about 6 percent relative to an extension of current policies, would probably result in about 1.5 percent less real GNP than a current policy budget, while the increase in social security and unemployment taxes would take off another 0.5 percent. The proposed reduction in personal and corporate income taxes is expansionary, and would by itself add 0.5 percent to real GNP.

In terms of unemployment, the spending cut would have the greatest effect, increasing the unemployment rate by an estimated 0.6 percentage points (or about 600,000 workers), compared to what it otherwise would be in the fourth quarter of 1977. The increases in social security and unemployment taxes would add another 0.2 point, while income tax reductions would reduce the rate by about 0.2 point.

The reduction in spending and the rise in the social security tax would both have noticeable effects on prices in the fourth quarter of 1977, not because of their impact on demand but because of direct impacts on costs. The spending reduction would have immediate deflationary impact due largely to the proposed ceiling on pay increases for federal employees rather than to reduced demand pressure. These ceilings would lower the cost of providing government services and hence their "price."

In contrast, the proposed increase in social security and unemployment taxes would spur the inflation rate by raising the labor costs that businesses must cover through their sales receipts. Because of

FISCAL AND MONETARY POLICY ALTERNATIVES

	GNP 1977: IV (billions of 1972 dollars)	Unemployment (percent) 1977: IV	Inflation (rate of change of GNP price index)		Federal Deficit [a] (billions of dollars fiscal year 1977)
			1976: IV to 1977: IV	1979 to 1980	
Current Policy Budget	1,355 to 1,375	6.4 to 6.9	+4.7 to +6.2	Not calculated	$55 to $65
	Changes Relative to the Current Policy Budget Option				
Budget Options	(percent)	(percentage points)			(billions of dollars)
PRESIDENT'S BUDGET					
Spending reductions	−1.5	+0.6	−0.1 [b]	−0.4	−20
Personal and corporate tax reductions	+0.5	−0.2	0	+0.1	+7
Social security and unemployment tax increases	−0.5	+0.2	+0.2	0	−5
Total	**−1.5**	**+0.6**	**+0.1**	**−0.3**	**−18**
OPTION I: $10 billion spending increase ($9 billion purchases, $1 billion transfers and grants)	+0.8	−0.3	+0.1	+0.2	+6
OPTION II: Lower interest rates	+0.8	−0.3	0	+0.2	−2
OPTION III: Higher interest rates	−0.5	+0.2	0	−0.1	+1

[a] In this table, the deficit is measured using national income concepts rather than unified budget concepts. Furthermore, the impact on the deficit of various policy alternatives includes not only direct effects of spending or tax law changes but also indirect effects due to income changes induced by each policy. For these reasons, deficit figures in this table are not directly comparable to those elsewhere in this report.

[b] The 1976–77 inflation effect shown for fourth-quarter to fourth-quarter changes does not include the impact of the pay ceilings, which are proposed to take effect in the fourth quarter of 1976. If enacted, the ceilings would slow the 1976 rate of inflation about −0.25 percentage points.

this inflationary feature, these tax increases would restrain output and employment more in the short-run than would equivalent dollar increase in income taxes.

Overall, the President's budget would be contractionary as compared to the current policy baseline: Real GNP would be 1.5 percent lower in the last quarter of 1977 and the unemployment rate higher by 0.6 percentage point. The effect on inflation in 1977 would be negligible, as the pay cap and the payroll-tax increases would work in opposite directions. After a time, however, the reduction in demand would probably dominate other factors, so that by 1980 the rate of inflation is estimated as about 0.3 percentage point lower than it would be under a continued current policy budget.

The Administration's implicit forecast of the impact of the President's budget on the economy is somewhat more optimistic about output and unemployment than those in the preceding table. Compared with the forecast underlying the CBO's estimates, the Administration's estimates assume stronger private demand which would offset the weaker spending by the federal government.

Compared with a current policy budget, the President's budget would reduce the federal deficit by about $18 billion in fiscal year 1977. Spending reductions below current policy would be greater than $18 billion, but they would to some extent be offset by revenue reductions. In part the revenue reductions would be due to tax cuts and in part due to the impact of the weaker economy caused by the spending cuts. This last factor--indirect effects on revenues caused by the impact of fiscal policy changes on the economy--would operate for each component of the President's proposals as well as for the total. In each case the <u>net</u> effect on the deficit shown in the last column of the table would be smaller than the direct effects alone.

The other fiscal-policy option analyzed in the table is an expansionary one--a $10 billion spending increase above current policy levels, assumed to be concentrated in purchases rather than in grants or transfers. It is estimated to raise real output by 0.8 percent and lower unemployment by 0.3 percentage point by the end of 1977, compared to the effect of a current policy budget. It would raise the inflation rate in the fourth quarter of 1977 by an estimated 0.1 percentage point, and in 1980 by an estimated 0.2 percentage point. Although the initial increase in the federal deficit would be $10 billion, the net effect would be only $6 billion in fiscal 1977, as higher revenues and savings in transfer payments that would result from the higher outlays softened the direct effect.

The stimulating effects of this higher spending option would be greater if the Federal Reserve took steps to offset the tendency of the policy to raise interest rates. The results in the table for this option as well as for the President's proposals, assume that the Federal Reserve does not undertake any such accommodation but continues to supply the same quantity of reserves as in the current policy case. If an accommodating monetary policy were assumed, the fiscal policy changes would have effects up to 50 percent greater on output and unemployment and, eventually, on inflation than the effects in the table. Effects on the deficit, in contrast, would be smaller than the ones shown.

The remaining two policies shown in the table embody two alternative paths for interest rates. The first assumes that short-term interest rates stay constant--specifically, that the three-month Treasury bill rate remains at the 5.2 percent it reached on March 1, 1976, instead of rising gradually to 6.8 percent as in the basic projections. Keeping interest rates constant would probably require annual growth in monetary aggregates about 1 percentage point greater than the basic forecast calls for. The estimated effect of this easier money policy would be to increase real output by 0.8 percent and reduce the unemployment rate by 0.3 percentage points by the last quarter of 1977, compared to the baseline interest rate assumption. Eventually, this policy would raise the rate of inflation by 0.2 percentage point. It would also lead to an estimated $2 billion reduction in the federal deficit in fiscal 1977.

The other monetary alternative would make short-term rates rise more rapidly than in the basic forecast: The three-month Treasury bill rate is assumed to rise above 7 percent in mid-1977 and reach 7.8 percent by the end of the year. The effects of this policy are opposite in direction to those of the easier money policy but, since departures from the basic interest rate assumptions would be not as large, their consequences would be smaller. The high-interest option would reduce real output by about 0.5 percent, raise the unemployment rate by 0.2 percentage point, and eventually reduce the rate of inflation by 0.1 percentage point.

The basic projections presented earlier in this section indicate that, barring unforeseen shocks to the economy, a budget based on current policy falls among those that would meet the objective for fiscal policy stated at the outset: to provide stimulus sufficient to sustain recovery and reduce unemployment without renewing high rates of inflation. Output is projected as growing and unemployment declining significantly, and inflation rates as falling very slightly. How well would the other policy alternatives meet this test?

On the inflation side, the overall impact of most of the alternatives would be quite minor in 1976 and 1977 and hence would not alter the projections significantly for that period. The increase in the tax rates for social security and unemployment insurance, which through its direct effects on labor costs and the $10 billion spending increase might raise the inflation rate slightly at the end of 1977. The pay ceilings incorporated in the Administration's spending proposals, on the other hand, would directly reduce the cost of government services and hence improve the inflation outlook slightly in 1977. In later years, the other policies would affect inflation rates as well, with more expansionary alternatives either causing an acceleration of inflation or holding reduction to a lower rate, and more restrictive alternatives either reducing inflation or holding down its rate of increase.

Under optimistic assumptions about the economy all of the alternatives appear consistent with continued recovery in production in 1976 and 1977. Because of new entrants into the labor force and improvements in productivity, output must grow at a rate of approximately 4 percent simply to keep the unemployment rate constant. Under the more optimistic of CBO's assumptions about the possible range of projected growth for 1977, the President's program would more than fulfill this requirement. The lower end of the range, however, suggests the possibility that a fiscal alternative significantly more restrictive than current policy might hold output growth below 4 percent in 1977 and halt the decline in unemployment.

No President--and no Congress--makes up a budget from scratch. There is little point in discussing whether social security benefits should be paid this year or whether the army should be continued. The important discussion is about decisions at the margin: whether old-age benefits should be increased faster than the cost of living; whether there should be 13 or 16 army divisions and how heavily they should be equipped. It is at the margin that the President gets a chance to express his philosophy of government and sense of priorities and that the Congress gets a chance to exercise its judgment.

Overview of the President's Budget

The budget for fiscal year 1977 proposed by the Administration expresses several basic points of view about the federal government:

- That the federal sector as a whole has been expanding too rapidly and that this expansion should be slowed.

- That the cost of many individual benefit programs has been escalating too fast and should be curtailed.

- That federal grants to state and local governments are far too numerous and complex and should be consolidated into block grants at generally restrained funding levels.

- That defense spending, especially for procurement, has not increased enough and should be substantially raised along with certain other high-priority activities, such as federal support for energy research and development.

The President's budget for fiscal year 1977 proposes outlays of $394 billion and budget authority of $433 billion. The outlay estimate represents a 5.5 percent increase over fiscal year 1976, a sharp reduction from past rates of increase. Outlays under the President's proposal would be $31 billion less than outlays needed to continue current policy under economic assumptions similar to those used by the President (CBO's Path B). In terms of budget authority, the President's proposed levels are $34 billion below the Congressional Budget Office current policy estimates (Path B).

About $18 billion of the difference in the outlay estimates lies in human resources programs. Another $5 billion involves proposed reductions in federal pay scales, military and civilian, below comparability with the private sector as defined by current law. Roughly

$6 billion reflects differences in estimates of offsetting receipts arising from asset sales and offshore oil leasing.

The President's proposed pay reductions would reduce the Defense Department's pay cost by about $3.6 billion below current policy estimates. Defense Department nonpay spending, on the other hand, would receive a 27 percent boost in funding and an 18 percent increase in outlays. Much of this increase would be for procurement, for which budget authority would rise 38 percent.

The President's budget proposes a 23.5 percent increase in budget authority, and a 35 percent increase in outlays for energy research and development programs. This implies a commitment to future increases of several billion dollars annually by the end of the decade as new technologies reach the large-scale demonstration stage. The President's budget also calls for the creation of an off-budget Energy Independence Authority, with $83 billion in authority in fiscal year 1977 for loans, loan guarantees, and investments in energy sources. The future impact of this program on the budget is difficult to assess primarily because it involves the federal government's assuming contingent liabilities. It is expected that the President's budget will be amended to request additional funds needed for the development of the strategic petroleum storage program, called for by the Energy Policy and Conservation Act of 1975. This program could cost from $5 to $10 billion over the next several years.

In the human resources area the President has recommended cost-saving legislative proposals which would consolidate some health, child-nutrition programs, and grants for education and social services into block grants; reduce some social security, medicare, and federal retirement benefits; phase out current programs for emergency manpower, unemployment assistance, and public-sector employment by the end of fiscal year 1977; and restrict eligibility for food stamps and readjustment benefits (the G. I. Bill). The proposals affecting the "relatively uncontrollable" entitlement programs would have a continuing and increasing budgetary impact--one that would triple by fiscal year 1981.

The Administration's cost-saving proposals in other program areas--notably community development, natural resources, and transportation--contemplate a combination of tight (often reduced) funding; reductions in existing budget authority (rescissions and deferrals) program termination; administrative actions to reduce program costs; construction slowdowns; and legislative changes to reduce program costs.

On the revenue side, the President proposes an additional reduction in individual and corporate income taxes of about $10 billion over and above the simple extension of the 1975-76 tax cuts assumed in CBO current policy estimates. The reductions affecting individuals are, on balance, skewed slightly more in favor of higher income tax payers than would be an extension or expansion of the 1975-76 tax cut. The President's proposals to encourage investment include:

- A mortgage interest tax credit, to help financial institutions maintain or increase their mortgage holdings.

- Accelerated depreciation provisions to stimulate investment in facilities and equipment in areas of high unemployment.

- Tax incentives for broadened stock ownership.

- A variety of investment incentives for electric utilities, intended to increase future capacity.

The Administration also proposes increases in the payroll taxes for social security and unemployment insurance that would raise fiscal year 1977 receipts by $5.4 billion over revenues under existing law.

The President's budget calls for a deficit of $43 billion in fiscal year 1977, about $31 billion below current policy estimate for the budget deficit in fiscal year 1976 and $12 to $22 billion below the deficit implied by the CBO current policy estimate for fiscal year 1977. As pointed out above, the President's budget proposes a more restrictive fiscal policy than a current policy budget and would tend to slow the economic recovery and the reduction of unemployment, in the interest of reducing future inflation rates.

Both the President's fiscal policy and his program priorities will be debated and discussed by the Congress, along with various alternatives, in the course of formulating a First Concurrent Resolution of the Budget for Fiscal Year 1977. The sections that follow focus on some of the key programmatic decisions that the Congress must make in formulating a budget this year.

Defense[5]

> Budget Issues for Fiscal Year 1977: Do threats to national security justify expanding and modernizing U.S. general-purpose forces or increasing spending on strategic weapons? What should be done to hold down defense manpower costs?

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5. For more detailed discussion of defense issues than is offered in this section, and five-year budget options, see Part II-1, Section A.

Defense spending accounts for about one-quarter of the federal budget--$91.9 billion in outlays in fiscal year 1976. Adjusted for inflation, defense expenditures declined steadily from the 1968 peak associated with the Vietnam War until last year. At the same time, Soviet military capability appears to have been growing significantly. Although it is generally agreed that U.S. forces are now capable of carrying out the tasks assigned to them, the major issue in this year's debate on defense spending is whether they will be in the future given the difference in trends between the U.S. and the Soviet Union. The Administration argues that the United States should respond to these trends by expanding and modernizing general-purpose forces--ground, sea, and tactical air forces--and by stepping up spending on new strategic systems such as the B-1 bomber. The opposite view sees present forces as more than adequate to meet any probable threat and suggests that a U.S. buildup might simply provoke an intensified Soviet expansion.

The proportion of the defense budget going to manpower costs has risen sharply over the last 10 years, and will continue to do so if current policies on pay and retirement benefits are maintained. This is a budget issue of major importance, whatever the size of forces.

The President's budget is austere with respect to manpower costs. However, it proposes substantial real growth for procurement of hardware and for other purchases. (See the following National Defense Budgets Table.) A current policy budget for national defense in fiscal year 1977 is estimated to require $111 billion in budget authority and $103 billion in outlays. It essentially maintains current manpower levels, increasing pay in accordance with statutory "comparability," and maintains constant real spending for purchases of goods and services. The President's request is $4 billion higher than current policy levels in budget authority, but more than $2 billion lower in outlays. If the current policy budget were recomputed using the Administration's pay assumptions, it would cost about $108 billion in budget authority--compared with the $115 billion requested by the President. The $7 billion difference is a measure of the real growth implied by the President's request.

Three largely independent issues thus dominate the choice of a defense budget for fiscal year 1977. The Congress faces decisions on (1) the size and pace of modernization of the general-purpose forces; (2) the character and pace of modernization of U.S. strategic forces; and (3) the level and rate of growth of military manpower costs. The following Alternative Defense Budgets Tables summarize the range of options for these decisions presented in this report.

NATIONAL DEFENSE BUDGETS (050)

[Billions of dollars, fiscal years]

	(1) 1976 estimate	(2) 1977 current policy estimate	(3) 1977 request	Difference (2 minus 3)
	Budget Authority			
Purchases	49.8	52.2	61.9	−9.7
Pay	49.4	55.8	51.9	+3.9
Subtotal	99.2	108.0	113.8	−5.8
ERDA and Other DOD Related Activities	1.8	2.0	1.1	+0.9
Total (050)	**101.0**	**111.0** [a] (107.6)	**114.9**	**−3.9**
	Outlays			
Purchases	40.8	45.8	48.3	−2.5
Pay	49.4	55.7	51.8	+3.9
Subtotal	90.2	101.5	100.1	+1.4
ERDA and Other DOD Related Activities	1.7	1.9	1.0	+0.9
Total (050)	**91.9**	**103.4** [a] (100.1)	**101.1**	**+2.3**

[a] Current policy estimate adjusted to show impact of the President's proposed manpower cost reductions.

ALTERNATIVE DEFENSE BUDGETS COMPARED TO THE PRESIDENT'S REQUEST FOR OUTLAYS FOR FISCAL YEAR 1977

[Billions of dollars]

Defense option	Difference from base	Cost
BASE		
President's Defense Budget:		
About 500 ships		
16 divisions with diminished support echelons		
26 USAF and 12 USN tactical air wings		
Intermediate strategic option—Procure B-1		
Manpower close to low option		
R&D 8 percent real growth above fiscal year 1976 levels		
Total Base		**101.1**
LOW OPTION		
Declining Forces:		
400 ships	—0.2	
13 divisions		
22 USAF and 10 USN tactical air wings	—0.4	
Low strategic option	—0.2	
Low manpower option	—0.3	
Minus 10 percent R&D	—1.7	
Total Low Option	**—2.8**	**98.3**
HIGH OPTION		
Increasing Forces:		
600 ships		
16 divisions	+0.3	
26 USAF and 13 USN tactical air wings		
High strategic option		
High manpower option	+4.4	
Plus 10 percent R&D	+0.3	
Total High Option	**+5.0**	**106.1**

ALTERNATIVE DEFENSE BUDGETS COMPARED TO THE PRESIDENT'S REQUEST FOR BUDGET AUTHORITY FOR FISCAL YEAR 1977

[Billions of dollars]

Defense option	Difference from base	Cost
BASE		
President's Defense Budget:		
About 500 ships		
16 divisions with diminished support echelons		
26 USAF and 12 USN tactical air wings		
Intermediate strategic option—Procure B–1		
Manpower close to low option		
R&D 8 percent real growth above fiscal year 1976 levels		
Total Base		**114. 9**
LOW OPTION		
Declining Forces:		
400 ships	−2. 5	
13 divisions	−0. 3	
22 USAF and 10 USN tactical air wings	−1. 3	
Low strategic option	−1. 6	
Low manpower option	−0. 3	
Minus 10 percent R&D	−1. 7	
Total Low Option	**−7. 7**	**107. 2**
HIGH OPTION		
Increasing Forces:		
600 ships	+2. 2	
16 divisions	+0. 3	
26 USAF and 13 USN tactical air wings	-------	
High strategic option	+0. 2	
High manpower option	+4. 4	
Plus 10 percent R&D	+0. 3	
Total High Option	**+7. 4**	**122. 3**

General Purpose Forces

This year decisions on the navy, the army ground forces, and the tactical air forces will focus on proposed major procurement programs. The outcomes of these decisions will have relatively little effect on outlays for fiscal year 1977 but will have major implications for future outlays, because procurement appropriations are spent over a period of several years. In the case of the navy, the question posed is essentially whether the United States shall adopt as a force goal a fleet of approximately 500 ships, the current level; a fleet of approximately 600 ships, the navy's apparent preference; or a fleet of about 400 ships, roughly the level toward which the navy would decline by the end of the next decade without enlarged shipbuilding programs. In addition to the size of the navy, nuclear propulsion is also likely to be on the agenda. The current legal requirement that all major surface escort ships be nuclear propelled adds substantially to the cost of any given size navy.

A decision on a target size for the navy has not yet emerged from the Department of Defense. The shipbuilding program for fiscal year 1977 is, however, approximately consistent with the goal of maintaining 500 ships in the fleet. As shown in the preceding Alternative Defense Budgets Tables, the difference in budget authority for fiscal year 1977 between a 400-ship, partially nuclear program and a 600-ship fully nuclear program is about $4.7 billion. The difference in outlays, however, is only about $0.2 billion because of the long lead times in shipbuilding.

The army has embarked upon programs to expand its divisions from 13 to 16 and to substantially increase its inventory of major weapons and equipment. For fiscal year 1977 the question is whether to endorse the army's 16-division program and to provide procurement funds to equip the new divisions. The divisions have been formed within a constant ceiling on army manpower and represent essentially transformation of support echelons into combat troops. That process has the effect of enhancing the combat power of the total force in relatively short conflicts but of diminishing its long-term staying power by reducing its support.

The high option for fiscal year 1977 shown in the preceding tables would establish 16 fully manned divisions; two of the three new divisions would be infantry and one would be mechanized. Army end strength would rise by 105,000 people by fiscal year 1979 to rebuild former levels of support. The low option would reduce the active army to 13 fully manned and equipped divisions, allowing army strength to fall by 37,000.

The difference in cost between the two options is about $0.6 billion of budget authority, or $0.3 billion of outlays in fiscal year 1977. It would grow to about $2.4 billion of budget authority by 1981.

For tactical aviation the problem is similar to that concerning the army: Shall Congress affirm the expansion of the tactical component of the U.S. Air Force from the equivalent of 22 wings to 26 wings and provide modern aircraft for these units? As with the ground forces, a decision to expand the tactical air forces would not cause a large increase in the fiscal year 1977 budget. The entire additional complement of aircraft need not be ordered this year and if the funds were appropriated, little additional would be spent before fiscal year 1978. Therefore the difference between the two tactical aviation programs is only about $0.4 billion in outlays in fiscal year 1977, but would rise to $3.5 billion in fiscal year 1981.

Strategic Forces

Developments in Soviet strategic forces have drawn attention to the character and pace of modernization of our own forces. The issues are not so much of force size; at the moment arms-limitation agreements constrain numbers. The decisions with immediate budgetary consequences concern whether to go ahead this year with the B-1 bomber and at what pace, and how rapidly to press ahead with the program of replacing Polaris-Poseidon ballistic missile submarines with the larger Trident submarines and missiles. In the background is research and development on a new generation of land-based missiles--called at the moment the MX--to augment or to replace the Minuteman force. In relation to the whole defense budget, these programs are not large, but their impact on the U.S. strategic posture would be significant.

The low option shown in the preceding tables would cancel the B-1, procure cruise missiles to extend the life of the B-52 force, and limit Trident procurement to 10 boats. The high option procures the B-1 as well as cruise missiles. Most of the difference between the two alternatives in both budget authority and the outlays for fiscal year 1977 is accounted for by the B-1 decision.

Pay and Related Manpower Issues

Manpower costs, including retirement pay, have come to absorb more than half of the defense budget. This proportion has grown substantially since the 1960s, and manpower is often regarded as draining off dollars that would otherwise go to procurement and other types of investment.

Assuming that force levels remain approximately the same, the major issue is whether the United States is currently paying more in cash and in benefits than is required to maintain a volunteer force of appropriate quality. In the short run spending could be held down by capping pay increases. This is the President's proposal, which assumes that pay increases can be held to an average of 4.7 percent in this year's budget by a combination of legislative and executive action. Although the caps would cut outlays sharply in fiscal year 1977, in the longer run, such a method may be less sensible than restructuring compensation and benefit packages, by, say, replacing benefits in-kind with cash payments.

Major savings in manpower--other than by capping pay--could come only with a smaller force. Demobilizing units, and--as the President proposes--cutting some civilian employment, would save money in the long run, but they cannot be done fast enough to reduce outlays substantially for fiscal year 1977.

Retirement pay is also important. Because of expected price increases and expected growth in the pool of retirees, this cost is likely to expand sharply in the future. Basic restructuring of the retirement system is a long-term project that promises substantial benefits in both force management and monetary savings over the next 30 years. In addition, some things could be done in the short run--for example, eliminating from the law the provision (the "kicker") that requires retirement pay to rise by 4 percentage points whenever the consumer price index rises by 3 percentage points. (The President has proposed this change.)

Social Security[6]

Budget Issue for Fiscal Year 1977: What, if anything, should be done this year to replenish reserves in the social security trust funds?

One out of every five dollars spent by the federal government goes for old age, survivors, and disability insurance (OASDI) benefits. Social security is financed primarily by special payroll taxes; at present a tax of 9.9 percent is levied on wages up to $15,300 a year; half is paid by the employee and half by the employer. These receipts are managed through trust funds and paid out to eligible beneficiaries.

In past years the social security trust funds took in more than they were paying out. Recently, however, due to rapidly rising benefit levels and the impact of recession on payroll tax receipts, the trust funds have been paying out more than was coming in and drawing

6. For more detailed discussion of social security and related programs and five-year budget options, see Part II-1, Section B.

down reserves. Under current law, payments are expected to exceed receipts in fiscal year 1977 by $3.5 billion to $5 billion. Year-end reserves will be about $40 billion, or approximately half the level of annual payments.

If deficits of this magnitude were to continue, they would eat away the reserves and require some kind of action--either to increase receipts or to reduce benefits. In May, 1975, the OASDI trustees predicted that the reserve would be exhausted by the early 1980s. But more recent estimates, both by the Administration and the CBO, are less pessimistic and project a decline in the annual deficit that would still leave fund reserves of about $30 billion in fiscal year 1981. A resumption of annual surpluses could be expected later in the 1980s.

Besides the short-run problem, a more certain and serious prospect of substantial deficits in the more distant future years (2015-50) is developing. The long-run problem is partly demographic: By the year 2015 the retirement rolls will be swollen with people born during the baby boom that followed World War II, while the work force will be showing the effects of more recent declines in the birth rate. In addition, the long-run problem of financing social security will be aggravated by a flaw in the benefit formula that overcompensates future beneficiaries for the effects of inflation, and hence increases benefits faster than real wages. There is general agreement that this flaw should be corrected by restructuring the benefit formula, which could eliminate about half of the expected long-run deficit; elimination of the other half would eventually require changes in benefit levels or taxes or both.

The Alternatives

The basic issue is one of timing: Should immediate action be taken to replenish reserves in the short run or is there time for more deliberate development of long-run remedies? At least five alternative types of action should be considered.

1. Raise Taxes Now. The President's budget proposes an increase in the payroll tax rate of 0.6 percent (on employers and employees combined) beginning in 1977. Receipts would rise about $3.5 billion in 1977 and about $9.9 billion in 1981; the annual deficit would disappear and reserves would grow to about $73 billion by 1981.

The main argument for this approach is that the continuing decrease in reserves shown even by recent projections may undermine public confidence in the social security system. Restoring reserves to about half the level of annual outlays in five years, as the President is proposing, would quiet public fears about "bankruptcy." Moreover, current economic projections may be too optimistic, and there may be increases in outlays not foreseen in current projections. Finally, a payroll tax increase now would not only replenish reserves in the short run, but also help solve the longer-run deficit problem.

Arguments against an immediate payroll tax increase suggest (1) that it is not necessary now, and could be undertaken later--should current economic assumptions prove too optimistic; (2) that while any tax increase would retard economic recovery, a payroll-tax increase would be especially ill-advised because it would raise labor costs and hence tend to exacerbate inflation as well as unemployment; (3) that payroll taxes are already hign, an increase would fall most heavily on lower-income working families, and hence would be undesirable--even in the longer run.

Of course, a tax increase need not be the one proposed by the President. An alternative would be to raise the wage base (that is, to tax earnings above $15,300) either for the employer only or for both the employer and the employee, beyond the increases that take place under current law as general wages rise. The burden of a wage-base increase would fall on middle- and upper-income groups, rather than on low-income workers who would bear the brunt of a rate increase. It should be remembered, however, that a wage-base increase for employees would mean larger benefits in the future.

2. Reduce benefits. The President proposes correction of the flaw in the benefit formula that overcompensates for inflation, although the details have not yet been made available. This change would make a major difference in benefit payments in the long run, but would have a negligible impact on the short-run deficit.

A number of selective reductions in benefits proposed by the President would mean savings that would start at about $800 million in 1977 and rise to $2.5 billion by 1981.

Except for across-the-board measures--such as major reductions in existing benefit levels or limitations on cost-of-living increases--benefit reductions are unlikely to save substantial sums in the near term.

3. Authorize temporary borrowing from the general fund. Borrowing from the general fund, but only in the event of actual depletion, would permit the fund to operate with smaller reserves without changing its self-financing nature.

4. Authorize the appropriation of general revenues. General revenues could be drawn on either as a one-time grant to replenish reserves depleted by the recession or as a permanent substitute for some of the current payroll tax. The argument against a temporary grant is that it would set a precedent and undermine the self-financing structure of social security.

5. Do nothing this year. Delay would permit a better assessment of the short-run problem and more careful consideration of the impact of short-run remedies on long-term options. If economic conditions worsened and reserves diminished more rapidly than is now expected, remedial action could still be taken next year. The main argument against delay is the alleged need to restore public confidence in the solvency of the system.

Income Assistance for the Poor[7]

Budget Issues for Fiscal Year 1977: Should programs of income assistance be altered this year and, if so, how?

In fiscal year 1976, about $34 billion will be spent on programs that transfer income, in cash or in kind, to poor families. These programs have expanded rapidly over the last decade and, as may be seen in the following tabulation, current policy projections imply further growth over the next five years.

CURRENT POLICY PROJECTIONS FOR INCOME ASSISTANCE,
FISCAL YEARS 1976, 1977, 1981
(Outlays, Billions of Dollars)

Program	1976	1977	1981
Aid to families with dependent children (AFDC)	$ 5.8	$ 6.5	$ 8.6
Supplemental security income (SSI)	5.5	6.2	8.9
Food stamps	5.9	6.7	10.4
Child nutrition	2.7	3.4	4.3
Medicaid	8.3	9.5	14.0
Veterans' pensions	3.0	3.1	3.6
Housing assistance	2.6	3.1	8.0
Total	$33.8	$38.5	$57.8

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7. For more detailed treatment of income assistance and five-year budget options, see Part II-1, Section B.

The Overall Problem

This set of programs does not represent a coherent national strategy for supplementing the income of the poor. The aid to families with dependent children (AFDC) program is aimed primarily at families headed by females and benefit levels vary greatly from state to state. The same is true of medicaid, though in some states it serves a somewhat broader group. Housing assistance reaches only a small portion of the poor. While the programs for food stamps and supplemental security income (SSI) for the elderly poor operate under national rules, they have enormous administrative problems. The net result is that while a family in one state might be eligible for several assistance programs and receive substantial total benefits, an equally needy family in another state might be eligible only for food stamps. Moreover, if a family stands to lose benefits from several assistance programs when its income rises, a strong disincentive to work may be created.

By general accord, these programs need "reform," but "reform" remains undefined. Three major approaches have been proposed:

- Tightening up by reducing the cost of existing programs through cutting benefits and concentrating them on those in greatest need.

- Comprehensive reform to replace most of these separate programs with a new overall program of cash assistance to low-income families that would put a national floor under incomes and offer incentives to work.

- Individual-program reform that would continue a mix of cash and in-kind programs, but reduce existing inequities--for example, by adopting national standards for AFDC or replacing medicaid with a national system of health insurance for low-income people.

Comprehensive reform is highly controversial and would take a major legislative effort unlikely to be undertaken in time to affect the budget for fiscal year 1977. Hence, any action this year is almost certain to involve incremental changes in existing programs. The President has offered a set of cost-saving changes, but other proposals call for spending more than is implied by current policy.

The President's Proposals

The President's budget makes proposals for reducing costs and shifting benefits to the poorest of low-income families. "Tightening up" is proposed in food stamps, SSI, AFDC, and housing assistance; child nutrition and medicaid are on the list of programs to be folded into block grants to the states with reductions in total federal funding and elimination of matching requirements. If all of these proposals were adopted, outlays for income assistance to the poor would be $4.9 billion below current policy levels for fiscal year 1977. More than half of this cut, however, would come out of medicaid (discussed with health programs below) and food stamps. Spending for the other programs would not fall significantly below current policy levels under the President's budget.

Alternatives to the Food Stamp Program

The food stamp program benefits about 19 million people, about 9 percent of the population. The program has become a "gap filler" for the groups left out of other income assistance programs, the working poor and intact low-income families. If no changes were made, the current program would cost about $6.7 billion in 1977.

The President's proposal would cut federal costs by $2.0 billion below the current policy budget level in fiscal year 1977 and would eliminate from the program over 5 million of the present 19 million recipients. It would limit benefits to families whose incomes fall below approximately 125 percent of the official poverty level.

An alternative approach, which would also reduce costs below the current policy level, would limit eligibility to the poorest families (those at or below the official poverty level) while requiring participating households to spend a minimum portion of their income for food. As a result, an estimated 8 million of the present beneficiaries would drop out, benefits for those still eligible would increase, and emphasis would lie on nutrition, rather than general income assistance. This approach would cut federal costs by $1.2 billion to $1.4 billion below a current policy budget.

A third basic proposal would expand spending over current policy levels and concentrate the benefits on the neediest families. Food stamps would be available free to families eligible on the basis of income. The number of participants would rise by 4 million to 8 million and the cost would increase above current policy levels by $1.2 billion to $2.5 billion in fiscal year 1977.

Supplemental Security Income Alternatives

The Supplemental Security Income program (SSI) is a federally administered and financed program which has replaced the state and locally administered programs of old-age assistance and aid to the blind and disabled. States may supplement the federal benefit. Because of its more liberal eligibility requirements and, in some states, higher benefit levels than the programs it replaced, SSI costs and caseloads have increased over the predecessor programs. By the end of fiscal year 1977, costs are estimated to reach $6.2 billion with 5.1 million participants.

The President's budget involves no changes in legislation, but projects a slower growth in benefit costs because of tighter review of eligibility determination. The administrative review could result in about a $250 million saving below the current policy level in 1977.

Other bills currently before the Congress would increase costs over the current policy level by $1.1 billion in fiscal year 1977. Included in the bills are provisions which (1) require the states now supplementing the federal benefit to pass through to the beneficiaries any increases in the federal benefit, rather than decreasing their supplement (federal payments would hold the states harmless); (2) provide recipients paying more than one-third of their income for housing costs with a special adjustment in their SSI benefit; (3) extend the SSI program to Guam, Puerto Rico, and the Virgin Islands; and (4) include liberalizations in the definitions of income, resources and eligibility.

Earned Income Credit[8]

In addition to the other alternatives discussed above, the Congress will consider extension or modification of the provisions of the Tax Reduction Act of 1975. This act provided a rebatable tax credit for families with dependent children equal to 10 percent of earned income subject to a maximum of $400 for the tax year 1975. The provision was extended for six months into calendar year 1976, pending enactment of permanent new tax legislation. The effect of this provision is to provide tax rebates for eligible low-income families of $0.3 billion in 1976 and $0.1 billion in 1977 and to make payments in excess of tax liability otherwise owed of $1.2 billion in 1976 and $0.6 billion in 1977. The current policy budget assumes extention of this provision through fiscal year 1977.

The President's proposal would not extend the earned income credit beyond June 30, 1976, its expiration date. Instead, it would increase personal exemptions and make certain other changes in individual income tax brackets, little if any of which would affect the persons previously benefited by the earned income credit. For this group, the loss in benefits in fiscal year 1977 would be about $1.5 billion per year.

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8. Whether the earned income credit is treated as an outlay or a tax expenditure (reduction in revenues) is an issue before the Congress.

Health[9]

Budget Issues for Fiscal Year 1977: What, if anything, should be done this year to hold down the cost--to the government and to the patient--of health care?

The nations's expenditures for health care have been growing much more rapidly than the general economy, in large part because of higher rates of inflation in the health sector. Total public and private expenditures on health care and related activities will exceed $133 billion in fiscal year 1976, 8.3 percent of GNP compared with 5.9 percent a decade ago. While the Consumer Price Index has not quite doubled since 1964, the cost of a hospital day has more than quadrupled. If, as seems likely, general inflation remains at historically high levels for the next few years, there will probably be no letup in increases in medical costs.

These rising costs have serious consequences. First, they drive up the cost of public programs devoted to medical-care delivery. Under a current-policy budget, federal outlays for health programs (function 550) in fiscal year 1977 are estimated to be $37.7 billion, $20.5 billion for medicare and $9.5 billion for medicaid. By 1981 outlays for health are expected to reach $58 billion, with about 90 percent of the increase accounted for by medicare and medicaid. Over 80 percent of the projected increase of $14.5 billion in medicare is attributable to higher costs and only about 17 percent to greater numbers of beneficiaries and higher utilization rates.

Second, inflation in medical care costs make it more difficult for individuals to finance health services without public help. Health expenditures per capita rose by 12 percent from 1974 to 1975, while income per capita went up by only 8 percent, creating a hardship for many low- and middle-income families. The most serious impact has perhaps been on the aged, whose health expenditures averaged $1,218 (per person) in 1975. Medicare, medicaid, and private health insurance paid only 66 percent of these costs, leaving the average aged person with out-of-pocket costs of $415 in 1974. About one-fourth of the nation's poverty population is ineligible for medicaid. Millions more, particularly workers in low-wage industries and high-risk individuals, are not insured because they find private coverage prohibitively expensive. In any case, private insurance usually provides inadequate protection against "catastrophic" medical expenses.

9. For more detailed discussion of health issues and five-year budget options, see Part II-1, Section B.

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Thus, medical care inflation increases the pressure to liberalize benefits or broaden coverage of federal programs for financing health care, just at a time when the cost of existing programs is escalating. Moreover, since increasing insurance coverage, whether public or private, tends to remove both patient's and doctor's incentives to economize on health services, liberalizing public programs is apt to add to the demand for medical care and escalate prices still further.

The Alternatives

In this difficult situation at least three general approaches are under consideration:

- Cutting the cost of existing federal programs by limiting reimbursement to providers, tightening eligibility rules and increasing beneficiary cost sharing.
- Targeting national health insurance to improve protection for those most seriously affected by increasing health costs--low-income groups and persons requiring treatment the cost of which is financially "catastrophic."
- Comprehensive national health insurance to cover everyone, through a program required by the federal government and financed either by premiums or taxes.

Only the first two approaches could significantly affect the fiscal year 1977 budget. Even if agreement were reached on comprehensive national health insurance, it could not be put into effect in time to require funding in fiscal year 1977, although some planning money might be provided.

The President's Proposals

The President's proposals, while directed mainly at constraining federal health expenditures, also include improved insurance coverage for medicare beneficiaries who suffer a catastrophe. Increases in federal outlays would be reduced by shifting responsibility for medicaid and 15 categorical health-service programs for the poor to the states under the Financial Assistance for Health Care Act. This block-grant program is funded at about $1 billion below the current-policy estimate for the consolidated programs in fiscal year 1977. Since the President proposes to expand the block grants at a rate below current-policy growth, a greater portion of the future program costs would fall on state budgets or on the beneficiaries themselves. The new program would be controlled through the regular appropriations process and would no longer be an open-ended, "uncontrollable" item in the federal budget.

The President also proposes three significant changes in the medicare program. The first two, limits on reimbursements to providers and cost sharing for beneficiaries, would reduce federal expenditures, while the third, a maximum on cost sharing by beneficiaries, would add to them.

This package of proposed medicare changes will simultaneously reduce federal outlays and protect medicare recipients against catastrophic expenditures. The majority of medicare recipients would pay more out of their own pockets for health services than they would under current policy, a provision intended to make them more cost-conscious.

A question arises, however, as to whether overall price increases in the health sector can be moderated by a program that controls reimbursements only to beneficiaries of public programs, and leaves open the possibility of shifting unreimbursed hospital costs to private patients. Particularly if hospital controls were maintained for a long time, discrimination against medicare and medicaid patients, in the form of lower-quality care, might become a real danger. Furthermore, physicians might circumvent the restrictions by billing patients directly to compensate for the lower increases in medicare reimbursement.

If adopted in its entirety, the President's proposals would result in federal outlays of $34.4 billion in fiscal year 1977, some $3.3 billion below the current-policy estimates.

Targeted National Health Insurance

Several proposals under consideration would provide uniform health protection for the poor ("federalizing medicaid") and universal protection against catastrophically high medical expenses. Its proponents argue that this approach would protect those most in need of assistance in the face of rising medical costs without displacing private coverage or adding greatly to federal budget costs.

Such a plan would probably cost about $5 billion over current levels of federal spending for health care services if passed in time to be fully operational in the second half of fiscal year 1977.[10]

Opponents argue that such a plan would add to inflationary pressures without effectively controlling the costs of medical care, and would encourage overuse of expensive procedures to prolong the lives of dying patients.

Comprehensive National Health Insurance

More than two dozen national health-insurance bills have been introduced, varying widely in coverage and benefits. Some aim to regulate and reorganize the health-care industry. Estimated added costs for the first full year include about $16.5 billion for a plan that would require most of the population to participate in private plans offered by employers, and about $75 billion for a tax-financed, publicly administered health-insurance plan with comprehensive benefits and no cost sharing.

Such a program has virtually no chance of being in operation soon enough to impose substantial costs in fiscal year 1977.

HEALTH FUNCTION (550) BUDGET OPTIONS, FISCAL YEAR 1977
(Outlays, Billions of Dollars)

Option	
Current Policy Level	$ 37.7
Changes from Current Policy Level	
President's Budget	- 3.3
Targeted Approach	+ 5.0[a]
National Health Insurance	+ 0.2[b]

a. Half-year of full implementation.

b. Assumes only planning and start-up money in fiscal year 1977.

10. The portion of this program aimed at the poor assumes that families of four are eligible whose incomes are $4,800 or less after they have paid their medical expenses and that state contributions continue at their present level; the portion that deals with catastrophes assumes a fixed-benefit deductible plan that pays hospital costs after the first 60 days and medical expenses over the first $2,000, with half the cost borne by the federal government.

Unemployment[11]

Budget Issues for Fiscal Year 1977: How much should the federal government spend for job-creating programs and in what form? What should be done to extend or alter unemployment compensation?

The continued high rates of unemployment, the expiration of programs that affect the unemployed and unemployment, and new legislative proposals will confront the Congress with major spending and revenue decisions in the unemployment area during fiscal year 1977.

There are four basic strategies with which the government attacks unemployment. First, stimulative or restrictive fiscal and monetary policy affect aggregate unemployment. Second, targeted expenditure and tax policies--for example, public-service employment, accelerated public works, counter-cyclical revenue-sharing job guarantees, and investment and employment tax credits--can further reduce unemployment. Third, in the long run, unemployment can be reduced by education, training, and activities that facilitate the workings of the market. Fourth, unemployment compensation reduces the financial burdens on the unemployed. Legislative proposals in the last session of Congress, being revised for this one, attempt to pull these strands together into comprehensive antiunemployment legislation. Since fiscal-monetary policy and long-run programs are taken up elsewhere, this section deals primarily with targeted policies to reduce unemployment and with unemployment compensation.

Job Creation

The major issues with respect to employment-creating activities are whether to continue existing job-funding legislation and, if so, at what levels. The Local Public Works Capital Development and Investment Act of 1975 (H.R. 5247), which authorized both an accelerated public-works program and a countercyclical revenue-sharing program, has been vetoed by the President and that veto has been sustained. The Emergency Employment Project Amendments of 1976, reauthorizing the Emergency Jobs Program (Title VI of the Comprehensive Employment and Training Act (CETA) of 1973), which expired in December, 1975, has passed the House of Representatives and is now under consideration in the Senate. The remainder of the CETA legislation, including authorization for another public-service employment program, expires in September, 1977.

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11. For more detailed discussion of unemployment issues and five-year budget options, see Part II-1, Section B.

The choice among funding levels and patterns for employment-creating activities depends on the performance of the various programs, and that depends on a number of factors: the rate of substitution (that is, the extent to which these programs simply create jobs that private activities or other government programs would have created anyway); the average salaries of the directly employed workers; the nonwage costs associated with their employment; the speed with which the activities can be started and stopped; and the fiscal multiplier, by which the spending of the new job holders spreads through the economy. The combination of low substitution, low wage and nonwage costs, and a high multiplier will result in a high net increase in jobs. If substitution is high, however, the net effect will be lower and comparable to that resulting from an untargeted tax cut or an increase in general spending. If the activities involve low-paying jobs, the average salaries of new job holders will be lower than those in jobs resulting from untargeted programs, but more jobs would be created. The available evidence suggests that the total net increase in the number of jobs 12 months after an expenditure of $1 billion in each of the employment-creating programs would be as follows:

	Thousands of jobs
Public-service employment	73 - 121
Accelerated public works	57 - 70
Countercyclical revenue sharing	70 - 97
General expenditures	40 - 70

The total number of jobs supported by a particular budget option depends on the mix of programs supported and their levels of funding. In Part II-1, Section B of this report, the section on unemployment estimates the effect of five alternative antiunemployment expenditure programs, including the President's budget proposals. The number of jobs supported ranges from approximately 350,000 to 1.1 million. The costs of each alternative are summarized in the following table. Outlay levels range from $2.1 billion to $11.2 billion.

Unemployment Compensation

During fiscal year 1977 the Federal Supplemental Benefits (FSB) and special unemployment assistance programs (SUA) are scheduled to expire. FSB provides unemployment compensation benefits for up to 26 additional weeks for individuals who have exhausted regular and extended benefits; SUA provides up to 39 weeks of benefits for individuals such as some state and local employees, domestic workers, and

EMPLOYMENT-CREATING BUDGET ALTERNATIVES
FISCAL YEAR 1976 AND 1977
(Outlays, Billions of Dollars)

Option	Public Service Employment	Counter-Cyclical Revenue Sharing	Accelerated Public Works	Total Employment Creating[a]
1976 Current Policy Level	3.7	0.4	0.3	5.3
1977 Current Policy Option	3.3	0.8	0.0	5.2
President's Budget	1.5	0.0	0.0	2.1
High Option	5.3	2.8	2.0	11.2
Low Option	2.3	0.8	0.0	4.2
Current Policy Reallocation Option[b]	5.1	0.8	0.0	7.0

a. Totals include programs for older Americans and summer jobs for youth, and the Job Opportunities Program.

b. Shifts funds from unemployment compensation to public-service employment, within a constant dollar total.

farm workers, who are not normally covered by unemployment compensation at all. If these programs expire on schedule in March 1977, approximately $1.77 billion less in unemployment compensation benefits would be provided during fiscal year 1977. Further legislative issues are also likely to develop, because outlays in fiscal year 1977 are expected to exceed revenues by $6 billion, even if SUA and FSB do lapse.

The questions are whether these two temporary programs should be continued and, if not, what permanent measure should be adopted in their place. The President's budget proposals would require that most workers currently covered by SUA come under regular state programs, and would allow the FSB program to expire. Another alternative actively under consideration by the Congress would require regular coverage of all state and local employees; allow the FSB program to expire; and alter the trigger mechanisms for the Extended Benefits Program. Both proposals would increase revenues for unemployment compensation by amending the payroll-tax system.

Outlays for unemployment compensation depend on the level of unemployment as well as the structure of benefits. To the extent that employment-creating programs succeed, outlays for unemployment compensation will fall.

The shortfalls of revenues below outlays have already spurred proposals to increase payroll taxes and the tax base. Consideration of the revenue and macroeconomic effects of alternative long- and short-term methods of eliminating this gap may be a principal focus of legislative deliberations for fiscal year 1977.

Transportation[12]

Budget Issues for Fiscal Year 1977: What should be the level of funding for highway programs, and should the Highway Trust Fund be diverted to other uses? What should be the funding level for Amtrak passenger, ConRail, and non-ConRail freight operations, and for mass transit, air, and water transport subsidies?

In the past, federal transportation programs have evolved primarily in response to specific crises or to perceived needs within particular segments of the transportation sector of the economy. This "modal" emphasis has hampered the development of a unified national transportation policy. The most obvious current crisis is the financial deterioration of the railroads. But this problem, together with the mounting cost of energy and concern with the environmental impact of transportation programs, has raised more fundamental questions about the federal role in transportation. To what extent should the government encourage or discourage the use of the automobile? What should be the size, content, and financing of the highway program? What is the future of mass transit, and to what extent should the federal government subsidize waterways and airways?

While no underlying theme dominates transportation issues this year, specific issues, such as the bankrupt Eastern railroads and the level of support for other railroads, do call for Congressional attention. In addition, regular budgetary needs and proposed

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12. For more detailed discussion of transportation issues and five-year budget options, see Part II-1, Section D.

modifications to existing programs require action. Most proposed changes are for shifts in emphasis or to enhance the flexibility of local authorities in using federal transportation funds (as with the highway program), rather than for major program expansions or contractions.

Highways

For the highway program, the issues concern long-run size and content of the program following the release in 1975 of impounded obligational authority. Congress may soon complete action to extend the current highway program for two more years, which would remove the issues from the agenda for fiscal year 1977. Nonetheless, either now or in the next few years, choices must be made among the following options:

- Expiration of the Highway Trust Fund;
- Return of gasoline taxes to the states as general revenues;
- Permission for states to carry out more liberal diversions to mass transit from the trust funds;
- Change the highway program level. For example, increased program levels could be accomplished by carrying out the interstate program more rapidly or waiving the interstate matching requirements; decreased program levels could be accomplished by reducing the commitment to noninterstate highways.
- Altering program content to begin funding interstate maintenance, melding the Highway Trust Fund into a unified transportation fund, or simply permitting more state and local flexibility in shifting funds among highway categories.

Depending on these choices, outlays in fiscal year 1977 could increase by about $0.8 billion or decrease by $2 billion compared with the current policy level shown in the summary table which follows.

Railroads

Legislative actions of the last few years have increased government financial support for rail transportation. Current issues involve decisions that could accelerate this movement.

- Amtrak was created in recognition of the heavy financial burden of providing rail passenger service, and has been provided with operating grants and loan guarantees under the Rail Passenger Service Act of 1970 and subsequent legislation. Deficits are incurred on every route, total losses have gradually expanded, and no financial improvement is in sight. Continuation of the existing routes seems certain to require an expansion in budget commitment. A decision to hold down Amtrak outlays, as proposed in the President's budget request, would lead to a reduction in routes or service. This in turn would force some travelers to increase their reliance on other forms of transportation. The President's budget, however, does include some funds for additional investment in new equipment and roadbed, which could mean reduced costs later.

- Northeast Corridor passenger service has received special attention. It has been supported by several pieces of legislation, most recently the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210), which stipulates service improvements and authorizes direct grants to Amtrak of $1.8 billion. The President's budget request incorporates a much more modest $1.2 billion program, and projects very low outlays through fiscal year 1977. The major issue involves overall program level and whether to accelerate the pace of outlays.

- ConRail, the consolidation of the bankrupt eastern lines according to the United States Railway Association (USRA) plan, is anticipated to require direct federal investment of about $2.1 billion through fiscal year 1980. Funding for the full five-year program is requested in the President's budget, including substantial supplementals for fiscal year 1976. Even if short-run commitments are made to restore adequate service, major budget issues would remain. How large an expenditure can be justified to maintain costly service? Should losses greater than those forecast by USRA lead to consideration of changes in other policies?

- Assistance for other railroads, beyond the eastern ones, seems certain to be a budget issue of continuing importance. The rail act authorizes a considerable expansion in financial support for maintaining deficit rail services, and for purchases of securities and loan guarantees. The appropriation of these funds would deepen federal financial involvement in several aspects of railroad operation.

The reduction of outlays under the President's proposals compared with CBO's current policy budget primarily reflects an effort to hold down Amtrak subsidies and to delay (beyond fiscal year 1977) outlays for Northeast Corridor and other rail service assistance programs.

CBO's low option assumes that only $0.1 billion of these outlays could be avoided in 1977 via such economies (larger differences would show up in later years). By contrast, CBO's high-option outlays of $1.8 billion could reflect further growth in Amtrak deficits (via maintenance of current routes and service) and higher spending levels for ConRail and for improvements in the Northeast Corridor. These alternatives are shown in the summary tabulation.

Mass Transit

In the short term, mass transit alternatives will center on the President's proposed change in use of formula grants. Urban Mass Transportation Administration (UMTA) formula grants are now available for operating or capital subsidies at local option. The President has proposed limiting the amount available for operating expenditures to a maximum of 50 percent; thus increasing the funds available for capital expenses, spreading outlays out over time and requiring greater state and local aid to transit or higher fares (or both). Escalating operating deficits also bring demands for a larger formula-grant program.

However, in the long run, the transit issue will center on increases in the funding level of the full range of UMTA programs. The bulk of UMTA's unobligated capital grant budget authority has been earmarked for new systems or additions in Atlanta, Baltimore, New York, and Philadelphia, leaving insufficient funds for immediate construction of major expansions or new systems elsewhere. Congress is unlikely to address this problem this year.

The CBO high option assumes that the formula grant program will be doubled in size and that $1 billion will be added to the capital grant program by fiscal year 1978 (with a negligible effect on fiscal year 1977 outlays). The CBO low option would cut formula grants in half and reduce capital grants by $400 million a year. Neither of these options would have its full impact on the budget in 1977 because of the time lag between approval of new grants and expenditures. These alternatives are set out in the summary table below.

Air Transportation

Air transportation issues concern the growing balance of about $1 billion in the Airport and Airways Trust Fund. This "surplus" could be either allowed to accumulate, or it could be reduced by decreasing user taxes, or by using the fund for at least some of the airway operating expenses now paid from general revenue ($1.5 billion) or for a new program aimed at reducing aircraft noise. Legislative action on this issue may be completed in fiscal year 1976.

Water Transportation

In water transportation the main issue is whether to impose charges on commercial users of the domestic waterway system, as the President proposes, and if so at what level and by what mechanism? Currently, all capital and operating costs are financed from general revenues. The President's proposal envisages revenues of $80 million.

BUDGET OPTIONS FOR SELECTED TYPES OF TRANSPORTATION, FISCAL YEARS 1976 AND 1977
(Outlays, Billions of Dollars)

	Outlays		
Option	Highways	Railroads	Mass Transit
1976 Current Policy	7.0	1.4[a]	1.5
1977			
Current Policy Option	7.0	1.5	1.7
President's Budget	6.7	1.2	1.8
High Option	7.8	1.8	2.2
Low Option	5.0	1.4	1.4

a. Incorporates funding in new legislation for ConRail.

Aid to State and Local Governments[13]

Budget Issues for Fiscal Year 1977: How much should the federal government spend to aid state and local governments? How much control should it exercise over the use of the funds?

Federal grants to state and local governments will total about $63 billion in fiscal year 1976, about 17 percent of all federal outlays and about 25 percent of all funds spent by state and local governments.

13. For more detailed discussion of aid to state and local governments issues and five-year budget options, see Part II-1, Section C.

There are four general forms of federal assistance to state and local governments:

- General revenue sharing ($6.4 billion) and other general assistance ($1.4 billion), in which the use of funds is virtually unrestricted.

- Block grants for community development, law enforcement, and employment and training ($7.5 billion), in which recipient governments can decide how to spend the funds within a broad functional area.

- More than 600 other grant programs that in total provide approximately $48 billion to state and local governments, whose uses are subject to fairly narrow federally imposed limitations.

- Tax expenditures (estimated cost to the Treasury of $15 billion), under which the use of the monetary benefits accruing to state and local governments is not restricted.

Two basic, and substantially independent, issues underlie the debate on federal aid to state and local governments:

Control. To what extent should the federal government determine the purposes for which federal funds are spent at the state or local level, and what role should it play in designing and implementing spending programs?

Categorical grant programs targeted on fairly narrowly defined kinds of spending give the federal government considerable control over how the money is spent. However, even these grants in effect provide some unrestricted assistance, because, in the absence of federal assistance, spending on the same or similar programs would not have been zero in most jurisdictions, and some of their own funds are thus freed for their discretionary use.

Recently, emphasis has shifted away from specifically targeted categorical grants to programs giving broader discretion to state and local governments. Categorical programs accounted for 98 percent of federal grant outlays in fiscal year 1966; in fiscal year 1975 the proportion was down to 77 percent.

Size. To what extent should the fiscal capacities of state and local governments be augmented through federal assistance?

Concern over the financial situation of state and local governments has at least three aspects. First, the state-local sector may be disadvantaged relative to the federal government in raising revenues, mainly because the federal income tax is highly responsive to economic growth and inflation, while revenue growth at the state and local level is somewhat more sluggish, and also because states and localities compete with each other for residents and for industry.

Second, state and local governments are especially vulnerable to recession. Most are forbidden by law to run budget deficits, and hence must either raise tax rates or cut service levels when recessions eat into their tax bases. These actions only serve to worsen the recession.

Third, state and local resources vary greatly, and some jurisdictions have inadequate capacity to meet their needs. New York City's recent fiscal crisis attracted renewed attention to fiscal problems of older cities. While the immediate problems of New York are unique, many other cities, as well as some states and rural areas, share basic problems such as a declining economy, dropping population and relative income, deteriorating physical plant, and spending pressures that threaten to exceed capacity to raise revenues.

These issues will be of particular concern to the Congress in this session for a number of reasons:

- Reauthorization of general revenue sharing must be considered.

- Antirecession grants to state and local governments, recently vetoed by the President, are likely to be reconsidered.

- Possible substitutes for, or complements to, the exclusion of interest on municipal bonds from federal income taxes are likely to be considered.

- The President proposes in his 1977 budget to convert categorical programs in education, health, child nutrition, and highways to less restrictive block grants and, in many cases, to reduce federal funding as well as the so-called matching requirements--the provision that states contribute amounts in some given proportion to the federal contribution.

Alternative actions in these four areas are considered below.

General Revenue Sharing

General revenue sharing was first enacted in 1972. Outlays in fiscal year 1975 were $6.1 billion; current policy levels for fiscal year 1977 would be $6.6 billion, or roughly 2.5 percent of projected state-local revenues from all sources. The President has proposed renewal of the program, which is due to expire in December, 1976, through 1982, with funding of $6.5 billion in fiscal year 1977 and annual increases of $150 million thereafter.

Letting the program expire, or reducing outlays, could reflect either preferences for low spending (if other kinds of aid were not increased to fill the gap), or tighter federal control (if block grants or categoricals were increased to compensate for reductions in general revenue sharing). An uncompensated cut would hurt low-income states most, because the program as it stands has some redistributive effects.

If the federal government cut taxes to compensate for cutting revenue sharing, the burden on citizens in the aggregate would not change. However, the distribution of services and of the taxes to pay for them would change in complex ways, depending on decisions by individual state and local governments. Again, low-income states would lose and high-income states would gain.

If the program is to be renewed, a number of options may be considered. In terms of budget impact, the important choices relate to funding levels. The President's proposed annual increases of $150 million would fall short of the roughly $400 million needed to keep up with expected inflation of about 5 to 7 percent. Changes in federal control of state-local spending can be accomplished by shifting funds from general revenue sharing to more restricted forms of grants, or vice versa.

Antirecession Grants

The President has recently vetoed a bill (H.R. 5247) that would have provided assistance to state and local governments where unemployment rates are high when national unemployment exceeds 6 percent. The estimate for such aid in 1977 is $750 million. While the President objected to the Congressionally enacted program, he indicated he might support some other form of antirecession assistance.

The vetoed bill would have provided an incremental $500 million per year for each percentage point of unemployment above 6 percent. This would offset about 10 percent of the total impact of a 1 percent increase in unemployment on state-local revenues.

Exclusion of Interest on Municipal Bonds from Federal Income Taxes

The tax expenditure represented by exclusion from federal income taxes of interest on municipal bonds apparently originated in the context of constitutional separation of powers; however, many legal experts now believe that the Constitution does not require it. The estimated cost to the Treasury in 1977 is $4.5 billion.

The exclusion provides fairly direct assistance to state and local governments by reducing the interest rates they pay. On the other hand, because some investors receive more interest than is actually required to induce them to buy the bonds, state and local governments lose an estimated 25 percent of the benefits of the federal tax expenditures. Moreover, increased perception of risk in municipal bonds, as well as heightened borrowing by states and cities, have narrowed the interest-rate differential between tax-exempt municipals and taxable bonds, further reducing the benefits to state and local governments.

Several alternatives now under discussion could be adopted either instead of, or along with, the current exclusion. Considering repeal of the exclusion as such, there are two possibilities: If interest on outstanding bonds were taxed, investors now holding them would lose about $4.5 billion per year. If only newly issued bonds were subject to tax, those investors would not lose. In either case, the costs to states and local governments now zero would rise, as taxable bonds bearing higher interest rates were issued.

New actions currently being discussed are:

<u>Subsidize Taxable Bonds</u>. Either along with or instead of the exclusion, state and local governments could be given the option of issuing taxable bonds on which a portion of the interest costs would be paid by the federal government. Very rough estimates based on a 40 percent subsidy indicate that gross subsidy costs in the initial year could be as high as $1.4 billion. To the extent that investors substitute taxable investments for current holdings of tax-free municipals, increased revenues would offset the subsidy cost; the offset could be as high as, or even higher, than the amount of the subsidy, but the actual response is difficult to predict. Subsidy costs and any revenue offsets would rise over time, as more subsidized taxable bonds were issued.

<u>Establish Federal Guarantees or Insurance, a Development Bank, or Other Pooling Mechanism</u>. All of these options represent moves toward federal assumption of risk. A public authority could raise funds by selling taxable bonds at market interest rates and then lend to state and local governments. If a subsidy were desired, the relending could be at a lower interest rate with the difference met through Congressional appropriation. Under one variant of this approach, the federal government would assist states in establishing development banks through insurance or direct subsidy; others are federal guarantees or insurance. A development bank or other pooling mechanism would especially enhance the marketability of bonds issued by small jurisdictions. All of these options would mitigate or eliminate the discipline now imposed on state and local

governments by the need to market their own bonds. Replacing this discipline by some sort of federal review, differential insurance premiums, or other mechanism is possible in theory but poses potentially thorny political and administrative problems.

Other Options. Repeal of the exclusion could also be compensated by increased general revenue sharing, by grants for capital expenditures, or by some combination of the two.

Most of the other kinds of assistance would tighten federal control, at least to some extent, and many of them might increase state-local uncertainty as to future benefits.

The President's Proposals for Categorical Grants

The President's 1977 budget would reduce federal spending as well as federal control in categorical programs. The President's proposals for grants are $60.5 billion, which is 13 percent below current policy budget estimates for the year. Most of the cuts come in categorical grants in human resource programs, whose service levels will have to be cut unless states or localities increase their contributions. The functions for which the President's proposals are significantly below current policy levels are the following:

- $1.6 billion less in community and regional development (function 450), for which the President omits outlays expected from passage of the Local Public Works Capital Development and Investment Act of 1975, and proposes reductions in Economic Development Administration programs.

- $4.6 billion less in education, training, and employment (function 500), where the President plans reductions in public-service employment and education.

- $1.7 billion less in health (function 550), where funding proposed for the Financial Assistance Health Care Act is less than current policy estimates for the replaced categorical programs.

For all human-resource programs combined (functions 500, 550, 600, and 700), the President's proposed grants to state and local governments are $7.3 billion, or 18 percent below current policy. In comparison with current policy, his proposals for general assistance (function 850) are $0.1 billion, or 1 percent lower, and for those other areas are $1.9 billion, or 9 percent lower.

The net distributional impact of these cuts on individual states and local jurisdictions, or the response of these governments to such cuts, is very hard to predict. Many recipient governments may be able

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to continue current service levels, some perhaps even without tax-rate increases. Others will have to cut programs or increase tax rates or both. The ultimate impacts on state-local fiscal situations, program beneficiaries, and taxpayers would vary considerably among jurisdictions.

The President's proposals would loosen federal control over state and local programs. Consolidation of categorical programs to block grants in health, education, child nutrition, and highways would permit states more freedom in allocating funds according to their own priorities, as would elimination of matching requirements in many programs. As with the other options, the President's proposals for grant consolidations can be dealt with separately from his proposed funding levels.

Summary of Budget Impacts

The following table summarizes the budget impacts of these options for fiscal year 1977. The President's proposals are compared with current policy levels for fiscal years 1976 and 1977; the table shows the impact of his veto of antirecession grants on general assistance, of his proposed shifts from categoricals to block grants, and of his overall lower levels of proposed funding. The last four columns list a wider range of options that illustrate possible choices with regard to spending levels and federal control; they are analyzed in detail in Part II-1, Section C of this report.

Federal Civilian Pay and Retirement[14]

Budget Issues for Fiscal Year 1977: What basic changes, if any, should be made in the annual process of adjusting federal pay or in the formula for computing civil service retirement?

Changes in pay levels for the federal work force have major impact on the size of the budget. Under present policy, spending on general schedule and related military pay, will increase from $49.3 billion in fiscal year 1976 to $74.3 billion in fiscal year 1981. In terms of impact on the federal budget, the general schedule (GS) is the most significant system since it determines the rates for three quarters of civilian pay and also affects military pay, which is linked to the GS pay schedule.

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14. For a more detailed discussion of civilian pay and retirement issues and five-year budget options, see Part II-1, Section E.

SUMMARY OF ILLUSTRATIVE OPTIONS FOR GRANTS TO STATE AND LOCAL GOVERNMENTS [a]

OUTLAYS

[Billions of dollars, fiscal years, path B]

	1976 current policy	1977		1977			
				Low outlay		High outlay	
		Current policy	President's proposals	Less control	More control	Less control	More control
General Assistance	7. 7	8. 2	7. 3	8. 2	6. 8	15. 4	7. 9
Block Grants	7. 5	8. 9	19. 7	7. 0	7. 0	12. 1	8. 9
Categorical Grants	47. 7	52. 8	33. 4	45. 0	52. 8	52. 5	63. 3
Total	**62. 9**	**69. 8**	**60. 5**	**60. 1**	**66. 6**	**80. 0**	**80. 1**
Tax Expenditures:							
Exclusion of interest on state-local debt	4. 2	4. 5	4. 5	4. 5	4. 2	4. 5	4. 2
Deduction of nonbusiness state and local taxes	10. 8	11. 1	11. 1	11. 1	11. 1	11. 1	11. 1

[a] For more details and methodology, see Part II–1, Section C.

To achieve full "comparability" with private sector wages, as defined under the present system, GS pay rates would have to increase by about 12 percent, or $3.2 billion, at the next adjustment, set for October, 1976. This amount includes a 3.7 percent "catch-up" due to the 5 percent "cap" imposed in the previous year. Annual increases over the period 1977-81 would average 8.6 percent increasing the annual cost for GS and related civilian pay from $30.1 billion to $40.6 billion.

The President has proposed a much more modest adjustment, which would average 4.7 percent with a minimum of 3 percent for the lower grades and a "cap" of 5 percent at the top. This proposal is predicated primarily on adoption of those recommendations of the President's Panel on Federal Compensation (Rockefeller Panel) that can be implemented administratively. These changes are (1) inclusion of secretaries and computer operators in the wage survey conducted to determine comparability, and (2) weighting of the survey results for composition of the federal work force.

The Options

The significant impact of federal pay on the budget and the mounting criticism of the current pay-setting process from a wide variety of sources have led to several proposals to alter the current system.

1. Move to a system of indexation. Indexation would provide automatic cost-of-living increases based on changes in one or more independent economic indicators. This alternative would probably raise costs for fiscal year 1977 by about $1.2 billion over current policy levels.

2. Extend collective bargaining to include compensation. Extending collective bargaining in the federal government to include compensation would be a far-reaching change but it would move the federal government closer to practices in the private and nonfederal governmental sectors of the economy. The collective-bargaining formulation discussed in part II of this report would probably increase GS and related civilian pay rates by about 12 percent in fiscal year 1977 over fiscal year 1976, the same amount as current policy.

3. Adopt the President's proposal. The President's proposed average adjustment of 4.7 percent would raise GS and related civilian pay by $1.3 billion in fiscal year 1977 over fiscal year 1976 levels; and would cost about $1.9 billion less than continuing current policy.

4. Place a moratorium on pay raises. A two-year moratorium on pay raises would result in no additional costs beyond the payroll base for fiscal year 1977 and would cut $3.2 billion from current policy costs.

Estimated impacts of these options on the federal budget in fiscal years 1977 and 1981 are shown below.

GENERAL SCHEDULE AND RELATED CIVILIAN PAY BUDGET OPTIONS
(Outlays, Billions of Dollars)

Option	1977	1981
Current Policy Level	30.1	40.6
Changes from Current Policy Level		
Collective Bargaining	0.0	+7.0
Indexation	+1.2	+1.2
Two Year Moratorium	-3.2	-7.3
President's Budget	-1.9	

Civilian Retirement

The statutory formula for adjusting civilian retirement includes a 1 percent "kicker," which represents an extra percentage point added to each cost-of-living adjustment. Annuities are increased whenever the CPI increases by 3 percent for three consecutive months. The kicker is intended to compensate for the lag between changes in the CPI and the effective date of the annuity increase. If the kicker were eliminated, reductions in annual outlays would start at $93 million in 1977 and reach $791 million in 1981, for a cumulative five-year reduction of $2.1 billion below the present system.

Putting the Decisions Together

In making budget decisions for fiscal year 1977 the Congress will make spending, revenue, and fiscal policy decisions that are consistent with each other. Indeed, the new budget process, which explicitly requires voting on spending by budget function, revenues, and the size of the deficit or surplus, requires the Congress for the first time to confront these three types of decisions simultaneously.

Although high spending is frequently associated with fiscal stimulus and low spending with fiscal restraint, this association is not at all necessary. If Congress wants spending for federal programs to increase substantially it can still pare the deficit down by keeping taxes high. Conversely, even if Congress wants to cut back on federal spending it need not adopt a contractionary fiscal policy. Expenditure cuts could be more than offset by tax reductions designed to increase private spending.

Realistically, however, the range of choices in any one year is constrained by economic forces and past decisions. The state of the economy virtually guarantees that the fiscal year 1977 budget will show a substantial deficit. The real questions are how large the deficit should be and what combination of spending and revenue changes should determine it. Moreover, built in growth in federal programs virtually guarantees that federal spending will be larger this year than last. The real questions are how much larger? Will the past tendency of federal spending to grow slightly faster than the economy in general be continued or reversed? Which programs will be held back and which will grow? Finally, built-in growth in spending, the inevitable deficit and reluctance to raise taxes in large jumps combine to make it unlikely that major funding will be available to finance new program initiatives in fiscal year 1977.

As the Congress looks further in the future, more diverse options open up. Concerted effort at the margin over several years could reduce the general level of federal spending to a substantially lower fraction of GNP or raise it to a higher one; shift priorities dramatically within a larger or a smaller spending total; cut back old programs to make room for new ones; achieve either a substantial budget surplus or a continuing deficit. Decisions made this year will influence these longer run decisions, but not determine them. Part II of this report deals in greater detail with major program areas and attempts to lay out some options for the next five years that Congress may wish to consider in making this year's decisions.

PART II

FEDERAL BUDGET CHOICES FOR FISCAL YEARS 1977-81

National Security (Function 050)

Introduction

Although two decades ago national defense spending constituted over half of the federal budget, today only about a quarter of the federal budget is devoted to this function (see following table). Most of these funds are spent by the Department of Defense (DoD) for pay to military, civilian, and retired personnel; for procurement, operations, and maintenance; and for research and development (R&D). The national defense function also includes foreign military assistance programs,[1] the nuclear weapons development and production activities of the Energy Research and Development Administration (ERDA), and a scattering of other minor activities, such as the Selective Service System.

Some tax expenditures also belong in the national defense function. Allowing Armed Forces personnel to exclude housing and subsistence allowances from taxable income is estimated to reduce federal revenues by $650 million in 1976. The exclusion of military disability pensions will reduce federal revenues by another $80 million in 1976.

Measured in dollars of constant purchasing power, expenditures for defense have declined steadily from their Vietnam peak in the late 1960s through fiscal year 1975, and are lower now than before the Vietnam buildup. The downward trend in real spending was halted in fiscal year 1976 and the President has proposed a real increase in fiscal year 1977 budget authority and a constant real level of outlays.

The current policy projections for defense budget authority and outlays in fiscal year 1981 are $139.5 billion and $135.6 billion respectively. Essentially these projections hold spending level in constant dollars. Military and civilian employment are held constant, and salaries are raised as specified by the Federal Pay Comparability Act of 1970. Increases in retirement costs are projected on the basis of automatic cost-of-living adjustments in benefits for retired military personnel, increases in the retired population, and the higher wage bases of the new retirees. Projections

1. The military assistance program is discussed briefly with International Affairs.

NATIONAL DEFENSE OUTLAYS AND TAX EXPENDITURES (FUNCTION 050)

[Billions of dollars, fiscal years, path B]

Function	1956	1966	1976 [a]	1981 [a]
Department of Defense—Military (051):				
Military personnel	10.7	15.2	24.7	36.2
Retired military personnel	0.5	1.6	6.9	12.6
Operations and maintenance	9.4	14.7	27.3	38.6
Procurement	12.2	14.3	15.6	23.6
Research, development, test, and evaluation	1.5	6.3	9.1	12.5
Other	1.4	2.3	4.8	8.7
Total (051)	**35.8**	**54.4**	**88.4**	**132.0**
Military Assistance (052)	2.6	1.7	1.9	1.2
Atomic Energy Defense Activities (053)	1.7	2.4	1.8	2.5
Defense-Related Activities (054)	0.6	−0.1	−0.1	−0.1
Total Outlays	**40.6**	**58.5**	**91.9**	**135.6**
As a percentage of total federal outlays	58%	43%	25%	24%
Tax Expenditures	NA	NA	0.7	0.8

[a] Current policy levels.

NA: not available.

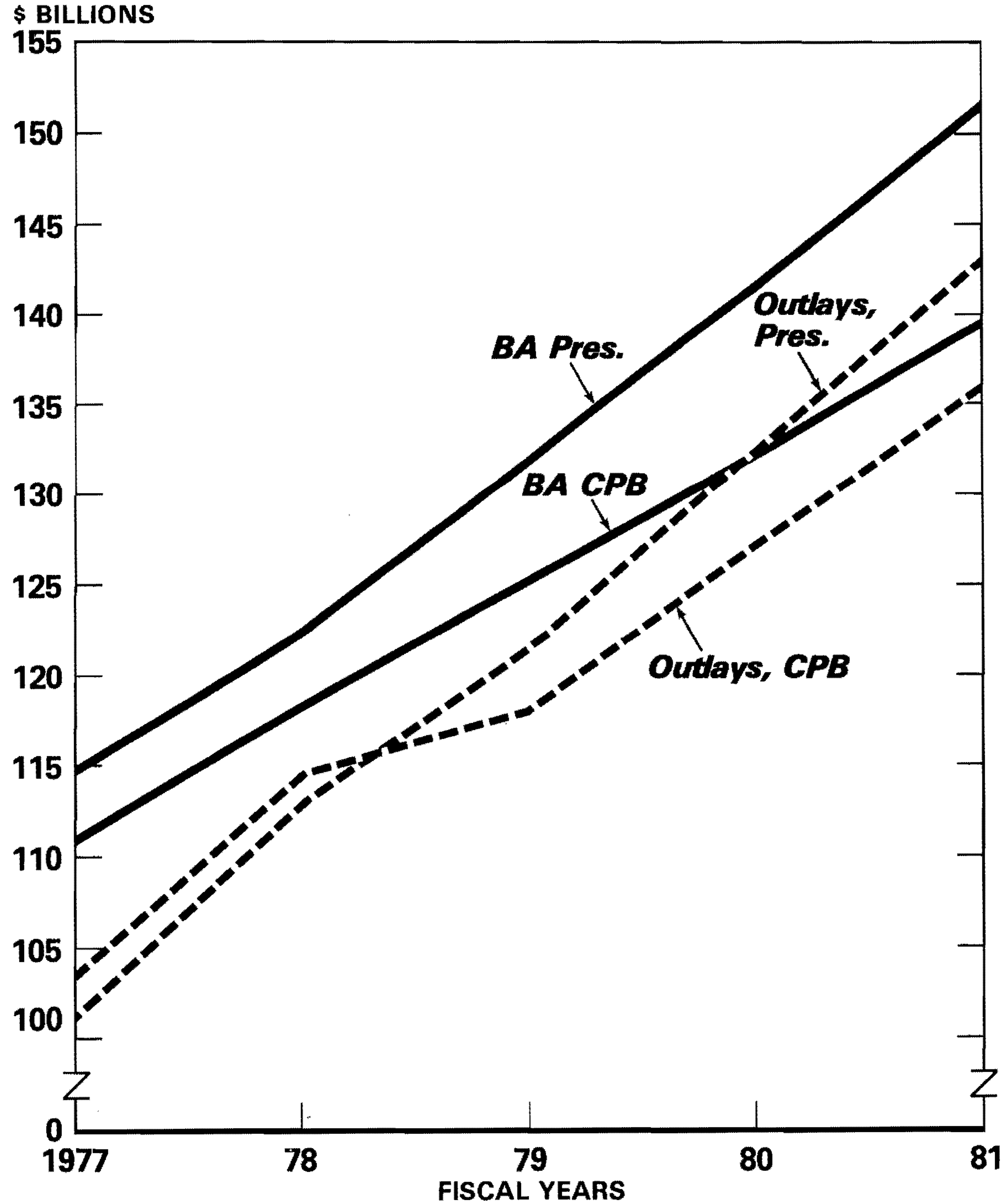
of DoD outlays for purchases of goods and services are at levels that just offset inflation. Not surprisingly, these projections imply a continuation of approximately the current relative importance of defense in the budget as a whole.

The current policy budget provides a baseline for discussion about increases or decreases in the defense budget, but it is important to realize that it does not necessarily imply a constant level of military forces. Unit costs of weapons have historically tended to rise faster than other prices. If this pattern continues, constant real budgets will almost certainly buy smaller forces over time. If the Defense Department achieves quality increases to compensate for quantity decreases, total force capability could remain the same or grow. But this is by no means assured, because the forces of presumed adversaries, against which our forces are designed to operate, also change in quantity and quality. Thus, the current policy budget will not necessarily maintain constant forces or a constant real military capability.

The President's fiscal year 1977 defense budget is at the same time a "turn around" budget and an austere budget. Real growth in outlays for fiscal year 1977 is only slightly over 1 percent. Yet real growth in requested budget authority is nearly 5 percent. Fiscal year 1977 outlays are held down by the President's proposals to limit increases in military, civilian, and retirement pay. This is why the President's 1977 budget is below the 1977 current policy outlay estimates (see the following chart). However, the current policy budget with the President's pay assumptions would be below the President's budget levels. Budget authority for procurement and R&D grow substantially, but these appropriations will be spent over a number of years, and their impact on outlays is therefore delayed. In budget authority, the President's budget lies above the current policy level in all years; outlays are higher than the current policy level after fiscal year 1978. The procurement and R&D initiatives in the President's budget, which raise budget authority in the early years, eventually result in larger outlays.

It should be noted that the President's fiscal year 1977 defense budget presumes that Congress will change existing legislation concerning stockpile sales, wage board pay increases, commissary surcharges, and retirement pay computation to allow savings of $1.2 billion, and further acquiesce in pay caps and reductions in family housing and military construction, allowing savings of from $1.4 to $2.6 billion.

The President's Defense Budget Projections and the Current Policy Budget (Path B Assumptions)



Note: BA is budget authority and CPB is current policy budget.

The Role of the Defense Establishment

The role of the defense establishment is to support the foreign policies of the United States. In time of peace, this means to prepare for conflict and to maintain forces ready for a variety of contingencies. The forces emphasize readiness for the contingencies thought most likely to occur in order to deter potential adversaries or to defeat them should deterrence fail.

Maintaining this state of peace is the central objective of U.S. foreign policy. However, the specific contingencies that may threaten the peace or other U.S. interests are far less clear, as is the desired balance of our varied interests. Such uncertainties mean that it is impossible to tie precisely alternative foreign policy objectives to alternative military force structures.

There is some agreement on the major components of both threats and interests:

- Nuclear war with the Soviet Union is one contingency for which the United States prepares. The probability of such a war is agreed to be low so long as the United States is able to inflict unacceptable damage on the USSR after having absorbed a massive nuclear strike.

- Another contingency that plays a major role in determining force structure is large-scale war against the Warsaw Pact in Europe. Here there is less agreement: If large-scale land war in Europe is not a real possibility, then perhaps other and smaller forces are called for, to cope with other contingencies. If there were to be large-scale war, would it immediately involve nuclear weapons? The answer to this question can greatly change ideas about the desirable structure of the major portion of U.S. general purpose forces.

- The greatest uncertainties, however, stem from the enormous variety of other possible contingencies. U.S. forces may be called upon to fight against many possible adversaries and in a variety of locales. How much--if anything--the U.S. should invest in forces specialized for use in areas other than those perceived to be of greatest importance to this country, or for use against paramilitary or terrorist threats depends on how important these threats are to the U.S.

The specific sections that follow discuss budgets for different sorts of military forces that vary primarily within the confines of current foreign policy: strong deterrence conditioned by possible arms control agreements; taking seriously the big-war threat in Europe; continued U.S. interests in the rest of the world that may require military force. An attempt has been made to indicate some of the implications for military budgets of substantially different foreign policy views.

The remaining sections of this chapter discuss major budget issues in the following areas:

- general purpose forces which are designed to deal with a variety of contingencies both local and world wide;
- strategic forces--land and sea based missiles and long-range bombers--which are designed to deter nuclear attack;
- research and development; and
- manpower costs which represent more than half of the defense budget.

General Purpose Forces

General purpose forces include the ground forces of the Army and Marine Corps, the tactical air forces of the Air Force and Navy, airlift and sealift forces, and naval forces other than the Polaris and Poseidon ballistic missile submarines. The following table shows the composition of these forces to which roughly two-thirds of the defense budget is devoted.

The potential threats that these general purpose forces are designed to meet come primarily from the USSR and the Warsaw Pact nations, and to a lesser extent from the Peoples Republic of China and North Korea. The USSR possesses formidable military forces. These forces have expanded considerably in the recent past, and the USSR is procuring modern equipment at a rapid rate. U.S. general purpose forces also are expected to be able to deal with other conflicts affecting U.S. interests; the Lebanon crisis of 1958 and the Dominican Republic intervention of 1965 are examples of such conflicts.

What these threats and expectations imply for U.S. force and budget decisions, however, can be interpreted in various ways. Both the high and low ends of the range of general purpose force budget options discussed here would enable the United States to engage in similar military actions around the world. At either end of the budget range, U.S. general purpose forces would be able to participate in a serious defense against large or small Soviet attack in Europe. At either end, the United States can project substantial military power to any place on the globe.

U.S. GENERAL PURPOSE FORCES

(July 1, 1975)

ACTIVE

Ground Forces:	
Army (Divisions)	14
USMC (Divisions)	3
Naval Forces:	
Aircraft Carriers	15
Major Surface Warships	161
Nuclear Attack Submarines	62
Amphibious Ships	64
Auxiliaries	127
Other	28
Total Ships	457
Tactical Air Forces:	
USAF:	
Squadrons (22 Air Wings)	71
Attack/Fighter Aircraft	2, 278
USN:	
Squadrons (14 Carrier Air Wings)	70
Attack/Fighter Aircraft	1, 326
USMC:	
Squadrons (3 Marine Air Wings)	25
Attack/Fighter Aircraft	489
Squadrons	166
Attack/Fighter Aircraft	4, 093

RESERVE

Ground Forces:	
Army (Divisions)	8
USMC (Divisions)	1
Naval Forces:	
Destroyers	32
Mine Warfare Ships	31
Total Ships	63
Tactical Air Forces:	
USAF:	
Squadrons	36
Attack/Fighter Aircraft	898
USN/USMC:	
Squadrons	17
Attack/Fighter Aircraft	271
Squadrons	53
Attack/Fighter Aircraft	1, 169

Source: Annual Defense Department Report, fiscal year 1977.

The differences between the highs and the lows are on the margins of time, risk-taking, and political effectiveness: How quickly can the U.S. respond? How long can it fight? How soon might the U.S. be faced with a decision between accepting imminent defeat and resorting to nuclear weapons? What would be the effect on U.S. allies of a reduction in U.S. forces in Europe? What would be the effect on neutral nations of an increase in U.S. ability to respond quickly in other areas?

The budget decisions of a single year rarely have profound or irreversible impact on the size, cost, or capabilities of the general purpose forces. Fiscal year 1977 is likely to be a typical year in this respect for the Army and Air Force. Both have ongoing replacement and modernization programs which could be associated in any given year with a range of ultimate force objectives. But the case of the Navy is different. Because of the expense and long time involved in ship procurement, there is a more definite link between choices in the fiscal year 1977 budget and the future size of the Navy.

Naval Forces

While the patterns of ship deployment overseas have remained much the same over the past decade, the size of the Navy has fallen from over 900 active fleet ships in 1964 to just under 500 in 1976. At the same time, the Soviet Navy has been growing in size and capability. The large decrease in the size of the U.S. Navy can only be interpreted as a substantial relative loss of naval power. Whether this downward trend should be stabilized or reversed, however, depends on the answers to two questions: First, was the loss from a position of such predominance that the United States still retains an edge? Second, has there been a change in the expected role of the Navy?

The size issue is exacerbated by the problem of aging ships. Eighty-three U.S. Navy ships are now at least 30 years old, and eight more will exceed 30 years between now and 1982. Thirty years is generally taken to be the limit of useful life of a Navy ship; therefore, it should be expected that these ships will have to be replaced within the next few years. The backlog of about 90 funded, but still undelivered, ships from previous years is enough to maintain the Navy at its present level for a while. But the average of about 12 ships per year procured since 1968 will not, in the longer run, sustain a Navy of 500 ships. The ship types on order do not correspond exactly to the ships that are reaching the end of their useful life and some shortfalls in certain ship types may occur.

The desirable size of the Navy depends on its mission. Aside from about 40 Polaris and Trident nuclear-missile submarines, the ships of the Navy are primarily a general purpose force. The Navy has traditionally had three general purpose missions:

- "presence," which emphasizes the political use of military force;

- "projection," in which the Navy supports friendly forces and punishes adversaries by tactical air strikes and by sending ashore amphibious forces; and

- "sea control," the prime objective of which is to deny the use of the sea to the enemy while allowing one's own relatively unhampered use.

The questions are: What is the future relevance of each of these missions? And what does this imply about Navy size and costs?

A Navy significantly smaller than the present one will not be able to sustain the present pattern and tempo of operations overseas. Decreasing presence abroad may be interpreted by allies and adversaries alike as a weakening commitment to defend U.S. interests. On the other hand, changing U.S. foreign policy may signal a redefinition of U.S. interests that would allow some degree of withdrawal without an implied weakening of resolution. In any case, the "presence" mission is not one for which the U.S. explicitly buys forces. It is something obtained as a peacetime by-product of the forces bought for "projection" and "sea control."

Lacking a basic change in foreign policy, it seems likely that the "presence" mission will continue to be important. The United States continues to have interests spread throughout the world. Carrier task forces and other fleet units provide a traditional and workable way of showing the flag in support of these interests without the degree of involvement implied by actual stationing of ground and air forces in a foreign country.

"Projection" has been the major role of the Navy in the last two wars. In Korea and Vietnam, the Navy contributed mainly by flying tactical air strikes in support of friendly forces ashore. Even though there was no naval opposition in those wars, and thus no need to divert part of the Navy to the task of "sea control," the resources of the Navy were taxed in carrying out its "projection" mission. Today the Navy is half the size it was then, and the U.S. faces a major naval adversary. For the future, it is not likely the differences in size of the Navy in the range considered in this report would make a critical difference in our "projection" capability. In conflicts

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involving the Soviet Union it is the "sea control" capability which is most important.

When examining the "sea control" mission, it is necessary to look at this country's major potential opponent. The Soviet Navy has been growing rapidly and now comprises a formidable force. War at sea against that nation would involve protection of U.S. and allied shipping and naval forces against submarines, surface engagements between U.S. and Soviet fleet units, as well as submarines and aircraft, and carrier air strikes against the forces of the Soviets and their allies ashore.

It is with regard to this mission that the major arguments are made for enlarging or at least maintaining the size of the U.S. Navy. In assessing the size of these tasks, it is important to note that the Soviet submarine force constitutes a credible threat in the northern Atlantic and Pacific Oceans, whereas the Soviet surface fleet would in all probability remain in areas where it could have cover from land-based tactical aircraft. It is also important to observe that U.S. antisubmarine forces are highly capable and that in a struggle against Soviet submarines in the North Atlantic the U.S. would likely be able to draw upon a substantial number of relatively modern and effective allied escort-type vessels.

A number of questions must be considered: How likely is a conflict that would involve such war at sea? What is the likelihood of a war in Europe lasting long enough to involve resupply by sea of NATO forces by vessels under attack by the Soviet Navy? How probable are Soviet attempts to interfere at sea with U.S. forces or supplies being transferred to combat in other areas? If these contingencies are regarded as unlikely, the "sea control" arguments for a larger Navy become less convincing.

All this bears on the fiscal year 1977 budget, because decisions on the shipbuilding budget will play an important part in determining the size and composition of the Navy to the end of this century and beyond. It would require a deliberate decision and major effort to move in the direction of a 600-ship Navy, a goal that would be difficult to achieve much before the end of the next decade. On the other hand, continuation of the trends of the past seven or eight years would result in a Navy of 400 ships or less by the end of the next decade. Further, although the Navy's shipbuilding budget is a relatively small part of the service's annual budget (on the average, about an eighth), the total number of Navy ships is a prime determinant of much of the rest of the Navy budget, such as operations and maintenance, weapons procurement, and manpower. Thus, the shipbuilding decisions of today will largely determine total Navy costs five and more years later, with an impact for several decades.

Major Alternatives. While naval forces of many different sizes are possible, three alternatives are examined here--a 500-ship force because that is roughly the size of the Navy now, a 600-ship force because that has been widely discussed as an appropriate force goal, and a 400-ship force because continuation of present trends will eventually result in a decline to this size.

In addition to the issue of the size of the Navy, the issue of the extent to which the major ships of the Navy should be nuclear-powered and the mix of ship types also affect the budget. In Title VIII of the Defense Appropriation Authorization Act of 1975, the Congress declared in favor of nuclear power for all new "major combatant vessels," prohibiting even a request for conventional power in such vessels unless accompanied by a Presidential finding that nuclear power in the particular case "is not in the national interest." The issue is obviously complex, but the budget price is reasonably clear: The funds which will buy three conventionally powered vessels will buy only two like vessels with nuclear power. There is also evidence to suggest that the operating cost of a nuclear vessel will be more over its life cycle, although direct fuel costs may be less. Unlike the issue of the size of the Navy, however, the conventional/nuclear power choice is largely a technical one: Whatever the naval mission, is it cheaper to provide fuel for a fleet away from home bases over a period of time by resorting to nuclear propulsion or by replenishment from support ships that go back and forth from home bases? Under most assumptions, replenishment costs less, but it is possible that wartime disruption of replenishment would favor nuclear ships.

The total number of ships is only one aspect of naval power; the mix of ships' capabilities is also most important. The mixes used for alternative forces are roughly consistent with Navy force objectives. Also, the costs of a one-third/two-thirds mix of nuclear/conventional major fleet escort ships respectively are compared to the all nuclear major ship force contemplated by Title VIII.

The 500-Ship Navy. There were 457 general purpose naval ships in the force as of July 1, 1975. If the 41 Polaris/Poseidon submarines are taken into account, the total comes to 498 ships. Assuming no unfunded backlogs and a fairly steady number of ships reaching obsolescence each year, a force this size could be sustained by building about 17 ships annually. The average annual shipbuilding budget that would sustain this building rate is about $4.4 billion in fiscal year 1976 prices if one-third of the major surface escort ships are nuclear powered, or $5.8 billion if they are all so powered (see the following table). Thus:

- a decision on the fiscal year 1977 shipbuilding budget to procure substantially less than 17 ships would imply a willingness to allow the Navy to fall below 500 ships, or an assumption that much larger shipbuilding budgets would be provided within the next few years.

- strict adherence to the requirements of Title VIII would imply a willingness to pay substantially more for a 500-ship fleet or to provide a smaller fleet.

The 400-Ship Navy. Since the Navy now has more than 400 ships, the sustaining shipbuilding rate for a 400-ship force would be seven or eight ships per year over the next five years. Further, unless it was decided to retire some ships early, decline to 400 ships would be quite gradual. This level would not be reached until the late 1980s. The average annual budget for this option would be about $2.2 billion in fiscal year 1976 prices for a force having a mixed nuclear/conventional major escort component, or $3.2 billion for full compliance with Title VIII. If shipbuilding budgets remained at about the same level as fiscal years 1970-76 in real terms, there would be some flexibility in the program to help smooth block obsolescence problems and fund maintenance and cost growth backlogs.

The 600-Ship Navy. An expansion to 600 ships would necessarily take place slowly. Ships budgeted in fiscal year 1977 will not begin to be delivered until fiscal years 1982 or 1983. If it were decided to achieve 600 ships by fiscal year 1987, all of the buildup would have to be funded in fiscal years 1977-81, and deliveries of about 37 ships a year would have to be made during the fiscal years 1982-87 period. The annual shipbuilding budget for fiscal years 1977-81 to pay for the expansion would be about $7.6 billion in fiscal year 1976 prices if a nuclear/nonnuclear mix of major escorts were allowed in the buildup, or $8.6 billion if Title VIII were complied with in full.

The President's Proposals. The President proposes to fund 16 ships in fiscal year 1977 at a direct cost of $4.5 billion. One of the ships is a Trident ballistic missile submarine costing about $800 million. This request is consistent with maintaining a Navy of 500 ships. Also requested in the President's 1977 budget is $1.6 billion for unfunded cost growth in past shipbuilding budgets. Similar costs would be required under the other alternatives.

SHIPBUILDING COSTS FOR ALTERNATIVE FLEET SIZES
(Billions of 1976 Dollars, Fiscal Years 1977-81)

Navy Force Goal	Average Annual Cost
500 Ships	4.4
(All Nuclear Major Escorts)	(5.8)
400 Ships	2.2
(All Nuclear Major Escorts)	(3.2)
600 Ships	7.6
(All Nuclear Major Escorts)	(8.6)
President's Proposal	4.5

Ground Forces

The mission of the ground forces of the United States is primarily to deter aggression against our NATO allies in Europe and against South Korea. They are also designed to be able to intervene in small conflicts that may not involve other major powers.

The Army is in the process of forming three new divisions out of existing support echelons. This will give the Army a total of 16 active divisions. This process of transforming "tail" to "teeth" has been carried out within the ceiling of 785,000 men authorized by the Congress, but is estimated to involve a capital cost of about $1.9 billion. Two of the new units are being formed as infantry divisions and the third as a mechanized division. While infantry divisions have lower initial equipment costs, they are less suited to combat in Central Europe against heavy opposing forces. Additional costs may result from attempts to rebuild support echelons to replace manpower shifted to the new combat divisions. There may also be shortfalls to be made good later in appropriate support for 16 active divisions.

The alternatives in ground forces really concern the rate at which major equipment is procured to outfit and modernize the forces, and the ultimate differential cost of maintaining more active divisions. The range of options under active discussion is not large: It goes from 16 active divisions (including the Marines) at the low end, to 19 active and fully equipped divisions at the high end.

Of the 17 existing divisions, 4 are in Europe, 2 in the Far East, and the remaining 11 are in the United States (with smaller units in the Canal Zone and elsewhere). The U.S.-based divisions are considered available for combat anywhere in the world, particularly Europe. The three new Army divisions now being formed are intended to be U.S.-based and mobile.

The difference between 19 and 16 ground force divisions is probably not the difference between being able or not to fight a major war in Europe, nor will this be the difference in Korea or elsewhere. Since the incremental forces will be U.S.-based, the initial burden of combat will be borne by the same units as before, whatever the total in the force structure. Rather, more combat units and more and better equipment will make it possible to fight longer and better after a war has begun.

Plans for war in Europe call for rapid reinforcement of the four U.S. divisions in place (plus the other NATO divisions) by airlifting forces from the United States. The function of the three new divisions--if the war continues, utilizing the initial Europe-based forces and the initial reinforcements--will be to enable the U.S. to fight it longer with more likelihood of a successful conclusion. The value of the three divisions in this case is thus composed of the likelihood placed on such a large-scale European war breaking out in the first place, the value attributed to avoiding a nuclear/nonnuclear decision if such a war were to occur, and the likelihood of not having had to make such decisions before the incremental forces are available.

The longer time period provided by the existence of the three divisions may serve to bridge the gap between use of active forces and full mobilization of reserves. Again, a key element in the importance of the three divisions is the estimated likelihood of a war lasting long enough so that this time gap, when active forces are becoming exhausted and reserve forces are needed, can be covered.

Although not within current plans, it would be possible within 16 (13 Army plus 3 Marine) divisions, to redeploy the forces, bringing divisions back from Europe or Korea. Militarily, the differences here would again be those of time: How rapidly could NATO forces with, for example, two U.S. divisions instead of four be reinforced from the U.S.? How long could they fight? Transcending the strictly military issues, however, is likely to be the foreign policy issue of the effect on the Western alliance of such a redeployment.

<u>Major Alternatives</u>. The direct connections between fiscal year 1977 budget decisions and the size of the ground forces is less clear than in the case of the Navy. Fiscal year 1977 may start in a particular direction, but the commitment to that direction need be less strong because lead times are shorter than with the Navy. Also, production rates for ground force equipment generally will be increasing over the next few years to fill out shortfalls and upgrade the equipment of existing active and reserve units. Thus, it is difficult to separate the resources associated with the formation of three additional active divisions.

The range of alternatives for ground forces includes:

The 16-Division Army. An alternative that called for 16 active Army divisions, fully manned, and supported by present standards, and 8 reserve divisions would entail an increase of Army strength of 105,000 people by the end of fiscal year 1979. This option would increase recurring annual costs by $300 million in fiscal year 1977 and by $1.5 billion in fiscal year 1981. Construction associated with the additional divisions plus additional equipment has been estimated to cost an additional $1.9 billion over the next five years.

The 13-Division Army. An alternative that limited the active Army to 13 divisions and 8 reserve divisions could either retain present Army end strength (total authorized manpower at the end of the fiscal year) or reduce Army end strength by 37,000 by the end of fiscal year 1979. The annual savings of the reduced strength would be $420 million but would not start until fiscal year 1978. The $1.9 billion of one-time construction and equipment costs over the next five years that are associated with the 16 division alternative would be avoided.

The President's Budget. The President's fiscal year 1977 budget is predicated upon achieving 16 active Army divisions by the end of the fiscal year. In addition, two newly formed maneuver brigades will be maintained separately, their places in the new divisions being taken by reserve brigades. Force modernization and readiness initiatives include eventual conversion of two infantry divisions to mechanized divisions (no fiscal year 1977 budget cost); increasing USMC division tank inventories; and increasing inventory objectives for medium tanks, armored personnel carriers, and antitank guided missile systems. The inventory objective increases are based on recalculation of expected loss rates in a war with the USSR in central Europe (presumably in the light of Israeli and Arab experience in the October war). The cost of the increased inventory objectives in fiscal year 1977 prices is $2.7 billion.

Tactical Air Forces

The tactical air forces operate with both land and sea forces and are designed to fight in the same kinds of battles as ground and naval forces. Thus, considerations governing the overall size of conventional forces discussed in the two previous sections also apply here. One specific tactical air issue involves finding the most effective ways to use air and ground forces together.

Tactical air forces perform three main missions in support of ground troops: air superiority, close air support, and interdiction. The air superiority role is to prevent enemy aircraft from hampering friendly operations. Close air support involves attacking enemy ground forces engaging or obstructing friendly ground forces. Interdiction involves attacking enemy supply lines, transport facilities, and reserve materiel in enemy territory. At sea, the tactical air forces provide fleet air defense and attack capability against enemy ships. Sea-based tactical air forces can also contribute to the land battle.

Issues concerning tactical air programs over the next five years are: first at what level to maintain force levels, assuming that the present air/ground mix is right; and second, how the changing threat and technological environment affect the mix and mission priorities as the force is modernized. As in the case of ground forces, it is not easy to distinguish the fiscal year 1977 budget decisions which would profoundly influence the long-run size of the tactical air forces. Since all the tactical air forces are engaged in large modernization programs, the decisions for fiscal year 1977 mainly relate to pace of modernization.

An important, longer-term fiscal issue, but one with less direct effect on fiscal year 1977 budget decisions, is force structure. Congress faces decisions now about the tactical air force structure in fiscal year 1981 and beyond. For the five year period, DoD proposes to increase Air Force wing equivalents from 22 to 26 (a 17 percent increase in aircraft), to retain 12 Navy[2] and 3 Marine Corps air wings, and to increase Army attack helicopter assets by a third. If it is determined that these force levels advocated by DoD are beyond reach because of their future cost implications, a concentrated search must be undertaken for the most effective force within the budget constraints.

Major Alternatives. Some of the alternatives available in the tactical air force area are:

The President's Proposals. The President's fiscal year 1977 budget includes budget authority increases in tactical aircraft procurement of about 30 percent for the Air Force and 10 percent for the Navy, with concomitant increases in numbers of aircraft that would be procured. These overall increases represent part of the real growth by DoD in spending on general purpose forces. Larger increases are programmed for future years, especially in the Air Force.

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2. A Navy proposal to retain 13 carrier air wings has not yet been acted on by DoD.

Lighter Forces. An alternative has been suggested by the success of Arab surface-to-air missiles (SAMs) and antiaircraft artillery in disrupting Israeli efforts to provide close air support and interdiction in the 1973 war. This is to move toward a force size and mix designed to maintain air superiority but with less emphasis on close air support and interdiction. This lighter tactical air force would hold the Air Force to 22 fully equipped wings (66 squadrons). Navy carrier wings would be reduced to 10, the number required to equip the 10 carriers in the 400-ship force. Marine Corps squadrons would be reduced from 25 to 24. Overall, the force would have a lower percentage of new, high technology aircraft than that which DoD plans. In fiscal year 1977 the cost of this alternative would be $1.3 billion below the levels requested in the President's budget (see following table).

Modernization. A second alternative program would maintain present force levels, but allow the pace of renewal/modernization requested by DoD. This alternative would retain the present and planned mix of mission capabilities and priorities for the Navy. The Air Force would have fewer aircraft than DoD now plans, but a higher percentage of new aircraft. In fiscal year 1977 this alternative would cost about $0.4 billion less than the President's proposal.

Expansion and Modernization. A third alternative would allow force expansion as well as modernization. The Air Force squadrons would expand to 26 fully equipped wings by fiscal year 1981 with more close air support capability than in the present force. The Navy would have 13 wings, maintaining the present mix of mission capabilities and priorities at higher force levels. While the cost of this alternative in fiscal year 1977 would be only marginally higher than the President's proposals, over the fiscal year 1977-81 period this alternative would cost about $1.2 billion 1976 dollars more.

COSTS OF ALTERNATIVE TACTICAL AIR PROGRAMS RELATIVE TO THE PRESIDENT'S PROPOSALS

BUDGET AUTHORITY

[Millions of dollars, fiscal years, path B]

Option	1977	1978	1979	1980	1981
Lighter Forces	−1,300	−2,100	−2,141	−2,704	−996
22 USAF Wings					
10 Navy Wings					
3 Marine Wings (24 Squadrons)					
Modernization	−370	−269	−368	−457	−381
22 USAF Wings					
12 Navy Wings					
3 Marine Wings (25 Squadrons)					
Expansion and Modernization	+33	+100	+313	+483	+493
26 USAF Wings					
13 Navy Wings					
3 Marine Wings (25 Squadrons)					

NOTE.—Army attack helicopters are not counted in the above forces. Over the next five years, the Army's planned modernization and expansion of this force will cost $700 million for R & D and procurement of Cobra helicopters with TOW missiles and $1.1 billion for the Advanced Attack Helicopter (AAH). Completion of the AAH program (fiscal years 1982–85) will cost an additional $1.6 billion.

Strategic Forces

U.S. strategic offensive forces are composed of three elements or a "Triad": bombers, intercontinental ballistic missiles (ICBMs), and submarine-launched ballistic missiles (SLBMs). The SLBM force is being modernized with the Trident submarine and missile program. Modernization is contemplated for the bomber force, with a decision on whether to procure the B-1 scheduled to be made in fiscal year 1977. Strategic cruise missile development is underway. Alternative successors to all or part of the Minuteman ICBM force are being considered. Whether to continue with a Triad of strategic forces and, if so, at what pace of modernization, with what systems design approach, and at what level and mix are major questions to be addressed in the fiscal year 1977 and subsequent budgets.

U.S. strategic defensive forces consist of anti-ballistic missile systems, air defense forces, and their associated warning and control systems. Since the early 1960s, the strategic air defense forces, such as interceptor aircraft and ground-to-air missiles have been deliberately reduced as the Soviet emphasis on ballistic missiles rather than bombers became apparent. The U.S. ABM deployment and development have been constrained by the 1972 ABM treaty and a decision to phase down operations at the one ABM site already constructed. In strategic defense forces, the major issues to be considered in the near term are whether to continue ABM research and development and, if so, on what scale and with what emphasis.

The strategic forces budget also includes a significant amount for extensive warning and command, control, and communications programs.

Since the early 1960s, strategic offensive and defensive forces have accounted for a relatively small and declining share of the defense budget. In fiscal year 1963, strategic forces accounted for 33 percent of the defense budget. In fiscal years 1970-75, they accounted for 14 to 15 percent. Consequently, even sharp reductions in the budget for strategic forces will not produce a major reduction in defense spending. Nor is the higher force option described below likely to raise total defense costs by more than about 2 percent.

U.S. strategic forces have as their primary objective deterrence of a first-strike nuclear attack upon this country. Strategic forces are also expected to deter attempts to coerce the United States and to deter nuclear threats or attacks against U.S. allies such as NATO and Japan. This extended deterrence objective requires a higher level and a different mix of strategic forces than would be needed simply for assured destruction of Soviet cities and industry following a first strike on the United States. The mix and level of U.S. strategic forces also are designed for high confidence in their ability to carry out their mission. Past decisions on their size and character took into account possible underestimates in the rate of growth of the threat and unlikely, but possible, contingencies, such as major operational failures or degradation of U.S. strategic forces. The result is a force which is deliberately redundant. U.S. forces are sufficiently large that the United States can attack a variety of other targets in addition to Soviet cities, or withhold some forces temporarily to deter Soviet escalation during a nuclear exchange.

The primary purpose of strategic defensive expenditures has shifted over the last several years from providing active defense against long-range Soviet strategic attacks to exploring technologies to anticipate and cope with possible Soviet ABM and other strategic force advances.

SALT. In May, 1972, the SALT I agreements relating to ABM and ICBMs and SLBMs were reached. The two principal U.S. objectives in SALT were: first, to increase the stability of mutual deterrence by limiting threats to the survivability and effectiveness of strategic offensive forces; and second, to constrain the costs of the strategic arms competition by limiting the level of the forces within which the competition would continue. The 1972 ABM treaty and the 1974 ABM protocol limited both ABM deployment and some types of ABM-related R&D. These agreements increased the likelihood that strategic missile forces would be able to penetrate to their targets, that both nations' cities would remain hostage to retaliatory attacks, and that the stability of deterrence would be thereby strengthened. In addition, the agreements permitted the United States to avoid spending about $11 billion programmed for ABM deployments between fiscal years 1973 and 1981. Thus, the ABM agreements seem to have advanced both the stability and cost-avoidance objectives.

In the case of strategic offensive forces, however, there is an open question whether the objectives of SALT, particularly that of stability, have been furthered by SALT I. There have been subsequent force developments, especially in Soviet programs. The SALT I Interim Agreement on Strategic Offensive Systems established a five-year ceiling on the numbers of U.S. and Soviet ICBM and SLBM launchers. The disparity in the levels established (1,710 for the United States, and 2,353 for the Soviet Union) was acceptable to the United States because strategic bombers were not included and because U.S. advantages in accuracy and MIRV deployment were judged to offset temporarily the Soviet advantages in numbers of missile launchers and in ICBM throw-weight. Within the overall limits, SALT I also set a limit on "modern heavy" ICBMs and restricted ICBM replacement and silo enlargement. The United States hoped that this limit would prevent conversion of the numerous "light" Soviet SS-11s into "modern heavy" missiles because the latter could have significant capability to destroy U.S. Minuteman sites. In approving the Interim Agreement, Congress stipulated that in a future treaty on strategic offensive weapons the United States not accept "levels of intercontinental strategic forces inferior to the limits provided for the Soviet Union." This principle of equality in numbers of delivery vehicles was reflected in the Vladivostok understanding of November, 1974. That accord, meant to guide an agreement lasting through 1985, stipulated that both the United States and the USSR accept a common aggregate ceiling of 2,400 launchers and a limit of 1,320 MIRVed launchers. Negotiations have continued since then on what vehicles are to be included within the 2,400 ceiling. In response to Congressional concern, a commitment has been made to negotiate reductions below the 2,400 ceiling as soon as the agreement on the implementation of the Vladivostok accord has been reached.

Since SALT I, the U.S. strategic force budget has declined in real terms, although the 1977 budget request sharply reverses that decline. Soviet strategic force budgets have grown considerably during this period. Since 1972, the United States has emphasized modernization of its strategic forces to promote stability of deterrence against first strikes. These developments include measures to enhance the probability of successful bomber penetration and to improve the survivability of both SLBM and bomber forces. U.S. MIRVs have relatively small yields and presently do not pose a more than modest threat to Soviet ICBMs. While hardening some ICBM silos and improving SLBM systems to enhance survivability, the Soviets have concentrated since SALT I on replacing three existing ICBM types without MIRVs with four new systems that can carry MIRVs. The two replacements for the widely deployed SS-11 have a surprisingly large increase in throw-weight. Their ability to launch relatively high yield MIRVs has undermined the U.S. attempt in SALT I to prevent replacement of the SS-11 with a "modern heavy" successor and poses a potentially serious threat to Minuteman.

Choosing a Program. In choosing a U.S. strategic force program, several fundamental questions must be considered. These include:

- Should U.S. strategic nuclear forces be expected to deter a broad variety of possible attacks and attempts at coercion? Should the requirements extend beyond assured destruction of Soviet cities and industries following a massive attack by the Soviets on the United States? Should we rely on U.S. strategic forces to deter nuclear attack and nuclear threats against allies, such as Germany and Japan, who might otherwise consider acquiring their own nuclear forces? All of these additional applications require forces above a minimum assured destruction level and impose requirements on command and control and force flexibility.

- In situations where deterrence has failed, such as a limited Soviet attack on U.S. military targets, should the United States have options other than a massive counterattack? Once a nuclear exchange has begun, is it feasible and worthwhile to have forces to withhold in hope of deterring further escalation or of affecting negotiations on termination of the war? These considerations lead in the direction of additional forces, capable of surviving attack and being used in a variety of possible counterattacks.

- Should the United States continue to maintain a "Triad" to hedge against failures and performance degradations and to complicate a Soviet surprise attack? Should the more vulnerable "Triad" components be eliminated? Should force elements be added, for example, mobile ICBMs or cruise missiles? How much should the United States be concerned that eliminating one of the "Triad" elements could enable the Soviets to concentrate resources on defeating the remaining elements?

- What are the most appropriate U.S. efforts in R&D and procurement to influence Soviet force developments and SALT outcomes? How would program choices affect long-term stability by limiting threats to the survivability and effectiveness of retaliatory forces? What posture will best provide an incentive for future reduction of forces by both the Soviet Union and the United States?

- How important are perceptions that the United States is equivalent to the Soviet Union in major force characteristics?

Answers to these questions do not lead precisely to a specific level and mix of forces but they are important considerations in choosing among possible alternatives.

Major Alternatives. Three alternative strategic forces are covered in the following discussion. The baseline force is similar to current Department of Defense plans. Lower and higher alternatives (both consistent with the Vladivostok limits) are also shown, together with 1975 levels.

"Baseline" Program. The baseline force maintains the current Triad, with gradual modernization to maintain or increase force viability and effectiveness. In mid-1975 the force consisted of 1,054 ICBMs, 656 SLBMs, and 497 long-range bombers. These numbers have been essentially constant (except for a decrease of about a hundred bombers) for the past eight years. The United States had 1,046 MIRVed launchers in mid-1975; in terms of both launchers and MIRVs, U.S. force levels are below the Vladivostok ceiling.

Modernization of the Triad has begun with the decision to produce the Trident I missile and 10 Trident submarines. In fiscal year 1977, a decision is expected on whether to produce the B-1 bomber as a successor to the B-52. In 1978 or 1979 DoD may propose to proceed with development of a new ICBM (the MX). Fiscal year 1977 and the near term will thus provide an opportunity to examine carefully the general requirements for strategic forces and, in particular, the need to continue a Triad. If a decision is made to modernize all or most of the existing three components with new systems, the absolute costs of strategic programs will increase considerably. Different funding levels would be possible, however, depending upon the pace of introduction, extent of replacement, and cost of the design approach chosen. For example, different versions of a new ICBM could vary significantly in cost depending upon the basing mode chosen (silo-based or one of several alternative mobile configurations).

The baseline option assumes that strategic forces for fiscal years 1977-81 will maintain about 2,300 launchers and retain all three force components. It assumes production of the B-1, with a force level goal of 244 beginning to enter the force by fiscal year 1980-81 and continuation of the Trident program. It also assumes no funding for procurement of an advanced ICBM (MX) to replace some Minuteman IIIs until after fiscal year 1981. The baseline program would be consistent with the Vladivostok accord's ceiling of 1,320 MIRVed missiles. Improvements in missile accuracy and yield could be continued or constrained, depending upon judgments about the evolution of new Soviet capabilities and U.S. needs.

Rationales for the baseline program assume that numerical parity in launchers is important to a stable strategic balance as U.S. technological leads are reduced or become more difficult to maintain; that reductions in force levels outside of SALT would remove Soviet incentive for agreed reductions; that perceived parity makes the Soviets more cautious and less likely to miscalculate, and strengthens U.S. and allied resolve, particularly in a crisis; and that it is important for the United States to be able to respond in a limited, selective manner to a limited Soviet nuclear attack.

The President's Proposals. The President's budget basically represents the cost of the baseline alternative for fiscal year 1977; it requests $9.4 billion for the direct costs of strategic forces. The fiscal year 1976 appropriation is estimated at $7.3 billion, the lowest in 15 years in constant dollars. The principal sources of the increase in fiscal year 1977 are continued modernization of the SLBM force with the Trident missile and submarine, proposed procurement of the B-1 bomber after a review in November, 1976, and of prototype testing and full scale development of air-launched and sea-launched strategic cruise missiles. The major increases are shown in the following table.

(Millions of dollars, fiscal years)

Weapon	1976 Planned Funding	1977 Proposed Funding	Increase
Trident	1,925	2,933	1,008
B-1	661	1,532	971
Development of Strategic Cruise Missiles	144	262	118

Higher Alternative. This alternative does not assume a formal breakdown of SALT, but it does assume a buildup to about 2,400 launchers. Not only would the B-1 be procured, but 1,000 air-launched cruise missiles would be procured for extending the viability of the B-52 force. The cost estimates provided in the following table are based on a fiscal year 1978 decision to accelerate the availability of an advanced ICBM for mobile deployment. By 1985, 150 of these would be produced as a substitute for 150 Minuteman IIIs.

The rationale for this alternative is that the deterrent value of the ICBMs must be preserved, and that this can best be done by making at least part of the force less vulnerable to growing Soviet capabilities to destroy silo-based ICBMs. The alternative also assumes heightened concern with improvements in Soviet air defense capabilities to degrade U.S. bomber effectiveness.

This alternative would increase strategic force costs $0.2 billion over the levels proposed by the President in fiscal year 1977. These incremental costs would grow to $2.3 billion in fiscal year 1981 (see the following table).

INCREMENTAL COSTS OF STRATEGIC ALTERNATIVES[a]
IN BUDGET AUTHORITY
(Billions of Dollars, Fiscal Years)

Alternative	1977	1978	1979	1980	1981
Lower Alternative	-1.6	-2.0	-2.8	-3.1	-3.3
Higher Alternative	+0.2	+0.3	+1.1	+1.7	+2.3

a. Changes are estimated from the Defense Department program underlying the President's budget projections.

Lower Alternative. One lower budget alternative to the baseline force permits a reduction in numbers of launchers to a level of about 2,000. To keep costs down in the near term, the B-1 would be cancelled and instead cruise missiles would be procured to prolong the utility of much of the B-52 force. Work would begin on developing a less expensive submarine than the Trident; procurement of Trident would end at 10 ships. The small force of Titan II ICBMs would be eliminated.

A rationale for this alternative could be based either upon reductions made possible by SALT or upon the assumption that numerical equality with the Soviets is not required for deterring an attack on the United States and that even somewhat reduced forces will remain adequate to deter nuclear coercion or attacks on allies. This alternative would reduce costs from the level proposed by the President by $1.6 billion in fiscal year 1977 and by larger amounts in subsequent years (see preceding table). The specific force levels of the alternatives are shown in the following table.

Research and Development

Military research and development efforts absorb about 8 to 10 percent of the defense budget. Their purpose is clear: to make sure that no enemy gains a technological advantage enabling it to cancel out or weaken a portion of U.S. defenses (and, conversely, to find such an advantage for the United States).

Research and development carries military forces into the future. In general, a desire for more military research and development is based on the belief that the United States must match the level of effort of potential enemies. Such a view may well favor R&D-limiting arms control agreements like the nuclear test ban, if they carry with them enough certainty that they will limit potential enemies as much as this country. A desire for less military R&D is most frequently based on two beliefs: First, that weapons get built because they have been invented, and used because they have been built, and that failure to invent will thus prevent use. The second belief complements the first and is that--contrary to the view that the United States must expend effort on R&D because an adversary will--the adversary's programs are a defensive response to U.S. programs and that if the United States exercised restraint, so would others, even without a formal arms control agreement.

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MID-1980s STRATEGIC OFFENSIVE FORCE GOALS AND 1975 FORCES

Strategic weapons	1975 force	Baseline 1980s force	Higher 1980s alternative	Lower 1980s alternative
Launchers:				
Total	2,207	2,290	2,370	1,992
MIRVed	1,046	1,206	1,286	1,206
Bombers	497	580	580	336
B–52	426	266	266	266
FB–111	71	70	70	70
B–1		244	244	
Air-launched cruise missile			(1,000)	(800)
ICBM	1,054	1,054	1,054	1,000
Titan II	54	54	54	
Minuteman II	450	450	450	450
Minuteman III	550	550	400	550
Mobile MX			150	
SLBM	656	656	736	656
Trident I SLBM on Trident SSBN [a]		240/10	240/10	240/10
Trident I SLBM on Poseidon SSBN [a]		160/10	160/10	160/10
Poseidon C–3 SLBM on Poseidon SSBN [a]	496/31	256/16	336/21	256/16
Polaris A–3 SLBM on Polaris SSBN [a]	160/10			

[a] Number of missiles/number of submarines.

These views do not translate neatly into annual budgets for military research and development, and the speculative nature of R&D makes such translation even more difficult. Thus CBO has arbitrarily included an increase and a decrease of 10 percent--plus or minus about $1 billion--from the current policy level of R&D, to represent the alternative views in structuring the major options.

Defense Manpower Issues

To man the military forces for fiscal year 1976, Congress has authorized employment of 4 million persons, including active duty military personnel, military reserves and National Guardsmen, and civilians. In addition, DoD must pay for 1.1 million military retirees. In fiscal year 1976 all these personnel will cost over $49 billion in pay and allowances.[3] This represents 54 percent of all national defense outlays in fiscal year 1976, up sharply from 43 percent in pre-Vietnam fiscal year 1964. Manpower costs will continue to increase to 56 percent of national defense outlays by fiscal year 1981 under current policy projections.

Because manpower costs consume a large and increasing part of the defense budget, attention has focused on ways to reduce them. The bulk of manpower costs can be cut by reducing the number of employees, either through reductions in military forces or through increases in efficiency, or by cutting costs per employee. Defense employment has already been reduced substantially in recent years, with 22 percent fewer active military personnel and 8 percent fewer civilians now than in fiscal year 1964, just before the Vietnam buildup. Meanwhile, costs per employee have risen rapidly--some 127 percent for civilians and 143 percent for active duty military employees over the fiscal year 1964-76 period. The major sources of these rapid increases are readily identifiable--making government pay comparable with the private sector, paying to recruit an all-volunteer military, etc. Short of more reductions in force levels, the only way to reduce projected manpower costs is to slow the growth in compensation costs per employee. Thus, this section concentrates on changes affecting two major types of compensation--basic pay and military retirement.

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3. Not included in the $49 billion are nonpay operating costs for military training, medical services, commissaries, and other benefits. These costs amount to more than $3 billion and could be considered part of manpower costs.

Basic Pay. The following discussion of basic pay issues centers on the possibility of imposing a 5 percent "cap" on salary increases and other compensations in the military salary system.

Five Percent Pay Cap. Since much of compensation for defense employees consists of civilian salary or military basic pay, reducing or "capping" the annual salary increase saves large amounts of money. The expected salary increase for military and general schedule civil servants is about 12 percent for fiscal year 1977 and about 8.8 percent for fiscal year 1978. Capping increases for these employees at 5 percent in fiscal year 1977 would save $2.2 billion, $1.6 billion in costs of active duty military employees and $0.6 billion in costs of DoD civilians. Another 5 percent cap for fiscal year 1978 would bring savings up to $3.7 billion annually. Changing current law so as to extend the 5 percent pay cap to wage board civil servants in fiscal years 1977 and 1978 would save an additional $0.2 billion in 1977 and $0.4 billion in 1978.

In departing from comparability for two years running, the obvious risk--aside from issues of fairness--is whether, given a reduced pay raise, DoD can compete successfully for the qualified manpower it needs. It is probable that DoD can compete, at least for military recruits, with a pay cap in fiscal year 1977. A fiscal year 1977 pay raise limited to 5 percent, along with projected increases in private sector salaries and employment, is estimated to reduce the number of highly qualified recruits[4] volunteering for military service by 7 to 12 percent below 1975 levels. However, due to the recession, 1975 was a banner year for military recruiting, and DoD should be able to meet its manpower requirements in 1977 without falling below historically acceptable standards of overall recruit quality. Though no shortfalls are expected for 1977, continuing pay caps may result in significant shortfalls in later years. A 5 percent cap on annual pay raises through 1981 would cause a major decline in recruiting of highly qualified persons--22 to 32 percent below 1975 levels. Consequently, the pay raise option in this section provides for raises above 5 percent in the years beyond 1978.

Military Salary System. Military personnel receive compensation in many forms other than basic pay: tax-free allowances for quarters and food, incentive pay for doing special jobs, bonuses for enlistment and reenlistment, free services such as medical care, and a retirement annuity for those who serve 20 years or more. Proposals to abolish these many forms of compensation in favor of a single military salary have existed for some time, in part because

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4. A highly qualified recruit is defined as a high school graduate who scores in the top 70 percent on the standard service entrance examination.

a salary system may save money, but also because the present system leads to inequities and difficulties in force management.

While savings under a salary system may be significant, any move toward it must take into consideration the complexities of the military compensation system. An increase in active duty basic pay, to compensate for eliminating allowances or free services, will increase retirement annuities, reserve pay, reenlistment bonuses, and separation payments, which are all a function of basic pay. These and many other interactions argue for a comprehensive, carefully studied reform, an event which is unlikely to occur in time to achieve savings in fiscal year 1977. However, each year that passes without an attack on the problem delays any savings to be achieved under a salary system.

Military Retirement. A number of reforms in the military retirement system could significantly affect its costs. These are discussed below.

Benefit Reform. The current military retirement system pays a lifetime annuity which can begin immediately after 20 years of service. The annuity after 20 years' service is 50 percent of basic pay at retirement, rising to 75 percent with 30 years' service. Military personnel do not contribute directly to this retirement system. These benefits and the absence of an offsetting contribution make military retirement very expensive. In fiscal year 1976 DoD will spend about $7.4 billion (about 8 percent of all outlays) on military retirement. Costs will increase to $12.8 billion by fiscal year 1981 (over 9 percent of all outlays) and will continue to increase in the future.

Not only is the current system expensive, it also provides little incentive for initial enlistment or reenlistment because personnel serving less than 20 years receive no retirement benefits. Most recruits leave after an initial term of four years. Of those who do stay in, most stay for 20 years, but few remain longer.

The Retirement Modernization Act (RMA) (HR 7769), which is currently before Congress, introduces reforms that are intended to reduce the number of 20-year careerists. RMA would do this by providing limited retirement benefits after 10 years' service and by reducing the annuity of 20-year careerists from 50 to 35 percent of basic pay for the first 10 years of their retirement. DoD estimates that RMA would save about $800 million per year in today's dollars by the year 2000. RMA would actually increase military retirement costs in the first few years, mainly because of the new benefits for those leaving after 10 years of service.

A more far-reaching retirement reform was proposed in 1971 by the Federal Interagency Committee (IAC). The IAC plan would make a 20-year career less inviting by reducing the annuity from 50 to about 30 percent of basic pay in the early years of retirement, and then restoring the full 50 percent only when the retiree attains age 60. IAC would also require that annuities be based on the average basic pay in the three years in which the retiree's pay was highest. The current system bases one's annuity on terminal pay and RMA bases it on pay in the single highest year. The IAC plan should save over $2 billion per year in today's dollars by the year 2000.

Contributory Retirement. Neither RMA nor the IAC plan requires individuals to make retirement contributions, which is another way to reduce retirement costs. Contributory retirement systems are in effect in the federal civil service and in many private retirement plans. A compulsory military retirement system that required contributions of 7 percent of basic pay from all personnel, with refunds to those who leave before retirement, would save about $1.2 billion in fiscal year 1977. Savings assume that contributory retirement is imposed in addition to the social security payments currently required of military personnel.

Contributory retirement will reduce the pay of those remaining in the military until retirement. Therefore, it should reduce the number staying until retirement, which may be desirable. However, some of the reduction in careerists may be achieved by reducing first-term reenlistments, which probably is undesirable. One way to avoid this undesirable effect is to consider contributory retirement as part of a package of benefit reforms. Such a package could incorporate the desirable features of contributory retirement while modifying benefits to offset any undesirable consequences.

The effects of contributory retirement should be considered with other changes in compensation. For example, a package of changes that includes both a 7 percent contributory retirement and a military pay raise limited to 5 percent would actually reduce take-home pay. Although recruiting may remain at satisfactory levels for 1977 with both a pay cap and contributory retirement, higher pay increases than currently projected may be needed to avoid shortfalls by the end of the decade.

One Percent Kicker. Military retirement costs can be significantly reduced by less fundamental changes than comprehensive retirement reform. One such change is elimination of the "1 percent kicker," a feature of the current retirement law which causes annuities of those who have already retired (military and civilian) to grow at more than the rate of inflation.[5] By eliminating the 1 percent kicker, and thereby limiting growth to the rate of inflation, DoD can reduce costs of military retirement pay by about $90 million in fiscal year 1977; savings increase to over $600 million in fiscal year 1981. Eliminating the kicker would also help get rid of retirement pay "inversions," situations in which retirees receive a larger percentage pay raise than the active force.

Retirement Pay Cap. Even if the 1 percent kicker is eliminated, inflation will probably drive military retirement annuities up by more than 5 percent in fiscal year 1977. In addition to eliminating the 1 percent kicker, capping increases in retirement annuities at 5 percent would be a reasonable companion to a 5 percent cap on increases in active duty pay and would save an additional $200 million, with larger savings beyond fiscal year 1977. Moreover, capping both active duty and retirement pay increases would eliminate the unusually heavy retirements which occur when increases in retirement pay exceed those in active duty pay for several years.

Recomputation. Pending before Congress is legislation which would significantly increase retirement costs. Until 1958, retirement annuities were generally increased at the same rate as active duty pay; since then retirement pay has been adjusted based on growth in consumer prices. Since 1958, retirement pay has grown by 230 percent whereas active duty pay has grown by 430 percent; the difference is due primarily to large "catch-up" pay increases given active duty personnel in the early 1970s and to increases in the standard of living throughout the economy during this period. This large difference in rate of growth means that some personnel retiring today receive larger annuities than personnel with higher ranks and greater years of service who retired in earlier years.

This situation has resulted in suggestions that all retirement annuities be recomputed using current pay tables. In 1975 Congress considered a bill (S.1969) calling for a more limited form of recomputation. This bill would allow recomputation based on pay scales in effect in January, 1972, when the retiree reaches age 60. Even this limited recomputation will increase military retirement costs by about $550 million in fiscal year 1977, increasing to $1.0 billion by fiscal year 1980.

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5. This issue is discussed in greater detail in the General Government section of this chapter.

Major Alternatives. The individual alternatives that have been described can be combined in a number of ways:

Current Policy. Under a continuation of current policies, costs of pay and allowances for defense manpower increase from about $56 billion in fiscal year 1977 to about $76 billion in 1981 (see the following table). This growth reflects uncapped pay increases and rising pension benefits.

Higher Alternative. One higher alternative would be to modify current policy to allow limited recomputation for older retirees. This would increase budget costs by $0.5 billion in fiscal year 1977 and $1.0 billion in fiscal year 1981 (see the following table).

Lower Alternative. While the largest amounts can be saved by reform of military retirement benefits and by movement to a salary system, savings from these changes will only be realized after a number of years. In the short run, such changes could even increase costs. One alternative, limited to changes that will save money in fiscal year 1977, includes a two-year, 5 percent cap on pay and retirement benefits, compulsory 7 percent contribution to the military retirement program, elimination of the 1 percent kicker, and the package of other compensation changes that have been proposed by the President. Taken together these changes would reduce defense manpower expenditures by $4.2 billion in fiscal year 1977 and $7.7 billion in 1981 from the current policy projection levels (see the following table).

The President's Budget. The President's fiscal year 1977 budget for defense manpower is about $51.9 billion, or 7 percent below the current policy level of $55.8 billion.[6] By fiscal year 1981, the President's budget falls to 11 percent below the current policy level, largely because the President's economic projections assume 5 percent less inflation in the fiscal year 1977-81 period than is assumed in the current policy projections.

In fiscal year 1977, the President's budget reduces manpower costs primarily by cutting compensation. Savings of $1.7 billion are realized by redefining the formula used to compute comparability raises; this redefinition reduces the fiscal year 1977 comparability raise for military and general schedule civilian personnel from about 12 percent to 6.3 percent. However, the President does not propose even a 6.3 percent raise; instead he recommends a pay cap which is lower than the one discussed in this section. Raises would

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6. CBO estimates savings to be only $3.4 billion, however, or 6 percent of current policy costs.

DEFENSE MANPOWER ALTERNATIVES

BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Option	1977	1978	1981
CURRENT POLICY	55. 8	60. 9	75. 9
HIGH OPTION: Current Policy plus limited recomputation	56. 3	61. 6	76. 9
LOW OPTION: Current Policy less savings from options 1–4 [a]	51. 6	54. 8	68. 2
1. 5 percent pay cap in fiscal year 1977 and fiscal year 1978 (military and GS civilian)	−2. 2	−3. 7	−4. 7
2. 7 percent compulsory contributory military retirement	−1. 2	−1. 2	−1. 2
3. Cap fiscal year 1977 and fiscal year 1978 military retired pay at 5 percent; eliminate 1 percent kicker beyond fiscal year 1978	−0. 2	−0. 6	−1. 1
4. Additional compensation cuts in President's fiscal year 1977 budget	−0. 7	−0. 7	−0. 9
PRESIDENT'S BUDGET	51. 9 [b]	56. 1	67. 2

[a] Savings for the options taken together are less than the sum of savings from the separate options because the pay cap reduces savings from Options 2 and 3.

[b] Administration estimate. CBO's estimate of current policy manpower costs is $52.4 billion in fiscal year 1977, when adjusted for the President's pay proposals.

be limited to 4.7 percent for general schedule civilians, 4.5 percent[7] for military, and 3.4 percent for wage board civilians. The President's budget also reduces compensation of defense employees by cutting average military and civilian grades, enlistment bonuses, family housing, and some types of reserve pay. These changes, which were included also in the low option, save about $0.7 billion in fiscal year 1977. Finally, the President's budget would reduce retirement pay by eliminating the 1 percent kicker.

Several important elements of the President's proposed reductions of compensation--including the wage board cap and elimination of the 1 percent kicker--can be realized only if Congress changes existing law. Also, a majority vote of either House of Congress can prevent the cap on pay raises for military and general schedule civilians.

Although the largest reductions in the President's fiscal year 1977 budget come through cuts in compensation, the budget also recommends changes in numbers of personnel. By the end of fiscal year 1977, there are to be 26,000 fewer DoD civilians than at the end of the transition quarter. Numbers of reserves in paid drill billets are also to be cut. However, numbers of personnel on active duty will remain essentially unchanged. A Navy gain of 12,000 is balanced by an equal reduction in the Air Force.

Major Defense Options

The alternative programs illustrated in the foregoing pages are not strongly interdependent, and can be grouped in different ways depending on the assessments of the merits of particular cases. Those who anticipate a high likelihood of contingencies that would call for a large Navy to assert wartime control of the seas might also be likely to see an important need for strategic capabilities beyond deterrence of an enemy first strike. Those who consider a long war in Europe so unlikely that 13 divisions of Army and three of Marine Forces would suffice might also be likely to feel little need for strategic capabilities beyond first-strike deterrence. It would also be quite consistent, however, to favor higher expenditures for general purpose forces and lower for strategic or vice versa.

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7. The effective raise for military personnel is lower than that for general schedule civilians because DoD intends to recoup part of the military raise by charging more for housing provided to some military personnel.

In order to show the size of the difference in defense budgets that results from accepting either all of the higher alternatives or all of the lower alternatives, two options with the following major features have been put together.

Current Policy Option. If current defense spending is increased to take account of inflation, budget authority and outlays for fiscal year 1977 will amount to $111 billion and $103.4 billion respectively (see the following table). By fiscal year 1981, both would grow by about $30 billion.

The Declining Forces Option. This option consists of:

*400-ship Navy
*13 active Army divisions
*22 USAF and 10 USN tactical air wings
*10 percent reduction in military R&D
*Lower strategic nuclear force alternative
*Lower manpower option

Compared to the current policy projections budget authority and outlays under this option would be $3.8 and $5.1 billion lower in fiscal year 1977 (see the following table). By fiscal year 1981 budget authority and outlays under this option would be $0.8 billion and $4.1 billion below current policy levels.

The Increasing Forces Option. This option includes:

*600-ship Navy
*16 active Army divisions
*26 USAF and 13 USN tactical air wings
*10 percent increase in military R&D
*Higher strategic nuclear force alternative
*Higher manpower option

In fiscal year 1977, budget authority and outlays would have to be $11.3 billion and $2.7 billion above current policy levels to achieve this option (see the following table). Five years later the comparable numbers would be $27.2 billion and $22.2 billion.

The President's Option. The option contained in the fiscal year 1977 budget consists basically of:

*500-ship Navy
*16 active Army divisions
*26 USAF and 12 USN tactical air wings
*8 percent increase in military R&D
*Baseline strategic force posture
*Manpower option somewhat higher than the CBO's low option

The cost implication of this option falls between the current policy option and the increasing forces option and involves for fiscal year 1977 budget authority that is $3.9 billion over current policy levels but outlays $2.3 billion lower than current policy levels. The reasons for this were discussed in the introduction to this section. By fiscal year 1981 budget authority under the President's program is $12 billion above current policy levels and outlays are $7.2 higher than these levels.

NATIONAL SECURITY BUDGET OPTIONS,[a]
OUTLAYS
AND BUDGET AUTHORITY (in parentheses)
FISCAL YEARS 1977 AND 1981
(Billions of dollars)

Option	1977	1981
Current Policy	103.4 (111.0)	135.6 (139.5)
Changes from Current Policy Level:		
1. Declining Forces Option	-5.1 (-3.8)	-4.1 (-0.8)
2. Increasing Forces Option	2.7 (11.3)	22.2 (27.2)
3. President's Budget Option	-2.3 (3.9)	7.2 (12.0)

a. For greater detail see summary tables.

SUMMARY TABLE: NATIONAL DEFENSE (050)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
Current policy	86. 7	91. 9	24. 8	103. 4	114. 5	118. 0	127. 2	135. 6
High option (increasing forces)				106. 1	118. 7	131. 1	144. 6	157. 8
Low option (declining forces)				98. 3	105. 8	112. 8	121. 9	131. 5
President's budget	86. 6	92. 8	25. 0	101. 1	112. 9	121. 5	132. 4	142. 8

SUMMARY TABLE: NATIONAL DEFENSE (050)

BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976	Transition quarter	1977	1978	1979	1980	1981
Current policy	92. 2	101. 0	24. 0	111. 0	118. 3	125. 3	132. 3	139. 5
High option (increasing forces)				122. 3	131. 2	144. 2	156. 0	166. 7
Low option (declining forces)				107. 2	111. 1	119. 5	128. 1	138. 7
President's budget	91. 9	102. 3	23. 4	114. 9	122. 4	131. 9	141. 6	151. 5

SUMMARY TABLE: COST IMPLICATIONS OF MAJOR NATIONAL DEFENSE OPTIONS (050)[a]

CURRENT YEAR OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1977	1978	1979	1980	1981
HIGH OPTION (increasing forces):					
600 ships		+0.2	+0.8	+1.2	+1.5
16 divisions	+0.3	+0.7	+1.1	+1.4	+1.5
26 USAF and 13 USN tactical air wings			+0.1	+0.2	+0.4
High strategic option		+0.1	+0.3	+0.8	+1.4
High manpower option	+4.4	+4.5	+6.9	+8.2	+9.7
Plus 10 percent R & D	+0.3	+0.3	+0.4	+0.4	+0.5
Total	**+5.0**	**+5.9**	**+9.6**	**+12.2**	**+15.0**
LOW OPTION (declining forces):					
400 ships	−0.2	−1.0	−1.6	−2.5	−3.3
13 divisions		−0.6	−0.7	−0.8	−0.9
22 USAF and 10 USN tactical air wings	−0.4	−1.3	−2.0	−2.7	−3.1
Low strategic option	−0.2	−1.0	−1.9	−2.5	−3.0
Low manpower option	−0.3	−1.3	−0.5		+1.0
Minus 10 percent R & D	−1.7	−1.9	−2.0	−2.0	−2.0
Total	**−2.8**	**−7.1**	**−8.7**	**−10.5**	**−11.3**

[a] Cost implications are shown relating to the President's fiscal year 1977 budget and accompanying projections.

SUMMARY TABLE: COST IMPLICATIONS OF MAJOR NATIONAL DEFENSE OPTIONS (050) [a]

CURRENT YEAR BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Options	1977	1978	1979	1980	1981
HIGH OPTION (increasing forces):					
600 ships	+2.2	+2.8	+2.5	+2.2	+0.7
16 divisions	+0.3	+0.8	+1.1	+1.4	+1.5
26 USAF and 13 USN tactical air wings	----------	+0.1	+0.3	+0.5	+0.5
High strategic option	+0.2	+0.3	+1.1	+1.7	+2.3
High manpower option	+4.4	+4.5	+6.9	+8.2	+9.7
Plus 10 percent R & D	+0.3	+0.3	+0.4	+0.4	+0.5
Total	**+7.4**	**+8.8**	**+12.3**	**+14.4**	**+15.2**
LOW OPTION (declining forces):					
400 ships	−2.5	−3.2	−4.1	−4.8	−6.6
13 divisions	−0.3	−0.8	−0.9	−0.9	−0.9
22 USAF and 10 USN tactical air wings	−1.3	−2.1	−2.1	−2.7	−1.0
Low strategic option	−1.6	−2.0	−2.8	−3.1	−3.3
Low manpower option	−0.3	−1.3	−0.5	----------	+1.0
Minus 10 percent R & D	−1.7	−1.9	−2.0	−2.0	−2.0
Total	**−7.7**	**−11.3**	**−12.4**	**−13.5**	**−12.8**

[a] Cost implications are shown relative to the President's fiscal year 1977 budget and accompanying projections.

PART II-1: PROGRAM ISSUES
SECTION A: NATIONAL SECURITY AND INTERNATIONAL AFFAIRS

International Affairs (Function 150)

Introduction

The largest portion of federal spending for international affairs (function 150) is devoted to foreign economic and financial assistance (see following table). Bilateral and multilateral development assistance, food aid under P.L. 480, the Peace Corps and such security supporting assistance as the aid for the Middle East fall in this category. The conduct of foreign affairs and the promotion of American exports through the Export-Import Bank constitute additional major budget items in the international affairs area. Military assistance, which is included in the national defense budget function and consists mainly of foreign military credit sales, represents a related kind of budget expenditure.

Outlays for international affairs are estimated to be $4.9 billion or 1.3 percent of the budget total in fiscal year 1976. Even excluding the special aid for Vietnam in the past, the relative budgetary importance of international affairs has declined over the past decade. The current policy projections indicate that it will take $9.9 billion in fiscal year 1981 to maintain approximately the same real level of spending in this area.

Tax expenditures in the international affairs area are estimated to reduce federal revenues by $2.1 billion in fiscal year 1976. The largest of the tax expenditures is the deferral of taxes on income earned by domestic international sales corporations (corporations which derive at least 95 percent of their gross receipts from exports). Other tax expenditures include the exclusion of income earned abroad by U.S. citizens, the deferral of tax on income earned by foreign subsidiaries of U.S. corporations, special tax rates for corporations doing all of their business outside of the United States but inside the Western Hemisphere, and preferred tax treatment for subsidiaries of U.S. corporations operating in less developed countries.

Foreign Economic and Financial Assistance

Development Assistance. Under the "New Directions" policy adopted by Congress in 1973, development assistance is to be aimed principally at helping the poorest peoples of the world overcome the problems of malnutrition, overpopulation, illiteracy, and poor health. The objectives of development aid are also defined by a desire to influence the behavior of

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INTERNATIONAL AFFAIRS OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1976, 1981 (FUNCTION 150)
(Billions of Dollars)

	1966	1976	1981[a]
Foreign Economic and Financial Assistance (151)	$4.0[b]	$4.1	$6.3
Conduct of Foreign Affairs, Foreign Information and Exchange Activities (152, 153)	0.6	1.1	1.6
International Financial Programs Export-Import Bank (155)	0.4	(1.5)[c]	2.6
Less Offsetting Receipts	0.1	0.4	0.5
Total (150)	4.1	4.9	9.9
Percent of Total Outlays	3.1%	1.3%	1.8%
Military Assistance (050)	$1.1	$1.6	$1.7
Tax Expenditures	NA	2.1	2.4

a. Current policy levels.

b. Excludes all aid to Vietnam.

c. The Export-Import Bank was carried as an off-budget agency in fiscal year 1976 and its outlays are not included in that year's total.

NA: Not available.

other countries in international forums, in regional conflicts, or in bilateral relations with the United States. At present, development assistance is directed through bilateral as well as multilateral channels. Multilateral channels include several international financial institutions, such as the International Development Association and the Inter-American Development Bank, as well as the United Nations Development Program.

In recent years, a strong concern has been expressed about the size and effectiveness of U.S. foreign aid programs. The amount of aid provided is too small to have a substantial impact on the problems to which it is addressed. Moreover, some critics feel that the strings and conditions under which development assistance is provided constitute an unwarranted intrusion by the United States into the affairs of other countries. At the same time, many developing nations are becoming increasingly hostile toward the foreign policies of the United States. The major issue with regard to development assistance, therefore, is whether present U.S. efforts are sufficiently desirable and effective to be worth continuing, and the major decision confronting Congress is whether the United States should increase or decrease this type of aid over the next several years.

Assistance Levels and Forms. Since it is impossible to determine analytically an appropriate size for the U.S. development assistance effort, debate has focused on simple rules of thumb. United Nations resolutions have affirmed a target of 0.7 percent of GNP for developed countries. The United States contribution is currently about 0.14 percent. Matching the U.N. target figure would mean an increase of more than $10 billion per year.

Increased aid could be either principally bilateral or multilateral. A bilateral emphasis would rest on the argument that the United States has particular expertise in some areas, particularly in agriculture, and can therefore achieve better results than multilateral agencies. Bilateral programs can also guarantee that adequate attention is paid to the needs of countries with which the U.S. has special geographic, economic, or political ties. Alternatively, increased aid could be channeled through multilateral agencies such as the World Bank and the United Nations Development Program. This method implies less political entanglement and is usually preferred by the developing countries. Although these channels insulate the U.S. from political ties, the United States does have some political influence in the World Bank and United Nations agencies because of its membership on the governing boards. The multilateral approach also takes advantage of the particular expertise of the international financial institutions in large capital development projects.

Aid to the Middle East

Security supporting assistance is nearly as large as development assistance, but is directed almost entirely to the countries of the Middle East. Here it is used for capital projects, to pay for needed imports, and to provide general support for national budgets.

The Middle East presents the United States with a set of interrelated and intractable problems for aid and military assistance policy. Israel and the Arab states have fought four wars in 25 years. The Interim Agreement of September, 1975, represents movement toward a settlement between Egypt and Israel, but a corresponding agreement between Syria and Israel over the Israeli-occupied Golan Heights will be difficult to achieve. The Egyptian-Israeli disengagement arrangements could also be endangered by political changes in either country or by failure to make progress toward a general settlement.

In such a situation, all of the options open to the United States involve substantial costs and risks. The current policy, which supports the interim agreement, is costly in aid requirements and risks an arms buildup in Egypt, Syria, and Israel that would make a next war more destructive than the last. But a collapse of the current arrangement might lead to a war even sooner, possibly one involving direct conflict between the United States and the USSR. That risk must be weighed against the costs of the assistance program; evaluation of the program should include assessment of its contribution to peace and stability.

The Middle East Agreement of September, 1975, calls upon the United States to be "fully responsive" to the defense, energy, and economic needs of Israel "on an ongoing and long-term basis." According to President Ford, the agreement also contains an implied commitment on the part of the United States to assist the Egyptian economy as well as to consider arms sales to Egypt.

With these obligations in mind, the Administration requested new budget authority in fiscal year 1976 of $2.73 billion to finance Middle East economic and military assistance programs (see following table). Of this amount, $1.67 billion is for security supporting assistance, which is in the international affairs (150) function. The remainder is for military assistance, within the national defense (050) function (see following table).

U.S. aid will enable Israel to acquire substantial quantities of modern arms. Egyptian and Syrian forces are likely to grow as well. Egypt, for example, is procuring tanks and fighter bombers from England and France. Syria has relied principally on Soviet supplies.

ECONOMIC AND MILITARY ASSISTANCE REQUESTED FOR MIDDLE EAST COUNTRIES, FISCAL YEAR 1976
(Millions of Dollars)

BUDGET AUTHORITY

	Military (050)	Economic (150)	Total[b]
Israel	825.0[a]	755.0	1,580.0
Egypt	0.0	750.0	750.0
Syria	0.0	90.0	90.0
Jordan	175.8	77.5	253.3
Lebanon	5.2	0.0	5.2
Special Requirements Fund	0.0	50.0	50.0
Totals	1,006.0	1,722.5	2,728.4

a. This budget authority will support a military sales program for Israel of $1.5 billion.

b. Totals exclude $181 million of assistance under P.L. 480 food assistance, assistance to American schools and hospitals abroad, housing guarantees, and assistance to refugees from the Soviet Union.

The Arab countries still outnumber Israel in both manpower and equipment. This numerical advantage, however, has been offset in past wars by Israel's higher quality of weaponry and fighting efficiency, especially in the area of combat aircraft, armored forces, and artillery. Israel has made good various qualitative deficiencies seen in her forces during the October War of 1973. Egypt and Syria have also improved their combat capabilities since the October War, although the effectiveness of these changes is hard to assess. Syria has acquired a limited number of MIG 23s from the Soviet Union, and the quality of Syrian training and organization reputedly has risen. The military balance is now probably no less favorable to Israel than it was in October 1973, but such a judgment rests on a weighing of highly uncertain organizational and qualitative advantages on the Israeli side against the quantitative superiority of the other side.

It is doubtful that the present balance in the Middle East could be maintained without continuing American assistance. Given the pressures on the Israeli economy, continuing U.S. aid appears to be important to Israel's security. At the same time, sustained, very high levels of aid to Israel might appear to shift the military balance in the Middle East more to Israel's favor. In this situation the Arab countries may seek once again to build up their own forces, with the help of the Soviet Union, the countries of Western Europe, or the United States itself. In any case, it should be emphasized that a military balance does not guarantee that future war in the Middle East can be prevented; in October 1973, Egypt and Syria were not deterred from war by a military balance thought to be strongly in favor of Israel.

International Financial Programs

The Export-Import Bank will again be placed in the budget in fiscal year 1977. The purpose of the bank is to promote American exports, primarily by extending loans to foreign purchasers of U.S. products. While the bank's role in East-West trade has received considerable attention, the major borrowers have been the Western industrialized countries. Recently, there has been considerable debate over the character and worth of the bank's operations.

The broad objectives of the bank are to help the U.S. balance of payments, to promote economic stability, to counter the export promotion programs of other governments, to further U.S. foreign policy interests, and to enhance U.S. gains from trade.

Criticism of the bank has focused on the following points:

(1) The bank's operations result in a subsidy benefiting U.S. suppliers, foreign purchasers, and U.S. banks. These may not be groups the United States wants to subsidize.

(2) Arguments supporting export subsidies are weakened now that the exchange rate is floating rather than fixed.

(3) It is hard to demonstrate, in any case, that the activities of the bank have resulted in a significant increase in exports.

Budget Options

The budget options described below are illustrative of the wide range of alternatives open in the international affairs area and the related military assistance programs.

INTERNATIONAL AFFAIRS BUDGET OPTIONS
BUDGET AUTHORITY AND OUTLAYS (IN PARENTHESES)[a]
(Billions of Dollars)

	1977	1981
Current Policy	9.5 (6.8)	12.3 (9.9)
Changes from Current Policy Level:		
High Option	+0.5 (0.2)	+8.4 (5.4)
Low Option	-0.9 (-0.2)	-8.9 (-6.0)
President's Budget	+0.2 (0.0)	

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a. For greater detail see summary table.

Current Policy. A continuation of current policy would imply budget authority and outlays for fiscal year 1977 of $9.5 billion and $6.8 billion respectively (see the preceding table). The corresponding levels for military assistance, which is part of the national defense budget function, would be $1.4 billion and $0.8 billion. By fiscal year 1981 the budget authority and outlays required to maintain current policy in the international affairs area would grow to $12.3 billion and $9.9 billion.

High Option. One alternative that involves an increased budget commitment to International Affairs could include:

- An increase by 1981 in development assistance to 0.42 percent of the GNP. This level is half way between the current U.S. effort and the U.N. goal.

- The current policy level of both military and security supporting assistance to the Middle East. This level reflects the increased requests made in fiscal year 1976.

- Continuation of the present program activity of the Export-Import Bank which has expanded to meet the demand for services. The current requested limitation on new program activity is $6.3 billion in fiscal year 1977, an increase of 13 percent over fiscal year 1976 levels. This level of program activity would require $3.3 billion in new budget authority in fiscal year 1977. (Most of the outlays from this, of course, will be for loans, which will be repaid with interest.)

In budget authority and outlays this option would cost $0.5 billion and $0.2 billion over current policy levels in fiscal year 1977 and reach $8.0 billion and $5.4 billion more than the baseline by fiscal year 1981 (see previous table).

Low Option. An alternative requiring a reduced level of budget commitment could include:

- A reduction of U.S. development assistance to the level required to make nominal contributions to the international financial institutions such as the World Bank.

- A phaseout of all assistance to the Middle East over the next five years.

- A gradual termination of the operations of the Export-Import Bank.

The option would save $0.9 billion in budget authority and $0.4 billion in outlays from the current policy in fiscal year 1977 (see previous table).

The President's Budget. The President proposes an overall reduction in development assistance for fiscal year 1977. While budget authority for bilateral aid increases slightly, budget authority requested for multilateral assistance programs declines by about $300 million in the fiscal year 1977 budget. This change is accounted for by reduced participation in U.N. development activities as well as the fact that new budget authority for the International Fund for Agricultural Development is not necessary in fiscal year 1977.

The President's budget for fiscal year 1977 proposes Middle East assistance levels somewhat lower than in fiscal year 1976, that is, about $2.9 billion, counting foreign military sales at "program" level. The Administration has also indicated that its request for Middle East assistance will likely remain at these levels in each of the next several years. Aid levels of this order are seen as strengthening Israel militarily and helping it to deter, as well as to counter, if need be, future Arab attack. Increased American assistance to Egypt and Syria may foster improved relations with those countries and perhaps encourage them to adopt more moderate policies toward Israel. By increasing assistance to the Arab countries, as well as Israel, the United States also seeks to limit the influence of the Soviet Union in the area, while increasing its own influence and capacity to mediate the Middle East conflict.

The President's budget also increases the current program activity of the Export-Import Bank by approximately 13 percent. Overall the budgetary impact of the President's request differs little from the current policy levels for fiscal year 1977 (see previous table).

SUMMARY TABLE: INTERNATIONAL AFFAIRS (150) [a]

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 150 items:								
Development assistance (151 part)	1.1	1.8	0.4	2.1	2.3	2.5	2.7	2.8
Security assistance to Middle East [b] (151 part)	0.4	1.1	0.2	1.4	1.8	2.0	2.1	2.2
Export-Import Bank (155)	(1.5)	(1.5)	(0.4)	1.6	1.8	2.1	2.4	2.6
Total Current Policy Option: International Affairs	**4.4**	**4.9**	**1.4**	**6.8**	**7.8**	**8.5**	**9.3**	**9.9**
HIGH OPTION								
Function 150 items:								
Development assistance (151 part)	1.1	1.8	0.5	2.2	3.0	4.3	6.0	8.1
Security assistance to Middle East [b] (151 part)	0.4	1.1	0.2	1.4	1.8	2.0	2.1	2.2
Export-Import Bank (155)	(1.5)	(1.5)	(0.4)	1.6	1.8	2.1	2.4	2.6
Total High Option: International Affairs	**4.4**	**4.9**	**1.4**	**7.0**	**8.6**	**10.4**	**12.7**	**15.3**

See footnotes at end of table.

SUMMARY TABLE: INTERNATIONAL AFFAIRS (150) [a]—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 150 items:								
Development assistance (151 part)	1.1	1.8	0.4	1.9	2.0	1.9	1.6	1.4
Security assistance to Middle East [b] (151 part)	0.4	1.1	0.1	1.4	1.4	1.1	0.7	0.3
Export-Import Bank (155)	(1.5)	(1.5)	(0.4)	1.4	1.1	0.7	0.3	−0.2
Total Low Option: International Affairs	**4.4**	**4.9**	**1.2**	**6.6**	**6.4**	**5.8**	**4.9**	**3.9**
PRESIDENT'S BUDGET								
Function 150 items:								
Development assistance (151 part)	1.1	2.2	0.6	2.1				
Security assistance to Middle East [b] (151 part)	0.4	1.1	0.1	1.3				
Export-Import Bank (155)	(1.5)	(1.4)	(0.4)	1.3				
Total President's Budget: International Affairs	**4.4**	**5.7**	**1.3**	**6.8**				

[a] Subtotals do not add to totals, which also include the conduct of foreign affairs (152), foreign information and exchange activities (153) and other foreign assistance (151).

[b] Does not include military assistance, which is in the national defense function.

SUMMARY TABLE: INTERNATIONAL AFFAIRS (150) [a]

BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 150 items:								
Development assistance (151 part)	1.4	2.3	0.3	2.5	2.7	2.8	3.0	3.1
Security assistance to Middle East [b] (151 part)	0.8	1.7	0.1	1.8	2.0	2.1	2.2	2.3
Export-Import Bank (155)	(1.4)	(3.2)	(0.8)	3.4	3.7	3.9	4.2	4.4
Total Current Policy Option: International Affairs	**4.4**	**6.0**	**1.0**	**9.5**	**10.3**	**11.0**	**11.6**	**12.3**
HIGH OPTION								
Function 150 items:								
Development assistance (151 part)	1.4	2.3	0.4	3.0	4.6	6.6	9.0	11.6
Security assistance to Middle East [b] (151 part)	0.8	1.7	0.1	1.8	2.0	2.1	2.2	2.3
Export-Import Bank (155)	(1.4)	(3.2)	(0.8)	3.4	3.7	3.9	4.2	4.4
Total High Option: International Affairs	**4.4**	**6.0**	**1.1**	**10.0**	**12.2**	**14.7**	**17.6**	**20.7**

See footnotes at end of table.

SUMMARY TABLE: INTERNATIONAL AFFAIRS (150) [a]—Continued

BUDGET AUTHORITY—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 150 items:								
Development assistance (151 part)	1.4	2.3	0.2	2.2	2.0	1.6	1.2	1.0
Security assistance to Middle East [b] (151 part)	0.8	1.7	0.1	1.6	1.2	0.8	0.4	0.0
Export-Import Bank (155)	(1.4)	(3.2)	(0.6)	3.0	2.4	1.6	0.8	0.0
Total Low Option: International Affairs	**4.4**	**6.0**	**0.9**	**8.6**	**7.5**	**6.0**	**4.6**	**3.4**
PRESIDENT'S BUDGET								
Function 150 items:								
Development assistance (151 part)	1.4	2.5	0.3	2.3				
Security assistance to Middle East [b] (151 part)	0.8	1.7	0.1	1.7				
Export-Import Bank (155)	(1.4)	(2.6)	(0.6)	3.3				
Total President's Budget: International Affairs	**4.4**	**6.5**	**0.9**	**9.7**				

[a] Subtotals do not add to totals, which also include the conduct of foreign affairs (152), foreign information and exchange activities (153) and other foreign assistance (151).

[b] Does not include military assistance, which is in the national defense function.

SUMMARY TABLE: MILITARY ASSISTANCE PORTION OF NATIONAL DEFENSE FUNCTION (050)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Military assistance to the Middle East	[a] 1.1	[a] 0.8	[a] 0.1	[a] 0.5	0.8	0.9	1.0	1.1
Other military assistance	0.6	0.7	0.1	0.3	0.2	0.3	0.4	0.4
Total Current Policy Option: Military Assistance	**[b] 1.7**	**1.5**	**0.2**	**0.8**	**1.0**	**1.2**	**1.4**	**1.4**
HIGH OPTION								
Military assistance to the Middle East	[a] 1.1	[a] 0.8	[a] 0.1	[a] 0.5	0.8	0.9	1.0	1.1
Other military assistance	0.6	0.7	0.1	0.3	0.2	0.3	0.4	0.4
Total High Option: Military Assistance	**[b] 1.7**	**1.5**	**0.2**	**0.8**	**1.0**	**1.2**	**1.4**	**1.4**
LOW OPTION								
Military assistance to the Middle East	[a] 1.1	[a] 0.8	[a] 0.1	[a] 0.5	0.7	0.6	0.4	0.3
Other military assistance	0.6	0.7	0.1	0.3	0.2	0.3	0.4	0.4
Total Low Option: Military Assistance	**[b] 1.7**	**1.5**	**0.2**	**0.8**	**0.9**	**0.9**	**0.8**	**0.7**
PRESIDENT'S BUDGET								
Military assistance to the Middle East	[a] 1.1	[a] 1.3	[a] 0.2	[a] 0.7				
Other military assistance	0.6	0.8	0.1	0.4				
Total President's Budget: Military Assistance	**[b] 1.7**	**2.1**	**0.3**	**1.1**				

[a] Includes emergency security assistance for Israel authorized in 1974.
[b] Excludes assistance to Vietnam.

NOTE.—Military assistance portion of national defense function also includes trust fund (advances, foreign military sales) and offsetting receipts not shown in table.

SUMMARY TABLE: MILITARY ASSISTANCE PORTION OF NATIONAL DEFENSE FUNCTION (050)—Continued

BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Military assistance to the Middle East	0.2	0.9	(b)	1.0	1.1	1.1	1.2	1.3
Other military assistance	0.7	0.4	0.1	0.4	0.4	0.4	0.5	0.5
Total Current Policy Option: Military Assistance	[a] **0.9**	**1.3**	**0.1**	**1.4**	**1.5**	**1.6**	**1.7**	**1.7**
HIGH OPTION								
Military assistance to the Middle East	0.2	0.9	(b)	1.0	1.1	1.1	1.2	1.3
Other military assistance	0.7	0.4	0.1	0.4	0.4	0.4	0.5	0.5
Total High Option: Military Assistance	[a] **0.9**	**1.3**	**0.1**	**1.4**	**1.5**	**1.6**	**1.7**	**1.7**
LOW OPTION								
Military assistance to the Middle East	0.2	0.9	(b)	0.8	0.6	0.4	0.2	0.0
Other military assistance	0.7	0.4	0.1	0.4	0.4	0.4	0.5	0.5
Total Low Option: Military Assistance	[a] **0.9**	**1.3**	**0.1**	**1.2**	**1.0**	**0.8**	**0.7**	**0.5**
PRESIDENT'S BUDGET								
Military assistance to the Middle East	0.2	0.9	(b)	0.6				
Other military assistance	0.7	0.6	0.1	0.5				
Total President's Budget: Military Assistance	[a] **0.9**	**1.5**	**0.1**	**1.1**				

[a] Excludes assistance to Vietnam.
[b] Less than $50 million.

NOTE.—Military assistance portion of national defense function also includes trust fund (advances, foreign military sales) and offsetting receipts not shown in table.

Income Assistance (Function 600+)

Introduction

The federal government engages in many programs that transfer resources to individuals. For the most part such activity is encompassed in the Income Security (600) budget function. However, one cannot fully comprehend the government's role in the income assistance area without considering other income assistance programs for the poor, such as medicaid and veterans pensions, found elsewhere in the budget.

There are two broad categories of income assistance--contributory and noncontributory programs. Contributory programs, which account for three-fourths of income assistance spending, include social security, civil service and railroad retirement, and unemployment insurance. These programs are financed by contributions or taxes from employees and employers and provide payments to workers (or their survivors or dependents) based on the employee's work history. Social security is by far the largest of these programs, accounting for about one-fifth of the federal budget and providing payments to over 31 million persons.

The noncontributory income assistance programs are directed primarily at low income persons, whose eligibility is determined by amount of income, assets and needs, and are financed from general revenues. Medicaid, food stamps, aid to families with dependent children (AFDC), and supplementary security income (SSI) are the most costly of the noncontributory programs. Some of the noncontributory programs are administered and partially financed by state and local governments.

In addition to the contributory and noncontributory programs there are 25 tax expenditures in the income assistance area. These include the nontaxable nature of the benefits provided by income assistance programs, sick pay, pension contributions and earnings, and other employee benefits. The list of income assistance tax expenditures also includes the extra exemptions provided to the aged and blind, the earned income credit, and a number of smaller tax preferences. Altogether these tax expenditures are expected to reduce federal revenues by roughly $23 billion in fiscal year 1976.[1]

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1. For a discussion of the limitations of tax expenditure estimates see page 381.

Over the past two decades federal expenditures for these income assistance programs have grown rapidly; spending has increased more than tenfold while the part of the budget devoted to such programs has increased from 15 percent in fiscal year 1956 to an estimated 37 percent in fiscal year 1976 (see following table). This rapid growth has occurred for a variety of reasons: new programs have been created, benefits of both new and existing programs have been made more generous, the populations eligible for income assistance programs have expanded and more of those who are eligible for benefits have asked to receive them. While income assistance expenditures will no doubt continue to grow, real benefit levels can be maintained under existing programs if spending grows at only a slightly faster pace than that of the current policy budget as a whole.

Because the issues raised by the contributory and noncontributory programs are fundamentally different, the two types of programs are treated separately. The discussion of contributory programs focuses exclusively on the social security program. Unemployment insurance, federal employees retirement programs, and military retirement programs are analyzed in other sections of this chapter.

Contributory Programs: The Case of Social Security

A number of the contributory income assistance programs face a growing imbalance between projected benefit payments and expected revenues collected in their trust funds. Concern over the solvency of the social security trust funds has received the greatest amount of attention. These trust funds are financed by a payroll tax (currently 9.9 percent) on all earnings up to $15,300 in 1976. However, the amount of earnings that is taxed is scheduled to increase as average wages rise.

Benefits, which in 1975 averaged $205 a month for retired workers and $225 for the disabled are paid out of the trust funds. Benefit payments are automatically increased to reflect increases in the cost of living.

The extraordinary combination of high inflation and a deep recession experienced during 1974 and 1975 has caused the social security trust funds to accumulate reserves much more slowly than anticipated. Because of this slowdown in the accumulation of funds and because of revised estimates of future reserves based on less optimistic economic forecasts for the next several years, the trustees of the social security trust funds forecast in May of 1975 that, beginning in 1976, the funds would pay out more in benefits than they received in revenues, continuing each year until the reserves of the Old Age and Survivors Insurance (OASI) and Disabled Insurance (DI) funds would be depleted by the early 1980s (see table page 130). More recent estimates made by both the Administration and CBO indicate that the pace of depletion will slow down and

INCOME ASSISTANCE OUTLAYS AND TAX EXPENDITURES

[Billions of dollars, fiscal years, path B]

	1956	1966	1976 [c]	1981 [c]
Income Security (600)				
Contributory Programs:				
Social security (601 part)	$5.6	$20.2	$72.7	$120.7
Railroad retirement (601 part)	0.6	1.2	3.4	4.2
Civil service retirement (602)	0.5	1.7	8.6	16.8
Unemployment insurance (603)	1.4	2.3	19.9	15.8
Total Contributory	**8.1**	**25.4**	**104.6**	**157.5**
Noncontributory Programs:				
AFDC (604 part)	0.4	1.2	5.8	8.6
Food stamps [a] (604 part)	0.1	0.2	5.9	10.4
SSI [a] (604 part)	1.1	1.6	5.5	8.9
Housing assistance (604 part)	[b] 0.0	0.2	2.6	8.0
Child nutrition (604 part)	0.1	0.3	2.7	4.3
Total Noncontributory	**1.6**	**3.5**	**22.5**	**40.2**
Other Income Security (600)	0.2	0.1	1.1	1.5
Total Income Security (600)	**10.0**	**29.0**	**128.2**	**199.2**
Other Income Assistance for the Poor:				
Medicaid (551 part) [a]	0.1	0.8	8.3	14.0
Veterans pensions (701)	0.8	1.9	3.0	3.6
Total Income Assistance	**10.9**	**31.7**	**139.5**	**216.8**
Percent of Total Outlays	15.5%	23.6%	37.2%	38.5%
Tax Expenditures	NA	NA	$22.8	$32.5

[a] For 1956 and 1976 includes commodity distribution; aid to the aged, blind and disabled; and medical vendor payments.
[b] Zero due to rounding.
[c] Current policy levels
NA: Not available.

Source: *Five-year Budget Projections, Fiscal Years 1977–81* Congressional Budget Office, and the *Budget of the United States* for 1958 and 1977.

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COMBINED ALTERNATIVE PROJECTIONS OF THE OASDI TRUST FUNDS [a]

[Billions of dollars, fiscal years]

	1975 actual	1976 est.	TQ (est.) [c]	1977	1978	1979	1980	1981
Trustees Report (May 1975):								
Annual Surplus or Deficit	+1.7	−5.0	−2.0	−5.1	−5.3	−6.0	NA	NA
Reserve [b]	47.8	42.8	40.8	35.7	30.4	24.4	NA	NA
Congressional Budget Office (January 1976):								
Annual Surplus or Deficit	+2.0	−2.9	−1.7	−5.2	−4.1	−3.7	−2.7	+1.9
Reserve [b]	48.2	45.3	43.6	38.4	34.3	30.6	27.9	29.8
President's Budget:								
Current Law Basis (January 1976):								
Annual Surplus or Deficit	+2.0	−3.0	−1.0	−3.5	−3.9	−3.0	−2.3	−1.5
Reserve [b]	48.2	45.2	44.1	40.6	36.7	33.7	31.4	29.9
President's Budget:								
With Proposed Tax Increase and Benefit Reductions								
Annual Surplus or Deficit	+2.0	−3.0	−1.0	+0.8	+3.2	+5.8	+8.1	+10.7
Reserve [b]	48.2	45.2	44.1	44.9	48.1	53.9	62.0	72.7

[a] The economic assumptions underlying these estimates are detailed in *The Trustees Report*, the *Budget of the U.S. Government, Fiscal Year 1977* and the Congressional Budget Office, *Five-Year Projections, Fiscal Years 1977–81*, January 26, 1976.

[b] End of fiscal years.

[c] TQ: Transition Quarter.

that reserves will begin to stabilize in the early 1980s. The projected stabilization of the funds does not resolve the question of whether additional action needs to be taken to build the funds up further. It is also important to note that these estimates project a loss of over one-third of the reserves in the trust funds between 1975 and 1980.

If the decision is made to build up the reserves of the funds, the effects on the long-range condition of the system must be considered. The trustees' report indicates that the trust funds are even now accumulating a future deficit that is of a different nature and far more serious than the short-run problem of year-to-year imbalances between revenues and outlays. A large part of this future deficit is the result of a feature of the benefit formula which overcompensates future beneficiaries for the effects of inflation occurring during their working years. If this feature were removed without changing the tax rate or reducing benefits, half the anticipated long-run deficit would be eliminated.

Alternatives for the Short Run. The basic issue is whether there is an immediate need for remedial action or whether there is time to develop a remedy adequate to solve both the short- and long-term problems. Here are some of the alternatives that could be considered.

Any action could be delayed for a year or two--Arguments for this approach include the fact that current estimates indicate a substantial, although significantly diminished, reserve at the end of fiscal year 1981. In addition it is possible that any tax increase in fiscal year 1977 would tend to retard economic recovery (and a payroll tax increase would be particularly unfortunate because it tends to increase inflation by increasing labor costs). However, should the current estimates prove too optimistic, tax and benefit adjustments could still be made in a year or two without endangering the future stability of the funds. A delay would also provide time for a better assessment of the short-term financial condition of the funds and for the development of a short-term plan that would be consistent with long-term considerations. In the end this could be a better way to restore public confidence than numerous short-run adjustments.

Limited changes could be made in the tax structure to eliminate the trust funds' short-term deficits--Arguments which favor an increase in taxes now include the fact that current economic assumptions may be too optimistic and that public confidence would be improved if action were taken now to increase the reserve fund above currently projected levels. In addition there may be unforeseen outlay increases from the trust funds for which no contingency has been made. Increasing the tax rate would distribute the burden to all taxpayers proportionately. Any increase in the tax rate of roughly .25 percent or more would balance the reserves in the funds over the period 1976-81. An argument against tax rate increases now, in addition to those cited in favor of a delay, is that taxes are already high and an increase would fall most heavily on lower-income working families.

An alternative to higher tax rates would be an increase in the wage base, i.e., the maximum wage subject to social security taxes--The short-term deficit could be eliminated if the wage base were raised higher than the currently scheduled increases. This alternative would redistribute the tax burden towards higher-income workers. One could argue that higher-income workers can more easily bear this additional burden, which would be at no greater rate than that paid by lower-income workers and which would relieve lower-income individuals of any additional deductions from their wages. On the other hand, the higher wage base would generate higher benefits in the future because benefits are tied to taxable wages. Therefore, increasing the wage base would increase the long-term deficit because future costs would be greater than future revenues. The possibility that this alternative could have adverse effects on private investment markets and on private capital formation should also be considered.

A modification of this alternative is the elimination of the ceiling on the wage base for the employer only--Such a change would be sufficient to eliminate the short-term deficit. It represents an alternative which would not result in higher employee benefits in the future. However, it would result in a sharp tax increase for employers, one that might be passed on to workers through smaller wage increases or reduced employment and increased reliance on equipment.

Selective reductions in benefit levels represent another means of dealing with the short-term deficit--What is contemplated here are prospective reductions, not reductions in benefit levels to current beneficiaries nor limiting or "capping" cost-of-living increases. These reductions could include (a) requiring a test for financial dependence as a condition for benefits to spouses and survivors; and, (b) limiting minimum benefits to current-dollar levels. These changes would reduce social security outlays by $300 million in fiscal year 1977 and $1.2 billion in fiscal year 1981. As a short-term measure selective benefit reductions would not provide sufficient savings unless the reductions were very substantial. Furthermore, this course of action could create hardships among future beneficiaries.

A grant from general revenues offers still another approach for dealing with fund deficits--This alternative would not require any shift in the tax rate or additional shifts in the wage base; nor would it require increases or decreases in benefit levels. On the other hand, it might be difficult to ensure that general revenue grants would be only a temporary measure; if they became a permanent fixture, a basic change would have occurred in the heretofore self-financing structure of the social security program.

Borrowing authority from the general fund--To the extent that the crisis is only short term, a limited authorization to cover temporary deficits without using long-term measures could be provided to the trustees of the funds to borrow funds from the Treasury. Since such borrowing would be used only in the event of actual depletion, it would permit the system to retain its self-financing structure. Given the current situation, this alternative could be retained as a safety valve to be used if needed. In the meantime a sound program of long-range changes in the benefit and tax structures could be developed.

The President's Budget. The President's budget contains a number of proposed changes in the social security system that are aimed primarily at eliminating the short-term deficit in the trust fund. Foremost among these changes is an increase in the social security (OASDI) tax from 9.9 percent to 10.5 percent. Individuals earning median wages would pay $36 more in 1977 than they would pay under current law. This tax increase would add $3.5 billion in income to the funds in 1977, and $9.9 billion in 1981. Rather than falling to $30 billion or 25 percent of outlays, the reserves in the OASDI funds would rise from $45 billion in 1976 to $72.7 billion or 60 percent of outlays by 1981.

The President's budget also calls for a prohibition on certain types of retroactive claims. Under current law, a person may file retroactively for up to a year's benefits if he would have been eligible for benefits during that period.

The President's proposal would prohibit retroactive claims if they resulted in reduced monthly benefits. The proposal is directed at persons whose effective retirement date would be earlier than age 65 thereby giving them a lump sum payment worth up to a year's benefits while reducing their monthly benefits up to 7 percent permanently thereafter. This prohibition would save $400 million in 1977 but in the long run these savings would be offset by higher future monthly benefits.

The President also has proposed a test of monthly postretirement earnings. Under current law, benefits can be paid for all months of the year if total postretirement earnings in the year are less than the prescribed annual limit ($3,000 in 1977). Furthermore, benefits can be paid for any month in which postretirement earnings are less than the monthly limit ($250),even if the money earned during those months when benefits are not paid exceeds the annual limit. The intention of the monthly measure was to permit low-income persons to take seasonal employment, e.g., summer camps, one-time projects, etc., without significant loss of retirement benefits. It has been abused by certain persons who crowd very large earnings into a single month. The President's proposal would prohibit the payment in any month if the annual earnings exceeded the annual limit. If this proposal were enacted, $200 million would be saved in 1977.

The President also proposes phasing out, over a four-year period, the benefits that since 1965 have been accorded to beneficiaries' children, 18 to 22, who are attending school. Similar provisions of the veterans benefit program, railroad retirement, and other programs would not be affected. This change would affect 581,000 beneficiaries, most of whom would probably increase their reliance on the benefits available under the Basic Educational Opportunities Program. The savings to the trust funds from this change have been estimated by the Administration to be $283 million in the first year rising to $1.4 billion the fourth year. The President's budget message also proposes changing the formula by which benefits are computed to correct overcompensation of future beneficiaries for inflation, but the details of the proposal have not yet been provided.

The budgetary impact of the President's proposals are summarized below:

(Billions of Dollars, Fiscal Years)

	1977	1978	1979	1980	1981
Additional income from taxes	3.5	5.6	6.9	8.2	9.9
Savings from benefit reductions	0.8	1.5	1.8	2.1	2.6
Increase to funds	4.4	7.1	8.7	10.3	12.5

Noncontributory Programs: Income Assistance for the Poor[2]

In recent years the noncontributory programs that provide income assistance for the poor have seemed unsatisfactory for a wide variety of reasons. First, although the number of poor has generally declined the costs of these programs have increased rapidly--some sixfold over the past decade. Second, significant gaps in coverage persist. For example, many of the children living in poor families do not qualify for benefits under important public assistance programs such as AFDC

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2. The "poor" and "low-income" families or households are used interchangeably in this section. When the "poverty level" or the aggregate number of poor families or individuals is referred to, the general definition used is the official cash income definition of the federal government which is estimated to average about $5,700 per year for a family of four in fiscal year 1977 under current policy assumptions.

and medicaid usually because they live in two-parent families. Moreover, only one in 12 low-income families receives any type of housing benefit. Third, benefit levels vary widely among those who receive benefits--largely because states administer and partially finance some income assistance programs, and the level of benefits varies from state to state. Fourth, there appears to be little coordination among the numerous programs available to an individual. Fifth, the nature of the programs may undermine long-term social goals. For example, the incentive to work may be weakened because of the cumulative loss of benefits resulting from earned income. In some instances, family stability may also be discouraged in order to meet eligibility requirements. The general dissatisfaction with existing income assistance programs for the poor has generated numerous efforts directed toward developing alternatives.

Alternative approaches for reforming income assistance for the poor can be evaluated in terms of their costs and their structures. For the purposes of this analysis, two of a number of possible approaches have been selected: (1) Adoption of individual program changes that leave the present loosely related separate cash and in-kind programs basically intact, and (2) Implementation of a highly integrated cash system, eligibility for which would be based on income, supplemented by a few in-kind programs.

Any program that transfers income from one group to another can be at a high cost or a low cost. The factors that drive up the costs are not inherent in the structure of the program. Basic policy decisions concerning who will be eligible, the benefit levels provided, and the amount by which benefits are reduced as a recipient's earnings rise will determine overall program costs regardless of how the program is structured. While structures and costs are not related, it would be difficult, for example, to initiate a comprehensive cash program without raising costs above current levels. It is unlikely that such a program using income and family size as a standard test for eligibility would cost less in the short run or would have more restrictive eligibility requirements than current programs.

The alternative approaches and their implied budget levels are grouped as follows:

- Current policy option: continuation of existing programs;
- Low cost option: more restrictive provisions applied to existing programs;
- High cost option: comprehensive cash program with a standard eligibility test based on income.

A brief description of the seven income assistance programs that are directed primarily at the poor precedes the discussion of these options.

Characteristics of the Present Programs

Aid to Families with Dependent Children (AFDC) provides cash assistance to low-income female-headed families with dependent children, and to families in which the father is disabled. In some states, intact families in which the father is unemployed are also eligible. AFDC families may also receive social security, but such benefits are counted as income in determining AFDC benefits. Families eligible for AFDC are also automatically eligible for medicaid benefits. Food stamps are received by 70 percent of AFDC beneficiaries. Standards for eligibility and payment levels vary widely among states which are required to administer and bear part of the cost of the program.

Supplemental Security Income (SSI) provides cash assistance, based on need, to the aged, blind, and disabled. Dependents are not included as beneficiaries. However, children of disabled fathers may be eligible for benefits under AFDC. About half of all SSI beneficiaries receive social security benefits; one-third receive food stamps. SSI beneficiaries are not automatically eligible for medicaid although most are eligible.

The food stamp program provides needy households with a monthly allotment of coupons redeemable for the purchase of food. Households pay a portion of their net incomes for the coupons that varies according to family size and income. The difference between the total value of the coupons and the amount a household pays for them is the benefit. All households receiving federal or state public assistance are automatically eligible for food stamp benefits, while other families, including single persons, may qualify on the basis of need.

Child nutrition programs provide indirect income subsidies to both needy and non-needy children through a variety of food assistance programs. These programs include the national school lunch program, the school breakfast program, the summer feeding program, the special milk program, the child care feeding program, and the special supplemental feeding program for women, infants, and children (WIC). Federal payments to states, schools, and other sponsors of the various programs are usually based on the family income of the participating child. Children receive free lunches, suppers, and breakfasts if their family income is below 125 percent of the poverty level; meals at reduced prices are provided for children in families whose income is between 125 and 195 percent of the poverty level. In addition, all children in participating schools from families with incomes above these levels have their breakfast, lunch, and milk costs reduced by more limited payments. The national school lunch program, will serve 26 million children in fiscal year 1976. Participating schools are reimbursed according to rates that are adjusted semiannually on the basis of changing food prices.

Medicaid[3] finances medical care to about 23 million needy people through federal/state programs. There is substantial variation from state to state both in categories of persons covered and in the benefits to which they are entitled. Almost half of medicaid recipients are under 21, while about another one-sixth are over 65. In states in which eligibility is restricted to AFDC and SSI recipients, large numbers of poor people do not qualify for medicaid support, for example, childless couples, single people between 21 and 65, the working poor, and intact families. A few states preclude coverage of the low-income aged, blind, and disabled.

Veterans' pensions[4] are received by disabled and aged war veterans and their dependents or survivors if their incomes are below certain levels. Pensioners can receive SSI and veterans pensions concurrently. SSI counts VA pensions as income in determining SSI eligibility, but the veterans program does not count SSI, welfare benefits, 10 percent of retirement benefits, or spouse's earnings as income when determining benefit levels. The stricter SSI eligibility requirements severely limit the number of veterans who receive SSI in addition to their veterans' pension.

Housing assistance[5] is received by an estimated 2.3 million low-income households. This represents only 8 percent of all households that could qualify for assistance under existing law. The program is limited by the availability of suitable, low-cost housing and by the appropriations provided for the program. Unlike the other programs discussed here, it is not an entitlement program for which anyone who meets the standards can apply and receive benefits. The major types of housing assistance are public housing and programs that provide rent and mortgage payment subsidies to low-income families.

Budget Options

Current Policy Option. If no new legislation were enacted to change these programs, the costs of the current income assistance programs would almost double by 1981--from $33.8 billion in fiscal year 1976 to $57.8 billion in fiscal year 1981 (see following table). With the exception of

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3. For a fuller discussion of this program see page 151.

4. For a fuller discussion of this program see page 193.

5. For a fuller discussion of this program see page 169.

housing assistance, these programs are all entitlements, that is, benefits must be paid to any individual meeting the eligibility requirements specified in the laws. Therefore, the costs of these programs will change according to economic conditions, growth in the eligible population, and the rate at which those eligible actually participate in the programs. Furthermore, in many cases federal costs rise as prices increase or as states decide to raise benefit levels. Deliberate changes in the amounts spent on these programs can be achieved only by altering the laws that govern the programs.

INCOME ASSISTANCE FOR THE LOW-INCOME POPULATION
BUDGET OPTIONS
(Billions of Dollars, Fiscal Years)

	1977	1978	1981
Current Policy Option	38.5	42.8	57.8
Changes From Current Policy Level			
Low Option	-7.1	-8.0	-14.4
High Option			
Outlays[a]	0.0	-2.3	-5.0
Tax Costs[b]	0.0	25.4	31.4
Total	0.0	23.1	26.4
President's Budget	-4.9		

a. For greater detail see summary tables.

b. A composite of income tax credits and direct cash transfers which is the net effect of substituting a standard tax credit for present personal exemptions and child care deductions including higher tax liabilities for upper-income taxpayers.

Inflation, which is assumed to average 6 percent a year, and a substantial growth in the AFDC, SSI, food stamps, and medicaid caseloads are the main factors which are increasing the costs of the current policy projections.

Low Budget Option. In the past, attempts to withdraw or reduce entitlement benefits have met with little success in part because of the strong resistance of the beneficiary populations. The most feasible means of reducing costs while maintaining the current program structure would be to concentrate on reducing the benefits accorded to those who are less poor. A possible approach could include the following modifications to current income assistance programs:

AFDC--The changes described below would reduce AFDC costs below projected current policy levels by $600 million in fiscal year 1977 and by $900 million by 1981:

1. Revision of the income disregard for work expenses. Instead of the current practice of disregarding the first $30 of earnings and one-third of the remainder (known as an income disregard) as well as other reasonable work expenses, a disregard of $60 plus child-care expenses plus one-third of the remainder would be substituted. This measure would save about $150 million in fiscal year 1977.

2. Calculation of benefits on the basis of prior month's living costs and income, instead of on anticipated costs. This modification would reduce errors and overpayments which rarely are recovered. The savings from this change would be about $300 million in fiscal year 1977.

3. In-kind support from non-needy household members would be required. This proposal would require that in-kind income such as the value of housing and utilities provided by the non-needy household member be counted as income in determining eligibility and benefit levels. In some states the in-kind support of non-needy stepparents is already counted. Such a measure would reduce costs by about $150 million below current policy levels for fiscal year 1977.

SSI--One possible saving in the SSI program would be elimination or the disregard of the first $20 of monthly income in establishing the amount of benefits to be received. Other possible savings could include tightening up of the disability definition, elimination of coverage for disabled children, and benefit reductions. Elimination of the $20 income exclusion would reduce SSI program costs by approximately $600 million in fiscal year 1977 and $860 million by 1981.

Food Stamps--There are a number of ways food stamp costs could be reduced. The plan proposed by the Administration in 1975 would lower food stamp costs by about $2 billion in fiscal year 1977 below the current policy level and would reduce the number of recipients by about five million in fiscal year 1977. The major elements of this plan are:

1. The substitution of a $100 per month standard deduction for the present set of specific itemized deductions used in determining eligibility;

2. A requirement that eligibility be set at the poverty level instead of at the less stringent levels set by the food stamp program;

3. Determination of income based on a previous three months' record rather than the present procedure which anticipates income for the future month;

4. Institution of a uniform purchase requirement, the amount of the recipient's net cash income which must be used for the purchase of food stamps, of 30 percent of net income rather than the present system in which purchase requirements vary according to income; and

5. Elimination of categorical eligibility of AFDC and SSI recipients, and, instead,require an income test of eligibility of all individuals who apply for food stamps.

In addition to this proposal, another low option would provide higher household benefit levels to those remaining eligible. It would eliminate all deductions and set income eligibility at the poverty line. Food stamp costs would be reduced by $1.2 billion below current policy levels in fiscal year 1977 and $1.9 billion in 1981.

Child Nutrition Programs--One cost reducing change in the program would be to limit the child nutrition programs to children in families whose income did not exceed the official poverty line. Recognizing that nutritional deficiency can occur at all ages, the reimbursement could include both school-age and preschool children. Grants could be provided to states on the basis of a formula that considered the cost of providing each needy child with one-third of his/her recommended daily dietary allowances for 225 days. Participation in the food stamp program presumably would cover the remainder of the child's nutritional needs. Grants could be adjusted to keep pace with increasing food costs. Such a proposal would reduce estimated expenditures by $1.4 billion in fiscal year 1977 and by $1.8 billion in fiscal year 1981.

Medicaid--A number of cost saving changes could be made in the medicaid program. These include:

1. Reduction in federal matching share. The federal payment to states could be reduced by 10 percent. As a result, states would either bear a larger share of medicaid costs or would cut back the program to match lower budget levels. This measure would reduce federal medicaid expenditures by $900 million in fiscal year 1977 and $1.4 billion by 1981.

2. Reimbursement limitation on hospitals and physicians. If increases in reimbursable physician charges were held to increases in the Consumer Price Index and permissible hospital rate increases were held slightly above those levels, the federal government would save $150 million in fiscal year 1977 and $1 billion by 1981.

Veterans' Pensions--If the veterans' pensions program were eliminated and the eligible beneficiaries transferred to the SSI and AFDC programs, veterans program costs would decrease. However, SSI and AFDC program costs would increase. The net effect on federal expenditures (offsetting SSI and AFDC increases against the veterans' pension reduction) would be a savings of about $2 billion in fiscal year 1977 and $2.2 billion by 1981. (For further discussion see the veterans' affairs section of this chapter.)

Housing Assistance--A low-cost option in the housing assistance area could include a freeze on the number of subsidized housing units and on operating subsidies for public housing. Only current contracts and commitments would be continued. Such an option would reduce housing assistance outlays by $0.3 billion in fiscal year 1977 and $4.4 billion in 1981.

Taken together, the alternatives described in this low budget option could reduce federal outlays for income assistance for the poor by roughly $7.1 billion in fiscal year 1977 and $14.4 billion in fiscal year 1981.

High Budget Option. A comprehensive cash program, with standard eligibility determined by income, represents one method of reforming the nation's income assistance programs. This approach focuses on the broad spectrum of income needs, improved program efficiency, and equity. While it may be preferable to reduce all benefits to cash to permit greater administrative efficiency and equity and a greater degree of independence for recipients, no serious proposals have been presented that would consolidate the cash programs like social security, unemployment insurance, or veterans benefits into a single comprehensive cash grant. Further, no proposal has been advanced which would convert all the in-kind programs, including medicaid and day care, into cash benefits.

The basic elements of a comprehensive cash assistance program are: (1) a basic guarantee of income that would be transferred to a family if its income were zero; (2) a specific benefit reduction formula which establishes how much that amount would be reduced as pretransfer income rises; and (3) a breakeven income level at which the transfer is zero. These three components, of course, do not fully describe a comprehensive cash system. The basic income guarantee can be modified according to the size and composition of the family, benefit reduction formulas can be varied depending upon the type of pretransfer income (e.g., social security, earned income), and the transfer could consist of direct cash transfers or transfers composed of both federal income tax credits and direct cash transfers.

Proponents of a comprehensive cash system point to a number of advantages in this approach. First, the need for income assistance is objectively arrived at and based upon uniform national standards. Second, assistance given in cash maximizes the benefits to recipients, since they can purchase the goods that they value most highly. Third, administrative costs could be reduced and quality of service improved as a result of consolidation of the benefit programs and the establishment of uniform laws and regulations. Fourth, work incentives could be strengthened since the reductions in benefits because of added earned income would not be cumulative as is the case with the present system. Fifth, one could argue that in the long run consistent treatment and limited growth of income transfer programs would be easier to achieve if they were contained in one piece of legislation rather than five or six, each of which is subject to independent alterations.

There are a number of disadvantages to the comprehensive approach. Since the comprehensive plan covers all households where income falls below the breakeven point, the cost of a comprehensive plan could be high. If the program is coupled with a general tax relief program for persons not receiving the cash grant but who are paying taxes the costs could become extremely high. Either tax assistance or moderately sized grants are important, because without them the basic guarantee may result in lower levels of assistance than are being received by many under existing programs.

A further disadvantage of a comprehensive plan is that it may not be acceptable to define fulfillment of need as simply adequacy of cash income. The continuation of programs directed toward access to medical care and housing and toward certain groups such as veterans might be required. If such special programs were to continue, many of the disadvantages thought to be avoided by a comprehensive plan, such as cumulative and inconsistent benefit reduction rules, separate administrative costs, etc., would still exist. Finally, most comprehensive plans assume that states will supplement the plan in order to adjust the nationally determined benefit to local or special needs. This raises questions as to equity among states.

Griffiths Plan. One example of a comprehensive cash program is the plan former Congresswoman Martha Griffiths developed after a thorough examination of the problem was conducted by the Joint Economic Committee. This plan was advanced in 1974 as a mechanism for reforming the present welfare system. The approximate costs of this plan have been calculated to illustrate the costs of a comprehensive system. The plan includes both a reformed tax system and a reformed welfare system.

On the tax side, the current personal exemptions would be replaced with a $225 per person tax credit. Any person whose tax liability did not exhaust the $225 credit would receive the difference in cash. The AFDC and food stamp programs would be eliminated and replaced with a comprehensive system of allowances to poor people. Private income would offset the allowances under varying benefit reduction formulas. Different formulas would apply to different types of income.

The SSI program would be continued as a separate program. The recipients of SSI would not be permitted to participate in the comprehensive cash system; moreover, dependents of SSI recipients (spouses and children) would be included in the SSI program. The medicaid program would continue separately. Under the Griffiths plan, 80 percent of the value of any housing subsidy received would be deducted from a familiy's basic allowance.

The combined benefits of tax credits and basic allowances would provide an income guarantee of $3,600 a year for a family of four. This amount is approximately three-fourths of the amount of income defined as the poverty level. (A more recent version of this proposal raises the minimum income guarantee to $4,300 per year for a family of four.) These benefit levels were not designed to be the sole vehicle for eliminating poverty. Some of the persons with the greatest needs would be assisted by SSI or other programs,and possibly state and local governments would aid others.

If the system were initiated in 1978 and cash allowances were raised to keep pace with inflation, the first year cash allowance outlays would be $2.3 billion less than levels needed to maintain current policy in the programs which the cash allowance would replace (AFDC and food stamps). However, the tax credit would reduce 1978 revenues and generate outlays estimated at $25.4 billion. Estimated costs do not assume an extension of the present earned income tax credit.

The net effect of the high option would be to raise federal outlays for income assistance for the lower-income population by $23.1 billion in 1977 and $26.4 billion by 1981.

A comprehensive income-tested program is not the only way of transferring more dollars to the poor. An alternative high-cost option would be to maintain the current program structure, but to increase benefits and/or coverage in some of the current income assistance programs. High cost options for programs such as housing assistance, veterans' pensions, and medicaid are discussed in the housing, veterans, and health sections of this report.

President's Budget Option. The President has proposed several cost-saving measures for income assistance programs for the poor. Taken together, the President's proposals would reduce program costs below the current policy level by $4.9 billion in fiscal year 1977 (see table, page 134). The specific changes required by the President include:

AFDC--In addition to $220 million saved in 1977 by procedures designed to improve state administration, the President has proposed reducing AFDC costs by an additional $256 million from current policy levels by:

1. Revising the income disregard for work expenses in the way discussed in the low budget option.

2. Simplifying AFDC federal/state matching formula by using the less complex medicaid matching formula. This measure would produce savings of $70 million in fiscal year 1977.

3. Including stepparent support in determining eligibility and benefits as was described in the low budget option. However, in focusing on stepparents only, this change does not produce as great a budget savings as the low-budget proposal which included the income of all non-needy persons living in the household. The President's proposal would save $37 million in fiscal year 1977, in contrast to the $150 million savings in fiscal year 1977 if the income of all non-needy family members were included in eligibility and benefit determination.

SSI--Although the President projects $245 million for fiscal year 1977 in savings from current policy levels due to redeterminations of eligibility and increased payment accuracy, his SSI budget includes no new legislative initiatives.

Food Stamp Program -- The President's budget proposes a $1.2 billion savings in the food stamp program in fiscal year 1977 below the President's current estimate and $2 billion below the current policy level. This saving is expected either through legislative action and/or regulatory change. The anticipated legislation bringing about this cost savings is the same as that included in the low-budget option.

Child Nutrition Program--The President's budget proposes the enactment of a Child Nutrition Reform Act, which would consolidate over 15 programs into one block grant program to states. Such measures would reduce fiscal year 1977 outlays by an estimated $0.7 billion below the President's current estimates and $1 billion below the current policy level. The low-budget option discussed earlier in this section would bring about a similar federal-state funding arrangement with similar program costs.

Medicaid--The President has proposed the consolidation of 16 health grant programs, including medicaid, into a single health care grant to states. This proposal is described in greater detail in the health section of this report.

Veterans'Pensions--The President does not propose to extend the 8 percent cost-of-living increase which is due to expire on September 30, 1976, and makes no provision for a cost-of-living increase in fiscal year 1977. As a result, the President's estimate is $0.3 billion below the current policy level for fiscal year 1977.

Housing Assistance--The President's budget proposes lower-income housing assistance outlays of $3.1 billion for 1977. Program highlights include (1) projected commitments for 400,000 subsidized units under the Section 8 program, which until now has been slow moving; (2) changes in laws and regulations that will result in requiring higher rent from public housing tenants, for an estimated saving in federal outlays of $0.1 billion in 1977.

Who Are The Poor: A Need For Basic Analysis

In considering these reform measures, attention should be given to the definition of poverty. This definitional problem goes well beyond the reform proposals which alter programs.

In spite of the rapid growth of income assistance programs, the "poverty gap" (the difference between the income of poor families and what that income would be if their incomes were raised to the poverty level) has not been closed even though total cash transfers are more than sufficient to close that gap. One reason is that some of this cash is transferred to those who are "officially" poor, that is, they meet the eligibility requirements for the various programs; and the resulting benefits from these programs move some of them well above the poverty line. They are then better off than individuals who are near the poverty line in terms of need but do not meet the eligibility requirements to receive benefits. This is one of the reasons that the percentage of needy families below the poverty line has changed only marginally in recent years and in fact may be increasing.

A major reason for this discrepancy is that the official definition of poverty does not include in-kind transfers as income. This probably means that there are fewer persons below the poverty income levels than the reported figures show, since in-kind transfers have been growing relatively more rapidly than cash assistance. Our existing programs, which are based on the narrower cash income definitions, direct their resources to those with low cash income but who may be already assisted with in-kind benefits. This may divert assistance from others with greater real needs.

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A basic analysis of the definition of poverty and the related alternatives for program restructuring is essential to understanding and overcoming the problems of the poor.

SUMMARY TABLE—INCOME ASSISTANCE (600)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 600 Items:								
Contributory Programs:								
Social Security (601 part)	65. 3	72. 7	19. 9	84. 5	93. 5	102. 6	111. 7	120. 7
Railroad Retirement (601 part)	3. 1	3. 4	0. 9	3. 7	3. 8	4. 0	4. 1	4. 2
Civil Service Retirement (602) [a]	7. 0	8. 6	2. 4	10. 2	11. 8	13. 2	15. 0	16. 8
Unemployment Insurance (603)	13. 5	19. 9	4. 6	19. 2	19. 4	18. 8	17. 5	15. 8
Subtotal Contributory	88. 9	104. 6	27. 8	117. 6	128. 5	138. 6	148. 3	157. 5
Noncontributory Programs:								
AFDC (604 part)	5. 1	5. 8	1. 7	6. 5	7. 0	7. 5	8. 0	8. 6
Food Stamps (604 part)	4. 6	5. 9	1. 5	6. 7	7. 5	8. 5	9. 4	10. 4
SSI (604 part)	4. 8	5. 5	1. 5	6. 2	6. 9	7. 5	8. 2	8. 9
Housing (604 part) [a]	2. 1	2. 6	0. 7	3. 1	3. 9	5. 1	6. 5	8. 0
Child Nutrition (604 part)	2. 0	2. 7	0. 8	3. 4	3. 6	3. 9	4. 1	4. 3
Subtotal Noncontributory	18. 6	22. 5	6. 2	25. 9	28. 9	32. 5	36. 2	40. 2
Other Income Security (Including Disabled Miners)	1. 1	1. 1	0. 3	1. 3	1. 4	1. 5	1. 5	1. 5
Total Function 600	**108. 6**	**128. 2**	**34. 3**	**144. 8**	**158. 8**	**172. 6**	**186. 0**	**199. 2**
Other Income Assistance for the Poor:								
Medicaid (551 part) [a]	6. 8	8. 3	2. 2	9. 5	10. 7	11. 8	12. 9	14. 0
Veterans' Pensions (701) [a]	2. 7	3. 0	0. 8	3. 1	3. 2	3. 3	3. 4	3. 6
Tax Expenditures [b]	18. 3	22. 8	[f] NA	24. 5	26. 1	28. 0	30. 1	32. 5

See footnotes at end of table.

SUMMARY TABLE—INCOME ASSISTANCE (600)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION								
Function 600 Items:								
Contributory Programs:								
Social Security (601 part) [c]	65.3	72.7	19.9	84.5	93.5	102.6	111.7	120.7
Railroad Retirement (601 part) [c]	3.1	3.4	0.9	3.7	3.8	4.0	4.1	4.2
Civil Service Retirement (602) [c]	7.0	8.6	2.4	10.2	11.8	13.2	15.0	16.8
Unemployment Insurance (603) [c]	13.5	19.9	4.6	19.2	19.4	18.8	17.5	15.8
Subtotal Contributory	88.9	104.6	27.8	117.6	128.5	138.6	148.3	157.5
Noncontributory Programs:								
Cash Allowance [d]					12.2	12.6	13.2	14.0
AFDC (604 part)	5.1	5.8	1.7	6.5				
Food Stamps (604 part)	4.6	5.9	1.5	6.7				
SSI (604 part) [c]	4.8	5.5	1.5	6.2	6.9	7.5	8.2	8.9
Housing (604 part) [c]	2.1	2.6	0.7	3.1	3.9	5.1	6.5	8.0
Child Nutrition (604 part) [c]	2.0	2.7	0.8	3.4	3.6	3.9	4.1	4.3
Subtotal Noncontributory	18.6	22.5	6.2	25.9	26.6	29.1	32.0	35.2
Other Income Security (Including Disabled Miners) [c]	1.1	1.1	0.3	1.3	1.4	1.5	1.5	1.5
Total Function 600	**108.6**	**128.2**	**34.3**	**144.8**	**156.5**	**169.2**	**181.8**	**194.2**
Other Income Assistance for the Poor:								
Medicaid (551 part) [c]	6.8	8.3	2.2	9.5	10.7	11.8	12.9	14.0
Veterans' Pensions (701) [c]	2.7	3.0	0.8	3.1	3.2	3.3	3.4	3.6
Loss of Tax Revenue Due to Cash Allowance Tax Provisions					25.4	25.6	28.3	31.4
Tax Expenditures [b]	18.3	22.8	[f] NA	24.5	26.1	28.0	30.1	32.5

See footnotes at end of table.

SUMMARY TABLE—INCOME ASSISTANCE (600)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 600 Items:								
Contributory Programs:								
Social Security (601 part) [c]	65.3	72.7	19.9	84.5	93.5	102.6	111.7	120.7
Railroad Retirement (601 part) [c]	3.1	3.4	0.9	3.7	3.8	4.0	4.1	4.2
Civil Service Retirement (602)	7.0	8.6	2.4	10.1	11.5	12.8	14.4	16.1
Unemployment Insurance (603) [c]	13.5	19.9	4.6	19.2	19.4	18.8	17.5	15.8
Subtotal Contributory	88.9	104.6	27.8	117.5	128.2	138.2	147.7	156.8
Noncontributory Programs:								
AFDC (604 part)	5.1	5.8	1.7	5.9	6.4	6.8	7.3	7.8
Food Stamps (604 part)	4.6	5.9	1.5	5.5	6.2	7.0	7.7	8.5
SSI (604 part)	4.8	5.5	1.5	5.6	6.2	6.8	7.4	8.0
Housing (604 part)	2.1	2.6	0.7	2.8	3.3	3.5	3.6	3.6
Child Nutrition (604 part)	2.0	2.7	0.8	2.0	2.1	2.3	2.4	2.5
Increases in SSI and AFDC to cover eligible Veterans	0.0	0.0	0.0	1.1	1.2	1.3	1.3	1.4
Subtotal Noncontributory	18.6	22.5	6.2	22.9	25.4	27.7	29.7	31.8
Other Income Security (Including Disabled Miners) [c]	1.1	1.1	0.3	1.3	1.4	1.5	1.5	1.6
Total Function 600	**108.6**	**128.2**	**34.3**	**141.7**	**155.0**	**167.4**	**178.9**	**190.2**
Other Income Assistance for the Poor:								
Medicaid (551 part)	6.8	8.3	2.2	8.5	9.4	10.2	11.0	11.6
Veterans' Pensions (701)	2.7	3.0	0.8	0.0	0.0	0.0	0.0	0.0
Tax Expenditures [b]	18.3	22.8	[f] NA	24.5	26.1	28.0	30.1	32.5

See footnotes at end of table.

SUMMARY TABLE—INCOME ASSISTANCE (600)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Function 600 Items:								
Contributory Programs:								
Social Security (601 part)	63. 6	72. 7	19. 9	82. 7				
Railroad Retirement (601 part)	3. 1	3. 5	0. 9	3. 7				
Civil Service Retirement (601 part)	7. 0	8. 3	2. 3	10. 0				
Unemployment Insurance (603)	13. 5	19. 4	4. 0	16. 9				
Subtotal Contributory	87. 2	103. 9	27. 1	113. 3				
Noncontributory Programs:								
AFDC (604 part)	5. 1	5. 9	1. 6	6. 0				
Food Stamps (604 part)	4. 6	5. 6	1. 2	4. 7				
SSI (604 part)	4. 8	5. 2	1. 4	5. 9				
Housing (604 part)	2. 1	2. 5	0. 7	3. 1				
Child Nutrition (604 part)	2. 0	2. 6	0. 5	2. 4				
Subtotal Noncontributory	18. 6	21. 8	5. 4	22. 1				
Other Income Security (Including Disabled Miners)	2. 8	2. 8	0. 3	1. 8				
Total Function 600	**108. 6**	**128. 5**	**32. 7**	**137. 1**				
Other Income Assistance for the Poor:								
Medicaid (551 part)	6. 8	8. 2	2. 2	[e] 8. 7				
Veterans' Pensions (701)	2. 7	2. 9	0. 8	2. 8				
Tax Expenditures [b]	18. 3	22. 8	[f] NA	24. 5				

[a] Also discussed elsewhere in this report.
[b] This represents the sum of 25 individual tax expenditure items associated with the income security and the veterans' pension exclusion. They are set out on pages 54–56 of CBO's Function *Five Year Budget Projections:* Fiscal Years 1977–81. For a discussior of the limitations of tax expenditure estimates see Tax Expenditure Chapter. In addition, the tax expenditure estimates are not adjusted for the impact of the budget options discussed in this report.

[c] Unchanged from current policy levels.
[d] Replaces AFDC and Food Stamps.
[e] Presumed share of health services block grant.
[f] NA: Not available.

PART II-1: PROGRAM ISSUES
SECTION B: AID TO INDIVIDUALS

Health (Function 550)

Introduction

Federal health expenditures (function 550) include efforts to finance and provide personal health care services, to support biomedical and other health research, to train health professionals, and to support public health activities. Related expenditures are found in the national defense (050) and veterans (700) functions which contain programs designed to provide and support health care for past and current military personnel, their families, and survivors.

In fiscal year 1976, the country will spend more than $133 billion, or one-twelfth of GNP, on health care and related activities; these expenditures are more than double the level of 1970. The $43 billion federal health budget represents almost one-third of all health expenditures, as shown in the following table. Over the past decade the relative budget importance of health has quadrupled. Whereas health expenditures were focused on public health and biomedical research, almost the entire increase since 1966 has been in programs, such as medicare and medicaid, that finance personal health services for groups that were not in the judgment of the Congress adequately protected by the private insurance industry--the aged, poor, and disabled.

The medicare program helps finance health services for the aged; medicaid helps welfare recipients--and in some states--the medically indigent. The federal government also supports personal health services through categorical grant programs (i.e., grant programs specifically for health) and directly provides personal health services for some civilians, including veterans and military personnel. The categorical grant programs were expanded in the late 1960s in an attempt to improve health service capacity in low-income and other areas where existing services were inadequate. Federal expenditures for these programs, which include community health centers, maternal and child health, and family planning, are just over $1.1 billion.

An additional major source of federal assistance for health service costs is the personal income tax deduction for health expenditures. This tax expenditure, which is estimated to reduce federal revenues by $2 billion in 1976, provides the greatest benefit to taxpayers in higher income brackets because the value of the deduction increases with the taxpayers' level of adjusted gross income. Also, employer contributions to employee health insurance plans are tax exempt; this tax

HEALTH OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1976, 1981 (FUNCTION 550)
(Billions of Dollars)

	1966	1976[a]	1981
Medicare	--	$17.6	$34.5
Medicaid	--	8.3	14.0
Other Health	3.3	7.0	9.5
550 Total	3.3	32.9	58.0
Percent of Budget Outlays	2.5%	8.8%	10.3%
Veterans' Health (770 part)	1.3	3.7	5.0
National Defense Health (050 part)	1.3	3.7	NA
Other	NA	3.1	NA
Tax Expenditures	2.3	6.6	11.3

a. Current policy levels

NA: Not available

expenditure will reduce federal tax revenues by $3.7 billion in fiscal year 1976. Further, deductions by individuals and corporations for their contributions to health charities and institutions reduced federal revenue by over $900 million in 1976.

About $38 billion in fiscal year 1977 and $58 billion in fiscal year 1981 would be required to maintain current health (function 550) policies and program levels. Over 90 percent of the projected increase between fiscal years 1976 and 1981 would be accounted for by the medicare and medicaid programs. More than 80 percent of the anticipated increases in these programs would result from higher medical costs, while less than 20 percent would result from an increase in the number of beneficiaries or higher rates of utilization.

This chapter explores the conflict between providing better access to health care and restraining health costs, considers some alternative federal directions, and estimates the additional savings or costs to the federal government of the alternatives.

Issues

Although federal expenditures to finance personal health care services have risen dramatically, millions of Americans still have inadequate financial means to pay for health care costs. This is largely because higher federal and private spending for health services has been dissipated by steep increases in health care costs. To remedy this situation, widely differing proposals have been made for future federal policy. Some suggest reducing the financial protection provided by federal programs and thereby lessening the pressures on prices; others advocate broadening the federal role through various forms of national health insurance to ensure that all individuals have adequate financial protection for health care costs. Some of the specific problems affecting federal health policy are:

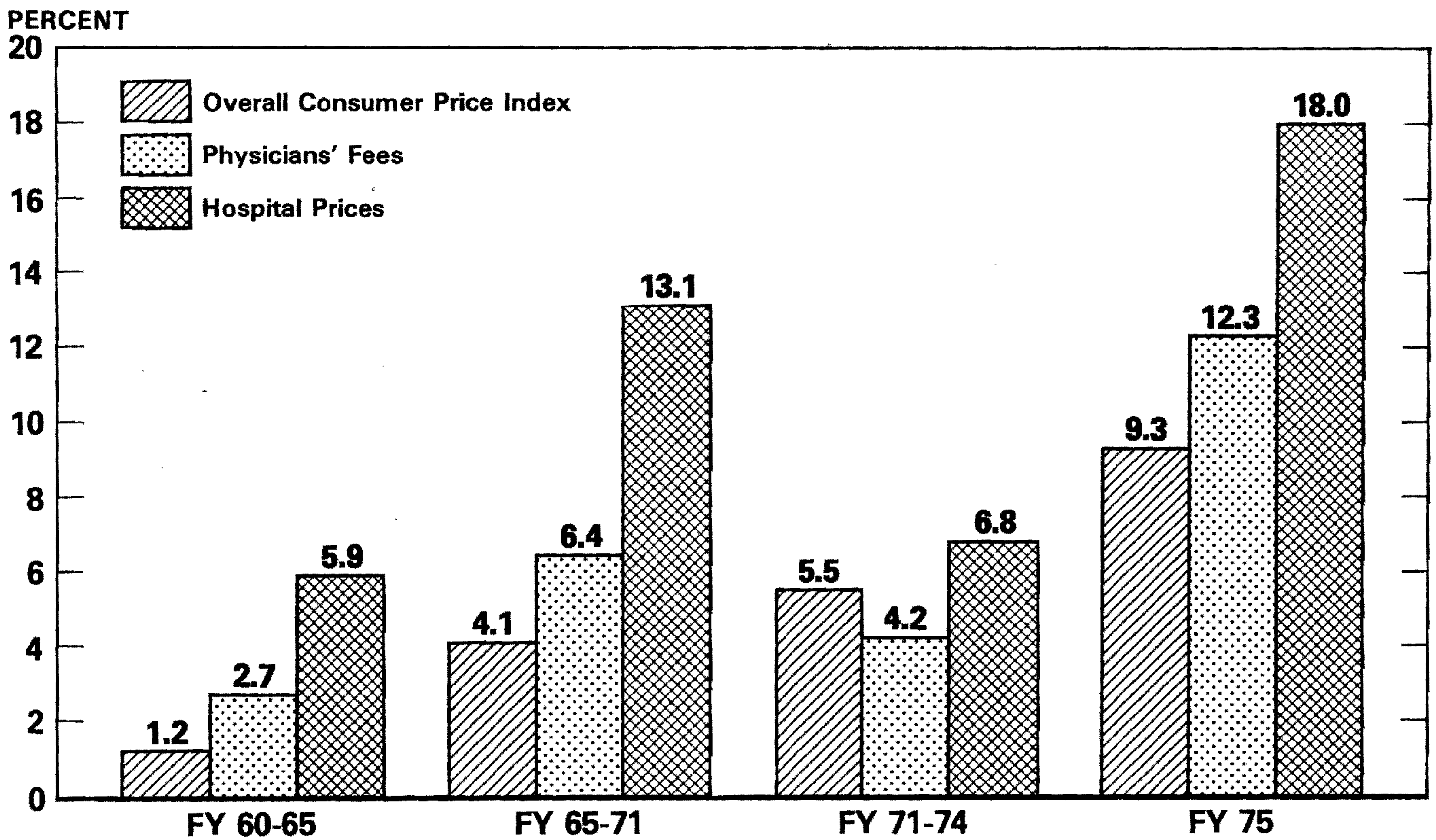
Incomplete Coverage. The present combination of categorical programs and public and private insurance arrangements fails to provide all persons with adequate protection. Although virtually all of the aged receive medicare benefits, the program pays less than 40 percent of their total health costs. Medicaid covers only three-fourths of the nations's poor, because eligibility is linked to receipt of federal welfare benefits and state-determined income limits. In some states low-income families with large medical expenses are covered although they do not receive public assistance; in other states, only those receiving welfare benefits are eligible. There are also gaps in private insurance coverage; more than one in eight of those under 65 are not insured. Many of these are workers in low-wage industries and individuals with histories of bad health or other problems that make them insurance risks; they find private insurance prohibitively expensive. In addition, private insurance usually does not provide adequate protection against very high health expenditures. Half the population does not have major medical coverage.

Nonfinancial Barriers to Care. Many low-income families--those covered by medicaid, private insurance, or not insured--face serious nonfinancial barriers to care because they lack access to facilities or health personnel, face discrimination, or are inexperienced in utilizing health services. The rural poor and low-income minority groups appear to be the most affected. Some categorical programs and programs that provide direct services to specific populations, such as Indians, have overcome nonfinancial barriers for a small proportion of these persons, but benefits are distributed unevenly.

Cost Increases. With the exception of the 32 months (August, 1971 to April, 1974) during which controls were imposed on health costs as part of the Economic Stabilization Program, health service prices, in recent years, have increased at a faster pace than that of the CPI, as shown in the following figure. The growth of public and private insurance coverage is in part responsible because insurance removes beneficiaries'

Average Annual Increase in Consumer Price Index All Items - Physicians' Fees - Semi Private Rooms

(Selected fiscal year periods 1960 - 1975)



concerns about the price of care and stimulates the use of high cost medical treatments.

Thus, individual financial protection cannot be improved substantially without risking more price inflation and greater inefficiencies in the use of resources. This conflict between social goals--protecting individuals and efficient use of health resources--is intensified by the nature and pricing methods of the health industry. In particular, the limited knowledge of consumers about the desirability of health care services and the ability of health professionals to recoup costs and set prices encourages the growth of expenditures. All of this poses a serious public policy dilemma, because only government regulation of the health industry would seem to permit improving individual protection without adding significantly to inflation.

Budget Options

The appropriate role of the federal government in addressing the issues and problems in the health area is much debated. While some seek to emphasize limiting federal budget costs and restraining medical price increases, others are concerned about inequities in access to care and financial protection. The latter would either attempt to fill the gaps in the current system or adopt a program of comprehensive national health insurance. Supporters of comprehensive insurance not only argue for its adoption on grounds of equity, but also contend that effective cost control can be achieved only through a consolidation of health financing programs.

These various objectives imply significantly different strategies and levels of federal expenditures than those that would result from current policy.

Current Services. If existing programs were continued and maintained at their current (real) service levels, federal health expenditures would increase from \$37.7 billion in fiscal year 1977 to \$58 billion in fiscal year 1981. As was mentioned previously, most of this growth would be associated with medicare and medicaid. Health-related tax expenditures would reduce federal revenues by \$7.3 billion and \$11.3 billion in fiscal years 1977 and 1981 respectively.

The President's Budget. The major thrust of the President's health proposals is to curtail the growth in federal health expenditures. If adopted, the proposals would result in federal outlays of \$34.4 billion in fiscal year 1977, \$3.3 billion below the current policy estimate.

The President's major legislative recommendation, the Financial Assistance for Health Care Act (FAHCA), would consolidate 15 categorical health service programs and medicaid into a state block grant. If adopted, this would reverse the 20-year-old trend toward increasing federal responsibility to assure the availability of health services. By including medicaid in the block grant, federal expenditures for this entitlement program would be controlled through the appropriations process.

FAHCA would distribute funds among the states on the basis of a formula that included three factors: the number of low-income families in a state, the state's tax effort, and the per capita income of its residents. This would produce a major redistribution of federal health funds from higher-income to lower-income states. FAHCA would also eliminate most federal control over the expenditures of these funds, thereby giving states wide discretion in determining levels and types of services and eligibility for them.

The President's budget also proposes three significant changes in the medicare program. The first two changes, limiting hospital and physician reimbursement; and increasing beneficiary cost-sharing would reduce federal expenditures. The third, placing a ceiling on beneficiary cost-sharing for medicare-covered services would add to federal outlays. The cumulative effect of these changes would be to lower medicare expenditures by $1.6 billion in fiscal year 1977.

Medicare reimbursement policies would be modified by placing a 7 percent ceiling on increases in hospital reimbursement per patient day and a 4 percent ceiling on physician fee increases. This is estimated to save $0.9 billion in fiscal year 1977. Beneficiary costs would be increased by requiring beneficiaries to pay the first 10 percent of hospital, nursing home, and hospital-based physician services and by indexing the current $60 deductible for supplementary medical insurance to future increases in social security cash benefits. These measures would reduce federal expenditures by $1.9 billion in fiscal year 1977. While the cost-sharing measure would provide the greatest savings in fiscal year 1977, the savings from the limits on reimbursement increases would be considerably greater in later years.

Finally, the President proposes "catastrophic" protection for medicare beneficiaries by placing annual limits on the amounts they would pay. These are $500 for covered hospital and nursing home services and $250 for physician and other services covered under the supplementary medical insurance program. At present there are no limits on beneficiary cost-sharing. These maximum out-of-pocket payments would raise medicare expenditures by $1.1 to $1.4 billion in fiscal year 1977 if the President's cost-sharing program were adopted.

Lower Option. One alternative to the President's proposal of reducing federal health spending is to maintain federal responsibility for the current mix of categorical services and financing programs but to cut back support for medicare and medicaid. These two programs dominate the growth in the federal health budget and their outlays under current law are estimated to rise by $4.1 billion in fiscal year 1977.

Two methods for reducing the budgetary impact of medicare and medicaid are:

- Restraining or even freezing levels of reimbursement to health care providers as has been done by several state medicaid programs.

- Increasing the share of costs paid by beneficiaries, as was proposed by the Administration, in an effort to make beneficiaries more "cost-conscious" and stiffen their resistance to price increases.

The first strategy could be accomplished by:

- Limiting increases in federal per diem payments to hospitals to a rate 3 percent above the overall inflation rate for a part year saving of almost $0.5 billion in 1977 and about $6.7 billion in 1981

- Limiting the increase in physician fees to the overall rate of inflation, which would yield a savings of $0.2 billion in 1977 and $0.9 billion in 1981.

The second strategy could be pursued by adopting such Administration proposals on medicare cost sharing as increasing the medicare supplementary medical insurance deductible and imposing a 10 percent coinsurance up to $500 per year on hospital and nursing home benefits.

Additional savings could be achieved by reducing the federal medicaid matching rate with the states by 10 percentage points for a savings of $0.95 billion in 1977 and limiting medicaid coverage to persons receiving benefits from federal cash assistance programs. Not all of the $4.3 billion currently spent on benefits for such persons would be saved by this last measure because, faced with the medical bills once paid by medicaid, many would become eligible for federal cash assistance.

The lower outlays shown in the following table include the savings from the limits on reimbursements to providers just described and from the lower medicaid matching rate. These policies would adversely affect the objectives of providing individual financial protection and equality of access to services. If physician reimbursement under medicare were decreased, many physicians would be likely to stop accepting medicare assignments and instead bill patients directly. Controls on hospitals are less likely to result in beneficiary hardship, but could eventually

HEALTH BUDGET OPTIONS IN HEALTH OUTLAYS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level	37.7	58.0
Changes From Current Policy Level		
President's Budget	-3.3 [b]	
Lower Option	-1.5	-9.0
Higher Options		
Targeted Approach[c]	9.5 to 11.4	24.8 to 27.8
Tax Expenditures	-1.1	-3.6
Comprehensive Approach (Premium Financial)	15.7 to 17.7	22.3 to 33.2
Tax Expenditures	0.5	0.9
Comprehensive Approach (Tax Financed)	74.7 to 77.2	104.2 to 139.6
Tax Expenditures	-5.7	-8.8

a. For greater detail see the summary tables.

b. Since publication of the President's budget, the Administration has increased its estimates of the cost of catastrophic protection under Medicare from $0.5 billion to $1.4 billion. Unless other reductions are made, the reestimates would have the effect of reducing the President's projected savings by $0.6 billion to $0.9 billion.

c. Total budget costs of this plan could be increased by the resolution of two budget policy questions. First, the proposed tax credit to employers offsetting their premiums could be treated as a tax expenditure. Second, any payments from general funds to the trust fund to meet deficits could be treated as an outlay. The issues are under consideration. Pending their resolution, the estimates of this plan assume that the credit will not be counted as a tax expenditure and that payments from the general fund will not be regarded as outlays.

lead to different levels of medical treatment for public beneficiaries, especially if the limits set are unrealistically low.

To the extent that increased cost sharing decreases use of health services by either of these beneficiary groups, thus lowering overall demand, inflation of health costs might be restrained. This might not occur, however, if providers recovered lost revenue by increasing charges to other patients.

Rather than modifying prices by making programmatic changes, cost controls could be reimposed on the entire health sector. Such controls would not lead to provider discrimination against public beneficiaries in particular. Judging from the experience under the Economic Stabilization Program, such controls would be effective only if they were viewed as a long-term policy and not merely as a temporary budget reduction device, for otherwise hospitals would not change their behavior to ensure efficient use of resources.

Higher Options. Expanding programs designed to fill gaps in financial protection or adopting a comprehensive national health insurance plan represent strategies that would lead to higher level of health expenditures.

Such strategies could change the delivery of health care in complex and far-reaching ways and, as a result, would have a profound and not altogether predictable effect on the cost of health care. Estimates of the increase in the federal cost that would result from various proposals range from $8.4 billion to $71.5 billion in fiscal year 1977, as shown in the previous table. These totals include tax expenditures. Even though the assumption is probably unrealistic, these cost estimates assume that the various proposals could be implemented fully in fiscal year 1977. This was done in order to make cost comparisons and to show the long-run impact on expenditures and of cost controls.

Targeted approach--The critical problems of providing coverage for all low-income families and universal protection against catastrophically high medical expenditures could be addressed with federal costs of about $9.5 billion, net of tax expenditures, over current policy levels. Low-income families could be protected by imposing uniform medicaid eligibility criteria. If income limits were set at the level of $4,800 for a family of four and uniform benefits were offered that are comparable to the more generous existing state plans, current federal and state expenditures for medicaid would be increased from slightly over $16 billion to about $24 billion in fiscal year 1977. Direct delivery systems supported by federal expenditures, such as the neighborhood health service, would continue in operation, but about $1 billion of their operating costs would be paid through medicaid. The outreach and case management services not provided in the private sector (and thus not recognized under medicaid reimbursement schedules) would require continued funding of about $250 million in fiscal year 1977.

A variety of plans have been proposed to provide protection against catastrophic medical costs. The important factors that influence the cost of any catastrophic insurance program include the level of protection provided, the extent to which it is financed through taxes rather than through premiums, and the extent to which the program imposes cost controls. A plan that paid for hospitalization after the first 60 days and medical expenses over the first $2,000 would cost between $10.5 and $11.5 billion in fiscal year 1977. If a majority of employers chose to provide catastrophic protection through private insurance, the federal cost of a residual public program would be from $6.5 to $7 billion. Since about $2.5 billion of this amount would represent transfers from existing federal programs, the added budget costs would be from $4 to $4.5 billion in fiscal year 1977. A wholly tax-financed plan would impose added budget costs in the range of $8 to $9 billion in fiscal year 1977.

The combination of a catastrophic plan in which half of the costs were borne by the federal government and a uniform medicaid program would raise federal health spending above current policy levels by roughly $10.5 billion in fiscal year 1977 and roughly $26 billion in fiscal year 1981. These amounts would be offset slightly by the reduction that would occur in health-related tax expenditures.

The targeted approach could not address all problem areas. The financial equality of access provided poor families through a federalized medicaid program might do little to alleviate the nonfinancial barriers to health care that are especially severe in the urban ghetto and rural areas where many families eligible for medicaid live. In particular, the increased ability of poor families to pay for physician services might mean little additional care because physicians are not available. While a federalized medicaid program could be administered more efficiently and equitably than the present programs, it still would offer little opportunity for system reform or cost containment.

Similarly, because catastrophic plans require beneficiaries to pay initial costs, they do not contain the programmatic means for cost control or improving efficiency. There is some danger that any insurance plan providing unlimited coverage would stimulate increased emphasis on high technology, institutional-based services, but the problem might be more pronounced in a catastrophic program that provided no support for basic or preventive care. An additional problem inherent in a fixed-deductible catastrophic plan is that those without adequate basic insurance might be bankrupted before they became eligible for catastrophic plan benefits. An income-related system would avoid this problem, but would have considerable complexity and higher administrative expenses.

Comprehensive Approaches--Comprehensive national health insurance could be adopted as a wholly tax-financed and publicly administered program; as a tax-financed but privately administered plan; or as a voluntary or compulsory mixed public and private system that covered the working population through employment-based insurance. The federal budgetary impact of national health insurance depends upon four factors: whether the plan is financed primarily through taxes or premiums, the range of benefits provided, the costs beneficiaries would be required to share, and the plan's cost control features. A totally tax-financed plan with no cost sharing for covered services could add from $104 to $140 billion to federal health expenditures by fiscal year 1981, while a compulsory, employment-based and premium-financed plan with cost-sharing could increase federal spending by $22 to $33 billion in 1981. The range of these federal cost estimates largely reflects varying assumptions about the effectiveness of cost controls. While a tax-financed plan would reduce the loss of revenues associated with health tax expenditures, the reverse would be true for a premium-financed plan.

The degree of individual financial protection provided by national health insurance would depend upon whether the program were voluntary or compulsory, tax or premium financed, and limited or comprehensive in benefits. A private, voluntary approach would presumably include tax incentives to offset a portion of insurance premium charges, coupled with (1) direct subsidies for low-income and high-risk persons and (2) regulations to prevent unreasonable discrimination in insurance sales practices. It is doubtful, however, that any combination of incentives, subsidies, and regulations could produce universal coverage.

Compulsory insurance, either publicly or privately administered, could provide greater equality of coverage and access to services. The degree to which it could guarantee individual financial protection, however, would depend upon the source of insurance and the range of benefits. Compulsory insurance could be financed by (1) a combination of tax-financed programs for groups with special needs and mandatory purchase of private insurance through employment for others or by (2) total public funding, through the tax system.

Although compulsory, employment-based insurance, combined with categorical programs, would cover more people than a voluntary system, it still would not be universal. This would result from the difficulty of devising special programs to include all those permanently or temporarily unemployed. Employment-based insurance also presents problems in achieving adequate levels of individual protection. The widely varying ability of employers to assume premium costs necessitates a relatively low level of mandatory benefits.

Insurance provided directly through the tax system would offer the best means of achieving universal coverage for either a full or limited range of benefits. It could also assure the highest general level of

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individual protection by relating premiums to income, rather than risk. Such a scheme would provide the greatest equality of access to services.

Effective control of health prices through insurance reimbursement is more difficult when there are multiple sources of funding. The fragmentation of purchasing power between public and private third-party reimbursement and consumer out-of-pocket spending reduces the leverage each can exert on provider charges. A single program covering the entire population would offer the greatest potential for controlling health costs through mechanisms such as establishing hospital budgets in advance and fee schedules for physicians and other professional providers. If that potential were not fully realized, however, a tax-financed public plan could be far more inflationary than the present mixed system.

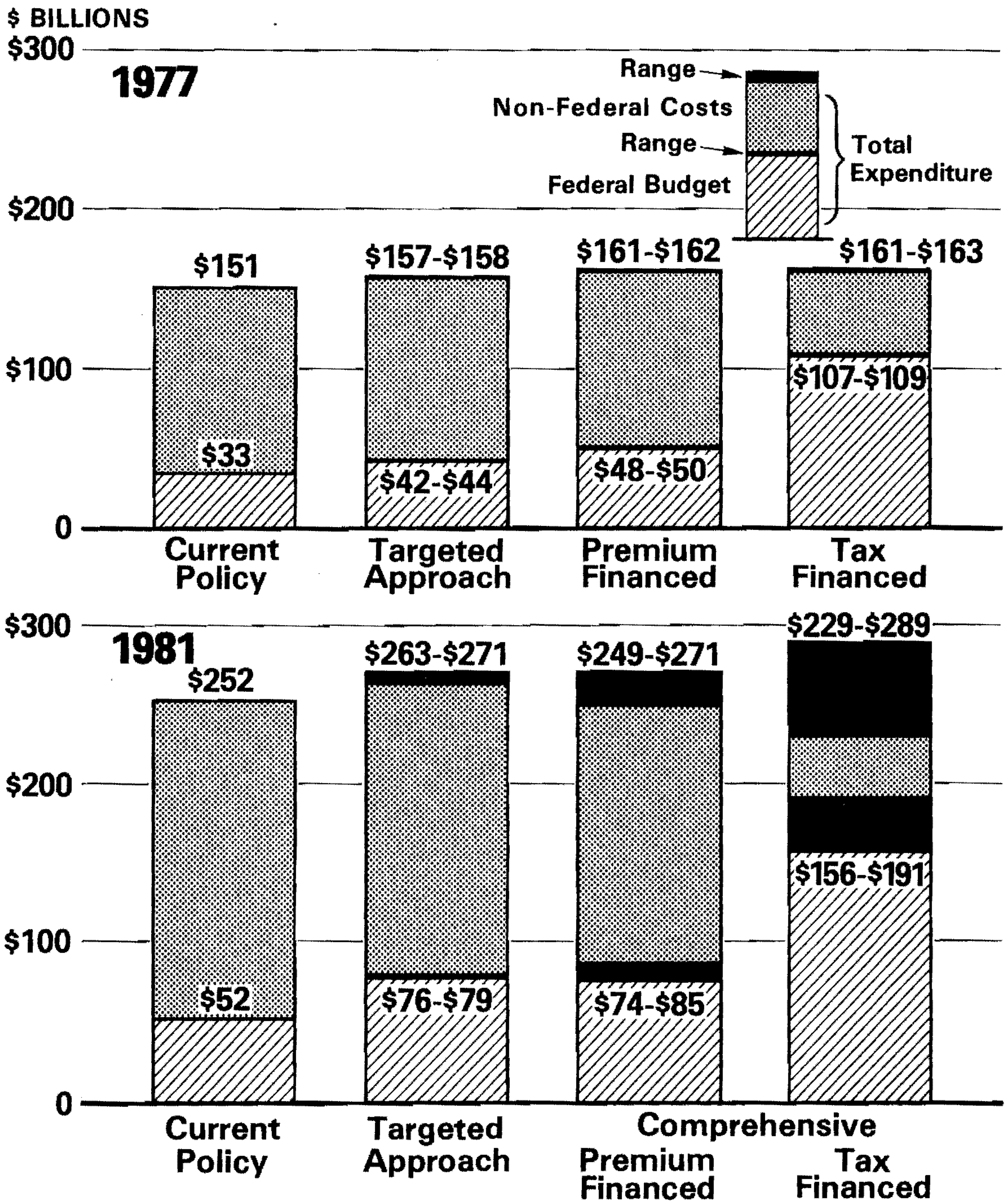
Manipulating complex controls of this nature without forcing the delivery system to be rigid would be a sensitive and difficult task. Furthermore, a tax-financed system with no cost sharing could encourage a high level of fraud and abuse because of limited patient concern over charges. Finally, comprehensive plans, whether tax or premium financed would not necessarily redress problems of nonfinancial barriers to access. In particular, if reimbursement rates were maintained at existing levels, they might even retard the movement of providers into communities with the greatest health care needs.

Long-Run Implications of Higher Options--Although the different national health insurance plans offer wide variations in population and benefit coverage, total--public plus private--national spending on health services would be roughly comparable in the first year under any of the proposals because the availability of services would impose an initial common constraint on overall spending. It is therefore useful to compare the relative costs of alternative plans assuming five years of full program operation because such estimates can reflect the easing of supply constraints and the imposition of cost controls, two factors that would not influence first year costs.

The following table and figure show total national spending for personal health services in fiscal year 1977 and fiscal year 1981 under current policy and the three prototype national health insurance approaches previously discussed. The ranges displayed for each proposal result from different assumptions regarding the effectiveness of cost controls. Two important points emerge from the projections: (1) Strong cost controls would yield significant savings by fiscal year 1981 and (2) adoption of a comprehensive national health insurance plan with rigidly enforced cost controls could, possibly, reduce national spending on personal health services below the levels projected under current policy.

Total National Spending and Federal Budget Costs, Personal Health Services for Fiscal Years 1977 and 1981

(Path B Assumptions)



TOTAL--PUBLIC PLUS PRIVATE--NATIONAL SPENDING FOR PERSONAL HEALTH SERVICES, 1977 AND 1981.
(Billions of Dollars)

	1977	1981
Current Policy	151	252
Targeted Approach	157-158	263-271
Premium Financed Compliance National Health Insurance	161-162	249-271
Tax Financed Comprehensive National Health Plan	161-163	229-289

Summary

It is probable that health services will absorb an increasing share of the nation's resources during the next five years. Paradoxically, devoting a larger share of our GNP to health services would not necessarily result in significant improvements in financial protection for individuals. Instead, if present trends continued, the growth in expenditures would largely finance higher prices for the same health care. The policy issue that must be addressed is therefore how to ensure that increasing health expenditures purchase significant improvements in protection and services rather than simply higher prices.

SUMMARY TABLE: HEALTH (550)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 550 items:								
Health care services (551)	23.4	28.0	7.5	32.3	36.9	41.4	46.1	51.4
Medicare (551 part)	14.8	17.6	4.8	20.5	23.7	27.0	30.5	34.5
Medicaid (551 part)	6.8	8.3	2.2	9.5	10.7	11.8	12.9	14.0
Other health services (551 part)	1.8	2.1	0.5	2.3	2.5	2.6	2.7	2.9
Other health services (552, 553, 554)	4.2	4.9	1.3	5.4	5.7	6.0	6.4	6.6
Total Current Policy Option: Health	**27.6**	**32.9**	**8.8**	**37.7**	**42.6**	**47.4**	**52.5**	**58.0**
Tax expenditures	5.7	6.6	1.6	7.3	8.2	9.1	10.2	11.3
HIGH OPTION I: Targeted Approach [a]								
Function 550 items:								
Health care services (551)	23.4	28.0	7.5	41.8–43.7	50.2–51.4	57.7–59.8	66.4–68.7	76.2–79.2
Other health (552, 553, 554)	4.2	4.9	1.3	5.4	5.7	6.0	6.4	6.6
Total High Option I: Targeted Approach [b]	**27.6**	**32.9**	**8.8**	**47.2–49.1**	**55.9–57.1**	**63.7–65.8**	**72.8–75.1**	**82.8–85.8**
Tax expenditures	5.7	6.6	1.6	6.2	6.6	6.9	7.4	7.7

See footnotes at end of table.

SUMMARY TABLE: HEALTH (550)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION II: Comprehensive Approach (premium financed) [a]								
Function 550 items:								
Health care services (551)	23.4	28.0	7.5	48.0–50.0	53.8–57.9	60.0–65.8	66.5–74.8	73.7–84.6
Other health (552, 553, 554)	4.2	4.9	1.3	5.4	5.7	6.0	6.4	6.6
Total Comprehensive Approach (premium financed) [c]	**27.6**	**32.9**	**8.8**	**53.4–55.4**	**59.5–63.6**	**66.0–71.8**	**72.9–81.2**	**80.3–91.2**
Tax expenditures	5.7	6.6	1.6	7.8	8.7	9.8	11.0	12.2
HIGH OPTION III: Comprehensive Approach (tax financed): [a]								
Function 550 items:								
Health care services (551)	23.4	28.0	7.5	107.0–109.5	117.9–127.9	130.3–148.7	142.7–168.6	155.6–191.0
Other health (552, 553, 554)	4.2	4.9	1.3	5.4	5.7	6.0	6.4	6.6
Total Comprehensive Approach (tax financed)	**27.6**	**32.9**	**8.8**	**112.4–114.9**	**123.6–133.6**	**136.3–154.7**	**149.1–175.0**	**162.2–197.6**
Tax expenditures	5.7	6.6	1.6	1.6	1.8	2.0	2.3	2.5

See footnotes at end of table.

SUMMARY TABLE: HEALTH (550)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 esti-mated	Transi-tion quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 550 items:								
Health care services (551)	23.4	28.0	7.5	30.8	33.5	36.5	39.4	42.4
Other health (552, 553, 554)	4.2	4.9	1.3	5.4	5.7	6.0	6.4	6.6
Total Low Option	**27.6**	**32.9**	**8.8**	**36.2**	**39.2**	**42.5**	**45.8**	**49.0**
Tax expenditures	5.7	6.6	1.6	7.3	8.2	9.1	10.2	11.3
PRESIDENT'S BUDGET								
Function 550 items:								
Health care services (551)	23.4	27.6	7.3	30.2	--------	--------	--------	--------
Medicare (551 part)	14.8	17.4	4.6	19.6	--------	--------	--------	--------
Medicaid (551 part)	6.8	8.2	2.2	[d] 8.7	--------	--------	--------	--------
Other health services (551 part)	1.8	2.0	0.5	[d] 1.9	--------	--------	--------	--------
Other health services (552, 553, 554)	4.2	4.5	1.0	[d] 4.2	--------	--------	--------	--------
Total President's Budget	**27.6**	**32.1**	**8.3**	**34.4**	--------	--------	--------	--------
Tax expenditures	5.7	6.6	1.6	6.3	--------	--------	--------	--------

[a] Range in expenditure estimates mostly results from varying assumptions on the effectiveness of cost controls.

[b] The additional Federal expenditure estimates are based on the assumption that 50 percent of the cost of the catastrophic plan will be public.

[c] This option would decrease outlays in Function 700 for 1977–81 by $0.8, $0.9, $1.0, $1.1, and $1.2 billions respectively.

[d] Proposed Financial Assistance for Health Care Act consolidates Medicaid and programs within the other subfunctions. Figures provided here conform to President's FY 1977 $9 billion outlay.

PART II-1: PROGRAM ISSUES
SECTION B: AID TO INDIVIDUALS

Housing

Current Programs

In recent years, federal housing policy has been directed primarily at providing better housing for lower-income families, reducing the costs of homeownership for families at all income levels, and affecting the levels of activity and employment in the construction industry. Many federal programs help to meet more than one of these objectives.

Major programs that directly affect housing appear in two places in the federal budget. Assistance to lower-income households is part of subfunction 604, public assistance and other income supplements. Activities aimed at financing housing make up all of subfunction 401, mortgage credit and thrift insurance.

The following table shows budget data for these two sets of programs. Under current policy assumptions, outlays for lower-income assistance would be $2.6 billion in fiscal year 1976 and would rise to $8.0 billion in fiscal year 1981. For credit and insurance programs, current policy assumptions imply outlays of $1.4 billion in fiscal year 1976, falling to zero by fiscal year 1980 and to minus $0.1 billion in fiscal year 1981. Tax expenditures are projected to rise from $10.4 billion in fiscal year 1976 to $14.9 billion in fiscal year 1981.

In the last 10 years, housing assistance outlays have risen dramatically, from $0.2 to $2.6 billion. This has been mostly caused by inflation and the addition of more subsidized housing units. Tax expenditures have also risen, although less dramatically, driven mostly by greater use of the allowable deductions, while mortgage credit and thrift insurance outlays have varied considerably with no clear trend. However, total expenditures for housing programs have not risen as fast as the federal budget as a whole.

Housing Assistance. The programs under housing assistance are aimed at lower-income households. Thus, they supplement other income assistance programs, such as AFDC and food stamps. Most lower-income housing assistance programs have provided the subsidized housing itself rather than distributing cash subsidies to the beneficiaries.

HOUSING OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1976, 1981
(Billions of Dollars)

	1966	1976[a]	1981[a]
Housing Assistance (604 part)	$0.2	$2.6	$8.0
Mortgage Credit and Thrift Insurance (401)	2.0	1.4	-0.1
Total	2.2	4.0	7.9
Percent of Total Outlays	1.7%	1.1%	1.4%
Tax Expenditures	NA	$10.4	$14.9

NA: Not available.
a. Current policy levels.

Currently the largest lower-income assistance program is the $1.6 billion subsidy to local public housing authorities to cover debt service and part of the operating costs of nearly 1.2 million low-rent public housing units. No significant increases in the number of units are planned for this program; however, assumed future inflation would increase outlays to $2.1 billion by fiscal year 1981.

Under the original Sections 235 and 236 interest rate subsidy programs, the federal government pays the difference between market mortgage interest rates and a subsidized rate that varies according to the net income of the occupants. Fiscal year 1976 current policy outlays are estimated to be $0.6 billion. The 235 program applies to new or rehabilitated units which are owner-occupied, while the 236 program covers new or rehabilitated rental and cooperative housing. In both cases, the developers and the owners of the housing are in the private sector. A moratorium on new commitments for both programs was declared in January, 1973. However, the Section 235 homeownership program was revived late in 1975, under new regulations which, among other things, limited the subsidy per unit. Existing legislative authority for the revived Section 235 program is sufficient for outlays to grow to an annual rate of as much as $0.25 billion over the next five years; actual outlays will depend on HUD implementation policy and private sector responses.

The biggest potential budget impact in the near future, however, comes from the new programs authorized under Section 8 of the 1974 Housing and Community Development Act. Rent payments are subsidized in both new housing built under the program and in existing housing. HUD area officials determine the appropriate mix of new and existing units in each area; owners or local housing authorities determine which families participate. Participating owners and local housing authorities set rents, up to HUD specified ceilings. The subsidy is equal to the difference between the rent and 25 percent (or 15 percent in special cases) of the tenant's adjusted income. While far less than the full amount has been obligated, authority provided both in the 1974 act and in the 1976 appropriation was estimated to be enough to subsidize up to 400,000 units. If 400,000 additional units are funded each year and implementation proceeds rapidly, annual outlays could grow to several billion dollars by fiscal year 1981.

Mortgage Credit and Thrift Insurance. There is a wide variety of federal programs designed principally to facilitate homeownership and spur housing production by affecting mortgage lending. (Most mortgages are financed by "thrift institutions," such as savings and loans associations.) The most important of these programs are:

- Government National Mortgage Association (GNMA) "Tandem Plans." The mechanics of these plans vary, but the basic idea is that mortgage lenders write mortgages at below-market interest rates under prior agreements with GNMA, which purchases the mortgages at par value. GNMA subsequently resells or otherwise refinances the mortgages at market value. Budget outlays for this program vary considerably from year to year, since they depend on GNMA decisions on when to sell mortgages it holds. When GNMA buys subsidized mortgages at par, it creates two separate effects: the subsidization of the mortgages and (at least potentially) a net injection of capital to the housing sector. The evidence is not conclusive as to whether this second effect actually occurs; some or all of the capital may have gone to the housing sector anyway. When GNMA resells or otherwise refinances the mortgages, the second effect may be partly negated.

- Rural housing loans, made by the Farmers' Home Administration (FmHA). These seek to alleviate shortages of credit in rural areas and often include an interest rate subsidy as well. As with GNMA, budget outlays vary considerably from year to year because they depend on FmHA portfolio management policy.

- Mortgage insurance and guarantees, principally under the Federal Housing Administration (FHA), the FmHA, and the Veterans Administration (VA). FHA insurance operations, which formerly yielded net income, have resulted in budget outlays recently ($1.1 billion in fiscal year 1975) because of increasing defaults. The defaults are almost entirely on mortgages on housing for lower-income occupants. Traditional FHA insurance programs still yield net income.

- Other programs to improve the short-term liquidity of mortgages and moderate fluctuations in supply or demand for credit in the housing sector. These are operated by the Federal Home Loan Bank Board (FHLBB) and by two government-sponsored private corporations--the Federal National Mortgage Association (FNMA), which has major responsibility for maintaining a secondary market in mortgages, and the Federal Home Loan Mortgage Corporation (FHLMC). Budget or off-budget outlays under these programs are principally the result of net lending to the private sector; budget credits (negative outlays) result in years when the private sector is a net repayer.

Tax expenditures are also an important part of federal housing policy. The deductibility of mortgage interest and property taxes on owner-occupied homes provides substantial benefits to homeowners and reduces federal revenue by an estimated $4.5 and $3.7 billion respectively in fiscal year 1976. For these two deductions combined, the revenue loss per household benefited is estimated to be $325. Other tax expenditures for housing cost the Treasury an estimated additional $2.2 billion in fiscal year 1976.

Projected Expenditures

Housing assistance outlays would grow from $2.6 billion in fiscal year 1976 to approximately $8 billion in fiscal year 1981, under current policy budget assumptions. The two main elements of growth in this projection are the Section 8 rent subsidy program and assistance to public housing. Section 8 accounts for about $4 billion of the projected $6 billion growth, under the assumption that current policy is to reserve subsidies for an additional 400,000 units each year. Such growth is, clearly, controllable by the Congress. Most of the rest of the projected rise is due to a combination of inflation and more modest growth in numbers of other subsidized housing units. Much of this growth is also controllable, but to a lesser extent and with greater adverse consequences to families currently receiving assistance.

Under credit and insurance programs, actual outlays are much more variable from year to year. Outlays for some programs are intended to vary, rising when housing credit is scarce or construction activity is depressed, and falling (to negative numbers) when credit is plentiful or construction is booming. Moreover, the actual outlays are strongly influenced by executive branch portfolio management decisions--how many mortgages to buy and how many to sell. Finally, the budget impact in a given year can be managed more or less independently of the immediate economic impact by recourse to transactions with off-budget agencies. Thus, these outlays in any one year are quite controllable by the executive branch but not easily influenced by the Congress. Other outlays, notably those of the FHA fund, are less subject to any short-run control, being determined in great part by defaults on FHA-insured mortgages. Any "current policy" assumptions on which to base budget projections for these programs thus require considerable discretion, and (even more so than for most other programs) reasonable people may well differ as to the appropriate choices. CBO's projections, showing outlays declining from $1.4 billion in fiscal year 1976 to minus $0.1 billion in fiscal year 1981, assume reduced levels of FHA defaults, stable outlays for interest rate subsidies, and net repayments of housing loans now outstanding to the private sector. These assumptions are generally consistent with the administration projections of economic recovery without increased inflation; less favorable economic results could increase the need for net positive outlays in housing finance programs.

Problems and Issues

The areas of concern in housing policy are discussed in this section.

Overall Distribution of Benefits. Under present policies, upper-income and middle-income families benefit substantially from federal homeownership incentives, notably from the income tax deductibility of mortgage interest and property taxes. Some lower-income families also receive substantial benefits from housing assistance programs, but the group as a whole fares less well. This overall view is shown in the following table.

DISTRIBUTION OF BENEFITS FROM HOUSING PROGRAMS
FISCAL YEAR 1972

Income Range	Percent of Benefits: Tax Expenditures	Percent of Benefits: Outlays[a]	Percent of Benefits: Total	Percent of Households in Income Range
Under $7,000	3	87	20	36.6
$7,000-$10,000	9	12	10	16.3
Over $10,000	88	1	70	47.1

a. For lower-income assistance programs only. Outlays under credit programs are not shown.

Equity Within Lower-Income Assistance Programs. Because of high costs per unit subsidized combined with the limited availability of funds, the proportion of lower-income households receiving federal housing assistance is small. Unlike many other income assistance programs, housing assistance is not provided to all applicants who can prove need as defined by regulations. The average federal expenditure of $935 per aided household in fiscal year 1975 was substantial when compared to the approximately $1,060 spent on housing by the typical poverty-level family. However, the 2.3 million households assisted by such federal programs represent only small fractions of the 9.9 million poverty-level households, or of the 27.7 million households whose income falls within the eligibility limits of current housing assistance programs. Even though many of those unaided families may not appear to have housing problems, the distribution of benefits is highly unequal.

High Unit Costs for Lower-Income Assistance Programs. Federal subsidies have been applied primarily to newly constructed housing, in part to help stimulate the construction industry. Because new housing is more costly than existing housing, this policy has meant that fewer households can be assisted with available subsidy dollars. Although new construction may be required in areas where low-cost housing is scarce, its inherently high costs raise the issue of whether subsidizing new construction is preferable to subsidizing consumers. This can be done at any level per unit and, hence, subsidies can be spread more evenly when funds are limited.

Problems Related to Homeownership and Construction. A number of diverse actual and potential problems are grouped here, because the same package of federal policies could be applicable to all of them.

- Rising costs are pricing homeownership out of the reach of more and more households--especially for new, detached single-unit buildings. Between 1971 and 1975, the median sales price of new single-family homes rose 42 percent, and that of existing single-family homes by 29 percent, while median household income rose only by 23 percent.

- The highly cyclical flow of capital to the housing sector creates a chronic problem for the construction industry (a cyclical problem shared by other durable goods of all types). Until recently the construction cycle has, to some extent, performed a useful economic stabilization function, since construction activity increased when interest rates fell as a result of recessions. In 1975, however, an additional problem arose--"stagflation," with recession and high inflation occurring simultaneously. Since interest rates did not decline despite the recession, housing construction was unable to perform its countercyclical role and, as a result, both the construction industry and the economy as a whole suffered at the same time. (The housing construction boom during 1972-74 may also have contributed to the 1975 slump.)

- A shortage of long-run capital supply could develop. The uncertainty about future inflation could lead investors to demand higher interest rates on long-term obligations, such as residential mortgages. Increasing government and private business borrowing may also raise interest rates. Because activity in the housing sector is more sensitive to interest costs than activity in other sectors, high interest rates tend to drive capital away from the housing market.

- In inflationary conditions, thrift institutions have trouble competing for funds. Their earnings depend on the long-term, fixed-interest mortgages which they hold. As interest rates elsewhere in the economy rise with inflation, these institutions cannot raise the interest they pay their depositors without suffering heavy losses. Federal regulations may also prevent them from raising interest rates on deposits. Therefore, the depositors move their savings to more profitable investments and the thrift institutions are caught in a serious liquidity squeeze.

- New multiunit rental housing has become a less attractive investment. Construction of these units has been depressed for some time.

- The stock of housing may be deteriorating faster than need be because the structure of market prices and costs in housing--which are partly the result of government policies--may tend to favor new construction rather than preservation and maintenance.

These six problems, actual or potential, can be ameliorated by federal actions affecting mortgage interest rates and housing credit in general.

Budget Options

Future housing programs will probably continue to reflect a mixture of the many different alternatives available. There is an almost infinite variety of program options available and each of these can be undertaken at different budget levels. The following higher and lower outlay options thus inevitably represent only

BUDGET OPTIONS SUMMARY FOR HOUSING PROGRAMS

OUTLAYS

[billions of dollars, fiscal years, path B]

Options	Housing Assistance (604 part)		Mortgage Credit and Thrift Insurance (401)		Total	
	1977	1981	1977	1981	1977	1981
Current policy	3.1	8.0	0.5	—0.1	3.6	7.9
Changes from current policy:						
Low-outlay option	—0.3	—4.4	—0.5	0.0	—0.8	—4.4
High-outlay options:						
Entitlement housing assistance[a]	+0.5	+4.7	+1.0	+2.0	+1.5	+6.7
Nonentitlement housing assistance[b]	—0.3	+4.7	+1.0	+2.0	+0.7	+6.7
Housing finance[c]	+0.1	+2.8	+1.4	+3.9	+1.5	+6.7
President's budget	0.0	NA	—1.1	NA	—1.1	NA

[a] High-Outlay Option 1.

[b] High-Outlay Options 2 or 3.

[c] High-Outlay Option 4.

an illustrative selection. Outlays and budget authority for the different options are summarized in the tables at the end of this section.

Current Policy Budget. Continuation of existing real program levels implies housing assistance outlays of $3.1 billion in fiscal year 1977 and $8 billion in fiscal year 1981. Tax expenditures will amount to $10.2 billion in fiscal year 1977 and $14.9 billion in fiscal year 1981. These projections imply that by 1981, almost 2 million housing units will be covered by the new Section 8 programs and that about 15 percent of the 31.5 million income-eligible households will benefit from one or another of the federal housing programs designed to assist lower-income households.

Higher Outlays. Outlay levels higher than those implied by the current policy budget could be achieved through any of a number of different approaches. Basic strategic choices include: how much to focus on lower-income families; whether to entitle all eligible families to assistance or to continue to limit total assistance levels by law; whether to attach subsidies to housing units or to give them directly to the intended beneficiary families; what relative priorities to assign to using, maintaining, and improving existing structures versus constructing new buildings; and (within a construction approach) what price levels to assist. Out of this potentially bewildering array, this report presents four possible combinations. The first two focus on lower-income families and give the assistance directly to them. The first--a housing allowance--is the bigger departure from present programs. This plan, which would entitle all lower-income households to assistance, could achieve lower subsidy costs per unit, but in practice would probably assist more households and hence have a higher total subsidy cost. The total estimated cost of this program, plus continuation of nonduplicative existing programs, is used to set the total assumed outlay level for each of the other three higher outlay options as well. Thus, in the other options, this report explores what can be bought, using other programs, for the cost of a comprehensive housing allowance. The second higher outlay option, a less radical change, would limit total outlays by appropriation. It could be implemented using the Section 8 program and emphasizing existing housing units. The third illustrative higher outlay option also focuses on lower-income households, but would emphasize new construction. Again, Section 8 could be used to implement such an option. The fourth option emphasizes increased construction and assistance to homebuyers. It is the least favorable to the poor; however, even the assumption of doubling the fiscal year 1977 current policy outlay level for these activities would cost only a fraction of the estimated cost of a comprehensive housing allowance, and thus would leave substantial funds available for other lower-income assistance programs as well, or for budget reduction.

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High Outlay Option 1: Entitlement Housing Assistance to Lower-Income Households. In contrast to current programs under which subsidies are attached to housing units, this approach would give a housing allowance (cash or vouchers) to eligible households, thus increasing their ability to pay for housing while leaving the choice of a specific housing unit to the household. All eligible households would be permitted to participate, with eligibility and level of assistance determined by household income and expenditures on housing, related to family size and possibly to the costs of modest housing in the area.

The effects of a housing allowance program on household consumption would probably be similar to those of a generalized cash assistance program. Most recipient households already spend a greater proportion of income for housing then they would likely be required to spend under the program; consequently, recipients would, in effect, be free to spend most or all of the allowance on other items. CBO has, therefore, chosen to treat housing allowances and general cash assistance as mutually exclusive alternatives whenever options for the budget as a whole are considered.

The arguments for and against a housing allowance strategy can be summarized as follows:

Pros:

- Equity: Households with the same income would be treated equally, and those with incomes just below the eligibility limit would not have more total income (income plus benefits) than nonparticipants who are just above the income limit.

- Freedom of Choice: Recipients could select the particular housing unit most suited to their needs, and move in response to changing circumstances without losing their subsidy.

- Lower Unit Costs: Existing housing units, which most recipients would be likely to choose, are typically less costly than new units. Incentives would be shifted towards maintenance and upgrading of existing housing. Furthermore, because the recipient would choose the unit, there would be incentives to seek the best value for the subsidy dollar.

Cons:

- The approach would be a major departure from past or present programs and unforeseen problems might arise. For example, if the supply of housing was not responsive to the increased demand produced by an allowance program, rents could be pushed up and much of the benefit of the allowance diverted to landlords.

- An allowance might not be sufficient, by itself, to overcome the lack of incentives to increase the supply of low-rent multiunit structures.

- Administrative requirements would include certification of participants' incomes, housing expenses, and perhaps the condition of housing occupied.

With regard to racial discrimination and segregation, the effects of a housing allowance--or indeed of other options--are unclear. Proponents of construction-oriented programs note, probably correctly, that large-scale integration will not happen soon without construction of new low-cost housing in areas now without such facilities. However, others note the strong local resistance to such programs and prefer to rely on the less politically sensitive, more gradual process of giving poor minority households the financial resources to move on their own, on an individual household basis, with assistance if necessary under civil rights laws.

A comprehensive allowance, entitling all lower-income families not covered by existing programs to assistance, is estimated to cost about $8.9 billion in fiscal year 1981. Allowing for population increases through 1981 and assuming that rents, incomes, and the general price level all rise at the same rate, 9.7 million participating households would receive an average allowance of $914 in that year.[1] An additional 2.7 million households would occupy subsidized housing units which would continue to be provided under existing federal subsidy contracts or which would come under contract from outstanding federal commitments. It is estimated that these contracts would cost $3.8 billion in fiscal year 1981, for a total estimated outlay of $12.7 billion for lower-income housing assistance in that year. Adding the estimated $1.9 billion in mortgage credit outlays would bring expenditures for all housing programs to $14.6 billion for fiscal year 1981. Assuming a gradual phase-in of an allowance program over the fiscal years 1977-81 period, 1977 outlays for the allowance plan might be on the order of $0.8 billion.

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1. It is estimated that some eligible famlies would choose not to participate.

High Outlay Option 2: Assistance to a Limited Number of Lower-Income Households. An approach providing direct assistance to lower-income households, but with total expenditures limited by law, could be implemented under legislation currently on the books in the Section 8 program.

For the same fiscal year 1981 outlays as the entitlement housing assistance option ($8.9 billion), an emphasis on Section 8 existing housing would assist 7 million households--4.3 million under Section 8 and 2.7 million under other current programs. The difference between this approach and that of option 1 is that under this plan, fewer households would be assisted (7 million versus 12.4 million) but at higher average cost.

The arguments for and against this option can be summarized as:

Pros:

- This plan would rely more on current policies and therefore represents a less radical break with the past and less chance of unexpected repercussions.

- Budget outlays could be controlled, because no entitlements would be involved.

Cons:

- Bureaucratic obstacles to implementation could be possible, since considerable control would be retained by both HUD and local agencies.

- Because of high unit costs, this approach would involve inequities unless the Congress provided sufficient funds to serve all eligible households. To subsidize the 9.7 million households that were assumed to participate in the housing allowance, 1981 costs would be about $20 billion under a Section 8 program emphasizing existing housing.

High Outlay Option 3: Production of Subsidized Housing for Lower-Income Households. This approach would also support employment and activity in the construction industry, and would be closer to past and current federal housing program structures than high outlay options 1 or 2. Emphasis on the Section 8 construction program (e.g., a mix of three new units for every two existing units) could be used to implement this approach.

For the same fiscal year 1981 outlays as the entitlement housing assistance option, an emphasis on the Section 8 construction program would assist roughly 5.2 million households: 1.5 million of those in newly constructed units at an average annual subsidy of $4,552 (1981 prices); 1.0 million under the Section 8 existing program at an average subsidy of $2,054; and 2.7 million assisted under other current programs. Slower start-up under this approach would imply lower fiscal year 1977 outlays than either an entitlement scheme or one emphasizing Section 8 existing housing.

The arguments for and against this option can be summarized as:

Pros:

- This approach would most closely follow current program structure.

- If effective, it would directly stimulate the construction industry and expansion of the housing stock.

- The mix of new versus existing units subsidized could be matched to local market conditions.

Cons:

- Because of higher unit costs, this approach would result in more inequities than options 1 or 2, unless the Congress provided sufficient funds to serve all eligible households. To subsidize the 9.7 million households that were assumed to participate in the housing allowance, fiscal year 1981 costs would be about $35 billion under this alternative.

- Even the substantial subsidies under the Section 8 new construction program might not be sufficient to induce developers to build the projected 1.5 million units by 1981. Administration estimates of new construction activity under Section 8 have been reduced several times due to lagging builder interest in the program.

High Outlay Option 4: Homeownership and Production of Middle-Income Units. Rather than stressing increased housing services for lower-income households, federal policy could be shifted towards subsidizing homeownership and spurring the construction of middle-income housing. Such an approach might emphasize: (a) retention of the present tax expenditures for homeowners, even under a low outlay assumption; (b) increased activity by FNMA and GNMA to increase the flow or mortgage money and to reduce mortgage interest rates; (c) regulatory changes to improve the functioning of housing finance institutions;

(d) federal subsidization of loss to mortgage lenders from interest rate fluctuations; (e) introduction of a mortgage investment tax credit for a portion of the mortgage interest earned by banks and thrift institutions; and (f) increased direct lending by the Federal Home Loan Bank Board to institutions granting mortgage loans, perhaps at subsidized rates. Some of these ideas are incorporated in legislation that is now before the Congress.

The arguments for and against such an approach can be summarized as follows:

Pros:

- It would stimulate construction activity.

- It would promote homeownership.

Cons:

- This approach would leave substantial housing needs unsatisfied among low-income families, unless total outlays plus tax expenditures were high.

- It would be more regressive since it would increase programs where benefits go mostly to middle- or upper-income families.

Elements (b), (d), and (f) of this strategy would involve increased federal outlays, and elements (a) and (e) would involve continued or new tax expenditures. For illustrative purposes this report assumes that higher outlays would be concentrated in a doubling of the real levels of outlays for interest subsidies by 1981--that is, it illustrates the option with emphasis on element (b). Total fiscal year 1981 outlays of $3.8 billion for mortgage credit and thrift insurance would be sufficient to subsidize mortgage interest rates by 2 percentage points for about 500,000 new housing units (as well as covering projected FHA losses, GNMA interest costs and administrative expenses, and assuming zero net portfolio changes in the Federal Home Loan Bank Board revolving fund). The estimate assumes that all subsidized mortgages are resold by GNMA in the year of purchase; under this assumption outlays represent the subsidy to borrowers plus operating costs. An even larger number of housing units could be assisted if GNMA sells or refinances mortgages already in its portfolio at the beginning of the year; however, this might raise interest rates on new nonsubsidized mortgages.

Even with this expanded GNMA outlay level, $10.8 billion would still be available for low- and moderate-income assistance--almost as much as under the other program options. Projecting $3.8 billion for current lower-income subsidy commitments in these programs, $7.0 billion would be available for allowances, a Section 8-type program, other initiatives, or budget reduction.

Lower Outlays. One of the many ways to achieve an austere budget for housing by fiscal year 1981 would be to halt all initiatives for lower-income housing programs and to hold down spending on current lower-income programs to $3.6 billion in 1981. This would imply that operating subsidies for public housing units are not increased beyond current levels. Local authorities and public housing tenants would be forced to bear the full brunt of cost increases. Under mortgage credit and thrift insurance, an austere budget could provide positive outlays only for operating expenses and inevitable deficiencies in FHA insurance activities; net outlays could be held to zero. In illustrative projections, tax expenditures have been reduced by 50 percent from the 1981 level projected under current tax policies. This could be accomplished, for example, by limiting the size of the deduction allowed per household. This austere budget would limit the number of lower-income households aided by federal programs in 1981 to 2.7 million, or 2 million below the current policy level for that year.

The President's Proposals. The President's fiscal year 1977 budget calls for housing outlays of $2.5 billion; $3.1 billion for lower-income assistance programs; and an offsetting credit of $0.6 billion in the mortgage credit and thrift insurance programs (see the first table at the end of this section). The President's proposals include:

- No additional GNMA commitments in 1977 to purchase mortgages. In fiscal year 1976 the President plans to commit $3 billion to support construction of an estimated 100,000 FHA-insured, multifamily units. Actual outlays for these units would not appear until after fiscal year 1977.

- Reduced emphasis on new construction within the Section 8 program--down from projected reservations for 300,000 units in the original 1976 budget to 125,000 units in 1976 and the transition quarter combined, and another 125,000 in 1977. However, in terms of actual performance, even reservation of 125,000 units per year would be a big increase over levels achieved so far.

- Linkage of current subsidy programs with properties owned by HUD, through default on an FHA-insured mortgage, or in danger of default. In fiscal year 1976 and the transition quarter, commitments are proposed for 30,000 such units under the public housing program and 110,000 under Section 8. Another 110,000 Section 8 commitments are proposed for fiscal year

1977. Resultant reductions in FHA insurance fund outlays are estimated by the President at $0.9 billion in 1976 and the transition quarter combined and $1.1 billion in 1977.

- Requiring higher rents from public housing tenants by changing the definition of adjusted income and establishing revenue standards for local housing authorities. Savings in operating subsidy payments are estimated by the President at $0.1 billion in fiscal year 1977.

- Reduced net outlays for mortgage credit and thrift activities, reflecting substantial outlay credits from net loan repayments, and interest income to the Federal Home Loan Bank Board and thrift insurance agencies (in addition to reduced FHA outlays as just noted).

On balance, the implications of the President's proposals for fiscal year 1977 outlays have more relative emphasis on lower-income assistance than a current policy budget would have. However, the difference lies in the President's lower outlay projections for mortgage credit and thrift insurance programs; his proposed outlays for lower-income assistance are the same as the current policy budget level. Achieving this level would represent substantial increases over fiscal year 1975 actual lower-income housing assistance outlays--$3.1 billion in 1977 compared to $2.1 billion in 1975.

The last two tables in this section summarize the budget implications of the various options. The first of these shows the outlay and tax expenditure amounts; the budget authority required to achieve these outlay levels is shown in the final table. For housing assistance, budget authority is much larger than the associated outlays because it represents the full potential obligations over the 15 to 40 year life of additional subsidy contracts proposed for that year. For mortgage credit and thrift insurance activities, the relation between future outlays and budget authority is complex, and depends on several assumptions. The assumptions made here are summarized in the footnotes to the last table; more details are available from the CBO staff.

Distributional Effects of Options

Each of the options discussed would change the past distribution of benefits that was shown in the table on page 173 . While it is not possible to estimate the size of the changes, the likely directions of change can be predicted in most cases, as shown in the following table.

RELATIVE BENEFIT DISTRIBUTIONS FOR HOUSING PROGRAM OPTIONS
(Fiscal Years)

	1972	Change by 1981 Under		Change by 1981 Under High Outlay Options				Change Under
Income Bracket	Distribution of Benefits	Current Policy	Low Outlays	Allowances	Section 8 Existing	Section 8 New	Homeownership	President's Budget
Under $7,000	20%	a	up	up	up	a	down	up
$7,000 to $10,000	10	up	a	a	a	up	a	a
Over $10,000	70	a	down	down	down	a	up	slightly down

a. Effect cannot be calculated.

SUMMARY TABLE: HOUSING

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Housing assistance (604 part):								
Additional low-income assistance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current programs	2.1	2.6	0.7	3.1	3.9	5.1	6.5	8.0
Subtotal housing assistance	2.1	2.6	0.7	3.1	3.9	5.1	6.5	8.0
Mortgage credit and thrift insurance (401)	2.8	1.4	0.9	0.5	0.2	0.1	0.0	−0.1
Total Current Policy Option: Housing	**4.9**	**4.0**	**1.6**	**3.6**	**4.1**	**5.2**	**6.5**	**7.9**
Tax expenditures [a]	11.4	10.4	2.6	10.2	11.1	12.2	13.5	14.9
HIGH OPTION I: Entitlement housing assistance to lower-income households through emphasis on allowances:								
Housing assistance (604 part):								
Allowances	0.0	0.0	0.0	0.8	2.6	4.7	7.1	8.9
Current subsidy commitments	2.1	2.6	0.7	2.8	3.4	3.6	3.7	3.8
Subtotal housing assistance (604 part)	2.1	2.6	0.7	3.6	6.0	8.3	10.8	12.7
Mortgage credit and thrift insurance (401)	2.8	1.4	0.9	1.5	1.6	1.7	1.8	1.9
Total High Option I: Emphasis on Allowances	**4.9**	**4.0**	**1.6**	**5.1**	**7.6**	**10.0**	**12.6**	**14.6**
Tax expenditures [a]	11.4	10.4	2.6	10.2	11.1	12.2	13.5	14.9

See footnotes at end of table.

SUMMARY TABLE: HOUSING—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION II: Assistance to a limited number of lower-income households through emphasis on section 8, existing units:								
Housing assistance (604 part):								
Additional section 8—Existing housing	0.0	0.0	0.0	0.0	1.3	4.0	7.1	8.9
Current subsidy commitments	2.1	2.6	0.7	2.8	3.4	3.6	3.7	3.8
Subtotal housing assistance (604 part)	2.1	2.6	0.7	2.8	4.7	7.6	10.8	12.7
Mortgage Credit and Thrift Insurance (401)	2.8	1.4	0.9	1.5	1.6	1.7	1.8	1.9
Total High Option II: Emphasis on section 8, existing units	**4.9**	**4.0**	**1.6**	**4.3**	**6.3**	**9.3**	**12.6**	**14.6**
Tax expenditures[a]	11.4	10.4	2.6	10.2	11.1	12.2	13.5	14.9
HIGH OPTION III: Production of subsidized housing for lower-income households through emphasis on section 8, new units:								
Housing assistance (604 part):								
Additional section 8—New construction	0.0	0.0	0.0	0.0	0.0	1.5	4.9	6.8
Additional section 8—Existing units	0.0	0.0	0.0	0.0	0.3	0.9	1.6	2.1
Current subsidy commitments	2.1	2.6	0.7	2.8	3.4	3.6	3.7	3.8
Subtotal housing assistance (604 part)	2.1	2.6	0.7	2.8	3.7	6.0	10.2	12.7
Mortgage credit and thrift insurance (401)	2.8	1.4	0.9	1.5	1.6	1.7	1.8	1.9
Total High Option III: Emphasis on section 8, new units	**4.9**	**4.0**	**1.6**	**4.3**	**5.3**	**7.7**	**12.0**	**14.6**
Tax expenditures[a]	11.4	10.4	2.6	10.2	11.1	12.2	13.5	14.9

See footnotes at end of table.

SUMMARY TABLE: HOUSING—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION IV: Emphasis on homeownership and production of middle-income housing:								
Housing assistance (604 part):								
Additional low-income assistance	0.0	0.0	0.0	0.4	1.8	3.5	5.5	7.0
Current subsidy commitments	2.1	2.6	0.7	2.8	3.4	3.6	3.7	3.8
Subtotal housing assistance (604 part)	2.1	2.6	0.7	3.2	5.2	7.1	9.2	10.8
Mortgage credit and thrift insurance (401)	2.8	1.4	0.9	1.9	2.4	2.9	3.4	3.8
Total High Option IV: Emphasis on homeownership and construction	**4.9**	**4.0**	**1.6**	**5.1**	**7.6**	**10.0**	**12.6**	**14.6**
Tax expenditures [a]	11.4	10.4	2.6	10.2	11.1	12.2	13.5	14.9
LOW OPTION								
Housing assistance (604 part):								
Additional low-income assistance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current subsidy commitments	2.1	2.6	0.7	2.8	3.3	3.5	3.6	3.6
Subtotal housing assistance	2.1	2.6	0.7	2.8	3.3	3.5	3.6	3.6
Mortgage credit and thrift insurance (401)	2.8	1.4	0.9	0.0	0.0	0.0	0.0	−0.1
Total Low Option: Housing	**4.9**	**4.0**	**1.6**	**2.8**	**3.3**	**3.5**	**3.6**	**3.5**
Tax expenditures [a]	11.4	10.4	2.6	9.7	9.1	8.6	8.0	7.4

See footnotes at end of table.

SUMMARY TABLE: HOUSING—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Housing assistance (604 part)	2.1	2.5	0.7	3.1				
Mortgage credit and thrift insurance (401)	2.8	1.3	0.3	−0.6				
Total President's Budget: Housing	**4.9**	**3.8**	**1.0**	**2.5**				
Tax expenditures [a]	11.4	10.4	NA	10.2				

[a] These totals represent the mathematical sum of the estimated fiscal year effect of each of six tax expenditure items: Depreciation on rental housing in excess of straight line; deferral of capital gains on home sales; deductibility of mortgage interest on owner-occupied homes; deductibility of property tax on owner-occupied homes; credit for purchase of new home; and exclusion of capital gains on home sales if over 65.

Also see footnotes at end of housing budget authority table.

SUMMARY TABLE: HOUSING

BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Housing assistance (604 part):								
Additional low-income assistance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current programs	44.4	18.3	0.1	38.1	41.6	44.1	46.4	48.8
Subtotal housing assistance	44.4	18.3	0.1	38.1	41.6	44.1	46.4	48.8
Mortgage credit and thrift insurance (401)	9.4	4.8	0.5	1.2	0.9	0.8	0.8	0.7
Total Current Policy Option: Housing	**53.8**	**23.1**	**0.6**	**39.3**	**42.5**	**44.9**	**47.2**	**49.5**
HIGH OPTION I: Entitlement housing assistance to lower-income households through emphasis on allowances:								
Housing assistance (604 part):								
Allowances	0.0	0.0	0.0	1.6	2.7	5.6	7.3	8.7
Current subsidy commitments	44.4	18.3	0.1	[a] 0.5	1.1	1.4	1.3	1.4
Subtotal housing assistance (604 part)	44.4	18.3	0.1	2.1	3.8	7.0	8.6	10.1
Mortgage credit and thrift insurance (401)	9.4	4.8	0.5	7.1	2.9	2.9	3.1	3.6
Total High Option I: Emphasis on Allowances	**53.8**	**23.1**	**0.6**	**9.2**	**6.7**	**9.9**	**11.7**	**13.7**
HIGH OPTION II: Assistance to a limited number of lower-income households through emphasis on Section 8, existing units:								
Housing assistance (604 part):								
Additional Section 8—existing housing	0.0	0.0	0.0	[b] 38.5	53.3	56.1	0.0	0.0
Current subsidy commitments	44.4	18.3	0.1	[a] 0.5	1.1	1.4	1.3	1.4
Subtotal housing assistance (604 part)	44.4	18.3	0.1	39.0	54.4	57.5	1.3	1.4
Mortgage credit and thrift insurance (401)	9.4	4.8	0.5	7.1	2.9	2.9	3.1	3.6
Total High Option II: Emphasis on Section 8, existing units	**53.8**	**23.1**	**0.6**	**46.1**	**57.3**	**60.4**	**4.4**	**5.0**

See footnotes at end of table.

SUMMARY TABLE: HOUSING—Continued

BUDGET AUTHORITY—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION III: Production of subsidized housing for lower-income households through emphasis on Section 8, new units:								
Housing assistance (604 part):								
Additional Section 8—new construction	0.0	0.0	0.0	[c] 81.2	104.0	0.0	0.0	0.0
Additional Section 8—existing units	0.0	0.0	0.0	[c] 9.6	12.3	13.0	0.0	0.0
Current subsidy commitments	44.4	18.3	0.1	[a] 0.5	1.1	1.4	1.3	1.4
Subtotal housing assistance (604 part)	44.4	18.3	0.1	91.3	117.4	14.4	1.3	1.4
Mortgage credit and thrift insurance (401)	9.4	4.8	0.5	7.1	2.9	2.9	3.1	3.6
Total High Option III: Emphasis on Section 8, new units	**53.8**	**23.1**	**0.6**	**98.4**	**120.3**	**17.3**	**4.4**	**5.0**
HIGH OPTION IV: Emphasis on homeownership and production of middle-income housing:								
Housing assistance (604 part):								
Additional low-income assistance	0.0	0.0	0.0	[d] 0.4	[d] 1.8	[d] 3.5	[d] 5.5	[d] 7.0
Current subsidy commitments	44.4	18.3	0.1	[a] 0.5	1.1	1.4	1.3	1.4
Subtotal housing assistance (604 part)	44.4	18.3	0.1	0.9	2.9	4.9	6.8	8.4
Mortgage credit and thrift insurance (401)	9.4	4.8	0.5	[e] 10.1	[e] 5.7	[e] 5.6	[e] 4.9	[e] 5.6
Total High Option IV: Emphasis on homeownership and construction	**53.8**	**23.1**	**0.6**	**11.0**	**9.6**	**10.5**	**11.7**	**14.0**

See footnote at end of table.

SUMMARY TABLE: HOUSING—Continued

BUDGET AUTHORITY—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Housing assistance (604 part):								
Additional low-income assistance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current subsidy commitments	44.4	18.3	0.1	[a] 0.5	1.0	1.3	1.2	1.2
Subtotal housing assistance	44.4	18.3	0.1	0.5	1.0	1.3	1.2	1.2
Mortgage credit and thrift insurance (401)	9.4	4.8	0.5	1.2	0.9	0.8	0.8	0.7
Total Low Option: Housing	**53.8**	**23.1**	**0.6**	**1.7**	**1.9**	**2.1**	**2.0**	**1.9**
PRESIDENT'S BUDGET								
Housing assistance (604 part)	44.4	19.4	0.1	17.1				
Mortgage credit and thrift insurance (401)	9.4	6.2	0.2	1.2				
Total President's Budget: Housing	**53.8**	**25.6**	**0.3**	**18.3**				

[a] BA carried over from fiscal year 1975 and 1976 of $23.0 billion under annual contributions contracts for assisted housing would not be required and could be rescinded.

[b] BA carried over from fiscal year 1975 and 1976 of $11.7 billion would be used in addition to the amount shown. An additional $11.3 billion originally provided for Section 8 new construction program would lapse.

[c] BA carried over from fiscal year 1975 and 1976 of $19.1 billion would be used in addition to the amount shown. An additional $3.9 billion would apse.

[d] BA shown equal to outlays. Actual BA required would depend on which programs were used for additional low-income assistance.

[e] BA shown assumes that GNMA portfolio remains constant. Actual BA required could be reduced (increased) by possible sales (purchases) from GNMA portfolio. Preceding year Tandem BA is carried over as permanent authority.

PART II-1: PROGRAM ISSUES
SECTION B: AID TO INDIVIDUALS

Veterans' Benefits and Services (Function 700)

Introduction

The programs available to veterans and their dependents or survivors, which comprise budget function 700, are for the most part based on long traditions of compensating former servicemen for hardships incurred in the course of military service and of redressing any inequities that might befall those drafted into the armed forces. The major veterans' programs provide benefits that are similar in many respects to human resource programs now available to those in the general population who are eligible.

Compensation is paid to veterans who have incurred disabilities in military service. Payments vary with the extent of disability and the amount of income foregone because of that disability. The severely disabled also receive special fixed statutory awards and dependents' allowances. Dependency and indemnity compensation is paid to survivors of veterans who died from service-connected causes. The average annual payment to veterans in 1975 was $1,715 and the maximum was almost $15,000. The average payment to survivors in 1975 was $2,326.

Pensions are paid to nonservice-disabled and aged war veterans and their dependents or to their survivors if the recipients' incomes fall below $3,300 for single beneficiaries or $4,500 for beneficiaries with dependents. However there are 18 income exclusions in determining eligibility for pensions. Among these are the exclusion of 10 percent of public or private retirement and either $1,200 or all of a spouse's earned income, whichever is greater.

Because of the income exclusions, the actual family income of the pensioner varies greatly--from below the poverty level to over $20,000 a year. In 1975, the average annual benefit paid was $1,461 for a veteran alone, $778 for a surviving spouse, and $1,500 for a veteran with dependents. The maximum payment under current law is $2,352. Selected pensioners who are permanently housebound or who require special aid and attendance may be eligible for additional payments.

Readjustment benefits provide financial assistance for education, training, and rehabilitation to veterans who serve more than 180 days in the military and to certain of their dependents or survivors. These benefits may be used for ten years after discharge. Allowances are based on the number of dependents and whether attendance is full time or less. They are paid for up to 36 months of education and training. An additional nine months is allowed if the veteran is pursuing an

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undergraduate degree. The average annual benefit in 1975 was $1,547.

Hospital and medical care is provided, usually in Veterans' Administration facilities, to service-disabled veterans, veteran pensioners, and veterans 65 and over, and any other veteran who states that he is unable to pay for the cost of care. Dependents of 100 percent service-disabled veterans and survivors of veterans who died from a service-connected disability are provided care through an insurance program administered by the Defense Department (CHAMPVA).

Other veterans' programs include direct and guaranteed housing loans, life insurance, and burial benefits. The Veterans' Administration also operates programs such as research and health manpower training to support its medical care system.

The nontaxable nature of veterans' benefits constitutes a tax expenditure that reduces federal revenues by approximately $0.9 billion.

Direct outlays for veterans' programs, which are estimated to be $19 billion in fiscal year 1976, will have more than tripled over the past decade as a result of the influx of Vietnam veterans, the aging of the veterans from the two world wars, and the liberalization of benefits (see following table). The fraction of the federal budget devoted to veterans' programs has increased from 4.4 to 5.1 percent over this period.

If current real program levels are maintained, outlays for veterans' programs will be $18.7 billion in 1977 and $21.1 billion in 1981.

Issues

The level of budgetary commitment to veterans' programs hinges on alternative determinations of the proper amount of postservice compensation and expenditure necessary to prepare veterans for reentry into civilian life. One widely held view is that military service gives a special status to veterans and makes them deserving of lifetime benefits separate from and superior to those of the general population. An opposing view is that military service is a responsibility of citizenship and that veterans should receive special benefits only to the extent that they have incurred special service-related hardships. From this perspective, it could be argued that only compensation for disabilities incurred in service and limited assistance for reentry into civilian life would be required.

A third approach is to continue to operate a wide range of veterans' programs but to coordinate them with more recently developed social

VETERANS' BENEFITS AND SERVICES (FUNCTION 700)
OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1976, 1981
(Billions of Dollars)

	1966	1976[a]	1981[a]
Compensation and Pensions	$4.2	$8.0	$10.1
Readjustment Benefits	b	6.1	4.5
Medical Care	1.2	3.8	5.0
Other	.5	1.2	1.5
Total	5.9	19.1	21.1
Percent of Total Outlays	4.4%	5.1%	3.7%
Tax Expenditures	NA	.9	.9

a. Current policy levels.
b. Less than $50 million.
NA: Not available.

programs. Veterans' programs would be altered as necessary to ensure equity and consistency within these programs and to differentiate more carefully between the benefits accorded the service disabled and nondisabled.

Proponents of each approach may also distinguish between benefits for peacetime versus wartime service and service under the draft versus service under an all-volunteer army.

Budget Options

Different views of appropriate veterans' programs suggest very different budget approaches ranging from enrichment of current programs to an elimination of special veterans' benefits except in cases of specific service-related hardship. Integration of the existing system--where possible--with the general social welfare system represents an intermediate approach. Alternatives such as these have been discussed for many years and some are under active consideration.

The ones illustrated here are not the only approaches available and are not recommendations.

Current Policy: If current policies are maintained, spending on veterans' programs will be $18.7 billion in fiscal year 1977 and $21.1 billion in fiscal year 1981. (See table below.)

VETERANS' BENEFITS AND SERVICES (FUNCTION 700)
BUDGET OPTIONS OUTLAYS
(Billions of Dollars, Fiscal Years)

Options	1977	1981
Current Policy	18.7	21.1
Changes From Current Policy Level		
President's Option	-1.5	
High Option	2.1	1.4
Lower Option	-4.4	-8.6
Intermediate Option	--	-0.4

Note: For greater detail see previous table.

These outlay levels reflect:

- a temporary decline in the number of pension cases caused by the deaths of World War I pensioners, although the caseload will increase in the 1980s as increasing numbers of World War II veterans reach 65.
- reduced GI Bill participation because Vietnam veterans are reaching the ten-year limit on eligibility for readjustment assistance and because there are fewer separations from the service.
- an assumed stable participation of aging and infirm veterans in the VA medical system.

The President's Proposals: The President's fiscal year 1977 budget calls for $17.2 to be spent on veterans' programs. This represents a reduction of $1.5 billion below current policy fiscal year 1977 levels. The legislative proposals in the budget would reduce outlays by $928 billion.

Approximately $712 million of the proposed reductions is in the readjustment benefits program. Readjustment benefits would be terminated for future members of the peacetime all-volunteer armed force and the current program for Vietnam-era veterans would be modified by (1) eliminating marginally effective flight and correspondence school training, (2) terminating PREP (predischarge) training, and (3) repealing the recent two-year extension of the time a veteran can use his benefits.

No legislative changes are proposed for the compensation and pension programs. However, the estimates assume that the 8 percent cost-of-living increase in pensions enacted last year will expire on September 30, 1976, and will not be extended with the result that benefits and income ceilings will revert to their former levels. The current policy estimate, which assumes both an extension of the 8 percent increase and an additional cost-of-living increase in both compensation and pensions in 1977, is $500 million higher than the President's estimate.

Outlays for medical care are estimated to be $4.1 billion in 1977. This level provides for an increase in staffing and number of patients treated. A legislative proposal would require the Veterans Administration to be reimbursed by private insurers for the treatment of nonservice-disabled veterans. Reimbursements are estimated to be $130 million.

It is also proposed that duplicate burial benefits be eliminated for a savings of $85 million and that a 50-50 grant program be instituted for the construction and operation of state veterans' cemeteries. The first-year federal cost is estimated to be $4 million.

High Option: A budgetary approach reflecting the view that veterans deserve special and more generous treatment than now provided might include the following new programs and modifications of existing programs:

- Elimination of the distinction between wartime and peacetime service in determining pension eligibility, and the institution of an automatic cost-of-living escalator. This would assure that benefits would keep pace with inflation but it would not correct certain structural problems in the system.

- Revision of the readjustment benefits program so that restrictions on participation because of regional differences in education costs could be corrected. This objective could be achieved through a tuition voucher which pays 80 percent of the cost of public education and a subsistence payment equal to the maximum HEW Basic Education Opportunity Grant ($1,400). This program would be more difficult to administer than the current one.

- Expansion of the VA medical program to pay for medical care received in non-VA facilities by veterans with service-connected disabilities rated at 50 percent or more. Currently more than 40 percent of those requiring hospitalization pay for their own care instead of receiving it in VA facilities or under VA contract.

Taken together, these policies would create budget outlays in fiscal year 1977 of $20.8 billion and $22.5 billion in fiscal year 1981. This is $2.1 billion over current policy levels in fiscal year 1977 but only $1.4 above that level in fiscal year 1981.

Low Option: If preferential treatment for nonservice-disabled veterans is not deemed necessary, those special programs currently available to them which are not in response to sacrifices made in the service could be eliminated. Such an approach could consist of:

- Elimination of the nonservice-connected pension program on the grounds that pensioners' current financial position bears no relationship to past military service and that other programs will provide income assistance to needy veterans. However, many present pensioners would be unable to meet the stricter income and assets test required to be eligible for the Supplemental Security Income (SSI) program or would be subject to state variations in payments under other programs. The general income support programs have also been criticized as inadequate and demeaning.

- Ending the eligibility of future enlistees for the GI Bill because it was intended to help servicemen drafted into wartime service at low pay readjust to civilian life. The United States is not at war and military service today is a career choice with competitive pay scales and generous in-service training programs. Postservice programs of education and training benefits for veterans may also inhibit military reenlistment goals. A bill similar in purpose has been passed by the House (H.R. 9576).

- Termination of eligibility for free medical benefits for nonservice-disabled veterans. Nonservice-disabled veterans could be charged for care received in VA facilities or some phasing down of VA hospital operations might be required with care provided to service-disabled veterans through contracts. The option of purchasing care through contracts provides greater flexibility and eliminates the geographic problems of access to VA facilities.

Budget outlays under this approach would be $14.3 billion in fiscal year 1977 and $12.5 billion in fiscal year 1981. This represents declines of $4.4 billion and $8.6 billion respectively from current policy levels (see previous table).

A termination of pension benefits would increase Supplemental Security Income (SSI) and Aid to Families With Dependent Children (AFDC) caseloads somewhat. Similarly, outlays under HEW education programs and under medicaid would rise with the termination of readjustment benefits and the reduction of special medical benefits for the nonservice disabled.

Intermediate Option: An approach which attempted to integrate current veterans' programs with broader existing social programs and also attempted to correct deficiencies or inequities that have developed could involve the following types of policy changes:

- Reformation of the pension system by establishing an income floor at the poverty line ($2,590 for an individual in 1975), equalizing treatment of different sources of income, and automatically increasing benefits with the cost of living. Present pensioners could be given the option of remaining under the current system at existing levels. Under the new system, approximately 30 percent of pensioners would receive higher benefits; certain anomalies in eligibility determination would be corrected; and real benefit levels would be maintained. A similar reform has been passed by the Senate (S. 2635).

- Continuation of the GI Bill for peacetime and all volunteer service, limiting its use to five years after discharge and fixing the allowance at the maximum level of the Basic Educational Opportunity Grants, and extension of supplementary loans from the VA Education Loan Fund with annual limits of $1,500 for a single veteran and $2,500 for a veteran with dependents. Both loans and grants would be extended to veterans because they tend to be older with more dependents than the usual school population. Benefits would be unchanged for Vietnam-era veterans and special assistance to disabled veterans would be continued.

- Integration of VA medical resources with those of the community in terms of location of facilities and services; concentration on more efficient utilization of staff and beds; and a requirement that VA hospitals must be reimbursed for treatment of nonservice-disabled veterans who are covered by private health insurance plans. If national health insurance is enacted, cost sharing by nonservice-disabled veterans would be required so that the cost of medical care could be approximately the same for veterans using either VA or non-VA facilities.

Pursuing these policies would require outlays of $18.7 billion and $20.7 billion respectively in fiscal years 1977 and 1981. These levels are the same as the current policy level in fiscal year 1977 and $400 million below current policy in fiscal year 1981 (see previous table).

SUMMARY TABLE: VETERANS' BENEFITS AND SERVICES (700)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 700 items:								
Compensation and pensions (701 part)	7.4	8.0	2.1	8.5	8.9	9.2	9.6	10.1
Readjustment benefits (702)	4.6	6.2	1.3	4.9	4.8	4.8	4.7	4.5
Medical care (703 part)	3.4	3.7	1.0	4.1	4.3	4.6	4.8	5.0
All other (704, 705 plus residual)	1.2	1.2	0.3	1.2	1.3	1.2	1.3	1.5
Total Current Policy Option: Veterans	**16.6**	**19.1**	**4.8**	**18.7**	**19.3**	**19.8**	**20.4**	**21.1**
HIGH OPTION								
Function 700 items:								
Compensation and pensions (701 part)	7.4	8.0	2.1	8.5	8.9	9.2	9.6	10.1
Readjustment benefits (702)	4.6	6.2	1.3	6.8	6.4	6.1	5.9	5.6
Medical care (703 part)	3.4	3.7	1.0	4.3	4.5	4.8	5.1	5.3
All other (704, 705 plus residual)	1.2	1.2	0.3	1.2	1.3	1.2	1.3	1.5
Total High Option: Veterans	**16.6**	**19.1**	**4.8**	**20.8**	**21.1**	**21.3**	**21.9**	**22.5**
MEDIUM-LOW OPTION								
Function 700 items:								
Compensation and pensions (701 part)	7.4	8.0	2.1	8.5	8.6	8.8	9.0	9.4
Readjustment benefits (702)	4.6	6.2	1.3	5.1	5.1	5.1	5.1	5.1
Medical care (703 part)	3.4	3.7	1.0	3.9	4.1	4.3	4.5	4.7
All other (704, 705 plus residual)	1.2	1.2	0.3	1.2	1.3	1.2	1.3	1.5
Total Medium-Low Option: Veterans	**16.6**	**19.1**	**4.8**	**18.7**	**19.1**	**19.4**	**19.9**	**20.7**

See footnotes at end of table.

SUMMARY TABLE: VETERANS' BENEFITS AND SERVICES (700)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 700 items:								
Compensation and pensions (701 part) [a]	7.4	8.0	2.1	5.5	5.7	5.9	6.2	6.5
Readjustment benefits (702)	4.6	6.2	1.3	4.9	4.7	4.5	4.2	3.7
Medical care (703 part) [b]	3.4	3.7	1.0	3.0	2.2	1.4	1.5	1.7
All other (704, 705 plus residual)	1.2	1.2	0.3	0.9	0.8	0.7	0.6	0.6
Total Low Option: Veterans	**16.6**	**19.1**	**4.8**	**14.3**	**13.4**	**12.5**	**12.5**	**12.5**
PRESIDENT'S BUDGET								
Function 700 items:								
Compensation and pensions (701 part)	7.4	8.0	2.1	8.0	------	------	------	------
Readjustment benefits (702)	4.6	6.0	1.1	4.2	------	------	------	------
Medical care (703 part)	3.4	3.8	0.9	4.0	------	------	------	------
All other (704, 705 plus residual)	1.2	1.2	0.3	0.9	------	------	------	------
Total President's Budget: Veterans	**16.6**	**19.0**	**4.4**	**17.2**	------	------	------	------

[a] This option would result in increased outlays in function 600 of $1.1, $1.2, $1.3, $1.3, $1.4 billions of dollars from 1977 to 1981, respectively.

[b] Assumes a 2-year phase-down of the medical system.

The Federal Budget and Unemployment

Introduction

The government uses four major approaches to deal with the continuing problem of unemployment:

1. stimulative fiscal policy in times of high unemployment (discussed in Part I of this report),

2. expenditure and tax programs directed at increasing public and private employment,

3. programs to train and educate potential workers and to facilitate the functioning of the labor market, and

4. direct cash assistance to reduce the financial burdens of unemployment.

This section deals with the latter three anti-unemployment programs. The table on page 206 shows programs grouped according to their primary purposes with their estimated fiscal year 1977 current policy outlay levels.

Unemployment: The Problem

The current recession left an average of 8.5 percent of the labor force (7.83 million individuals) unemployed during 1975. If the additional 1.08 million "discouraged workers" who left the labor force because they believed jobs to be unavailable were added to the unemployed, they would have created a "jobless rate" of 9.5 percent. High rates of unemployment can be expected to continue in the near future. If federal expenditures and revenues are maintained at current policy levels, the unemployment rate is estimated to average approximately 6.9 percent during fiscal year 1977.[1]

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1. The fiscal year 1977 outlay estimates in the remainder of this chapter were calculated on the basis of an assumed fiscal year 1977 average unemployment rate of 7.5 percent. If the unemployment rate falls to 6.9 percent as now estimated, current policy unemployment benefit costs would decline by about $1.5 billion.

Causes. Unemployment is both a short-run and a long-run problem: short run when caused by inadequate demands for goods or services; long run when caused by imbalances between the skill levels of available workers and the skill requirements of the jobs to be filled, disparities between geographic location of jobs, and delays experienced by workers while they search for jobs. Unemployment caused by the latter factors is not easily remedied by traditional fiscal policy measures and is commonly referred to as "structural unemployment." Unemployment may also be increased by the work disincentives created by income assistance programs that aid the unemployed.

Distribution. Just as its causes vary, so does the level of unemployment vary among segments of the labor force. Among the patterns that have been reflected over time and during the current recession are:

1. By Family Status: Although family heads normally have lower rates of unemployment, their unemployment has increased dramatically during the current recession. In January 1974, 2.9 percent or 1,533,000 household heads were unemployed. By November 1975, this rate had grown to 5.6 percent and the number to 2,980,000.[2]

2. By Age: Younger workers have above average unemployment rates during periods of both low and high unemployment. Although workers 16 to 24 account for only about 20 percent of the civilian labor force, they accounted for approximately 48 percent of the unemployment brought on by the recession between 1973 and 1974.

3. By Race: Nonwhite workers--of all sexes and ages--consistently have higher unemployment rates than do their white counterparts. During the recent recession, the gap between the unemployment rates of whites and nonwhites grew from 4.3 percent in the fourth quarter of 1974 to 6.1 percent in January 1976.

4. By Education: Unemployment rates of more educated workers are consistently lower than those with less education. In March 1975, the unemployment rate of college graduates was 2.9 percent while the rates for workers who had not graduated from high school and for all workers were 15.2 and 9.2 percent respectively. Less educated workers also suffer a higher share of unemployment during recession.

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2. Unpublished data from the Bureau of Labor Statistics.

5. By Type of Work: During recessions workers in some industries are more susceptible to high unemployment rates than are other workers. For example, workers in the manufacturing and construction industries account for disproportionately high shares of recession-induced unemployment.

The causes of unemployment vary among population groups. The chronically high unemployment rates of teenagers are due primarily to their lack of job skills and work experience, the limited attractiveness and uncertain future of the jobs to which they have access, their more limited need for income, and the impact of current minimum wage levels. The higher unemployment rates of nonwhites can be attributed both to past discrimination leading to lower educational attainments and to current discrimination within the labor market. The higher unemployment rates of less-educated workers are primarily the result of their disproportionate employment in industries with highly variable job availability, although even when they are within stable industries, they are more likely to be subject to unemployment. Workers in the manufacturing and construction industries are more subject to cyclical variations in overall economic activity.

Possible Federal Solutions to the Problem

All federal expenditure and revenue policies taken together affect employment levels. This chapter deals only with those federal programs which are intended to bring about:

1. Direct increases in employment, through public service employment, public works, and revenue-sharing programs in which the money spent directly creates jobs.

2. Improvements in the "employability" of workers, through education in general and manpower training in particular.

3. Improvements of the financial status of the unemployed, through either unemployment compensation or general income assistance.

The Fiscal Year 1977 Anti-unemployment Budget Based on Current Policy Assumptions

If the federal government continues its current policies in fiscal year 1977 as shown on the table on page 206, it will spend \$42.1 billion in direct outlays and \$5 billion in tax expenditures for programs and policies that are oriented--ultimately or immediately--toward affecting the level and costs of unemployment. These programs and policies together can be thought of as the federal anti-unemployment

FISCAL YEAR 1977 CURRENT POLICY ESTIMATE OF THE FEDERAL ANTI-UNEMPLOYMENT BUDGET

OUTLAYS

[Billions of dollars]

	Programs and Policies Aimed Primarily at—		
	Creating Employment Directly	Increasing the Employability of Workers	Providing Income Assistance to Unemployed Individuals
EXPENDITURE PROGRAMS			
Temporary employment assistance [a]	2.77		
Countercyclical revenue sharing [b]	0.75		
Accelerated public works [b]	NA		
Older Americans employment	0.10		
Job opportunities (EDA) [a]	0.50		
Summer youth	0.51		
Higher education		2.84	
Elementary, secondary, and vocational education		5.38	
Comprehensive manpower assistance [a]	0.56	2.26	
Manpower training and services [a]		1.50	
Veterans' education, readjustment benefits [a]		4.90	
Vocational rehabilitation		0.85	
Unemployment compensation [a]			19.20
Total Expenditure Program	**5.19**	**17.73**	**19.20**
TAX POLICIES			
WIN tax credits	.01		
Tax deduction for child care		0.42	
Child care facilities	.01		
Tax expenditures for education		1.72	
Tax exemption for unemployment compensation			2.86
Total Tax Policies	**.02**	**2.14**	**2.86**

[a] CBO estimate.

[b] Included in second concurrent resolution but not enacted.

budget. Of the $42.1 billion in total outlays, 12 percent is for programs that directly increase employment, 43 percent is for programs that improve employability and 45 percent is for programs that provide income assistance to the unemployed.

Alternatives to the Current Policy "Anti-Unemployment" Budget

Alternatives to the anti-unemployment budget can reflect changes in the funding levels of specific programs and the internal make-up of programs. The aggregate size of this budget depends upon a series of decisions about the worth of its component programs and a decision about the relative priorities of unemployment reduction and other needs. Changes in the funding levels of programs that make up the anti-unemployment budget can be based on a number of criteria including:

1. Employment Impact

   -- jobs created per $1 billion of program expenditure.
   -- jobs created per $1 billion of budget deficit.

2. Timing

   -- start-up time.
   -- phase-out flexibility.
   -- short- versus long-term effects.

3. Other Effects

   -- impact on inflation.
   -- distortion of the economy.
   -- value of output.
   -- targetability on specific groups or areas.
   -- replacement of income lost from unemployment.

Impacts of Different Types of Programs

Direct Employment-Creating Programs. Programs like public service employment decrease unemployment by creating jobs over and above those stemming from the fiscal effects associated with any new government spending. The net number of jobs created by these programs depends on several factors: The extent to which the money is used to create new jobs instead of simply replacing funds which would have been otherwise available from other sources (technically, the rate of fiscal substitution); the average salaries of the jobs created; and the proportion of the funds which is devoted to costs other than salaries, e.g., raw materials and equipment. The speed with which the program can be started or stopped affects the number of jobs in any one year.

The effect on the unemployment rate depends on the share of the newly created jobs held by people who would otherwise have been counted among the unemployed. If all the new jobs were filled by people who had previously dropped out of the labor force, there would be a smaller change in the nominal unemployment rate.

The inflationary impact of any job-creating program will depend on the extent to which it is directed toward groups and regions with idle capacity, and on whether the program is phased down as the economy comes out of its slack period.

Public service employment programs with average salaries of $7,500 and nonwage costs of 10 percent are estimated to increase total employment through direct and fiscal effects by 73,000 to 121,000 workers per $1 billion in outlays within 12 months following their initiation.[3] Because these outlays will create tax payments and the additional employment will reduce unemployment compensation benefits, the net budget cost per $1 billion of outlays will be from $506 million at the lower end of the range of employment increases to $435 million at the upper end.

The employment effects of accelerated public works programs and counter-cyclical revenue sharing differ from those of public service employment because of differences in wage levels, proportions of expenditures going to wages, and expected rates of fiscal substitution. The total employment effects of an accelerated public works program and a counter-cyclical revenue sharing program would be 57,000 to 70,000 jobs and 70,000 to 90,000 jobs per $1 billion in outlays respectively.[4] As a baseline for comparison of these programs, the effect of $1 billion of general government purchases of goods and services would be to create 40,000 to 70,000 jobs. As in the case of public service employment, returns to the treasury in increased taxes, reduced unemployment benefits, etc., for these other programs would cut the net budget costs well below $1 billion, as shown in the following table.

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3. This and following job creation estimates are derived from "Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives," CBO, September 2, 1975, assuming 25-75 percent fiscal substitution and a 1.6 fiscal multiplier.

4. The estimates here are for net job creation, allowing for fiscal substitution and for spending multipliers, as discussed above. The total number of jobs funded is 120,000 for public service employment, 27,000 for accelerated public works, and 52,000 for revenue sharing.

NET JOB CREATION AND BUDGET EFFECTS OF ANTI-UNEMPLOYMENT INSTRUMENTS [a]

	Net jobs created after 12 months [a] per $1 billion of outlays [b] (thousands)	Net budget costs (millions of dollars)
DIRECT EMPLOYMENT-CREATING PROGRAMS		
Public service employment average wage=$7,500	73–121	$506–435
Accelerated public works	57–70	537–510
Countercyclical revenue sharing	70–97	590–570
EMPLOYABILITY—INCREASING PROGRAMS		
Moderate substitution	51–85	558–523
Heavy substitution	39–53	565–545
INCOME ASSISTANCE PROGRAMS		
Unemployment compensation	39–53	565–545
GENERAL INCREASES IN GOVERNMENT PURCHASES	40–70	600–590

[a] These jobs include both the net direct jobs and those resulting from fiscal stimulus.

[b] Aside from the direct employment creating programs, the job-creating effects of the programs in this table are estimated as the result of only the fiscal stimulus of federal spending of these types.

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Other policies that can increase employment directly include tax expenditures--e.g., Investment Tax and Employment Tax Credits--and job guarantee programs such as those outlined in H.R. 50. The effects of these programs will be evaluated in a CBO study currently underway for the Joint Economic Committee.

Employability-Increasing Programs. The short-run effect of more federal spending on employability-increasing (education and training) programs is primarily that of its fiscal impact, as with other federal spending programs. Over a much longer period of time, these programs are intended to increase employment by educating and training people for jobs provided by the economy, but there are no good numerical estimates of these effects, and in any case most of them are beyond our five-year time frame.

Income Assistance to the Unemployed. Programs like unemployment compensation that provide income to the unemployed reduce unemployment indirectly through the fiscal stimulus provided by their outlays, working the same way as a tax cut--by giving people more spending power. Unemployment compensation, however, may increase unemployment because of the disincentive created by the availability of benefits as an alternative to job earnings. One study of these disincentives estimates that the regular 26-week unemployment compensation program increases the unemployment rate by from 0.2 to 0.35 percentage points during periods of low unemployment.[5] During periods of high unemployment, the work disincentives are probably significantly lower.

Four Alternative Budgets

Given the number of programs that make up the anti-unemployment budget, a vast number of alternatives to the current policy budget are possible. The following four were chosen as illustrations:

1. Alternative I: Reallocation of Present Resources

This alternative would reallocate funds from the unemployment compensation system and therefore from those who remain unemployed to public service employment (or other employment-creating activities) in order to reduce unemployment.[6] This alternative reflects a desire to maximize employment without making a commitment to increasing the aggregate level of the anti-unemployment budget. In fact, the net

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5. Stephen T. Marsten, "The Impact of Unemployment Insurance on Job Search," Brookings Papers on Economic Activity, 1975 No. 1, pp. 13-60.

6. The funds could, of course, be reallocated from any other federal programs and functions, such as government purchases.

FISCAL YEAR 1977 ALTERNATIVE FUNDING LEVELS AND PATTERNS FOR THE ANTI-UNEMPLOYMENT BUDGET

OUTLAYS

[Billions of dollars]

Options	Increasing employment directly	Improving the employability of workers	Providing income assistance to unemployed individuals	Total anti-unemployment budget
Current policy [a]	5. 19	17. 73	19. 20	42. 12
Reallocate current policy	6. 96	17. 73	17. 23	41. 92
Increase employment increasing programs	11. 19	17. 73	18. 13	47. 05
Reduce all program areas	4. 19	16. 73	18. 97	39. 89
The President's fiscal year 1977 budget request [b]	2. 10	15. 54	16. 87	34. 51

[a] Assuming a fiscal year 1977 unemployment rate of 7.5 percent.

[b] Assuming a fiscal year 1977 unemployment rate of 6.9 percent.

budget costs of the anti-unemployment budget would actually be reduced because public service employees pay taxes while unemployment compensation benefits are tax exempt. The specifics of Alternative I are as follows:

If the Special Unemployment Assistance Program (SUA)[7] and the Federal Supplemental Benefits Program (FSB)[8] were not extended in fiscal year 1977, approximately $1.77 billion in outlays would be available for public service employment programs.[9] If the average salary in the public service employment program were $7,500, the number of public service employment jobs created would be from 129,000 to 214,000, but taking the $1.77 billion from unemployment insurance would reduce that by 69,000 to 94,000 because of the reduced fiscal stimulus of less federal spending on unemployment benefits. Similarly, taking the $1.77 billion for general government spending would reduce the number by 71,000 to 124,000.

The net job gain would thus be on the order of 60,000 to as much as 120,000. Because of the difference in the tax treatment of salaries and unemployment compensation benefits, this reallocation would result in a net budget saving of approximately $540 million.

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7. Special Unemployment Assistance (SUA). The Emergency Jobs and Unemployment Assistance Act of 1974 established a temporary two-year program of federally supported unemployment assistance for workers who are not eligible for unemployment benefits under any other law. The major groups affected are state and local government employees, and farm workers. The maximum duration of benefits is thirty-nine weeks. An individual's period of eligibility and weekly benefit amounts are based on state law.

8. Federal Supplemental Benefits Program (FSB). In 1971, Congress established a temporary program to pay an additional 13 weeks of emergency unemployment compensation benefits. It brought the potential maximum duration of benefits to 52 weeks--26 regular, 13 EB and 13 FSB. An additional 13 weeks of benefits--bringing the potential maximum to 65--was provided by the second Emergency Unemployment Compensation Act in 1974. The FSB program is supported by repayable advances from general federal funds.

9. Although the full amount of SUA and FSB outlays is estimated at $2.4 billion in fiscal year 1977, approximately $0.6 billion are needed to continue payments to those individuals who would be already receiving benefits at the beginning of the fiscal year. This outlay estimate is based on an assumed fiscal year 1977 unemployment rate of 7.5 percent.

2. Alternative II: Add to Employment-Creating Programs

This second budget alternative would increase the outlays for employment-creating programs while leaving the other sectors of the anti-unemployment budget essentially fixed. The specifics of Alternative II are as follows:

If the outlays for the public service employment, accelerated public works, and counter-cyclical revenue sharing programs were each increased by $2 billion, 398,000 to 576,000 net additional jobs would be created and the unemployment rate would decline by 0.4 to 0.5 percentage points.[10] Assuming that 80 percent of the new job holders would have been otherwise unemployed and that 70 percent of these would have received unemployment compensation benefits of $3,900 per person, the unemployment compensation budget would decline by approximately $887 million to $1.25 billion. Thus, the total direct anti-unemployment budget would only increase by $4.9 billion, if $6 billion were added to the employment-creating programs. The overall net budget cost of this $6 billion budget increase would be approximately $3.1 billion because of stimulated revenue increases and outlay decreases.

The calculated employment effects of this budget increase would be greater if all the resources were allocated to public service employment. However, a mixed employment-creating system may more effectively reach the various high unemployment target groups and suffer smaller fiscal substitution and displacement effects than might confront a large-scale single program. Because a mixed system spreads federal resources more thinly among sectors of the economy, the multiple programs can be "triggered-off" with less severe consequences to the aided sectors.

3. Alternative III: Commitment to Lower Aggregate Funding Level

This option reflects a desire to lower the funding level of the anti-unemployment budget. It reflects a willingness to accept a higher unemployment rate and a desire to cut back on all types of programs (direct employment-creating, employability-increasing, and aid to the unemployed) that affect unemployment. The specifics of Alternative III are as follows:

If the SUA unemployment compensation program were eliminated, fiscal year 1977 outlays would be reduced by $0.60 billion and approximately 23 to 32,000 jobs would be eliminated, simply by the reduction of fiscal stimulus. A $1 billion decrease in employability-increasing programs would reduce employment by 39,000 to 53,000 jobs for similar

10. This spending option would provide federal funds for approximately 1.1 million jobs.

reasons. A $1 billion decrease in public service employment funding would reduce employment by 73,000 to 121,000 jobs. The direct effect of this $2.60 billion outlay reduction would be a loss of 135,000 to 206,000 jobs and an increase in the fiscal year 1977 unemployment rate of 0.14 to 0.23 percentage points. The decline in the unemployment compensation outlays would be slightly less than the $0.60 billion in SUA program costs because of the newly unemployed former job holders. If 80 percent of all the former job holders become unemployed[11] and 70 percent of these qualify for unemployment compensation benefits, outlays for the regular unemployment compensation programs will increase by $295 to $450 million. The net effects of the across-the-board anti-unemployment budget cut would be an outlay decline of about $2.23 billion and an unemployment rate increase of approximately 0.13 to 0.22 percentage points. Because of offsetting decreases in revenues, the net budget savings of this outlay reduction would be approximately $1 billion.

4. Alternative IV: The President's Proposed Anti-Unemployment Budget

The President has proposed significant changes in several components of the fiscal year 1977 anti-unemployment budget. Largely because of his preference for stimulating private, rather than public service employment, the President has requested no new budget authority for employment-creating expenditure programs. His recommended outlays of $2.10 billion are $3.09 billion below the fiscal year 1977 current policy estimate. The President's outlay estimate for unemployment compensation is $16.87 billion. He proposes to extend regular program coverage to most of those workers now covered by SUA and allow the FSB program to expire during fiscal year 1977. If current law were continued and unemployment falls to 6.9 percent, unemployment compensation outlays would be $17.98 billion in fiscal year 1977.

The President's proposals for education and training programs (the the employability-increasing component of the anti-unemployment budget) include budget changes and program consolidations. Education program and budget changes are discussed elsewhere in this report. In total, the President's budget estimate for employability-increasing programs includes $15.54 billion in outlays for fiscal year 1977. The

11. The remainder become discouraged and leave the work force. The actual percentage who become discouraged may be lower because the possibility of receiving unemployment compensation benefits will reduce these workers' incentives to leave the labor force.

THE PRESIDENT'S FISCAL YEAR 1977 FEDERAL ANTI-UNEMPLOYMENT BUDGET [a]

OUTLAYS [b]

[Billions of dollars]

	Programs and Policies Aimed Primarily at—		
	Creating Employment Directly	Increasing the Employability of Workers	Providing Income Assistance to Unemployed Individuals
EXPENDITURE PROGRAMS			
Temporary employment assistance	1.07		
Countercyclical revenue sharing			
Accelerated public works			
Older Americans employment			
Job opportunities (EDA)	0.22		
Summer youth	0.40		
Higher education		2.64	
Elementary, secondary, and vocational education		4.62	
Comprehensive manpower assistance	0.41	2.89	
Manpower training and services		0.36	
Veterans' readjustment benefits		4.25	
Vocational rehabilitation		0.78	
Unemployment compensation			16.87
Total Expenditure Program	**2.10**	**15.54**	**16.87**
TAX POLICIES			
WIN tax credits	0.01		
Tax deduction for child care		0.42	
Child care facilities	0.01		
Tax expenditures for education		1.72	
Tax exemption for unemployment compensation			2.51
Total Tax Policies	**0.02**	**2.14**	**2.51**

[a] CBO estimate derived from President's 1977 budget documents.

[b] Does not include effect on fiscal year 1977 outlays of fiscal year 1976 proposed rescissions in budget authority.

President's anti-unemployment budget is summarized in the table on the preceding page.

The employment stimulating effects of the President's budget proposal are lower than those resulting from the current policy budget. The $3.09 billion decline in public service employment program funding would result in approximately 226,000 to 374,000 fewer jobs existing by the end of fiscal year 1977, including both the decrease in the number of jobs created directly and the decreased fiscal stimulus associated with the drop in dollar funding. As noted in Part I, Chapter 2 of this Report, the overall result of the decreased fiscal stimulus of the President's budget as a whole, compared to current policy, would be a 0.6 percent increase in the unemployment rate by the end of calendar 1977. This is the equivalent of more than half a million unemployed people, and, because of labor-force dropouts, a larger number of lost jobs.

SUMMARY TABLE: THE ANTI-UNEMPLOYMENT BUDGET AND FUNCTION 500

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 500 items:								
Included—anti-unemployment budget:								
Employment creating manpower (504 part)	0. 3	4. 7	1. 4	4. 4	4. 3	3. 9	3. 6	3. 3
Employability increasing:								
Education (501, 502)	6. 7	7. 6	1. 7	8. 2	8. 6	9. 2	9. 6	10. 1
Manpower (504 part, 505)	3. 9	3. 7	1. 1	3. 8	4. 0	4. 2	4. 4	4. 6
Social services vocational rehabilitation (506 part)	0. 8	0. 8	0. 2	0. 9	0. 9	1. 0	1. 0	1. 1
Not included anti-unemployment budget:								
Education (503)	0. 9	0. 9	0. 2	1. 0	1. 0	1. 1	1. 1	1. 2
Social services (506 part)	2. 5	3. 2	0. 8	3. 5	3. 5	3. 6	3. 7	3. 8
Other (500 part)	0. 0	0. 1	0. 0	0. 1	0. 1	0. 2	0. 2	0. 2
Total Function 500	**15. 2**	**21. 0**	**5. 4**	**21. 8**	**22. 5**	**23. 1**	**23. 6**	**24. 2**
Plus nonfunction 500 activities included in anti-unemployment budget:								
Employment creating:								
Countercyclical revenue sharing (450 part)[a]	0. 0	0. 4	0. 4	0. 8	----------	----------	----------	----------
Accelerated public works (450 part)[a]	0. 0	0. 3	0. 1	----------	----------	----------	----------	----------
Employability increasing veterans' education, training and rehabilitation (702)	4. 6	6. 2	1. 2	4. 9	4. 8	4. 8	4. 7	4. 5
Income assistance:								
Unemployment compensation:								
Reg/EB (603 part)	----------	16. 8	----------	16. 4	15. 9	15. 6	15. 2	14. 4
FSB (603 part)	----------	1. 6	----------	1. 2	1. 7	1. 6	0. 8	----------
SUA (603 part)	----------	1. 3	----------	1. 2	1. 2	1. 1	1. 0	0. 8
FUBA (nonSUA) (603 part)	----------	0. 1	----------	0. 6	0. 6	0. 6	0. 6	0. 5
Total Unemployment Compensation (603)	13. 5	19. 9	4. 6	19. 2	19. 4	18. 8	17. 5	15. 8
Total Current Policy: Anti-unemployment Budget	**29. 8**	**43. 5**	**10. 7**	**42. 1**	**42. 0**	**41. 9**	**40. 9**	**39. 4**
Tax Expenditures	NA	5. 0	NA	5. 0	5. 0	4. 9	5. 0	5. 0

See footnotes at end of table.

SUMMARY TABLE: THE ANTI-UNEMPLOYMENT BUDGET AND FUNCTION 500—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION								
Function 500 Items:								
Included—anti-unemployment budget:								
Employment creating manpower (504 part)	0. 3	4. 7	1. 4	6. 4	6. 4	6. 2	6. 0	5. 8
Employability increasing:								
Education (501, 502)	6. 7	7. 6	1. 7	8. 2	8. 6	9. 2	9. 6	10. 1
Manpower (504 part, 505)	3. 9	3. 7	1. 1	3. 8	4. 0	4. 2	4. 4	4. 6
Social services vocational rehabilitation (506 part)	0. 8	0. 8	0. 2	0. 9	0. 9	1. 0	1. 0	1. 1
Not included anti-unemployment budget:								
Education (503)	0. 9	0. 9	0. 2	1. 0	1. 0	1. 1	1. 1	1. 2
Social services (506 part)	2. 5	3. 2	0. 8	3. 5	3. 5	3. 6	3. 7	3. 8
Other (500 part)	0. 0	0. 1	0. 0	0. 1	0. 1	0. 2	0. 2	0. 2
Total Function 500	**15. 2**	**21. 0**	**5. 4**	**23. 8**	**24. 6**	**25. 3**	**25. 9**	**26. 7**
Plus nonfunction 500 activities included in anti-unemployment budget:								
Employment creating:								
Countercyclical revenue sharing (450 part) [a]	0. 0	0. 4	0. 4	2. 8	2. 1	2. 2	2. 4	2. 5
Accelerated public works (450 part) [a]	0. 0	0. 3	0. 1	2. 0	2. 1	2. 2	2. 4	2. 5
Employability increasing veterans' education, training, and rehabilitation (702)	4. 6	6. 2	1. 2	4. 9	4. 8	4. 8	4. 7	4. 5
Income assistance: Unemployment compensation (603)	13. 5	19. 9	4. 6	18. 1	17. 2	15. 7	13. 8	11. 9
Total High Option: Anti-unemployment Budget	**29. 8**	**43. 5**	**10. 7**	**47. 1**	**46. 1**	**45. 4**	**44. 2**	**42. 9**
Tax Expenditures	NA	5. 0	NA	4. 8	4. 7	4. 4	4. 5	4. 5

See footnotes at end of table.

SUMMARY TABLE: THE ANTI-UNEMPLOYMENT BUDGET AND FUNCTION 500—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
MEDIUM OPTION								
Function 500 items:								
Included—Anti-unemployment budget:								
Employment creating manpower (504 part)	0. 3	4. 7	1. 4	6. 2	7. 2	5. 6	5. 3	4. 1
Employability increasing:								
Education (501, 502)	6. 7	7. 6	1. 7	8. 2	8. 6	9. 2	9. 6	10. 1
Manpower (504 part, 505)	3. 9	3. 7	1. 1	3. 8	4. 0	4. 2	4. 4	4. 6
Social services vocational rehabilitation (506 part)	0. 8	0. 8	0. 2	0. 9	0. 9	1. 0	1. 0	1. 1
Not included anti-unemployment budget:								
Education (503)	0. 9	0. 9	0. 2	1. 0	1. 0	1. 1	1. 1	1. 2
Social services vocational rehabilitation (506 part)	2. 5	3. 2	0. 8	3. 5	3. 5	3. 6	3. 7	3. 8
Other (500 part)	0. 0	0. 1	0. 0	0. 1	0. 1	0. 2	0. 2	0. 2
Total Function 500	**15. 2**	**21. 0**	**5. 4**	**23. 6**	**25. 4**	**24. 7**	**25. 3**	**25. 1**
Plus nonfunction 500 activities included in anti-unemployment budget:								
Employment creating:								
Countercyclical revenue sharing (450 part) [a]	0. 0	0. 4	0. 4	0. 8	----------	----------	----------	----------
Accelerated public works (450 part) [a]	0. 0	0. 3	0. 1	----------	----------	----------	----------	----------
Employability increasing veterans' education, training and rehabilitation (702)	4. 6	6. 2	1. 2	4. 9	4. 8	4. 8	4. 7	4. 5
Income assistance: Unemployment compensation (603)	13. 5	19. 9	4. 6	17. 2	16. 0	16. 5	15. 1	14. 4
Total Medium Option: Anti-unemployment budget	**29. 8**	**43. 5**	**10. 7**	**41. 9**	**41. 5**	**41. 2**	**40. 2**	**38. 9**
Tax expenditures	NA	5. 0	NA	4. 7	4. 5	4. 6	4. 7	4. 8

See footnotes at end of table.

SUMMARY TABLE: THE ANTI-UNEMPLOYMENT BUDGET AND FUNCTION 500—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 500 items:								
Included—anti-unemployment budget:								
Employment creating manpower (504 part)	0.3	4.7	1.4	3.4	3.3	2.8	2.5	2.1
Employability increasing:								
Education (501, 502)	6.7	7.6	1.7	8.2	8.6	9.2	9.6	10.1
Manpower (504 part, 505)	3.9	3.7	1.1	2.8	2.9	3.1	3.3	3.4
Social services vocational rehabilitation (506 part)	0.8	0.8	0.2	0.9	0.9	1.0	1.0	1.1
Not included anti-unemployment budget:								
Education (503)	0.9	0.9	0.2	1.0	1.0	1.1	1.1	1.2
Social services (506 part)	2.5	3.2	0.8	3.5	3.5	3.6	3.7	3.8
Other (500 part)	0.0	0.1	0.0	0.1	0.1	0.2	0.2	0.2
Total Function 500	**15.2**	**21.0**	**5.4**	**19.8**	**20.4**	**20.8**	**21.3**	**21.8**
Plus Nonfunction 500 activities included in anti-unemployment budget:								
Employment creating:								
Countercyclical revenue sharing (450 part)[a]	0.0	0.4	0.4	0.8	----	----	----	----
Accelerated public works (450 part)[a]	0.0	0.3	0.1	----	----	----	----	----
Employability increasing veterans' education, training and rehabilitation (702)	4.6	6.2	1.2	4.9	4.8	4.8	4.7	4.5
Income assistance: Unemployment compensation (603)	13.5	19.9	4.6	19.0	19.1	19.0	18.0	16.4
Total Low Option: Anti-unemployment Budget	**29.8**	**43.5**	**10.7**	**39.9**	**39.5**	**39.8**	**39.0**	**37.6**
Tax Expenditures	NA	5.0	NA	5.0	5.0	4.9	5.0	5.1

See footnotes at end of table.

SUMMARY TABLE: THE ANTI-UNEMPLOYMENT BUDGET AND FUNCTION 500—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Function 500 Items:								
Included—anti-unemployment budget:								
Employment creating manpower (504 part)	0.3	7.2	1.9	2.1				
Employability increasing:								
Education (501, 502)	6.7	7.3	1.4	7.2				
Manpower (504 part, 505)	3.9	[b]NA	[b]NA	3.2				
Social services vocational rehabilitation (506 part)	0.8	0.7	0.2	0.8				
Not included anti-unemployment budget:								
Education (503)	0.9	0.8	0.2	0.8				
Social services (506 part)	2.5	2.9	0.7	2.9				
Other (500 part)	0.0	0.0	0.0	0.0				
Total Function 500	**15.2**	**18.9**	**4.4**	**17.0**				
Plus nonfunction 500 activities included in anti-unemployment budget:								
Employment creating:								
Countercyclical revenue sharing (450 part)[a]	0.0	0.0	0.0	0.0				
Accelerated public works (450 part)	0.0	0.0	0.0	0.0				
Employability increasing veterans' education, training, and rehabilitation (702)	4.6	6.0	1.1	4.2				
Income assistance: Unemployment compensation (603)	13.5	19.4	4.0	16.9				
Total President's Anti-unemployment budget	**29.8**	**40.6**	**8.6**	**34.5**				
Tax expenditures	NA	5.0	NA	4.7				

[a] Not enacted.

[b] These figures included in "employment creating manpower" above.

PART II-1: PROGRAM ISSUES
SECTION D: AID TO INDIVIDUALS

Education (Part Function 500)

Introduction

During fiscal year 1976 the federal government will spend over $23 billion for education purposes and academic research, through hundreds of programs found in at least nine budget functions. This chapter deals only with the educational spending carried in the education, training, employment, and social service function (500). The current policy budget for this function is an estimated $9 billion in fiscal year 1976; it is projected to grow to $11.9 billion by fiscal year 1981.

Outlays for early childhood, elementary and secondary, and higher education activities in fiscal year 1976 are estimated to be $1.14 billion, $4.37 billion, and $2.57 billion respectively. The President has proposed fiscal year 1977 education outlays of $8.7 billion, including $1.2 billion for early childhood; $4.1 billion for elementary and secondary; and $2.6 billion for higher education programs (see table below).

The federal government supports educational activities for a number of reasons. Among the most important objectives are the following:

1. Increasing the quantity and quality of education provided to populations that are inadequately served--e.g., programs that provide compensatory educational services to disadvantaged and handicapped school children and preschools and day care for younger children.

2. Increasing the amount of education acquired and decreasing the resulting financial burdens on families and individuals--e.g., programs that provide financial assistance to needy college students, veterans, social security beneficiaries, and medical students, and tax policies that benefit families with dependents in day care and college.

3. Providing financial assistance to educational institutions--e.g., programs that provide assistance to colleges facing financial problems and school districts in federally impacted areas--those with federal civilian or military employees or tax-exempt federally owned buildings or other facilities.

4. <u>Stimulating increased financing of education by nonfederal sources</u>--e.g., the tax deductibility of contributions to educational institutions; federal matching grants for state scholarship programs; and subsidies for higher education loan programs.

5. <u>Improving the knowledge about and increasing the quality of the educational process</u>--e.g., federal support for education research, development, and innovation and support for particular kinds of educational activities.

EDUCATION OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1977, 1981 (FUNCTION 500)
(Billions of Dollars, Fiscal Years)

	1966	1976[a]	1977[a]	1981[a]
Early Childhood (501 part, 506 part)	NA	$1.1	$1.2	$ 1.4
Elementary and Secondary (501 part)	NA	4.4	4.8	5.8
Higher Education (502)	NA	2.6	2.8	3.5
Other Education (503)	NA	0.9	0.9	1.2
Total Education (500 part)	2.5	9.0	9.7	11.9
Percent of Total outlays	1.86%	2.40%	2.28%	2.11%
Tax Expenditures	NA	$1.9	$2.1	$ 2.9

a. Current policy level.

NA: Not available.

The proportion of the education sector's resources provided by the federal government can be calculated in several ways. One is to count the share provided directly to educational institutions for their spending. By this approach, it is estimated that the federal government accounted for 10.7 percent of the resources in fiscal year 1975 (see table below).

PATTERNS OF SUPPORT FOR EDUCATIONAL INSTITUTIONS
BY SOURCE AND LEVEL, FISCAL YEAR 1975
(Billions of Dollars)

	Level of Education					
Source of Support	Elementary and Secondary		Higher Education		Total	
Federal	$5.5	8.0%	$6.1	15.2%	$11.6	10.7%
State	24.7	36.1	11.8	29.3	36.5	33.6
Local	31.5	46.0	1.8	4.5	33.3	30.6
Other[a]	6.8	9.9	20.5	51.0	27.3	25.1
Total	68.5	100.0	40.2	100.0	108.7	100.0

Source: "Projections of Educational Statistics to 1984-85," National Center for Educational Statistics, U.S. Office of Education, pp. 73-75.

a. Mainly parents, students, and donors.

But the revenue and expenditure reports of educational institutions significantly understate the actual scale of federal educational involvement, because many educational services are not institutionally provided--e.g., child care services--and many federal programs provide resources to students, parents, benefactors, and state and local governments--which in turn are counted as the sources of funds in institutional revenue accounts. If all such fiscal year 1975 federal outlays are counted, the federal share becomes 18.8 percent as opposed to 10.7 percent.

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The remainder of this chapter is devoted to estimating the effects of alternative early childhood, elementary and secondary, and higher education budgets. The estimations of effects should be viewed cautiously. There is little empirical evidence showing direct connection between federal outlays and educational performance and there has been little research directed toward analyzing the effects of federal financing policies on other sources of support.

For each level of education four alternative budgets are analyzed: a current policy budget that would continue programs at the present level of services; a high budget option that would increase federal financing primarily for programs for inadequately served populations including lower- and middle-income college students; a low budget option that would reduce support for most activities (with disproportionate reductions in programs that provide general financial support to educational institutions); and the budget proposed by the President.

Early Childhood Care and Education

The federal government supports early childhood care and education in several ways. In fiscal year 1976, the Head Start program will serve about 349,000 children. (There are 2.3 million children younger than 5 in families below the poverty level.) Social Security Title XX Social Service grants to states will finance day care services for about 77,000 children (on an annualized basis) during fiscal year 1976. These two programs will account for approximately $1 billion in fiscal year 1976 outlays. Additional federal support for early childhood care and education will cost about $137 million in outlays and $335 million in tax expenditures in fiscal year 1976. Thus, total outlays in fiscal year 1976 will be $1.14 billion. The outlays needed to maintain current policies will grow to $1.2 billion in fiscal year 1977 and $1.4 billion in fiscal year 1981.

A higher spending option could simultaneously increase the number of children served, raise the staff/child ratio and encourage the employment of welfare recipients as child care workers. This could be accomplished by (1) increasing the support for Head Start by $200 million; (2) accepting the Department of Health, Education, and Welfare's proposed standards for staff/child ratios and providing the financial support needed to raise present ratios; and (3) allowing tax credits for providers of day care who employ welfare recipients.

The last two changes would increase outlays and net tax expenditures by $217 million and $13 million respectively. They would not, however, increase the number of children receiving services. They would, however, change the staffing patterns but there is no empirical evidence to indicate that changes in either staff/child ratios or types of staff significantly affect service quality.

The increased $200 million Head Start funding would allow about 150,000 additional children to be served. The limited evidence on the Head Start program's effectiveness suggests that the test scores (intelligence and achievement) of children in model programs are better than those of children not enrolled, but that these differences tend to disappear during elementary school.[1] The fiscal year 1977 cost of this high budget option would be $1.6 billion. If this option were continued until fiscal year 1981, the cost would increase to $1.8 billion.

A low spending budget option aimed at reducing early childhood services could cut Head Start funding by $200 million and delay indefinitely the implementation and funding of the proposed staffing standards for Title XX day care services. This would reduce the fiscal year 1977 early childhood education and care budget to $1 billion and reduce the number of children served by Head Start from 349,000 to 199,000.

The President's budget proposal for fiscal year 1977 provides another option for the early childhood budget. It does not include additional resources to implement the proposed day care standards; funding for Head Start would be held at the estimated fiscal year 1976 level. If the costs per Head Start enrollee increased by 8 percent between fiscal years 1976 and 1977, the $434 million outlays in the President's fiscal year 1977 budget would support about 25,000 fewer Head Start participants than are now in the program.

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1. Sheldon H. White and others, "Federal Programs for Young Children: Review and Recommendations," Department of Health, Education, and Welfare, 1973, Vol. IV, The Huron Institute, Contract No. HEW-OS-71-170, Publication No. (OS)74-100.

ALTERNATIVE EARLY CHILD CARE AND EDUCATION BUDGETS
SUMMARY OF EFFECTS: FISCAL YEARS 1977 AND 1981
(Billions of Dollars)

Option	Outlays: Elementary Education (501)	Outlays: Social Services (506)	Outlays: Total	1981 Tax Expenditures/Revenue Declines
Current Policy Level	0.62	0.60	1.21	1.37
High Option	+0.2	+0.22	+0.42	+0.45
Low Option	-0.2	--	-0.2	-0.24
President's Fiscal Year 1977 Budget Proposal	-0.05	--	-0.05	

Elementary and Secondary Education

During fiscal year 1976, total outlays for elementary and secondary education contained in subfunction 501 will be $4.4 billion; $2.45 billion of these funds supports increased services for inadequately served populations and $0.86 billion supports school districts facing particular financial and educational problems. Another $0.67 billion supports vocational education activities.

These resources provide support through a variety of programmatic mechanisms.

Title I--ESEA: Grants to school districts for supplementary services for disadvantaged students. The allocation formula is primarily based on number of students from families with incomes below the poverty level.

Bilingual Education: Grants for exemplary demonstration projects and teacher training.

Education for the Handicapped: Grants to states for supplemental services, deaf-blind centers, and teacher training.

Indian Education:	Grants for special services for Indian children operated by the U.S. Office of Education (OE) and operation of schools on Indian reservations administered by the Bureau of Indian Affairs (BIA).
Impact Aid:	Support for local education agencies to compensate for lost revenue due to federal activities.
Emergency School Assistance:	Grants to local education agencies undergoing desegregation.
Vocational Education:	Categorical grants to states to support vocational education activities.

The major federal elementary and secondary education programs are arrayed according to the primary objectives they serve in the table below.

Many elementary and secondary (and higher education) programs are funded a year before the year in which they are spent. For example, appropriations enacted in calendar year 1976 for fiscal year 1977 will typically be spent in school year 1977-78. Consequently, current budget decisions will have little effect on fiscal year 1977 outlays for these programs, unless Congress were now to approve supplementals or rescissions that would affect enacted fiscal year 1976 appropriations. Therefore, the fiscal year 1977 outlay effects ascribed to the options below would require supplementals or rescissions consistent with the option. The effects would be shifted to fiscal year 1978 if the Congress were to enact the option for fiscal year 1977 rather than as a supplemental or rescission to fiscal year 1976 budget authority.[2]

As in early childhood education, there are several alternatives to the current policy budget for elementary and secondary education. A high budget option aimed primarily at increasing the share of federal resources devoted to services for inadequately served populations could add $250 million to Title I, ESEA; $100 million to bilingual education; $100 million to OE and BIA Indian education programs; and $90 million

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2. Programs which are forward-funded receive budget authority (i.e., the ability to make obligations or commitments of funds) in the year prior to the one in which the program will operate. Spending levels (appropriations) for programs which are advance-funded are also determined a year in advance, but budget authority is not provided (i.e., obligations cannot be made) until the fiscal year in which the program will operate. Budget authority provided in fiscal year 1977 for forward-funded programs will not have substantial effect on outlays until fiscal year 1978. Budget authority provided in fiscal year 1977 for advance-funded programs results from fiscal year 1976 appropriations and will be available for spending in fiscal year 1977.

FEDERAL ELEMENTARY AND SECONDARY EDUCATION PROGRAMS
AND OBJECTIVES, FISCAL YEAR 1977
(Outlays in Billions of Dollars)[a]

	Primarily Oriented Toward			
Program	Increasing Service for Inadequately Served Populations	Providing Assistance for Educational Institutions	Increasing the Quality of Service	Other
ESEA-Title I[b]	2.002	--	--	--
Bilingual Education	0.103	--	--	--
Handicapped Education[b]	0.207	--	--	--
Indian Education (OE and BIA)	0.286	--	--	--
Impact Aid (SAFA)	--	0.633	--	--
Emergency School Assistance	--	0.283	--	--
Vocational Education	--	--	0.713	--
Other (501)	--	--	--	0.558
Total	2.598	0.916	0.713	0.558

a. Based on the current policy budget.

b. Preprimary portion excluded.

to the handicapped education program. The increase in Title I funds could both add some children to the 5.5 million now being served and increase the average support per child. In 1974, about 6 million school-age children were in families with incomes below the poverty level.

The increased support for bilingual education would allow about twice as many projects (1,000 versus 513) to be funded. The increased funds for Indian education would increase the number of children served by OE programs and increase the average level of service provided by BIA projects by 33 percent. The increased outlays for handicapped education would allow full funding for the fiscal year 1977 authorizations in P.L. 93-344.

The illustrative low budget option would concentrate the reductions in areas of general operating support. A budget cut of about $1 billion from the fiscal year 1977 current policy base could require a cut in impact aid of $319 million, in vocational education of $200 million, in Title I ESEA of $250 million, and in other subfunction 501 activities of $200 million.

The decreased impact aid would allow funding of entitlements only for children whose parents both live and work on federal property ("A" children). No funding of entitlements or "hold harmless" payments for children whose parents either live or work on federal property or live in federally supported public housing ("B" children) would be made.[3]

The vocational education funding cut would necessitate increased state and local revenue support of about 3 percent if service levels were to be kept constant. If services were cut, the cuts would probably be disproportionately in services for disadvantaged and handicapped vocational students, because the federal share of support for their services is higher. The cut in Title I funding might reduce the number of children served by approximately 600,000; and state and local governments probably would not provide replacement financial support. Alternatively, the Title I budget cut could result in a combination of a decrease in the number of children served and in the average support per child.

The President's budget proposal for elementary and secondary education includes both programmatic and budgetary changes. The President proposes to consolidate funding for 24 education programs into a single block grant to states, funded at $3.3 billion in comparison to a current policy level funding of $3.8 billion. The interstate allocation formula for these grants has not yet been specified, but at least 75 percent of the funds would go to local education agencies, and 75 percent of the total funds would have to be spent on services for disadvantaged and handicapped children. There is no method for accurately estimating the effect of this block grant proposal except that the decline in federal control might mean that federal resources will be more likely to substitute for, rather than supplement, state and local resources. Furthermore, the reduced funding implies that states and localities would have to either become more efficient or provide additional resources from their own revenue sources if current service levels were to be maintained.

The effects of the proposed requirements for the distribution of resources among state and local agencies would differ among different states. Although, on average, states provide 36 percent and local units 46 percent of the funding for elementary and secondary schools, the shares vary widely among the states. For example, in Alaska the state

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3. This funding change in impact aid would require a change in the authorizing legislation.

and local shares are 65 and 10 percent respectively, while in New Hampshire the comparable shares are 6 and 86 percent.

The President's budget also includes an alternate proposal of support for the current programs, to be effective if his block grant proposal is not adopted. In comparison to the current policy budget, the President proposes $112 million less for Title I, $22 million more for handicapped education, $32 million less for vocational education, and $326 million less for other subfunction 501 program outlays.

The other major change proposed in the President's budget for elementary and secondary education programs is reduced funding for the impact aid program--$438 million in outlays in comparison to a current policy estimate of $633 million. This lower amount would fund essentially all the entitlements for "A" children, and a share both of the entitlements for "B" children and of the "hold harmless" amounts remaining from fiscal year 1976 obligations. The President's budget is based on a legislative proposal for impact aid that decreases fiscal year 1977 budget authority and outlays and substantially reduces outlays in fiscal year 1978 by eliminating all payments for "B" children.

ALTERNATIVE ELEMENTARY AND SECONDARY EDUCATION BUDGETS
FISCAL YEARS 1977 OR 1978, 1981
(Outlays in Billions of Dollars)

	Primarily Oriented Toward					
Option	Increasing Service for Inadequately Served Populations	Providing Assistance for Educational Institutions	Increasing the Quality of Service	Other	1977 Total	1981 Total
Current Policy Level	2.6	0.92	0.71	0.56	4.79	5.84
High Option	+0.58	--	--	--	+0.58	+0.73
Low Option	-0.25	-0.32	-0.2	-0.2	-0.97	-1.14
President's Budget Proposal	-0.1	-0.26	-0.03	-0.33	-0.71	

Higher Education

The fiscal year 1977 current policy budget for higher education (subfunction 502) includes \$2.8 billion in outlays and \$1.7 billion in tax expenditures. Most of the resources in this category support student assistance programs--i.e., grants, subsidized loans, and subsidized jobs--that are intended to expand enrollment possibilities for students from low- and moderate-income families; reduce the financial burdens for these and middle-income students; and stimulate increased financing from nonfederal sources.

The federally-supported student assistance programs include:

Basic Educational Opportunity Grants:	Direct aid to students on the basis of their family's capacity to pay and college costs.
Guaranteed Student Loans:	Subsidies for student loans from commercial lenders and participating colleges and universities.
Supplemental Educational Opportunity Grants:	Support for institutionally administered, need-based grants.
College Work-Study:	Support for institutionally administered student employment programs.
National Direct Student Loans:	Capital contributions to institutions for low-interest student loans.
State Scholarship Incentive Grants:	Matching grants (50/50) to states for scholarship programs.

The fiscal year 1977 current policy budget would allow several patterns of funding for the various higher education programs. If the funding level of each program were simply increased by the amount of inflation, outlays would be kept constant in real terms. Alternatively, if the basic educational opportunity grant program (BEOGs) remained in its current form (the awards equal \$1,400 minus expected family contribution or one-half the cost of college attendance, whichever is less), the participation rate reached 77 percent, and it is fully funded as an entitlement program, it would account for approximately \$1.17 billion outlays during fiscal year 1977.[4] The guaranteed student loan program (GSL) interest subsidies and default

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4. This outlay estimate was derived by adding the effect of increases in BEOGs recipients (resulting from an increase in the participation rate from 74 percent to 77 percent; an increase in enrollment; and an increase in the classes covered) to the fiscal year 1976 outlay estimate of \$1 billion.

payments would account for another $0.58 billion in outlays in fiscal year 1977. If the funding for the campus-based student assistance programs remained constant between fiscal year 1976 and fiscal year 1977, fiscal year 1977 outlays for these programs would reach $0.97 billion. The funding for these student assistance programs would total $2.71 billion; the total current policy budget would allow for only $0.09 billion for other higher education programs--including state scholarship incentive grants (SSIGs), aid to developing institutions, and support for special institutions. The budgets for these other programs would be $0.46 billion if they were maintained at real dollar levels.

As another option, the current policy budget could include the funding of this latter group of programs at constant real levels if the funding of campus-based student assistance programs were reduced from $0.97 billion to $0.6 billion (see table below).[5]

ALTERNATIVE HIGHER EDUCATION FUNDING OUTLAYS
WITHIN THE CURRENT POLICY BASE
(Billions of Dollars, Fiscal Year 1977)

	With BEOGs as an Entitlement Program		
Program	Constant Real Funding Levels	Maintaining Student Assistance At Real Levels	Maintaining Other Programs At Real Levels
Basic Grants	1.06	1.17	1.17
Guaranteed Loans	0.58	0.58	0.58
Supplemental Grants	0.28	0.28	0.15
Work-Study	0.38	0.38	0.25
Direct Student Loans	0.30	0.30	0.20
Other Programs	0.20	0.09	0.46
Total	2.80	2.80	2.80

5. This reduction would require the repeal of legislation which sets minimum appropriation levels for direct loans before basic grants can be funded. (The minimum levels for supplemental grants and work-study would still be met under this current policy option.)

Under each of the current policy budget level alternatives, higher education tax expenditures would be $1.72 billion--composed of $0.22 billion from the exclusion of scholarships and fellowships; $0.72 billion from the personal exemption allowed parents with student dependents aged 19 and over; and $0.78 billion from the deductibility of contributions to educational institutions.

A high budget option for higher education that continues the emphasis on student assistance within the federal budget could include an expanded BEOGs program that provided grants of $1,800 minus an expected family contribution;[6] continued funding of the GSL program; and funding of the campus-based student assistance programs at constant real levels. If the SSIG program funding were increased to $100 million, the total student assistance component of this high budget option would be $3.6 billion. If the other higher education programs were funded at constant real levels (totaling $0.41 billion) and a direct institutional grant program of $0.20 billion were funded in order to provide some general support for higher education activities (funding grants to institutions averaging $27 per full-time equivalent enrollee), the fiscal year 1977 outlays for the high budget option would be $4.23 billion. By fiscal year 1981, this budget option would grow to $5.9 billion.

The student assistance components of this high budget option would provide campus-based program award patterns equal to those provided by the current policy budget and higher BEOG awards. The average BEOG award would increase from $865 to $937 and the pattern of awards among students would shift. These increased BEOG awards would increase enrollment by low- and moderate-income students and reduce the students' financial costs of attending both low- and high-cost colleges and universities (see table below). The total fiscal year 1977 cost (in outlays) of this expanded BEOG option would be $1.97 billion if the participation rate were 85 percent.

A low fiscal year 1977 budget option for higher education might include current policy level funding for BEOGs ($1.17 billion) and GSLP interest payments and defaults ($0.58 billion); elimination of the college work-study (CWS) and SSIG programs; and a reduction in the outlays for the National Direct Student Loan[7] and SEOG programs to $0.20 billion and $0.15 billion respectively. This budget option would reduce the federal role in higher education largely to the provision of grants to low- and moderate-income students and support of subsidized loans. If the other higher education programs were

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6. A legislative change would be required to enable higher basic grants to be awarded in fiscal year 1977.

7. This would require repeal of legislation which sets minimum appropriations levels for the work-study and direct loan programs before basic grants can be funded.

PATTERNS OF BEOG AWARDS FOR REPRESENTATIVE CASES
ESTIMATED AT FULL FUNDING OF BEOG PROGRAM

	Family Income Level			
	$6,000		$11,000	
Cost of School	$2,200	$4,000	$2,200	$4,000
BEOG Grant if Award is				
(a) $1,400 less family contribution or half cost[a]	$1,100	$1,200	$400	$400
(b) $1,800 less family contribution or half cost	$1,100	$1,600	$800	$800

a. Current policy estimate.

restricted to low funding levels the total fiscal year 1977 outlays for higher education could be reduced to $2.24 billion. If this program were continued through fiscal year 1981, its cost would rise to $3.1 billion.

The President's higher education budget for fiscal year 1977 calls for $2.3 billion in outlays including $0.72 billion for BEOGs; $0.56 billion for GSL interest subsidies and default payments; $0.31 billion in federal support for direct loans; and $0.38 billion for the CWS program. The President has also proposed legislative changes for these programs that would reduce federal budget costs beginning in fiscal year 1978. These changes include reducing the maximum BEOG award from half-cost to half-need,[8] lowering the federal share of CWS payments from 80 percent to 50 percent by fiscal year 1980, and raising the ceilings on student interest payments in the GSL program from 7 percent to 8 percent for new borrowers.

8. Need is defined as cost minus expected family contribution.

The President's social security proposals include an elimination of the support for student dependents. Because this support is included in the BEOGs calculation of an expected family contribution, this change would increase the BEOGs full funding level by approximately $50 million in fiscal year 1977.

The President's proposal would eliminate the SEOG and NDSL programs. The elimination of SEOG support would result in 445,000 fewer grants in comparison to the current policy budget. The elimination of further federal support for the NDSL loan funds would restrict total borrowing to the level that would be supported by repayments of previous loans to institutionally maintained revolving funds. This would either reduce the number of loans to 365,000 from 834,000 (if average loans remain the same), or average loans would drop to $300 from $690 (if the number were held constant). [9] In total, the President proposes to provide $2.64 billion in higher education funding in fiscal year 1977.

Total Cost of Alternative Education Budgets

If the current policy budget were enacted, the total support for education activities in function 500 in fiscal year 1977 would be $9.7 billion. By 1981, this budget would grow to $11.9 billion. A high budget option that would increase support for early childhood care and education, elementary and secondary education programs for inadequately served populations, and higher education assistance for low- and middle-income students and institutions would cost $12 billion in fiscal year 1977. This budget could be expected to grow to $15.5 billion by fiscal year 1981. A low budget option that would cut services below their current policy level would cost $7.9 billion in fiscal year 1977 and $10.1 billion by fiscal year 1981. The President's proposed budget and suggested supplementals would provide $8.4 billion in education support in fiscal year 1977 (see table below and summary tables).

9. The cut in NDSL support might result in increased borrowing under the GSLP program or from other sources.

ALTERNATIVE EDUCATION SUPPORT BUDGETS
(Outlays in Billions of Dollars, Fiscal Years)

Option	Subfunction: 501 (1977)	502 (1977)	503 (1977)	506 (1977)	Total Education Support in Function 500 (1977)	(1981)
Current Policy Level	$5.4	$2.8	$0.9	$0.6	$9.7	$11.9
High Option	+0.7	+1.4	NC	+0.2	+2.3	+3.6
Low Option	-1.2	-0.6	NC	NC	-1.8	-1.8
President's Proposed Budget	-0.8	-0.2	NC	NC	-1.0	

NC: No change.

SUMMARY TABLE: EDUCATION PORTION OF FUNCTION 500

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 500 items:								
Elementary and secondary education (501) [a]	4.6	4.9	0.9	5.4	5.6	6.0	6.3	6.6
Higher education (502)	2.1	2.6	0.8	2.8	3.0	3.2	3.3	3.5
Other education (503)	1.0	0.9	0.2	0.9	1.0	1.0	1.1	1.2
Social services grants for child care (506)	0.5	0.6	0.1	0.6	0.6	0.6	0.6	0.6
Total Current Policy Option: Education Portion of Function 500	**8.1**	**9.0**	**2.0**	**9.7**	**10.2**	**10.8**	**11.3**	**11.9**
Tax Expenditures	1.8	1.9	NA	2.1	2.3	2.5	2.7	2.9
HIGH OPTION								
Function 500 items:								
Elementary and secondary education (501) [a]	4.6	4.9	0.9	6.1	6.5	6.9	7.2	7.6
Higher education (502)	2.1	2.6	0.8	4.2	4.9	5.3	5.6	5.9
Other education (503)	1.0	0.9	0.2	0.9	1.0	1.0	1.1	1.2
Social services grants for child care (506)	0.5	0.6	0.1	0.8	0.8	0.8	0.8	0.8
Total High Option: Education Portion of Function 500	**8.1**	**9.0**	**2.0**	**12.0**	**13.2**	**14.0**	**14.7**	**15.5**
Tax Expenditures	1.8	1.9	NA	2.2	2.3	2.5	2.7	2.9

See footnotes at end of table.

SUMMARY TABLE: EDUCATIO N PORTION OF FUNCTION 500

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 500 items:								
Elementary and secondary education (501)[a]	4.6	4.9	0.9	4.2	4.5	4.7	5.0	5.2
Higher education (502)	2.1	2.6	0.8	2.2	2.5	2.7	2.9	3.1
Other education (503)	1.0	0.9	0.2	0.9	1.0	1.0	1.1	1.2
Social services grants for child care (506)	0.5	0.6	0.1	0.6	0.6	0.6	0.6	0.6
Total Low Option: Education Portion of Function 500	**8.1**	**9.0**	**2.0**	**7.9**	**8.6**	**9.0**	**9.6**	**10.1**
Tax Expenditures	1.8	1.9	NA	2.1	2.3	2.5	2.7	2.9
PRESIDENT'S BUDGET								
Function 500 items:								
Elementary and secondary education (501)[a]	4.6	4.9	0.9	[b]4.6				
Higher education (502)	2.1	2.6	0.8	[b]2.6				
Other education (503)	1.0	0.9	0.2	0.9				
Social service grants for child care (506)	0.5	0.6	0.1	0.6				
Total President's Budget: Education Portion of Function 500	**8.1**	**9.0**	**2.0**	**8.7**				
Tax Expenditures	8.1	1.9	NA	2.1				

[a] Includes preprimary (early childhood) programs.

[b] Excludes effects of rescission requests transmitted with budget.

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SUMMARY TABLE: FUNCTION 500 TOTALS RESULTING FROM COMBINING ANTI-UNEMPLOYMENT AND EDUCATION OPTIONS

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Elementary, secondary, and vocational education (501)	4.6	4.9	0.9	5.4	5.6	6.0	6.3	6.6
Higher education (502)	2.1	2.6	0.8	2.8	3.0	3.2	3.3	3.5
Research and general education aids (503)	0.9	0.9	0.2	0.9	1.0	1.0	1.1	1.2
Training, employment, and other labor services (504, 505)	4.3	8.4	2.6	8.3	8.3	8.2	8.0	8.0
Social services (506)	3.3	4.0	0.9	4.3	4.4	4.6	4.7	4.9
Total Current Policy Option: Function 500	**15.2**	**20.9**	**5.4**	**21.8**	**22.4**	**23.1**	**23.5**	**24.3**
Tax expenditures for current policy option: function 500	NA	5.2	NA	5.6	6.2	6.7	7.4	8.2
HIGH OPTION								
Elementary, secondary, and vocational education (501)	4.6	4.9	0.9	6.1	6.5	6.9	7.2	7.6
Higher education (502)	2.1	2.6	0.8	4.2	4.9	5.3	5.6	5.9
Research and general education aids (503)	0.9	0.9	0.2	0.9	1.0	1.0	1.1	1.2
Training, employment, and other labor services (504, 505)	4.3	8.4	2.6	10.2	10.4	10.4	10.4	10.4
Social services (506)	3.3	4.0	0.9	4.5	4.6	4.8	4.9	5.1
Total High Option: Function 500	**15.2**	**20.9**	**5.4**	**25.9**	**27.4**	**28.4**	**29.2**	**30.2**
Tax expenditures for high option: function 500	NA	5.2	NA	5.2	6.1	6.7	7.5	8.2

SUMMARY TABLE: FUNCTION 500 TOTALS RESULTING FROM COMBINING ANTI-UNEMPLOYMENT AND EDUCATION OPTIONS—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
MEDIUM OPTION								
Elementary, secondary, and vocational education (501)	4. 6	4. 9	0. 9	5. 4	5. 6	6. 0	6. 3	6. 6
Higher education (502)	2. 1	2. 6	0. 8	2. 8	3. 0	3. 2	3. 3	3. 5
Research and general education aids (503)	0. 9	0. 9	0. 2	0. 9	1. 0	1. 0	1. 1	1. 2
Training, employment, and other labor services (504, 505)	4. 3	8. 4	2. 6	10. 0	11. 2	9. 8	9. 6	8. 8
Social services (506)	3. 3	4. 0	0. 9	4. 3	4. 4	4. 6	4. 7	4. 9
Total Medium Option: Function 500	**15. 2**	**20. 9**	**5. 4**	**23. 4**	**25. 2**	**24. 6**	**25. 0**	**25. 0**
Tax expenditures for medium option: function 500	NA	5. 2	NA	5. 6	6. 2	6. 7	7. 4	8. 2
LOW OPTION								
Elementary, secondary, and vocational education (501)	4. 6	4. 9	0. 9	4. 2	4. 5	4. 7	5. 0	5. 2
Higher education (502)	2. 1	2. 6	0. 8	2. 2	2. 5	2. 7	2. 9	3. 1
Research and general education aids (503)	0. 9	0. 9	0. 2	0. 9	1. 0	1. 0	1. 1	1. 2
Training, employment, and other labor services (504, 505)	4. 3	8. 4	2. 6	6. 2	6. 2	5. 9	5. 8	5. 5
Social services (506)	3. 3	4. 0	0. 9	4. 3	4. 4	4. 6	4. 7	4. 9
Total Low Option: Function 500	**15. 2**	**20. 9**	**5. 4**	**17. 8**	**18. 6**	**18. 9**	**19. 5**	**19. 9**
Tax expenditures for low option: function 500	NA	5. 2	NA	5. 6	6. 2	6. 7	7. 4	8. 2

SUMMARY TABLE: FUNCTION 500 TOTALS RESULTING FROM COMBINING ANTI-UNEMPLOYMENT AND EDUCATION OPTIONS—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Elementary, secondary, and vocational education (501)	4.6	4.6	1.0	4.4				
Higher education (502)	2.1	2.7	0.4	2.6				
Research and general education aids (503)	0.9	0.8	0.2	0.9				
Training, employment, and other labor services (504, 505)	4.3	7.2	1.9	5.4				
Social services (506)	3.3	3.6	0.9	3.7				
Total President's Budget: Function 500	**15.2**	**18.9**	**4.4**	**16.9**				
Tax expenditures for president's budget: function 500	NA	5.6	NA					

PART II-1: PROGRAM ISSUES
SECTION C: GRANTS TO OTHER GOVERNMENTS

Introduction

This chapter is different from the others in Part II. The others each focus on programs in one or two budget functions: national security, energy, housing, etc. The matters they deal with can be identified with one or a few executive branch departments. This chapter, in contrast, analyzes federal grants to lower levels of government. Because they are designed to meet a wide variety of objectives, these grants appear in virtually every budget function. This "cross-cutting" analysis shows the impact of options for various grant programs (discussed elsewhere in this report) on overall levels of federal aid to state and local governments, and permits further analysis of general revenue sharing in light of these other programs.

Major federal programs that aid state and local governments are: (1) general revenue sharing ($6.4 billion)[1] and other general assistance ($1.4 billion); in which the use of funds is virtually unrestricted; (2) tax expenditures (estimated cost to the Treasury of $15 billion), where the use of the monetary benefits accruing to state and local governments is not restricted; (3) block grants for community development, law enforcement, and employment and training ($7.5 billion), in which recipient governments have freedom to decide how to spend the funds within a broad functional area; and (4) more than 600 other programs that in total provide approximately $48 billion to state and local governments in so-called "categorical grants," for everything from aid to families with dependent children to highway safety.[2] Some federal aid, especially the categorical grants, impose requirements on the recipient governments: Federal grants must sometimes be matched with state or local contributions, certain types of people must be served, certain minimum standards must be met, etc.

Decisions about program levels in categorical programs, and also in block grants, have been influenced more by the particular goals of each program than by considerations of federal-state-local fiscal relationships. However, all four _types_ of aid, plus the _kinds_ of

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1. Estimates in this paragraph refer to 1976 current policy budget levels. The definition of grants to state and local governments is the same as that used in Special Analysis O of the President's budget.

2. The classification of particular programs as "categorical" or "block grant" sometimes is a matter of judgment which could go either way.

requirements accompanying that aid, do affect the fiscal situations of state and local governments. For example, replacement of medicaid by federally operated national health insurance would have relieved the states of about $6 billion of expenditures this year.

Issues facing the Congress in the current session include: reauthorization of general revenue sharing and law enforcement assistance; consideration of antirecession grants; the President's proposals in his fiscal year 1977 budget to convert categorical programs in education, health, child nutrition, and highways to less restrictive block grants and, in many cases, to reduce funding; possible substitutes or complements to the exclusion of interest on municipal bonds from federal income taxes; and possible administration proposals for future authorizations of community development block grants.

Congressional decisions about general economic conditions also significantly affect state and local government revenues, interest expenses, and public service requirements. The biggest impact is on state and local tax receipts, which depend heavily on economic conditions. A cyclical change in the unemployment rate of one percentage point would change aggregate state-local revenues by $4 to $6 billion, which at projected 1977 levels amounts to 1.5 to 2 percent of their total receipts.

Current Programs

In fiscal year 1976, estimated federal outlays for state-local aid equal approximately $62.9 billion, about 17 percent of total federal outlays. Federal grant programs have increased in numbers as well as in budgetary significance since 1966, when there were fewer than 350 programs with outlays of $13 billion, comprising 9.6 percent of the federal budget. If current policy levels are maintained, outlays in federal grant programs will be $69.8 billion in fiscal year 1977 and $79.8 billion in fiscal year 1981. This is shown in the following table.

Federal aid programs currently provide funding for about one-quarter of all state and local government expenditures. Federal grant outlays grew rapidly during the late 1960s and early 1970s, increasing the proportion of state and local budgets financed by federal funds (see following chart).

State governments receive more direct federal grant funds than local governments, although their share has been declining (see second table on following page). The increase in the share of local governments is largely attributable to the $4 billion per year they receive from revenue sharing. However, state governments redistribute a portion of their federal grant funds to local governments. No data are available to the extent of pass-through; thus, a precise determination of the ultimate distribution of federal funds is not possible.

Federal Grants as a Proportion of State and Local Expenditures

Note: Grants are defined as in the U.S. Budget. State and local expenditures derived from National Income Accounts.

FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS OUTLAYS
FISCAL YEARS 1966, 1976,[a] 1981[a]
(Billions of Dollars)

Program Type	1966	1976[a]	1981[a]
General Assistance	0.2	7.7	8.3
Block Grants	0	7.5	9.4
Categorical Grants	12.8	47.7	62.1
Total	13.0	62.9	79.8
Percent of Total Outlays	9.6%	16.8%	14.2%

a. Current policy levels.

DIRECT RECIPIENTS OF FEDERAL GRANT FUNDS
(Amounts in Billions of Dollars, Fiscal Years)

	State Governments		Local Governments	
Year	Amount	Percent	Amount	Percent
1969	16.9	88	2.2	12
1970	19.3	88	2.6	12
1971	22.8	87	3.4	13
1972	26.8	85	4.5	15
1973	31.4	80	7.9	20
1974	31.6	76	10.2	24

Source: U.S. Census, Governmental Finance in 1973-74 (and other volumes).

Note: Pass-throughs (subsequent state grants to local governments) are not shown.

In two important grant programs, medicaid and AFDC, the grant funds are in essence passed through to individuals. In the other grant programs, funds are spent by recipient governments to provide services; for example, schools, day care, etc.

The importance of federal aid in the various categories of state and local spending is shown in the table on page 250. In 1974, the federal contribution financed over half of state-local expenditures on public welfare,[3] housing and urban renewal, and social insurance administration (unemployment compensation administration and employment service). Considering changes since 1969, the federal share remained relatively constant in health, education, and welfare; increased in natural resources and housing; and decreased in highways and social insurance.

The proportion of total federal outlays in each function accounted for by grant programs is shown in the first three columns of the table on page 251. Where the percentage figure is high, as in community development and education, heavy reliance is placed on state and local governments to administer federally funded programs; where the percentage is low, as in agriculture and law enforcement, the federal government administers most programs directly.

The distribution of total federal aid among the several functions is exhibited in the second three columns of the table on page 251. In 1974, income security, and education, employment training, and social services received the most grant funding. However, the relative importance of these functions, as well as of commerce and transportation, has decreased over time. The shift toward general purpose aid is shown by the increasing share of total grant outlays found in the revenue sharing function.

While grants are distributed through more than 600 programs found in 140 accounts in the budget, about 80 percent of current outlays are in only 21 accounts. These accounts are shown in the table on page 252.

In addition to federal budget outlays under grant programs, state and local governments are assisted by federal tax expenditures. Major items are detailed in the table on page 253.

All of the tax expenditure items provide assistance of a general nature to state and local governments. The bond interest exclusion allows state and local governments to borrow at lower interest rates, but the resulting savings to them are less than the revenue lost by the federal government. The property tax and gas tax deductions, which

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3. Medicaid is included in the Census' public welfare category.

GRANTS AS A PERCENT OF STATE-LOCAL EXPENDITURES BY PURPOSE

[Billions of dollars, fiscal years]

Purpose	1968-69			1973-74		
	Federal grants	Total state-local expenditure	Grants as percent of state-local expenditure	Federal grants	Total state-local expenditure	Grants as percent of state-local expenditure
Education	$4.8	$47.3	10%	$7.5	$75.9	10%
Highways	4.4	15.5	28	4.6	20.0	23
Public Welfare	6.4	12.3	52	12.8	25.0	52
Health and Hospitals	0.7	8.6	8	1.1	16.1	7
Natural Resources	0.3	2.6	12	0.8	3.7	20
Housing and Urban Renewal	0.9	1.9	48	2.4	3.5	69
Air Transportation	0.1	0.7	16	0.3	1.3	19
Social Insurance Administration	0.6	0.7	92	0.8	1.3	63
Other	1.3	24.0	6	12.6	45.1	28
Interest	0.0	3.7	0	0.0	7.7	0
TOTAL	$19.4	$117.3	17%	$42.9	$198.6	22%

Source: U.S. Bureau of the Census, *Governmental Finances in 1968–69*, GF69, No. 5, Table 6; and *Governmental Finances in 1973–74*, GF75, No. 5, Table 6.

GRANT OUTLAYS BY FUNCTION

[Fiscal years]

	Function	Grants as a percent of total federal outlays for each function			Distribution of grants outlays among functions, each function as a percent of total		
		1968	1971	1974	1968	1971	1974
050	National Defense	0	0	0	0	0	0
150	International Affairs	0	0	0	0	0	0
300	Natural Resources, Environment, and Energy	9	16	31	2	3	5
350	Agriculture	12	14	23	3	2	1
400	Commerce and Transportation	41	47	40	23	18	12
450	Community and Regional Development	73	79	68	7	10	8
500	Education, Training, Employment, and Social Services	66	73	75	25	23	20
550	Health	28	30	33	15	16	17
600	Income Security	13	13	10	23	25	20
700	Veterans' Benefits and Services	0	0	0	0	0	0
750	Law Enforcement and Justice	2	15	26	0	1	1
800	General Government	3	3	3	0	0	0
850	Revenue Sharing and General Purpose Fiscal Assistance	95	93	100	2	2	16
	Total	**10%**	**13%**	**16%**	**100%**	**100%**	**100%**

Source: Office of Management and Budget, *Federal Government Finances* (supplemental material to fiscal year 1977 Budget)

MAJOR GRANT OUTLAYS BY ACCOUNT

[Billions of dollars, fiscal years]

Account	1974 actual	1975 actual	1976 estimate	Presidential budget request fiscal year 1977
EPA Construction Grants (304 part)	1.6	1.9	2.4	3.8
Highway Trust Fund (404 part)	4.4	4.6	6.2	6.6
Urban Mass Transportation (404 part)	0.3	0.7	1.3	1.5
Community Development Grants (451 part)	0.0	([b])	0.8	1.6
Urban Renewal Fund—Capital Grants (451 part)	1.2	1.4	1.4	1.0
Elementary and Secondary Education (501 part)	1.7	2.3	2.3	1.9
Occupational and Vocational Education (501 part)	0.6	0.7	0.7	0.7
Human Development (501 part, 506 part)	1.2	1.6	1.6	1.6
Comprehensive Manpower (504 part)	1.1	2.5	3.0	2.5
Temporary Employment Assistance (504 part)	0.0	0.3	2.3	1.1
Public Assistance/Social Services (506 part) [a]	1.5	2.0	2.4	2.5
Alcohol, Drug Abuse, and Mental Health (551 part)	0.3	0.6	0.5	0.4
Health Services (551 part)	0.5	0.6	0.6	0.3
Public Assistance/Health Care (551 part) [a]	5.8	6.8	8.2	
Financial Assistance for Health Care (555 part)				9.0
Health Resources, (552 part)	0.6	0.7	0.6	0.4
Unemployment Trust Fund (603 part)	0.5	0.6	0.9	0.9
Child Nutrition Reform (604 part)				2.0
Grants for Child Food Assistance (604 part)	0.7	1.4	2.1	0.3
Public Assistance/Income Supplements (604 part) [a]	5.4	5.1	5.9	6.0
Housing Payments (604 part)	1.1	1.3	1.4	1.5
Justice (754 part)	0.6	0.7	0.8	0.7
Revenue Sharing (851 part)	6.1	6.1	6.3	6.5
Total, these accounts	**35.2**	**41.9**	**51.6**	**52.8**

[a] Social Services, Health Care, and Income Supplements are in the same appropriation account.
[b] Less than $50 million.

COST OF MAJOR FEDERAL TAX EXPENDITURES AIDING STATE AND LOCAL GOVERNMENTS, FISCAL YEARS 1967 AND 1976
(Billions of Dollars)

Tax Expenditure	1967	1976
Exclusion of interest on state and local debt	1.8	4.2
Deductability of nonbusiness state and local taxes (other than on owner-occupied housing)	2.8	7.1
Deductability of property taxes on owner-occupied homes	1.8	3.7

shift the burden of state and local tax levies, also provide subsidies to housing and transportation activities respectively.

Analysis

Two issues underlie debates over federal aid to state and local governments:

- Who should have control in determining priorities and in designing and implementing programs?
- To what extent should the fiscal capacities of state and local governments be augmented through the federal tax system?

Control Over Priorities

Categorical grant programs are expressions of priority choices, at the federal level, about what state and local efforts need encouragement, redirection, or simply more money. Matching provisions are often included to influence the allocation of state or local resources. Even so, some portion of the federal funds inevitably substitutes for local funds when, in some jurisdictions at least, spending on the same or similar programs would have been high even without federal assistance. Thus, even specifically designed categorical grants provide, in effect, some unrestricted assistance.

Recently, emphasis has shifted away from specifically targeted categorical grants to programs giving broader discretion to state and local governments. Categorical programs accounted for 98 percent of federal grant outlays in fiscal year 1966; in fiscal year 1975 the proportion was down to 77 percent. This shift was a response to the view that the state and local governments are able to design programs which are more in line with local preferences and better adapted to local conditions. However, some additional specifically targeted programs, such as drug abuse treatment, have been initiated recently.

The shift toward fewer restrictions on federal aid may affect how much aid goes to the poor. This question is complex, because the form of aid affects allocation both among people and among jurisdictions.

Benefits of grants are most likely to be concentrated on poor people when federal regulations and review so require. Under less restrictive forms of assistance, some states and local jurisdictions may emphasize assistance to the poor while others may not.

Distribution among jurisdictions depends partly on whether the funds are allocated by formula or by project. General assistance, block grants, and some categorical grants are allocated by formulas; the funds are widely distributed and the formulas can and do consider local concentrations of poverty in making the allocations. Other categorical grant programs, however, require submission and approval of applications for specific projects. In these programs fewer jurisdictions tend to benefit, and some of those left out may contain many poor people. In such cases federal aid may be effectively targeted on the poor within the jurisdictions that receive the grants, but may miss other poor people completely.

Thus, for maximum concentration on the poor as well as equity among jurisdictions, highly focused categorical grants with formula allocations of funds are likely to be most effective (except perhaps for assistance directly to individuals). For assistance to relatively poor or fiscally distressed jurisdictions, formula allocation is again most likely to be effective, but the restrictions of categorical programs are less relevant.

Fiscal Capacity of State and Local Governments

Concern over the financial situation of state and local governments has three different focuses: (1) the general fiscal capacity of the sector; (2) short-term fiscal problems related to recessions; and (3) fiscal difficulties faced by governments where spending pressures exceed capacity to raise revenues.

Fiscal Capacity of the State-Local Sector. State and local governments in the aggregate tax the same individuals and draw resources from the same economy as the federal government. Yet, it has been argued that the state-local sector is disadvantaged, relative to the federal government, in raising revenues to meet growing public service needs. The supposed disadvantage stems in part from federal government reliance on a progressive income tax which is highly responsive to economic growth and inflation, while revenue growth at the state and local level is somewhat more sluggish. A second reason why state and local governments may have more difficulty in raising revenues is that they compete with each other for residents and for industry. Sharp increases in tax rates may weaken a jurisdiction's tax base as people or industries move, over time, to other places where taxes are lower. Although there may not be much sensitivity to moderate differentials in tax rates, the phenomenon may well become important in extreme cases when declining tax bases and residents' growing needs for services may reinforce each other's negative effect on the fiscal situation of local government.

Whether or not state and local governments face a disadvantage in raising revenues, they have in fact raised their effective tax rates and increased their own revenues faster than has the federal government, as shown in the following chart.

Fiscal Weakness Related to Recessions. Recessions cause problems for state and local governments, particularly when they are accompanied by persistent inflation. Revenues drop as the economy weakens and taxable income and consumption decline; expenditures rise as the number of individuals eligible for welfare programs increases. Since most state and local governments are required by law to have balanced budgets, many are faced with the choice between cutting back services or increasing taxes as a result of recessions. A survey conducted in 1975 by the Joint Economic Committee indicated that state and local governments planned to draw down surpluses, enact tax increases of $3.6 billion, cut back expenditures by $3.3 billion, and delay or cancel $1 billion of capital construction.[4] The greatest fiscal difficulties are being experienced in the older industrial states which also have high unemployment.

Specific Fiscal Difficulties. New York City's recent fiscal crisis attracted renewed attention to fiscal problems of older cities. While the immediate problems of New York are unique, many other cities, as well as some states and rural areas, share the basic problems that in part produced the New York crisis. These problems include a sagging economy, a population declining in size and relative income, and an old, deteriorating physical plant in need of reinvestment. As the fiscal position of a jurisdiction worsens relative to other communities in the metropolitan area, greater numbers of businesses and individuals choose no longer to bear the higher tax burden and/or reduced services. Therefore, they decide to relocate, and thus further reduce the tax base.

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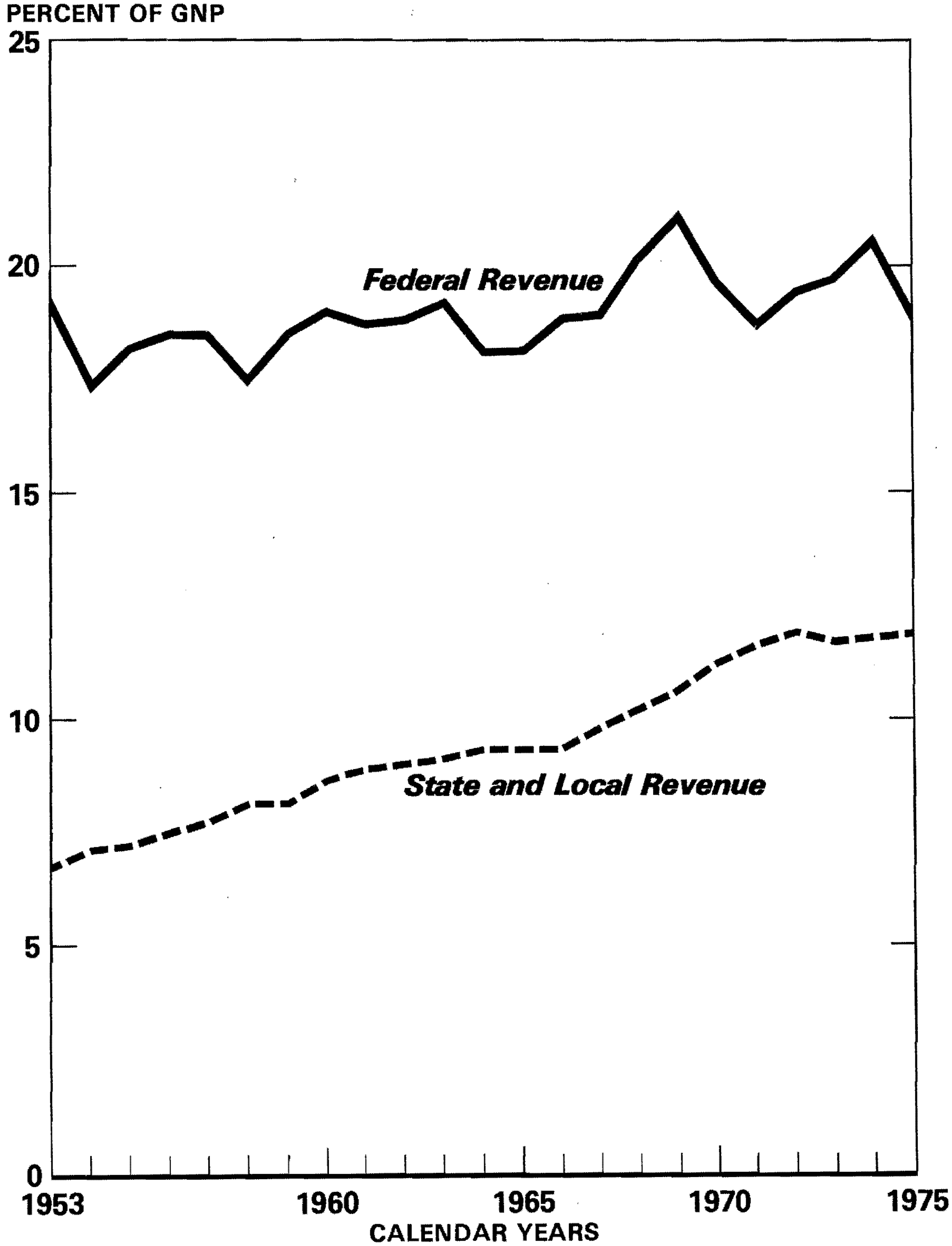
4. U.S. Congress, Joint Economic Committee, The Current Fiscal Position of State and Local Governments (May 6, 1975).

Total Revenue as a Percentage of GNP



Note: Calculated from National Income Accounts data in the Economic Report of the President, January 1976.

Options

When considering the federal grant system as a whole, there are two basic dimensions of possible change: spending and control. The Congress can choose to assume more or less of the costs now carried by state and local governments. It can also reshape the grant system to expand or restrict federal influence over priority setting and program design.

The two dimensions are only weakly related; in most programs the Congress can alter the funding level, and can independently shift the structure of a program so as to increase or decrease restrictions on uses of funds. Moreover, the overall mix of federal control can be altered by increasing funding for programs with greater (or lesser) federal control and decreasing funding for those with lesser (or greater) control.

Increasing federal funding of some programs, while decreasing that of others, can also be done on criteria other than control. For example, there have been recommendations for a full federal takeover of income assistance, with a compensating elimination of federal aid to education.

Illustrative packages of options for each kind of basic change--more or less spending, more or less control--are shown in the following table. It must be remembered that this is only a partial analysis--the important specific program criteria related to each categorical and block grant program are not taken into account; only the federal viewpoint on aid to state and local governments is considered. Under the low outlay option, more federal control could be gained by emphasizing categorical grants and deemphasizing general assistance. Under the high outlay option federal control could be reduced by replacing some categorical grants by general assistance or (as proposed by the President) block grants, or by unrestricted federal grants to individuals. To increase federal control, categoricals could be retained or replaced by restricted direct federal grants to individuals. General assistance obviously would be emphasized under the less control option and reduced under the more control option. Decisions on block grants would depend on the degree of change of control desired.

To move from the general directions of the abovementioned table to dollar estimates for budget options (shown in the table on page 259) requires additional assumptions. The budget options shown are again only illustrative.

Low Outlay Options

For the low outlay, less federal control option, it is assumed that all of the cost-saving options are adopted for the categorical programs discussed in the program sections of this report, while general

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ILLUSTRATIVE PACKAGES OF OPTIONS

Program	Less Spending		More Spending	
	Less Control	More Control	Less Control	More Control
General Revenue Sharing	Retain or reduce.	Reduce or eliminate.	Increase.	Reduce or eliminate.
Block Grants (CD, LEAA, CETA)	Reduce or eliminate.	Reduce; increase matching requirement.	Increase, or transfer funding to general revenue sharing.	Retain or increase for moderately more control; reduce or eliminate for much more control. Require matching.
Categorical Programs	Reduce or eliminate.	Retain or reduce.	Limit, reduce or transfer funding to general revenue sharing, block grants, or unrestricted federal grants to individuals.	Increase number of programs and/or total funding; switch to restricted direct federal grants to individuals.
Tax Expenditures	Retain.	Reduce or eliminate.	Retain; add subsidized taxable-bond options.	Eliminate or reduce; enact capital spending subsidies subject to federal review of projects.

VARIOUS OPTIONS FOR GRANTS TO STATE AND LOCAL GOVERNMENTS: PART A[a]

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1976	1977	1978	1979	1980	1981
CURRENT POLICY OPTION						
General assistance[b]	7.7	8.2	7.7	8.0	8.1	8.3
Fiscal relief from federalization of programs[c]	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Block grants[d]	7.5	8.9	9.5	9.4	9.4	9.6
Health and welfare programs[e]	15.0	17.4	19.2	20.9	22.6	24.4
Other categorical grant programs[f]	32.7	35.4	37.3	38.1	37.5	37.5
Total Current Policy Option	**62.9**	**69.8**	**74.1**	**76.4**	**77.6**	**79.8**
Tax Expenditures:						
Exclusion of interest on state-local debt	4.2	4.5	4.9	5.2	5.7	6.2
Deduction of nonbusiness state and local tax[g]	10.8	11.1	12.3	13.7	15.2	16.9
PRESIDENT'S BUDGET						
General assistance	7.2	7.3				
Fiscal relief from federalization of programs	(0.0)	(0.0)				
Block grants	6.9	19.7				
Health and welfare programs	15.2	6.6				
Other categorical grant programs	30.6	26.8				
Total President's Budget	**59.8**	**60.5**				
Tax Expenditures:						
Exclusion of interest on state-local debt	4.2	4.5				
Deduction of nonbusiness state and local tax	10.8	11.1				

See footnotes at end of table.

VARIOUS OPTIONS FOR GRANTS TO STATE AND LOCAL GOVERNMENTS: PART B[a]

OUTLAYS

[Billions of dollars, fiscal years, path B]

Level of Outlays	Degree of Federal Control											
	Option A: Less						Option B: More					
	1976	1977	1978	1979	1980	1981	1976	1977	1978	1979	1980	1981
LOW												
General assistance[b]	7.7	8.2	7.7	8.0	8.1	8.3	7.7	6.8	4.8	3.6	2.3	1.1
Fiscal relief from federalization of programs[c]	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Block grants[d]	7.5	7.0	7.2	7.9	7.4	7.4	7.5	7.0	7.2	7.9	7.4	7.4
Health and welfare programs[e]	15.0	15.5	17.0	18.4	19.7	20.9	15.0	17.4	19.2	20.9	22.6	24.4
Other categorical grant programs[f]	32.7	29.5	31.6	31.5	30.3	29.6	32.7	35.4	37.3	38.1	37.5	37.5
Total	**62.9**	**60.1**	**63.4**	**65.8**	**65.5**	**66.2**	**62.9**	**66.6**	**68.4**	**70.5**	**69.8**	**70.5**
Tax Expenditures:												
Exclusion of interest on state-local debt[h]	4.2	4.5	4.9	5.2	5.7	6.2	4.2	4.2	4.2	4.2	4.2	4.2
Deduction of nonbusiness state and local tax[g]	10.8	11.1	12.3	13.7	15.2	16.9	10.8	11.1	12.3	13.7	15.2	16.9
HIGH												
General assistance[b]	7.7	15.4	15.6	19.2	21.4	23.1	7.7	7.9	7.2	7.3	7.3	7.4
Fiscal relief from federalization of programs[c]	(0.0)	(0.0)	(0.8)	(1.7)	(2.6)	(3.5)	(0.0)	(0.0)	(0.8)	(1.7)	(2.6)	(3.5)
Block grants[d]	7.5	12.1	13.2	14.2	14.8	15.4	7.5	8.9	9.5	9.4	9.4	9.6
Health and welfare programs[e]	15.0	23.0	28.1	32.8	37.6	43.4	15.0	23.0	28.1	32.8	37.6	43.4
Other categorical grant programs[f]	32.7	29.5	31.6	31.5	30.3	29.6	32.7	40.3	43.9	48.4	50.6	52.3
Total	**62.9**	**80.0**	**88.5**	**97.7**	**104.1**	**111.5**	**62.9**	**80.1**	**88.6**	**98.0**	**104.9**	**112.6**

See footnotes at end of table.

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VARIOUS OPTIONS FOR GRANTS TO STATE AND LOCAL GOVERNMENTS: PART B[a]—Continued

OUTLAYS

[Billions of dollars, fiscal years, path B]

Level of Outlays	Degree of Federal Control											
	Option A: Less						Option B: More					
	1976	1977	1978	1979	1980	1981	1976	1977	1978	1979	1980	1981
Tax Expenditures:												
Exclusion of interest on state-local debt[h]	4.2	4.5	4.9	5.2	5.7	6.2	4.2	4.2	4.2	4.2	4.2	4.2
Deduction of nonbusiness state and local tax[g]	10.8	11.1	12.3	13.7	15.2	16.9	10.8	11.1	12.3	13.7	15.2	16.9

[a] Estimates of grant outlays are calculated by applying the percentage of total outlays for each subfunction accounted for by grant programs (based on the President's 1976 budget) to CBO current policy budget totals. High and low options are consistent with presentations elsewhere in this report.

[b] Includes function 850 and antirecession grants. In high-outlay Option A outlays for general assistance and block programs equal current policy levels plus an amount equal to the difference between other categorical grant program outlays in high outlay Option B and low outlay Option A.

[c] Federalization of either health or welfare programs will relieve states of obligations under current law, thereby releasing funds for other purposes. The amount listed is the estimated savings to states from the partial federalization of medicaid; they are not included in the outlays totals.

[d] Includes community development block grants (451), law enforcement assistance (754), and part of employment training (504).

[e] Includes AFDC (604), medicaid and health service grants (551). Other health and welfare programs are included in the other categorical grant total. Budget estimates are consistent with options discussed in this report. The high-outlay option assumes: (1) the partial federalization of medicaid and elimination of other health service grants, and (2) the maintenance of AFDC at current policy levels. A comprehensive income assistance program could be adopted instead of or in addition to federalization of medicaid.

[f] Includes all other grant programs. Consistent with presentations elsewhere in this report, the programs that vary between the high- and low-outlay assumptions are: EPA construction grants, highway trust fund, urban mass transportation assistance, public works, public housing, child nutrition and educational grants. Other grant programs are held at current policy levels.

[g] Includes tax deduction of state gasoline taxes, property taxes on owner-occupied homes and other non business state and local taxes. The gas tax and property tax deductions also provide subsidies for transportation and housing respectively.

[h] In Option B the tax exclusion of interest earned on state and local bonds is repealed, effectively on bonds issued in 1977 and thereafter. Under the high-outlay assumption, a categorical grant to assist state and local construction efforts is substituted and funded at levels equal to the projected increase in the tax expenditure under current policy.

assistance programs are maintained at current policy levels. Alternatively, for more federal control, general assistance is reduced while categorical programs are maintained at current policy levels. In both cases, block grant programs are set at levels slightly below current policy.

High Outlay Options

Current policy levels for general assistance and block grants plus the high outlay levels for categoricals (analyzed elsewhere in this report) are treated as a total which can be redistributed according to how much federal control is desired.[5] To increase federal control, funds are shifted to categorical grant programs. For less federal control, funding for most categorical programs is reduced below current policy and the increment is assigned to general assistance and block grant programs.

Income assistance and health grant programs are treated differently from other categoricals, in the preceding table. This is because the high outlay options for income assistance and health programs involve replacing aid to state and/or local governments with direct federal grants to (or insurance of) individuals. State and local governments would be eliminated from the programs. Although they would no longer receive federal grants, they would be free to eliminate their own expenditures on the programs. The net effect would be to free up several billion of their own revenues.

Under these assumptions, options for general revenue sharing could range from elimination to an increase to $19.6 billion per year in fiscal year 1981, and antirecession grants[6] could range from zero to $2.5 billion. Adding other general purpose fiscal assistance of $1.1 billion produces the 1981 totals shown as "general assistance" in the preceding table. The high outlay option also includes fiscal relief of $3.5 billion in 1981, based on partial federalization of medicaid. From the viewpoint of state and local governments, this is roughly equivalent to general assistance in the same amounts. Therefore, the net effect of such changes on unrestricted assistance, as felt by state and local governments, is the total of the amounts shown in the preceding table for "general assistance" and "fiscal relief from federalization of programs." Thus, for all general assistance, the high outlay option

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5. This report does not attempt to estimate state-local "needs" for assistance. The most important reason for avoiding such an approach is that the very concept of "needs" as a gap to be filled is questionable. Federal aid levels affect both tax and expenditure policies of state and local governments; therefore, the numbers that would be used to compute the "need" in fact depend on federal choices about how much of that "need" to fill.

6. Also known as counter-cyclical revenue sharing.

ranges from $26.6 billion (for less federal control) to $10.9 billion (for more federal control); this can be compared to current policy budget levels for fiscal year 1981 estimated at $8.3 billion. For all three of the major existing block grant programs combined, the high outlay option range is from $15.4 to $9.6 billion in 1981.

A more detailed discussion of specific options for general revenue sharing is presented in Section F of Part I of this report.

The President's Budget

In terms of this analysis, the implications of the President's fiscal year 1977 budget for aid to state and local governments are a low spending, low federal control option. Proposed grant outlay totals for 1977 are $60.5 billion, or about 13 percent below current policy budget estimates. If the President's proposals are adopted, programs will have to be cut unless states or localities increase their contributions.

The aggregate effects of the President's proposals for increases in block grant programs and corresponding decreases for categoricals are shown in the preceding table. The President's proposed outlays in each functional area are contrasted with historical and current policy levels in the following table. The President's proposals are significantly lower than current policy levels in:

- Community and regional development, where the President omits outlays expected as a result of the Local Public Works Capital Development and Investment Act of 1975.

- Education, training, employment, and social services, where the President plans reductions in public service employment and education.

- Health, where funding proposed for the Financial Assistance Health Care Act is less than current policy estimates for the replaced categorical programs.

Shifts in emphasis in the President's proposals would reduce federal control over state and local programs. Recipient governments would be freer to allocate funds to their own high priority uses, and the proposed elimination of matching requirements in many programs would further increase state-local discretion over their spending and taxing patterns.

The effects of adopting the President's proposals are difficult to predict. Some state and local governments may choose to maintain service levels even when faced with reduced federal grants, and indeed some of those governments may even be able to do so without increasing tax rates.

PRESIDENT'S PROPOSALS FOR AID TO STATE AND LOCAL GOVERNMENT, BY FUNCTION

OUTLAYS

[Billions of dollars]

Function	1975 actual	1976 Current policy budget	1976 President's proposals	1977 Current policy budget	1977 President's proposals
050 National Defense	0.1	0.1	0.1	0.1	0.1
300 Natural Resources, Environment, and Energy	2.5	2.9	3.1	4.6	4.5
350 Agriculture	0.4	0.5	0.5	0.4	0.6
400 Commerce and Transportation	5.9	8.7	8.2	9.4	9.0
450 Community and Regional Development	3.3	4.8	4.0	5.5	3.9
500 Education, Training, Employment, and Social Services	11.6	16.4	14.4	17.1	12.5
550 Health	8.8	10.2	10.0	11.9	10.2
600 Income Security	9.3	11.0	11.2	12.4	11.4
700 Veterans, Benefits	[a] 0.0	0.1	0.1	0.1	0.1
750 Law Enforcement	0.7	0.9	0.8	0.8	0.8
800 General Government	0.1	0.1	0.1	0.1	0.1
850 Revenue Sharing and General Purpose Fiscal Assistance	7.0	7.3	7.2	7.4	7.3
Total	**49.7**	**62.9**	**59.8**	**69.8**	**60.5**

[a] Less than $50 million.

Other less prosperous jurisdictions will have to cut services or raise taxes. The ultimate impacts of the President's proposals on program beneficiaries, taxpayers, and state-local fiscal situations would thus vary considerably from one jurisdiction to another. As is true of the other options, the President's proposals for consolidation of programs can be analyzed separately from his proposed funding levels.

SUMMARY TABLE: FUNCTIONS (450, 750 AND 850) ASSOCIATED WITH FEDERAL AID TO STATE AND LOCAL GOVERNMENTS

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 850: Revenue sharing and general purpose fiscal assistance:								
General revenue sharing (851)	6.1	6.4	1.6	6.6	6.8	7.0	7.1	7.2
Other (852)	0.9	1.0	0.4	0.8	0.9	1.0	1.0	1.1
Total Current Policy Option: Function 850	**7.0**	**7.3**	**2.1**	**7.4**	**7.7**	**8.0**	**8.1**	**8.3**
Tax expenditures:								
Exclusion of interest on state and local debt	3.8	4.2	NA	4.5	4.9	5.2	5.7	6.2
Deduction of nonbusiness state and local taxes	8.5	6.5	NA	6.7	7.4	8.2	9.1	10.1
Exclusion of income earned in U.S. possessions	0.2	0.2	NA	0.3	0.3	0.3	0.4	0.4
Function 750: Law enforcement and justice: [a]								
Federal law enforcement, judicial and correctional activities (751, 752, 753)	2.1	2.5	0.8	2.7	2.9	3.0	3.2	3.4
Law enforcement assistance administration (754)	0.9	0.9	0.2	1.0	1.0	1.0	1.0	1.1
Total Current Policy Option: Function 750	**2.9**	**3.4**	**0.9**	**3.7**	**3.9**	**4.0**	**4.2**	**4.5**
Function 450: Community and regional development:								
Community development grants (451 part)	[d] 0.0	0.9	0.4	2.3	3.0	3.2	3.4	3.6
Urban renewal and model cities (451 part)	1.7	1.5	0.2	0.9	0.5	0.2	0.0	0.0
Other community development (451 part)	1.4	1.6	0.4	1.5	1.6	1.8	1.9	2.0
Area and regional development (452)	0.9	1.5	0.4	1.6	1.7	1.8	1.9	2.0
Disaster relief and insurance (453)	0.4	0.5	0.1	0.5	0.6	0.6	0.6	0.7
All other [b]	0.0	1.0	0.6	0.8	0.9	0.4	0.2	0.0
Total Current Policy Option: Function 450	**4.4**	**7.0**	**2.1**	**7.6**	**8.3**	**8.0**	**8.0**	**8.3**
Tax expenditures [c]	0.1	0.1	NA	[d] 0.0	[d] 0.0	[d] 0.0	[d] 0.0	[d] 0.0

See footnotes at end of table.

SUMMARY TABLE: FUNCTIONS (450, 750 AND 850) ASSOCIATED WITH FEDERAL AID TO STATE AND LOCAL GOVERNMENTS—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION								
Function 850: Revenue sharing and general purpose fiscal assistance:								
General revenue sharing (851)	6. 1	6. 4	1. 6	11. 8	12. 5	16. 0	18. 1	19. 6
Other (852)	0. 9	1. 0	0. 4	0. 8	0. 9	1. 0	1. 0	1. 1
Total High Option: Function 850	**7. 0**	**7. 3**	**2. 1**	**12. 6**	**13. 4**	**17. 0**	**19. 1**	**20. 7**
Tax expenditures:								
Exclusion of interest on state and local debt	3. 8	4. 2	NA	4. 5	4. 9	5. 2	5. 7	6. 2
Deduction of nonbusiness state and local taxes	8. 5	6. 5	NA	6. 7	7. 4	8. 2	9. 1	10. 1
Exclusion of income earned in U.S. possessions	0. 2	0. 2	NA	0. 3	0. 3	0. 3	0. 4	0. 4
Function 750: Law enforcement and justice: [a]								
Federal law enforcement, judicial and correctional activities (751, 752, 753)	2. 1	2. 5	0. 8	2. 7	2. 9	3. 0	3. 2	3. 4
Law enforcement assistance administration (754)	0. 9	0. 9	0. 2	1. 4	1. 5	1. 7	1. 8	2. 0
Total High Option: Function 750	**2. 9**	**3. 4**	**0. 9**	**4. 1**	**4. 4**	**4. 7**	**5. 0**	**5. 4**
Function 450: Community and regional development:								
Community development grants (451 part)	[d] 0. 0	0. 9	0. 4	3. 5	4. 4	5. 3	5. 9	6. 3
Urban renewal and model cities (451 part)	1. 7	1. 5	0. 2	0. 9	0. 5	0. 2	0. 0	0. 0
Other community development (451 part)	1. 4	1. 6	0. 4	1. 5	1. 6	1. 8	1. 9	2. 0
Area and regional development (452)	0. 9	1. 5	0. 4	1. 6	1. 7	1. 8	1. 9	2. 0
Disaster relief and insurance (453)	0. 4	0. 5	0. 1	0. 5	0. 6	0. 6	0. 6	0. 7
All other [b]	0. 0	1. 0	0. 6	4. 8	4. 2	4. 5	4. 7	4. 9
Total High Option: Function 450	**4. 4**	**7. 0**	**2. 1**	**12. 8**	**13. 0**	**14. 2**	**15. 0**	**15. 9**
Tax expenditures [c]	0. 1	0. 1	NA	[d] 0. 0	[d] 0. 0	[d] 0. 0	[d] 0. 0	[d] 0. 0

See footnotes at end of table.

SUMMARY TABLE: FUNCTIONS (450, 750 AND 850) ASSOCIATED WITH FEDERAL AID TO STATE AND LOCAL GOVERNMENTS—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 850: Revenue sharing and general purpose fiscal assistance:								
General revenue sharing (851)	6. 1	6. 4	1. 6	5. 2	3. 9	2. 6	1. 3	0. 0
Other (852)	0. 9	1. 0	0. 4	0. 8	0. 9	1. 0	1. 0	1. 1
Total Low Option: Function 850	**7. 0**	**7. 3**	**2. 1**	**6. 0**	**4. 8**	**3. 6**	**2. 3**	**1. 1**
Tax expenditures:								
Exclusion of interest on state and local debt	3. 8	4. 2	NA	4. 2	4. 2	4. 2	4. 2	4. 2
Deduction of nonbusiness state and local taxes	8. 5	6. 5	NA	6. 7	7. 4	8. 2	9. 1	10. 1
Exclusion of income earned in U.S. possessions	0. 2	0. 2	NA	0. 3	0. 3	0. 3	0. 4	0. 4
Function 750: Law enforcement and Justice: [a]								
Federal law enforcement, judicial and correctional activities (751, 752, 753)	2. 1	2. 5	0. 8	2. 7	2. 9	3. 0	3. 2	3. 4
Law enforcement assistance administration (754)	0. 9	0. 9	0. 2	1. 0	0. 9	0. 9	0. 9	1. 0
Total Low Option: Function 750	**2. 9**	**3. 4**	**0. 9**	**3. 7**	**3. 8**	**3. 9**	**4. 1**	**4. 4**
Function 450: Community and regional development:								
Community development grants (451 part)	[d] 0. 0	0. 9	0. 4	1. 9	2. 3	3. 2	3. 0	3. 2
Urban renewal and model cities (451 part)	1. 7	1. 5	0. 2	0. 9	0. 5	0. 2	0. 0	0. 0
Other community development (451 part)	1. 4	1. 6	0. 4	1. 5	1. 6	1. 8	1. 9	2. 0
Area and regional development (452)	0. 9	1. 5	0. 4	1. 6	1. 7	1. 8	1. 9	2. 0
Disaster relief and insurance (453)	0. 4	0. 5	0. 1	0. 5	0. 6	0. 6	0. 6	0. 7
All other [b]	0. 0	1. 0	0. 6	0. 8	0. 9	0. 4	0. 2	0. 0
Total Low Option: Function 450	**4. 4**	**7. 0**	**2. 1**	**7. 2**	**7. 6**	**8. 0**	**7. 6**	**7. 9**
Tax expenditures [c]	0. 1	0. 1	NA	[d] 0. 0	[d] 0. 0	[d] 0. 0	[d] 0. 0	[d] 0. 0

See footnotes at end of table.

SUMMARY TABLE: FUNCTIONS (450, 750 AND 850) ASSOCIATED WITH FEDERAL AID TO STATE AND LOCAL GOVERNMENTS—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Function 850: Revenue sharing and general purpose fiscal assistance:								
General revenue sharing (851)	6. 1	6. 3	1. 6	6. 6	--------	--------	--------	--------
Other (852)	0. 9	0. 9	0. 4	0. 8	--------	--------	--------	--------
Total President's Budget: Function 850	**7. 0**	**7. 2**	**2. 0**	**7. 4**	--------	--------	--------	--------
Tax expenditures:								
Exclusion of interest on state and local debt	3. 8	4. 2	NA	4. 5	--------	--------	--------	--------
Deduction of nonbusiness state and local taxes	8. 5	6. 5	NA	6. 7	--------	--------	--------	--------
Exclusion of income earned in U.S. possessions	0. 2	0. 2	NA	0. 3	--------	--------	--------	--------
Function 750: Law enforcement and justice: [a]								
Federal law enforcement, judicial and correctional activities (751, 752, 753)	2. 1	2. 5	0. 7	2. 6	--------	--------	--------	--------
Law enforcement assistance administration (754)	0. 9	0. 9	0. 3	0. 8	--------	--------	--------	--------
Total President's Budget: Function 750	**2. 9**	**3. 4**	**0. 9**	**3. 4**	--------	--------	--------	--------
Function 450: Community and regional development:								
Community development grants (451 part)	[d] 0. 0	0. 8	0. 4	1. 6	--------	--------	--------	--------
Urban renewal and model cities (451 part)	1. 7	1. 6	0. 3	1. 0	--------	--------	--------	--------
Other community development (451 part)	1. 4	1. 5	0. 3	1. 1	--------	--------	--------	--------
Area and regional development (452)	0. 9	1. 4	0. 4	1. 3	--------	--------	--------	--------
Disaster relief and insurance (453)	0. 4	0. 6	0. 1	0. 6	--------	--------	--------	--------
All other [b]	0. 0	0. 0	0. 0	0. 0	--------	--------	--------	--------
Total President's Budget: Function 450	**4. 4**	**5. 8**	**1. 5**	**5. 5**	--------	--------	--------	--------
Tax expenditures [c]	0. 1	0. 1	NA	[d] 0. 0	--------	--------	--------	--------

[a] No tax expenditures are included in Function 750.
[b] Includes accelerated public works and antirecession grants.
[c] 5 year amortization for housing rehabilitation.
[d] Less than $50 million.

PART II-1: PROGRAM ISSUES
SECTION D: NATURAL RESOURCES AND COMMERCE

Energy (Subfunction 305)

Federal energy expenditures (subfunction 305) support research and development programs, general operating programs such as uranium enrichment and energy conservation, and regulatory agencies including the Federal Power Commission and the Nuclear Regulatory Commission. The federal government also operates other energy-related programs such as the Tennessee Valley Authority (part of subfunction 301).

Most federal energy expenditures support programs designed to accelerate research on and development of new technologies (see table below). In the past, the bulk of federal research and development spending has been devoted to nuclear technology; while this still is the case, the emphasis is shifting more toward other alternatives, such as synthetic fuels and geothermal and solar power. There has also been an increased effort to develop conservation techniques that will make more efficient use of the energy that is currently consumed. General operating and regulatory programs together account for less than one-third of federal energy spending.

In addition to the direct expenditure programs, the federal tax code contains various provisions intended to stimulate energy production. The major provisions permit (1) exploration and development costs to be expensed (that is, these costs may be deducted from income as they are incurred, rather than as income from them is realized), and (2) deduction of a fixed percentage of sales receipts as a depletion allowance, regardless of the amount invested. Together these tax expenditures are estimated to reduce federal revenues in fiscal year 1976 by roughly $2.45 billion.[1]

The energy-related expenditures in the federal budget have grown rapidly during the last two years, from $606 million in fiscal year 1974 to an estimated level of $2.4 billion in fiscal year 1976. Projections suggest that $3.2 billion would be required in fiscal year 1977 and $4.4 billion in fiscal year 1981 to maintain current policy. Under the President's budget proposals, energy spending would increase to $3.4 billion in fiscal year 1977.

Despite the rapid increase, direct federal spending on energy-related activities still represents less than 1 percent of the federal budget. But the share of the budget understates the significance of the federal activities in the energy area for several reasons. First, the impact of federal regulations is greater than might be indicated by the expenditures for regulatory activities. Second, some energy-related

1. The investment tax credit has not been included in these estimates. In fiscal year 1976, the revenue loss from this provision was about $1.4 billion.

ENERGY OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1974, 1976, 1981 (Subfunction 305)
(Billions of Dollars)

	1966	1974	1976[a]	1981[a]
General Operating Programs	NA	$-0.2[b]	$0.5	$0.8
Regulation	NA	0.1	0.2	0.2
Research and Development	NA	0.7	1.7	3.4
Total	0.5	0.6	2.4[c]	4.4
Percent of Total Outlays	0.3%	0.3%	0.6%	0.8%
Tax Expenditures	NA	NA	$2.4	$4.4

a. Current policy levels.
b. Negative net outlays in fiscal year 1974 result primarily from sale of federal uranium enrichment services.
c. The President's fiscal year 1976 outlay estimate is $0.2 billion higher than projected in the current policy budget, primarily due to the inclusion of estimated expenditures for programs not yet enacted by the Congress.
NA: Not available.

activities and initiatives are not carried on the budget or involve relatively small commitments of current resources that have the potential of requiring significant expenditures in future years. For example, the operations of the Administration's proposed Energy Independence Authority would be determined by a board of directors, and would not appear on the budget. Only the net profits or losses would appear. The Administration's proposals for the Energy Independence Authority, the Nuclear Fuel Assurance Act, and federal support for the commercialization of synthetic fuels would require relatively low expenditures in fiscal year 1976, but might require significant outlays in the long term.

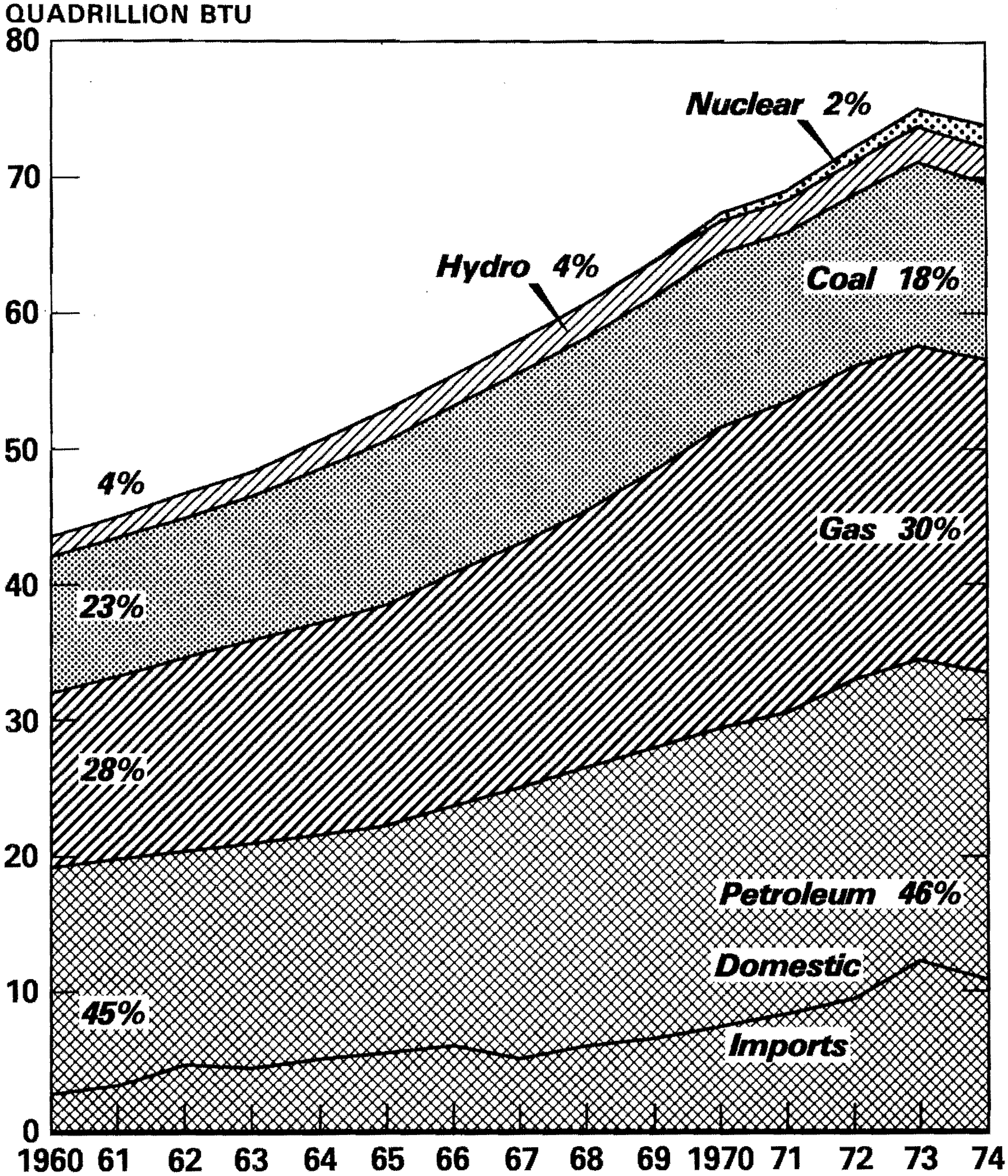
The remainder of this section discusses briefly the government's efforts to resolve the current debate over national energy policy, the impact of federal budget decisions on energy research and development, and significant pending actions that could bear directly on future federal energy budgets.

The Energy Crisis and Its Aftermath

As both a cause and effect of economic growth, worldwide energy consumption rose substantially during the 1960s and early 1970s. The rise was particularly rapid in the United States (see the chart below). In part, the growth in consumption was a result of low energy prices. The availability of low-priced imports from the Middle East kept oil prices from rising relative to prices in general, while the price of interstate natural gas was kept low by Federal Power Commission regulation. Low prices and an increasing awareness of the environmental impact of energy production and consumption led to a shift toward the use of oil and gas as clean fuels. However, in the late 1960s and early 1970s, production from traditional domestic sources of oil and gas peaked and began to decline. The most productive and accessible deposits had been discovered, and the search for new sources had to focus on fields that were smaller, deeper, or in previously untapped areas, such as the coast of Alaska and the Atlantic Ocean.

Steadily increasing consumption, coupled with declining domestic production, led to marked increases in the demand for imported oil. In response to this situation, oil import quotas, which had helped to maintain orderly--if somewhat artificial--domestic oil markets, were abandoned in 1973. Then the markets were disrupted by the price rises imposed by the producer countries and the embargo of late 1973. These events heightened public concern about the nation's vulnerability to precipitate price changes and capricious disruptions of imports by the producing countries. Responding to this concern, President Nixon announced in 1974 that it should be the goal of this country to be completely independent of foreign energy supplies by 1985.

U.S. Energy Consumption Patterns By Source, 1960-74



Source: *Energy Facts II*, Prepared for the Subcommittee on Energy Research, Development, and Demonstration of the Committee on Science and Technology, U.S. House of Representatives, Ninety-Fourth Congress, First Session, by the Science Policy Research Division, Congressional Research Service, Library of Congress, August 1975, p. 52.

Achievement of total independence would have significant economic and environmental costs. While there is a consensus that U.S. reliance on imports should be reduced, as yet there is no general agreement on the level to which imports should be reduced or the length of time that it should take to achieve the goal. Indeed, the central issue in the energy debate remains one of determining the level of imports that is consistent with national security concerns, and the acceptability of both the economic and environmental costs associated with a long-range strategy of increased independence.

Since the 1973-74 embargo, increasing attention has been focused on long-range energy futures, which may be shaped by technologies that are now only on the drawing boards or in the laboratory. Many such technologies are being pursued: solar energy, the liquid metal fast breeder nuclear reactor, controlled thermonuclear reactions, and synthetic fuels, for example. For some, questions of technical feasibility remain to be resolved; for others, technical feasibility has been established but economic feasibility has not.

Increasing perception of the limits on traditional sources of energy has led to a parallel concern over growth in energy use. Again, there is general consensus--profligate use of energy should be discouraged--but little agreement concerning the policies or costs that might be imposed to cut energy consumption.

The Federal Response

In response to these energy problems, the Congress and the Administration have initiated a series of proposals and programs to ensure a secure domestic energy supply while minimizing adverse economic effects. Immediately after the OPEC oil embargo was imposed, the Administration set up a Federal Energy Office (FEO) to administer energy pricing and allocation programs. Congress subsequently converted this office into the Federal Energy Administration (FEA).

In an attempt to minimize the economic effects of rocketing prices and shortages, Congress placed ceilings on the price of "old" oil (i.e., that drawn from domestic wells producing in 1973). At the same time, to encourage enhanced domestic production, Congress allowed the price of "new" oil (that drawn from new wells or sources) to rise to the market level. The expiration of this initial pricing legislation in the latter part of 1975 sparked considerable debate about future policy. Congress decided at this point not to decontrol energy prices totally, thereby preventing them from rising to world market levels. Such a rise would have provided a means of reducing U.S. consumption and accelerating the commercial viability of alternative energy systems. However, it was decided that continued market regulation was essential if the economic recovery from the 1974 recession was to proceed without setbacks.

The Energy Policy and Conservation Act, passed in December, 1975, has extended price controls for 40 to 60 months. The act set ceilings for the average prices of domestic oil but, recognizing that over the long run energy prices will inevitably rise, it allows some price increases in the interim.

In another initiative, Congress consolidated and expanded previous fragmented and uneven federal energy research and development (R&D) efforts by creating the Energy Research and Development Administration (ERDA). ERDA was charged not only with the nuclear research and development functions of the former Atomic Energy Commission (AEC) but also with expanding the government's nonnuclear R&D program and creating new initiatives in energy conservation research. A new Nuclear Regulatory Commission (NRC) assumed the AEC's licensing and safety programs. Additionally, Congress directed ERDA to prepare, submit to the Congress, and implement a plan to develop new energy technologies that would provide for the nation's near-term, mid-term and long-term energy needs. ERDA published its plan, "Creating Energy Choices for the Future," in June, 1975, and its first annual update is expected to be issued in March, 1976.

In order to reduce dependence on imports and to make more clean-burning oil and natural gas available for priority uses, Congress amended the 1970 Clean Air Act to allow selected power plants to burn coal, provided that health standards are not violated. In addition, Congress has mandated a number of energy conservation efforts that could reduce consumption, thus stretching domestic supplies and allowing additional time to evaluate the potential of alternate sources of energy.

In taking the actions summarized above, Congress has focused heavily on nonbudgetary methods to control energy supply and demand.

Research, Development, Demonstration, and Commercialization

As federal nuclear and nonnuclear technology efforts grow, decisions will be required about the possible expansion of federal participation in research, development, demonstration, and commercialization (R,D,D,& C). With the exception of certain nuclear programs, federal involvement has focused on basic R&D, leaving demonstration and commercialization largely to private industry.

But the success of a process in the laboratory or at the somewhat larger pilot plant scale does not necessarily ensure its adoption by the energy industry. Substantial uncertainties--particularly with regard to costs and reliability--must be resolved before that experience can be translated into full-scale production. ERDA is increasingly involved in initiatives to "demonstrate" technologies at near-commercial scale. The number of such demonstration projects is an important determinant of the level of the R&D budget.

Beyond demonstration, a further step is often required: the building of a commercial plant that reliably produces a product that can be sold at a profit. The size of investment required--often $1 billion per plant or more--is a major barrier to commercialization in the energy area. The federal government can employ a number of policies to reduce this barrier and minimize investors' risks, including providing federal loan guarantees to finance the project, promising price supports or guarantees to purchase the products, and making outright grants to assist in plant construction.

Key Issues

Debate is now focusing on two issues: (1) alternative energy technologies and the role of federal research and development in bringing these to the point of commercialization; and (2) appropriate financial incentives to accelerate the commercialization process and the extent to which the federal government should share in the risks of commercialization.

The level of future federal energy budgets depends heavily on how Congress resolves the question of the federal role in commercialization. If it is to be federal policy to participate in commercialization directly (by funding projects in whole or in part), federal energy budgets will rise dramatically over the next two decades. This would be particularly true if the government had to provide operating subsidies if the product (for example, synthetic fuels made from coal) were not commercially competitive.

If the government participated in commercialization indirectly (by providing loan guarantees or additional tax incentives), the budget impact would be more uncertain. Considerable cost could result if private industry were forced to invoke federal loan guarantees.

The question of direct or indirect federal participation will come before Congress in several forms. For example, Congress is being asked to decide who should build the next generation of uranium enrichment facilities, which to date have been a government monopoly. The Administration has proposed that the facilities be financed by private capital, with the federal government guaranteeing both the technology and financing. This proposal clearly could reduce near-term federal outlays, assuming that the projects were successful and that the guarantees would not be invoked. At the same time, the government would forego (except for royalties) substantial future revenues that would be realized from the sale of enriched uranium were the facilities to continue to be government owned. This would result in the loss of offsetting receipts. On the other hand, if the government were to build these facilities itself, the federal energy budget would significantly increase during the near-term, but revenues from sales would eventually amortize the substantial start-up costs.

Budget Options

The major budget issues are the extent to which federal financial support should shape future technology developments and stimulate their commercialization.

At one extreme, it is argued that development of energy sources should be left entirely to the private sector, that rising prices will induce conservation and appropriately constrain demand, and that the forces of the marketplace will generate new supplies as necessary to meet demands. At the other extreme, it is argued that the marketplace will not provide stimuli adequate to achieve larger social goals, such as timely reduction in reliance on imports or preservation of environmental quality, and that the federal government will have to offer further financial and regulatory inducements to achieve social goals.

Another issue--with less potential budget impact--is that of petroleum storage. Oil stored during periods of adequate supply could be used to cushion the impact of a new embargo. The Energy Policy and Conservation Act of 1975 mandates creation of a petroleum reserve, and requires the Administrator of FEA to study and recommend to Congress measures for implementation. Depending on the measures actually chosen, budget impacts could be important in fiscal year 1977 as well as later in the decade.

The range of budget options presented below represent the probable range of decisions on the federal role in energy. While no explicit assumption is made concerning energy markets, the low budget option would perhaps be most consistent with a decision to move toward ultimate deregulation of oil and gas prices. The heavy intervention in the marketplace that characterizes the high budget option might be viewed as most consistent with a policy of continued regulation. Nevertheless, neither in the budgets below nor in the economic projections elsewhere in this volume is the role of regulation explicitly treated.[2]

Four budget options for energy are presented: (1) a current policy budget, (2) a high budget, (3) the President's budget, and (4) a low

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2. For a discussion of the economic impact of energy price changes, see U.S. Congress, Congressional Budget Office, Recovery, How Fast and How Far? 94th Cong. First Session, (Washington, September 17, 1975).

budget. It is important to note that programs with significant funding implications may not be reflected in the budget: For example, loan guarantees might be treated as off-budget items.

Current Policy Budget. The current policy budget projections reflect continuation of ongoing programs, which include general operating programs, regulation, and R&D activities. Among them are activities relating to the analysis and development of energy policy (primarily by the FEA), uranium enrichment (by ERDA), and activities to encourage energy conservation (primarily by FEA). From year to year, both budget authority and outlays have varied fairly widely due to the inclusion of activities with large receipts, such as uranium enrichment. Because of the erratic effect of these receipts, it is difficult to establish a clear base level of general operating activity, but current net outlays are about $500 million. The current policy budget assumes no major increases for enrichment programs (the single largest item in this category). This would imply no additions to uranium enrichment capacity beyond those currently planned and a need to provide some other means of meeting needs expected to arise toward the middle of the next decade. The current policy budget also assumes continuation of other activities at present levels of effort. No major funding for petroleum storage programs is included.

Federal energy regulation activities include controls over nuclear power by NRC, interstate natural gas and electricity by the Federal Power Commission (FPC), and allocation and pricing of petroleum by FEA. Outlays for these activities have been increasing slightly, due to the postembargo need for elaborate controls over petroleum, but still total less than $200 million per year. The current policy projections assume no increases beyond those required to compensate for inflation.

Both advanced nuclear and other energy R&D programs are approaching --or, in some instances, have reached--the point at which major expenditures will be needed to test processes at new, larger scales. To cite but one example, the fossil energy capital equipment program for fiscal year 1976 contains about $20 million for advanced engineering and procurement of long-lead time components for a "demonstration" plant to derive clean boiler fuels from coal; that plant could cost over $400 million. Even if a large share of the cost were paid by private industry, the federal share could be $200 to $300 million--or about twice as much as was spent on the entire federal coal research program in fiscal year 1975.

If existing activities in subfunction 305 were to be continued at current levels, no funds would be available for either petroleum storage or the continued acceleration of major initiatives in energy R&D begun in fiscal year 1976 and earlier budgets. On the other hand, total energy funds need not be used exactly as in the past. With reprogramming, a current policy budget level would permit some important programs to go forward, while sacrificing others. For example, the current policy budget totals would probably provide for one of the following: (1) additions to federal uranium enrichment capacity, (2) full funding of a major demonstration project for either nuclear or fossil energy, or (3) beginning the development of a petroleum reserve. However, some tradeoffs with other programs would be necessary.

A current policy budget for fiscal year 1977 would provide for budget authority of $3.8 billion and outlays of $3.2 billion (see table below). Under this option, budget authority and outlays would rise gradually to $4.5 and $4.4 billion, respectively, in fiscal year 1981. The bulk of the increase would be needed to continue ongoing R&D activities.

ENERGY BUDGET OPTIONS, OUTLAYS, AND BUDGET AUTHORITY[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level		
Outlays	3.2	4.4
Budget Authority	3.5	4.5
Changes from Current Policy Level		
High Budget Option		
Outlays	0.4	2.2
Budget Authority	3.9	2.1
Low Budget Option		
Outlays	-0.3	-0.7
Budget Authority	-0.2	-0.8
President's Budget		
Outlays	0.2	---
Budget Authority	0.5	---
Tax Expenditures	2.7	4.4

a. For greater detail see summary tables.

High Budget Option. A high budget option could provide for a number of major initiatives; it reflects markedly increased federal activity in energy markets. Such a budget level could be constructed as follows:

- All programs receive increases for inflation.

- General operating programs are increased an additional $200 million in fiscal year 1977 to further expand uranium enrichment capacity; that addition is retained in budgets of subsequent years.

- Regulatory programs continue to be fully funded.

- Funding for R&D receives further major increments in fiscal years 1977 and 1978, and grows at a slower rate (4 percent above inflation) thereafter.

- Budget authority is provided on-budget in fiscal year 1977 for a program of loan guarantees for commercialization of the equivalent of up to 350,000 barrels per day of production of synthetic fuels from coal and oil shale (this would parallel a previous Administration proposal).

- Major funding is provided for the new petroleum storage program.

Fiscal year 1977 budget authority for the high option would more than double the fiscal year 1976 level. However, much of the increase in budget authority would be for on-budget treatment of loan guarantees and other incentives to commercialize synthetic fuels. These would be unlikely to lead to major outlays in the early years. However, as a result of increases in research and uranium enrichment programs, outlays for energy would rise 50 percent in fiscal year 1977 and an additional 36 percent in fiscal year 1978.

The high option in effect would support, on budget, many of the more expensive initiatives that have been suggested in recent years. While the development and commercialization of some new technologies would be supported, this budget level would not support all-out government development of all new sources.

Of course, the same funding level could be allocated in other ways. For example, a far more aggressive (or expensive) storage program could be pursued, research could proceed at a more measured pace, and responsibility for uranium enrichment could be transferred to the private sector. Or, emphasis could be placed on furthering the federal development of new technologies on the theory that, once demonstrated, technologies would be economically viable and thus not need commercialization support.

Further, there are many choices within the individual components of the estimate. For example, the large increases in energy R&D would support new demonstration of several technologies. Demonstration funding could be concentrated in one area--such as nuclear power or coal--or used to demonstrate a smaller number of processes in each of a larger number of programs. While not all proposed energy activities could be funded, the high budget option would provide a great deal of flexibility in choosing methods of working toward the goal of energy independence. The total increases in outlays would average about $1.6 billion annually above the projected current policy budget totals for fiscal year 1977 through fiscal year 1981.

The President's Budget. For fiscal year 1977, the President has proposed an energy program that is very similar to that outlined in the high budget option. The President's fiscal year 1977 energy budget, however, is significantly lower ($3.4 billion) in terms of budget authority than the high budget option. The difference is chiefly attributable to the fact that several of the President's most significant initiatives would be carried off-budget and would constitute contingent liabilities that would not necessarily translate into budget authority or outlays. In addition, certain of the President's proposals call for enactment of legislation in fiscal year 1976 and are not reflected in his fiscal year 1977 energy budget. These include the potential budgetary consequences of the Administration's proposed Nuclear Fuel Assurance Act. This act would permit transfer of government-owned uranium enrichment technology to the private sector and would authorize up to $8 billion for a cooperative government/industry program to provide financial guarantees to participating companies. Because the guarantees are contingencies, the Office of Management and Budget does not reflect the $8 billion in budget authority or outlays. However, the amounts would be counted against budget authority or outlays if and when the guarantees were invoked. There are, however, direct budgetary consequences of this proposal. The revenues from the sale of enrichment services that would otherwise have come to the government would instead go to the private uranium industry. By 1990, such net revenues could be as much as $1.5 billion annually. In addition, the tax expenditure implications of this program would cost the government as much as $100 million annually by 1981 and $300 million annually in the mid-1980s.

There are two major and related commercialization initiatives in the President's budget, an Energy Independence Authority (EIA) and a synthetic fuels commercialization program. EIA would be empowered to make $100 billion of loans, loan guarantees, and direct investments in private sector energy projects during its 10-year life span. Because the EIA's expenditures generally would be recovered from loan payments, interest, and returns on investments, the $100 billion in spending authority is not carried on the budget. Only EIA's gains or losses would appear in the annual budget. Thus, although the President anticipates that EIA will use up to $10 billion of its $100 billion authority in fiscal year 1977, only $650 million will actually be expended, and only $42 million of this--the estimated EIA operating loss for that year--appears in the President's budget as a fiscal year 1977 outlay.

The EIA would not be responsible for basic energy research and development, which would be continued primarily by ERDA. Rather, it would be charged with financing a variety of projects, such as commercialization of advanced energy technologies (e.g., nuclear sources), and facilities that generate and transmit electricity from power plants not fueled by oil or gas.

The Administration has also proposed a $2 billion loan guarantee program to support private-sector commercialization of synthetic fuels. An initial request for $503 million, to be contained in a fiscal year 1976 supplemental, would be a reserve fund to cover any loan defaults. The fiscal year 1976 budget authority would be administered by ERDA but transferred to the EIA--and thereby become off-budget--should that agency be established. Therefore the President's fiscal year 1977 budget request reflects no authority or outlays for synthetic fuels. The Administration anticipates that the total amount of loan guarantees needed for support of synthetic fuel production will reach $6 billion by fiscal year 1977. If Congress does not create the EIA, any fiscal year 1977 appropriation for a loan guarantee reserve for a synthetic fuels program would be in addition to the budget authority requested in the President's proposed fiscal year 1977 budget.

The President's fiscal year 1977 budget also includes $304 million in outlays to finance the exploration, development, and increased production of petroleum from naval petroleum reserves and for planning a petroleum storage program. It does not, however, include funds for fully implementing petroleum storage and other aspects of the Energy Policy and Conservation Act; implementation could well require fiscal year 1977 budget authority and outlays in addition to those proposed by the President.

In addition, the President's budget incorporates an increase of 24 percent in budget authority and 35 percent in outlays for energy R&D. Half of the increase would go for further research on nuclear technologies, continuing the dominance of nuclear research in this account.

Low Budget. The low budget option presumes a change in the direction of policies presently governing the federal budget for energy. The change is consistent with a greater reliance on the marketplace and an unwillingness to make large-scale commitments of federal funds. The low option budget was calculated as follows: (1) continuing general operating programs at a current policy level, with no additions to federal uranium enrichment capacity beyond those now planned and budgeted for, (2) cutting back funding for regulatory programs, (3) continuing R&D

funding with only a modest real increment for fiscal year 1977 and compensation for inflation in subsequent years, and (4) providing no explicit funding for storage or commercialization programs.

Within the budget constraints of the low option, the storage program could be accommodated, but only at the expense of a real decline in the research program, perhaps to fiscal years 1975 or 1976 levels. Probably not more than one major demonstration plant could be accommodated at any one time, and even that would cut into the diversity and scale of investigation in other areas. The consequence for energy supply of the low option budget would be reduced federal support for commercialization and heavier reliance on the marketplace for demonstration of new technologies, leading to reduced confidence that such technologies would ultimately be introduced in time to make the desired contribution to the national energy supply.

The low budget option would result in fiscal year 1977 budget authority and outlays below those implied by current policy--reductions of $0.3 billion and $0.2 billion respectively. This would reflect a substantial reduction in federal involvement in energy markets, departing from the President's program and--even more dramatically--from the high budget program and current policies.

Other Considerations

Two additional considerations affecting choices in regard to any of the budget options are: (1) the off-budget financial implications and (2) the potential effect of alternatives on federal revenues due to energy-related tax expenditures. The important points can be summarized as follows:

- Provision of off-budget incentives such as federal loan guarantees or continuing price supports would make it easier to raise private capital for expensive energy ventures. The low-risk or no-risk feature would be more attractive to investors and lenders alike. Availability of capital and assurance of markets could hasten the development and commercialization of alternative energy sources and lessen dependence on oil and gas.

- In providing any such incentives, the federal government assumes the risk of being forced to make outlays in the future. If new technologies were not as successful as anticipated, leading to defaults or causing other contingent liabilities to materialize, direct budget outlays would be required.

- Even if such contingencies did not become actual liabilities, and on-budget outlays were not required, the use of certain financing incentives could raise the total public debt outstanding. For example, if federal loan guarantees were provided to a private corporation to finance a given project, the Federal Financing Bank (FFB), which is authorized to purchase bonds guaranteed by any federal agency, could then purchase bonds issued by that corporation to finance its project. The funds used by FFB to purchase these bonds are raised through the sale of FFB securities, either to private lenders or to the U.S. Treasury. Although FFB outlays are not counted in the budget totals, its borrowing does count as part of the public debt. Such a series of transactions could reduce the cost of energy initiatives borne by the producers and users of energy, and hence the level of additional incentives required, since industry would pay lower interest rates to the FFB than to private lenders. However, off-budget outlays equal to the amount of loan guarantees would also result, thus converting loan guarantees to direct loans in all but name if the FFB elected to purchase such bonds.

- Through tax expenditures, the federal government provides significant subsidies for exploration and development of energy resources. The tax provisions allowing exploration and development costs (mostly for oil and gas) to be treated as current expenses rather than being capitalized and written-off over time are expected to cost about $0.8 billion in lost revenue in fiscal year 1976, while percentage depletion for oil and gas and other minerals will cost over $1.5 billion. The investment tax credit used by energy industries costs about $1.4 billion.

New proposals may have important tax aspects. For example, the investment tax credit available to any industry under current law could be applied to a new uranium enrichment industry under the Nuclear Fuel Assurance Act. Tax expenditures in that case could rise gradually to some $300 million annually by 1984, but would decrease thereafter. Also, the Administration is proposing further tax expenditures to assist electric utilities. Briefly, the proposed Electric Power Facility Construction Incentives Act would increase the investment tax credit for electric utilities from 10 to 12 percent, extend certain five-year amortization provisions, allow depreciation of capital investments before completion of construction, and defer certain investor tax liabilities. The anticipated fiscal year 1977 revenue loss from this proposal is expected to amount to $0.8 billion.

Summary

Even more than most industrialized nations, the United States is an energy consumer. The U.S. economy is inextricably dependent upon heavy rise of energy and energy availability and price levels have major effects on inflation, employment, and GNP growth. Events of the last two years, in particular, have raised concerns about future energy supplies, prices, and U.S. reliance on imports.

The U.S. energy outlook can be summarized as follows: Demand will continue to grow, although at rates below those experienced since World War II. Easily-tapped domestic supplies of oil and gas will dwindle; extraction of less accessible supplies will be more expensive and technologically difficult. Alternate energy sources will also be more costly and, in some cases, will require major technological advances and financial backing to become commercially available. This is true even of the two alternatives, coal and nuclear power, that are closest to being commercially viable. The United States has ample supplies of coal, but significant questions remain regarding costs of strip mining, transportation systems, and conversion to preferable liquid and gaseous forms. Nuclear fission now supplies a growing percentage of electricity needs, but natural uranium supplies are scarce, and concerns continue about safety and ultimate waste disposal. Fusion is not yet a proven technology. Plentiful foreign oil supplies will continue to be highly priced--compared to costs of production and historic price levels--but will still cost less than most of the alternatives.

Given this outlook, there is little question that the United States will move to become much less dependent on oil and gas and much more reliant on alternate sources. The question is how quickly and at what social, economic, and environmental price.

Congress shortly will face a sequence of major decisions regarding the speed and the acceptable price of bringing new energy sources on-line. The decisions, for the most part, take the form of determining the appropriate level of federal activity in the process from research through development and demonstration to commercialization of new technologies. Choices that have comparatively modest impacts on the fiscal year 1977 budget can nevertheless shape federal activities for years to come and, in particular, create the potential need for major federal expenditures toward the end of the decade and through the mid-1980s.

Choice of a low budget option could be based partly upon a judgment that private-sector marketplace mechanisms will balance supply and demand while achieving other desired goals such as reducing imports to an acceptable level. This option includes a substantial federal research component, but it does not provide further inducements to industry to develop alternative energy sources on a commercial scale.

Choice of a high option or the President's budget could rest on a judgment that private marketplace mechanisms cannot balance supply and demand while achieving other desired goals. Specifically, it would be based on the presumption that near-term technical and economic risks will be such as to inhibit private investment in new and emerging technologies in time to increase domestic production, and therefore reduce future imports to levels such that the resulting overall risk of interruption or price rise would be acceptable. It would also be based on the presumption that the considerable budgetary costs of commercialization incentives and the inevitable high unit cost of energy from emerging technologies would be acceptable.

Finally, the choice between the President's strategy and the approach represented by the high option rests principally on the extent to which contingent federal obligations should be carried on the budget. Although the high option shows higher budget authority and outlays, the President's budget implies a far higher level of federal involvement, particularly in light of EIA (off-budget) and commercialization proposals. The extent to which the guarantees of that commitment are invoked--and thus the real budget cost of the President's program--are uncertain.

ALTERNATIVE ENERGY BUDGETS (305)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION							
Operating Programs	0.5	0.2	0.6	0.7	0.7	0.7	0.8
Regulation	0.2	([a])	0.2	0.2	0.2	0.2	0.2
R & D	1.7	0.5	2.4	2.7	2.9	3.2	3.4
Synfuels							
Petroleum Storage							
Total Current Option	**2.4**	**0.7**	**3.2**	**3.6**	**3.8**	**4.1**	**4.4**
Tax Expenditures	2.4	NA	2.7	3.0	3.3	3.9	4.4
HIGH OPTION							
Operating Programs	0.5	0.2	0.7	0.8	0.9	0.9	1.0
Regulation	0.2	([a])	0.2	0.2	0.2	0.2	0.2
R & D	1.7	0.5	2.5	3.3	3.7	4.1	4.4
Synfuels			([a])	([a])	0.1	0.1	0.2
Petroleum Storage			0.2	0.6	1.2	0.8	0.8
Total High Option	**2.4**	**0.7**	**3.6**	**4.9**	**6.1**	**6.1**	**6.6**
Tax Expenditures	2.4	NA	2.7	3.0	3.3	3.9	4.4
LOW OPTION							
Operating Programs	0.5	0.2	0.6	0.7	0.7	0.7	0.8
Regulation	0.2	([a])	0.1	0.1	0.1	0.1	0.1
R & D	1.7	0.5	2.2	2.6	2.7	2.8	2.8
Synfuels							
Petroleum Storage							
Total Low Option	**2.4**	**0.7**	**2.9**	**3.4**	**3.5**	**3.6**	**3.7**
Tax Expenditures	2.4	NA	2.7	3.0	3.3	3.9	4.4

See footnotes at end of table.

ALTERNATIVE ENERGY BUDGETS (305)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET							
Operating Programs	0.4	([a])	0.5				
Regulation	0.2	([a])	0.2				
R & D	2.0	0.5	2.7				
Synfuels/EIA	([a])	([a])	([a])				
Petroleum Storage			([b])				
Total President's Budget	**2.6**	**0.6**	**3.4**				
Tax Expenditures	2.4	NA	2.7				

[a] Less than $100 million.

[b] Included with general operating programs.

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ALTERNATIVE ENERGY BUDGETS

BUDGET AUTHORITY

[Billions of dollars, fiscal years, path B]

Option	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION							
Operating Programs	0.5	0.2	0.6	0.6	0.7	0.7	0.8
Regulation	0.2	([a])	0.2	0.2	0.2	0.2	0.2
R & D	2.5	0.6	2.7	2.9	3.0	3.3	3.5
Synfuels							
Petroleum Storage							
Total Current Option	**3.2**	**0.8**	**3.5**	**3.7**	**3.9**	**4.2**	**4.5**
HIGH OPTION							
Operating Programs	0.5	0.2	0.8	0.9	0.9	1.0	1.0
Regulation	0.2	([a])	0.2	0.2	0.2	0.2	0.3
R & D	2.5	0.6	3.1	3.6	4.0	4.3	4.5
Synfuels			3.1	([a])	([a])	([a])	([a])
Petroleum Storage			0.2	0.6	1.2	0.8	0.8
Total High Option	**3.2**	**0.8**	**7.4**	**5.3**	**6.3**	**6.3**	**6.6**
LOW OPTION							
Operating Programs	0.5	0.2	0.6	0.6	0.7	0.7	0.8
Regulation	0.2	([a])	0.1	0.1	0.1	0.1	0.1
R & D	2.5	0.6	2.6	2.7	2.7	2.8	2.8
Synfuels							
Petroleum Storage							
Total Low Option	**3.2**	**0.8**	**3.3**	**3.4**	**3.5**	**3.6**	**3.7**
PRESIDENT'S BUDGET							
Operating Programs	NA	NA	0.7				
Regulation	NA	NA	0.2				
R & D	NA	NA	3.1				
Synfuels/EIA	0.5	NA	([a])				
Petroleum Storage	NA	NA	([b])				
Total President's Budget	**3.5**	**0.8**	**4.0**				

[a] Less than \$100 million.

[b] Included with general operating program.

PART II-1: PROGRAM ISSUES
SECTION D: NATURAL RESOURCES AND COMMERCE

Transportation (Subfunctions 404 through 407)

In the past, the federal government has not implemented a unified "transportation policy," although the recent statement by the Secretary of Transportation attempted to articulate such a policy. Rather, federal action has responded to crises, pressures, or perceived needs for particular types of transportation with a variety of spending programs, taxes, tax expenditures, and regulatory activities. The major areas of spending include:

- The highway programs, which generally provide financial support for the interstate system and state highway construction.
- The mass transit program, which provides grants for transit capital and operating costs.
- The rail programs, which support Amtrak intercity rail passenger service and the new federal investment program in ConRail.
- The air transport programs, which assist airport construction, fund air traffic control and aeronautical research, and subsidize local service air carriers.
- The water transport programs, which support the Coast Guard and provide subsidies for the construction and operation of U.S. flag ships. Another major water transport program is composed of Army Corps of Engineers navigation projects (included in function 301).

The federal government's regulatory activities, conducted primarily by the Civil Aeronautics Board (CAB), the Interstate Commerce Commission (ICC), the Federal Maritime Commission, and the National Highway Traffic Safety Administration, cost little but are thought to result in relatively large spending by the regulated industries.

Associated with federal transportation programs are a number of special taxes and fees, including the 4 cent a gallon federal gasoline tax and an 8 percent airline ticket tax. Receipts from such taxes and fees are estimated to total $6.7 billion in fiscal year 1976. A number of tax expenditures also encourage transportation activities. These include the five-year amortization of railroad rolling stock, the deduction for nonbusiness state gasoline taxes, and deferral of taxes on maritime shipping profits. In total, transportation-related tax expenditures are estimated to reduce federal revenues by $0.7 billion in fiscal year 1976.

Federal spending for transportation (subfunctions 404 through 407) represents less than 5 percent of the federal budget; its relative importance has changed little over the past decade (see table below). If current transportation policies were maintained, such spending would increase by about 17 percent over the next five years; from $14.4 billion in fiscal year 1976 to $17.9 billion in fiscal year 1981.

TRANSPORTATION OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1976, 1981
(SUBFUNCTIONS 404 THROUGH 407)
(Billions of Dollars)

	1966	1976[a]	1981[a]
Ground Transportation[b] (404 part)	4.1	9.9	11.9
Air Transportation (405)	1.0	2.7	3.5
Other Transportation[c] (404 part, 406, 407)	0.7	1.8	2.5
Total	5.7	14.4	17.9
Percent of Total Outlays	4.2%	3.8%	3.2%
Tax Expenditures	0.6	0.7	1.1

For greater detail, see summary tables.

a. Current policy levels.

b. Includes the funding category Federal-Aid Highways, rail including new legislation) and mass transit.

c. Includes Maritime Administration, Coast Guard, minor highway programs, and various other categories.

While federal transportation spending represents only about 4 percent of the nation's total transportation expenditures, federal policies, both budgetary and regulatory, exert a major influence on the character and cost of the nation's transportation system. For example, in 1975, state and local governments are estimated to have spent about $21 billion on highways in contrast to federal outlays of about $6 billion. Much of the $21 billion, however, was required for joint federal-state highway construction projects or for required maintenance of highways built under these programs in previous years.

Federal policy makers face a number of immediate transportation problems--including the financial deterioration of the railroads, the dependence of the current system on costly and increasingly imported petroleum products, and concern over the effects of transportation on environmental quality--which in turn have raised some very basic questions concerning the federal role in transportation. These questions include: To what extent should the government encourage or discourage the use of the automobile? What should be the size, content, and financing of the highway program? What should be the future federal role in mass transit? And to what extent should the federal government subsidize waterways and airways?

The remainder of this section discusses the transportation system and the effect of the federal budget on its development, briefly describes the various and often conflicting objectives of federal transportation policies, summarizes specific federal policy issues, and outlines four illustrative budget options.

The Transportation System and the Federal Role

Several features of the nation's transportation system and federal support for it should be noted to put transportation issues into context:

- Highways dominate the transportation system, accounting for over 84 percent of public and private domestic transportation expenditures. While railroads have been in decline since the 1920s, they continue to be the largest mover of intercity freight as measured by ton-miles, accounting for 38 percent of the total in 1973. However, trucking, which accounts for only 20 percent of the freight ton-miles, now earns the most freight revenues. The recent growth of trucking, despite its relatively high cost, is attributable to the faster movement and generally better service it provides. In moving passengers, the automobile is the unquestioned leader in terms of both passenger-miles and expenditures. While passenger travel by auto has grown continuously since World War II, the long-term decline in transit has been halted in the last three years and ridership has increased slightly.

- Although their share has declined considerably over the last decade, almost half of the federal transportation budget is devoted to highway programs (see table on page 306). While railroads and mass transit each account for less than one-tenth of the total, their shares have increased considerably in recent years. Funding for air transportation has increased slightly in the past decade, while funding for water transportation has stayed relatively constant. The addition of off-budget activities and tax expenditures to budget outlays does not markedly change this picture of government activity in the transportation area.

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Estimates of budget expenditures overstate federal aid to highway and air transportation because federal costs are partially offset by user charges which reduce the subsidy from the general taxpayer. While all major modes (except pipelines) receive significant subsidies, highway users pay the largest portion of federal costs through federal gasoline taxes and other fees (see table below). In fact, historically, highway users have received little or no net federal subsidy. However, the release of impounded funds in 1975 caused fiscal year 1976 outlays to be much larger than Highway Trust Fund receipts. User charges amount to about one-third of current federal spending on air transportation; however, current law prevents revenue from these charges from being applied to air traffic control and other operating costs of the Federal Aviation Administration (FAA).

ESTIMATED FEDERAL TRANSPORTATION SUBSIDIES FOR FISCAL YEAR 1976

Mode	Net Subsidy (in billions)	Share of Subsidy	Subsidy as Percent of Outlays and Off-Budget Items
Highways[a]	$1.9	22.6%	25.1%
Railroads[b]	0.9	10.9	69.9
Mass Transit	1.5	17.9	100.0
Air[a]	1.7	20.2	63.8
Water	2.4	28.4	100.0
All Modes	8.5	100.0	54.5

a. Excludes interest paid on cash balances in trust funds.

b. Excludes ConRail aid (secured by debentures and preferred stock) but includes off-budget loans to Amtrak (since no provision is made for repayment and future aid will take the form of on-budget grants).

National Transportation Policy Objectives and Issues

Because federal interest in transportation has focused on improving national communication for economic, social, and political purposes, the development of national water, rail, highway, and air networks has been encouraged. However, transportation policies have also been expanded and now include matters of regional and local concern.

The overriding national transportation issue is the extent to which efficiency should be sought at the expense of other objectives. Clearly, it would be desirable to encourage the development of a transportation system that moved goods and people as efficiently as possible. However, other objectives may be affected by such a policy. A strict pursuit of economic efficiency in the transportation area may result in unemployment and disruption of other segments of the economy. The mobility of certain groups--the aged and low-income persons--might be seriously impaired by a transportation system which, in a strict economic sense, was efficient. Pollution, congestion, and urban development are important considerations that should be weighed against efficiency objectives in developing a national transportation policy.

Those trade-offs become apparent when the issues and options facing federal policy are examined in each area of concern.

Highways. The federal government continues to make a major investment in the nation's interstate and local highway systems. Since 1956, the bulk of this program has been financed by highway-related excise taxes that are dedicated to the Highway Trust Fund. Between 1967 and early 1975, the highway program level was below that authorized by the Congress due to Executive Branch impoundments totaling over $11 billion in obligational authority. This authority has since been released and therefore highway outlays will increase over the next several years as the backlog of construction contracts is completed.

Serious debate over the long-run nature of the highway program remains: How much should be spent? For which programs? How should they be financed?

Arguments for maintaining or for increasing federal highway spending are based on this mode's dominance as a carrier of passengers and freight, the freedom of movement provided by the highway network, and the vital role federal funds play in the interstate highway system.

There is also pressure to reduce federal highway spending by diverting highway funds to other modes or by cutting highway-related taxes. Arguments for less highway spending include: National policy should encourage modes that are more energy efficient or less environmentally damaging; increased funding should be given to competitive modes, which have been relatively neglected in the past; and increased local control over transportation expenditures would improve the allocation of funds among modes.

There are a large number of directions in which the highway program could move. These include the following:

- Return to 1967-74 program levels (about $4.5 billion). Since this reduction would result in more income from user charges than is spent by the federal government on highways, the present 4 cent federal gas tax could be reduced. Each penny cut in federal taxes would provide about $7 per automobile to taxpayers, or an opportunity for about $1 billion in additional state revenue if state gas taxes were increased.

- Since it is widely contended on energy efficiency and environmental grounds that mass transit is preferable to the individual auto, it might be desirable to permit more liberal use of federal highway funds for mass transit projects. Such fund shifts, called "interstate transfers," which are financed from general revenues, could be financed from the Highway Trust Fund.

- Moving further in the same direction, the Highway Trust Fund could be made part of a unified transportation trust fund. This would be predicated on the belief that restrictions on uses of the various funds seriously bias federal, state, and local choices among modes.

- It is also possible to broaden use of the receipts further by letting the fund expire, but continuing the taxes. The receipts from the highway taxes could be given as a general grant to state and local governments.

- Construction of the interstate highway system could be speeded by reducing the matching requirements or increasing the funding level for segments where the national interest seems high.

- Certain maintenance items on the interstate system could be supported through the trust fund. At present, trust funds can be used solely for construction.

- Greater flexibility than is presently allowed could be given to the states to shift funds from one category of highways to another.

Railroads. Over the last half century, the competitive position of the rail industry has deteriorated dramatically for a number of reasons. Competitors for freight traffic, such as trucks, barges, and pipelines have benefited from more technological advances and/or have received substantial government support. Rail facilities constructed long ago cannot easily be trimmed back or moved in response to new conditions and geographic shifts in economic activity. Finally, government regulation, management failures, rigid labor contracts, and obsolete capacity and technology within the industry have added to the list of problems which have bankrupted several eastern railroads, and left the remaining carriers financially weakened.

Despite these problems, the railroads continue to play an important role in the economy. In order to preserve rail capability, and to avert the economic disruption that a railroad shutdown might bring, the federal government has become increasingly involved in the railroad business.

Amtrak is the government-funded corporation providing most intercity passenger service. Despite some success in attracting riders, Amtrak has been unprofitable since it began operations in 1971. Based on reported fully allocated costs, every Amtrak route showed a deficit in 1975, and no immediate improvement is expected. Total federal commitments amounted to $1.6 billion through 1975.

The Amtrak Improvement Act of 1975 extended authorizations only through fiscal year 1977 in order that a major review of Amtrak could be undertaken. It further called for the development of criteria under which Amtrak could add or discontinue routes within its authorized spending limits. If Amtrak proves unable to restore the viability of intercity rail passenger service and attract a high volume of riders, even with substantial federal subsidy, then a basic reexamination of the justifications for long-term federal subsidy would be required. Amtrak options, then, include not only consideration of the level of subsidy, but, where other public transportation alternatives such as bus service exist, the possibility of eliminating public support of rail service.

Amtrak subsidies have been supported both because many individuals, firms, and communities depend on rail service and because rail provides an alternative that is safe and relatively fuel-efficient and pollution free. Further, outmoded equipment and deteriorating roadbed may not have allowed a fair test of rails' market potential. However, it is clear that continuation of the existing route structure would lead to an inexorable increase in budget commitment.

In the metropolitan areas between Washington and Boston, the high population densities and travel demands, the moderate distances between major urban centers, and the existence of substantial highway and air congestion all suggest greater potential for expanded and improved Northeast Corridor rail passenger service. However, this would require substantial capital expenditures: Simply improving rail performance and reliability moderately between Washington and New York could cost $1.5 billion; significantly faster service could cost over $3 billion.

The Railroad Revitalization and Regulatory Reform Act of 1976 (Omnibus Rail Act) stipulates goals of 3-hour-and-40-minute schedules between Boston and New York and 2-hour-and-40-minute schedules between New York and Washington, and authorizes grants to Amtrak of $1.8 billion to acquire and improve roadbed and equipment in the corridor. Funds have not yet been appropriated to implement this authorization, however.

The financial collapse of eight eastern railroads has put the federal government squarely into the subsidization of rail freight operations, simply to avoid extreme, if short-term, economic disruption. Consolidation of the bankrupt eastern lines into ConRail is expected to require direct federal investment totaling $2.1 billion through 1980. Even if short-run budget commitments were made to ConRail in order to restore adequate service over the system, several major issues will still remain unresolved. These include:

- How large a continuing subsidy is justified by national objectives?
- Would "unacceptable" losses by ConRail lead to changes in other areas such as federal policies toward railroad labor, regulatory reform, or the level of financial support for competing trucks and barges?

Minor federal assistance for solvent railroads has been offered in the form of loans from the United States Railway Association (USRA) and occasional disaster assistance. However, the Omnibus Rail Act authorizes direct subsidies to solvent railroads of almost $500 million for branch lines and passenger operations, as well as $600 million for purchase of rail securities and $1 billion in loan guarantees for improvements. While federal financial involvement in several aspects of railroad operation has expanded substantially, the question remains as to whether this trend should be continued or curtailed.

Urban Mass Transit. The Urban Mass Transportation Administration (UMTA) provides federal funding for three major programs: (1) capital grants of about $1.1 billion a year that cover 80 percent of the cost of transit vehicles and facilities; (2) formula grants of about $650 million per year that can be used for either operating or capital expenses; and (3) highway transfers, whereby, at local initiative, federal aid for planned urban and interstate highway projects can be used for transit projects instead.

The major options over the next few years relate to the overall funding level for urban mass transportation and the range of transit uses to which federal funds may be put by local governments. The federal mass transit program formerly provided large grants only for capital expenditures. The law was changed in 1974 to add a program of formula grants which, at local option, can be used either for capital or operating expenses.

Fiscal year 1976 was the first full year for the formula grants program, and about 90 percent of the available money is expected to be used for operating expenses.

The level of federal funding for the UMTA programs has grown in recent years, but so have the number of cities desiring new transit systems or major additions. Federal commitments of capital grants have been made to Atlanta, Baltimore, New York City, Philadelphia, and Washington, D.C. These systems require major investments which, coupled with rapid inflation in the construction industry, threaten to exceed the funds authorized under the current UMTA program. As a result, the desires of all cities planning new or expanded systems cannot be satisfied unless federal funding is increased several-fold. At the same time, overall operating deficits of existing systems have been growing sharply, increasing the demand for operating subsidies.

Changes in UMTA capital grant authorizations would not be reflected immediately in outlays because of the time required to approve new grant applications and to complete the capital projects. However, changes in formula grants could result in near-term outlays for operating subsidies An increase in formula grants from $650 million for fiscal year 1976 to $900 million for fiscal year 1980 is already authorized, and most of these funds would probably be used as subsidies for operating costs.

Further, as indicated above, the "interstate transfer" option permits localities to build transit facilities instead of highways. Proposals for interstate highway segments with federal costs of about $1.3 billion have already been withdrawn and transit projects will probably be substituted, although through 1975 transit grants of only $132 million have been approved. These funds are drawn from general revenues, and the monies allocated for the withdrawn interstate segments are returned to the Highway Trust Fund. Although actual use has been small, potential additions to federal transit outlays are substantial, reflecting the high costs of urban interstate segments that would be dropped. In addition, the $800 million a year of authorizations from the Highway Trust Fund for the urban systems programs are currently available, at local option, for either transit capital expenses or highways. This program allows local governments more flexibility in meeting their transportation needs, although its use for transit has been relatively limited so far.

Airways. Air traffic, as measured by available seat miles, grew almost four-fold between 1960 and 1969. This growth brought substantial congestion on the ground and in the air, leading to concerns about the safety of air travel and the adequacy of airport investment.

Congress responded by passing the Airport and Airway Development Act of 1970, which created a program to expand and improve airports and airways, financed by a variety of taxes on aviation users. These taxes are paid into the Airport and Airway Trust Fund, monies from which can be used for airport construction grants and for air traffic control and navigation facilities and equipment, but not to defray operating and maintenance costs. The airways operating costs, about $1.5 billion in 1976, are appropriated from the general fund. In part due to these restrictions, a surplus has accumulated in the trust fund that will amount to almost $1 billion by the end of 1976, and could reach $2.5 billion by 1980.

If the aviation user taxes are to serve as a vehicle for reducing the subsidy now provided air travelers, then use of fund receipts for airways operating costs could be considered. The statute as it now stands taxes the general public to provide services for air travelers whose incomes are well above average. General revenue funding for some operating costs may, of course, be desirable to pay for benefits to the public-at-large.

On the other hand, if the user taxes are meant solely to finance improvements and expansion of the airport and airway system, there are several options for expanding the program, including:

- Expand the program of aid to airports so as to reduce air congestion, enhance air safety, or increase the convenience of the traveling public by providing not only better-equipped airports, but also airports in every city of a certain size.

- Reduce the annoyance to the public from aircraft noise. This could be achieved by federally funded programs either to install noise abatement equipment in existing aircraft or to purchase land adjacent to airports to create "noise buffer zones."

Finally, a reasonable case could be made for substantially reducing the size of the program. Air traffic growth rates have fallen from an annual average of 16 percent in the 1960s to 2.1 percent in the 1970s. Moreover, the number of scheduled flights has fallen by 8 percent since 1970 and the congestion experienced in the late 1960s has abated so significantly that the percentage of flights delayed by 30 minutes or more has fallen by 71 percent since 1968. User taxes could be reduced to support a modest airway expansion and improvement program to serve only areas experiencing continued congestion.

Waterways. The federal government assists water transportation through several programs, including those of the Army Corps of Engineers, the Coast Guard, and the Maritime Administration. The waterways remain free of user charges despite the federal government's extensive investment. A major issue in this area is whether this policy should be changed and user charges imposed.

General Federal Regulatory Reform. Overlaying many of the above specific issues are the constraints on economic efficiency resulting from federal regulations. The economic and safety regulation of transportation is extensive. Interstate movements by air and rail, and some water and truck transportation, must follow federal pricing and other rules.

An important aspect of regulation concerns the growth of that which is not regulated. Trends of the last two decades suggest that the lack of economic regulation (such as most of water and an important segment of the trucking industry) is a stimulus to traffic growth; regulated carriers are generally in decline or at best growing slowly in contrast to their unregulated competition.

Some regulatory constraints were imposed initially in response to technologies that seemed to preclude competition; newer technologies have often altered these conditions; for example, railroad monopolies in long-distance freight movement caused the creation of the ICC; the response to a newer technology--trucking--was to bring a portion of that industry under the same regulatory mechanisms.

In other cases, the national objectives addressed by regulation include regional equity and stability of service. CAB airline regulation, for example, results in part from the fear that without route and rate regulation competition could become cutthroat, and that major markets would be overserved and possibly congested, while smaller cities would not be served at all.

The major issue in the area of regulation is whether such intervention should be reformed and reduced. Congress enacted regulatory changes in the 1976 Omnibus Rail Act that should move the railroads into a more competitive stage, with rates and services more closely approximating those that would prevail in a free market.

The Administration and members of Congress have proposed many other major legislative changes, including regulatory reform for truck and air service. These changes would ease entry and exit from various markets, eliminate policy inconsistencies resulting from separate regulatory control over different transportation modes, and otherwise move toward a free-market allocation of transportation resources and services.

If implemented, such changes would represent a very different mix of transportation policy objectives. They probably would also result in altered relative costs among modes, perhaps causing a major change in the structure of the industry. Services that formerly were required by regulation might no longer be offered; rates could change sharply. Excess capacity for some modes in some markets probably would result, so adjustments would be required in both employment levels and capital commitments. Thus, regulatory reform could affect not only the availability and cost of transportation services, but also the existing distribution of income and wealth.

Budget Options

The major budgetary choices outlined above imply a wide range of possible federal commitment to transportation. For illustrative purposes, four comprehensive options have been constructed. These involve maintenance of current policy, increased federal involvement, reduced federal support, and the President's budget proposals.

Current Policy Base. The current policy option reflects continuation at real levels of the ongoing federal programs and activities discussed above. The new ConRail legislation, which will affect 1976 spending, has been incorporated in these projections. Continuation of current programs would result in federal outlays for transportation in fiscal year 1977 of an estimated $15.4 billion, an increase of $1 billion over 1976 (see table below). By 1981, current policy outlays would be an estimated $17.9 billion.

TRANSPORTATION BUDGET OPTIONS
(Outlays in Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level[b]	15.4	17.9
Changes from Current Policy Level:		
High Option (increased federal involvement)	+1.7	+4.9
Low Option (reduced federal support)	-3.7	-6.5
President's Budget	-0.5	NA

a. For greater detail, see summary tables.

b. Includes new legislation entry in summary tables.

NA: Not available.

High Option (Increased Federal Involvement). If decisions were made to increase federal investment in the transportation system, with marginal changes toward greater economic efficiency and environmental and energy improvements, the transportation budget would increase relative to the current policy level by $1.7 billion in 1977 and by $4.9 billion in 1981. This budget option reflects:

- Highways--additional expenditures of $1.5 billion each year. This spending need not go for highways alone, but could stress refunds to the states, federally funded highway maintenance, or a liberalized transit substitution program supported from the trust fund. The primary objective could be to increase flexibility, thus allowing state and local governments to better meet their transportation needs through federal programs.

- Transit--double formula grants available for operating subsidies, and add $1 billion more per year for the capital grant program in 1978 and later years. This program would permit expanded local transit service with relatively modest fare increases.

- Railroads--the current Amtrak system is maintained, and subsidies and capital grants are funded at $100 million over the highest level forecast in the most recent Amtrak plan. ConRail funding could be expanded beyond current authorizations; $2 billion (including loan guarantees and continuation subsidies) could be provided to ailing railroads nationally; improvements in the Northeast Corridor could be made that would move toward the development of trains traveling up to 150 miles per hour.

- Air--expanded aid to airports and aircraft noise abatement programs, and the use of trust fund monies to finance some FAA operating costs.

- Water--continuation of 1976 Corps of Engineers navigation project level and current maritime subsidies. Waterway user charges would be phased-in equal to Corps operating and maintenance costs for navigation projects.

Low Option (Reduced Federal Support). This option would reduce outlays relative to current policy by $3.7 billion in 1977 and by $6.5 billion in 1981, and would require difficult choices for all modes. These estimates reflect:

- Highways--federal highway programs limited to faster interstate program ($4 billion) and continuation of forest and public lands road programs at 1975 levels; reliance solely on reduced speeds for highway safety; and reduced gasoline and other excise taxes. This option would reflect the high national interest in the interstate system and highways on public lands, but would phase out support of highway programs that are mainly state and local in nature; it implies that government safety programs have been much less effective than low speed limits in reducing highway fatalities.

- Transit--cut formula grants in half and cut capital grants by $400 million per year beginning in fiscal year 1977. The probable effect would be increased local transit fares and delayed completion or reduction of rail systems in Atlanta, Baltimore, and Washington, D.C.

- Railroads--hold the line on current ConRail funding, reduce Amtrak grants (capital and/or operating) slightly, and gradually phase out service continuation subsidies and labor protection payments.

- Air--discontinue civil aviation R&D ($300 million); reduce aid to airports (by $200 million); change legislation to fund all air program outlays from the trust fund and increase user taxes.

- Water--cut the ship construction subsidy by half, allow ship operating subsidy contracts to lapse, cut Corps of Engineers navigation projects construction program by half, and hold all other programs constant.

The President's Budget. The President's budget request for 1977 comprises more or less a continuation of recent trends. Highway outlays would rise in response to the release in late 1975 of $11 billion in previously impounded funds. Mass transit outlays would continue to grow, while those for railroads would stabilize at about $1.2 billion, reflecting approval of ConRail and Administration determination to hold down increases in the Amtrak subsidy. Essentially level programs are requested in the remainder of the transportation area. Overall, the President's budget projects transportation outlays of $14.9 billion in fiscal year 1977, about $0.5 billion below the current policy level. The major proposals contained in the budget include:

Highways--The President's budget request for fiscal year 1977 emphasizes restraint of highway authorizations to a lower program level than was funded over the previous two years. At the same time, proposed legislation would concentrate more effort on completing priority segments of the interstate system and would increase local flexibility in the use of noninterstate funds.

Transit--The Administration's budget request continues the past level of support for mass transit at about $2.5 billion, including expanded use of the interstate transfer option. Also proposed is a restriction that no more than 50 percent of the formula grant program be spent on operating subsidies. Since capital funds are spent more slowly, this would reduce federal outlays for 1977 by about $230 million. However, a greater state and local contribution to transit operations would be required to maintain existing fare levels; otherwise, at current ridership levels, average fare increases of about 12 percent--about 4 cents per ride--would result.

Railroads--The President's request for 1977 allows for an increase in Amtrak outlays, but it would not cover projected operating losses for the current route structure and service level. It proposes service reductions on the least efficient routes. Amtrak claims that a reduction of about 45 percent in route-miles would be required to keep its deficit within the President's proposed subsidy level. Modest budget levels for Northeast Corridor improvements are proposed, but full implementation of ConRail is requested, with funding levels for the latter following current legislation.

Air--The President proposes to hold total outlays for air transportation to about the 1976 level, and to set a $350 million maximum level for airport grants. A major change in the financing mechanism, which could eventually eliminate the trust fund surplus but would not affect short-term outlays, is the proposed use of the Airport and Airway Trust Fund to defray about one-quarter of the airway operating costs.

Water--Current programs are continued. However, a significant proposal in the President's budget message is to impose a charge on commercial domestic waterway users. While the level of cost recovery would be relatively small in 1977 ($80 million), this is an important change from past policy and, if full cost recovery is the eventual goal, could be a significant revenue item in the future.

The four budget options that have been described reflect the current practice of attacking problems on a mode-by-mode basis. The interactions between different modes have not been specifically taken into account. Explicit long-term objectives for the nation's overall transportation system are being raised more often in Congressional debate, but have not yet been agreed to by the Congress or incorporated in the options presented. Agreement on such objectives is essential to future implementation of a unified transportation policy.

FEDERAL TRANSPORTATION BUDGET BY MODE—FISCAL YEARS 1966 AND 1976[a]

Mode	Budget Outlays				Budget Outlays, Off-Budget Outlays, and Tax Expenditures			
	1966		1976		1966		1976	
	(Dollars in millions)	(Percent)	(Dollars in millions)	(Percent)	(Dollars in millions)	(Percent)	(Dollars in millions)	(Percent)
Ground:								
Highways	$4, 001	69. 7%	$6, 765	48. 3%	$4, 674	67. 5%	$7, 628	48. 5%
Railroads	13	0. 2	1, 179	8. 4	83	1. 2	1, 330	8. 5
Mass Transit	19	0. 3	1, 524	10. 9	19	0. 3	1, 524	9. 7
Regulation	27	0. 5	52	0. 3	27	0. 4	52	0. 3
Air	967	16. 8	2, 695	19. 3	967	14. 0	2, 695	17. 2
Water	711	12. 4	1, 703	12. 2	1, 147	16. 6	2, 411	15. 3
Other	3	. 1	77	0. 6	3	-------	77	0. 5
Total Transportation	**$5, 741**	**100. 0%**	**$13, 995**	**100. 0%**	**$6, 920**	**100. 0%**	**$15, 717**	**100. 0%**

[a] The budget outlay figures are taken from the Budget of the U.S. Government, commerce and transportation tables. The figures for budget outlays, off-budget outlays and tax expenditures also include: in the highway area, U.S. Department of Agriculture and Department of Interior road funds, and tax expenditures for state gasoline tax deductions; in the railroad area, off-budget outlays of the U.S. Railway Association, Amtrak and ConRail, and tax expenditures for rapid amortization of rolling stock; and, in the water area, the Army Corps of Engineers' navigation projects and tax expenditures for deferral of profits of shipping companies.

SUMMARY TABLE: COMMERCE AND TRANSPORTATION (400)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 400 items:								
Ground transportation (404):								
Federal-aid highways (404 part)	4.7	7.0	1.8	7.4	7.3	7.3	7.3	7.4
Railroads (excludes ConRail carried in new legislation) (404 part)	0.6	0.6	0.3	0.6	0.7	0.7	0.8	0.8
Mass transit (404 part)	0.9	1.5	0.3	1.7	2.0	2.2	2.4	2.6
Air transportation (405)	2.4	2.7	0.6	2.9	3.1	3.2	3.4	3.5
Other transportation (including Coast Guard and Maritime) (404 part, 406, 407)	1.9	1.8	0.6	1.9	2.1	2.2	2.3	2.5
Subtotal Transportation	10.5	13.6	3.6	14.5	15.2	15.6	16.2	16.8
Mortgage credit and thrift insurance (401)	2.8	1.4	0.9	0.5	0.2	0.1	0.0	−0.1
Postal Service (402)	1.9	1.7	0.4	1.7	1.6	1.5	1.3	1.2
Other advancement and regulation of commerce (403)	0.9	0.9	0.3	1.0	1.0	1.1	1.2	1.2
New legislation (404 part)		0.8	0.2	0.9	0.9	1.0	1.0	1.1
Deduction for offsetting receipts	−0.1	−0.1	(a)	−0.2	−0.2	−0.2	−0.2	−0.2
Total Function 400	**16.0**	**18.3**	**5.4**	**18.4**	**18.7**	**19.1**	**19.5**	**20.0**
Plus nonfunction 400 items related to commerce and transportation: Corps of Engineers navigation projects (301 part)	0.6	0.6	0.2	0.6	0.7	0.8	0.9	1.0
Total Current Policy Option: Commerce and Transportation	**16.6**	**18.9**	**5.6**	**19.0**	**19.4**	**19.9**	**20.4**	**21.0**
Tax expenditures (See tax expenditure estimates by function in the Tax Expenditure Chapter)	(c)	44.2	NA	47.8	52.7	57.2	62.0	67.1

See footnotes at end of table.

SUMMARY TABLE: COMMERCE AND TRANSPORTATION (400)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION (increased federal involvement)								
Function 400 items:								
Ground transportation (404):								
Federal-aid highways (404 part) (Additional $1.5 billion per year for refunds to states, or expanding the transit option and funding from trust receipts, or federal commitment to maintenance of Interstate, or some combination)	4.7	7.0	1.8	7.8	8.8	8.9	8.9	9.0
Railroads (404 part) (Amtrak subsidies continue to grow, ConRail needs exceed current authorizations, other ailing railroads aided, more extensive improvements in NE Corridor)	0.6	1.4	0.5	1.8	2.4	2.7	3.0	3.3
Mass transit (404 part) (Increase local-option formula grants available for operations and expand capital grants program)	0.9	1.5	0.3	2.2	3.1	3.6	4.0	4.2
Air transportation (405) (Trust fund support of FAA operations, expanded aid to airports and/or aircraft noise abatement)	2.4	2.7	0.6	3.3	3.4	3.5	3.6	3.7
Other transportation (including Coast Guard and Maritime) (404 part, 406, 407)	1.9	1.8	0.6	2.0	2.2	2.3	2.4	2.6
Subtotal Transportation	10.5	14.4	3.8	17.1	19.9	21.0	21.9	22.8
Mortgage credit and thrift insurance (401):								
Policy emphasis on allowances	2.8	1.4	0.9	1.5	1.6	1.7	1.8	1.9
Policy emphasis on homeownership and production of middle income housing	(2.8)	(1.4)	(0.9)	[b] (1.9)	(2.4)	(2.9)	(3.4)	(3.8)
Postal Service (402) increased subsidy	1.9	1.7	0.4	3.3	4.6	5.7	7.3	8.5
Other advancement and regulation of commerce (403)	0.9	0.9	0.3	1.0	1.0	1.1	1.2	1.3
Deduction for offsetting receipts	−0.1	−0.1	([a])	−0.2	−0.2	−0.2	−0.2	−0.2
Total Function 400 [b]	**16.0**	**18.3**	**5.4**	**22.7** [b] **(23.1)**	**26.9** **(27.7)**	**29.3** **(30.5)**	**32.0** **(33.6)**	**34.3** **(36.2)**
Plus nonfunction 400 items related to commerce and transportation: Corps of Engineers navigation projects (301 part)	0.6	0.6	0.2	0.6	0.7	0.8	0.9	1.0
Total High Option: Commerce and Transportation	**16.6**	**18.9**	**5.6**	**23.3** **(23.7)**	**27.6** **(28.4)**	**30.1** **(31.3)**	**32.9** **(34.5)**	**35.3** **(37.2)**
Tax expenditures (See tax expenditure estimates by function in the Tax Expenditure Chapter)	([c])	44.2	NA	47.8	52.7	57.2	62.0	67.1

See footnotes at end of table.

SUMMARY TABLE: COMMERCE AND TRANSPORTATION (400)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION (reduced federal support):								
Function 400 items:								
Ground transportation (404):								
Federal-aid highways (404 part) (Faster interstate beginning 1977, but no additional federal-aid program; speed limit restriction replacing all other highway safety)	4.7	7.0	1.8	5.0	4.4	4.3	4.3	4.2
Railroads (404 part) (Reduce Amtrak grants slightly, gradually phase out continuation subsidies and labor protection, hold ConRail funding to current authorizations)	0.6	1.4	0.5	1.4	1.5	1.5	1.6	1.4
Mass transit (404 part) (Cut local-option grants and capital grants)	0.9	1.5	0.3	1.4	1.4	1.4	1.3	1.2
Air transportation (405) (Discontinue NASA aviation R&D and CAB subsidies, reduce aid to airports and fund all air program outlays from trust fund)	2.4	2.7	0.6	2.3	2.5	2.6	2.7	2.8
Other transportation (including Coast Guard and Maritime) (404 part, 406, 407) (Reduce ship construction subsidy, allow operating subsidy contracts to lapse)	1.9	1.8	0.6	1.4	1.5	1.5	1.6	1.7
Subtotal Transportation	10.5	14.4	3.8	11.5	11.3	11.3	11.5	11.3
Mortgage credit and thrift insurance (401) (increased GNMA sales from portfolio)	2.8	1.4	0.9	0.0	0.0	0.0	0.0	−0.1
Postal Service (402) (elimination of deficit)	1.9	1.7	0.4	4.6	1.6	1.5	1.3	1.2
Other advancement and regulation of commerce (403)	0.9	0.9	0.3	1.0	1.0	1.1	1.2	1.3
Deduction for offsetting receipts	−0.1	−0.1	(a)	−0.2	−0.2	−0.2	−0.2	−0.2
Total Function 400	**16.0**	**18.3**	**5.4**	**16.9**	**13.7**	**13.7**	**13.8**	**13.5**
Plus nonfunction 400 items related to commerce and transportation: Corps of Engineers navigation projects (301 part) (reduce navigation construction program)	0.6	0.6	0.2	0.5	0.5	0.5	0.5	0.5
Total Low Option: Commerce and Transportation	**16.6**	**18.9**	**5.6**	**17.4**	**14.2**	**14.2**	**14.3**	**14.0**
Tax expenditures (See tax expenditure estimates by function in the Tax Expenditure Chapter)	(c)	44.2	NA	47.8	52.7	57.2	62.0	67.1

See footnotes at end of table.

SUMMARY TABLE: COMMERCE AND TRANSPORTATION (400)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Function 400 items:								
Ground transportation (404 part):								
Federal-aid highways (404 part)	4.7	6.4	1.9	6.7				
Railroads (includes ConRail) (404 part)	0.6	1.2	0.4	1.2				
Mass transit (404 part)	0.9	1.5	0.4	1.8				
Air transportation (405)	2.4	2.7	0.7	2.8				
Other transportation (including Coast Guard and Maritime) (404 part, 406, 407)	1.8	2.2	0.5	2.4				
Subtotal, Transportation	10.4	14.0	3.9	14.9				
Mortgage credit and thrift insurance (401)	2.8	1.3	0.3	−0.6				
Postal Service (402)	1.9	1.7	0.4	1.5				
Other advancement and regulation of commerce (403)	0.9	0.9	0.2	0.9				
Deduction for offsetting receipts	−0.1	−0.1	([a])	−0.1				
Total President's Budget: Function 400	**15.9**	**17.8**	**4.8**	**16.6**				
Plus nonfunction 400 items related to commerce and transportation: Corps of Engineers navigation projects (301 part)	0.6	0.7	0.2	0.6				
Total President's Budget: Commerce and Transportation	**16.5**	**18.5**	**5.0**	**17.2**				
Tax expenditures (See tax expenditure estimates by function in the Tax Expenditure Chapter)	([c])	44.2	NA	47.8				

[a] Less than $50 million.

[b] Acceptance of policy emphasis on homeownership leads to higher totals in parentheses.

[c] Not available on a comparable basis.

PART II-1: PROGRAM ISSUES
SECTION D: NATURAL RESOURCES AND COMMERCE

Agriculture (Function 350)

Introduction

Federal spending for agricultural programs (function 350) is of two types. Commodity programs (subfunction 351), intended primarily to stabilize farm income, provide commodity loans and purchases, disaster payments, and direct (deficiency) payments to farmers if market prices fall below specified levels. Agricultural research and services (subfunction 352) includes cooperative extension, marketing, regulatory, and economic data collection and analysis, in addition to funds for research.

Outlays for agriculture are highly influenced by the commodity programs, whose costs vary with market prices and support levels (see table below). Commodity program costs, which account for $1.6 billion of the estimated $2.6 billion total for fiscal year 1976, have fluctuated widely over recent years--from $4.6 billion in fiscal year 1972 to $0.8

AGRICULTURE OUTLAYS AND TAX EXPENDITURES
FISCAL YEARS 1966, 1976, 1981 (FUNCTION 350)
(Billions of Dollars)

	1966	1976[a]	1981[a]
Farm Income Stabilization (351)	$2.7	$1.6	$1.5
Agricultural Research and Services (352)	0.5	1.0	1.3
Total (350)	3.2	2.6	2.8
Percent of Total Outlays	2.4%	0.7%	0.5%
Tax Expenditure	NA	$1.4	$2.0

a. Current policy levels.
NA: Not available.

billion in fiscal year 1975. The fraction of the federal budget devoted to agriculture over the last decade has declined from 2.4 to 0.7 percent.

Tax expenditures for agriculture include special treatment of expenses, provisions for capital gains, and exemptions for agriculture cooperatives. These agriculture-related provisions of the tax code will reduce federal revenues by about $1.4 billion in fiscal year 1976.

If current agricultural policies were continued, outlays are estimated to be $2.3 billion in fiscal year 1977 and $2.8 billion in fiscal year 1981. These outlay levels would represent:

- The slight growth in outlays for the commodity programs that would occur if weather were normal, disaster payments did not increase, export credit levels continued to be $450 million annually, and dairy and peanut program costs continued to increase.

- The maintenance of current real program levels for agricultural research services.

Because of their strong influence on budget outlays and their pivotal role in U.S. farm policy, the commodity programs and their budget implications are the primary focus of this section.

The Background

Agriculture in the United States has changed significantly since the beginning of this decade. Oversupply and its attendant problems of low farm prices and large, costly government stockpiles have given way to a tight market and higher prices. As a result of this situation, U.S. agriculture has become an even more important force in the world market than it was previously. Yet, with this new situation have come new problems: higher retail food prices, increased price instability for both farmers and consumers, increased interest in foreign food aid and the cost of providing it, and general uncertainty about the future agricultural outlook and how governments will respond to it.

During the 1950s and 1960s, the nations that exported the most grain, particularly the United States, held large grain stocks, and the quantity of land used for production was adjusted through farm program incentives. These factors were used to cushion the effects on prices of short-term fluctuations in supply induced primarily by weather. This helped keep world commodity prices relatively stable throughout the period. In the late 1960s and early 1970s, the major grain exporting nations succeeded in reducing government stockholdings in order to lower budget costs. In the United States, federal budget costs for commodity programs fell from about $4 billion in fiscal year

1969 to $0.8 billion in fiscal year 1975. This decline was caused both by the prevailing worldwide supply/demand situation and by changes in policy.

In 1972, the reduction in stocks coincided with a number of other important changes in the world agricultural situation: poor harvests in many growing regions, a decision by the Soviet Union to make up for its domestic shortages through purchases from abroad, an acceleration in the demand for food (particularly livestock products) due to rapidly rising incomes and worldwide economic prosperity, and the stimulation of U.S. exports by dollar devaluation. Further, as a result of U.S. programs, several million acres of cropland were withheld from agricultural production. Predictably, the combination of these events and the extraordinary occurrence in 1974 of another decline in world food production, caused world agricultural prices to skyrocket. Within two years, many commodity prices doubled and some tripled.

As a major supplier of food, the United States experienced a surge in exports that continues at about 150 percent of the volume levels of the late 1960s. As a result North American agriculture has increasingly become the major source of world grain exports. By contrast the volume of U.S. food aid has been sharply lower in recent years.

These trends will not necessarily continue, and farm program budget costs will not necessarily remain low. Agricultural budgets cannot be fully controlled by federal policy. Among the other influences, two are especially difficult to predict: weather and the policies of foreign governments. Changes in these factors over the next five years could substantially change world and U.S. supply and demand situations. Further, a number of conflicting demands could alter current government policy and its cost.

Existing Agricultural Policy and Conflicting Demands

Present U.S. farm policy reflects increased reliance on the private market and less on governmental intervention. However, only certain commodities--principally wheat, feedgrains, and upland cotton--are subject to the increased market orientation established under terms of the Agriculture and Consumer Protection Act of 1973.[1] This act created a

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1. Under this law, wheat, feedgrain, and cotton producers are currently not restricted in production and become eligible for income support through deficiency payments if market prices fall below "target prices." Commodity loans provide financing and set a floor under farm prices. Current market prices are considerably above these support levels, particularly for wheat and feedgrains. If market prices fall below the support levels, the government is obligated to take over the commodity, at the option of the producer.

system of low (relative both to past support levels and to current production costs) price supports, supplemented by direct payments. Unless market prices fall below specified target prices, no payments are made; current market prices, for the reasons indicated above, are substantially higher than target levels for all three commodities.

Because the 1973 act expires in 1977, new legislation will be prepared over the coming months. The future of agricultural policy will depend partially on how the Congress chooses to respond to a new set of policy demands. For example:

- Farmers are urging that their incomes be better protected from escalating costs of production. Though commodity prices and current farm incomes are much higher than they were four or five years ago, the cost of production has increased significantly since 1972. Livestock producers are concerned that strong export demand for grains will cause their costs to rise further; grain producers are concerned that these foreign markets might weaken, leaving them with a depressed domestic market.

- Consumers are concerned about the sharp increases in retail food prices and the absence of any effective federal effort to limit or control these increases. They are asking that future agricultural policies consider their interests too. Between 1972 and 1973, food accounted for just over half of the total cost-of-living increase and, in the following year, about 30 percent of the increase. As a result, the share of after-tax personal income spent for food increased for the first time in many years. However, much of the increased consumer price of food is due to higher costs of processing and marketing, not to higher farm prices.

- Foreign countries that buy U.S. agricultural products are seeking assurance that these supplies will not be cut off or reduced during periods of shortage and rising domestic prices. On a limited number of occasions over the past three years, the United States has restricted foreign access to U.S. grain markets. At a minimum, there is strong interest both here and abroad, in U.S. adoption of a clearly articulated set of criteria for allocating limited agricultural supplies among foreign customers.

- The major grain-exporting nations, including the United States, are looking for a means by which the costs of stockpiling can be shared more equally with the large grain-importing nations. Historically, importing nations have avoided this cost by relying on the large, government-held stocks of the exporting nations to even out year-to-year price variations. With government-held stocks nearly depleted in the exporting countries, variations in export demand directly affect the exporters' domestic market prices. If stocks are used to prevent this price instability, exporting nations will seek to transfer at least a portion of the cost to the sources of export instability. The recent five-year grain trade agreement between the United States and the Soviet Union represents a move in this direction.

- Hard hit by recent cutbacks in U.S. food aid, less developed countries are looking for a more reliable source of aid. There is also increased recognition of the limitations of food aid as a long-term solution to the food problems of these nations and of the need for a more effective means of increasing their productive capacity.

Major Policy Options and Alternative Budgets

How are these forces to be dealt with in the context of a national food and agricultural policy? Some of the principal options and estimates of their budgetary impacts are discussed below.[2]

1. Continuation of current policy. This option would continue the market-oriented approach of recent years. As called for in the 1973 Farm Act, it would allow for some adjustment in the level of wheat, feedgrain, and cotton target prices, based on changes in costs of production as reflected by the index of prices paid by farmers and average yields. Price supports would provide a low floor price, but no price ceiling. Price instability of the nature experienced over the past few years probably would continue to affect agriculture and the domestic economy generally. However, the budget costs would be low.

Assuming weather conditions are normal, the level of disaster payments stays constant, and export credits are held at $450 million annually, outlays in fiscal year 1977 would be $2.3 billion and would grow to $2.8 billion by 1981 (see table below). Most of the growth in outlays in the stabilization programs is attributable to the dairy and peanut programs. Supply and demand are projected to remain at levels that would keep market prices above target prices, so no deficiency payments would be required.

To date the Administration has not put forward its proposals for new legislation. However, the outlays in the President's 1977 budget request appear to be based on a continuation of current policy.

The current policy estimate for fiscal year 1977 is about $0.6 billion larger than the President's budget. However, the difference stems primarily from the fact that the President's budget includes a

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2. J. B. Penn and Ted Moriak, Commodity Economics Division, Economic Research Service, United States Department of Agriculture, provided access to the policy simulation model used in deriving these estimates.

AGRICULTURE BUDGET OPTIONS, OUTLAYS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1978	1981
Current Policy Level	2.3	2.5	2.8
Changes from Current Policy Level			
President's Budget	-0.6	--	--
Higher Target Price Option	+0.2	+1.9	+2.6
Grain Reserve Option	0.0	+0.4	+0.2

a. For more detail see summary table .

planned sale of loans from the Agricultural Credit Insurance Fund in fiscal year 1977 that would produce higher receipts.

2. Continuation of existing authority, but with higher target prices and loan levels. While preserving the structure and procedures of the present authority, this option would increase target prices and loan levels above the levels allowed under the 1973 act. This would raise the level of farm income protection and increase its stability. The risk of low prices for grain and cotton producers would be reduced because higher loan rates would more closely reflect current production costs. Budget costs would be higher than those implied by continuing current policy. Just how much higher would depend upon how much target prices were raised.

For example, target prices and loan rates for crop year 1976 could be increased 50 percent over the crop year 1975 levels specified by the law. This would approximate the change that occurred in the index of prices paid by crop producers for production items from 1972 to 1975. If this were done and adjustments were made after 1976 in target prices and loan rates in accordance with the procedures contained in the 1973 Farm Act, deficiency payments would result. Agricultural outlays in 1977 would be $0.2 billion larger than those implied by a continuation of current policy. By 1981 these costs would be $2.6 billion higher than those of a current policy budget.

3. Establishment of a government-held domestic grain reserve. Through government acquisition and sale of grain reserves, fluctuations in commodity prices could be kept within prescribed limits. Market prices could be left to fluctuate within a relatively wide range to

minimize the frequency and cost of governmental intervention. A grain reserve might require some form of periodic government intervention in the international trading of grain. The budgetary costs of this option could be modest, but would depend upon the size of the reserve and length of time over which it was acquired.

The supply and demand projections that underlie the current policy budget estimates indicate that a government grain reserve of 10 million tons could be built up over the fiscal years 1978 to 1980 without significantly increasing domestic prices. Such a reserve would represent about 15 percent of recent U.S. export levels.

Acquisition of 3.3 million tons of grain each year, storage, and interests costs would increase annual outlays by $0.4 billion over the levels required to maintain current policy from 1978 to 1980. Once the reserve was built, outlays would be $0.2 billion over the current policy budget levels. These estimates do not include any revenues that might result from sales of stocks.

The supply/demand projections on which all of these outlay estimates are based reflect normal or expected yields and exports. One recent study estimates that with the continuation of current policy there is a 70 percent chance that deviations from expected yields on exports would be too small to result in higher budget outlays.[3] There is about a 5 percent chance that export demand and yields in crop year 1977 would deviate sufficiently from expected values, given current policy, to cause projected outlays in fiscal year 1978 to increase from $2.5 billion to $5.3 billion. Under the higher target prices and loan rates option, the same deviation in yields and exports would result in projected outlays rising from $4.4 billion to $7.8 billion.

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3. Daryll Ray and Luther Tweeten, "Alternative Agricultural and Food Policy Directions for the U.S.--With Emphasis on Continuation of Minimal Provisions of the 1973 Agricultural and Consumer Protection Act"(paper prepared for Agricultural Policy Research Workshop, sponsored by the North Central Regional Public Policy Research Task Force, Economic Research Service of the U.S. Department of Agriculture, the Farm Foundation, and the Western Agricultural Economic Research Council, January 15 and 16, Washington, D.C.; processed, p. 17.)

SUMMARY TABLE: AGRICULTURE (350)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY								
Farm income stabilization (351)	0.8	1.6	0.6	1.3	1.4	1.4	1.5	1.5
Agricultural research and services (352)	0.9	1.0	0.3	1.0	1.1	1.2	1.2	1.3
Total Current Policy: Agriculture (350)	**1.7**	**2.6**	**0.9**	**2.3**	**2.5**	**2.6**	**2.7**	**2.8**
Tax expenditures (special treatment of capital costs and farm income and farm cooperatives)	([a])	1.4	NA	1.5	1.7	1.8	1.9	2.0
HIGHER TARGET PRICES								
Farm income stabilization (target prices increased 50 percent above those required by law) (351)	0.8	1.6	0.6	1.5	3.3	4.4	4.6	4.1
Agricultural research and services (352)	0.9	1.0	0.3	1.0	1.1	1.2	1.2	1.3
Total Higher Target Prices: Agriculture (350)	**1.7**	**2.6**	**0.9**	**2.5**	**4.4**	**5.6**	**5.8**	**5.4**
Tax expenditures (special treatment of capital costs and farm income and farm cooperatives)	([a])	1.4	NA	1.5	1.7	1.8	1.9	2.0

See footnote at end of table.

SUMMARY TABLE: AGRICULTURE (350)—Continued

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
STRATEGIC GRAIN RESERVE								
Farm income stabilization (Government buildup of 10 million ton strategic grain reserve) (351)	0. 8	1. 6	0. 6	1. 3	1. 8	1. 9	2. 0	1. 7
Agricultural research and services (352)	0. 9	1. 0	0. 3	1. 0	1. 1	1. 2	1. 2	1. 3
Total Strategic Grain Reserve: Agriculture (350)	**1. 7**	**2. 6**	**0. 9**	**2. 3**	**2. 9**	**3. 1**	**3. 2**	**3. 0**
Tax expenditures (special treatment of capital costs and farm income and farm cooperatives)	([a])	1. 4	NA	1. 5	1. 7	1. 8	1. 9	2. 0
PRESIDENT'S BUDGET								
Farm income stabilization (351)	0. 8	1. 9	0. 5	0. 7	-------	-------	-------	-------
Agricultural research and services (352)	0. 9	1. 0	0. 3	1. 0	-------	-------	-------	-------
Total President's Budget: Agriculture	**1. 7**	**2. 9**	**0. 8**	**1. 7**	-------	-------	-------	-------
Tax expenditures (special treatment of capital costs and farm income and farm cooperatives)	([a])	1. 4	NA	1. 5	-------	-------	-------	-------

[a] Not available on a comparable basis.

PART II-1: PROGRAM ISSUES
SECTION D: NATURAL RESOURCES AND COMMERCE

Natural Resources and Science (Functions 250 and 300)

Introduction

This section discusses federal programs in the areas of general science, space, and technology (function 250) and natural resources and environment (function 300 except energy). While major redirections of policy are possible, these areas appear less likely than energy, transportation, and agriculture to attract major Congressional attention--or to have major effects on the economy or the federal budget--in fiscal year 1977. Accordingly, these subjects are not treated in the detail accorded the others; however, the brevity of this treatment does not reflect the importance of these functions. Decisions are being made about basic research and advanced technologies to be supported, about the nation's role in space and the role of space technology in meeting needs on earth, about management of land, water, and mineral resources, and about regulation of energy markets and the environment. Such decisions will have pervasive, long-range implications for the nation's economy, technology, environment, and quality of life.

Included in the category of general science, space, and technology are: the National Science Foundation's (NSF) basic research activities in all disciplines and the ERDA high-energy research activities (subfunction 251)--and the space research and technology programs of the National Aeronautics and Space Administration (NASA) (subfunctions 253, 254, and 255[1]).

In fiscal year 1976, outlays for general science, space, and technology are expected to total $4.3 billion and, under a current policy budget, would reach $5.7 billion in fiscal year 1981 (see the following table). The increase would result primarily from inflation. The fiscal year 1976 outlays represent a real decline from the fiscal year 1966 total of $6.7 billion, due largely to a major phasing-down of manned space flight activities. These decreased from $4.2 billion in fiscal year 1966 to about $1.7 billion in fiscal year 1976.

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1. The activities of the U.S. Geological Survey used to be included as subfunction 252; beginning in fiscal year 1977, this function has been combined with subfunction 306 (other natural resources) and is discussed with the activities in that subfunction. All figures used in this section have been adjusted to account for this change.

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GENERAL SCIENCE, SPACE, AND TECHNOLOGY OUTLAYS
FISCAL YEARS 1966, 1976, 1981
(SUBFUNCTIONS 251, 253, 254, 255)
(Billions of Dollars)

	1966	1976[a]	1981[a]
General Science & Basic Research	$0.9	$1.1	$1.6
Space Research & Technology	5.8	3.2	4.1
Total[b]	6.7	4.3	5.7
Percent of Total Outlays	5.0%	1.1%	1.0%

a. Based on the current policy level.

b. Adjusted to reflect the transfer of earth sciences outlays (former subfunction 252) to function 306.

The subfunctions water resources and power (301), conservation and land management (302), recreation resources (303), pollution control and abatement (304), energy (305), and other natural resources (306) encompass federal activities dealing with management of the nation's land, water, and mineral resources. Since fiscal year 1966, total outlays for these activities have more than tripled, and the fraction of the budget devoted to these programs has risen from 1.9 to 2.4 percent (see the following table). The single largest increase has been in pollution control and abatement, due almost entirely to 1972 legislation that authorized a multiyear $18 billion program of federal grants to states and municipalities for construction of public sewage treatment facilities. Federal outlays for this purpose grew from less than $150 million in fiscal year 1966 to about $350 million in fiscal year 1970 and to an estimated $2.1 billion in fiscal year 1976. The current policy outlay projection for fiscal year 1981 is $10.8 billion for all of function 300 except energy, which represents a decrease in real dollars. This estimate may well be unrealistic, however, because it assumes that Congress will authorize no new funding for construction grants after the original $18 billion has been obligated.

NATURAL RESOURCES AND ENVIRONMENT OUTLAYS AND TAX EXPENDITURES[a] (FUNCTIONS 300 EXCEPT SUBFUNCTION 305), FISCAL YEARS 1966, 1976, 1981
(Billions of Dollars)

	1966	1976[b]	1981[b]
Water Resources & Power (301)	$1.7	$4.0	$5.4
Conservation & Land Management (302)	0.6	1.2	1.5
Recreational Resources (303)	0.2	0.9	1.4
Pollution Control & Abatement (304)	0.2	2.8	1.9
Other Natural Resources[c] (306)	0.3	1.0	1.2
Offsetting Receipts and Other	-0.4	-0.6	-0.6
Total	2.6	9.3	10.8
Percent of Total Outlays	1.9%	2.4%	1.9%
Tax Expenditures	NA	$.39	$.79

a. All figures in this table exclude energy figures (subfunction 305). To obtain totals for the entire 300 category, these figures must be added to the similar table in the energy section of this chapter.

b. Current policy levels.

c. Includes the former 252 subfunction (earth sciences).

N.A. Not available.

Offsetting receipts from present policies and programs for management of land, water, and mineral resources are significant, particularly when rents and royalties from sale of oil and gas leases on the Outer Continental Shelf (OCS) are included. In fiscal year 1966, offsetting receipts (excluding OCS receipts of $248 million but including other energy-related receipts) were $390 million. This total is estimated to be $814 million in fiscal year 1976. Receipts from bonuses, rents, and royalties on the Outer Continental Shelf, which are carried in function 900, were $248 million in fiscal year 1966, and are expected to total from $2.2 billion to $2.8 billion in fiscal year 1976. (The fiscal year 1976 figure is given as a range because of the difficulties of predicting OCS revenues. In fiscal year 1976, for example, the Administration's original $8 billion estimate has been revised downward several times, and is now $3 billion.)

The remainder of this section treats each of the areas in more detail. It presents the President's fiscal year 1977 budget proposal and high and low options.

General Science, Space, and Technology (250)

General Science and Basic Research (251). As indicated above, this subfunction includes all basic research by the National Science Foundation (NSF), and high-energy physics and other ERDA basic research activities.

The President's fiscal year 1977 budget in this category provides for a 12.5 percent increase in budget authority, but only a 4.2 percent increase in outlays. Emphasis in the increase is on basic research.

GENERAL SCIENCE AND BASIC RESEARCH BUDGET OPTIONS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy		
Budget Authority	1.3	1.6
Outlays	1.3	1.6
Changes from Current Policy		
High Option		
Budget Authority	0.0	0.4
Outlays	0.0	0.4
Low Option		
Budget Authority	0.0	0.0
Outlays	0.0	0.0
President's Budget		
Budget Authority	0.0	
Outlays	-0.1	

a. For greater detail see summary outlay table.

The high option for this function assumes that in each year programs will grow at a rate of 5 percent above inflation. This would begin a return to a generally higher level of support for science than has been the case recently.

The low option is set at the same level as the current policy projection. Although most NSF and ERDA activities could be increased or decreased, relative to the past, support in this area is at a low level; in the past few years, real dollar support has been declining.

Space (253, 254, 255). The basic long-term issue facing NASA is the appropriate direction and level of support for space activities, now that the moon phase of the manned space program has been completed. Recent NASA budgets have emphasized development of a space shuttle, which is designed to be the basis for a new generation of space services and future experiments.

The Administration's fiscal year 1977 request for NASA is below a current policy level and would result in a decrease in the activity of the agency (see the following table), although the first two space shuttles would still be launched on schedule, and several new projects would start. The decrease would include a reduction of 500 permanent personnel positions (for all NASA functions) and postponement of procurement of the third shuttle vehicle.

SPACE BUDGET OPTIONS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy		
Budget Authority	3.5	4.4
Outlays	3.4	4.1
Changes from Current Policy		
High Option		
Budget Authority	0.1	1.2
Outlays	0.1	1.4
Low Option		
Budget Authority	-0.3	-0.2
Outlays	-0.2	-0.1
President's Budget		
Budget Authority	-0.2	
Outlays	-0.1	

a. For greater detail see summary outlay table.

The high option is predicated on 5 percent real growth in NASA space programs. This would allow all three space shuttles to be launched on schedule and some expansion in space science and applications programs.

A low option budget would constrain the fiscal year 1977 NASA budget to the fiscal year 1976 dollar level and is adjusted for inflation from fiscal year 1978 onward. This budget would require a further reduction of 4 percent below the President's space program. If the bulk of this cut were allocated to the space shuttle, the schedule for the first manned orbital flight in the space shuttle could be delayed as much as 24 to 30 months. Accordingly, additional long-term total system costs could result from the delay; program benefits also would be postponed. It is therefore perhaps appropriate to ask whether such a low budget option would represent an efficient policy choice. A more coherent low option would necessitate reconsidering the nation's current commitments to future uses of and investigations in space. Curtailing the space shuttle for example, would mean accepting a significantly reduced level of space activity in the 1980s and beyond. This analysis has not addressed the costs or budget implications of such a decision.

Other Research and Development Activities. Function 250 contains only a small fraction of the government's full scientific R&D program. Government-wide obligations for research and development amount to over $20 billion (see the following table).

FEDERAL RESEARCH AND DEVELOPMENT OBLIGATIONS
(Billions of Dollars, Fiscal Years)

	1975	1976	TQ[a]	1977
Conduct of R&D				
Defense	9.6	10.6	2.7	12.0
Space	2.5	2.7	0.7	2.9
Civilian	6.9	8.0	2.0	8.6
R&D Facilities	0.8	0.9	0.1	1.2
Total	19.8	22.2	5.5	24.7

Source: Budget of the U.S. Government, Fiscal Year 1977, Special Analyses, pp. 276-277.

a. TQ: Transition quarter.

Defense accounts for about 50 percent of R&D in all three years. The major thrusts in the President's budget for fiscal year 1977 are to increase defense R&D, to emphasize energy research, and to increase funding for basic research. Federal support for basic research would increase from $2.4 billion to $2.6 billion. Major issues in these areas are discussed elsewhere in this volume where appropriate.

Water Resources and Power (301). Water resource programs encompass the construction of dams, canals, locks, and other facilities for water supply, navigation, hydroelectric power, flood control, and other purposes.

The Tennessee Valley Authority (TVA) is treated differently for budget purposes from most other major water resource agencies. From time to time, it receives large amounts of long-term borrowing authority. For example, TVA was given $10 billion borrowing authority in fiscal year 1976 for a long-term capital construction program. It is assumed that TVA will receive no similar, large, new budget authority through 1981. Thus all budget authority estimates from the transition quarter through 1981 include only the other water resource agencies. Unlike the practice with other agencies, only those TVA outlays net of receipts are shown on the budget.

The Army Corps of Engineers and--especially--the Bureau of Reclamation have large backlogs of projects whose construction has been authorized but for which funds have not been completely appropriated.

The President's budget would increase budget authority for these activities by 3 percent--a decline in real terms. The high and low options as well as the current policy level are calculated assuming that no new water or power projects are authorized prior to 1981. Construction would go forward on the backlog of previously authorized projects, although at differing rates. The high option assumes increases over current policy levels in budget authority for water resource programs ($500 million in fiscal years 1977 and 1981, and $1 billion in the intervening years) (see the following table). This would either allow authorized projects to proceed at approximately their optimal construction schedules, or permit the start of a modest number of new projects from among those authorized but not yet funded. In the low option, budget authority for water resource programs is assumed to decline in real terms at 5 percent per year. Such a budget would imply a decision to do one or more of the following: further delay completion of authorized construction projects, further defer required maintenance; and/or cancel a number of projects which have been authorized but not yet started.[2]

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2. Outlays for current policy and low option water programs are assumed equal to budget authority from 1977 through 1981. Outlays for the high option, which involves a substantial increase in budget authority, are calculated as two-thirds of current year budget authority plus one-third of prior year budget authority. In both cases, current policy projections of TVA outlays are included.

WATER RESOURCES AND POWER[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level		
Budget Authority	2.8	3.5
Outlays	4.3	5.4
Changes from Current Policy Level		
High Option		
Budget Authority	0.6	0.7
Outlays	0.3	0.8
Low Option		
Budget Authority	-0.1	-0.8
Outlays	-0.1	-0.8
President's Budget		
Budget Authority	0.2	
Outlays	-0.4	

a. For greater detail see summary outlay table.

Conservation and Land Management (302). This subfunction includes the Department of Interior's (DOI) Bureau of Land Management and several components of the Agriculture Department.

The President proposes a decline in this subfunction that would include substantial reductions in the agricultural conservation program, and a smaller, but nonetheless real, reduction in certain of the Forest Service and Bureau of Land Management's management functions (see the following table). Both high and low options assume no major new programs that would require substantial additional budgetary authority. The low option is approximated by current policy, and the high option assumes a real growth in services of 3 percent per year.

Tax expenditures equivalent to $215 million in fiscal year 1976 result from capital gains treatment of certain forms of timber income.

CONSERVATION AND LAND MANAGEMENT BUDGET OPTIONS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level		
Budget Authority	1.2	1.5
Outlays	1.2	1.5
Changes from Current Policy Level		
High Option		
Budget Authority	0.0	0.0
Outlays	0.0	0.0
Low Option		
Budget Authority	-0.4	-0.5
Outlays	-0.4	-0.5
President's Budget		
Budget Authority	-0.2	
Outlays	-0.2	
Tax Expenditures	0.2	0.3

a. For greater detail see summary outlay table.

Recreational Resources (303). The recreation subfunction includes two categories: land acquisition by means of the Land and Water Conservation Fund (L&WCF) and land management.

Congress has authorized creation of many new recreation areas. Acquisition of the land within these areas--and to complete some older parks--is financed by the Land and Water Conservation Fund. In addition, 60 percent of the L&WCF is available to states to finance acquisition and development of recreation areas. In recent years, authorization of new areas--coupled with the effects of inflation on the cost of land--have exceeded the capacity of the fund, so that an increasing backlog of authorizations has built up.

The President's budget assumes that pending legislation that would increase funding for the L&WCF will not become law (see the following table). The low option assumes a cut of 50 percent (or $150 million) in appropriations from the L&WCF for fiscal year

RECREATIONAL RESOURCE BUDGET OPTIONS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level		
Budget Authority	1.1	1.4
Outlays	1.1	1.4
Changes from Current Policy Level		
High Option		
Budget Authority	0.1	0.5
Outlays	0.1	0.4
Low Option		
Budget Authority	-0.4	-0.6
Outlays	-0.3	-0.6
President's Budget		
Budget Authority	-0.2	
Outlays	-0.1	

a. For greater detail see summary outlay table.

1977, and constant funding at that level with no adjustments for inflation thereafter. Because neither of these options would reduce the rate at which the backlog is increasing--and the low option would accelerate that rate--consideration might have to be given in these cases to reassessing both the backlog and trends in authorization of new areas.

The high option assumes passage of legislation that would increase the annual authorized funding from the L&WCF: the high option level in fiscal year 1977 would be $450 million: for 1978, $600 million; for 1979, $750 million; and for both 1980 and 1981, $800 million.[3]

3. There is a distinction between authorization to acquire lands, and authorization to appropriate funds (from the L&WCF) for that acquisition.

For the management and operations category, the President's budget would continue funding for the Park Service at approximately current levels and increase the manning level by about 5 percent. Funding for the Fish and Wildlife Service would decrease--primarily in the construction account. Because of the Bicentennial and generally increased use of federal recreational facilities in recent years, the high option assumes real growth (above current policy) at 15 percent for two years and 3 percent annually thereafter. The low option assumes the maintenance of current policy.

Pollution Control and Abatement (304). This subfunction includes two components: grants for construction of sewage treatment plants and operating programs.

Funding for this subfunction is dominated by outlays for sewage treatment grants. In 1972, $18 billion was authorized for such grants. Obligations from this authority have been made each year since then, and current outlays result from those obligations. The $18 billion budget authority is not expected to be exhausted until the end of fiscal year 1977 or sometime in fiscal year 1978. Accordingly, all options (the President's budget, the current policy budget, and the high and low options) assume that no new budget authority is granted in fiscal year 1977, and that outlays for fiscal year 1976, the transition quarter, and fiscal year 1977 are similar to current policy projections (see the following table).

However, a major issue will come before the Congress next year for fiscal year 1978. The sewage treatment plants constructed under the initial $18 billion authorization will not be sufficient to raise water quality to the goals for 1983 and 1985 set forth in the Federal Water Pollution Control Act (FWPCA) Amendments of 1972. The Environmental Protection Agency has estimated that at least $42 billion more will be required to meet the goals of the act.

The high option assumes that new budget authority of $7 billion annually will be made available for the six years beginning in 1978, to provide the required $42 billion.[4] The President's budget does not address this issue. By definition, a "current policy" budget would not provide any such authority; nor does the low option. Under neither could established water quality goals be met. Such low options might not be realistic. A more plausible low option might provide new authority at a rate similar to the average rate of grant obligations in recent years.

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4. Outlays are assumed to follow historical spendout curves: obligations in a given year result in outlays in respective succeeding years of 11.9, 40.2, 25.9, 10.7, 7.1, 3.3, 0.7, and 0.2 percent.

POLLUTION CONTROL AND ABATEMENT BUDGET OPTIONS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level		
Budget Authority	0.6	0.8
Outlays	4.3	1.9
Changes from Current Policy Level		
High Option		
Budget Authority	0.1	7.2
Outlays	0.1	6.4
Low Option		
Budget Authority	0.0	0.0
Outlays	0.1	0.0
President's Budget		
Budget Authority	0.0	
Outlays	0.1	
Tax Expenditures	0.2	0.5

a. For greater detail see summary outlay table.

Since existing authority is not exhausted, decisions on the extent to which current water quality goals should be met, and the extent to which the federal government will provide financial assistance in meeting them, may not have to be made in the fiscal year 1977 budget cycle.

Two tax expenditures apply to this subfunction. Their purpose is to provide incentives to invest in pollution control equipment. They are the exclusion of interest on government pollution control bonds and a five-year amortization provision. In fiscal year 1976, their cumulative effect will be about $180 million.

For the other portions of subfunction 304 (over 90 percent of which is EPA's annual operating budget), the low and current policy options assume increases at the rate of increase in the CPI, and the high option assumes growth at a rate 5 percent above increases in the CPI. The President's budget requests reduction in funds for several small grant programs, and other decreases totaling 8 percent of the EPA budget.

Other Natural Resources (306). This subfunction includes the activities of the National Oceanic and Atmospheric Administration (NOAA), the Geological Survey, and the research and data services (other than energy) of the Bureau of Mines. The President's budget would provide a current policy level for NOAA and would decrease research activities of the Bureau of Mines (see the following table). It would provide for only a 4 percent increase--less than current policy--in budget authority for the Geological Survey, and it calls for substantial shifts of emphasis within the program, reducing general geologic investigations and increasing energy-related activities.

OTHER NATURAL RESOURCES BUDGET OPTIONS[a]
(Billions of Dollars, Fiscal Years)

Option	1977	1981
Current Policy Level		
Budget Authority	0.9	1.2
Outlays	0.9	1.2
Change from Current Policy Level		
High Option		
Budget Authority	0.3	0.6
Outlays	0.2	0.6
Low Option		
Budget Authority	0.1	0.1
Outlays	0.1	0.1
President's Budget		
Budget Authority	0.1	
Outlays	0.0	

a. For greater detail see summary outlay table.

For both NOAA and the Bureau, the low option assumes no new program authority or responsibilities which could not be absorbed by reprogramming existing budget resources. For the Geological Survey,

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it assumes continuation in the aggregate of the present level of effort, at the same rate as increases in the CPI. However, the present trend of reprogramming resources within the survey toward energy data collection and analysis, and away from geological research, will probably continue.

The high option assumes limited new authorities for NOAA and the bureau equivalent to a real rate of growth of about 3 percent per year. For the survey, it assumes passage and implementation of several initiatives, such as federal responsibility for exploration of oil and gas on the OCS and/or increased mapping of coal and mineral reserves. The increment added by these initiatives is estimated at roughly $0.1 billion in fiscal year 1977 and a further $0.2 billion in fiscal year 1978. These increments may be offset to some extent by expected increases in OCS lease bonuses (subfunction 953) resulting from the reduced level of uncertainty of OCS operations that would result from government exploration. No attempt has been made to estimate the extent of that offset.

Neither the high nor low option assumes major new grant programs for the Coastal Zone Management Office in NOAA.

Summary

As indicated earlier, neither the budgets for the individual resources and science functions, nor their total, reflect the importance of decisions in these areas. The Administration expects fiscal year 1977 outlays for functions 250 and 300, for instance, to total only $18.3 billion, or 4.6 percent of total net federal outlays for that year. Yet decisions about this fiscal year will have important long-range implications for the future.

The fact that few "big-ticket" choices in these areas are likely to come before the Congress this year does not imply that these functions can be taken lightly. Basic nonbudgetary policy issues in these areas will be resolved. These include decisions on future mechanisms for allocating the rights to use land, water, and air resources. Legislative initiatives regarding land use planning, the location of energy facilities, and environmental quality--and regulations concerning air and water quality issued under legislative authority--will be a potent force in shaping the nation's future.

Budgetary choices are also significant. Decisions concerning public works projects--especially in the water resource account--can influence regional development, employment, and the environment even though major redirections are not proposed for fiscal year 1977. The decisions on water quality (whether the current 1983 goals should be retained and to what extent the federal government should help finance their achievement) could lead to programs that would increase expenditures in function 300 by half, but those decisions can possibly be postponed until fiscal year 1978.

Very much smaller budget choices can have great leverage. Precisely because these budgets are relatively small, increases involving small increments to the total federal budget could totally redirect one or more programs. For example an increase of less than $100 million in the budget of the National Park Service could lead to a reversal of recent trends in park patrol and maintenance, and change markedly the prospects for long-term preservation and enjoyment of the nation's scenic heritage.

SUMMARY TABLE: GENERAL SCIENCE, SPACE AND TECHNOLOGY (250)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 250 items:								
Science portion (251, 252):								
General science and basic research (NSF, ERDA) (251)	1.0	1.1	0.4	1.3	1.4	1.5	1.5	1.6
Earth sciences (Interior) (252)[a]	------	------	------	------	------	------	------	------
Space portion (253, 254, 255):								
Manned space flight (NASA) (253)	------	------	------	------	------	------	------	------
Space science applications and technology (NASA) (254)	------	------	------	------	------	------	------	------
Supporting space activities (NASA) (255)	------	------	------	------	------	------	------	------
Subtotal space portion (253, 254, 255)	3.0	3.2	0.8	3.4	3.7	3.9	4.1	4.1
Total Current Policy Option: Function 250	**4.0**	**4.3**	**1.2**	**4.7**	**5.1**	**5.4**	**5.6**	**5.7**
HIGH OPTION								
Function 250 items:								
Science portion (251, 252):								
General science and basic research (NSF, ERDA) (251)	1.1	1.1	0.4	1.3	1.5	1.7	1.8	2.0
Earth sciences (Interior) (252)[a]	------	------	------	------	------	------	------	------
Space portion (253, 254, 255):								
Manned space flight (NASA) (253)	------	------	------	------	------	------	------	------
Space science applications and technology (NASA) (254)	------	------	------	------	------	------	------	------
Supporting space activities (NASA) (255)	------	------	------	------	------	------	------	------
Subtotal space portion (253, 254, 255)	3.0	3.2	0.8	3.5	3.9	4.4	4.9	5.5
Total High Option: Function 250	**4.0**	**4.3**	**1.2**	**4.8**	**5.4**	**6.1**	**6.7**	**7.5**

See footnotes at end of table.

SUMMARY TABLE: GENERAL SCIENCE, SPACE AND TECHNOLOGY (250)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
LOW OPTION								
Function 250 items:								
Science portion (251, 252):								
General science and basic research (NSF, ERDA) (251)	1.1	1.1	0.4	1.3	1.4	1.5	1.5	1.6
Earth sciences (Interior) (252) [a]	-------	-------	-------	-------	-------	-------	-------	-------
Space portion (253, 254, 255):								
Manned space flight (NASA) (253)	-------	-------	-------	-------	-------	-------	-------	-------
Space science applications and technology (NASA) (254)	-------	-------	-------	-------	-------	-------	-------	-------
Supporting space activities (NASA) (255)	-------	-------	-------	-------	-------	-------	-------	-------
Subtotal space portion (253, 254, 255)	3.0	3.2	0.8	3.2	3.3	3.5	3.9	4.0
Total Low Option: Function 250	**4.0**	**4.3**	**1.2**	**4.5**	**4.7**	**5.0**	**5.4**	**5.6**

See footnotes at end of table.

SUMMARY TABLE: GENERAL SCIENCE, SPACE AND TECHNOLOGY (250)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Function 250 items:								
Science portion (251, 252):								
General science and basic research (NSF, ERDA) (251)	1.0	1.1	0.3	1.2				
Earth sciences (Interior) (252) [a]								
Space portion (253, 254, 255):								
Manned space flight (NASA) (253)	1.5	1.7	0.5	1.9				
Space science applications and technology (NASA) (254)	1.1	1.1	0.3	1.1				
Supporting space activities (NASA) (255)	0.3	0.3	0.1	0.3				
Subtotal space portion (253, 254, 255)	3.0	3.2	0.8	3.3				
Total President's Budget: Function 250	**4.0**	**4.3**	**1.2**	**4.5**				

[a] The CBO fiscal year 1977 current policy projections and all fiscal year 1976 budgets carried the Geological Survey ($0.3 billion) as a separate subfunction (252) within function 250. The President's fiscal year 1977 budget, and all these tables, include the survey with subfunction 306, and the current policy budget has been adjusted accordingly.

SUMMARY TABLE: NATURAL RESOURCES, ENVIRONMENT, AND ENERGY (300)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
Function 300 items:								
Water resources and power (301)	3. 3	[a] 4. 0	1. 0	4. 3	4. 6	4. 8	5. 1	5. 4
Conservation and land management (302)	1. 3	1. 2	0. 3	1. 2	1. 2	1. 3	1. 4	1. 5
Recreation resources (303):								
Purchase of new recreation areas (303 part)	(0. 3)	(0. 3)	(0. 1)	(0. 3)	(0. 3)	(0. 3)	(0. 3)	(0. 3)
Operation of recreation resources (303 part)	(0. 5)	(0. 6)	(0. 1)	(0. 7)	(0. 8)	(0. 9)	(1. 0)	(1. 1)
Subtotal recreation resources (303) [b]	0. 8	0. 9	0. 2	1. 1	1. 2	1. 2	1. 3	1. 4
Pollution control and abatement (304):								
Sewage plant construction grants (304 part)	(1. 9)	(2. 1)	(0. 8)	(3. 7)	(4. 2)	(3. 9)	(2. 3)	(1. 1)
Other (304 part)	(0. 6)	(0. 7)	(0. 3)	(0. 6)	(0. 7)	(0. 7)	(0. 8)	(0. 8)
Subtotal pollution control and abatement grants (304)	2. 5	2. 8	1. 1	4. 3	4. 9	4. 6	3. 1	1. 9
Energy (305) [c]	1. 5	2. 4	0. 7	3. 2	3. 6	3. 8	4. 1	4. 4
Other natural resources (306) [d]	0. 8	1. 0	0. 3	0. 9	1. 0	1. 1	1. 2	1. 2
Deductions for offsetting receipts [e]	−0. 8	−0. 9	−0. 4	−1. 0	−1. 0	−1. 1	−1. 2	−1. 3
New legislation [e]		0. 3	0. 1	0. 5	0. 6	0. 6	0. 6	0. 7
Total Current Policy Option: Function 300	**9. 4**	**11. 7**	**3. 3**	**14. 5**	**16. 1**	**16. 3**	**15. 6**	**15. 2**
Tax expenditures	([f])	2. 8	NA	3. 1	3. 6	4. 0	4. 6	5. 2
HIGH OPTION								
Function 300 items:								
Water resources and power (301)	3. 3	[a] 4. 0	1. 0	4. 6	5. 5	6. 0	6. 3	6. 2
Conservation and land management (302)	1. 3	1. 3	0. 4	1. 2	1. 2	1. 3	1. 4	1. 5
Recreation resources (303):								
Purchase of new recreation areas (303 part)	(0. 3)	(0. 3)	(0. 1)	(0. 5)	(0. 6)	(0. 8)	(0. 8)	(0. 8)
Operation of recreation resources (303 part)	(0. 5)	(0. 6)	(0. 1)	(0. 7)	(0. 8)	(0. 8)	(0. 9)	(1. 0)
Subtotal recreation resources (303) [b]	0. 8	0. 8	0. 2	1. 2	1. 4	1. 6	1. 7	1. 8
Pollution Control & Abatement (304):								
Sewage plant construction grants (304 part)	(1. 9)	(2. 1)	(0. 8)	(3. 7)	(5. 0)	(7. 5)	(7. 7)	(7. 3)
Other (304 part)	(0. 6)	(0. 7)	(0. 3)	(0. 7)	(0. 8)	(0. 9)	(0. 9)	(1. 0)
Subtotal pollution control and abatement grants (304)	2. 5	2. 8	1. 1	4. 4	5. 8	8. 4	8. 6	8. 3

See footnotes at end of table.

SUMMARY TABLE: NATURAL RESOURCES, ENVIRONMENT, AND ENERGY (300)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION—Continued								
Function 300 items—Continued								
Energy (305)[c]	1.5	2.4	0.7	3.6	4.9	6.1	6.1	6.6
Other natural resources (306)[d]	0.8	1.0	0.2	1.1	1.3	1.5	1.6	1.8
Deductions for offsetting receipts [e]	−0.8	−0.9	−0.4	−1.0	−1.0	−1.1	−1.2	−1.2
New legislation [e]		0.3	0.1	0.4	0.6	0.6	0.6	0.7
Total High Option: Function 300	**9.4**	**11.7**	**3.3**	**15.5**	**19.7**	**24.4**	**25.1**	**25.7**
Tax expenditures	([f])	2.8	NA	3.1	3.6	4.0	4.6	5.2
LOW OPTION								
Function 300 items:								
Water resources and power (301)	3.3	[a]4.0	1.0	4.2	4.3	4.4	4.5	4.6
Conservation and land management (302)	1.3	1.3	0.4	0.8	0.8	0.9	1.0	1.0
Recreation resources (303):								
Purchase of new recreation areas (303 part)	(0.3)	(0.3)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Operation of recreation resources (303 part)	(0.5)	(0.6)	(0.1)	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)
Subtotal recreation resources (303)[b]	0.8	0.8	0.2	0.8	0.8	0.8	0.8	0.8
Pollution control and abatement (304):								
Sewage plant construction grants (304 part)	(1.9)	(2.1)	(0.8)	(3.7)	(4.2)	(3.9)	(2.3)	(1.1)
Other (304 part)	(0.6)	(0.7)	(0.3)	(0.7)	(0.7)	(0.7)	(0.8)	(0.8)
Subtotal pollution control and abatement grants (304)	2.5	2.8	1.1	4.4	4.9	4.6	3.1	1.9
Energy (305)[c]	1.5	2.4	0.7	2.9	3.4	3.5	3.6	3.7
Other natural resources (306)[d]	0.8	1.0	0.2	1.0	1.1	1.2	1.3	1.3
Deductions for offsetting receipts [e]	−0.8	−0.9	−0.4	−1.0	−1.0	−1.1	−1.2	−1.2
New legislation [e]		0.3	0.1	0.4	0.6	0.6	0.6	0.7
Total Low Option: Function 300	**9.4**	**11.7**	**4.4**	**13.5**	**14.9**	**14.9**	**13.7**	**12.8**
Tax expenditures	([f])	2.8	NA	3.1	3.6	4.0	4.6	5.2

See footnotes at end of table.

SUMMARY TABLE: NATURAL RESOURCES, ENVIRONMENT, AND ENERGY (300)—Continued

OUTLAYS—Continued

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
Function 300 items:								
Water resources and power (301)	3.3	[a] 3.8	1.2	3.9				
Conservation and land management (302)	1.3	1.3	0.5	1.0				
Recreation resources (303):								
Purchase of new recreation areas (303 part)	(0.3)	(0.3)	(0.1)	(0.3)				
Operation of recreation resources (303 part)	(0.5)	(0.6)	(0.2)	(0.6)				
Subtotal recreation resources (303)[b]	0.8	0.9	0.2	1.0				
Pollution control and abatement (304):								
Sewage plant construction grants (304 part)	(1.9)	(2.4)	(0.6)	(3.8)				
Other (304 part)	(0.6)	(0.7)	(0.2)	(0.6)				
Subtotal pollution control and abatement grants (304)	2.5	3.1	0.8	4.4				
Energy (305)[c]	1.6	2.6	0.6	3.4				
Other natural resources (306)[d]	0.8	0.9	0.2	0.9				
Deductions for offsetting receipts[e]	−0.8	−0.8	−0.3	−0.8				
New legislation[e]								
Total President's Budget: Function 300	**9.5**	**11.8**	**3.3**	**13.8**				
Tax expenditures	([f])	2.8	NA	3.1				

[a] One-time $10 billion borrowing authority for TVA is not reflected in outlays.
[b] Subtotals may not add due to rounding.
[c] See details in energy chapter.
[d] The CBO fiscal year 1977 current policy projections and all fiscal year 1976 budgets carried the Geological Survey ($0.3 billion) as a separate subfunction (252) within function 250. The President's fiscal year 1977 budget—and all these tables—include the Survey with subfunction 306, and the current policy budget has been adjusted accordingly.
[e] That provided in second concurrent resolution for fiscal year 1976.
[f] Not available on a comparable basis.

SUMMARY TABLE: UNDISTRIBUTED OFFSETTING RECEIPTS (950)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Estimates	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY ESTIMATE [a]								
Function 950 items:								
Employer share, employee retirement (951)	−4.0	−4.1	−1.0	−4.4	−4.7	−5.0	−5.3	−5.6
Interest received by trust funds (952)	−7.7	−8.5	−2.1	−9.0	−9.5	−10.2	−11.0	−12.1
Offshore oil leasing receipts (953)	−2.4	−4.5	−1.3	−1.9	−3.8	−2.1	−2.3	−1.9
Total Current Policy Estimate	**−14.1**	**−17.1**	**−4.4**	**−15.3**	**−18.0**	**−17.3**	**−18.6**	**−19.6**
HIGH RANGE ESTIMATE [b]								
Function 950 items:								
Employer share, employee retirement (951)	−4.0	−4.1	−1.0	−4.4	−4.7	−5.0	−5.3	−5.6
Interest received by trust funds (952)	−7.7	−8.5	−2.1	−9.0	−9.5	−10.2	−11.0	−12.1
Offshore oil leasing receipts (953)	−2.4	−2.8	−0.7	−4.2	−5.7	−2.9	−2.5	−2.2
Total High Range Estimate	**−14.1**	**−15.4**	**−3.8**	**−17.6**	**−19.9**	**−18.1**	**−18.8**	**−19.9**
LOW RANGE ESTIMATE [b]								
Function 950 items:								
Employer share, employee retirement (951)	−4.0	−4.1	−1.0	−4.4	−4.7	−5.0	−5.3	−5.6
Interest received by trust funds (952)	−7.7	−8.5	−2.1	−9.0	−9.5	−10.2	−11.0	−12.1
Offshore oil leasing receipts (953)	−2.4	−2.2	−0.5	−2.8	−4.0	−2.3	−1.7	−1.6
Total Low Range Estimate	**−14.1**	**−14.8**	**−3.6**	**−16.2**	**−18.2**	**−17.5**	**−18.0**	**−19.3**
PRESIDENT'S BUDGET								
Function 950 items:								
Employer share, employee retirement (951)	−4.0	−4.2	−1.0	−4.5				
Interest received by trust funds (952)	−7.7	−8.0	−2.1	−8.4				
Offshore oil leasing receipts (953)	−2.4	−3.0	−0.5	−6.0				
Total President's Budget	**−14.1**	**−15.2**	**−3.6**	**−18.9**				

[a] Offshore oil leasing receipts (953) are projected from the $4.5 billion level for fiscal year 1976 assessed in the second concurrent resolution.

[b] The Congressional Budget Office's best estimate is that the amount of function 950 will lie within these high and low ranges.

PART II-1: PROGRAM ISSUES
SECTION E: GENERAL GOVERNMENT

Introduction

This section focuses on the budgetary significance of the federal work force, the Postal Service, and the provisions in the President's budget for law enforcement (750) and other general government programs (800). The federal work force directly affects the budget through civilian and military pay and civil service and military retirement programs and indirectly through the payments to the Postal Service.

Federal pay and retirement programs are estimated to cost $73.6 billion for fiscal year 1976 (see the following table). During the past decade, such expenditures have declined slightly as a percentage of the total budget. However, if current policies are maintained this trend will be reversed over the next five years; pay would increase at approximately 8.5 percent per year and outlays for military and civilian retirement programs would almost double. The anticipated increase in retirement outlays is attributable to increases in the number of beneficiaries, cost-of-living adjustments, and expected changes in the earnings of retiring employees.

Federal pay determinations are based on the procedures prescribed by the Federal Pay Comparability Act of 1970, which provide generally that federal salaries should be commensurate with private sector salaries for similar types of work. The General Schedule (GS) determines the rates for nearly 77 percent of civilian pay--about $26.9 billion annually--and directly affects military pay as well. Military and reserve salaries linked to the GS pay schedule cost $22.4 billion annually. Decisions on the GS system thus affect civilian and military salaries amounting to $49.3 billion. Each 1 percent change in GS pay rates could increase or decrease the federal budget by $493 million a year. There are other pay systems that govern the wages paid blue-collar workers and some other federal employees. However these systems are not discussed in this report, except under the President's proposals.

The Postal Service is an independent, off-budget establishment. Nevertheless, the Congress does appropriate funds for the service, which in 1975 constituted about 15 percent of the service's revenues. The payment to the Postal Service Fund is intended to reimburse the Postal Service for public service costs and the loss in revenue associated with free and reduced-rate mail. Appropriations have also been made to meet the former Post Office Department's liabilities to the employees' compensation fund and to postal employees for

FEDERAL COMPENSATION, RETIREMENT PROGRAM AND THE POSTAL SERVICE OUTLAYS[a]
FISCAL YEARS 1966, 1976, 1981
(Billions of Dollars)

	1966	1976[b]	1981[b]
Compensation and Retirement			
General Schedule and Related Compensation	$11.5	$26.9	$40.6
Military Personnel Compensation	11.6	22.4	33.7
Wage Board and Other Compensation	4.6	8.0	13.9
Civil Service Retirement	1.7	8.6	16.8
Military Retirement	1.6	7.4	12.8
Other Retirement	NA	0.3	0.5
Total	31.0	73.6	118.3
Percent of Total Outlays	23.0%	19.6%	21.0%
Postal Service	$ 0.9	$ 1.7	$ 1.2

a. Since historically comparable data are not available for some of the categories presented in this table, the figures should be regarded as approximations. The 1976 compensation figures include the annualized cost of the pay increases received during the fiscal year. The Postal Service figure for 1966 represents the federal contribution to the postal fund exclusive of postal revenues.

b. Current policy levels.

NA: not available.

unused annual leave as of June 30, 1971. Personnel compensation and benefits for the 680,000 postal employees represent approximately 88 percent of the Postal Service's total operating expenses.

While budget outlays for the Postal Service appear to have increased moderately over the past decade, historical comparisons are not particularly meaningful because of the changed nature of the system. In 1966 the Post Office Department was included in the budget as an executive department, and federal outlays were equivalent to the difference between postal receipts and total expenditures. Under current policy levels, the payment to the Postal Service will decline gradually from its estimated fiscal year 1976 level of $1.7 billion to $1.2 billion in fiscal year 1981.

The remainder of this section deals with the issues raised by federal pay as illustrated in the General Schedule system, the civilian retirement programs, and the federal payment to the Postal Service. The latter issue has become a concern because the Service has continued to run deficits while having to raise rates. Issues of military pay and retirement are treated in the national security section of this chapter.

Federal Compensation

The Federal Work Force and GS Pay System

Civilian employment in the federal government (including the Postal Service) was 2.9 million in October, 1975; 2.85 million of these employees worked in the executive branch. In 1975 federal civilian employment represented 3 percent of the total civilian work force and 19 percent of all government employment (federal, state, and local). The overall number of federal civilian employees has remained relatively stable since 1970, and, hence, such employment has declined both as a percentage of total civilian employment in the United States and as a percentage of total government employment.

During the period since 1970, there has, however, been a significant shift in the distribution of the federal work force. The civilian employees of the Department of Defense (DoD), who represented 41 percent of all federal civilian employees during the period 1965 to 1970, declined to 37 percent in 1975; the actual number of civilian employees in DoD has decreased by 12.7 percent since 1970. Significant percentage losses also have occurred in the Agency for International Development and the National Aeronautics and Space Administration. The reduction of 151,955 in civilian employment in DoD since 1970 has almost been matched by a gain of 128,657 by HEW, Labor, Treasury, Justice, and the Veterans Administration.

Pay for the federal work force is a topic of increasing public awareness and concern, in part because of the budgetary impact of pay decisions. The current system for determining pay rates on an annual basis dates from the relatively recent Federal Pay Comparability Act of 1970. However, the principles underlying federal pay go back many years. The term "comparability" has come to mean many things to each of the active participants in the federal pay process--the Office of Management and Budget and the Civil Service Commission, the employees and the employee unions, the President, and the Congress. Broadly defined, comparability means that federal salaries should be commensurate with private sector salaries for similar types of work at the same level of responsibility.

Budget Options

The budgetary impact of federal pay policy over the next few years can be illustrated by describing the effects of a number of alternative approaches to determining federal pay. Six options are considered here:

- Retain the present comparability system (current policy) with or without modifications.
- Establish a system of collective bargaining and arbitration.
- Index the level of total changes in compensation to one or more independent economic indicators.
- Continue the 5 percent "cap" on the size of annual adjustments for fiscal years 1977 and 1978.
- Place a two-year moratorium on pay increases.
- Accept the approach taken in the President's budget.

These options, of course, do not represent all possible alternatives nor do they take into account economies which could be realized by reductions in the size of the federal work force. Also, the relative desirability of each option should not be measured solely on the basis of costs involved.

Current Policy. Under the present system, federal civilian and military pay related to the GS system is estimated to increase at an average annual rate of 8.6 percent over the next five years, reaching a level of $74.3 billion by fiscal year 1981 (see the following table). Because of the 5 percent pay "cap" that was placed on federal pay increases in fiscal year 1976, the increase in fiscal year 1977 is expected to be about 12 percent under the current policy option.

FEDERAL PAY BUDGET OPTIONS[a]
FISCAL YEARS 1977 AND 1981
(Billions of Dollars)

Option	1977	1981
Current Policy	55.2	74.3
Changes from Current Policy Level:		
Collective Bargaining	NA	+ 9.0
Indexation	+ 2.2	+ 2.3
Retain 5% "Cap"	- 3.4	- 7.0
Two-Year Moratorium	- 5.9	-13.3
President's Budget	- 3.6	---

a. For greater detail see summary table.

These projections, of course, depend critically on assumptions that must be made concerning economic conditions.

The current policy is not rigidly defined. The criteria used to compare federal pay rates with analogous rates in the private sector allow considerable latitude for judgment in their application. These criteria relate primarily to the design of the Professional, Administrative, Technical, and Clerical Pay (PATC) Survey used in the comparison and to the interpretation of data included therein. Some of the modifications of the present system that would influence the level of pay significantly are listed in the table below. If all of these modifications were made, the cost of federal pay in fiscal year 1977 would be $6 billion over the estimated current policy level.

Collective Bargaining. Extending collective bargaining in the federal government to include compensation would require legislative authorization, and would move the federal government closer to practices followed in the private and nonfederal sectors of the economy. Application of collective bargaining would alter both legal and management authorities significantly but would facilitate comprehensive consideration of salary and "fringe" benefits in a "total compensation" approach.

FIRST-YEAR IMPACT OF CHANGES IN COMPARABILITY CRITERIA
(Civilian and Military Pay)

Criterion	Percent	Cost (billions)
Changes Increasing Compensation		
1. Adopting the employee union proposal to use the fourth pay step of a grade as reference point and a constant percentage differential between grades	+3.3%	+$1.6
2. Increasing the minimum size of establishments surveyed from 250 to 2,500 employees	+8.2%	+$4.0
3. Eliminating the 6-month time lag between the survey date and the effective date of the adjustment	+4.4%	+$2.2
4. Reflecting private sector shorter work week in the computations[a]	+1.8%	+$0.9
Change Decreasing Compensation		
5. Incorporating the secretarial and computer operator occupations in the survey and weighting the survey results for composition of the federal work force[a]	-5.5%	-$2.7

a. The basic data for these computations was provided by the Civil Service Commission. The computations represent one set of assumptions; different combinations would produce different results, such as including employees of state and local governments and nonprofit organizations or reflecting some of the basic structural changes recommended by the President's Panel on Federal Compensation (December, 1975).

It is extremely difficult to predict the impact that collective bargaining would have on federal pay. If under collective bargaining, pay were maintained at the current policy level for fiscal year 1977 and all modifications to the present system listed in the preceding table were included over the next four years, federal outlays for pay would be some $9 billion over the current policy level by fiscal year 1981 (see table on page 347). Of course, only experience can tell whether collective bargaining would in fact result in these changes or others.

Indexation. This approach would relate the amount of pay adjustment to one or more independent economic indicators--such as the Index of Average Hourly Earnings for the Private Non-Farm Economy. Indexation would remove much of the judgment factor from determining the size of the adjustment, thereby avoiding some of the criticisms now directed toward the survey approach. It could eliminate or reduce the six-month lag between the March survey date and the October effective date of the adjustment; but would leave the distribution of the increase among GS grades still to be determined. The indexation approach would require legislative authorization.

If the amount of pay adjustment were tied to the Index of Average Hourly Earnings for the Private Non Farm Economy, and the time lag were eliminated, federal outlays for pay would be about $2 billion higher than the current policy level in fiscal year 1977. In the long run, however, the rate of increase in federal pay would be little different from that under the present system.

The 5 Percent "Cap." This option would continue the 5 percent limit imposed on GS and military pay adjustments in fiscal year 1976 through fiscal year 1978. The two-year period of the "cap" would allow time to develop a "total compensation" approach for adjusting federal pay that would equate to private sector compensation. The adjustments after fiscal year 1978 would be comparable to the rate changes experienced in the private sector. However, the 1978 salary schedule would become the base for rate changes in succeeding years--in other words, no adjustment would be made to compensate for the fact that federal pay levels would fall below those of the private sector during the 1976-78 period. Legislative action may be required to authorize such an approach.

This alternative would reduce GS-related pay outlays by about 6 percent in fiscal year 1977 and 9 percent in fiscal year 1981 (see table on page 347).

Two-Year Moratorium on Pay Increases. This option, even more severe than the five percent "cap," would place a two-year moratorium on pay increases. The rationale for such an alternative probably would be derived from a Congressional determination that circumstances

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in the economy and budget priorities required a concerted effort to hold down the government's payroll costs. This alternative would result in more than a 10 percent reduction in outlays for the civilian and military work force whose pay is related to the GS schedule (see table on page 347).

<u>The President's Proposals</u>. For general schedule and military pay, the President's fiscal year 1977 budget proposals assume an average increase of 4.7 percent, with a minimum increase of 3 percent for the lower grades and a "cap" of 5 percent at the top. The budget assumes that steps will be taken to modify the PATC comparability survey to include data on secretaries and computer operators and that the survey results will be weighted for composition of the work force. The average increase of 6.5 percent that would result from such a change in fiscal year 1977 would be reduced to 4.7 percent by continuing the 5 percent "cap." The effect of these changes would be to reduce outlays by almost $4 billion below the current policy level.

For blue-collar workers, the budget proposes legislation to change certain provisions governing wage board pay rates which purportedly place federal blue-collar workers ahead of their nongovernment counterparts. This would result in pay increases averaging 3.4 percent compared to 9.4 percent in 1975.

The modifications in current pay policy proposed in the President's budget reflect some of the recommendations of the President's Panel on Federal Compensation (Rockefeller Panel). This panel, which released its report in December, 1975, was established to conduct a thorough examination of federal compensation policies and practices. Some of the panel's major recommendations dealing with the issues discussed in this section include:

- The many separate federal civilian pay systems should be reviewed, and combined with other pay systems or eliminated if no longer needed.

- The principle of comparability with the private sector should be reaffirmed as the basis for federal paysetting.

- Consideration should be given to conducting major federal pay surveys less frequently than once a year, with interim adjustments based on an appropriate statistical indicator.

- The principle of comparability should be extended to include benefits as well as pay. Development and testing should take place over the next two years to determine the best approach to implementation.

- The present General Schedule, which covers white-collar employees, should be replaced by a Clerical/Technical Service and a Professional/Administrative/Managerial/Executive Service.

- The Clerical/Technical Service should be paid local or other geographical rates.

- Merit, rather than length of service, should be the principal basis for within-grade pay advancement for employees in the Professional/Administrative/Managerial/Executive Service.

- Federal pay laws should be amended to permit the inclusion of state and local governments in federal pay surveys when needed.

- The President's Agent should continue its efforts to improve the statistical techniques used in the white-collar survey design and pay rate determination processes.

It is important that the federal government be able to attract and retain a high quality work force. Federal pay policy may influence this ability. It is difficult to assess the effect that any of the options discussed in this section would have on the quality of the federal work force. Data presently available do not provide a basis for firm judgments. However, the Rockefeller Panel concluded that "a serious problem of pay compression has developed at senior levels of the General Schedule, the Foreign Service, and the Department of Medicine and Surgery" and that a situation has been created "in which key executives, scientists, engineers, and diplomats are resigning or opting for premature retirement at an alarming rate." This suggests that the current policy or any new system should be monitored carefully for its effect on the quality of the federal work force.

Civilian Retirement

The civil service retirement program provides retirement benfits for the civilian employees of the federal government; these employees are not covered by the social security system. Employees normally are required to contribute 7 percent of their annual salaries. Retirement benefits are based on a complex formula: The federal worker retiring at age 55 after 30 years of service would receive an annuity of about 56 percent of the average of his highest three years' earnings.

Outlays on this program for fiscal year 1976 are estimated to be $8.6 billion--five times what they were a decade earlier. If current policies are maintained, such programs will almost double by fiscal year 1981 (see the following table).

SUMMARY TABLE: CIVIL SERVICE RETIREMENT (602) [a]

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION	7.0	8.6	2.4	10.2	11.8	13.2	15.0	16.8
HIGH OPTION (continue current policy level)	7.0	8.6	2.4	10.2	11.8	13.2	15.0	16.8
MEDIUM OPTION (eliminate 1-percent kicker)	7.0	8.6	2.4	10.1	11.5	12.8	14.4	16.1
LOW OPTION (eliminate 1-percent kicker)	7.0	8.6	2.4	10.1	11.5	12.8	14.4	16.1
PRESIDENT'S BUDGET	7.0	8.4	2.3	10.0	-------	-------	-------	-------

[a] Estimates for civil service retirement and disability fund, excludes retirement estimates for other systems in small accounts under legislative, judicial, labor, and state.

The major budgetary issue with respect to the civil service retirement program relates to the statutory formula that adjusts retirement benefits for increases in the cost of living. Presently the formula includes a 1 percent "kicker" which represents an extra percentage point added to each cost-of-living adjustment. Annuities are increased whenever the Consumer Price Index (CPI) increases by 3 percent and maintains the higher level for three consecutive months. The "kicker" is intended to compensate for the lag between changes in the CPI and the effective date of the annuity increase. Excepting the military retirement program, other federal programs which are indexed for price changes do not provide for such frequent adjustments or have a "catch-up" feature. Social security adjusts once a year, with a five-month lag; food stamps are indexed twice a year, with a five-month lag; and white-collar civilian pay and military pay are adjusted once a year, with a six-month lag.

The President's budget recommends that the cost-of-living adjustments for civilian and military retirement pay be revised to eliminate the 1 percent "kicker." This would require new legislation. While the budgetary impact of such a change would be small in the first year, by 1981 expenditures on civilian retirement would be reduced nearly $700 million below the current policy level (see the following table).

CIVILIAN RETIREMENT BUDGET OPTIONS
FISCAL YEARS 1977 AND 1981
(Billions of Dollars)

Option	1977	1981
Current Policy	10.2	16.8
Changes from Current Policy Level:		
1 Percent Kicker Eliminated	- 0.1	- 0.7

Financing Postal Operations--Alternative Approaches and Their Budgetary Implications

Background. The United States Postal Service was created as an "independent establishment" of the Executive Branch by the Postal Reorganization Act of 1970. The intent of the legislation was to provide a "business-like" environment for postal operations in which postal officials could improve the quality and scope of service while achieving financial self-sufficiency over a period of years. The goal of financial self-sufficiency, as expressed in the act, states: "Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service."

The act also established the formula for determining the amount of subsidy (Congressional appropriation) that was to be provided the Postal Service, and authorized certain activities allowing the Postal Service to operate as a business enterprise. These included collective bargaining and the authority to borrow money and issue and sell obligations. These obligations could be used for both capital investment and operating expenses.

The Nature of Postal Finances. Approximately 84 percent of the Postal Service's total revenue comes from postage and certain other fees. Appropriations constitute 15 percent of total revenue, with investment income providing the remainder. First class and air mail represent more than half of the mail volume and almost half of the total revenue (see the following table).

The subsidies appropriated to the Postal Service are of two principal types: (1) a "public service" reimbursement for postal operations which are not deemed self-sustaining, primarily post offices in small or rural communities ($920 million in fiscal year 1975); and (2) "revenue lost or foregone" reimbursements for providing mail service at reduced rates to newspaper and magazine publishers; shippers of books, records, and certain other fourth class mail; and nonprofit organizations. It also reimburses the Postal Service for free mail, such as that for blind and handicapped persons. The total appropriation in fiscal year 1975 for this category was $613 million. In addition, the Postal Service is authorized transitional appropriations which have been requested to meet the liabilities of the former Post Office Department to the Employees' Compensation Fund and to postal employees for unused leave as of June 30, 1971.

REVENUE AND MAIL VOLUME BY CLASS OF MAIL
(Fiscal year 1974)

Source of Revenue	Percent of Mail Volume	Portion of Revenue Dollar
1st Class and Air Mail	58.8	.489
3rd Class Mail	25.0	.113
4th Class Mail	1.0	.067
Government Mail	3.5	.044
Priority Mail	.2	.037
International Mail	1.0	.032
2nd Class Mail	9.8	.019
Controlled Circulation Mail	.7	.004
Special Services and Other Income	-	.003
Subtotal	100.0	.838
Appropriations	---	.153
Investment Income	---	.009
Total	100.0	1.000

The Postal Reorganization Act authorizes the Postal Service to borrow money and issue and sell obligations. The Act sets a limit of $10 billion on the aggregate amount of such obligations. It also limits the net annual increase in the amount of obligations outstanding to $1.5 billion for capital improvements and $500 million for operating expenses. On the expense side of the ledger, personnel compensation and benefits totaled $11.2 billion in fiscal year 1975, representing approximately 88 percent of total operating expenses. Transportation was the next largest item, at about $1 billion or 7 percent of expenses.

Issues. The Postal Service has experienced an operating deficit in each of its five years of operation. The amount of the deficit has grown rapidly, increasing from $175 million in fiscal year 1972, its first year of operation, to an estimated $1.3 billion in fiscal year 1976 (see following table). The accumulated deficit at the end of fiscal year 1976 is estimated to be $2.9 billion.

Increased costs of personnel compensation and benefits and the lack of growth in mail volume are the major factors which contributed to the large differences between expected and actual financial results. Under the policy set forth in the 1970 act, compensation and benefits are to be maintained "on a standard of comparability to the compensation and benefits paid for comparable levels of work in the

FINANCIAL HISTORY OF THE U.S. POSTAL SERVICE,
FISCAL YEARS 1972-76
(Millions of Dollars Unless Otherwise Indicated)

	1972	1973	1974	1975	1976 (est.) (Billions)
Expenses	9,530	9,853	11,215	12,671	14.2
Less: Revenue and Other Income	7,993	8,463	9,140	10,149	11.3
Accrued Net Expenses	1,537	1,390	2,075	2,522	2.9
Less: Appropriations[a]	1,361	1,377	1,637	1,533	1.6
Net Income or Loss	-175	- 13	-438	-989	-1.3
Accumulated Deficit	-175	-188	-627	-1,616	-2.9

Source: U.S. Postal Service.

a. Does not include appropriation for nonfunded liabilities.

private sector of the economy." The collective bargaining process is used for most employees. During the period from fiscal years 1971 to 1975 personnel compensation and benefits increased 51 percent, from \$7.4 billion to \$11.2 billion. Personnel costs will continue to increase during the period covered by the current labor agreement with the postal unions that runs through July 20, 1978. This agreement now provides for fixed-dollar increases each year (approximately 12 percent over the three-year period) plus a cost-of-living adjustment based on the CPI.

Mail volume is sensitive to economic conditions (three-fourths being originated by businesses) and, in the short run, to postal rate increases. In the 1970s economic downturns and rate increases slowed volume growth and made accurate volume forecasting more difficult. The increasing mail volumes projected at the inception of the U.S. Postal Service have not materialized. Mail volume, which was projected by the Postal Service to reach 110 billion pieces by 1975, has been averaging 90 billion pieces per year. This situation is significant because revenues were overestimated in projecting the postal rate requirements in each of the first four years of the

Postal Service's existence. Thus, the Postal Service experienced a $474 million accumulated shortfall in revenues during the period.

Financing Postal Operations--The Current System and Some Alternatives

It is difficult to discuss financing alternatives without examining the differing policy positions which became manifest before the Congress enacted the Postal Reorganization Act of 1970. Debate still continues on the "public service" vis-a-vis the "business" aspects of postal operations and alternative cost allocations between taxpayers and mailers. Under the Congressionally mandated goal of self-sufficiency, the Postal Service is required by law to operate with rates which will cover expenses in excess of subsidies.

Other countries pay higher rates; first class stamps cost 19 cents in West Germany and the Netherlands and 20 cents in Sweden. In the United States recent economic conditions adversely affecting mailers, the Postal Service, and the taxpayers, have resulted in renewed demands for the Congress to hold down postage rates by increasing subsidies. Thus, the Congress is being asked to reconsider the arguments on financing postal operations. Each of the following options depicts both the budgetary implications and the cost of first class postage of a different financing approach.

Continue Present Financing Arrangements. If the basic system for financing postal operations provided by the Postal Reorganization Act remains unchanged, the federal appropriation will decline steadily but postage rates will have to rise substantially (see the following table). The Postal Service's projected increases in first class postage are based on the following assumptions:

- Appropriations will remain at the levels provided under current law.
- There will be no major changes in service levels.
- Personnel compensation for fiscal years 1976 to 1978 is based on the provisions of the current labor contract; for fiscal years 1979 to 1981 it increases at a rate equal to 1 percent greater than the projected increase in the CPI.
- There will be no major cost reduction or productivity gains.
- Postal rates are set at a level that will eliminate the accumulated deficit.

POSTAL SERVICE APPROPRIATIONS BUDGET OPTIONS AND FIRST CLASS POSTAGE RATES

Options	Appropriations [a] (billions of dollars)					1st class postage (cents)				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
CURRENT SYSTEM:										
Continue Self-sufficiency	$1.7	$1.6	$1.5	$1.3	$1.2	17¢	17¢	19¢	19¢	21¢
ALTERNATIVE 1:										
Eliminate the Existing Deficit Now With Congressional Appropriation	5.1	1.6	1.5	1.3	1.2	16	16	18	20	21
ALTERNATIVE 2:										
Increase Dependence on Congressional Appropriations [b]	2.6	3.5	4.4	5.1	6.2	13	13	13	13	13
PRESIDENT'S BUDGET	1.4					[c] 17				

[a] Does not include appropriations for nonfunded liabilities.

[b] Does not include funds for recovery of accumulated deficit.

[c] If the President's proposal to deny funds for extended phasing for reduced-rate mail is accepted, there would be rate increases in other than first class postage.

Source: Cost data for the options were provided by the U.S. Postal Service

Eliminate the Deficit Now. One possible alternative is a variation of the current financing approach. It would involve "wiping the slate clean" by a one-time appropriation in fiscal year 1977 to eliminate the present accumulated deficit which is estimated to be \$3.4 billion at the start of fiscal year 1977. The public service and revenue foregone subsidies would continue as presently provided. This alternative would preclude the need for an allowance in future postage rates to recover the present deficit.

Under both the current system and this option, improvements in the rate-making process could be instituted which would reduce the time lags so that rates could reflect current economic conditions more accurately.

Increase Dependence on Congressional Appropriations. This alternative would require a basic change in policy under which the Congress would shift a significant proportion of the cost burden of postal operations from the mailers to the general taxpayers. Under this alternative the increased appropriations would permit a stabilization of first class and other postage rates at their current levels. The Postal Service projects a modest increase in mail volume on the basis that the stabilized rates would become competitive relative to alternative means of communication. Under this alternative, appropriations would have to increase to \$6.2 billion by fiscal year 1981--\$5 billion over the current policy level.

The President's Proposals. The federal payment to the postal service fund in fiscal year 1977 would be \$1,458 million. The President's proposed payment to the Postal Service does not include \$307 million for the extended phasing of postal increases for reduced-rate mail as provided by Public Law 93-328, approved June 30, 1974.

A Word about Cost Reductions

While significant savings could be realized by major cost reductions in postal operations, such savings would not be sufficient by themselves to eliminate the need for rate increases. However, these cost reductions could help lessen the financial burden on postal operations. Institution of some of them would be highly unpopular; others would require changes in law, union contracts, or regulation. An inventory of some of the major possibilities is provided in the following table.

MAJOR POSSIBLE COST REDUCTIONS IN POSTAL OPERATIONS

Activity	Current Practice	Cost Reduction	Approximate Annual Savings (Millions of Dollars)
Delivery to remote places	Generally 6 days per week	Reduce to 2 days per week	$400
All other delivery	6 days per week	Reduce to 5 days per week	$250
Small post offices	12,220 3rd class	Reduce to 6,000	$ 68
	6,241 4th class	Eliminate	$ 62
Larger post offices	Maintain	Close or consolidate 2,000 for economic reasons	$ 30
		Total	$810

Source: Comptroller General of the United States; letter to Edward J. Derwinski, B-114874 (October 9, 1974)

Other General Government (Function 800) and Law Enforcement (Function 750)

Amounts requested in the President's fiscal year 1977 budget for other general government programs are slightly less than estimates for fiscal year 1976 (-$86 million in Budget Authority and -$114 million in outlays). The most significant decreases in budget authority occur in amounts for trust territories (-$73 million), the Treasury Department (-$21 million, with most attributable to the Internal Revenue Service), and the General Services Administration (-$35 million, primarily operating expenses for supply activities). For property management, new GSA building construction would remain at approximately the same level ($28.1 million in fiscal year 1977 compared to $30.2 million for fiscal year 1976). However, for repair and alteration of existing buildings, there would be a 40 percent reduction in new authority ($105 million in 1976 to $60.7 million in 1977). The general government estimates for the Civil Service Commission remain level at $114 million.

Resources for law enforcement and justice would remain at the fiscal year 1976 level. However, there are some significant changes in program content. Appropriations requested for law enforcement assistance to state and local governments would be reduced by $98 million; requests for federal judicial and correctional activities would increase by approximately $114 million. Federal law enforcement and prosecution activities would remain essentially at fiscal year 1976 levels.

Overall, the President's requests in general government and law enforcement areas are below the levels needed to maintain current policy, that is the level of current services adjusted for inflation.

SUMMARY TABLE: IMPACT OF PAY ALTERNATIVES ON CURRENT POLICY BASE [a]

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
HIGH OPTION (comparability system without change):								
National defense (051)	NA	NA	NA					
Civilian agencies	NA	NA	NA					
Total High Option								
MEDIUM OPTION (comparability system with changes decreasing compensation):								
National defense (051)	NA	NA	NA	−1.7	−1.9	−2.1	−2.2	−2.3
Civilian agencies	NA	NA	NA	−1.0	−1.1	−1.1	−1.3	−1.3
Total Medium Option				**−2.7**	**−3.0**	**−3.2**	**−3.5**	**−3.6**
LOW OPTION (continue 5-percent cap for fiscal year 1977 and fiscal year 1978):								
National defense (051)	NA	NA	NA	−2.2	−3.6	−3.9	−4.2	−4.4
Civilian agencies	NA	NA	NA	−1.2	−2.0	−2.2	−2.4	−2.5
Total Low Option				**−3.4**	**−5.6**	**−6.1**	**−6.6**	**−6.9**

[a] Figures are increments from current policy base. For choice of any option, increments should be added to or subtracted from current policy base estimates for pay under national defense agencies (051) and the consolidated civilian agency pay allowances respectively.

SUMMARY TABLE: U.S. POSTAL SERVICE (402)

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION	1.9	1.7	0.4	1.7	1.6	1.5	1.3	1.2
HIGH OPTION (increase subsidy)	1.9	1.7	0.4	2.6	3.5	4.4	5.1	6.2
MEDIUM OPTION (eliminate deficit)	1.9	1.7	0.4	5.1	1.6	1.5	1.3	1.2
LOW OPTION (continue current policy option)	1.9	1.7	0.4	1.7	1.6	1.5	1.3	1.2
PRESIDENT'S BUDGET	1.8	1.7	0.4	1.5				

NOTES.—These estimates are carried under Function 400, commerce and transportation. Estimates for fiscal years 1977–81 do not include appropriations for nonfunded liabilities.

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SUMMARY TABLE: GENERAL GOVERNMENT AND LAW ENFORCEMENT

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
CURRENT POLICY OPTION								
750 Law enforcement	2.9	3.4	0.9	3.7	3.9	4.0	4.2	4.5
800 General government	3.1	3.3	0.9	3.6	3.8	4.0	4.3	4.7
Total Functions 750, 800	**6.0**	**6.7**	**1.8**	**7.3**	**7.7**	**8.0**	**8.5**	**9.2**
Plus carried elsewhere:								
Payment to Postal Service (402)	1.9	1.7	0.4	1.7	1.6	1.5	1.3	1.2
Civil service retirement (602)	7.0	8.6	2.4	10.2	11.8	13.2	15.0	16.8
Defense pay allowance (051)	NA	1.4	0.5	4.9	4.2	4.2	3.9	4.1
Civilian pay allowance	NA	0.8	0.1	2.2	1.9	1.9	1.8	1.8
Total Current Policy Option	**14.9**	**19.2**	**5.2**	**26.3**	**27.2**	**28.8**	**30.5**	**33.1**
HIGH OPTION								
750 Law enforcement	2.9	3.4	0.9	4.1	4.4	4.7	5.0	5.4
800 General government	3.1	3.0	0.9	3.6	3.8	4.0	4.3	4.7
Total Functions 750, 800	**6.0**	**6.7**	**1.8**	**7.7**	**8.2**	**8.7**	**9.3**	**10.1**
Plus carried elsewhere:								
Payment to Postal Service (402)	1.9	1.7	0.4	2.6	3.5	4.4	5.1	6.2
Civil service retirement (602)	7.0	8.6	2.4	10.2	11.8	13.2	15.0	16.8
Defense pay allowance (051)	NA	1.4	0.5	4.9	4.2	4.2	3.9	4.1
Civilian pay allowance	NA	0.8	0.1	2.2	1.9	1.9	1.8	1.8
Total High Option	**14.9**	**19.2**	**5.2**	**27.6**	**29.6**	**32.4**	**35.1**	**39.0**

SUMMARY: GENERAL GOVERNMENT AND LAW ENFORCEMENT—Continued

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
MEDIUM OPTION								
750 Law enforcement	2.9	3.4	0.9	3.7	3.9	4.0	4.2	4.5
800 General government	3.1	3.3	0.9	3.6	3.8	4.0	4.3	4.7
Total functions 750, 800	**6.0**	**6.7**	**1.8**	**7.3**	**7.7**	**8.0**	**8.5**	**9.2**
Plus carried elsewhere:								
Payment to Postal Service (402)	1.9	1.7	0.4	5.1	1.6	1.5	1.3	1.2
Civil service retirement (602)	7.0	8.6	2.4	10.1	11.5	12.8	14.4	16.1
Defense pay allowance (051)	NA	1.4	0.5	3.2	2.3	2.1	1.7	1.8
Civilian pay allowance	NA	0.8	0.1	1.2	0.8	0.8	0.5	0.5
Total Medium Option	**14.9**	**19.2**	**5.2**	**26.9**	**23.9**	**25.2**	**26.4**	**28.8**
LOW OPTION								
750 Law enforcement	2.9	3.4	0.9	3.7	3.8	3.9	4.1	4.4
800 General government	3.1	3.3	0.9	3.6	3.8	4.0	4.3	4.7
Total functions 750, 800	**6.0**	**6.7**	**1.8**	**7.3**	**7.6**	**7.9**	**8.4**	**9.1**
Plus carried elsewhere:								
Payment to Postal Service (402)	1.9	1.7	0.4	1.7	1.6	1.5	1.3	1.2
Civil service retirement (602)	7.0	8.6	2.4	10.1	11.5	12.8	14.4	16.1
Defense pay allowance (051)	NA	1.4	0.5	2.7	0.6	0.3	−0.3	−0.3
Civilian pay allowance	NA	0.8	0.1	1.0	−0.1	−0.3	−0.6	−0.7
Total Low Option	**14.9**	**19.2**	**5.2**	**22.8**	**21.2**	**22.2**	**23.2**	**25.4**

SUMMARY: GENERAL GOVERNMENT AND LAW ENFORCEMENT—Continued

OUTLAYS

[Billions of dollars, fiscal years, path B]

Options	1975 actual	1976 estimated	Transition quarter	1977	1978	1979	1980	1981
PRESIDENT'S BUDGET								
750 Law enforcement	2.9	3.4	0.9	3.4				
800 General government	3.1	3.5	1.0	3.4				
Total Functions 750, 800	**6.0**	**6.9**	**1.9**	**6.8**				
Plus carried elsewhere:								
Payment to Postal Service (402)	1.9	1.7	0.4	1.4				
Civil service retirement (602)	7.0	8.4	2.3	10.1				
Defense pay allowance (051)	NA	NA	NA	1.4				
Civilian pay allowance	NA	NA	NA	0.8				
Total President's Budget	**14.9**	**17.0**	**4.6**	**20.5**				

In theory, spending options for federal programs can be combined any number of ways to raise federal spending above current policy levels, lower it, or maintain roughly the same level. But in practice shifts of any great magnitude are difficult to make in one year, since much of a current year's spending is dictated by past decisions, and new programs take time to implement. For example, some major new initiatives require long lead times. A restructuring of the welfare system must be designed and made operational over several years. Similarly, deployment of a complex new weapons system frequently requires a decade or more, starting with research and development. Thus, decisions made one year will significantly affect the range of choice available to Congress in future years.

It is very difficult to combine specific choices about next year's budget with more general choices about the less certain future. To illustrate what budgets so constructed might look like, CBO has combined spending options into hypothetical five-year budgets. It must be emphasized that these combinations were selected simply for purposes of example; these and other options could be combined in a variety of ways.

The first hypothetical budget is based on a combination of all the high options; the second, on the low options. Together, these define the limits of probability. The other three hypothetical combinations illustrate ways in which budgets could be constructed to give more emphasis to national security, reform and enlargement of social welfare programs, or decentralization of responsibility to the private sector and state and local governments.

Illustrative Budgets

High and Low Options

A very high spending budget, involving major federal initiatives in defense, energy, transportation, agriculture, and virtually all social programs,[1] would substantially increase federal spending by 1981 not only in dollars, but also as a portion of GNP. If this budget were adopted, federal spending would account for 24 percent of GNP, as compared to

1. The high option selected for health care is a combination of expanded health care financing through catastrophic health insurance and the federalization of medicaid. This is not the highest option.

21 percent if current policies were extended to 1981.[2] This high budget probably would require tax increases to keep from setting off significant inflation.

If all the low options were combined in an austere spending budget, taxes would have to be cut to maintain economic growth at a 5 percent annual rate; deeper cuts would be required to effect a 6 percent annual rate. Federal spending would decline as a percent of GNP from 21 to 19 percent.

Outlays under the high option budget would be $452.7 billion in fiscal year 1977, compared to $398.0 under the low option budget. By 1981, the gap would widen to about $141 billion, with the high option budget requiring outlays of $662.8 billion, and the low option budget, $521.7 billion (see following table).

HIGH AND LOW OPTION BUDGETS
FISCAL YEARS 1977-81
(Billions of Dollars)

Outlays	1977	1978	1979	1980	1981
High Option Budget	$452.7	$504.5	$561.9	$612.9	$662.8
Low Option Budget	398.0	424.1	456.1	487.7	521.7

National Security Emphasis

One possible view of the proper role of the federal government is that it should be narrowly defined to the promotion of private commerce and the provision of national security. Implicit in this view would be pessimism about the prospects for peace and a belief that the federal government intrudes too deeply into the lives of its citizens. In programmatic terms, such a strategy could entail:

- A substantial increase in defense programs.
- Increased federal initiatives in energy R&D, technology demonstration, incentives for commercialization of energy production, and increased resource development program support.

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2. Expressing federal spending as a percent of GNP overstates the government's share, since much of the spending is for transfer programs. For purposes of comparison here, however, the overstatement is not important.

- Decontrol and deregulation of private markets.

- Curtailment of most human resource programs, including aid to state and local governments.

These program options and outlays for the different functions are detailed in the following two tables. This budget would fall below current policy budget levels (path B) by $9.7 billion in fiscal year 1977 and $12.0 billion above in fiscal year 1981, and account for about the same percentage of GNP. Thus, if this budget were adopted, tax cuts might be called for to maintain economic growth at a 5 percent rate and deeper cuts for a 6 percent rate.

This budget initially reduces spending below current policy levels and stimulates the economy through tax cuts, and later through government spending and tax cuts. Therefore, it preserves a wide margin of future budget discretion. For example, instead of additional tax cuts in fiscal year 1980 or 1981, Congress would be free to adopt new spending initiatives, without disrupting programs initiated in fiscal year 1977.

Concentrating Federal Resources on Social Programs

Another view of the future might be that the nation's security is not fundamentally threatened and that the primary role of the federal government is to promote the public welfare. Inherent in this view would be a belief that nuclear deterrence is basically stable and could be achieved with less redundancy in delivery systems; that the United States has vital security interests at stake in relatively few areas of the world; and that security mainly rests in a healthy economy and the well-being of citizens. Concentration of federal resources on domestic programs would permit major reforms to make the delivery of social services more equitable and efficient.

Programmatically, this view would entail:

- Enlargement of temporary antirecession programs--such as public service employment, accelerated public works, and countercyclical revenue sharing--until unemployment is substantially reduced.

- Larger and more comprehensive social welfare programs--in particular, incorporating aid to families with dependent children, food stamps, housing assistance, and other income assistance programs into an integrated cash assistance program and establishing a targeted expansion of health care financing through catastrophic health insurance and federalization of medicaid.

EMPHASIS ON NATIONAL SECURITY

A. Expansion and Modernization of the Armed Forces

--Begin to expand the Navy toward 600 ships.
--Fully equip and modernize the Army's 16 divisions.
--Equip 26 Air Force and 13 Navy wings with modern aircraft.
--Increase military R&D by 10 percent.
--Procure the B-1 bomber, an air-launched cruise missile, and an advanced, mobile ICBM.
--Phase down foreign assistance to nominal levels.

B. Decontrol and Deregulate Private Markets, Increase Levels of Federal Support for Energy, Natural Resource Development, and General Science Programs; Maintain Transportation and Agriculture Programs at Current Levels

--Increase flexibility and efficiency of the national transportation system, through changes in regulation; maintain current level of support for federal-aid highways, aviation programs, rail, mass transit, water, and other transportation programs.
--Stimulate major industrial adjustment to constrained energy markets, by increasing federal initiatives in energy R&D and technology demonstration, providing incentives for commercialization of energy research and production, phased decontrol and deregulation of domestic energy markets, and increasing support for other resource development programs.
--Maintain present price support system in agriculture.
--Increase federal support for general science and space technology.

C. Curtail Most Human Resources Programs, Including Aid to State and Local Governments

--Reduce educational support, especially general support for institutions.
--Cut employment programs and unemployment compensation by $2.6 billion.
--Decrease income assistance to those less poor and limit assistance to those most in need.
--Reduce federal cost growth for categorical health services programs and install cost-sharing system in medicare and medicaid programs.
--Reduce federal support for low-income housing; establish limit on mortgage interest and property tax deductions from taxable income.
--Maintain current veterans' programs.
--Limit funding for general revenue sharing and block grants; eliminate or greatly reduce categorical programs which aid state and local governments.

D. Lower General Government Costs by Modifying Retirement Systems and Maintaining the Present Self-Sufficiency Goal of the Postal Service

--Eliminate 1 percent retirement kicker.
--Maintain present comparability system for civil service pay.
--Continue present system of limited federal support to the Postal Service.

E. Tax Cuts, Stressing Corporate Incentives to Increase Private Investment

EMPHASIS ON NATIONAL SECURITY

OUTLAYS

[Billions of dollars, fiscal years, path B]

	Function	1977	1978	1979	1980	1981
050	National Defense	106. 1	118. 7	131. 1	144. 6	157. 8
150	International Affairs	6. 6	6. 4	5. 8	4. 9	3. 9
250	General Science, Space, and Technology	4. 8	5. 4	6. 1	6. 7	7. 5
300	Natural Resources, Environment, and Energy	15. 5	19. 7	24. 4	25. 1	25. 7
350	Agriculture	2. 3	2. 5	2. 6	2. 7	2. 8
400	Commerce and Transportation	17. 9	18. 5	19. 0	19. 5	20. 0
450	Community and Regional Development	7. 2	7. 6	8. 0	7. 6	7. 9
500	Education, Training, Employment, and Social Services	17. 8	18. 6	18. 9	19. 5	19. 9
550	Health	36. 2	39. 2	42. 5	45. 8	49. 0
600	Income Security	141. 7	155. 0	167. 4	178. 9	190. 2
700	Veterans' Benefits and Services	18. 7	19. 3	19. 8	20. 4	21. 1
750	Law Enforcement and Justice	3. 7	3. 8	3. 9	4. 1	4. 4
800	General Government	3. 6	3. 8	4. 0	4. 3	4. 7
850	Revenue Sharing and General Purpose Fiscal Assistance	6. 0	4. 8	3. 6	2. 3	1. 1
900	Interest	41. 4	48. 9	57. 2	66. 7	77. 3
	Allowances	2. 2	1. 9	1. 9	1. 8	1. 8
950	Undistributed Offsetting Receipts	−16. 9	−19. 1	−17. 8	−18. 4	−19. 6
	Total	**414. 8**	**455. 0**	**498. 4**	**536. 5**	**575. 5**

- Reduction in the size and capabilities of the armed forces.

- Decontrol and deregulation of private industry, moving more toward competitive markets insulated somewhat from international commodity shortages.

- Investment in public transportation.

The specific options assembled for this budget and the outlays required for each function are shown in the following tables.

Spending for this budget would exceed the current policy budget in fiscal year 1977 by $9.9 billion and by about $40.7 billion in fiscal year 1981. It might allow tax cuts by 1981 to maintain either a 5 or 6 percent rate of economic growth. It would account for a slightly larger proportion of GNP than the current policy budget.

This budget would commit substantial future budget outlays. Entitlement programs--such as those typically found in human resources activities--are difficult to change once begun. Thus, if this option were adopted, the Congress would limit its future flexibility to start other new programs without tax increases or cuts in existing programs.

Returning Control to State and Local Government and the Private Sector

A third view of the future might stress the need to reduce the concentration of decision-making power in the federal government, relying instead on state and local governments and on more autonomous (and competitive) private markets. Implied in this position would be the belief that present spending for national defense programs is at about the right level and that revitalized industry is the best means for further contribution to the nation's security. Also consistent with this view would be a concern that federal control of social programs results in waste, inequity, and ineffectiveness, and that state and local governments are better able to allocate resources among social service programs.

The programmatic options included in this budget and the required outlays are listed in the following tables. They stress:

- Increased federal investment in energy and related programs.

- Deregulation of business and provision of incentives to increase investment and stimulate innovation.

- Reduction of federal payments to individuals, but expansion of aid to states and localities and a shift of program control to them.

EMPHASIS ON SOCIAL PROGRAMS

A. Reduction in the Size and Capabilities of the Armed Forces

--Cut back shipbuilding to reduce fleet toward 400 ships.
--Reduce the Army's personnel strength by 37,000 spaces and cut its divisions to 13.
--Reduce tactical air wings to 22 in the Air Force and 10 in the Navy.
--Reduce strategic nuclear missile launchers to about 2,000; eliminate B-1 and Titan II, procure air-launched cruise missiles and fewer TRIDENT submarines; develop less expensive alternative to TRIDENT.
--Maintain foreign aid at current levels.

B. Decontrol and Deregulate Private Markets, Increase Federal Support for Public Transportation, Maintain Current Levels of Federal Support for Energy, Natural Resource Development, and Environmental Programs

--Increase flexibility and efficiency of the national transportation system, through changes in regulation, increased support for federal-aid highways, aviation programs, rail and mass transit.
--Establish domestic grain reserve.
--Maintain present level of federal support for energy, scientific R&D, space technology, other resource development and environmental programs.

C. Reform and Expand Human Resources Programs to Provide More Equity in Coverage, Reduce Benefit Overlaps, and Shift to Cash Assistance Where Warranted

--Add to employment-creating programs such as accelerated public works, countercyclical revenue sharing, and public service employment.
--Shift income assistance programs to comprehensive income-conditioned cash assistance program.
--Establish a catastrophic illness health insurance plan and federalize medicaid.
--Maintain present support for low income housing.
--Conform veterans assistance to other civilian program benefits.
--Maintain present level of aid to state and local governments, but shift mix toward general revenue sharing and away from categorical programs.

D. Increase General Government Spending by Increasing Postal Service Subsidy and Maintaining Present Pay Comparability and Retirement Systems

--Continue present retirement system.
--Maintain present comparability system for military and civil service pay.
--Increase Postal Service subsidy.

E. Tax Cuts Focused Mainly on Increasing Personal Income

EMPHASIS ON SOCIAL PROGRAMS

OUTLAYS

[Billions of dollars, fiscal years, path B]

	Function	1977	1978	1979	1980	1981
050	National Defense	100.5	109.4	116.7	126.1	135.9
150	International Affairs	6.8	7.8	8.5	9.3	9.9
250	General Science, Space, and Technology	4.7	5.1	5.4	5.6	5.7
300	Natural Resources, Environment, and Energy	14.5	16.1	16.3	15.6	15.2
350	Agriculture	2.3	2.9	3.1	3.2	3.0
400	Commerce and Transportation	21.7	25.5	27.7	30.2	32.3
450	Community and Regional Development	12.4	12.5	12.4	12.8	13.3
500	Education, Training, Employment, and Social Services	23.8	24.6	25.3	25.1	26.7
550	Health	42.8	50.8	58.8	67.6	77.7
600	Income Security	144.8	156.5	169.2	181.8	194.2
700	Veterans' Benefits and Services	18.7	19.1	19.4	19.9	20.7
750	Law Enforcement and Justice	3.7	3.9	4.0	4.2	4.5
800	General Government	3.6	3.8	4.0	4.3	4.7
850	Revenue Sharing and General Purpose Fiscal Assistance	7.3	7.6	7.8	8.0	8.2
900	Interest	41.5	48.4	55.4	62.7	70.0
	Allowances	2.2	1.9	1.9	1.8	1.8
950	Undistributed Offsetting Receipts	−16.9	−19.1	−17.8	−18.4	−19.6
	Total	**434.4**	**476.8**	**518.1**	**559.8**	**604.2**

EMPHASIS ON RETURNING CONTROL TO STATE AND LOCAL GOVERNMENTS AND THE PRIVATE SECTOR

A. Maintain Current Real Levels of Military Expenditure

--Maintain about a 480-ship Navy with some increase in average age.
--Maintain current size of the Army and defer some reequipment.
--Maintain 22 Air Force understrength tactical air wings and 13 Navy wings.
--Modernize the strategic forces at a slower rate than proposed by the President.
--Maintain foreign aid at current levels.

B. Stimulate Public and Private Capital Formation and Promote Energy Independence

--Act to increase flexibility and efficiency of the national transportation system, through changes in regulation, increased support of federal-aid highways, aviation programs, rail and mass transit.
--Stimulate major industrial adjustment to constrained energy markets, by increasing federal initiatives in energy R&D and technology demonstration, providing incentives for commercialization of energy research and production, and phased decontrol and deregulation of domestic energy markets.
--Increase level of agricultural price support programs.
--Increase federal support to general science, space technology, and environmental programs.

C. Curtail Most Human Resources Programs, Expand Aid to State and Local Governments

--Reduce educational support, especially general support for institutions.
--Cut employment-creating and increasing programs, and unemployment compensation by $2.6 billion.
--Decrease income assistance to those less poor by targeting eligibility criteria to those most in need.
--Reduce federal cost growth for categorical health services programs and install cost-sharing system in medicare and medicaid programs.
--Increase federal support for homeownership and housing construction programs.
--Conform veterans assistance to other civilian program benefits.
--Expand funding for general revenue sharing and block grants; eliminate or greatly reduce categorical programs which aid state and local governments.

D. Modify General Government Spending by Raising Postal Service Subsidy, Reforming Retirement Systems, and Reducing Federal Pay

--Eliminate 1 percent retirement kicker.
--Continue 5 percent cap on military and civil service pay for fiscal year 1977 and fiscal year 1978.
--Increase Postal Service subsidy.

E. Tax Cuts Focused Primarily on Investment Incentives in Energy and Related Fields

EMPHASIS ON RETURNING CONTROL TO STATE AND LOCAL GOVERNMENTS AND THE PRIVATE SECTOR

OUTLAYS

[Billions of dollars, fiscal years, path B]

	Function	1977	1978	1979	1980	1981
050	National Defense	101. 2	110. 9	114. 1	123. 0	131. 2
150	International Affairs	6. 8	7. 8	8. 5	9. 3	9. 9
250	General Science, Space, and Technology	4. 8	5. 4	6. 1	6. 7	7. 5
300	Natural Resources, Environment, and Energy	15. 5	19. 7	24. 4	25. 1	25. 7
350	Agriculture	2. 5	4. 4	5. 6	5. 8	5. 4
400	Commerce and Transportation	23. 1	27. 7	30. 5	33. 6	36. 2
450	Community and Regional Development	8. 0	8. 8	9. 8	10. 2	10. 9
500	Education, Training, Employment, and Social Services	17. 8	18. 6	18. 9	19. 5	19. 9
550	Health	36. 2	39. 2	42. 5	45. 8	49. 0
600	Income Security	141. 7	155. 0	167. 4	178. 9	190. 2
700	Veterans' Benefits and Services	18. 7	19. 1	19. 4	19. 9	20. 7
750	Law Enforcement and Justice	4. 1	4. 4	4. 7	5. 0	5. 4
800	General Government	3. 6	3. 8	4. 0	4. 3	4. 7
850	Revenue Sharing and General Purpose Fiscal Assistance	12. 6	13. 4	17. 0	19. 1	20. 7
900	Interest	41. 4	48. 7	55. 0	64. 0	72. 1
	Allowances	1. 0	−0. 1	−0. 3	−0. 6	−0. 7
950	Undistributed Offsetting Receipts	−16. 9	−19. 1	−17. 8	−18. 4	−19. 6
	Total	**422. 1**	**467. 7**	**509. 8**	**551. 2**	**589. 2**

Outlays would be $2.4 billion below current policy levels in fiscal year 1977 and $25.7 billion above current policy levels in fiscal year 1981; and would represent about the same percentage of GNP. Small tax cuts would be necessary for either a 5 or 6 percent rate of economic growth. Since one emphasis of this budget would be on capital investment, tax cuts might be designed to increase investment incentives.

Future Congressional flexibility would be somewhat reduced by the adoption of this national strategy. If Congress were to decide in fiscal year 1978, for example, that additional resources were required to protect national security, the price might well be cuts in other programs or a tax increase.

Conclusion

There is no simple way to link the immediate, hard decisions required in the fiscal year 1977 budget with the more uncertain and discretionary possibilities in the future. Unpredictable events and the capricious behavior of a complex economy can be depended upon to frustrate any attempt to plan the future in detail.

Nor is there any magic in either the underlying philosophies or the spending totals of the three budgets presented here. Each was devised as an illustration of the spending implications of a relatively "pure" philosophy, moderated only by the evolutionary character of the options. Many other possibilities exist, and the Congress will undoubtedly assemble its own.

But it is extremely difficult to weigh the competing demands of short-term fiscal policy, individual program decisions, long-term economic growth, and price stability against conceptions about broad national priorities. The budgets presented in this chapter were designed to illustrate how competing demands might logically be accommodated in different ways.

Introduction

The income tax system is not just simply a method for raising part of the federal revenues. By creating special tax provisions, the government also has sought to encourage people to do certain things, for example, to give to charity or to buy business machinery, and to help people in special cases, such as the blind or those with unusually high medical expenses.

The encouragement or the help, as the case may be, takes the form of a reduced income tax liability. The amount of the reduction from the "normal" tax owed has come in recent years to be called a tax expenditure. In theory, at least, the government could have collected the full tax and used some part of it in some other way--by a federally administered grant or loan program, for example--to encourage the same behavior or help the same people.

Thus, last year the government sought to revive the sagging housing industry by the offer of a tax credit up to $2,000 for people who bought new homes. The provision will mean an estimated revenue loss of $725 million. That same money could have been spent in other ways to stimulate activity in the housing industry, but instead the decision was to "expend" it in the form of tax reductions for new-home buyers.

The concept of tax expenditures is only about nine years old and is still being refined. But the concept was sufficiently mature to have been incorporated in the Congressional Budget Act of 1974, which in several of its provisions requires the listing of present and proposed tax expenditures and a calculation of their revenue loss implications. In particular, Section 202(f)(1) requires the Director of CBO to report annually on the "levels of tax expenditures under existing law" and to take account of "any changes in those levels" proposed by the President.

Calculating Tax Expenditure Revenue Losses

There are some definitional and technical problems both in identifying tax expenditures and in measuring the revenue losses attributable to them.

The definitional problem arises because tax expenditures are reductions from the normal tax payable, and there is not complete agreement on the definition of a "normal" income tax. The budget act dealt with this problem by providing that revenue losses stemming from any "special exclusion, exemption, or deduction from gross income," or any

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"special credit, preferential rate of tax, or deferral of tax liability" are tax expenditures.

The statutory definition produces some results which suggest that a tax expenditure is not always a substitute for direct federal financing with the same objective. For example, current tax law grants a couple a low income allowance of $2,100; alternatively, the couple may subtract 16 percent (up to $2,800) from adjusted gross income. The low income allowance does not fit the definition of tax expenditure and is therefore part of the "normal" tax structure. The 16 percent deduction, to the extent it exceeds the low income allowance, does cause a tax expenditure, because it substitutes for itemized deductions which would themselves be tax expenditures; but no one can say what those other items--and their purposes--might have been.

The revenue loss measurement difficulty can be illustrated by the case of the itemized deduction for property taxes on owner-occupied homes. This tax expenditure is estimated to cost $3.7 billion in 1976. But if it were repealed, many of the affected taxpayers would no doubt switch from itemizing and use the standard deduction instead, so the net revenue gain would not reach $3.7 billion.[1]

Changes in rates also affect the calculation of tax expenditures. The current rate schedule progresses from 14 percent to 70 percent. Therefore, the deductibility of a $100 gift to charity results in a tax expenditure ranging from $14 to $70. But if the rates were changed to a range from 12 percent to 65 percent, obviously the tax expenditures would decline as well.

Despite the technical difficulties, revenue losses from tax expenditures are calculated. The technique now in use is to examine each tax expenditure provision separately, assume that it alone is repealed, that rates are not changed, and that taxpayers will not change their behavior as a result of the repeal. The dollar results produced from such assumptions are approximations.

Furthermore, totaling separately calculated revenue losses may not be particularly useful, because in the actual world tax expenditures interact with each other. If a group of tax expenditures were repealed, the effects on federal revenues would be different from summing the estimated effects of their repeal, one at a time.

However, tax expenditure totals do help in gaining an impression of year to year trends in their importance as part of all federal

1. A similar measurement problem often is present with direct outlay programs as well. For example, if veterans' college benefits were ended, outlays would probably rise in the basic educational grant program.

expenditures. In 1967 their total was equal to 23 percent of budget outlays. In 1976 their estimated total is equal to 25 percent of budget outlays.

The following table does three things. It lists all the provisions which CBO classifies as tax expenditures; it assigns all of them to functional categories of the budget; and it estimates the revenue losses attributable to each, assuming continuation of the tax laws in effect on January 1, 1976.

Some Characteristics of Tax Expenditures

By such devices as raising the value of a personal exemption from $600 to $750 and providing a low income allowance, the Congress in recent years has changed the "normal" tax structure so that the level of income at which people begin to owe any tax has been rising. Those who fall below that level cannot benefit from tax expenditures which, by definition, are reductions from the normal tax owed.

There is one exception to the rule just stated. The earned income credit contained in the Tax Reduction Act of 1975 was a tax expenditure. It provided cash "refunds" up to $400, even though the taxpayer's income was so low as to result in no normal tax payable.[2] With this single exception, the benefits of tax expenditures are confined to those who owe some normal tax. But, as the earned income credit shows, it would be wrong to conclude that tax expenditures are inherently for the rich and unavailable to the poor.

Tax expenditures have varying effects on the progressivity of the federal income tax. Those which take the form of a deduction or exclusion from income--like the state gasoline tax deduction, or the exclusion of interest on a municipal bond--are worth more the higher one's tax bracket and thus tend to lessen progressivity.

But some tax expenditures--like the earned income credit--increase the system's progressivity, since they reduce the effective tax rate more in percentage terms at the lower end than at the higher end.

There is much more uncertainty about the progressivity effects of tax expenditures available to corporations. Economists do not agree on who bears what share of the burden of the corporate income tax: stockholders, employees, or consumers. When that burden is lessened by a tax expenditure, the question of who bears it still remains.

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2. OMB decided in October, 1975, to treat the refundable portion of the credit as an outlay rather than a tax expenditure, a practice not currently followed by CBO.

TAX EXPENDITURE ESTIMATES, BY FUNCTION [a]

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
National defense (050):										
Exclusion of benefits and allowances to armed forces personnel						650	650	650	650	650
Exclusion of military disability pensions						90	100	110	120	130
International affairs (150):										
Exclusion of income earned abroad by U.S. citizens						160	175	195	205	220
Exclusion of gross-up on dividends of LDC corporations	55	55	55	55	55					
Deferral of income of domestic international sales corporations (DISC)	1, 420	1, 460	1, 495	1, 580	1, 735					
Deferral of income of controlled foreign corporations	365	365	365	365	365					
Special rate for Western Hemisphere trade corporations	50	50	50	50	50					
Natural resources, environment and energy (300):										
Exclusion of interest on state and local government pollution control bonds	170	220	265	300	330	75	100	125	145	160
Expensing of exploration and development costs	840	1, 045	1, 285	1, 540	1, 850	195	245	305	365	435
Excess of percentage over cost depletion	1, 020	1, 015	1, 110	1, 215	1, 325	575	625	640	670	695
Pollution control: 5-year amortization	15	5								
Capital gains treatment of royalties on coal and iron ore	20	20	25	25	30	50	60	65	75	85
Capital gains treatment of certain timber income	165	175	190	200	215	65	70	75	80	85
Agriculture (350):										
Expensing of certain capital outlays	115	120	130	135	150	360	370	380	390	400
Capital gains treatment of certain income	40	40	45	50	50	565	655	705	760	820
Cooperatives: deductibility of noncash patronage dividends and certain other items	455	485	520	555	595					
Commerce and transportation (400):										
Exemption of credit unions	135	145	155	165	175					
Corporate surtax exemption	6, 185	6, 745	7, 300	7, 865	8, 455					
Deferral of tax on shipping companies	130	155	180	205	230					
Railroad rolling stock: 5-year amortization	10	5								
Financial institutions: excess bad debt reserves	570	635	730	900	1, 060					
Deductibility of nonbusiness state gasoline taxes						600	665	735	815	910
Depreciation on rental housing in excess of straight line	125	135	145	155	170	455	480	510	545	580
Depreciation on buildings (other than rental housing) in excess of straight line	280	300	325	350	375	215	235	250	275	300

See footnotes at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION [a]—Continued

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
Expensing of research and development expenditures	695	725	755	785	815					
Capital gains: Corporate (other than farming and timber)	900	1,015	1,090	1,170	1,260					
Investment credit	7,585	8,045	8,480	8,890	9,310	1,530	1,635	1,750	1,870	1,995
Asset depreciation range	1,630	1,825	2,000	2,095	2,135	175	195	220	230	235
Dividend exclusion						350	370	385	405	425
Capital gains: Individual (other than farming or timber)						6,225	7,360	7,905	8,490	9,145
Capital gains at death						7,280	8,120	9,015	10,005	11,105
Deferral of capital gains on home sales						890	935	980	1,030	1,080
Deductibility of mortgage interest on owner-occupied homes						4,710	5,225	5,800	6,440	7,150
Deductibility of property tax on owner-occupied homes						3,825	4,245	4,710	5,230	5,805
Deductibility of interest on consumer credit						1,075	1,195	1,325	1,475	1,635
Exclusion of interest on state and local industrial development bonds	195	235	270	315	355	90	110	130	150	170
Excess 1st year depreciation	165	180	200	220	240	85	95	105	115	130
Expensing of construction period interest and taxes	1,065	1,110	1,150	1,190	1,230	570	595	620	645	670
Credit for purchase of new home						100				
Community and regional development (450):										
Housing rehabilitation: 5-year amortization	25	20	15	10	10	40	25	15	15	15
Education, training, employment, and social services (500):										
Exclusion of scholarships and fellowships						220	235	245	255	270
Parental personal exemption for student age 19 and over						715	735	760	780	805
Deductibility of charitable contributions (education)	280	325	355	390	430	500	555	610	670	735
Deductibility of child and dependent care expenses						420	460	510	560	615
Child care facilities: 5-year amortization	5	5								
Credit for employing AFDC recipients and public assistance recipients under work incentive program	10	10	10	10	10					
Deductibility of charitable contributions (social services)	352	402	446	489	536	3,124	3,468	3,847	4,274	4,740
Health (550):										
Exclusion of employer contributions to medical insurance premiums and medical care						4,225	4,730	5,300	5,935	6,650
Deductibility of medical expenses						2,095	2,325	2,580	2,865	3,175
Deductibility of charitable contributions (health)	173	198	219	241	264	831	922	1,023	1,136	1,260

See footnotes at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION [a]—Continued

[Fiscal years, in millions of dollars]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
Income security (600):										
Exclusion of social security benefits:										
Disability insurance benefits	--------	--------	--------	--------	--------	370	415	470	525	595
OASI benefits for aged	--------	--------	--------	--------	--------	3, 525	3, 965	4, 460	5, 020	5, 645
Benefits for dependents and survivors	--------	--------	--------	--------	--------	565	635	715	805	905
Exclusion of railroad retirement system benefits	--------	--------	--------	--------	--------	200	215	230	245	260
Exclusion of unemployment insurance benefits	--------	--------	--------	--------	--------	2, 855	2, 655	2, 470	2, 295	2, 135
Exclusion of workmen's compensation benefits	--------	--------	--------	--------	--------	640	705	775	855	940
Exclusion of public assistance benefits	--------	--------	--------	--------	--------	130	145	165	185	210
Exclusion of special benefits for disabled coal miners	--------	--------	--------	--------	--------	50	50	50	50	50
Exclusion of sick pay	--------	--------	--------	--------	--------	350	370	385	405	425
Net exclusion of pension contributions and earnings:										
Employer plans	--------	--------	--------	--------	--------	6, 475	7, 120	7, 835	8, 620	9, 480
Plans for self-employed and others	--------	--------	--------	--------	--------	965	1, 065	1, 180	1, 300	1, 440
Exclusion of other employee benefits:										
Premiums on group term life insurance	--------	--------	--------	--------	--------	895	965	1, 050	1, 135	1, 230
Premiums on accident and accidental death insurance	--------	--------	--------	--------	--------	60	65	70	80	85
Income of trusts to finance supplementary unemployment benefits	--------	--------	--------	--------	--------	5	5	5	5	5
Meals and lodging	--------	--------	--------	--------	--------	305	320	335	350	365
Exclusion of capital gains on home sales if over 65	--------	--------	--------	--------	--------	50	55	60	65	70
Excess of percentage standard deduction over minimum standard deduction	--------	--------	--------	--------	--------	1, 560	1, 635	1, 720	1, 805	1, 895
Additional exemption for the blind	--------	--------	--------	--------	--------	25	25	25	25	25
Additional exemption for over 65	--------	--------	--------	--------	--------	1, 220	1, 280	1, 340	1, 410	1, 480
Retirement income credit	--------	--------	--------	--------	--------	110	100	90	80	70
Earned income credit: nonrefundable portion	--------	--------	--------	--------	--------	280	270	255	245	235
Earned income credit: refundable portion	--------	--------	--------	--------	--------	1, 110	1, 065	1, 025	985	945
Exclusion of interest on life insurance savings	--------	--------	--------	--------	--------	1, 855	2, 025	2, 210	2, 410	2, 625
Deductibility of casualty losses	--------	--------	--------	--------	--------	330	355	380	405	430
Maximum tax on earned income	--------	--------	--------	--------	--------	505	580	670	770	885
Veterans' benefits and services (700):										
Exclusion of veterans' disability compensation	--------	--------	--------	--------	--------	595	595	595	595	595
Exclusion of veterans' pensions	--------	--------	--------	--------	--------	30	30	30	30	30
Exclusion of GI bill benefits	--------	--------	--------	--------	--------	280	265	255	240	230

See footnotes at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION [a]—Continued

(Millions of dollars, fiscal years)

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
General government (800):										
Credits and deductions for political contributions	-------	-------	-------	-------	-------	65	40	50	50	85
Revenue sharing and general purpose fiscal assistance (850):										
Exclusion of interest on general purpose state and local debt	3, 150	3, 375	3, 630	3, 925	4, 300	1, 390	1, 490	1, 605	1, 735	1, 880
Exclusion of income earned in U.S. possessions	285	305	325	350	375	-------	-------	-------	-------	-------
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes and gasoline)	-------	-------	-------	-------	-------	6, 680	7, 415	8, 230	9, 140	10, 140
Interest (900):										
Deferral of interest on savings bonds	-------	-------	-------	-------	-------	685	765	845	925	1, 005

Source: Staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation.

[a] Sum of the Tax Expenditure Items by Type of Taxpayer and Fiscal Year [1]

(Millions of dollars)

Fiscal year	Corporations and individuals	Corporations	Individuals
1977	105,970	28,680	77,290
1978	115,600	30,950	84,650
1979	125,475	33,315	92,160
1980	136,250	35,790	100,460
1981	148,160	38,485	109,675

[1] These totals represent the mathematical sum of the estimated fiscal year effect of each of the 82 tax expenditure items included in this table.

Tax expenditures are often like direct outlay program entitlements in that the expenditures are not subject to a budgeted limit, but rather are paid to everyone who qualifies. For example, by allowing a deduction for medical expenses which exceed 3 percent of an itimizing taxpayer's adjusted gross income, the government assumes some part of the health care costs for that taxpayer. In order to qualify for the help, the taxpayer has only to incur the costs. The expenses in distributing such help are limited to those of the Internal Revenue Service in administering the tax laws.

Another characteristic of tax expenditures is that they often raise questions of equity among taxpayers. For example, the extra personal exemption for those past 65 is a tax expenditure which means that a 64-year old couple (or any younger couple) with $10,000 earned income, and no other income, must pay more income tax than an otherwise identically situated 65-year old couple with $11,499 income.

There is another characteristic of many tax expenditures: the confusion and uncertainty which surrounds their actual effects. Some tax expenditures subsidize conduct which would have been required in any event, for example, installation of equipment to end the discharge of poisonous wastes into rivers. Other tax expenditures represent a grant to people for doing something they were going to do anyhow. This may have been the case with many of those who qualified for the new-home buyer's $2,000 credit in 1975.

The President's Fiscal Year 1977 Tax Expenditure Proposals

Some of the President's tax proposals, if enacted, would change the normal tax structure by reducing rates--both for corporations and individuals. The necessary effect is to reduce the value of tax expenditures; thus, the deductibility of a $100 charitable gift, now worth $48 in tax savings to a corporation, would be worth only $46 if the Congress accepts the proposal to reduce the maximum corporate tax rate to 46 percent.

Others of the President's proposals would directly change existing tax expenditures or create new ones. These proposals and their estimated revenue effects are shown in the following table.

The largest proposed tax expenditure change affecting individuals is that flowing from the President's recommendation that the low income allowance and the percentage standard deduction be abolished and replaced with a flat standard deduction. The present tax expenditure consisting of the excess of the percentage deduction over the low income allowance would simply vanish. But individual tax burdens would not be raised by the $1,560 million shown in the table for 1977, because the change is part of a package which also lowers rates and raises the income floor below which no "normal" tax is owed. The actual impact on any particular taxpayer, or on any income class, depends on applying the entire package of proposed changes.

The second largest tax expenditure change affecting individuals is the proposal to let the earned income credit expire. In this instance, the impact will be real. Low income earners with children--the only taxpayers now qualifying for the rebate (up to $400) mentioned earlier--will experience an actual income loss. An estimated six million families would be affected.

The overall effect of the President's tax expenditure proposals is to lessen progressivity. The first year revenue loss flowing from those proposals is generally less than half the revenue loss projected for fiscal year 1981, with most of the growth occurring between the first and second year.

The President has also proposed a partial integration of the corporate and personal income tax systems to be phased-in over several years commencing in January 1, 1978. While enactment of any proposal changing the tax system so substantially would affect the level of tax expenditures, no estimate of that effect has been made pending further specification of details.

EFFECT OF PRESIDENT'S TAX PROPOSALS ON THE LEVEL OF TAX EXPENDITURES

(Millions of Dollars, Fiscal Years)

Expenditure	1977		1978		1979		1980		1981	
	Ind.	Corp.	Ind.	Corp.	Ind.	Corp.	Ind.	Corp.	Ind.	Corp.
Earned income credit: nonrefundable portion	- 280		- 270		- 255		- 245		- 235	
Refundable portion	-1,110		-1,065		-1,025		- 985		- 945	
Excess of percent standard deduction over low income allowance	-1,560		-1,635		-1,720		-1,805		-1,895	
Additional exemption for the blind	5		5		5		5		5	
Additional exemption for over 65	235		245		255		270		280	
Investment credit[a]	100	1,215	500	2,800	600	2,900	600	3,000	700	3,100
Corporation surtax exemption[a]		1,675		2,200		2,400		2,600		2,800
Financial institutions' excess bad debt reserves		- 215		- 495		- 530		- 580		- 645
Mortgage interest income tax credit	10	255	50	600	55	680	65	760	70	845
Electric utilities:										
Investment credit		105		205		235		250		270
Pollution control[b]										
Conversion facilities[b]										
Depreciation of progress payments		320		810		1,010		1,155		1,255
Deferral of tax on reinvested dividends	350		330		345		355		365	
Broadened stock ownership	300		445		540		635		670	
Accelerated depreciation in areas of high unemployment	40	250	115	530	170	715	200	845	220	810
TOTAL	-1,910	3,605	-1,280	6,650	-1,030	7,410	- 905	8,030	- 765	8,435

[a] These items are included in the levels of tax expenditures shown in the prior table. They are, however, technical increases because they will expire on June 30, 1976, unless extended by Congress.

[b] Insignificant

GLOSSARY[1]

BUDGET AUTHORITY. Budget authority is provided by law to enter into obligations which generally result in immediate or future outlays of government funds. The authority to insure or guarantee the repayment of indebtedness incurred by another person or government is usually not considered to be budget authority. The basic forms of budget authority are: appropriations, contract authority, and borrowing authority. Budget authority may be classified by the period of availability (one-year, multiple-year, no-year), by the timing of Congressional action (current or permanent), or by the manner of determining the amount available (definite or indefinite).

CONSTANT DOLLARS. Spending in constant dollars is valued at the prices of some base period (1972 in the GNP accounts). Over time, changes in constant-dollar spending measure changes in the volume of goods and services purchased; changes in the price level have been removed by a statistical procedure known as "deflation."

CONTROLLABILITY. Controllability is the ability of the Congress or the President under existing law to control outlays during a given fiscal year. "Relatively uncontrollable" usually refers to spending that cannot be increased or decreased without changes in existing substantive law. Such spending is usually the result of open-ended programs and fixed costs, such as social security and veterans' benefits, but also includes payments due under obligations incurred during prior years.

CURRENT DOLLARS. Spending in current dollars means that purchases are valued at the prices at which the transaction actually took place. Over time, the value of spending in current dollars can vary both because of changes in the volume of goods and services purchased and because of changes in the level of prices of the goods and services purchased.

DEFERRAL OF BUDGET AUTHORITY. This is any action or inaction by any officer or employee of the United States which temporarily withholds, delays, or effectively precludes the obligation or expenditure of budget authority, including the establishment of reserves under the Antideficiency Act. Under section 1013 of the Congressional Budget and Impoundment Control Act of 1974, the President is required to report each proposed deferral to the Congress in a special message. Deferrals may not extend beyond the end of the current fiscal year and may be overturned by the passage of an impoundment resolution by either House of Congress.

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1. Where available, definitions are from Budgetary Definitions by the Comptroller General of the United States, U.S. General Accounting Office, November, 1975.

EXPENDITURES. This is a term generally used interchangeably with outlays. (See OUTLAYS). The term has a somewhat different usage for budget execution and accounting purposes.

FULL-EMPLOYMENT SURPLUS. A full-employment surplus is the difference between what government receipts and expenditures are estimated to be if the economy were operating at potential output (4 percent unemployment). If full-employment receipts are less than full-employment expenditures, there is said to be a full-employment deficit. These calculations are usually made for the federal government but can also be made for state and local governments. Changes in the full-employment surplus are not sensitive to the choice of the unemployment rate used, and so are sometimes used as a rough measure of changes in the thrust of fiscal policy.

INDIRECT MULTIPLIER EFFECTS. An addition to aggregate demand affects national output directly by increasing the output of the commodity demanded: this is the direct multiplier effect. This increase in production increases incomes of workers and businesses as hours worked are lengthened, new workers hired, and profits rise. Workers and businesses then increase their spending on consumer and capital goods, which raises national output further. It is this "induced" spending on consumer and capital goods which is known as the indirect multiplier effect. A decrease in aggregate demand lowers output both directly and indirectly through a reversal of the process just described. The total multiplier effect is the sum of the direct and indirect multiplier effects.

M_1. M_1 is currency plus demand deposits (checking accounts) held by the public. It includes (1) demand deposits at all commercial banks other than those due to domestic commercial banks and the U.S. government, less cash items in the process of collection and Federal Reserve float; (2) foreign demand balances at Federal Reserve Banks; and (3) currency outside the Treasury, Federal Reserve Banks and vaults of all commercial banks. Also known as the "money stock" or the "narrowly defined money supply."

M_2. M_2 is M_1 plus time deposits at commercial banks other than large certificates of deposit. It includes, in addition to currency and demand deposits, savings deposits, time deposits open account, and time certificates of deposits other than negotiable time certificates of deposit issued in denominations of $100,000 or more by large weekly reporting commercial banks.

MACROECONOMICS. This is the branch of economics that deals with the level of aggregate economic behavior, as measured by national output; utilization of resources, as measured by capacity utilization and the unemployment rate; and the level and rate of change of prices. The other branch is microeconomics, which deals with the behavior of individual firms, industries, and consumers, usually in a context of full employment of resources.

OBLIGATIONS. Amounts of orders placed, contracts awarded, services rendered, or other commitments made by federal agencies during a given period that will require outlays during the same or some future period are obligations.

OFF-BUDGET FEDERAL AGENCIES. These are agencies, federally owned in whole or in part, whose transactions have been excluded from the budget totals under provisions of law, e.g., the Federal Financing Bank. The fiscal activities of these agencies are not included in either budget authority or outlay totals, but are presented in the Budget Appendix as "Annexed Budgets."

OUTLAYS. Outlays are checks issued, interest accrued on the public debt, or other payments, net of refunds and reimbursements. Total budget outlays consist of the sum of the outlays from appropriations and funds included in the unified budget, less offsetting receipts. Off-budget federal agencies are not included in the unified budget and, for purposes of the budget, are treated as private entities.

POTENTIAL OUTPUT. Potential gross national product is an estimate of what the economy would produce if all of its resources were fully utilized, given the technology and institutional arrangements that existed at that time. Full utilization does not mean the potential that could be achieved during wartime conditions but rather the utilization that could be achieved with an unemployment rate of 4 percent. See Business Conditions Digest (U.S. Department of Commerce, Bureau of Economic Analysis) for further details.

REAL INCOME, SPENDING, DOLLARS, GROWTH. The term "real" used in these contexts is equivalent to "constant dollar " (see above).

RESCISSION. A rescission is a legislative action which cancels budget authority previously provided by Congress prior to the time when the authority would otherwise have lapsed.

UNIFIED BUDGET. This is the present form of the budget of the federal government, in which receipts and outlays from federal funds and trust funds are consolidated. When these fund groups are consolidated to display budget totals, transactions which are outlays of one fund group to the other fund group (interfund transactions) are deducted to avoid double counting. The fiscal activities of off-budget federal agencies are not included in the unified budget.

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