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ENTITLEMENT CAP WOULD REQUIRE DEEP CUTS IN ENTITLEMENT PROGRAMS

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Summary

Budget legislation introduced in May by Rep. Jeb Hensarling and 58 House co-sponsors (H.R. 2290) includes a provision that would impose an annual cap on expenditures for entitlement programs other than Social Security.[1] The cap would be set at levels that would require entitlement programs to be cut *by $2.1 trillion* over the next ten years.

This legislation is now being considered in discussions that the House Leadership has instituted among House Republican leaders, various committee chairmen, and other Members. These discussions are intended to produce budget legislation that the Leadership has said it intends to move some time after the August recess.

Under the entitlement cap provision in H.R. 2290, a limit would be imposed each year on total expenditures for entitlement programs other than Social Security. These annual caps would be set at levels significantly below what the entitlement programs are projected to cost under current law, and cuts of sufficient magnitude would have to be made to fit entitlement costs within the caps. The caps are designed in such a manner that with each passing year, they fall farther below what the entitlement programs would cost under current law, necessitating steadily deepening cuts to meet the caps. In any year that Congress and the President failed to cut entitlements enough to fit within the cap for that year, *automatic* cuts in entitlement programs would be triggered.

The Depth of the Cuts

The Congressional Budget Office issues detailed cost projections and related data on entitlement programs, and analysts can use these data and projections to estimate the levels at which the entitlement caps would be set under the Hensarling proposal. The CBO projections and data show that over the ten years ending in 2015, the entitlement caps would be set a total of $2.1 trillion below the projected cost of entitlement programs under current law. The proposal thus would mandate $2.1 trillion in cuts over the coming decade.

[1] The Hensarling legislation, H.R. 2290, addresses many aspects of the budget process. This analysis examines only the provision capping entitlements, which is similar, but not identical, to the entitlement cap contained in a proposal that Rep. Hensarling offered in June 2004.

In 2015 alone, the required cuts would reach $424 billion. This would require the elimination by 2015 of *more than one of every four dollars* that would otherwise be provided in entitlement benefits.

TABLE 1

Entitlement Reductions Over 10 Years If Congress Cut All Entitlements Proportionately In Response to Entitlement Caps

(in billions of dollars)

Program	Amount
Medicare	$919
Medicaid	460
Federal civilian retirement and disability	127
Military retirement and disability	74
Unemployment compensation	73
Earned Income and Child Tax Credits	72
Supplemental Security Income	69
Veterans' benefits	56
Food Stamps	54
TANF and other family support	37
Child Nutrition	25
Commodity Credit Corporation price supports	21
TRICARE for life	16
Other federal retirement and disability	15
Foster Care and Adoption Assistance	13
Student loans	13
Universal Service Fund	11
State Children's Health Insurance Program	8
Social services (Title XX, voc rehab)	7
Other miscellaneous	22
TOTAL	**2,092**

Why the Cuts Would be So Large

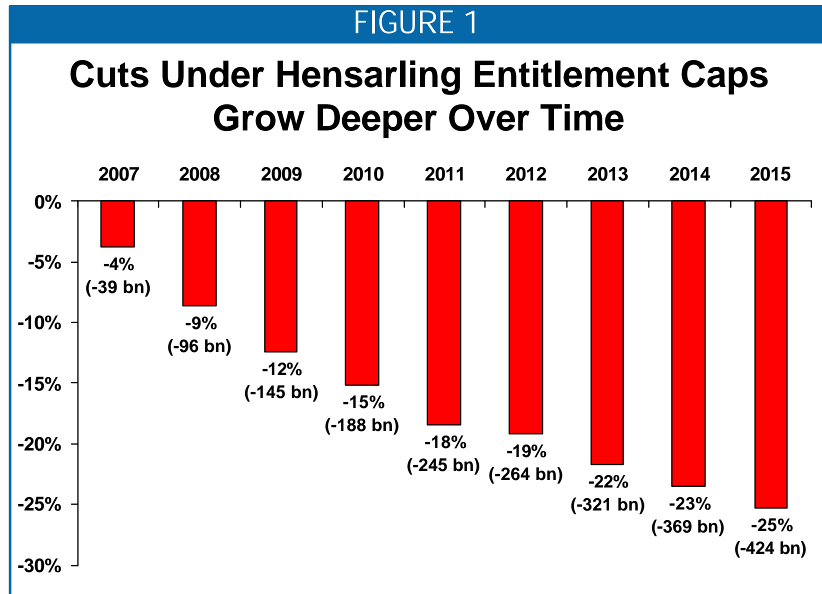
The required cuts would be this large for two reasons: the proposal's failure to take increases in health care costs into account in setting the level of the entitlement caps, and the proposal's inclusion of interest payments on the national debt as an entitlement program.

- Under the proposal, the entitlement cap for each year would be set at a level equal to the sum of the costs of all entitlement programs except Social Security in the prior fiscal year, with two adjustments. An adjustment would be made for projected increases or decreases in the number of people eligible for each entitlement program. The second adjustment would incorporate, for each program, the cost-of-living adjustment required in that program's governing statute or the projected increase in the Consumer Price Index, whichever was greater.

- These two adjustment factors, however, ignore the fact that Medicare and Medicaid costs rise with increases in the cost of health care, *not* with increases in the Consumer Price Index. As is well known, health care costs are rising rather rapidly in the private and public sectors alike and are increasing at a considerably faster pace than the general inflation rate. The Hensarling entitlement cap is set at a level that makes room for Medicare and Medicaid costs per beneficiary to rise at an average rate of *only 2.4 percent per year* over the coming decade, far below the expected rate of increase in health care costs.

  Hardly any employer in America can hold increases in health insurance premiums to 2.4 percent per beneficiary per year. Health care costs are climbing much faster than that. Accordingly, CBO projects that Medicare and Medicaid costs will grow at an annual average rate of 6.3 percent per beneficiary over the coming decade, far above the 2.4 percent that the Hensarling caps make room for. *This difference between the projected increases in health care costs per beneficiary in Medicare and Medicaid and the much smaller adjustments the Hensarling proposal would allow would cause a $1 trillion divergence between projected entitlement costs and the entitlement caps.* The proposal's failure to take rising health care costs into account thus would require $1 trillion in entitlement cuts. Moreover, because any entitlement (except Social Security) could be cut to

comply with the cap, *all* entitlements other than Social Security — not just Medicare and Medicaid — would be at risk of steep cuts.



- Exacerbating these problems, the Hensarling proposal treats interest payments on the debt as an entitlement program. Whenever interest payments rose faster than inflation, the entitlement cap would be breached and additional cuts in entitlement programs would be mandated. (Interest costs cannot themselves be cut directly.) The inclusion of interest payments within the entitlement cap is extremely significant since interest payments are projected to rise sharply over the coming decade, both because interest *rates* are expected to climb from their current unusually low levels and because the amount of debt on which interest will be paid will continue to escalate, as the government continues to rack up large deficits each year.

  Of particular note, if the 2001 and 2003 tax cuts are extended without being "paid for," deficits and debt — and hence interest payments on the debt — will be even greater than they otherwise would be. Under the proposed entitlement cap, action to extend the tax cuts consequently would trigger deeper cuts in entitlement programs. In fact, each time that Congress enacted a new tax cut without paying for it, interest costs would rise further and cause entitlement programs to have to be cut more severely. Assuming that the existing tax cuts and relief from the Alternative Minimum Tax are continued, the projected growth of interest costs over the coming decade would necessitate *an additional $1.1 trillion in entitlement cuts* under the proposal, beyond the $1 trillion necessitated by Medicare and Medicaid cost growth.

- The combined effect of these two factors — health care costs and interest payments — is that entitlement programs would have to be cut $2.1 trillion over the next ten years to fit within the entitlement caps.

- Even deeper cuts would be required if various events that are beyond policymakers' control occurred and caused entitlement expenditures to increase. For example, a flu epidemic or the onset of some other major disease could cause Medicare and Medicaid costs to rise, while an improvement in international harvests could cause farm prices to fall — and farm price support costs to increase (see box on page 6). These and other such unforeseen developments that cause entitlement costs to rise cannot be predicted in advance and may not pose ongoing budgetary threats (because the spike in expenditures ends when the event that triggered the spike passes). Moreover, entitlement programs exist, in part, as insurance against such unforeseen events. The proposed entitlement cap, however, generally would require deeper cuts in entitlement programs when such events occur. The cap would thereby undercut the safety-net or insurance nature of these programs, forcing deeper cutbacks in these or other programs in the very years they are most needed.

How Would Particular Programs be Affected?

How deeply would Congress cut a particular program to meet the caps? The exact size of the cutbacks in each program would depend on decisions that Congress and the President would make. In theory, Congress and the President could initially decline to enact any legislation cutting entitlement programs and let *automatic* entitlement cuts do all of the "dirty work." Under the proposal's rules for automatic cuts, some programs (such as Medicare hospital insurance) would be exempt from the automatic cuts, and certain other programs (such as veterans' programs, Medicare physicians' coverage, the new drug benefit, and Medicaid) would be cut no more than two percent through an automatic cut. (It should be noted that all cuts would be *permanent,* and that programs in which the automatic cut would not exceed two percent would be reduced an *additional* two percent each time an automatic cut occurred. As a result, the automatic cuts in these programs could mount to substantial levels over time. If automatic cuts occurred every year, these programs could be cut as much as 17 percent — or one-sixth — by 2015.)

It is unthinkable, however, that the bulk of the reductions would occur through automatic cuts. The automatic cuts are designed to be so unpalatable that Congress and the President would feel compelled to enact legislation making cuts in various entitlements in order to avert (or minimize) the automatic cuts. If all of the reductions needed to comply with the proposed entitlement cap were made through automatic cuts, then programs that would be fully subject to the automatic cuts (i.e., the programs that would have no protection from the automatic cuts) would be entirely *eliminated* by 2010. Those programs include, among others, farm-price supports and crop insurance, extended unemployment benefits and trade adjustment assistance, the Earned Income Tax Credit, vocational rehabilitation, child care payments to states, and the Social Services Block Grant (Title XX) — as well as the salaries of Senators Member of Congress.

Needless to say, it is inconceivable that Congress would sit idly by and allow these programs — and Members' own salaries — to be eliminated. Congress clearly would seek to spread the pain more broadly by enacting legislation that cut more heavily into entitlement programs that had some protection from the automatic cuts, such as Medicare and Medicaid. It is important to understand that when the Hensarling proposal exempts a particular entitlement program from *automatic* cuts, it does *not* exempt that program from cuts that Congress could enact to meet the caps. The only truly protected program would be Social Security, because only Social Security would be outside the caps.

The bottom line is that all entitlement programs except Social Security would be at serious risk of being cut deeply, given that $2.1 trillion in reductions would be mandated over the next ten years. The table on page 2 shows the magnitude of the cuts that would be made in each entitlement program over the next ten years if all programs other than Social Security were cut by the same percentage.

Additional Issues Raised by the Proposal

Four additional points are worth noting. First, the required entitlement cuts would reach more than 25 percent — more than one dollar in every four — by 2015. In programs such as veterans' disability benefits or food stamps, the benefits that each person receives could be cut by one quarter. The situation is different, however, in Medicare and Medicaid. Those programs deliver benefits by paying doctors and hospitals to provide health care to people who are elderly or disabled or have low income. If doctors and hospitals were paid 25 percent less, many or most would likely choose not to treat those patients, and the programs could collapse. The only plausible ways to cut Medicare and Medicaid by 25 percent are to reduce sharply the number of elderly, disabled, or low-

Broad-based Opposition to Entitlement Cap Proposal

Last year, a broad array of organizations expressed strong opposition to entitlement-cap proposals. For example, in a letter to Speaker Dennis Hastert on June 22, 2004, the American Legion stated: "The American Legion opposes any and all entitlement cap proposals. Although we fully support deficit reduction, we consider an entitlement cap in any form to be the wrong approach, and a potential breach of national trust." Similarly, the Paralyzed Veterans of America wrote in a letter to Members of Congress on June 22, 2004: "PVA would also like to urge you to oppose any proposed amendment that would enact caps on entitlement spending." In a strong letter sent on June 21, 2004, the AARP stated: "AARP urges you to reject any entitlement caps because they would jeopardize the health and economic security of millions of vulnerable Americans."

income people who are eligible for public health insurance (for example, by raising to well above 65 the age that a person must attain to become eligible for Medicare), or to require sick people to make up for federal reductions in payments to health-care providers by paying more out of their own pockets. People who are poor — as well as many middle-income elderly and disabled people who have serious illnesses or medical conditions that require extensive treatment — would likely have great difficulty affording the large added out-of-pocket costs that would result.

Second, under the proposed cap, deep cuts would continue to occur even in years when the economy is weak, which could push a faltering economy into recession or cause an existing recession to become deeper and more protracted. Moreover, during economic downturns, Congress often enacts temporary increases in some benefits, such as extensions of unemployment insurance benefits and temporary increases in federal matching payments for Medicaid. Such legislation provides relief to families in distress while also helping to stabilize the economy. The proposed cap could make the enactment of such forms of economic stimulus more difficult (because the stimulus measures could breach the cap), or could force the stimulus measures to be offset by other cuts that withdraw needed cash from the economy. The cap could thereby interfere with sound fiscal policy.

Third, despite the wide-ranging nature of the entitlement cap proposal, it would *exempt* an entire class of entitlement programs — those that Federal Reserve Board Chairman Alan Greenspan has called "tax entitlements" and that the Joint Committee on Taxation refers to as "tax expenditures." These are the many hundreds of billions of dollars of entitlement-style subsidies that are delivered through the tax code, via special tax breaks, write-offs, preferences, shelters, and the like. Whereas middle-class and low-income Americans receive the bulk of their government benefits through program entitlements, wealthy individuals and corporations receive the majority of their government benefits and subsidies through tax entitlements. By exempting tax entitlements from the cap, the proposal effectively favors affluent individuals and powerful corporations over ordinary Americans.

Finally, despite the severe cuts that the Hensarling proposal would require, the proposal would not necessarily result in deficit reduction. The Hensarling bill would not place any limitations, or any form of fiscal discipline, on tax cuts. To the contrary, the bill would make *permanent* tax cuts easier to pass.[2] As a result, nothing in the bill would prevent deep cuts in entitlement benefits for the elderly, people with disabilities, veterans, low-income children, and others from being used to make room in the budget for further rounds of tax cuts for affluent Americans and special interests with high-priced lobbyists.

[2] The Hensarling bill includes a provision repealing the Senate rule that bars budget reconciliation bills from *increasing* deficits in years beyond the years that the reconciliation directive covers. This rule is a central reason why the 2001 reconciliation legislation had to include sunsets on its tax cuts, rather than making them permanent. Repeal of this rule would make permanent tax cuts easier to pass.

Factors Beyond Policymakers' Control that Could Cause the Entitlement Cap to be Breached and Cuts to be Required

The following are some of the uncontrollable factors that could boost entitlement expenditures and thereby require even deeper cuts in entitlement programs. Most of these factors would increase costs only on a temporary basis. But all entitlement reductions made as a result of automatic cuts would be permanent.

Entitlement costs would rise farther beyond permitted levels — and deeper cuts consequently would be required — if:

- *International harvests improved*, since farm prices would fall as a result and price support costs would rise;
- *Unforeseen weather conditions damaged some crops,* as that could cause crop insurance costs to increase;
- *A flu epidemic occurred or some other disease spread*, raising health-care costs, or if a new treatment were developed for a major illness that improved patients' health but increased costs;
- *A major flood occurred,* because the government provides flood insurance that is widely used in threatened areas;
- *Federal pension-insurance costs grew substantially*, as would happen if several large corporations with defined-benefit retirement plans — such as those in the airline, steel, or auto industries — found themselves unable to meet their pension commitments and the Pension Benefit Guarantee Corporation (PBGC) had to pick up much of the costs.
- *A terrorist attack on the U.S. was especially expensive,* because the government provides back-up insurance to businesses against losses from terrorist attacks if the costs exceed a certain threshold;
- *Taxes were cut or revenues rose more slowly than expected for other reasons,* such as because of more widespread use of a tax shelter, as that would cause deficits to increase and interest payments on the debt to rise;
- *Interest rates rose more than expected*, because that would make interest payments on the debt and student loan subsidies more expensive;

In fact, establishment of an entitlement cap could doom chances to reach a "grand bargain" in which all parts of the budget are placed on the table and major deficit-reduction is achieved through a bipartisan agreement, as occurred in 1990. Advocates of entitlement cuts would have no reason to join a grand bargain if, through an entitlement cap, they have already achieved their policy objectives. Yet history suggests that unless all parts of the budget — including revenues, entitlements, and discretionary programs — are on the table and a spirit of "shared sacrifice" is invoked, large-scale deficit reduction is unlikely to be achieved.

How the Entitlement Cap Would Work

Starting in 2007, a ceiling would be placed each year on total "mandatory" (or entitlement) spending outside of Social Security. The ceiling or cap would be set each year by taking the cost of each entitlement program in the prior fiscal year, adjusting that cost in one or two ways (the specific

adjustments are described below), and adding up the resulting amounts for each entitlement program. The grand total would be the level at which the cap was set.[3]

The caps would be binding. Each year, Congress would be required to devise and enact legislation bringing the total cost of entitlement programs down to the cap for the coming fiscal year. Congress could meet the overall cap in any manner it chose, by cutting any set of entitlements by whatever amount it preferred. Only Social Security would be exempt.

Automatic Cuts Are Intended to be a Doomsday Machine, Not a Way to Achieve Budget Cuts

To enforce the requirement that Congress devise and enact sufficient entitlement cuts to meet the caps, the bill includes a "doomsday machine" — a requirement that the President order *automatic* cuts in certain entitlements if total entitlement spending outside Social Security for a fiscal year would exceed the cap for that year and Congress has failed to pass legislation cutting entitlements enough to fit within the cap. The automatic cuts would have to be of sufficient magnitude to shrink entitlement spending so it fits within the cap. Once a program is cut by such an automatic reduction — such as by cutting benefit levels or reducing the federal share of the costs of a joint federal-state program — the reduction would be *permanent.*

OMB would determine, when Congress adjourned each fall, whether the cost of mandatory spending in the fiscal year that had just started (on October 1) would breach the entitlement cap. If so, the President would be required to order the automatic entitlement cuts.

Some major entitlements would be exempt from these automatic cuts, and the magnitude of the automatic cuts in certain other programs would be limited. All remaining entitlements would then be cut across-the-board by as large a percentage as was needed to shrink total entitlement spending enough to fit within the cap. (See the appendix for a more detailed discussion of how the automatic cuts would be instituted.) Because the automatic cuts would spare some programs and cut certain other programs by limited amounts, the entitlement programs that would not have such protection could be subject to extraordinarily deep cuts. If automatic cuts were the sole method by which the cap was adhered to, all of the programs without protection would be entirely eliminated by 2010.

The total elimination of the programs in question, which include the salaries of Senators and Members of Congress, is not plausible politically. And that is the point. The automatic cuts are designed to be so unthinkable that Congress and the President will instead feel compelled to enact cuts that are spread more broadly across entitlement programs. For this reason, advocates of a program that would be exempt from the *automatic* cuts, such as Medicare hospital insurance (Medicare Part A) or civil service retirement, should take little solace from that exemption; programs protected from the *automatic* cuts would be fully on the table as Congress struggled to design and enact entitlement reductions of sufficient magnitude to comply with the cap.

It also should be noted that if some Members of Congress sought to avoid having to make such cuts — by raising the entitlement cap for the coming year or by otherwise stopping the automatic

[3] The proposal makes an except for Medicare Part D, the new prescription drug benefit. The entitlement cap for 2007 would be based on the estimated *2007* cost of the prescription drug program, rather than the *2006* cost of that program as adjusted. For 2008 and beyond, the entitlement cap would be based on the cost of each program (including Medicare prescription drugs) in the prior year, as adjusted.

cuts from being implemented — they would find it very difficult to pass legislation to accomplish those ends. Such legislation would need *67 votes* to pass in the Senate.

TABLE 2

"Excess" Cost Growth Under the Hensarling Entitlement Cap
(cumulative total through 2015)

Medicare & Medicaid	$1.0 trillion
Interest on the debt	1.1
All other	-0.1
TOTAL	2.1

Does not add due to rounding

Calculating the Entitlement Cap and the Resulting Cuts

As noted, the entitlement cap for each year would equal total entitlement spending for the prior year (excluding Social Security), with two adjustments.

- First, the costs of each program would be assumed to grow with inflation. Inflation would be measured either by the Consumer Price Index or, if the statute governing a program specified a different inflation adjustment for that program (such as the "cost-of-food" adjustments in the school lunch and food stamp programs), by the specified inflation adjustment if the adjustment would be greater than the projected increase in the CPI.[4]

- Second, the cost of an entitlement program would be adjusted to reflect changes in the estimated size of the population eligible for the program, in cases where such an adjustment was applicable.

These two adjustments, however, would fall far short of reflecting actual increases in entitlement program costs for two fundamental reasons. First, they ignore the fact that continued advances in medicine, along with other factors, are causing health care costs in both the private and public sectors to rise significantly faster than the general inflation rate. Second, they ignore the continued growth of interest costs, which rise because the debt (and hence interest payments on the debt) increases each year that the budget remains in deficit. The two adjustments also fail to take into account a number of other factors that can raise entitlement costs, usually on a temporary basis, for reasons beyond policymakers' control — such as the sudden onset of a new disease or a flu epidemic, which can further push up health care costs, weather conditions and other factors that affect the prices of agricultural commodities (and hence the cost of agricultural subsidies), and increases in interest rates that raise the cost of interest payments on the debt. (See box on page 6.)

The Congressional Budget Office publishes data on the projected growth of entitlement costs over the coming decade, breaking out the components of entitlement spending growth for groups of programs and showing how much is due to projected increases in caseloads and how much is due to other factors.[5] For Medicaid and Medicare, CBO also issues back-up documentation showing projected caseloads and the growth rate of specified Medicare price indexes.

The CBO data show that the two adjustments the proposal would make in calculating the caps would miss nearly $1 trillion in cost increases projected to occur in Medicare and Medicaid over the

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[4] The specific wording of H.R. 2290 provides that the cap is to be calculated by assuming that the cost of an entitlement in the prior year will be "increased by the higher of the change in the Consumer Price Index for All Urban Consumers or the inflator (if any) applicable to that program..."

[5] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, January 2005, Table 3-5. We have updated the figures in the CBO table to reflect CBO's revision to its baseline, issued March 2005.

2007-2015 period because health care costs in the United States are rising faster than inflation. (The period 2007-2015 is used here because the proposed entitlement cap would first take effect in 2007.) For this reason alone, the entitlement cap would require nearly $1 trillion in entitlement cuts over this period.

Moreover, this $1 trillion discrepancy accounts for only about half of the entitlement cuts that the proposal would require. An even larger factor is the proposal's inclusion of interest payments on the debt as an entitlement program.

When the entitlement cap was being calculated each year, an allowance would be made for interest payments to grow only at the rate of the Consumer Price Index. (In setting each year's cap, the amount of interest payments made in the prior year would be adjusted by the projected increase in the CPI, as would be done for all entitlement programs that do not include a statutory cost-of-living adjustment.) Yet interest costs will rise much faster than the CPI. They are projected to increase at an average annual rate of 8.9 percent over the coming decade, far above projected growth in the CPI of a little over 2 percent per year.

Interest payments are projected to grow this rapidly for three reasons. First, interest rates are now unusually low; CBO projects they will rise in future years, an assumption consistent with statements by Federal Reserve Chairman Alan Greenspan. Second, the federal debt, on which interest must be paid, increases every year that the budget is in deficit, which in turn causes interest payments to rise further. Third, because Social Security is outside the caps under the Hensarling proposal, the interest payments that would be counted in determining whether overall entitlement expenditures would breach the cap would include the interest payments that the Treasury pays to the Social Security trust fund. This would make the amount of interest payments counted much larger and also cause the rate of growth in interest costs to be somewhat greater. For these reasons, interest costs are projected to grow much faster than the CPI.

This growth in interest costs would push entitlement spending much further above the caps, necessitating deeper program cuts. The inclusion of interest payments on the debt drives up the amount by which the caps would be exceeded by another $1.1 trillion over ten years, requiring an additional $1.1 trillion in entitlement cuts.[6] This brings the total amount of entitlement cuts that would be required under the proposal to $2.1 trillion through 2015.[7]

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[6] If no cuts were made in entitlement programs, projected interest payments through 2015 would cause the cap to be exceeded by $1.5 trillion, rather than $1.1 trillion. Because entitlement cuts must be made to comply with the cap, however, those cuts would produce savings that would lower the projected debt and hence reduce the projected amount of interest paid on the debt. These interest savings would lower to $1.1 trillion the amount by which interest payments would cause the cap to be breached.

[7] In June 2004, Rep. Hensarling offered an entitlement cap as an amendment to a budget-process bill being considered on the House floor. (The amendment was defeated.) Rep. Hensarling's proposed amendment of last year and his proposed bill of this year use exactly the same formula for calculating entitlement caps. Last June, we estimated that the caps contained in the amendment he was offering at that time would require $1.6 trillion in cuts over ten years, while we estimate now that his new proposal would require cuts of $2.1 trillion. Our new estimates are higher than last year's estimates for several reasons. First, CBO now assumes somewhat faster growth of health care costs than it assumed last year. Second, the ten-year period in question has been delayed one year; it now starts in 2006 and runs through 2015. Last year's estimates covered the 2005 – 2014 period. Last year's estimates also benefited from the fact that certain entitlements such as unemployment compensation had an unusually high base-year cost then because of the lingering effects of the recession; therefore, cost growth relative to the base year was lower. This year that phenomenon is less pronounced because the base year is more distant from the trough of the recession.

The Amount of Required Entitlement Cuts Could Change Because of Tax Legislation or Discretionary Appropriations

Interest costs depend on what is going on in the rest of the budget. Interest costs grow in part because the debt is projected to grow. The debt increases each year by the amount of that year's deficit.[8]

If Congress cuts taxes or increases discretionary spending, deficits will be higher than projected, and debt and interest costs will be higher than projected, as well. The extra interest costs in turn would mean that the entitlement cap would squeeze harder, since the additional interest costs would require even deeper cuts to be made in entitlements to meet the entitlement cap.

To illustrate the interaction between the entitlement cap and other legislation, consider our estimate that $2.1 trillion in cumulative entitlement cuts would be needed over the period 2007-2015 to meet the entitlement cap. The deficit projections that we use to project interest costs over the coming decade assume that the 2001 and 2003 tax cuts will be extended and relief from the Alternative Minimum Tax will be continued (by indexing the AMT's parameters for inflation). Suppose, however, that Congress repeals the AMT altogether without offsetting the costs, as a number of policymakers are proposing. If so, deficits would be $393 billion higher through 2015 than we have assumed, and interest costs would be $81 billion greater. As a result, cuts in entitlement programs of $2.2 trillion (rather than $2.1 trillion) would be needed to adhere to the entitlement cap..

Entitlement Programs Outside of Health Care Are Not Contributing to the "Overage"

As shown in Table 2 on page 10, projected increases in Medicare, Medicaid, and interest costs account for *all* of the $2.1 trillion amount by which mandatory spending would exceed the proposed caps. The other entitlements would not cause any "excess costs."

Two other technical points should be noted. First, under the proposal, "offsetting receipts" such as rents and royalties from oil drilling on the continental shelf, which are recorded in the budget as "negative mandatory spending," also would be counted as an entitlement. Under the CBO baseline, this "negative mandatory spending" is projected to grow slightly faster than inflation and thus would offset a small fraction of the growth in entitlement costs. It would reduce the amount of entitlement cuts that otherwise would be needed by $35 billion though 2015.

Second, the projections used here of entitlement costs under current policies assume that the 2001 and 2003 tax cuts will be extended. These tax cuts expanded eligibility for and benefits under the Child Tax Credit, and slightly modified the Earned Income Tax Credit. Those tax credits are "refundable," and for technical reasons, refunds that exceed income-tax liability are classified in the federal budget as entitlement costs rather than as revenue reductions. Assuming that the 2001 and 2003 tax cuts are extended increases projected costs of entitlement programs, and therefore the required entitlement cuts, by $62 billion through 2015.

[8] Our projection of deficits, and therefore of interest payments, starts with the "baseline" deficits projected by CBO in March 2005. As CBO itself notes in its annual report, however, its official baseline has much smaller deficits than are likely to occur, for two reasons. The first is that the baseline includes *no* costs for operations in Iraq and Afghanistan in any year, because no 2005 funding for these operations had been enacted at the time the CBO baseline was issued. (An $81 billion supplemental appropriation was subsequently enacted.) The second reason is that the official CBO baseline assumes that all the tax cuts enacted in 2001 and 2003, including relief from the Alternative Minimum Tax, will be allowed to expire on schedule. CBO provides alternative estimates, showing the cost of extending the 2001 and 2003 tax cuts and AMT relief, as well as a hypothetical path for the costs of operations in Iraq and Afghanistan, assuming that they diminish each year. We use these alternative CBO projections, rather than the official baseline, to calculate projected interest payments.

Indeed, the CBO data show that under current law, the total cost of mandatory programs other than Social Security, Medicare, Medicaid, and interest payments will *decline* significantly as a share of the economy over the coming decade, falling from 3.4 percent of GDP in 2005 to 2.6 percent in 2015. These other entitlement programs also are projected to decline significantly as a share of total entitlement spending and of the total budget. The other entitlement programs — unemployment compensation, civil service retirement, military retirement, Supplemental Security Income, the Earned Income and Child Tax Credits, veterans' benefits, food stamps, and others — thus are not contributing to either the short-term or long-term growth of the budget deficit.

This basic fact suggests that the phrase "entitlement problem" is too broad a generalization. The nation must face issues related to the financing of Social Security, and also must face much more challenging issues with respect to the costs of, and access to, health care (in both the private and public sectors). There does not, however, appear to be a general cost-growth problem with the other entitlement programs.

Nevertheless, many or most of the other entitlement programs would likely be hit hard by the proposed entitlement cap, because it is unthinkable that Congress and the President would cut Medicare and Medicaid by $2.1 trillion over ten years or anything remotely close to that. (Cutting Medicare and Medicaid that deeply also would represent extraordinarily ill-advised public policy, as it would cause severe hardship, likely result in many deaths, and seriously disrupt the health care sector of the U.S. economy.)

Cost Growth in the Health Care Programs

As noted, outside of growing interest payments on the debt, all of the "excess" entitlement expenditures that the Hensarling proposal seeks to eliminate stem from the rate at which health care costs are rising. It is important to understand that the rapid rise in health care costs in the United States is not due to flaws in Medicare and Medicaid: health care costs in the private sector are rising just as fast, if not faster, and comparable private-sector payment rates to health care providers tend to be higher. The rapid increases in health care costs in both the public and private sectors largely reflect advances in medical technology, as well as other factors that are endemic to the U.S. health care system as a whole.

For example, Medicaid costs per beneficiary have risen more *slowly* in recent years than private insurance costs. A recent study by Urban Institute researchers, commissioned by the Kaiser Family Foundation, found that Medicaid acute-care costs per enrollee rose an average of 6.9 percent per year from 2000 to 2003, which was a little more than half the 12.6 percent growth per year in the cost of private health insurance premiums found by a survey conducted by the Kaiser Foundation.[9] Moreover, Medicaid costs per beneficiary are substantially *lower* than those for private health insurance. Another recent Urban Institute study found that, after adjusting for differences in health status and other characteristics, average medical expenditures for adults enrolled in Medicaid were nearly 30 percent lower than medical costs for those individuals would be under private health

[9] John Holahan and Arunabh Ghosh, "Understanding the Recent Growth in Medicaid Spending, 2000-2003," *Health Affairs*, January 26, 2005; Kaiser Family Foundation, news release, "A Sharp Rise in Enrollment During the Economic Downturn Triggered Medicaid Spending to Increase by One-Third from FY 2000-03," January 26, 2005.

insurance. Similarly, average medical expenditures for children enrolled in Medicaid were found to be 10 percent lower than the costs would be under private insurance.[10]

The high cost of health care stems in part from problems in the structure of health care in the United States, as compared with other western industrialized countries where health care costs consume a smaller share of the economy. Since the demise of the Clinton health care plan in 1994, however, policymakers have been afraid to tackle the restructuring of the U.S. health care system. Indeed, the recent Medicare drug bill was replete with dubious subsidies for HMOs, PPOs, and some other providers — and kid-glove treatment for the pharmaceutical industry — despite the fact that those features of the legislation increased its cost.

The high cost of health care in the United States is not due primarily to irresponsible behavior by elderly and disabled Medicare beneficiaries or low-income children, families, and elderly and disabled people insured through Medicaid. Under the proposed entitlement cap, however, Medicare and Medicaid beneficiaries would likely be among the principal victims. A feature of the entitlement cap proposal that stands out is the high probability that it would heavily punish the innocent.

Moreover, the fact that health care costs are growing rapidly in the public and private sectors means that sharply reducing the rates of growth in Medicare and Medicaid costs *without* achieving equivalent reductions in the rate of growth in health care costs system-wide — i.e., in the private sector as well — can generally be accomplished only in one or more of five unappealing ways:

- by curtailing eligibility for Medicare and Medicaid and thereby pushing large numbers of low-income or elderly and disabled Americans into the ranks of the uninsured;
- by substantially scaling back the types of health care services and treatments covered by Medicare and Medicaid, with the result that major ailments or illnesses could go untreated and Medicaid and Medicare could end up offering second-class health care;
- by shifting a significant share of the costs of these programs (or at least of Medicaid) to the states;
- by shifting costs from Medicare and Medicaid to the private sector and making health care providers raise their charges to private-sector payers (such as employers and insurance companies, and ultimately the people whom they insure) to make up for their losses in treating

Development of Implantable Defibrillators Illustrates How Medical Breakthroughs Can Raise Costs

In January, the Center for Medicare and Medicaid Services (CMS) announced that it had approved Medicare coverage for the cost of implantable cardioverter defibrillators (ICDs). These are new, credit-card-size electric-shock devices that can substantially increase a heart-patient's chances of survival, as demonstrated by a four-year trial recently published in the *New England Journal of Medicine*. CMS's announcement said that Medicare expected to pay for at least 25,000 ICDs in the first year, "potentially saving up to 2,500 lives." In an indication of the importance that professionals assign to ICDs, CMS Administrator Mark McClellan personally made the announcement.

Implantable defibrillators are in the public eye in part because one was implanted in Vice President Cheney in 2001. The treatment is estimated to cost between $40,000 and $60,000 per implant and will increase Medicare costs by an estimated $3 billion to $15 billion a year, depending on how many heart patients are implanted with the device.

Medicare and Medicaid patients; or

- by increasing Medicare premiums, deductibles, and co-payments substantially and shifting more costs directly onto the elderly and people with disabilities.

In short, the proposed entitlement caps would almost inevitably lead to deep cuts in Medicare and Medicaid that resulted in millions of vulnerable Americans becoming uninsured or underinsured (or in costs being shifted on a large scale to states, the private sector, or beneficiaries), as well as in deep cuts in an array of other basic programs even though those programs are generally well-behaved from a budgetary standpoint.

Entitlement Cap Could Impede Sound Economic Policy

Under the proposal, entitlements would have to be cut deeply regardless of whether the economy was weak in a particular year and in need of stimulus. The deep cuts that would have to be instituted during recessions would themselves aggravate the nation's economic problems. Such cuts would further weaken consumer demand and consumer spending and thus slow the economy even more, causing the loss of additional jobs.[11]

Moreover, the proposal would not make provision for some kinds of temporary stimulus legislation that would be particularly appropriate during periods of economic weakness. Among the types of stimulus measures that can be useful are temporary funding to help states, which are required to balance their budgets even during economic hard times. States' actions to balance their budgets during recessions — whether by cutting state expenditures or raising state taxes — further weaken consumer demand and further slow an already struggling economy. Federal assistance to states, such as that enacted on a temporary basis in 2003, can lessen the degree to which states need to cut programs or raise taxes in the middle of a downturn and thus can reduce the economic damage. Temporary increases in unemployment benefits, which almost invariably occur during recessions, also may run afoul of the proposed entitlement cap.

Favoring the Wealthy and Powerful Over Ordinary Americans

In unveiling his tax cut in 2001, President Bush declared that there would be plenty of money left over after the tax cut to finance his proposed increases for education and defense, as well as a prescription drug benefit. In fact, he said, the government would run surpluses *outside of* Social Security (so that Social Security surpluses could be devoted to reducing the debt in anticipation of the baby boomers' retirement). He also said that as much as $1 trillion over ten years in *non*-Social Security surpluses would remain to cover the cost of unexpected contingencies. He turned out to be mistaken on all counts.

Rather than consider scaling back (or not extending) some parts of the tax cuts to help pay for the war on terrorism or the prescription drug benefit, however, proponents of the entitlement cap favor making permanent both the 2001 and the 2003 tax cuts — including tax-cut provisions that confer very large tax benefits on the wealthiest Americans — while cutting an array of basic benefit

[11] The Hensarling proposal includes an adjustment to cover increases in entitlement costs that result from more people becoming eligible for programs during a recession. The adjustment does not, however, relieve Congress of the need to cut entitlements during recessions to meet the entitlement cap. The cap would continue to be breached in the absence of substantial cuts, as result of factors such as the continued increase in health care costs.

programs for poor and middle-income families and elderly and disabled people. This approach directly favors affluent individuals and powerful corporations over ordinary Americans.

The proposal also would favor the affluent in a second way. Middle-class and low-income Americans receive the bulk of their government benefits and subsidies through entitlement programs — Medicare, Medicaid, student loans, veterans benefits, school lunches, Supplemental Security Income for the elderly and disabled poor, and the like. By contrast, affluent Americans and corporations receive the bulk of their government subsidies through the tax code.

Each year, both OMB and the Congressional Joint Committee on Taxation, Congress' official scorekeeper on tax matters, publish a list of what they term the "tax expenditures" in the federal tax code. As this term implies, these items are akin to spending programs, except that they are embedded in the tax code. Tax expenditures are measures through which the tax code is used to provide subsidies to various individuals and businesses.

These tax expenditures effectively operate as entitlements. They are not limited by a fixed amount that Congress appropriates each year. In most cases, their cost is open-ended. This is why, in testimony before the Bipartisan Commission on Entitlement and Tax Reform in 1994, Federal Reserve Chairman Alan Greenspan explicitly called these measures "tax entitlements" and urged that deficit reduction efforts consider both spending entitlements and tax entitlements.

These tax entitlements are costly. OMB estimates that tax expenditures cost many hundreds of billions of dollars a year.[12]

The entitlement cap in the Hensarling bill protects these tax entitlements. It exempts them from the entitlement cap. It even goes one step further: it would bar restraining a tax entitlement, such as an abusive corporate tax shelter, as a way to reduce entitlement costs so they fit within the entitlement cap.

The entitlement cap thus is highly imbalanced. New tax entitlements could be created, and existing ones could be expanded. No limit or restraint would be placed on such activity. But program entitlements for the middle class and the poor would be cut deeply.

An example may help illustrate the imbalanced nature of this approach. The federal government provides child care subsidies to households at all income levels. The child care subsidies for low- and moderate-income households are provided through program expenditures. Funding for those programs is quite limited, with the result that only about one in seven low- or moderate-income children who meet the federal eligibility criteria for child care assistance actually receives a subsidy. Child care subsidies also are provided to higher-income families, with those subsidies being provided through several tax expenditure provisions, including a provision under which the child care subsidies are worth the most to people in the highest income-tax brackets. Furthermore, unlike the child care subsides for the lower-income families, which are limited to about one-seventh of the families that qualify, the child care tax subsidies for the high-income families are available to *every* family that meets the criteria for these tax subsidies.

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[12] President's 2006 Budget, Analytical Perspectives. Although OMB estimates the cost of each individual tax expenditure, it does not provide an estimate of the combined cost of all tax expenditures because it does not measure the interaction effects among tax expenditures. The amounts listed in the Analytical Perspective suggest that the total cost may exceed $1 trillion per year.

Incentives for Budget Gimmicks

The entitlement cap also would create powerful incentives for policymakers to resort to rosy economic forecasts and other budget gimmicks to make it appear as through entitlement caps were being met. The pressure to resort to such devices would likely become intense in election years. For example, as occurred in response to the Gramm-Rudman-Hollings law in the second half of the 1980s, the entitlement cap would likely spawn maneuvers to shove entitlement costs into the following year, to accelerate "offsetting receipts" (which are considered negative expenditures) into the current year, and to use highly optimistic economic and technical assumptions to make it appear as though entitlement costs would be lower than would actually be the case.

Under the proposed entitlement cap, the child care subsidies for the lower-income working families could — and likely would — be cut. The subsidies for the higher-income families would not be touched. Moreover, any effort to even this out — by modestly scaling back the child-care tax subsidies for higher-income families so that the subsidies for the lower-income families would not be cut as deeply — would be prohibited.

Another example involves the Earned Income Tax Credit, a key tax benefit for the working poor. EITC payments that exceed a family's income tax liability are technically considered "mandatory spending." Such payments, however, often simply offset the payroll and federal excise taxes the family pays. Under the proposed entitlement cap, the EITC would be counted as an entitlement and subject to cuts. The proposed entitlement cap thus could — and in all likelihood, would — lead to tax increases on the working poor even as it protected tax breaks and tax cuts for the well-to-do and the well-connected and left the door open to more such tax cuts.

Shifting Cost to States

State governments likely would be hit hard under the entitlement cap, as the proposed cap could easily lead the federal government to seek to comply with the cap partly by shifting billions of dollars in costs to the states.

For example, whether entitlement cuts were implemented through congressional decisions or automatic reductions, Medicaid almost certainly would be cut substantially. And it is not easy to design deep reductions in federal Medicaid costs without shifting significant costs to the states. Indeed, if the entitlement cuts required by the bill were implemented through automatic cuts, the automatic cuts would almost certainly be implemented in Medicaid by reducing the federal share of state Medicaid costs — and thereby saddling states with costs that the federal government is supposed to cover (see the Appendix). Moreover, such reductions in the federal share of state Medicaid costs would be permanent. And numerous other grant programs to states, such as grants for child care, social services, and vocational rehabilitation, would be cut, as well, if automatic reductions were triggered or if Congress enacted legislation to cut entitlements enough to meet the caps.

The end result would likely be the equivalent of an unfunded mandate of very large proportions, with states subject to various federal requirements regarding these programs but with a significant amount of federal funding having been withdrawn.

May Set Back Opportunities for Deficit Reduction

The establishment of an entitlement cap could doom chances to reach a "grand bargain," under which all parts of the budget would be placed on the table and major deficit-reduction achieved through a bipartisan agreement. History suggests that unless all parts of the budget — including revenues, entitlements, and discretionary programs — are on the table and a spirit of "shared sacrifice" is invoked, large-scale deficit reduction is unlikely to be achieved. (That achievement of large-scale deficit reduction depends upon putting all parts of the budget on the table is true for two reasons. First, policymakers who fiercely defend particular parts of the budget are much more likely to try to block or limit the degree of savings from the parts of the budget that they champion if other major parts of the budget are being given special protection. Second, unless all parts of the budget are on the table, there will be strong temptation to use savings secured in one part of the budget — such as savings from reductions made in entitlement programs to comply with an entitlement cap — to finance measures adding new costs in another part of the budget, such as new tax cuts.)

If an entitlement cap is imposed, the chances of reaching a "grand bargain" in which all parts of the budget contribute to deficit reduction and large-scale deficit reduction is secured will be materially lessened. Significant *additional* reductions in entitlements will likely be off the table and policymakers, and interest groups that favor continual tax cuts and oppose revenue-raising measures will see little reason to assent to a deficit-reduction agreement that increases revenues without making additional cuts in entitlement programs. Indeed, with the approval of an entitlement cap, these policymakers and interest groups will have succeeded in securing the adoption of a mechanism designed to force cuts in popular entitlement programs *without* having had to give any ground on tax cuts. Adoption of an entitlement cap consequently risks greatly diminishing the potential for a large bipartisan deficit-reduction agreement.

Conclusion

Efforts to restore fiscal discipline should cover all parts of the budget, including entitlements, taxes, and appropriated programs. An "entitlement cap," however, is an exceedingly ill-advised way to approach this matter. It would represent unsound economic policy, requiring deep cuts even when the economy was in recession and erecting barriers to some important steps Congress might otherwise take to assist the economy, thereby risking making recessions more frequent and deeper. It also would raise severe equity problems: it would likely lead to large cuts in important programs that are not rising rapidly in cost or contributing to deficits, and would tend strongly to favor the well-to-do over ordinary middle- and low-income families and state governments. In addition, an entitlement cap could disrupt the delivery of health care in the United States and swell the ranks of the uninsured.

The entitlement cap proposal in the Hensarling bill would do substantial damage, requiring $2.1 trillion in cumulative cuts in mandatory programs over ten years. These massive reductions would be implemented at the same time that highly lucrative tax reductions for the nation's wealthiest were continuing to phase in, untouched by any fiscal constraints. In fact, despite the massive cuts required by the entitlement cap, they could produce no deficit reduction at all — they could merely cover the costs of, and provide the budgetary rationale for, additional tax cuts. In fact, the entitlement cap might *reduce* the overall prospects for serious deficit reduction by decreasing the likelihood of a grand budgetary bargain covering all parts of the budget — entitlements, taxes, and appropriated programs.

APPENDIX

How the *Automatic* Cuts Would Work

As explained on pages 7 and 8 of this analysis, it is inconceivable that Congress would allow all or most of the entitlement cuts required by H.R. 2290 to be made through the automatic-cut mechanism. The automatic cuts would be so unequally distributed as to require the total elimination by 2010 of an array of popular programs, as well as the salaries of Senators and Members of Congress. The obvious purpose of the automatic-cut mechanism is to force Congress to enact entitlement cuts that are more broadly based. In the real world, the question of how a particular entitlement is treated under H.R. 2290's automatic cuts thus is likely to be of limited importance. Nevertheless, because considerable interest in the design of the automatic cuts was expressed when an earlier version of this legislation was introduced in 2004, we describe the automatic cuts in this appendix.

Under the Hensarling entitlement cap, if automatic entitlement cuts are triggered (because the cap otherwise would be exceeded), most entitlement programs would be treated in one of three ways. They would be: 1) exempt from the automatic cuts; 2) cut no more than two percent per year; or 3) cut by whatever percentage was necessary to shrink overall entitlement spending enough to it fit within the cap.

Only a few programs would fall into the first of these three categories and be exempt from automatic cuts. Social Security would be exempt from automatic cuts because it would not be subject to the caps to begin with. Medicare Part A (hospital insurance) and Part C (Medicare "Choice" plans), civil service retirement, and regular (state-funded) unemployment insurance benefits all would be subject to the overall entitlement cap but exempt from the automatic cuts.

Programs that would be cut no more than two percent when automatic cuts were triggered would include Medicare Part B (physician services) and Part D (the new drug benefit), some (but not all) low-income benefit programs (such as Medicaid), the military retirement program, and veterans' disability compensation, pensions, and education benefits. These programs could be cut two percent each time an automatic cut was triggered.[13] If automatic cuts were triggered in five years, these programs could be cut close to 10 percent by the fifth time that such a cut was instituted.

It should be emphasized that if Congress sought to pass legislation to reach the caps *without* triggering the automatic cuts, there would be no limit on the magnitude of the cuts that could be made in any of the foregoing programs (except Social Security).

Finally, there is the category of programs in which there would be no limit on the depth of the automatic cuts that could be imposed. Programs in this category would be eliminated by 2010, in the unlikely event that cuts were made every year solely through the automatic-cut mechanism. This category of programs includes, among other programs:

- The refundable portion of the Earned Income Tax Credit and the Child Tax Credit,

[13] The automatic cut in these programs would be less than two percent only under an unlikely circumstance: if the reductions needed to reach the cap in a given year could be achieved by cutting both the "two-percent" programs *and* the "unlimited-cut" programs by a single across-the-board percentage of less than two percent.

- Extended unemployment benefits, which are paid during economic downturns in especially hart-hit states,
- Trade adjustment assistance,
- Farm-price supports and crop insurance,
- Child care,
- Vocational rehabilitation,
- The Social Services Block Grant,
- Child support enforcement,
- Tricare-for-life, which provides health benefits to military retirees age 65 or older,
- The Universal Service Fund, which makes payments to telecommunications carriers to subsidize universal coverage in high-cost or low-income areas, and
- The salaries of Members of Congress.

The remainder of this appendix describes how automatic cuts would be instituted in various programs if such cuts were triggered.

Application of Automatic Cuts to Veterans' Disability Compensation, Student Loans, Social Services, Crop Insurance, Trade Adjustment Assistance, and Medicaid

The entitlement cap proposal in H.R. 2290 does not prescribe exactly how automatic cuts would be implemented in each entitlement program but does include "special rules" prescribing how such cuts would be made in certain programs. This appendix describes how the automatic cuts would be instituted in a number of programs, based on these special rules where applicable, and on the basic structure of the entitlement programs in other cases.

The programs examined here include: veterans' disability compensation, the Social Services Block Grant (Title XX), the child care entitlement to states, vocational rehabilitation, student loans, crop insurance, Trade Adjustment Assistance, and Medicaid.

Compensation for Disabled Veterans

Automatic cuts made in certain entitlements could not exceed two percent per year. One of those programs is veterans' disability compensation, under which veterans who suffer service-connected disabilities receive monthly payments, with the dollar amounts being set by statute.

The automatic cuts would impose permanent reductions in benefits. Each time the automatic cuts were triggered, benefits would be cut an *additional* two percent, with the cuts compounding over time. If automatic cuts were instituted every year, the cut in the veterans' disability program would reach 17 percent by 2015.

The Department of Veterans Affairs likely would achieve the required savings by reducing the amount of the monthly benefit payments. If automatic cuts were instituted each year, the monthly checks thus would likely be cut by two percent in 2007 and 17 percent by 2015.

In addition, the annual cost-of-living adjustments in veterans' disability benefits, which are routinely passed by Congress each year, could be in jeopardy.[14]

Social Services Block Grant (Title XX)

The Social Services Block Grant is a "capped entitlement" that pays $1.7 billion per year to state social service departments, distributed in proportion to each state's population. The automatic cut would be accomplished by reducing the program cap from $1.7 billion to a lower figure. This program is *not* one in which the automatic cut would be limited to two percent per year. If the entitlement cap were enforced *solely* through automatic cuts, the automatic cuts in the Social Services Block Grant would reach *100 percent* by 2010, and the program would be eliminated.[15]

A number of other "capped entitlement" programs that make payments to states — such as vocational rehabilitation grants to states — would be reduced in precisely the same manner. Other programs that would be cut in the same manner include child care payments to states (made through the child care entitlement to states program), distributions of certain unemployment compensation receipts under the Reed Act, funds for promoting safe and stable families, and natural resources receipts that are shared by formula with states or counties.

Student Loans

The student loan programs (direct student loans and guaranteed student loans) are treated differently under H.R. 2290 than any other programs. H.R. 2290 specifies that if automatic cuts are required, the sole effect of the automatic cuts on these programs would be to increase the origination fees paid by students by ½ percentage point. In effect, the automatic cut would increase the interest rate that students must pay on new loans made after the automatic cuts are instituted by ½ percentage point, thereby reducing the ultimate cost to the government. (Students and graduates with outstanding loans on the date of the automatic cuts would not be affected; only new loans would be made more expensive.)

Under H.R. 2290, automatic cuts are permanent. Thus, if automatic cuts occur in each year through 2015, new student loans made in 2015 and all subsequent years would carry origination fees

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[14] Veterans' Disability Compensation is a unique entitlement in one respect: the amounts of the disability benefits are not indexed for inflation. But Congress invariably enacts an across-the-board increase in disability benefits — a cost-of-living adjustment, or COLA — each year in a percentage equal to the growth of the Consumer Price Index. This COLA is considered so customary that congressional budget scorekeeping rules treat it as a given. The existence of an entitlement cap could, however, change the political dynamic associated with the annual COLA legislation. Under H.R. 2290, Congress would always be faced with the question of how to reduce entitlement costs for the coming year down to the level specified by the cap. Failure to enact a compensation COLA would reduce the total amount by which entitlements were over the cap. Consequently, failure to enact a compensation COLA would make it marginally easier for Congress to meet the cap; the magnitude of the cuts required in *other* entitlement programs such as Medicare, Medicaid, civil service retirement, child care, and so on would be modestly smaller. If Congress took this view, enactment of the entitlement-cap provisions of H.R. 2290 might impede enactment of the annual COLAs in Veterans' Disability Compensation.

[15] For an explanation of why the automatic cuts could eliminate programs like the Social Services Block Grant after being in effect for a few years, see a prior Center on Budget and Policy Priorities analysis, "Claims that Proposed Entitlement Cap Would Shield Medicare and Not Cause Massive Cuts Are Incorrect," June 9, 2004.

that are five percentage points higher than the fees now required. (Fees would be increased by ½ percentage point per year for ten years.) In other words, the costs to students of a student loan would be increased by five percentage points.

While this unique rule protects the student loan programs from being eliminated or having their eligibility restricted under automatic cuts, the favored treatment comes with a price — student loans would be placed first in line for automatic cuts. If the automatic cuts required in a given year are very small (perhaps because Congress tried to meet the cap through legislation but OMB determined that the cap was nevertheless breached by a very small amount), student loans would have their origination fees raised by ½ percentage point *first*, before any other program was automatically cut. If the savings in the student loan programs sufficed to make up for the breach in the entitlement cap, no other programs would be subject to automatic cuts that year.

Federal Crop Insurance

This program enables farmers to purchase insurance at a subsidized rate to protect themselves against losses due to droughts, floods, pests, and other natural disasters. This is another of the entitlement programs for which there would be no limit on the magnitude of the automatic cuts that could be instituted. If the entitlement cap were enforced solely though automatic cuts, the cuts in the crop insurance subsidy would reach 100 percent by 2010, as would the cuts in payments that assist companies in marketing crop insurance to farmers..

After that, the Department of Agriculture would not be able to subsidize any new crop insurance contracts or assist in their marketing. The program would therefore cease to exist. If the automatic cuts were, say, 50 percent, the Department would likely reduce the subsidy it provides to help farmers purchase crop insurance, shrinking the subsidy (and thereby raising the price of the insurance) to the degree needed to cut the cost of the program in half.

Trade Adjustment Assistance

This program makes payments to workers who have lost their jobs because of certain circumstances related to international trade. There would be no limit on the size of the automatic cuts that could be made in this program either. Here, too, if the entitlement cap were enforced solely though automatic cuts, the cuts made in the program would reach 100 percent by 2010. From then on, the federal government would pay no trade adjustment benefits. If the automatic cuts were, say, 50 percent, the Labor Department would likely cut each worker's benefits in half.

Medicaid

Medicaid is one of the programs that would be subject to automatic cuts of up to two percent per year. Under current law, the federal government reimburses each state for a portion of its annual Medicaid costs, using a formula based on a state's per-capita income. For more affluent states, the federal government pays 50 percent of program costs. For the poorest state, Mississippi, the federal government will pay 76 percent of costs in 2006. The federal share of a state's Medicaid costs is known as the FMAP (the Federal Medical Assistance Percentage).

APPENDIX TABLE 1		
Percentage Increase in the Share of Medicaid Costs Borne by States After Automatic Entitlement Cuts Under HR 2290		
	2007	**2015**
Arkansas	5.6%	46.8%
Indiana	3.4%	28.3%
Texas	3.1%	25.6%
Wisconsin	2.7%	22.6%
California	2.0%	16.6%

For more detail, see Appendix Table 2 on page 21.

Although the proposed entitlement cap does not specify how the automatic cuts would be instituted in Medicaid, it is likely that the Department of Health and Human Services would simply reduce quarterly reimbursement payments to states below the amounts that HHS otherwise would pay. If the automatic entitlement cut is two percent, the federal government would pay each state 98 percent of what it otherwise would pay. If automatic cuts were instituted every year, by 2015, the federal government would be paying states 83 percent of what they otherwise would receive.

A reduction of this sort in federal payments is the same as a reduction in the federal matching percentage, or the FMAP. Imagine that the total cost of the Medicaid program in California is $20 billion in 2014. Because the federal match for California is 50 percent, the federal government would pick up $10 billion of the total cost, and California would pay $10 billion from its own funds. Now imagine that the entitlement cap, through the imposition of successive automatic cuts, has reduced the federal payments to 83 cents on the dollar by 2015. Instead of paying $10 billion to California, the federal government would pay $8.3 billion, and California would be left with costs of $12.7 billion. In effect, the entitlement cap would have reduced California's federal matching percentage from 50 percent to less than 42 percent. This would constitute a 17 percent reduction in federal costs and a 17 percent increase in California's costs.

The budgets of poorer states would be hit harder. Consider how Texas would fare. Imagine that, like California, Texas' Medicaid program costs a total of $20 billion in 2014. Under current law, the federal matching rate for Texas is 60.7 percent, so the federal government would pay $12.1 billion and Texas would pay $7.9 billion of Medicaid costs. Now imagine that by 2015, successive automatic entitlement cuts have reduced the federal payments to 83 cents on the dollar. The federal payment would drop from $12.1 billion to $10.1 billion, and Texas's costs would correspondingly rise from $7.9 billion to $9.9 billion. This would constitute a 17 percent reduction in federal costs but a *26* percent increase in Texas' costs.

The table on page 21 shows the results of a two-percent automatic cut in federal Medicaid payments in 2007, and a 17 percent reduction in federal Medicaid payments in 2015, for each state and the District of Columbia.

Note: The figures cited here reflect the assumption that if federal Medicaid funding was cut, states would provide additional state resources to make up for the lost federal funds, rather than cutting back their Medicaid programs. This is an optimistic view. In the face of lower federal matching payments, it is likely that many states would cut back their Medicaid programs. If that occurred, the beneficiaries most at risk would likely be working-poor families that earn too much to qualify for welfare and elderly and disabled people in nursing homes. Federal law does not guarantee Medicaid coverage to these classes of beneficiaries, but most states choose to cover some of these people under Medicaid. Faced with major increases in state Medicaid costs because of reductions in the federal matching payments, states could reverse their decisions to cover these types of low-income beneficiaries, leaving many of them uninsured.

APPENDIX TABLE 2

Reduction in FMAPS From the Repeated Application of "Two-Percent Sequestration"

	Federal Share of Medicaid Costs			State Share of Medicaid Costs			Percentage Increase in State Costs	
		2.0% cut	*16.6% cut*					
State	**2006**	**2007**	**2015**	**2006**	**2007**	**2015**	**2007**	**2015**
Alabama	69.5%	68.1%	58.0%	30.5%	31.9%	42.0%	4.6%	37.9%
Alaska	50.2%	49.2%	41.8%	49.8%	50.8%	58.2%	2.0%	16.7%
Arizona	67.0%	65.6%	55.8%	33.0%	34.4%	44.2%	4.1%	33.7%
Arkansas	73.8%	72.3%	61.5%	26.2%	27.7%	38.5%	5.6%	46.8%
California	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Colorado	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Connecticut	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Delaware	50.1%	49.1%	41.8%	49.9%	50.9%	58.2%	2.0%	16.7%
Dist Columbia	70.0%	68.6%	58.4%	30.0%	31.4%	41.6%	4.7%	38.8%
Florida	58.9%	57.7%	49.1%	41.1%	42.3%	50.9%	2.9%	23.8%
Georgia	60.6%	59.4%	50.5%	39.4%	40.6%	49.5%	3.1%	25.6%
Hawaii	58.8%	57.6%	49.0%	41.2%	42.4%	51.0%	2.9%	23.7%
Idaho	69.9%	68.5%	58.3%	30.1%	31.5%	41.7%	4.6%	38.6%
Illinois	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Indiana	63.0%	61.7%	52.5%	37.0%	38.3%	47.5%	3.4%	28.3%
Iowa	63.6%	62.3%	53.0%	36.4%	37.7%	47.0%	3.5%	29.1%
Kansas	60.4%	59.2%	50.4%	39.6%	40.8%	49.6%	3.1%	25.4%
Kentucky	69.3%	67.9%	57.7%	30.7%	32.1%	42.3%	4.5%	37.5%
Louisiana	69.8%	68.4%	58.2%	30.2%	31.6%	41.8%	4.6%	38.4%
Maine	62.9%	61.6%	52.4%	37.1%	38.4%	47.6%	3.4%	28.2%
Maryland	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Massachusetts	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Michigan	56.6%	55.5%	47.2%	43.4%	44.5%	52.8%	2.6%	21.7%
Minnesota	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Mississippi	76.0%	74.5%	63.4%	24.0%	25.5%	36.6%	6.3%	52.6%
Missouri	61.9%	60.7%	51.6%	38.1%	39.3%	48.4%	3.3%	27.0%
Montana	70.5%	69.1%	58.8%	29.5%	30.9%	41.2%	4.8%	39.8%
Nebraska	59.7%	58.5%	49.8%	40.3%	41.5%	50.2%	3.0%	24.6%
Nevada	54.8%	53.7%	45.7%	45.2%	46.3%	54.3%	2.4%	20.1%
New Hampshire	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
New Jersey	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
New Mexico	71.2%	69.7%	59.3%	28.9%	30.3%	40.7%	4.9%	41.0%
New York	50.0%	49.05	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
North Carolina	63.5%	62.2%	52.9%	36.5%	37.8%	47.1%	3.5%	28.9%
North Dakota	65.9%	64.5%	54.9%	34.2%	35.5%	45.1%	3.9%	32.1%
Ohio	59.9%	58.7%	49.9%	40.1%	41.3%	50.1%	3.0%	24.8%
Oklahoma	67.9%	66.6%	56.6%	32.1%	33.4%	43.4%	4.2%	35.2%
Oregon	61.6%	60.3%	51.3%	38.4%	39.7%	48.7%	3.2%	26.6%
Pennsylvania	55.1%	53.9%	45.9%	45.0%	46.1%	54.1%	2.4%	20.4%
Rhode Island	54.5%	53.4%	45.4%	45.6%	46.6%	54.6%	2.4%	19.9%
South Carolina	69.3%	67.9%	57.8%	30.7%	32.1%	42.2%	4.5%	37.6%
South Dakota	65.1%	63.8%	54.3%	34.9%	36.2%	45.7%	3.7%	31.0%
Tennessee	64.0%	62.7%	53.4%	36.0%	37.3%	46.6%	3.6%	29.5%
Texas	60.7%	59.4%	50.6%	39.3%	40.6%	49.4%	3.1%	25.6%
Utah	70.8%	69.3%	59.0%	29.2%	30.7%	41.0%	4.8%	40.2%
Vermont	58.5%	57.3%	48.8%	41.5%	42.7%	51.2%	2.8%	23.4%
Virginia	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
Washington	50.0%	49.0%	41.7%	50.0%	51.0%	58.3%	2.0%	16.6%
West Virginia	73.0%	71.5%	60.9%	27.0%	28.5%	39.1%	5.4%	44.9%
Wisconsin	57.7%	56.5%	48.1%	42.4%	43.5%	51.9%	2.7%	22.6%
Wyoming	54.2%	53.1%	45.2%	45.8%	46.9%	54.8%	2.4%	19.7%