How Much of the Enlarged Surplus is Available for Tax and Program Initiatives?

Available Funds Should be Devoted to Real National Priorities

James Horney
Robert Greenstein

CENTER ON BUDGET AND POLICY PRIORITIES

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Authors

James Horney is a Senior Fellow at the Center on Budget and Policy Priorities specializing in federal budget issues.

Robert Greenstein is Executive Director of the Center on Budget and Policy Priorities.

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Center on Budget and Policy Priorities
820 First Street, N.E., Suite 510
Washington, DC 20002
(202) 408-1080

E-mail:center@cbpp.org
Web: www.centeronbudget.org

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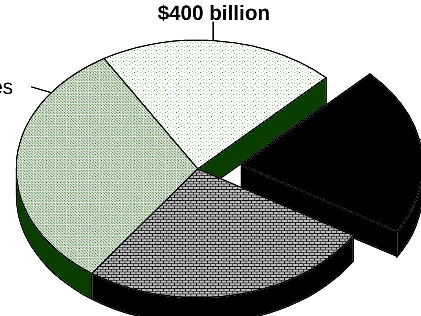
Executive Summary

New budget estimates released June 26 by the Office of Management and Budget project that surpluses will total nearly $1.9 trillion over the next 10 years, not counting the surpluses in the Social Security trust funds. These projections are likely to intensify pressures for large tax cuts, and to a lesser extent, increases in expenditures for a variety of programs. Many policymakers and members of the public apparently believe that $1.9 trillion is now available for these purposes.

How Much of the Projected Surpluses is Really Available to Fund Changes in Current Tax and Program Policies?

Total Non-Social Security Surplus FY2001-2010: $1.9 trillion



In fact, the amount available is much smaller than that. When surpluses in the Medicare Hospital Insurance (HI) trust fund are placed off-limits along with Social Security surpluses, as both parties are moving to do, and the cost of maintaining *current* policies in areas such as aid to farmers, middle-class tax burdens, and discretionary spending are taken into account, the $1.9 trillion figure is cut in half. Furthermore, a significant portion of the remaining funds will be needed to help restore long-term Social Security and Medicare solvency, since policymakers in both parties overwhelmingly reject restoring solvency largely or entirely through benefit reductions or payroll tax increases. As a result, the amount actually available for tax cut and program initiatives (other than Social Security and Medicare solvency measures) may be in the vicinity of $400 billion over 10 years rather than $1.9 trillion.

- One of the few things that the President and Congress have agreed on in recent years is that Social Security surpluses should be used only for Social Security, by which they generally mean that the surpluses should be used to pay down the federal debt and not to finance increases in other programs or tax cuts. The arguments for setting the Social Security surpluses to the side in this manner apply equally to surpluses in the Medicare HI Trust Fund, and the President and Congress seem close to agreement to wall off those surpluses. The House and Senate both have recently approved legislation to this effect. According to Administration estimates, this would reduce surpluses potentially available for changes in tax or spending policies by more than $400 billion, from $1.9 trillion over 10 years to less than $1.5 trillion.

- The projected non-Social Security, non-Medicare HI surpluses that are potentially available to finance tax cuts and program initiatives are further reduced when realistic assumptions are made about renewing an array of expiring tax credits that Congress routinely extends, preventing the encroachment of the Alternative Minimum Tax into the middle class, continuing current "temporary" payments to farmers, and maintaining current discretionary spending levels, adjusted for inflation and changes in the size of the U.S. population. Using realistic assumptions that simply assume the continuation of current policies in these areas (including the real costs of continuing current policies in the baseline does not imply that continuing those policies is necessarily desirable) reduces the estimate of the surpluses available for other uses by close to $600 billion over 10 years. This shrinks the available surpluses from $1.5 trillion to approximately $900 billion.

- In addition, a significant part of the projected surpluses ultimately will be needed as part of Social Security and Medicare reform legislation to restore long-term solvency to these programs; nearly all of the major Social Security proposals offered by lawmakers of either party entail the transfer of large sums from the non-Social Security budget to the retirement system. This is true both of proposals that include individual accounts as a partial replacement for Social Security and of proposals that do not follow such a course.

  It is not possible to estimate with any precision how much of the surpluses will be needed as part of solvency packages, since that depends on how far lawmakers are willing to go in reducing Social Security and Medicare benefits or increasing payroll taxes. However, $500 billion or more is likely to be needed for this purpose over the next 10 years. If a Social Security reform package is enacted in the near future that includes benefit cuts and payroll tax increases covering about 70 percent of the amount needed to restore long-term solvency — a level of benefit and tax changes that will be very difficult to achieve politically — then closing the remaining 30 percent of the long-term financing gap will require an infusion of approximately $500 billion over the next 10 years from the non-Social Security, non-Medicare HI part of the budget. If action on Social Security and Medicare reform packages is delayed, a smaller amount of the projected surpluses may be needed over the coming decade, but then still-larger sums are likely to be needed in the future.

If none of the surpluses projected for the next 10 years are set aside for this purpose — and the surpluses are largely used for permanent tax cuts and program increases instead — the amounts needed to help restore Social Security and Medicare solvency are likely to be still greater in the future, but less money will be available to meet these demands. This argues for setting funds aside for this purpose now, even if Social Security and Medicare solvency legislation will not be enacted quickly.

If approximately $500 billion is needed for Social Security and Medicare reform (this amount could be larger or smaller, but almost certainly will total hundreds of billions of dollars), the projected surpluses that remain available for other policy initiatives will equal about $400 billion over 10 years. (This $400 billion would have to cover the cost of the increased interest payments on the debt that would result from using some of the surpluses for tax cuts or increased program

How Much of the Projected Surpluses is Available to Fund Changes in Tax and Program Policies?

(in trillions of dollars)	**Fiscal Years 2001 - 2010**
Administration's June 2000 baseline projection of non-Social Security surpluses	$1.9
Minus:	
Medicare Hospital Insurance Trust Fund surpluses	-$0.4
Amounts needed to maintain current policies	-$0.6
Amounts likely to be needed for Social Security and Medicare reforms to achieve long-term solvency	-$0.5
Remaining surpluses available to fund changes in current tax and program policies (including resulting increase in interest costs)	$0.4

> expenditures, as well as the cost of the tax cut and program increases themselves.) While $400 billion is a substantial sum, it is far less than the $1.9 trillion some policymakers seem to think is available for tax cuts and program expansions.

Whatever the amount that is available for tax and program initiatives, decisions about the best uses of this money should be made carefully and based on a vigorous debate about the needs and priorities of the nation. The emergence of large non-Social Security surpluses is a very recent phenomenon. Neither lawmakers nor the public have yet gone through a process of weighing the most appropriate uses of the surpluses and establishing priorities. Current Congressional proposals to use the surpluses seem to be more a response to short-term political currents before the fall elections — and to demands from interest groups that have been able to mobilize quickly and get to the front of the line (and in some cases, make large campaign contributions) — than the product of careful, systematic consideration of how to take advantage of the opportunity the economic boom presents to establish priorities for addressing the nation's most critical needs. Before enacting measures such as the pending legislation to repeal the estate tax, at an ultimate cost of $50 billion a year, lawmakers ought to consider the range of potential uses of the projected surpluses and weigh these uses against each other.

How Much of the Surplus is Available for Initiatives?

The economic and technical assumptions that underlie the new budget projections could turn out to be too optimistic (or too pessimistic). But if the assumptions prove to be on the mark, the non-Social Security surpluses that will develop if current policies remain unchanged will be considerably smaller than $1.9 trillion over 10 years.

Medicare Trust Fund Surpluses

The President and Congress have agreed that Social Security surpluses should be used only for Social Security, by which they generally mean that these surpluses should be used to pay down the federal debt and not to finance other programs or tax cuts. The arguments for using Social Security surpluses solely for Social Security, rather than for program expansions or tax cuts elsewhere in the budget, apply equally to the Medicare HI trust fund.

Social Security and Medicare payroll taxes are withheld together from paychecks. The payroll taxes collected for both programs are placed in trust funds in which balances are accumulating now, but all of the funds ultimately will be needed to meet future benefit requirements. If the surpluses in the Social Security trust funds are set aside and considered unavailable for tax cuts or program initiatives, the same should logically be true of the Medicare HI trust fund. Some $400 billion of the roughly $1.9 trillion in projected non-Social Security surpluses over the next 10 years consists of projected surpluses in this trust fund.

Both parties now are moving to make surpluses in the Medicare HI trust fund off-limits for tax cuts or increases in other programs. The Administration has proposed such an approach.

And, as noted above, the House of Representatives on June 20 passed a measure intended to have this effect by a 420-2 vote.

It is important to note that while dedicating all of the Social Security and Medicare HI trust fund surpluses to debt reduction may be a wise policy today and represents a generally desirable goal, it is not a sound idea in all circumstances. It makes sense now, when the economy is booming. But if the economy were to slow markedly or plunge into recession and anticipated surpluses evaporated, it would be foolish to enact tax increases or spending cuts just to ensure that the rest of the budget is balanced and all of the Social Security and Medicare surpluses go to reduce debt. Instead, a fiscal policy that helped to stimulate the economy would be appropriate in such circumstances.

Taxes and Mandatory Spending

When the Administration and the Congressional Budget Office construct the budget "baselines" on which their surplus projections rest, they follow a series of basic rules. Under these rules, OMB and CBO generally assume no legislation will be enacted that makes any changes in current laws related to taxes or entitlement programs, even if legislation is needed simply to extend a current policy. Because of this rule, these two agencies *exclude* from their surplus projections the costs of legislation that is needed in several politically sensitive areas to maintain current policies and is virtually certain to be enacted. This includes legislation to maintain payments to farmers in future years, legislation to extend an array of popular tax credits that are scheduled to expire every few years and that Congresses and Administrations of both parties routinely renew, and legislation to prevent the Alternative Minimum Tax from hitting millions of middle-class families that do not use tax shelters and raising their taxes in the years ahead. (The Alternative Minimum Tax was created to prevent wealthy investors from using so many tax shelters that they owe little or no income tax; in the years ahead, however, it will have a much more widespread impact unless changes in it are enacted.) Whatever the respective merits of these pieces of legislation (and there is question about the wisdom of some of them), they would merely continue current policy. Virtually every knowledgeable observer agrees that legislation to continue these policies is almost certain to be enacted.

The budget surplus projections do not include the cost of any of these steps. The surplus projections essentially assume that payments to farm operators will be slashed compared to current levels, that all of the tax credits coming up for renewal will be allowed to die, and that millions of middle-class families will become subject to the AMT for the first time and face sizeable tax increases. Maintaining current policies in these areas is likely to consume more than $200 billion of the projected surpluses over the next 10 years.

Discretionary Spending

Administration and CBO projections generally assume that discretionary spending (spending for non-entitlement programs that is controlled by annual appropriation bills) will grow only at the rate of inflation, without any increase to reflect growth in the U.S. population. The projections thus assume that overall expenditures for discretionary programs will decline in purchasing power on a per person basis (or, to use more technical terms, the projections assume that these expenditures will decline on a real *per capita* basis). This means, for instance, that the amount of education spending per pupil will decline in inflation-adjusted terms.

As former CBO directors Rudolph Penner and Robert Reischauer have observed, this is not realistic. There is a consensus among a majority in Congress and the Administration that defense spending (almost all of which is discretionary spending) should grow. In addition, non-defense discretionary spending grew 20 percent after adjusting for inflation between 1990 and 2000 and 10 percent after adjusting for population growth as well as inflation. If non-defense discretionary spending grew at these rates during a period marked primarily by pressures to shrink budget deficits, such spending is unlikely to be treated parsimoniously in a period of surpluses. The notion that real *per capita* discretionary spending (spending adjusted for inflation and population growth) will fall amidst budget surpluses is not credible. (It may be noted that when measuring spending growth in Texas, Governor George W. Bush and his campaign regularly measure changes in spending on a real *per capita* basis. They have argued, reasonably, that this is the appropriate standard to use.)

Assuming that overall discretionary spending will remain unchanged in purchasing power on a per person basis reduces the projected surpluses available for tax and program initiatives by an additional $350 billion over the next 10 years. While this is a much more realistic assumption than assuming that discretionary spending will keep pace only with inflation and will decline in real terms on a per person basis, it probably understates the likely path of discretionary spending. As Robert Reischauer has noted, “it will be a Herculean feat” to keep discretionary spending from growing in real *per capita* terms in a time of surpluses.

Using realistic assumptions about renewing the expiring tax credits, continuing payments to farmers, fixing the AMT, and maintaining discretionary spending on a real *per capita* basis — and setting aside the surpluses in the Medicare HI trust fund — results in a total reduction of the amount of projected surpluses available for tax and program initiatives from nearly $1.9 trillion over 10 years to approximately $900 billion.

Funding Needed for Long-term Social Security and Medicare Reform

Despite the improved budget outlook, Social Security and Medicare face rising costs and funding shortfalls when the number of baby-boomers who draw benefits grows in the decades ahead. Both parties have pledged to enact reforms that will ensure that Social Security and Medicare remain solvent and able to pay promised benefits for decades to come.

Proposals to extend the solvency of the Social Security and Medicare trust funds by relying solely on benefit reductions or payroll tax increases do not appear politically feasible; they are shunned by both parties. As a consequence, making substantial transfers from the general fund to these trust funds appears to be an essential component of any politically feasible reform package to restore long-term solvency to these programs. For example, even the Medicare reform legislation that Senator John Breaux and Representative Bill Thomas have proposed, which contains controversial changes in the Medicare benefit structure that many lawmakers think go too far, would close less than half of the long-term Medicare financing gap. It would leave a need for large general revenue infusions unless payroll taxes are raised significantly.

It is impossible to know precisely how much funding will be needed from the general budget to help restore long-term Social Security and Medicare solvency. But it is hard to imagine these funding requirements will not amount to some hundreds of billions of dollars over the next 10 years. According to the Social Security Trustees, solvency of the Social Security trust funds for 75 years would be achieved if permanent increases in trust fund income or reductions in Social Security expenditures equal to 1.89 percent of taxable payroll were enacted. The 1.89 percent of taxable payroll amounts to more than $1 trillion over the next 10 years. The amount needed to restore the solvency of the Medicare HI Trust Fund, using the Medicare trustees' forecast, would amount to about $700 billion over the next 10 years.

Even if the general fund contribution to Social Security and Medicare solvency were to constitute only about 30 percent of a reform package enacted now, the contribution needed would be approximately $500 billion over the next 10 years. Of course, Social Security and Medicare reform is not likely to occur in the immediate future, and general fund contributions may not begin for a number of years. Delaying reform, however, will have the effect of increasing the annual amounts needed in the future. Moreover, taking portions of current general fund surpluses that eventually will be needed for these solvency efforts — and using those funds instead to fund permanent tax cuts or program increases — would mean that fewer resources would be available in the future to cover the larger amounts that would be needed as part of a solvency package. Failing to set aside a portion of the projected surpluses for general-revenue transfers would likely make it more difficult to pass legislation at a later date that ensures long-term solvency.

If $900 billion is available over 10 years for tax cuts and program initiatives and $500 billion of this amount is set aside for Social Security and Medicare solvency legislation (the exact amount to set aside for solvency legislation is somewhat arbitrary), that would leave $400 billion over 10 years for other purposes. Even if the amount needed for Social Security and Medicare solvency efforts proves to be only $300 billion (although assuming that no more than this amount will be needed probably is not wise), the available surpluses will be about $600 billion. While these are substantial amounts, they are considerably less than the $1.9 trillion some policymakers may be tempted to dispose of. (Note: To avoid creating a deficit, the costs of tax cuts and program increases must be less than the amount of the available surpluses. Tax cuts and spending increases will cause the federal debt to be higher than OMB's baseline projections assume, which will cause interest payments on the debt to be greater than the baseline projections show and to consume a portion of the available surpluses.)

Assessing National Priorities

Whatever the exact amount that remains available for changes in taxes and programs, Congress and the President should carefully assess national priorities in allocating resources among competing claims. The surpluses anticipated in the next 10 years present a unique opportunity to deal with critical national needs. This opportunity should not be squandered either by allocating more resources than is prudent or by dividing up the resources based on which interest groups manage to gin up effective (if often misleading) public relations campaigns most quickly or on what public opinion polls indicate about the near-term appeal of certain proposals, especially when the longer-term costs and consequences of such proposals are largely hidden from view.

Congress and the President should carefully weigh, and foster debate on, the relative long-term benefits of various uses of the available surpluses. There should be a national debate on what the nation's most critical priorities are. In our view, the leading contenders include the following (not all of which could be funded adequately from the surpluses that realistically are available):

- Greatly reducing the number of people without health insurance, which now stands at 44 million — or more than 16 percent of the U.S. population — a level unheard of among other western industrialized nations.

- Assisting those who have not enjoyed the fruits of the economic boom of the 1990s — particularly working-poor families and poor elderly and disabled individuals — and mounting significant efforts to reduce child poverty, which remains far higher here than in Canada or western Europe. In addition, modest increases in U.S. economic aid targeted on poor nations could result in substantial benefits for the 1.2 billion people who, according to the World Bank, survive on less than $1 a day, and whose living conditions often include severe health risks.

- Bringing the Medicare benefit package into the 21st century, including providing prescription drug coverage, protection against catastrophic costs, and some long-term care insurance. (These benefit expansions may be partially paid for by premiums.)

- Providing increased funds (in the case of discretionary spending, above current levels adjusted for inflation and population) for activities that represent investments in the future, such as selected education, job training, environmental clean-up and protection, and infrastructure improvements. (It may be possible to offset a portion of these costs through reductions in funding for programs that no longer provide significant benefits, but additional resources still would be needed.)

Tax cuts also have a place on this list. The scope of tax reductions needs to be restrained, however, to avert revenue losses that are overly costly either now or in years outside the 10-year budget window. In addition, tax cuts that primarily benefit high-income individuals, the group that has gained the most income and wealth during the economic boom, should not qualify as pressing national priorities. Preference should be accorded to tax reductions that assist lower- and moderate-income working families, as well as tax changes that make the tax system simpler, fairer, and more supportive of economic growth by lowering rates for most workers and broadening the tax base, rather than by piling more special tax breaks into the tax code.

When critical national needs are carefully weighed, it is difficult to believe there would be a national consensus that policies such as repealing the estate tax — which would ultimately cost $50 billion a year and provide extremely large tax reductions to the nation's wealthiest individuals while doing little or nothing to promote economic growth — should be accorded higher priority than reducing the ranks of the uninsured, ameliorating child poverty, strengthening the Medicare benefit package, addressing environmental dangers, or reducing taxes in ways that distribute the tax cut benefits more broadly and equitably and have the potential to increase growth.

I. The Dimensions of the Available Surplus

The Administration's new budget projections indicate that surpluses outside the Social Security system will total $1.9 trillion over the next 10 years.[1] These new projections reflect an increase in projected non-Social Security surpluses of more than $1.1 trillion since the Administration issued its previous projections less than six months ago. CBO is expected to release updated budget estimates in the next few weeks which project that non-Social Security surpluses will equal or exceed $2 trillion over 10 years.

As with all budget projections that cover periods of more than a few years, the new projections are highly uncertain. If projections of the non-Social Security surpluses can more than double in less than six months when no legislation significantly affecting the projections has been enacted and no dramatic changes in the economy have occurred, the surplus projections also can be revised downward by large amounts in coming years if the economic and technical assumptions underlying the projections prove too optimistic. (The assumptions could, of course, also turn out to be too pessimistic, in which case the projected surpluses may grow still larger.)

But even if the assumptions turn out to be on the mark, the non-Social Security surpluses realistically available to fund tax cuts or new program initiatives are likely to be substantially smaller than $1.9 trillion for two reasons that are discussed in this chapter. First, a consensus seems to be developing rapidly among the President and Congress that the Medicare Hospital Insurance trust fund surpluses, which the Administration estimates will total about $400 billion over the next 10 years, should be used to pay down the debt rather than to fund tax cuts or increases in spending. Second, the costs of maintaining current policies that are not reflected in the baseline projections are very likely to reduce the available surpluses further, to less than $900

[1] See Office of Management and Budget, *Mid-Session Review of the Budget for Fiscal Year 2001* (June 26, 2000). The Social Security surpluses are projected to total $2.3 trillion in 2001 through 2010, producing projected total budget surpluses of $4.2 trillion over 10 years.

billion. (As chapter II explains, a significant part of this $900 billion is likely to be needed as part of reform packages to restore long-term solvency in Social Security and Medicare, further reducing the amount available to fund tax cuts and other program initiatives.)

Medicare Trust Fund

One of the more striking budget developments of the past few years has been the emergence of a consensus among most Members of Congress and the President — and the apparent Republican and Democratic nominees for President — that Social Security surpluses should be "used only for Social Security." In general, this means the Social Security surpluses should be used to pay down the federal debt.

The arguments advanced for setting aside the Social Security surpluses in this manner are that: 1) the Social Security payroll taxes that workers pay are supposed to be dedicated to Social Security and should not be used to finance other government programs; 2) the Social Security surpluses represent funds needed to meet Social Security liabilities currently accumulating (i.e., promises to pay benefits to current workers in future years) and hence these surpluses should not be considered available for other purposes; and 3) Social Security surpluses should be used to pay down the federal debt so that in future decades, the government (and the economy) will better be able to afford to redeem the Treasury securities the Social Security trust fund holds and to finance the increasingly large Social Security benefits that will be due in those years.

If these arguments apply to Social Security, they apply equally to the Medicare HI trust fund.[2] Like Social Security payroll taxes, Medicare payroll taxes are deposited in a trust fund that currently is running annual surpluses but eventually will go into deficit. Also like Social Security, when the Medicare HI trust fund moves into deficit status, it will need to redeem the Treasury securities it accumulated during the years of surpluses. As a result, there seems to be a growing consensus that the surpluses in the Medicare HI trust fund should be walled off from the rest of the budget and used to pay down the debt, along with the Social Security surpluses.

The Clinton Administration has now proposed such a course. In addition, both the House of Representatives and the Senate have recently approved legislation intended to guarantee that

[2] There also is a Medicare Supplemental Medical Insurance (SMI) Trust Fund. That fund is fundamentally different in nature, however, from the Social Security and HI trust funds. The SMI trust fund is *not* financed through payroll taxes. Instead, it is financed by premiums that beneficiaries pay (which cover about 25 percent of SMI costs) and by general funds (which cover about 75 percent of costs). Moreover, the SMI trust fund is not supposed to accumulate large surpluses that will be drawn down in later years.

Originally, the HI Trust Fund largely covered inpatient hospital costs, and the SMI Trust Fund largely covered physician services. While that remains true to a substantial degree, the distinction between the services that the two Medicare trust funds cover has become somewhat blurred with the growth of managed care and a variety of non-physician outpatient services. CBO has projected that the SMI trust fund will have a small deficit over the next 10 years.

Medicare HI surpluses are not used to fund non-Medicare spending or tax cuts. Excluding the projected Medicare HI trust fund surpluses from the amounts potentially available for tax cuts or program initiatives reduces the amount available for those purposes by approximately $400 billion over the next 10 years.

It is important to note that the general goal of using the Social Security and Medicare HI surpluses to pay down the federal debt should not be treated as an absolute rule. In the current circumstances, using both the Social Security and Medicare HI surpluses to pay down the debt is a good idea. With a booming economy, the budget outlook is extremely bright for the next decade or so. But as increasing numbers of baby-boomers become eligible for Social Security and Medicare (and, in the case of baby-boomers with low or moderate incomes, rely on Medicaid for long-term care), there will be intensifying pressure on the budget. One of the best things that can be done to prepare the nation to deal with that pressure is to use the currently projected Social Security and Medicare HI surpluses to pay down the federal debt. That will increase national saving, modestly boosting economic growth. It also will improve the fiscal position of the federal government, freeing up room in the budget now occupied by the more than $200 billion a year in interest payments on the debt and making it safe economically for the government to borrow in future decades if that proves necessary to meet national needs. In short, it will put the government in a better position in coming years to meet the demands of the increasing numbers of senior citizens. But there is nothing magical about using all of the Social Security and Medicare HI surpluses in every year to pay down the debt; adhering to that policy does not guarantee that the government will be able to meet the future demands of an aging population, and deviating from that policy will not suddenly put the future of those programs at risk. In some circumstances, it may make sense to pay down the debt by more than the amount of the Social Security and Medicare HI surpluses. In other circumstances — such as an economic slowdown that causes non-Social Security, non-Medicare HI surpluses to shrink or disappear — it would be foolish to raise taxes or cut spending to ensure that every penny of the Social Security and Medicare HI surpluses is used to pay down the debt. The general rule that using the surpluses to pay down the debt is a good idea must be weighed against existing circumstances and other needs.

Costs of Continuing Current Policies

The Administration and CBO projections are generally assumed to reflect what the surpluses will be if current policies are maintained and no tax cuts or program increases are enacted. This belief is not entirely accurate. In several key respects, these forecasts assume changes in current policies will occur. These assumed policy changes cause the surplus projections to swell. These effects are seen in the estimates of taxes and entitlement spending under current laws, as well as in the projections of discretionary spending.

Tax and Entitlement Spending

The Administration and CBO baseline projections generally assume that no changes will be made in the laws governing taxes and entitlements, regardless of whether such changes in law are required simply to maintain current policies or how likely it is that such changes will be enacted.[3] That assumption leads, however, to an underestimate of the cost of maintaining current policies in at least three areas: aid to farmers, an array of popular tax credits (and a few other tax provisions) that Congress extends every few years, and the Alternative Minimum Tax.

Payments to Farmers

The budget projections assume that Congress and the President will enact no legislation over the next 10 years that would provide any aid to farmers over and above the amounts farmers are scheduled to receive under the terms of the 1996 Freedom to Farm Act. That act provided for farm price support payments that were supposed to be relatively high in the first few years after enactment and then to decline substantially. When payments to farmers began to decline, however, and farm prices turned out to be lower than had been anticipated in 1996, Congress and the President enacted new legislation to provide billions in additional "temporary" payments to farmers. Such legislation has been enacted in *each of the last three years*, providing about $6 billion for 1999, $14 billion for 2000, and $2 billion already for 2001, with substantially more for 2001 likely to be enacted before that fiscal year is over.

As noted, under the rules the Administration and CBO follow in making baseline budget projections, they generally assume there will be no changes in laws affecting entitlement programs. As a result, the Administration and CBO projections assume there will be no payments to farmers at any time over the next 10 years, other than the shrunken payments the Freedom to Farm Act provides.[4] Although some may view such a course as wise policy, it does not represent a continuation of the current policy of providing more support than is afforded by the Freedom to Farm Act. Furthermore, in light of the farm legislation enacted in each of the

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[3] Taxes and entitlement spending are governed by permanent laws in most cases, so leaving those laws unchanged generally results in a continuation of current policies. But some laws governing taxes and entitlement programs expire, which means that continuing current policies (the policies in place right now) requires enactment of new legislation to extend the existing law.

It should be noted that there are two exceptions to the rule that the baseline assumes no change in law. One exception requires the Administration and CBO to assume that a *program* with annual outlays of $50 million or more will be continued even if the law governing the program is scheduled to expire. The other requires the Administration and CBO to assume that excise taxes credited to trust funds (such as the gasoline tax that is dedicated to the Highway Trust Fund) are continued beyond any scheduled expiration date.

[4] The Administration and CBO do not apply the $50 million program exception described in footnote 3 to assume that the "temporary" farm funding provided in each of the last three years will be continued in the future. This is because the "temporary" funding, which is administered through the existing farm support program, is viewed as an expiring provision of a continuing program rather than as a separate program that expires. The $50 million rule applies only to *programs* that expire, not to *provisions* that expire.

past three years — and with continuing low farm prices, widespread dissatisfaction with the Freedom to Farm Act among farm-state legislators, and competition among the political parties for votes in farm states — the chances that these budget projections regarding payments to farmers will prove accurate, and that these billions of dollars a year in additional payments to farmers will cease to be made, are essentially zero. The current policy of providing substantial additional payments to farm operators is virtually certain to be continued in the years ahead.

"Expiring" Tax Provisions

The Administration and CBO projections also contain unrealistic assumptions regarding approximately 20 tax credits and other tax provisions that Congress regularly extends for a few years at a time, including the research and experimentation credit and the work opportunity credit. As noted above, the baseline ground rules generally require the Administration and CBO to assume that provisions of the tax code set to expire actually will expire as scheduled rather than being renewed. As a result, the Administration and CBO budget projections assume that these 20 tax credits and other provisions — most of which are popular, command strong bipartisan support, and are virtually certain to continue being renewed — will die in the years ahead. Here, too, the probability of this occurring is essentially zero.

At the end of last year's session, Congress passed legislation extending the expiring tax credits and other expiring provisions of tax law at a cost of about $5.5 billion in fiscal year 2002.[5] Congress routinely passes such legislation every time these tax provisions are scheduled to expire, usually extending them for another year or two. (Congress extends these credits only a year or two at a time to minimize the cost of the extension.) To develop a realistic estimate of future budget surpluses available for tax or program initiatives, it is necessary to factor in the costs of maintaining these tax credits, as Congress is sure to do. CBO estimates that continuing these expiring tax provisions will cost about $50 billion over the next 10 years.

The Alternative Minimum Tax

Just as likely as enactment of legislation to continue these tax credits is legislation to prevent the alternative minimum tax from subjecting millions of middle-class families to greatly increased tax complexity and sizeable tax increases. The alternative minimum tax was established to address concerns that some high-income individuals were largely avoiding the federal income tax by investing heavily in tax shelters. Because key features of the AMT are not indexed for inflation, however, the AMT's impact will change markedly in the years ahead in ways that Congress never intended. If no change in law is made, the number of taxpayers whom the AMT hits will jump from about 2 million this year to more than 15 million by 2009. The Department of Treasury estimates that by that time, 45 percent of families with two children would be affected. Virtually all observers agree that policymakers will not stand by and allow

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[5] This cost does not include the cost of a provision related to the Alternative Minimum Tax, which is discussed below.

millions of middle-class taxpayers to become subject to the AMT and saddled with higher tax bills as a consequence. Policymakers will act to prevent that from occurring.

Because the Administration and CBO budget projections assume no changes in tax law, however, these projections essentially assume that no changes will be made in the AMT law and that more than 15 million tax filers will be affected by it and pay higher taxes by 2009. Once again, the chances of this occurring are near zero. Enactment of legislation to prevent a vast increase in the number of middle-class taxpayers subject to the AMT is a virtual certainty. Such legislation could cost $80 billion over the next 10 years and $20 billion in 2010 alone.[6]

Adding These Three Items Together

The combined cost of maintaining current payments for farm operators, renewing the expiring tax credits, and preventing the AMT from raising the taxes of millions of middle-income taxpayers is more than $200 billion over 10 years. This estimate includes the $50 billion that CBO estimates it would cost to extend the expiring tax provisions, $60 billion for maintaining additional farm aid at the 1999 level (which may be low, given the $14 billion in additional farm payments provided for the current year), and $80 billion for the AMT provisions, plus the increased debt service payments that would result from these three steps since there would be a larger federal debt on which interest had to be paid. None of these costs are included in Administration or CBO baseline projections.

This is not to suggest the Administration or CBO has done anything inappropriate in constructing the budget baselines. Budget baselines are supposed to reflect current entitlement and tax law, not a revised version of the law. But policymakers, journalists, and commentators mislead the public — and themselves — if they fail to take into account the cost of legislation that is virtually certain to be enacted (and simply maintains current policies) when they develop or report on plans to tap the projected surpluses.

Discretionary Spending

The surplus projections also assume levels of spending for "discretionary" programs (i.e., programs that are not entitlements) that are unrealistically low. Discretionary spending covers a wide swath of government activities, including virtually all of the defense budget, most of the education budget, health and science research, veterans medical care, environmental programs, food safety inspection, air traffic control, highway construction, Head Start and numerous other social programs, the Federal Bureau of Investigation, and the National Park Service, among others.

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[6] Based on CBO and Joint Committee on Taxation estimates, it would cost about $80 billion to continue a current temporary provision in the tax code that allows taxpayers to take full advantage of nonrefundable tax credits without regard to the AMT, as well as to index the AMT exemption for inflation.

In both the Administration's and CBO's projections, discretionary spending is assumed to decline in real *per capita* terms. The budget projections assume that total discretionary spending will grow with inflation, but the projections do not include an adjustment for increases in the size of the U.S. population.[7] But surely, maintaining current policies means maintaining current services *per person*. If every school child is currently provided with a book, current policy is not maintained if the number of students increases but the number of books provided remains the same. As the population grows, it generally takes more resources to provide the same level of services on a per-person basis.

This basic proposition is acknowledged in a special provision in the baseline rules that provides that the Administration's and CBO's projections of administrative expenses for the Medicare, Social Security, Unemployment Insurance and Railroad Retirement programs must be adjusted for projected growth in the beneficiary population for those programs, as well as for inflation. That proposition is not applied, however, to the rest of discretionary spending. Administrative funding for these four programs represents less than 1.5 percent of total discretionary spending. The other 98.5 percent is not adjusted for population growth.

Most analysts believe it is highly unrealistic to assume that in a period of budget surpluses, discretionary spending will simply remain even with inflation and consequently decline in purchasing power on a *per capita* basis. Rudolph Penner, director of the Congressional Budget Office from 1983 to 1987 and currently a senior fellow at the Urban Institute, recently wrote: "The CBO's projections of that surplus [i.e., the non-Social Security surplus] assume discretionary spending will be held constant in real terms, a highly unlikely situation." Penner noted that defense spending is very likely to be increased and that "Congress seems in no mood to be stingy with regard to civilian spending."[8] Similarly, Robert Reischauer, the CBO director from 1989 to 1995 and now president of the Urban Institute, recently observed that "in any era of surpluses, it will be a Herculean feat just to hold *real per-capita* discretionary spending constant over a 10 year period."

Historical data support Penner and Reischauer. From 1990 to 2000, non-defense discretionary spending grew by 20 percent in real terms (i.e., after adjustment for inflation), despite pressure through most of this period to reduce or eliminate budget deficits. On a real *per capita* basis, non-defense discretionary spending grew by 10 percent during this period. This

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[7] CBO also produces two other baseline projections of discretionary spending: one that assumes discretionary spending will comply with the statutory caps on such spending through 2002 and grow at the rate of inflation thereafter, and another that assumes discretionary spending will be frozen for 10 years at the current level without any adjustment for inflation. Neither of these assumptions is remotely realistic. Congress and the President have essentially evaded the caps for the last two years, and complying with the cap in 2001 would require cutting discretionary appropriations by $60 billion below the level set just last April in the Congressional budget resolution for 2001. Freezing discretionary spending at the 2000 level for 10 years would require a 20 percent real cut in discretionary spending by 2010.

[8] Rudolph Penner, "Trends," Milken Institute Review, Second Quarter 2000.

leads to a fairly obvious point: if non-defense discretionary spending grew at such a rate during a period largely marked by deficits, it is very likely to grow during a period of surpluses. To assume it will decline in purchasing power on a *per capita* basis amidst mounting budget surpluses is not realistic.

To be sure, *total* discretionary spending did not increase during much of the 1990-2000 period, but that was due to sizeable reductions in the defense budget after the end of the Cold War. With an apparent consensus among a significant majority in Congress and both of the principal Presidential candidates that defense spending should grow, there is little prospect that defense budget cuts will be made to offset future increases in non-defense discretionary spending. To the contrary, increases in *both* defense and non-defense discretionary expenditures are likely.

This raises the question of what assumptions should be made in the discretionary spending area if one wishes to develop realistic budget surplus projections. As Penner and Reischauer have observed, simply assuming that total discretionary spending stays even with inflation, with no adjustment for population growth, is not realistic. An alternative approach is to assume that total discretionary spending will remain constant as a share of the gross domestic product (GDP); this is the basic assumption that CBO uses for all years *after* the next 10 years when it issues its long-term budget forecasts. Assuming that discretionary spending remains constant as a share of GDP could provide a useful assumption, but it also could place the assumed level of discretionary spending too high. Discretionary spending has been declining as a share of GDP for many years. (Discretionary spending is currently at the lowest level relative to the size of the economy ever recorded. For fiscal year 2000, the Administration estimates total discretionary spending will equal 6.2 percent of GDP. That compares with 12.7 percent of GDP in 1962, the earliest year for which figures are available on discretionary spending as a separate budget category.)

Between these two assumptions — that discretionary spending will rise only with inflation and that it will rise with GDP — lies the assumption that discretionary spending will remain unchanged in real *per capita* terms (that is, that it will stay constant in purchasing power on a per person basis, rising at the rate of inflation plus population growth). A strong case can be made that this is the most sensible measure of the cost of maintaining current policy in this part of the budget, particularly in an era of surpluses.

Indeed, this is a case that Republican Presidential candidate George W. Bush has made when assessing budget growth in Texas. Earlier this year, the *Wall Street Journal* reported a Steve Forbes charge that state spending in Texas has grown 36 percent under Governor Bush's tenure and a Bush response that Forbes' charge was incorrect because Texas state spending has increased only 2.7 percent.[9] As the *Wall Street Journal* explained, Bush measured the change in state spending by taking the level of spending at the time he took office, adjusting that level for

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[9] Jackie Calmes, "On Spending, Forbes Takes Cue from Bush," *Wall Street Journal*, (November 5, 1999).

both inflation *and state population growth* since that year, and using the resulting figure as the baseline against which he measured the actual spending that has occurred. Governor Bush has adopted the same approach in other formats as well, including campaign debates, where he has presented figures on budget growth in Texas after adjustment for both inflation and population growth and explicitly stated that he was making these adjustments.[10]

Furthermore, assuming that total discretionary spending will simply remain unchanged in real *per capita* terms in an era of surpluses is a conservative assumption. As noted, non-defense discretionary spending rose 20 percent over the past 10 years after adjustment for inflation. If discretionary spending rises at the rate of inflation plus population growth over the next 10 years, it will rise less than half that much in the decade ahead.[11] Moreover, if discretionary spending grows at that rate, it will continue to fall as a percentage of GDP.

As mentioned earlier, Robert Reischauer has warned it will be a remarkable feat to hold discretionary spending to this level. It would be imprudent for policymakers to use assumptions of levels of discretionary spending lower than this when assessing how much of the non-Social Security surplus is available for other purposes.

Maintaining real per capita discretionary spending at current levels would require nearly $300 billion in additional expenditures for discretionary programs over the next 10 years, compared to the levels the Administration and CBO baselines assume. When the additional interest payments on the debt that would be made are taken into account, the projected surplus would be reduced by about $350 billion over 10 years.

The combined effect of using this more-realistic assumption about discretionary spending and using realistic assumptions about farm payments, expiring tax credits, and the AMT is to reduce the amount of projected surpluses potentially available for other purposes by a total of about $600 billion in the decade ahead.

Resulting Potentially Available Surpluses

Under the more-realistic assumptions discussed here regarding tax credits, the AMT, payments to farmer and discretionary spending, the projected surpluses are reduced by about $600 billion over 10 years. If the surpluses in the Medicare HI trust fund are set to the side, that reduces the amounts available for other purposes by an additional $400 billion. As a result, the amount potentially available for other purposes appears to be a little less than $900 billion.

[10] Similarly, the Bush campaign web site declares that "the three budgets adopted by Governor Bush cut the rate of growth in *real per capita spending* to 2.7 percent..." (emphasis added).

[11] If non-defense discretionary spending stayed level on a real per capita basis over the next 10 years, such spending would rise eight percent after adjustment only for inflation . That would be less than half the 20 percent rate at which it grew during the 1990s. This projection is based on the intermediate assumption of the Social Security Trustees that the U.S. population will rise at the rate of 0.8 percent per year over the next 10 years.

II. Funds Needed for Long-term Social Security and Medicare Reform

Although the budget outlook has grown brighter, Social Security and Medicare still face escalating costs and funding shortfalls when the number of baby boomers who draw benefits from these programs mounts in coming decades. According to the latest Social Security trustees' report issued last March, Social Security and Medicare spending will grow from 6.5 percent of the Gross Domestic Product (GDP) today to 10.2 percent of GDP over the next 25 years. The Medicare HI Trust Fund will begin to run an annual deficit by 2017, and trust fund assets will be exhausted by 2025. The Social Security trust funds will begin to run deficits by 2025, and the reserves in these trust fund are projected to run out by 2037.

Using most of the potentially available non-Social Security surpluses to finance large tax cuts or entitlement initiatives before enacting reforms to ensure long-term Social Security and Medicare solvency is likely to make it more difficult to enact reforms to shore up these programs for the long term. Addressing the long-term solvency problems of Medicare and Social Security almost certainly will require some mix of reductions in benefits and, particularly in Medicare, increases in payroll taxes. Despite the rhetoric of some proponents of so-called "lock box" legislation that is intended to ensure that Social Security and Medicare surpluses are set aside and used to pay down the federal debt, such an outcome does not directly affect Social Security or Medicare solvency.[12]

[12] All surpluses in the trust funds are automatically credited to the trust funds. Thus, the balances — and the solvency — of those trust funds are the same whether the surpluses they generate are used to pay down the debt or to fund other activities of the government. See Robert Greenstein and James Horney, *A Small Non-Social Security Deficit In Fiscal Year 2000 Would Not Adversely Affect Social Security*, Center on Budget and Policy Priorities (September 1999).

There are limits, however, to the benefit reductions and payroll tax increases that seem politically achievable in these programs. As a result, it is highly unlikely that either Medicare or Social Security solvency can be restored without significant infusions of general funds, which will need to come from the non-Social Security surpluses. If the projected non-Social Security surpluses are largely consumed by big tax cuts and large increases in entitlement programs, insufficient surplus funds will remain to help secure enactment of long-term Social Security and Medicare reform.

Consider Medicare's situation. The controversial Medicare plan that Senator John Breaux and Representative Bill Thomas put forward last year would significantly reduce projected Medicare spending. Yet it would close less than half of the gap between projected Medicare expenditures and anticipated revenues over the next 30 years. That even a proposal such as the Breaux-Thomas plan — which calls for changes in Medicare that many lawmakers think go to far — would close no more than a minority of the long-term Medicare financing gap makes clear that some non-Social Security surplus funds will be needed to help achieve Medicare solvency unless payroll taxes can be raised rather substantially. For these reasons, a politically diverse panel of Medicare experts that the National Academy of Social Insurance convened concluded unanimously last year that the provision of new revenues for Medicare will have to be part of the debate on long-term Medicare solutions.[13]

Similarly, any politically feasible plan to ensure the solvency of Social Security will almost certainly require substantial transfers from the non-Social Security surpluses. This is true not only of plans that explicitly call for a transfer of general funds to the Social Security trust funds, such as the plan that President Clinton has proposed, but also of most plans that propose to establish private accounts. Many Social Security "privatization" plans promise both to establish individual accounts and to restore Social Security solvency *without any benefit reductions or payroll tax increases*. The only way to achieve such an outcome is to use a very large portion of the non-Social Security surpluses either to fund the private accounts directly or to replace funds diverted from the Social Security trust funds to the private accounts.

Under the Social Security plan that Reps. Bill Archer and Clay Shaw have developed, for example, the government would deposit into an account in each worker's name an amount equal to two percent of the worker's wages (up to the Social Security payroll tax cap, now $76,200). When a worker retired, his or her account would be converted into an annuity, administered by the Social Security Administration, that would provide a monthly benefit payment until the worker died. If the monthly annuity payment a worker received was less than the monthly Social Security benefit to which a worker otherwise was entitled, as would be the case for most retirees, Social Security benefit payments would make up the difference.

[13] Members of the National Academy of Social Insurance Study Panel on Medicare Financing, *The Financing Needs of a Restructured Medicare Program* (September 1999).

In the long term, Social Security solvency might be achieved under such an approach, since the Social Security trust funds would make substantially smaller benefit payments than under current law. (The Social Security benefit payments that most beneficiaries would receive would be reduced one dollar for each dollar the beneficiary received in monthly annuity payments from his or her individual account.) But the reductions in Social Security benefit costs would not reach substantial levels until many years from now. As a result, there would be a multi-decade "transition period" during which the contributions the federal government would pay into workers' individual accounts would require much higher levels of overall federal spending.

The Social Security actuaries have estimated that the net costs of the Archer-Shaw plan — the costs of the government's deposits into the individual accounts, plus the higher interest payments the government would have to make on the federal debt, minus the savings the plan would produce in Social Security costs — would total more than $1.4 trillion over the next 10 years and equal between $300 billion and $700 billion *each year* from 2016 through 2042.[14] This money would have to come from non-Social Security surpluses, while such surpluses lasted.

Most Social Security privatization plans rely in this manner on the transfer of hundreds of billions of dollars — and in many cases, trillions of dollars — from the non-Social Security budget to either the Social Security trust funds or private accounts. This is true even of privatization plans that entail substantial Social Security benefit reductions, such as the plan that Reps. Jim Kolbe and Charles Stenholm have introduced in the House and Senators Judd Gregg and John Breaux have introduced in the Senate. The Social Security proposals that President Clinton and Vice President Gore have advanced do not replace a portion of Social Security with individual accounts, but they, too, envision large transfers from the non-Social Security budget to Social Security.

It is not possible to determine in advance exactly how much of the general fund surpluses will be needed to facilitate Social Security and Medicare reform. That depends on the political will to make changes in Social Security and Medicare benefits and payroll taxes or to invest a portion of trust fund balances in private securities that produce a higher average rate of return than Treasury bonds. But it is possible to give some idea of the magnitude of the hole that will need to be filled under various plans to restore long-term solvency to these programs.

According to the Medicare trustees' report issued in March 2000, the Medicare HI funding gap is equal to 1.21 percent of taxable payroll over the next 75 years. That means that either an increase in income to the trust fund or a reduction in trust fund costs equal to 1.21

[14] These figures are in current dollars. See Stephen C. Goss, Deputy Chief Actuary, Social Security Administration, "Long-Range OASDI Financial Effects of the Social Security Guarantee Plan — INFORMATION," April 29, 1999.

percent of taxable wages over the next 75 years would restore solvency over the 75-year period.[15] That 1.21 percent of taxable payroll equals more than $600 billion over the next 10 years.

As described above, the Medicare plan that Senator Breaux and Rep. Thomas have proposed would close less than half of the long-term Medicare financing gap. Thus, even if program changes as far-reaching as those in the Breaux-Thomas plan were adopted, general fund transfers on the order of $300 billion or more over 10 years would still appear to be needed to restore long-term Medicare solvency, unless Medicare payroll taxes were raised.

The amounts needed to ensure Social Security solvency could be even larger. The Social Security trustees estimate that increases in trust fund income or reductions in benefit costs equal to an average of 1.89 percent of taxable payroll over the next 75 years are necessary to provide solvency for the 75-year period. If half of the funding gap in Social Security has to be covered by general fund transfers — which could easily be the case given Congressional reluctance to reduce benefits or increase payroll taxes — the transfers would total roughly $500 billion over the next 10 years.

Because the amount of the projected surpluses needed to facilitate reforms to restore long-term Social Security and Medicare solvency depends on the willingness of lawmakers to make tough choices in these programs, it is not possible to predict with any precision what that amount will be. But since it is clear that it will be difficult politically to enact benefit cuts and payroll tax increases that cover most of the long-term funding gaps, the amount of general fund support required is likely to be large. For instance, even if lawmakers are able to enact cuts in benefits and increases in payroll taxes sufficient to fill as much as 70 percent of the long-term funding gaps in Social Security and Medicare, general fund transfers of approximately $500 billion over the next 10 years would be needed to achieve 75-year solvency. Of course, Social Security and Medicare reform is not likely to occur in the immediate future, and general fund contributions may not begin for a number of years. Delaying reform, however, will have the effect of increasing the annual amounts needed in the future. Moreover, taking portions of current general fund surpluses that eventually will be needed for these solvency efforts — and using these funds instead to fund permanent tax cuts or program increases — would mean that fewer resources would be available in the future to cover the larger amounts that would be needed as part of solvency packages. As a result, failing to set aside a portion of the projected

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[15] The trustees' report states that this percentage "can be interpreted as the percentage that would have to be added to the current law income rate in each of the next 75 years, or subtracted from the cost rate in each year, to bring the funds into actuarial balance." Social Security and Medicare Board of Trustees, *Status of Social Security and Medicare Programs: A Summary of the 2000 Annual Reports* (April 2000). The "current law income rate" is defined as the "Ratio of tax revenues ...to the ... taxable payroll for the year." The "current law cost rate" is defined as "the ratio of the cost (also called outgo, expenditures, or disbursements) of the program to the taxable payroll...."

surpluses now for general-revenue transfers would likely make it more difficult to pass legislation at a later date that ensures long-term solvency.[16]

[16] This does not mean that general fund transfers to the trust funds need to begin in advance of action on substantive reform packages. In fact, it would probably be better to make the transfers conditional on enactment of substantive reforms. All that is necessary now is to ensure that the funds are not used to pay for tax cuts or program increases. Using the funds to pay down the debt effectively saves funds that can be used later for transfers. Creating some sort of reserve fund to reflect money set aside for future transfers, and used now to pay down the debt, might help to ensure that the money is not used for tax cuts or program increases.

III. National Needs and Priorities

Whatever the exact portion of the projected surpluses that is available to finance changes in taxes and programs, it ought to be allocated among competing demands only after careful consideration of national needs and priorities. The emergence of large non-Social Security surpluses is a very recent phenomenon. Neither lawmakers nor the public have yet gone through a process of weighing the most appropriate uses of the surpluses and establishing priorities. Current Congressional proposals to use the surplus seem to be more a response to short-term political currents before the fall elections than the product of careful, systematic consideration of how to take advantage of the unique opportunity the economic boom presents to set priorities and address the nation's most critical needs. Before enacting measures such as the pending legislation to repeal the estate tax, at an ultimate cost of $50 billion a year, lawmakers ought to consider a range of uses of the projected surpluses and weigh these uses against each other.

In our view, uses that should be given serious consideration — and that qualify as national priorities — include the following, not all of which can be fully funded from the surplus amounts that are realistically available:

Extending Health Insurance to the Uninsured

The economic boom has not helped to alleviate one of the most serious problems that many Americans face — the lack of affordable health insurance. In 1998, approximately 44 million Americans — 18.4 percent of the non-elderly population — were uninsured. That is up from about 15 percent who lacked insurance a decade earlier. Roughly 85 percent of those currently uninsured are members of a family with a working adult. In addition, nearly one of every four low-income children — children in families with incomes below 200 percent of the poverty line — lacks health insurance.

The number of uninsured can be reduced partly by undertaking more intensive efforts to enroll more of those who are eligible for Medicaid or separate state health insurance programs. This is particularly true for children; approximately 95 percent of all uninsured low-income children in the country satisfy the income eligibility criteria for a publicly funded health insurance program.[17] In addition, proposals like the Family Care plan included in the Administration's budget could expand health care coverage dramatically for low-income working parents. Additional steps could be taken to cover individuals not eligible for Medicaid or current state health insurance programs, including low-income adults who are not elderly, disabled, or raising children.

Adapting the Medicare Benefit Package to Changing Conditions

Medicare has been successful in ensuring that the nation's elderly have access to high quality medical care without having to bear the full cost of that care out of limited retirement income. The benefits that Medicare provides, however, are not keeping pace with developments in medicine and health care financing in recent decades. As a result, many Medicare beneficiaries will find it increasingly difficult to obtain adequate health care without paying too much out of their own pockets. In 1999, Medicare beneficiaries 65 and older not living in institutions were projected to spend an average of $2,340 — or 19 percent of income — on out-of-pocket health care costs.[18] The percentage of elderly individuals' income that is consumed by out-of-pocket by health care expenditures is expected (under current policies) to increase further over the next 25 years.[19]

The most obvious, and politically salient, shortcoming is the lack of an adequate prescription drug benefit. Modern medicine is increasingly reliant on drug therapies, which provide improved health outcomes and reduce the need for expensive, unpleasant, and potentially dangerous surgical and other invasive procedures. But the Medicare benefit package has not been adapted to changing circumstances, and Medicare beneficiaries have much less-generous prescription drug benefits than most employer-based private health insurance plans provide. Because many of the new drugs are very expensive, this imposes hardship on many Medicare beneficiaries and is eroding the success of Medicare in keeping the elderly from having to sacrifice adequate food and housing to pay for health care.

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[17] A modest portion of these children are ineligible for publicly-funded health insurance despite meeting the income criteria because of their immigration status or because their families have assets that exceed the asset limit for these programs in the nine states that still apply asset tests for children's eligibility for health insurance.

[18] AARP Public Policy Institute Issue Brief, *Out of Pocket Spending on Health Care by Medicare Beneficiaries Age 65 and Older: 1999 Projections* (December 1999).

[19] Marilyn Moon, Urban Institute, *Growth in Medicare Spending: What Will Beneficiaries Pay?* (January 1999).

In addition, Medicare does not adequately protect the elderly against catastrophic health care costs. Patients with extended hospital stays or very large doctors' bills can end up with crippling expenses if they have not been able to afford Medigap insurance, which can be expensive. Medicare also does not provide protection against the cost of long-term care, except for limited stays in skilled nursing facilities.

Providing Funds for Investments in the Future

With the current bright economic and budget outlook, it would be wise to use part of the projected surpluses to fund investments that can produce long-term economic and social benefits. Carefully targeted public investments can help to increase the productivity of American workers, so that the rate of economic growth is not constrained unduly by the relatively slow growth of the work force expected in coming decades.

Investments in a variety of areas have the potential to produce long-term benefits, including:

- Education and job training (including improved financial assistance to enable more low-income youth to receive higher education), which can help better prepare American workers to develop and use new technologies and new means of production. This should enable those workers to be more productive, which would allow them to fare better in a global economy and help keep the U.S. economy strong;

- Research and development in a variety of areas, which can help keep the U.S. economy competitive and may produce breakthroughs that lead to longer, healthier lives;

- Targeted improvements in the nation's infrastructure, which can promote productivity and economic growth through more efficient transportation and communications; and

- Environmental protection and cleanup, which should help protect natural resources needed to foster better health and more productive workers and also provide future generations the opportunity to enjoy America's natural wonders.

Assisting Working Poor Families and Reducing Poverty at Home and Abroad

The current economic boom has created many new millionaires and helped millions of others to improve their standard of living. But there are a significant number of Americans who, for a variety of reasons, have not shared much in the fruits of prosperity. For instance, although the booming economy has pushed the poverty rate significantly below the levels reached during the recession of the early 1990s, the overall poverty rate remained higher in 1998 (the latest year for which data are available) than in nearly all years of the 1970s. Moreover, the poverty rate for children — 18.9 percent in 1998 — remains substantially above the child poverty rate in most other industrialized nations, and more than one in every three black and Hispanic children still are poor.[20] The Blair government in the United Kingdom recently established a national policy goal of cutting child poverty in half in 10 years. Although the United States has both a higher child poverty rate than the United Kingdom and far more national wealth, we have no goal in this area. In addition, the poverty rate for elderly women living alone in the United States, at 18.5 percent in 1998, is nearly as high as the poverty rate for children.[21]

On the international front, 1.2 billion people survive on less than $1 a day and live in conditions of extreme poverty and destitution. Modest increases in U.S. economic aid for poor nations could result in significant improvements in living standards for these people.

There are a variety of initiatives that could assist low-income working families and others in need. Given the extent of national wealth that we now enjoy and the magnitude of the disparities in income in the United States between rich and poor — which are wider than the disparities in any other western industrialized nation — such initiatives merit particular attention. These initiatives — which are spelled out here in more detail than are the other priorities described in this paper because of the Center's particular focus and experience on these matters — include the following:

- *Expanding the earned-income tax credit (EITC) to increase the rewards of work for low-income families*. The EITC helps to reduce taxes, supplement wages, and make work more attractive than welfare. Recent research indicates the EITC has a strong effect in increasing employment among single female parents and that the EITC lifts more children out of poverty than any other program or category of program.[22] But the EITC can be improved. The official poverty rate remains a stunning 29 percent for children in families with more than two children, more than double the poverty rate among children in smaller families. An enhanced EITC for families with three or more children, proposed in the Administration's budget and in legislation recently introduced by a bipartisan group of Senators,

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[20] See Center on Budget and Policy Priorities, *Low Unemployment, Rising Wages Fuel Poverty Decline* (October 1, 1999)

[21] The figures cited here are the official poverty rates. Under an alternative measure of poverty that counts non-cash benefits such as food stamps and housing subsidies, subtracts income and payroll taxes, and adds Earned Income Tax Credit payments, the poverty rate for children was 14.3 percent in 1998, while the poverty rate for elderly women living alone was 15 percent. Among elderly widows, the official poverty rate was 16.8 percent in 1998, and the rate under the alternative poverty measure was 14.2 percent.

[22] Robert Greenstein, *Should EITC Benefits Be Enlarged for Families with Three or More Children*, Center on Budget and Policy Priorities (March 21, 2000).

makes sense, as do proposals to reduce the marriage penalty the EITC can engender and the marginal tax rates that families face in the income range where the EITC drops as earnings rise.

- *Reforming the unemployment insurance system*. The UI system provides inadequate protection for low-wage workers, and unemployment insurance reform is needed to prevent welfare reform from leading to considerable hardship in the next recession, when many low-income parents who lose their jobs may not be able to receive either unemployment insurance (due to the problems in the UI system) or public assistance (due to time limits). A blue-ribbon, Congressionally chartered commission on the UI program chaired by Janet Norwood, the respected former Commissioner of the Bureau of Labor Statistics, reported in the mid-1990s that the UI system was failing to perform adequately for many low-wage workers; the commission recommended a series of improvements to address these shortcomings. These improvements have never been acted upon, in substantial part for budgetary reasons. With emerging budget surpluses, these reforms warrant serious consideration.

- *Improving child care assistance for low-income working families*. Expansion of Head Start and other child care programs — along with expanding the Dependent Care Tax Credit and making it refundable so it assists low-income working families that have out-of-pocket child care costs, as well as middle- and upper-income families — should be considered.

- *Reforming the child support system so more child support is collected and reaches the children for whom it is intended*. Needed reforms in this area include financial incentives to encourage states to discontinue procedures under which 100 percent of the child support paid by the non-custodial parents of children who receive public assistance is retained by the state and does not reach the children. This practice discourages the payment of child support and deepens child poverty.

- *Providing housing vouchers to more low-income families, particularly working poor families*. Despite a strong economy, the shortage of affordable housing has continued to grow. Census data show that the number of low-income households with "worst case housing needs" — households that spend more than half of their income on housing or live in severely substandard housing — reached a record-high 5.4 million households in 1997. A majority of these "worst-case-housing-needs" households are low-income working households.[23] More housing

[23] In fact, low-income working households constitute 70 percent of all worst-case-housing-needs households that are not elderly or disabled households. These data are from U. S. Department of Housing and Urban Development, *Rental Housing Assistance — The Worsening Crisis: A Report to Congress on Worse Case Housing Needs* (March (continued...)

vouchers (and other forms of housing assistance) could help address these problems. Recent research suggests that vouchers also can be helpful in increasing employment and earnings among low-income parents, in conjunction with well-run welfare reform programs.[24]

- *Improving food stamp assistance, especially for working poor families with children*. Food stamp participation has declined by 11 million people — nearly 40 percent — since 1994, a much larger decline than can be explained by the improvement in the economy and the food stamp eligibility restrictions included in the 1996 welfare law. Census data show that in 1995, there were 88 children receiving food stamps for every 100 children below the poverty line. By 1998, there were 72 children receiving food stamps for every 100 children below the poverty line. There are growing concerns that poor families that leave welfare for work, or never go on welfare in the first place, are missing out on food stamp benefits for which they qualify (and often on Medicaid coverage as well). A recent Urban Institute study found that only 42 percent of families that left welfare but had incomes below the food stamp eligibility limits continued to receive food stamps. In this post-welfare reform era, the food stamp program should serve low-income working families with children more effectively.

- *Improving assistance to the elderly poor*. Although poverty rates for the elderly as a group have declined dramatically over the past 40 years, poverty remains high among elderly widows and other elderly women living alone. One factor contributing to the problems in this area is that key parts of the benefit structure in the Supplemental Security Income program, a program created under President Nixon that is the nation's basic assistance program for the elderly and disabled poor, have not been adjusted for inflation in more than a quarter century. As a result, the level of income that many poor elderly and disabled people receive from a combination of SSI and modest Social Security checks has been declining in purchasing power for years. Given emerging budget surpluses, adjustments are warranted to make up, at least in part, for the effects of inflation on the SSI benefit structure so these elderly and disabled individuals can receive benefits that are

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[23] (...continued)
2000). A working household is defined in this study as one that receives more than half of its income from earnings. An elderly household is one in which the household head or the head's spouse is 62 or over and no children are present. A disabled household is defined as a household consisting of a single person who receives Supplemental Security Income benefits and lives alone or with non-relatives.

[24] Center on Budget and Policy Priorities, *Research Evidence Suggests That Housing Subsidies Can Help Long-term Welfare Recipients Find and Retain Jobs* (June 27, 2000), and Barbara Sard and Jeff Lubell, *The Value of Housing Subsidies to Welfare Reform Efforts*, Center on Budget and Policy Priorities (February 24, 2000). See also, Cynthia Miller, *Explaining MFIP's Impacts by Housing Status*, Unpublished Paper, Manpower Demonstration Research Corporation (1998).

closer in purchasing power to the benefits President Nixon and Congress established in the early 1970s, and so that the poverty of several million elderly and disabled poor people, many of whom are poor women living alone, can be somewhat alleviated. Substantial additional progress can be made in this area through revisions in the Social Security benefit structure, which should be considered in conjunction with Social Security solvency legislation.

- *Boosting saving among low- and moderate-income working families*. Proposals to enable low- and moderate-income families to build assets through savings accounts into which the government provides matching contributions hold promise and are developing bipartisan support. Such initiatives are particularly significant for low- and moderate-income working families that have little or no savings and cannot participate in employer-sponsored pension plans.

- *Improving assistance for poor legal immigrant children, parents, and elderly and disabled people who remain subject to unduly harsh restrictions on eligibility for various means-tested programs*. Although some of the severe restrictions the welfare law contained in this area were eased by legislation enacted in 1997 and 1998, other harsh restrictions remain in effect. For example, legal immigrant parents who entered the United States before the welfare law was signed and who are working for poverty wages are barred from receiving food stamps. (Their children may be eligible.) In addition, poor legal immigrant children and pregnant women, as well as individuals who have become disabled after entering the United States, are barred from Medicaid and the Child Health Insurance Program for at least five years if they entered the country after August 22, 1996, the date the welfare law was signed.

- *Boosting U.S. foreign economic aid devoted to helping people in the world's poorest nations*. According to estimates from the World Bank, there are 1.2 billion people in developing countries living on less than $1 a day. Nevertheless, as a percentage of government spending, U.S. economic aid to other nations is on track soon to reach its lowest level in half a century.[25] The U.S. aid level continues to drop even though our nation already spends a much smaller share of its resources on such aid than any other industrialized nation. The United States should strengthen funding of carefully targeted anti-poverty efforts in the world's poor countries, particularly in the areas of health, education, and combating hunger. In addition, we should fully fund U.S. debt relief commitments, including the commitments the President made in conjunction with the other six leading

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[25] See Isaac Shapiro, *Trends in U.S. Development Aid and the Current Budget Debate,* Center on Budget and Policy Priorities, (April 2000).

industrialized nations to fund the Heavily Indebted Poor Country (HIPC) initiative to provide debt relief to the world's poorest nations.

Tax Cuts and Tax Reform

Tax cuts are likely to consume a significant share of the potentially available surpluses. Wisely chosen tax cuts could constitute an appropriate and beneficial use of a portion of the surpluses. But tax cuts should meet several criteria:

- They should be limited in size so they do not consume so much of the surpluses that insufficient funds remain to help ensure the long-term solvency of Medicare and Social Security, modernize the Medicare benefit package, moderate poverty rates and reduce the ranks of the uninsured, and fund investments in education, research, and other initiatives that can produce long-term benefits.

- The benefits of a tax cut package should be distributed equitably. Using the budget surplus to fund tax cuts primarily for high-income individuals, the group that has benefitted the most from the economic boom, would not be appropriate. Any tax-cut package should include provisions that help those who are struggling to make ends meet, such as improvements in the earned income tax credit and the dependent care tax credit, including making the dependent care credit refundable so low- and moderate-income working families are not denied access to the child care subsidies that this credit provides to families at higher income levels.

- Major tax cuts should be considered in connection with tax reform that makes the tax code simpler, fairer, and more supportive of economic growth. Such a plan would generally combine lower tax rates with a broader tax base, rather than carving out still more exceptions to reward certain groups and certain types of endeavors.

Conclusion

The nation faces an unprecedented opportunity to address some of our most serious national problems and make this a better country than it already is. But there is a potential for this great opportunity to be squandered. Policymakers need both to resist temptations to commit more of the projected surpluses for tax and program initiatives than are realistically available and to make farsighted decisions on how to use the projected surpluses, based on a vigorous national debate about the nation's priorities.

CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Ph: 202-408-1080, Fax: 202-408-1056
http://www.cbpp.org

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HOW MUCH OF THE NEW CBO SURPLUS IS AVAILABLE FOR TAX AND PROGRAM INITIATIVES?

The Congressional Budget Office today released new baseline budget projections that show non-Social Security surpluses of nearly $2.2 trillion over the next 10 years under current policies. Although CBO's projections are somewhat more optimistic than the baseline estimates released by the Administration a few weeks ago, the points made in the Center on Budget and Policy Priorities' July 7 paper, *How Much of the Enlarged Surplus is Available for Tax and Program Initiatives? Available Funds Should be Devoted to Real National Priorities,* apply as well to the new CBO projections. Those points are:

- The surpluses that are realistically available to fund tax cuts and new program initiatives are much smaller than the projected non-Social Security surpluses; and,
- The Congress should carefully weigh various possible uses of the surplus and establish priorities before voting to use whatever amount of surpluses is available.

How Much Of the Surplus is Available For Initiatives?

CBO projects that non-Social Security surpluses will total nearly $2.2 trillion in 2001 through 2010 if policies are unchanged and discretionary spending is maintained at the current level, adjusted for inflation. But the amount that is realistically available to fund tax cuts and program initiatives is much smaller than that.

- The House, the Senate, and the President have apparently agreed that the surpluses of the Medicare Hospital Insurance (HI) Trust Fund, as well as the surpluses of the Social Security trust funds, should be used to pay down the federal debt. According to CBO, the surpluses of the Medicare HI Trust Fund will total $360 billion over the next 10 years. Excluding those surpluses reduces the surpluses available to pay for tax cuts and program initiatives to $1.8 trillion.
- CBO's projections, like the Administration's, do not reflect the full cost of maintaining current policies. Assuming that current policy truly is continued — that payments to farmers that have been provided for the last three years will be continued in future years, that current tax credits will be extended instead of being allowed to expire, that the Alternative Minimum Tax will not be allowed to take a bigger and bigger bite out of the pocket of middle-income taxpayers, and that inflation-adjusted discretionary spending will increase at the rate the U.S. population grows — reduces the available surpluses by about $600 billion, to $1.2 trillion over 10 years.

- A substantial amount of the remaining surpluses will almost certainly be required to facilitate reforms that will ensure the long-term solvency of the Social Security and Medicare programs. The amount that will be required for this purpose depends on the willingness of Congress and the President to reduce benefits in those programs or to raise payroll taxes; given the political difficulty of such substantive reforms, the amount needed from the non-Social Security, non-Medicare surpluses to close the remaining funding gap and ensure long-term solvency is likely to be at least $500 billion over the next 10 years. That would leave about $700 billion in surpluses to fund tax cuts and other program initiatives. That is a substantial amount, but it is far less than the $2.2 trillion some lawmakers may think is available.

How Much of the Projected Surpluses is Available to Fund Changes in Tax and Program Policies?

(in trillions of dollars)	**Fiscal Years 2001 - 2010**
CBO's July 2000 baseline projection of non-Social Security surpluses	$2.2
Minus:	
Medicare Hospital Insurance Trust Fund surpluses	-$0.4
Amounts needed to maintain current policies	-$0.6
Amounts likely to be needed for Social Security and Medicare reforms to achieve long-term solvency	-$0.5
Remaining surpluses available to fund changes in current tax and program policies (including resulting increase in interest costs)	$0.7

Assessing National Priorities

Whatever the amount that is available for tax and program initiatives, decisions about the best uses of this money should be made carefully and based on a vigorous debate about the needs and priorities of the nation. The emergence of large non-Social Security surpluses is a very recent phenomenon. Neither lawmakers nor the public have yet gone through a process of weighing the most appropriate uses of the surpluses and establishing priorities. Current Congressional proposals to use the surpluses seem to be more a response to short-term political currents before the fall elections — and to demands from interest groups that have been able to mobilize quickly and get to the front of the line (and in some cases, make large campaign contributions) — than the product of careful, systematic consideration of how to take advantage of the opportunity the economic boom presents to establish priorities for addressing the nation's most critical needs.