CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

CBO

Choices for Deficit Reduction

NOVEMBER 2012

Notes

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

Numbers in the text and tables may not add up to totals because of rounding.

Numbers related to the Congressional Budget Office's baseline and alternative fiscal scenario come from *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012).

Contents

Summary

The United States is facing fundamental budgetary challenges. Federal debt held by the public exceeds 70 percent of the nation's annual output (gross domestic product, or GDP)—a percentage not seen since 1950—and a continuation of current policies would boost the debt further. Although debt would decline to 58 percent of GDP in 2022 under the current-law assumptions that underlie the Congressional Budget Office's (CBO's) baseline projections, those projections depend heavily on significant increases in taxes and decreases in spending that are scheduled to take effect at the beginning of January. If, instead, lawmakers maintained current policies by preventing most of those changes from occurring—what CBO refers to as the alternative fiscal scenario—debt held by the public would increase to 90 percent of GDP 10 years from now and continue to rise rapidly thereafter.

Federal debt cannot grow faster than the nation's output indefinitely, and prolonged increases in debt relative to GDP can cause significant long-term damage to both the government's finances and the broader economy. Higher debt leads to larger federal interest payments; making those payments would eventually require some combination of lower government spending and higher taxes. In addition, increases in debt tend to reduce national saving, leading to more borrowing from abroad and less domestic investment, which in turn reduces the growth of income. Moreover, when debt rises, lawmakers are less able to use tax and spending policies to respond to unexpected challenges, such as economic downturns, natural disasters, or financial crises. Rising debt could itself precipitate a fiscal crisis by undermining investors' confidence in the government's ability to manage the budget, thus making it harder for the government to borrow money at affordable interest rates.

With the population aging and health care costs per person likely to keep growing faster than the economy, the United States cannot sustain the federal spending programs that are now in place with the federal taxes (as a share of GDP) that it has been accustomed to paying. To put the budget on a path that is more likely to be sustainable than if current policies were continued, lawmakers will need to adopt a combination of policies that require people to pay more for their government, accept less in government benefits and services, or both. However, making policy changes that are large enough to shrink the debt relative to the size of the economy—or even to keep the debt from growing—will be a formidable task.

This report reviews the scale and sources of the federal government's budgetary imbalance, various options for bringing spending and taxes into closer alignment, and criteria that lawmakers and the public might use to evaluate different approaches to deficit reduction. The report focuses on CBO's alternative fiscal scenario, rather than on the current-law baseline, to show the size of the policy changes—relative to policies now in place—that would be necessary to put the budget on a more sustainable path.

The discussion builds on estimates that CBO has published previously and, for simplicity, focuses on potential deficit reduction in one year: 2020. Lawmakers could set various deficit reduction goals for that year, such as the following:

- Bringing the federal budget into balance by 2020, which would require policy changes that would reduce the deficit in that year by about $1 trillion relative to the effects of the current policies embodied in CBO's alternative fiscal scenario;

- Keeping debt held by the public the same size relative to GDP at the end of 2020 that it will be early in 2013—roughly 75 percent—which would require deficit reduction of about $500 billion in 2020 compared with the alternative fiscal scenario; or

- Reducing the deficit in 2020 by $750 billion relative to the alternative fiscal scenario, which is roughly the difference between the deficits (excluding interest costs) projected for 2020 in that scenario and in the current-law baseline.

Very few policy changes, taken individually, can shrink the deficit enough to achieve any of those objectives. Ultimately, significant deficit reduction is likely to require a combination of policies, many of which may stand in stark contrast to policies now in place. This report briefly reviews some potential policy changes that lawmakers might consider, showing how far those changes would go toward reducing the deficit in 2020. The policy options come from CBO's March 2011 report *Reducing the Deficit: Spending and Revenue Options* and from other CBO analyses. They are meant to be illustrative only; many other possible policy changes could be considered.

In evaluating policy changes that would reduce budget deficits, lawmakers and the public may weigh several factors. The types of changes that people will be willing to accept will depend in part on their view of the proper size of the federal government and the best allocation of its resources. People may also want to consider the distributional implications of proposed changes—that is, who would bear the burden of particular cuts in spending or increases in taxes and who would realize any long-term economic benefits. In addition, some policy changes would have a large and immediate impact on the budget, whereas others would have effects that would grow considerably over time.

A related consideration is how policy changes would influence the pace of economic recovery and longer-term economic performance. Lawmakers face difficult trade-offs in deciding how quickly to implement policies to reduce budget deficits. For example, CBO projects that the significant tax increases and spending cuts that are due to occur in January will probably cause the economy to fall back into a recession next year, but they will make the economy stronger later in the decade and beyond. In contrast, continuing current policies would lead to faster economic growth in the near term but a weaker economy in later years. Potential policy changes would have different effects on federal borrowing, people's incentives to work and save, and government investment, all of which would affect the nation's output and income during the next few years and over the longer term.

In sum, a wide gap exists between the future cost of the services that the public has become accustomed to receiving from the federal government—especially in the form of benefits for older people—and the tax revenues that the public has been sending to the government to pay for those services. Because the federal budget is on an unsustainable path under current policies, those policies will need to be changed in significant ways. It is possible to keep tax revenues at their historical average percentage of GDP—but only by making substantial cuts, relative to current policies, in the large benefit programs that aid a broad group of people at some point in their lives. Alternatively, it is possible to keep the policies for those large benefit programs unchanged—but only by raising taxes substantially, relative to current policies, for a broad segment of the population. Changes in other federal programs can affect the size of the changes needed in taxes or large benefit programs, but they cannot eliminate the basic trade-off between those two parts of the budget.

Choices for Deficit Reduction

With the federal budget deficit surpassing $1 trillion for the fourth year in a row and federal debt climbing rapidly, the need is growing to address the government's budgetary situation. Major changes to current tax or spending policies will be necessary to put the budget on a more sustainable path, but such changes will require significant trade-offs between deficit reduction and other policy goals. This report highlights the scale of the nation's budgetary challenges, shows how far some illustrative policy changes that the Congressional Budget Office (CBO) has analyzed in past reports would go toward meeting those challenges, and discusses important factors that policymakers and the public might consider when evaluating budget plans.

How Big Are Projected U.S. Deficits and Debt?

To provide a benchmark against which potential changes in law can be measured, CBO constructs so-called baseline projections of what federal revenues and spending will be in the future if current laws generally remain unchanged. On that basis, the budget deficit is projected to shrink markedly in coming years: from 7.0 percent of gross domestic product ($1.1 trillion) in fiscal year 2012 to 2.4 percent of GDP ($387 billion) in 2014. Between 2015 and 2022, deficits fluctuate in a narrow range, from 0.4 percent to 1.2 percent of GDP, in CBO's baseline projections. With those deficits, debt held by the public is projected to rise from 73 percent of GDP at the end of 2012 to 77 percent in 2014 but then decline relative to the size of the economy, to 58 percent of GDP in 2022—still higher than the roughly 20 percent to 50 percent range seen between 1957 and 2008.

Those baseline projections, however, are heavily influenced by policy changes that are scheduled to occur under current law—changes that in many cases represent a significant departure from recent policies. To illustrate the budgetary consequences of maintaining the tax and spending policies that have been in effect recently, CBO has also produced budget projections under an alternative fiscal scenario.[1] That scenario incorporates the following assumptions:

- That all expiring tax provisions (other than the recent reduction in the payroll tax for Social Security), including tax provisions that expired at the end of December 2011, are extended;
- That the parameters of the alternative minimum tax (AMT) are indexed to increase with inflation after 2011 (starting from the 2011 exemption amount);
- That Medicare's payment rates for physicians' services are held constant at their current level; and
- That provisions of the Budget Control Act of 2011 that established automatic enforcement procedures designed to reduce discretionary and mandatory spending beginning in January 2013 do not go into effect, although the law's original caps on discretionary appropriations remain in place.[2]

Under that alternative fiscal scenario, deficits would be much larger during the 2013–2022 period than in CBO's baseline, averaging 4.9 percent of GDP rather than 1.1 percent (see Table 1). With deficits totaling nearly $10 trillion during that decade, debt held by the public

1. CBO discussed several alternative tax and spending policies, including the ones reflected in the alternative fiscal scenario, in *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), pp. 21–23.

2. Discretionary spending is spending that is controlled through the Congress's annual appropriation process. Mandatory spending is not controlled through that process; rather, it stems from funding provided in other types of legislation or from eligibility criteria and benefit or payment rules set in law.

Table 1.

Deficits Projected in CBO's Baseline and Under the Alternative Fiscal Scenario

	Actual, 2012[a]	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total 2013-2017	Total 2013-2022
							In Billions of Dollars						
							CBO's August 2012 Baseline						
Revenues	2,449	2,913	3,208	3,541	3,817	4,083	4,328	4,551	4,790	5,039	5,295	17,562	41,565
Outlays	3,538	3,554	3,595	3,754	4,003	4,206	4,407	4,681	4,932	5,183	5,509	19,111	43,823
Deficit	**-1,089**	**-641**	**-387**	**-213**	**-186**	**-123**	**-79**	**-130**	**-142**	**-144**	**-213**	**-1,549**	**-2,258**
Debt Held by the Public at the End of the Year	11,280	12,064	12,545	12,861	13,144	13,371	13,536	13,746	13,964	14,181	14,464	n.a.	n.a.
							Alternative Fiscal Scenario						
Revenues	2,449	2,583	2,825	3,111	3,361	3,596	3,808	3,996	4,196	4,399	4,608	15,476	36,483
Outlays	3,538	3,621	3,748	3,921	4,193	4,430	4,678	4,999	5,298	5,599	5,970	19,913	46,457
Deficit	**-1,089**	**-1,037**	**-924**	**-810**	**-832**	**-833**	**-870**	**-1,003**	**-1,102**	**-1,200**	**-1,362**	**-4,437**	**-9,975**
Debt Held by the Public at the End of the Year	11,280	12,460	13,478	14,391	15,321	16,258	17,215	18,298	19,477	20,749	22,181	n.a.	n.a.
							As a Percentage of Gross Domestic Product						
							CBO's August 2012 Baseline						
Revenues	15.8	18.4	19.6	20.3	20.6	20.7	20.8	20.9	21.1	21.2	21.4	20.0	20.6
Outlays	22.8	22.4	21.9	21.5	21.6	21.4	21.2	21.5	21.7	21.8	22.3	21.7	21.7
Deficit	**-7.0**	**-4.0**	**-2.4**	**-1.2**	**-1.0**	**-0.6**	**-0.4**	**-0.6**	**-0.6**	**-0.6**	**-0.9**	**-1.8**	**-1.1**
Debt Held by the Public at the End of the Year	72.6	76.1	76.6	73.8	70.8	67.9	65.2	63.2	61.4	59.8	58.5	n.a.	n.a.
							Alternative Fiscal Scenario						
Revenues	15.8	16.3	17.2	17.8	18.1	18.3	18.3	18.4	18.5	18.5	18.6	17.6	18.1
Outlays	22.8	22.8	22.9	22.5	22.6	22.5	22.5	23.0	23.3	23.6	24.1	22.6	23.0
Deficit	**-7.0**	**-6.5**	**-5.6**	**-4.6**	**-4.5**	**-4.2**	**-4.2**	**-4.6**	**-4.8**	**-5.1**	**-5.5**	**-5.0**	**-4.9**
Debt Held by the Public at the End of the Year	72.6	78.6	82.3	82.5	82.5	82.5	82.9	84.1	85.7	87.5	89.7	n.a.	n.a.
Memorandum:													
Deficit: Alternative Fiscal Scenario Minus CBO's August 2012 Baseline													
In billions of dollars	n.a.	-396	-537	-597	-647	-711	-791	-873	-960	-1,056	-1,149	-2,888	-7,717
As a percentage of GDP	n.a.	-2.5	-3.3	-3.4	-3.5	-3.6	-3.8	-4.0	-4.2	-4.5	-4.6	-3.3	-3.8

Sources: Congressional Budget Office; Department of the Treasury.

Notes: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario also include the incremental interest costs associated with projected additional borrowing.

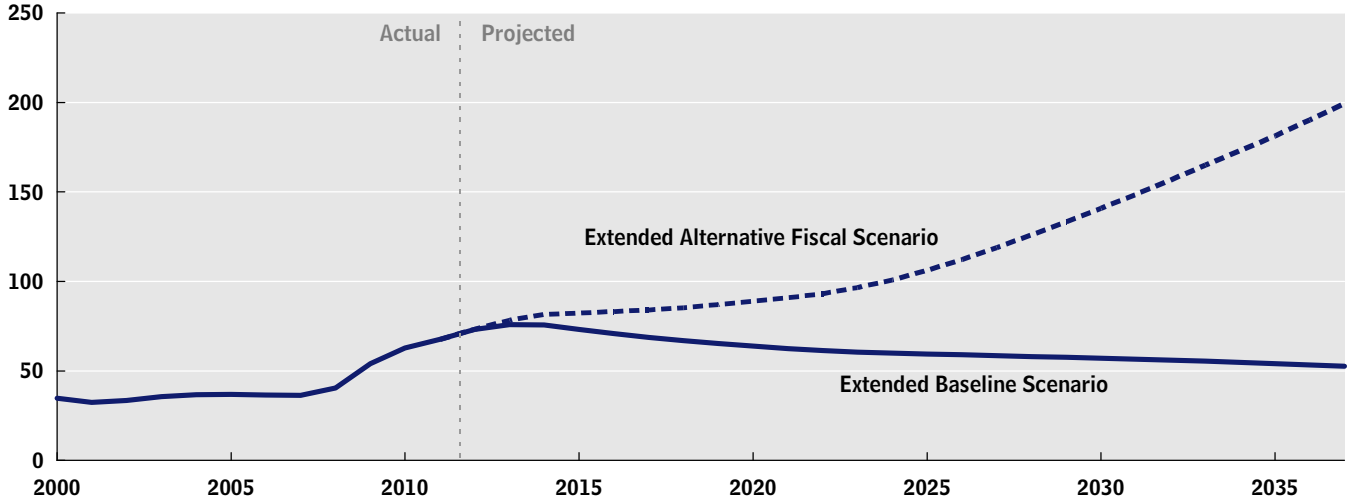
n.a. = not applicable.

a. Numbers for 2012 were derived from information reported in Department of the Treasury, *Final Monthly Treasury Statement of Receipts and Outlays of the United States Government for Fiscal Year 2012 Through September 30, 2012, and Other Periods* (September 2012), www.fms.treas.gov/mts/index.html.

Figure 1.

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



Source: Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012).

Note: The extended baseline scenario generally adheres closely to current law, following CBO's 10-year baseline budget projections through 2022 and then extending the baseline concept for the rest of the long-term projection period. The extended alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario also include the incremental interest costs associated with projected additional borrowing.

would climb to 90 percent of GDP in 2022, the highest percentage since just after World War II. Thus, under that scenario, the United States would quickly head into fiscal territory unfamiliar to it and most other developed nations. Moreover, federal debt would continue to grow over the longer term, more than doubling relative to GDP between 2022 and 2037 (see Figure 1).[3]

This report focuses on the alternative fiscal scenario, rather than on CBO's current-law baseline, to illuminate more clearly the consequences of continuing tax and spending policies that the nation has become accustomed to. Focusing on the alternative scenario also demonstrates the size of the policy changes—relative to policies currently in place—that would be necessary to put the budget on a more sustainable path.

What Factors Are Putting Increasing Pressure on the Budget?

The aging of the baby-boom generation portends a significant and sustained increase in coming years in the share of the population that will receive benefits from Social Security and Medicare and long-term care services financed through Medicaid. Moreover, per capita spending on health care is likely to continue to grow faster than per capita spending on other goods and services for many years. (The size of the future gap between those growth rates is uncertain and will undoubtedly vary from year to year. On average, over the past 25 years, health care costs per person have grown about 1½ percentage points faster per year than potential GDP per person.)[4]

3. See Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012).

4. For more details about how CBO calculated that difference in growth rates during the past 25 years, see Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012), p. 53. Potential GDP is the level of GDP that corresponds to a high rate of use of labor and capital.

Without significant changes in the laws governing Social Security, Medicare, and Medicaid, those factors will boost federal outlays as a percentage of GDP well above the average of the past several decades—a conclusion that applies under any plausible assumptions about future trends in demographics, economic conditions, and health care costs. Unless the laws governing those programs are changed—or the increased spending is accompanied by sufficiently lower spending on other programs, sufficiently higher revenues, or a combination of the two—deficits will be much larger in the future than they have tended to be in the past.

For example, under the alternative fiscal scenario, which generally reflects a continuation of recent policies, federal spending would average 23 percent of GDP over the coming decade and equal 24 percent of GDP by 2022, CBO projects, compared with an average of 21 percent over the past 40 years (1972 to 2011). Revenues would remain close to 18 percent of GDP, about their average over the past four decades. As a result, the deficit under the alternative fiscal scenario would equal about 5 percent of GDP in 2020 and larger percentages thereafter—significantly greater than the 3 percent average seen in recent decades. (By comparison, in CBO's current-law baseline, federal spending is projected to average 22 percent of GDP over the next 10 years and revenues nearly 21 percent of GDP, both above their 40-year averages. Projected deficits in the baseline average about 1 percent of GDP over that period.)

To illustrate the sources of the large deficit increases under the alternative fiscal scenario, it is useful to compare the experience of the past few decades with CBO's projections for several broad categories of the budget: spending for Social Security, Medicare, and other major health care programs; all other spending (except interest on federal debt); net interest outlays; and revenues (see Figure 2).

Spending for Social Security and Major Health Care Programs

With the oldest baby boomers now at retirement age, the number of people age 65 or older is projected to increase by about one-third in the next 10 years. In addition, health care costs per person are projected to continue rising, and the Affordable Care Act (ACA) will substantially increase the number of people who receive federal assistance in obtaining health care.[5] As a result, outlays for Social Security and the federal government's major health care programs (Medicare, Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending) are projected to total 11.5 percent of GDP in 2020 under the alternative fiscal scenario, up from 9.6 percent in 2012 and an average of 7.1 percent over the past 40 years.[6]

Spending for Social Security alone will total 5.3 percent of GDP in 2020, CBO projects (see Table 2 on page 8), up from 4.9 percent in 2012 and an average of 4.3 percent over the past four decades. Net outlays for major health care programs are projected to equal 6.3 percent of GDP in 2020 under the alternative fiscal scenario, compared with 4.7 percent in 2012.[7] Federal outlays for such health care programs averaged 2.7 percent during the past 40 years. The increase in spending for health care programs is much greater than the increase for Social Security because the health care programs are affected by rising costs per beneficiary and legislated expansions in benefits, as well as by the aging of the population.

Most of the outlays for Social Security and major health care programs are spent on benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly able-bodied people. Specifically, CBO estimates that more than four-fifths of Social Security spending in 2020 will go toward benefits for retired workers and their dependents and survivors; the remainder will go toward benefits for disabled workers and their spouses and children. In addition, despite the significant expansion of federal support for health care for lower-income people enacted in the ACA, about half of

5. The ACA refers to the Patient Protection and Affordable Care Act and the health care provisions of the Health Care and Education Reconciliation Act of 2010.

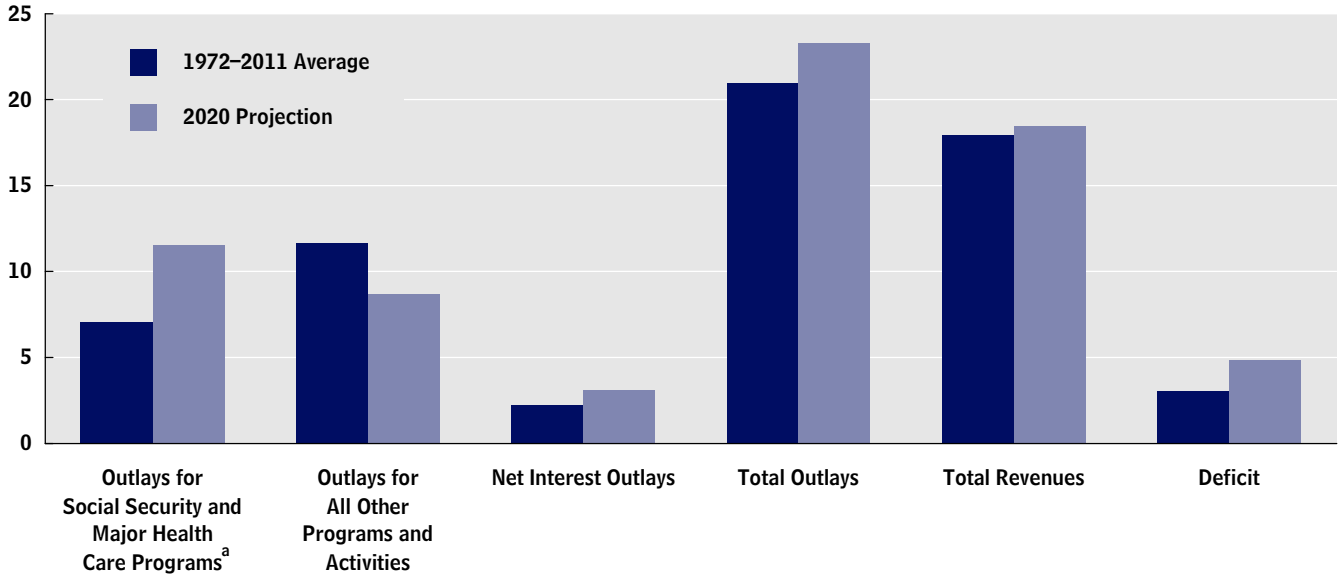
6. The 40-year average covers a period of diverse economic and fiscal activity and is the benchmark that CBO generally uses when describing budgetary trends. However, other time periods can also provide valid benchmarks.

7. CBO and the staff of the Joint Committee on Taxation estimate that the provisions of the Affordable Care Act that expand health insurance coverage will have a net cost equal to 0.6 percent of GDP in 2020—the result of an increase of 1.0 percent of GDP in outlays for Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending, partly offset by an increase of 0.3 percent of GDP in revenues. Under the ACA, reductions in other federal spending and other increases in revenues will slightly more than offset the net cost of the coverage provisions, yielding a net reduction in the deficit, according to CBO's estimates.

Figure 2.

Components of the Federal Budget in 2020 Under the Alternative Fiscal Scenario, Compared with Their Averages Since 1972

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario also include the incremental interest costs associated with projected additional borrowing.

a. The federal government's major health care programs consist of Medicare, Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending.

spending for major health care programs in 2020 will finance care for people over age 65, CBO projects. Another quarter will finance health care for blind and disabled people, and the remaining quarter will finance care for able-bodied nonelderly people.

Other Noninterest Spending

Besides Social Security and major health care programs, the federal government spends money on a wide variety of programs and services—including national defense, income security programs, retirement benefits for federal civilian employees and military personnel, transportation, health research, education, law enforcement, agriculture, and many other activities. Unlike spending for Social Security and major health care programs, spending on all of those activities would decline considerably relative to the size of the economy over the next 10 years under both the alternative fiscal scenario and CBO's baseline. Taken together, outlays for that broad collection of other programs and activities would equal 8.7 percent of GDP in 2020 under the alternative fiscal scenario, compared with an average of 11.6 percent over the past 40 years.[8]

Thus, the United States is already on track to significantly shrink the federal resources dedicated to activities other than Social Security and major health care programs to a

8. Defense spending accounts for about two-fifths of the outlays for that category. Over the past four decades, outlays for defense have averaged 4.7 percent of GDP (they declined from 6.7 percent of GDP in 1972 to 3.0 percent between 1999 and 2001 and then rose to a peak of 4.8 percent in 2010). Under the alternative fiscal scenario, the caps on funding set by the Budget Control Act (excluding the automatic spending reductions scheduled to occur in January) would cause defense spending to grow more slowly than the economy, leaving total outlays for defense at 3.3 percent of GDP in 2020, CBO projects.

Table 2.

Budget Projections for 2020 in CBO's Baseline and Under the Alternative Fiscal Scenario

	CBO's August 2012 Baseline		Alternative Fiscal Scenario	
	Billions of Dollars	Percentage of GDP	Billions of Dollars	Percentage of GDP
Revenues				
Individual income taxes	2,542	11.2	2,055	9.0
Social insurance taxes	1,412	6.2	1,412	6.2
Corporate income taxes	473	2.1	424	1.9
Other	363	1.6	305	1.3
Total Revenues	4,790	21.1	4,196	18.5
Outlays				
Mandatory spending				
Social Security	1,202	5.3	1,202	5.3
Medicare[a]	750	3.3	793	3.5
Medicaid	514	2.3	514	2.3
Other major health care programs[b]	117	0.5	117	0.5
Other mandatory spending	523	2.3	566	2.5
Subtotal	3,104	13.7	3,190	14.0
Discretionary spending				
Defense	696	3.1	750	3.3
Nondefense	620	2.7	653	2.9
Subtotal	1,316	5.8	1,403	6.2
Net interest	512	2.3	704	3.1
Total Outlays	4,932	21.7	5,298	23.3
Deficit	-142	-0.6	-1,102	-4.8
Debt Held by the Public at the End of the Year	13,964	61.4	19,477	85.7

Source: Congressional Budget Office.

Notes: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario include the incremental interest costs associated with projected additional borrowing.

GDP = gross domestic product.

a. Outlays for Medicare include offsetting receipts from premium payments and from payments by states from savings on Medicaid prescription drug costs.

b. Other major health care programs consist of the Children's Health Insurance Program and subsidies offered through new health insurance exchanges and related spending.

much smaller share of the economy than they have represented for the past several decades. Such reductions may prove unpopular once they take effect or, in the case of discretionary programs, once policymakers determine the size of the cuts to specific benefits and services. As a result, those reductions may be difficult to carry out and maintain.

Net Interest and Total Spending

Net interest payments by the federal government would equal 3.1 percent of GDP in 2020 under the alternative fiscal scenario, compared with an average of 2.2 percent during the past 40 years. Interest payments would be greater as a share of GDP because the government's indebtedness would be larger relative to the size of the economy.

The substantial decline in other federal spending relative to GDP would not be enough to offset the increased burden on the budget from rising outlays for Social Security, major health care programs, and interest payments. Putting those pieces together, CBO projects that total outlays under the alternative fiscal scenario would equal 23.3 percent of GDP in 2020, compared with an average of 21.0 percent since 1972.[9]

Revenues

Under the alternative fiscal scenario, the increase in spending as a share of GDP (relative to the historical average) would not be matched by a corresponding increase in revenues. Federal revenues would amount to 18.5 percent of GDP in 2020, CBO estimates, slightly above the 17.9 percent average recorded over the past 40 years.[10] The alternative scenario incorporates the continuation of certain tax policies that have been in place for a number of years—specifically, the extension of all expiring tax provisions (other than the payroll tax cut) and the indexing of the AMT for inflation after 2011. If those policies are not continued, and instead the changes scheduled to occur under current law take place, revenues will rise to 21.1 percent of GDP in 2020, by CBO's estimate.

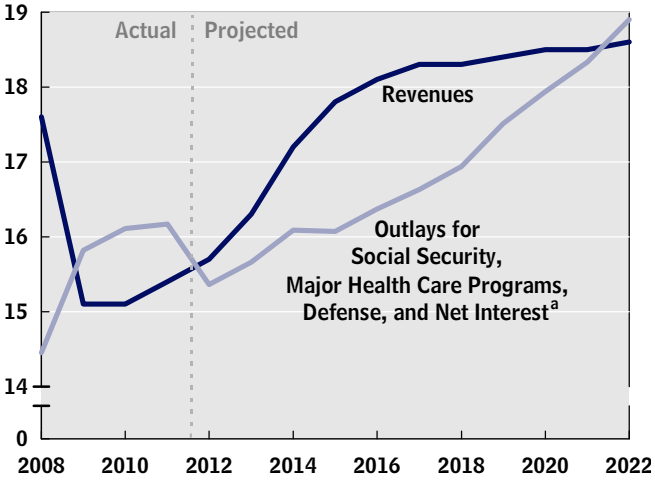
9. For the 40 years between 1968 and 2007 (a period that excludes the effects of the recent recession), total outlays averaged 20.6 percent of GDP.

10. Over the 40-year period ending in 2007 (which excludes the effects of the recent recession), total revenues averaged 18.2 percent of GDP.

Figure 3.

Outlays for Major Programs Compared with Total Revenues Under the Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario also include the incremental interest costs associated with projected additional borrowing.

a. The federal government's major health care programs consist of Medicare, Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending.

One way to understand the size of the gap between revenues and outlays under the alternative fiscal scenario is to compare revenues with spending for a few key programs. CBO projects that, in total, spending for Social Security, Medicare, other major health care programs, defense, and interest payments under that scenario would nearly equal all of the government's revenues in 2020 and would exceed them from 2022 onward—leaving no revenues to cover any other federal activities, such as income security programs, retirement benefits for federal civilian and military employees, transportation, research, education, law enforcement, and many other programs (see Figure 3).

What Are the Consequences of Rising Federal Debt?

If annual budget deficits were large enough to keep federal debt increasing relative to GDP for the next decade and beyond, that growing debt would have significant harmful effects on the budget and the economy—which in turn would cause debt to grow even faster. In particular, rising debt would have the following consequences:

- *Higher federal spending on interest payments.* For example, about half of the projected increase in net interest outlays between 2012 and 2020 under the alternative fiscal scenario is attributable to the greater debt that would result from the policies in that scenario. Such an increase in interest costs would eventually require higher taxes, a decrease in government benefits and services, or some combination of the two.

- *A reduction in national saving.* That reduction would lead to more borrowing from abroad and less domestic investment, which in turn would decrease income in the United States relative to what it would be otherwise.

- *Limits on policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns, natural disasters, or financial crises.* With policymakers' options limited, unexpected events could have worse effects on the economy and people's well-being than they would otherwise.

- *An increase in the likelihood of a fiscal crisis.* During such a crisis, investors would lose confidence in the government's ability to manage its budget, and the government would thereby lose the ability to borrow funds at affordable interest rates.

Under the alternative fiscal scenario, those negative consequences would worsen during the coming decade as debt grew faster than GDP. Because debt would rise indefinitely as a percentage of GDP and never stabilize, the alternative scenario is ultimately unsustainable.

Other trajectories for federal debt are possible—for example, stabilizing the debt relative to the size of the economy at the level projected for early 2013. Such an outcome would result in lower interest payments and higher national income than under the alternative fiscal scenario. However, a stable but high level of debt would still leave the country with less ability to respond to unexpected developments and at greater risk of a fiscal crisis than if the debt was stabilized at a lower level. It is impossible to predict with any confidence whether or when a fiscal crisis might occur in the United States; in particular, there is no identifiable level of debt relative to GDP that indicates that a crisis is likely or imminent. At any given time, the risk of such a crisis depends not only on the debt levels and economic conditions in the United States and other countries at the time but also on expectations about budgetary and economic developments in the future. All else being equal, however, the greater the amount of federal debt, the greater the risk of a fiscal crisis.[11]

What Kinds of Policy Changes Could Lead to a More Sustainable Budgetary Path?

If lawmakers want to put the federal budget on a path that is more likely to be sustainable than the one that would occur under current policies, they will have to change those policies in at least one of the following ways:

- Make major reductions in the benefits that people receive when they get older, relative to the benefits envisioned in current policies;

- Substantially decrease the other activities of the federal government, relative to the size of the economy, beyond the reductions that are already projected to occur; or

- Raise revenues significantly above their historical average as a percentage of GDP.

Under the alternative fiscal scenario, the deficit would total $1.1 trillion (4.8 percent of GDP) in 2020, CBO projects, and federal debt would be on an upward trajectory as a percentage of GDP.[12] Such continually rising debt would eventually prove untenable. In the rest of this report, CBO examines policy changes that could produce a fiscal path that is more likely to be sustainable than the alternative fiscal scenario.

11. For more details, see Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis* (July 2010).

12. In CBO's August 2012 baseline, the deficit is projected to total 0.6 percent of GDP in 2020, and debt held by the public is on a downward trajectory.

Possible Targets for Deficit Reduction

Although the nation cannot sustain continuous growth in debt as a percentage of GDP indefinitely, people may differ about what is a sustainable path. Thus, the precise amount of deficit reduction required to put the budget on such a path is not clear, and various objectives are possible:

- One potential goal would be to balance the federal budget by 2020, which would require policy changes that would save roughly $1 trillion in that year relative to the alternative fiscal scenario (with interest savings contributing the remaining deficit reduction). Maintaining a balanced budget in the years after 2020 would put federal debt on a steadily declining path relative to GDP.

- Another possible goal would be to have debt held by the public equal the same percentage of GDP at the end of 2020 that it will early in 2013: roughly 75 percent. Achieving that goal would require deficit reduction (excluding interest savings) of about $500 billion in 2020.

- An objective midway between those two goals would be to reduce the deficit projected for 2020 by $750 billion relative to the alternative fiscal scenario—roughly the difference between the deficits projected for 2020 in that scenario and in CBO's current-law baseline (excluding the difference in interest costs). Reductions of that magnitude would keep future deficits stable at a relatively small percentage of GDP and thus would put debt on a slightly downward-sloping trajectory relative to GDP, as would occur under the baseline.

Many other budgetary goals are also possible. For the potential objectives listed above, depending on the path chosen to meet the goal, total noninterest deficit reduction over the 10-year period from 2013 to 2022 would range between $3 trillion and $8 trillion relative to the alternative fiscal scenario.

Overview of Options to Reduce the Deficit

To provide some perspective about the scope and scale of policy changes that would be necessary to put the budget on a more sustainable path, this section presents various options for reducing mandatory or discretionary spending or increasing revenues. Many of the policy changes come from a collection of budget options that CBO publishes periodically to help inform lawmakers about possible fiscal choices. (The most recent volume, published in March 2011, included more than 100 options for cutting federal spending or raising revenues.)[13] Other policy options discussed here come from other recent CBO analyses.

The rough estimates of the options' effect on the deficit in 2020 are based on hypothetical proposals and are presented for illustrative purposes only. In most cases, CBO has not updated its estimates of the options to reflect its current baseline budget projections. Estimates of legislative proposals related to these options might differ from the estimates shown here because of specific details that might be incorporated into proposed legislation, or because of revised baseline projections, or for other reasons. Moreover, some of the options interact in ways that would cause their total effect to differ from the sum of the individual effects described here.

The options discussed in this report are intended to reflect a range of possibilities rather than a ranking of priorities or a comprehensive list. Many of the policy changes could be implemented in ways that would achieve more or less budgetary savings than are reported here. Moreover, numerous other policies that would decrease spending or increase revenues to a greater or lesser extent could be considered as lawmakers work to reduce the deficit. For example, various proposals for future budgetary savings have included establishing a premium support system in Medicare, which would involve setting a fixed federal contribution toward the cost of premiums, with beneficiaries bearing any difference between that amount and actual premiums. That policy change is not included here because CBO did not publish an estimate for such an option in its March 2011 volume and does not currently have an estimate for such a proposal.

The timing for implementing policy changes would affect the total amount of deficit reduction in any given year. The more the deficit was reduced in earlier years, the greater the impact that reduction would have in lowering the government's future interest costs. The more that changes were delayed until later, the larger those changes would ultimately have to be to achieve similar deficit reduction.

13. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011).

For simplicity, this analysis focuses on a single year, 2020, but the policy changes would have varying budgetary effects over time. For instance, options that were phased in by applying only to people below a specific age would tend to have effects that continued to grow over time, compared with options that were fully implemented right away. In addition, options that changed the annual growth rate of benefits would tend to have effects that grew more quickly over time (as the differences in growth rates compounded) than would options that changed the level of benefits. Similarly, options that changed the way tax brackets are indexed for inflation would have effects that continued to increase over time, compared with options that immediately changed tax rates.

The options presented in this report illustrate how challenging it would be to shrink the deficit by as much as $500 billion, $750 billion, or $1 trillion in 2020. Very few policy changes that CBO has examined in the past are large enough, by themselves, to accomplish a sizable portion of that deficit reduction. Moreover, many of the options that would have a substantial budgetary impact would require large numbers of people to pay more in taxes or receive less in government benefits or services; others would shift significant costs to state governments, leaving them to decide whether to increase the taxes they collect or to cut the benefits or services they provide.

CBO's March 2011 volume of budget options summarizes some advantages and disadvantages of each of the options. This report does not repeat those points, but a later section discusses broad criteria that policymakers and the public might use in making choices about deficit reduction.

Another approach to deficit reduction, which could be combined with choosing specific policy changes, would be to adopt "fiscal rules"—specific numerical targets for spending, revenues, deficits, or debt in future years—and to create procedures that would take effect if those targets were not met. However, experience in the United States suggests that fiscal rules are not a substitute for making difficult budgetary choices and that if consensus about budgetary goals erodes, fiscal rules will not necessarily prevent lawmakers from spending more or taxing less than the rules allow. Rather, fiscal rules are most useful in formalizing goals and enforcing budgetary choices to which policymakers have already agreed and generally remain committed. (For more about fiscal rules and their application, see the appendix.)

Options That Would Reduce Mandatory Spending

Outlays for programs that are not funded through the annual appropriation process make up roughly 60 percent of the federal government's noninterest spending. Under both current law and the alternative fiscal scenario, mandatory outlays are projected to grow more rapidly near the end of the 2013–2022 period, largely because of the aging of the population and rising spending for health care. That rapid growth will occur even though mandatory spending for activities other than Social Security and major health care programs is projected to decline as a percentage of GDP. By 2020, mandatory outlays are projected to total $3.2 trillion, or 14.0 percent of GDP, under the alternative fiscal scenario.

CBO has previously analyzed a number of options to decrease mandatory spending (see Table 3 on page 14). Those options can be grouped in three categories:

- *Health care programs.* Of the health-related proposals for which CBO has published an estimate, the one with the largest savings would repeal provisions of the Affordable Care Act that expand health insurance coverage (while leaving other provisions of that law unchanged). That option would decrease spending for major health care programs by nearly 15 percent in 2020 and would reduce the deficit by roughly $150 billion in that year, according to estimates by CBO and the staff of the Joint Committee on Taxation (JCT).[14] The option would also increase the number of people without health insurance coverage by an estimated 29 million in 2020. Various other changes to health care programs for which CBO has published estimates would save between $5 billion and $50 billion each in 2020 (not counting interactions with other potential policy changes).

- *Social Security.* Of the proposals involving Social Security for which CBO has published estimates, the three with the largest savings would raise the ages at which people qualify for benefits or reduce the size of their initial benefit. Any of those changes would decrease outlays by about $30 billion in 2020.

14. CBO and JCT have estimated that repealing all of the provisions of the ACA would increase the deficit in 2020 by $25 billion. See Congressional Budget Office, letter to the Honorable John Boehner providing an estimate for H.R. 6079, the Repeal of Obamacare Act (July 24, 2012).

- *Other mandatory programs.* Of the proposals in this category for which CBO has published an estimate, the one with the largest savings involves allowing the automatic enforcement procedures in the Budget Control Act to take effect. Doing so would reduce outlays for a large number of mandatory programs, including some health-related programs, by a total of $15 billion in 2020. A second proposal in this category involves changing the rate structure for student loans, which would reduce mandatory outlays by $10 billion in 2020.

The options listed in Table 3 would generally decrease the amount paid to beneficiaries of various programs or reduce payments to state governments or health care providers. Some of the options would also encourage changes in the systems for financing or providing health care, create incentives for people to work longer or save more before they retire, or have various other economic and social consequences.

If policymakers wanted to reduce the deficit by $750 billion in 2020, the savings from enacting all of the options shown in Table 3 would achieve about 80 percent of that goal and would result mainly from changes to major health care programs and Social Security.[15] (If interactions among the various policies were taken into account, the total savings would be smaller.) Some of those options would save significantly more in later years as the affected population increased and health care costs continued to rise. Also, many of the policy changes could be implemented in ways that would produce greater budgetary savings, although such alternatives would generally impose larger burdens on program beneficiaries, state governments, or health care providers than the versions shown here.

Mandatory programs other than Social Security, Medicare, and Medicaid are a good deal smaller than those three programs, so the options for changing them that CBO has analyzed in the past would generally produce smaller savings. Specifically, CBO projects that spending on other mandatory programs will total about $700 billion in 2020.[16] Thus, generating hundreds of billions of dollars in savings from those programs would require very large percentage cuts in spending.

Among options discussed in recent CBO publications, altering the interest rate structure for student loans and reducing income-eligibility limits and maximum benefits for the Supplemental Nutrition Assistance Program (formerly known as Food Stamps) would together save about $15 billion in 2020. CBO has also analyzed a number of changes to smaller mandatory programs, such as those involving agriculture: prohibiting new enrollment in the Department of Agriculture's Conservation Stewardship Program, limiting enrollment in the Conservation Reserve Program, reducing the premium subsidy in the crop insurance program, and reducing the share of a farmer's base acreage eligible for direct payments from the department. Each of those options would result in savings smaller than those shown in Table 3; together, they would save less than $15 billion in 2020.

For the most part, the individual options presented in Table 3 would involve spending cuts of less than 10 percent for specific programs in 2020. Larger reductions in particular programs are possible. For example, converting the Supplemental Nutrition Assistance Program to a block grant to states that would grow more slowly than the spending projected under current law could result in greater savings. However, CBO has not recently estimated the budgetary impact of specific large changes of that sort.

Options That Would Reduce Discretionary Spending

Nearly 40 percent of federal noninterest outlays stem from budget authority provided in annual appropriation acts. Those discretionary outlays pay for a wide variety of federal activities, including most programs related to national defense, transportation, elementary and secondary education, veterans' health care, international affairs, and law enforcement.

Before the enactment of the Budget Control Act of 2011, CBO's baseline projections for discretionary spending

15. The estimated budgetary effects shown in Table 3 were not calculated relative to the alternative fiscal scenario but rather relative to CBO's baseline projections (generally, the January 2011 baseline, unless otherwise noted). Measuring the options against the alternative fiscal scenario would probably not materially alter the rough magnitude of the estimates.

16. Of that projected total, about half is for veterans' benefits, the Supplemental Nutrition Assistance Program, Supplemental Security Income, unemployment compensation, child nutrition, and foster care. Nearly one-third is for federal civilian and military retirement benefits, and the remainder is for other mandatory programs. The $700 billion total excludes offsetting receipts, which reduce outlays.

Table 3.

Approximate Potential Savings in 2020 from Selected Options to Reduce Mandatory Spending

	Approximate Potential Deficit Reduction in 2020 (Billions of dollars)
Health Care Programs	
Repeal the expansion of health insurance coverage under the Affordable Care Act[a,b]	150
Convert the federal share of Medicaid's payments for long-term care services into a block grant (indexed to changes in the employment cost index)	50
Repeal the individual health insurance mandate[a,c]	40
Increase the basic premium for Medicare Part B to 35 percent of the program's costs	40
Raise the age of eligibility for Medicare to 67[a,c,d]	30
Reduce the floor on federal matching rates for Medicaid services[c]	20
Add a "public plan" to the health insurance exchanges[a,c]	15
Require manufacturers to pay a minimum rebate on drugs covered under Medicare Part D for low-income beneficiaries	15
Reduce Medicare costs by changing the cost-sharing structures for Medicare and medigap insurance	10
Limit medical malpractice torts[a]	10
Consolidate and reduce federal payments for graduate medical education costs at teaching hospitals	10
Eliminate the critical access hospital, Medicare-dependent hospital, and sole community hospital programs in Medicare	10
Reduce Medicare's payment rates across the board in high-spending areas	10
Adopt a voucher plan and slow the growth of federal contributions for the Federal Employees Health Benefits program[e]	5
Introduce minimum out-of-pocket requirements under TRICARE for Life	5
Social Security	
Link initial Social Security benefits to average prices instead of average earnings	30
Raise the full retirement age in Social Security[d]	30
Raise the earliest eligibility age for Social Security[d]	30
Base Social Security cost-of-living adjustments on an alternative measure of inflation[f]	20
Apply the Social Security benefit formula to individual years of earnings	20
Reduce initial Disability Insurance benefits by 15 percent[g]	20
Lengthen by three years the computation period for Social Security benefits	10
Extend the waiting period for Disability Insurance benefits to 12 months[g]	10

Continued

reflected the assumption that the most recent year's budget authority would be provided in each future year, with adjustments for projected inflation. The Budget Control Act established caps on discretionary funding that are set to constrain such spending significantly. The automatic enforcement procedures contained in that law, which are scheduled to take effect in January, are set to reduce discretionary funding even further.[17]

Under the alternative fiscal scenario—which includes the original spending caps in the Budget Control Act but not the reductions stemming from the automatic enforcement procedures—discretionary outlays would total $1.4 trillion in 2020. That amount would equal 6.2 percent of GDP, down from an estimated 8.3 percent in 2012 and well below the average (8.7 percent of GDP) seen over the past 40 years. Indeed, under that alternative scenario, the government's discretionary spending would represent a smaller share of the economy by 2020 than it has for nearly all of the past 40 years. (Discretionary

17. For more information about the provisions of the Budget Control Act, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011), Box 1-1, and *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), Box 1-1.

Table 3. Continued

Approximate Potential Savings in 2020 from Selected Options to Reduce Mandatory Spending

	Approximate Potential Deficit Reduction in 2020 (Billions of dollars)
Other Mandatory Programs	
Allow the automatic enforcement procedures in the Budget Control Act to take effect[h]	15
Change the interest rate structure for student loans	10
Reduce income eligibility limits and maximum benefits for the Supplemental Nutrition Assistance Program[i]	5

Source: Congressional Budget Office.

Note: The options shown here are the same as those included in Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), unless otherwise noted below. Options with savings of at least $20 billion in 2020 are rounded to the nearest $10 billion; options with savings below that amount are rounded to the nearest $5 billion. Updated estimates of any of the options could result in more or less savings in 2020 than shown here. In addition, some of the options interact with one another, meaning that the sum of the estimates shown in the table would not equal the savings if all of the options were enacted at the same time.

a. This option would affect revenues as well as outlays; the total effect on the deficit is shown here.

b. See Congressional Budget Office, letter to the Honorable John Boehner providing an estimate for H.R. 6079, the Repeal of Obamacare Act (July 24, 2012).

c. This estimate does not incorporate the effect of the Supreme Court's decision in *National Federation of Independent Business v. Sebelius,* which established that the expansion of Medicaid in the Affordable Care Act is optional for states.

d. See Congressional Budget Office, *Raising the Ages of Eligibility for Medicare and Social Security* (January 2012).

e. This option would also affect discretionary spending.

f. In this option, cost-of-living adjustments for inflation would be made using the chained consumer price index for all urban consumers (chained CPI-U) instead of the consumer price index for urban wage earners and clerical workers (CPI-W). CBO estimates that over the next decade, the chained CPI-U is likely to grow at an average annual rate that is 0.25 percentage points less than the growth rate of the CPI-W. If this option was applied to other federal benefit programs, it would reduce the deficit by an additional $10 billion in 2020.

g. See Congressional Budget Office, *Policy Options for the Social Security Disability Insurance Program* (July 2012).

h. This estimate, which includes the option's effects on health care programs but excludes its effects on discretionary spending, comes from CBO's August 2012 baseline projections. See Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012).

i. See Congressional Budget Office, *The Supplemental Nutrition Assistance Program* (April 2012).

spending would be even lower if funding for the war in Afghanistan and similar activities diminished; both CBO's baseline and the alternative fiscal scenario incorporate the assumption that such spending will continue at the amount appropriated for 2012, with increases for inflation.) Thus, significant reductions in discretionary outlays as a share of GDP are already embodied in the alternative fiscal scenario.

One broad policy change that would generate a large amount of additional deficit reduction relative to the alternative fiscal scenario involves maintaining appropriations at the amounts designated for 2013 (as originally provided for in the Budget Control Act). If appropriations covered by the discretionary spending caps were maintained at their 2013 amounts rather than increasing modestly each year, total discretionary outlays in 2020 would be about $145 billion lower than under the alternative fiscal scenario: $75 billion lower for defense programs and $70 billion lower for nondefense programs (see Table 4). Maintaining appropriations at their 2013 level would represent a cut of 12 percent relative to the amount of funding that would result if those appropriations grew at the projected rate of inflation.

Another broad option would be to allow the automatic enforcement procedures of the Budget Control Act to take effect in January (which is not assumed in the alternative fiscal scenario). Those automatic procedures would reduce defense and nondefense discretionary spending

Table 4.

Approximate Potential Savings in 2020 from Selected Options to Reduce Discretionary Spending

	Approximate Potential Deficit Reduction in 2020 (Billions of dollars)
Defense Discretionary Programs	
Keep appropriations at the level originally set by the Budget Control Act for 2013[a]	75
Allow the automatic enforcement procedures in the Budget Control Act to take effect[a,b]	54
Limit the TRICARE benefit for military retirees and their dependents[b]	14
Reduce the across-the-board adjustment for federal civilian employees' pay	4
Increase cost sharing for pharmaceuticals under TRICARE[c]	2
Cap increases in military basic pay	2
Nondefense Discretionary Programs	
Keep appropriations at the level originally set by the Budget Control Act for 2013[a]	70
Allow the automatic enforcement procedures in the Budget Control Act to take effect[a,b]	34
Limit highway funding to expected highway revenues	11
Reduce the across-the-board adjustment for federal civilian employees' pay	6
Eliminate federal grants for wastewater and drinking water infrastructure	4
Reduce funding for the National Institutes of Health	4
Increase payments by tenants in federally assisted housing	4
Increase fees for aviation security	2
Eliminate the transit Starts programs	2
Reduce Department of Energy funding for energy technology development	2
Eliminate certain grant programs for elementary and secondary education	2
Eliminate grants to large and medium-sized hub airports	1
Restrict Pell grants to needier students[c]	1
Eliminate funding for national community service programs	1
Finance the Food Safety and Inspection Service through fees[d]	1

Source: Congressional Budget Office.

Note: The options shown here are the same as those included in Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), unless otherwise noted below. Estimates are rounded to the nearest $1 billion. Updated estimates of any of these options could result in more or less savings in 2020 than shown here.

a. This estimate is calculated from CBO's August 2012 baseline projections. For more details about those projections, see Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012).

b. This option would also affect mandatory spending and revenues.

c. This option would also affect mandatory spending.

d. The fees collected under this option could be recorded in the budget as offsetting collections (discretionary), offsetting receipts (usually mandatory), or revenues, depending on the specific language used to establish the fees.

in 2020 by a total of $88 billion relative to the amounts projected in the alternative fiscal scenario.[18] Although the savings from such broad options can be estimated in the aggregate, lawmakers would ultimately have to make detailed program-by-program decisions about how to apportion such reductions.

Specific options for cutting discretionary spending that CBO has examined recently would produce much smaller budgetary savings than would those broad options—or most of the options for changing mandatory spending or revenues discussed elsewhere in this report—because the amounts of funding provided for most individual discretionary programs are relatively small. Estimates for most of those specific options were based on appropriations provided for 2011, but they can be used

18. They would also reduce mandatory spending by about $15 billion in 2020.

to approximate savings relative to more recent appropriations. The specific options that would produce the largest savings in discretionary spending in 2020—$10 billion to $14 billion (see Table 4)—are the following:

- Limiting the health care benefits provided to military retirees and their dependents through the Department of Defense's TRICARE program (which combines access to military hospitals and clinics with coverage for services received from civilian health care providers),
- Limiting the amount of highway funding to match the highway revenues expected to be collected at current tax rates,[19] and
- Reducing annual across-the-board salary adjustments for both defense and nondefense civilian employees.

Enacting all of the specific changes shown in Table 4 would reduce discretionary spending by a total of about $60 billion (or 4 percent) in 2020, compared with amounts of funding that would rise with inflation. That total would not be enough to keep discretionary budget authority in line with the caps originally set in the Budget Control Act; greater reductions would be required just to comply with those caps, and even larger cuts would be necessary to comply with the automatic enforcement procedures that are scheduled to take effect in January.

Because of the caps on budget authority established by that law (even without the automatic reductions set to occur in January), discretionary outlays would be $86 billion lower in 2020 than they would be if the funding provided for 2012 was continued in later years with increases for inflation; that difference would mean a 6 percent decrease in the real (inflation-adjusted) resources available for a large collection of government programs and activities. However, even if 2012 funding levels continued, with adjustments for inflation, the resources available for some programs could be insufficient to continue current policies. For example, if current enrollment rules stay the same, the cost of veterans' health care will rise more rapidly than inflation, CBO projects.[20] Similarly, keeping award amounts for Pell grants at their current levels will require greater funding than the 2012 appropriation increased for inflation. Maintaining such programs in their present form without increasing deficits would require even larger cuts to other discretionary programs.

In 2012, just over half of discretionary outlays went to defense programs—mainly for operations and maintenance, military personnel, and procurement. Cuts in defense spending could be targeted toward personnel levels, pay rates, and benefits; training and supplies; day-to-day operating and administrative costs; procurement, operation, and maintenance of existing weapon systems; or research and development aimed at producing more advanced weapon systems.[21] However, large and sustained reductions in funding in those areas could have substantial effects on military capabilities and thus could require changes in broad strategic objectives, with significant implications for national security.[22]

Similarly, large cuts in nondefense discretionary spending could affect a broad range of activities—covering such areas as education, transportation, housing subsidies, health-related research, and public health. Decisions about specific programs would have effects beyond their impact on the federal budget. For example, many federal programs provide funds to state and local governments. Reducing federal support for such programs would force other levels of government to make decisions about decreasing the scope of the programs, increasing their own funding, or some combination of the two.

Options That Would Increase Revenues

Lawmakers could raise revenues by modifying existing taxes—either by increasing tax rates or by expanding tax bases (the measures, such as personal or corporate income, on which taxes are assessed). For example,

19. Most federal funding for highways (and for certain other ground and air transportation programs) is controlled by obligation limitations and is not subject to the caps on discretionary budget authority.

20. See Congressional Budget Office, *Potential Costs of Veterans' Health Care* (October 2010).

21. Under the Budget Control Act, war-related funding is not constrained by the discretionary caps. However, such funding may decline significantly in coming years because U.S. military activities in Iraq have already wound down and operations in Afghanistan are scheduled to follow suit.

22. This report does not include options related to military procurement because CBO has previously analyzed such options relative to the Department of Defense's 2011 Future Years Defense Program (a plan covering 2012 to 2016) and has not estimated their effects in 2020. Several such options in CBO's March 2011 *Reducing the Deficit* report were estimated to save a total of about $11 billion in 2016 relative to the Defense Department's plan.

Table 5.

Approximate Potential Savings in 2020 from Selected Options to Increase Revenues

	Approximate Potential Deficit Reduction in 2020 (Billions of dollars)
Reverse Changes in Law Assumed in the Alternative Fiscal Scenario[a]	
Let tax cuts originally enacted in 2001, 2003, and 2009 expire as scheduled; let estate and gift tax provisions enacted in 2010 expire as scheduled; and do not index the AMT for inflation	550
Extend certain tax cuts originally enacted in 2001, 2003, and 2009 for taxpayers below a specific income threshold; extend estate and gift tax provisions enacted in 2010; and index the AMT for inflation[b]	110
Modify Existing Taxes[c]	
Limit the tax benefit of itemized deductions to 15 percent	150
Eliminate the deduction for state and local taxes	110
Increase the payroll tax rate for Medicare Hospital Insurance by 1 percentage point	80
Increase the maximum taxable earnings for the Social Security payroll tax[d]	60
Gradually eliminate the mortgage interest deduction	50
Tax Social Security and Railroad Retirement benefits in the same way as distributions from defined-benefit pensions	50
Accelerate and modify the excise tax on high-cost health care coverage	40
Include employer-paid premiums for income replacement insurance in employees' taxable income[d]	40
Extend the period for depreciating the cost of certain investments	30
Increase excise taxes on motor fuels by 25 cents per gallon	30
Include investment income from life insurance and annuities in taxable income	30
Curtail the deduction for charitable contributions	30
Replace the tax exclusion for interest income on state and local bonds with a direct subsidy for the issuer	30
Repeal the deduction for domestic production activities	20
Expand Social Security coverage to include newly hired state and local government employees	20
Use an alternative measure of inflation to index some parameters of the tax code[e]	10

Continued

various tax bases could be expanded by eliminating or curtailing tax expenditures (the many exclusions, deductions, exemptions, credits, and other features of the tax system that resemble government spending programs by providing assistance to specific activities, entities, or groups of people).[23] Alternatively, lawmakers could impose new taxes on income, consumption, or particular activities. All of those approaches would have effects not only on the amount of revenues collected but also on economic activity, the distribution of the tax burden among households, and the complexity of the tax system.

CBO's March 2011 volume of budget options and more recent publications contain a variety of alternatives for raising revenues. Those options, which were analyzed by JCT and CBO, include changes to income tax rates and the income tax bases for individuals and corporations, expansions of the Social Security tax base, increases in excise taxes, and several new taxes (see Table 5).[24] Many of the revenue options would make broad enough

23. For more discussion of tax expenditures, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012), Chapter 4.

24. The options shown in the table are illustrative. They could be combined as part of a comprehensive deficit reduction plan, but the total additional revenues from such a combination would probably differ from the sum of the revenues shown for the individual options, for three reasons. First, some of the options would interact in ways that would cause their total effect to vary from the sum of the individual provisions. Second, the added revenues from the two options that would extend the earlier tax cuts for some or all taxpayers were estimated relative to the policies in the alternative fiscal scenario, whereas the effects of the other provisions in Table 5 were measured relative to the current-law baseline. Third, estimates for the options to extend the tax cuts are based on more recent economic and technical assumptions than estimates for the other options are.

Table 5. Continued

Approximate Potential Savings in 2020 from Selected Options to Increase Revenues

	Approximate Potential Deficit Reduction in 2020 (Billions of dollars)
Establish New Taxes[c]	
Impose a 5 percent value-added tax on a broad base	320
Impose a price on emissions of greenhouse gases	140

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: The options shown here are the same as those included in Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), unless otherwise noted below. Estimates are rounded to the nearest $10 billion. Many of the options interact with one another (for example, limiting the tax benefit of itemized deductions would reduce the savings from eliminating specific deductions). In addition, the estimates for the first two options are based on more recent economic and technical assumptions than the estimates for the other options and reflect savings relative to the alternative fiscal scenario rather than changes from current law (as is the case for the other options). As a result, the sum of the estimates shown in the table would not equal the savings if all of the options were enacted at the same time.

AMT = alternative minimum tax.

a. The estimates in this section are of savings relative to the alternative fiscal scenario, which incorporates the assumption that legislative action extends title I of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (which extended for 2011 and 2012 income tax provisions enacted in 2001, 2003, and 2009) and title III of that act (which modified estate and gift taxation for 2010 through 2012). The alternative fiscal scenario also incorporates the assumption that the exemption amount for the AMT (which was increased through the end of 2011) is extended at its higher amount and, together with the AMT's tax brackets, is indexed for inflation after 2011. In addition, the treatment of nonrefundable personal credits (which was also continued through the end of 2011) is assumed to be extended. These estimates are based on CBO's August 2012 economic and technical assumptions. See Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), Table 1-5.

b. Under this option, the tax cuts would expire as scheduled only for couples filing joint tax returns with income over $250,000 per year and for single taxpayers with income over $200,000. The option also includes the assumptions that the AMT would be indexed for inflation and that the estate and gift tax provisions enacted in 2010 would be extended. See Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), Table 1-5.

c. The estimates in this section are of savings relative to CBO's current-law baseline and do not incorporate the assumptions of the alternative fiscal scenario. The estimates are based on CBO's January 2011 economic and technical assumptions. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011).

d. This option would affect mandatory spending as well as revenues; the total effect on the deficit is shown here.

e. In this option, the federal government would use the chained consumer price index for all urban consumers (chained CPI-U) to adjust various parameters of the tax code for inflation instead of using the traditional CPI-U. CBO estimates that over the next decade, the chained CPI-U is likely to grow at an average annual rate that is 0.25 percentage points less than the growth rate of the traditional CPI-U.

changes to the tax code to have larger effects on the deficit than many of the changes to individual spending programs discussed above. Among the options to alter existing taxes, the ones that would have the greatest impact on revenues—an additional $110 billion to $550 billion in 2020—are the following:

- Letting various tax cuts expire as scheduled and not indexing the alternative minimum tax for inflation,
- Limiting the extent to which taxes can be reduced through itemized deductions to 15 percent of the deductions' value, and
- Eliminating the income tax deduction for payments of state and local taxes.

The option with the largest revenue impact—allowing the tax cuts originally enacted in 2001, 2003, and 2009 to expire as scheduled; allowing estate and gift tax provisions enacted in 2010 to expire as scheduled; and not indexing the AMT for inflation after 2011—would reduce the deficit in 2020 by about $550 billion relative to the alternative fiscal scenario. That option would thus provide about three-quarters of the deficit reduction needed to cut the deficit by $750 billion in 2020 relative to the alternative fiscal scenario, for example. (Those

policies are already embodied in CBO's current-law baseline projections.) If those tax cuts expired as scheduled only for high-income taxpayers but were extended for everyone else, the estate and gift tax provisions were extended, and the AMT was indexed for inflation, the amount of deficit reduction in 2020 would be much smaller: about $110 billion. Many other changes to tax policies are possible, some of which would yield even more revenues and some a good deal less.

In many cases, choices about tax policies involve significant trade-offs between deficit reduction and other policy goals, such as providing incentives for economic growth or distributing the tax burden fairly among households. For example, raising tax rates would reduce the deficit but also lessen people's incentives to work and save. Alternatively, expanding tax bases would reduce the deficit and generally have a smaller negative effect, or even a positive effect, on how efficiently the economy operates.

What Criteria Might Be Used to Evaluate Policy Changes?

Reducing the deficit by $500 billion, $750 billion, or $1 trillion in 2020 relative to the alternative fiscal scenario would be a formidable task. As lawmakers consider changes in budget policies, many factors may play a role in their decisions. The size and composition of the changes they choose to make to federal spending and revenues will affect the total amount and types of output produced and consumed in the United States, the distribution of that output among different segments of society, and people's well-being. The rest of this report discusses several factors that policymakers and the public might consider in evaluating budget plans:

- How big would the government be?
- How would the government's resources be allocated among various priorities?
- How much would deficits be reduced in the next 10 years and beyond?
- What would the economic impact be in the short term as well as in the medium and long term?
- Who would bear the burden of proposed changes in tax and spending policies?

The way that people think about those criteria, and the relative importance they attach to such considerations, will vary according to their individual preferences.

How Big Would the Government Be?

The approach that lawmakers choose to take toward deficit reduction will be determined partly by their view of the proper size and scope of the federal government. One approach, for example, would be to provide government services and benefits so that total spending remained at about 23 percent of GDP (the percentage estimated for 2012 and the average during the coming decade under the alternative fiscal scenario). With spending at that level, reducing the deficit would require significantly higher taxes than the nation has been accustomed to paying. A starkly different approach would be to keep revenues at roughly 18 percent of GDP (the average percentage over the past 40 years and the average during the coming decade under the alternative fiscal scenario). With revenues at that level, significant spending cuts would be required to shrink the deficit. Many other objectives—either within the range defined by those two approaches or outside that range—are also possible. Moreover, the size and scope of the government depend not just on the magnitude of total spending and revenues relative to GDP but also on the nature of spending programs and the tax code, the government's regulatory activities, and other factors.

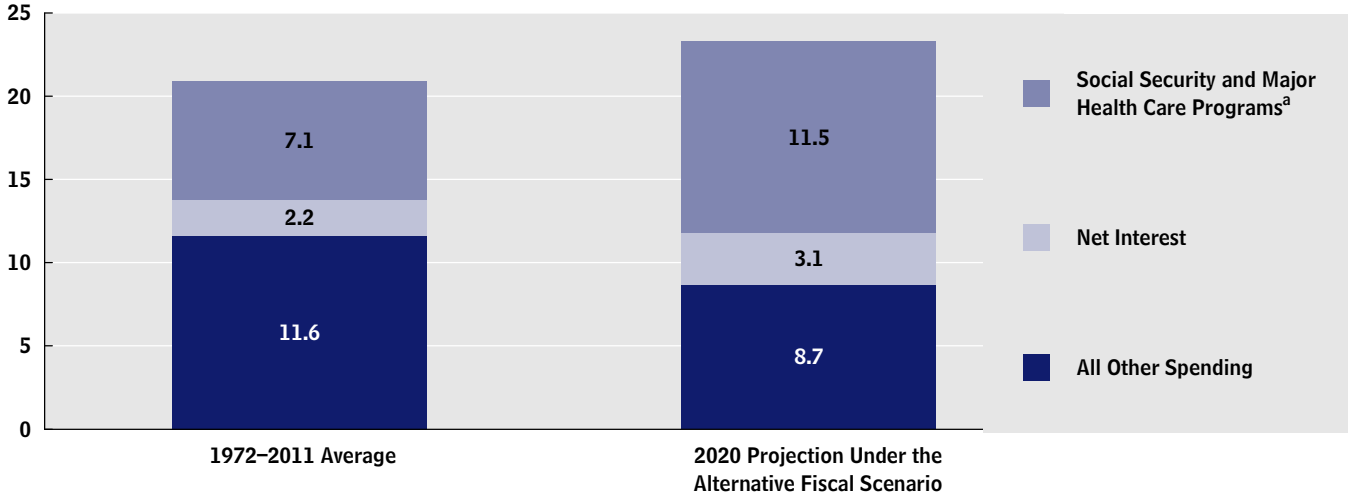
How Would the Government's Resources Be Allocated?

Fiscal policies are judged not only by their effects on the sustainability of the federal budget but also by the extent to which they accomplish other national goals. Under current law, the United States is on track to have a federal budget that will look very different from budgets of the past: As the population ages, a much larger share of federal spending will go toward benefits for older people and a much smaller share will go toward other types of benefits and services. If federal spending for purposes other than Social Security, health care, and net interest declined sharply relative to the size of the economy over the next decade—as it would under either CBO's current-law baseline or the alternative fiscal scenario (see Figure 4)—the services that the government provides in the areas of national defense, income security, education, and transportation would probably be cut substantially compared with other goods and services in the economy. Conversely, if significant reductions were made to spending

Figure 4.

Components of Federal Spending in 2020 Under the Alternative Fiscal Scenario, Compared with Their Averages Since 1972

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario also include the incremental interest costs associated with projected additional borrowing.

a. The federal government's major health care programs consist of Medicare, Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending.

for Social Security or major health care programs, the average benefits received by older people would probably be much smaller than they would be under current policies.

Changes to the tax code can also affect the way in which federal resources are allocated to achieve various social goals. For example, if revenues were increased by curtailing the number or size of deductions or credits in the tax system, the support that the government provides for various private activities could be cut substantially. Thus, in considering policies aimed at reducing deficits, policymakers and the public will need to make judgments about what types of programs and activities are appropriate for the government to carry out or subsidize and about what priorities they attach to various types of spending and to various benefits conveyed through the tax system.

How Much Would Deficits Be Reduced in the Next 10 Years?

Policymakers will also need to make judgments about how much deficit reduction should be accomplished within the next 1, 5, or 10 years. For any given amount of deficit reduction, looking at different slices of the budget—such as spending for Social Security and major health care programs, other noninterest spending, and revenues—illustrates how large policy changes would need to be to bring about that reduction. For instance, cutting the deficit by $750 billion in 2020 relative to the alternative fiscal scenario could require changes of the following sizes:

- If the deficit reduction came entirely from Social Security and major health care programs, that reduction would need to total about 30 percent of the nearly $2.6 trillion projected to be spent on those programs under the alternative fiscal scenario in 2020.

- If the deficit reduction came entirely from other noninterest spending (including national defense), it would have to total nearly 40 percent of the estimated $2.0 trillion in such spending projected for 2020 under the alternative fiscal scenario.

- If the deficit reduction came entirely from taxes, revenues would need to rise by almost 20 percent from the $4.2 trillion estimated to be collected in 2020 under the alternative fiscal scenario.

If the policy changes involved two of those three categories rather than just one, they would still need to be large. For example, if half of the $750 billion in deficit reduction came from Social Security and major health care programs and half came from revenues, that combination would require a cut of 14 percent in spending for those programs and an increase of 9 percent in tax collections. The changes would be one-third smaller or larger if the deficit reduction target for 2020 was $500 billion or $1 trillion.

How much the deficit is cut in the next few years will have a number of consequences. The longer that significant deficit reduction is deferred, the larger the government's accumulated debt will be (with its associated costs and risks), and the greater the policy changes will need to be when deficit reduction begins. Conversely, the sooner that the deficit is cut, the less time that households, businesses, and state and local governments will have to plan and adjust their behavior. In addition, the timing of the steps taken to put fiscal policy on a sustainable course will affect different generations differently and will have a substantial impact on the economy (as discussed below).

How Much Would Deficits Be Reduced in the Long Term?

Because the aging of the population and the continuing growth of health care costs have consequences well beyond the next 10 years, the fiscal challenges facing the nation are long term in nature. CBO projects that under the alternative fiscal scenario, spending on major federal health care programs alone would grow from roughly 5 percent of GDP today to more than 10 percent in 25 years (see Figure 5) and would continue to increase thereafter. Spending on Social Security is projected to rise much less sharply, from about 5 percent of GDP today to more than 6 percent in 2037 and subsequent decades.[25] Unless those programs are changed, or the increased spending is accompanied by some combination of sufficiently lower spending on other programs and sufficiently higher revenues, deficits will be much larger in the future than they have tended to be in the past.

Thus, putting the nation on a sustainable fiscal path requires steps that will reduce or constrain deficits over the long term. Some policy options would have much greater budgetary effects after the next 10 years than they would during the next decade. For example, if changes in the full retirement age for Social Security or in the eligibility age for Medicare were phased in gradually or did not apply to people currently age 55 or older, they would have much larger effects in future decades than in the next several years.[26] Similarly, if the growth rate of Medicare spending per beneficiary was effectively restrained through some policy change, the budgetary effects would compound over time, and the long-term savings would be much larger than the short-term savings. As another example, reducing initial Social Security Disability Insurance benefits by 15 percent (as shown in Table 3 on page 14) would cut spending by about 10 percent relative to the total benefits that would be paid under current law in 2020 but by about 15 percent relative to current-law benefits in 2035. Changes that reduced benefits in that way would have larger effects not only on future budget deficits but also on the future income of affected individuals.

What Would the Economic Impact Be in the Short Term?

Under current law, the deficit is set to shrink by about $450 billion (or 3.0 percent of GDP) between fiscal years 2012 and 2013, CBO estimates, mostly because of scheduled increases in taxes and, to a lesser extent, scheduled reductions in spending. In CBO's view, that fiscal tightening will cause real GDP to decrease slightly in calendar year 2013—the result of a contraction in the first half of the year and a modest expansion in the second half.[27] Given the pattern of past recessions (as identified by the National Bureau of Economic Research), such an

25. See Congressional Budget Office, *The 2012 Long Term Budget Outlook* (June 2012).

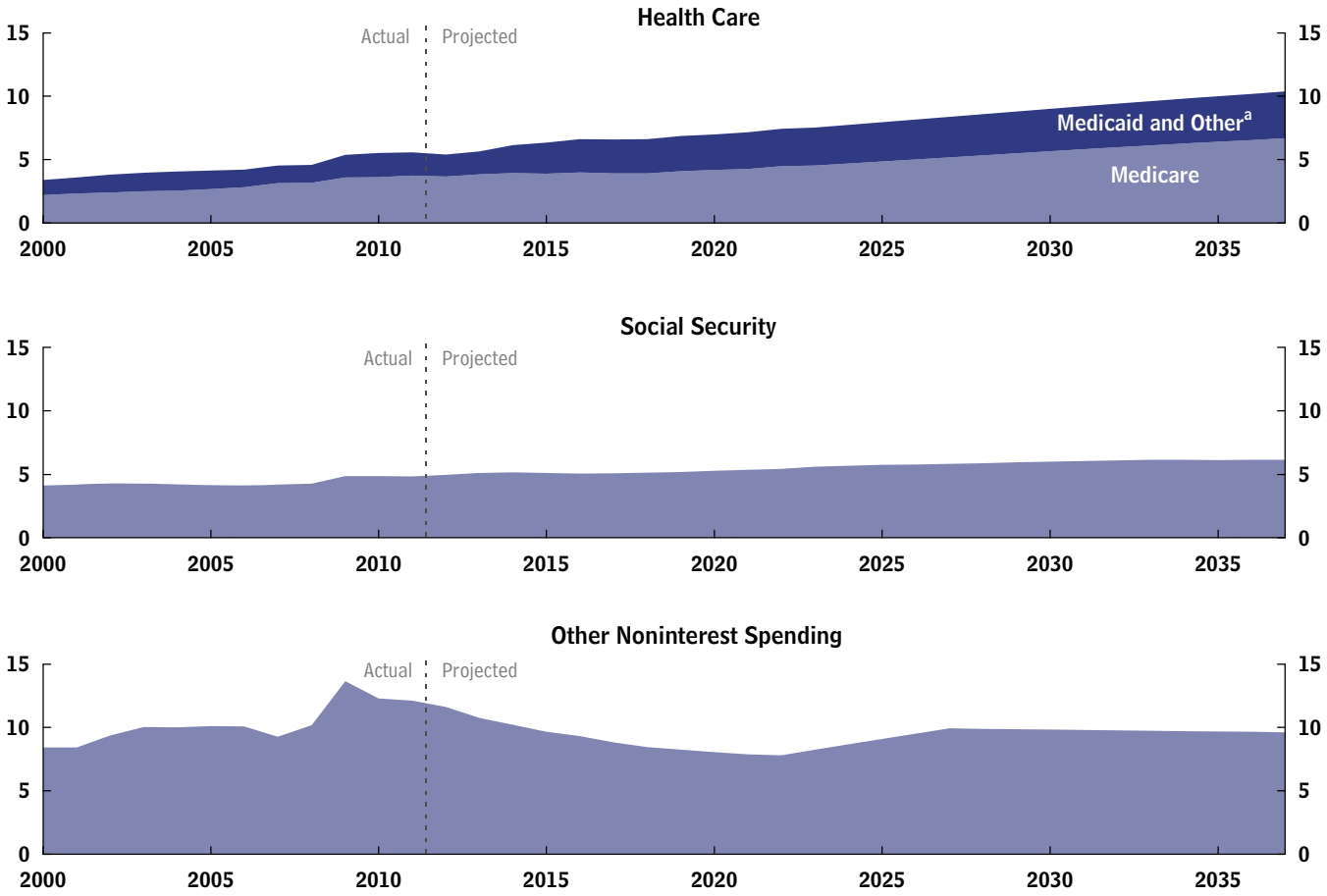
26. If such changes excluded people who are 55 or older now, they would not affect roughly 60 percent of the baby-boom generation. If policy changes excluded people who will be 55 or older in 2015, they would not affect roughly 75 percent of baby boomers.

27. For a more detailed discussion of the economic impact of the fiscal tightening set to occur in January, see Congressional Budget Office, *Economic Effects of Policies Contributing to Fiscal Tightening in 2013* (November 2012).

Figure 5.

Components of Noninterest Spending Under the Extended Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012).

Note: The extended alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. Outlays under that scenario also include the incremental interest costs associated with projected additional borrowing.

a. Other major health care programs consist of the Children's Health Insurance Program and subsidies offered through new health insurance exchanges and related spending.

economic contraction in the first half of 2013 would probably be judged a recession. That projected effect of sharp deficit reduction on short-term economic growth under current law is one illustration of the difficult trade-offs that lawmakers face in deciding how quickly to implement policies to reduce the deficit.

Lawmakers might address the short-term economic challenge by eliminating or reducing the fiscal tightening that is scheduled to occur next year without tackling the fiscal challenges that remain in the future. That approach would not be sustainable indefinitely, however, and it would have substantial economic costs over the longer term. Alternatively, policymakers could move rapidly to address the longer-term budgetary problem by allowing the full measure of fiscal tightening now embodied in current law to take effect next year, although that course would have substantial economic costs during the year.

Intermediate possibilities would be to extend some, but not all, current policies indefinitely (perhaps with offsetting changes in other policies); to phase out current policies more gradually; or to extend or enact certain policies for a limited period. In particular, if policymakers wanted to minimize both the short-term economic costs of shrinking the deficit very quickly and the longer-term costs of allowing large deficits to persist, they could enact a combination of changes in tax and spending policies that would increase the deficit in 2013 relative to what it would be under current law but that would reduce deficits later in the decade relative to what would occur if current policies were extended. That approach, however, would allow a greater amount of federal debt to accumulate and might raise doubts about whether longer-term deficit reduction would actually take place. Households, businesses, state and local governments, and participants in the financial markets would be more likely to believe that the future deficit reduction would truly take effect if the future policy changes were specific and widely supported.[28]

What Would the Economic Impact Be in the Medium and Long Term?

The effects of deficit reduction on the economy beyond the next few years would depend on the specific policy changes that were made to achieve that reduction. A decrease in federal borrowing would increase the stock of private capital (such as factories, vehicles, and computers) and thereby raise future output and income relative to what they would be otherwise. However, the policy changes used to reduce federal borrowing could have other effects on future output and income as well.

For example, increasing revenues by raising marginal tax rates on labor (the rates that would apply to an additional dollar of a taxpayer's income from work) would reduce people's incentive to work and therefore reduce the amount of labor supplied to the economy, whereas increasing revenues to a similar extent by broadening the tax base would probably have a smaller negative effect, or even a positive effect, on the amount of labor supplied.[29] A reduction in the labor supply, by itself, would decrease output in the medium and long term. Similarly, increasing marginal tax rates on capital would tend to reduce people's incentive to save and thus the amount of private saving, which would also decrease output in the longer term (excluding the effects of less federal borrowing). Alternatively, cutting government benefit payments, such as unemployment insurance or retirement benefits, would probably strengthen people's incentives to work and save, although the impact would depend on the nature of the cuts. Another alternative, reducing federal investment in such things as infrastructure and education, would decrease future output (also excluding the effects of less federal borrowing).

Therefore, to assess the overall economic impact of a deficit reduction plan in the medium and long term, the favorable effects of less federal borrowing must be combined with the effects of the specific changes in taxes and spending.[30] However, even if lawmakers reduced federal budget deficits through policy changes that worsened incentives to work and save and that trimmed federal investment, the net impact on the nation's long-term output and income would probably be positive.

For example, CBO recently compared the economic outcomes that would result from the policies included in the current-law baseline and the alternative fiscal scenario.[31] Relative to the alternative fiscal scenario, adherence to current law would probably increase output and income later in this decade and beyond. The expiration of the tax provisions would raise tax rates on capital income and

28. For a more detailed discussion of the economic impact of fiscal policy in the short term, see the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Budget Committee, *Policies for Increasing Economic Growth and Employment in 2012 and 2013* (November 2011); CBO's methods for analyzing such policies are summarized on pages 22–25 of that testimony. For additional information, see Felix Reichling and Charles Whalen, *Assessing the Short-Term Effects on Output of Changes in Federal Fiscal Policies*, CBO Working Paper 2012-08 (May 2012).

29. Broadening the tax base would have opposing effects on labor supply. On the one hand, reducing taxpayers' after-tax income would tend to cause them to work more to make up for the loss in income. On the other hand, some approaches for broadening the tax base would raise some taxpayers' marginal tax rates—by pushing them into higher tax brackets, for example—which would tend to cause them to work less. Whether the net effect was positive or negative would depend on the details of the policy change.

30. See the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Joint Select Committee on Deficit Reduction, *Confronting the Nation's Fiscal Policy Challenges* (September 2011), pp. 43–47. For a discussion of the methods that CBO uses to assess such effects, see Congressional Budget Office, *The Economic Impact of the President's 2013 Budget* (April 2012), pp. 13–18.

31. See Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), pp. 35–36.

labor earnings, which would decrease private saving and the supply of labor; those responses, by themselves, would reduce future output. However, the effects of those responses would probably be outweighed by the impact of the substantial decrease in budget deficits, which, by itself, would increase future output by a growing amount over time. Hence, by CBO's estimates, the policy changes scheduled to occur under current law would, on balance, have a positive medium- and long-term effect on the economy. Conversely, if lawmakers decided to maintain current policies and extend the expiring tax provisions, output and income would be lower in the medium and long term than they would be under current law, CBO estimates.[32]

To the extent that deficit reduction led to greater economic output in the medium and long term, the accompanying increases in taxable income would reduce the deficit further by raising revenues. In addition, the decrease in federal borrowing would lower interest rates, which would cut the government's interest payments. Thus, somewhat smaller policy changes would be needed to achieve any particular target for deficit reduction than calculations that exclude such macroeconomic effects would imply. However, the additional deficit reduction that would result from those economic effects would probably be small relative to the underlying impact of the policy changes. Specifically, CBO has estimated that the increase in taxable income and the reduction in interest rates that would result from a gradual decrease in deficits over the coming decade would generate additional deficit reduction in 2020 that would be roughly 10 percent of the size of the deficit reduction in that year resulting directly from policy changes.[33]

Some policymakers have proposed broadly restructuring the individual income tax system, the corporate income tax system, or both as part of an effort to reduce deficits. If such restructuring strengthened the economy in the medium and long term, it would increase taxable income and thereby reduce deficits. However, the deficit reduction would probably be small relative to the gap between federal spending and revenues in the alternative fiscal scenario.

As an illustration, suppose that tax restructuring lowered the effective marginal tax rate on labor earnings by 5 percentage points (roughly the increase in that rate scheduled to occur between 2011 and 2015). Suppose also that the revenue loss was made up exactly—without incorporating any macroeconomic effects—by expanding the tax base. According to a rough estimate by CBO, the resulting increase in GDP would probably boost tax revenues by less than half a percent of GDP, or less than $100 billion in 2020.[34] Changes to the tax code that reduced effective marginal tax rates to a lesser extent and also had no net impact on deficits in the absence of any macroeconomic effects would generally have smaller effects on GDP and tax revenues. However, the impact of any particular plan for tax restructuring would depend not only on the size of changes in marginal tax rates but also on the distribution of those changes among taxpayers

32. CBO's recent estimates apply to the alternative fiscal scenario as a whole, which includes not only the indexation of the AMT and the extension of the tax provisions originally enacted in the previous decade but other changes in federal taxes and spending. However, the AMT and tax cut provisions represent a larger share of the budgetary effect of the alternative scenario than the other changes do, so the economic impact of those key provisions accounts for most of the economic impact of the alternative scenario as a whole. For an earlier analysis of the effects of those key tax changes alone, see the statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices* (September 2010).

33. See Congressional Budget Office, *The Macroeconomic and Budgetary Effects of an Illustrative Policy for Reducing the Federal Budget Deficit* (July 2011). CBO's economic projections for later in this decade and beyond incorporate the favorable long-term impact of the small deficits that will result under current law. Therefore, a reduction in deficits relative to the alternative fiscal scenario would probably not lead CBO to project higher output and income over the medium and long term than are already reflected in the baseline projections.

34. Lowering the effective marginal tax rate on labor earnings by 5 percentage points would require a larger reduction in statutory tax rates, because some forms of compensation are excluded from taxable income and because some options for broadening the tax base increase people's taxable income and thereby push some of them into higher tax brackets. CBO's reading of the evidence about how the supply of labor responds to changes in tax rates suggests that such a substantial cut in the tax rate would probably increase the labor supply by 2 percent or less; see Congressional Budget Office, *How the Supply of Labor Responds to Changes in Fiscal Policy* (October 2012). Tax restructuring could also boost the capital stock by reducing the effective marginal tax rate on capital income, which would encourage saving, and by generating higher earnings by workers, which would also boost total saving. If those effects together increased the long-term capital stock by an amount comparable to the increase in the labor supply, GDP would rise by 2 percent or less. An increase in GDP of that magnitude would boost federal tax revenues by less than half a percent of GDP.

and the impact on the allocation of resources in the economy.

Who Would Bear the Burden of Proposed Changes in Tax and Spending Policies?

Different types of tax increases and spending cuts would affect various groups of people to different extents. Those effects could be direct, such as changes in the amount of taxes that people owe or the amount of benefits or services they receive, or indirect, such as changes that alter the state of the economy. Indirect effects are harder to anticipate because they depend on the behavior of many different participants in the economy.

Most changes in taxes and spending programs would affect how tax burdens and government benefits and services are distributed among people at different income levels. In addition, many such changes would alter the relative tax burdens of, and benefits received by, people who have similar income but who differ in other ways. Policy changes might also influence the distribution of taxes and spending among generations.

Under current law, the federal tax system is progressive, meaning that average tax rates rise with income. In 2009, households in the bottom one-fifth (quintile) of the income distribution—who had an average before-tax income of $23,500, including transfer payments such as Social Security benefits—paid a total of about 1 percent of their income in federal taxes (counting individual income taxes, payroll taxes, corporate income taxes, and excise taxes). Households in the middle quintile, with average before-tax income of $64,300, paid 11 percent; and households in the highest quintile, with average before-tax income of $223,500, paid 23 percent. Within the top quintile, average tax rates were higher for higher-income groups: For instance, households in the top 1 percent of the income distribution had an average tax rate of about 29 percent.[35]

Policy changes that increased revenues would probably affect the distribution of the tax burden, but the effects would depend on the type of tax raised and the nature of the increase. Raising income tax rates for higher-income people would make the tax system more progressive. By contrast, increasing most excise taxes—such as those on tobacco or gasoline—would boost the relative tax burdens of lower-income people, who tend to spend a greater proportion of their income on those items. Alternatively, taxes could be raised in such a way as to maintain the current distribution of the tax burden.

Cuts in spending programs would also affect households differently depending on their income. For example, reducing maximum benefits in the Supplemental Nutrition Assistance Program would increase burdens on the program's beneficiaries, who have low income. As another example, raising the full retirement age for Social Security would reduce people's lifetime benefits and would be particularly burdensome for recipients with low income, who tend to rely heavily on Social Security benefits. Such a policy change could be especially difficult for people who could not adjust their work patterns or qualify for Social Security Disability Insurance benefits in response to the change. Other cuts in government benefits or services could have different effects on people with lower or higher income.

Some policy changes that would reduce deficits would affect people with similar income differently. For instance, reducing or eliminating the child tax credit would lessen the economic well-being of people who have dependent children compared with that of people at similar income levels who do not; and eliminating the deduction for state and local taxes would increase tax payments more for people who live in states with high taxes. As another example, some observers gauge the fairness of highway spending by considering the share of funding that comes from taxes paid by highway users rather than from general taxpayer funds, or the share of funding that comes from people in rural versus urban areas.

Policy changes can also be evaluated in terms of how they affect different generations. Deficit reduction policies that took effect now would generally increase burdens on people living today. Depending on the specific policy choices, future generations might also receive fewer government benefits and services or pay higher taxes; in some cases, those effects could be greater than the effects on current generations. However, future generations would also benefit from a larger economy and greater income in the longer term if deficits in the next several years were lower than would otherwise be the case.

35. See Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2008 and 2009* (July 2012), p. 3.

Appendix: Are Fiscal Rules a Useful Tool for Achieving Budgetary Goals?

One way that some governments attempt to manage their budgets is by setting numerical limits—known as fiscal rules—on budget totals, such as spending, revenues, or deficits. According to the International Monetary Fund (IMF), few countries had fiscal rules until the 1990s, when the accumulation of publicly held debt led more governments to look to such rules to achieve fiscal sustainability.[1] By early 2012, 76 of the IMF's 188 member countries had either national rules, supranational rules, or both. Numerous other countries are actively considering such rules. The U.S. government has implemented fiscal rules and other constraints on budgetary decisions in the past and continues to employ them in the current budget process.

Merely adopting a fiscal rule is not likely to improve budgetary outcomes.[2] In particular, experience in the United States and elsewhere suggests that fiscal rules are not a substitute for making difficult choices about the budget. Rather, fiscal rules appear to be useful for enforcing budgetary goals when there is a consensus about those goals and about the policy changes needed to meet them. Rules can make it harder for policymakers to succumb to pressure to stray from agreed-upon policy decisions.[3] But when consensus about budgetary goals erodes, rules will not necessarily stand in the way of policymakers who want to spend more or tax less than the rules allow.

Adopting a fiscal rule requires policymakers to decide about a wide range of possible attributes of the rule.[4] One of the most important of those attributes is transparency—in accounting, forecasting, and institutional arrangements. Misrepresenting the true size and timing of future fiscal obligations can seriously undermine a rule. Hence, the presence of supporting institutions, such as audit institutions and independent fiscal agencies, can enhance the effectiveness of rules. Perhaps equally important is a rule's enforceability. Although the legal status of fiscal rules can vary—some are constitutional, some

1. See Andrea Schaechter and others, *Fiscal Rules in Response to the Crisis—Toward the "Next-Generation" Rules, a New Dataset,* Working Paper 12/187 (International Monetary Fund, July 2012), www.imf.org/external/pubs/cat/longres.aspx?sk=26094.0.

2. Researchers have tried to find a statistical relationship between fiscal rules and fiscal performance. A few studies that looked at policies aimed at significantly reducing a government's annual budget deficits and accumulation of debt showed a positive relationship between rules and improved fiscal performance (such as a given reduction in debt over a specified period). However, the studies noted that the results were not conclusive and could have been affected by other factors. For instance, a strong political commitment to fiscal discipline, which might be reflected in the introduction of a fiscal rule, could lead to improvements in budgetary performance that would have occurred even without the rule. See Manmohan Kumar and others, *Fiscal Rules—Anchoring Expectations for Sustainable Public Finances,* Policy Paper (International Monetary Fund, December 2009), www.imf.org/external/pp/longres.aspx?id=4402; Kevin Fletcher and others, *United Kingdom: Selected Issues Paper,* Country Report 10/337 (International Monetary Fund, November 2010), www.imf.org/external/pubs/cat/longres.aspx?sk=24338.0; and Stephanie Guichard and others, *What Promotes Fiscal Consolidation: OECD Country Experiences,* Economics Department Working Paper 553 (Organisation for Economic Co-operation and Development, May 2007), http://dx.doi.org/10.1787/180833424370.

3. See Allen Schick, "The Role of Fiscal Rules in Budgeting," *OECD Journal on Budgeting*, vol. 3, no. 3 (2003), pp. 7–34, www.oecd-ilibrary.org/governance/the-role-of-fiscal-rules-in-budgeting_budget-v3-art14-en.

4. See George Kopits and Steven A. Symansky, *Fiscal Policy Rules,* Occasional Paper 162 (International Monetary Fund, 1998). The authors conclude that a model fiscal rule should be well-defined, transparent, adequate, consistent, simple, flexible, enforceable, and efficient. However, the authors assert that no rule (or set of rules) combines all of those desirable attributes, partly because some of the attributes inevitably involve trade-offs with others.

legislative, and some simply stated agreements—the consequences of noncompliance, in whatever form they may take, should be agreed to in advance.

Types of Fiscal Rules

Fiscal rules can apply to various parts of a budget. *Balance, surplus,* or *deficit rules* operate through numerical limits on the budget's bottom line, specifying that spending should not exceed revenues by a particular amount over a given period. Many countries have tried to use a simple annual balanced budget rule, but such a rule gives governments little flexibility to respond to economic weakness by increasing spending or decreasing taxes.[5]

More complex balanced budget rules aim to provide such flexibility through a cyclically adjusted or structural balance rule, which allows for the full operation of "automatic stabilizers" (the automatic ways in which revenues and outlays respond to developments in the economy), although such rules do not allow for new legislation that provides fiscal stimulus. Other rules require budgetary targets to be met over the course of a business cycle and allow for additional adjustments in response to economic conditions. Simple balanced budget rules also give governments little leeway to respond to other unexpected domestic and international challenges. Therefore, some versions of balanced budget rules allow for exceptions when a large percentage of legislators vote for them.

Expenditure rules usually set limits on either total spending, primary spending (which excludes interest costs), or specific categories of spending. Such limits can apply to the amount of spending—in absolute terms or as a percentage of gross domestic product (GDP)—or to the growth rate of spending. *Revenue rules* generally set ceilings on the amount or growth rate of revenues. They are extremely rare among national governments.

Debt rules set either an explicit limit or a target for publicly held debt, whether as a percentage of GDP or in absolute terms. Like balanced budget rules, debt rules give policymakers little flexibility to respond to economic weakness and other challenges, unless specific provisions are included to provide that flexibility. (In many cases, debt rules can even exacerbate economic weakness.)

Experiences with Fiscal Rules at the Federal Level in the United States

Since the 1980s, the federal budget process in the United States has involved a changing collection of rules focused on deficit control. Those rules have taken the form of deficit targets, spending caps, and pay-as-you-go (PAYGO) procedures, which apply to certain types of legislation and attempt to restrict a net increase in the deficit. (PAYGO procedures usually are not classified as fiscal rules under the traditional definition; in a broader sense, however, PAYGO rules are meant to provide a fiscal constraint and thus are included in this discussion.)

Experience in the United States indicates that such budget procedures are much better at enforcing deficit reduction agreements already in place than at forcing such agreements to be reached. Budget procedures that highlight and penalize deviations from agreements can be helpful, but they work only to the extent that lawmakers choose to enforce them; they have not been effective as a stand-alone substitute for specific policy measures.

The Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as Gramm-Rudman-Hollings) was enacted with the goal of reducing the deficit to a specified level each year until spending was in balance with revenues. If the law's annual deficit targets were not met, automatic across-the-board spending cuts (known as sequestration) were supposed to take effect. Although deficits shrank somewhat in the late 1980s, they exceeded the statutory targets, in some years by large margins. Nevertheless, no significant sequestration was ever implemented.

Part of the reason for that outcome was that the targets—both those set in 1985 and the revised targets adopted a few years later—were not linked to any agreement on the policy changes needed to meet them. Moreover, the targets did not make allowances for worsening economic conditions or other complicating factors, such as the savings and loan crisis of the late 1980s and early 1990s. Thus, there was a strong incentive to adopt overly optimistic economic assumptions in the calculations used to determine whether the deficit target for the year had been

5. Nearly all U.S. state governments also have some form of balanced budget requirement. Those requirements are usually statutory or constitutional in nature; they range from requiring the governor to submit a balanced operating budget to mandating that the governor sign a balanced budget. Such state-level fiscal rules are beyond the scope of this report. For more discussion, see National Conference of State Legislatures, *State Balanced Budget Provisions*, NCSL Fiscal Brief (October 2010), www.ncsl.org/issues-research/budget/state-balanced-budget-requirements-provisions-and.aspx.

exceeded. For those reasons, actual deficits remained above the targets while the law was in effect.[6]

The Budget Enforcement Act of 1990 (BEA) contained a set of deficit-reducing policy changes that had been agreed to at a 1990 budget summit; it also created new processes to enforce budgetary discipline. The law's procedures did not force further reductions in deficits or require policymakers to adopt new policies to compensate for unrealized expectations about the economy. Instead, the BEA set annual caps on discretionary budget authority and the outlays resulting from that budget authority. It also established a PAYGO procedure requiring that Congressional actions that affected revenues or mandatory spending not add to the deficit. Deficits shrank steadily from 1993 through 1997 and were followed by budget surpluses from 1998 through 2001—in large part because of a surge in tax revenues stemming mainly from robust economic growth as well as from further deficit reduction measures such as those enacted in the Omnibus Budget Reconciliation Act of 1993 and the budget deal of 1997.[7] The amount of federal debt held by the public declined as a percentage of GDP for most of the years that the BEA was in effect.

Many observers agree that as long as a consensus remained to rein in budget deficits, the discretionary spending caps and PAYGO requirements in the BEA helped achieve that goal.[8] But when deficits gave way to surpluses, the spending caps were overridden in the appropriation process, and new laws affecting mandatory spending and revenues were enacted with significant costs and no offsetting savings. Lawmakers allowed the BEA to expire in 2002. In the absence of statutory requirements between 2002 and 2009, the House and Senate often adopted rules through budget resolutions and other measures that attempted to enforce PAYGO requirements.

In 2010, the Congress and the President established new statutory PAYGO requirements and directed the Administration to enforce compliance with them through a sequestration mechanism. The following year, lawmakers made another attempt to incorporate a fiscal rule in the budget process by enacting the Budget Control Act of 2011. That law created caps on discretionary budget authority; it also provided for automatic spending cuts if deficit reduction legislation originating from a bipartisan committee of legislators was not enacted by January 15, 2012. The committee was unable to produce a legislative proposal, so the automatic cuts are part of current law and are scheduled to begin in January 2013. Some lawmakers have proposed adjusting or eliminating the reductions, however.

Throughout the past few decades, some lawmakers have supported imposing fiscal rules through amendments to the Constitution. The proposed rules have generally involved a balanced budget constraint, sometimes accompanied by a spending limit or revenue limit. The Congress has never approved such an amendment, however.

Experiences with Selected Fiscal Rules in Europe

European nations, and the European Union (EU) as a whole, have also experimented with fiscal rules. In many cases, the rules themselves have been insufficient to achieve the desired budgetary outcomes. Where they have been effective, transparency and enforceability have been key components of their success.

To qualify for entry into Europe's Economic and Monetary Union, known as the euro zone, countries were required to meet fiscal targets defined in the Treaty of Maastricht and later enshrined in the Stability and Growth Pact (SGP). Those targets included keeping annual budget deficits at no more than 3 percent of GDP and gross debt at no more than 60 percent of GDP (or approaching the debt target at a satisfactory pace).[9]

6. For additional discussion, see the statement of Robert D. Reischauer, Director, Congressional Budget Office, before the Subcommittee on Legislation and National Security of the House Committee on Government Operations, *Budget Enforcement Act* (May 13, 1993).

7. That deal comprised two laws: the Balanced Budget Act of 1997 and the Taxpayer Relief Act of 1997.

8. For further discussion, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004–2013* (January 2003), Appendix A; and Allen Schick, "The Role of Fiscal Rules in Budgeting," *OECD Journal on Budgeting,* vol. 3, no. 3 (2003), pp. 7–34, www.oecd-ilibrary.org/governance/the-role-of-fiscal-rules-in-budgeting_budget-v3-art14-en.

9. "Gross debt" in the European context differs from the measure used in the United States. For European countries, according to definitions used by the IMF and the Organisation for Economic Co-operation and Development, gross debt consists of total financial liabilities for all levels of government (central, state, and local). In the United States, by contrast, gross federal debt consists of debt issued by the federal government to the public as well as debt issued by the Treasury to other federal accounts (intragovernmental debt); it does not include the financial liabilities of state or local governments.

Although many countries made an initial push to meet the targets when the euro zone was established in 1999, those efforts were scaled back over time once the euro had been fully introduced and membership in the zone had been granted.[10]

Some countries have circumvented the deficit limit with overly optimistic economic forecasts and creative accounting. Such actions have reduced the pressure to make substantial short- and medium-term changes in policies. Using overly optimistic forecasts enabled countries to project favorable budgetary outcomes and then blame poor results on the economy. Some nations have also used accounting measures to exclude certain types of spending—such as government support for public companies—from calculations of budget deficits.[11] In addition, in the wake of the global financial crisis and recession, some countries have found it extremely difficult or impossible to meet the targets specified earlier. (At the same time, the SGP's rules have restricted some governments' ability to respond to those economic problems.)

The euro zone's rules have also been plagued by enforcement problems, for several reasons.[12] First, review by the Economic and Financial Affairs Council—a body of national ministers from all member states that has power to issue warnings to members and impose fines as a recourse—has been an ineffective means of oversight. Second, financial penalties for noncompliance have not been pursued. Third, only a few member countries have translated the rules of the SGP into operationally enforceable targets.

In response to Europe's current debt crisis and in an effort to reform the SGP rules, most members of the EU have agreed to a new fiscal pact to prevent member countries from pushing up their debt levels. Among its various provisions, the pact includes fiscal targets with enforcement mechanisms that are purported to be stronger than recent versions. Although the pact was agreed to and signed by officials of most EU countries, it must still be officially ratified by 12 euro zone members before going into effect. Even if ratification occurs, whether member states will comply with the agreement and enforce it effectively remains to be seen.

Although the SGP rules have not provided the budgetary discipline that was originally envisioned, some countries have successfully instituted national rules to achieve fiscal sustainability (in some cases as a way to meet the SGP targets). For example, in the mid-1990s, a fiscal crisis in Sweden led the government there to adopt a new fiscal policy framework, which included two targets at the national level: multiple years of expenditure ceilings, and surplus targets covering the general government sector over an economic cycle.[13]

Some observers conclude that the ceilings have helped Sweden maintain stable finances.[14] They attribute the nation's favorable budgetary outcomes in part to support for the fiscal framework by the major political parties. In fact, the expenditure ceilings and surplus targets are based neither in legislation nor in a constitution; the political commitment itself acts as the binding force. There are no explicit sanctions for breaching the framework, but policymakers appear to believe that a violation would come at a significant political cost. The ceilings and targets are highly transparent: On several occasions, when fiscal monitors reported that the framework was threatened, that information was published by the media, and corrective actions by the government followed.

10. Euro zone membership consisted of 12 countries originally and grew to 17 countries in the late 2000s. Many countries that became members did not in fact meet all of the conditions for entry into the euro zone. However, the rules stipulated that if countries were approaching the specified levels of each condition at a satisfactory pace, they could be considered to have satisfied the condition.

11. See Anke Weber, *Stock-Flow Adjustments and Fiscal Transparency: A Cross-Country Comparison*, Working Paper 12/39 (International Monetary Fund, January 2012).

12. See Ludger Schuknecht and others, *The Stability and Growth Pact: Crisis and Reform*, Occasional Paper 129 (European Central Bank, September 2011), www.ecb.int/pub/scientific/ops/date/html/opsall.en.html.

13. See Urban Hansson Brusewitz and Yngve Lindh, "Expenditure Ceilings and Fiscal Policy: Swedish Experiences," in Banca d'Italia, *Public Expenditure* (2005), pp. 667–682.

14. See, for example, Gösta Ljungman, *Expenditure Ceilings—A Survey,* Working Paper 08/282 (International Monetary Fund, December 2008).

List of Tables and Figures

Tables

Figures

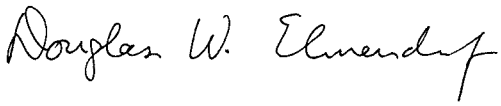
About This Document

This Congressional Budget Office (CBO) report was prepared at the request of the Chairman of the Senate Budget Committee. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

Leigh Angres, Christi Hawley Anthony, Barry Blom, and Janet Holtzblatt of CBO wrote the report, under the direction of Jeffrey Holland, Theresa Gullo, Holly Harvey, and Peter Fontaine. Additional assistance was provided by numerous analysts within CBO's Budget Analysis Division, Macroeconomic Analysis Division, Tax Analysis Division, and Office of the General Counsel.

Jim Horney of the Center on Budget and Policy Priorities, Keith Hennessey of the Stanford University Graduate School of Business, George Kopits of the Woodrow Wilson International Center for Scholars, and Donald Marron of the Urban Institute provided helpful comments. (The assistance of external reviewers implies no responsibility for the final product, which rests solely with CBO.)

Christian Howlett edited the report, and Maureen Costantino and Jeanine Rees prepared it for publication. An electronic version is available on CBO's Web site (www.cbo.gov).



Douglas W. Elmendorf
Director

November 2012