THE NATION'S FISCAL OUTLOOK

Over the past four years, the Administration and the Congress have responded to the challenges posed by recession, terrorist attacks, corporate scandals, and the War on Terror. The responses included enacting tax relief, reducing regulatory burdens, promoting trade, supporting entrepreneurship, and making a substantial investment in our homeland security and defense. Working with the Congress, this Administration took steps to help generate and fuel the economic recovery.

Sustaining economic expansion now requires additional action, especially strong Federal spending discipline. While the Administration and the Congress succeeded in slowing the growth in non-security discretionary spending during the President's first term, more needs to be done to ensure Federal spending growth does not place unsustainable demands on our economy.

When the Federal Government focuses on its priorities and limits its claim on resources taken from the private sector that helps sustain a stronger, more productive economy. When it is achieved through spending restraint rather than through tax increases, deficit reduction bolsters confidence in America's economy. This confidence in global capital markets brings important advantages to America's economy in the form of lower interest rates and lower borrowing costs, which in turn lead to more investment and more jobs. Keeping America's fiscal house in order, while holding taxes down, sustains growth and justifies investors' confidence in the U.S. economy.

A strong economy and a strong fiscal condition are mutually reinforcing goals. Just one year ago, the Nation's economy was still emerging from the effects of multiple shocks. Last year's Budget estimated a deficit of 4.5 percent of Gross Domestic Product (GDP) in 2004, or $521 billion. Private and other forecasters had similar deficit expectations. Largely because economic growth generated stronger revenues than originally estimated, and because the Congress adhered to the spending restraint called for in the President's Budget, the 2004 deficit came in $109 billion lower than expected, at $412 billion, or 3.6 percent of GDP.

The 2005 Budget, while providing needed increases for overall homeland security and defense spending, still held overall discretionary spending growth to 4 percent for the second year in a row. Non-security discretionary spending growth declined for the fourth year in a row, down from a high of 15 percent in the final budget year of the prior Administration to about one percent in 2005.

The President's 2006 Budget demonstrates even greater restraint: it is the first Budget to propose a cut in non-security discretionary spending since the Reagan Administration. Even with significant increases in security-related spending, the 2006 Budget holds overall discretionary spending to 2.1 percent growth, which is just below the projected rate of inflation. In other words, after providing substantial increases for protecting America at home and abroad, overall discretionary spending will still be reduced in real terms.

In the area of non-defense discretionary spending, this Budget proposes more than 150 program reductions and eliminations, saving a total of about $20 billion dollars in 2006 alone. Discretionary spending is subject to the annual appropriations process and is therefore easier to control because legislation must generally be enacted each year for programs to continue.

Spending on mandatory programs is more difficult to restrain because these programs generally operate based on formulas that are not subject to annual review. Consequently, when these programs grow faster than originally envisioned, which is often the case, there is no automatic mechanism to

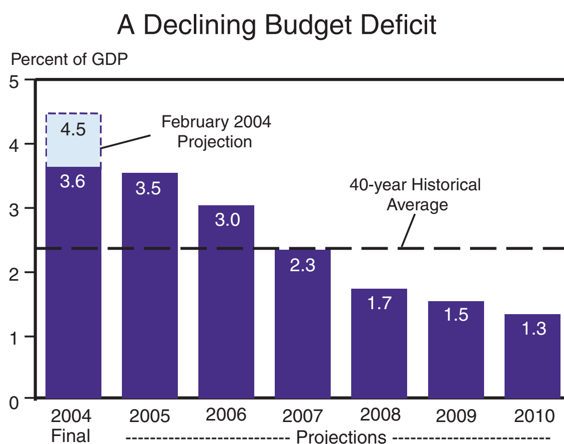
impose restraint. The only way to constrain the growth of mandatory spending is by enacting new laws that change the rules governing spending. The 2006 Budget proposes significant reforms in mandatory programs, saving a total of $137 billion over a 10-year period.

Among the many reforms the Budget proposes are changes to Federal high school funding programs, which have for years focused on narrow purposes that have not proven effective in improving student academic achievement or job prospects. The Budget proposes to consolidate the funding for these programs, and use that funding for more testing, intervention programs for struggling readers, and other reforms. The Budget also creates a new economic development program that will replace the current system of duplicative efforts that often do not show positive results. By focusing resources on the creation of jobs and economic opportunity, and on private partnerships, this reform will improve accountability and results. And the Budget proposes reforms in Medicaid to reduce inefficiencies and overpayments, while extending to States more flexibility in determining Medicaid eligibility and how benefits are delivered.

When evaluating the Nation's fiscal outlook, it is important to consider two different time frames: what happens in the near-term, and what happens thereafter with the retirement of the Baby Boom generation. With continued pro-growth policies and responsible spending restraint, the fiscal condition of the Federal Government shows steady and solid improvement over the five-year budget window. This period of relative success will end roughly a decade from now when the retirement of Baby Boomers begins in earnest, and the costs of the Nation's entitlement programs explode. At that point, the Federal Government's deficits are expected to begin a dramatic rise, and the entitlement programs that are currently manageable will eventually overwhelm the rest of the Federal budget—unless appropriate and effective reforms are enacted.

THE NEAR-TERM FISCAL OUTLOOK

The best way to compare annual deficit levels is by analyzing their size relative to the overall size of the economy, as measured by GDP. Such a comparison gives the most meaningful measure of the size and scale of deficits, spending, and revenue. After all, a deficit of $100 billion is less than 1 percent of our $12 trillion economy. But $100 billion would have represented 10 percent of the $1 trillion economy of 1970.

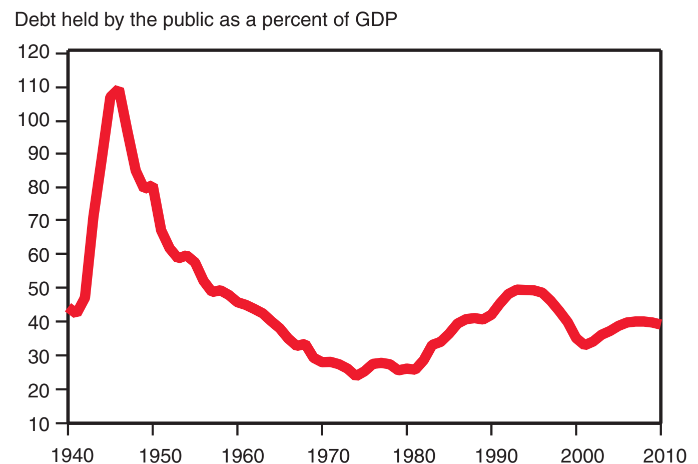


Near-term budget projections show a trend of steady decline in deficits as receipts grow and the spending restraint in this Budget is enforced. The Administration, like private forecasters, projects that the economy will grow at a strong and steady pace in coming years. Fueled by the President's pro-growth policies, the Administration projects tax receipts to grow faster than outlays in each of the next five years. From 2005 to 2010, receipts are projected to rise by an average of nearly 7 percent annually, more than two percentage points faster than average growth in spending.

Last year, the Administration's Budget projected a deficit of 4.5 percent of GDP in 2004. But by the end of the year, the deficit had shrunk to 3.6 percent of GDP, which while still too large, was only the 10th largest deficit in the last 25 years. Even with renewed economic growth and current and past spending restraint measures, the Administration expects that deficits for 2005 and 2006 will be higher than projected last year. The 2005 deficit estimate in last year's Budget did not include the costs

of 2005 supplemental appropriations to fund continuing operations in Afghanistan and Iraq. Since that Budget was released, the Congress enacted $25 billion in additional appropriations to support military operations. The Administration intends to submit a supplemental appropriations request of approximately $81 billion primarily to support operations for the remainder of the fiscal year. The 2006 Budget's spending and deficit projections fully reflect the outlay effects of these two supplemental requests. However, the Budget does not reflect the effect of undetermined but anticipated supplemental requests for ongoing operations in Iraq and Afghanistan beyond 2005.

While the 2005 deficit rises in nominal dollar terms to $427 billion, it falls to 3.5 percent of GDP. And in 2006, the deficit is expected to fall further still, to 3.0 percent of GDP, which would be only the 15th largest in 25 years. All these projections assume both the continued economic growth we have seen, as well as the spending restraint included in this Budget. If we maintain these policies, we cut the deficit by more than half from its originally estimated 2004 peak—to just 1.5 percent of GDP, which is well below the 40-year historical average of 2.3 percent.



Financial markets look at deficits using additional methods. One important measure is the ratio of all publicly-held Federal debt to GDP. This ratio, which has varied between 34 percent and nearly 50 percent over the past 20 years, is projected to be 40 percent at the end of 2007, and to fall to 39 percent in 2010. This decline is expected to occur because projected deficits as a share of GDP are modest, and because economic growth is projected to be strong over this period.

THE LONG-TERM FISCAL CHALLENGE: A CALL FOR REFORM

As discussed above, the Federal Government's near-term fiscal outlook is expected to improve steadily over the next several years. The same cannot be said of the long-term deficit picture as a result of long-standing imbalances between what major entitlement programs currently promise in benefits and the resources expected to be available to meet those promises. Due to a combination of demographic and cost pressures, Social Security's and Medicare's unfunded obligations pose the real fiscal danger to the Federal budget and to our economy in general.

Social Security

Social Security today operates on what is known as a "pay-as-you-go" basis, in which current worker payroll taxes are used immediately to pay for the benefits of current retirees and other beneficiaries. However, demographic trends indicate that the ratio of workers to beneficiaries will continue to decline. In 1950, there were about 16 workers paying for every beneficiary. Today, there are slightly more than three—and by the time today's young workers retire, there will be only two workers to support each person on Social Security. Despite multiple efforts in the past to patch the system with cuts in benefits and increases in the payroll tax and the retirement age, the Social Security system remains on a clear path to fiscal failure.

A snapshot of the Social Security system today gives no hint of the trouble to come because it shows Social Security with a cash surplus estimated to be $76 billion in 2006. However, this surplus begins

to decline in 2008 as the first wave of Baby Boomers retire. In 2018, the Social Security system will collect less in taxes than it pays in benefits and will shift into a permanent cash deficit. In 2042, Social Security will exhaust its Trust Fund assets and will be bankrupt. If Social Security's problems are left unresolved, today's young workers will see their benefits sharply and suddenly cut, their children's payroll taxes raised, or both.

Another measure of Social Security's long-term fiscal condition comes from the long-run net present value of its future income and promised benefits. Looking out over the next 75 years, Social Security is carrying a deficit of $3.7 trillion, a figure that includes its existing Trust Fund balances of $1.5 trillion.

The picture is actually worse, because the 75-year window takes credit for the payroll taxes paid by the next generation of workers while failing to count benefit payments owed to them beyond the 75-year timeframe. A more accurate way to describe Social Security's financial jeopardy is by calculating how much it would cost to fix the problem permanently. An analysis that captures the net present value of all Social Security tax collections and promised benefits shows Social Security facing a deficit of $10.4 trillion, allowing for the present value of Social Security's Trust Fund balance. That figure is estimated to rise by around $600 billion in 2005, and by increasing amounts each year thereafter, if no reforms are enacted.

The long-term fiscal imbalance in Social Security is well known to investors at home and abroad. Failure to rectify Social Security's finances could cause financial markets to question the Federal Government's commitment to sustainable fiscal policies. Such a conclusion would at some point find its expression in steadily rising real borrowing costs to the Federal Government, a drop in confidence in the American economy that would lead to less business investment, and slower overall economic growth.

Only significant changes in policy can prevent Social Security from driving the Federal Government to debt levels that are unsustainable. The sooner necessary policy changes are made, the less disruptive they will have to be. The President's Commission to Strengthen Social Security presented three options as the basis for reform in its 2001 report. Many other proposals have been advanced in the intervening period as well.

The President has made clear that in 2005, he will pursue legislation that permanently fixes Social Security, building on recent reform efforts and following these guiding principles:

- Benefits for today's retirees or those near retirement should not be changed. Americans who have already put in an entire working career are counting on Social Security benefits. We must continue to honor the commitments we have made to our seniors.
- Payroll taxes must not be increased. Past shortfalls in Social Security have been addressed by repeatedly raising payroll taxes on current workers and employers. These efforts have never corrected the problem. Moreover, higher taxes would hurt economic growth, which is vital to both near-term and long-term deficit reduction.
- Social Security reform must also include the creation of voluntary personal accounts so that younger workers can have greater control over and actual ownership of their payroll tax dollars. These accounts will enable American workers to build a nest egg for retirement.

Voluntary personal accounts under Social Security involve financing the transition from today's unsustainable "pay-as-you-go" system. The creation of these accounts would therefore have important consequences for Federal finances in both the near-term and in the long-run, but these effects do not have the same impacts on the economy as traditional debt financing.

The effect of creating personal accounts would be to protect some portion of worker payroll taxes from the reach of the Federal Treasury. The Federal Government might therefore have to increase its borrowing in the private capital markets by an amount equal to the annual flow of payroll taxes into

the personal accounts. While the creation of personal accounts would increase Federal borrowing, they would also reduce the Federal Government's future spending obligations by an equal amount. Both effects must be shown and understood together—both the size of near-term investments in personal accounts, under reasonable participation assumptions, and the corresponding amount by which reform would reduce future unfunded obligations. It is misleading to measure only the near-term impacts.

Social Security: The Need for Action

In 2008—just four years from now—the first cohort of the Baby Boom generation will reach 62, the earliest age at which Social Security retirement benefits may be claimed and the age at which about half of prospective beneficiaries choose to retire; in 2011, these individuals will reach 65 and will thus be eligible for Medicare. At that time, under the intermediate assumptions of the OASDI trustees, there will still be more than three covered workers for each OASDI beneficiary; by 2025, this ratio is projected to be down to 2–1/4. This dramatic demographic change is certain to place enormous demands on our nation's resources–demands we almost surely will be unable to meet unless action is taken. For a variety of reasons that action is better taken as soon as possible.

Alan Greenspan, Chairman of the Federal Reserve
Testimony, House Budget Committee
February 25, 2004

Even under a wide range of assumptions, CBO's projections point to a financial imbalance in the Social Security system over the long run. Changes in economic growth can affect the system's finances. But because the initial benefits paid to new recipients are indexed to the overall growth of earnings, the effect of such changes is muted. For the most part, the future financial status of Social Security will be driven not by economic conditions but by long-term demographic shifts–most notably, the aging of the population. That trend is generally predictable, because anyone who will receive retirement benefits during the next 62 years has already been born.

Congressional Budget Office
"The Outlook for Social Security"
June 2004

Our Social Security challenge is more urgent than it may appear. Failure to take remedial action will, in combination with other entitlement spending, lead to a situation unsustainable both for the federal government and, ultimately, the economy.

General Accounting Office
"Social Security: Analysis of Issues and Selected Reform Proposals"
January 15, 2003

The fundamentals of the financial status of Social Security and Medicare remain problematic under the intermediate economic and demographic assumptions. Social Security's current annual cash surpluses will soon begin to decline and then turn into rapidly growing cash deficits toward the end of the next decade as the baby-boom generation retires. . . . As the reserves in Social Security and [the Medicare Hospital Insurance Trust Fund] are drawn down and [Medicare Supplementary Medical Insurance Fund] general revenue financing requirements continue to grow, the pressure on the Federal budget will intensify. We do not believe the currently projected long run growth rates of Social Security and Medicare are sustainable under current financing arrangements.

Social Security and Medicare Boards of Trustees
"Status of the Social Security and Medicare Programs"
2004

Under most circumstances in which the Federal Government borrows funds, it is because the Government is spending more on goods, services, and transfer payments than it is taking in. In the case of personal accounts, however, the reduction in national savings from the Federal Government's increased borrowing exactly matches the increase in private saving that occurs through the personal accounts. There is no net reduction in national saving arising from this arrangement, nor is there any reduction in the flow of saving available to the private sector. For this reason, the creation of personal accounts is not expected to have any detrimental effect on financial markets or on the overall economy.

Comprehensive reform that includes personal accounts would permanently eliminate the unfunded obligations of the current system. Ultimately, that is the standard by which any legislation to strengthen the Social Security system must be held. To achieve this, the long-term growth in annual Social Security outlays cannot be greater than the long-term growth in program-generated receipts.

Projections regarding various proposals' fiscal effects and their impact on beneficiaries will be based on analyses provided by the non-partisan actuaries and other technical experts at the Social Security Administration.

Medicare and Other Entitlement Programs

Medicare's financial problems are in part driven by the same demographics we see in Social Security, but Medicare's problems are compounded by the rising cost of health care. This suggests that effective solutions to Medicare's long-term financial shortfall may differ significantly from the solutions for Social Security. For example, policies that foster a strong economy will tend to reduce Medicare's shortfall because a strong economy produces additional receipts without generating additional promised benefits. By comparison, an increase in Social Security payroll tax receipts arising from a strong economy produces commensurate increases in promised benefits.

In 2003, the President signed into law the Medicare Modernization Act (MMA), which added a prescription drug benefit to the program and created the Medicare Advantage program, in which private health plans compete for seniors' business by providing enhanced benefits. Seniors and other beneficiaries will now have access to prescription drugs and more preventive services under Medicare. And importantly, the legislation lays the foundation for addressing Medicare's long-term financing challenge by dramatically increasing beneficiary choices and introducing market-based competition, which are the essential ingredients for greater efficiency and quality in our health care system.

Among its reforms, the MMA created new tax-favored Health Savings Accounts (HSAs). These accounts allow workers to save tax-free for their out-of-pocket health costs, and are paired with low-premium, high-deductible health plans that cover hospitalization and other major health care costs. HSAs represent an innovation in health care coverage with improved incentives.

HSAs make basic health insurance more affordable, and promote health care decisions that are more effective for both patients and the entire health care system. For example, people with HSAs have a financial incentive to stay healthier, since fewer doctor visits mean more dollars left over in the savings accounts. When consumers use their accounts to pay for out-of-pocket expenses, they are more likely to seek out the best quality and the lowest price. This should drive health care providers to become more efficient and more cost-conscious, to the benefit of all health care consumers.

Individuals and families with HSAs are less likely to be dependent on employment or the insurance policies of a single employer for their health coverage. The President has proposed extending the benefits of HSAs in two important ways: he has proposed giving small business owners a refundable tax credit for contributions made to employees' HSAs; and he has proposed increasing the availability of HSAs for low-income families by providing a $1,000 direct contribution to their HSA in conjunction

with a refundable tax credit of up to $2,000 toward the purchase of a low-premium, high-deductible health care plan.

The President has also advanced policies to accelerate the integration of the latest information technologies into health care. He has set a goal that most Americans have electronic health records within the next 10 years. Electronic health records are already making a difference in our health care system, making patient records available to doctors in emergency situations and routine visits, promoting accurate medical notations and prescriptions, and helping to prevent avoidable medical errors, all while protecting patient privacy. By improving efficiency and reducing errors, we will see health care savings, making all health care in America more affordable and accessible.

The President is also proposing medical liability reforms. The costs of medical liability insurance are driving doctors out of practice, or are being passed on to patients and their employers in higher insurance rates. In addition, the pressure of medical liability lawsuits is causing more doctors to practice medicine defensively and order more lab tests or exams than is necessary, which is driving up health care costs even further. By enacting national medical liability reform we will be able to address the problem of junk lawsuits against doctors, clear our court system of unnecessary litigation, and help to control health care inflation.

These policies will increase competition and individual choice in the health care marketplace, drive the industry toward much greater efficiency, and eliminate some of the pressures that are lifting health care costs. Taken together, they will slow the rate of health care inflation, slow the rate of increases in Medicare costs, and thereby diminish Medicare's unfunded obligations.

Much can also be done within Medicare itself to bring down its unfunded obligations. For example, to help address the program's long-term fiscal challenges, the MMA requires the Medicare Trustees in their annual report on the program's financial soundness to analyze the combined fiscal status of the two Medicare Trust Funds and warn the Congress and the President when Medicare's reliance on general revenue funding will exceed 45 percent. If the Trustees determine that general revenue funding will exceed 45 percent in two consecutive years, a Medicare Funding Warning is issued, which makes available special legislative procedures to allow the President and the Congress to address the shortfall in the Medicare Trust Funds. This new fiscal safeguard will alert the Congress and the President should Medicare's dedicated revenues fall below adequate levels. The Administration supports efforts to integrate Medicare's financing structure and monitor the program's reliance on general revenue funding, such as a unified Medicare Trust Fund.

Other entitlement programs pose similar challenges to the long-term fiscal condition of the Federal Government. For example, the Medicaid program, which was created in 1965 to help States provide health care benefits to low-income families with children, has evolved into an extremely complicated program that emphasizes institutional settings, when home and community-based settings could be more appropriate. And the program is growing rapidly. Counting the States' share of costs, it is now larger than Medicare. Total Medicaid expenditures will reach a projected $338 billion in 2006. Medicaid has become the largest expenditure in many State budgets, surpassing even primary and secondary education. Yet, because of the program's cumbersome structure, there are many very low-income Americans who are not helped by Medicaid.

Over the long term, Medicaid is not only a serious fiscal challenge for both Federal and State governments, but its current structure is not the most efficient way to deliver modern medical care to the poor. The Administration proposes to restore Medicaid's original promise to protect and promote the health of the least financially fortunate among us, while fostering a more balanced Federal-State partnership that improves the program's long-term financial stability. The program's open-ended finance structure encourages efforts by States to draw down Federal matching funds, sometimes inappropriately. These financing practices undermine the Federal-State partnership required by the Medicaid statute and jeopardize the financial stability of the program. The 2006 Budget proposes

several program integrity measures to reduce inappropriate use of Federal commitments under Medicaid. Also, the Administration proposes to apply lessons learned from the successful State Children's Health Insurance Program by giving States more flexibility to provide needed care to larger numbers of the uninsured, while reducing needless overhead and waste. Together with his package of proposals to help the uninsured, this reform will focus on increasing health insurance coverage for low-income families while also promoting more efficient and rational ways of delivering care, such as community-based care alternatives for persons with disabilities. (For a more complete description of reforms in the Medicaid program, please see the Department of Health and Human Services chapter.)

BUDGET ENFORCEMENT AND PROCESS REFORM

To enforce spending discipline in the 2006 Budget, as well as maintain spending discipline over the long-term, the Administration proposes several budget process reforms.

The Administration supports the establishment of overall discretionary spending caps and pay-as-you-go (PAYGO) rules for mandatory spending. To further this goal, the Administration transmitted in April of last year the Spending Control Act of 2004. The Administration plans to repropose that legislation, including appropriate updates and revisions.

In addition, this Budget proposes that the Congress adopt the Administration's discretionary cap, PAYGO requirement, long-term unfunded obligations controls, and associated reforms as part of its 2006 Budget Resolution.

The Administration's proposals are based largely on the lapsed Budget Enforcement Act (BEA). From 1991 to 2002, the BEA set statutory budget authority and outlay limits on discretionary spending and a PAYGO requirement for all other legislation that were enforced by across-the-board spending reductions. Until budget surpluses surfaced in 1998, the BEA proved to be an effective brake on the growth in spending.

Discretionary Spending Limits. The Administration proposes annual statutory limits on discretionary spending through 2010 that would be adhered to throughout the budget process. The President's proposal would require a three-fifths vote of the Senate for an appropriations bill that caused these limits to be exceeded. If an appropriations bill was enacted that caused these limits to be exceeded, OMB would be required to make across-the-board cuts to eliminate the excess spending.

Currently, there are inadequate incentives in budget scoring rules to fund program integrity activities to ensure that taxes owed to the Government are collected, eliminate the estimated $40 billion in improper payments, and combat other fraud and abuse in Government programs. For example, if the Budget allocates $100 million for the collection of $500 million in delinquent tax payments, the savings of $400 million are not counted as a form of savings. Thus, neither the Congress nor the Administration has a budget scoring incentive to provide for such program integrity activities. The Administration proposes an incentive for funding these activities by adjusting discretionary caps upward to allow additional funding for continuing disability reviews, health care fraud detection, unemployment insurance integrity, and Internal Revenue Service delinquent tax collections.

Mandatory Spending Controls. Mandatory spending constitutes spending that is not generally under the discretion of the Congress in the annual appropriations process. When President Kennedy was in office, mandatory spending represented one-third of the budget. Today, it amounts to nearly two-thirds of the budget.

The Administration's proposal would modify the PAYGO mechanism that was in existence from 1991-2002 to require legislative proposals that increase mandatory spending to be offset by reductions in other mandatory spending. Budget enforcement mechanisms should be focused on controlling spending, not on raising taxes on America's workers and families. Under the proposal, tax increases

could not be used to offset mandatory spending increases; nor would tax relief legislation be subject to PAYGO procedures. Like the discretionary spending enforcement mechanism, this proposal would require a three-fifths vote of the Senate for legislation that violated this requirement. If legislation was enacted that caused a net increase in mandatory spending, OMB would be required to make across-the-board reductions in non-exempt programs.

Long-term Unfunded Obligations. The real fiscal danger is posed by the long-term unfunded obligations of the Social Security, Medicare, and other entitlement programs. Spending decisions on entitlements often have ramifications on the budget outlook far beyond the conventional 10-year window used to score changes in policy. Enforcement mechanisms are needed to address the long-term impact of entitlement spending expansions. The Budget proposes to establish a new measure to analyze the long-term impact of legislation on unfunded obligations of major entitlement programs. If legislation caused an increase in these obligations, it would require a three-fifths vote of the Senate.

Line-Item Veto Authority. A perennial criticism of the Federal Government is that spending and tax legislation contain too many provisions, or earmarks, that would likely not become law if considered as a stand-alone bill. The persistence of these items in the Budget diverts resources from higher priority programs.

The President proposes that the Congress address this issue by providing him and future Presidents with a line-item veto that would withstand constitutional challenge. From the Nation's founding, Presidents have exercised the authority not to spend appropriated sums. However, the Congress sought to curtail this authority in 1974 through the Impoundment Control Act, which restricted the President's authority to decline to spend appropriated sums. The Line-Item Veto Act of 1996 attempted to give the President the authority to cancel spending authority and special interest tax breaks, but the U.S. Supreme Court found that law unconstitutional. The President's proposal would correct the constitutional flaw in the 1996 Act.

Specifically, the President proposes a line-item veto linked to deficit reduction. This proposal would give the President the authority to defer new spending whenever the President determines it is not an essential Government priority. All savings from the line-item veto would be used for deficit reduction, and could not be applied to augment other spending.

The Budget proposes other budget process reforms, including proposals to give the budget resolution the force of law, move to a biennial budget and appropriations process, and prevent Government shutdowns through an automatic continuing resolution.

In addition to these legislative proposals, the Administration plans on augmenting its own controls. To contain the cost of administrative decisions that can increase the cost of mandatory spending, the Office of Management and Budget plans to establish an internal review process that requires agencies, when proposing substantial administrative decisions that increase mandatory spending, to also propose other offsetting administrative decisions that reduce mandatory spending. This "administrative PAYGO" approach would complement congressional adoption of PAYGO for legislated increases in mandatory spending.

The reductions and reforms in the 2006 Budget will contribute to an even stronger near-term outlook for the Federal budget. And they will help strengthen the Federal Government's long-term fiscal outlook. Federal programs that place a large and rising claim on current tax dollars represent a real danger to our current and future fiscal health, and to our economy as a whole. It is critical that we take steps to confront these rising costs, and promote responsible reforms that place our entitlement programs on a path towards balance.

THE NATION'S FISCAL OUTLOOK

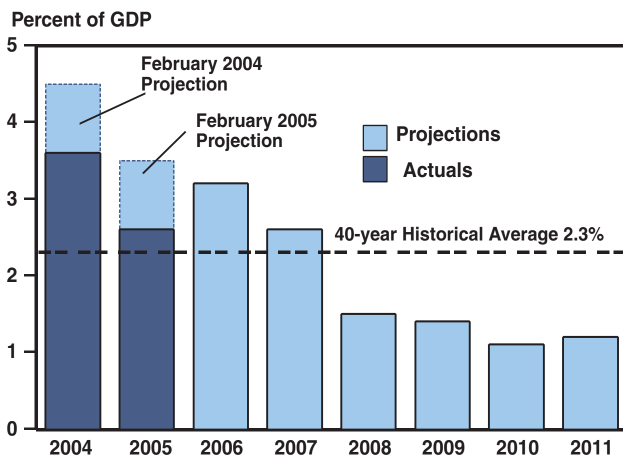
> *The first pillar of sound economic policy is spending restraint in Washington, D.C.*
>
> President George W. Bush
> February 8, 2005

The President's 2007 Budget addresses the Nation's fiscal challenges in both the near term and long term through policies that promote economic growth and restrain spending.

The prospects for improvement in the budget position in the near term are encouraging. For 2005, the most recently completed fiscal year, the deficit came in sharply below initial projections, largely due to higher-than-anticipated tax receipts. Although the deficit is projected to rise in 2006 from its 2005 level, the policies in this Budget are projected to return the deficit to its downward trajectory after 2006, keeping us on track to meet the President's goal of cutting the deficit in half by 2009.

In contrast to the trend of declining deficits in the near term, the longer-term fiscal outlook is more troubling. Without action to reform the Nation's large entitlement programs—particularly Social Security and Medicare—deficits, tax rates, or both, will increase to unprecedented levels and threaten future economic growth and standards of living.

THE NEAR-TERM OUTLOOK



The size of the deficit is best assessed in relation to the economy as a whole, as measured by Gross Domestic Product (GDP). Two years ago, with the 2004 deficit projected to peak at 4.5 percent of GDP, or $521 billion, the President set a goal of cutting the deficit in half by 2009. Since then, the deficit has declined. The 2005 deficit fell to 2.6 percent of GDP, or $318 billion, sharply below initial estimates. This reduction was largely due to the strength of tax receipts, which in 2005 grew 14.5 percent, or $274 billion, as a result of the economic expansion now under way.

In last July's Mid-Session Review, the Administration forecast a higher deficit in 2006 than in 2005 partly because of the implementation of the new Medicare prescription drug benefit, which went into effect January 1. However, the deficit for 2006 is now projected to be even larger than that prior estimate, due in significant part to the cost of the Federal response to Hurricanes Katrina and Rita, which came after the Mid-Session Review. In addition to the $84 billion the Congress has already enacted in emergency appropriations and enhanced flood insurance authority, the Budget includes the outlay effects of additional supplemental

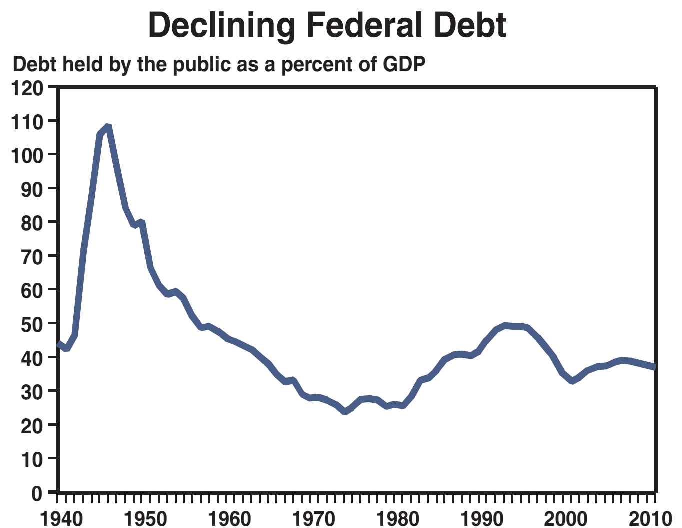
funding that will be needed to continue the hurricane recovery and rebuilding. The 2006 deficit estimate also includes the effect of $50 billion in emergency funding already enacted for operations in Iraq and Afghanistan in 2006, as well as the expected costs of an additional request for the remaining projected requirements through the end of the fiscal year. Also, the deficit forecast assumes that the Congress will pass a bill providing a one-year extension of relief from the Alternative Minimum Tax.

While this projected increase in the deficit is unwelcome, the resulting deficit is still well within historical range. At 3.2 percent of GDP, or $423 billion, the projected 2006 deficit would be smaller as a percent of GDP than the deficits in 11 of the last 25 years.

More importantly, the deficit is expected to resume its steady decline in 2007 and each of the following three years. In 2007, the Budget projects a decline in the deficit to 2.6 percent of GDP, or $354 billion. This estimate assumes enactment of $50 billion in emergency funding for operations in Iraq and Afghanistan for 2007. While additional funding beyond this level may be required before the end of 2007, depending on conditions on the ground, the amounts are uncertain at this time.

By 2009, the deficit is projected to be cut by more than half from its originally anticipated peak of 4.5 percent of GDP in 2004, to just 1.4 percent. A deficit of this size would be well below the 40-year historical average, and lower than those in all but 5 of the last 25 years.

An important indicator of the fiscal outlook is the trend in Federal debt—essentially, the accumulation of past deficits—in relation to the economy. The ratio of publicly held debt to GDP has ranged between 33 and 49 percent over the last two decades. Recent deficits have increased this ratio modestly since 2001, with the level projected to reach 39 percent of GDP at the end of 2007. This projected level would be well below the current average debt ratio for other major industrial nations. The declining deficits projected in this Budget would bring the debt ratio down after 2007, falling to 37 percent of GDP in 2011.



The President has outlined a two-pronged approach to reducing the deficit:

First, he has pursued policies to promote a strong economy, a critical ingredient in generating increased revenues to the Treasury without imposing new taxes.

Second, he has worked with the Congress to restrain the growth of both discretionary and mandatory spending.

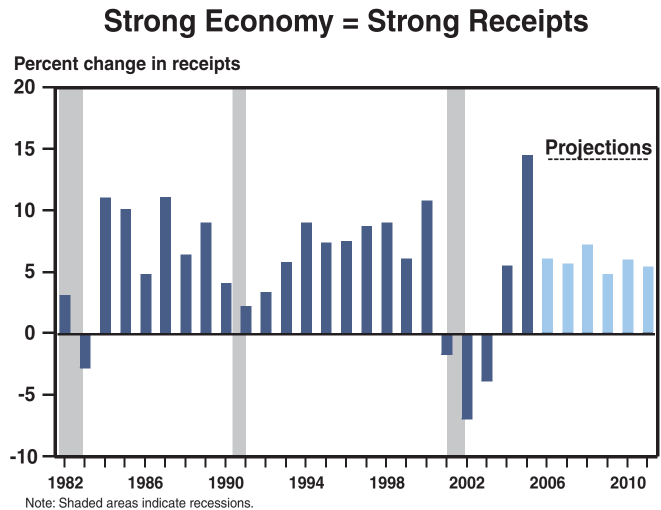
While the fiscal results in any particular year may vary—as reflected in the lower-than-expected deficit in 2005 and the projected increase in the deficit in 2006—this combination of pro-growth policies and spending restraint is well-designed to deliver the desired reductions in the deficit without damaging the overall economy.

Increasing Revenues through Economic Growth

The strength of the economy drives the level of tax receipts. Prior to the Administration's first term, an overvalued stock market had driven Treasury receipts to artificially high levels. Taxes from realized capital gains, stock options, and other income helped generate peak revenues of $2.025 trillion, or 20.9 percent of GDP in 2000—a level that equaled the all-time high reached during World

War II. The subsequent bursting of the stock market bubble and the recession that followed led to a massive drop in tax receipts. Receipts fell in 2001, again in 2002, and again in 2003, reaching $1.783 trillion in 2003, or 16.5 percent of GDP. This was the first time since 1923 that receipts declined for three consecutive years.

The President's program of comprehensive tax relief was well-timed to respond to the weak economy. Tax relief enacted in 2001 granted immediate tax rebates, reduced marginal tax rates, and lowered the marriage tax penalty. That tax relief, along with further tax legislation in 2002 that encouraged business investment, acted to jump-start the economy out of the recession and counter the economic headwinds from the September 11th terrorist attacks. The 2001 tax relief did not have its full potential effect because many of its provisions were to be phased in over a number of years. Tax relief in 2003 accelerated much of the remaining tax relief from 2001 and also reduced tax rates on dividends and capital gains. This full implementation of the President's tax relief gave real strength to the economic recovery that was beginning to take hold. Real economic growth in 2004 was a strong 4.2 percent, followed by estimated growth of 3.6 percent in 2005, with healthy growth in jobs and investment.



As a direct result of this strong economic growth, receipts to the Treasury have returned to healthy growth in the past two years, with increases of 5.5 percent in 2004 and an extraordinary 14.5 percent in 2005, more than five percentage points above the projection in last year's Budget. Growth in corporate receipts in 2005 was an astounding 47 percent. Total receipts reached 17.5 percent of GDP, up from a low of 16.3 percent of GDP in 2004. The Administration projects that receipts will increase 6.1 percent in 2006 and an average of 5.9 percent annually through 2011. This cautious forecast is far slower than the 14.5 percent growth experienced in 2005, but still faster than the projected rate of economic growth.

The revenue and deficit estimates in this Budget fully reflect the President's plan to extend tax relief enacted by the Congress in the 2001 and 2003 tax acts. Preserving this favorable low-tax environment is vital to continuing economic growth.

Spending Restraint

With receipts returning to historically healthy levels as a result of a strengthening economy, substantial deficit reduction is achievable so long as the Federal Government restrains growth in spending.

The Administration has focused resources on meeting the unavoidable costs arising from the September 11th terrorist attacks, the subsequent War on Terror, and more recently the response and rebuilding in the wake of Hurricanes Katrina and Rita. At the same time that the budget has funded these requirements, the Congress and the President have imposed enhanced restraint on the non-security, discretionary portion of the budget. From a peak of 15 percent in the final budget year of the prior Administration, the Congress and this Administration have brought the growth rate in this area of spending down each year. The Congress achieved this spending discipline by reducing funding for programs that were not getting results or were not fulfilling essential priorities.

In last year's Budget, the President proposed to hold the rate of growth in overall discretionary spending below the rate of inflation. The Congress delivered on that goal. The President also proposed an outright cut in spending on non-security discretionary programs—the first such proposed cut since the Reagan Administration—and Congress delivered appropriations bills that met that goal as well. Finally, the President proposed major reductions or outright terminations for 154 programs. The Congress responded by terminating or reducing funding for 89 of the programs.

The President's 2007 Budget continues this restraint, holding growth in overall discretionary spending below the projected rate of inflation for fiscal year 2006 of 3.3 percent, and again proposing an actual cut in non-security discretionary spending. The Budget proposes 141 major reductions and terminations in discretionary programs, saving nearly $15 billion in 2007 alone.

Spending on discretionary programs is relatively controllable because funding decisions are revisited each year in the annual appropriations process. Mandatory programs are more difficult to restrain because they operate under multi-year or permanent authority, with no requirement for annual review. While spending in mandatory programs is more difficult to control, the President has proposed to reduce the growth in this area as well. Last year's Budget proposed significant reforms in mandatory programs, totaling $61 billion in net mandatory savings over a five-year period. The Congress in its budget resolution initially committed to $35 billion in net mandatory savings over five years. As of the time of printing, both houses of the Congress had passed a reconciliation bill that achieved $40 billion in net mandatory savings. Assuming the Congress completes this work upon its return, it will have not only produced the first significant net savings from entitlement programs in eight years, but it also will have exceeded the savings called for in its own budget resolution.

This Budget continues to propose significant reforms in mandatory programs beyond those in the pending reconciliation bill. The Budget proposes $65 billion in net mandatory savings over the five-year period 2007-2011, including savings from reforms in Medicare, agriculture programs, and pension insurance programs.

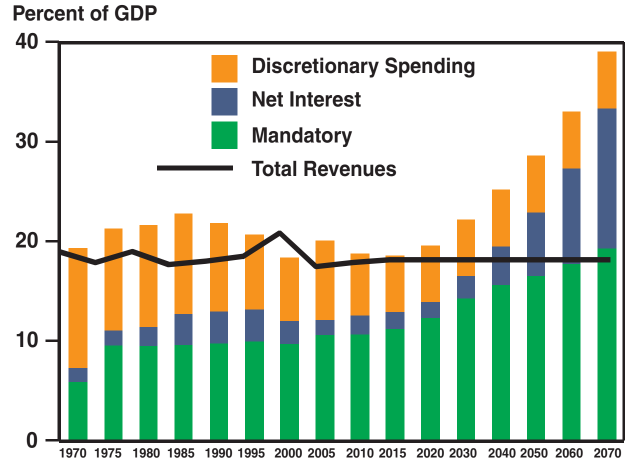
If the policies of spending restraint proposed in this Budget are adopted, outlays in 2009 are projected to fall to 19.1 percent of GDP, well below the average of the past 40 years.

THE LONG-TERM OUTLOOK

While the near-term outlook for shrinking deficits is encouraging, the long-term picture presents a major challenge due to the expected growth in spending for major entitlement programs. In only two years, the leading edge of the baby boom generation will become eligible for early retirement under Social Security. In five years, these retirees will be eligible for Medicare. The budgetary effects of these milestones will be muted at first. But if we do not take action soon to reform both Social Security and Medicare, the coming demographic bulge will drive Federal spending to unprecedented levels and threaten the Nation's future prosperity.

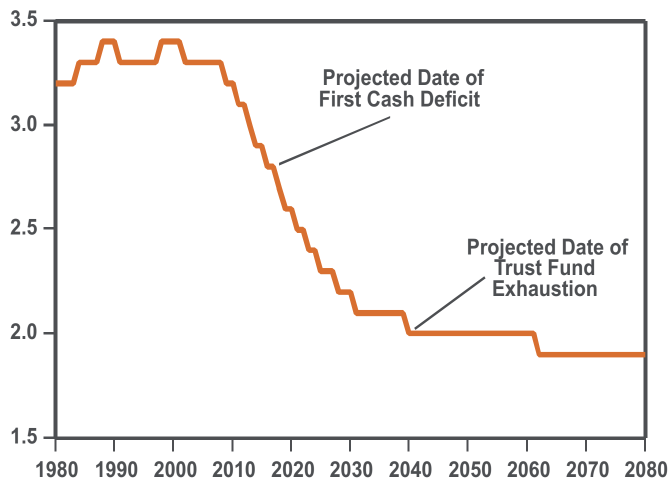
No plausible amount of cuts to discretionary programs or tax increases can help us avert this major fiscal challenge. As the accompanying chart shows, assuming mandatory spending continues on its current trajectory and the tax burden is held at historical levels, by 2040 Federal spending will accelerate to a level at which mandatory outlays and debt service would consume *all* Federal revenue. By 2070, if we do not reform entitlement programs to slow their growth, the rate of taxation on the overall economy would need to be more than doubled, placing a crushing burden on the economy that is required to produce the revenues to support the Government programs in the first place.

Social Security



Social Security was designed to be a self-financing program, in which current workers pay taxes to support benefits received by current retirees. In the early years of the program, there were more than 16 workers for every beneficiary, which allowed the program to be financed with a very low payroll tax rate. Currently, there are 3.3 workers for every beneficiary, and a much higher tax rate. As the baby boom generation retires, the ratio of workers to beneficiaries will shrink further, to an estimated 2.9 workers in 2015 and 2.2 workers in 2030. As a result, starting in 2017, Social Security will collect less in dedicated taxes than it pays out in benefits, creating a gap that grows progressively wider over time. By 2030, revenues will be sufficient to finance only 79 percent of promised benefits, falling to 68 percent by 2080.

The President has called for Social Security reform that would place the program's finances on a sustainable basis for future generations, while preserving full scheduled benefits for those already in or near retirement. The benefits that can be paid out of future payroll taxes are well below the levels in existing benefit schedules, creating uncertainty for current and future workers and virtually guaranteeing that these workers will receive even lower rates of return on their payroll taxes than now projected based on current benefit schedules.



In order to put the program on a sustainable footing without increasing tax rates and damaging the economy, the President has embraced the idea of indexing future benefits for wealthier workers to inflation, rather than wage growth. Even with such indexing of future benefits, even the wealthiest workers would receive more benefits in real terms than today's seniors. At the same time, by indexing benefits for those workers to inflation rather than wages, the Government would save significant sums in future decades, money that could be used to provide low-income seniors with promised benefits, which exceed what the system can currently afford to pay. By complementing this reform with voluntary personal retirement accounts for each worker born after 1949, with the money coming from a portion of a worker's payroll taxes, younger workers would have an opportunity to earn higher yields than are possible in the current system, while building a retirement asset they can call their own.

Adding voluntary personal retirement accounts to Social Security requires financing the transition from today's unsustainable "pay-as-you-go" system. Although this transition financing is incorporated into the deficit projections in this Budget, financing personal accounts should not have the same effect on capital markets as traditional Federal borrowing. First, such financing essentially

brings forward obligations already present in the form of promised future Social Security benefits, and as a result, would reduce existing future obligations by a nearly equivalent amount. Second, unlike debt issued to fund Government spending, there would be no impact on net national saving, because every dollar of transition financing would be saved in a personal account and invested in the capital markets. Comprehensive reform that includes both personal accounts and other measures like progressive indexing of future benefits will reduce accumulated benefit obligations by far more than the near-term transition financing, substantially improving the Government's overall financial position over the long term.

Health Care Entitlements

As the Nation's largest health care entitlement programs, Medicare and Medicaid face similar demographic challenges as Social Security, and those challenges are compounded by the particular economics of health care. Our Nation's $1.9 trillion health care system provides an increasing level of technology and supply of innovation that has allowed Americans to lead longer and healthier lives—but at increasing cost to anyone who pays for health care. The Federal Government pays for about a third of U.S. health care spending and as a result, health care inflation is a major Federal fiscal issue. Medicare and Medicaid face problems not only larger in dollar terms than those faced by Social Security, but significantly more complex. Unlike Social Security, which could be reformed and strengthened with relatively simple adjustments to the terms by which the program operates, the challenges of these programs require a broader range of strategies, some of which relate to the Nation's health care system as a whole.

The Administration has taken steps and proposed additional reforms designed to reduce health care inflation, expand health care coverage, and improve the quality of care. Many of these initiatives are predicated on the policy goal of returning more control and choice to health care consumers—patients and their families. Under the Medicare Modernization Act of 2003, the President signed into law the creation of Health Savings Accounts (HSAs), which permit individuals to combine a high-deductible health insurance policy, offering preventive coverage and protection against emergencies, with a tax-free account for all other health care expenses. HSAs belong to the individual, giving that individual greater financial resources to shop for health care carefully, and to save for future expenses.

The creation of HSAs is leading to a major shift in health care spending in America. More employers are able to afford high-deductible health insurance combined with HSAs, so an increasing number of workers are gaining control over their health care dollars. In addition, HSA-based insurance allows more workers to have insurance for major medical events, which should reduce the financial burden currently carried by various government and non-profit entities in essentially providing care for free. The Budget proposes to expand HSAs to allow every worker to receive tax treatment comparable to those workers who today receive employer-provided health insurance.

The President has also proposed the creation of Association Health Plans (AHPs), which will allow employers to purchase health insurance across State boundaries and to reap the benefits of buying insurance in bulk—bringing greater price efficiencies to the health insurance market and reducing the impact of State-by-State regulations. By allowing small businesses to band together and negotiate on behalf of their employees, AHPs would give working families greater access to affordable health care.

Medical liability reforms would protect America's patients, doctors, and hospitals from the staggering costs of out-of-control lawsuits and help reduce the likelihood that doctors and hospitals would order more tests or procedures than clinically necessary, a common cause of health care inflation. Such defensive medicine tends to be used by practitioners to help protect against liability claims, but it has little or no medical benefit. President Bush continues to call for medical liability reforms

that would protect a patient's right to sue and would place reasonable limits on the extent of such lawsuits.

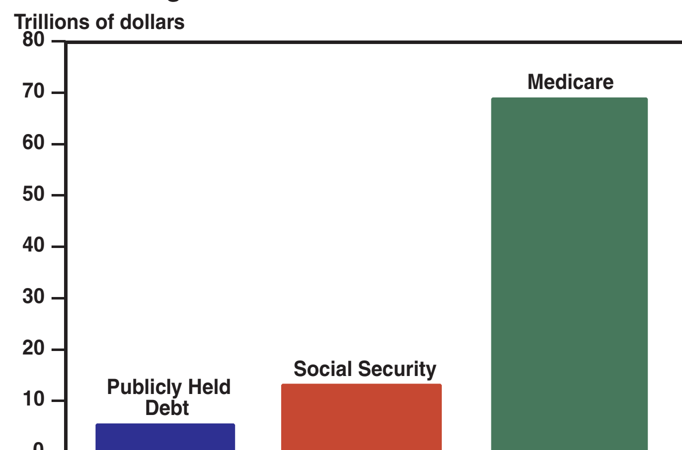
In his first term, the President pressed for, and signed into law, reforms to help speed the introduction of generic pharmaceuticals into the market. Generic drugs provide a more cost-effective way to deliver much-needed medicine to patients, but have often been blocked in the past by loopholes in patent law. Since the reforms, generics are more likely to reach the marketplace without delay after a patent has expired, helping reduce inflation in the drug market.

And finally, the President and the Congress have aggressively supported innovations in health care information technology. Such technology has the capacity to link together doctors, patients, and hospitals in seamless, digital environments, making it possible for a patient's record to be transferred accurately and with all necessary privacy protections in an emergency to new doctors. The technology has already developed to the point that many hospitals and medical systems use it as a means to track patient records, lab tests, drug administration, and follow-up care. Federal efforts to aid harmonization and implementation of such technologies are expected to improve efficiency and accuracy of care, which would reduce the need for redundant medical tests, as well as the likelihood of expensive and often fatal errors.

These reforms are expected to help moderate the effect of health care inflation on the Federal Medicare and Medicaid programs in coming years. Even so, direct measures will continue to be essential to bringing the cost pressures on these programs under control.

Medicare

Medicare is similar to Social Security in that it is tied to the number of retirees in the general population. But because its costs are also tied to health care inflation, its fiscal challenges are greater than Social Security's in nature, magnitude, and complexity.



Medicare's dedicated revenues—consisting primarily of payroll taxes and premiums paid by beneficiaries—currently finance 62 percent of benefits. The remaining gap of 38 percent is covered by the transfer of general revenues into Medicare Parts B and D. By 2030, however, dedicated taxes and premiums are projected to finance less than 40 percent of total benefits, creating a "financing gap" of more than 60 percent that would need to be paid for by the general fund of the Treasury.

Filling gaps of this size with general revenues would require dangerously high tax increases, and borrowing to finance the gaps would bring debt to unprecedented and unsustainable levels. In fact, the accumulated size of Medicare's financing gap is more than 14 times as large as today's publicly held debt. The only realistic solution is to bring the program's costs into line with available resources.

As a starting point, any policies that control overall health care inflation will have direct benefits for Medicare's finances. Trends in the larger health-care market are already improving the fiscal position of the Medicare program. Lower-than-projected growth in prescription-drug inflation has reduced estimated net Medicare spending for the drug program by nearly $10 billion in 2006, the first year of the program, and by $130 billion from 2006 through 2015. Beneficiary premiums for the drug benefit are lower than expected as well—an average of $25 per month, rather than the $37 per

month initially estimated. In addition, plan participation in the Medicare drug benefit is robust, and plans are competing to attract beneficiaries. Vigorous competition among firms has led to innovative benefit and cost-sharing options. As a result, beneficiaries can choose among a wide variety of plans, picking the drug-coverage option that best meets their individual needs.

The 2007 Budget includes proposals to moderate Medicare spending growth by addressing a range of issues and challenges in Medicare and focusing on promoting high-quality and cost-efficient care for beneficiaries. In total, the Medicare proposals in the Budget will save $36 billion over five years.

For example, the Budget proposes to continue the Administration's support for quality initiatives by ensuring that patients are served in the most medically appropriate and cost-efficient setting for high-quality post-acute care.

In order to foster greater competition in the Medicare program, the Budget proposes to establish competitive bidding for clinical laboratory services. The Administration also plans to use existing authority to implement competitive bidding of certain physician-administered drugs and medical supplies and equipment.

In addition, the Budget proposes to consider advances in medical technologies and the delivery of care, as well as other management improvements, in making productivity adjustments to provider updates. As part of a comprehensive package of reforms to make Medicare more sustainable, it is prudent to adjust payment rates to encourage efficiency.

The Budget also focuses on longer-term challenges to Medicare's fiscal status. The Medicare Modernization Act of 2003 (MMA) took an important first step toward improving Medicare sustainability by requiring the Medicare trustees' report to include a new, comprehensive fiscal analysis of the program's financing and issue a warning if this analysis projects that the share of Medicare expenditures funded through general revenues will exceed 45 percent within the next seven years. However, while this warning requires the President to propose legislation to restore Medicare spending to sustainable levels, it does not mandate congressional action to do so.

The Budget proposes to strengthen the MMA provision by automatically slowing the rate of Medicare growth if the MMA threshold is exceeded. The lower growth would be achieved through a four-tenths of a percent reduction to all payments to providers beginning the year the threshold is exceeded. The reduction would grow by four-tenths of a percent every year the shortfall continues to occur. This provision is designed to encourage the President and the Congress to reach agreement on reforms to slow Medicare spending and bring it back into line with the threshold established by the MMA.

Medicaid

In the deficit reduction bill pending before the Congress at the time of printing, the Congress has addressed the Administration's goals of reducing inappropriate spending and giving States flexibility to provide health care services through Medicaid more efficiently. The bill reduces Medicaid overpayments for prescription drugs, encourages citizens with considerable assets to plan and pay for their long-term-care expenses rather than rely on Medicaid, and allows States to tailor health care services and cost sharing to the needs of their populations. These reforms will help increase the efficiency and effectiveness of the Medicaid program.

Even with these reforms, Medicaid spending growth continues to be high, with average annual growth projected to exceed seven percent over the next decade. During the coming year, the Administration will take further actions to improve the fiscal integrity of Medicaid. These actions include payment reforms to shore up the integrity of the Medicaid matching rate system between the Federal Government and States, reform of reimbursement policies for certain services that are prone

to claims abuse, and further reductions in overpayments for prescription drugs. These proposals will strengthen the Federal-State partnership and improve Medicaid's long-term financial stability.

BUDGET PROCESS REFORMS AND MANAGEMENT AGENDA

The current budget process makes it difficult to confront the Nation's near-term and long-term fiscal challenges. During the 1990s, the budget process was controlled by the now-expired Budget Enforcement Act (BEA). The BEA imposed year-by-year limits on discretionary budget authority and outlays and required that all other legislation not increase the deficit. Violations of these provisions led to across-the-board spending reductions. The BEA helped to restrain spending until the emergence of budget surpluses in the late 1990s eroded spending discipline.

As part of its 2007 Budget, the Administration proposes a number of reforms to control spending, including limits on discretionary and mandatory spending, a line-item veto, and reforming programs to deliver results. The Administration's proposals are based in part on the spending controls in the BEA.

Mandatory Spending Restraint

Less than half of spending each year is subject to the appropriations process and must be enacted into law year by year. The majority of spending, in what are known as "mandatory" or "entitlement" programs, takes place automatically under standing authority, and this form of spending is growing far faster than the rest of the budget.

Because of the emphasis on discretionary programs in the annual budget process, those programs tend to receive greater scrutiny than mandatory programs. Recently, the Administration and the Congress have worked together to hold discretionary spending to fixed spending limits, but holding mandatory spending to such limits is difficult, as most mandatory programs grow automatically by formula according to permanent law.

Efforts to restrain mandatory spending are further complicated by an upward bias in the design and treatment of entitlement spending programs. While changes to discretionary spending are measured relative to the previous year's level, changes to mandatory spending are measured from a "baseline" that builds in automatic spending growth under current law. This difference allows critics of mandatory spending restraint to characterize a reduction in the scheduled rate of growth of entitlement spending as an actual cut in the level of entitlement spending. For example, the Administration last year proposed to slow average annual growth in Medicaid and the State Children's Health Insurance Program (SCHIP) from 7.4 percent to 7.2 percent over the next 10 years. The proposal would still have allowed funding for these two programs to double from $194 billion in 2005 to $387 billion in 2015. Because the Administration's proposed growth was less than what was built into the baseline, it was characterized as a "cut" by some critics.

The Budget proposes to place limits on new mandatory spending. In addition to the enhanced fiscal control mechanism for the Medicare program described earlier, the Administration would require that any legislated increases in mandatory spending be offset by a reduction in other mandatory spending. Legislation that violated this requirement would be subject to a three-fifths point of order in the Senate. In the event that cumulative legislation enacted during a Congressional session had the effect of causing a net increase in mandatory spending, the Office of Management and Budget (OMB) would be required to reduce such spending across-the-board in non-exempt programs to eliminate the overage.

Another goal of the Budget is to address the challenge created when minor changes to a benefit formula are made. In some cases, these minor changes can have small costs in the short run but much

greater costs in the longer term, outside the 10-year window used for budget scoring. The Budget proposes to establish a new measure to analyze the impact of legislation on unfunded obligations of major entitlement programs beyond the usual 10-year scoring window. If legislation caused an increase in these obligations, it would require a three-fifths vote of the Senate.

In addition to these legislative proposals, the Administration has augmented its own controls on mandatory spending. On May 23, 2005, OMB established an internal review process that requires agencies, when proposing substantial administrative actions that increase mandatory spending, to propose at the same time offsetting administrative actions that reduce mandatory spending by a comparable amount.

Discretionary Spending Limits

As noted earlier, the Congress has made important progress over the past 5 years in applying budget discipline to discretionary spending. The 2007 Budget proposes to strengthen our ability to continue this discipline through statutory limits on discretionary spending each year through 2011 that would control action throughout the budget process. Any appropriations bill that caused these limits to be exceeded would be subject to a three-fifths vote of the Senate. If cumulative appropriations action breached the spending limits, OMB would be required to make across-the-board cuts to eliminate the excess spending.

Currently, there are inadequate incentives in budget scoring rules to fund programs to collect overdue taxes owed to the Government, eliminate the estimated $37 billion in improper payments, and combat other fraud and abuse in Government spending. For example, if the Budget allocates $100 million for the collection of $500 million in delinquent tax payments, the savings of $400 million are not counted for purposes of evaluating the budgetary effects of the proposal. Thus, neither the Congress nor the Administration has a budget scoring incentive to fund programs that actually improve the overall fiscal position of the Government. The Administration proposes to properly align incentives for these activities by allowing an increase in the discretionary caps in the amount of additional funding needed for programs that save the Government money, such as the Social Security Administration's continuing disability reviews, health care fraud detection, unemployment insurance integrity programs, and Internal Revenue Service delinquent tax collections.

Focusing Spending on Priorities

Notwithstanding the recent progress in restraining discretionary spending, there is a widespread public perception that the number of earmarked spending items is excessive, and that too many of them are difficult to justify on the merits. The large number of earmarks, the lack of transparency, and the lack of a rigorous justification process make it difficult to assure taxpayers that their dollars are being spent wisely. The Administration looks forward to working with the Congress to reform the current approach to earmarks so that citizens can have greater confidence that their tax dollars are funding important National priorities.

As a further tool to focus spending on priorities, the President proposes that the Congress provide him and future Presidents with a line-item veto that is designed to withstand constitutional challenge. From the Nation's founding, Presidents have exercised the authority not to spend appropriated sums. However, the Congress sought to curtail this authority in 1974 through the Impoundment Control Act, which restricted the President's authority to decline to spend appropriated sums. The Line-Item Veto Act of 1996 attempted to give the President the authority to cancel spending authority and special interest tax breaks, but the U.S. Supreme Court found that law unconstitutional. The President's proposal is designed to correct the constitutional flaw in the 1996 Act.

Specifically, the President's Budget proposes a line-item veto linked to deficit reduction. This proposal would give the President the authority to defer new spending whenever the President determines it is not an essential Government priority. All savings from the line-item veto would be used for deficit reduction, and could not be applied to augment other spending.

The Administration would also support enhanced rescission authority as a supplement or alternative to this line-item veto. While the Impoundment Control Act contains provisions for the expedited consideration of proposed rescissions, these procedures are flawed and have almost never been used to enact a rescission. The Budget proposes these procedures be strengthened to ensure a vote on the President's proposed rescissions.

Sunset and Results Commissions

Statutory and other barriers make it difficult to reform programs to ensure agencies can maximize results for the American people at the lowest cost to the taxpayer. On June 30, 2005, the Administration transmitted the Government Reorganization and Program Performance Improvement Act, proposed legislation that would create bipartisan Results Commissions and a Sunset Commission to improve agency and program performance and reduce unnecessary costs to taxpayers. Results Commissions would consider proposals to restructure or consolidate programs or agencies in areas where duplication and overlapping jurisdictions hinder improvements in performance. Proposals from Results Commissions would be approved by the President and taken up in the Congress under expedited procedures. The Sunset Commission would consider Presidential proposals to retain, restructure, or terminate agencies and programs according to a schedule set by the Congress. Agencies and programs would automatically terminate according to the schedule unless reauthorized by the Congress.

Other Reforms

The Administration also proposes to improve the budget process with a joint budget resolution, Government shutdown prevention, and biennial budgeting. The current budget resolution does not require the President's signature and therefore does not have the force of law. A joint budget resolution would bring the President into the process at an early stage, allowing the President and the Congress to reach agreement on overall fiscal policy before individual tax and spending bills are considered, and could be enforced through automatic across-the-board spending cuts if its provisions were not honored.

The Administration's proposed provision to prevent Government shutdowns would address the chronic practice of using "continuing resolutions" to provide temporary funding for the Government when the Congress fails to enact appropriation bills by the October 1st start of the fiscal year. Under the President's proposal, if an appropriations bill has not been enacted, funding would be automatically provided at the lower of the President's Budget or the prior year's level. Important Government functions should not be held hostage simply because of an impasse over temporary funding bills.

Finally, biennial budgeting would free up time in the Congress now spent debating annual appropriations bills so that lawmakers could devote more attention to oversight responsibilities to ensure that taxpayers' money is spent wisely and efficiently. A biennial budget process, under which two-year appropriations bills would be enacted in each odd-numbered year, would also promote longer-range planning and improved fiscal management in the Executive Branch.

THE PATH FORWARD

With a commitment to spending restraint and with continued focus on strengthening the economy, we can make significant reductions in the deficit over the next several years. In the longer term, unconstrained spending in the Nation's large entitlement programs poses a serious threat to the Federal budget and to the health of the economy. If we take action to restrain spending, reform entitlements, and improve the budget process, the Nation's longer-term fiscal outlook will improve markedly.

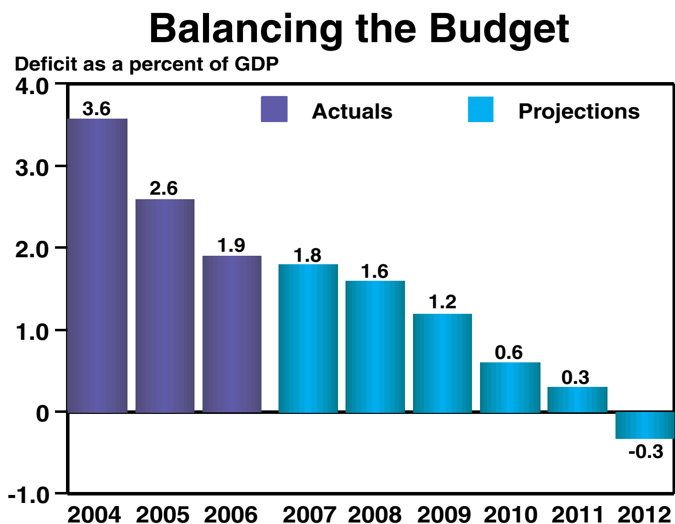
THE NATION'S FISCAL OUTLOOK

The President's 2008 Budget addresses the Nation's near-term and long-term fiscal challenges through pro-growth economic policies and spending restraint. Three years ago, the President set a goal to cut the deficit in half by 2009 from its projected peak in 2004. The President's fiscal approach succeeded, and the results—including two consecutive years of double-digit revenue growth—allowed the President to achieve that goal in 2006, three years ahead of schedule. The Administration's fiscal strategy of pro-growth tax policy, restraint in discretionary spending, and reductions in the growth of entitlement spending, will further reduce the deficit and balance the budget by 2012. This steady improvement in the deficit outlook is welcome news. Yet despite this improvement in the near term, the Nation continues to face pressing long-term fiscal challenges arising from our key entitlement programs. The President has made clear that he wants to work with the Congress to address this longer-term problem of the unsustainable growth in entitlement spending.

THE NEAR-TERM FISCAL OUTLOOK

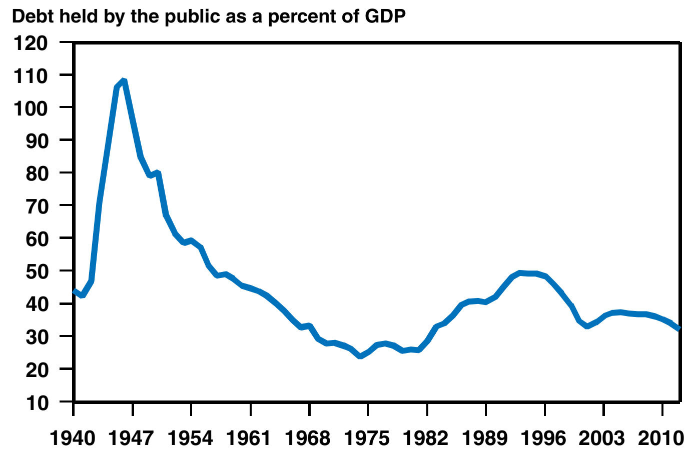
Since the beginning of his Administration, the President has pursued pro-growth economic policies to give all Americans the opportunity to share in the Nation's prosperity. Strong economic growth is also essential to generating the revenue needed to reduce the deficit. The President has pursued spending restraint in the face of enormous challenges, from the significant costs arising from the September 11th terrorist attacks and the subsequent War on Terror, to the response and rebuilding after Hurricane Katrina.

The size of the deficit and the debt is best assessed in relation to the economy as a whole, as measured by Gross Domestic Product (GDP). In his 2005 Budget, the President set a goal to cut the deficit in half by 2009 from its projected peak in 2004. The President achieved his goal in 2006, three years ahead of schedule. The deficit fell from a projected 4.5 percent of GDP, or $521 billion, to 1.9 percent of GDP, or $248 billion. This deficit is below the 40-year historical average of 2.4 percent of GDP, and is smaller than the deficit as a percent of GDP in 18 of the previous 25 years.



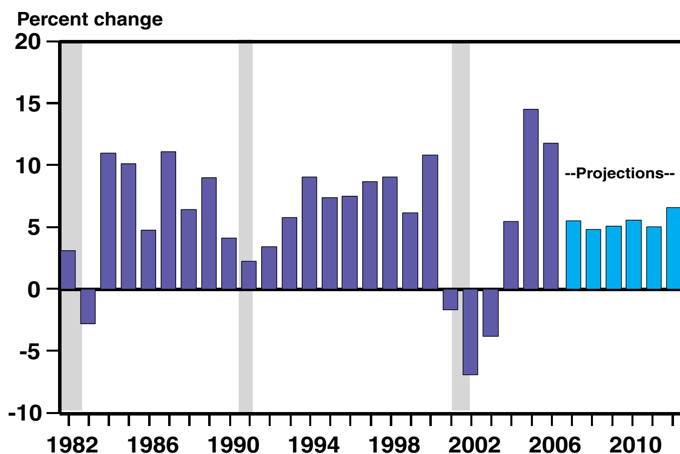
The Budget reflects the projected full costs of the War on Terror for 2007 and 2008. It also includes an allowance for at least a portion of the anticipated costs for 2009; actual funding needs will be determined by conditions at that time. In addition, the Budget assumes the extension for one year of relief from the Alternative Minimum Tax (AMT). Even with these added costs, the deficit is projected to decline in both dollar terms and as a share of the economy in 2007. By 2012, the Budget is projected to generate a surplus of $61 billion. The Budget projects these results while increasing funding for the Nation's security, investing in education and supporting other key national priorities, including making permanent the President's tax relief.

The Nation's fiscal outlook is reflected in both the annual budget deficit and the amount of Federal debt held by the public, which is debt issued to finance past and current deficit spending. Debt held by the public has ranged from 33 to 49 percent of GDP over the past 20 years, and has averaged 35 percent over the past 40 years. For 2006, debt held by the public declined from 37.4 percent to 37.0 percent of GDP. For 2012, debt held by the public is expected to be 32 percent, below the 40-year historical average, providing further evidence that the President's pro-growth economic policies and spending restraint are working to improve the Nation's fiscal outlook.



Strong Economy: Fueled by Pro-Growth Policies

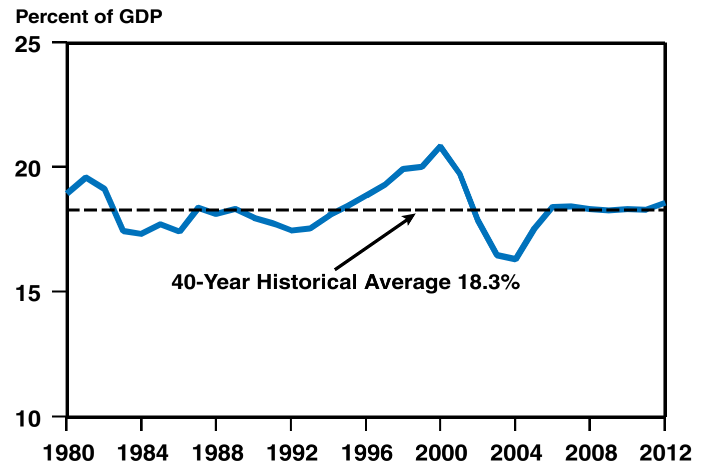
The President's pro-growth economic policies, beginning with his tax relief proposals, have promoted America's entrepreneurial spirit, rewarding the hard work and risk-taking of the Nation's workers and entrepreneurs. The tax relief included reducing marginal individual income tax rates, doubling the child tax credit, reducing the marriage penalty, reducing capital gains and dividend tax rates, encouraging retirement savings, reducing the estate and gift tax, and increasing incentives for small business investment. On May 17, 2006, the President signed the Tax Increase Prevention and Reconciliation Act of 2005, extending through 2010 capital gains and dividend tax rate relief and extending through 2009 a provision to encourage small business investment by raising the expensing limits for equipment purchases. On August 17, 2006, the President signed the Pension Protection Act of 2006, tightening the rules relating to defined-benefit plans and making permanent some of the President's proposals to encourage retirement and education savings.



Note: Shaded areas indicate recessions.

Because of the positive economic impact his tax relief program has had in the short term, and would continue to have over the long term, the President's policy is to make tax relief permanent rather than allowing it to expire as scheduled at the end of this decade. Since the President's tax relief was fully implemented in 2003, the Nation's economy has generated more than seven million jobs. This strong economic growth has been good for the Nation's workers and the resulting revenue growth has been good for the Federal budget.

For 2006, tax receipts of $2.4 trillion were 11.8 percent greater than in 2005, and in 2005 receipts were 14.5 percent higher than in 2004. Each year constituted record receipts and together made for the highest two-year percentage growth in receipts in the past 25 years. The Budget conservatively projects future revenue growth that averages 5.4 percent over the next six years, about equal to the projected overall growth in the economy.



The tax proposals in the 2008 Budget promote continued economic growth and, consequently, continued growth in the Government's tax receipts. The Budget proposes to make permanent tax relief that was enacted in 2001 and 2003. In addition, the Administration proposes to change the tax code to encourage savings for retirement, to make it easier for all Americans to afford health insurance, and to increase small business investment. Furthermore, the Administration proposes to simplify the tax code for families, close tax loopholes, and increase tax compliance.

In addition to tax relief, the President will continue to strengthen the economy by advancing basic research and development, promoting innovation and accountability in education, reducing the burden on business of Government paperwork and regulations, reducing costly and unnecessary litigation, and eliminating trade barriers and opening overseas markets to American products and services.

National Security Spending: Protecting the American People

Security spending includes spending for the Department of Defense, homeland security, and international diplomatic efforts. International affairs spending finances efforts to create a stable government in Iraq, rebuild the economy in Afghanistan, and enhance security by promoting democracy and building alliances around the world. Between 2001 and 2006, security spending increased 41 percent overall: 36 percent for defense, 38 percent for international affairs, and 209 percent for homeland security. These significant increases were necessary to protect the Nation's homeland and pursue the War on Terror after September 11th.

In his 2008 Budget, the President includes a further 10.5 percent increase in base defense spending. This includes funding to maintain a high level of military readiness to support the Global War on Terror and to continue to transform the military to meet the challenges of the 21st Century. The Budget includes a 17.1-percent increase in spending for international affairs to support key allies in the Global War on Terror, promote democratic institutions and values, counter the spread of HIV/AIDS, and provide humanitarian assistance to those affected by continuing violence and instability. In addition, the Budget includes a 6.7-percent increase to defend the Nation's homeland by funding nuclear detection capabilities, strengthening the country's borders, developing high-tech screening capabilities, and maintaining close partnerships with State and local law enforcement officials.

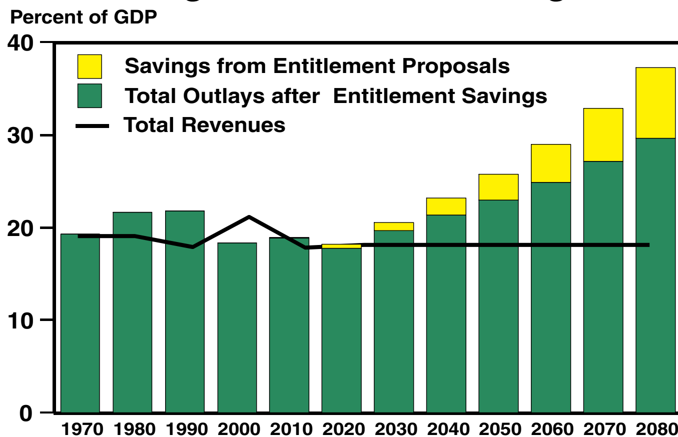
Spending Restraint: Slowing Growth in Non-Security and Entitlement Spending

The near-term budget outlook has improved in large part because of the double-digit growth in tax receipts and also because of spending restraint. Due to the need for increased spending on defense

and homeland security as part of the Global War on Terror and the automatic increases in spending for entitlement programs, outlays rose to $2.7 trillion in 2006, or 20.3 percent of GDP. Despite these spending pressures, spending remained below the 40-year historical average of 20.6 percent of GDP. This is largely because over the past two years, the Congress and the President have reduced the growth rate in non-security discretionary spending—which grew by more than 16 percent in the last year of the previous Administration—to below the rate of inflation. In addition, in February 2006, the Congress enacted and the President signed into law the Deficit Reduction Act of 2005, generating nearly $40 billion in mandatory savings over five years.

The 2008 Budget achieves spending restraint by holding growth in non-security discretionary spending to one percent in 2008 and for the five-year period. The Budget reduces or eliminates 141 programs saving $12.0 billion, and slows spending growth through sensible reforms in entitlement and other mandatory programs, resulting in savings of $96 billion over five years, and growing to savings of $309 billion over 10 years. This total includes $66 billion in savings in Medicare and $6.8 billion in Medicaid and the State Children's Health Insurance Program (SCHIP) over five years, as discussed below. The Budget also proposes to increase premiums paid to the Pension Benefit Guaranty Corporation (PBGC) by corporations with defined-benefit pension plans, providing $5.5 billion over five years to put the PBGC on a path to solvency. And, the Budget proposes to increase user fees, saving $7 billion over five years, to capture more fully the costs to the Government of providing particular goods and services.

THE LONG-TERM OUTLOOK

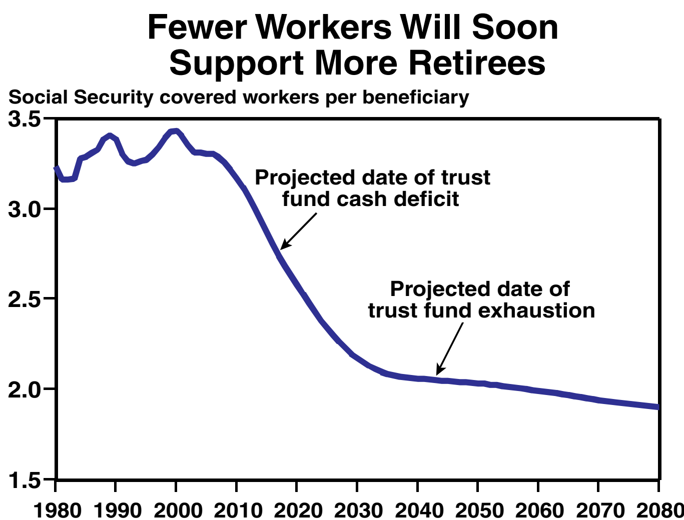


While the near-term outlook of smaller deficits and a surplus starting in 2012 is encouraging, the current structure of the Federal Government's major entitlement programs will place a growing and unsustainable burden on the budget in the long-term. Currently, spending on Medicare, Medicaid, and Social Security is approximately eight percent of the Nation's GDP. With the first of the baby boom generation becoming eligible for Social Security in 2008, Social Security spending will accelerate. Three years later, the problem will become more pronounced as these individuals become eligible for Medicare, under which program costs rise even faster due to health care inflation. By 2050, spending on these three entitlement programs is projected to be more than 15 percent of GDP, or more than twice as large as spending on all other programs combined, excluding interest on the public debt.

The mandatory savings proposals in the 2008 Budget will not solve the Government's long-term fiscal challenges, but they are an important and meaningful step, producing a significant improvement over the long term. Under the President's Budget policies, the deficit in 2050 is projected to be 4.7 percent of GDP. In contrast, if the Congress fails to adopt the President's mandatory proposals and permits current law to remain in force, the deficit in 2050 is projected to be 7.5 percent of GDP. A more detailed analysis of the Government's long-term fiscal outlook is provided in the Stewardship chapter of the *Analytical Perspectives* volume of the Budget.

Social Security: Promised Benefits Outpacing Resources

Social Security was designed as a pay-as-you-go, self-financing program whereby current workers pay taxes directly and indirectly, through their employers, to support the benefit payments for current retirees, disabled persons, and survivors (collectively, beneficiaries). Such a system can only be sustained if the number of workers and the taxes they pay align with the number of beneficiaries and the benefits they receive. In 1950, when there were 16 workers for every program beneficiary, the combined payroll tax rate was very low at 3 percent of taxable wages. Currently, there are 3.3 workers for every beneficiary and the tax rate is 12.4 percent. The ratio of workers to beneficiaries is expected to decline further as the first of the baby boom generation becomes eligible for Social Security in 2008, and will fall to 2.2 workers per beneficiary in 2030.



Even after the baby boom generation is fully retired, the ratio of workers to beneficiaries will continue to fall, reaching 1.9 in 2080 primarily because of the growing difference between projected life expectancy and the age at which seniors become eligible for Social Security benefits. The increase in longevity, coupled with the fact that Americans are spending fewer years in the workforce, means that Americans are spending a greater proportion of their lives in retirement than ever before. Since 1940, life expectancy at age 65 has increased by approximately 40 percent and is projected to increase by an additional 20 percent by 2080.

The growth in retirees resulting from the retirement of the baby boom generation and increases in life expectancy will create a large and rapidly growing mismatch between scheduled Social Security benefits and the resources available to the program under current law. Through 2016, Social Security is projected to collect more in cash receipts than it pays in benefits. Beginning in 2017, however, Social Security benefit payments are projected to exceed the cash income dedicated to the trust funds. From this point forward, the Federal Government must borrow, tax, or cut other spending to pay excess Social Security benefits. Receipts are projected to continue falling to 70 percent of promised benefits by 2080.

There are many ways to summarize the extent of the mismatch between expected Social Security receipts and benefits. One such summary is the discounted present value of all future scheduled benefits net of receipts, or unfunded obligations under Social Security. The concept is to compare scheduled benefits and receipts under current law into the indefinite future, and to recognize through discounting that a dollar tomorrow is worth less than a dollar today. Based on the 2006 Social Security Trustees' Report, the unfunded obligation of Social Security totals $15.3 trillion over the indefinite future. To put this figure into perspective, this is about three times the amount of Federal debt currently held by the public.

The President is committed to strengthening Social Security through a bipartisan reform process in which participants are encouraged to bring different options for strengthening Social Security to the table. The President has identified three goals for reform: to strengthen permanently the safety net for future generations without raising payroll tax rates; to protect those who depend on Social Security the most; and to offer every American a chance to experience ownership through voluntary personal retirement accounts.

The 2008 Budget again reflects the President's proposal to allow workers to use a portion of the Social Security payroll tax to fund voluntary personal retirement accounts. These accounts will permit Americans to have greater control over their retirement planning, giving them an opportunity to obtain a higher return on their payroll taxes than is possible in the current Social Security system. The result will be to shift Social Security from an entirely pay-as-you-go system of financing toward a system that is less dependent on current workers. Beginning in 2012, workers will be allowed to use up to four percent of their Social Security taxable earnings, up to a $1,300 annual limit, to fund their personal retirement accounts; the $1,300 cap will be increased by $100 each year through 2017.

As one component of reforms to make the system sustainable, the President has embraced the idea of indexing future benefits of the highest-wage workers to inflation while continuing to index the wages of lower-wage workers to wage growth. Over time, wages tend to rise faster than prices, and so "progressive indexing" provides a higher rate of indexing for lower-wage workers than for higher-wage workers. This proposal would help restore the solvency of Social Security, while protecting those who most depend on Social Security. Comprehensive Social Security reform including personal retirement accounts, changes in the indexation of wages, and other modest changes will ensure the sustainability of the program for future generations, and help slow the unsustainable growth in total entitlement spending.

Health Care: Reforms to Improve Quality and Reduce Cost

The Nation spends more than $2 trillion per year on health care, permitting Americans to live longer and healthier lives than at any time in the Nation's history. The Federal Government is the Nation's largest purchaser of health care, accounting for approximately one-third of U.S. health care spending. As a result, economic developments in the health care sector, including the high rate of growth in health care inflation that confronts individuals and companies, are becoming acute fiscal problems for individuals and businesses, and for the Federal Government. Despite an enormous investment and enormous gains in the quality of care overall, health care inflation, the extent of private health care insurance coverage, and gaps in the availability of high-quality care are problems the Nation continues to face.

The 2008 Budget proposes a number of reforms to improve the Nation's health care system. The Administration is proposing a significant change in the tax treatment of health insurance purchases and expenditures for out-of-pocket health care costs. Under this proposal, all individuals and families who buy at least a catastrophic health plan will receive the same tax benefits, in the form of a flat $15,000 deduction. The Administration's proposal will make health insurance more affordable for millions of American families and reduce the number of the uninsured. This policy will also eliminate the tax bias toward high-cost insurance, making health care purchasers more price conscious and thereby marshalling market forces more effectively to restrain health care inflation. The Administration continues to promote the use of health information technology to enhance the health care delivery system, including the availability of price and quality information to individuals. This would allow health care consumers to spend their health care dollars more wisely, and avoid unnecessary procedures and treatments.

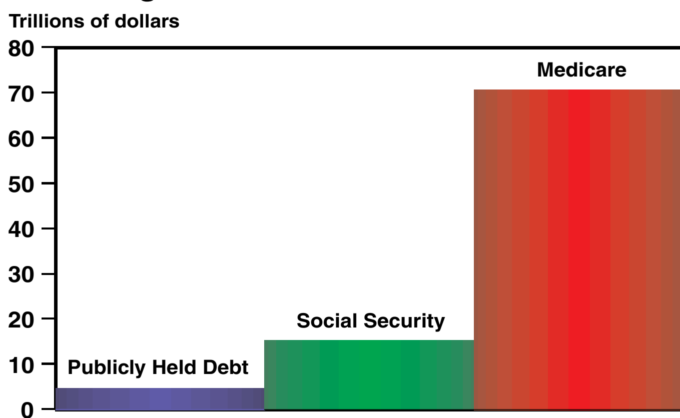
The President has also asked the Secretary of Health and Human Services to work with the Congress and the States on an Affordable Choices Initiative to redirect existing resources in the health care system to help poor and hard-to-insure citizens afford private insurance. This initiative would help avoid costly and unnecessary emergency room visits and improve health care quality and efficiency.

Medicare: Slowing Cost Growth through Reforms

The single largest fiscal challenge we face is the unsustainable growth in the Medicare program. The Medicare Part A Hospital Insurance program receives designated payroll taxes from employees and their employers, which are deposited in the Medicare trust fund held by the Government. Medicare Part A is therefore similar to Social Security in that it is an inter-generational transfer program with current workers paying benefits for current beneficiaries. In contrast, under Medicare Part B, the Supplementary Medical Insurance program, and Part D, the new drug benefit, beneficiaries pay premiums to cover some of the costs and the balance is paid out of general revenues.

As in the case of Social Security, Medicare will face increased cost pressures over the next several decades as the baby boom generation becomes eligible for and receives Medicare benefits. But because of rising health care costs, Medicare is projected to have much higher cost-per-beneficiary growth than Social Security in the coming decades.

Medicare's dedicated revenues from designated payroll taxes and from premium payments cover only 57 percent of current benefits. The remaining 43 percent is financed from general tax revenues. By 2030, the pressure from Medicare on general revenues will be substantially greater as dedicated revenues are projected to finance only 38 percent of total benefits, leaving 62 percent of program costs relying on general tax revenues. This projected rate of growth in Medicare benefits is not sustainable over time.



The 2006 Medicare Trustees' report shows that future dedicated payroll taxes and premiums are sufficient to cover only a portion of Medicare's projected costs. This results in an unfunded obligation (the gap between dedicated receipts and projected costs) of $71 trillion over the infinite horizon. This is more than four times as large as the gap between receipts and projected costs for Social Security and 14 times as large the total amount of Government debt that is held by the public. Within Medicare, the Hospital Insurance trust fund, which is mostly funded by the Medicare payroll tax, has unfunded obligations, or a gap between dedicated receipts and projected costs, of $28 trillion. Meeting these obligations would require tripling the Medicare payroll tax. If the Medicare payroll tax were used to pay for Medicare's entire $71 trillion unfunded obligation, the Medicare payroll tax would have to be increased by 500 percent. This would be a huge tax increase on workers and companies that would cripple the Nation's economy. The only realistic solution is to reduce program growth to a sustainable level.

In the long run, part of the solution to Medicare and Medicaid's unsustainable growth must lie with slowing health care inflation. Recent trends in the overall health care market have already improved Medicare's finances. Spending on the Medicare drug program has been lower than originally expected because of lower-than-projected growth in prescription drug inflation. Medicare drug program spending in 2006, the first year of the benefit, was $15 billion lower than initially estimated. In addition, the drug program spending for 2007 is projected to be $25 billion lower than initially estimated, and for 2007 through 2016 the spending is projected to be $189 billion lower. The slower growth in prescription drug prices has been good for beneficiaries as well. Beneficiary premiums for

the drug benefit are lower than expected: an average of $22 per month in 2007 rather than $39 per month as initially estimated. Controlling health care inflation is critical to the success of reform, but other significant reforms are also needed.

With an unfunded obligation of $71 trillion, and annual increases in spending well above inflation and other domestic spending, there has been increasing focus on the need to address Medicare growth rates. The 2008 Budget proposes to restrain Medicare spending both in the near term and in the long term. These proposals save $66 billion over five years and reduce the present value of future net costs by an estimated $8 trillion over 75 years. These are sensible reforms, most of which have been proposed in previous budgets. The aggregate impact of the proposed reforms only slows the rate of growth of the Medicare program from 7.4 percent over 10 years to 6.7 percent.

To achieve these savings, the Budget proposes to promote high-quality and cost-efficient care through competition and innovation. Specifically, the Budget proposes to adjust permanently provider payments to encourage efficiency and productivity, taking advantage of advances in medical technology and the delivery of care, and other management improvements. The Budget also proposes to establish competitive bidding for clinical laboratory services.

The Budget also proposes to encourage greater responsibility for health care use and costs for high-income beneficiaries. In addition, the Budget proposes to modernize and rationalize Medicare policies to encourage efficient and cost-effective payments. For example, the Budget proposes to ensure that patients are served in the most medically appropriate and cost-efficient setting for post-acute care, and that payments for medical equipment be brought in line with actual costs.

In addition to proposing specific reforms to reduce the unsustainable rate of growth in the near term, the Budget also proposes a new mechanism to address the long-term funded unfunded obligation in Medicare. The Budget proposes to build on the progress made in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) with respect to Medicare financing. Under current law, MMA requires the Medicare Trustees issue a "funding warning" if, for two consecutive years, the Trustees find that more than 45 percent of projected Medicare expenditures will require funding from general tax revenue (rather than dedicated resources) within the next six years. In the 2006 Trustees' Report, the Trustees found that general revenue funding would first reach the 45 percent level in 2012, within the seven-year window specified in the MMA.

The 2008 Budget proposes to add an incentive for reform to the MMA funding warning. Specifically, in the year in which the 45 percent threshold is exceeded, there would be automatic payment reductions to providers by four-tenths of one percent per year. The provider payments would continue to be reduced by an additional four-tenths of one percent per year, as long as Medicare's receipts cover 55 percent or less of program costs. The provision is intended to encourage the Congress and the Administration to reach agreement on reforms needed to slow the growth in program costs.

Medicaid: Proposals Ensure Fiscal Integrity

Medicaid is the Federal entitlement program that provides medical assistance, including acute and long-term care, to low-income families with dependent children and to low-income individuals who are elderly, blind, or disabled. As with Medicare, Medicaid costs will increase substantially in the coming decades as the baby boomers retire and begin to have greater health care needs. An increasing number of low-income elderly individuals will come to rely on Medicaid for non-hospital care, including long-term care. In addition, as with Medicare, Medicaid will be under increasing fiscal pressure in the coming decades as a result of health care inflation.

The President's Budget proposes a package of program integrity reforms. These reforms save approximately $6.8 billion over five years, including additional increased funding for the State

Children's Health Insurance Program (SCHIP). The Budget builds on previous initiatives, some of which were included in the Deficit Reduction Act of 2005, to promote sound financial practices, increase market efficiencies, and eliminate Medicaid overpayments. The proposals included in the 2008 Budget help to ensure the fiscal integrity of Medicaid by lowering its rate of growth. These proposed changes reduce the rate of growth of Medicaid from 7.7 percent to 7.6 percent over the next 10 years.

BUDGET REFORMS

During the 1990s, budget decisions were governed by the now-expired Budget Enforcement Act (BEA). Under the BEA, discretionary spending (including both budget authority and actual outlays) was limited each fiscal year to a maximum amount specified in law. In addition, under the BEA, pay-as-you-go rules required all legislation involving new mandatory spending or tax cuts was required to be deficit neutral. Violations of the discretionary spending caps or the pay-as-you-go provisions triggered across-the-board spending reductions. The BEA generally succeeded in preventing the Government's budgetary outlook from deteriorating.

Based in part on the spending controls in the BEA, the President has proposed a number of budget process reforms, including new caps on discretionary spending, a pay-as-you-go requirement for mandatory spending, a line-item veto, and earmark reform. In addition, the Administration implemented its own pay-as-you-go controls to limit mandatory spending resulting from agency administrative action. Specifically, on May 23, 2005, the Office of Management and Budget (OMB) began requiring that proposed agency administrative action that increases mandatory spending be offset by administrative actions that reduce mandatory spending by the same amount.

Federal spending is generally divided into three major categories: discretionary spending (approximately 38 percent of the Budget), mandatory spending (53 percent), and interest on the debt (9 percent).

Discretionary Spending Caps: Restraining Annual Appropriations

Discretionary spending is generally thought of as funding the day-to-day operations of Government and is the only spending subject to annual review and appropriations by the Congress and the President. As distinct from mandatory spending, discretionary spending must be enacted into law every year before Government agencies may obligate and spend money. Hence, discretionary spending is not subject to the same automatic, uncontrolled growth characteristic of some mandatory spending. Nevertheless, without active restraint reinforced by effective rules governing the legislative process, discretionary spending will tend to increase steadily over time. The 2008 Budget proposes to reinstate BEA controls on discretionary spending. Specifically, the Budget proposes placing statutory limits or "caps" on discretionary spending each year through 2012. Any appropriations bill that causes the caps to be exceeded would be subject to a point of order, requiring a three-fifths vote, in the Senate. If, in the aggregate, appropriations actions exceed the spending caps, then OMB would be required to make across-the-board cuts to reduce total discretionary spending to the statutory caps.

Within these proposed spending caps, the Budget proposes to devote resources for program integrity efforts. Program integrity efforts are designed to eliminate spending to those not eligible for benefit payments and to collect unpaid taxes due to the Government. Since program integrity efforts can generate as high as a ten-to-one return to the Government, the Administration proposes an adjustment to the statutory discretionary spending limits for amounts dedicated to program integrity.

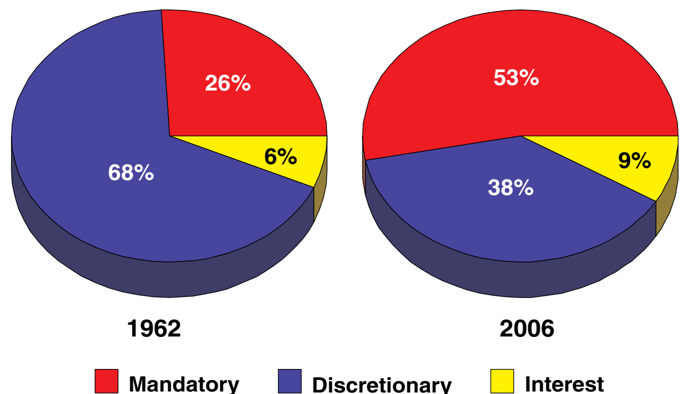
Mandatory Spending Controls: Restraining Automatic Spending

The vast majority of spending for mandatory programs takes place automatically every year without any action on the part of the Congress or the President. It is made up of "entitlement" programs, for which the amount of spending is based on the number of qualifying beneficiaries and benefit formulas specified in law. This spending provides income security and health care to individuals who are elderly, disabled, widowed, or orphaned. These programs are effectively exempt from the annual review and approval in the budget process because the benefit qualifications and benefit formulas are specified in law, resulting in an automatic appropriation of benefit payments.

In 1962, mandatory spending accounted for just over one-quarter of total Government outlays and discretionary spending accounted for slightly more than two-thirds of Government outlays; the remainder of outlays was for interest. Today, the picture is dramatically different, with mandatory spending having doubled as a share of total outlays, now accounting for 53 percent of all Government spending. Without intervention, entitlement spending over the next four decades will become unsustainable. With the baby boom population beginning to become eligible for Social Security in 2008 and Medicare in 2011, the time to address this problem is now.

The 2008 Budget proposes to place limits on new mandatory spending. In addition to the proposal to address excessive general revenue spending in Medicare, discussed above, the Budget also proposes a pay-as-you-go requirement such that any legislation that increases mandatory spending be offset by reductions in other mandatory spending. Any legislation that increases mandatory spending without an equal offset would be subject to a point of order, or a three-fifths vote in the Senate. If, at the end of a Congressional session, the enacted new mandatory spending legislation increases the deficit, then OMB would be required to make across-the-board cuts to non-exempt mandatory programs to eliminate any increase in the deficit.

Mandatory Spending is Overwhelming the Rest of the Budget



In addition, the Budget proposes to adopt a new measure to limit legislated expansions in spending for Social Security, Supplemental Security Income, Medicare, Federal civilian and military retirement, and veterans disability compensation. The new measure would be the change in the actuarial unfunded obligations for each of these programs. The Administration is proposing that any legislation that has the effect of increasing the actuarial unfunded obligation for any of these programs be subject to a point of order, or a three-fifths vote in the Senate.

Earmarks: Reforms to Ensure Tax Dollars are Spent Wisely

An earmark is a spending provision the Congress inserts in legislation. Frequently, these provisions are not publicly disclosed during the legislative process and often they are special interest projects. A number of organizations track earmarks. The Congressional Research Service (CRS) and Citizens Against Government Waste (CAGW) have been tracking earmarks for over a decade. While they do not use the same definition, their data show similar trends. Earmarks have expanded dramatically in recent years, with the numbers and costs of earmarks more than tripling since the early 1990s. According to CAGW, the Congress added nearly 550 earmarks at a cost of $3 billion to

the Budget in 1991. The number of earmarks peaked in 2005. CAGW has estimated that earmarks grew to almost 14 thousand at a cost of $27 billion. CRS data show a similar trend, with earmarks reaching more than 16 thousand in 2005 at a cost of $52 billion. OMB has also been tracking earmarks during recent years and estimates that the number of earmarks grew to over 13 thousand at a cost of nearly $18 billion. OMB is in the process of developing the capability to track earmarks during the legislative process.

One major concern about earmarks is the lack of transparency. Most earmarks do not appear in statutory language. Instead, they are included in committee reports that accompany legislation. According to CRS, more than 90 percent of earmarks are in report language. This means that the vast majority of earmarks do not appear in the statutory language that the Congress actually votes on or that the President signs into law. Also, earmarks frequently surface in the late stages of the legislative process, in conference committees between the House and Senate.

The President has called on the Congress to fully disclose all earmarks to reduce the amount of wasteful and unnecessary spending. Taxpayers should feel confident that their tax dollars are being spent wisely. Unfortunately, the large number of earmarks and the lack of transparency in the earmarking process make it difficult to assure the public that the Government is spending the people's money on the Nation's highest priorities. The President has proposed that the Congress provide justification for earmarks, and identify the sponsor, costs, and recipients of each project. In addition, the President has proposed that the Congress stop the practice of placing earmarks in report language. Finally, he has called on the Congress to cut the number and cost of earmarks by at least 50 percent.

Line-Item Veto: A Tool to Reduce Wasteful Spending

The President is again proposing that the Congress enact a legislative line-item veto to improve the budget process. Forty-three of the Nation's governors have a line-item veto, authority that permits them to identify and eliminate wasteful and unnecessary spending.

From the Nation's founding, Presidents have exercised the authority not to spend appropriated sums. However, the Congress sought to curtail this authority in 1974 through the Impoundment Control Act, which restricted the President's authority to decline to spend appropriated sums. The Line-Item Veto Act of 1996 attempted to give the President the authority to cancel spending authority and special interest tax breaks, but the U.S. Supreme Court found that law unconstitutional. The President's proposal is designed to correct the constitutional flaw in the 1996 Act.

The legislative line-item veto would give the President and the Congress an effective tool to eliminate wasteful spending and special interest tax breaks. Under the President's legislative line-item veto proposal, if the Congress were to pass legislation that includes wasteful spending or targeted tax benefits, the President could send back to the Congress the individual items for an up-or-down vote without amendment under fast-track legislative procedures. If the Congress were to pass the package of line items that the President proposes for cancellation, all savings would be used for deficit reduction and could not be used to augment other spending.

Results and Sunset Commissions: Focusing on Performance

In his 2008 Budget, the President proposes to create bipartisan Results Commissions and a Sunset Commission. Results Commissions would consider ways to restructure or consolidate programs or agencies where duplication or overlapping jurisdiction has been identified as an obstacle to performance. Proposals from Results Commissions would be reviewed and if approved by the President, transmitted to the Congress to be considered under expedited procedures. The Sunset Commission would consider Presidential proposals to retain, restructure, or terminate agencies and programs

according to a schedule set by the Congress. Agencies and programs would automatically terminate according to the schedule unless reauthorized by the Congress.

Other Reforms: Increasing Order and Accountability in the Budget Process

In addition to the proposals directed at restraining spending and improving Government program and agency performance, the Budget proposes several changes to the budget process that would enhance accountability, improve management, and bring greater order to the budget process. Specifically, the Budget proposes a joint budget resolution, biennial budgeting, and a means to prevent Government shutdowns.

The Budget proposes a joint budget resolution that is passed by the Congress and signed by the President. The current budget resolution does not require the President's signature and, therefore, does not have the force of law. A joint budget resolution would bring the President into the process at an early stage, allowing the President and the Congress to reach agreement on overall fiscal policy before individual tax and spending bills are considered.

The Budget proposes biennial budgeting for all Executive Branch agencies, programs, and accounts in which two-year appropriations bills would be enacted in each odd-numbered year. This would permit the Executive Branch to engage in better mid-term and long-term planning, and improve fiscal management. It would also permit the Congress to engage in more extensive oversight.

The Budget proposes to prevent Government shutdowns by allowing funding to be automatic for those agencies, programs, or accounts for which an appropriations bill has not been enacted by the start of the fiscal year. If an appropriations bill has not been enacted, funding would be automatically provided at the lower of the President's Budget or the prior year's enacted level. This proposal would prevent Government shutdowns and would prevent the uncertainty and confusion that arises when the Congress enacts continuing acts or continuing resolutions.

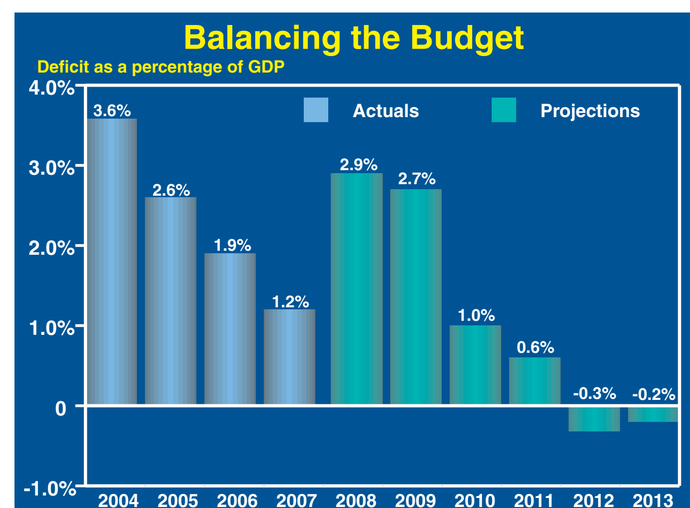
THE NATION'S FISCAL OUTLOOK

The President's 2009 Budget proposes to boost near-term economic growth, restrain spending, and reform entitlements, leading to a balanced budget by 2012 and a more fiscally prudent path for the long term. By adopting pro-growth economic policies and spending restraint, the President has succeeded in reducing the deficit. The deficit fell in 2007 for the third year in a row and was very low by historical standards. Despite these recent improvements in the deficit and an economy that retains a solid foundation, short-term economic challenges exist and the strong economic growth of the last few years cannot be taken for granted. The 2009 Budget includes an economic growth package that will provide temporary and immediate tax relief to bolster consumer spending and business investment in order to maintain a healthy economy and ensure that the Budget remains on a path to balance.

While achieving a balanced budget in 2012 is important, the longer-term budget outlook remains sobering. Rising health care costs and the aging of the Nation's population are expected to put enormous and unsustainable pressures on Medicare, Medicaid, and Social Security. The 2009 Budget proposes to begin addressing the Nation's long-term fiscal challenges by reforming these programs in a sensible way. The President is committed to meaningful entitlement reform that will preserve these vital programs for future generations.

BALANCING THE BUDGET IN THE NEAR-TERM

The 2009 Budget continues to reflect the President's priorities of promoting economic growth and restraining Federal spending, which benefit both taxpayers and the Nation's treasury. The September 11th terrorist attacks, the subsequent Global War on Terror, and Hurricane Katrina all put significant fiscal pressures on the Federal budget. Despite these challenges, the deficit fell $250 billion in the last three years.

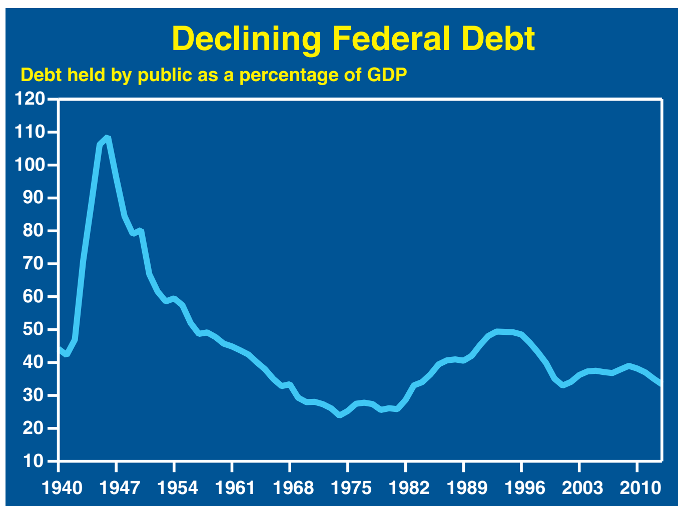


For 2007, the deficit was $162 billion, lower than the deficits in each of the previous four years. To compare annual deficits over a period of time, it is helpful to consider the deficit in comparison to the size of the Nation's economy, typically represented by gross domestic product (GDP), or the total amount of final goods and services produced in the economy.

The 2007 deficit was 1.2 percent of GDP, well below the 40-year average of 2.4 percent of GDP. Four years ago, the President announced in his 2005 Budget that by 2009 he would cut the deficit in half from its projected peak. The President achieved his goal three years ahead of schedule, in 2006, when the deficit fell from a projected peak of 4.5 percent of GDP, or $521 billion, to 1.9 percent of GDP, or $248 billion. Last year, the President announced a new goal of balancing the budget. The policies in this Budget continue the effort to reach that goal.

The 2008 deficit is projected to be $410 billion, or 2.9 percent of GDP, and the 2009 deficit is projected to be $407 billion, or 2.7 percent of GDP. The primary reason for increasing deficits in the near term is the President's economic growth package and an expected slowing of receipt growth, due to an expected reduction in corporate tax receipts from recent high levels. Another reason for increases in the projected near-term deficits is increasing defense and emergency spending.

The Budget reflects the full cost of the Global War on Terror for 2008. Actual funding needs for 2009 and beyond will be determined by security conditions in Iraq and Afghanistan, and will continue to be evaluated. In addition, the Budget reflects a one-year extension of Alternative Minimum Tax relief for the 2008 tax year and an allowance for the cost of an economic growth plan. The Budget proposes to allow Americans to invest in voluntary personal retirement accounts beginning in 2013 and makes permanent the President's tax relief. Taken together, the President's policies are expected to lead to fiscal improvements, with a deficit of $160 billion, or 1.0 percent of GDP, in 2010 and surpluses of $48 billion and $29 billion, or 0.3 percent and 0.2 percent of GDP, projected for 2012 and 2013, respectively.



To understand the Nation's fiscal outlook, it is helpful to consider both the budget deficit and the amount of debt held by the public. Debt held by the public reflects the amount of money that the Government has borrowed from outside the Government to finance current and past deficits. Debt held by the public has ranged from 33 to 49 percent of GDP over the past 20 years and averaged 35.6 percent over the past 40 years. At the end of 2007, debt held by the public was $5.035 trillion, or 36.8 percent of GDP, falling from 37.1 percent in 2006. For 2012, debt held by the public is projected to be 35.1 percent, below the long-term historical average. Declining deficits and reductions in the debt held by the public demonstrate that the President's pro-growth policies, coupled with spending restraint, are working to improve the Nation's fiscal outlook.

Promoting Economic Growth

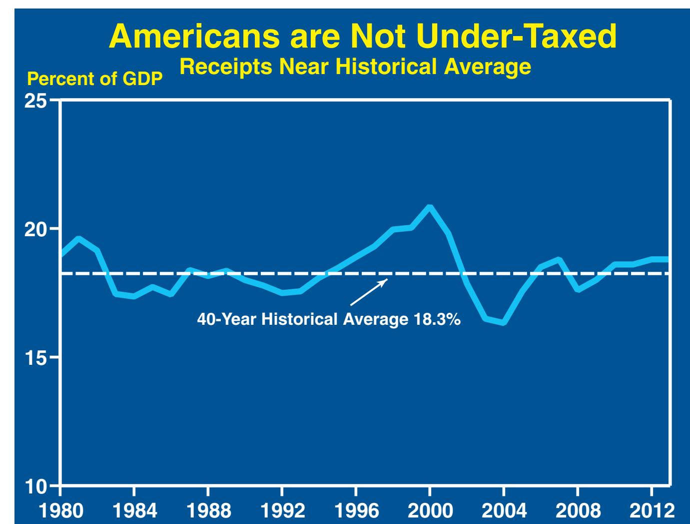
The foundation for the President's pro-growth economic agenda is his tax relief policy. Permitting hard-working individuals to keep a greater portion of their income and encouraging prudent risk-taking among investors create an economic climate in which workers and businesses thrive. Through the President's tax relief efforts, tax rates for individual income, capital gains, dividends, estates and gifts have all been cut. In addition, the President's efforts have doubled the child tax credit, reduced the marriage tax penalty and increased incentives for retirement savings, education savings, and small business investment.

Since the President's tax relief program was fully implemented in 2003, the economy has created more than 8.3 million jobs. The jobs gains and relatively low unemployment reflect the sustained economic growth of the past six years, a period during which real GDP growth averaged 2.8 percent per year.

The growth in tax receipts in recent years has been particularly impressive. 2007 was the third year in a row in which receipts grew faster than GDP. The strong showing in 2007—with tax receipts

of $2.568 trillion, 6.7 percent greater than in 2006—follows two years of double-digit growth in receipts in 2005 and 2006, with 2005 witnessing a 14.5 percent increase and 2006 witnessing an 11.8 percent increase. At 18.8 percent of GDP, receipts for 2007 were above the 40-year historical average of 18.3 percent.

Even with this recent strong economic and receipt growth, 2008 has already shown mixed economic signals and the Administration recognizes that economic growth cannot be taken for granted. For this reason, the Budget reflects an allowance for an economic growth plan that provides an immediate and temporary boost to private-sector spending and investment. The President has called on the Congress to work with him to enact a package that provides tax relief for individuals and tax incentives for businesses, and that is substantial enough to have an impact on the Nation's large and dynamic economy. Any economic growth package should be built on broad-based tax relief and should not include any tax increases.



The 2009 Budget proposes to continue, for the longer term, tax policies that promote entrepreneurship, job creation, and economic growth. The Budget proposes to make permanent those provisions of the 2001 and 2003 tax relief packages that are set to expire at the end of this decade. The Budget also proposes tax modifications to close loopholes, simplify the tax code for families, increase compliance, promote retirement savings, increase small business investment, and make health care affordable for all Americans.

In addition to tax relief, the President will continue to promote economic growth through many other initiatives. Specifically, the Administration is working to: advance basic research and development; promote innovation and accountability in education; reduce the paperwork burden and unnecessary regulations imposed on business; reduce costly and unnecessary litigation; open new markets for American exporters; and advance pro-growth energy policies.

Protecting Americans

Keeping Americans safe, both at home and abroad, continues to be the President's top priority, and the President believes that being both safe and free is essential to the Nation's continued prosperity. In his 2009 Budget, the President proposes funding levels that will continue the Global War on Terror militarily and diplomatically, and that will transform the military for the 21st Century.

Between 2001 and 2007, security spending increased 48 percent overall. Spending increased 43 percent for the Department of Defense, 219 percent for homeland security, and 46 percent for international affairs (non-homeland). These increases were essential after the September 11th terrorist attacks on the Nation's homeland.

The 2009 Budget proposes an 8.2 percent increase in total security spending. A 7.5 percent increase for defense will be used to maintain a high level of military readiness that can support the Global War on Terror and respond, if necessary, to other military threats. In addition, the defense increase will be used to continue to transform the military to ensure that it has the flexibility to meet ever-changing defense challenges. To protect the Nation's homeland, the Budget proposes a 10.7 percent increase in funding for improving nuclear detection capabilities, expanding cyber security protections, securing

the Nation's borders and removing those individuals in the country illegally, and developing stronger identification and screening capabilities. To support the Nation's diplomatic and international development efforts overseas, the Budget proposes a 14.9 percent increase for international affairs. These funds will be used primarily to support key allies in the Global War on Terror and improve response to international crises, to promote democracy throughout the world, to expand education for the world's poorest children, and to combat global HIV/AIDS and malaria.

Slowing Growth in Non-Security and Entitlement Spending

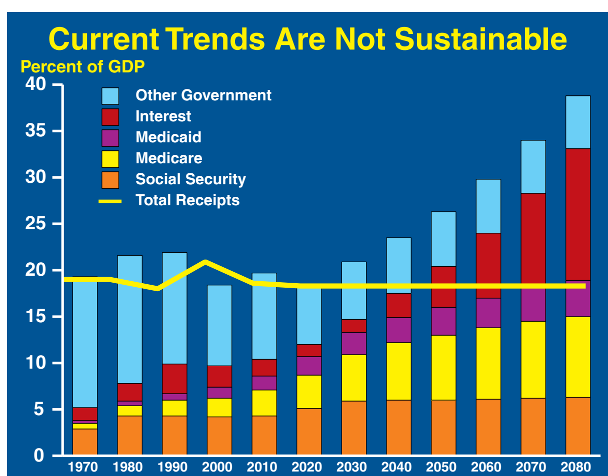
Several years of strong receipt growth and spending restraint have improved the near-term budget outlook. Total outlays for 2007 were $2.73 trillion, or 20.0 percent of GDP, slightly below the 40-year historical average of 20.6 percent. Outlays in 2007 were only 2.8 percent higher than in 2006, representing the smallest percentage increase in outlays in 10 years.

The Budget will maintain 2009 outlays as a share of GDP at close to the historical level of 20.6 percent by restraining non-security spending and entitlement growth. The Budget proposes sensible reforms to entitlement programs that result in savings of $16 billion in 2009, $208 billion over the five-year budget horizon and $619 billion over the 10-year horizon. In total, the Budget proposes to eliminate or reduce 151 discretionary programs, saving over $18 billion in 2009.

As discussed below, the majority of entitlement savings, $603 billion over the 10-year period, are derived from reforms to Medicare and Medicaid. In addition to changes to Medicare and Medicaid, the Budget proposes to increase premiums paid to the Pension Benefit Guaranty Corporation, eliminate Social Services Block Grants, terminate the Perkins loan program, and modify the Disability Insurance program.

FACING FUTURE BUDGETARY CHALLENGES

For the near-term, the 2009 budget deficit is projected to equal 2.7 percent of GDP, with smaller deficits in the years that follow and small surpluses projected beginning in 2012. Although the five-year budget horizon projects manageable deficits by historical standards, and even small surpluses beginning in 2012, the long-term outlook is much less optimistic.



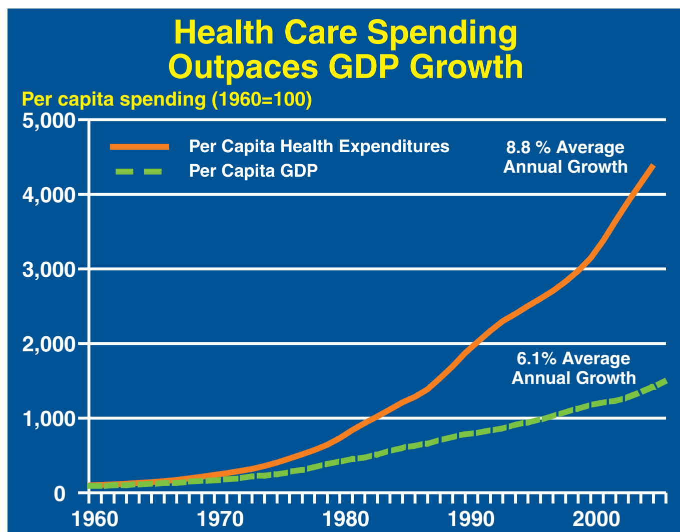
Long-term projections of all Government programs and interest on Government debt show that by 2080, the deficit could exceed 20 percent of GDP if receipts are held at the 40-year historical average of 18.3 percent of GDP. In addition, these deficits could lead to unsustainable levels of borrowing, with debt held by the public exceeding 280 percent of GDP by 2080.

To understand how the Nation might avert a fiscal crisis, it is helpful to review how the Nation arrived on its current fiscal path. In 1970, spending on the Government's three largest entitlement programs—Medicare, Medicaid, and Social Security—was equal to 3.8 percent of GDP. This figure has more than doubled, reaching 8.4 percent today. If health care costs continue to outpace inflation, 75 years from now spending on these three programs is projected to be 19 percent of GDP. This means that in 2080

these three programs alone could account for about as much spending, expressed as a percentage of GDP, as total Government spending does today.

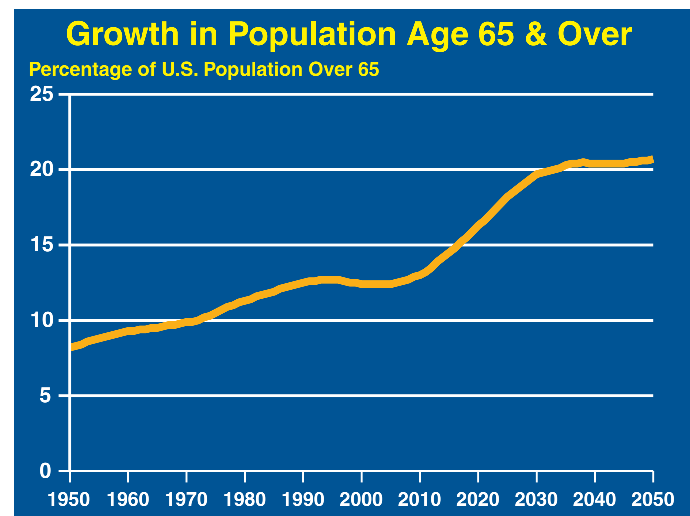
Health Care Costs and Longer Life Expectancy Impact Federal Programs

The reasons for the projected dramatic increases in costs for Medicare, Medicaid, and Social Security are growing health care costs and an aging population.



First, since 1960, health care costs have grown 2.7 percentage points faster per year than the economy as a whole. This growth in overall health care costs is particularly problematic for the Federal Government because it is the Nation's largest purchaser of health care, accounting for approximately one-third of all health care spending in the country. The Government provides health care to seniors and low-income individuals through its two largest health care programs, Medicare and Medicaid, and to veterans, active duty military, and civilian personnel through a number of other programs. In 1966, Medicare and Medicaid accounted for only 1 percent of all Government expenditures, but now they account for 20 percent. The Medicare program's Board of Trustees assumes that Medicare costs will continue to outpace overall economic growth by an average of 1 percent per year over the next seven decades.

Second, beginning this year, the first of the Nation's 78 million baby boomers, those individuals born between 1946 and 1964, will begin to collect retirement benefits under Social Security. Three years from now, beginning in 2011, these oldest baby boomers will be eligible for Medicare benefits. Compounding this unprecedented growth in new beneficiaries are the continued growth in life expectancy and the decline in the working population relative to the retired population. Over the next 25 years, the share of the population aged 65 and older is forecast to increase from 12 percent to 20 percent, and the share of the population that is working in paid employment is forecast to fall from its current 60 percent to 55 percent.



The first factor affecting the Government's long-term costs, health care cost growth, cannot be predicted with certainty, but can be influenced significantly by Government policies. The second factor, the aging of the Nation's population, can be predicted with a fair degree of certainty. The Budget takes into account these economic and demographic realities by proposing practical policy changes to alleviate some of the long-term fiscal pressure that the Government will be facing. In an

attempt to reduce the growth in overall health care costs and the costs of Medicare and Medicaid in particular, the Budget is proposing a number of health care reforms. In addition, the Budget proposes several sensible reforms to Social Security. These proposals, coupled with other Budget proposals, are important and meaningful steps to putting the Nation on a more prudent fiscal path.

Strengthening Social Security

Because of the increase in the number of retirees, increasing life expectancy, and the resulting decline in the number of workers relative to the retiree population, Social Security benefit payments are projected to exceed the program's dedicated cash income beginning in 2017. This mismatch between benefit payments and cash income must be addressed, and the sooner it is addressed, the more moderate and fair the changes to the program can be.

The President is committed to strengthening Social Security and supports a bipartisan reform process in which all participants are encouraged to bring options for strengthening Social Security to the table. The Budget reflects the President's proposal to allow workers to use a portion of the Social Security payroll tax to fund voluntary personal retirement accounts. These accounts would give Americans an opportunity to build a nest egg and pursue a higher return on their payroll taxes than is possible in the current system, thereby giving them greater control over their retirement finances. Under the President's proposal, beginning in 2013 workers will be allowed to use up to four percent of their Social Security taxable earnings, up to a $1,400 annual limit, to fund their personal retirement accounts. The $1,400 cap will be increased by $100, adjusted for wage growth, each year beginning in 2014 and continuing until 2018.

The President has also embraced the idea of progressive indexing as part of a solution to restore Social Security to sustainable solvency. Over time, wages tend to rise faster than prices. Currently, the first Social Security payment that a person receives is based on a formula that indexes an individual's earnings to the rate of growth in wages. Under progressive indexing, a lower wage earner would continue to have his or her earnings indexed to wage growth, but a higher wage earner would have his or her earnings indexed to inflation; middle-income workers would receive benefits that are indexed in part to wage growth and in part to inflation. By providing a higher rate of indexing for lower wage workers than for higher wage workers, progressive indexing protects those who most rely on Social Security.

REFORMING HEALTH CARE

In his Budget, the President proposes reforms to the Nation's health care system including private health insurance and the Federal health care programs of Medicare, Medicaid, and the State Children's Health Insurance Program (SCHIP). The President's proposals are designed to give all Americans access to affordable health care and to address the cost pressures health care places on the economy and the Federal budget.

The President proposes replacing the existing—and unlimited—tax exclusion for employer-sponsored insurance with a standard health insurance tax deduction. As long as families have at least a catastrophic health insurance policy, they will be able to deduct $15,000 from their income ($7,500 for an individual). This will foster a true marketplace for health care, encourage competition, improve the efficiency of the system, and reduce the ranks of the uninsured.

The Budget also proposes three initiatives to restructure health insurance markets. The first will establish association health plans to allow small employers, civic groups, and community organizations to use collective purchasing power to negotiate lower-priced coverage for their employees, members, and their families. The second will create a competitive marketplace across State lines,

which will maintain strong consumer protections. The third will reform medical liability law to increase access to high-quality, affordable health care for all Americans and to reduce frivolous, time-consuming legal proceedings against doctors and health care providers.

The President continues his commitment to consumer-focused policies that emphasize transparency of price and quality information. The Budget proposes to modify the standard IRS W-2 form to require employers to include the amount they paid for health insurance premiums on each employee's behalf. Additionally, the Budget contains a package of proposals that promote the use of health savings accounts, including allowing health plans with at least 50 percent coinsurance to qualify as high-deductible health plans.

To help States offer health insurance options to hard-to-insure populations, the President proposes $75 million in both 2009 and 2010, as authorized by the State High Risk Pool Funding Extension Act of 2006.

Fostering Affordable Choices in the Health Care System

Over the past year, the Secretary of Health and Human Services (HHS) has spoken with various health care stakeholders, including the Nation's governors and Members of Congress, about opportunities to improve access to affordable insurance.

The Federal Government's current system of paying for health care results in billions of dollars being spent inefficiently through a patchwork of subsidies and payments to providers. In addition to directly funding the costs of health care for enrollees, the Medicare and Medicaid programs make separate payments that subsidize a provider's operating expenses or fund indirectly the cost of uncompensated care. The health care system could operate more efficiently if some portion of these separate payments to institutions were redirected to help people with poor health or limited income afford health insurance. The uninsured often use emergency rooms as a source of primary care, which leads to suboptimal care and spending outcomes. If this spending were focused on helping the uninsured purchase private insurance, people would receive the care they need in the most appropriate setting.

The health care system needs to be transformed in a way that avoids costly and unnecessary medical visits and emphasizes up-front, affordable private health insurance options. This transformation could happen by subsidizing the purchase of private insurance for low-income individuals. However, any such health care reforms need to be State-based and budget neutral within health care spending, and must not result in the creation of a new entitlement program or affect savings proposed in the President's Budget. The Federal Government would maintain its commitment to the neediest and most vulnerable populations, while acknowledging that States are best situated to craft innovative solutions to move people into affordable insurance.

Preserving Quality, While Slowing the Unsustainable Growth in Medicare

The Medicare program, established in 1965, offers health care services to individuals aged 65 and older and certain people with disabilities. In 2007, nearly 44 million people were enrolled in the Medicare program. Medicare has traditionally consisted of two parts: Hospital Insurance, also known as Part A, and Supplementary Medical Insurance, also known as Part B. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) reformed Medicare by providing new voluntary prescription drug coverage, also known as Part D, which began on January 1, 2006. In addition, the MMA created the Medicare Advantage program, also known as Part C, which offers greater choices and higher-quality care to beneficiaries through competition among private health plans. These programs offer Medicare beneficiaries additional coverage, more choice, and health care savings.

According to the 2007 Medicare Trustees' Report, Medicare's dedicated revenues from designated payroll taxes and from premium payments covered 59 percent of benefits in 2006. The remaining 41 percent was financed from general tax revenues. By 2030, dedicated revenues are projected to finance only 47 percent of total Medicare benefits, leaving 53 percent of program costs to be funded by general tax revenues. This projected rate of growth in Medicare benefits is not sustainable over the long run.

The Administration is committed to reforming Medicare to ensure efficient and high-quality care and to improve the fiscal sustainability of the program for the future. Currently, Medicare spending is growing at an annual rate of 7.2 percent. The 2009 Budget includes proposals to slow the annual rate of growth in the Medicare program to 5.0 percent. Over five years, these proposals are estimated to produce a total of $178 billion in savings.

Improving Fiscal Sustainability

The Administration is committed to slowing Medicare's rate of growth while also promoting the delivery of high-quality services to program beneficiaries. For two consecutive years, the Medicare Trustees have found that more than 45 percent of projected Medicare expenditures will require funding from general tax revenue (rather than dedicated resources) within the current or next six years. Accordingly, the Budget proposes legislation that will reduce Medicare spending by $556 billion over 10 years and more than $10 trillion over 75 years.

In addition to proposing specific reforms to reduce the unsustainable growth in the near term, the Budget also proposes to address the long-term unfunded obligation in Medicare by adding to the MMA funding warning an incentive for Medicare reform. Specifically, in the year in which the 45-percent threshold is exceeded, provider payments would be automatically reduced by four-tenths of one percent per year. The provider payments would continue to be reduced by an additional four-tenths of one percent per year as long as Medicare's dedicated funding sources cover 55 percent or less of program costs. The provision is intended to encourage the Congress and the Administration to reach agreement on reforms needed to slow the growth in program costs.

Encouraging Provider Competition, Efficiency, and High-Quality Care

Competition and efficiency improve care for beneficiaries by encouraging quality and lowering costs. The 2009 Budget proposes to adjust annual provider updates to encourage implementation of best practices that will restrain costs and improve efficiency. The Budget supports payment reforms for providers, such as hospital value-based purchasing, that do not increase Medicare spending and that encourage providers to administer high-quality, efficient care. In addition, the Budget proposes incentives that encourage high-quality hospital services and reduce medical errors. The Budget also proposes to introduce more competition into Medicare by establishing competitive bidding for clinical laboratory services and accelerating the transition to competitive contracts for fee-for-service claims processing.

Aligning Medicare Payments with Current Costs and Practices

Medicare's payment policies need to be updated to keep pace with evolution in health care treatments and settings. The Budget includes proposals that ensure that patients are served in the most medically appropriate and cost-efficient setting for post-acute care, and that payments for medical equipment and services do not exceed their costs.

Increasing Beneficiary Responsibility for Health Care Choices

One reason for the excessive growth in health care spending is the lack of knowledge consumers have about their health care choices and costs. The Budget proposes to encourage greater individual responsibility for health care use and costs for high-income beneficiaries, who are most able to contribute to the costs of their coverage. This will be facilitated by a number of steps the Administration has taken already that increase the transparency of health care costs and quality, and support greater health care value for Medicare beneficiaries.

Improving Program Integrity

Medicare program integrity efforts have yielded savings from the recovery of overpayments and the collection of criminal fines and penalties from Medicare fraud. The Budget proposes additional funds to address program integrity vulnerabilities.

Promoting Fiscal Responsibility in SCHIP and Medicaid

Established in 1997, SCHIP provides health care coverage to low-income, uninsured children who do not qualify for Medicaid. The Medicare, Medicaid, and SCHIP Extension Act of 2007, P.L. 110-173, extended SCHIP funding through March 31, 2009. The President's Budget includes a robust SCHIP reauthorization proposal that refocuses SCHIP on low-income children, as was originally intended.

Established in 1965, Medicaid is an open-ended health care entitlement financed jointly by the Federal Government and States. The Federal Government pays, on average, 57 percent of Medicaid expenses. In 2009, it will cover approximately 51 million low-income children and families, pregnant women, seniors, and disabled individuals. Federal Medicaid outlays are estimated to be $218 billion.

Focusing SCHIP Coverage on Low-Income Children

The President is fully committed to reauthorizing SCHIP in a fiscally responsible manner. It is critical that SCHIP be reauthorized in a way that continues to cover the Nation's neediest children.

The Administration and the Congress have not been able to find common ground on the best way to reauthorize SCHIP. The Budget includes a fiscally responsible reauthorization proposal that would cover, on average, 5.6 million low-income children by 2013.

When SCHIP was established, the focus was on low-income children, primarily children below 200 percent of the Federal poverty level. The Budget continues to focus on these children by increasing funding to States by $19.7 billion through 2013. The Budget also includes outreach grants of $50 million in 2009 and $100 million in each of the following four years for States, localities, schools, and community-based organizations to reach eligible uninsured children.

At the same time, the Administration proposes policies that will increase the long-term sustainability of SCHIP. The Budget reauthorization proposal helps those who are now uninsured obtain health insurance, but does not move those who now have private health insurance into Government programs. The Budget also clarifies SCHIP eligibility by clearly defining income.

Enhancing Access to and Ensuring Continuity of Health Coverage

The Budget includes proposals to ensure continued access to health care for eligible individuals. First, the Budget proposes to extend coverage through September 30, 2009, for Medicaid beneficiaries who qualify for Transitional Medical Assistance benefits or who qualify for Medicare

Part B premium assistance as Qualified Individuals. Second, the Budget proposes modifications to the Health Insurance Portability and Accountability Act of 1996 to give greater continuity in coverage for Medicaid/SCHIP beneficiaries. Lastly, the Budget proposes modifications that will make it easier for States to implement premium assistance programs.

Strengthening Program Integrity and Accountability in Medicaid

In addition to proposals that enhance access and continuity of coverage, the Budget proposes reforms to improve program integrity, increase State flexibility, and promote cost-effective management of Medicaid dollars. Many reforms build on past efforts by the Congress and the Administration to improve Medicaid fiscal integrity and to increase program efficiencies.

Long-Term Care. To preserve Medicaid for the neediest individuals, the Budget proposes to maintain the home equity limit, which partly determines an individual's eligibility for Medicaid Long Term Care (LTC), at $500,000. The Budget also proposes to give States more flexibility to tailor acute care benefits in a manner that better meets the needs of higher-income LTC populations. The Budget further includes an administrative action to clarify what types of inflation protection must be included in LTC insurance plans offered through the Partnership for LTC program.

Managed Care. To ensure that savings generated by managed care are spent appropriately and to remove ambiguity about how those savings can be used, the Administration will issue a regulation detailing which services are allowable under section 1915(b)(3) of the Social Security Act. Additionally, to give States greater flexibility in coordinating care for special populations, the Budget proposes to allow States to require all Medicaid beneficiaries to be enrolled in managed care. Further, the Administration proposes extending the renewal period for section 1915(b) waivers from two years to three years to simplify program administration.

Prescription Drugs. The President supports market-based prescription drug reforms. The Budget proposes to remove "best price" from the Medicaid rebate calculation to allow manufacturers to negotiate deeper discounts in the private sector without affecting rebate levels. The Budget also proposes to rationalize reimbursement for multiple-source prescription drugs and to implement Medicare-Medicaid drug claim data sharing, which would allow States to better manage beneficiary care.

Reimbursement Reform. The Federal Government generally reimburses States for medical services at the statutory Federal Medical Assistance Percentage (FMAP) and at 50 percent for administrative activities under Medicaid, but exceptions exist. To create consistency and preserve the integrity of the matching structure across Medicaid, the Budget proposes to align reimbursement for family planning services and for premium assistance provided to Qualified Individuals at FMAP. The Budget also proposes to align reimbursement rates for all Medicaid administrative services and case management at 50 percent.

Financing Reforms. The Budget proposes to restructure Medicaid financing to increase program efficiencies and fiscal integrity. The Budget proposes to recoup duplicative administrative payments that were inappropriately included in the Temporary Assistance for Needy Families block grants. Also, the Administration will codify the longstanding HHS policy not to bill Medicaid when services are provided free of charge to the public.

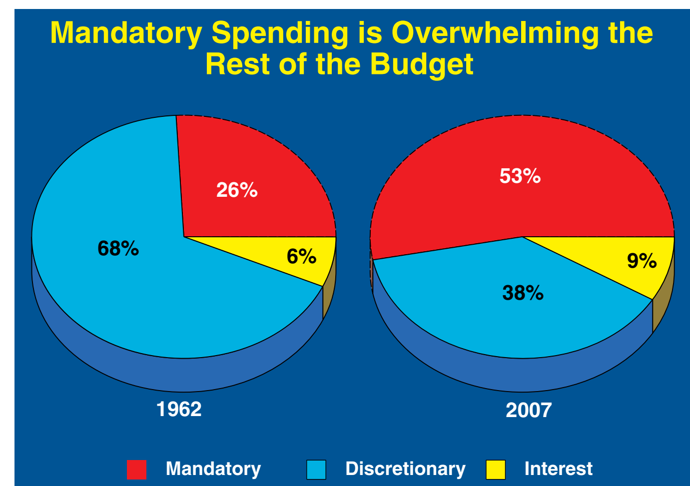
Reducing Improper Payments. The Budget includes proposals that will help States reduce improper payments, including: 1) enhancements to third-party liability law that strengthen Medicaid's position as payer of last resort; 2) two proposals that give States tools to help identify improper provider claims and duplicative benefits received by the same beneficiary in more than one State; and 3) a permanent extension with modifications of a demonstration using web-based tools to verify the assets of Medicaid applicants.

Accountability and Transparency. The Budget proposes to require States to report on performance measures and link State performance to grant awards. The Budget also proposes to require an annual report on Medicaid's financial status.

COMMON-SENSE BUDGET REFORMS

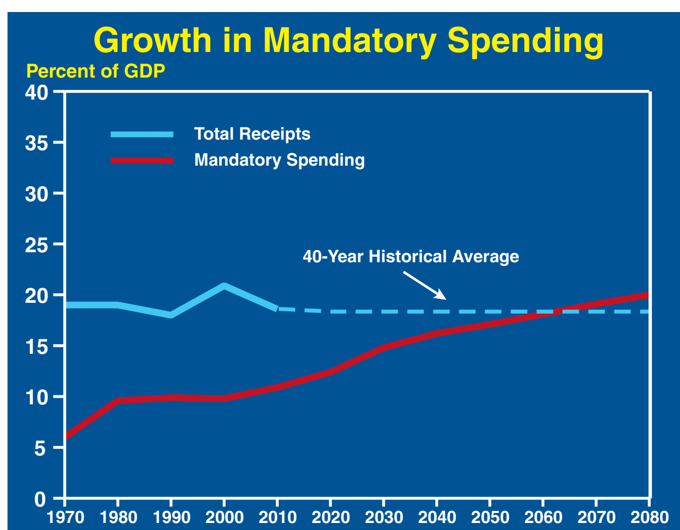
With tax relief and other pro-growth policies, plus his proposals to limit discretionary spending and reduce the future costs of the Nation's major entitlement programs, the President has demonstrated his commitment to fiscal responsibility. In this Budget, the President is again proposing a number of common-sense reforms to improve the way that the Congress and the President make decisions about how best to spend taxpayer dollars.

Restraining Automatic Spending



Nearly two-thirds of all Government spending occurs automatically, without any action by the Congress or the President. This spending includes payments for interest on Federal debt and spending for "entitlement" programs in which the law specifies both the criteria that entitle an individual to a payment from the Government and the formula that establishes the amount of the payment. The automatic nature of spending for entitlement programs ensures that the health care and income needs of seniors and persons who are disabled, widowed, or orphaned will be met. Because interest and entitlement program spending is automatic or "mandatory," the Congress and the President must enact legislation to change the path of this spending.

As a share of total Government spending, mandatory spending has grown dramatically over the past four decades. In 1962, mandatory spending accounted for 26 percent of all Government spending. By 2007 that percentage had more than doubled, reaching 53 percent.



In relation to GDP, mandatory spending has also more than doubled from 1962 to 2007, growing from 4.9 percent of GDP to 10.6 percent. If changes to entitlement programs are not made, mandatory spending is projected to increase to 20 percent of GDP by 2080, which, as a share of GDP, would be roughly equal to total Government spending today. Stated differently, if left unchanged, mandatory spending alone is projected to exceed total projected Government receipts in approximately 50 years.

To prevent the mandatory spending problem from becoming worse while also keeping taxes low, the Budget proposes to impose a new

statutory pay-as-you-go requirement on any legislation that affects mandatory spending. Under the proposal, any legislation that increases mandatory spending could not result in an increase in the deficit; any increase would have to be offset by a reduction in mandatory spending in the same or other mandatory programs. Any legislation that increases mandatory spending without an equal offset would be subject to a point of order and would need 60 votes, or a three-fifths vote, in the Senate. If, at the end of a congressional session, the enacted mandatory spending legislation results in an increase in the deficit, then OMB would be required to make across-the-board cuts to non-exempt mandatory programs to eliminate any deficit increase. Unlike the current pay-as-you-go rules adopted by the Congress, the Administration's pay-as-you-go proposal would be statutory and could not simply be waived by 60 votes in the Senate. In addition, the Administration's proposal would ensure that additional spending is not financed by burdening the American people with additional taxes.

In addition to the pay-as-you-go rule for mandatory spending, the Budget proposes to curtail expansions in long-term obligations for Social Security, Supplemental Security Income, Medicare, Federal civilian and military retirement, and veterans disability compensation. Under the proposal, any legislation that increases the actuarial unfunded obligation of any of these programs would be subject to a point of order, or a three-fifths vote, in the Senate.

Restraining Annually Appropriated Spending

As distinct from mandatory spending, which occurs automatically without new congressional or Presidential action, "discretionary" spending is subject to annual review and appropriations action by the Congress and the President. Without laws enacting annual appropriations, most agencies cannot obligate or spend money to carry out their day-to-day operations. Discretionary spending has tended to increase steadily over time, which is why the President's Budget proposes to place statutory limits or "caps" on discretionary spending each year beginning in 2009 and continuing through 2013. Under the proposal, any appropriations bill that causes the caps to be exceeded would be subject to a point of order, or a three-fifths vote, in the Senate. If the total spending enacted in the appropriations laws exceeds the spending caps in any year, OMB would be required to make across-the-board cuts to reduce total discretionary spending to the statutory limit.

The Budget proposes to exempt program integrity efforts from the proposed statutory spending caps by adjusting the caps for amounts dedicated to such efforts. Program integrity efforts are intended to stop payments to individuals not eligible for benefits and to collect unpaid taxes due the Government and can generate as high as a ten-to-one return to the Government.

Spending Tax Dollars Wisely

Legislative Line-Item Veto. In his Budget, the President is again proposing that the Congress enact a legislative line-item veto. Under the proposal, if the Congress were to enact legislation that includes wasteful spending provisions or targeted tax benefits, the President would return to Congress for cancellation individual provisions that would be voted up or down without amendment under expedited legislative procedures. If the Congress were to pass some or all of the President's proposed cancellations, any savings associated with the approved cancellations would be used for deficit reduction and could not be used to offset other spending. Forty-three of the Nation's Governors are authorized to exercise a line-item veto, and the President should be authorized to do the same with respect to Federal Government spending.

Earmark Reforms. The President is also proposing that the Congress continue to make reforms to the earmarking process. Earmarks are provisions in legislation or congressional committee reports that designate a portion of a larger sum of money to be used for a particular purpose, where the recipient or location is named or where the legislation otherwise circumvents a competitive or merit-based process for awarding funds. The number and cost of earmarks have grown dramatically in recent years, more than tripling since the early 1990s. In an effort to bring greater transparency to earmarks, the Administration provides detailed information about these spending provisions at *www.earmarks.omb.gov*. OMB estimates that the number of earmarks grew to over 13,000 in 2005 at a cost of nearly $19 billion. The need for the line-item veto tool was again underscored with the recent congressional action on the 2008 appropriations, which contain more than 11,700 earmarks and other wasteful spending provisions. Last year, the President called on the Congress to provide greater transparency and full disclosure of earmarks by eliminating wasteful earmarks, reducing the number and cost of earmarks by half, and placing earmarks in statutory language rather than report language. The President remains committed to earmark reform and urges the Congress to make earmark reform a top priority for 2008.

Bipartisan Results Commission and Sunset Commission. In addition to proposing a line-item veto and a reduction in earmarks, the President proposes to create bipartisan Results Commissions and a bipartisan Sunset Commission. Results Commissions would propose ways to restructure or consolidate programs or agencies where duplicative or overlapping responsibilities have been identified. If approved by the President, the Results Commissions' proposals would be transmitted to the Congress and considered under expedited legislative procedures. The Sunset Commission would review all Federal agencies and programs on a 10-year schedule and recommend to the President whether the agencies and programs should be continued.

Ensuring an Efficient and Transparent Budget Process

The President is committed to promoting an orderly and transparent budget process. An orderly and efficient budget process would inform the public about the use of their tax dollars and permit Government managers to anticipate likely funding levels for the programs they manage. To bring greater transparency to Federal spending as it is proposed and after it has been spent, the Administration places information on the Internet so it is available to the taxpayer. Such sites include *www.omb.gov* with details of the President's Budget, *www.ExpectMore.gov* with results on how Federal programs are working, *www.results.gov* with scorecards on the performance of Federal agencies, and *www.USAspending.gov* with data showing how Federal dollars were spent.

Joint Budget Resolution. In his Budget, the President is again proposing that the Congress be required to pass each year a joint budget resolution that has the force of law. The current budget resolution that is passed by Congress does not require the President's signature, thereby excluding the President from the early stages of the congressional budget process. Requiring the President's signature on a joint budget resolution would bring the President into the budget process earlier in time and permit the President and the Congress to reach agreement on overall fiscal policy before Congress begins its work on individual tax and spending bills.

Biennial Budgeting. To further improve the efficiency of the budget process, the President is proposing that biennial budgeting be adopted for all Executive Branch agencies. Appropriations legislation would be adopted in odd-numbered years and authorizing legislation would be adopted in even-numbered years. Biennial budgeting would give the Congress and Executive Branch officials more time to devote to program oversight. It would also give Government managers more certainty regarding funding levels, permitting them to devote more time to day-to-day program management and longer-term program planning.

Government Shut-down Prevention. To serve the American taxpayers without interruption, the 2009 Budget proposes to prevent Government shutdowns by allowing funding to occur automatically for those agencies, programs, or accounts for which appropriations bills have not been enacted at the start of the fiscal year. Funding would automatically be provided at the lower of the President's request or the prior year's enacted funding level. This would prevent an interruption in vital services to American taxpayers and prevent the uncertainty and confusion that arises when the Congress does not complete its work on appropriations bills and must instead write last-minute continuing resolutions to keep Government operations running temporarily.