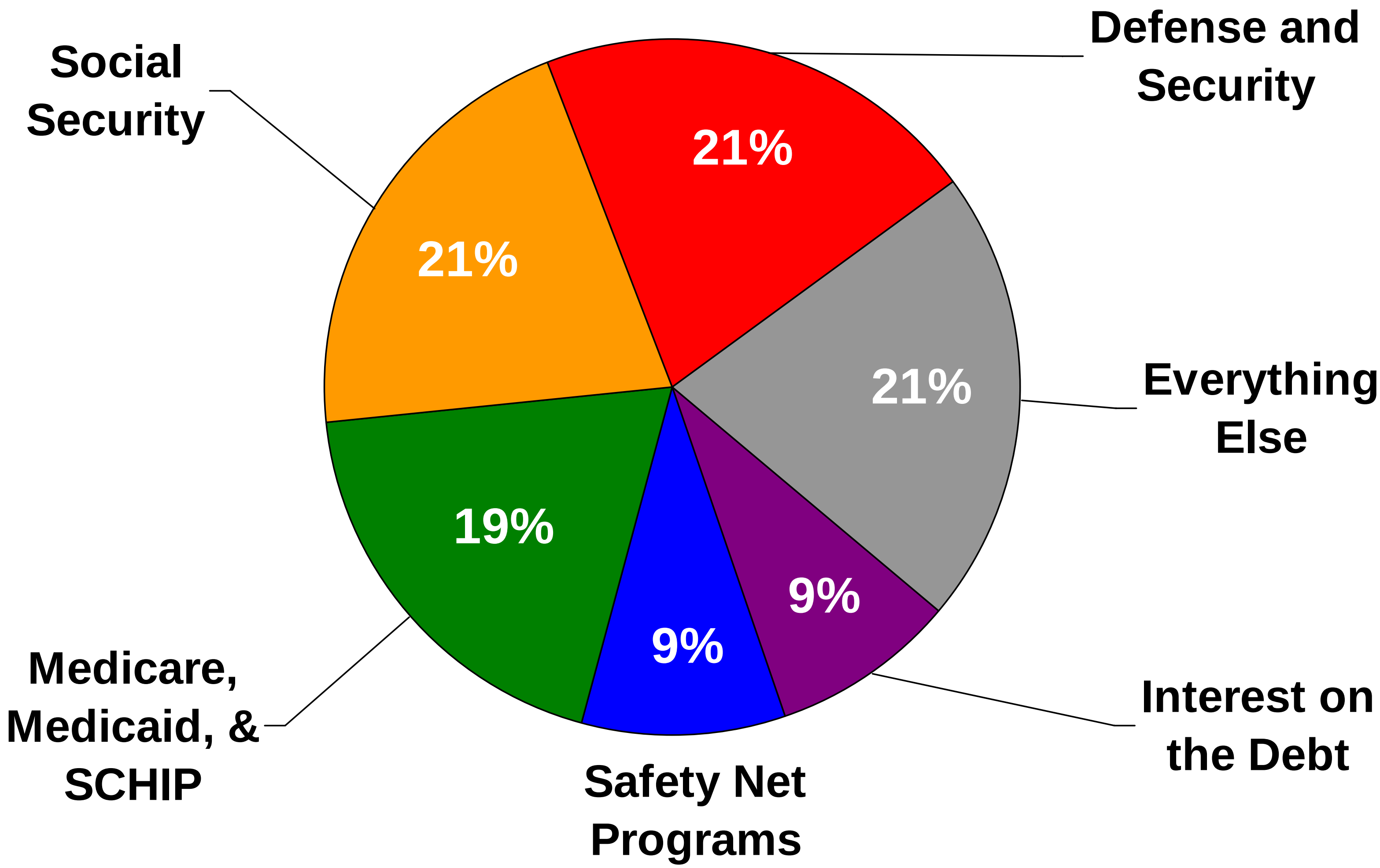
I. Background on the Federal Budget

Composition of the Federal Budget in 2006



Source: Office of Management and Budget data.

In 2006, Social Security accounted for a fifth of federal expenditures, as did Medicare, Medicaid, and the State Children's Health Insurance Program (SCHIP) put together. Defense and other security expenditures accounted for another fifth of the budget. Safety net programs that provide aid to individuals and families facing hardship accounted for slightly less than one-tenth of the budget. Interest on the national debt also accounted for about a tenth of the budget.

The Federal Budget in 2006

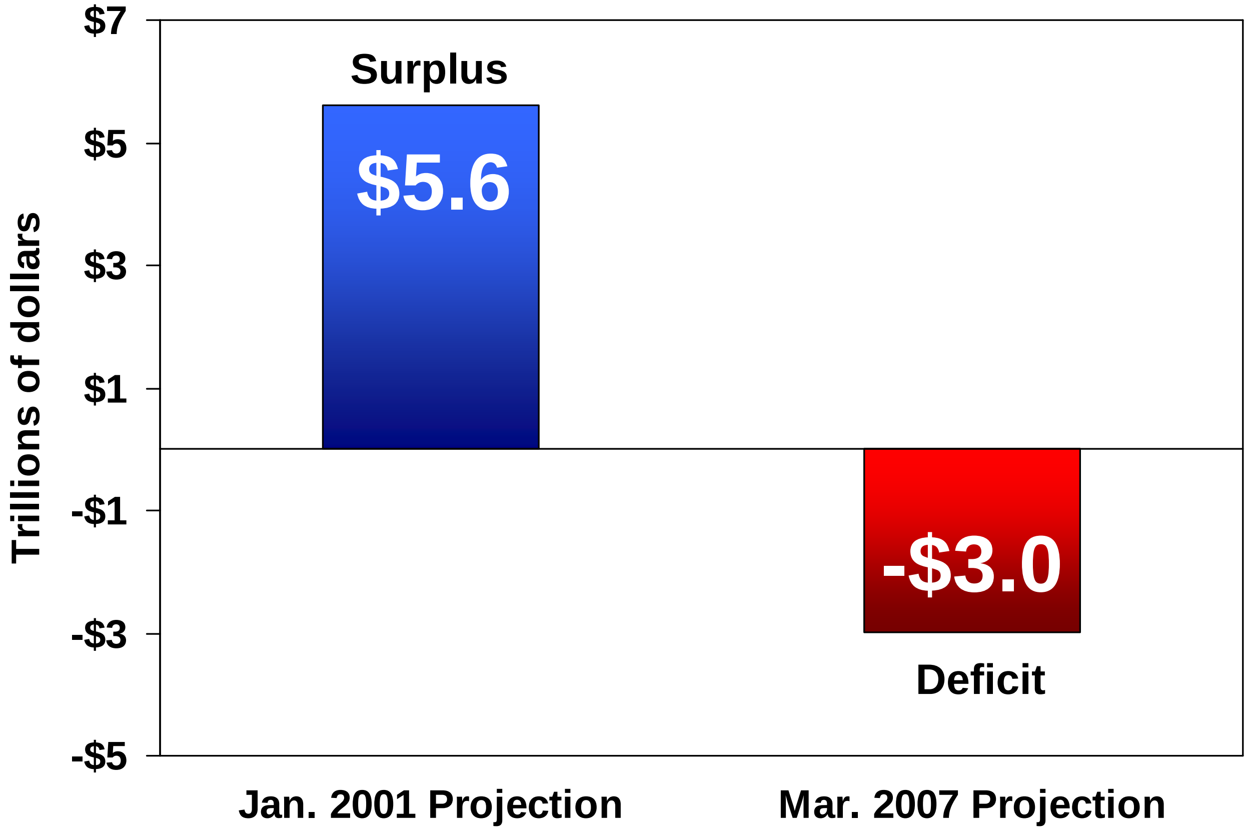
Revenues	$2.407 trillion
Expenditures	$2.655 trillion
Deficit	$ 248 billion

Source: Congressional Budget Office.

Because federal revenues were $248 billion less than federal expenditures in fiscal year 2006, the federal government ran a deficit of $248 billion last year.

From Large Surpluses to Large Deficits in Just 6 Years

Cumulative Surpluses/Deficits, 2002-2011

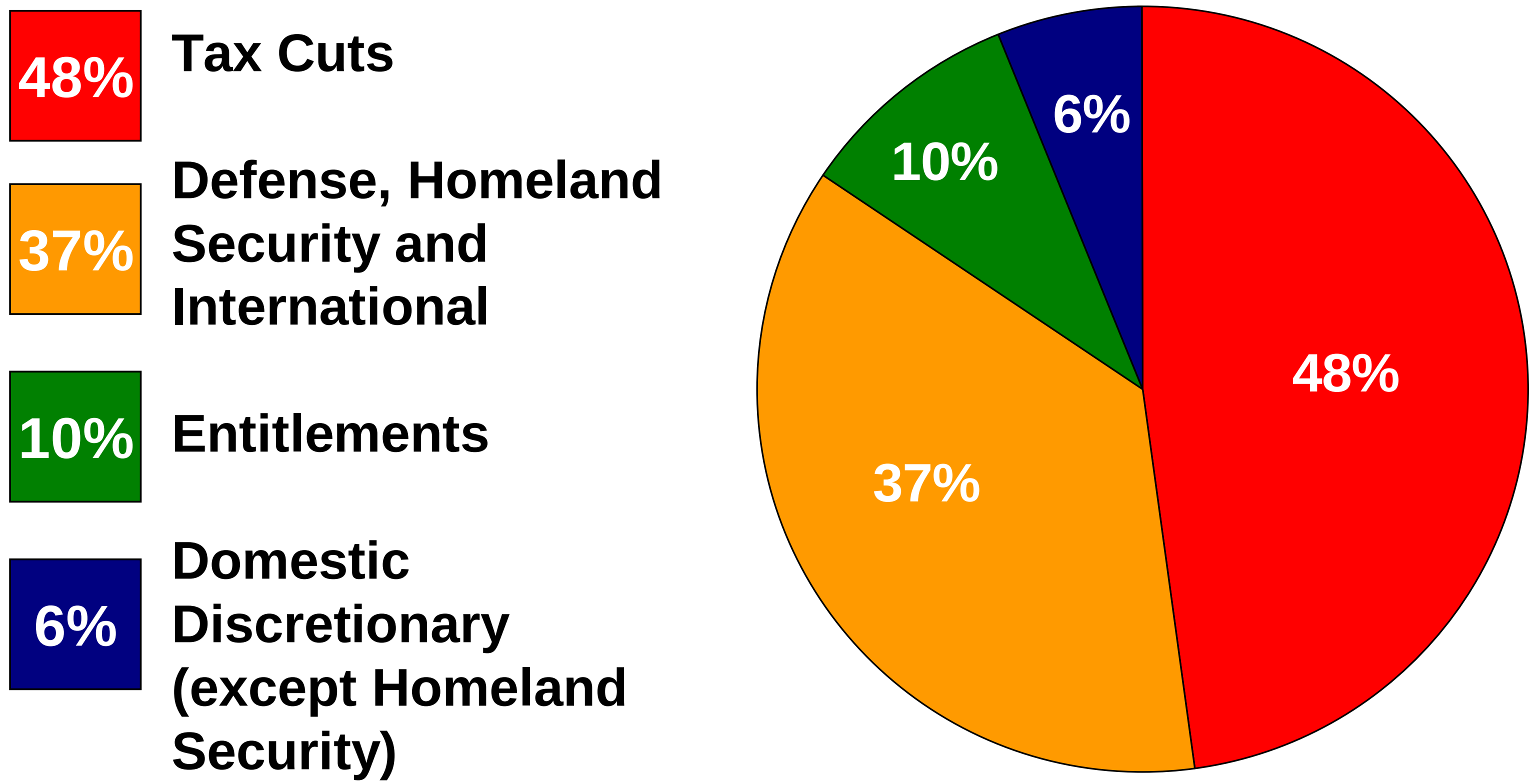


Source: CBPP calculations based on Congressional Budget Office data.

Just several years ago, we had large budget surpluses, not large deficits. In January 2001, the Congressional Budget Office projected that the federal government would amass $5.6 trillion in *surpluses* over the period 2002-2011 if policies did not change. CBO's most recent projections, issued in March 2007, indicate that the federal government will amass *deficits* of $3.0 trillion during the same 2002-2011 period, assuming continuation of the President's tax cuts and AMT relief, funding of the President's defense requests, and a gradual phasedown of operations in Iraq. In other words, there has been a negative swing of roughly $8.6 trillion for this ten-year period, from projected surpluses of $5.6 trillion to projected deficits of $3.0 trillion.

Legislation Adding to Deficits: Mostly Tax Cuts and Defense

Cost, 2002-2011, of policy changes since January 2001

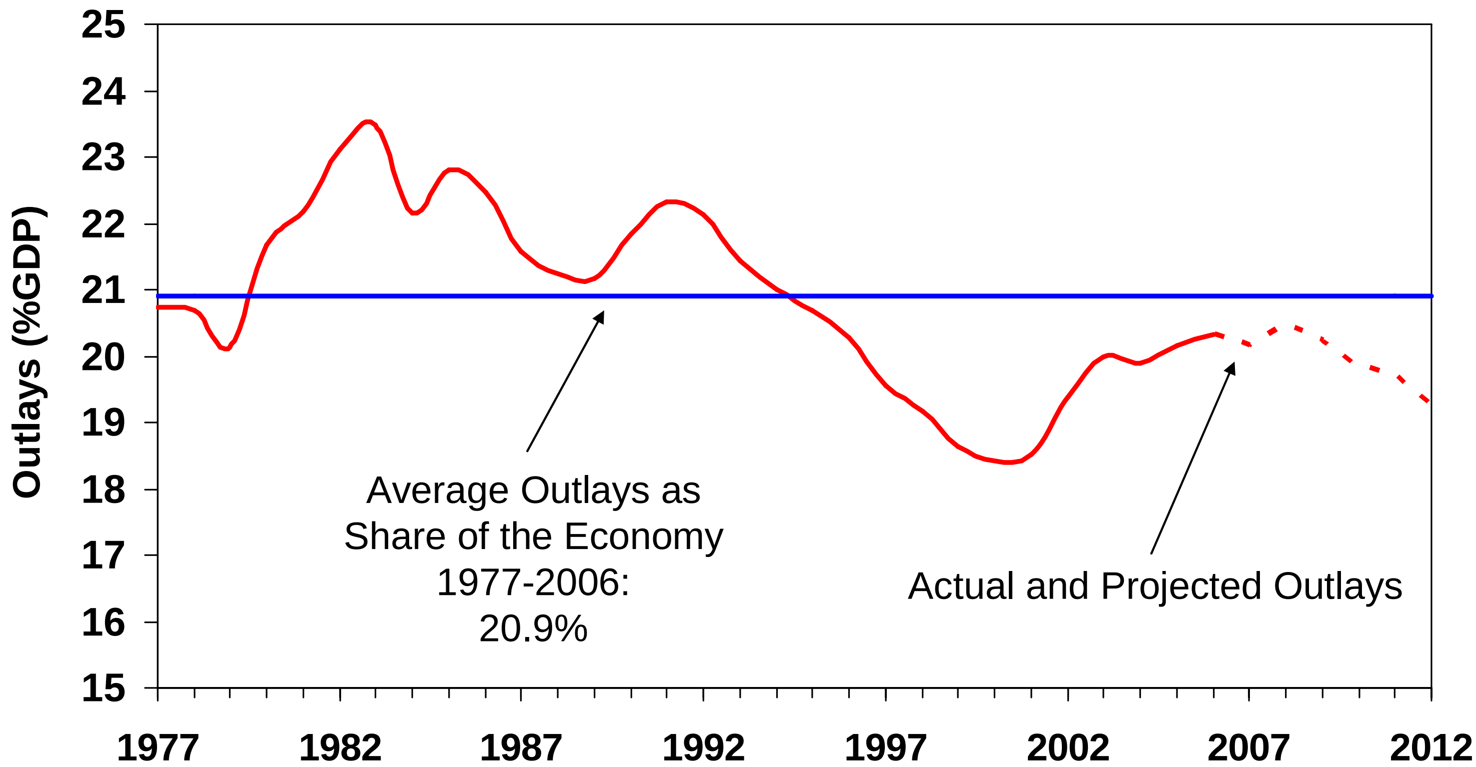


Source: CBPP calculations based on Congressional Budget Office data. Assumes extension of the President's tax cuts, continuation of Alternative Minimum Tax relief, a gradual phasedown of operations in Iraq and Afghanistan, and underlying defense spending in line with the President's FY 2008 budget.

The bulk of the deterioration in the budget since the start of 2001 — some 75 percent of it — has come from policy changes (i.e. tax cuts and spending increases), rather than from economic and technical factors outside policymakers' control.

As this graph shows, nearly 85 percent of the additional costs from 2002 to 2011 resulting from policy changes consist of tax cuts and increases in defense, homeland security, and other international spending. Increases in domestic spending account for about 15 percent of the cost of legislation enacted since the beginning of 2001.

Even with Iraq and Afghanistan, Federal Spending is Below Average for Recent Decades

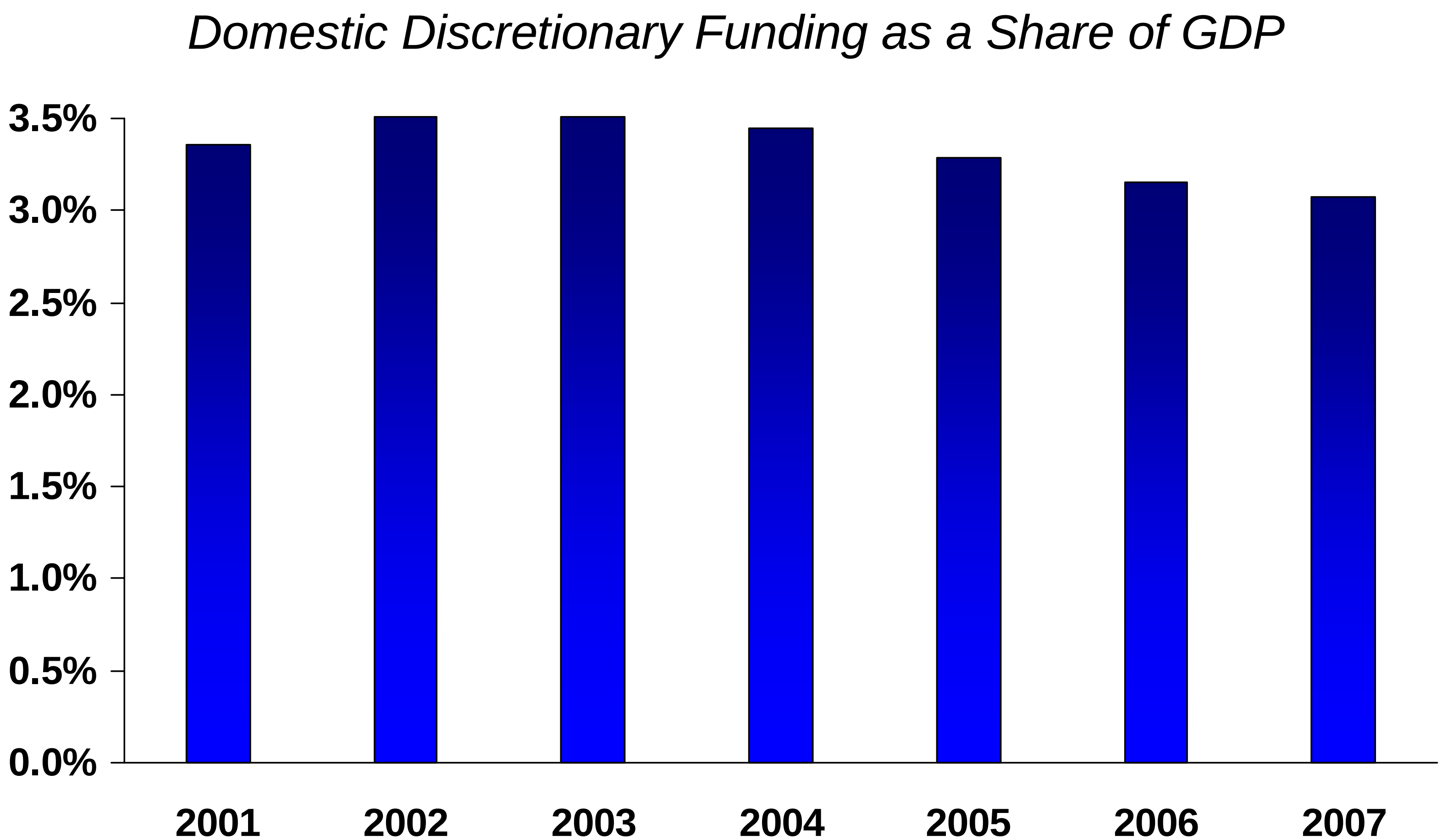


Source: CBPP calculations based on Congressional Budget Office data.

Some people claim that large deficits have emerged in recent years because spending has "exploded." The data show this claim is not correct. The principal way that analysts measure trends in federal spending and revenues over time is as a share of the U.S. economy (that is, as a share of the gross domestic product). The data show that while federal spending has risen since 2001, it remains lower as a share of the economy than its average level over the last 30 years, even when expenditures for Iraq, Afghanistan, and relief from the recent hurricanes are included. In short, federal spending is not unusually high. (Of course, the fact that outlays are near the historical average does not establish whether they are at an appropriate level, which requires a substantive policy judgment. But claims that spending has "exploded" are incorrect.)

Note: Figures for 2007 and later assume extension of the President's tax cuts, continuation of Alternative Minimum Tax relief, a gradual phasedown of operations in Iraq and Afghanistan, and funding of the defense requests in the President's FY 2008 budget.

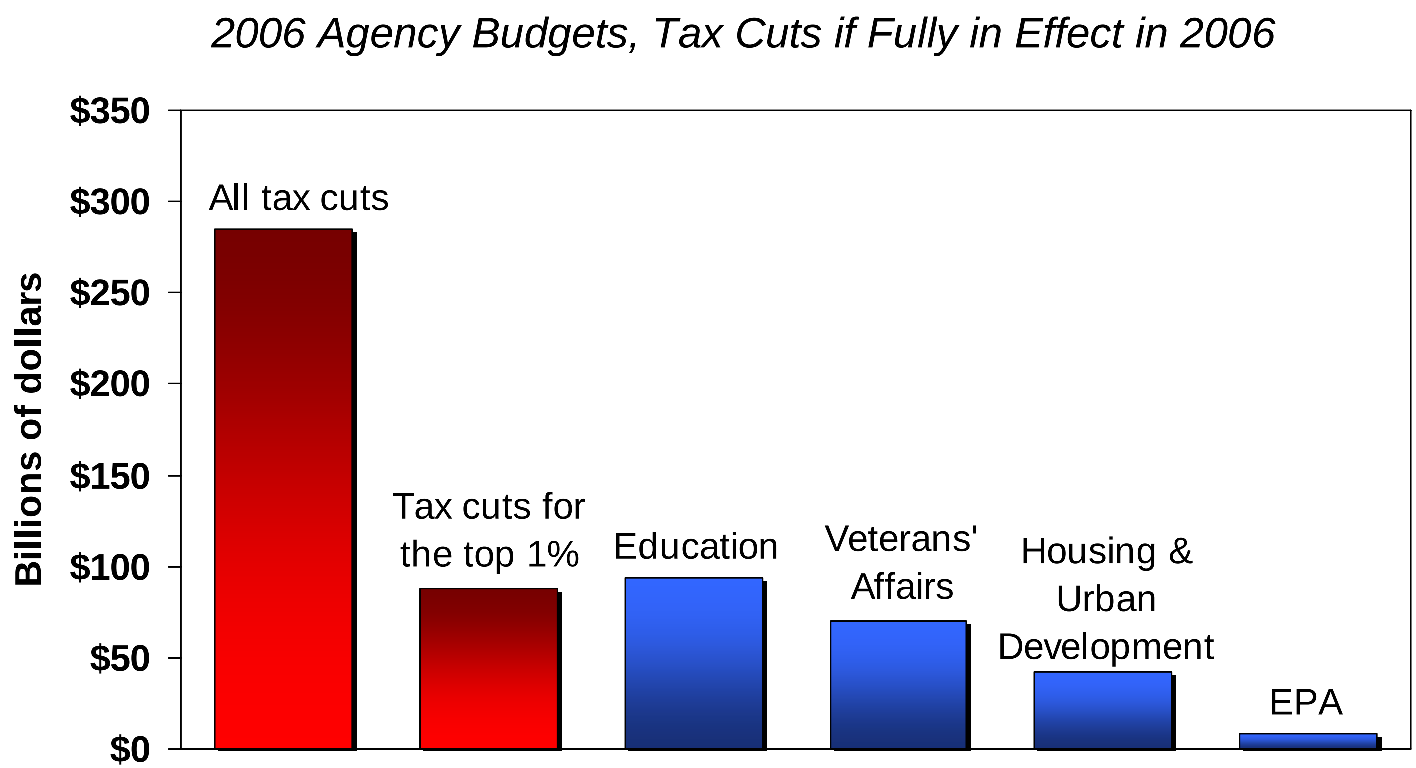
Since 2001, Funding for Domestic Discretionary Programs Has Fallen as a Share of the Economy



Source: CBPP calculations based on CBO data. To avoid distortions, figures do not include funding for homeland security or hurricane relief.

Some have argued that, even if overall spending is not unusually high, funding for "domestic discretionary" programs (the budget category that includes most federal programs dealing with education, environmental protection, housing, veterans medical care, transportation and many other essential functions) *has* "exploded." In fact, measured as a share of the economy, domestic discretionary funding (outside of homeland security) has now fallen below its 2001 level.

Tax Cuts Cost More Than Most Agency Budgets



Source: CBPP calculations based on Office of Management and Budget, Congressional Budget Office, Joint Committee on Taxation, and Urban-Brookings Tax Policy Center data.

The recent tax cuts are the single largest factor driving the return of deficits. When fully in effect, the President's tax cuts and AMT relief will cost:

- more than seven times as much as all federal programs for K-12 and vocational education
- about four times as much as all veterans' programs, including veterans' health care, pensions, and disability compensation; and
- as much as all of these federal departments and agencies combined: Education, Veterans Affairs, Homeland Security, State, Energy, and EPA.

Note: The tax-cut figures shown here represent the annual cost of the President's tax cuts and AMT relief when fully in effect, adjusted to reflect the size of the economy in 2006.

WHAT WOULD IT TAKE TO BALANCE THE BUDGET WHILE PRESERVING THE TAX CUTS?

To balance the budget by 2012 while extending the tax cuts and continuing AMT relief, policy makers would have to:

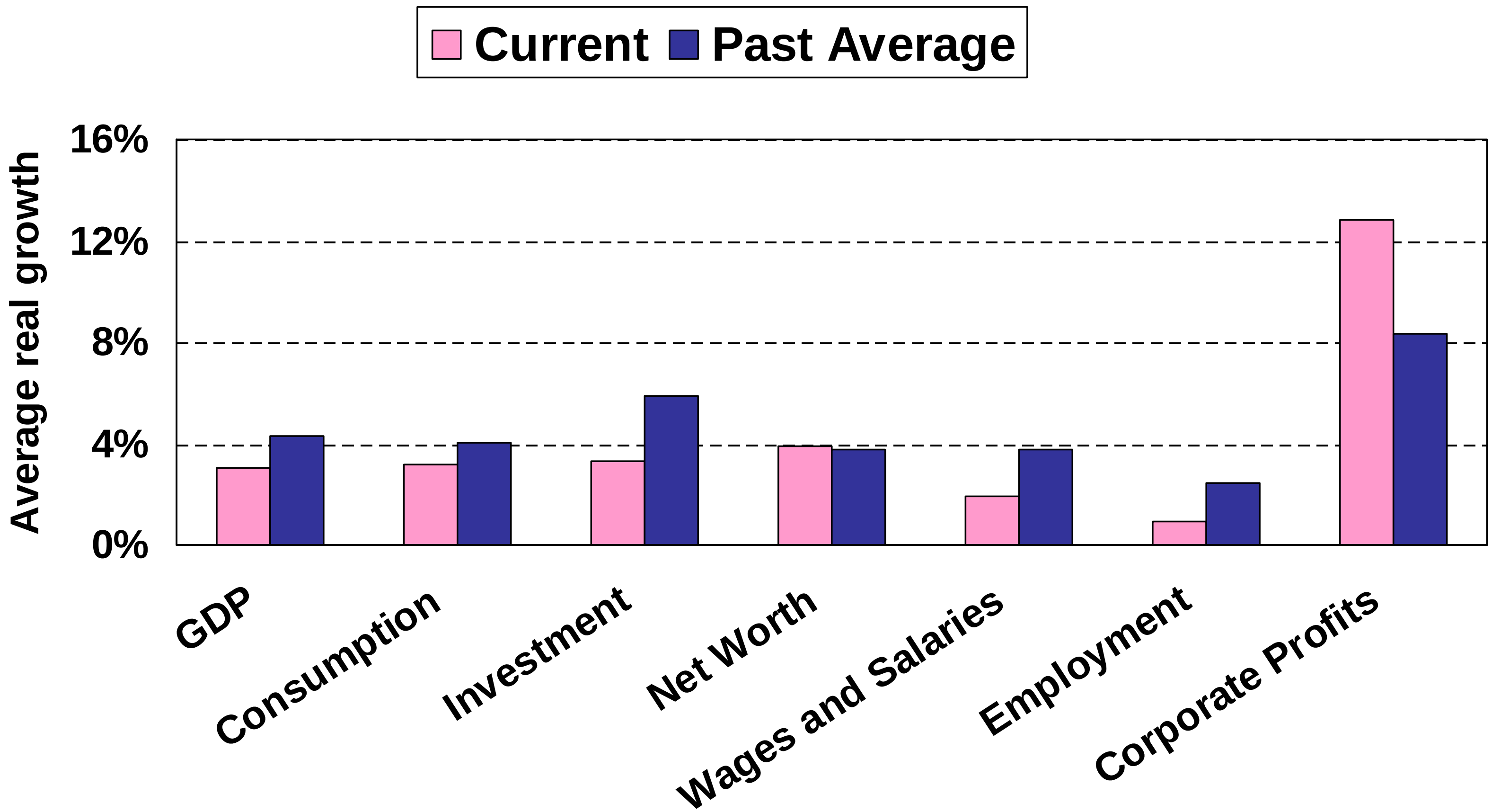
- Cut Social Security benefits by.................................... 32%
- Or cut defense spending by 42%
- Or cut Medicare by.. 51%
- Or cut every other program except Social Security, Medicare, defense by... 20%

Source: CBPP calculations based on Congressional Budget Office data.

Balancing the budget while keeping the President's tax cuts and extending relief from the Alternative Minimum Tax would require making painful and unwise cuts in essential programs. If the President's tax cuts were allowed to expire, then the budget would see a small surplus of 0.3 percent of GDP in 2012. In contrast, extending the tax cuts would result in a deficit of 1.6 percent of GDP in 2012.

II. The State of the Economy

The Current Expansion Has Been Weaker Than Average; Only Corporate Profits Have Grown Rapidly



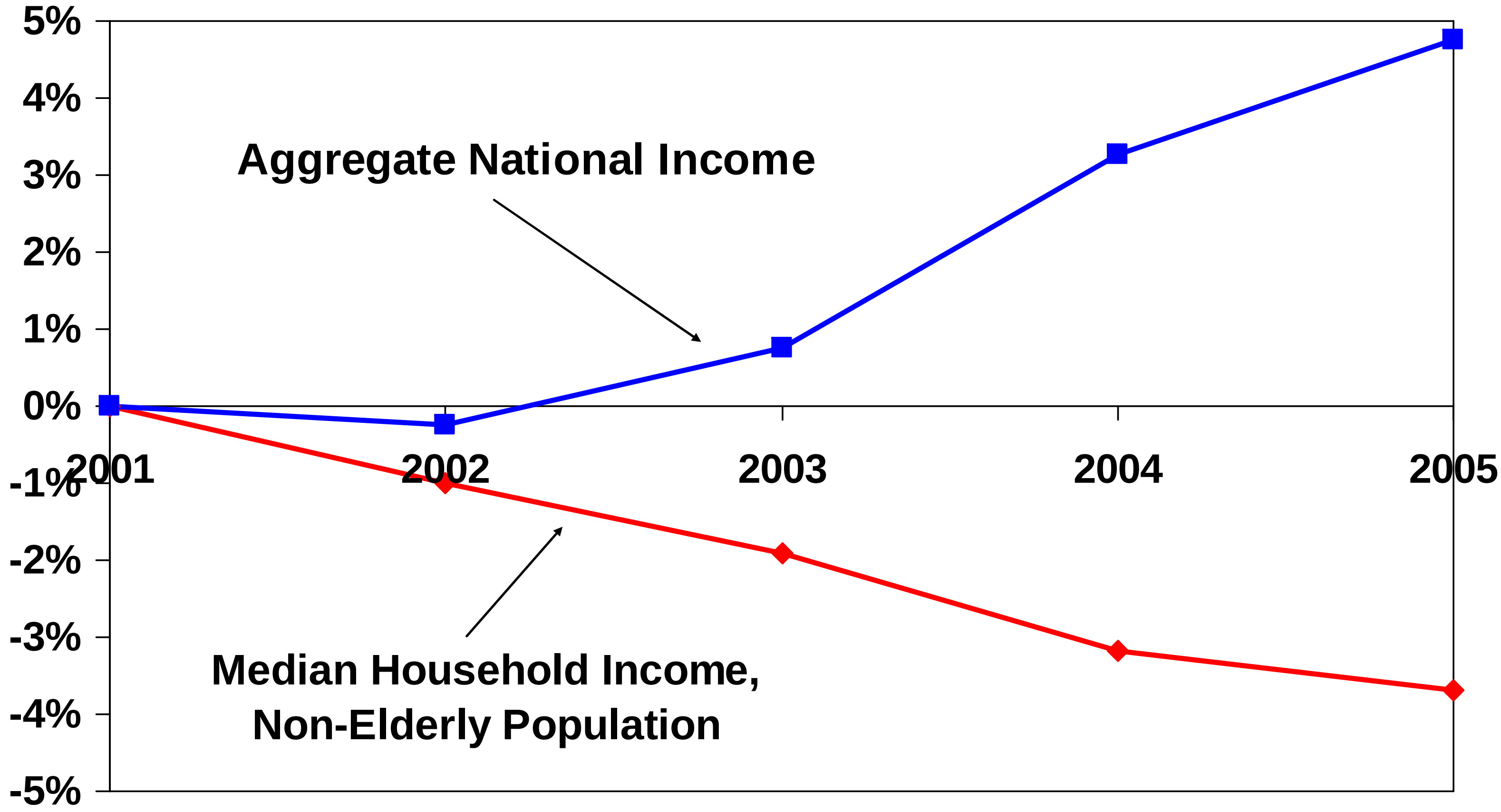
Source: CBPP calculations based on Commerce Department, Labor Department, and Federal Reserve data. Employment data through March 2007. All other data through the fourth quarter of 2006.

Supporters of the 2001 and 2003 tax cuts often contend that the tax cuts have ushered in a period of robust economic growth. By most economic measures, however, the current economic expansion has been weaker than the average expansion since the end of World War II. Out of seven economic indicators, this expansion has substantially outperformed other recent expansions in only one area: the growth of corporate profits.

Note: For more details, see Aviva Aron-Dine, Richard Kogan, and Isaac Shapiro, “How Robust is the Current Economic Expansion?,” Center on Budget and Policy Priorities, revised January 19, 2007, http://www.cbpp.org/8-9-05bud.htm.

Typical Working-Age Household Has Seen Income *Losses* During the Current Expansion

Cumulative Percent Change Since Recession Ended in 2001



Source: Census Bureau and Commerce Department data.

Even while *aggregate* national income has grown, the incomes of typical households have fallen. Since the end of the 2001 recession, the typical working age household has actually seen income *losses*. Census data show that among households headed by someone under age 65, median income, adjusted for inflation, has fallen $2,000 below its level during the 2001 recession. Meanwhile, high-income households have experienced large income gains since 2001.

Key Social Indicators Have Performed Poorly in the Current Expansion

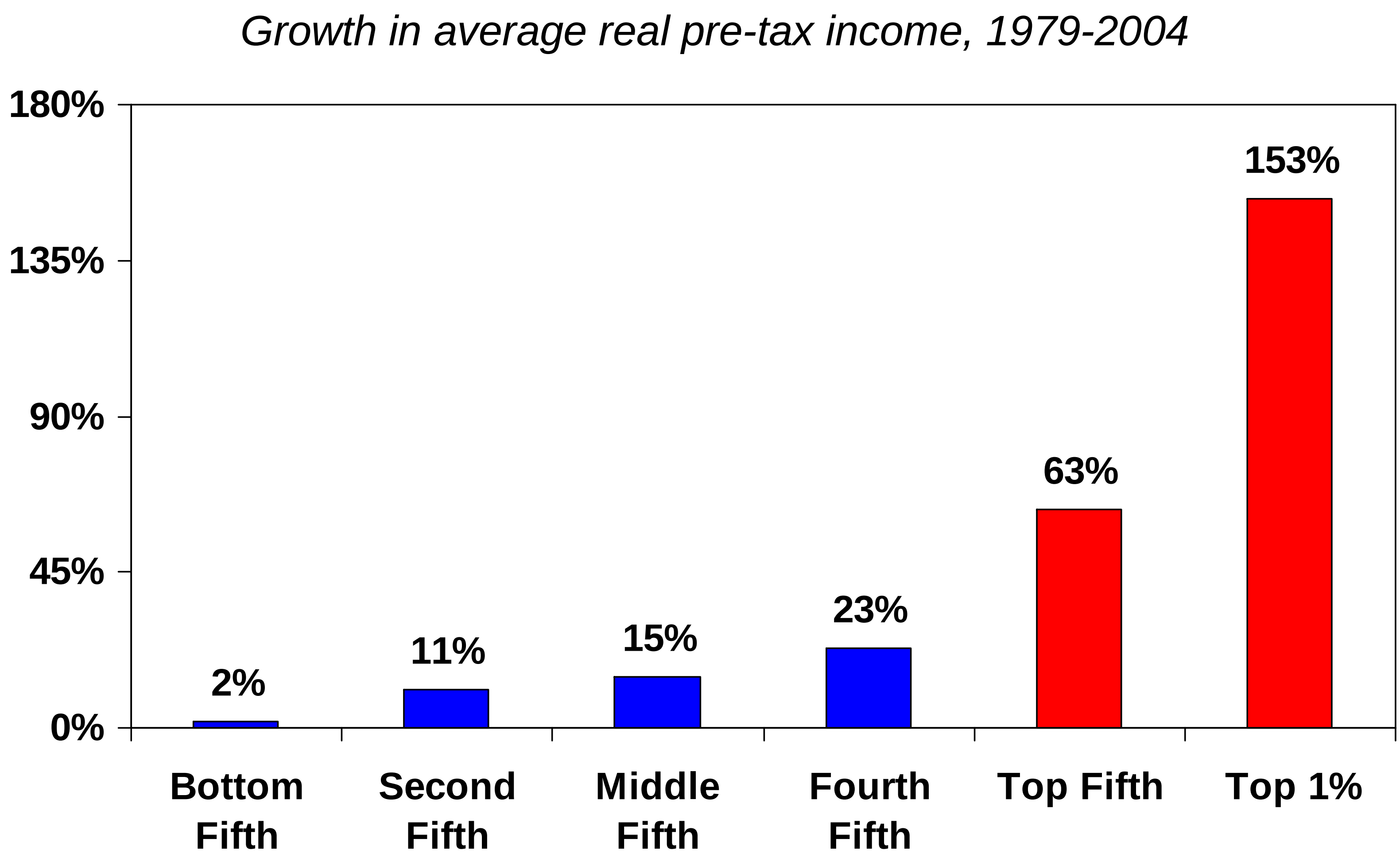
Share of population	2005	Change from 2001
In poverty	12.6%	+0.9%
In deep poverty	5.4%	+0.7%
Lacking health insurance	15.9%	+1.2%
Food insecure	12.1%	- 0.1%
w/ very low food security	3.7%	+0.4%

Source: Census Bureau and Department of Agriculture data.

The economic growth the nation has seen over the last several years has not brought improvement in several important social indicators. Since 2001, the share of Americans living in poverty has increased, and the nation has also seen a continued increase in the share of the population that is uninsured, largely the result of continued erosion in employer-provided health insurance. Meanwhile, the nation has made essentially no progress in reducing the number of Americans who live in households that are food insecure, that is, that have difficulty providing enough food for all households members.

The present economic expansion has also brought worrisome increases in measures of severe deprivation. The share of the population living in deep poverty, that is, below 50 percent of the poverty line, has increased markedly since 2001, as has the share of the population living in households that report extreme food insecurity (very low food security).

Last 25 Years Have Seen Rapid Income Growth at the Top, Virtually No Growth at the Bottom



Source: CBPP calculations based on Congressional Budget Office data.

This expansion's combination of poor economic performance for low and middle-income Americans and exceptional performance for high-income Americans continues a trend toward increased economic inequality that is at least 25 years old. From 1979 through 2004, the most recent year for which data are available, the average income of a household in the top 1 percent of households more than doubled. Over the same period, households in the middle quintile saw total income growth of just 15 percent, while households at the bottom saw virtually no income growth at all.

III. The President's Fiscal Year 2008 Budget

Key Elements of the President's Fiscal Year 2008 Budget Proposal

Key Components

- Permanent extension of the 2001and 2003 tax cuts
- Cuts in domestic discretionary programs that grow deeper over time
- Cuts in Medicaid that shift significant costs to states
- Proposals for the State Children's Health Insurance Program that would put significant numbers of low-income children at risk of losing coverage
- Proposed changes in the Food Stamps program that could cause 300,000 people to lose eligibility

Net Effect

- Worsens recent trends toward increased income inequality
- Increases projected deficits according to CBO figures

Prominent Leaders, Including President Bush, Have Acknowledged the Need to Confront Rising Inequality

"I know some of our citizens worry about the fact that our dynamic economy is leaving working people behind. We have an obligation to help ensure that every citizen shares in this country's future. The fact is that income inequality is real; it's been rising for more than 25 years. "

- President Bush

"[R]ising inequality is a concern in the American economy. It's important for our society that everyone feels that they have an opportunity to participate in the opportunities that the economy is creating."

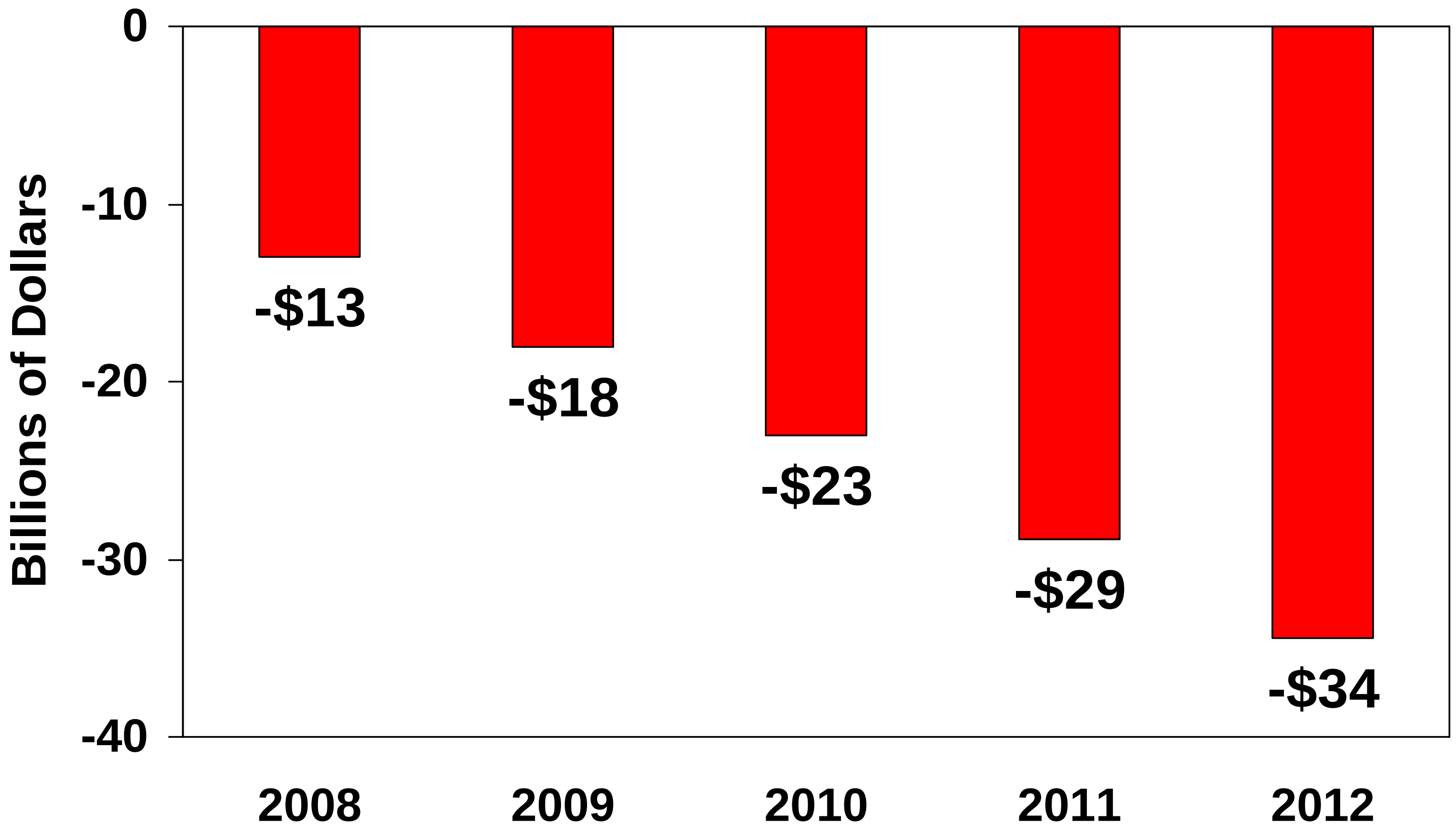
- Federal Reserve Chairman Bernanke

"[There is a] really serious problem here, as I've mentioned many times before this [House] committee, in the consequent concentration of income that is rising..."

- Fmr. Fed. Chairman Greenspan

As shown in earlier slides, the last 25 years have seen rapid income growth for high-income people and much slower growth for low and middle-income people, with the result that the income gap between these groups has grown markedly. In recent years, a wide array of scholars, political leaders, and government officials have acknowledged this trend and the need to address it. President Bush himself did so in remarks he delivered on Wall Street just one week before the release of his fiscal year 2008 budget.

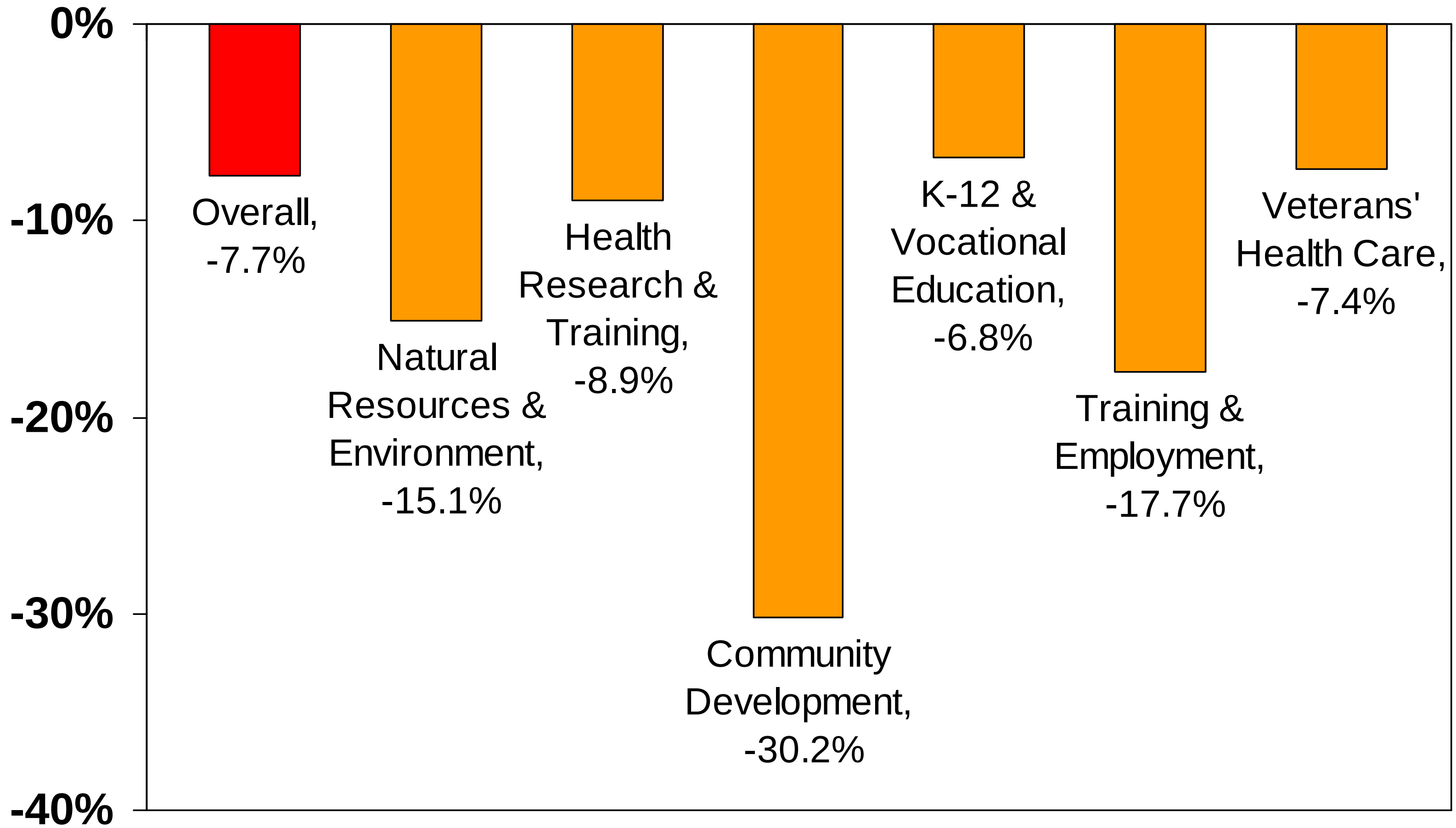
President's Proposed Cuts in Domestic Discretionary Funding Grow Deeper Over Time



Source: CBPP calculations based on CBO's analysis of the President's budget, CBO's March baseline, and OMB documents.

Unfortunately, the policies included in the President's budget would make inequality worse, not better. At the same time that the Administration is proposing to extend tax cuts that disproportionately benefit the wealthiest Americans, it is also proposing deep cuts in domestic discretionary programs (i.e. non-entitlement domestic programs). The Administration's 2008 budget would reduce funding for domestic discretionary in each of the next five years compared to the 2007 funding levels adjusted for inflation. The reductions would grow from $13 billion (an average of 3.2 percent) in 2008 to $34 billion (an average of 7.7 percent) in 2012. These cuts would fall the hardest on low and middle-income people.

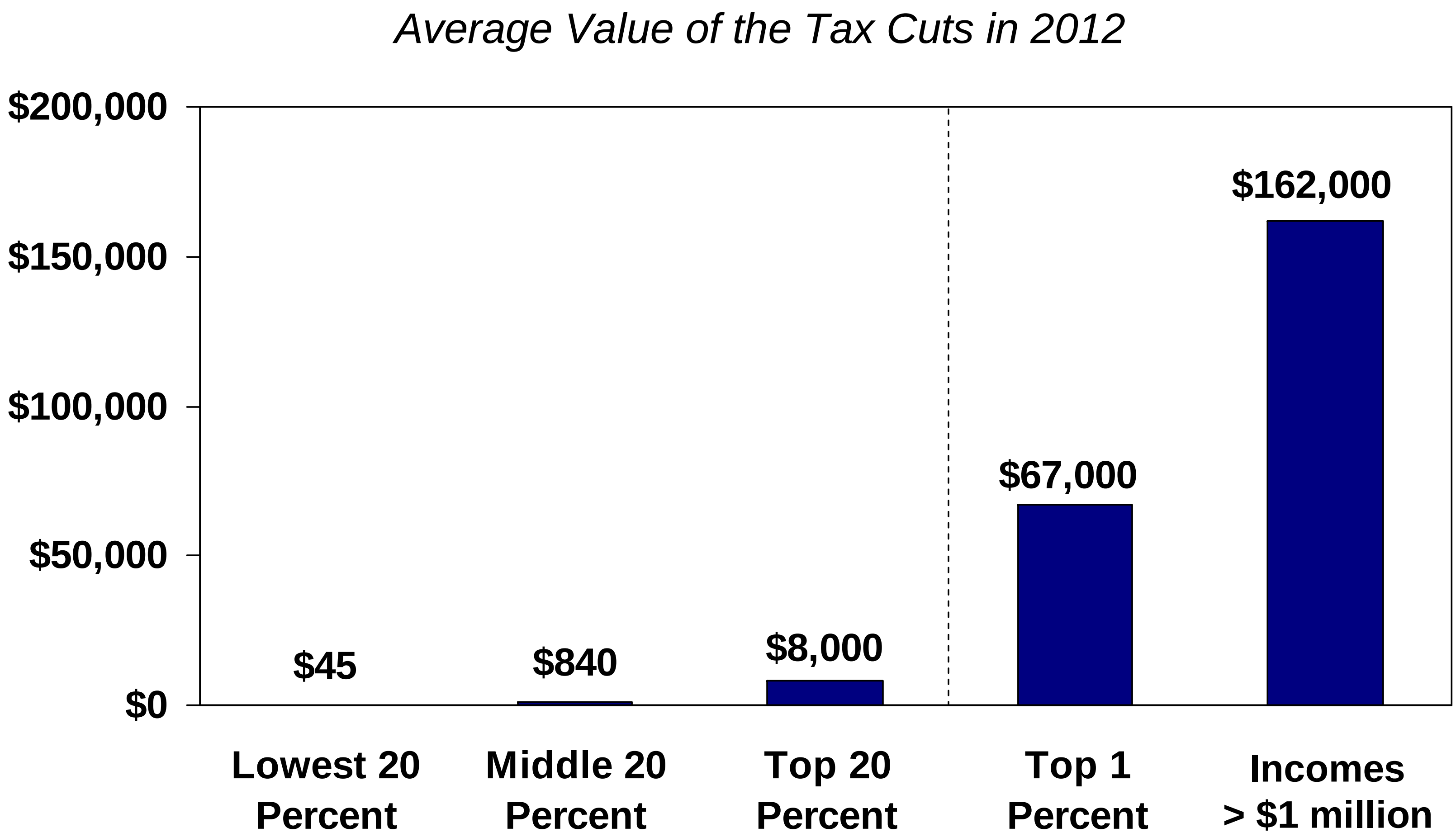
President's Budget Calls for Deep Cuts to Discretionary Programs in 2012



Source: CBPP calculations based on CBO's analysis of the President's budget, CBO's March baseline, and OMB documents.

By 2012, the President's proposed cuts in domestic discretionary programs would affect virtually every program category except those related to science, space, and technology. Almost all other areas, including education, the environment, medical care for veterans, medical research, and low-income housing, to name just a few, would be cut significantly.

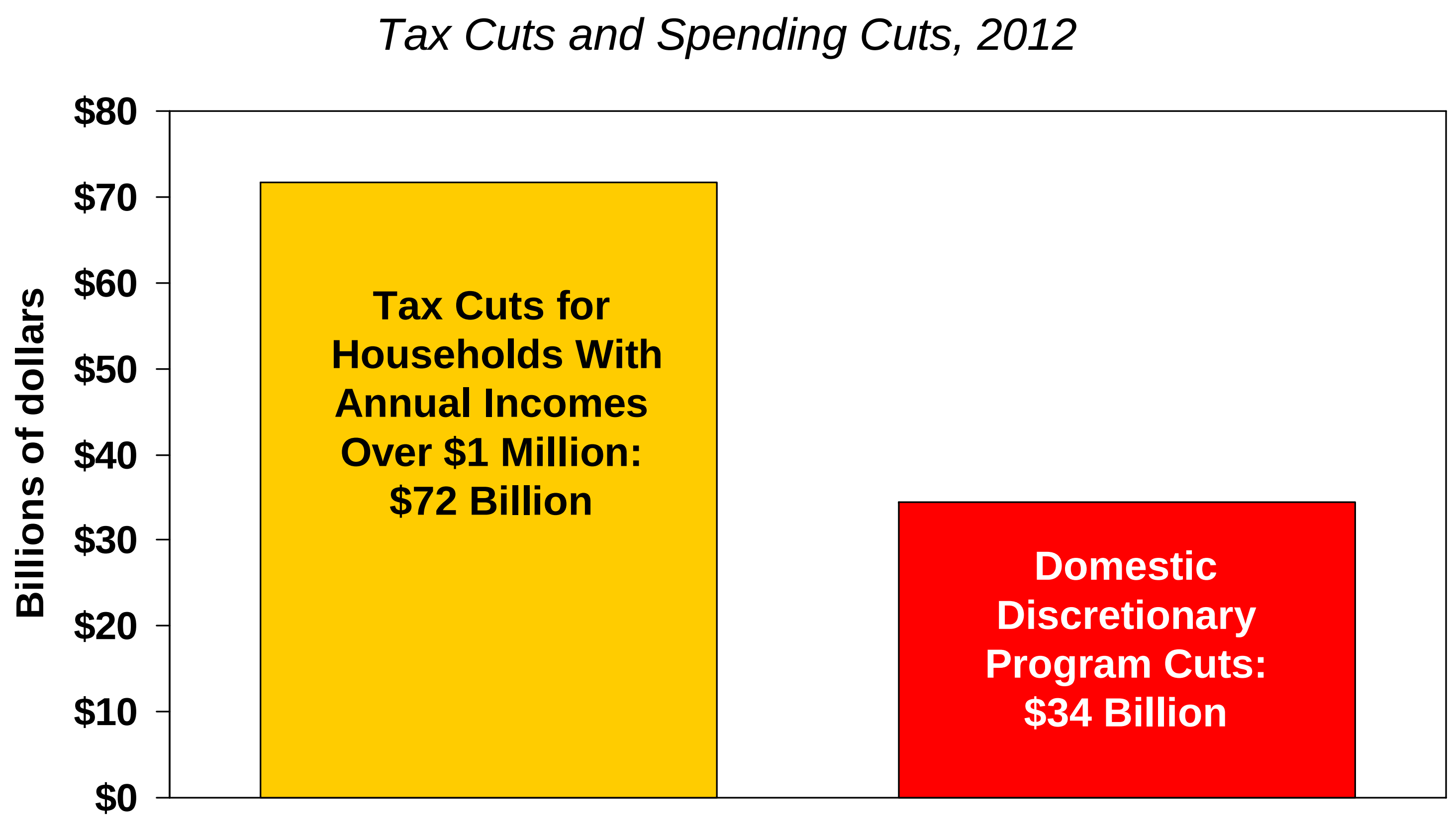
Benefits of President's Tax Cuts Flow Disproportionately to High-Income Households



Source: Urban-Brookings Tax Policy Center.

The centerpiece of the President's budget is extension of the 2001 and 2003 tax cuts. In contrast to the cuts in discretionary programs, which would have the greatest effect on low and middle-income households, the benefits of extending the tax cuts go disproportionately to high-income households. In 2012, the first year in which the effects of extending the tax cuts would be fully felt, the average household with annual income over $1 million will receive $162,000 from these tax reductions, according to the Brookings Institution-Urban Institute Tax Policy Center.

President's Budget Proposes Deep Cuts in Domestic Programs, But Tax Cuts for Millionaires Are Larger

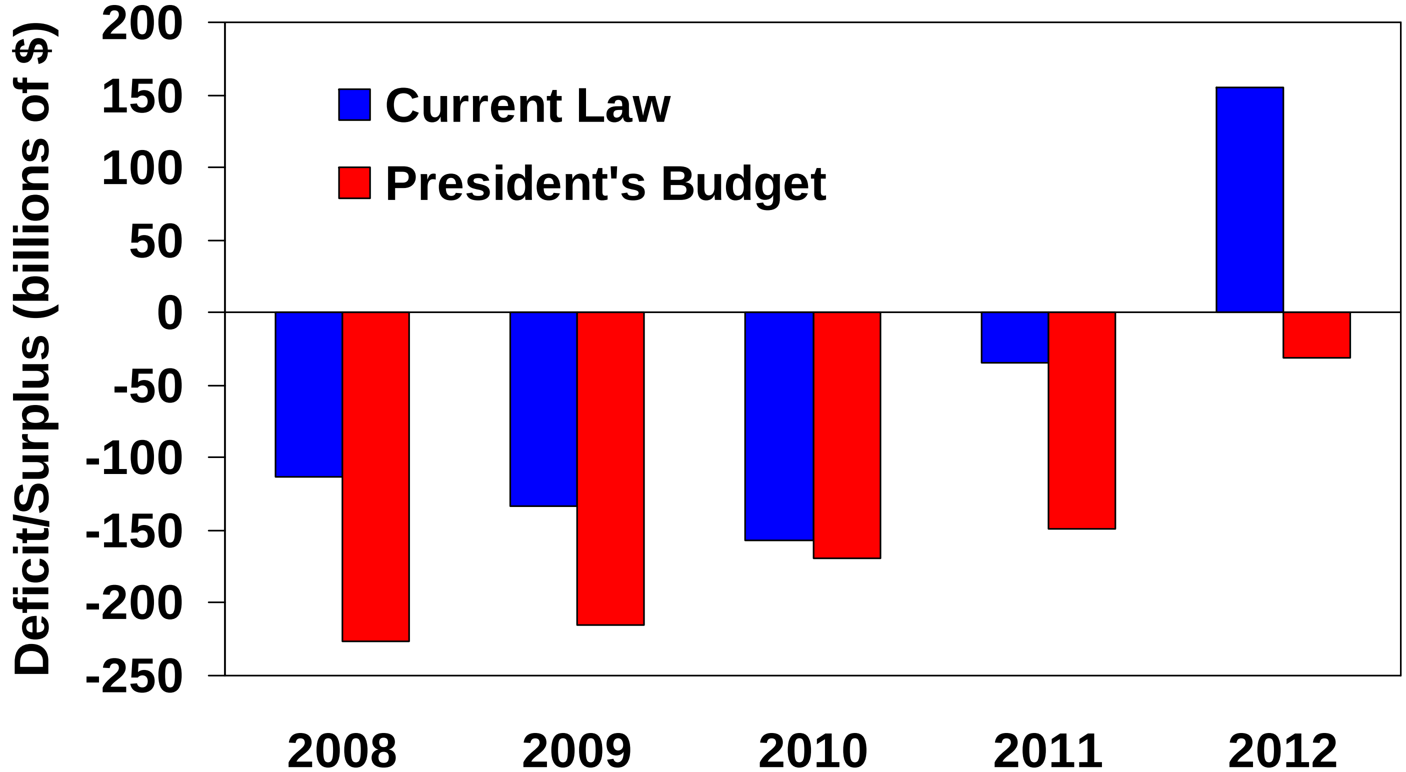


Source: CBPP calculations based on Office of Management and Budget, Congressional Budget Office, Joint Committee on Taxation, and Urban-Brookings Tax Policy Center data.

The savings that would be achieved by the proposed discretionary cuts would be less than the cost of the tax cuts just for households with incomes above $1 million. In 2012, the President's budget would cut domestic programs by $34 billion; the cost of tax cuts for households with incomes above $1 million would be $72 billion.

In essence, the budget would use the resources from these program cuts, which would fall hardest on millions of low- and middle-income families, to defray a small portion of the costs of the President's tax cuts, which are providing very large tax benefits to the wealthiest families in the country. Indeed, the Urban Brookings Tax-Policy Center has found that, if the tax cuts were fully paid for through spending cuts similar to these, then low and middle-income households would, on net, be left worse off as a result of the tax cuts.

President’s Budget Would Increase Deficits Relative to Current Law



Source: Congressional Budget Office.

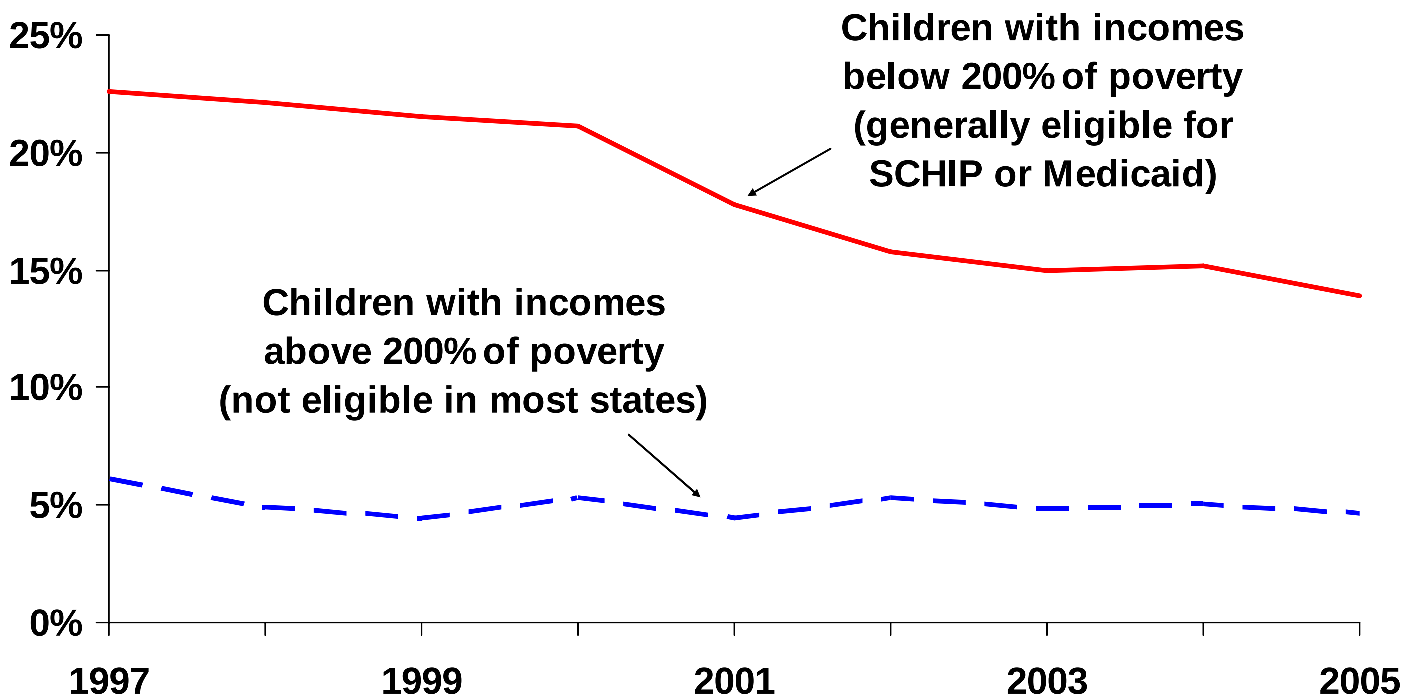
In addition to increasing income inequality, the President’s budget would greatly worsen the nation’s fiscal problems. According to Congressional Budget Office (CBO) estimates, the President’s policies would make deficits larger (or reduce surpluses) in *every one* of the next five years relative to what they would be under current law. All told, the CBO figures show that the President’s proposals would increase deficits (or reduce surpluses) by $507 billion over the years 2008-2012. The biggest swings would come in 2011 and 2012, when the President’s proposal to extend the 2001 and 2003 tax cuts would cause large reductions in revenues.

The President’s budget makes deficits larger despite the fact that it omits major costs. Namely, the budget assumes that the Alternative Minimum Tax will be allowed to affect millions more taxpayers in coming years and that military operations in Iraq and Afghanistan will require no additional funding after 2009.

IV. Major Issues in This Year’s Budget Debate

Creation of SCHIP Reduced Share of Low-Income Children Who Are Uninsured by a Third

Percent of Children Without Health Insurance



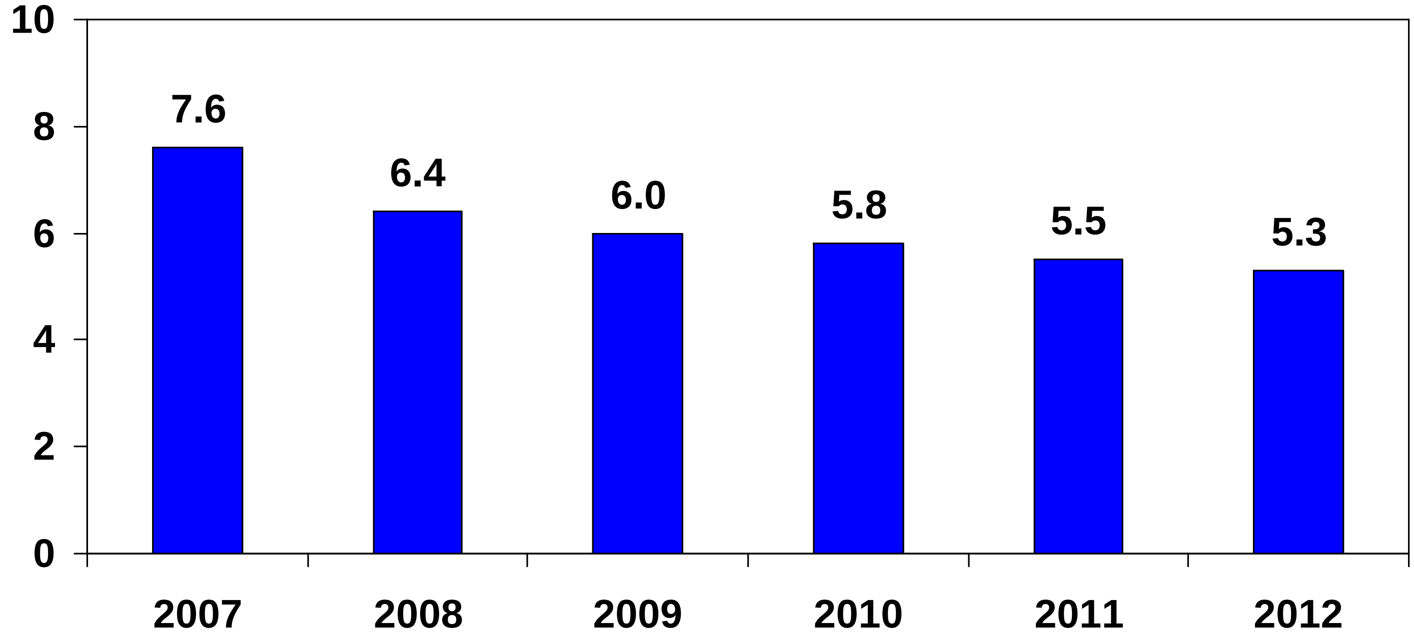
Source: National Health Interview Survey data as analyzed by CBPP.

While the President's budget failed to address long-standing trends toward increased inequality, Congress will have several important opportunities to do so this year. Among the most important such opportunities will be legislation to reauthorize the State Children's Health Insurance Program (SCHIP), which expires at the end of the current fiscal year. SCHIP gives state governments funding to provide health insurance to low-income children who are not eligible for Medicaid (and, in some states, low-income parents and pregnant women as well).

The creation of SCHIP substantially reduced the share of low-income children without health insurance, both by enrolling uninsured children in state SCHIP programs and by spurring states to streamline their Medicaid enrollment procedures. The core group of SCHIP and Medicaid-eligible children is those with incomes below 200 percent of the poverty line. Since the creation of SCHIP in 1997, the share of this core group that lacks health insurance has fallen from 22.6 percent to 13.9 percent, or by more than a third. In contrast, children above 200 percent of the poverty line, who are not eligible for SCHIP (nor Medicaid) in most states, have seen only small declines in their rates of uninsurance.

Freezing SCHIP Funding Would Place Children and Pregnant Women At Risk of Losing Coverage

Enrollment of Children and Pregnant Women in SCHIP if 2007 funding level extended (millions)



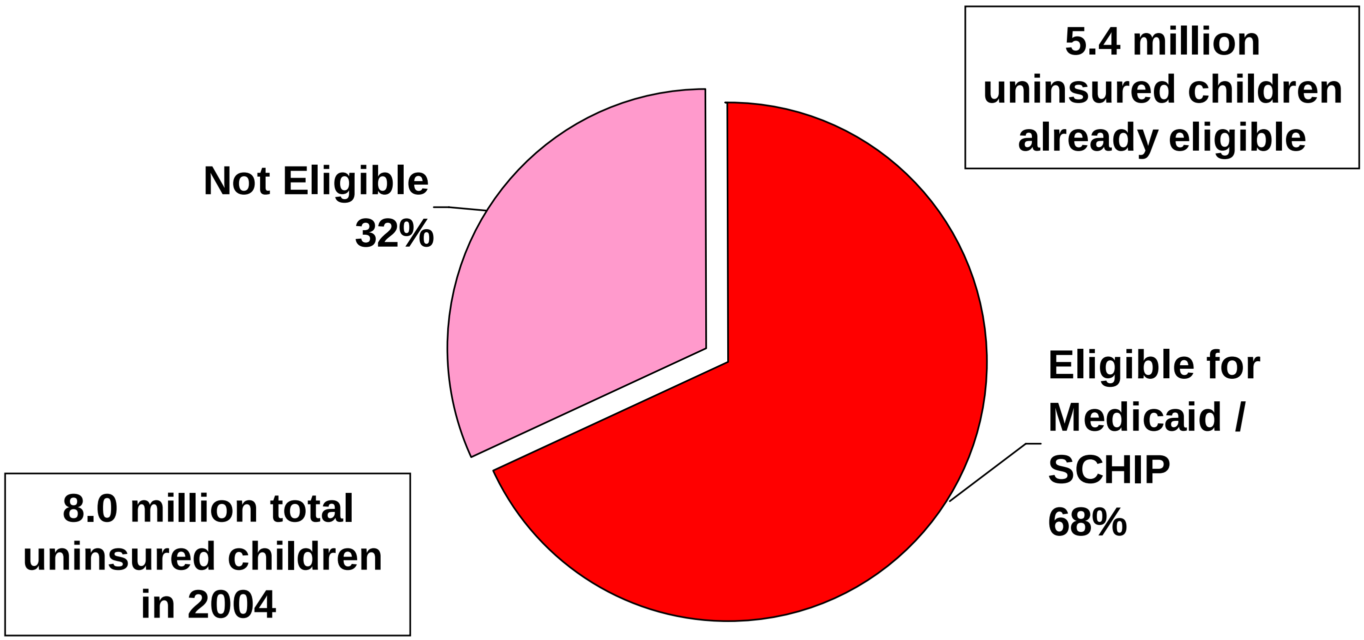
Source: Fact sheet for CBO's March 2007 baseline, State Children's Health Insurance Program. Assumes Congress will fill the fiscal year 2007 shortfall completely. Estimates reflect total number of people enrolled for any part of the year, not the number enrolled at any particular point in time.

Continuing SCHIP's success will require substantial additional resources. If Congress were to freeze funding for SCHIP at its 2007 level of $5.04 billion per year when it reauthorizes the program, then the number of children and pregnant women enrolled in SCHIP would decline from 7.6 million in 2007 to 5.3 million in 2012, a reduction of 2.3 million people.

According to the Congressional Budget Office, ensuring that states can continue operating their existing programs will require $13.4 billion in additional SCHIP funding over the years 2008-2012 . Notably, the President has proposed providing just $4.8 billion in additional funding over that period. His budget also proposes changes that would make it more difficult for states to cover certain classes of beneficiaries as well as certain other technical changes. On net, the President's SCHIP proposals would leave more than one million SCHIP enrollees at risk of losing coverage.

SCHIP Reauthorization Provides An Opportunity to Reach More Uninsured Children

Share of Uninsured Children Who Are Eligible for SCHIP or Medicaid

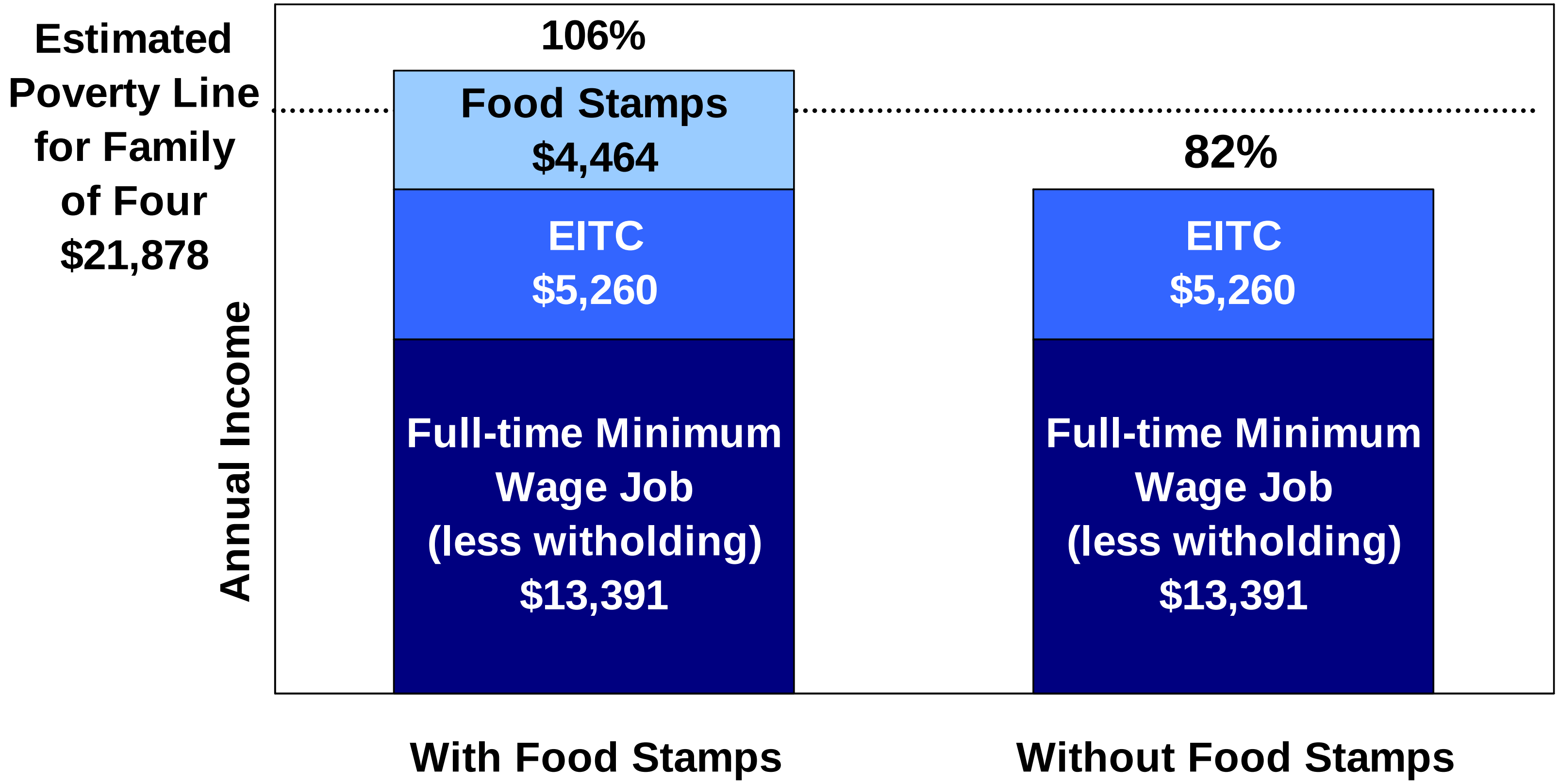


Source: Urban Institute analysis of the March 2005 Current Population Survey (CPS). All estimates reflect an adjustment for underreporting of health insurance coverage in the CPS. Note, revisions to the weighting of the March 2005 CPS were made subsequent to the completion of this analysis and are not reflected in these estimates. The impact of these weighting revisions however would be negligible.

Providing states with the funding they need to continue operating their existing programs is an absolute necessity. There is an emerging bipartisan consensus, however, that Congress should go further and make major progress toward covering the millions of uninsured low and moderate-income children.

One important way to make progress toward this goal would be to reach the 5.4 million children who are eligible for SCHIP or Medicaid but who are not currently enrolled. As shown above, these children constitute more than two-thirds the total number of uninsured children.

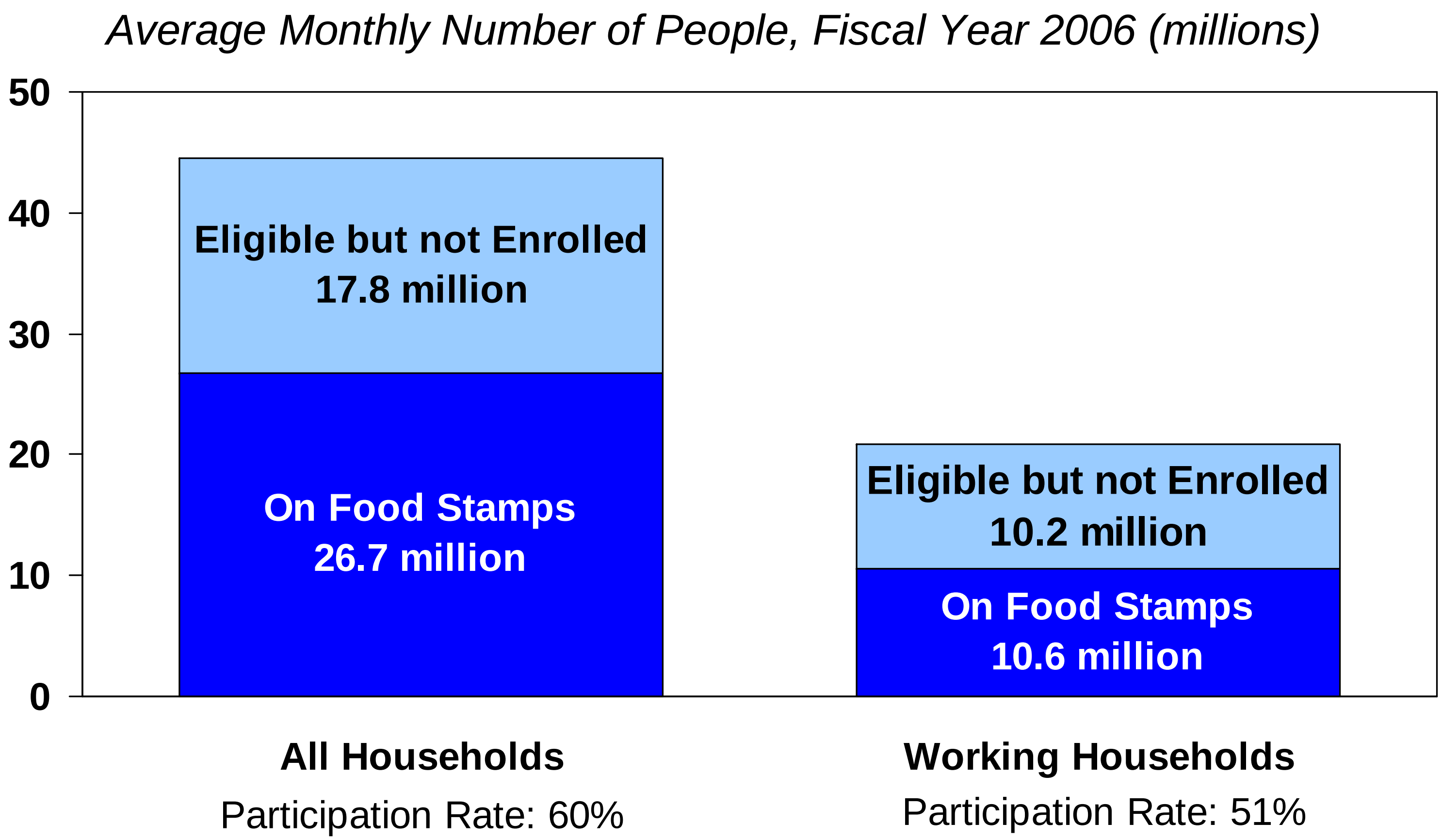
The Food Stamp Program Helps Lift Working Families to the Poverty Line



Source: CBPP estimates based on USDA and CBO Data. Amounts reflect projections for 2009. EITC includes additional child credit of $334. Calculations assume 2000 hours of work per year and enactment of the increase in the minimum wage from $5.15 to $7.25 per hour passed by the House and the Senate.

The Food Stamp Program, which provides low-income households with the resources they need to purchase an adequate diet, is also up for reauthorization this year as part of the 2007 farm bill reauthorization. The Program is widely credited with essentially eliminating severe hunger and malnutrition in the United States. Moreover, as shown above, food stamps are a critical part of the safety net for working families. When and if the proposed increase in the minimum wage takes effect in 2009, food stamp benefits, together with a full-time minimum wage job and the earned income tax credit, will lift a working family of four to 106 percent of the poverty line. Without food stamps, the family's income would sit at just 82 percent of the poverty line.

Low-Income Americans are Missing Out on Food Stamps



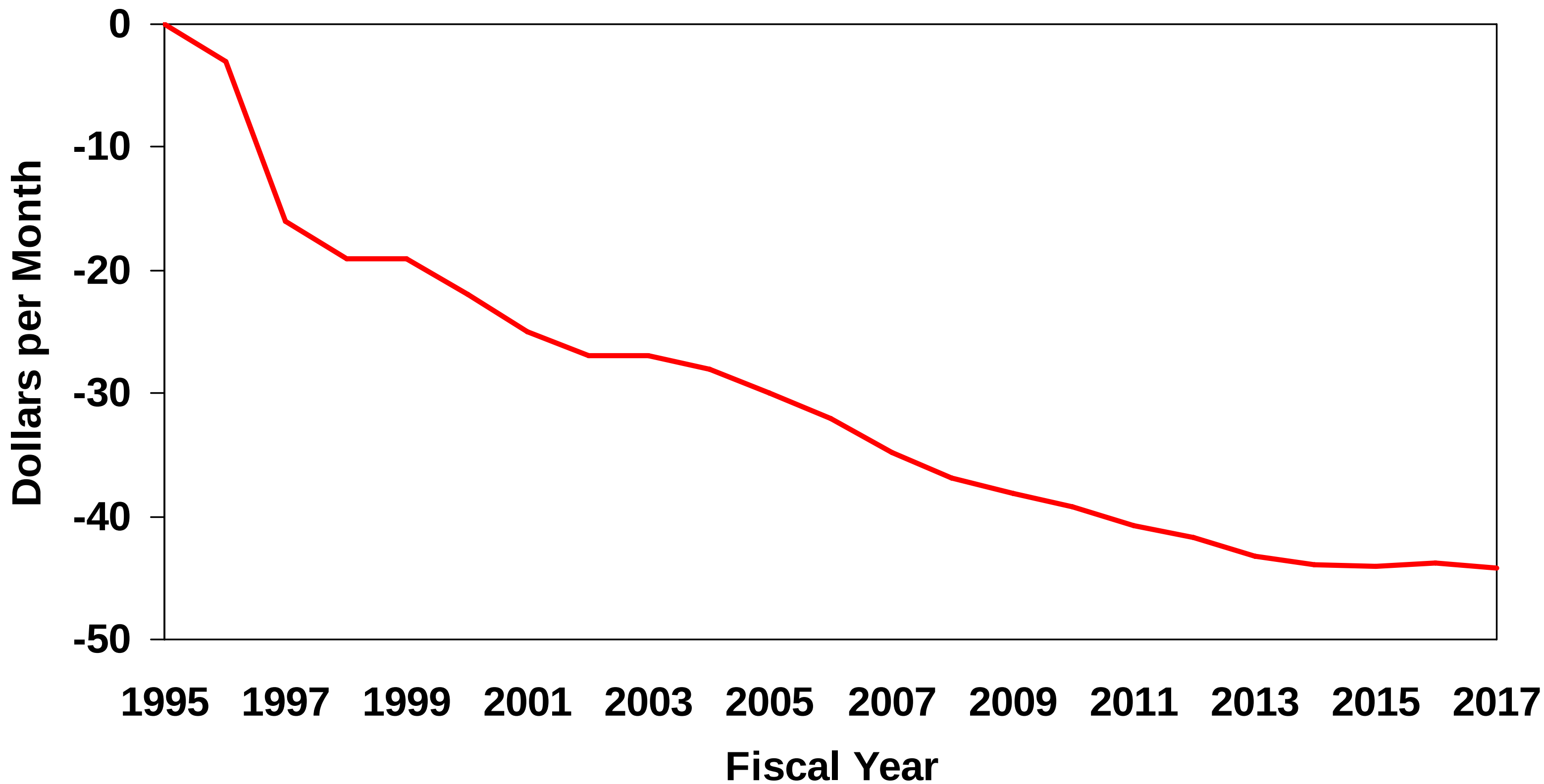
Source: CBPP estimates based on USDA data.

Despite the progress made by the Food Stamp Program, Census data indicate that in 2005 12.1 percent of Americans lived in households that had difficulty providing enough food for all households members. Congress could make important progress in reducing food insecurity by removing barriers that keep eligible households from enrolling in the Program. In 2006, on average, there were 17.8 million people who were eligible for the program but not enrolled, representing nearly 40 percent of all eligible individuals. Nearly 10.2 million of those people were in working households.

Congress could reduce barriers to enrollment by streamlining the food stamps application process. For example, Congress could permit states to enroll eligible individuals over the phone or make it easier for states to coordinate their efforts to enroll people in the Food Stamp Program with their efforts to enroll people in other public programs.

Food Stamp Benefits Have Been Eroding Since 1996

Monthly Benefit Cut for a Typical Working Household of Three (FY2008 Dollars)

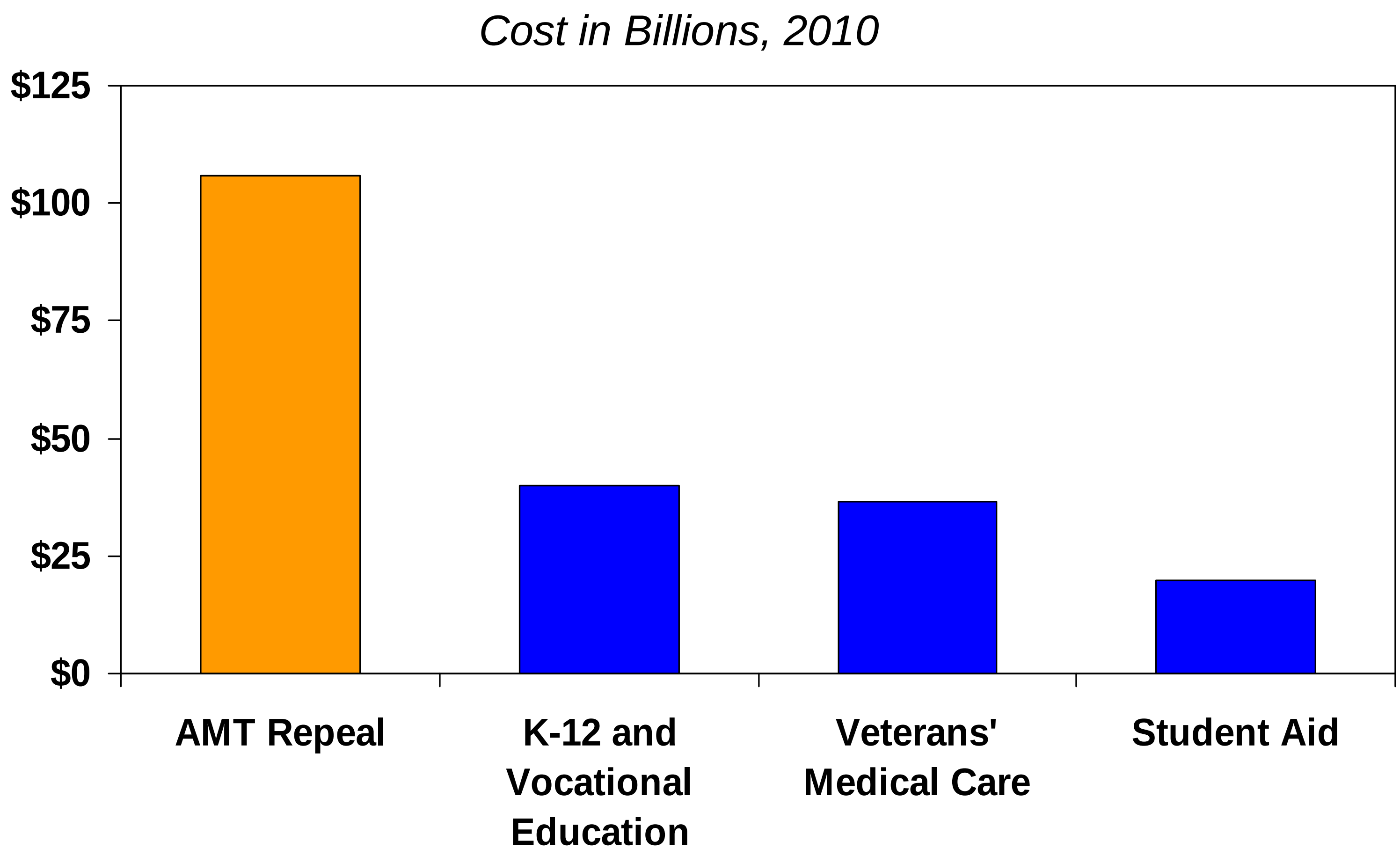


Source: CBPP estimates based on USDA and Congressional Budget Office data.

In addition to seeking to increase enrollment, Congress should take action to improve the adequacy of food stamp benefits, which currently average only about a dollar per person per meal (or, to be precise, $1.05 in 2007). Food stamp benefits have been eroding in real terms since the mid-1990s due to two changes made in the 1996 welfare law, with the result that families' food stamp benefits purchase less food each year than in the year before.

By 2008, that reduction in purchasing power for a typical working household of three will have grown to $37, and that cut will continue growing over the coming decade. Congress should take the opportunity presented by the 2007 farm bill to address this matter and improve the adequacy of food stamp benefits for the nation's neediest families.

Cost of AMT Repeal Dwarfs Cost of Maintaining Current Funding Levels for Important Programs



Source: Urban-Brookings Tax Policy Center and Congressional Budget Office data. Costs shown are 2007 discretionary funding levels adjusted for inflation.

Also on Congress' agenda is dealing with the Alternative Minimum Tax (AMT), a parallel tax system originally designed to ensure that high-income taxpayers could not avoid paying any tax in a given year. Under current law, the Alternative Minimum Tax will begin to affect a growing number of taxpayers, a growing fraction of whom will reside in middle and upper-middle income households.

Some have proposed dealing with this problem by repealing the tax altogether. Doing so, however, would be extremely expensive and would greatly exacerbate the nation's fiscal problems. Indeed, the revenue costs in 2010 alone would exceed the cost of continuing to fund important priorities like K-12 and vocational education, veterans' medical care, and college student aid at their current levels, adjusted for inflation.

V. Drivers of the Long-Term Fiscal Problem

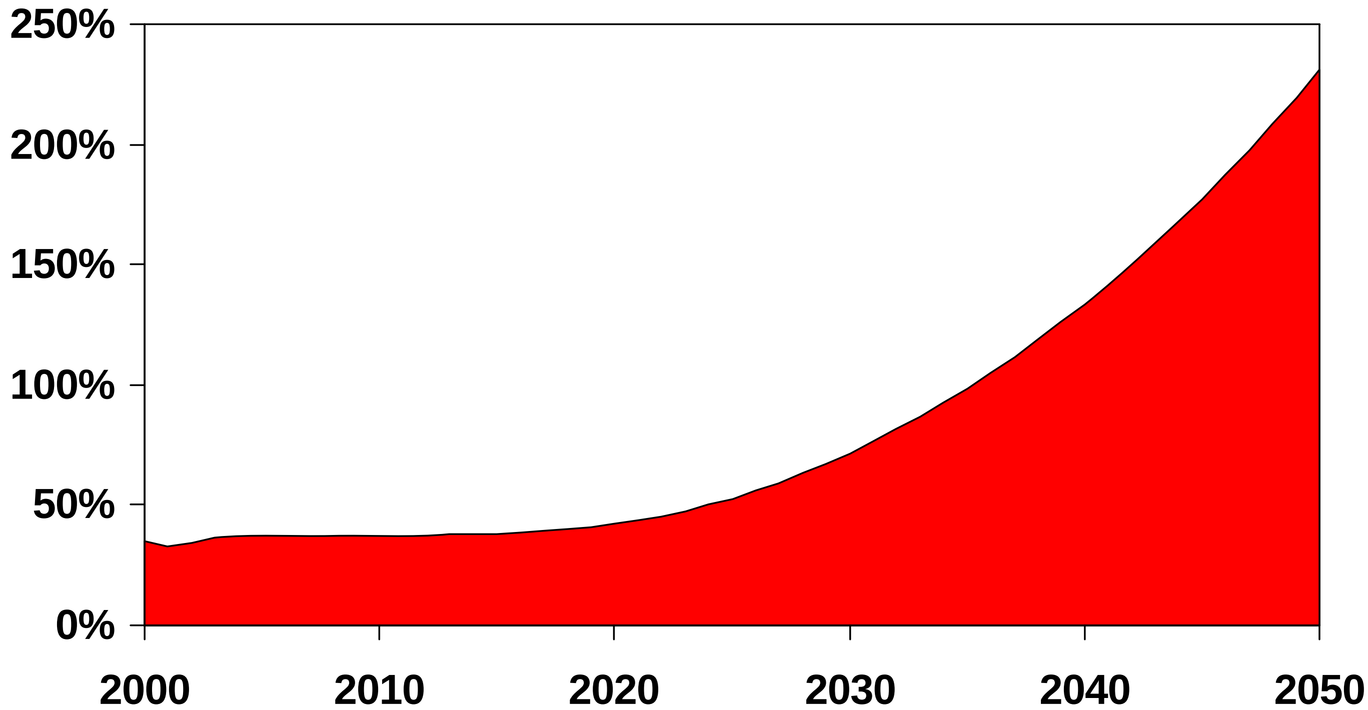
- Rising health care costs in the private and public sectors alike.

- Large tax cuts.

- The aging of the population, which raises the costs of Social Security, Medicare, and Medicaid.

Under Current Policies, Debt Will Reach 231 Percent of GDP in 2050

Debt as a Share of GDP

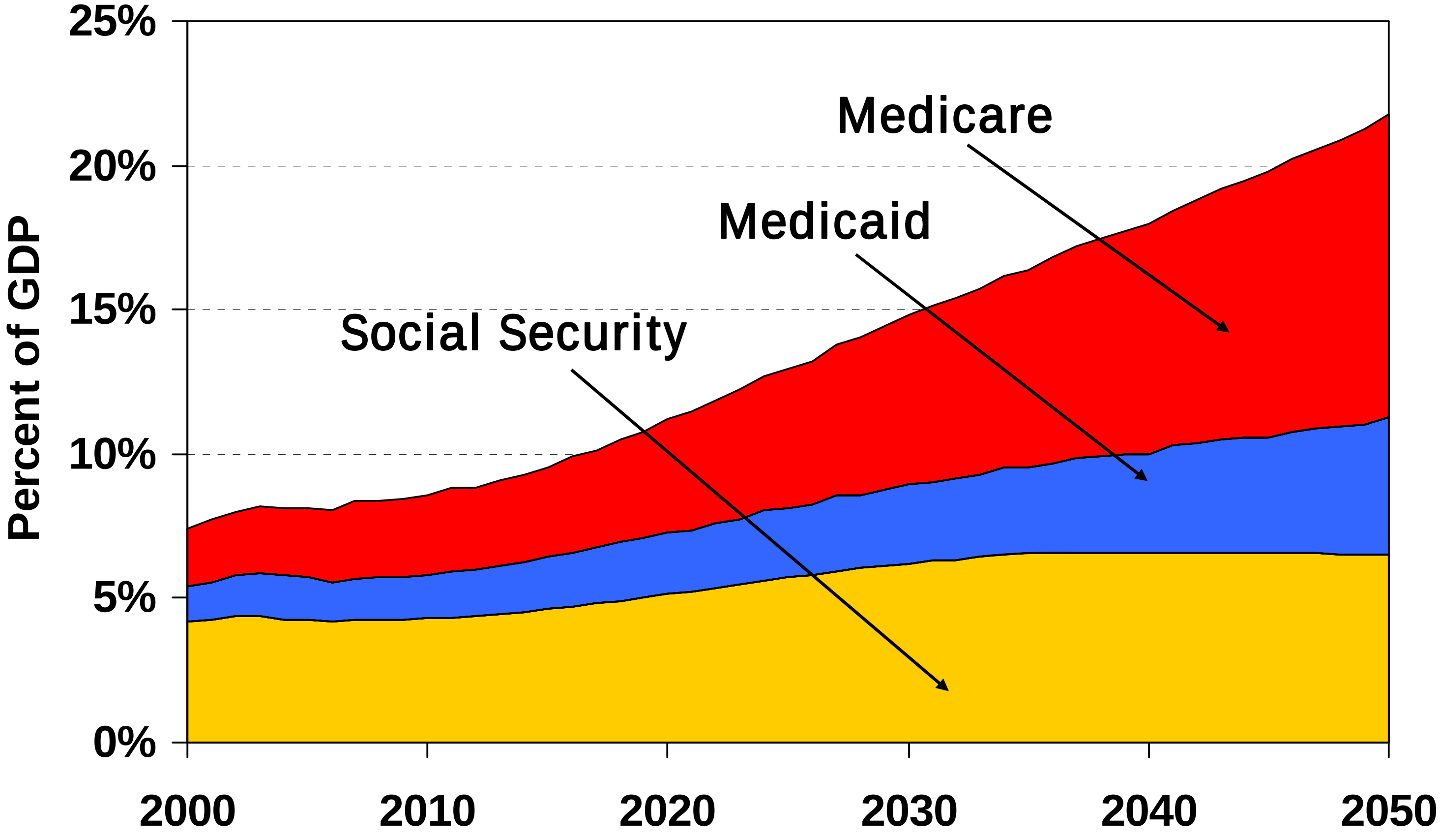


Source: CBPP projections based on Congressional Budget Office data.

The long-term fiscal outlook is considerably bleaker than the outlook for the next ten years. The combination of rising health care costs, demographic shifts caused by the retirement of the baby boomers, and the recent tax cuts (if extended and not offset) will expand deficits to levels that are economically unsustainable. Deficits will reach about 20 percent of the Gross Domestic Product by 2050, and the national debt will climb to 231 percent of GDP by that year, or more than twice the size of the U.S. economy. Debt-to-GDP ratios in this range are unprecedented in the United States, even during major wars.

Note: The figures above are CBPP projections based on Congressional Budget Office data. For details on CBPP's long-term projections, see Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, "The Long-Term Fiscal Outlook is Bleak," Center on Budget and Policy Priorities, January 29, 2007, http://www.cbpp.org/1-29-07bud.htm.

Medicare, Medicaid, and Social Security Expected to Rise Rapidly



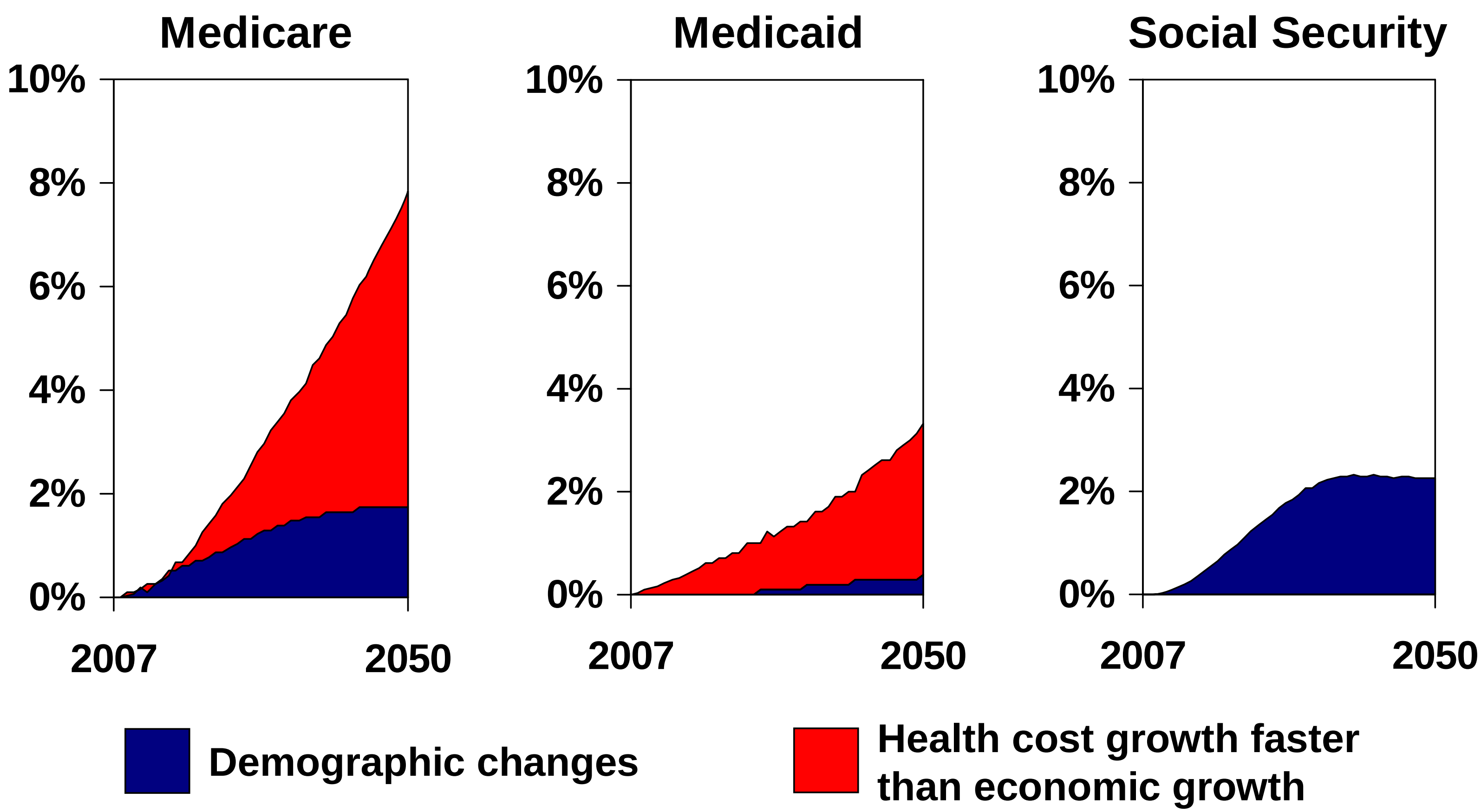
Source: CBPP projections based on Congressional Budget Office data.

On the expenditure side, the major driver of the long-term fiscal problem is rapid growth in Medicare, Medicaid, and Social Security (the "big three"). This chart shows that the combined costs of Medicare, Medicaid, and Social Security will rise substantially over the next several decades, with the largest share of the increase occurring in Medicare.

Note: The figures above are CBPP projections based on Congressional Budget Office data. For details on CBPP's long-term projections, see Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, "The Long-Term Fiscal Outlook is Bleak," Center on Budget and Policy Priorities, January 29, 2007, http://www.cbpp.org/1-29-07bud.htm.

Rising Health Costs are the Main Driver of Growth in the “Big Three”

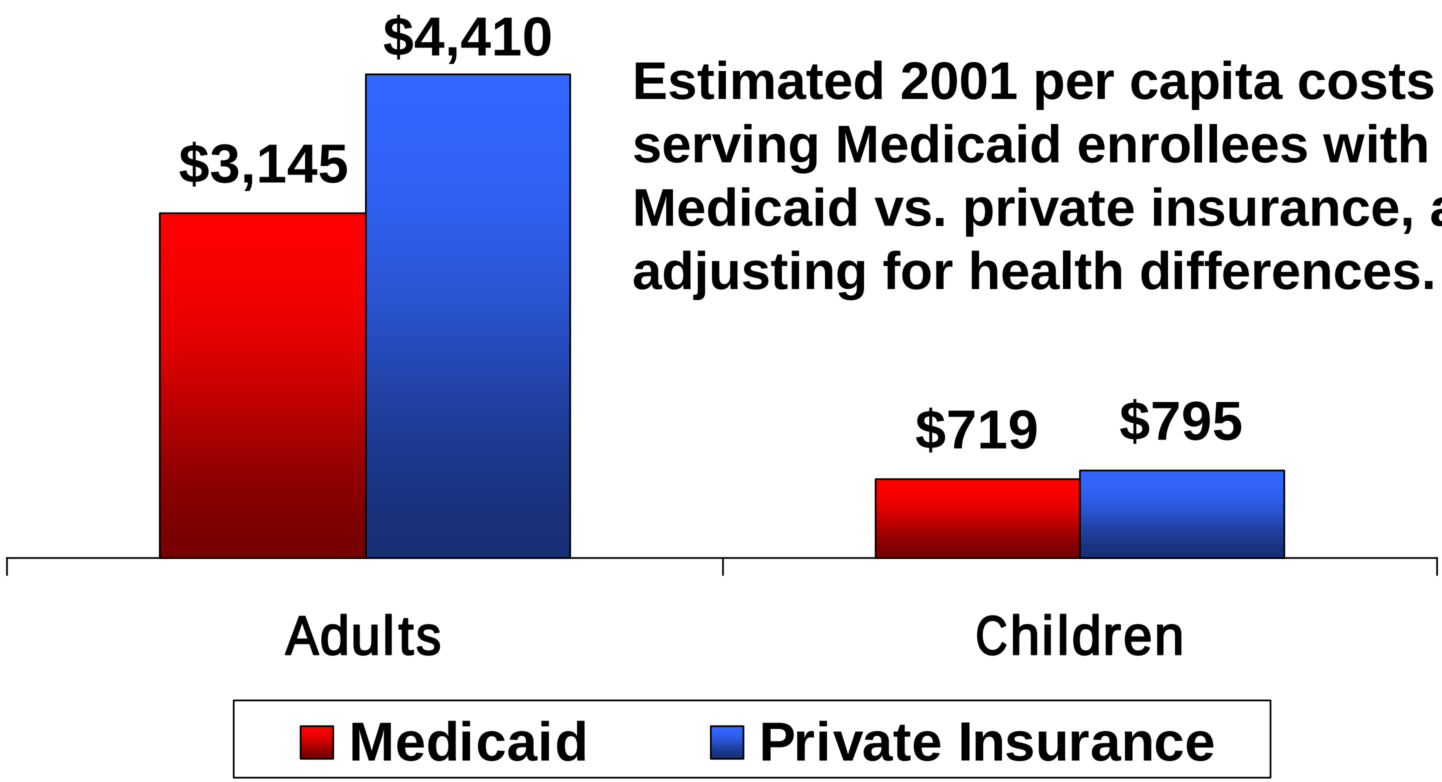
Sources of cost growth in the “Big Three” as a share of GDP



Source: CBPP projections based on Congressional Budget Office data.

The single biggest factor behind the growth in Medicare and Medicaid and, therefore, behind the overall growth in expenditures over the next several decades, is rising health care costs. Also contributing to growth in the “big three” programs is the aging of the population. Population aging increases the number of people eligible to enroll in Medicare and receive benefits from Social Security. It also increases the number of people eligible to receive long-term care through Medicaid.

Medicaid Costs Less Than Private Health Insurance

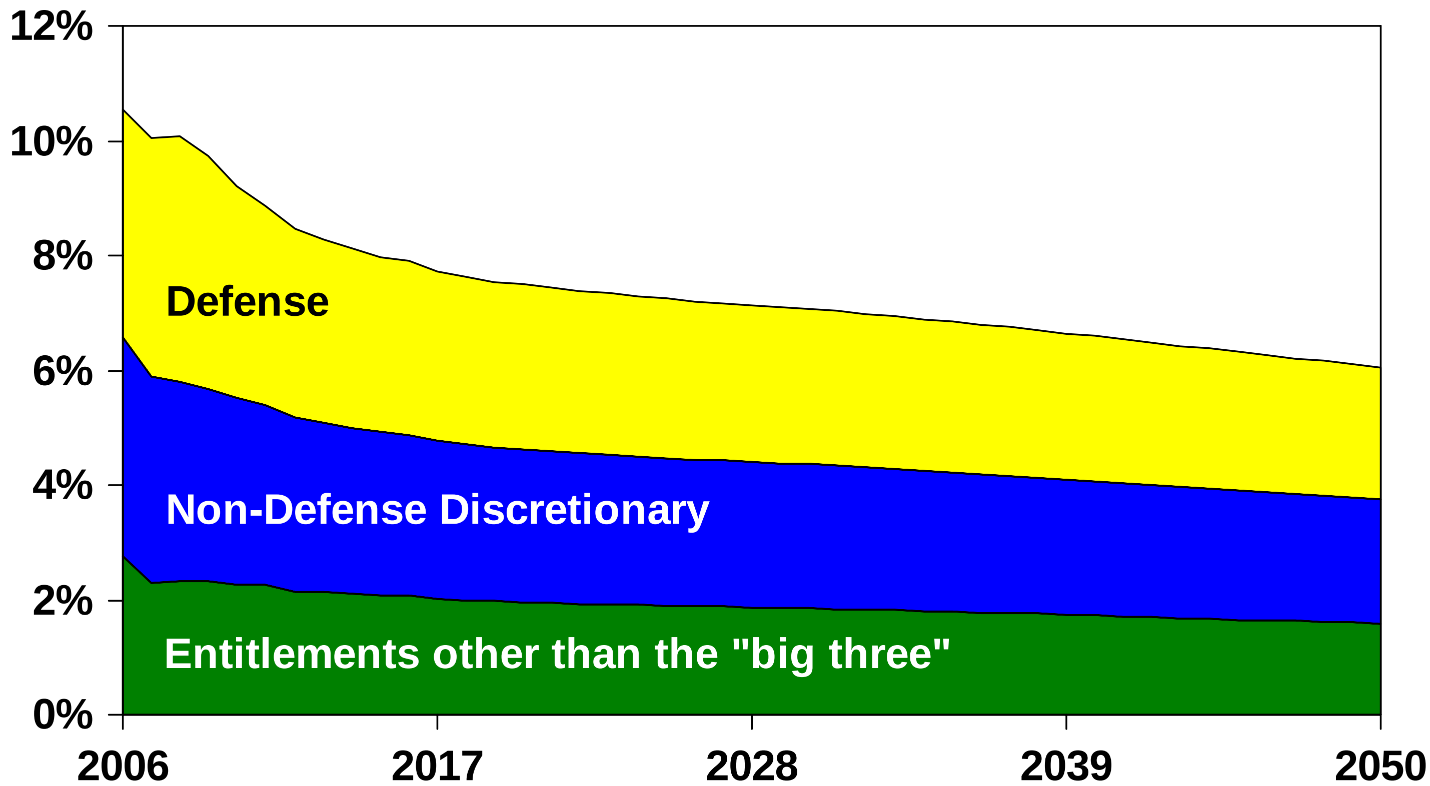


Source: Hadley and Holahan, *Inquiry,* 2004

The projected increases in Medicare and Medicaid costs do not mean these programs are more expensive or less efficient than private insurance. This chart, which presents findings from an important Urban Institute study, shows that Medicaid actually costs *less* per beneficiary than private health insurance does. In addition, in recent years, Medicare and Medicaid costs per beneficiary have risen at about the same rate as private-sector health insurance costs. This indicates that addressing the rising costs of Medicare and Medicaid will require making reforms to the entire US heath care system.

Long-Term Fiscal Problem Not a General "Entitlement Crisis"

Program spending as a Share of GDP



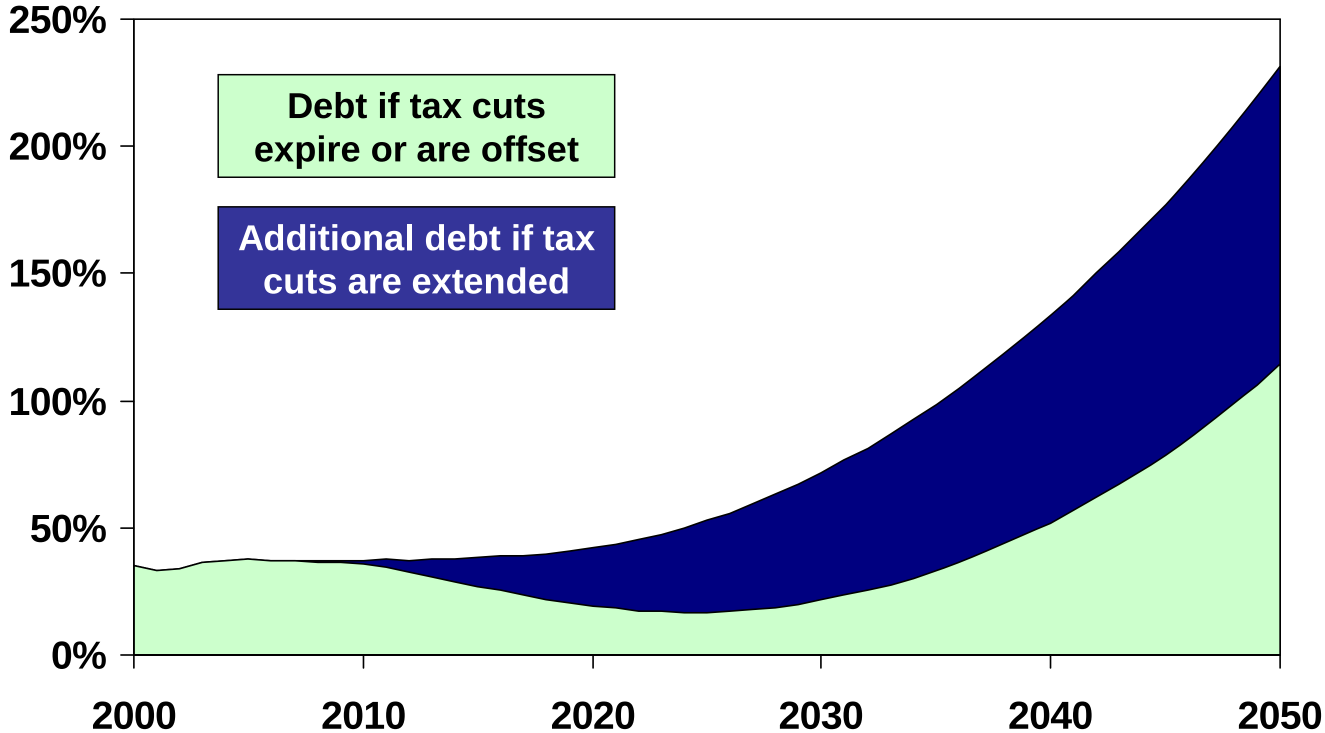
Source: CBPP projections based on Congressional Budget Office data.

All programs other than the "big three" are projected to grow *more slowly* than the economy in coming decades and consequently do not contribute to the projected rise in deficits and debt. Of particular note, *entitlement programs* outside of the "big three" are projected to grow more slowly than the economy. Common pronouncements that the nation's fiscal problems result from a general "entitlement crisis" or from an "explosion" in discretionary spending are thus mistaken.

Note: The figures above are CBPP projections based on Congressional Budget Office data. For details on CBPP's long-term projections, see Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, "The Long-Term Fiscal Outlook is Bleak," Center on Budget and Policy Priorities, January 29, 2007, http://www.cbpp.org/1-29-07bud.htm.

Debt With and Without Unpaid for Extension of Recent Tax Cuts

Debt as a Share of the Economy



Source: CBPP projections based on Congressional Budget Office data.

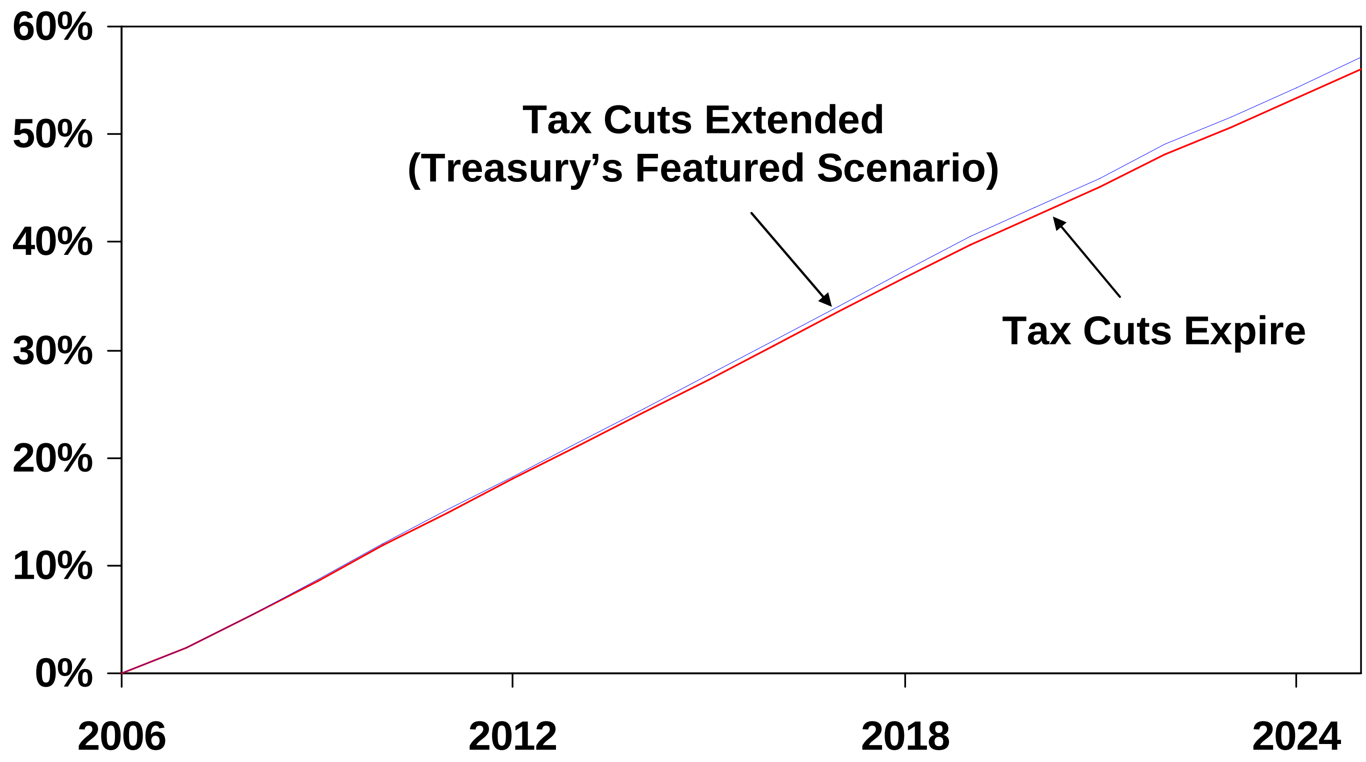
Upcoming tax policy decisions will have a substantial effect on the size of the long-term fiscal problem. As shown above, even if the tax cuts are not extended (or are extended but their costs are offset), the long-term outlook is bleak. Under those circumstances, the debt will reach over 114 percent of the economy in 2050. Debt has never reached this level in the United States, even at the end of World War II.

But extending the tax cuts enacted since 2001 without paying for them would sharply worsen this already bleak long-term fiscal outlook. The tax cuts reduce revenues by about 2 percent of GDP each year. In addition, each year of extending the tax cuts without paying for them would add to the national debt and therefore to interest payments. Those additional interest payments would compound over time, with the result that extending the tax cuts without paying for them would essentially double the size of the debt in 2050.

Note: The figures above are CBPP projections based on Congressional Budget Office data. For details on CBPP's long-term projections, see Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, "The Long-Term Fiscal Outlook is Bleak," Center on Budget and Policy Priorities, January 29, 2007, http://www.cbpp.org/1-29-07bud.htm.

Treasury Department: Long-Run Effects of Tax Cuts on Economy Small, Possibly Negative

Percent Increase in Real GDP through 2025



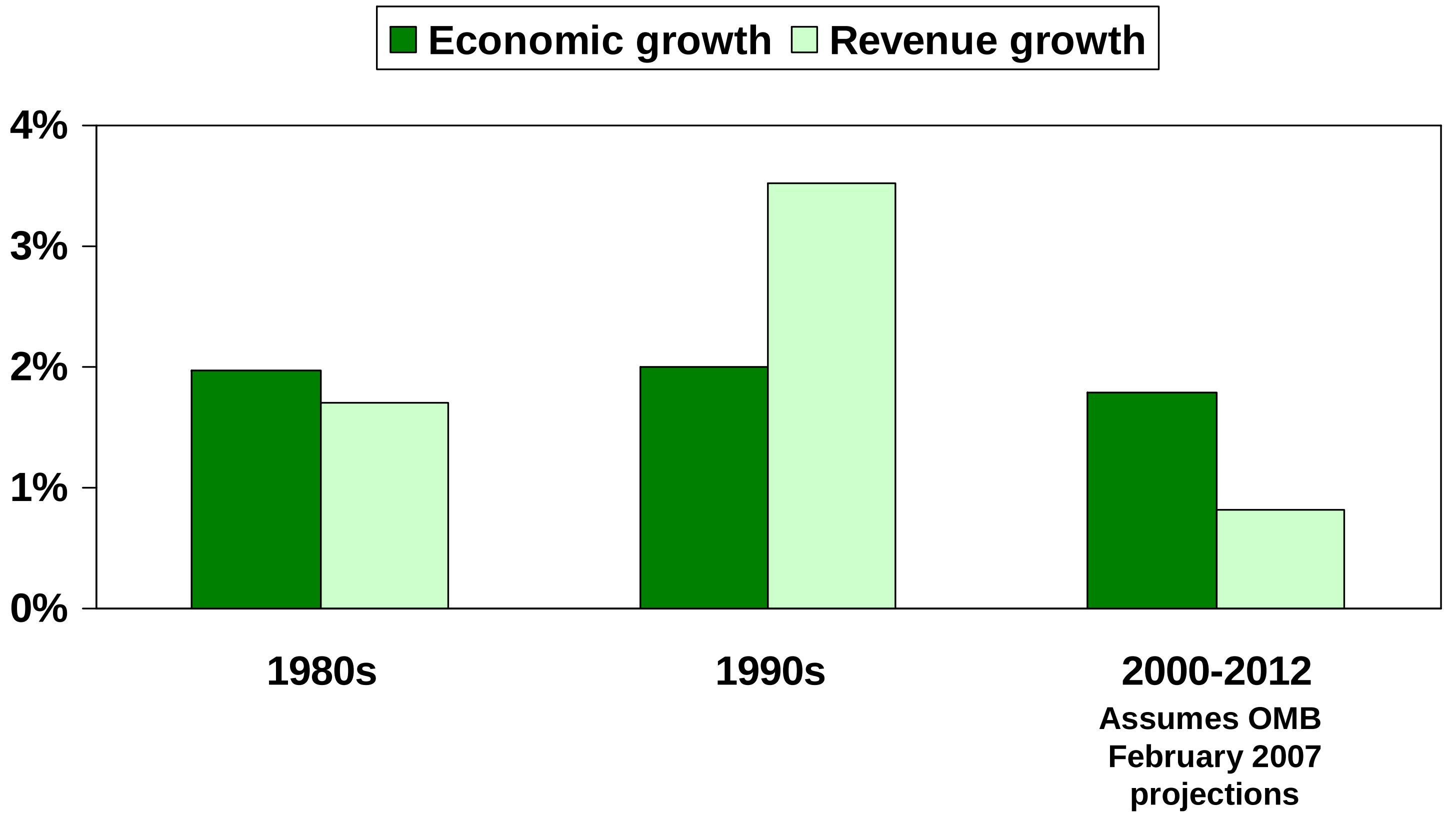
Source: CBPP calculations based on Treasury "Dynamic Analysis." Treasury did not provide year-by-year figures, so the path provided is illustrative only. Path assumes full benefits materialize by 2025.

Proponents of extending the President's tax cuts argue that allowing the tax cuts to expire would greatly reduce long-run growth. But a study by the Bush Administration's own Treasury Department has concluded that any economic benefits of the President's tax cuts would be nearly imperceptible.

Specifically, in its featured scenario, Treasury found that if the tax cuts were paid for with spending cuts, then extending the tax cuts would increase the size of the economy by less than one percentage point in the long-run. In other words, the Treasury study implies that if total economic growth through 2025 would be 56 percent without the tax cuts, then total economic growth through 2025 would be 57 percent with the tax cuts (assuming that the full economic benefits had materialized by that year). Treasury also found that if the tax cuts were extended but not paid for with spending cuts, then they would actually reduce economic growth.

Economic and Revenue Growth Following 1980s and Recent Tax Cuts and 1990s Tax Increases

Growth Rates, Adjusted for Inflation and Population Growth



Source: CBPP calculations based on Commerce Department and Office of Management and Budget data.

Some proponents of tax cuts even contend that they "pay for themselves" — in other words, they cause so much additional economic growth that total revenues end up being larger than if the tax cuts were not enacted. The data shown here contradict that claim. They show that the economy grew just as quickly during the 1990s, when taxes were raised, as during the 1980s, when taxes were cut, and that *revenues* grew much more quickly during the 1990s than the 1980s.

Moreover, the Administration itself estimates that if the 2001 and 2003 tax cuts are extended, economic growth between 2000 and 2012 will be no faster than in the 1990s or 1980s, and revenue growth between 2000 and 2012 will lag well behind economic growth. Normally, when there are no significant changes in tax policy, revenues grow at about the same pace as the economy.

Studies Find Recent Tax Cuts, If Not Offset, Are at Least as Likely to Reduce Long-Term Economic Growth as to Increase It

"Nearly all of the simulations [done of the tax cuts' effects on the economy] showed that the tax cuts would have positive effects in the short run and negative effects in the long run."

-- Congressional Research Service

"making the 2001 and 2003 tax cuts permanent would raise the cost of capital for new investments, reduce long-term investment, and reduce economic growth."

-- William Gale, Brookings Institution; and Peter Orszag (formerly of the Brookings Institution, now director of Cong. Budget Office)

Studies by **Federal Reserve economists, the Congressional Budget Office, the Joint Committee on Taxation**, and other noted experts have produced similar findings regarding the effects of unpaid for tax cuts.

In addition, most mainstream economic institutions that have considered the economic effects of the tax cuts have concluded that, because they are deficit-financed, they are very unlikely to produce significant economic gains over time and, in fact, are at least as likely to *reduce* long-term growth as to increase it. This has been the conclusion of economists at institutions such as the Congressional Research Service, the Congressional Budget Office, the Brookings Institution, the Federal Reserve, and Congress's Joint Committee on Taxation.

Sources: Mark Labonte, "What Effects Have the Recent Tax Cuts Had on the Economy?" Congressional Research Service, April 14, 2006; Gale & Orszag, "Budget Deficits, National Saving, and Interest Rates," prepared for the Brookings Panel on Economic Activity, September 2004, p. 34; Elmendorf & Reischneider (Federal Reserve economists), "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," National Tax Journal, Sept. 2002, pp. 357-86; Congressional Budget Office, The Budget and Economic Outlook: An Update, Aug. 2003, p. 45; Joint Committee on Taxation, "Macroeconomic Analysis of HR 2," Congressional Record, May 8, 2003, pp. H3829-32.

VI. Where Do We Go From Here?

Likely Consequences of *Un*balanced Approach to Deficit Reduction

- Large cuts over time in programs for the poor.
- Increases in number of uninsured Americans.
- Federal government may be unable to fulfill some core functions.
- More costs shifted to states.

Long-term deficit reduction is an imperative. There are different approaches to that goal, however. For simplicity's sake, one can think of two broad paths to deficit reduction: an unbalanced approach and a balanced approach.

Some policymakers are now promoting an unbalanced approach, consisting of ever-increasing tax cuts and with significant parts of the budget (such as revenues and defense spending) "off the table" for possible deficit-reduction measures. This approach is likely to lead not only to large deficits, but also to substantial cuts over time in programs for less-fortunate Americans, an erosion of the federal government's ability to perform various core functions, a further widening of gaps between rich and poor, and the shifting of substantial costs to states. Thus, it is crucial that both sides of the budget – revenues and expenditures – be on the table when serious conversations about deficit reduction begin.

The Goal: *Balanced* Approach To Deficit Reduction

- Balanced approach would include revenue increases as well as spending cuts.
- Cuts would not fall disproportionately on low-income programs and would focus on “weak claims,” not “weak clients.”
- Balanced approach was taken in 1990 and 1993 by Presidents Bush and Clinton.

A balanced approach to deficit reduction puts all parts of the federal budget on the table and goes after “weak claims,” not “weak clients.” In the 1980s, President Reagan’s budget director David Stockman argued that deficit-reduction efforts should focus on policies that are weak on their merits (“weak claims”), not on policies that assist people who lack money and influence (“weak clients”).

A balanced deficit-reduction path is not alien to American political culture. It is the approach followed by the major deficit-reduction bills enacted in 1990 (under the first President Bush) and 1993 (under President Clinton).

The Big Enchilada:
The U.S. Health Care System

- The largest factor behind the grim budget forecast is the rising cost of Medicare and Medicaid.
- The rising costs of these programs essentially reflect the rapidly rising costs in the entire U.S. health care system.
- To cut future costs in Medicare and Medicaid sharply *without* restraining costs in the health care system as a whole would necessitate draconian cuts in these programs.
- Thus, the key to addressing the future implosion of the budget is to reform the U.S. health care system

In addition, responsibly addressing the nation's budget problems will require more than making changes to both sides of the budget. It will also require fundamental reforms to the entire U.S. health care system. As noted earlier, health care costs are the single largest contributor to the long-run budget problem, and cost growth in Medicare and Medicaid tends to mirror — and is driven to a very large extent by — cost growth in the health care system as a whole, including private-sector health care.

Consequently, trying to slow public-sector health care cost growth appreciably without addressing private-sector health care cost growth would require draconian cuts in Medicare and Medicaid that would have severe effects on the poor, the elderly, and those with serious disabilities. For this reason, any reforms aimed at reducing the rate of growth of Medicare and Medicaid must be part of a package of reforms designed to slow cost growth throughout the health care system.

Some First Steps Under a Balanced Approach to Deficit Reduction

- Abide by “Pay As You Go” rules requiring both tax cuts and increases in entitlement programs to be paid for.
- Shelve tax cuts not yet fully in effect; do not extend expiring tax cuts unless they are paid for.
- Adopt recommendations from congressional Medicare commission to curb excessive Medicare payments to health-care providers.
- Pare back earmarks in appropriations bills.
- Adopt Joint Tax Committee proposals to curb unproductive tax breaks and shelters and reduce tax avoidance.
- Use better inflation measure for everything from Social Security cost-of-living adjustments to indexing of the tax code.

Pursuing a balanced approach to deficit reduction will take bipartisan action. Unfortunately, the major steps it would entail do not seem likely in the immediate future. There are, however, some initial steps that could begin to take us down that path. Several examples of such steps are listed here.