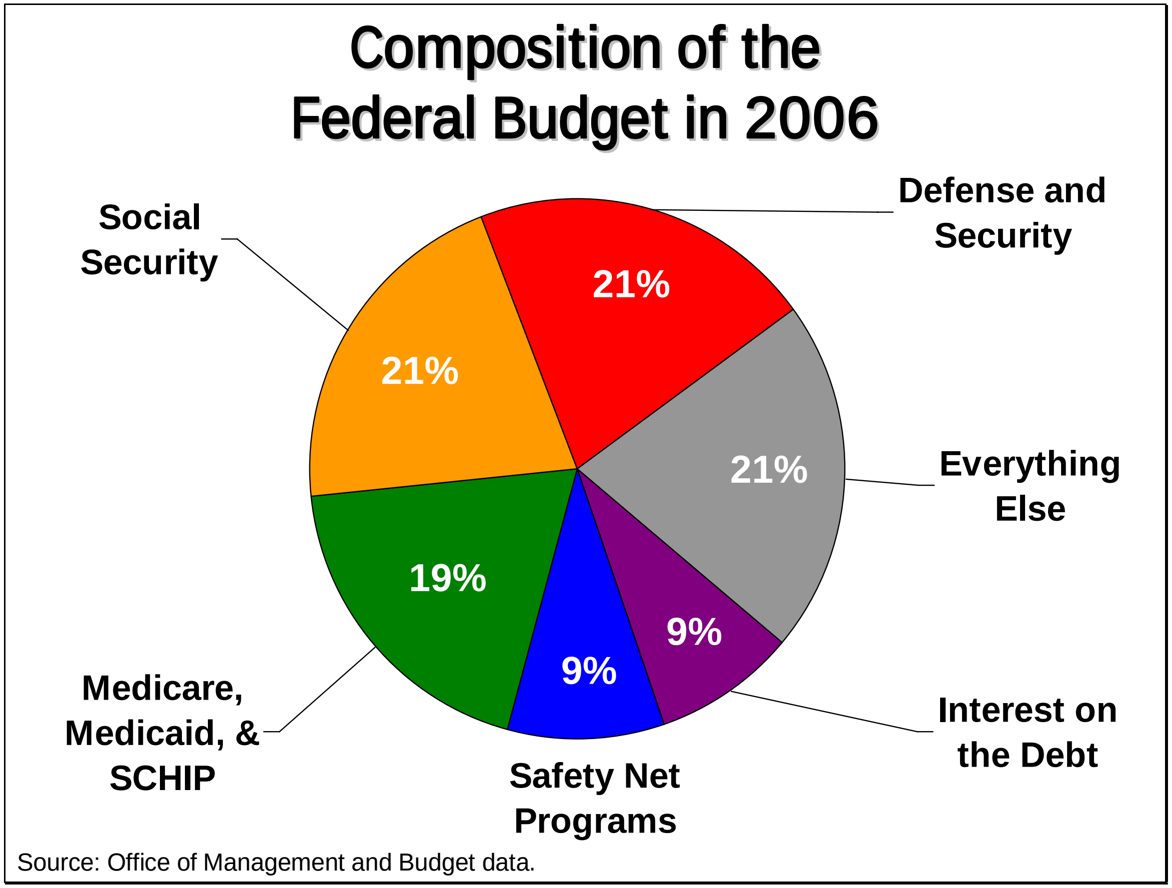
I. Background on the Federal Budget

Slide 2



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 remaining fifth of the budget funded a wide variety of public services. These include providing health care and other benefits to veterans and retirement benefits to retired federal employees, assuring safe food and drugs, protecting the environment, and investing in education, scientific and medical research, and basic infrastructure such as roads, bridges, and airports

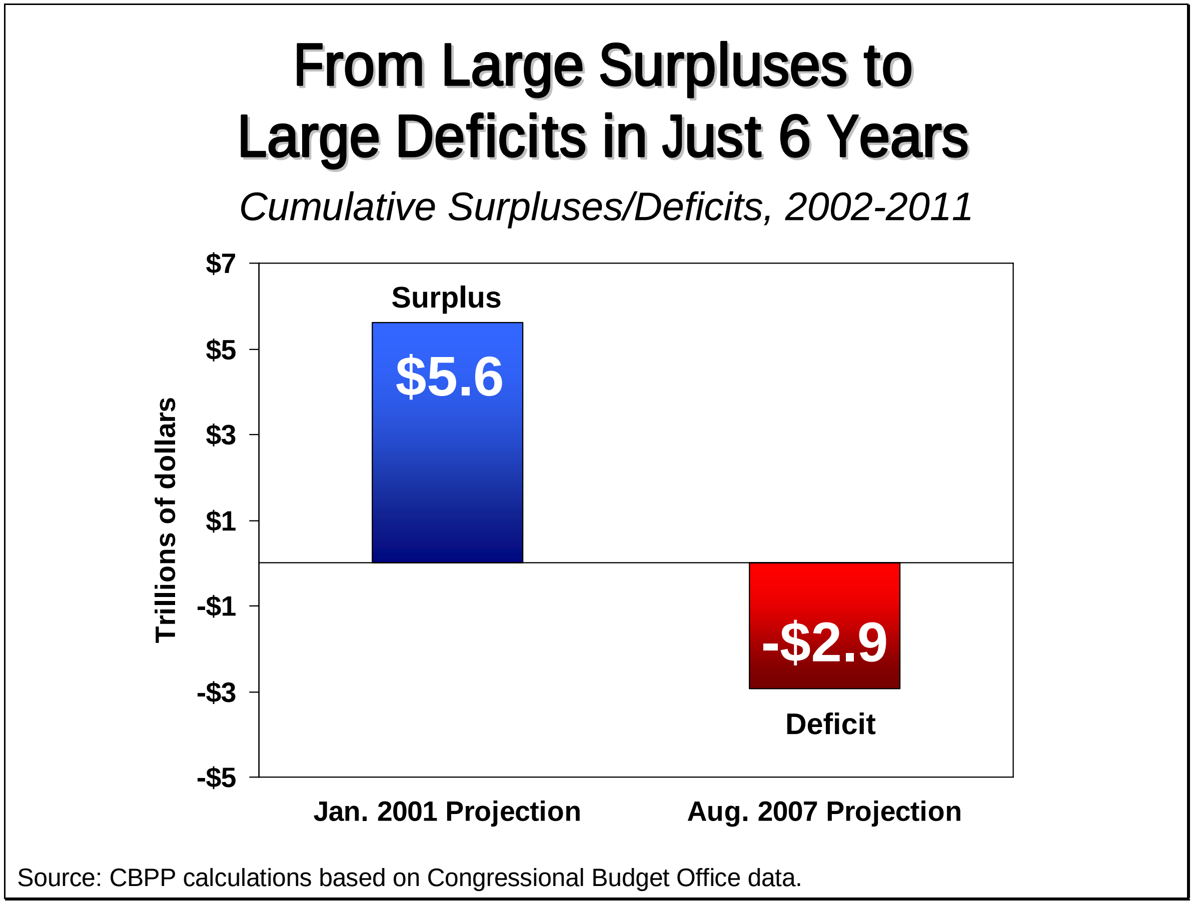
The Federal Budget in 2007

Revenues	$2.568 trillion
Expenditures	$2.731 trillion
Deficit	$ 163 billion

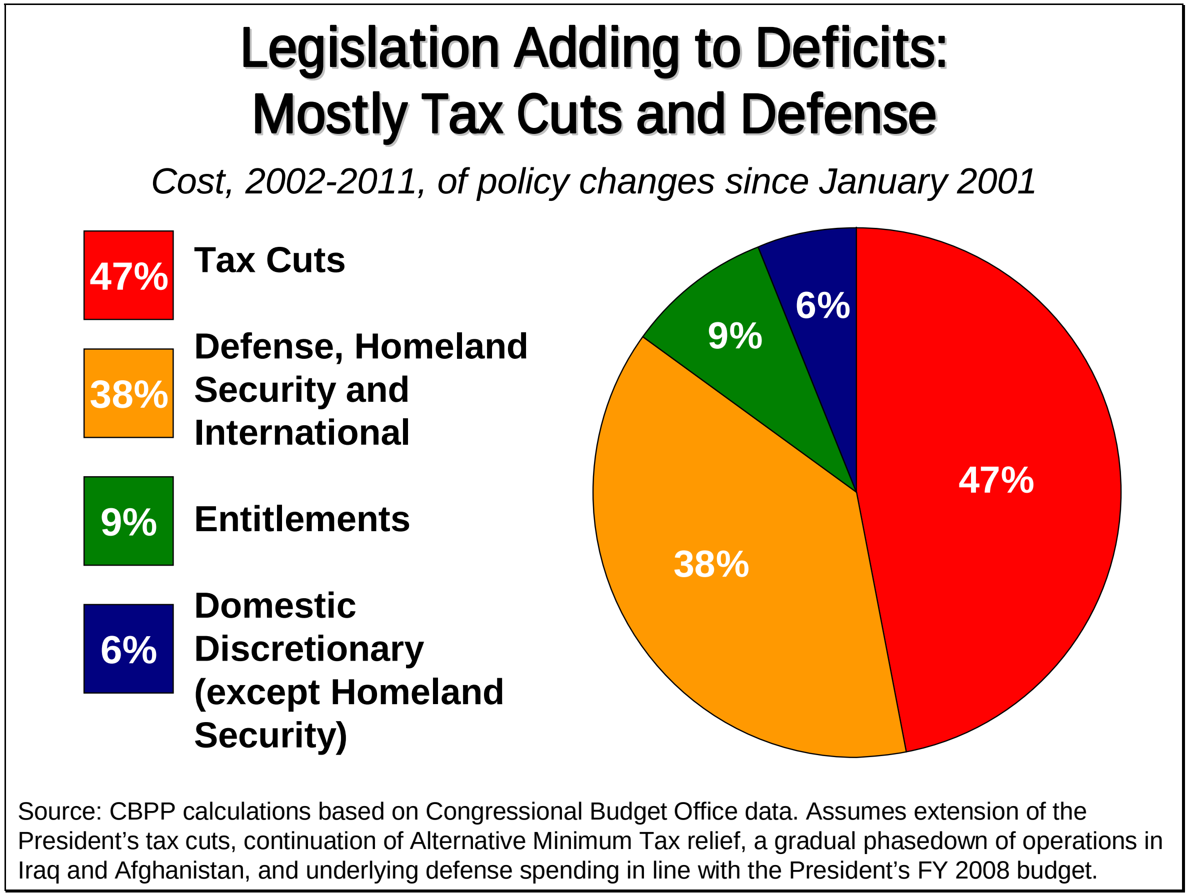
Source: Congressional Budget Office.

Because federal revenues were $163 billion less than federal expenditures in fiscal year 2007, the federal government ran a deficit of $163 billion last year.

Slide 4

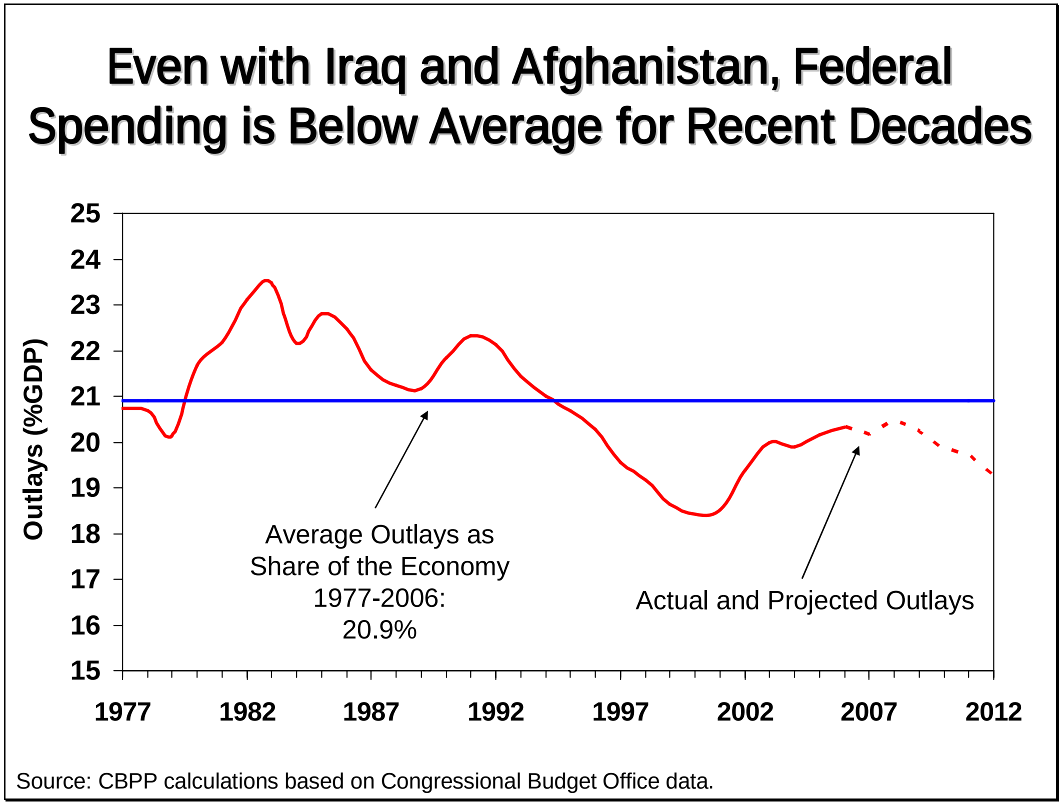


Just several years ago, we had large budget surpluses, not large deficits. In January 2001, the Congressional Budget Office projected that the federal government would amass $5.6 trillion in *surpluses* over the period 2002-2011 if policies did not change. CBO's recent projections, issued in August 2007, indicate that the federal government will amass *deficits* of $2.9 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 $8.5 trillion for this ten-year period, from projected surpluses of $5.6 trillion to projected deficits of $2.9 trillion.



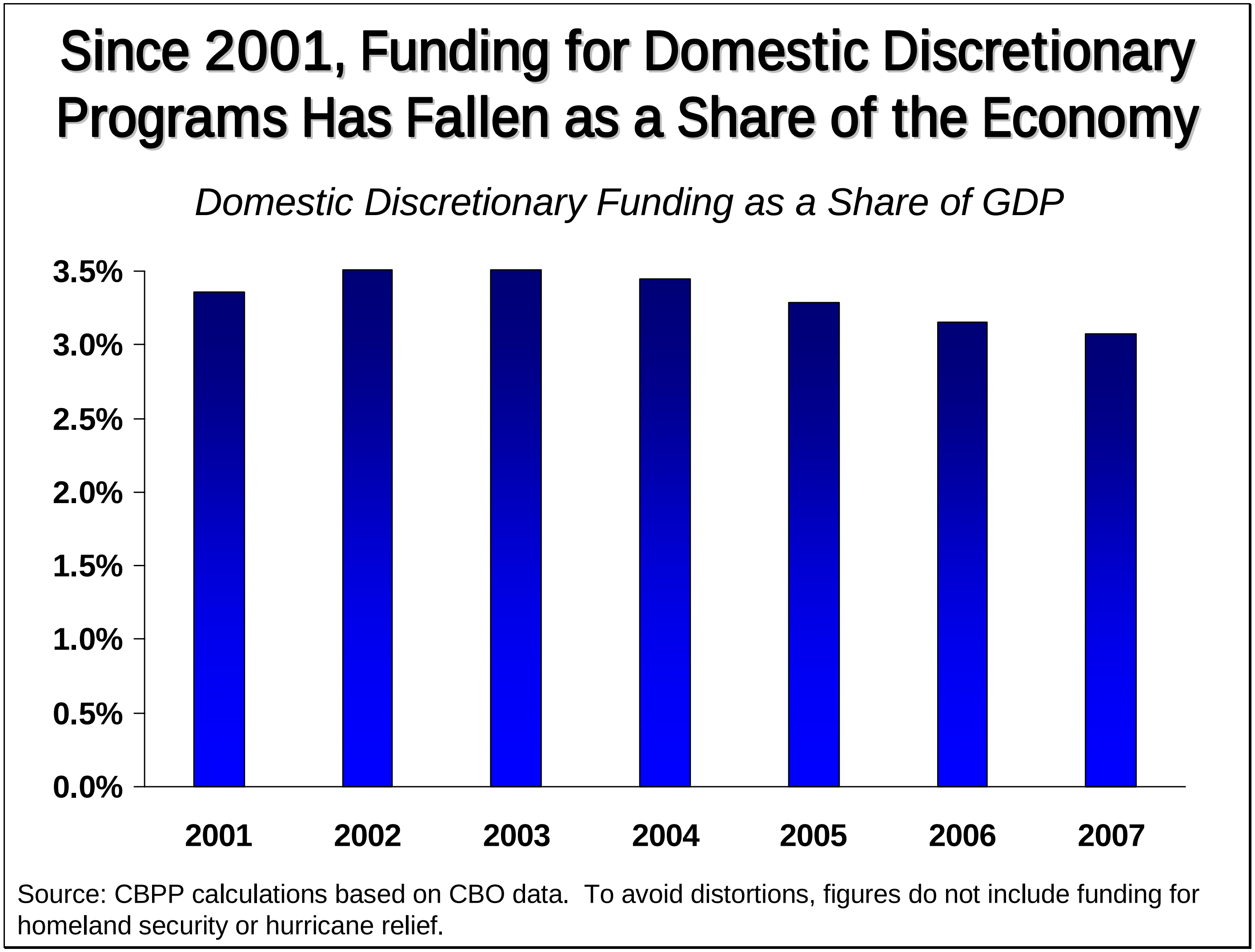
The bulk of the deterioration in the budget since the start of 2001 — some 75 percent of it — has come from policy changes (i.e. tax cuts and spending increases), rather than from economic and technical factors outside policymakers' control.

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.



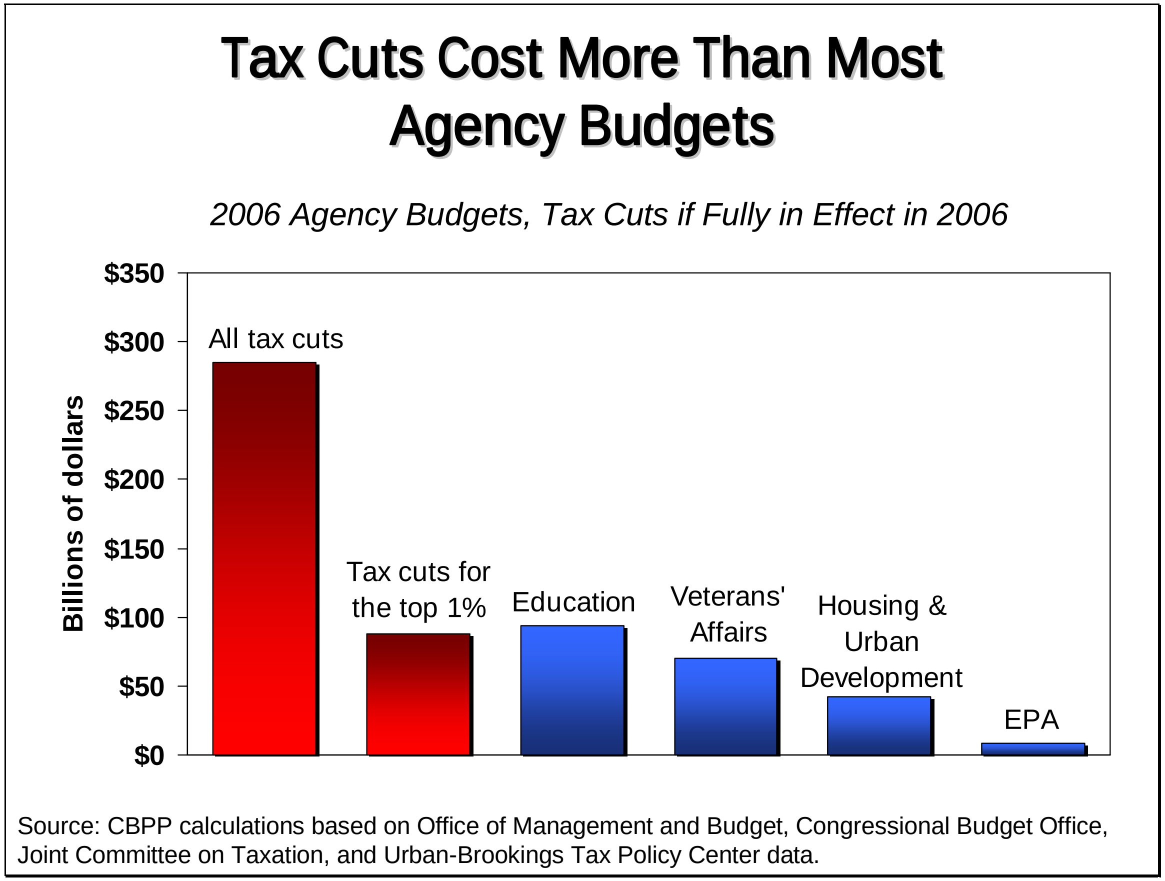
Some people claim that large deficits have emerged in recent years because spending has "exploded." The data show this claim is not correct. The principal way that analysts measure trends in federal spending and revenues over time is as a share of the U.S. economy (that is, as a share of the gross domestic 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.



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.

Slide 8



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.

Slide 9

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.

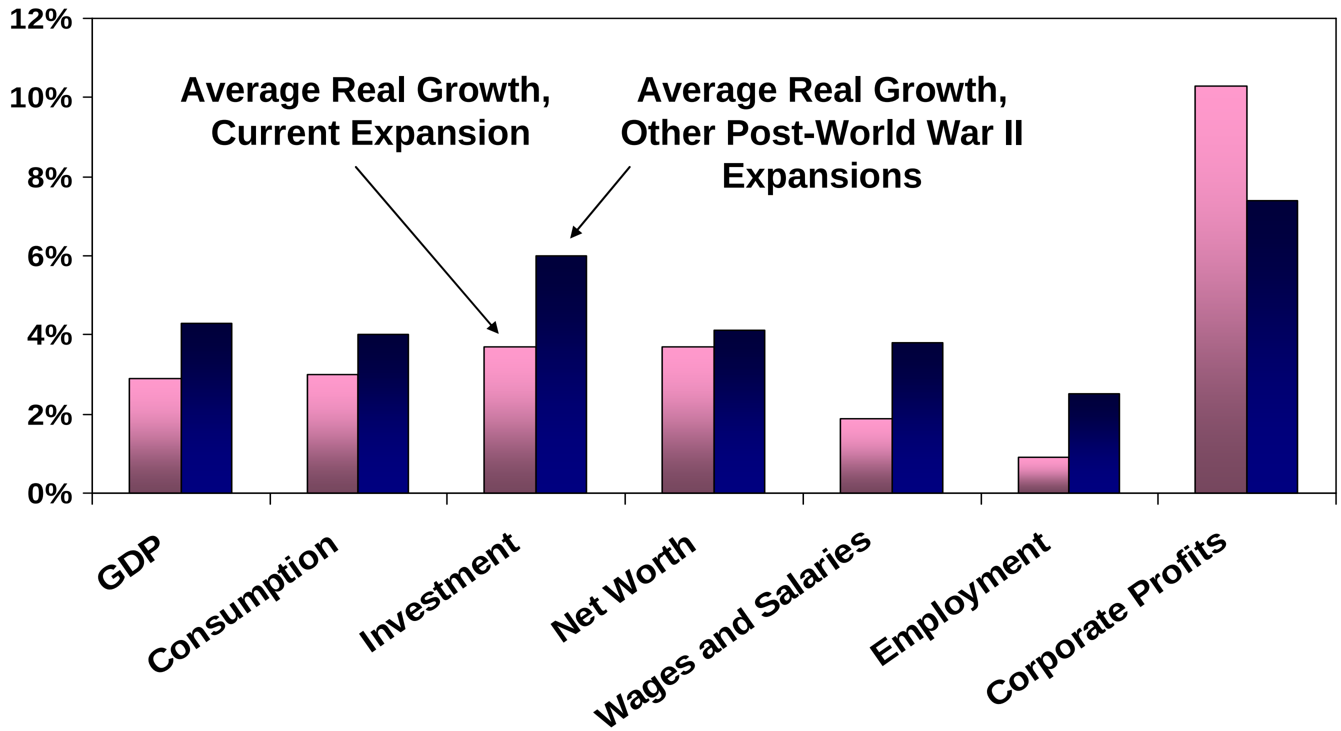
Congress' options for eliminating that deficit would include cutting Social Security benefits by almost a third, eliminating more than half of Medicare, or reducing defense spending by about two-fifths. Alternatively, if changes were not made in Social Security, Medicare, or defense, then balancing the budget by 2012 would require eliminating one-fifth of the rest of the federal government.

Note: The President's fiscal year 2008 budget claimed to achieve balance in 2012 without program cuts of the magnitude shown above. For two reasons, however, the President's claim is not credible. First, the White House employed relatively optimistic revenue assumptions. Under the more realistic assumptions used by the Congressional Budget Office, the President's policies would lead to a deficit of $31 billion in 2012, not the surplus of $61 billion projected by the White House. Second, the President's budget omitted several key costs, including the cost of continuing relief from the Alternative Minimum Tax and the cost of providing funding for operations in Iraq and Afghanistan after 2009. With these costs included, the needed cuts are far deeper.

The calculations above assume a gradual phasedown of operations in Iraq and Afghanistan and funding of the defense requests in the President's FY 2008 budget. The figures further assume that the program cuts are phased in over the next five years.

II. The Economic Record of the Last Seven Years

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

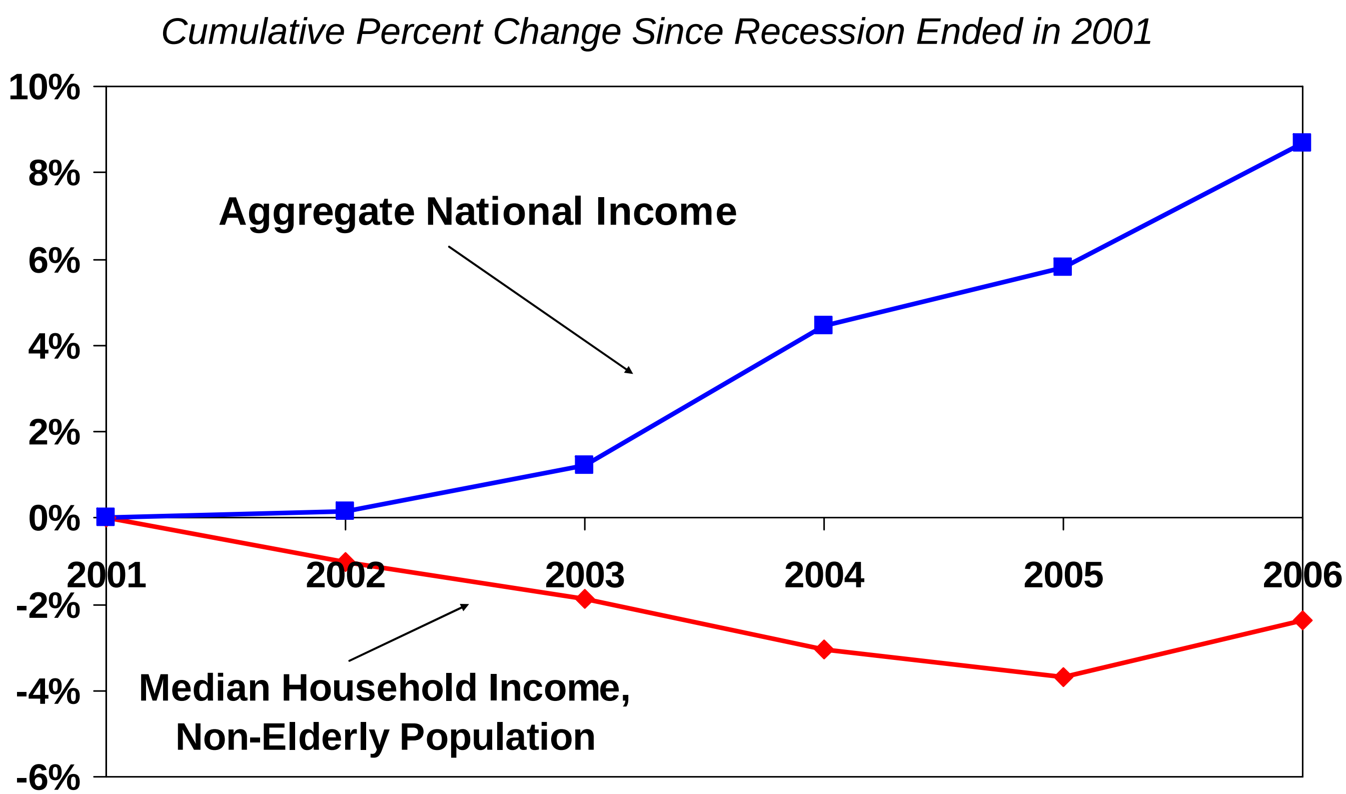


Source: CBPP calculations based on Commerce Department, Labor Department, and Federal Reserve data. Employment data through December 2007. All other data through the third quarter of 2007.

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 outperformed other recent expansions in only one area: the growth of corporate profits.

Note: For more details, see Aviva Aron-Dine, Chad Stone, and Richard Kogan, "How Robust is the Current Economic Expansion?," Center on Budget and Policy Priorities, revised January 14, 2008, http://www.cbpp.org/8-9-05bud.htm.

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



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 $1,300 below its level during the 2001 recession. Meanwhile, high-income households have experienced large income gains since 2001.

Note: Figures adjusted for inflation and population growth.

State of the Nation: Alternative Measures

Share of population	2006	Change from 2000
In poverty	12.3%	+1.0%
In deep poverty	5.2%	+0.7%
Lacking health insurance	15.8%	+1.6%
Food insecure	12.1%	Unch.
w/ very low food security	3.8%	+0.7%

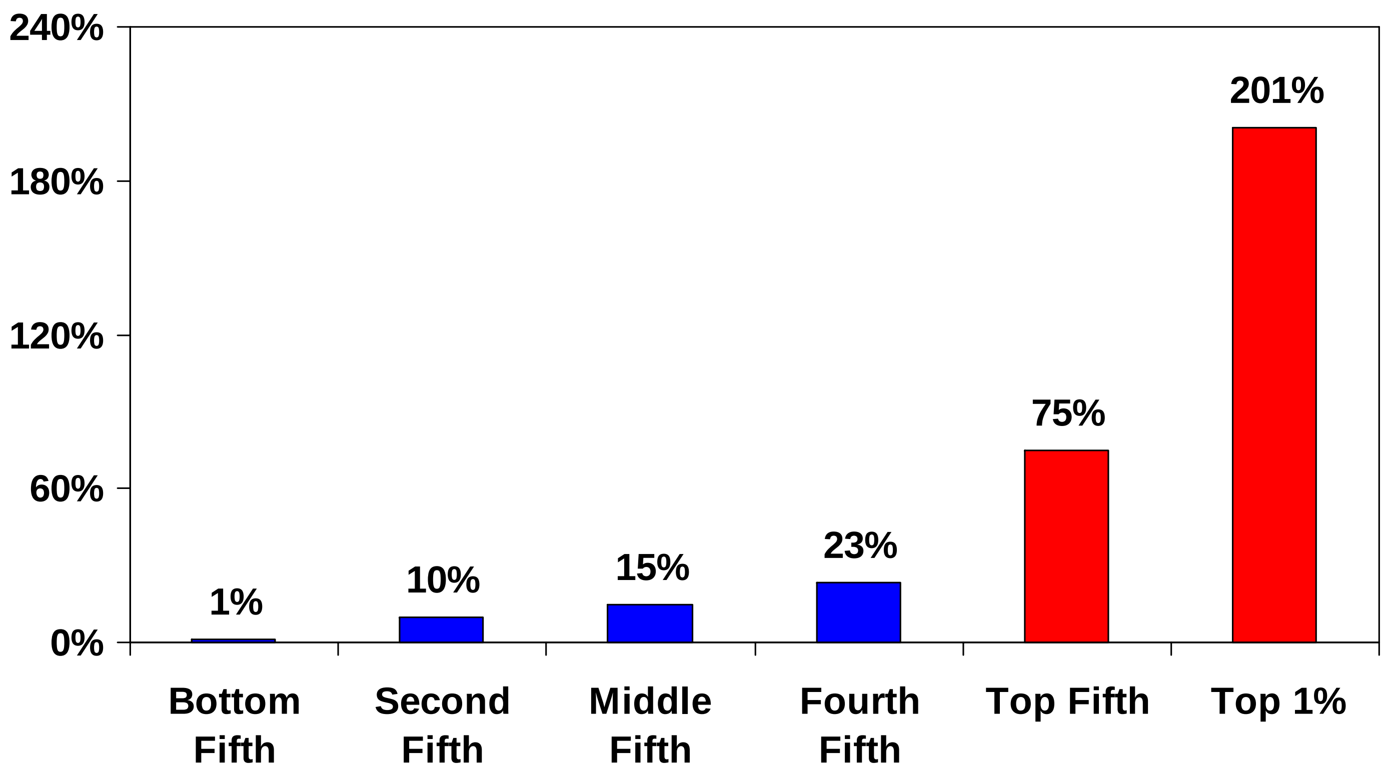
Source: Census Bureau and Department of Agriculture data.

The economic growth the nation has seen over the last several years has not brought improvement in several important social indicators. Since 2000, 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 2000, as has the share of the population living in households that report extreme food insecurity (very low food security).

Last 26 Years Have Seen Rapid Income Growth at the Top, Virtually No Growth at the Bottom

Growth in average real pre-tax income, 1979-2005



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 over 25 years old. From 1979 through 2005, the most recent year for which data are available, the average income of a household in the top 1 percent of households tripled. 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.

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."

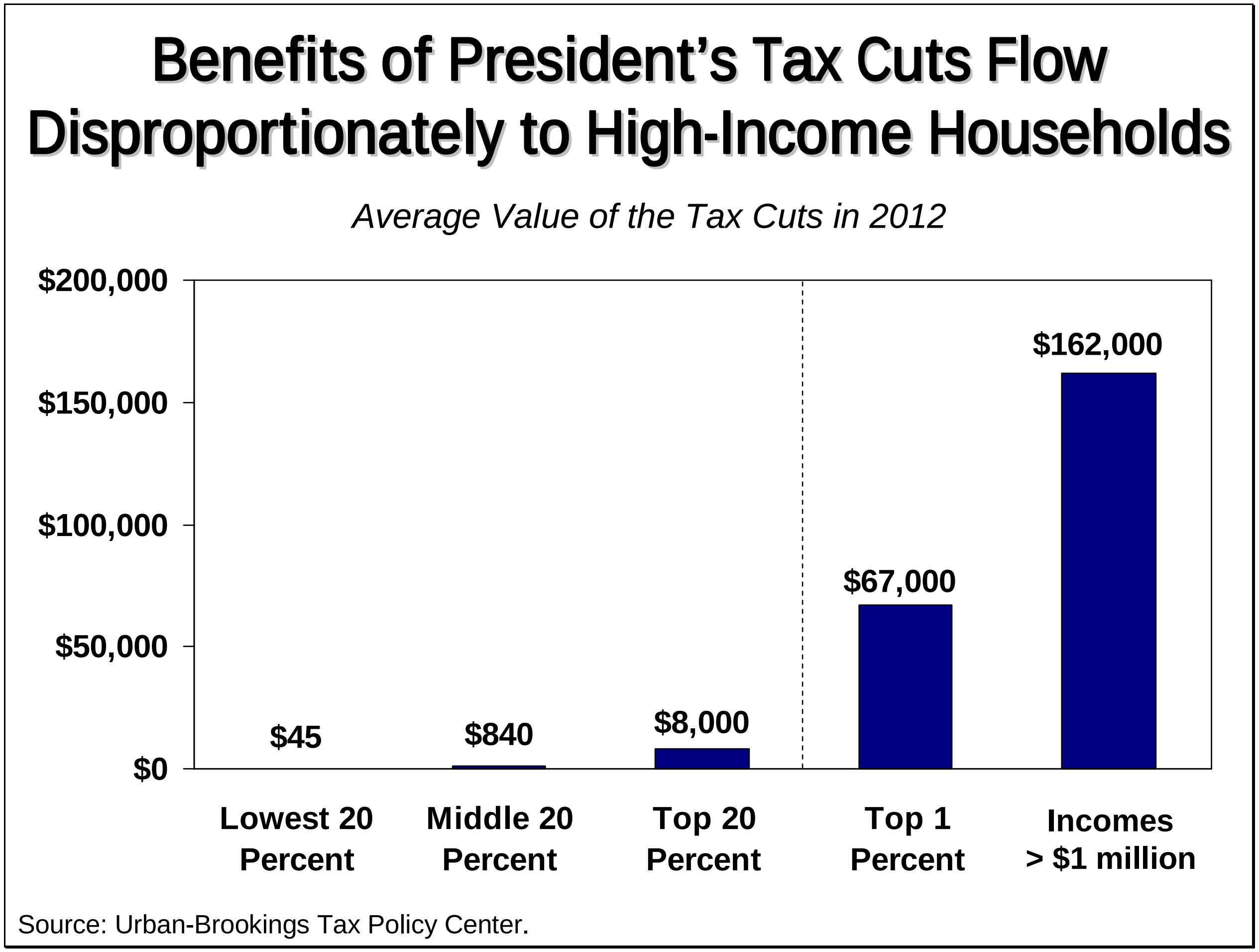
- Federal Reserve Chairman Bernanke

"[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.

Sources: Remarks of President Bush in New York City, January 31, 2007, http://www.whitehouse.gov/news/releases/2007/01/20070131-1.html. Testimony of Ben Bernanke before the House Financial Services Committee, http://financialservices.house.gov/pr02152006d.html. Testimony of Alan Greenspan before the House Financial Services Committee, July 20, 2005, http://financialservices.house.gov/media/pdf/109-47.pdf.

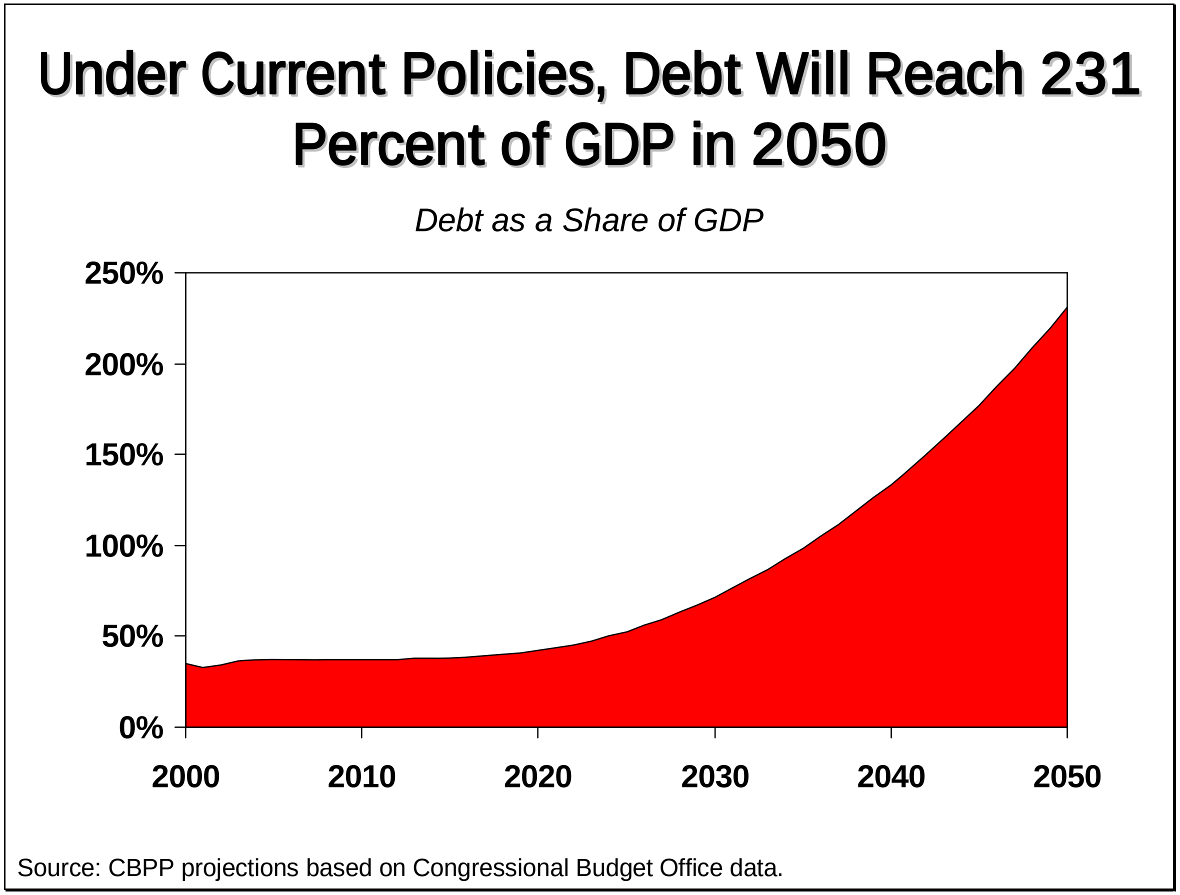


The centerpiece of the President's fiscal year 2008 budget was the extension of the 2001 and 2003 tax cuts. In contrast to the cuts in discretionary programs, which would have the greatest effect on low and middle-income households, the benefits of extending the tax cuts go disproportionately to high-income 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.

Note: Amounts include the tax cuts enacted since 2001 plus the cost of associated relief from the Alternative Minimum Tax.

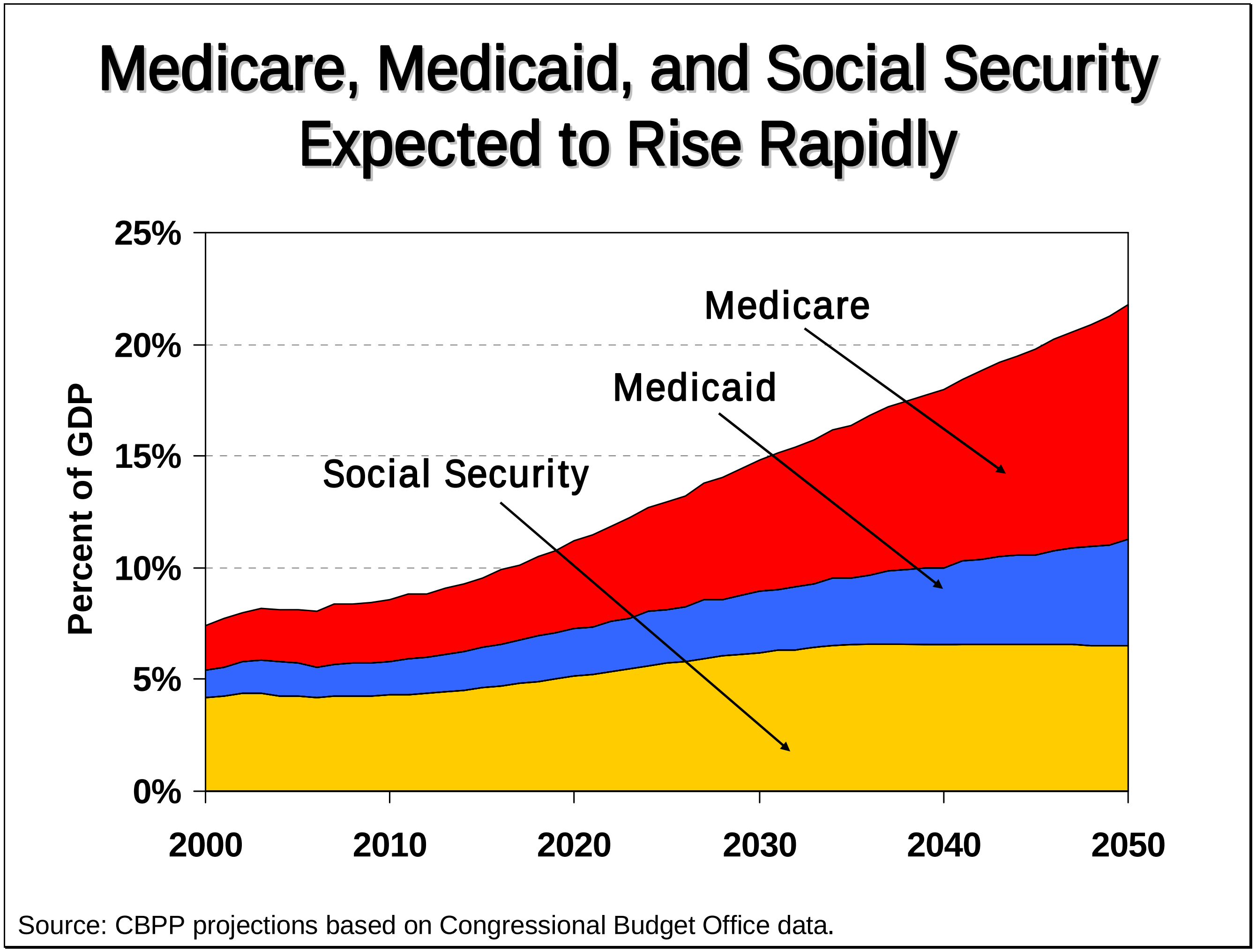
III. Drivers of the Long-Term Fiscal Problem

- 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.



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.

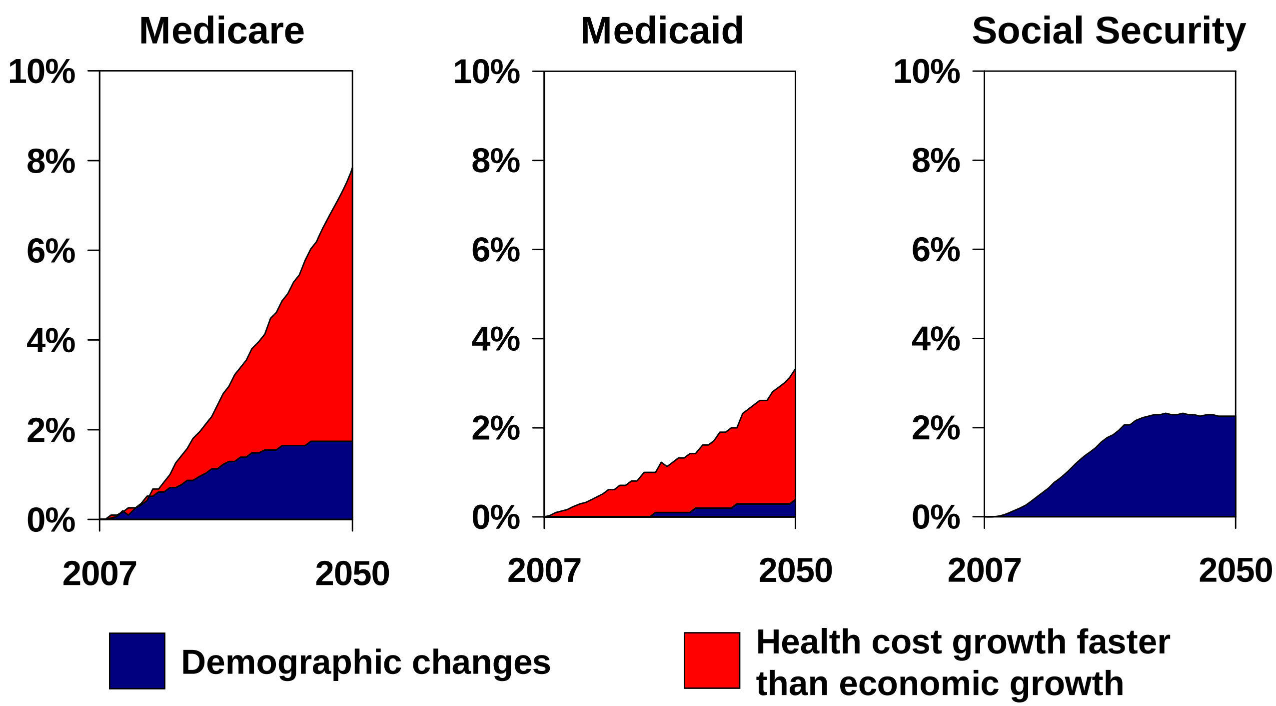


On the expenditure side, the major driver of the long-term fiscal problem is rapid growth in Medicare, Medicaid, and Social Security (the "big three"). This chart shows that the combined costs of Medicare, Medicaid, and Social Security will rise substantially over the next several decades, with the largest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

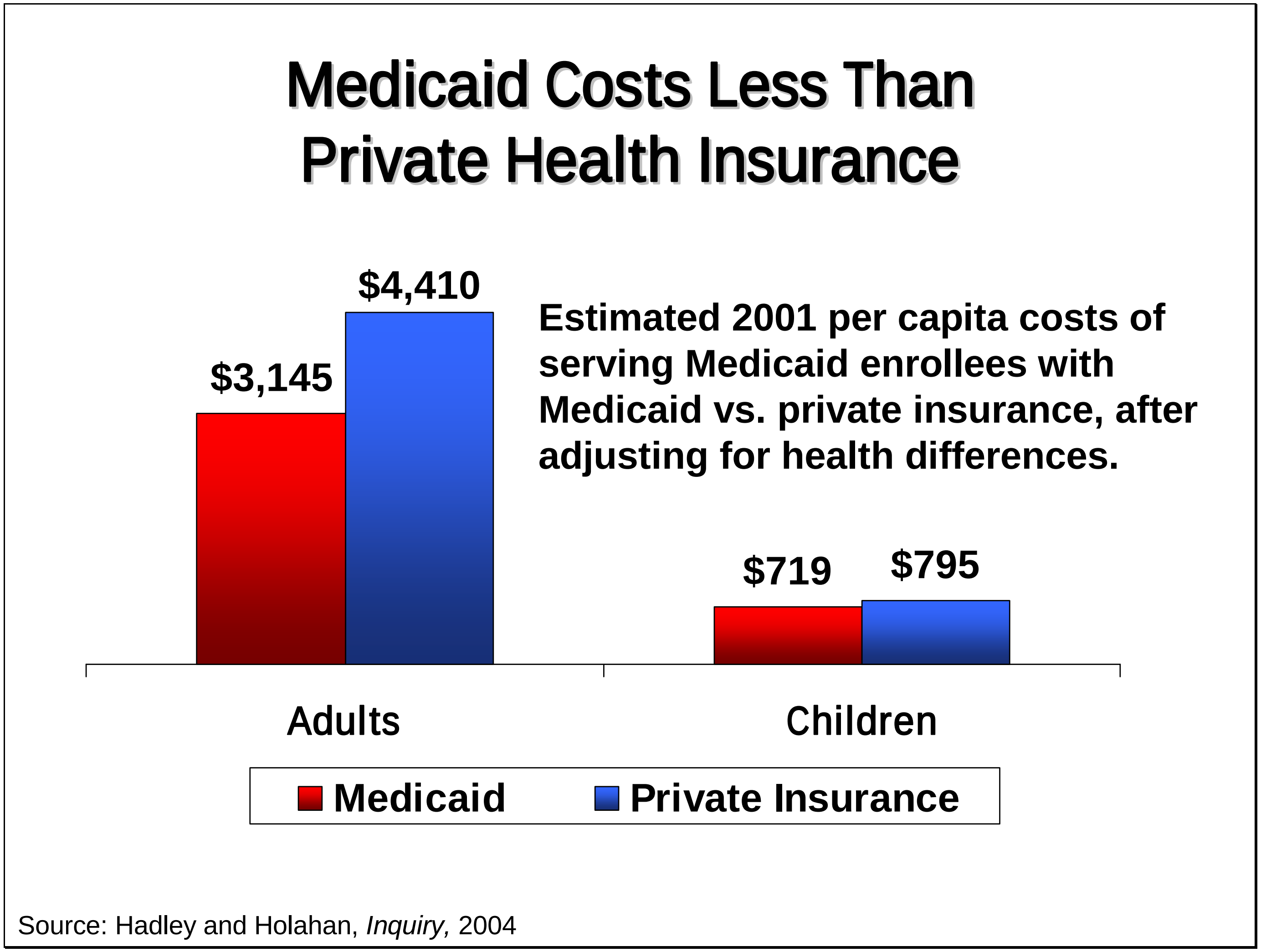
Rising Health Costs are the Main Driver of Growth in the "Big Three"

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

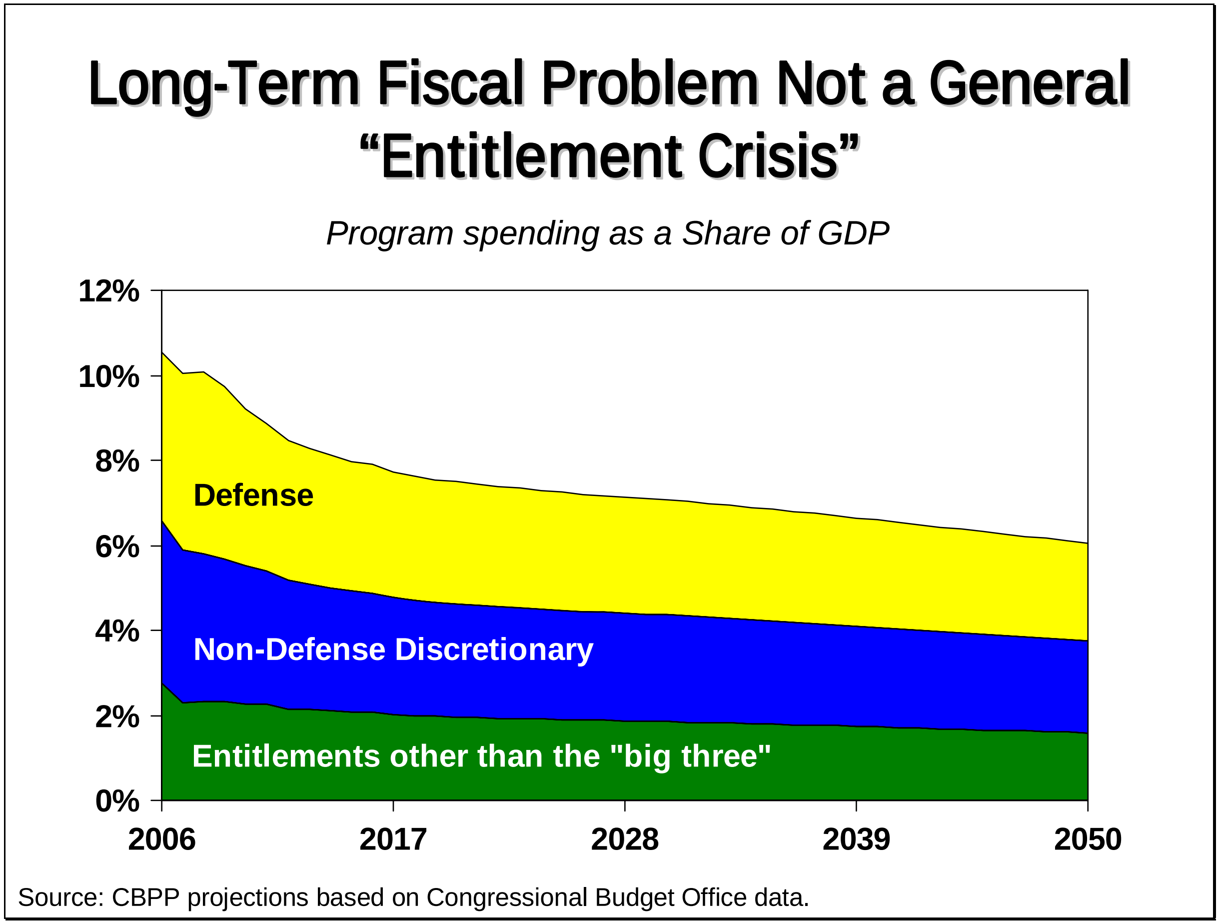


Source: CBPP projections based on Congressional Budget Office data.

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.

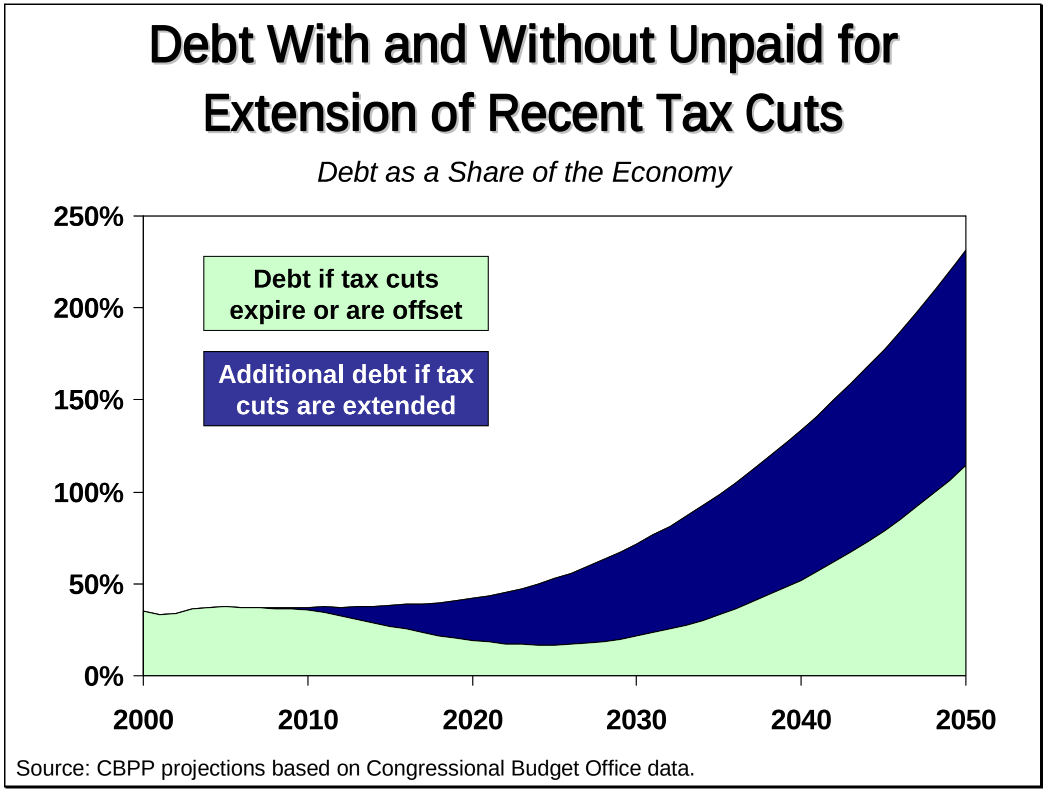


The projected increases in Medicare and Medicaid costs do not mean these programs are more expensive or less efficient than private insurance. This chart, which presents findings from an important Urban Institute study, shows that Medicaid actually costs *less* per beneficiary than private health insurance 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.



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.

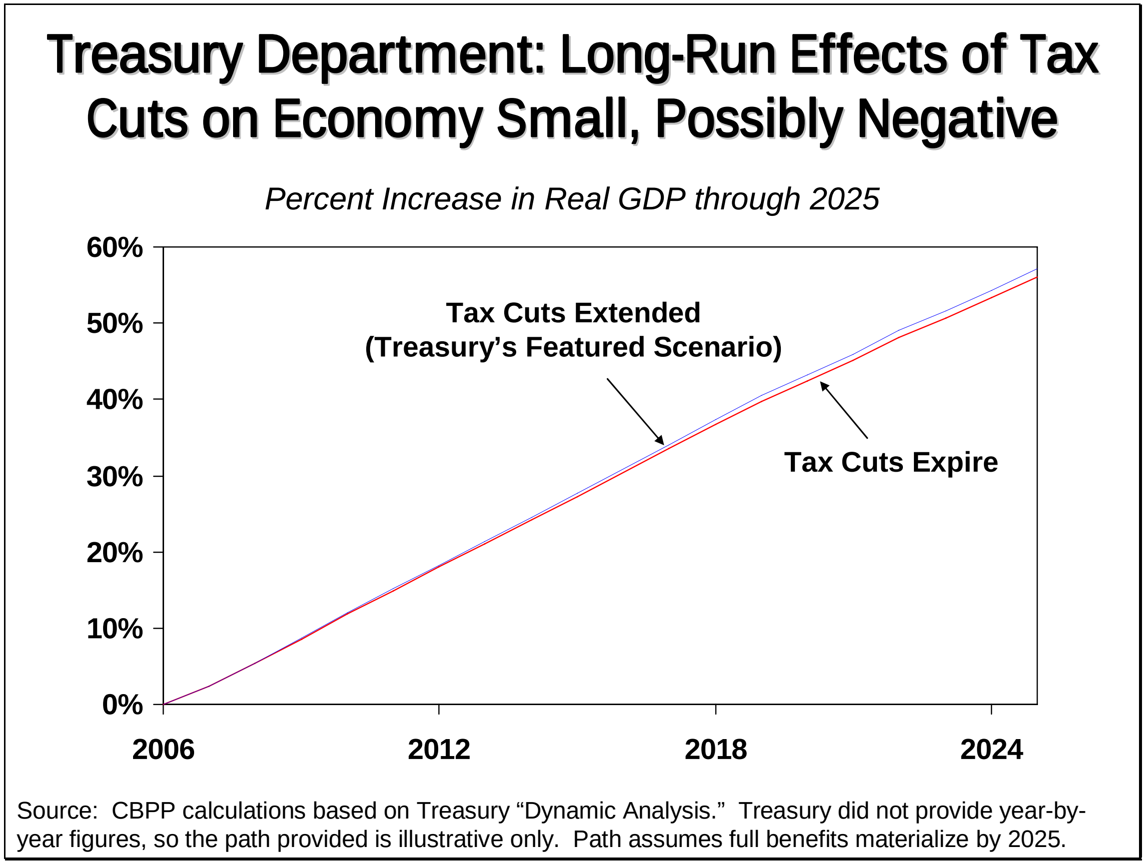
Note: The figures above are CBPP projections based on Congressional Budget Office data. For details on CBPP's long-term projections, see Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, "The Long-Term Fiscal Outlook is Bleak," Center on Budget and Policy Priorities, January 29, 2007, http://www.cbpp.org/1-29-07bud.htm.



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.

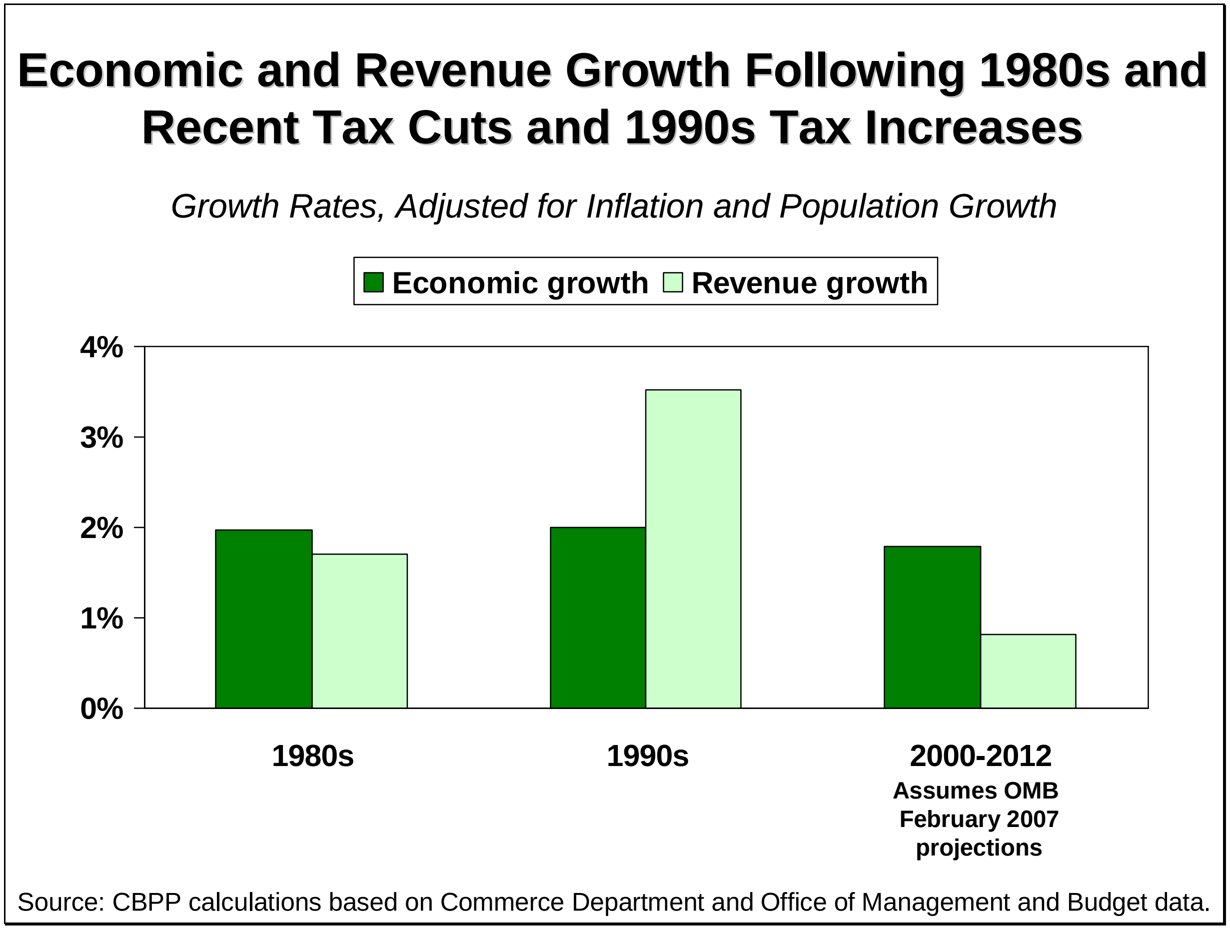
But extending the tax cuts enacted since 2001 without paying for them would sharply worsen this already bleak long-term fiscal outlook. The tax cuts reduce revenues by about 2 percent of GDP each year. In addition, each year of extending the tax cuts without paying for them would add to the national 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.



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.



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.

IV. Where Do We Go From Here?

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).

Slide 30

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.