

FISCAL CHALLENGES FACING NEXT PRESIDENT

AMERICANS FOR TAX REFORM
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In January of 2009, the next president of the United States will be taking over the White House, appointing cabinet heads, and inheriting significant pressing fiscal challenges. How the next president handles the scheduled expiration of the Bush tax cuts, unsustainable spending growth, and state and local government challenges will frame the next four to eight years.

Expiration of Bush Tax Cuts

Allowing the 2001 and 2003 tax cuts to expire would defeat any pro-growth policy goals of the next president. Individual taxpayers, small businesses, and investors are watching the status of the tax cuts and any change will guide future decisions.

It appears likely that at least a few of the tax cuts will be made permanent, regardless of the winner in 2008. Unfortunately, these “progressive” tax cuts, such as the increased child tax credit and elimination of the marriage penalty, are the least likely to spur economic growth. More responsive components include the capital gains and dividend tax cuts.

According to the Congressional Budget Office, since the 2003 capital gains tax cut, collections are up 152 percent. Failing to extend the tax cuts for capital gains and dividends and ignoring the dynamic effects on the economy and federal revenues would raise the capital gains tax rate by one-third, from 15 to 20 percent and the tax on dividends to 39.6 percent in 2010.

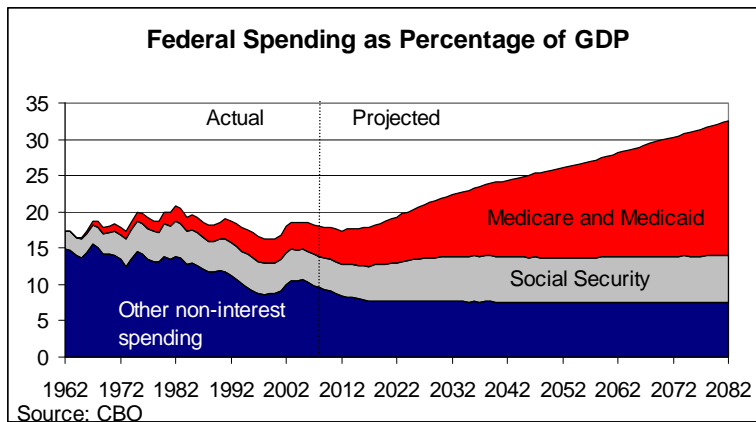
The next president will face significant pressure to raise taxes and allow the Bush tax cuts to expire in the name of “deficit reduction.” It is important to note previous recent tax increases offer lessons to those claiming higher taxes will reduce the deficit. In 1982, President Ronald Reagan signed off on a tax increase with the understanding that for each dollar of higher taxes, Congress would reduce spending by three dollars. Congress consumed the revenue from the tax increase and did not cut spending. In fact, the deficit rose from \$128 billion in 1982 to \$212 billion in 1985 – an increase of 66 percent. Over this period, spending swelled by 27 percent while revenues declined from over 19 percent of the economy to 17.7 percent.

The component fueling the gap between revenues and outlays is not the tax cuts, it is federal spending.

Federal Spending Growth

By far the largest challenge facing the next president is the unsustainable spending path paved by the current budget. Medicaid, Social Security and discretionary spending levels are set to consume increasing shares of national income. Federal revenues are expected to consume 19 percent of gross domestic product (GDP) in 2009, high by historical standards.

After three years of declining deficits, faster spending growth coupled with slowing revenue streams is expected to push the deficit up from 1.2 percent of GDP in 2007 to 1.5 percent in 2008. Add on the anticipated supplemental spending for the war on terror and Iraq this year and 2008 will likely see an even larger gap between collections and outlays.



The retirement of the baby boomers, and the corresponding upward pressure on entitlement spending, has long been pushed aside as a problem for the future. As some baby boomers become eligible for Social Security benefits in 2008, the future is now. CBO projects Social Security spending rising from a 5.1 percent

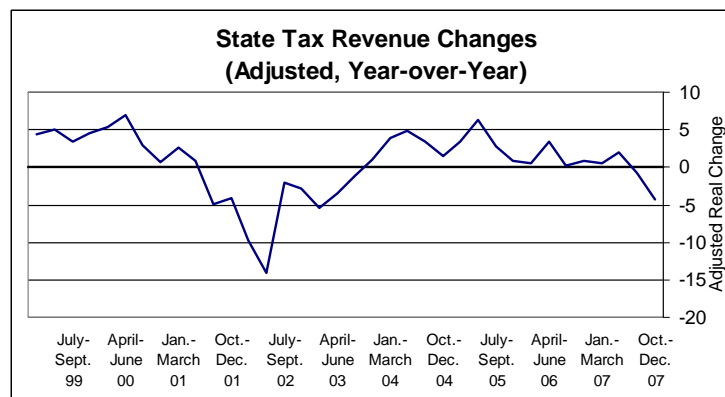
growth rate in 2008 to 6.4 percent in 2018. Medicare and Medicaid spending is projected to grow from 4.6 percent of national income in 2007 to 19 percent by 2082, consuming the same share of the economy as the entire federal budget does now.

There are concrete options for free market reform of Medicare, Medicaid and Social Security that would allow continuity in benefits while fundamentally shifting the entitlement programs to personal accounts. Individual control of health care and retirement financing will avert the baby-boom spending train wreck while fostering the independent creation of wealth.

State Fiscal Challenges

Further complicating the challenges with federal fiscal policy, the next president will be faced with calls to step in and bail out state and local governments facing declining revenue growth and rising costs from existing programs. As most states have balanced budget rules in place, they are unable to follow the same borrowing practices as the federal budgeters. The pattern of the last two recessions is one of increased federal aid, declines in spending growth and higher taxes.

The last quarter of 2007 showed state revenues at their lowest levels in five years. The chart below, based on data from the Rockefeller Institute for Government shows the real percent change in state revenues. Capital gains taxes are a large component of adjusted gross income, thus revenues will continue to drop as the economy continues to slow and as speculation over the lapse of the 2001 and 2003 tax cuts undermines investor confidence. According to the National Governor's Association, 35-40 states are facing budget problems for fiscal year 2009.



Although over the last 25 years states have turned away from raising broad-based income and sales taxes and toward raising taxes on smaller, targeted populations, this strategy may prove to be tapped out. During the current slow down, there will be increased pressure to raise broad taxes on the state and local level. Higher taxes on the state and local level will dampen economic growth nation-wide.

On the spending side, unfunded liabilities in public pension funds is estimated by the National Council of State Legislatures around \$400 billion and will likely grow in an economic slowdown as the approximately 70 percent of the funds' assets are invested in equities. Unfunded health care and other non-pension post employment benefits for state employees has been estimated to exceed \$1 trillion. Baby boomers' retirements will impose a heavy pressure on these unfunded costs and state and local governments will call on Congress and the next president for a federal bailout.

Conclusion

These three challenges are the major, but by no means the only fiscal issues facing the next administration. Repeal of the alternative minimum tax (AMT), corporate tax reform, increased transparency in spending and earmark processes, and other pressing issues will require action in the next few years. Little progress will be made on these issues before the election; it will be up the next administration to extend the 2001 and 2003 tax cuts, restrain and reform spending programs, and face state and local fiscal constraints with broad implications for the nation as a whole.