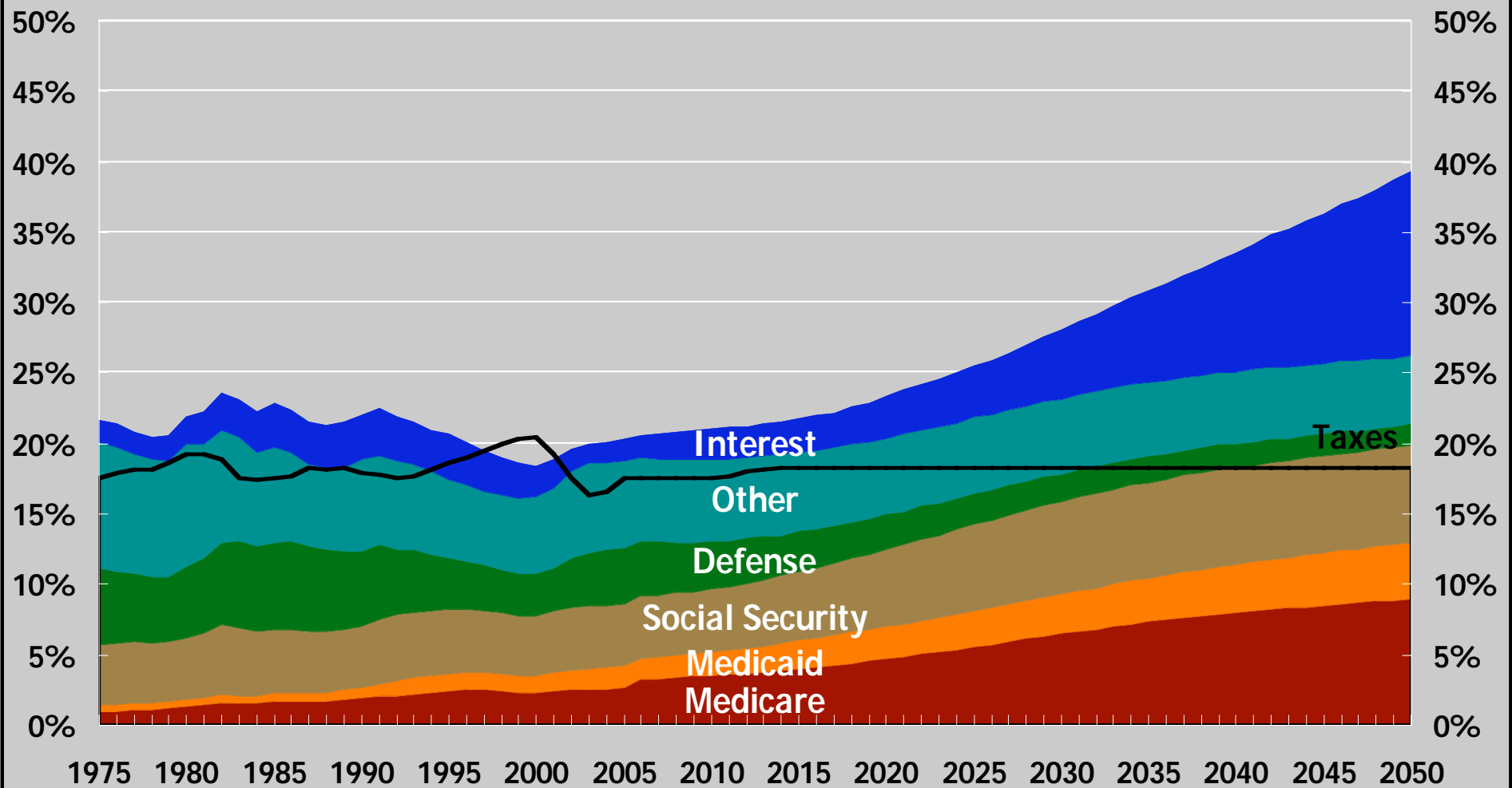


The U.S. Fiscal Situation: Tough Choices Ahead

*Alison Acosta Fraser
The Heritage Foundation
September, 2006*

Spending driven by entitlements threatens long-term fiscal stability

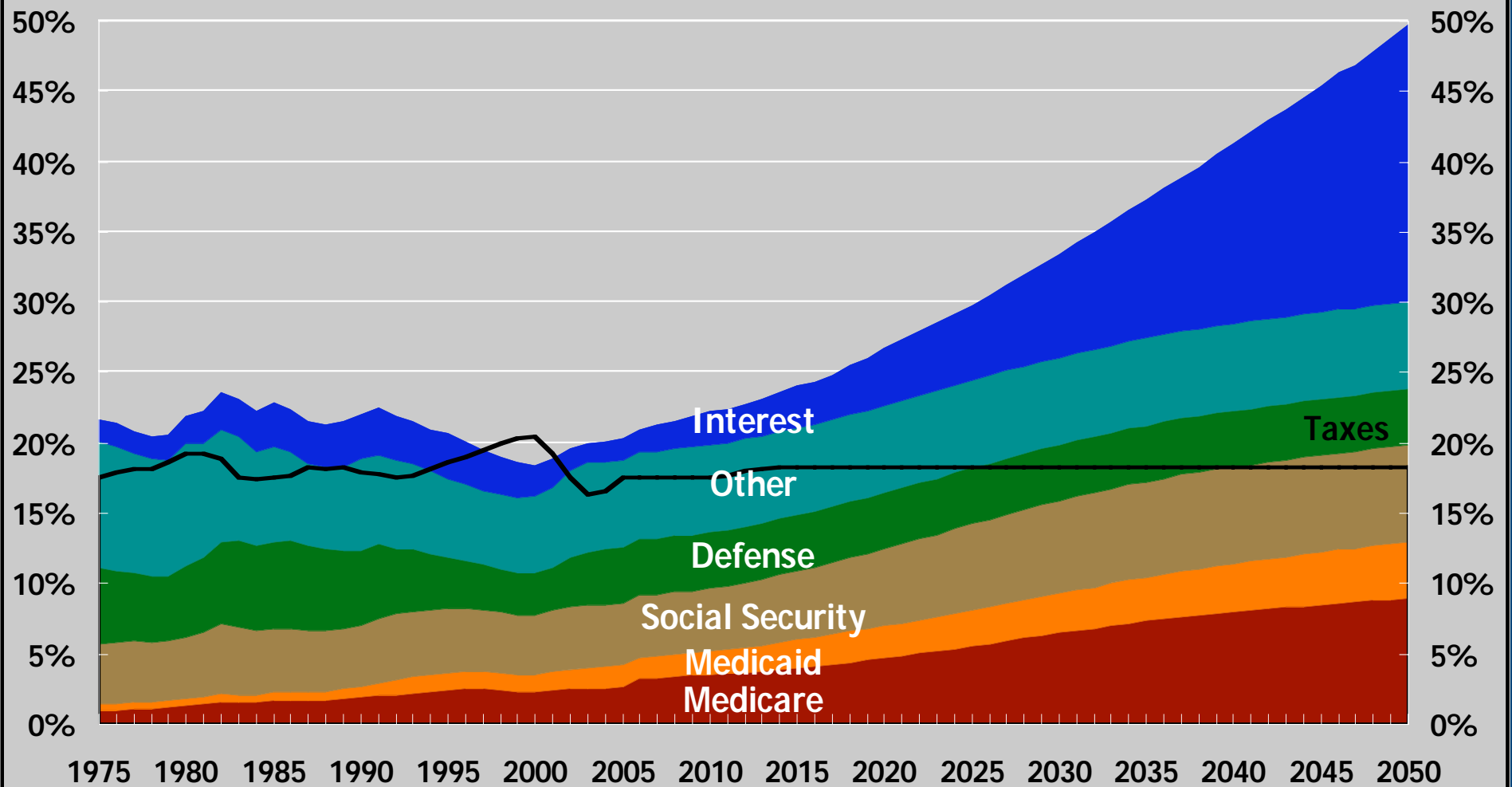
Federal Spending and Revenue as a Percentage of GDP with Optimistic Discretionary Assumptions



Source: The Heritage Foundation's Interactive Budget Calculator using CBO and Trustees Data.

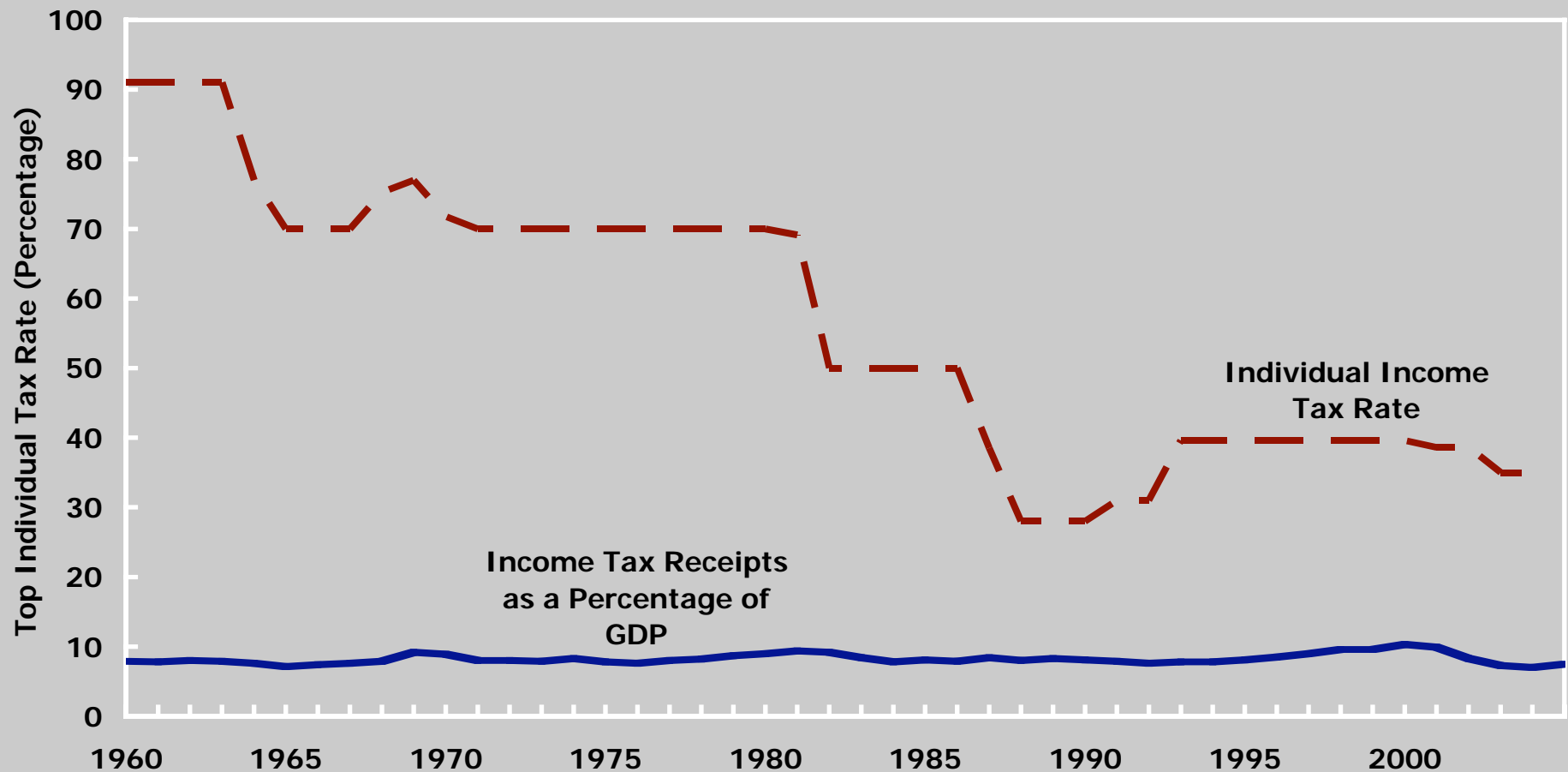
Under current trends federal spending consumes ½ of the economy

Defense and "Other" Spending as a Constant Share of GDP



History suggests a natural level of revenue regardless of rate

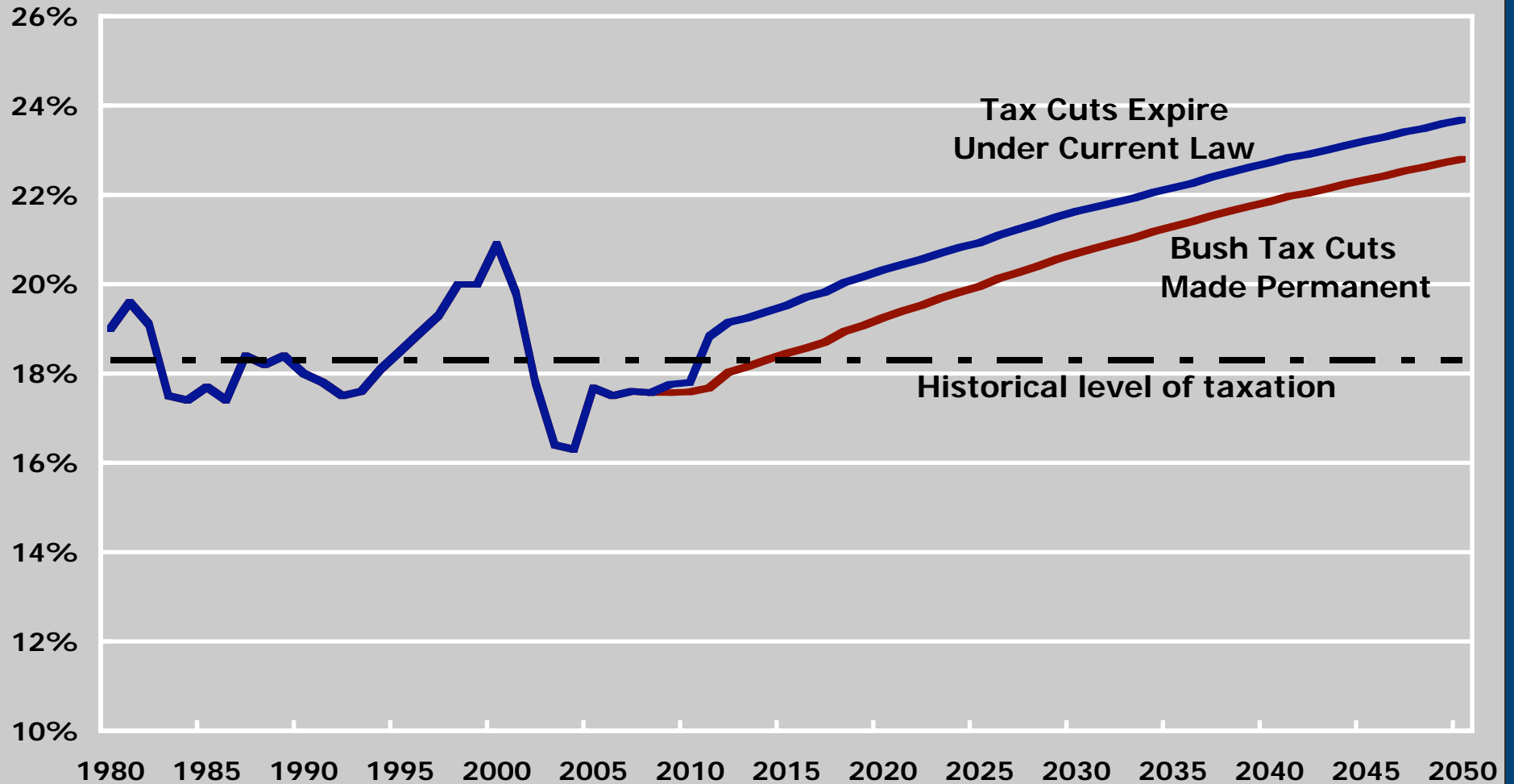
Top Federal Individual Income Tax Rates and Receipts



*Source: Rates from Joint Committee on Taxation publication #JCX-6-01;
Receipts from FY 2007 Historical Tables, Budget of the United States Government, Table 2.3.*

Future tax levels trend upward and don't come close to resolving the spending problem

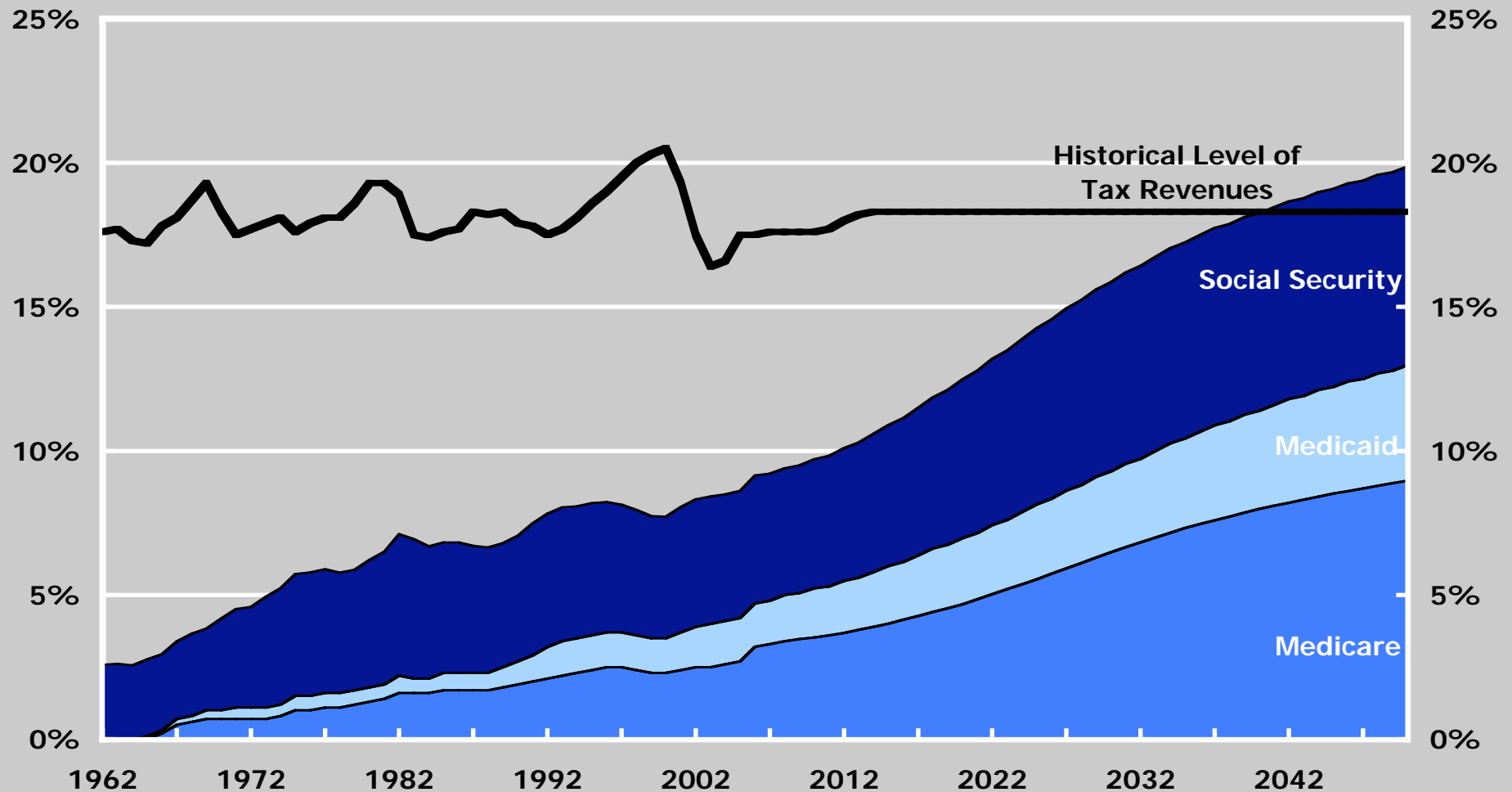
Long-Term Federal Tax Revenue as a Percentage of GDP



Source: CBO Long-Term Budget Outlook, December 2005, (Scenario 2 Data)

Entitlements crowd out everything else and collide with historical level of taxes

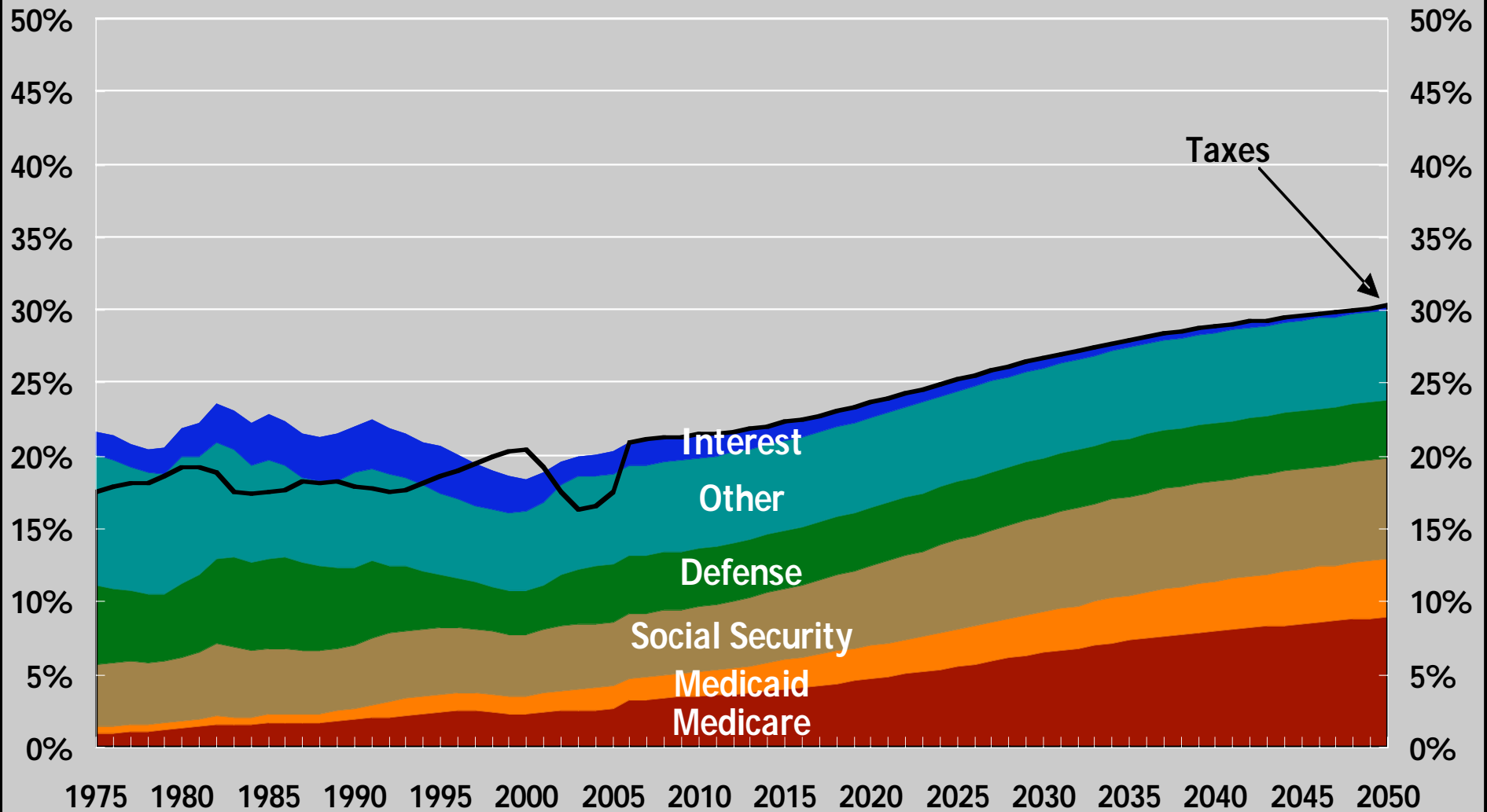
Three Major Entitlements and Tax Revenues as a Percentage of GDP



Source: Spending and Revenues from CBO Long-Term Budget Outlook, December 2005 (Scenario 2 Data), 2006 Social Security and Medicare Trustees Report.

Choice 1: Raise taxes to balance spending

Requires ever increasing taxes - reaching European levels

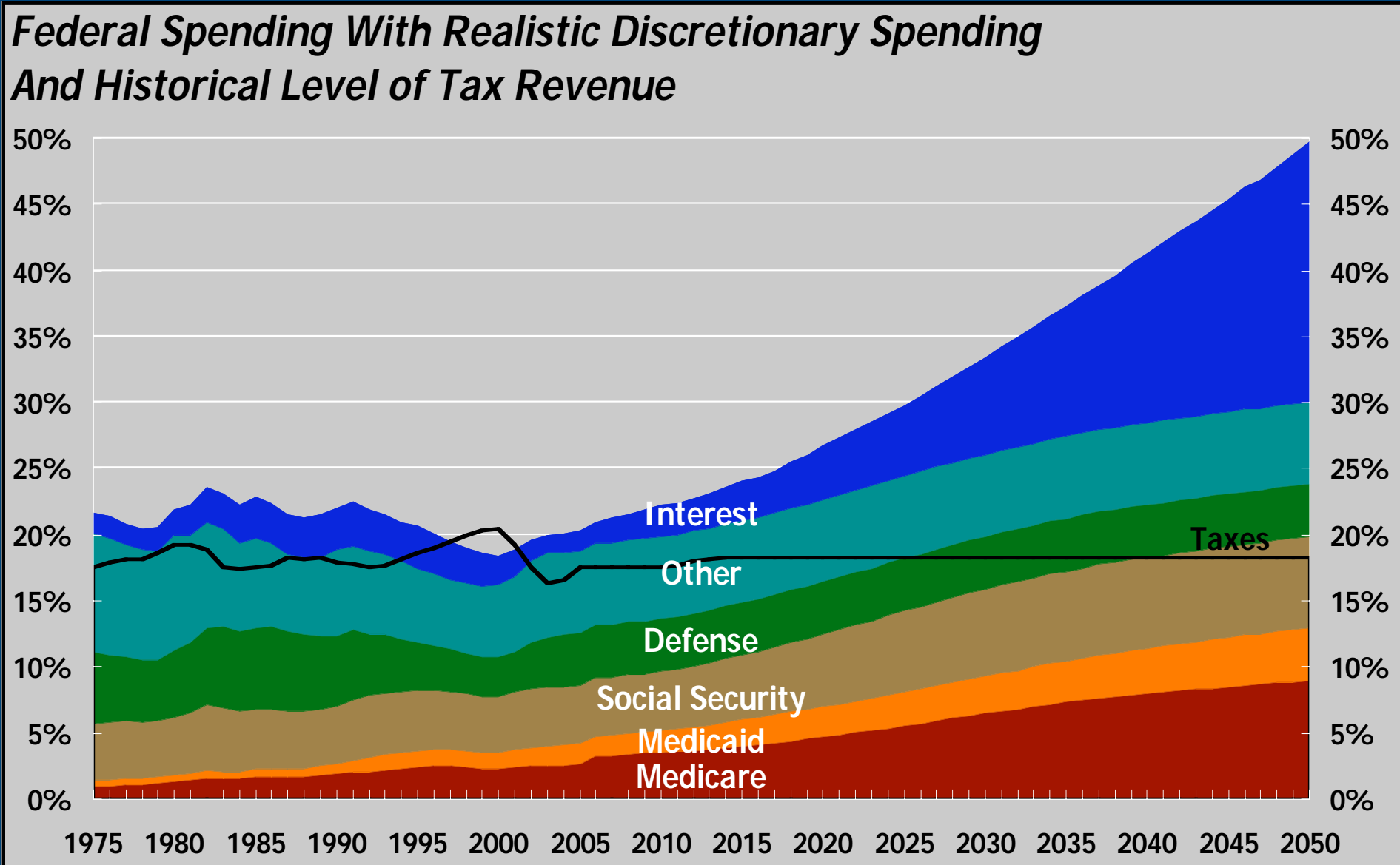


Source: The Heritage Foundation's Interactive Budget Calculator using CBO and Trustees Data.

Choice 1: Balanced Budget Considerations

- *By 2050, federal tax revenue will grow from about 17% of GDP today to about 30%.*
- *With State and local taxes total taxation would be about 40% of GDP.*
- *By comparison: Germany 36%, The Netherlands 39%, UK 36%, Greece 36%, France 44%.*
- *What about economic consequences?*

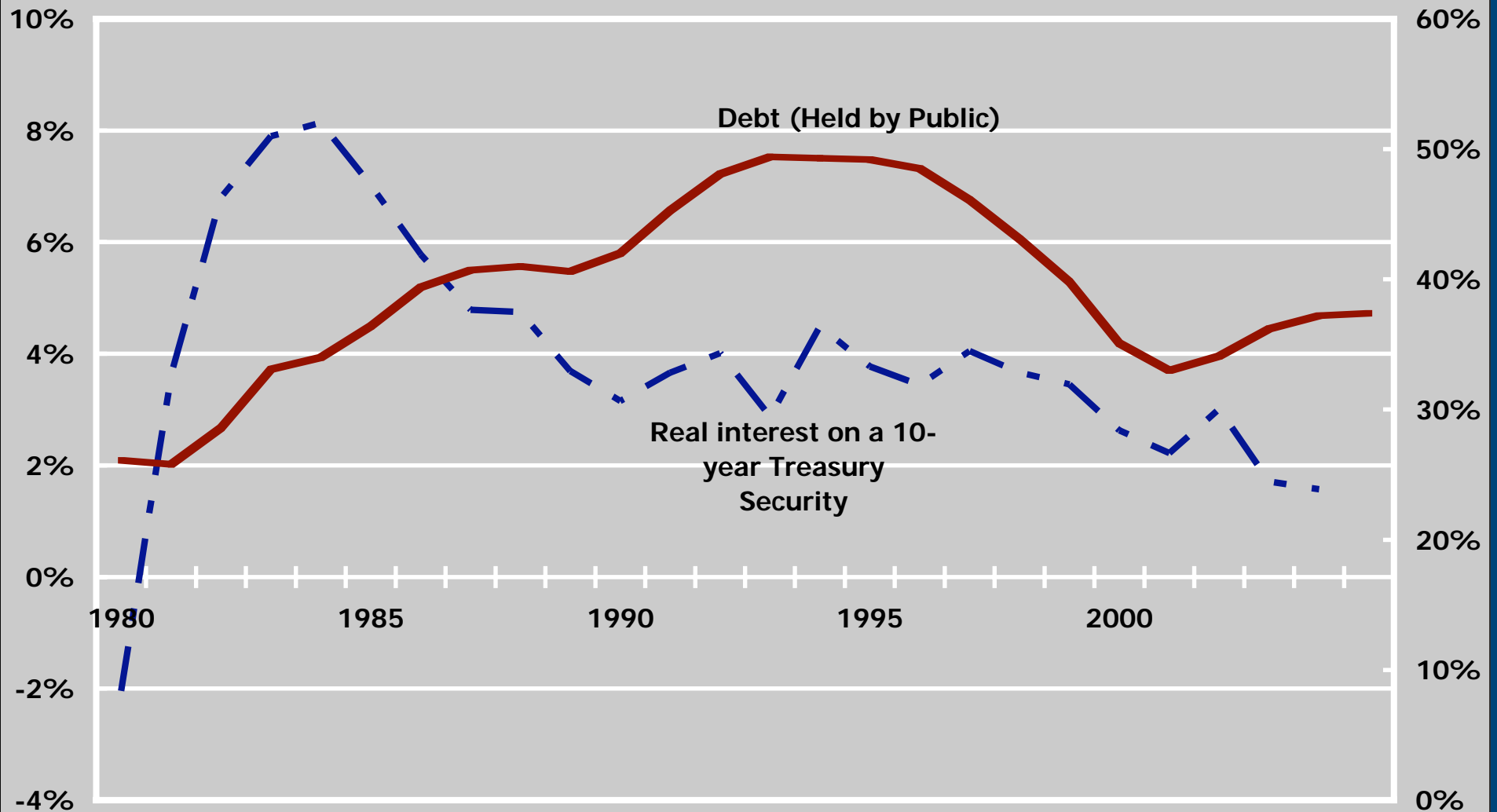
Choice 2: Hold taxes constant and let deficit rise



Source: The Heritage Foundation's Interactive Budget Calculator using CBO and Trustees Data.

Past debt has not been closely linked to interest rates

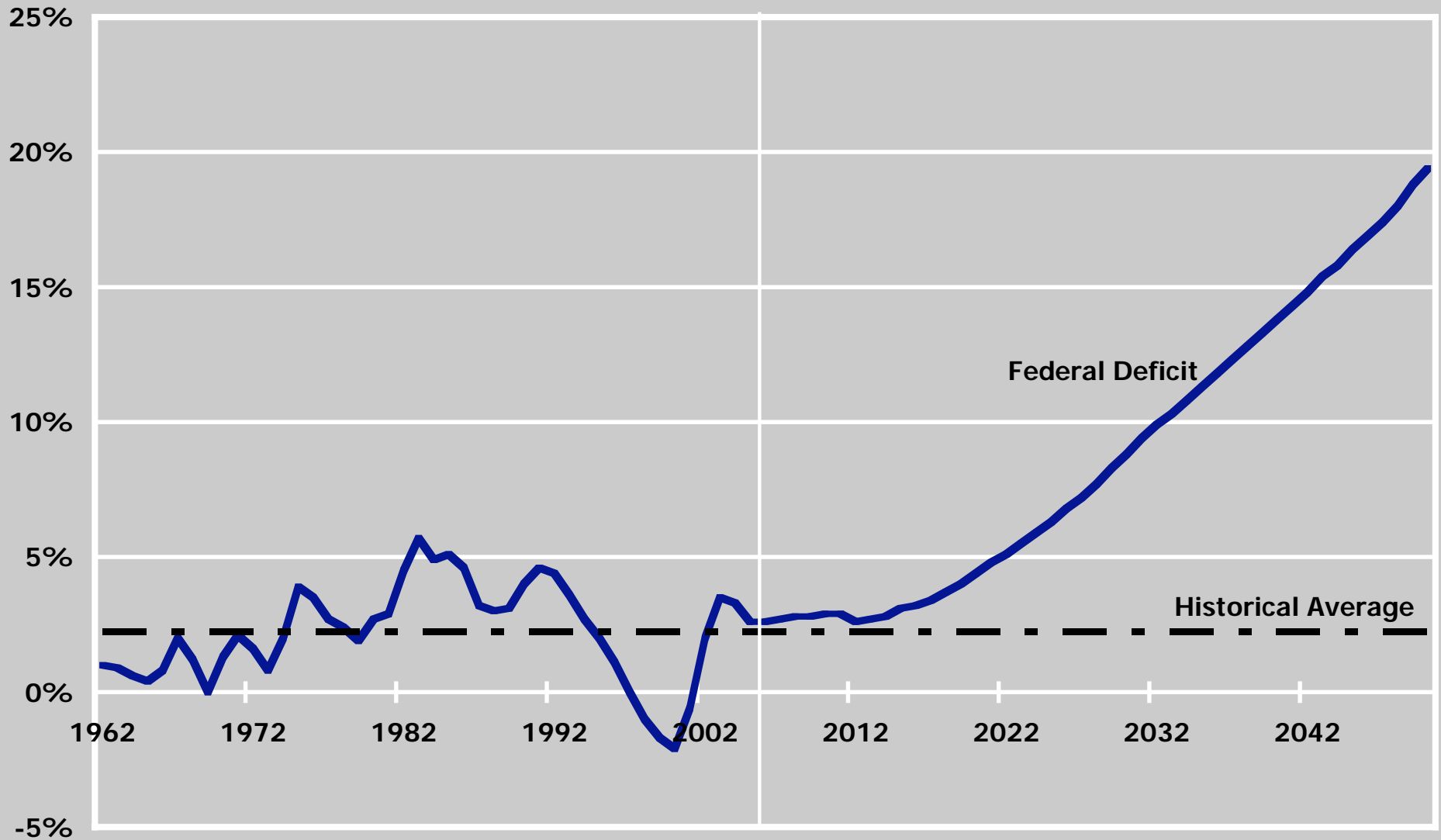
Federal Debt as a Percentage of GDP and Real Interest on a 10-Year Treasury Security



Source: *Economic Report of the President, 2006, Tables B-79, B-73, and B-63.*

But future deficits will be unprecedented

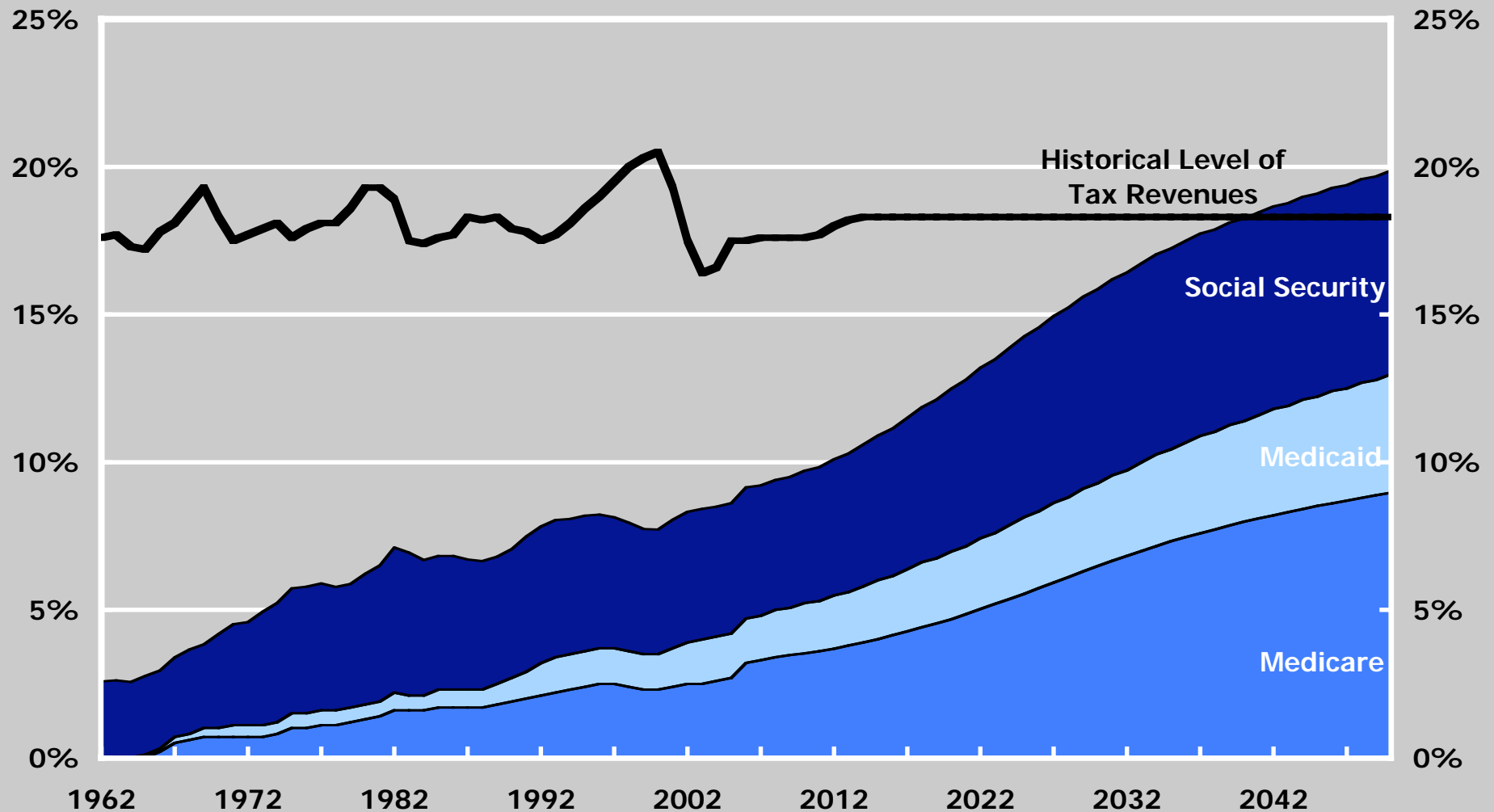
Federal Deficit as a Percentage of GDP



Source: CBO Long-Term Budget Outlook, December 2005, (Scenario 2 Data).

Choice 3: Let entitlements preempt other spending

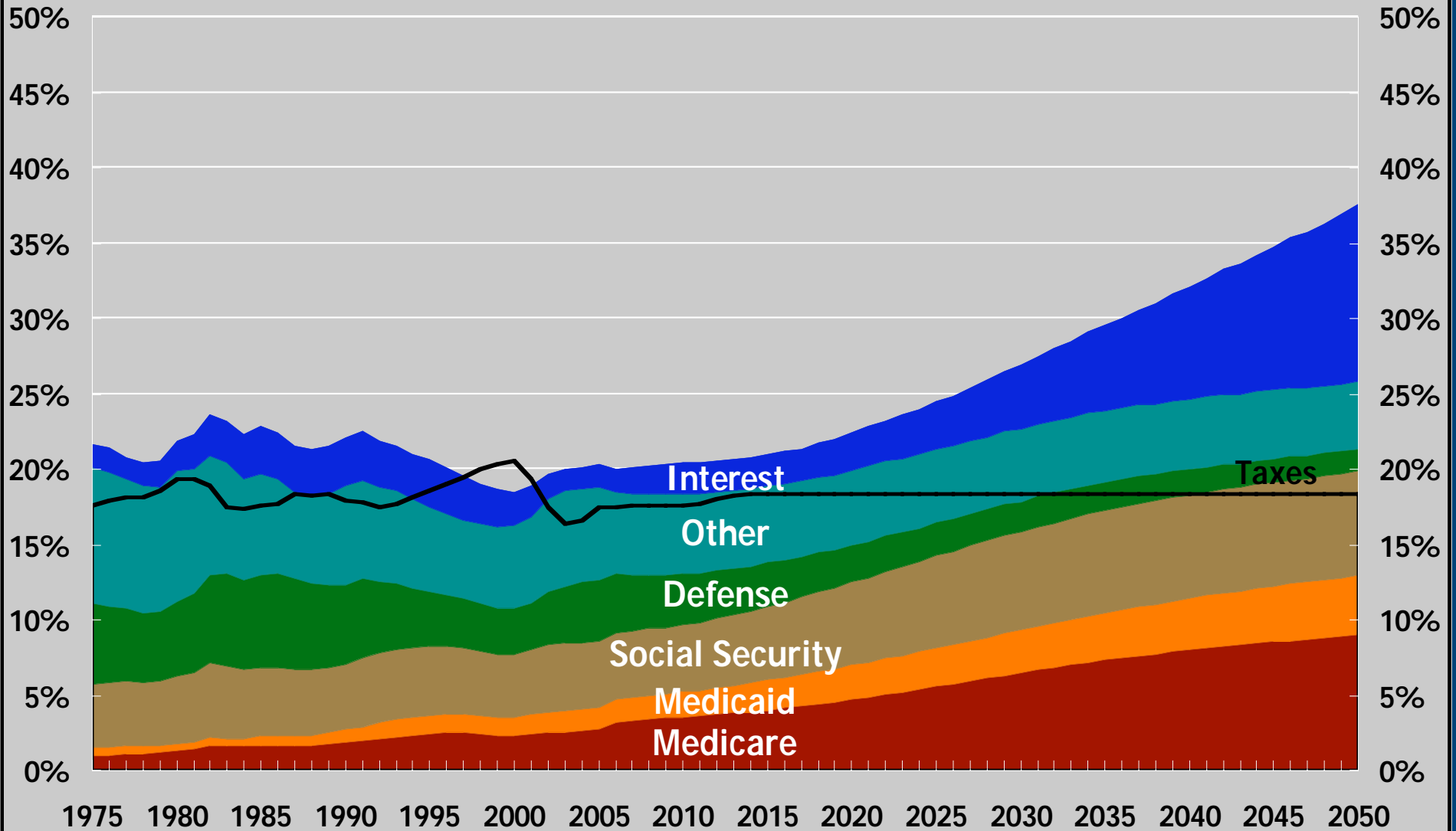
Three Major Entitlements and Tax Revenues as a Percentage of GDP



Source: *Spending and Revenues from CBO Long-Term Budget Outlook, December 2005 (Scenario 2 Data), 2006 Social Security and Medicare Trustees Report.*

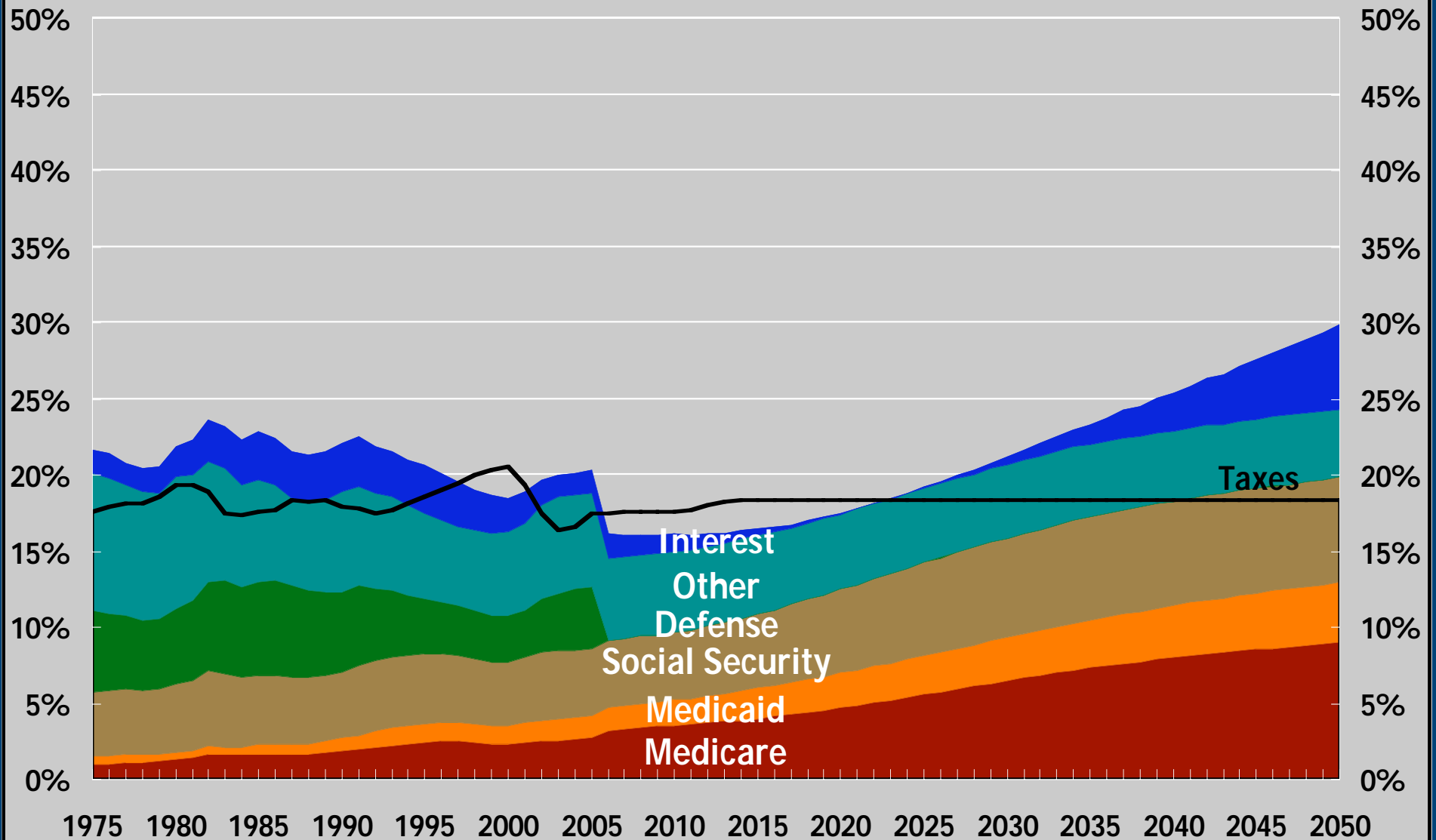
Some options for cutting spending even with optimistic assumptions

Eliminating NEA, Foreign Aid, NASA, and Pork have little impact



Ultimately Defense spending will be crowded out

The spending problem isn't solved even if Defense is also eliminated



Choice 3: Considerations

- *Middle class entitlements should not take precedence over spending priorities - whether a conservative priority like defense or liberal priority like education. By 2041, the budget will only have room for Social Security, Medicare, and Medicaid.*
- *“Mandatory” and “discretionary” is not an appropriate distinction. All spending functions should compete on a level playing field in the budget.*
- *We should establish a long-term budget for entitlements with budget triggers to change benefits automatically.*
- *We should rethink principles of social insurance and focus on the truly needy.*