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PRESIDENT BUSH'S FY2007 BUDGET

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In early February, the President released his $2.8 trillion budget for FY2007. By and large, the budget did not focus on addressing the needs of families. Many of the proposed budget cuts and 141 program eliminations were in social, educational and health programs that benefit families. However, the President's emphasis on research and development, investment in science and math education, and energy independence, were bold and welcome ideas. Moreover, the President's proposal to establish Career Advancement Accounts, which could allow up to 800,000 people annually to pay for training or tuition costs to update their skills or develop new skills, is a good idea. This proposal is similar to the Personal Reemployment Account proposal the President made in 2003. However, this time the proposal is more preventative medicine than simply reactive action. One problem with our current workforce system of trade adjustment assistance and unemployment insurance is that its largely reactive—workers only have access to new funds for training if they lose their job or the factory shuts down. The Career Advancement Accounts would allow workers to upgrade their training or acquire new skills before they lose their jobs, or to allow them to change careers or gain skills to start their own business. This forward-looking idea is better suited for an economy where the average worker now changes jobs on average every five years.

The real story of the budget for families and taxpayers is its tax and spending portions. The tax relief of the past few years has helped put more money into the pockets of the average family and has eliminated many families from the tax roles altogether. However, the largest issue for the nation and for the families is the state of the nation's fiscal health going forward.

The budget numbers released this week should be viewed in three parts. There is the short term, say five years, that is, today through the end of the decade. Then the medium term, that looks over the next 10 years. Then the long term, what happens after ten years.

In the short term, the situation isn't all that bad. The FY07 budget just released calls for a $420B deficit in 2007, higher than the roughly $350B deficit for 2006. The Bush deficits are problematic, though as a share of the national economy, they are below those of Presidents Ronald Reagan, Woodrow Wilson and Franklin Roosevelt. Bush inherited a very challenging economy in the first year of his presidency. The burst of the technology bubble combined with the shock of September 11, 2001, severally crippled economic growth in 2001 and 2002. The tax cuts passed shortly afterwards, combined with low interest rates and a rebound in economic confidence, have returned the U.S. economy to strength.

Now in 2006, the U.S. faces a different economic picture. While overall economic production as defined by the gross domestic product slowed in the 4th quarter of 2005, the estimate for 2006 of 3.5 percent is higher than Europe or Japan and strong by historical standards. The Dow Jones Industrials hover near 11,000, and more Americans own stock than ever before. Productivity growth remains strong, inflation remains under control and overall unemployment in January fell to 4.7 percent. Moreover, for the first time since before September 11, the number of high-paying jobs is growing faster than lower-wage employment.

The first economic issue the President raised in his State of the Union speech is the decision Congress faces of whether or not to make the tax cuts of the past few years permanent. This tax issue has two parts—equity/incentives and having sufficient revenue. In terms of equity/incentives, Congress has had an opportunity to engage in meaningful tax reform over the past few years as the President has called for. America can do a better job of rewarding work while not over-burdening investment by replacing the corporate tax with a progressive consumption tax. Because stagnant real wages for workers remain a serious concern and because the U.S. savings rate dipped into negative territory last year for the first time since 1933, payroll and corporate taxes should give way to a consumption tax as the best way to raise revenue. A flat tax would be an improvement over the current system as it would drastically reduce the lobbying influence now from earmarks. A presidential

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commission last year concluded there should be tax reform yet Congress has done little to act on it.

In terms of having sufficient funds, the problem is hardly the tax rates alone. U.S. tax revenues increased by more than 14 percent in 2005 and are expected to rise by more than 7 percent in 2006. A majority of states are experiencing a surge in revenues. A strong economy has given America a strong inflow of income.

However, spending has been out of control. It continues to rise because of Iraq and Afghanistan, homeland security, post-Katrina rebuilding, the prescription drug benefit, an increased federal role in education, and earmarks in appropriations bills. Despite their pledges to control spending, Congress and the administration have not demonstrated restraint. For example, the number of earmarks has risen from about 1,400 a year a decade ago to more than 15,000 last year.

In the medium term there is some reason for fiscal optimism if the tax cuts are scaled back or not made permanent. If the tax cuts are allowed to expire at the end of the decade, by 2012, the deficit could become a small surplus. If spending is restrained, some of the cuts that reward investment could be reinstated, or the Alternative Minimum Tax—which increasingly is levied on middle income Americans—could be addressed.

The real problem is in the long term. The long term fiscal challenge for America is mandatory, not discretionary, spending. The President's 2007 budget holds down the increases in health entitlement spending, but Medicare, Social Security and Medicaid remain the serious long term budget issues. The President has called for a bipartisan commission to examine the full impact of baby boom retirements on the budget. However, more than a commission is needed. The retirement of the baby boomers and the drop in the ratio of workers to retirees to 2:1 within a decade mean severe long term economic and budgetary woes. The short term economic picture looks good, but it won't last unless America addresses its demographic and long term mandatory spending problems. Families who hope to rely on Social Security and Medicare and hope to avoid higher taxes in another decade should pay attention to the current fiscal direction and the need for reform.