

APRIL 2010

STATE OF THE UNION'S FINANCES

A CITIZEN'S GUIDE



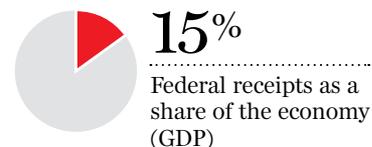
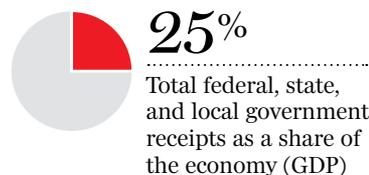
Peter G. Peterson
Foundation

Our America. Our Future.

STATE OF THE UNION'S FINANCES

FACTS AT A GLANCE

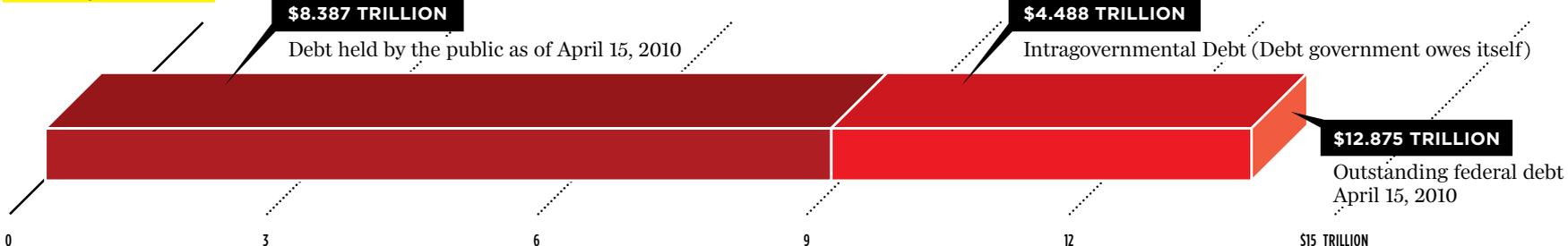
2009 GOVERNMENT RECEIPTS



PROJECTED FEDERAL DEFICIT FOR 2010

\$1.368 trillion

FEDERAL DEBT



FEDERAL BUDGET

71%

OF THE 2010 FEDERAL BUDGET WILL BE SPENT ON

20% Social Security
26% Health Programs
19% Defense
6% Net Interest

FEDERAL SPENDING VS. REVENUE

🏠 = \$1,000



All amounts are projections for 2010 unless otherwise noted.

Our Fellow Americans,

4 The fiscal year that ended on September 30, 2009 was not a good one for the United States government and for many Americans. As you will find in this Citizens' Guide, the U.S. Government experienced the largest deficit (in dollar terms) in its history—\$1.4 trillion. In addition, the federal government was in a \$61.9 trillion financial hole comprised of explicit liabilities and unfunded promises, principally Social Security and Medicare, as of the end of fiscal year 2009. That is over \$200,000 per American, up from about \$70,000 per American at the end of fiscal year 2000.

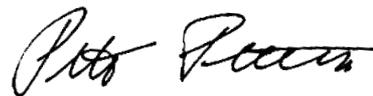
Importantly, while the fiscal 2009 year deficit and the projected \$1.3 trillion-plus deficit for fiscal year 2010 are matters of public concern, they are largely due the effect of the recession and a weak economy, two undeclared and unfinanced wars, the stimulus bill, and several federal assistance and bailout efforts. All of these factors are temporary and will pass over time. Therefore, the real threat to our collective future is the longer-term structural deficits, escalating debt levels and burgeoning interest payments that we are projected to experience after the economy recovers, after unemployment levels decline, after the wars are over, and once we are past the recent crises.

We must begin to take steps to address this major challenge before we pass a tipping point and our foreign lenders lose confidence in our ability to put our federal financial house in order. Yes, we can take steps to create a better future if “We the People” become informed and involved. However, we must take steps to ensure that our elected representatives make tough choices in connection with federal budget and spending controls, social insurance reforms (in particular, Social Security and Medicare), and tax reform, which will generate more revenues. The sooner we act the better because time is not working in our favor.

We at the Peter G. Peterson Foundation are dedicated to promoting more federal financial responsibility and accountability today in order to create more opportunity tomorrow. This includes raising public awareness about key economic challenges, and working to bring Americans together to find sensible and sustainable solutions that transcend age, party lines and ideological differences.

Please join our fight for America's future by signing up at www.pgpf.org. Working together, we will keep America strong and the American Dream alive for future generations.

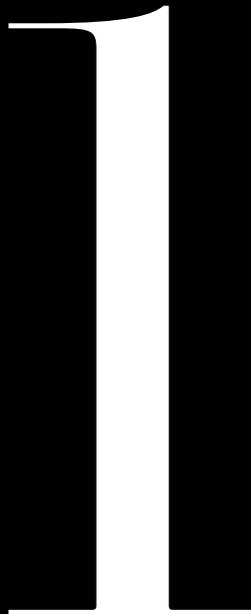
Sincerely,



Peter G. Peterson
CHAIRMAN OF THE BOARD



David M. Walker
PRESIDENT AND CEO



Executive Summary

The U.S. faces a looming fiscal crisis. With escalating deficits, mounting levels of public debt, growing unfunded promises for large individual entitlement programs, and increasing reliance on foreign lenders, we as U.S. citizens should be very concerned about the deteriorating financial condition of our nation.

Last year, at **\$1.4 trillion** or 9.9 percent of gross domestic product (GDP), the US deficit was the largest since the end of World War II. By the end of this year the estimated deficit will again reach **\$1.4 trillion**. Our current national debt is \$12.9 trillion, or nearly 90 percent of GDP. Of this debt, the amount held by the public (i.e., by individuals, corporations, state or local governments, and foreign entities) is over **\$8 trillion, or 57 percent of GDP**. Even adjusting for inflation, both of these numbers are **more than double** their size from just 10 years ago.

The deficits for fiscal years 2009 and 2010 are largely attributable to significant declines in revenue due to a recession and weak economy, the cost of the wars in Iraq and Afghanistan, and various government bailouts and stimulus actions. These items do not represent long-term and recurring fiscal challenges. However, even after the economy recovers, the special federal interventions are complete, the wars are over, and unemployment levels are down, deficits and debt are expected to grow at a rapid rate. As a result, the U.S. will find itself in an unsustainable fiscal position in the years to come. If current policies are left unchanged, debt held by the public is projected to spike even further, reaching over **300 percent** of GDP in 2040 (see Figure 1).

National attention is now focused on what it will take to recover from a severe recession that has affected the livelihoods of millions of Americans. In March 2010, 9.7 percent of the U.S. population was jobless, comparable to unemployment levels of the early 1980s. Many additional workers were under-employed. Policymakers are likely to provide funding in 2010

→ **Failure to address the long-term problem will lead to compounding interest costs, which, absent dramatic reforms, will account for an overwhelming portion of the budget in the future.**

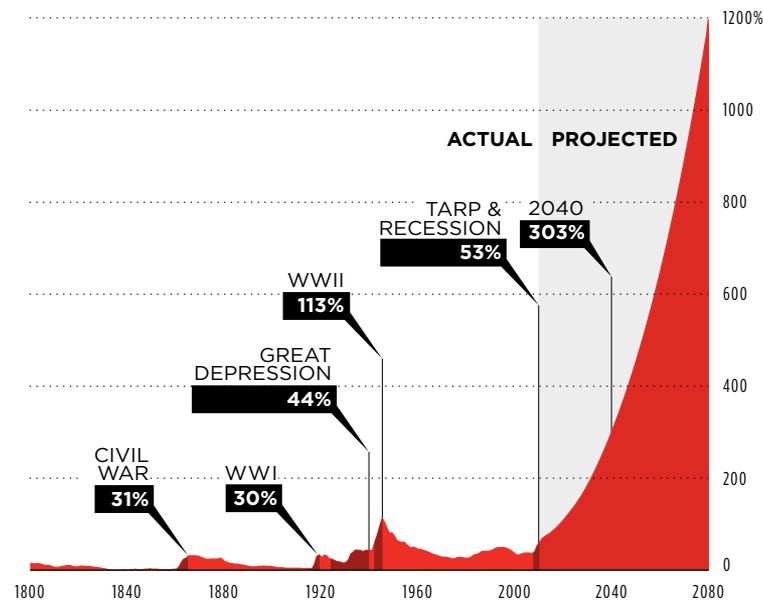
that is intended to support job creation and economic growth. Although the additional spending will increase the near-term deficit, it will help to boost economic activity. In the medium-term, however, our nation still has to grapple with the policies contributing to our growing red ink.

An aging population and rising healthcare costs exacerbate our fiscal dilemma. Within the next year, the oldest of the 78 million baby

FIGURE 1.

U.S. DEBT HELD BY PUBLIC

(PERCENT OF GDP)



SOURCES: Data from the Congressional Budget Office, *Long-Term Budget Outlook: June 2009*, the Government Accountability Office, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, alternative simulation using Congressional Budget Office assumptions. Compiled by PGPF.

boomers will reach full retirement age for Social Security and Medicare. Meanwhile, healthcare costs continue to grow at an unprecedented rate. In ten years, healthcare costs are anticipated to reach roughly **\$12,000 per person** (an increase of over 50 percent from this year's estimate).

Why should we be concerned? Delaying action will make it that much more difficult to reverse our fiscal course. As the debt grows, interest on

the debt will skyrocket. In fact, in just a dozen years based on our present path, our **interest expenses will quadruple**, becoming the largest single line item in the federal budget —larger than defense, Medicare or Social Security. Today the U.S. government spends 1 percent of the total economy on interest on the debt. By 2040, assuming that the U.S. does not have to pay a risk premium, federal interest costs will account for 14 percent of the entire U.S. economy.

→ **The time for meaningful action to defuse our fiscal time bomb has come.**

IO Current interest rates are low compared to historical levels. If interest rates rise just two percentage points, interest costs alone could represent about 20 percent of the economy by 2040. Failure to address the long-term problem will lead to compounding interest costs, which, absent dramatic reforms, will account for an overwhelming portion of the budget in the future.

Borrowing at the levels projected under our current policy path would call into question our ability to manage our nation's fiscal affairs, and result in sharply higher interest rates. That, in turn, would be likely to cause even more severe economic challenges, including further downward pressure on the dollar; higher prices for oil, food and other goods; and greater levels of unemployment. Hard as it is to imagine, our nation is on course towards an even worse economic crisis than during the past few years.

What needs to be done? Our elected officials must **wake up** and, once the economy recovers, take steps to close the gap between spending and revenue. By 2024, historical revenue levels of about 18 percent of GDP will not even cover projected costs of net interest, Social Secu-

riety, Medicare and Medicaid. This means the government will need to borrow to pay for other essential programs such as education, transportation, national defense and homeland security.

To help address our fiscal challenges, the President established the National Commission on Fiscal Responsibility and Reform on February 18, 2010. This bipartisan commission is charged with the task of providing recommendations on how to balance the budget by 2015 (excluding interest costs on the federal debt) and examining long-term solutions for our growing entitlement programs. The commission, chaired by former Clinton Chief of Staff Erskine Bowles and former Republican Senate Whip Alan Simpson, will issue its recommendations by December 1, 2010. While the outcome from this commission remains to be seen, the undeniable truth is that the time for meaningful action to defuse our fiscal time bomb has come.



Our Growing Fiscal Challenge

THE FEDERAL BUDGET

The federal budget is a key instrument in national policymaking. Through the annual budget process, the legislative and executive branches determine national priorities and allocate resources among the many federal programs.

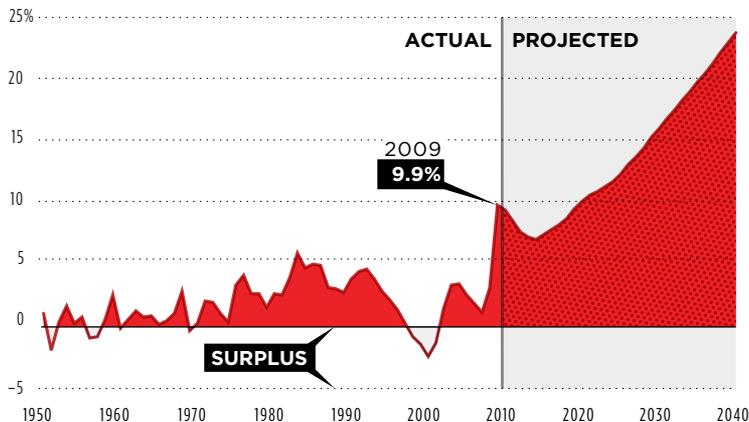
They also determine how to finance those decisions, whether through collecting taxes from individuals and businesses, assessing various premiums or fees, or borrowing from domestic and international lenders.

Up until the Great Depression in the 1930s, the U.S. experienced more budget surpluses than deficits. Since World War II, we have balanced the federal budget only a dozen times, with only four of those, fiscal years 1998-2001, occurring in the past 40 years (see Figure 2). Of the four years when we had surpluses, only in fiscal year 2000 did the federal government have an operating surplus (which excludes consid-

FIGURE 2.

FEDERAL DEFICITS

(PERCENT OF GDP)



SOURCES: Data from the Office of Management and Budget, *A New Era of Responsibility: The 2011 Budget*, Historical Tables and the Government Accountability Office, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, alternative simulation using Congressional Budget Office assumptions. Compiled by PGPF.

eration of the Social Security surplus). In the past 40 years, deficits as a percentage of the economy have averaged slightly over 3 percent.

In fiscal year 2009, we experienced a record deficit of nearly 10 percent of GDP. That shortfall was a result of a lower level of revenue (15 percent of GDP) largely due to the recession, and higher spending (25 percent of GDP) primarily reflecting the Troubled Asset Relief Program (TARP), Fannie Mae and Freddie Mac support, increased unemployment benefits and other stimulus and bailout actions by the federal government. What's even more troubling is that under current law the gap between revenue and spending widens steadily over the next 30 years and beyond, continuing well after full economic recovery (see Figure 3). These

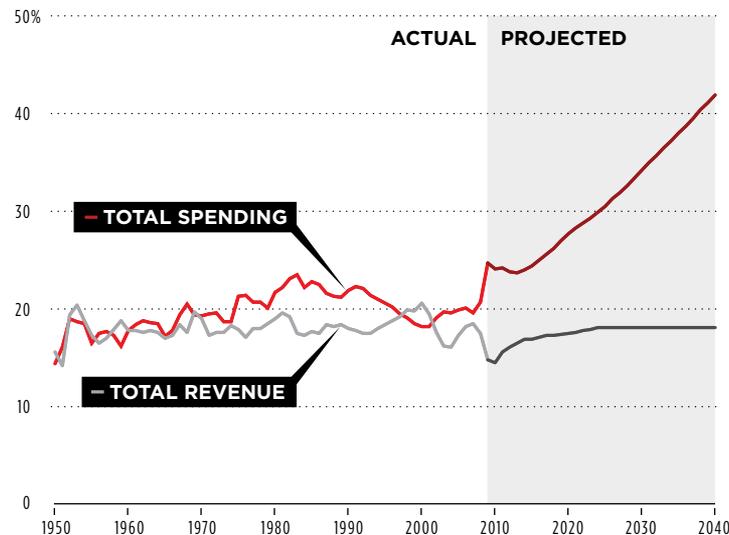
annual shortfalls are the structural deficits, which, if left unchecked, will threaten the state of our nation.

What do all of these numbers ultimately mean for us as citizens? If we continue down this path, rising deficit and debt levels will impact our everyday lives by threatening our nation's economic strength (lower investment and growth), our international status (weaker standing in the world and international capital markets), our standard of living (higher interest rates for loans and mortgages, higher unemployment rates, lower wages), and possibly our national security (higher dependency

FIGURE 3.

FEDERAL SPENDING AND REVENUES

(PERCENT OF GDP)



SOURCES: Data from the Office of Management and Budget Historical Tables, Government Accountability Office's *The Federal Government's Long-term Fiscal Outlook: January 2010 Update*, alternative simulation using Congressional Budget Office assumptions. Compiled by PGPF.

on foreign governments that purchase U.S. debt). Moreover, higher debt levels mean more resources devoted to compounding interest payments on the debt, which increasingly go abroad rather than stay in this country. Thus, we have fewer resources available for domestic investment in research and development, education, infrastructure and other crucial investments that maintain our economic competitiveness.

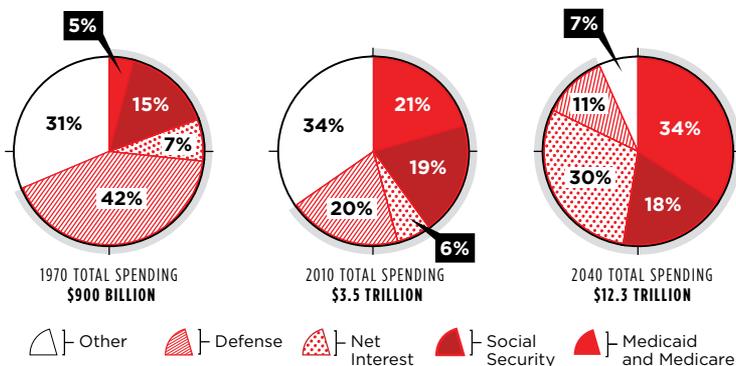
Changing Composition of Spending

Federal spending can be divided into five major categories: net interest (interest costs on the federal debt), Social Security, Medicare and Medicaid, national defense, and all other programs, which includes areas like education, income security, transportation, agriculture, housing space and science, natural resources, and health programs like the National Institute of Health and Center for Disease Control and Prevention (see Figure 4).

FIGURE 4.

COMPOSITION OF FEDERAL SPENDING

(PERCENT OF TOTAL SPENDING, IN CONSTANT 2009 DOLLARS)



SOURCES: Data derived from the Office of Management and Budget, *A New Era of Responsibility: The 2011 Budget, Historical Tables and the Congressional Budget Office, Preliminary Analysis of the President's Budget*; March 2010. Calculated by PGPF.

Since 1970, the decline in defense spending as a portion of the total budget has been offset by the growth in the major entitlement programs (Social Security, Medicare and Medicaid). Spending as a percentage of GDP has grown from its historical average of 20 percent of GDP over

→ **Rising deficit and debt levels will impact our everyday lives by threatening our nation's economic strength, our international status, our standard of living, and possibly our national security.**

the last 50 years to roughly 24 percent of GDP in 2010, and is anticipated to reach 40 percent of GDP in 2040 under current policies. The three major entitlement programs (Medicare, Medicaid and Social Security) are the primary drivers of that long-term growth. Of these, Medicare and Medicaid represent the greatest challenge.

Economic Recovery

As the United States continues to recover from one of the most severe economic downturns in recent history, we will continue to see additional spending in the near term for job creation and economic recovery. The recent recession—which lasted from late 2007 through mid-2009—disrupted the housing and financial markets, left millions of Americans unemployed, and created a greater need for income assistance programs. Last year, revenue levels dropped to their lowest point in recent history, falling to under 15 percent of GDP (well below the historical average of about 18 percent of GDP).

The Congressional Budget Office (CBO) estimates that the American Recovery and Reinvestment Act of 2009 (ARRA), the economic stimu-

lus package, has increased federal spending by \$158 billion and lowered revenues by \$114 billion through December 2009. The higher spending levels were primarily for government purchases of goods and services, aid to state and local governments, and income transfer payments to individuals. The revenue reduction primarily reflected tax cuts for lower and middle-income people, extension of first-time homebuyer credit, and changes to corporate taxes. CBO estimates that the stimulus package added between 1 million and 2.1 million jobs and increased the GDP by 1.5 percent to 3.5 percent in October through December 2009.

HEALTHCARE REFORM

HEALTH CARE IS THE MAJOR PLAYER AT THE HEART OF OUR FISCAL crisis. Medicare, which retirees rely on for their health insurance, and Medicaid, which provides health care for low-income individuals, account for most of the projected long-term growth in spending. Together, they account for 5 percent of today's GDP (20 percent of spending); within 30 years they are projected to cost 11 percent of GDP (25 percent of spending). By 2080, according to projections, the two programs alone will represent 18 percent of GDP, equal to the historical average level of federal revenues (see Figure 5). Consequently, any long-term plan to stabilize the national debt as a percentage of the overall economy will depend on successfully controlling the costs of federal health programs.

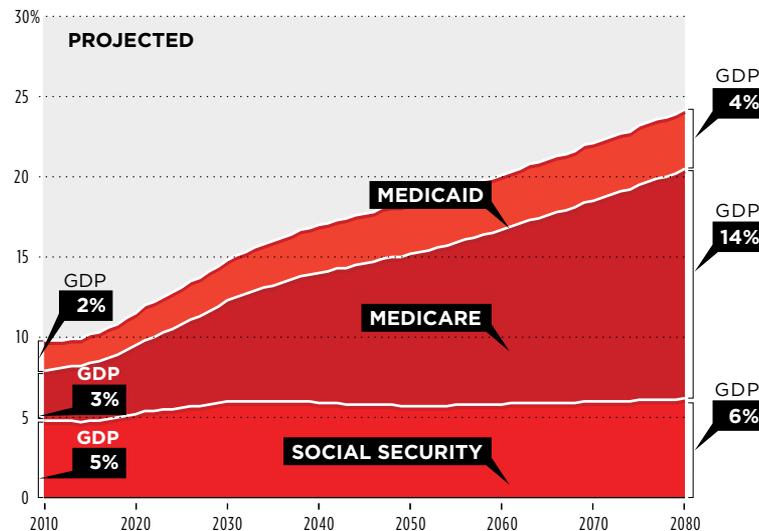
There are two core reasons why the cost of Medicare is growing so fast: as baby boomers retire and people live longer after the age of 65, the number of retirees is increasing; and overall health care costs in the U.S. are rising rapidly. It is the growth in health care costs that represents the major threat to our standard of living.

Currently, Americans spend on average \$8,000 per year on health care—far more than any other developed nation. Comparable high-income countries such as England, Germany, Japan, and Canada spend between one-half and two-thirds of what the U.S. spends on health care

FIGURE 5.

PROJECTED ENTITLEMENT GROWTH

(PERCENT OF GDP)



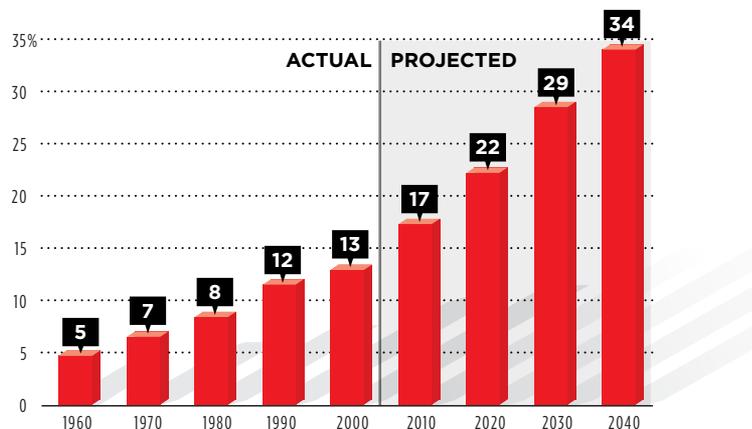
SOURCES: Data from the Government Accountability Office, *The Federal Government's Long-Term Fiscal Outlook*: January 2010 Update, alternative simulation using Congressional Budget Office Assumptions. Compiled by PGPF.

per capita. Yet, our health outcomes are no better, and by some measures are even worse. For example, the US ranks poorly among Organisation for Economic Co-operation and Development (OECD) countries in terms of obesity and infant mortality. U.S. health care costs are projected to grow even further in the near future, eating up a larger and larger share of our economy. In 1980, health care spending made up 8 percent of our economy. By 2000 it grew to nearly 14 percent, and by 2020 it is anticipated to exceed 20 percent. From 2020 on, health care

FIGURE 6.

NATIONAL HEALTH EXPENDITURES

(PERCENT OF GDP)



SOURCES: Data from the Congressional Budget Office, *The Long-Term Fiscal Outlook*, June 2009. Compiled by PGPF.

costs are projected to skyrocket, absent systemic reform (see Figure 6).

Studies by economist Uwe Reinhardt, the McKinsey Global Institute and the International Federation of Health Plans suggest that a major reason why U.S. health care is so much more expensive than the rest of the world is that the price of our medical services is higher. A medical appointment, prescription drug, surgery or test will, in general, cost more in the U.S. than in Europe. But prices are not the only driver of national costs. Americans also receive a lot of unnecessary medical care. Studies by the Dartmouth Atlas Project have shown that some regions of the country, such as Florida, New Jersey, and Texas, consume many more expensive medical services than the rest of the country—and are no healthier for it.

Most experts agree that the way that health care is paid for in the U.S. drives up costs. Doctors in the United States are paid on a fee-for-service basis, meaning that they have an incentive to order more procedures and schedule more appointments. They are paid more if they deliver a lot of treatments (especially more expensive procedures such as CAT scans and MRIs), a system that may not result in making patients healthier. Moreover, most American consumers are not aware of how much they spend on health care. Insurance pays for most health care costs, and employers pay for most insurance. Economic research (Gruber and Krueger, 1991) shows that employers give smaller raises because of health care costs. As a result, the process of paying for health care is so indirect and opaque that most people have little reason to consider whether or not they are getting good value for their health care dollar.

Reforming health care to be more cost effective requires changing the economics of medicine. It means replacing the current fee-for-service system with a system that rewards doctors for keeping patients healthy and avoiding unnecessary or inappropriate procedures. It also

→ **U.S. health care costs are projected to grow even further in the near future, eating up a larger and larger share of our economy.**

means giving consumers an incentive to keep doctors and other providers accountable for quality and cost. Those changes will involve difficult choices for society. Health is precious and most consumers do not want to spare any expense that might potentially improve their health. Nevertheless, choices have to be made because costs are growing faster than the government or our people can afford and sustain.

In March 2010, Congress passed and President Obama signed into

law sweeping health care reform. CBO estimates that by 2019 the new law will provide federally-subsidized health insurance for about 32 million Americans who would otherwise be uninsured. The historic law takes steps in the direction of more cost-effective care by promoting experiments with new payment systems, comparative effectiveness research, and electronic health records.

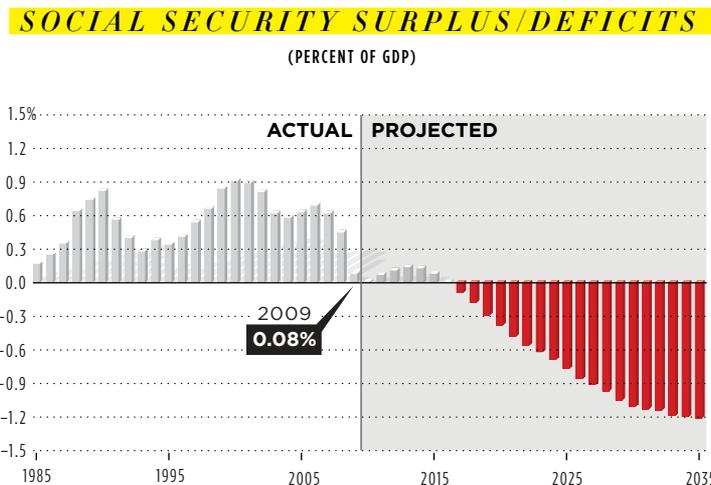
Under the new law, the expansion of health insurance coverage is mostly paid for by slowing the growth of Medicare payments to hospitals and other providers, and increasing Medicare payroll taxes. For reduced Medicare payment rates to be sustainable the overall health care system will have to become more efficient and keep down unnecessary costs. Otherwise Medicare payments will not be in line with the costs of the overall health care system. That in turn could limit Medicare beneficiaries' access to providers, or contribute to cost-shifting to private payers. Either result could eventually force an upward revision in payment rates.

The projected payment rate cuts and new payroll tax income would significantly reduce unfunded Medicare promises over the next 75 years, but those resources will be needed to pay for the new health insurance subsidies. Consequently, much work remains to stabilize health care costs as a percentage of the federal budget and the overall economy and keep total federal spending for health care from growing faster than our willingness to pay.

SOCIAL SECURITY

SOCIAL SECURITY IS THE MAJOR SOURCE OF INCOME FOR MOST retirees in America, and most workers pay more in Social Security payroll taxes than in income taxes. Payroll taxes are credited to the combined Social Security trust fund, which, like the Medicare trust fund, is an accounting mechanism that tracks dedicated payroll tax income and benefit payments. While the trust funds carry distinct legal, political and moral significance, they do not have immediate budgetary or economic impact.

FIGURE 7.



SOURCES: Data from the Congressional Budget Office, *The Long-Term Fiscal Outlook*: June 2009. Compiled by PGPF.

Over the past 25 years, Social Security has consistently brought in more tax revenue than it has paid out in benefits, creating a positive balance in the trust fund. If it had not been for the Social Security cash surpluses, our past deficits would have been even larger. By 2016 Social Security will start adding to the federal deficit instead of reducing it (see Figure 7). More recent projections show the recession causing a temporary cash deficit in the near term. As more baby boomers retire, benefit payments will increasingly outgrow Social Security tax revenue. That wave of baby boomer retirements is not a demographic blip: the U.S. population will continue to include a larger proportion of older people than it has up to now. Given current policy, the Social Security trust fund will be depleted and, absent policy changes, the program will lack sufficient resources to pay all of its scheduled benefits as early as 2037.

The root cause of Social Security's shortfalls is the same growth in retirees that is affecting Medicare's finances. Longer life spans mean more years of collecting Social Security benefits and thus more financial de-



The recession has caused a temporary cash deficit, and by 2016 Social Security will start adding to the federal deficit instead of reducing it

mands on the system. At the same time, people have been having fewer children than they did when Social Security was created, slowing growth in the number of younger workers paying Social Security taxes. In 1950, there were 16 workers paying taxes to support each retiree. Now there are 3.3, and by 2040 there will be only 2. Unless Social Security taxes increase, or benefit payments decrease, Social Security will require special appropriations from Congress to fulfill current benefit promises.

DISCRETIONARY SPENDING

ALTHOUGH MEDICARE, MEDICAID, AND SOCIAL SECURITY ARE MANDATORY spending programs that do not depend on annual congressional action to pay benefits, over one-third of the budget consists of discretionary programs that have to be funded through annual appropriations legislation.

The largest category of discretionary spending is defense. In fact, for many years national defense was by far the largest portion of the federal

budget. Since the end of World War II, we have gradually reduced defense spending from over half of the budget to about one-sixth of the budget by the year 2000. However, the invasions of Afghanistan and Iraq have caused defense spending to increase as a share of the budget, and it now stands at about one-fifth of all federal spending.

The discretionary budget also includes many vital non-defense programs. Such spending pays the salaries of most government employees and allows the government to operate. Homeland security, foreign relations, education, research and development, disaster assistance, highways, air traffic control, the Congress, the Supreme Court, and the operations of the White House are all examples of discretionary spending. About 19 percent of the 2010 budget consists of nondefense discretionary spending.

REVENUE

NOTHING IS FREE, AND OUR GOVERNMENT COSTS AMERICANS MONEY. Most Americans pay taxes on their income, money that is used to support the federal government. Historically, around 18 percent of national income is paid to the federal government in the form of taxes. That money is then used to fund government's operations and spending programs.

The majority of the government's revenue comes from three types of taxes: individual income taxes, payroll taxes, and corporate income taxes. Income taxes are progressive, meaning higher income individuals face higher tax rates. However, payroll taxes are regressive because they only apply to the first \$106,800 of wage income (in 2010), and any earnings beyond that are not subject to payroll taxes. The more an individual earns above the limit (which is indexed to inflation), the smaller his or her payroll taxes are as a portion of income. Corporate income taxes reduce earnings for the shareholders of corporations, who generally have larger incomes. Corporate income taxes also result in higher prices to consumers.

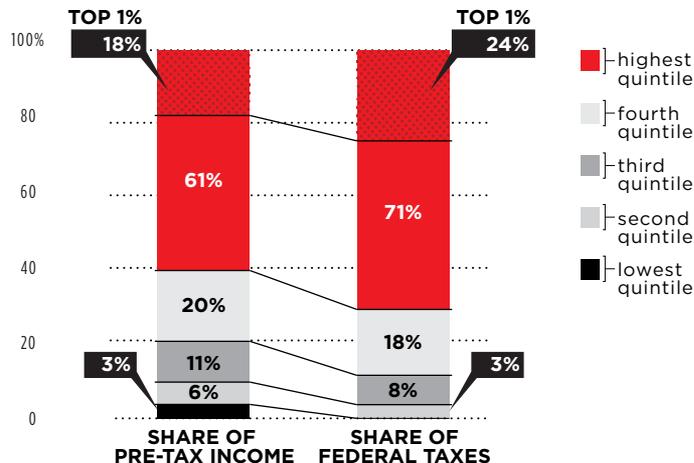
The highest-earning 1 percent of Americans pay for about 24 percent

of the government’s tax revenue, and the top 20 percent pay about 71 percent of total federal taxes (see Figure 8). In 2010, an estimated 45 percent of taxpayers will pay no income taxes or will receive a refundable (cash) tax credit, but only 13 percent will have to pay no income tax (or receive a credit) and no payroll tax.

FIGURE 8.

SHARES OF PRE-TAX INCOME AND TOTAL FEDERAL TAXES

(HOUSEHOLDS BY INCOME QUINTILES IN 2010)



SOURCES: Data from the Tax Policy Center. Compiled by PGPF.

The U.S. tax code is riddled with special exemptions, deductions, and credits that affect people’s tax liabilities. For example, homeowners can deduct the interest cost on their primary mortgages from their taxable income, and the value of health insurance provided by an employer is exempt from taxation. Renters and people who buy their own health

insurance don’t get the similar tax benefits.

All of these special exemptions and tax breaks are similar to direct government spending in that they also have a cost (in the form of reduced revenues) that affects the government’s “bottom line.” The Treasury reported that tax exemptions and deductions for health care cost alone added over \$250 billion per year (or nearly half of the cost of the Department of Defense). Tax policy experts estimate that if we eliminated all of the special deductions and credits we could raise 44 percent more revenue than we do now without actually raising tax rates.

Most Americans do not want higher taxes. But since the Federal government does not have enough revenues to pay for the commitments it has made, tax revenues will have to go up unless programs are cut. The money for government programs will have to come from somewhere: higher income tax rates, fewer special exemptions, or perhaps a new tax altogether such as a consumption tax.

DEBT

“The debt of the United States... was the price of liberty.”

ALEXANDER HAMILTON
1790, *First Report On The Public Credit*

THE DEBT IS THE CUMULATIVE TOTAL OF ALL OF OUR PREVIOUS deficits and surpluses and other federal financial transactions. Since the founding of our country, when the Revolutionary leaders needed to borrow to fight the war against the British for independence, the United States has dealt with the process of borrowing, repaying, and recording debt. Our debt has never, however, reached the levels that are currently projected for the near future, absent major policy changes.

The federal debt—which is displayed in a “national debt clock”—is

comprised of two parts: intragovernmental debt—Treasury securities held by federal trust funds (e.g., Social Security and Medicare) and other government accounts—and debt held by the public, which are marketable securities issued by the Treasury and sold to both domestic and foreign investors. Because Americans have low savings rates, the federal government has become increasingly dependent on foreign lenders to finance the nation’s deficits and debt. As of April 2010, foreign investors hold 47 percent of public debt.

→ **Debt is, perhaps, the “price of liberty,” but what is the price of debt?**

In February 2010, Congress voted to raise the debt ceiling, or the upper limit of our national debt, to **\$14.3 trillion**. The debt ceiling is now \$2 trillion higher than it was just a year ago. The total debt more than doubled in the past decade from \$5.6 trillion to **\$12.9 trillion as of April 2010**. Debt held by the public has also more than doubled in the last decade, rising from about \$3.4 trillion in 2000 to about **\$8.3 trillion** as of April 2010.

With deficits projected to reach over \$1 trillion through 2011, and to remain above \$700 billion for the next ten years, the national debt level is expected to grow dramatically.

Debt levels, at the highest they have been since World War II, could lead to substantial interest payments in the future, if they persist. By 2012, projected spending on interest will exceed spending on Medicaid. By 2018, interest spending will exceed Medicare spending. By 2046, interest spending will exceed total federal revenues (*see Figure 9*).

The implications of these high debt levels, however, extend beyond just higher interest payments and lower levels of investor confidence. The United States may be an unlikely candidate for defaulting on its debt, but debt at the level projected in coming decades would be

FIGURE 9.

INTEREST COSTS ARE PROJECTED TO EXCEED...

BUDGET CATEGORY	IN YEAR*
Medicaid spending, 1.7% of GDP	2012
Defense spending, 3.6% of GDP	2017
Medicare spending, 3.9% of GDP	2018
Social Security, 5.4% of GDP	2022
All other spending, 5.4% of GDP**	2022
Total Revenues, 18.1% of GDP	2046

*Assumes interest rate of 5.4 percent. If interest rates rise, projected interest costs will exceed projected program costs earlier than shown.

**Projections are constant share of GDP after 2020.

SOURCES: Data from the Congressional Budget Office, Preliminary Analysis of the President’s Budget: March 2010 and Government Accountability Office *The Federal Government’s Long-Term Fiscal Outlook: January 2010 Update*. Compiled by PGPF.

unsustainable, and could lead to lower standards of living, lower domestic investment, and higher interest and inflation rates over time. Interest rates are currently at an historic low—three-month rates are close to zero, while they hovered around 8 percent as recently as 1990. The interest cost on our debt would increase dramatically if rates rise in the future.

The Maastricht criteria, which must be met by European Monetary Union states looking to adopt the Euro as their currency, is an internationally recognized standard for fiscal policy. The criteria limits inflation and interest rates based on international averages, and caps deficit and public debt levels at 3 percent and 60 percent of a country’s GDP, respectively.

Countries with higher debt-to-GDP levels often also face both economic and political crises. Greece, a country whose debt-to-GDP ratio exceeded 110 percent in April 2010, is facing correspondingly lower bond ratings, concern over political credibility, and international pressure to make swift and drastic policy changes. Ireland and Spain, whose deficits were more a result of loss in tax revenue related to the recession than to poor fiscal policies, are seeing the implications in high unemployment rates and major decreases in international investor confidence.

MAJOR FISCAL EXPOSURE

THE TERM “FISCAL EXPOSURES” IS A MEASURE (IN PRESENT VALUE) of federal liabilities, commitments, contingencies, and unfunded promises, which, under current law, will cost the government at a future date.

Referring to *Figure 10*, the federal government was in a \$61.9 trillion-plus hole as of September 30, 2009 (an increase of \$5.5 trillion from the previous year).

Right now, each American’s share of the \$61.9 trillion in fiscal exposures is over \$200,000. Every year in which there are no down payments or reforms made to these liabilities and promises, the total grows by \$2 to 3 trillion—or \$6,500 to \$10,000 per person—on autopilot.

Some exposures are explicit and known liabilities that the federal government is legally obligated to fulfill. Commitments and contingencies represent contractual requirements that the federal government is expected to fulfill when or if specified conditions are met.

The largest category of exposures, however, contains the growing unfunded promises for Social Security and Medicare benefits for current and future beneficiaries. Although people rely on the promise of those benefits, the Congress and the President can—and at times do—change the programs in ways that increase or decrease the value of expected benefits, and thus alter the size of the implicit exposure. For example, in the past, policymakers have increased payroll tax contributions,

FIGURE 10.

MAJOR FISCAL EXPOSURE

(\$TRILLIONS)

	2000	2009
EXPLICIT LIABILITIES	\$6.9	\$14.1
• Publicly-held debt	3.4	7.6
• Military & civilian pensions & retiree health	2.8	5.3
• Other Major Fiscal Exposures	0.7	1.3
COMMITMENTS & CONTINGENCIES	0.5	2.0
• E.g., Pensions Benefit Guaranty Corporation, undelivered orders		
SOCIAL INSURANCE PROMISES	13.0	45.8
• Future Social Security benefits	3.8	7.7
• Future Medicare benefits	9.2	38.2
• Future Medicare Part A benefits	2.7	13.8
• Future Medicare Part B benefits	6.5	17.2
• Future Medicare Part D benefits	--	7.2
TOTAL	\$20.4	\$61.9

NOTE: Estimates for Medicare and Social Security promises are from the Social Security and Medicare Trustees reports which are as of January 1, 2009 and show unfunded liabilities for the next 75 years. Future promises are discounted to present value based on a real interest rate of 2.9% and CPI growth of 2.8%. The totals above do not include liabilities on the balance sheets of Fannie Mae, Freddie Mac, and the Federal Reserve. Assets of the U.S. government not included. May not add due to rounding.

SOURCES: Data from the Department of Treasury, *2009 Financial Report of the United States Government*. Compiled by PGPF.

increased the retirement eligibility age, changed cost-of-living adjustments, and increased beneficiary premiums applicable to such pro-

→ **Right now, each American's share of the \$61.9 trillion in fiscal exposures is over \$200,000.**

grams. In addition, the U.S. Supreme Court has ruled that the benefits under those programs can be changed at any time through legislation.

SHORTCOMINGS OF THE BUDGET AND BUDGET PROCESS

THE FEDERAL BUDGET IS INTENDED TO PROVIDE A GUIDELINE TO annual fiscal policymaking. It does, however, have major weaknesses when it comes to both understanding and managing the finances of the United States government.

- First, the annual budget process focuses on the near term, rather than on the long-term impacts of fiscal choices. Decision makers do not devote the same level of scrutiny to future outcomes as they do to current costs. As a result, the longer-range impact on the nation's structural budget has been neglected.
- Second, children cannot vote, and younger people are less engaged in the political process. As a result, those individuals that will carry most of the future burden of current fiscal irresponsibility are not represented in the decision-making.
- Third, the budget is primarily cash-based, and thus ignores future costs that are likely to result from various activities and tax policies

of the federal government. Some of those costs reflect federal liabilities and legal obligations. Others are obligations for benefits that will be paid in the future, including Social Security and Medicare.

- The budget process lacks effective means to achieve and preserve sound budgetary objectives and desired outcomes. Statutory tools that contributed to budget surpluses in the late 1990s have since expired (*see Box 1*).

BOX 1.

BUDGETARY TOOLS

STATUTORY PAY-AS-YOU-GO (PAYGO) AND CAPS ON DISCRETIONARY SPENDING WERE IN PLACE FROM 1990 TO 2002 AND WORKED WELL TO CONTROL DEFICITS.

- **Under PAYGO**, if lawmakers want to pass a tax cut, they need to pass either a corresponding reduction in mandatory spending or a tax increase. If Congress wants to increase mandatory spending, it needs to pass either a corresponding tax increase or decrease spending in other areas. In February 2010, a less stringent PAYGO rule was enacted into law. Since the current PAYGO requirements exclude certain mandatory programs and assume extended tax cuts, the budgetary tool may prove to be less effective than before.
- **Caps on discretionary spending** provide lawmakers with another way to control spending. Such caps were also put into place between 1990 and 2002. They set enforceable limits on discretionary spending, but can be adjusted to allow for unexpected emergencies. Spending caps force tradeoffs between programs and encourage policymakers to set priorities instead of just providing more funds.



Solutions

Our fiscal situation is grave, but it is not hopeless. We can improve it if “We the People” decide to fix it. But there is no easy fix, and it will require a combination of spending cuts and revenue increases to prevent our national debt from rising to unsustainable levels.

Some policymakers may want to try to solve the problem with only spending cuts, while others may want to keep spending the same and only raise taxes. Both approaches are unrealistic and the respective groups will have to make concessions if we are going to solve the problem. Figure 11 displays a list of illustrative policy options that would help lower the rising long-term debt levels. Many other solutions are possible.

Right now, our political institutions are generally ineffective at addressing our long-term fiscal challenges. Politicians fear the wrath of an electorate that dislikes tax increases and spending cuts. It is much easier to expand government programs and provide tax cuts, reap the

short-term political benefits, and then let future politicians—and citizens—deal with the consequences.

Congress has shown that it is able to control spending when it has to by using tools like pay-as-you-go and discretionary caps. But these mechanisms only prevent the problem from getting worse; they will not prevent the projected rise in debt that will happen if elected officials do not change major policies. Many politicians will agree in private that they need to do something about escalating deficits and debt levels, but

→ **It is much easier to expand government programs and provide tax cuts, reap the short-term political benefits, and then let future politicians—and citizens—deal with the consequences.**

believe that building a political coalition around a fiscal responsibility and sustainability package is too difficult. Many doubt whether normal congressional procedure can ever produce a meaningful solution.

The bipartisan fiscal commission that President Obama recently created may help break the logjam on sustainable fiscal policies. That executive commission is charged with achieving a balanced budget excluding interest costs on the debt in 2015 and identifying policies that would improve the long-run fiscal outlook. This goal should be supplemented by additional goals to stabilize the debt-to-GDP ratio at a reasonable level, and to achieve a significant reduction in the tens of trillions in unfunded promises that the federal government already has.

The Commission will be required to produce a proposal that has support from at least 75 percent of its members, which means that both parties will have to support it. Unfortunately, because neither the Congress nor the President is under any obligation to adopt the Commis-

FIGURE 11.

POLICY OPTIONS**BUDGET REFORM**

- 1. Reimpose budget controls**
 - PAY-Go
 - Spending Caps
- 2. Recognize long-term impacts**
- 3. Set debt-to-GDP target (e.g. 60%)**

DEFENSE AND OTHER SPENDING

- 1. Eventually reduce defense spending to pre-war levels**
- 2. Implement Department of Defense reforms**
 - Review weapons systems
 - Make procurement programs more efficient
 - Make military compensation and benefits more affordable
- 3. Review and eliminate other ineffective programs**

SOCIAL SECURITY

- 1. Gradually raise the retirement age**
- 2. Increase payroll tax revenues**
 - e.g., raise the payroll tax wage-cap
- 3. Reduce growth in benefits for the better-off**
- 4. Reduce COLA for Social Security benefits**

HEALTH CARE

- 1. Reduce the rate of growth in health care**
 - Move away from fee-for-service
 - Enforce better coordination throughout system
 - Introduce malpractice reform
 - Reduce administrative costs
 - Adopt electronic medical records

HEALTH CARE
(continued)

- Reduce medical errors
- Increase physician and hospital accountability
- Create smarter healthcare consumers
- Make better decisions about end-of-life care

2. Promote prevention and wellness

3. Implement Medicare reforms

- Federal budget for health care
- Raise premiums for Medicare Part B and D
- Gradually raise eligibility age

TAX

1. Reconsider Bush tax cuts

2. Restructure consumption tax

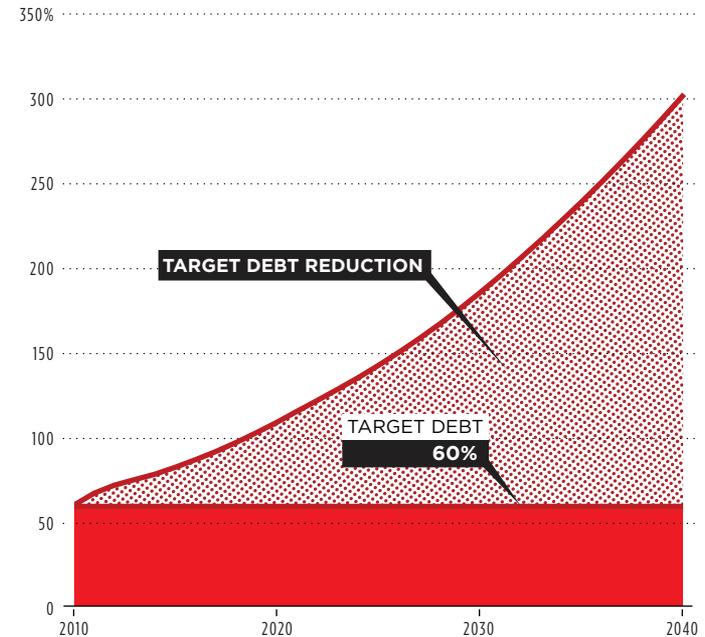
3. Simplify the tax code

be achieved through program reforms and budgetary constraints will ultimately have to come from higher taxes. The key is to act sooner rather than later, because if we allow the debt to creep up too high, interest costs will make our fiscal challenge much tougher than it is now.

FIGURE 12.

A SUSTAINABLE DEBT TARGET

(PERCENT OF GDP)



SOURCES: PGPF calculations based on data from the Congressional Budget Office, *Budget and Economic Outlook: FY 2010 to 2020*: January 2010.

sion’s proposals, it is far from certain that the commission will succeed, especially if it does not engage in meaningful citizen education and engagement efforts that will help build public understanding and support for its important task.

Government projections show that if current policy remains unchanged, debt held by the public is projected to exceed 300 percent of GDP by 2040. If that happens, then interest on the debt will be so expensive that we will not have much hope of getting debt down again. Furthermore, if we lose the confidence of our foreign investors and pass a “tipping point,” America and the world could face a global depression.

To keep the debt below a manageable level—e.g., 60 percent of GDP (as discussed earlier in the debt section)—everything will have to be on the table, but addressing the growth in health care costs is essential. CBO estimates that debt held by the public will be 62 percent of GDP when fiscal year 2010 ends. Figure 12 compares a debt level of 60 percent of GDP to current long-term projections. In the final analysis, whatever spending reductions and productivity improvements cannot

WHAT CAN WE DO AS CITIZENS?

- Register to vote
- Become informed about the key issues facing our country and society
- Demand that Washington policymakers begin to address these issues, and that candidates for federal office disclose their proposed solutions
- Hold elected officials accountable for acting on large, known, and growing key challenges and delivering on their promises
- Rethink our priorities: Focus on critical societal needs, and on programs and policies that work and create a better future
 - Assign to the government only the responsibilities we are willing to pay for in taxes. Programs that are scheduled to grow faster than the economy are unsustainable
 - Recognize that there are no easy answers
- Build a consensus in favor of constructive and responsible change by building and sharing awareness of the fiscal challenge, the need for timely action, and the cost of inaction
- Join with other citizens to broaden public knowledge about our fiscal challenges and support civic groups that are working to address them

WHAT CAN WE DO AS INDIVIDUALS?

- Establish a personal budget and stick to it
- Formulate a financial plan that considers the following questions:
 - What are my short- and long-term personal financial objectives?
 - What major milestones do I need to prepare for (e.g., education, family, retirement)?
 - When do I see myself retiring? Have I considered that for each year I delay my retirement, I can substantially increase my retirement income for the rest of my life?
- Put that personal financial plan into immediate action

- Become more responsible in decisions to spend and use credit, save for the future, and invest savings wisely
- Teach children the importance of planning, saving, budgeting, investing, and making responsible use of credit
- Invest wisely not just in different types of real and financial assets, but also in my family's knowledge and education

LEARN MORE. GET INVOLVED.***Federal Government Websites***

- Centers for Medicare and Medicaid Services: www.cms.gov
- Congressional Budget Office: www.cbo.gov
- Economic Recovery: www.recovery.gov
- The Federal Reserve: www.federalreserve.gov
- Government Accountability Office: www.gao.gov
- House Budget Committee: www.budget.house.gov
- House Ways and Means Committee: waysandmeans.house.gov
- Joint Committee on Taxation: www.jct.gov
- MedPAC: www.medpac.gov
- Office of Management & Budget: www.whitehouse.gov/omb
- Senate Appropriations Committee: www.appropriations.senate.gov
- Senate Budget Committee: www.budget.senate.gov
- Senate Finance Committee: www.finance.senate.gov
- Social Security Administration: www.ssa.gov
- U.S. Treasury's Office of Tax Policy: www.treas.gov/offices/tax-policy

Other Organizations

- American Enterprise Institute: www.aei.org
- The Brookings Institution: www.brookings.edu
- CATO Institute: www.cato.org
- Center for American Progress: www.americanprogress.org
- Center on Budget and Policy Priorities: www.cbpp.org

- The Center for Economic and Policy Research: www.cepr.net
- Center for Retirement Research at Boston College: crr.bc.edu
- Choose to Save: www.choosetosave.org
- Citizens Against Government Waste: www.cagw.org
- The Committee for Economic Development: www.ced.org
- The Committee for a Responsible Federal Budget: www.crfb.org,
and its blog, US Budget Watch: www.usbudgetwatch.org
- The Concord Coalition: www.concordcoalition.org
- Employee Benefit Research Institute: www.ebri.org
- Financial Planning Association: www.fpaforfinancialplanning.org
- The Fiscal Times: www.thefiscaltimes.org
- The Heritage Foundation: www.heritage.org
- The Kaiser Family Foundation: www.kff.org
- National Academy for Public Administration: www.napawash.org
- National Academy of Social Insurance: www.nasi.org
- OMB Watch: www.ombwatch.org
- Peterson Institute for International Economics: www.iie.com
- Progressive Policy Institute: www.ppionline.org
- Public Agenda: www.publicagenda.org
- Tax Foundation: www.taxfoundation.org
- The Tax Policy Center: www.taxpolicycenter.org
- Institute for Truth in Accounting: www.truthinaccounting.org
- The Urban Institute: www.urban.org

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Our mission is to increase public awareness of the nature and urgency of key economic challenges threatening America's future and accelerate action on them. To meet these challenges successfully, we work to bring Americans together to find sensible, sustainable solutions that transcend age, party lines and ideological divides in order to achieve real results.



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