STATE OF THE UNION’S FINANCES
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The mission of the Peter G. Peterson Foundation is to increase public awareness of the nature and urgency of key fiscal challenges threatening America’s future and to accelerate action on them. To address these challenges successfully, we work to bring Americans together to find and implement sensible, long-term solutions that transcend age, party lines and ideological divides in order to achieve real results.

For more information about federal finances, and to find ways to become an advocate for fiscal sustainability, please visit our website at www.pgpf.org.
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Introduction

Our nation’s long-term fiscal outlook is unsustainable. Publicly held debt currently equals 70 percent of gross domestic product, the most common measure of an economy’s size. Our current policy path leads to debt of nearly 200 percent of GDP over the next 30 years. In all likelihood, such high and rising levels of debt would have a disastrous impact on the U.S. economy long before they reach that level.

Fortunately, the past year has brought substantial progress in raising awareness of America’s fiscal challenges. The bipartisan National Commission on Fiscal Responsibility and Reform, led by Democrat Erskine Bowles and Republican Alan Simpson, catalyzed the public discussion. Since then, both congressional Republicans and President Obama have presented frameworks for long-term deficit reduction; a bipartisan group of senators has sought to build on the work of the Bowles-Simpson commission; a number of independent organizations have offered blueprints for putting the budget on a sustainable long-term path, and the President signed into law the Budget Control Act (BCA) of 2011, which included provisions intended to improve America’s budget path over the next 10 years.

Despite broad awareness that the country must address its fiscal problems, and the enactment of the BCA, lawmakers have made scant
progress toward addressing our true long-term structural challenges. Those challenges stem primarily from the aging of the population and fast growth of health care costs, which will push expenditures on Medicare, Medicaid, and Social Security far above projected levels of federal revenues over the next 25 years. Yet, this year, Washington focused largely on controlling deficits over the next 10 years—not over the long term—and its major legislative achievement, the BCA, focused most of its attention on discretionary spending. That helps, but that part of the budget is not the cause of our structural long-term deficits. Moreover, the failure of the “supercommittee,” as the bipartisan group established by the BCA was known, to identify $1.5 trillion in deficit reduction over the next ten years has reinforced deep concerns about political gridlock in Washington and underscored how much work lawmakers still have to do to reach an agreement to address the country’s long-term fiscal challenges.

What the country needs is a grand fiscal bargain that would stabilize long-term debt at levels that our economy can afford, make resources available for critically needed investment, and substantially improve the prospects for future economic growth. If federal lawmakers can tame future budget deficits and put the nation on a fiscally sustainable path, the United States will become an environment more favorable to innovation, business development, and job creation. Such a plan would also keep Social Security, Medicare, Medicaid, and other social safety net programs strong for those who need them. Finally, while a comprehensive agreement would put this problem behind us and allow our policymakers to focus on other national needs, it would also reduce risk of a fiscal crisis.

However, if we continue on our current path, we will have to devote more and more resources to financing our debt. Using even an optimistic set of baseline assumptions, hundreds of billions of dollars a year will be sent to foreign creditors. We will have less money to invest in areas such as education, research, and infrastructure, which underpin a productive workforce and a thriving economy. Social Security and, particularly, Medicare
benefits will be put increasingly at risk by deteriorating federal finances. Perhaps worst of all, the consequences of our inaction will fall on future generations of Americans, who will have to pay our bills.

People on all sides agree that such outcomes are unthinkable and must be prevented. To change our current course, Americans must understand our fiscal challenges and be willing to support the difficult choices that policymakers confront as they search for solutions.

This guide aims to provide an objective, nonpartisan look at the fiscal facts and the decisions policymakers have to make. Those decisions...
must be made in the broader context of the economy and society we are trying to build. Questions of social welfare, generational equity, and the desire to encourage or discourage certain behaviors all have a bearing on economic growth and the individual programs and policies contained in the federal budget. Because the federal budget touches every American, it is a reflection of who we are as a nation and the priorities we seek to establish for the future.

**Our Current Path**

Stated simply, the federal government’s budget is currently in deficit because the government spends more each year than it receives from taxes and other sources of revenue. To cover that annual shortfall, the government has to borrow from the public. Over time, annual budget deficits can add up to sizable government debts.

The federal government’s annual budget deficits have been $1.3 trillion or higher for each of the past three years—in the neighborhood of 10 percent of GDP. However, much of the rise in the deficit is cyclical and reflects the current weakness of the economy. Although our recent deficits have been historically large, the government’s debt today is still manageable—it is about 70 percent of GDP—and global financial conditions are still relatively favorable for the U.S. Moreover, the large deficits of recent years have helped prop up and stabilize our economy as it suffered the deepest and longest recession since the Great Depression.

However, once the global economy recovers, continued high levels of government borrowing will eventually push up interest rates, making it more difficult for the private sector to create jobs and make new investments in factories, equipment, and housing. Because government borrowing will reduce the funds available for the private sector, budget deficits will crowd out private investment, slow the long-run growth of the economy over time, and raise the risk of fiscal crisis.
Although the BCA imposes limits on federal spending and establishes a process to curb projected deficits and debt even further, beyond 2021, the United States will still face a daunting long-term fiscal challenge. That is because structural deficits—deficits rooted in long-term demographic, longevity, and health care spending trends coupled with revenues that will not keep pace—and the growing cost of paying interest on the national debt are projected to push the debt to dangerously high levels. The BCA did not address those longer-term fundamental budgetary pressures.

Many economists believe that a debt-to-GDP ratio of 60 percent or less is a desirable fiscal goal. Carmen Reinhart and Ken Rogoff, two

Data from PGPF’s Long Term Model of the Federal Budget, baseline assumptions; the Congressional Budget Office, The Long-term Budget Outlook, June 2009; and OMB, The Budget of the United States Government for Fiscal Year 2013, February 2012. Compiled by PGPF.
highly regarded economic historians, have shown that debt above 90 percent of GDP can be risky for economic growth. If we do not change our current policies, official projections show that our debt is on an explosive and unsustainable path. The Congressional Budget Office projects that U.S. public debt will climb to nearly 100 percent of GDP by 2021 and then soar to more than 200 percent of GDP by 2040. By 2035, federal debt could cause the economy to shrink by 7 to 18 percent, which would be equivalent to reducing income in the United States by $3,000 to $8,000 per person in 2011. Moreover, long before debt reached 200 percent of GDP, financial markets would probably lose confidence in the United States and provoke an economic crisis that would cause interest rates to skyrocket, the value of the dollar to plummet, and unemployment rates to soar.

**Demographics, Health Care Costs, and the Future of the Social Safety Net**

Over the next two decades, the combination of low birth rates, the retirement of 78 million baby boomers, and lengthening life expectancies will result in a doubling of the number of Americans over age 65. Furthermore, the number of people age 85 and over is projected to triple by 2050. Longer life spans are good news, but they add to budget difficulties because health care spending on people over 85 is seven times higher than spending on adults under 65. Not only will more seniors be drawing Social Security and Medicare benefits, but they also will draw benefits for more years than older individuals of previous generations. And as the U.S. population ages, proportionally fewer workers will be available to pay for retiree benefits.

In addition, spending for the federal government’s two largest health care programs—Medicare and Medicaid—is, like the rest of the nation’s
health spending, growing faster than the economy. That growth is widening the gap between benefits and the revenues available to pay for them. Today, one-fourth of the federal budget (excluding interest) is spent on health care: That portion is projected to grow to a third in 20 years, and to increasingly larger shares of the budget in future decades.

The reality is that as the number of beneficiaries increases and health care costs grow, Social Security and, especially, Medicare will require larger shares of federal resources, increasing pressure within the budget. These programs, which form the core of the social safety net that many Americans rely on, could become financially precarious and leave the most vulnerable members of our society at risk—unless policymakers put our nation’s budget on a sustainable path.

**Defense, Taxes, and Other Programs**

In addition to Social Security and health care programs, defense is the third major category of federal spending. The United States spends more on defense than the next 17 highest-spending countries combined, which is twice as much of our GDP as other developed countries. While members of both political parties want to ensure that America is protected, a robust national defense depends upon a strong and resilient economy.

On the other side of the federal ledger, the tax code is overly complex and does not provide sufficient revenue to meet either our current or projected spending needs. The tax code is full of income deductions, exclusions, and other special provisions—known as tax expenditures—many of which are intended to influence or distort the economic behavior of individuals and businesses and are supported by strong special interest groups. The federal government loses about $1.3 trillion each year from tax expenditures, which include a number of popular tax advantages such as the exclusion of employer-provided health benefits from
individuals’ taxable income, the interest deduction for home mortgages up to $1 million, tax-advantaged retirement savings, accelerated depreciation of business investment, and other business investment incentives. Because tax expenditures are more valuable at higher marginal tax rates, their benefits skew toward higher-income earners.

Federal interest costs also add to our nation’s fiscal challenges. As the federal government runs deficits, it accumulates more debt, which causes interest costs to rise. Within 10 years, interest expense is projected to increase more than 2.5 times from its current level of 1.4 percent of GDP, to 3.7 percent of GDP. In addition, the projected rise in U.S. debt could cause lenders to question the creditworthiness of the United States and demand higher interest rates, greatly increasing interest costs and making it harder to find resources to invest in education, infrastructure, research and development, and other activities that will help our economy grow. For instance, if interest rates rise just 1 percentage point, the federal government’s interest costs could increase by about $1 trillion over 10 years, according to the Congressional Budget Office.
Currently, about half of our publicly held debt is owned by foreign creditors (up from just 5 percent in 1970). Paying interest to these creditors diverts resources from our economy that could be used to finance investments to help us grow faster. According to a study by the Peterson Institute for International Economics, federal interest costs will grow from 1.3 percent of GDP today to 13 percent of GDP in 2035. That would be four times the current percentage of GDP that the federal government spends on education, research, and infrastructure combined.

Our growing dependence on foreign creditors could also put other countries in a position to influence unduly our domestic and foreign policy choices. To reduce this dependence on foreign credit, the United States government must borrow less, and the American public must save more.

**The Benefits of a Fiscally Sustainable Future**

By laying out a path for long-term deficit reduction now, policymakers can build a foundation for a competitive, prosperous economy, with critical investments, reasonable tax rates, and a strong social safety net—including Social Security, Medicare, and Medicaid. Given the fragility of our economic recovery, it is necessary to address short-term economic needs and return to robust growth and job creation. Aggressive deficit reduction now could harm the recovery. But over the long run, our fiscal challenge poses a more significant threat. If policymakers from both parties agree to a plan that can be implemented gradually after the economy has recovered, they can create an economic climate that is more favorable to growth as well as establish a credible path to long-term fiscal sustainability. If, instead, they continue to delay action, they will narrow our options and make the tough choices even more painful.

Putting the U.S. on this path will require difficult decisions by policymakers and the public alike, including a willingness to modify both spending and taxes. To stabilize debt at today’s levels over the long
run with spending cuts or tax increases alone would require cutting federal spending by about 30 percent or raising taxes by about 45 percent — and that is if policymakers act today. Clearly, all options have to be on the table. Agreeing now to a plan of both revenue increases and spending cuts is the most reasonable approach.

Finding solutions is a test of leadership and commitment: leadership on the part of elected officials who have the power to shape our fiscal future, and a commitment from all Americans to stand with those who are willing to make difficult decisions.
As the U.S. economy continues to emerge from recession, why should policymakers focus on the long-term deficit? Two reasons: deciding on action now will allow us to make changes gradually rather than having to cut spending and increase revenue drastically and suddenly, which could be necessary if we allow our fiscal situation to deteriorate to the point of crisis; and agreeing on a plan now would reduce uncertainty and restore business and consumer confidence that elected officials can work together to keep our economic and fiscal affairs in order.

Economic growth is a key part of the equation for long-term fiscal sustainability. Thus, it is essential that the President and members of Congress continue to do all that is necessary to strengthen economic growth in the near term. But growth alone will not solve our long-term fiscal imbalances. It is also important to establish a credible fiscal plan with clear benchmarks and enforcement mechanisms that can put the debt burden on a downward path over the next few decades.

Establishing a framework for long-term fiscal sustainability will narrow the gap between federal revenues and spending, and, by doing so, improve prospects for economic growth. Lower projections for federal borrowing resulting from a long-term plan will help to keep
interest rates at reasonable levels as the economy recovers and make it possible to expand public and private investments in education, infrastructure, and research, all of which fuel innovation and growth. Improving confidence will spur greater private sector investment and job creation. And a healthy, growing economy will ensure that we have the resources to support a robust national security strategy.

Furthermore, with a stronger economy made possible through sensible fiscal reforms, Social Security and Medicare will be more stable. Tens of millions of Americans count on these programs to provide for them in their old age—and nearly 80 million more Americans will rely on them in coming decades. A growing economy will help to ensure that these essential programs are stable for the long run, allowing us as a nation to keep an important commitment.

The International Dimension

The U.S. is not the only country facing fiscal challenges driven chiefly by an aging population. The debt-to-GDP ratio in advanced countries is projected to approach an unsustainable 200 percent of GDP by 2035, according to the Peterson Institute. Realistically speaking, a financial crisis is likely to occur well before national debts reach that level. With nations around the world trying to finance their burgeoning debts, capital is likely to become scarcer and more expensive and global financial markets more volatile.
The United States currently enjoys a privileged position within the world’s capital markets because the dollar is a global reserve currency and the U.S. political and economic system is considered an eminently safe bet. But if federal policymakers cannot hold borrowing to manageable levels, creditors’ confidence in our ability to pay back our debt could be shaken and they may demand higher interest rates to buy U.S. debt. Or, they may simply shift their investments to other countries. Such changes could come suddenly, creating sharp, painful disruptions to the U.S. economy and a steep decline in the value of the dollar.

Simply put, our future economic growth, prosperity, and national security depend on putting the nation on a fiscally sustainable path. The sooner policymakers can agree to a plan, the sooner we can reinforce the confidence of credit markets, stabilize vital social programs, and establish a foundation for investments and tax policies that contribute to long-term economic growth.

Preserving the American Dream

What is ultimately at stake is the American Dream. A future of slower economic growth, rising debt, fewer investments, and higher taxes is not what anyone wants for their children and grandchildren—or for themselves. Since our nation’s founding, we have pursued our dreams and made sacrifices so that the next generation would have opportunities to do the same.

In 2011, the Gallup Organization reported that for the first time since it began asking the question in 1983, a majority of Americans believe the next generation will be worse off than today’s adults. Is that the legacy we want to leave?
Figure 5
The 2011 Federal Budget

$2.3 trillion in revenues

- Payroll Taxes: $819 billion
- Individual Income Taxes: $1,091 billion
- Corporate Income Taxes: $181 billion
- Other Taxes: $204 billion
- Estate & Gift Taxes: $7 billion

$3.6 trillion in spending

- Defense: $700 billion
- Social Security: $725 billion
- Major Health Care Programs: $856 billion
- Net Interest: $227 billion
- All Other Spending: $1,091 billion

Data from CBO, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012. Compiled by PGPF.
Controlling our structural budget deficits will require major changes in budget policy. Congress and the President will have to make hard decisions about spending as well as taxes. To help better understand those choices, we need to look at the key elements of the budget.

Federal spending is divided into two large categories: discretionary spending and mandatory spending. Discretionary spending covers some of the federal government’s major activities, such as defense and homeland security, education, transportation, research, food safety, science and space programs, disaster assistance, environmental protection, federal law enforcement and the courts, and a host of other priorities. Each year, Congress and the President set spending levels for individual discretionary programs through the appropriations process. If lawmakers do not enact appropriations in a given year, these programs have no funding to operate.

Mandatory spending includes programs such as Social Security, Medicare, Medicaid, unemployment insurance, and food stamps. Unlike discretionary spending, lawmakers do not provide specific funding levels for mandatory spending. Instead, they specify who is eligible for benefits as well as the type and level of benefits that they can receive.
But total spending on those programs depends on how many people actually claim benefits. For example, the unemployment insurance program has eligibility criteria that, once met, entitle an individual to a certain level of benefits. But, the total amount of spending on the program depends on the number of people who file for unemployment. Moreover, most mandatory programs continue indefinitely without action by lawmakers. For that reason, spending on nearly all mandatory programs is considered to be on “automatic pilot.”

The term “mandatory” doesn't mean that lawmakers are powerless to alter this spending, however. Elected officials can at any time adjust the eligibility criteria and benefit formulas that determine spending on mandatory programs, as they did with Social Security in 1983. However, if Congress and the President take no action, the current formulas remain in place year after year, and the spending flows without interruption.

Interest on the debt is another category of mandatory spending. When the federal government issues debt, it agrees to make payments to bondholders at pre-determined intervals. The amount of money the federal government spends on interest in any given year is determined by the amount of debt outstanding and the interest rates at which the government borrowed. The interest rates reflect judgments by creditors about the creditworthiness of the U.S. government.

Tax policies also have an impact on budget deficits and debt. Congress and the President enact tax laws that allow the federal government to collect revenue in multiple ways. The largest source of revenue is the individual income tax. Payroll taxes are the second largest source of revenues for the federal government. They are paid by both employees and employers and are collected to fund Social Security and Medicare. Corporate income taxes are the third largest revenue source and contribute about 9 percent of federal revenues.

While it is important to keep in mind that thousands of policy decisions come into play with each year’s budget, four programs represent
a disproportionate amount of spending, and therefore offer the most significant opportunities for change on the spending side of the budget: the two major health care programs (Medicare and Medicaid), Social Security, and defense. These four spending areas alone account for 60 percent of the federal budget. Given their size, addressing the fiscal challenge cannot be successful without reforming commitments in these areas. At the same time, given the aging population and the growth in overall health care costs, stabilizing the debt will be very difficult through spending changes alone. Taxes should also be on the table.

**Health Care**

The federal government spends around $1 trillion a year on health care programs. Different communities—the elderly, the disabled, military and civilian federal employees, low-income individuals and their families, and others—benefit from these programs. The two largest programs are Medicare and Medicaid. The government also subsidizes private insurance because it does not tax workers’ compensation provided in the form of employer-sponsored health insurance.

Medicare has several sources of financing, including payroll taxes on wages, beneficiary premiums, and contributions from the states. However, the largest single source of support—representing more than 40 percent of Medicare’s costs—comes from general federal revenues (that is, income taxes and other

**Figure 6**
Sources of Financing for Medicare

![Diagram showing sources of financing for Medicare]
THE FEDERAL GOVERNMENT AND HEALTH CARE

Here are some of the various programs run and funded by the government:

**Medicare**—A program of health insurance for Americans over 65 and for certain individuals who are disabled.

**Medicaid**—A program for low-income individuals that is jointly funded by the federal government and the states. Under the provisions of the Patient Protection and Affordable Care Act of 2010, Medicaid coverage will expand.

**TRICARE**—The health care program for military personnel, their families, and military retirees.

**Federal Employee Health Benefit Program**—The health care program for federal employees and their families.

**Veterans Health Administration**—The health care system for eligible veterans.

**Health Exchanges**—A new program, authorized by the Affordable Care Act, which is to begin in 2014. Exchanges will be administered by the states and offer health insurance policies to individuals and their families. The federal government will provide subsidies to certain low-income individuals who are receiving insurance through the exchanges.

**Tax Exclusion of Employer-Provided Health Insurance**—Provision in the tax code that enables employers to provide tax-free health insurance to their workers. The provision subsidizes employees' health insurance by treating employer payments for their employees' health care as a deductible cost of doing business and excluding those payments from employees' taxable income. By insulating workers from the full cost of the insurance, this tax subsidy encourages them to choose more expensive health insurance plans.

receipts) and public borrowing. General federal revenues also fund Medicaid, whose costs are shared by federal and state governments.

Why are health care costs growing so rapidly? There are many reasons. A major factor is that a significant portion of health care in the United States is financed through “fee for service” payments. This type of system pays health providers for services they deliver but not necessarily for quality of health achieved. Because providing more services produces more payments, fee-for-service can encourage unnecessary,
ineffective, or even harmful care. Reducing health care costs will require reforming the incentives so that only necessary and effective services are delivered, while wasteful and ineffective care is reduced or eliminated. Accomplishing that task will not be easy.

To control its health care program costs, the federal government can increase beneficiary premiums, cut payments to doctors or hospitals, reduce benefits, or limit eligibility for subsidies. These measures are difficult to implement because Medicare and Medicaid are popular programs that benefit vulnerable populations. Moreover, controlling federal costs does not necessarily reduce health spending overall. Cuts to federal spending may “shift” costs onto other payers, such as private insurance and individuals, as providers try to make up lost revenue.

Health care reform needs to balance a set of legitimate concerns. Patients want to protect their access to care. Providers and hospitals must meet their own costs. The government needs to watch its bottom line. And taxpayers want their money to be spent responsibly. These goals are not always aligned, and the push and pull of the democratic process makes balance difficult to achieve. But we cannot avoid the

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**Figure 7**

**Annual Per Capita Health Care Costs**

Data from the OECD. Compiled by PGPF. **NOTE:** Per capita health expenditures in 2009, except Japan and Australia data which are from 2008. Foreign health spending was converted into U.S. dollars using purchasing power parity.
fact that health care costs will overwhelm the federal budget at some point in the future and that something must be done. Most would agree that it would be better to eliminate wasteful spending than to reduce access to necessary and effective care.

In 2010, total national spending on health care (public and private) was $2.6 trillion, or 18 percent of GDP. Yet, even though we spend proportionately more on health care than other developed countries, some health outcomes are often no better. For this reason, health experts believe that we can increase the quality of our care while also reducing our costs.

Looking forward, the outlook for health care costs is daunting. According to government projections, total health care expenditures could climb to 27 percent of GDP by 2035. Over the same period, federal spending on health care is projected nearly to double.

**Solutions**

Because of the large size of health care spending relative to the American economy, an enormous amount of time, energy, and research is under way to support cost-containment efforts and increase incentives to improve health care value. Private reforms have already begun: Integrated health care delivery systems are leading to better coordinated care among hospitals, physicians, and other outpatient care providers; government and private insurers are experimenting with new payment systems, such as tying physician and hospital payments to patient

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**NOTE:** Figures reflect data on Medicare patients in calendar year 2010.
WHY ARE HEALTH COSTS SO HIGH?

Public and private health care costs in the United States are high for many reasons. Here are some of the important ones:

Insurance and provider payments — One of the most defining characteristics of the health care market is the widespread prevalence of insurance. As a result, treatment costs are largely borne by third parties and not patients themselves. Moreover, physicians and other health care providers are usually paid for the quantity of services they perform. These features create an incentive to provide more care regardless of costs.

Subsidies for coverage — Employees do not pay taxes on employer-provided health insurance. That tax subsidy hides the full cost of care, and encourages the overutilization of health services, which results in higher spending.

Technology — Insurance, fee-for-service payment, and subsidies for coverage create incentives for the development and expansion of expensive medical technologies whose benefits may not be worth the additional costs. According to CBO, the proliferation of these high-cost technologies is the single largest contributor to the growth of health care costs.

Fragmentation in the delivery system — Health care delivery in the United States is fragmented, which results in poor coordination of care among patients, providers, and insurers. This fragmentation creates costly inefficiencies in our system and exposes patients to the risk of inappropriate care.

Medical malpractice — The legal system encourages the proliferation of malpractice and liability lawsuits, which prompts physicians to over-treat and over-prescribe — a practice known as “defensive medicine.” This drives up overall spending and creates a culture of overuse.

Increasing incidence of chronic conditions — Chronic conditions — such as hypertension, diabetes, and obesity — are on the rise in the United States. When these ailments are not managed carefully, they increase health care spending.

Income — Higher income countries tend to spend more on health care, and the United States has one of the highest per capita national incomes in the world.
outcomes, and employers and insurance companies are incentivizing preventive care and healthier lifestyles.

Initial solutions have focused on these goals:

- Improved coordination of care to address the needs of the whole patient and increase the quality of care delivered
- Promotion of best practices and the consistent delivery of care that is demonstrated to be the most effective, and elimination of known bad or ineffective practices
- More transparency in the payment system, so that health care purchasers and consumers can better evaluate questions related to performance and cost
- Better decision-making about the allocation of scarce health care resources.

Medicare, because it has access to extraordinarily detailed data on cost, volume, and the quality of patient care, is in a very good position to reward good performance and penalize bad performance. Several pilot programs are under way to improve health care value, and more are planned as a result of the 2010 Patient Protection and Affordable Care Act. In addition, the ACA created the Independent Payment Advisory Board to make recommendations to improve Medicare’s efficiency.

Changing the way health care is delivered and financed will require changes to the way our whole society—families, the elderly, employers, insurance companies, providers, the legal system, and, of course, governments—thinks about health care. Policymakers and the public must also show greater willingness to adopt measures to reduce the estimated 30 percent of care delivered that is deemed ineffective, unnecessary, wasteful, or outright harmful.
**Social Security**

Social Security accounts for more than 20 percent of total federal spending. In 2012, Social Security paid benefits to about 54 million people, or about 1 in 6 Americans.

Of these beneficiaries, 37 million were retirees and their dependents, 10 million were disabled Americans and their dependents, and an additional 6 million were the survivors of deceased workers. As the number of beneficiaries grows, Social Security’s costs under current law will increase by about 20 percent over the next 25 years—from 5 percent of GDP in 2012 to 6.2 percent of GDP in 2035.

Social Security has been financed chiefly on a pay-as-you-go basis, which means that current workers pay for current beneficiaries. This arrangement worked well as long as there was a consistently high ratio of workers to beneficiaries. But, as the population ages, this ratio will decline from 3 workers for 1 beneficiary now, to about 2 to 1 in 2035.

The main source of Social Security funding is the payroll tax. The Social Security portion of that tax is 12.4 percent of the first $110,100
of 2012 wages, with half paid by the employee and half paid by the employer. To help stimulate the economy, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 reduced the employee share of the payroll tax by 2 percentage points through the end of 2011, to 4.2 percent. That payroll tax cut was extended through the end of 2012 by the Middle Class Tax Relief and Job Creation Act of 2012.

According to the latest government estimates, Social Security has begun a period of permanent cash-flow deficits, paying out more in benefits than the combined revenue it will bring in each year. Absent significant reform, Social Security will lack the budgetary authority to pay full scheduled benefits after 2036. At that time, projections by the Social Security actuary indicate that benefits will have to be cut by about 23 percent if laws are not changed.

The existence of the Social Security Trust Fund has given rise to the notion that Social Security is a self-sustaining program that poses no threat to the broader fiscal outlook. The reality, however, is that Social Security is part of the federal government. Although Social Security payroll taxes exceeded benefit costs and contributed to an accumulation of a Trust Fund balance (often referred to as a “surplus”) for the past 25 years, those surplus funds were spent on other programs. To keep track of the Social Security’s surplus, the federal government provided special-purpose Treasury bonds, which represent promises to provide funds to the program when needed in the future. Once Social Security’s benefit costs exceed its annual income—an event that is expected to occur in 2023—it will begin redeeming those Treasury securities in the Trust Fund and use the proceeds, raised from other federal revenues or borrowing from the public, to pay benefits. Therefore, Social Security Trust Fund balances represent a commitment of the federal government to the program that could increase federal debt held by the public.
Solutions
Despite many challenges, there is still time to make changes to Social Security that will improve the financial position of the program while protecting the most vulnerable beneficiaries. Options for reforming Social Security are relatively well-defined. Most solutions can be classified into one of the following two categories.

**Options that would increase Social Security’s income:**
- Increase the payroll tax rate above its current level of 12.4%
- Raise or eliminate the taxable maximum for Social Security, which is $110,100 in 2012, and index that tax cap for inflation in subsequent years. Under this policy, a larger share of total wages will be subject to the payroll tax
- Increase taxes on benefits of more affluent retirees.

**Options that would decrease Social Security’s expenses:**
- Use a more accurate measure of inflation to calculate cost-of-living adjustments for Social Security benefits
- Change the formula for calculating benefits for new retirees, including options that reduce benefits for high earners, such as progressive price indexing
- Phase in an increase in the retirement age for future beneficiaries or encourage later retirement through higher benefits.
Many of these possible solutions would affect different age cohorts and yield different savings depending on the date the reforms are phased in. Considering the role that Social Security plays in providing basic income to elderly Americans, changes to benefits could be delayed until 2022 to avoid affecting workers aged 55 and older and who are close to retirement. Young workers would have time to adjust their retirement plans.

**Defense**

Defense spending accounts for about 20 percent of all federal spending—nearly as much as Social Security, or the combined spending for Medicare and Medicaid. It is also more than the combined defense budgets of the next 17 highest-spending countries. Over the past 10 years, defense spending has increased 42 percent (from 3.3 percent of GDP to 4.7 percent of GDP), to $680 billion in 2012, primarily reflecting continuing commitments in Afghanistan and Iraq. In December 2011, the last U.S. combat forces left Iraq, and the administration plans to wind down engagement in Afghanistan beginning in 2013; we can expect a gradual reduction in defense spending in coming years. Even so, our defense spending will remain substantially higher than the roughly 2 percent spent by many other developed countries.

The growth of our nation’s debt is a threat to our national security, and, given the sheer size of the defense budget, reduced defense spending can help
address that threat. In face of spending limits imposed by the Budget Control Act and the end of the conflicts in Iraq and Afghanistan, the Department of Defense has initiated changes in its strategic framework, but spending for national security continues to use assumptions inherited from the Cold War. The global security environment has changed over the past few decades and provides an opportunity to align the defense budget more closely with current and probable future security requirements.

**Solutions**

To operate within a transformed security environment, the Pentagon should conduct a broad review of the nation’s interests, threats to those interests, and strategies to meet those threats. An updated strategic framework will guide defense policymakers’ efforts to align force structures, defense investments, and budgets to reflect today’s international challenges and current U.S. priorities. Revising our strategic framework will lead planners to scale back some legacies of the Cold War—such as our nuclear weapons program and some overseas commitments—and reevaluate threats to the U.S. and our citizens, our allies, and the global commons (shared resources such as sea lanes, electronic networks, the earth’s atmosphere and space). It may also reduce the need for expensive, outmoded equipment and align the size and mix of our military personnel to meet the challenges of the 21st century.

Once agreement is reached about national security interests, threats, strategies and missions, the defense budget must be redesigned to fulfill those requirements. All aspects of the budget, including personnel costs, operations and equipment purchases, must be examined so that national security objectives are fulfilled efficiently without incurring undue risk to our nation.

Making changes to the defense budget will be difficult. There is general agreement that the U.S. military should continue to play a significant role internationally, but there are questions about how to best fulfill those
commitments. Many ideas to reduce defense spending have already been suggested, and there is recognition that the Department of Defense should be subject to close review when it comes to budget-making.

**All Other Spending**

Although the major health care programs (i.e., Medicare, Medicaid, CHIP, and subsidies for the health insurance exchanges created by the ACA), Social Security, and defense account for substantial portions of the federal budget, the rest of the budget also funds many important national priorities. Programs such as education, research and development, veterans’ health care, transportation, environmental protection, diplomatic activities, and public housing fall into this category. Some are discretionary programs funded each year through annual appropriations. Others are mandatory programs that are not

<table>
<thead>
<tr>
<th>Category</th>
<th>FY12 Request</th>
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<tbody>
<tr>
<td>Military personnel</td>
<td>$135 billion</td>
</tr>
<tr>
<td>Operations and maintenance</td>
<td>$209 billion</td>
</tr>
<tr>
<td>Procurement</td>
<td>$99 billion</td>
</tr>
<tr>
<td>Research, Development, Testing, and Evaluation</td>
<td>$69 billion</td>
</tr>
<tr>
<td>Military construction, family housing, and revolving management funds</td>
<td>$13 billion</td>
</tr>
<tr>
<td>Overseas Contingency Operations (e.g., Iraq/Afghanistan)</td>
<td>$88 billion</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$613 billion</strong></td>
</tr>
</tbody>
</table>

Data from OMB, *The Budget of the United States Government for Fiscal Year 2013*, February 2012. Compiled by PGPF. **NOTE:** Figures are for budget authority, not outlays. Numbers may not add due to rounding.
part of the annual appropriations process, such as subsidies for agriculture, flood insurance, loans to undergraduate and graduate students, and federal pension programs.

All other non-interest spending has accounted for about one third of all spending in the last three decades. However, these programs are not responsible for the projected growth of our nation’s debt over the next 25 years: Looking forward, spending on these programs is projected to remain at a roughly stable percentage of GDP and become an increasingly smaller share of the budget as other categories—especially

Data from CBO, The Budget and Economic Outlook: Fiscal Years 2012 to 2022, January 2012; and OMB, The Budget of the United States Government for Fiscal Year 2013, February 2012. Compiled by PGPF.
health care—grow. We will not solve the problem simply through eliminating foreign aid and getting rid of earmarks. In 2010, Congress ended the practice of earmarking, which totaled less than 1 percent of the budget. Many argue that eliminating earmarks will not “save” anything because members can still direct funds at different stages of the budget process. But, to address the long-term fiscal challenge, policymakers will need to take a hard look at every program in the budget, and programs in this category are no exception. But, to address the long-term fiscal challenge, policymakers will need to take a hard look at every program in the budget, and programs in this category are no exception. Although the fiscal problem cannot be solved through reducing spending in this area of the budget alone, such reductions could play a role in putting the budget on a sustainable path.

**Solutions**

This category of the budget can be reduced through across-the-board cuts or, with more precision, by establishing and enforcing priorities, eliminating ineffective programs, merging duplicative programs, and streamlining the work of federal agencies.

However, some programs in this category of the budget can promote economic growth. For instance, this category includes programs that make investments in education, research and development, and infrastructure. Those activities offer the promise of long-term dividends by creating a better-trained, more highly skilled workforce, laying the groundwork for growth-enhancing innovation, and improving the U.S. business climate. Both the public and private sectors play an important role in driving U.S. competitiveness; determining the most effective role for the federal government will be critical to the long-term health of our economy.
Although revenues fluctuate with the economy, in the post-World War II era the federal government has collected an average of 18 percent of GDP in annual revenues. During the recent recession, revenues plunged to 15 percent of GDP. Once the economy has fully recovered, the Congressional Budget Office expects revenues to rise gradually to 21 percent of GDP in 2022 under current law. However, those current-law projections assume that many popular tax cuts will expire at the end of 2012. Since those tax cuts have been extended in the past, many observers expect that policymakers will do so again, especially given the weak economy. If those tax cuts are permanently extended, the CBO projects that revenue as a proportion of GDP will hover around 18 percent once the economy recovers. However, this level of revenue will not be sufficient to meet future spending, which will be pushed up by higher spending on Medicare,

**Figure 15**

**Portion of Income Earned and Federal Tax Paid**

<table>
<thead>
<tr>
<th>Quintile</th>
<th>Pre-Tax Income Share</th>
<th>Federal Tax Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest Quintile</td>
<td>0.2%</td>
<td>4%</td>
</tr>
<tr>
<td>Second Quintile</td>
<td>3%</td>
<td>8%</td>
</tr>
<tr>
<td>Middle Quintile</td>
<td>9%</td>
<td>13%</td>
</tr>
<tr>
<td>Fourth Quintile</td>
<td>18%</td>
<td>20%</td>
</tr>
<tr>
<td>Top Quintile</td>
<td>70%</td>
<td>55%</td>
</tr>
</tbody>
</table>

* A quintile is one fifth of the distribution. The top quintile is the richest 20% of households, while the bottom is the poorest 20%.
Medicaid, and Social Security. By the CBO’s estimates, spending will rise to 24 percent of GDP in 2022 under current policies—well above the current policy ratio for revenue of 18 percent of GDP.

The greatest proportion of the federal government’s revenue comes from three sources: the individual income tax, the corporate income tax, and the payroll tax. Other taxes collectively generate a relatively small amount of revenue.

The federal income tax system is in many ways intended to be “progressive”—that is, the amount of taxes owed increases with the amount of income earned. As shown in Figure 15, the top 20 percent of households receives a disproportionate amount of total income (55 percent), but also pays a disproportionate amount of federal taxes (70 percent).

**Tax Expenditures**

Tax expenditures are often referred to as hidden spending, because Congress uses the tax code to direct subsidies to specific constituencies.

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**Table 2**

Top 5 categories of tax expenditures

<table>
<thead>
<tr>
<th>Estimated Tax Revenue Foregone (FY2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Exclusion of employer contributions for medical insurance and care</td>
</tr>
<tr>
<td>2. Exclusion of pension contributions and earnings</td>
</tr>
<tr>
<td>3. Lower rates on dividends and long-term capital gains</td>
</tr>
<tr>
<td>4. Deduction of mortgage interest on owner-occupied homes</td>
</tr>
<tr>
<td>5. Deduction for state and local taxes</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

Data from OMB, *The Budget of the United States Government for Fiscal Year 2013*, February 2012. Compiled by PGPF.
INEQUALITY

Income inequality has grown considerably in recent decades. The most recent data from the Congressional Budget Office show that the average income of a household in the top 1 percent (the top 110,000 households) is 17 times more than that of the average household. In 1980, the average household in the top 1 percent earned 7 times more than the average household did. Many observers worry that this large and growing disparity in income could undermine the social cohesion of our democracy. The progressive nature of our tax system is intended to offset some of these differences because taxpayers with higher incomes face higher tax rates. As a result, tax payments by the top 1 percent make up 26 percent of total federal revenue, while the bottom 20 percent of households contribute 0.2 percent to revenue.

and activities. Tax expenditures—exemptions, deductions, credits, and other special provisions—allow households and qualifying corporations to reduce their tax liabilities. They also are expensive and cost about $1.3 trillion each year, more than any agency or spending program in the budget, including Social Security and the Department of Defense. Because high-earning taxpayers pay the most taxes, they also receive the bulk of the subsidies through the tax system.

Policymakers use tax expenditures to influence consumer and business behavior and to achieve economic outcomes. For example, the mortgage-interest deduction encourages taxpayers to buy homes instead of renting, the exclusion of employer-provided health insurance from taxable income encourages businesses to offer employees better health insurance benefits instead of providing wage increases, and depreciation provisions encourage new purchases of equipment. In all, there are more than 150 tax expenditures written into the individual and corporate tax codes.
Solutions
How can the federal government increase revenue? There are three broad classes of options.

- Raise current tax rates
- Introduce a new type of tax to supplement or replace the existing system. Carbon taxes are often highlighted as a way to raise revenue and discourage emissions. Others have proposed progressive consumption taxes to encourage savings
- Broaden the tax base by eliminating tax expenditures. This could apply to both the individual and corporate tax codes. Some, including the Bowles-Simpson commission, have recommended broadening the base (or increasing the amount of income that is subject to tax), and using some of the revenue gained to lower marginal tax rates and some to reduce the deficit.

Given the large number of deductions and benefits contained in the tax code, special interests across the political spectrum make fundamental reform of the system difficult. For an individual taxpayer, the loss of a tax benefit is very noticeable, while the overall gain to the economy is easy to overlook. But momentum is building for some action on taxes. Ideally, the path chosen should increase tax efficiency, reduce complexity, and raise enough revenue to improve the nation’s fiscal outlook.

A Better Budget Process
The annual federal budget process makes the budget picture harder to understand and encourages members of Congress and the executive branch to neglect long-term planning. Reforming the budget process could shift the focus to long-term issues, improve budgetary decision-making, and make the budget more transparent.
Budget process reforms can also be particularly valuable in helping to enforce budget deals to reduce the deficit once agreement has been reached. By making it more difficult for future Congresses to undermine those agreements, reforms can help reinforce and perpetuate a consensus among policymakers about the continuing need to maintain policies that reduce the deficit over the long run.

Several potential reforms could address shortcomings with the current budget process.

**Long-Term Focus**

The long-term impact of federal policies is disconnected from that annual budget process. Although the President’s budget submission includes information about the long-term impact of proposed policy, that information is buried in a technical appendix. To be sure, the Congressional Budget Office publishes a long-term budget outlook annually, and the Government Accountability Office issues its analyses twice a year. But the official estimates of the budgetary impact of legislation—the only ones that truly matter in legislative debate—generally cover only a 10-year period, which discourages reforms that would involve short-term political costs but produce improvements to the budget’s long-term outlook.

Simple measures to provide more information about the long-term budget outlook could help to overcome the short-term focus of the current process. One approach would be to require the budget agencies to provide a long-term baseline at the beginning of the budget process. Another would be to require the President and Congress to evaluate the impact of their proposed policies on the long-term structural deficits and to report annually on the progress made toward fiscal sustainability. Official cost estimates, which are prepared when the Congress considers legislation, could also be extended beyond 10 years when policy proposals would have a significant impact on long-term deficits and debt.
Fiscal Targets

Despite the projected level of our deficits and debt, there are no overall goals or targets incorporated into the budget process to guide decision-making. Without a consensus about overall budget goals, it is more difficult to maintain fiscal discipline. To address this problem, Congress and the President could, for example, establish statutory medium-term targets for the national debt (such as a long-run stabilization of debt at 60 percent of GDP, as the Peterson-Pew Commission on Budget Reform has recommended), or require the budget to be in balance over the business cycle (that is, run surpluses when the economy is growing and allow deficits when the economy is weak).
Budget Enforcement Rules
Statutory pay-as-you-go rules, commonly known as PAYGO, mandate that lawmakers offset any mandatory spending increase or new tax cut with an equal reduction in mandatory spending or a tax increase. In the 1990s, PAYGO rules were particularly helpful in enforcing the deficit reduction that had been achieved with the 1990 budget deal. Those rules have been credited with helping to bring the federal budget into surplus in the late 1990s. However, these rules expired in 2002.

In 2010, Congress and the President enacted a new PAYGO statute. The new statute is less restrictive than the earlier PAYGO law because it exempts some policies (such as the extension of expiring middle-class
tax cuts) from the PAYGO requirement. The PAYGO rules could be strengthened by scaling back or eliminating those exemptions.

**Accounting for Budgetary Performance**

Lawmakers could require the Congressional Budget Office to publish an annual report at the end of each session of Congress that details the progress made (or lost) during the year toward closing the gap between long-term promises and projected revenues. If the Congress passed a budget resolution (which sets a blueprint for spending and revenues for the year), the CBO report could also analyze the extent to which the Congress actually adhered to the resolution during the year. If the Congress adopts a set of fiscal targets, the report could also assess the performance of the Congress in meeting those targets. Such a report would increase transparency in the budget process and would hold the Congress accountable if it failed to meet its own targets.

Similarly, lawmakers could require the President to report annually to the Congress on actions taken that have improved or worsened the nation's long-term fiscal outlook.
A Brighter Economic Future

America’s economic future depends on policymakers’ willingness to agree on a plan that will put our nation on a sustainable fiscal course. Actions Congress and the President take now will have consequences for decades.

A comprehensive fiscal plan would address all budget elements discussed in this guide. No single program or tax provision should be viewed in isolation. Instead, every choice about a particular budget element has ramifications for other choices. For instance, a decision to keep benefits and services at a certain level will affect how much revenue the federal government will need to collect through payroll and income taxes. Alternatively, a decision to set revenue at a certain new level would require spending decisions across the budget to reflect that amount of revenue. Whatever policy agreements are made, a better budget process, with greater transparency and accountability, would help Congress and the President stay focused on meeting and maintaining their long-term fiscal policy goals.

A bipartisan plan to address our long-term fiscal challenges would put to rest several nagging questions about our future. Will America have the resources necessary to remain an innovation leader, producing
discoveries that not only improve our lives, but also support the jobs of the future? Will programs like Social Security, Medicare, and Medicaid be strong enough to meet the needs of Americans who depend on them? Will the next generation of Americans have the same opportunities to prosper as previous generations have had? Will the American Dream continue to be within reach of all Americans? If we want to lay a foundation for future growth and prosperity, we must make a commitment to long-run fiscal sustainability today.

This guide has outlined America’s fiscal options and offered a series of questions that policymakers will have to ask. But charting a long-term, sustainable budget path will ultimately require all Americans to ask basic questions about the kind of society we want, the level of government services we desire, and our willingness to pay for those services. In a country as large and diverse as ours, it is unlikely that we will all agree on the answers to those questions. But by considering our obligations to each other and to future generations, we should be able to move beyond our differences and find common goals and common ground.

We have done this before. After World War II, America’s debt reached nearly 110 percent of GDP. Following the great show of national unity that brought us through the war, we set about paying our bills, reducing our debt, and making investments—in the G.I. Bill and in major infrastructure projects, for instance—that fueled economic growth and rising incomes for decades.

We can do it again.

The challenge is clear. Solutions are available. Now we must act.
Learn More

For more information about America’s fiscal challenge and potential solutions, visit the Peter G. Peterson Foundation at www.pgpf.org. The following websites also provide a wealth of information on the U.S. budget and various policy areas.

American Enterprise Institute  www.aei.org
The Bipartisan Policy Center  www.bipartisanpolicy.org
The Brookings Institution  www.brookings.edu
CATO Institute  www.cato.org
Center for American Progress  www.americanprogress.org
Center for Retirement Research at Boston College  www.crr.bc.edu
Center on Budget and Policy Priorities  www.cbpp.org
Centers for Medicare and Medicaid Services  www.cms.gov
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<td>Citizens Against Government Waste</td>
<td><a href="http://www.cagw.org">www.cagw.org</a></td>
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<tr>
<td>Columbia Teachers College</td>
<td><a href="http://www.understandingfiscalresponsibility.org">www.understandingfiscalresponsibility.org</a></td>
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<td>The Comeback America Initiative</td>
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<td>Committee for Economic Development</td>
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<tr>
<td>The Committee for a Responsible Federal Budget</td>
<td><a href="http://www.crfb.org">www.crfb.org</a></td>
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<td>The Concord Coalition</td>
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<td>Congressional Budget Office</td>
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For more information, please visit:
WWW.PGPF.ORG