THE CONCORD COALITION

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America's Public Debt: How Do We Keep It From Rising?

Senate Finance Committee Subcommittee on Long-Term Growth and Debt Reduction

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Chairman Smith, Senator Kerry, and members of the Committee, thank you for inviting me to discuss the nation's public debt and how we can keep it from rising. It is an important question to ask in assessing our nation's long-term fiscal and economic outlook. The short answer is that to keep the public debt from rising we will need to reassert budget balance as our fiscal policy goal and make the necessary trade-offs to achieve that goal. Budget rules can help in this regard, but they are not a substitute for political will. Moreover, no strategy for keeping the debt from rising will succeed over the long-term unless we find a way to reduce projected costs, particularly for health care. A realistic strategy will likely require some mix of spending reductions, and revenue increases — negotiated in a bipartisan process — aimed at preventing total spending, taxes or debt from reaching levels that could reduce economic growth and future standards of living.

I am here representing The Concord Coalition, a nonpartisan organization dedicated to strengthening the nation's long-term economic prospects through sound and sustainable fiscal policy. Concord's co-chairs are former senators, Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). They, along with Concord's President former Commerce Secretary Peter G. Peterson and our nationwide membership, have consistently urged Washington policymakers to produce a credible plan for long-term fiscal sustainability.

My testimony today will address:

- The overall budget outlook; short-term and long-term

- The importance of public engagement in addressing fiscal challenges, and

- Broad options for change and the necessary trade-offs

I. Overview of the Budget Outlook

It is often said that our political system only responds to a crisis. If that turns out to be true, our children and grandchildren are in big trouble.

Our nation is about to undergo an unprecedented demographic transformation — with no plan to pay for it other than running up the public debt. The coming age wave is not a temporary challenge that will recede once the baby boom generation passes away. The baby boomers' retirement is ushering in a permanent transformation to an older population—and a permanent rise in the cost of programs such as Social Security, Medicare and Medicaid, which already comprise 40 percent of the federal budget.

It may seem that there is no immediate crisis, yet a broad bipartisan consensus exits that current fiscal policy is on an unsustainable path. No one can say when a crisis will hit, but by the time it does the economy will likely be burdened with a debilitating amount of debt; leaving painful benefit cuts and steep tax increases as the only options. Doing nothing to avoid such a gut-wrenching outcome would be an act of fiscal and generational irresponsibility.

The basic facts are a matter of arithmetic, not ideology. Over the next 25 years the percentage of the population aged 65 and up will grow by 50 percent while the number of workers is estimated to rise by only 13 percent. The imminent retirement of the baby boom generation will set off an era of extraordinary demands on the nation's workers. At the same time, one of the major engines of economic growth — an expanding workforce — will slow substantially due to the large exodus of older workers from the labor force and lower birth rates following the baby boom. This combination of factors presents a distinct challenge for the economy in the future, which will be called upon to transfer a large and rising share of real resources from workers to retirees.

Demographic change, however, is only part of the problem. Health care prices continue to outpace economic growth and this phenomenon greatly compounds the growing costs attributable to the rising number of aged. If historic growth rates persist, by 2050 Medicare and Medicaid will grow by nearly 5 times as a share of the economy (GDP).[1] They will absorb as much of our nation's economy by the late 2040's, as the entire federal budget does today.

Without a change in policy, by the time today's 20-year olds reach retirement age the cost of government as a share of the economy is on track to reach levels not seen since the nation was fighting World War II — the big difference being that instead of spending the

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[1] Outlays for the two programs equal 4.6 percent of GDP in 2006. Under an historic growth rate scenario, CBO projects that they would reach 21.9 percent of GDP by 2050. By comparison, Social Security is projected to grow by about 60 percent as a share of GDP by 2050, from 4.2 percent to 6.6 percent.

money on a life and death struggle against totalitarian aggression we would be spending it on an ever-rising stream of benefit payments.

Today, governmental expenditures absorb 20.3 percent of the economy (GDP). At the high end of what the Congressional Budget Office (CBO) sees as a possible range, federal spending could rise to 56 percent of GDP in 2050. In contrast, federal spending never went above 44 percent of GDP throughout World War II.

While it may be unrealistic to assume that half the nation's economic output could be consumed by government programs, even if the cost of government rose to 30 percent of GDP, the share of the economy needed would be 50 percent greater than it is today.

This raises an obvious question: how will we pay for it?

Federal tax receipts have hovered in the range of 18 percent of GDP over the past half century.[2] If retirement and health care entitlements are allowed to grow on autopilot pushing total federal spending to 30 percent of the economy, and Americans' intolerance for taxes above 20 percent of GDP holds true, the resulting deficits will rapidly escalate to dangerous levels. A deficit equaling 10 percent of GDP in today's terms is the equivalent of $1.3 trillion. That amount is roughly half of today's total government expenditures. The prospects of being able to carry that amount of new debt, year after year, without stifling the economy are nil.

Borrowing our way through this is not a viable option because the rising cost of entitlements is not a temporary blip. It gets bigger with time. Incurring ever-rising levels of debt would result in staggering interest costs and ultimately a level of debt that would crush the economy.

The real choices require scaling back future benefit promises, raising taxes to pay for them or some combination of both. Economic growth alone will not be enough, nor will trimming everyone's favorite target — waste fraud and abuse.

The choices we make now will determine what kind of society our children and grandchildren inherit 20 and 30 years from now. There is little time for political gridlock. With the first of the 77 million baby boomers on the verge of retirement, the window of opportunity to act is rapidly closing.[3] Inaction now increases the prospects of severe changes later. Every year that change is postponed greatly raises the risk of large tax increases or sudden benefit reductions in the future.

The question is whether we will face up to the challenge and fulfill our generational stewardship or put the future at risk by waiting for a crisis.

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[2] They reached 20.9 percent of GDP in 2000, but as a result of tax reductions and economic factors fell below 17 percent in 2003 and 2004 before rising back to a projected 18.3 percent this year.

[3] The oldest segment of the 77-million baby boom generation, now turning 60, will begin drawing on their Social Security benefits in two years. In five years they will be eligible for Medicare.

Short-term outlook

There is at least one positive thing to report on the budget front: at a projected $260 billion, the deficit in 2006 will be lower than the $318 billion deficit in 2005. This is the second year in a row of declining deficits.

Does this mean that we are on a smooth and easy road back to balanced budgets? Not at all. Both CBO and the President's Office of Management and Budget (OMB) project an increase in the deficit next year.[4] More significantly, in an ominous sign of things to come, CBO projects that the cost of Social Security, Medicare, and Medicaid will grow from 8 percent to 10.2 percent of GDP over the 10-year outlook — a 27 percent increase.[5] As a result, these three programs, which consumed 40 percent of the budget in 2006, will consume 51 percent by 2016 — and that is just the tip of the demographic iceberg.

Budget projections over the 10 years covered by the CBO baseline (FY 2007-2016) are unusually complicated by a number of factors — some on the spending side and some on the revenue side.

On the spending side, projections are complicated by the treatment of operations in Iraq and Afghanistan. The Bush Administration has chosen to treat each year's expense as a one-time event on the theory that future costs are unknowable. This has the effect of understating outlays in the President's budget projections because it assumes no new funding for operations in Iraq and Afghanistan beyond 2008 even though, as the Administration acknowledges, that will not be the case.

On the other hand, the CBO's latest budget projections probably overstate likely costs for these operations because, in keeping with the scoring conventions of budget laws, it assumes that this year's level of appropriations (including the war costs) will continue each year adjusted for inflation. The effect of this is to assume that operations in Iraq and Afghanistan (along with Hurricane Katrina relief efforts) will continue at their current level for the next 10 years. While this outcome is not impossible, a more probable projection would fall somewhere between 10-year costs at the current level and the Administration's official assumption that there will be no further costs beyond those requested in this year's budget.

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[4] CBO, *The Budget and Economic Outlook, An Update*, August 2006. OMB, *Mid Session Review*, July 2006. While the President's budget shows a steep decline in the deficit after 2007, this assumes no continuing war costs beyond 2008 and an implicit revenue windfall from the Alternative Minimum Tax (AMT). Neither of these assumptions is consistent with administration policy, which diminishes the usefulness of the projections.

[5] Medicare numbers in this calculation include offsetting receipts.

Projections on the revenue side of the budget are complicated by two factors; the scheduled expiration by 2011 of the tax cuts enacted since 2001 and the growing toll of the Alternative Minimum Tax (AMT), which if not adjusted will apply to roughly eight times as many taxpayers by 2010 as it does today. In preparing its baseline, CBO must assume that current law is carried out. Thus, however politically improbable, the baseline assumes a revenue windfall from expiring tax cuts in 2011 and rapidly growing receipts from the AMT.

Taking all these factors together, CBO's baseline is too optimistic. A more plausible deficit path based on recent experience would:

- Assume a phase-down of supplemental funding for Iraq and Afghanistan and assume that regular appropriations grow with the economy instead of at the rate of inflation as assumed in the projections.
- Assume that all expiring tax cuts are extended.
- Assume continuing relief from the AMT by adjusting it for inflation.
- Assume scheduled cuts in Medicare payments to doctors will not take effect.
- Deduct debt service cost on the above changes.

Under that scenario, deficits would total $5.2 trillion over the 2007 to 2016 period rather than $1.7 trillion as in the CBO August baseline. As a percentage of the economy, deficits in this plausible baseline steadily rise to 4 percent by 2016 and average 3 percent over the 10-year period. Deficits of that size would drain national savings, raise the debt to GDP ratio and increase interest costs. This would be a very untimely mix because it would come at a time when we should be doing the opposite: increasing national savings, lowering the debt to GDP ratio, and reducing interest costs in preparation for the fiscal challenges that come in the following decade.

As the government's debt increases, its interest costs grow as well. Those costs use up precious resources that could be directed to other purposes. Comparing CBO's official baseline and the more plausible scenario outlined above demonstrates the difference in how the public debt could grow and the importance of acting in the short-term to strengthen our fiscal position for the tougher challenges ahead.

Under CBO's official projections, debt held by the public shrinks from 37.3 percent of GDP in 2007 to 32.2 percent by 2016, primarily because of the assumed revenue windfall from expiring tax cuts and the AMT. However, under the more plausible scenario outlined above, debt held by the public would reach 48 percent of GDP by 2016. The last time that debt held by the public was over 50 percent of GDP was in the 1950s. At that time, however, debt was coming *down* from the heights it achieved to pay for World War II.

Meanwhile, according to CBO's latest projections, the federal government's interest costs will total $220 billion in 2006 — more than the combined cost of all mandatory programs for income support such as Supplemental Security Income (SSI), unemployment compensation, food stamps, child nutrition, the earned income tax credit and child tax

credits. It is more than either the federal government's share of Medicaid or the costs of military operations in Iraq and Afghanistan.

In 2016, net interest costs will rise to $333 billion, according to the official baseline Under the plausible scenario outlined above, however, interest costs by 2016 would approach $500 billion.

The fact that we've had high deficits before and managed to get out of them offers no reason to ignore them now. For one thing, Congress and Presidents George H. W. Bush and Bill Clinton engaged in a series of legislative actions, many of them bipartisan, designed to bring the deficit under control. Moreover, the end of the cold war allowed us to shrink defense expenditures from 6 percent of GDP in 1985 to 3 percent by 2000. That was a big help in keeping total spending under control. Today's situation is far different. While defense spending has not gone back to anything approaching Cold War proportions, it has risen back to about 4 percent of GDP.

More fundamentally, however, the boomers' retirement in those days was a generation away. Now, the first boomers will begin retiring in just two years, so we face a much more urgent, and difficult, situation than we did 20 years ago.

Moreover, the plausible baseline outlined above is not a worse case scenario. It assumes a healthy economy over the next decade. The return to deficits and the projection of continuing deficits, even at the levels in the CBO baseline, is not the result of cyclical economic factors. We have a structural deficit and it is likely to get worse in the absence of legislative actions to correct it.

Unfortunately, the deficit reduction reflected in CBO's new projections is the result of technical and economic re-estimates, things over which Congress has no control. Legislative actions, which Congress does control, have actually increased the deficit. According to CBO, the net impact of legislation enacted by Congress this year would increase the deficit by $132 billion over the next five years (measured against earlier projections). The modest savings on the entitlement side from the Deficit Reduction Act were more than canceled out by the impact that tax cut extensions, additional spending for military operations and other increases had on the deficit. These may all be worthy initiatives in the abstract, but taken together they don't add up to a strategy that will keep the debt from rising.

To add insult to injury, the savings from the Deficit Reduction Act barely register. Last year, CBO projected that entitlements (mandatory spending) would grow from 10.7 percent of GDP in 2006 to 11.7 percent in 2015. This year, after passage of the spending cut bill, CBO is projecting that mandatory spending will reach 11.8 percent of GDP in 2015 — a small *increase*. In other words, for all the political pain involved in passing this bill, it didn't have any real impact on the long-term budget outlook

In sum, we are risking a decade of large sustained deficits at a particularly bad time because as CBO warns, "growing resource demands for [Social Security, Medicare and

Medicaid] will exert pressure on the budget that economic growth alone is unlikely to eliminate." As a result, CBO concludes, "A substantial reduction in the growth of spending and perhaps a sizable increase in taxes as a share of the economy will be necessary for fiscal stability to be at all likely in the coming decades."[6]

The real question is whether we will face up to this challenge or be content to let these developing problems fester in hopes that future lawmakers — with fewer choices and perhaps acting under crisis circumstances — can find solutions.

Long-term outlook

For all the twists and turns in the 10-year outlook, the basic story over the long-term is pretty clear: current policy is unsustainable and the sooner we begin to take corrective actions the better.

The Government Accountability Office (GAO) and the CBO have each published long-term scenarios under alternative sets of assumptions. In GAO's view, "Under any reasonable set of expectations about future spending and revenues, the risks posed to the nation's future financial condition are too high to be acceptable."[7]

To illustrate the point, one GAO scenario uses assumptions very similar to those outlined in the Concord Coalition's 10-year plausible outlook described in the prior section. Discretionary spending grows with GDP and expiring tax provisions are extended. Here are some notable signposts on that unsustainable path:

2024 — Social Security, Medicare, Medicaid and net interest consume all revenues; the deficit hits 10 percent of GDP.

2025 — Net interest costs more than Medicare; debt held by the public exceeds 100 percent of GDP.

2035 — Net interest exceeds Medicare and Medicaid; debt held by the public equals 200 percent of GDP.

2037 — The deficit reaches 20.5 percent of GDP, exceeding the size of today's entire federal budget

2039 — Social Security, Medicare and Medicaid consume all revenues

2041 — Debt held by the public equals 300 percent of GDP.

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[6] CBO, *The Budget and Economic Outlook: Fiscal Years 2007-2016*, January 2006, Summary p.XIV.

[7] GAO, The Nation's Long-Term Fiscal Outlook, September 2006 Update p.1. GAO-06-1077R.

2045 — Debt held by the public equals 400 percent of GDP.

2046 — Interest costs, at 21.6 percent of GDP, exceed the size of today's entire federal budget.

2047 — Debt held by the public equals 500 percent of GDP.

2049 — GAO model blows up

The CBO scenarios include variations on health care cost assumptions, revenues and discretionary spending. The most significant difference between the high cost and intermediate cost assumptions is whether health care costs go up at the historic rate or come down to roughly the level assumed in the Medicare Trustees Report.

The lower revenue scenario assumes that revenues permanently lock-in at 18.3 percent of GDP (by coincidence, where revenues stand this year). The higher revenues scenario assumes that the tax cuts sunset and that revenues grow from 17.8 percent of GDP in 2010 to 23.7 percent by 2050.

Combining the revenue and spending assumptions of the CBO scenarios adds further support to the conclusion that current policy is unsustainable.

- If revenues level off at 18.3 percent of GDP and entitlements grow on their current course, CBO projects a deficit of 14 percent of GDP by 2030 with debt rising to 137 percent of GDP. By 2040, the deficit is 24 percent of GDP and debt is at 261 percent of GDP.

- Even if the tax cuts sunset, CBO projects that the deficit would reach 8.3 percent of GDP by 2030 and the debt would reach 91 percent of GDP without a slowing of entitlement costs. By 2040, the deficit would reach 15 percent of GDP and debt would be 165 percent of GDP under this scenario. Keep in mind that this assumes revenues go up to 21.7 percent of GDP in 2030 and 22.8 percent of GDP in 2040.

The GAO and CBO scenarios are valuable tools for policymakers in outlining the dimensions of the fiscal challenge we are facing and why spending cuts and revenue increases will likely be needed to bring about a sustainable fiscal policy.

Beyond fiscal imbalance, however, the policies embedded in today's budget threaten to place ever-tighter constraints on the ability of future citizens and policy makers to determine their own fiscal priorities. The share of federal resources pledged to aging baby boomers and the generations immediately preceding them is growing, leaving shrinking amounts for all other purposes.

What if nothing changes? Future taxpayers will be forced to pay far higher taxes than we pay today, or they will either have to accept much lower spending for all other public

purposes—including national defense, homeland security, and education—or face rapidly escalating deficits and the resulting negative consequences for the economy and future standards of living.

Conventional economic wisdom holds that persistent deficits should result in higher interest rates, lower investment and slower growth. However, despite the sharp reversal in fiscal fortunes and despite rising short-term rates, long-term interest rates have remained relatively low. That circumstance has allowed some pundits to claim that deficits don't matter. In the absence of "pain" or a clear crisis, elected officials seem unwilling to take the actions necessary to reduce the budget's red ink. And yet, postponing action while deficits rise is not a generationally equitable or economically sustainable policy. It mortgages the future to pay for the unwillingness of today's policymakers to require trade-offs.

Interest rates have remained low in part because foreign sources of capital have been willing to finance our federal deficits (as well as make up for our low private savings rates). The level of our public debt held by foreign investors has increased substantially in recent years from 36 percent in 2001 to 51 percent now. That foreign investment, however, has distinct downsides. For example, through the interest rate function, it increases the budget's exposure to international capital markets and decisions made by foreign interests. The current favorable environment could change quickly — driving down the value of the dollar and driving up domestic interest costs for the federal government and everyone else. In addition, debt service payments go to bond holders from abroad and drain financial resources away from the U.S economy and taxpayers.

We could cross our fingers and hope that the U.S. economy is sufficiently resilient to overcome anticipated fiscal challenges without any change to current policies. However, this outcome is highly unlikely. No plausible rate of economic growth would be enough and wishful thinking is not a sound fiscal strategy. A far more prudent and secure path to bettering the fiscal outlook would be to once again undertake constructive action to reassert control over fiscal policy and to restore budget discipline. There is no shortage of warning signs:

- Economic growth, while strong today, will slow as the proportion of retirees to active workers increases. CBO projects that real economic growth will decline from an annual rate of 3.5 percent to 2.5 percent between 2006 and 2016. As the economy expands more slowly, it will be harder to fulfill the needs of a growing and aging population.

- CBO projects that real growth in Medicare and Medicaid will outpace the annual growth in the economy. Those estimates don't anticipate costly advances in treatment and technology that could drive costs even higher and place greater pressure on the budget.

- Private employers also face pressures as a result of the aging population. Many private defined benefit pension plans are underfunded and require additional

employer contributions to bring plan assets more into line with liabilities. In addition, rising health insurance costs make it harder for employers to maintain benefit levels for their retirees. If the private sector cuts back its support for retirement income and health insurance, there will be greater pressure to increase public programs.

- The economy faces many uncertainties. Oil and energy prices are unpredictable. World events may affect the international economy and place additional demands on U.S. resources. The United States would be in a stronger position to weather difficult times if it had greater flexibility and strength in its fiscal position.

- The strength of the future economy depends on an educated workforce, productive capacity, sources of energy and solid infrastructure. If there is no financial slack in public budgets because available resources are already committed to supporting the standards of living of older people and paying debt service, it will be harder to find the funding to invest in children, research and development, transportation and communication, and other factors that will promote future growth.

We could credibly claim that the budget outlook is improving if we were taking actions to close the gap between spending and revenues. As long as we are content to ignore the unsustainable long-term trend and to keep near-term revenues at 18 percent of GDP while allowing spending to grow far above 20 percent of GDP, as projected, we are a long way from being able to declare victory.

II. The importance of public engagement and the Fiscal Wake-Up Tour

Daunting as the long-term projections are, there is nothing inevitable about a fiscal crisis. The problems we face — essentially a structural imbalance between what government promises and what it collects in taxes to pay for those promises — is one that can be cured in a timely way if we begin to address it now. In other words, the solution is in our own hands. As Concord Coalition President and former Commerce Secretary Peter G. Peterson has written:

> If America chooses the right future, it will be because we learn again to cooperate politically and embrace a positive vision of what our nation can become. Yes, we have to make some tough choices. But instead of obsessing over the tax hike that outrages us, or the benefit cut that shocks us, we need to focus on everything our nation can achieve if we all made an effort to come to terms with our future [8]

There is no better time to begin such an effort than now. The lessons of Hurricane Katrina have important implications for our long-term fiscal challenge. Known dangers

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[8] *Running on Empty*, Peter G. Peterson, Farrar, Straus and Giroux, 2004 p.224.

should be acknowledged in advance of a crisis and dealt with in a straightforward manner. By all means, we should debate the options and trade-offs. But we must act. Whether through increased taxes or constrained spending (or some combination thereof), action by lawmakers will be necessary to restore balance between future governmental receipts and expenditures. Economic growth alone will not be enough to close the gap. Moreover, the sooner action is taken, the more gradual the remedies can be. The political system can adjust to unexpected good news. More problematic are the potentially harsh adjustments of deferring action on bad news projections that prove correct.

Because these options are politically difficult, the active involvement of the American people is critical. That is what the Fiscal Wake-Up Tour is all about. Without greater understanding of the problem among the public, community leaders, business leaders and home state media, elected leaders are unlikely to break out of their comfortable partisan talking points — and unlikely to find solutions.

The Fiscal Wake-Up Tour is a joint public awareness initiative by The Concord Coalition, the Budgeting for National Priorities Project at The Brookings Institution, and The Heritage Foundation. U. S. Comptroller General David Walker is an advisor and has participated in each of the Tour's public events.

For the past year we have visited many cities including Portland (OR), Kansas City, Durham, Omaha, Philadelphia, Wilmington and San Diego. We have also spoken to various organizations such as the National Conference of State Legislatures and the National Conference of Editorial Writers. Many other events are being planned for the fall and into next year. In fact, today some of my Fiscal Wake-Up Tour colleagues are in Austin Texas for a series of forums.

The purpose of this Tour is to explain in plain terms why budget analysts of diverse perspectives are increasingly alarmed by the nation's long-term fiscal outlook. Our emphasis is on the key areas in which we have found consensus, such as:

- The overall dimensions of the problem
- The nature of the realistic trade-offs that must be confronted in finding solutions
- The adverse and inequitable consequences for future generations if we fail to make serious changes, sooner rather than later.

Our mission is to cut through the usual partisan rhetoric and stimulate a more realistic public dialogue on what we want our nation's future to look like, along with the required trade-offs. We believe that elected leaders in Washington know there is a problem, but they are unlikely to act unless their constituents better understand the need for action, and indeed, demand it.

Members of the Fiscal Wake-Up Tour do not necessarily agree on the ideal levels of spending, taxes and debt, but we do agree on the following key points:

- Current fiscal policy is unsustainable

- There are no free lunch solutions, such as cutting waste fraud and abuse or growing our way out of the problem.

- The best way to make the hard choices is through a bipartisan process with all options on the table.

- Public engagement and understanding is vital in finding solutions.

- This is not about numbers. It is a moral issue.

A typical stop on the Fiscal Wake-Up Tour will include a public forum, a breakfast meeting with community/business leaders and an editorial board meeting with the local newspaper. In most cases, the venue for the public forum is a college or university.

The program generally consists of presentations by four or five panelists and an extended Q&A session with the audience. Panelists use PowerPoint presentations to show:

- The current budget numbers in historic context as a percentage of GDP

- Where the budget is headed on autopilot

- The driving forces behind the long-term projections

- The magnitude of the changes in either spending or tax policies that are needed to bring about a more sustainable and generationally equitable outcome

- Potential consequences of failure to change course

We do not recommend specific policy solutions. Indeed, we are upfront about the fact that we do not necessarily agree on solutions. However, we remind audiences that each of the realistic options comes with economic and political consequences that must be carefully weighed, and that there must be tradeoffs. Those who want to raise taxes are asked to explain what level of taxation they are willing to support and the manner in which the new revenue should be raised. Those who argue that spending must come down from projected levels are asked which programs they would target and how the savings would be achieved. Those who are unwilling to do either are asked how much debt they are willing to impose on future generations.

Our experience is that when audiences are told the facts, and shown that if they demand their "rights" to programs or policies it will have damaging economic effects to other groups or generations represented in the audience, they begin to accept the need for

tradeoffs.The Fiscal Wake-Up Tour does not presume to know the "correct" answers, but we are trying to make sure that the American people and their elected leaders are asking the correct questions.

In addition to the Fiscal Wake-Up Tour, the same group of analysts from Concord, Heritage and Brookings have been working with Public Agenda and ViewPoint Learning, (both chaired by Dan Yankelovich) on a project designed to provide insight into how attitudes evolve as people discuss difficult trade-offs with regard to long-term fiscal policy.

Three intensive day-long "Choice Dialogues" were conducted earlier this year in San Diego, Kansas City and Philadelphia. Public Agenda and ViewPoint Learning are in the process of reviewing the results. A report will be released sometime late in the year. As a preliminary matter, however, the following observations stand out:

- The public is strongly averse to big increases in the size of the national debt and, with the right kind of leadership, is prepared to accept sacrifices to avoid it.

- For most people, the overriding concern is not resistance to taxes but a profound lack of trust in government. People are willing to pay for what they want so long as they can be satisfied that government will spend the money wisely and for the purposes intended.

- Americans are willing to make changes in entitlements, but again on condition that trust and accountability exist.

- While there is continued strong support for defense spending, it is accompanied by the widespread perception that funds are misallocated and often wasted.

- Americans want to be engaged in addressing these issues and are frustrated by the lack of engagement that contributes to their mistrust of government

III. Broad strategies for Change and necessary trade-offs

While there is no quick fix, there are things we can begin doing now that will result in a much brighter picture for future generations. These do not include "slashing" entitlements or "killing the economy with tax increases." They do require that everything be on the table. The following are some recommendations and entitlement reform criteria that The Concord Coalition has long supported and continues to support:

1. Set a goal of balancing the budget

Fiscal policy must have a firm and responsible goal to guide decision making. Having such a goal underscores the need to make trade-offs between competing desires — distinguishing wants from needs. Without a fiscal policy goal, budget deficits are more

likely to reach harmful levels because there is nothing to force hard choices between politically popular spending increases and tax cuts.

The most responsible goal is a balanced budget. Aside from being fiscally responsible, balancing the budget is the goal most likely to be broadly understood, supported and enforced. It is also the most generationally responsible goal. Americans understand that it is wrong to provide ourselves with more government services than we are willing to pay for and then send the bill to our children. The best way to avoid such unjust burden shifting while laying a solid long-term foundation for a strong economy is to adhere as much as possible to the balanced budget goal. Policymakers should put everything on the table—including entitlement cuts and tax increases—and negotiate the necessary tradeoffs.

2. Reinstate caps on annual appropriations and pay-as-you-go rules for taxes and entitlement spending

Although budget rules alone will never be able to solve the nation's fiscal problems, enforcement mechanisms can bring greater accountability to the budget process and help provide Members of Congress with the political cover to make the tough choices necessary to reduce the deficit. Pay-as-you-go rules (PAYGO) for all tax and entitlement legislation and spending caps for appropriations are proven tools for fiscal discipline. These enforcement rules, enacted in 1990 and extended in 1997 with bipartisan support, were an important part of getting a handle on the deficits in the early 1990s and getting the budget back into balance.

Reinstating PAYGO rules and spending limits on appropriations alone would not balance the budget, but doing so would represent an important first step in bringing discipline to the budget process. Statutory caps on appropriations helped hold such spending flat from 1991 to 1996 and restrained its growth to 3.7 percent a year between 1996 and 2000. The PAYGO rules required anyone proposing tax cuts or entitlement expansions to answer the question: "How do you pay for it?" Renewing the discipline imposed by an answer to this question is perhaps the most important thing politicians can do in the short-term to restore fiscal discipline in Washington.

3. Don't put Social Security reform on the back burner.

There is no good reason why this issue should be kept off the 2007 legislative agenda. The demographic and fiscal challenges facing Social Security in the years ahead are well known. Failure to change current law amounts to complacency with the prospect of deep benefit cuts for today's young workers, or steep payroll tax increases. It is understandable that political leaders will disagree on the details of any reform plan. But what's needed now is rejection of the "Do Nothing Plan."

Any Social Security reform plan should be designed to meet three fundamental objectives — ensuring Social Security's long-term fiscal sustainability, raising national savings, and improving the system's generational equity:

- **Reform should ensure Social Security's long-term fiscal sustainability.** The first goal of reform should be to close Social Security's financing gap over the lifetimes of our children and beyond. The only way to do so without burdening tomorrow's workers and taxpayers is to reduce Social Security's long-term cost.

- **Reform should raise national savings.** As America ages, the economy will inevitably have to transfer a rising share of real resources from workers to retirees. This burden can be made more bearable by increasing the size of tomorrow's economy. The surest way to do this is to raise national savings, and hence ultimately productivity growth. Without new savings reform is a zero-sum game.

- **Reform should improve Social Security's generational equity.** As currently structured, Social Security contributions offer each new generation of workers a declining value ("moneysworth"). Reform must not exacerbate--and ideally it should improve--the generational inequity underlying the current system.

Meeting these objectives will require hard choices and trade-offs. There is no free lunch. Policymakers and the public need to ask the following questions to assess whether reforms honestly face up to the Social Security challenge--or merely shift and conceal the cost:

- **Does reform rely on trust-fund accounting?** Trust-fund accounting obscures the magnitude of Social Security's financing gap by assuming that trust-fund surpluses accumulated in prior years can be drawn down to defray deficits incurred in future years. However, the trust funds are bookkeeping devices, not a mechanism for savings. The special issue U.S. Treasury bonds they contain simply represent a promise from one arm of government (Treasury) to satisfy claims held by another arm of government (Social Security.) They do not indicate how these claims will be satisfied or whether real resources are being set aside to match future obligations. Thus, their existence does not, alone, ease the burden of paying future benefits. The real test of fiscal sustainability is whether reform closes Social Security's long-term annual gap between its outlays and its dedicated tax revenues.

- **Does reform rely on hiking FICA taxes?** Hiking payroll taxes to meet benefit obligations is neither an economically sound nor a generationally equitable option. The burden will fall most heavily on lower and middle-income workers and on future generations. Younger Americans in particular will be skeptical of any plan that purports to improve their retirement security by increasing their tax burden and by further lowering the return on their contributions.

- **Does reform rely on new debt?** Paying for promised benefits--or financing the transition to a more funded Social Security system--by issuing new debt defeats a fundamental purpose of reform. To the extent that reform relies on debt financing, it will not boost net savings and may result in a decline. Without new savings, any gain for the Social Security system must come at the expense of the

rest of the budget, the economy, and future generations. Resort to borrowing is ultimately a tax increase for our kids.

- **Does reform rely on outside financing?** Ideally, reform should achieve all necessary fiscal savings within the Social Security system itself. Unrelated tax hikes and spending cuts may never be enacted, or if enacted, may easily be neutralized by other measures, now or in the future. Unless the American public sees a direct link between sacrifice and reward, the sacrifice is unlikely to happen.

- **Does reform use prudent assumptions?** There must be no fiscal alchemy. The success of reform should not depend upon rosy projections of future economic growth, presumed budget surpluses or lofty rates of return on privately owned accounts. All projections regarding private accounts should be based on realistic assumptions, a prudent mix of equity and debt, and realistic estimates of new administrative costs.

While fixing Social Security's problems, reform must be careful to preserve what works. Social Security now fulfills a number of vital social objectives. Policymakers and the public need to ask the following questions to assess whether reform plans would continue to fulfill them:

- **Does reform keep Social Security mandatory?** The government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on the safety net in retirement. Moving toward personal ownership need not and should not mean “privatizing” Social Security. Any new personal accounts should be a mandatory part of the Social Security system. Choice is not important in a compulsory social insurance program whose primary function is to protect people against poor choices.

- **Does reform preserve Social Security's full range of insurance protection?** Social Security does more than write checks to retirees. It also pays benefits to disabled workers, widows, widowers, and surviving children. A reformed system should continue to provide insurance protection that is at least equal to what the current system offers.

- **Does reform maintain Social Security's progressivity?** While individual equity (“moneysworth”) is important, so too is social adequacy. Social Security's current benefit formula is designed so that benefits replace a higher share of wages for low-earning workers than for high-earning ones. Under any reform plan, total benefits, including benefits from personal accounts, should remain as progressive as they are today.

- **Does reform protect participants against undue risk?** Under the current system, workers face the risk that future Congresses will default on today's unfunded pay-as-you-go benefit promises. While reducing this “political risk,” personal account reforms should be careful to minimize other kinds of risk, such

> as investment risk, inflation risk, and longevity risk--that is, the risk of outliving ones assets.

If we reform Social Security today, the changes can be gradual and give everybody plenty of time to adjust and prepare. If we wait much longer, change will come anyway--but it is more likely to be sudden and arrive in the midst of economic and political crisis.

We have a crisis today only because of the threat of political gridlock. Inaction now increases the prospects of severe changes later. Every year that alterations are put off greatly raises the risk of large tax increases or sudden benefit reductions in the future. Reforming Social Security today would not free society from that future stress, but it would be a good start.

It is worth recalling that President Bush is not the first president in recent years to put Social Security on the political agenda. In 1998, President Clinton made Social Security reform one of his top domestic priorities. Here is how President Clinton summarized the situation at a forum hosted by The Concord Coalition and AARP in July 1998:

> We dare not let this disintegrate into a partisan rhetorical battle. Senior citizens are going to be Republicans and Democrats and independents. They're going to come from all walks of life, from all income backgrounds, from every region of this country, and therefore, so will their children and their grandchildren. This is an American challenge and we have to meet it together.

4. Medicare is in worse shape than Social Security. We must engage on a bipartisan basis to make Medicare both effective and affordable over the long-term.

As currently structured, Medicare is financially unsustainable. Costs are growing faster than the payroll taxes and premiums that finance the program. Costs are also growing faster than the overall economy, and faster than can be reasonably supported by the federal budget unless spending priorities change dramatically.

Health care costs are rising faster than wages. Consequently, the payroll taxes that fund Medicare are falling short of program costs. At the same time, the number of beneficiaries will climb steeply when the baby boom generation begins receiving benefits in 2011. Moreover, people who reach age 65 are living longer. People aged 85 and older are the fastest growing segment of our population. Medicare spending averages more than twice as much for people over 85 as it does for those age 65.

The addition of Medicare's prescription drug benefit merely compounded the program's shaky financial foundation. According to the President's Office of Management and Budget, the new prescription drug benefit will add $45 billion to the FY2006 deficit and $361 billion over the next five years. Indeed, estimates by the administration indicate that the unfunded obligations of the Medicare Part D drug benefit are roughly 50 percent more than those of the entire Social Security program. Congress and the President must look for ways to make the benefit more efficient, better targeted and less expensive.

Putting the Medicare program on a financially sustainable path will require some combination of reductions in services, increased cost-sharing by beneficiaries, increasing the eligibility age, bringing more revenues into the system and improving the cost effectiveness of Medicare and the health care system overall. We cannot pretend that there are simple fixes that don't require anyone to give anything up such as clamping down on fraud, or cutting back on excessive paperwork, or eliminating all the unnecessary tests and procedures. Pure "waste" is no easier to pinpoint in the health system than it is in the federal budget. And even if we could identify and eliminate all of it, the underlying cost drivers — from technology to expectations to aging — would soon cause spending to grow again as fast or faster than before.

Health care spending on the elderly will continue to grow faster than the economy so long as we pretend that costs can be controlled without any sacrifice. Costs aren't rising because of the proliferation of useless medical services. They're rising because medical science can do more for more people--and because what it can do is often very expensive.

Setting limits in Medicare will mean moving toward a whole new paradigm--one in which prospective budgets at the program level and capitation at the beneficiary level finally compel us to make tradeoffs between health care and other national priorities.

Before thinking about specific ways to address the Medicare problem, it is important to establish a set of criteria against which various proposals can be evaluated. Listed below are the criteria that the Concord Coalition believes should guide decision makers in reforming Medicare.

- <u>Quality care</u>: Medicare insurance should cover a level of care that is commensurate with the care available to working age people. This does not mean that taxpayers must be expected to finance a "high option" insurance plan for all seniors. If individuals wish to purchase supplementary insurance to augment their Medicare benefits, they should be permitted to do so. However, there must be an affordable insurance plan to provide a reasonable level of medical care available to the elderly, regardless of their ability to pay.

- <u>Fiscally responsible and generationally sustainable</u>: Concord believes that each generation should pay as much as possible of the cost of its own retirement package, including Medicare, Social Security and long-term care. No generation should have an automatic claim on taxpayer resources simply because of its chronological age. People of all ages have problems that the government could address, ranging from prenatal care, to child development and education, to job training, to old age assistance. A fiscally responsible program is one that can reasonably be expected to operate within the resources available to finance it. A program that assumes a perpetually open spigot from the Treasury gushing an ever-increasing flow of spending is not fiscally responsible. If it is decided that program costs should be permitted to increase, (i.e., filling the "donut hole" or

adding long-term care) then fiscal responsibility demands that a commensurate stream of revenue be identified to pay for the program.

- Income-related cost sharing: As a group, seniors enjoy a better income and less poverty than other age groups, particularly children. Therefore, Medicare's medical insurance premiums should be geared to income levels.

- Efficient provision of medical care: Whatever new system of medical insurance for the elderly is devised, it should contain incentives for both providers and patients to use resources in a cost-effective manner. Treatments that have little or no promise of achieving any appreciable improvement in a patient's well-being should not be financed with taxpayer dollars. A distinction must be drawn between wants and needs.

- Prompt action: Changes in Medicare should be enacted promptly. Entitlement programs for the elderly are long-term commitments between the government and the citizenry. People base their behavior and make their plans based on current provisions. Therefore changes in the Medicare health insurance commitment should be undertaken in time to permit gradual changes and give people time to plan and adjust.

- Medicare changes should not be made in a vacuum: Medicare is only one of the long-term commitments citizens have made to support seniors, along with Social Security and, in the case of long-term care, Medicaid. When program reforms are considered one at a time, it is possible to ignore the ripple effect of changes in the cost or financing for other programs serving the elderly. And once a stream of revenues has been committed to pay for one of the programs on which elderly people rely, it can no longer be used to shore up other programs. Both Social Security and Medicare tax the same people (mostly workers) to pay benefits to the same people (mostly retirees). What matters fiscally and economically is the total burden of senior benefits. Because controlling health benefit spending will be so difficult, it is all the more urgent to save what we can in Social Security.

5. Tax cuts scheduled to expire should not be permanently extended absent a plan for long-term fiscal sustainability.

Circumstances have changed dramatically since the bulk of the tax cuts were enacted in 2001. The surplus era in which the tax cuts were enacted has been replaced by deficits and the budget faces new demands for the war on terrorism and homeland security. Moreover, no action has been taken to prepare for the costs of the baby boomers' retirement and health care needs that will begin to place a growing strain on the budget in the years ahead. In fact, the burden has been dramatically increased with the addition of a Medicare prescription drug benefit.

In light of all of this, it makes sense to reassess whether we should continue all of the tax cuts enacted in the surplus era. In has been suggested by some that the recent high increase in the growth rate of federal taxes proves that tax cuts have not increased the deficit because they “pay for themselves” through greater economic growth. While revenue growth has indeed been very impressive over the past two years, we should not leap to the conclusion that tax cuts lead to “higher” revenue. Keep in mind:

- While this year’s revenues (estimated to be $2.4 trillion) will set a record in dollar terms, it represents a much lower percentage of the economy (GDP) than in 2000 — 18.3 percent of GDP as opposed to 20.9 percent.

- Revenues this year will be almost identical to 2000 revenues adjusted for inflation. In 2000, revenues were 2.025 trillion. In 2006, CBO projects revenues to be $2.40 trillion, which translates to $2.029 trillion in 2000 dollars adjusted by CPI. Done in reverse, 2000 revenues would be $2.397 trillion adjusted for inflation.

- Individual income taxes are still *below* 2000 levels, adjusted for inflation. CBO projects individual income taxes of $1.059 trillion in 2006, which translates to $894 billion in 2000 dollars, well below the $1.004 billion in individual income taxes collected in 2000. If individual income taxes had kept pace with inflation since 2000, they would be $1.189 trillion.

- Setting a record for revenues in nominal dollars is not remarkable; revenues almost always set a record in nominal dollars every year as revenues naturally increase with inflation, economic growth and other factors. What is remarkable is that the revenue record set in 2000 ($2 trillion) was not broken until 2005. Between 2001 and 2003 revenues actually declined for three years in a row for the first time since the 1920’s.

There is not an inevitable connection between tax cuts, economic growth and higher revenues. For example, in the five years following the tax increases of 1993, annual real economic growth averaged 3.8 percent. In the five years since the tax cut policies began in 2001, annual real economic growth has averaged 3.1 percent. Certainly, this does not establish that tax increases are better for the economy than tax cuts, but it does establish that tax cuts enacted over the past few years are not necessarily needed beyond their expiration date to ensure economic growth.

It is also worthy of note that the $2.66 trillion of *spending* in 2006 will also be a record in dollar terms. Spending restraint is, of course, the key to maintaining a sustainable fiscal policy and allowing future generations more of a choice in setting their own priorities. But experience has demonstrated that attempting to reduce spending simply by cutting taxes, or “starving the beast,” is a failed strategy. The tax burden is ultimately determined by the government’s spending commitments and not the other way around. Unless we reduce spending over the long-term we are not really cutting taxes over the long-term but

merely shifting the tax burden from ourselves to our children. The best fiscal policy is one that balances spending and revenues at a sustainable level over the long-term.

6. Establish a bipartisan fiscal commission

The Dean of my law school had a saying that seems apt to the political task ahead. When referring to unlikely solutions to tough problems he would remind us that, “Water doesn’t run uphill without a pump.”

Reducing promised benefits or raising taxes to pay for them strikes me as the political equivalent of expecting water to run uphill. It goes against nature and is unlikely to happen without some intervening force. One such force would be a crisis. A far better one would be a bipartisan commission — provided that it is organized and selected in a way that recognizes fiscal and political realities. As Concord Co-Chairs former Senators Warren Rudman (R-NH) and Bob Kerrey (D-NE) wrote in a recent *Washington Post* op-ed, the commission would need five elements to succeed:

- First, it must be truly bipartisan. Any perception that the commission’s purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It must have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.

- Second, it must have a broad mandate. While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the commission should examine all aspects of fiscal policy.

- Third, all options must be on the table. If either side sets preconditions, the other side will not participate. This means that Republicans cannot take tax increases off the table and Democrats cannot take benefit reductions off the table.

- Fourth, the commission must engage the public in a genuine dialogue about the trade-offs inherent in realistic solutions. In our experience, when people are armed with the facts and given the opportunity for honest dialogue, they are willing to set priorities and make hard choices.

- Fifth, the commission’s recommendations should be given an up or down vote in Congress, allowing for amendments that would not reduce the total savings. Absent that, the report would likely join many others on a shelf.

The full text of the op-ed is attached.

washingtonpost.com

Securing Future Fiscal Health

By Bob Kerrey and Warren Rudman
Monday, August 28, 2006; A15

The economic and moral case for long-term reform of fiscal policy is clear. Yet politicians refuse to act. If this stalemate persists, it could end in catastrophe.

Over the next 30 years, spending on federal programs is on track to go up by 50 percent as a share of the economy. If revenue remain at their historical level, the resulting deficits will approach 20 percent of gross domestic product by 2036 -- almost 10 times the current size. The debt will surge to 200 percent of GDP -- twice what it was at the end of World War II.

Political realities explain why nothing has been done about this. Changing course would require substantial spending cuts from projected levels or equivalent tax increases. Neither party wants to be the first to propose these tough choices out of fear that the other side would attack it. Similarly, neither side wants to discuss possible compromises of its own priorities, out of fear that the other side will take the concessions and run. Unfortunately, these fears are justified.

Since the regular legislative process seems incapable of dealing with the impending crisis, some alternative has to be found. President Bush has suggested a commission. Having served on many commissions, we understand their potential value. We also understand how they can go wrong. In our view, a new commission could be very useful, but only if it recognizes fiscal and political realities. It needs five elements to succeed.

First, it has to be truly bipartisan. Any perception that the commission's purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It must have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.

Second, it must have a broad mandate. While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the commission should examine all aspects of fiscal policy.

Third, all options must be on the table. If either side sets conditions, the other won't participate. Republicans cannot take tax increases off the table, and Democrats cannot take benefit reductions off the table.

Fourth, the commission needs to engage the public in a genuine dialogue about the trade-offs inherent in realistic solutions. When people are armed with the facts and given the opportunity for honest dialogue, they are willing to set priorities and make hard choices.

Fifth, the commission's recommendations should be given an up-or-down vote in Congress, allowing for amendments that would not reduce the total savings. Absent that, the report would likely join many others on a shelf.

Rep. Frank Wolf (R-Va.) and Sen. George Voinovich (R-Ohio) have put forward a proposal that satisfies most of these elements. They would create a bipartisan commission with a broad mandate to examine long-term fiscal challenges. All policy options would be on the table. The commission would solicit input from the public and develop legislation that Congress and the president would be required to act on. Its work would address four key concerns: the unsustainable gap between projected spending and revenue, the need to increase national savings, the implications of foreign ownership of U.S. government debt and the lack of emphasis on long-term planning in the budget process.

A commission with these attributes could give all parties the political cover they need to tackle the tough choices and develop a bipartisan consensus for solutions. This would be invaluable regardless of who controls Congress or the White House.

In the end, of course, elected representatives, not a commission, will have to make the hard decisions. But a commission that produced solutions with meaningful bipartisan support would provide a catalyst for action. If Congress were required to vote on the commission's recommendations, opponents would be challenged to produce solutions of their own.

Advocates of extending tax cuts would be challenged to say how they would restrain spending enough to avoid cascading debt once the baby boomers begin to retire in large numbers. Those who oppose reductions in current entitlement promises would be challenged to say how they would fund those promises without squeezing out other priorities or raising taxes to unacceptable levels that could damage the economy.

The Wolf-Voinovich proposal has been greeted with silence or outright hostility. It deserves better. This is a serious proposal by two leaders who regard the debt burden and draconian policy options we are leaving to future generations as a moral stain on our nation's character.

To be sure, their proposal has shortcomings that must be corrected. Two improvements that are critical to the success of a commission are providing for bipartisan co-chairs and dividing the membership more evenly between parties than the current 9-6 split in favor of Republican appointments. These problems are not minor technicalities, but they could be fixed in negotiations with potential Democratic co-sponsors.

Time is running out to enact reforms. Wolf and Voinovich have come up with a credible way to get the process started. Any takers?