

Fiscal Futures Committee Paper--Federal Section

Susan Irving and Joe Minarick

This is part of a series of papers dealing with the importance of addressing the long-term federal budget deficit facing the United States¹. The Committee finds that (a) this structural fiscal imbalance cannot be solved by small changes at the margins and almost certainly not by economic growth alone; and (b) failure to deal with this imbalance will have significant consequences for the economy both at the federal level and in terms of relations between federal, state and local governments. Dealing with the fiscal challenge requires a national discussion about what Americans want from their government and how much they are willing to pay for those things. This discussion—and consideration of any of the tough policy choices necessary to address the long-term shortfall—may demand better measures, changes in process, and national public education campaign in order to effectively address this challenge.

The factors that drive the long-term outlook are both larger and more certain than those affecting the near- and medium-term. Over the next few years the deficit will fluctuate and differ from projections because of the pace of economic recovery and inevitable forecasting errors as well as policy decisions. However, our long-term fiscal outlook will be driven inevitably by a number of known factors, including the retirement of the “baby boom” generation.”

Why focus on the Long-Term Fiscal Challenge? Why does it matter?

A more detailed discussion of the ill effects of large budget deficits will follow. However, an understanding of the inevitability of those consequences is essential at the outset.

Today the fiscal policy is on an unsustainable path: promises [either explicit or implicit] built into the structure of current programs far exceed the revenue stream built into today’s tax laws. As a joint statement by the Committee for Economic Development (CED), Concord Coalition, and the Center for Budget & Policy Priorities (CBPP) said last year:

Deficits matter. Over the long term, large, persistent deficits absorb national savings and crowd out productive investment. They put upward pressure on interest rates. They reduce the fiscal flexibility to deal with unexpected developments. And they raise the cost of servicing the national debt.²

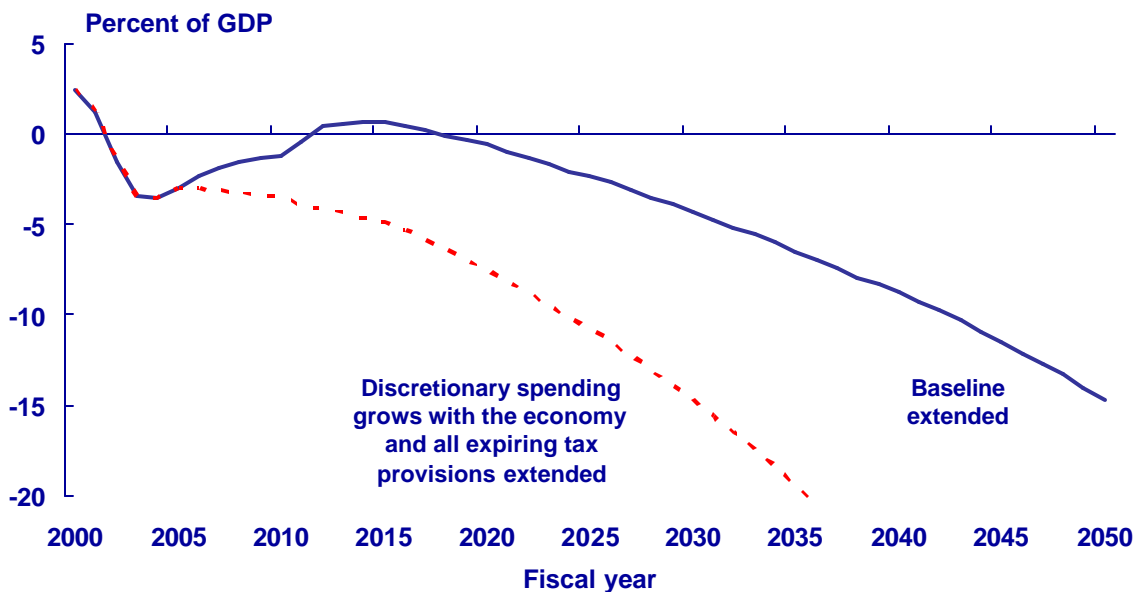
Simulations by the Congressional Budget Office (CBO), the Government Accountability Office (GAO), Brookings and other independent groups all show that absent a change in policy, deficits and debt will grow to unsustainable levels.

¹ Other papers address State & Local fiscal situation and Concepts & Processes.

² “The Developing Crisis – Deficits Matter,” Joint Statement of the Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities, September 29, 2003, page 5.

The figure below shows unified deficits as a share of Gross Domestic Product (GDP)[GAO simulations] under two different assumptions. The “Baseline Extended” scenario starts with the CBO 10-year baseline [discretionary spending grows with inflation and tax cuts are allowed to sunset/expire as under law as of the CBO March 2005 update], after which discretionary spending and revenues stay constant as a share of the economy. Under the alternative scenario, discretionary spending grows with the economy beginning in the very first year and the expiring tax provisions are extended, after which tax receipts stay constant as a share of GDP. Neither scenario assumes an alternative minimum tax (AMT) “fix,” which would reduce revenues from the scenario level. Although the timing differs, in both instances the deficit grows faster than the economy, without limit.

Chart 1
Unified Surpluses and Deficits as a Share of GDP
Under Alternative Fiscal Policy Simulations



Note: Assume currently scheduled Social Security benefits are paid in full throughout the simulation period.

Source: GAO’s March 2005 analysis.

Quoting again from the joint CED-Concord-CBPP statement,

...if [they are] sustained over time at the levels projected, deficits ultimately will lead to slower growth and a lower standard of living. If they are financed by borrowing from domestic lenders, the economy will have less money available for investing in plant and equipment, education for our children and training for our workers, research and development, and the other building blocks of our economic future. If foreigners finance them, we will owe a mushrooming debt to the rest of world, with growing interest costs that must be serviced every year.

However they are financed, sustained large deficits reduce our future standard of living. If left unchecked, these deficits could leave future generations less well-off than their predecessors for the first time in American history.³

Under any plausible assumptions, faster economic growth does not eliminate the problem. Once deficits build themselves into accumulated debt, and debt bears compounding interest costs, the ultimate burden on the federal budget can grow to overwhelm the benefits of economic growth. In short, these adverse consequences of deficits are driven by the universally recognized power of compound interest. They cannot be out-waited or ignored.

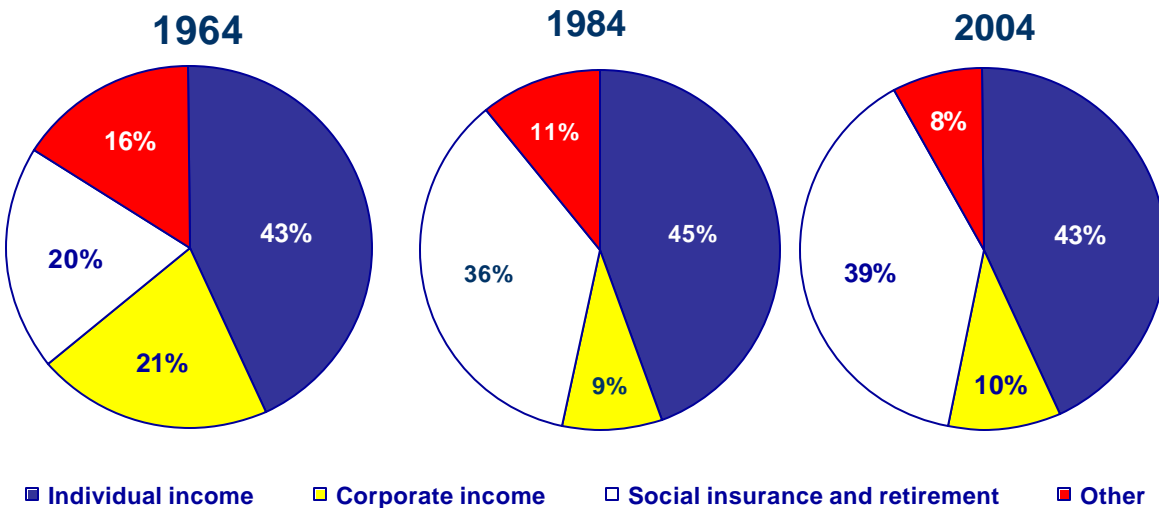
I. Description of the Problem: The numbers

A. Background on the Federal Budget

The federal budget is not just a set of numbers. It is a statement about priorities. The President’s budget – submitted every year between the first Monday in January and the first Monday in February --- presents the President’s priorities and fiscal policy. It describes the policy world the President would like to see: how much revenue shall be raised and in what form; on what should the government spend money — and in what way; and identifies the projected gap between revenues and spending. With its legislative actions, the Congress reacts to and modifies those priorities.

In FY 2004 the federal government took in \$1.880 trillion in revenues and spent \$2.292 trillion. The pie charts below show how the government raised its revenue and on what it was spent.

Chart 2
Composition of Federal Receipts by Source

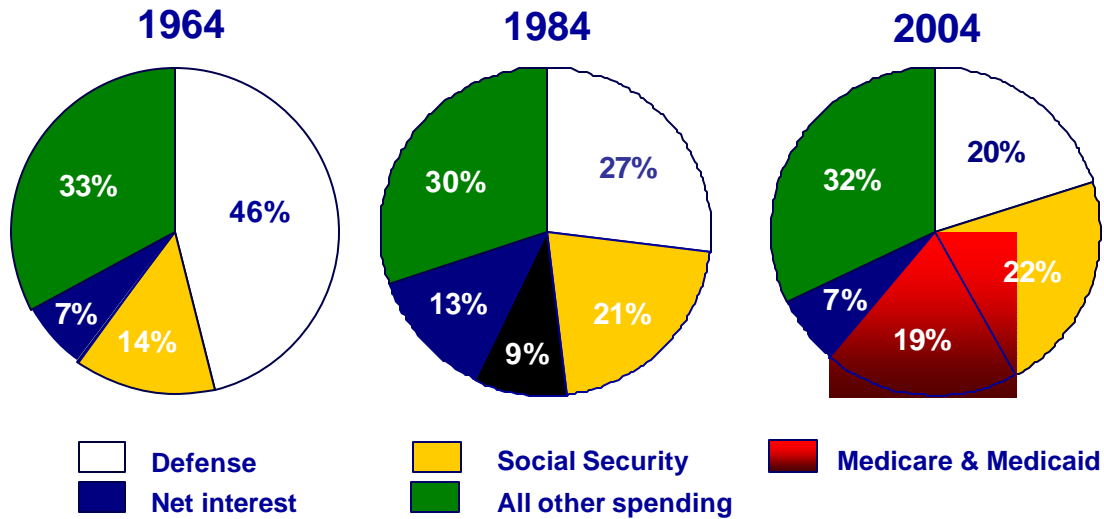


Note: Numbers do not add to 100 percent due to rounding.
Source: Office of Management and Budget.

³ Ibid.

To get a sense of how things have changed, the charts below show the composition of spending over time. The spending side has seen a marked shift in composition, toward spending on entitlement programs, most notably those relating to health care.

Chart 3
Composition of Federal Spending

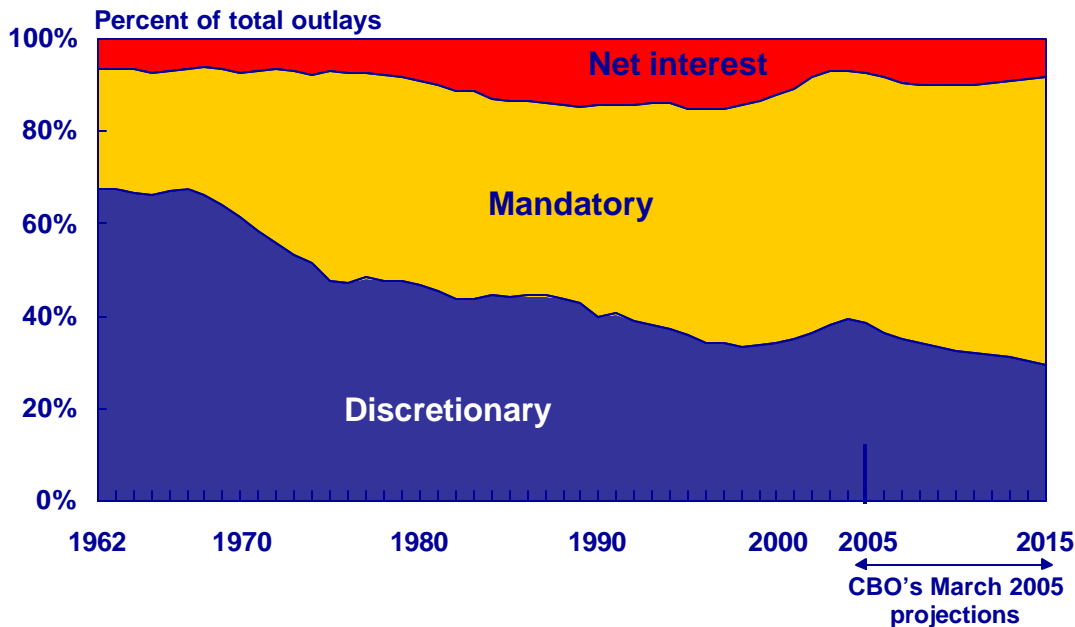


Source: Office of Management and Budget.

Another view of the trends is important as we look to the future: the growth of spending in programs not controlled through the annual appropriations process. These programs--often called “mandatory”--are on “automatic pilot,” unless changes are made to their authorizing statutes; and these trends are likely to continue. Over the next 30 years, the number of people ages 65 and older will double while the number of adults under age 65 will increase by less than 15 percent. This means that fewer workers will support more people eligible to receive Social Security and Medicare benefits.

CBO notes that costs per enrollee in federal health care programs are likely to continue growing much faster than inflation. In December 2003, under that assumption, CBO projected that the increases in beneficiary population and in costs will cause federal spending for Social Security, Medicare and Medicaid to grow dramatically as a share of the economy—from 8% of GDP in 2004 to almost 28% in 2050 (lower alternative scenarios were also presented).

Chart 4
Composition of Federal Outlays
Projections Assume Discretionary Spending
Grows with Inflation after 2005



Source: Office of Management and Budget (February 2005) and Congressional Budget Office (March 2005).

In sum, the greatest challenge to the budget in the coming years is the beginning of a period of rapid growth in the elderly population compounding the likely continuation of growing health-care costs.

Definitions: What is the deficit?

The deficit is the difference between what the government takes in and what it spends— and therefore, how much it must borrow to fund its operations. It is an annual flow figure. The most-often used measure of the deficit is the “unified” deficit. This measures all the flows to and from the federal government—including both general income taxes and dedicated payroll taxes. It also recognizes both outlays from the government’s general fund and outlays from its trust fund programs. The unified deficit is the difference between total receipts and total spending. In FY 2004 it was \$412 billion, or about 3.6 percent of GDP.

Largely for symbolic purposes, the budget has been divided into “on budget” and “off budget” components. Social Security is “off budget.”⁴ It is important to note that this distinction has no

⁴ Something about Post office & how small it is

economic significance; it is a notational and accounting device [see text box on Trust Funds]⁵ As OMB notes in the budget [Analytical Perspectives p. 346], “The off-budget Federal entities conduct programs of the same type as the on-budget entities.” For all practical purposes the distinction between “on budget” and “unified” is the presentation of the Social Security trust funds [SSTF]. Because Social Security currently takes in more than is needed to pay benefits, the SSTF surplus offsets part of the unified deficit. In FY 2004 the on-budget deficit of \$568 billion [4.9% of GDP] was “offset” by trust fund surpluses of \$153 billion. The sum of the two is the unified deficit of \$413 billion [3.6% of GDP].

Analysts also sometimes distinguish between the cyclical and the structural deficit. The composition of the US Budget means that revenues fall and the deficit increases when economic activity lags [GDP growth slows, unemployment rises]. It is not the cyclical deficit --that portion of the deficit that reflects a response to slower economic growth-- that raises concern, because, when economic growth resumes, that portion of the deficit erodes. Rather, it is the deficit beyond the cyclical deficit-- the part that is built into the structure of the spending and tax decisions on the books--that causes worry. This deficit—which is the structural deficit--does not go away with stronger growth.

It is also important to distinguish between deficits and debt. The deficit is an annual number, a yearly flow. The debt is roughly the accumulation of all previous deficits and surpluses. Some debt is held by the public, and the rest is held internally—by government trust funds. Surpluses run by programs that hold government trust funds reduce the amount the government must borrow from the public, at least temporarily. However, when the trust fund program needs to call on those monies to pay benefits, the general fund must “repay” the trust fund—either by cutting spending, or raising taxes, or increasing borrowing from the public. [For a fuller discussion of trust funds or of debt, see *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions* [GAO-01-199SP, February 2001], *The Impact of Trust Fund Programs on Federal Budget Surpluses and Deficits*, [CBO Long-Range Fiscal Policy Brief No. 5, November 2002,] *Federal Debt: Answers to Frequently Asked Questions—An Update* [GAO-04-485 SP, August 2004], *Federal Debt and the Commitments of Federal Trust Funds*, [CBO Long-Range Fiscal Policy Brief No. 4, revised May 2003], Cashell, *The Federal Government Debt: Its Size and Economic Significance* [CRS Report RL31590, November 2003] or Labonte and Mackinen, *The National Debt: Who Bears Its Burden?* [CRS Report RL 30520 Updated May 2003]]

⁵ see also, .. [cite GAO FAQs volume, does CBO have something? CRS?]

Trust Funds

Federal trust funds represent one accounting mechanism used to link earmarked receipts with the expenditures of those receipts. The Office of Management and Budget (OMB) and the Department of the Treasury determine budgetary designation as a trust fund when a law both earmarks receipts to a program and identifies the account as a “trust fund” account. The Congress creates a federal trust fund in law and designates a funding source. In the federal budget the meaning of the term “trust” differs significantly from its private sector usage. In contrast to a private trust fund, the federal government does not have a fiduciary responsibility to the trust beneficiaries, and it can raise or lower future trust fund collections and payments or change the purposes for which the collections are used by changing existing laws.

The unified budget, as conceived by the 1967 Report of the President’s Commission on Budget Concepts, includes the full range of federal activities, regardless of their fund type or whether they are on- or off-budget. The unified budget can be divided into two fund groups: (1) federal funds and (2) trust funds. There are two types of trust funds: (1) nonrevolving and (2) revolving. Trust funds are created to account for monies that are earmarked (that is, dedicated for a specific purpose). While earmarked monies are heavily concentrated in trust funds, trust funds are not the only way earmarked monies can be accounted for in the federal budget. For example, special and public enterprise funds also are used for programs financed primarily by earmarked collections.

The major difference among the four types of earmarked funds is whether the activities they finance are business- or non-business-type activities—not whether the funds are labeled “trust funds.” Both revolving trust funds and public enterprise funds are used primarily for business-type activities, whereas both nonrevolving trust funds, such as Social Security, and special funds are used primarily for non-business-type activities. Nonrevolving trust and special funds obtain revenues primarily through earmarked receipts, such as Social Security payroll taxes, and, to a far lesser extent, offsetting collections. In contrast, revolving trust and public enterprise funds operate primarily through offsetting collections resulting from their business-type activities. By definition, the only difference between them is whether the word “trust” is included in the legislation establishing the account.

The vast majority of earmarked funds take in more than their current needs. On an annual basis, this is often described as having a “surplus.” The accumulated surpluses result in these funds having a “balance.” The relationship between earmarked fund balances and the claim on future resources depends on whether the program financed by the fund was structured so that earmarked receipts would cover the future program claims. Not all funds are structured to be actuarially sound. Depending on the financing structure, the balance may or may not equal the future claim. For example, the current and expected earmarked receipts from Social Security are not structured to cover the expectations for future payments stemming from the program’s defined benefit structure.

Annual surpluses can accumulate into large trust fund balances. However, because these balances are bookkeeping credits to the fund with the actual cash commingled with other collections, the accumulation of large balances does not by itself affect the government’s ability to meet long-term commitments or make a program more sustainable in the future. In other words, accumulated balances do not increase the government’s ability to acquire future resources to meet long-term commitments. Nor do they necessarily represent the full future cost of existing commitments. From a macro perspective, the critical question is not how much a trust fund has in assets but whether the government as a whole has the economic capacity to finance the claims on the trust funds for benefits now and in the future and at what cost to other competing claims for scarce resources.

Source: Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions, GAO-01-199SP (February 2001).

Federal Debt

Gross debt—also known as total debt—is the measure that captures all of the federal government’s outstanding debt, measured by outstanding bills, notes, bonds, and other debt instruments of the United States. The debts of the U.S. government consist of money that the government owes to the public and money that the government owes to itself. The federal debt held by the public is the value of all federal securities sold to the public that are still outstanding—about \$4.3 trillion (37.5 % of GDP) at the end of fiscal year 2004. The level of debt held by the public is a useful measure because it reflects how much of the nation’s wealth is absorbed by the federal government to finance its obligations. Thus, debt held by the public best represents the cumulative effect of past federal borrowing on today’s economy and on the current federal budget. Debt held by the public is owed to a wide variety of investors, including domestic private investors such as individuals, businesses, financial institutions, and pension funds. Other investors include the Federal Reserve System, state and local governments, and international investors. The Treasury estimates that international investors, including central banks as well as private investors, hold slightly more than one-third of this debt. Debt held by government accounts (intragovernmental debt)—about \$3.0 trillion at the end of fiscal year 2004—represents balances in the federal government’s accounts, primarily trust funds, that accumulate surpluses. From the standpoint of the government as a whole, debt held by government accounts represents amounts loaned from one part of the government to another.

Debt held by the public approximates current federal demand on credit markets. It represents a burden on today’s economy, and the interest paid on this debt represents a burden on current taxpayers. Federal borrowing from the public absorbs resources available for private investment and may put upward pressure on interest rates. Further, debt held by the public is the accumulation of what the federal government borrowed in the past. In contrast, debt held by government accounts (intragovernmental debt) and the interest on it represent a claim on future resources. Special federal securities credited to government accounts (primarily trust funds) represent the cumulative surpluses of these accounts that have been lent to the general fund. These transactions net out on the government’s consolidated financial statements. Debt issued to government accounts does not affect today’s economy and does not currently compete with the private sector for available funds in the credit market.

However, debt held by government accounts reflects a future burden on taxpayers and the economy. The special federal securities held in the accounts represent legal obligations of the Treasury and are guaranteed for principal and interest by the full faith and credit of the U.S. government. When a government account needs to pay expenditures exceeding its receipts from the public, the Treasury must provide cash to redeem debt held by the government account. For example, according to 2004 Trustees projections, the Social Security trust funds will have insufficient tax income to pay scheduled benefits by 2018. The trust funds will begin drawing on the Treasury to cover the cash deficit, first relying on interest income and eventually drawing down accumulated trust fund assets. The government must obtain cash to finance this spending in excess of earmarked tax receipts either through increased taxes, spending cuts, increased borrowing from the public, retiring less debt (if the unified budget is in surplus), or some combination thereof.

Source: Federal Debt: Answers to Frequently Asked Questions—An Update, GAO-04-485SP (August 2004). For further information, see also “Federal Borrowing and Debt,” Analytical Perspectives: Budget of the United States Government, Fiscal Year 2005, Office of Management and Budget, February 2004.

Near-term outlook

The figure below shows the deficit outlook, as projected by the CBO, for the next 10 years under two different sets of assumptions. The first is what CBO calls the baseline.

The assumptions that must be used in the CBO baseline forecast/projection are set in law. CBO assumes that all of current law continues without change (that is, that tax cuts that are scheduled to expire do so), and that annual appropriations continue with the total growing just at the rate of inflation [i.e., discretionary spending is held constant in real terms]. This forecast is not a prediction of what will actually happen, but rather a referent point against which to measure policy changes. Under the unlikely circumstances that the baseline assumptions were actually to match policy, the unified deficit would fall slowly and inconsistently until 2011, when the baseline rules require that the temporary tax cuts in the current law are permitted to expire. After that the deficit would achieve small unified surpluses through 2015.

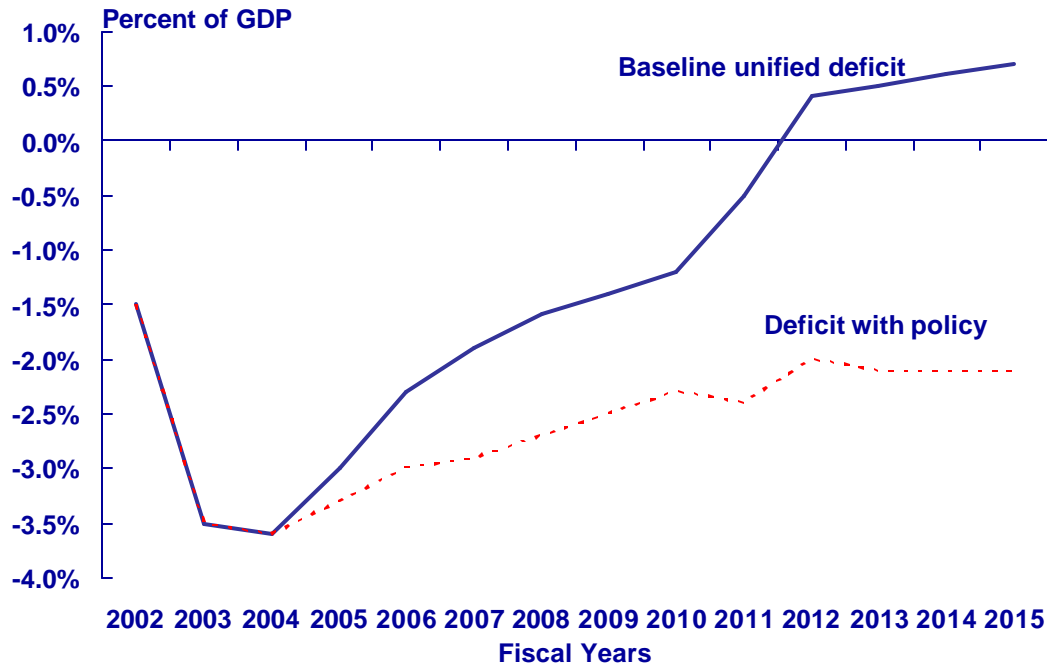
Given the near certainty that policy actions [i.e., laws] will overturn some baseline assumptions, CBO has begun to provide supplementary information describing a number of the most likely actions. The second line is developed from that information: it shows the 10-year projection under the assumptions that expiring tax cut provisions in the current law are extended, the impending bite of the current individual alternative minimum tax is eased, and the costs of the global war on terror continue but ease downward over time (whereas the baseline assumes that there will be no additional appropriations after 2004 – omitting even the supplemental appropriation already enacted in 2005). These assumptions show a deficit that never falls below \$342 billion [and never below 2.0% of GDP], and that is growing in the next decade. After 2012, the deficit is rising as a percentage of the GDP, and the accumulated public debt grows continually relative to the size of the economy – that is, our ability to repay, or even service, the debt. [**Note:** for a fuller explanation of the different paths, see CBO, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, January 2005.]

Table 1
CBO's Projected Deficits and Surpluses
Under Alternative Fiscal Policy Simulations

Percent of GDP	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
January Baseline														
Unified														
Deficit	-1.5%	-3.5%	-3.6%	-3.0%	-2.3%	-1.9%	-1.6%	-1.4%	-1.2%	-0.5%	0.4%	0.5%	0.6%	0.7%
Resulting Deficit														
Deficit														
With														
Policy	-1.5%	-3.5%	-3.6%	-3.3%	-3.0%	-2.9%	-2.7%	-2.5%	-2.3%	-2.4%	-2.0%	-2.1%	-2.1%	-2.1%

Source: The Budget and Economic Outlook: Fiscal Years 2006 to 2015, CBO (January 2005), tables 1-2 and 1-3, with computations by NAPA.

Chart 5
Projected Deficits and Surpluses as a Share of GDP
Under Alternative Fiscal Policy Simulations



Source: The Budget and Economic Outlook: Fiscal Years 2006 to 2015, CBO (January 2005), tables 1-2 and 1-3, with computations by NAPA.

In sum, although (as noted above) temporary short-term deficits are not a cause of concern, the deficits the US faces are not temporary. And the policy actions likely to be taken in the next few years mean the deficit will decline very little before it begins to rise again. Further, the ten-year budget horizon just begins to catch the budgetary stress that will come as the baby boom retires—beginning in 2008. From that point on, the outlook worsens markedly. While the 10-year outlook is important, given the timing of the demographic shift it can be misleading—and it does not tell the whole story. We must look beyond a decade to the long-term outlook.

Long-Term Outlook

As noted above, neither the current deficit nor the projections for the next 10 years would be problematic if the trend lines showed a declining deficit. The long-term outlook, however, shows an acceleration of both deficits and debt.

CBO, GAO, Concord-CED-CBPP, the Heritage Foundation, the Committee for a Responsible Federal Budget, CATO, and the Brookings Institution have all called attention to the long-term fiscal challenge facing the United States. Budget simulations that go out 20, 30 or 50 years show

rising deficits and debt—absent a change in policy. Differences in assumptions regarding economic growth rates, inflation rates, or other important parameters yield only minor differences in the outcomes. The bottom line is the same in every case: the deficit and the debt soon begin to grow exponentially and without limit.

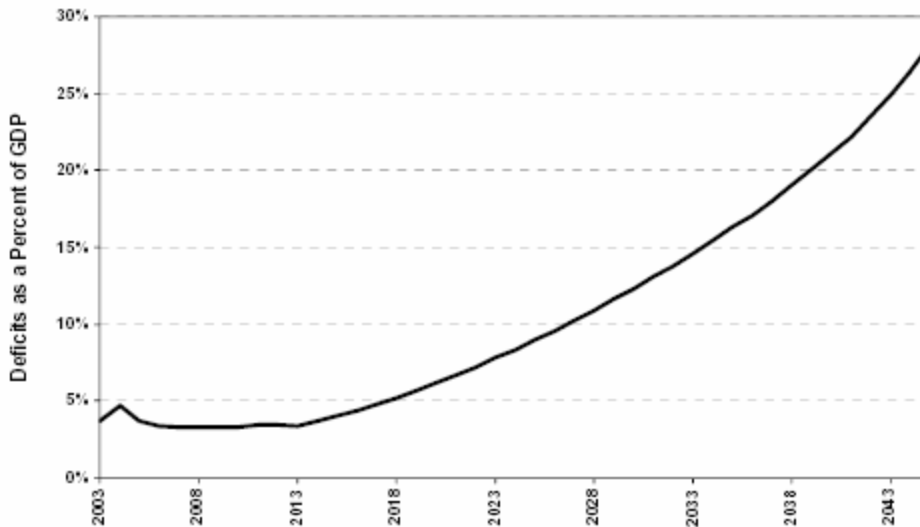
Table 2

**Long-Term Simulation Illustrating
the Unsustainability of Current Budget Policies
(As a percent of GDP)**

Fiscal Year	Unified deficit	Publicly held debt
2003	-3.7%	37%
2013	-3.4%	51%
2020	-6.2%	69%
2030	-12.3%	130%
2040	-21.1%	250%

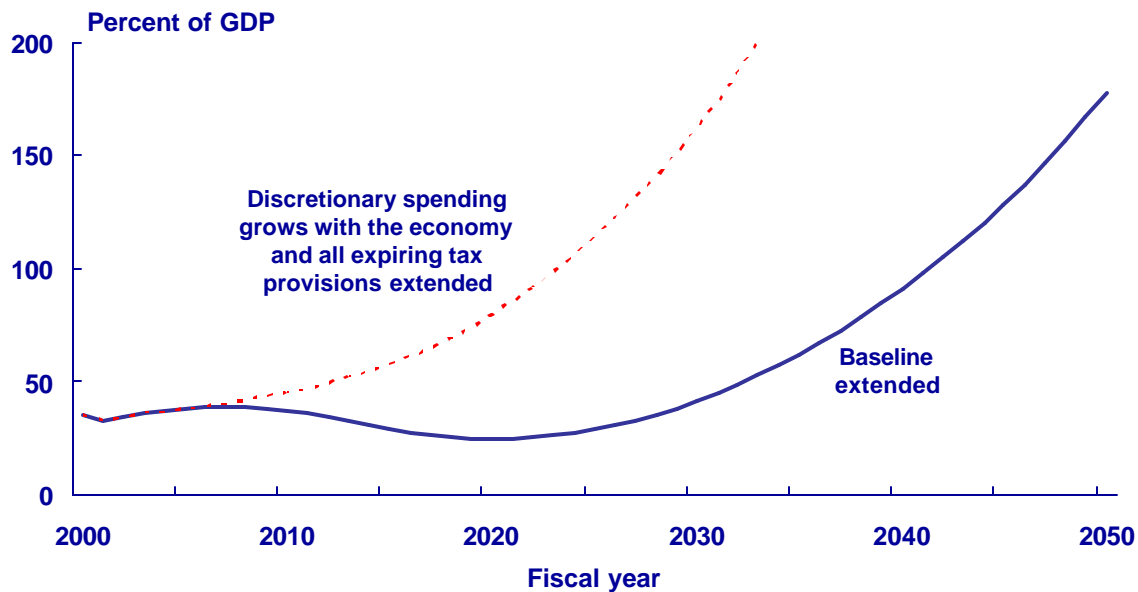
Source: CED-Concord-CBPP Mid-Term and Long-Term Deficit Projections, September 29, 2003.

**Chart 6
The Rise to Record Deficits
(Deficit as a Percent of GDP, 2003-2045)**



Source: CED-Concord-CBPP Mid-Term and Long-Term Deficit Projections, September 29, 2003.

Chart 7
**Debt Held by the Public as a Share of GDP
 Under Alternative Fiscal Policy Simulations**



Note: Assume currently scheduled Social Security benefits are paid in full throughout the simulation period.

Source: GAO's March 2005 analysis.

While all projections are uncertain, as noted above the long-term outlook is driven by trends already in place: the retirement of the baby boom generation, increased life expectancy, lower fertility rates and the growth in health care costs. These simulations are not projections—like the familiar near-term budget baseline they assume no policy action. However, their results demonstrate that action must be taken. A failure to act leads to escalating deficits and debt. Before the end point would be reached, some sort of crisis would have forced action. The challenge is to act before the crisis.

One should take little solace from Stein's Law⁶ that things that cannot go on forever will stop. Clearly, current policy and current deficit trends cannot go on forever. However, how these stop matters, crucially. Do we bring about a planned and controlled change of course, or does some crisis force a sudden and uncontrolled change with potentially destructive consequences?

⁶ Named after Herbert Stein, Chairman of the President's Council of Economic Advisers (CEA) under Presidents Nixon and Ford.

Transition: Why does it matter?...

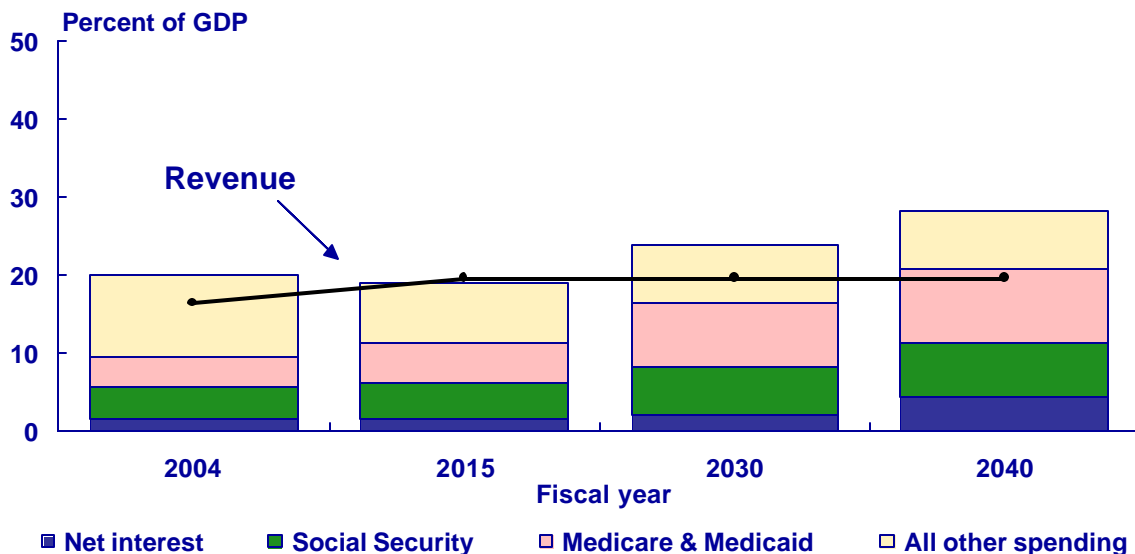
As noted in the opening of the paper, many groups have noted that continuing on this path would at least gradually erode, if not suddenly damage, our economy and our standard of living. As the federal government faces this challenge the Committee notes that the problem also has implications for governance—the ability of the federal government to respond to national needs—and for the intergovernmental system.

This is not just a matter of selfishly passing the bill on to our children and their children. Continued large deficits will hurt us—our economy, our standard of living, and our place in the world. In a recent book, *Restoring Fiscal Sanity*, Alice Rivlin and Isabel Sawhill note, “If nothing is done, the national debt is projected to increase by \$5.3 trillion in the next decade alone.” They go on to argue that “The interest on this extra borrowing will cost the average household \$3000 a year” and that the economic impact of the deficits will lower the average household’s income by about \$1800.

II. Why does it matter? Impact on governance, loss of budget flexibility

As the figure below shows, to assume no change in budget policy—and specifically, to assume no structural change in Social Security, Medicare and Medicaid—is to envision a very different federal government: one that mails checks to bondholders, Social Security recipients and perhaps their health care providers, but also one that has little revenue left to provide the kinds of everyday programs and services—homeland security, housing assistance, FBI, national parks, education, national defense, transportation, etc.—that the American people have come to expect of their government. It is also to envision a government much less able to respond to changing needs or sudden shocks. The nation did not need to debate the federal government’s commitment to the response to the September 11 attacks, because at that time there was anticipation of a substantial surplus. With a budget deficit of the magnitude that we observe today, there would be a much more wrenching concern about how to respond to a humanitarian need—or any other emergency.

Chart 8
Composition of Spending as a Share of GDP
Under Baseline Extended

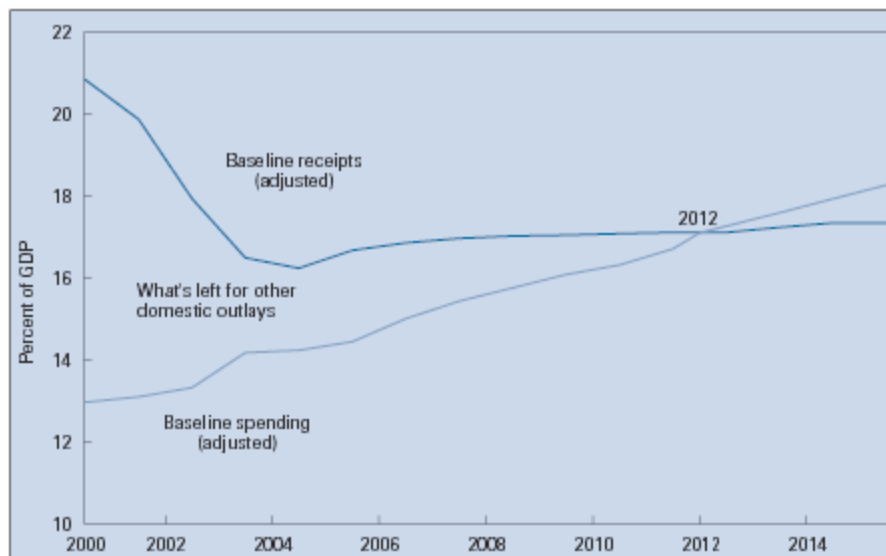


Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Source: GAO’s March 2005 analysis.

Another picture of the squeeze focuses on the declining resources available for families and children.

Chart 9
The Current Squeeze



Source: Eugene Steuerle, Adam Carasso, and Meghan Bishop, The Urban Institute, 2003. Based on data from CBO and OMB budget documents.

III. Why does it matter? Impact on intergovernmental system

In addition, having the federal government under such tight constraints and without flexibility is likely to create stresses on the intergovernmental relationship. This does not mean that a tight federal budget automatically translates into more mandates on states and localities. Rather, a federal government under sustained budget pressure would be much more likely to constrain discretionary spending that flows to other levels of government and much less able to respond to new needs or new challenges. Similarly, it would be unlikely or unable to engage in a productive discussion about how the various levels of government might work together to address challenges or issues that require cooperative effort by all more than one level of government.

- ◆ Issues to consider here might be: The assertion that in the past there has been somewhat of a dialectic: when the federal government is constrained (defined as either political or fiscal gridlock), states step up to be policy innovators; when states are constrained, such as in a recession, the federal government has resources to drive change. If both levels are constrained and facing structural deficits, then this reduces slack in the system to drive innovation and address changing circumstances.
- More than ever, the source of states' constraint is one joint federal-state program: the state share of the cost of Medicaid is over 20 percent of state budgets. As a result, if

states are to fulfill their role as partner in good faith, they must impose unprecedented and disproportionate cuts elsewhere in their budgets. So, states in some real way lose control over their own priorities based on these unique needs in our system. Whether the federal government sees the states as a fiscal dumping ground or as partners, this dynamic raises questions as to whether we have fiscally and politically viable states with capacity to respond to unique needs in our system.

- These issues are likely to be discussed more by papers and panels focused on the intergovernmental system or state and local levels of government.

IV. Solving this problem requires hard choices & big steps

- Plainly put, the United States will not simply grow its way out of this problem. While faster growth can help, we cannot avoid some difficult policy choices:
 - Simulations by two nonpartisan congressional support agencies—CBO and GAO—indicate that to keep the debt from exploding the economy would have to grow at rates far exceeding what the economy has been able to sustain over extended periods, even during the postwar booms. Both also note that growing debt will itself slow economic growth. Furthermore, the economy will be under a growth handicap in the decades to come, as the retirement of the baby-boom generations cuts sharply into the rate of growth of the workforce. Therefore, to maintain the same overall rates of economic growth, the economy will have to achieve even faster rates of growth of workforce productivity – making a commitment to solving the budget problem through economic growth an even riskier gamble.
- Furthermore, the problem cannot be solved by nibbling around the edges with marginal across-the-board changes, nor by focusing only on tax increases or spending cuts.
 - Closing this gap with only tax increases or only spending cuts requires changes too great to be plausible.
 - GAO simulations show that balancing the budget in 2040 could require actions as large as cutting total federal spending by 60% or raising taxes to 2 ½ times today’s level.
 - Another way to look at this is the “fiscal gap”—the size of the immediate and permanent tax increase or spending cut necessary to close the gap. Over a 75 year time horizon, GAO’s simulation shows a fiscal gap of about 3 ½ % of

GDP if you assume that tax cuts sunset and discretionary spending grows only with inflation for the next 10 years; if the tax cuts are extended and discretionary spending grows with the economy that gap grows to 7 ½ %.

- Failure to come to grips with the problem in some coherent way will only increase the stress on the system over time.
 - If the federal budget is totally constrained it reduces the ability to deal with new challenges. For example, the nation would have done whatever was necessary after September 11, but our financial ability to respond was helped by the preceding three years of budget surpluses and debt buydown. Now, as the nation proceeds to what are perhaps even harder tasks – a sustained conflict with the terrorists, and protection of their many conceivable targets – the budget deficit constraint enters many policy discussions. Today’s situation, of course, is but a minor prelude to future contingencies should the deficit grow to the proportions in the projections presented above.
 - Furthermore, the rising deficit would reduce the likelihood that we would think carefully through any allocation of new assignments across levels of government; and could increase the chances of “dumping” of assignments on other levels of government or on private sector.
 - Finally, with so little maneuvering room in the budget, it would become more likely that the federal government would leave untouched and unchanged too many programs and activities. With too much pressure on the annual appropriations for core functions of government, it would become unfortunately likely that the congressional process would take the institutionally least painful course: delaying final action, and ultimately passing bills with across-the-board cuts and little oversight or policy innovation. These broad across-the-board spending cuts—often invoked in the name of “fairness”—can be the least fair approach. Further, they could lead to the creation of a “hollow government”—under which vital but seemingly work-a-day government functions are de-funded to the extent that they cannot come close to meeting their objectives.
 - Extreme budgetary stress can lead as a path of least resistance to across-the-board cuts, implicitly taking as “given” current programs or activities with simple reductions of the prior year’s funding levels. This would not be sustainable in the long term. A fundamental reexamination of all programs and activities—what does the government do and how—is needed.

V. What must be done?

There are no easy solutions to the fiscal challenge facing the nation. But policymakers —and the public — must begin now to confront openly and honestly the difficult trade-offs that are required to restore a sustainable fiscal policy.

It is vital that this process begin very soon. As noted earlier, the first of the baby-boom generation, those born in 1946, will begin to collect reduced social security benefits at age 62, in 2008 – a scant four years from now. That same knife edge of the aging population will reach the eligibility point for Medicare in 2011 – just three years later. But deficits since 2002 have been large enough to raise the ratio of the nation’s debt to its GDP – that is, its ability to service and ultimately to repay that debt – and according to CBO’s projections with likely near-term policies, the deficit will remain in that rising-debt danger zone indefinitely. The longer the nation waits to face up to this problem, the more debt will have accumulated, and the heavier the burden of the ultimate adjustment will be.

As noted above, this problem is too big to be solved solely on the spending side or the tax side of the budget:

- In other words, regardless of the assumptions used, all simulations indicate that the problem is too big to be solved by economic growth alone or by nibbling around the edges of established tax and spending policies. A more fundamental reexamination of tax and spending policies and priorities is needed.
- It is not NAPA’s role to recommend or even necessarily to discuss particular policy options. Many partisan and non-partisan organizations, and many voices in government, have presented alternative policy “menus” or expressed their views on these choices. However, NAPA can and should help the body politic to recognize the problem, and to find the way to make the best possible decisions. NAPA can help create a situation in which it is understood that both tax and spending policies must be “on the table”—at least at the beginning of the “conversation.” It can help with the development of processes that bring forth the important decisions and present a better view of the costs of decisions.
- The nation needs a real discussion about basic elements of the problem and the potential solutions, such as:
 - What do we, collectively, want from government, and what are we willing to pay for it?
 - What share of the economy and the budget should be devoted to the elderly, to their health, and to the young, and their education (among many other choices)?
 - What government programs are outdated? What programs respond to problems that have already been solved, or address circumstances that have since changed? What programs address problems that have now fallen to lower priorities among national issues?

NAPA would not discuss specific options; but would raise these key issues, and facilitate their debate and resolution.

V. **Needed: better communication & engagement**

For the necessary national conversation and debate to happen, we need better ways of communicating the problem and engaging a broad range of people....We see the following as needed elements:

- Improved understanding of the nature of the problem, and of the composition of the budget. The dialog is significantly hindered by the widely held but mistaken preconceptions—that the deficit can be eliminated by cutting “foreign aid,” or “welfare,” or —“waste, fraud and abuse.”
- A more realistic view of the potential role of increases in economic growth, and of the efficacy of apparently painless policies to achieve it.
- A better understanding of why the deficit problem matters, and how it could affect their lives adversely if it is not addressed.
- Better measures for both the American people and their policymakers of:
 - the size of the problem, particularly in its multi-year dimension: how the apparently benign current situation bears all of the makings of an extraordinarily painful and politically divisive future; and
 - the impact of particular choices over the long term and on other levels of government.
- Broader education on the nature of the problem and why it matters—including a better understanding of the relations between taxes and services—for the many citizens whose understanding of these and other economic issues is limited.
- Finally, a process at the governmental level for discussing choices.

NAPA is well-positioned to contribute to this essential task. In particular, NAPA has important collective expertise on policy-making processes within government, and on the process and fiscal-policy aspects of relations between levels of government. The stakes are almost immeasurably high. This project therefore has the potential to make an important contribution to the public good, for years and even generations to come.

