



# FACING FACTS QUARTERLY

## A Report about Entitlements & the Budget from The Concord Coalition

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### Why Economic Recovery Requires Confronting the Long-Term Fiscal Challenge

In this hour of financial emergency, the prevailing wisdom in Washington is that any effort to control the long-term growth in entitlement spending must be deferred as we apply whatever fiscal stimulus is needed to jumpstart the economy. In other words, fiscal discipline can be pushed to a distant back burner.

The prevailing wisdom is mistaken. As the financial markets and economy continue to deteriorate, it is becoming clear that our most critical near-term challenge is not crafting the optimal stimulus package, but restoring public trust. This in turn requires the government to take credible steps to reduce the massive unfunded benefit obligations in the federal budget. Our long-term fiscal challenge must be confronted in tandem with the near-term economic challenge. If it isn't, measures to address the current crisis may be largely ineffective.

The long-term budget outlook was already unsustainable before the crisis hit—and now it will become even uglier. Ordinarily, people might be willing to look the other way. But today everyone has been hyper-sensitized to financial chicanery, public as well as private. Global investors are questioning the underlying worth of every asset and projected end game of every debtor. At a time when everyone is fleeing toward quality, we would be foolhardy to suppose that a government that keeps raising its projected debt trajectory without a thought about the future cannot lose credibility. It doesn't help that the shadow now looming over our federal budget bears such a striking resemblance—the dubious accounting, the lack of transparency, the official complacency—to the shadows that loomed over so many giant companies that are no longer with us.

There's another, more fundamental reason why the long-term deficit problem must be addressed at the same time as the near-term financial emergency. The two problems not only have structural similarities, but are causally related. The tens of trillions of dollars in unfunded retirement and health-care promises that the federal government has made to U.S. households have themselves helped to create the current crisis by tilting our economy toward consumption and away from savings.

To be sure, everyone recognizes that getting the economy growing again may require a huge dose of fiscal stimulus. President-elect Obama is correct that we need to "spend money now" and that "we shouldn't worry about the deficit short term." However, we had also better legislate a firewall against the long-term deficit—and we had better do it near the beginning of the next administration.

The stock market and housing market bubbles have burst. But there's another and much larger bubble that is still growing—the entitlements bubble. If America is to emerge from the current crisis with its economic prospects restored, it will have to restructure and rebalance its economy. It will have to raise savings and reduce debt on all balance sheets—household, business, government, and foreign. This cannot be done without tackling entitlements.

### A Perfect Fiscal Storm

America stands on the cusp of a new era of relentless fiscal pressure. For the past quarter century, experts have warned that federal entitlement spending would begin a steep upward climb as the leading edge of the baby boom generation passed the threshold of old age. With the first boomers qualifying for Social Security early retirement benefits this year, that once-distant future has arrived.

Over the next ten years, between 2008 and 2018, the CBO projects that federal spending on Social Security, Medicare, and Medicaid, the three major entitlement programs, will grow by 2.1 percent of GDP. Between 2018 and 2040, when the boomer retirement is in full swing, it is

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### ISSUE IN FOCUS

*by Neil Howe and Richard Jackson*

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projected to grow by another 6.0 percent of GDP. We could try to pay for the spending growth by raising taxes—but that would ultimately require doubling federal income tax rates. We could also try to pay for it by cutting other federal spending—but that would ultimately require zeroing out the federal government's entire discretionary budget, from the national parks to national defense. In the end, absent entitlement reform, the result will be widening deficits that undermine national savings and economic growth.

Back in the 1990s many hoped that the United States would accumulate large near-term budget surpluses while boomers were still in the workforce that could later be drawn down to help finance their retirement. Alas, that didn't happen. We now face the on-rushing age wave with a budget that is already deep in deficit—and that is sinking deeper day by day.

The latest CBO *Budget and Economic Outlook*, published in September, projects a deficit of \$438 billion for the 2009 fiscal year that has just gotten underway. Although the ink is hardly dry on the report, this projection is already hopelessly out of date. It didn't anticipate the severity of the

recession, which will push up safety-net outlays and pull down revenues. It didn't count the bail out of Fannie Mae and Freddie Mac and the passage of the Troubled Asset Relief Program, or TARP, with its \$700 billion price tag. Nor did it include President-elect Obama's promised fiscal stimulus package, which may total another \$700 billion.

Even conservative estimates now suggest that the deficit will reach at least \$1 trillion in 2009, which would not only be more than double the previous record in dollars, but would also constitute a new postwar record as a share of GDP. If the recession proves to be as deep and lingering as many economists fear, the deficit could remain in this range for several years. None of this, moreover, factors in the cost of major new domestic initiatives like health-care reform—or the likelihood that new security threats will arise in a troubled global economic environment.

Even before the current crisis, the growing awareness that America is living beyond its means, both publicly and privately, had begun to erode confidence in our long-term economic future—and prompt warnings from international agencies like the IMF about the “irresponsibility” of U.S. fiscal policy that are usually reserved for developing nations. Up to now, however, the assumption was always that America could still change course before the age wave rolled in. The huge spike in the near-term deficit combined with the magnitude of the long-term cost spiral has created a perfect fiscal storm that now makes observers wonder if America will ever get its fiscal house in order.

### “Super-Subprime Crisis”

Even more worrisome than the projected deficits themselves is the possibility that global investors might respond to them before U.S. policymakers. Appearances matter, and unfortunately there are many disturbing parallels between the time bombs that are detonating in our financial system and the entitlements time bomb that is about to explode in the federal budget. David Walker, former U.S. comptroller general and president of the Peterson Foundation, likens the looming fiscal meltdown to a “super subprime crisis.”

There is the same lack of attention to who bears the ultimate cost and risk. As Walker explains, “Just as originators of mortgages let themselves off the hook by unloading packages of dubious loans onto others, lawmakers have increased spending, expanded entitlements, and cut taxes while expecting future generations to pay the bill.” There is the same misleading accounting, with trust funds that consist of nothing but IOUs the government has written to itself counted as genuine savings. There is the same lack of transparency, with entitlement obligations showing up nowhere on the federal government's official balance sheet. And there is the same abdication of effective government oversight. Absolutely nothing in the budget process requires Congress to review the budget outlook beyond the next ten years, much less take corrective action.

There is, however, one crucial respect in which the near-term financial crisis and long-term fiscal crisis differ: their magnitude. To be sure, the financial crisis is huge. According to IHS Global Insight, roughly \$9 trillion in U.S. household net worth has already been wiped out since September 2007—and it is by no means clear that all the air has

yet escaped from the housing market and stock market bubbles. Yet however high the ultimate cost of the financial crisis is reckoned, it pales when compared with the size of unfunded obligations for federal entitlement programs. One way to measure these obligations is to look at what the government is promising in benefits above and beyond what today's and tomorrow's workers and beneficiaries are scheduled to pay in payroll taxes and premiums. By this measure, the unfunded obligations for Social Security and Medicare now total \$102 trillion, or a nearly \$1 million off-the-books lien on every U.S. household. (See Concord Indicator page.)

If the new administration and Congress do nothing to restore fiscal trust, world markets may suddenly decide (exactly when cannot be predicted) that the similarities are too obvious to ignore. If U.S. Treasuries ever acquire a “junk” premium, the global financial consequences could be catastrophic.

### A More Fundamental Connection

Beyond the disturbing parallels, there's a more fundamental connection between our near-term and long-term problems. Our entitlement system, like our financial system, has helped get us into the current economic mess by encouraging overconsumption and undersaving.

The uncontrolled growth in entitlements obviously reduces national savings to the extent that it contributes to the federal deficit. When the government borrows to finance consumption, it siphons off private savings that otherwise would have financed productive investment—which is why large chronic deficits undermine the growth in living standards. It may not make much difference to the individual saver if his or her thrift ends up buying a tractor or a T-bill, but it makes a great deal of difference to the economy.

The anti-savings bias of our entitlement system, however, runs much deeper than its impact on the deficit. The accumulation of unfunded benefit obligations is itself one of the reasons that U.S. private savings is so low to begin with. After all, what's a net liability to government is a net asset to households. Because Social Security and Medicare promise future unfunded benefit income, households put less into other fully funded forms of savings.

There's more: Our entitlement system not only crowds private investment out of capital markets, it also crowds public investment out of the federal budget. Already today, entitlements account for 54 percent of federal outlays, up from just 27 percent in 1965. President-elect Obama can speak passionately about investing in new and future-oriented social agendas. But if entitlements are left on autopilot, there is no way he will be able to afford them.

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## Possible Objections

Some may object that it is impossible to address the long-term and near-term problems at the same time, since entitlement reform pushes in the opposite direction of fiscal stimulus. What the economy needs now is for households to spend more and save less—so why would we want to slam the foot on the brakes and the gas at the same time?

But actually there is no contradiction, since the fiscal stimulus and the fiscal savings would occur in different time periods. The goal is to combine near-term stimulus with confidence-enhancing changes in the long-term rules governing entitlement spending. The purpose of the stimulus is to ensure an immediate change in behavior—more spending. The purpose of the rule changes is to restore trust. Behavior of course would change too, but only gradually and with a long lag.

Another objection is that the market crash and recession have already gone a long way toward curing the economy's overconsumption bias. With trillions of dollars in household net worth wiped out, people are sure to begin saving more because of what columnist Robert Samuelson calls a "reverse wealth effect." So why would we want to pile cuts in entitlement benefits on top of that? The answer is that a wrecked financial system is hardly a desirable long-term cure for overconsumption. Everyone wants to see the markets and the economy recover. What we need to ensure is that we emerge with a higher-saving economy.

In recent years, some economists have argued that it isn't necessary for the United States to save more since we can always count on foreign savers—and particularly younger and more rapidly growing economies in the developing world—to lend us whatever we need to plug the gap between what we consume and what we produce. Indeed, this is precisely what we have been doing. But as we explained in a previous *Facing Facts*, America's current account deficit poses enormous financial and political risks—and is in any case economically unsustainable.\* We continue down this road at our national peril.

## A New Course

The Chinese character for crisis is a combination of two separate characters, one for danger and one for opportunity. Among the many dangers posed by current events, there is also reason for hope: Today's difficulties may compel us to do what we always needed to do anyway—deleverage our economy. Coinciding with a realigning election, the current crisis offers a once-in-a-generation opportunity to set America on a new and more sustainable course.

Many Washington insiders say that it is politically impossible to tackle entitlement reform at a time of pervasive economic uncertainty when Americans are worried about losing their jobs and homes. But history teaches that it is precisely in times of economic crisis that social contracts are rewritten. When government is enacting sweeping emergency measures almost daily, it becomes easier, not harder, for it to undertake necessary longer-term reforms.

It may be helpful to recall how past leaders overcame

\* See "Can Foreign Creditors Avert America's Day of Reckoning?" *Facing Facts Quarterly*, IV:1 (June 2008).

the great economic challenges of their time by combining bold near-term policy measures with fundamental long-term restructuring. With the nation in the grips of a calamitous depression, FDR created emergency jobs programs—but also put in place a safety net for America's newly urbanized industrial workforce that would take decades to mature. With the nation in the grips of stagflation, Ronald Reagan pursued a policy of drastic monetary tightening to squeeze inflation out of the economy—but also laid the groundwork for longer-term growth with a far-reaching program of tax and regulatory reform. Overcoming the great economic challenges of our time will require the same combined attention to both the near and the long term.

One obvious place to start is to ensure that emergency measures that address the financial and economic collapse do not make the long-term budget outlook any worse than it already is. The best way to accomplish this would be to require that all additional spending be strictly discretionary. At the very least, there must be no new entitlements without corresponding savings in existing entitlements or new revenues to pay for them. The economic crisis is not a reason to abandon paygo rules. Rather, it is a reason to strengthen them.

Even strict adherence to paygo, however, only prevents further damage. It may keep us from digging a deeper fiscal hole, and so constitutes an important first-line firewall. But it won't help us climb out of the hole we are already in—and we can't renew trust unless we start climbing. Reformers have long urged that some rule compel Congress to confront the long-term budget challenge. One approach proposed by the Concord Coalition is to require Congress to vote on long-term targets for federal revenues and outlays by major spending category as part of its annual budget resolution.† Process is of course no substitute for programmatic action. But by compelling both parties to go on record about their long-term budget priorities, this second-line firewall would at least focus everyone on the nature of the choices before us—and so might pave the way for cost-saving reform.

This reform could take many shapes. For cash benefit programs, we could begin to control costs by raising eligibility ages, means-testing benefits, or introducing "demographic stabilizers" that index benefits to changes in the ratio of contributors to beneficiaries—as many countries, including Germany, Japan, and Sweden, have recently done. For health benefits, we could begin to control costs by implementing a global budget for health-care spending and by researching and mandating best-practice standards.

Up to now, we have always found ways to put off the hard choices. But this time, there is no more room for delay, diversion, and denial. The economy is sinking into what may be the worst recession since the 1930s, even as the leading edge of the baby boom generation begins to retire. The net national savings rate for the year 2008 will be negative for the first time since 1934. We have finally arrived at the juncture where the nation's near-term and long-term economic challenges have become inseparable. If we don't act on both together, we risk solving neither. ■

† See "Beyond Paygo: How to Encourage Long-Term Fiscal Discipline," *Facing Facts Quarterly*, II:4 (December 2006).

Federal Budget: Debt & Deficits			Fed Outlays: FY 2008		
	Bil \$	% GDP		Bil \$	% Budg
Gross Federal Debt: End of October 2008	\$10,574	73.3%	Social Security	\$607	20.4%
Statutory Debt Limit	\$11,315	NA	Medicare	\$462†	15.5%
Publicly Held Debt: End of October 2008	\$6,303	43.7%	Medicaid	\$201	6.7%
Debt Held by Foreigners: End September 2008*	\$2,861	52.7%	Other Entitlements	\$530†	17.8%
Budget Balance in FY 2008	-\$455	-3.2%	Domestic Discretionary	\$520†	17.5%
Budget Balance in FY 2009: CBO Projection	-\$438	-3.0%	Defense	\$595	20.0%
Budget Balance in FY 2009: Concord Projection	-\$536	-3.6%	Net Interest	\$260	8.7%
10-yr Balance (FY 2009-18): CBO Projection	\$-2,313	NA	Offsetting Receipts	-\$196†	-6.6%
10-yr Balance (FY 2009-18): Concord Projection	-\$7,779	NA	TOTAL OUTLAYS	\$2,979	100%
Budget Balance in FY 2018: CBO Projection	-\$135	-0.6%	TOTAL REVENUES	\$2,524	NA
Budget Balance in FY 2018: Concord Projection	-\$1,133	-5.1%	TOTAL DEFICIT	-\$455	NA

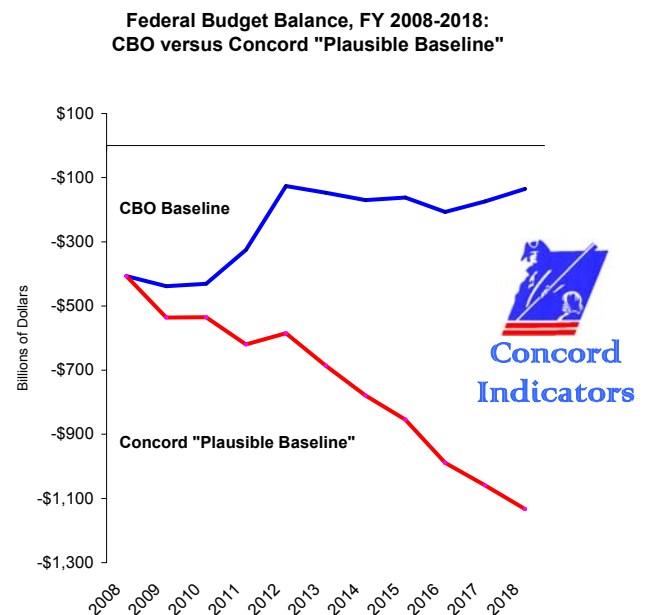
Note: All projections are based on data as of September 2008 and so do not reflect the full impact of the financial rescue or the recession. CBO projections refer to the September CBO baseline; Concord projections refer to Concord's "plausible baseline," which assumes that discretionary spending grows with GDP, operations in Iraq and Afghanistan are scaled back to about one-third of today's level, and all expiring tax provisions are extended with AMT relief. †Percent of publicly held debt. ‡Concord estimates.

GAO's Long-Term Budget Scenario* (% GDP)					
	1962	1980	2000	2020	2040
Discretionary	12.7%	10.1%	6.3%	7.9%	7.9%
Entitlements*	4.9%	9.6%	9.8%	13.4%	18.2%
Net Interest	1.2%	1.9%	2.3%	3.2%	9.7%
Revenue	17.6%	19.0%	20.9%	18.4%	18.6%
Budget Balance	-1.3%	-2.7%	2.4%	-6.2%	-17.2%
Pub Held Debt	43.7%	26.1%	35.1%	69.5%	206.6%

\*GAO Sept. 2008 update. Assumes discretionary spending grows with GDP and all expiring tax provisions are extended; entitlements are net of offsetting receipts.

National Savings (% GDP)		
	2007	3rd QTR 2008
Personal Savings Rate*	0.6%	1.1%
Net Private Savings	3.3%	2.8%
State & Local Savings	0.1%	-0.7%
Federal Savings	-1.7%	-3.8%
Net National Savings	1.7%	-1.7%
Current Account Balance	-5.2%	-4.9%
Intl Investment Position	-17.7%	NA

\*Percent of disposable income.



Note: Concord's "plausible baseline" assumes that discretionary spending grows with GDP, operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and all expiring tax provisions are extended with AMT relief.

Social Security & Medicare*	Social Security	Medicare HI	Medicare SMI	Social Security & Medicare
Payroll Cost Rate in 2008	11.2%	3.2%	2.7%†	17.1%†
Payroll Cost Rate in 2040	16.8%	7.4%	7.6%†	31.7%†
75-Year Liability (PV \$)**	\$6.6 TRILLION	\$12.7 TRILLION	\$23.6 TRILLION	\$42.9 TRILLION
Infinite-Horizon Liability (PV \$)**	\$15.9 TRILLION	\$34.7 TRILLION	\$51.2 TRILLION	\$101.8 TRILLION
Date of First Cash Deficit	2017	2007	NA	NA
Date of Trust-Fund Insolvency	2041	2019	NA	NA
Cash Deficit in Year of Insolvency (2008 \$)	-\$337 BILLION	-\$76 BILLION	NA	NA

\*Data are from 2008 Trustees reports. \*\*Unfunded liabilities are not offset by trust-fund assets. †Figures for Medicare SMI are net of beneficiary premiums. Although SMI is not financed with payroll taxes, net expenditures are shown here as a percent of payroll to facilitate comparison.