Election 2008

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Key Questions

Voters Should Ask Candidates About the Budget and Our Nation's Fiscal Future

THE CONCORD COALITION

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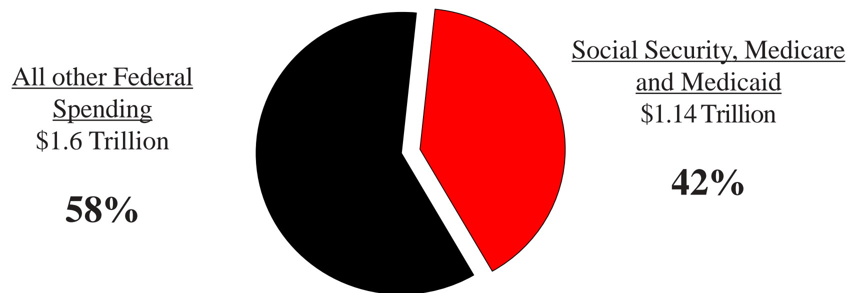
A Fiscal Wake-Up Call

Our nation is undergoing an unprecedented demographic transformation against the backdrop of rising health care costs and falling national savings. It is a dangerous combination for the future health of the economy.

The baby boomers' retirement, starting in 2008, will usher in a permanent shift to an older population — and a permanent rise in the cost of programs such as Social Security, Medicare and Medicaid, which already comprise 42 percent of the federal budget.

There is no plan to pay for it all other than running up the national debt. Some say that our political system only responds to a crisis. If that turns out to be true, we're in big trouble.

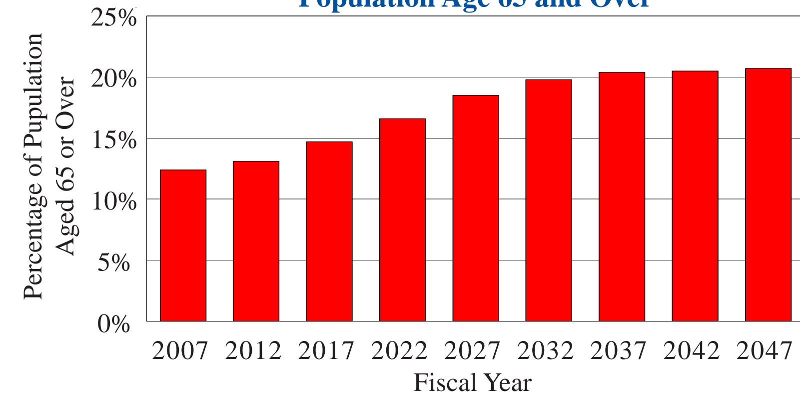
Social Security, Medicare, and Medicaid as a Percentage of the Federal Budget



Source: Congressional Budget Office, 2008

Over the next 25 years, the number of Americans aged 65 and up is expected to nearly double, growing from 12 percent of the population to 20 percent. The working age population will grow by only 10 percent over this time. As a result, the ratio of workers paying into Social Security and Medicare relative to the number of beneficiaries will fall by roughly one-third.

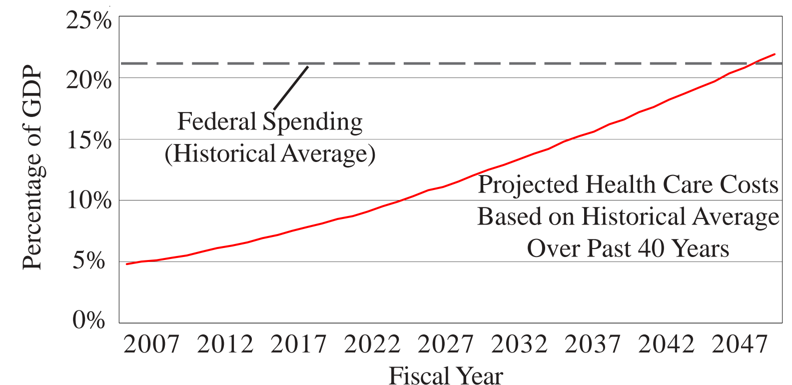
America's Population is Aging



Source: Social Security and Medicare Trustees' Report, April 2007

Demographic change, however, is only part of the problem. For the past 40 years health care spending has consistently grown faster than the economy. If the same growth rate continues over the next 40 years, Medicare and Medicaid will represent nearly as much of our nation's economy as the entire federal budget does today.

Projected Health Care Costs



Source: Congressional Budget Office, 2008

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 this would be an act of fiscal and generational irresponsibility.

Key Questions
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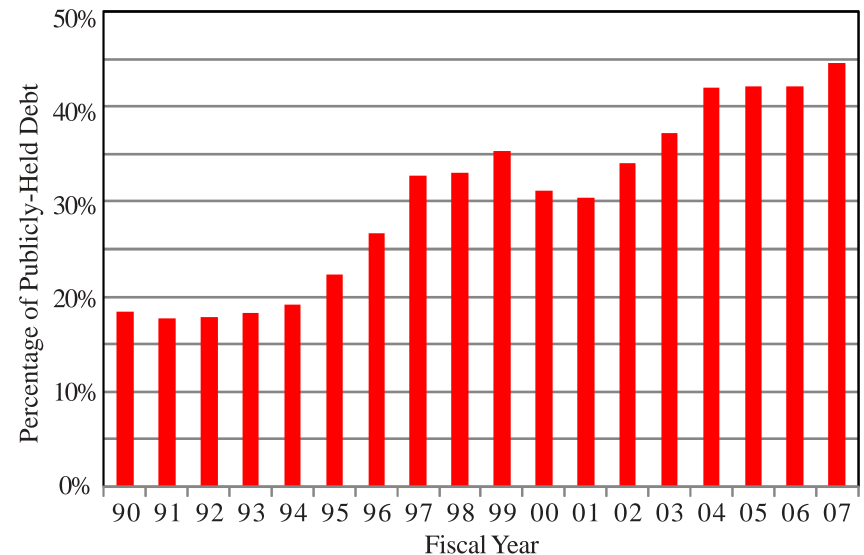
The following questions provide a framework for ensuring that candidates address some of the toughest choices they will face concerning the federal budget if they are elected. Background information is given to provide context and to help with follow-up questions, which should be asked whenever you believe that you have not been given a complete answer.

Do you believe that budget deficits matter?

If deficits don't matter then there is no reason for politicians and the public to worry about them. After all, most people would like to have more government services with lower taxes. That is why politicians often sound like Santa Claus. While many are tempted to downplay the importance of deficits in election years, it is a dangerous game. Like being drawn into an addiction, deficits are easy to acquire and hard to get rid of.

To be clear, no single year's deficit will harm the economy. It is the accumulation of large deficits, year after year, that burdens taxpayers and undermines future living standards. It does so by soaking up national savings and crowding out productive investment. It also puts upward pressure on interest rates, reduces fiscal flexibility to deal with emergencies, and raises the cost of interest payments on the national debt. Last year, the government spent $238 billion on interest payments — nine percent of the budget and roughly twice as much as was spent on military and reconstruction operations in Iraq and Afghanistan.

Government borrowing to finance budget deficits leaves less money for the building blocks of our economic future — research and development, investing in plants and equipment, transportation infrastructure, educating our children and training our workers. Borrowing from abroad is an alternative, and in fact the portion of our debt held by foreign investors has risen dramatically since 2001 — from roughly 30 percent to nearly 50 percent. However, such reliance increases the budget's exposure to international capital markets and decisions made by foreign interests.



Source: Office of Management and Budget, Analytical Perspectives, FY 2009

It also means that more interest payments on the national debt go to bond holders from abroad — draining financial resources away from the U.S economy. This acts as a growing mortgage on future national income.

Beyond fiscal imbalance, today's budget policies threaten to place ever-tighter constraints on the ability of future citizens to determine their own fiscal priorities. The United States would be in a stronger position to weather difficult times, address emerging national needs and invest in future economic growth if it had greater flexibility and strength in its fiscal position.

Do you believe that either Congress or the President has a realistic plan to balance the budget? If not, what would you do differently?

There is at least one positive thing to report on the budget front: 2007 marked the third straight year that the deficit declined (from over $413 billion to $163 billion.) This does not mean, however, that we are on a smooth and easy road back to balanced budgets. Both the Congressional Budget Office

(CBO) and the President's Office of Management and Budget (OMB) expect that the deficit will exceed $400 billion this year.

President Bush and the Democratic leaders of Congress share the goal of balancing the budget by 2012, but there is reason to be skeptical that they are prepared to make the necessary trade-offs required to achieve that goal. Both rely on optimistic assumptions.

On the spending side, both plans understate likely costs of operations in Iraq and Afghanistan. Through 2007, Congress has approved more than $600 billion for these efforts. The President has asked for another $197 billion in 2008. Beyond that time, his budget simply contains $70 billion for 2009 and nothing thereafter. The Congressional budget plan also incorporates this assumption.

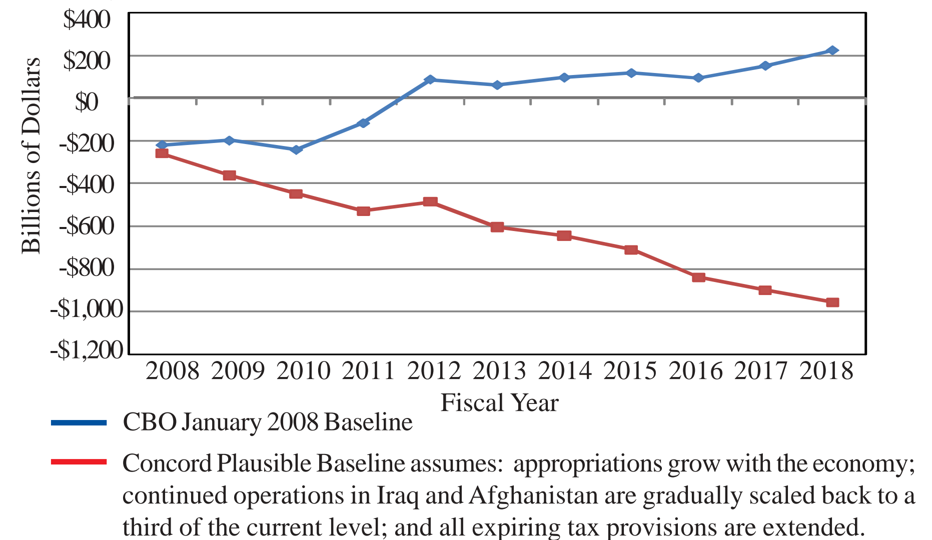
Both plans also assume that regular appropriations for everything else the government does will grow more slowly than they have in recent years. In fact, the President essentially assumes a five-year freeze on non-security appropriations. Congress assumes a modest increase in the next few years but far less than recent trends. Such fiscal austerity is much harder to achieve in practice than it is in theory.

On the revenue, side both plans assume an unlikely windfall of roughly $300 billion over five years from the Alternative Minimum Tax (AMT). The AMT was orginally intended to prevent the very wealthy from avoiding taxation. However, it is not indexed for inflation and if not adjusted will apply to roughly eight times as many taxpayers by 2010 as it does today — in effect becoming a backdoor tax increase taking away benefits of the recent tax cuts.

Based on experience, a more plausible outlook than these budget plans would assume:

- a phase-down, but not phase-out, of funding for Iraq and Afghanistan.
- that regular appropriations grow at the same rate as the economy.
- that all expiring tax cuts are extended.
- continuing relief from the AMT by adjusting it for inflation.
- debt service cost on the above changes due to added borrowing.

Current Policy Trends Lead to Large Sustained Deficits



Source: Congressional Budget Office and Concord Coalition Analysis, Feb. 2008

Under that scenario, there would be a deficit of $485 billion in 2012 rather than a small surplus. The cumulative deficit over the next 10 years would total $6.4 trillion. These deficits would drain national savings, raise the debt to GDP ratio and increase interest costs at the very time when we should be doing the opposite in preparation for the fiscal challenges that loom in the following decades as demographics and health care costs run up projected spending.

Each annual deficit adds to the total national debt. The government's debt held by its outside creditors (debt held by the public) is currently 36 percent of GDP. Under the scenario outlined above, debt held by the public would reach 48 percent of GDP by 2017 and heading sharply higher. 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.

One strategy for improving the near-term budget outlook would be to identify savings from wasteful and unnecessary programs, improve efficiency and eliminate narrowly targeted tax breaks that add to the

complexity of the tax code without producing any meaningful economic benefit. Such political "pork" diverts resources from more pressing national needs and increases public cynicism about the fairness of the federal budget process.

Similarly, there is the potential for increased revenues by pursuing strategies to close the so-called "tax gap" — the difference between taxes that are owed and the revenues that are actually collected. The Internal Revenue Service estimates that the tax gap is about $300 billion.

However, such seemingly painless options will not be nearly enough to get the job done. A serious effort to address the deficit will require policymakers to tackle the underlying structural problems resulting from existing entitlement and tax laws.

The CBO has warned, "as the percentage of the population age 65 and older continues to increase, spending for Medicare, Medicaid, and Social Security will, under current law, exert such pressure on the federal budget as to make the current path of fiscal policy unsustainable. As a result, CBO concludes, "substantial changes in federal spending and tax policies will be necessary to maintain fiscal stability."

Do you support budget enforcement laws such as caps on annual appropriations and a pay-as-you-go requirement for tax cuts and entitlement expansions?

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 backbone 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 laws were an important part of bringing the budget back into balance from 1998 through 2001. They were allowed to expire in 2002, just as the budget was slipping back into deficit.

Last year, Congress took a positive step to bring back PAYGO budgeting by enacting parliamentary rules, but stopped short of writing these rules into law. Congress thus gave itself a mechanism that could be waived by a majority vote in the House and 60 votes in the Senate. Statutory PAYGO would put additional teeth into the PAYGO rule by establishing a mechanism that could not be so easily overridden. It would also restore the "sequestration" process which required an across the board cut to make up for any violation of the caps or PAYGO law.

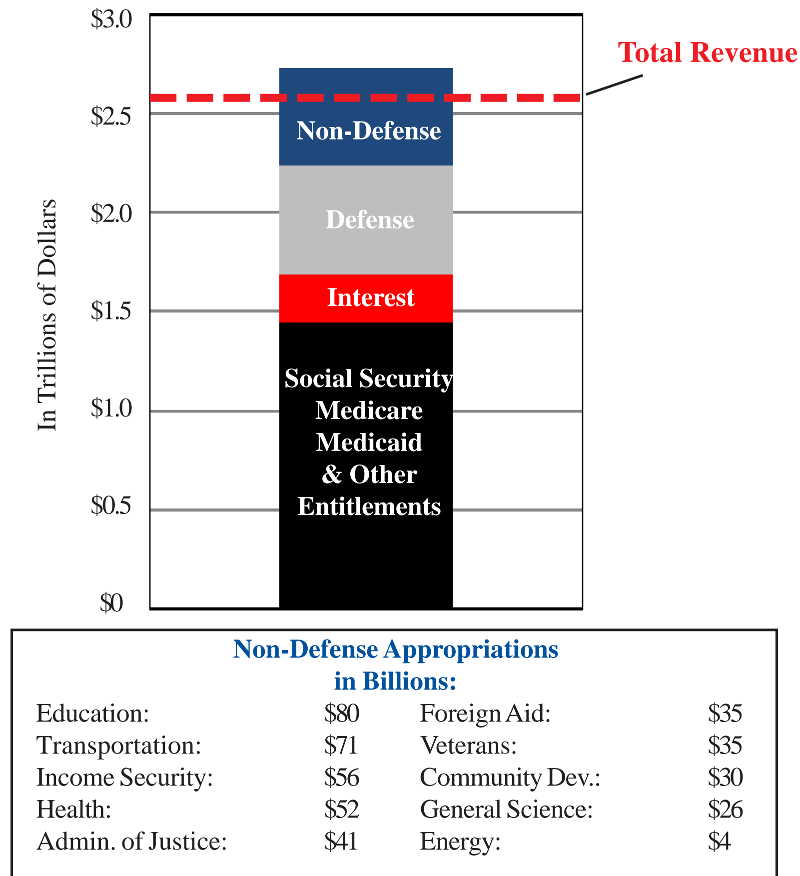
Some PAYGO proposals would exempt tax cuts. However, the common sense way to restore fiscal discipline is to apply budget rules to all legislation that would increase the deficit. Since spending and tax decisions both have consequences for the budget, there is no good reason to exempt either from enforcement rules. Moreover, exempting tax cuts from PAYGO would encourage an expansion of so-called 'tax entitlements' where benefits are funneled through the tax code rather than by direct spending. In addition, exempting tax cuts from PAYGO rules would encourage the false notion that debt is a painless alternative to taxation.

What specific spending cuts would you propose to help balance the budget?

Politicians often talk tough on spending without mentioning what programs they would cut. This is a convenient way to avoid making hard choices. Evaluating how serious a candidate is about spending restraint requires some perspective on the dimensions of the problem.

If Congress had been required to balance the budget last year without raising taxes, it would have had to enact a 10 percent cut in all federal programs — not an easy task. But if Social Security, Medicare and Medicaid were exempted, the cut would have been nearly 20 percent. If national security programs were also exempted the cut to all other programs would have been over 30 percent. These numbers demonstrate that exempting popular programs from fiscal scrutiny is not a viable strategy for balancing the budget and that simply cracking down on everyone's favorite target, "waste, fraud and abuse," is not enough to get the job done.

Composition of the Actual FY 2007 Federal Budget



Non-Defense Appropriations in Billions:

Education:	$80	Foreign Aid:	$35
Transportation:	$71	Veterans:	$35
Income Security:	$56	Community Dev.:	$30
Health:	$52	General Science:	$26
Admin. of Justice:	$41	Energy:	$4

Source: *Office of Management and Budget, FY 2009.*

It is impossible to cut spending without cutting something that someone wants in the budget. If everyone insists on only cutting someone else's priorities, talk about deficit reduction will remain just that.

Historically, the American people have been extraordinarily willing to sacrifice in order to better equip the nation for whatever challenges it faced. During World War II and the Korean War, Presidents Roosevelt and Truman proposed major cuts in domestic spending while raising taxes substantially. Very few political leaders ask for sacrifice now, even in a time of war. We need to again make hard choices that will allow us to confront challenges without passing all the costs to future generations.

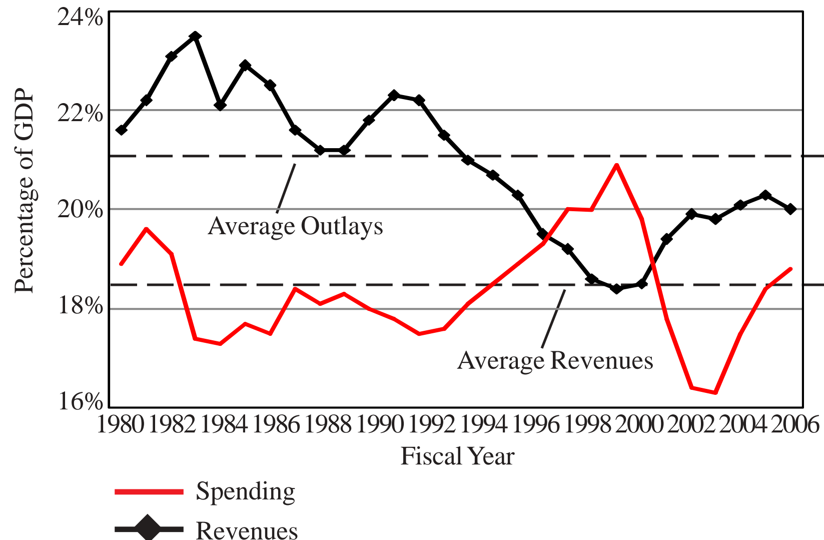
The tax cuts passed since 2001 are set to expire by 2011. Do you support extension of the expiring tax cuts and, if so, how would you address the budgetary implications?

Since January 2001, Congress has enacted four tax cut packages with "sunsets" that cause most of them to expire at the end of 2010. Circumstances have changed dramatically since the bulk of these tax cuts were enacted. The surplus era has been replaced by deficits, and the budget faces new demands for the war on terrorism and homeland security. In light of this, it makes sense to reassess whether we can afford to continue all of the tax cuts enacted in the surplus era.

New legislation is required to extend the tax cuts. The Congressional Budget Office projects that extending all of them would cost $3.4 trillion over the next 10 years. This will present tough choices for Congress and the President. To avoid a significant increase in the debt, they will either have to make substantial spending cuts or raise other revenues. Among the most prominent provisions set to expire are the reduction of income tax rates, the capital gains rate reduction, repeal of the estate tax, and relief from the Alternative Minimum Tax.

Some politicians argue that tax cuts do not increase the deficit because they pay for themselves through greater economic growth. This alluring claim is not supported by economic theory or actual experience. Economic growth has not been unusually strong since the recent tax cuts were passed. In fact, it has often fallen short of projections. Moreover, a Treasury Department study in 2006 estimated that positive economic feedback from extending the tax cuts would offset roughly 10 percent of the revenue loss and then only if matched by spending cuts.

It is true that revenues are at "record" levels if inflation is ignored, but adjusted for inflation 2007 revenues are roughly equal to 2000 revenues. Setting a dollar record for revenues is not remarkable — revenues almost always set a record every year because they naturally increase with inflation, economic growth and other factors. What is remarkable is that revenues *did not* set a record in the four years after the tax cuts were passed in 2001. Between 2001 and 2003 revenues actually declined for three years in a row for the first time since the 1920s.



Source: Congressional Budget Office, Jan. 2008.

Measured as a share of the economy revenues are still substantially lower than before the tax cuts were enacted.

Taxes and spending cannot be considered in isolation from one another. The revenues lost by extending the expiring tax provisions must be weighed against the fact that policymakers have not taken action to prepare for the costs of the baby boomers' retirement and health care needs which will begin to place a growing strain on the budget in the years ahead. Ironically, the first baby boomers will qualify for Medicare and full Social Security retirement benefits at age 65 in 2011 — the very year when the tax cuts are set to expire.

How do you propose to keep Medicare from overwhelming the federal budget?

Medicare costs are projected to grow faster than the economy, and faster than can be reasonably supported by the federal budget. Health care prices have outpaced overall economic growth since 1960. This phenomenon greatly compounds the growing fiscal problems associated with the rising number of beneficiaries. Unless health costs slow, by 2050, the cost of Medicare and Medicaid as a share of GDP will be roughly the same as the entire federal budget today.

Putting Medicare 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.

Here are some criteria for evaluating candidates' reform proposals:

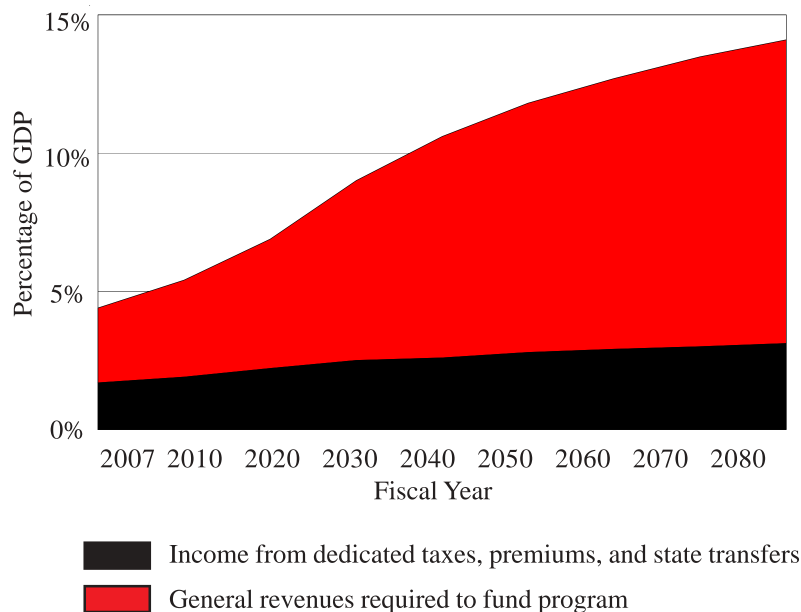
1) Scope of benefits: Medicare should cover a level of care commensurate with the care available to working-age people. This does not mean that taxpayers must be expected to finance a "high option" insurance plan for all seniors.

2) Fiscally responsible: 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 is not fiscally responsible.

3) Income-related cost sharing: As a group, seniors enjoy a better income and less poverty than other age groups, particularly children. Therefore, Medicare's premiums, which help fund Parts B (physician care) and D (prescription drugs), should be geared to income levels. Currently, premiums cover only 25 percent of costs for Parts B and D. General tax revenues cover the rest. Payroll taxes only cover Medicare Part A (hospital insurance). Given the large general revenue subsidy and the need for long-term savings, beneficiaries who can afford to pay more of their fair share should do so.

4) 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 cost-effectively. 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.

Medicare Income and Costs as a Percent of GDP



Source: Report of the Medicare Trustees, 2007

Businesses run on "best practices." Medicare does not. Many studies have shown that comparable patients receive very different care — at very different costs — depending on where they get care, because of different styles of practice from one region to another, or even from one hospital to another. Better targeting of recourses could lead to substantial savings. Over one five-year study period, Medicare could have saved $1.7 billion in the Los Angeles area alone, if the resource-intense hospital care there matched the pattern of care in lower cost areas of the state.

The most striking finding from these comparisons of costs among regions is that higher spending and more resource-intensive care does not produce better patient outcomes. For policymakers, the key point is that there are choices in the way care is delivered and that the most expensive choice is not necessarily the best — not for patients, and not for society. Any package of reforms should include greater attention to research on the comparative effectiveness of treatments and incentives for patients and providers to use the results of such research in making decisions on the best care.

Health benefit spending on the elderly will continue to grow far faster than the economy so long as we pretend that costs can be controlled without any sacrifice. Costs aren't just rising because of inefficient or wasteful medical services. They're rising because medical science can do more for more people — and because what it can do is often very expensive. Ultimately our nation must decide what level of health care we wish to provide as an entitlement and how much we are willing to pay for it. Americans have yet to confront this choice.

Putting Medicare on a fixed budget would be one way to compel trade-offs. If program costs exceed targeted levels, Congress and the President would be required to take corrective action. If it is decided that program costs should be permitted to increase, (for example, by filling the prescription drug "donut hole" or adding long-term care coverage) then fiscal responsibility demands that an equal stream of revenue be identified to pay for the higher expenses or savings be found elsewhere.

Ultimately, the growth in Medicare costs must be addressed through fundamental health care reform. That is no reason, however, to avoid incremental steps that make sense on their own and that can achieve substantial savings. Medicare is a leader in the health care system, accounting for 20 percent of total spending. If the next President, with the help of Congress, can agree on meaningful Medicare reforms, it may well lead the way for necessary reforms of the broader health care system.

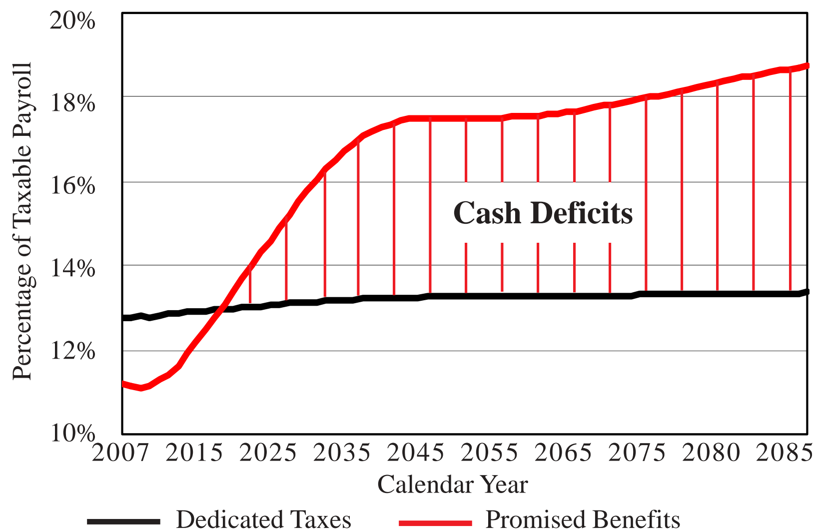
What steps would you take to close Social Security's long-term funding gap?

Over the next 30 years, Social Security will place a mounting burden on the budget and the economy. By 2035, the program's projected annual cost of $1.4 trillion (adjusted for inflation) will equal 6.3 percent of GDP an increase of roughly 50 percent.

It is true that the Social Security trust fund shows a positive balance through 2040. However, trust fund solvency is a misleading measure of the program's long-term viability. Social Security cannot be viewed in isolation from the overall federal budget. The trust fund is simply an accounting device keeping track of the program's claims on general revenues with "assets" consisting of Treasury IOU's. It says nothing about how society will meet the growing fiscal burden reflected in those trust fund balances. The key point is that the trust fund assets are also promises to spend future tax dollars.

What matters fiscally and economically is Social Security's cash balance—that is, the annual difference between outlays and earmarked tax revenues. Social Security will begin running annual cash deficits in 2017. Between 2017 and 2040 the U.S. Treasury will have to come up with more than $4.2 trillion in today's dollars to redeem the bonds in the trust fund. In order to generate the cash to pay these IOU's, policymakers will need to cut spending on other programs, raise taxes, or borrow the money. And even then, stemming the cash hemorrhage would ultimately require cutting benefits by

Promised Benefits Far Exceed Dedicated Taxes



Source: Report of Trustees of the Social Security Trust Fund, 2007

one-third or raising payroll taxes by one-half. Thus, the existence of trust fund balances on paper does not change the fact that Social Security will place growing pressures on rest of the budget and future taxpayers as well as the economy as a whole.

Candidates who promise to preserve benefits at the levels promised under current law should explain where the money will come from to fund these promises. Likewise, candidates who promise to oppose any tax increases should explain what changes they would make to restrain the growth of Social Security costs to stay within current tax levels.

Taxation Options:

One often mentioned proposal is to make more of the earnings of higher income workers taxable. Currently, the Social Security payroll tax (12.4 percent) is capped at $97,500 of wages. This option would bring in more money, but as a means of assuring the sustainability of Social Security, it would be considerably less effective than proponents allege. It would only provide a few more years of positive cash flow to the system and, unless the link between taxable earnings and benefits were to be eliminated, it would add to the system's long-term cost by providing higher benefits to those who need them the least.

Raising taxes in some form would be more fiscally responsible than unlimited borrowing. It may also be a necessary component in any plan that is capable of winning broad bipartisan support. But before resorting to this option, candidates must carefully weigh the magnitude of the looming demands that Social Security and health care entitlements will place on the income of future workers and the economy overall. Levying higher taxes to meet rising costs could hinder an economy that will also have to cope with near stagnant workforce growth.

Higher revenues today will not reduce Social Security's future burden unless matched by a mechanism to ensure that the extra money generates increased personal savings and a larger future economy.

Personal Accounts:

One way that higher Social Security contributions could generate new savings would be if they were used to create personally owned accounts within the Social Security system. This reform could provide a more reliable method of funding benefits because the money would be beyond the reach of government. In other words, they would provide a "lockbox" no politician could pick.

However, the money to establish personal accounts must come from somewhere. To the extent that the source of funding is additional government borrowing, no new savings for the economy will result, because the increase in government borrowing would cancel out the "savings" in personal accounts. Moreover, personal accounts alone would not close the existing gap between dedicated revenues and promised benefits.

Cost saving options:

Approximately 55 percent of the rise in Social Security's cost over the next 75 years is due to an increase in the number of beneficiaries and improvements in life expectancy. The remaining 45 percent is due to a projected increase in the value of the benefits, which are indexed to wage gains rather than prices. Because wages tend to grow faster than prices over time, the "real" (inflation adjusted) value of benefits increases for each new group of recipients. Two logical ideas to gradually constrain cost growth would thus be to adjust eligibility for increasing longevity or to index initial benefit levels to price increases rather than wage increases. Neither of these options would change benefits for current recipients.

Longevity adjustments. Raising the age at which retirees are eligible for full benefits (now 66 and scheduled to go up to 67 by 2025) is logical for several reasons: 1) longevity is increasing steadily, and longer life spans mean longer, and more costly, lifetime benefits; 2) older Americans are generally healthier than in the past and can work more years, especially as jobs have become less physically demanding; and 3) in coming decades, the pool of working-age Americans will virtually stop growing, depriving our nation of this engine of economic growth. Raising the full benefit-eligibility age could help augment the labor force by encouraging older people to remain at work for a few more years.

Some proposals would raise the full-benefit age in the future. Others would set up an automatic provision, referred to as "longevity indexing," where the age to receive full benefits would increase automatically based on changes in longevity.

Price indexing. Another option would be to index initial benefits to the growth in prices for commonly used goods and services, as measured by the Consumer Price Index. This reform is simple and creates large savings. According to the most recent estimate by the Social Security actuaries, moving to price indexing would more than close the program's projected gap.

An alternative, called "progressive price indexing" would mitigate the effects of reform on low and moderately low-income workers by wage-indexing benefits for the lowest third of benefits (as under current law), phasing in an element of price-indexing for the middle third, and fully price-indexing benefits for the top third. According to the Social Security actuaries, this reform would close roughly 80 percent of the cash deficit by 2080. It would thus substantially improve the system's fiscal sustainability while preserving all promised benefits for those who rely on them most.

Options such as these often produce allegations that proponents seek to "cut benefits." However, voters should be wary of assertions about how much reform plans would reduce benefits below the level promised under current law. Current law promises more than it can afford to pay. Finding a cure for what ails Social Security won't happen without sacrifice — a reality most lawmakers have not accepted. But "painless" solutions that don't ask anyone to accept less or pay more will neither reduce the long-term cost of the program, nor contribute to a larger economy so that the remaining costs will be more affordable.

About The Concord Coalition

The Concord Coalition is co-chaired by former U.S. Senators Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). Former Secretary of Commerce Peter G. Peterson serves as President. The Concord Coalition was founded in 1992 by Rudman, Peterson and the late Senator Paul E. Tsongas (D-MA).

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