



ACHIEVING A SUSTAINABLE FISCAL PATH

A Bipartisan Effort to Address the Nation's Rising Debt





This report is dedicated to former Senator Warren Rudman (1930-2012), one of four co-chairs of the *Strengthening of America* initiative. Senator Rudman remains a hero to all who seek to protect future generations of Americans by putting the country on a sound fiscal course.



Co-chairs

Former Senator Sam Nunn (D-GA)
Former Senator Pete Domenici (R-NM)
Former Senator Warren Rudman (R-NH)
Former Senator Evan Bayh (D-IN)

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Bob Bennett (R-UT)	Jane Harman (D-CA)
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A Moment of Decision

Unless the President and Congress act swiftly, the simultaneous impact of indiscriminate spending cuts and broad tax increases set to take effect on January 1, 2013—the so-called “fiscal cliff”—will likely plunge the country back into recession.

Despite this urgency, however, there is no guarantee that the Obama Administration and lame-duck Congress will achieve a “grand bargain.” While Democrats and Republicans have at times demonstrated a willingness to compromise on a single legislative package of spending cuts and increased revenue to stabilize the federal debt over the next decade, both sides are reluctant to compromise on what they perceive as core principles.

It is almost certain that no plan enacted this month will be large enough or comprehensive enough to put the federal budget on a sustainable path. At best, it will be a “down payment” on further deficit reduction. While this would be preferable to the alternative, we must not try to avoid near-term distress by courting long-term catastrophe.

The fiscal cliff is fast approaching and must be avoided, but it is the long-term debt burden this country faces that threatens our existence as a global power. More will have to be done to bring health care costs under control. The tax code will still be in need of pro-growth reform. Social Security will still face a growing gap between benefit payments and dedicated revenues.

“I believe that our existence as a powerful nation, able to uphold the values that we hold dear, is threatened today.”

—Former Senator Pete Domenici (R-NM)



“We cannot have growth without fiscal stability or fiscal stability without growth.”

—Former Senator Sam Nunn (D-GA)

“Many of the solutions will only bear fruit ten, twenty, thirty years from now. But in doing so, we’ll strengthen our country and enrich our children’s lives. That is a true test of statesmanship.”

—Former Senator Evan Bayh (D-IN)



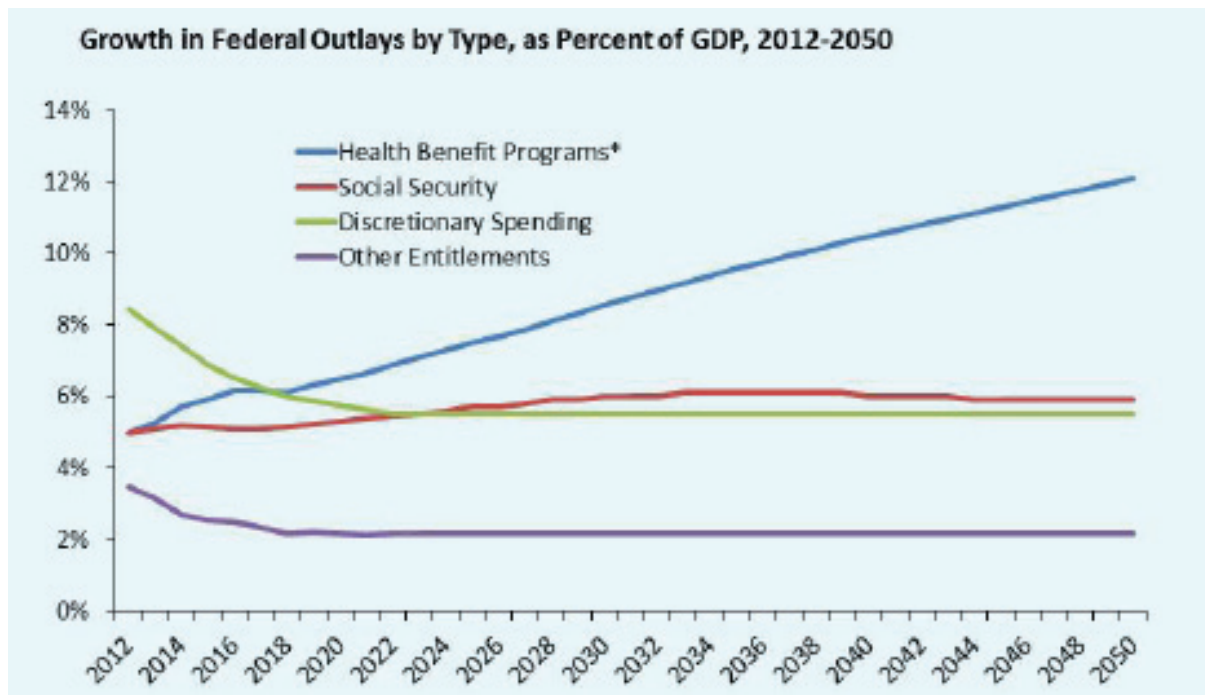
Regardless of how the fiscal cliff is resolved, the President and Congress should agree on a framework for a fiscal sustainability plan, a process for enacting legislation to fulfill the plan, and a more realistic back-up mechanism than a new “cliff” if no further progress is made.

This was our starting premise when we formed the bipartisan initiative *Strengthening of America – Our Children’s Future* earlier this year. Our goal was straightforward: to show that bipartisan consensus is both essential and possible to achieve a fiscally sustainable plan to strengthen the economy, save future generations from rising debt, and protect the nation’s security.

In September we convened four high-profile forums designed to resemble congressional hearings. The forums focused on the economic, foreign policy, and national security implications of the debt, pro-growth tax reform, the imperative of entitlement and health care cost control, and bipartisan solutions.

The point of the hearings was the same as this brief report: to present the facts to Members of Congress and all Americans in as unvarnished a way as possible to allow them to reach their own conclusions.

We are not advocating for a particular plan and do not presume to know the exact negotiating formula to get to ‘yes.’ But we do offer a clear and common call for action. America’s unsustainable debt is too important to our children’s future to leave it to those in either party committed to fixed ideology or short-term political gain.



* Includes Medicare, Medicaid, CHIP, and exchange subsidies.
Source: CBO Alternative Fiscal Scenario (CBO, 2012) and Bipartisan Policy Center calculations

“I believe that those who reject the need for revenue increases and those who reject the need for entitlement reform have the obligation to show the full specifics of an alternative whose substantive effects are fully understood and that’s politically doable.”



—Robert Rubin, Former Secretary of the Treasury

“A sovereign debt crisis can hit pretty quickly. And the longer we go on like this, the greater risk that something truly adverse will happen.”



—James A. Baker, III, Former Secretary of the Treasury and Secretary of State

To quickly summarize the five broad principles that emerged from our forums:

- 1) **The U.S. debt is a ticking time-bomb for our economy.**
- 2) **The most significant threat to our national security is our debt.**
- 3) **We cannot have economic growth without fiscal stability or fiscal stability without growth.**
- 4) **We cannot put our debt on a sustainable path without reductions in the projected cost of entitlement programs, cuts in discretionary spending, and higher revenues.**
- 5) **Solving this problem is achievable if our national leaders are willing to compromise.**

It is essential for the American public to have a greater understanding of the magnitude of the problem, the potential consequences, the trade-offs of various solutions, and the urgency of action. Debt is a silent killer, slowly eating away at our state and society. This is not a Republican debt or a Democratic debt. It is an American debt. And it requires an American solution.

Ultimately, this is a moral issue. We inherited a country with a sound balance sheet that underpinned a growing economy in which children could look forward to being better off than their parents. Unless we act now, we will pass along to our children and grandchildren a nation weighed down by unmanageable debt.

The policies embedded in the fiscal cliff were never intended to be a rational deficit-reduction plan. They are a default position designed—like a suicide pact—to force reluctant policymakers to make hard choices. So far, that has not worked.

Fortunately, there are those in Washington who put the country’s future before their political parties. Americans should get behind these courageous leaders — and soon. We can no longer afford to act out Winston Churchill’s prediction that America will always do the right thing after it has explored every other alternative. It’s time to do the right thing. ▶

Our Nation's Fiscal Challenges

AN OVERVIEW

Current fiscal policy is on an unsustainable path. Our debt-to-GDP ratio is higher than it has been since 1950 and that was when it was coming down from the height of WWII borrowing. Today, by contrast, the projection is for ever-rising debt. Within 10 years debt held by the public will approach 100 percent of GDP. It is important to note that this growth is not caused by traditional factors such as war and recession, although those factors have certainly been a factor in recent years. Instead, the projected growth is caused by a fundamental mismatch between spending promises and revenues. This is what economists call a “structural deficit” because it will persist even when the economy fully recovers and war spending subsides. That is why our first task must be to stabilize the growth of debt so that it is no longer growing faster than the economy. But note that even if we do this our debt-to-GDP ratio will still be almost double what it has averaged in the post-WWII period and the budget will remain out of balance. So, the second task must be to make sure that our fiscal plan is based on policies that will also put the debt-to-GDP ratio on a downward path.

The most direct and noticeable consequence of the growing debt on the budget is the cost of servicing that debt. We currently spend a little over \$200 billion a year on interest. However, under current policies that expense is projected to swell to over \$900 billion within 10 years. To put this number in context, consider that \$900 billion would be more than projected defense spending by the end of the decade, or alternatively, more than all domestic appropriations combined.



“Every day we delay is a day that we increase the risk and that we’re taking a chance that we don’t need to take

with the country’s financial future.”

— Lawrence H. Summers, Former Secretary of the Treasury and Director of the White House U.S. National Economic Council

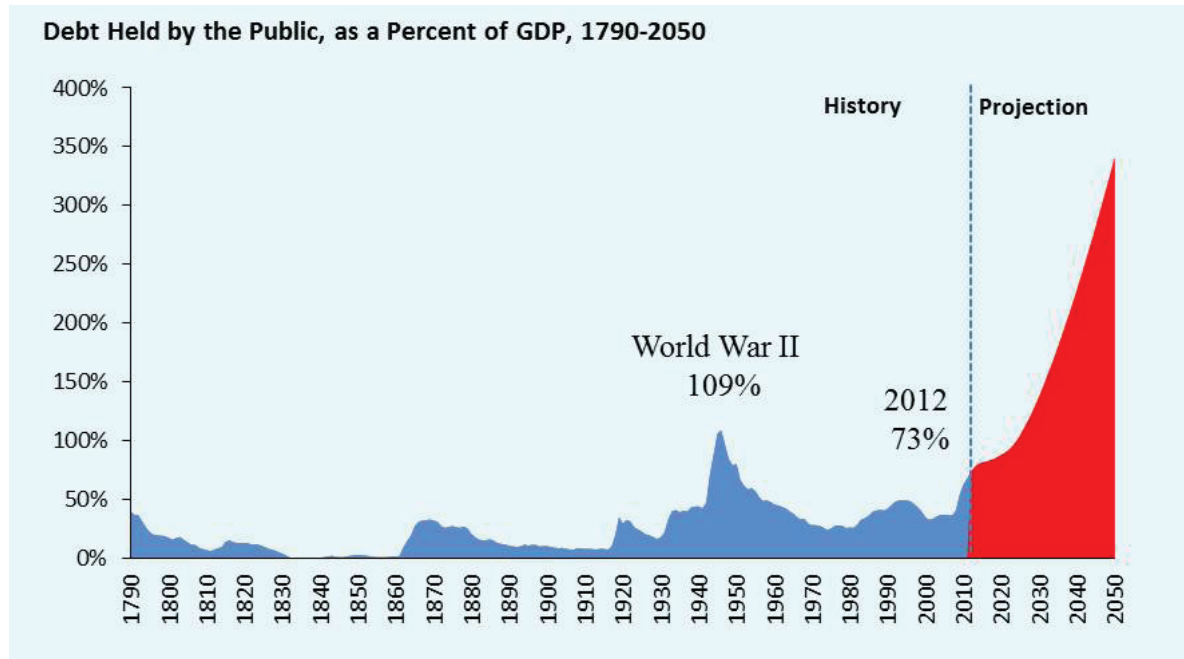
“When they say, let’s reduce government spending and not increase tax revenue,



I say, that’s a false dichotomy because much of the spending done by the federal government is done through the tax code.”

—Dr. Martin Feldstein, Former Chairman of the Council of Economic Advisers and President of the National Bureau of Economic Research

CURRENT FISCAL POLICY IS ON AN UNSUSTAINABLE COURSE



Source: OMB historical data and GAO Alternative Fiscal Scenario (GAO, 2012)

Keep in mind also that this only assumes a gradual increase in interest rates from their current rock bottom levels (below 2 percent on 10-year bonds) back to 5 percent by 2018.

If we experience a spike in interest rates due to uncertainty about the fiscal outlook interest costs would go even higher. In short, we are taking on a massive amount of new debt at very low cost today, but like “teaser rates” on consumer loans the temptation to load-up on debt now could hurt us when we have to roll over that debt at more traditional interest rates.

Looking ahead, the main cost-drivers of federal spending come from entitlement programs and interest costs, all of which run on autopilot. That is, they are not controlled annually by the appropriations process. Interest costs are determined by outstanding debt and interest rates. The entitlement programs are based on formulas written into law. They only change if Congress changes the law.

The combination of increased beneficiaries and rising health care costs will have a profound impact on federal spending through the major entitlement

programs, pushing it up by roughly 6 percent of GDP over the next 25 years. Keep in mind that the entire defense budget today is about 4.3 percent of GDP. So in the future we are on track to add an annual amount of spending that is the equivalent of more than doubling the defense budget. Or, to look on the tax side, individual income taxes would need to go up by more than 80 percent to cover the cost (today’s individual income taxes equal 7.2 percent of GDP). Thus, the main question of fiscal sustainability is how do we accommodate the projected explosion of entitlement spending? The question cannot be avoided.

The trend lines are clear. If left on autopilot, entitlement spending will continue to outpace the cost of discretionary programs, including defense, which are projected to steadily shrink as a percentage of GDP. As a practical matter, Congress will have less and less control over the budget as entitlement spending grows in cost. So while Congress often engages in pitched battles over a few billion dollars here and there for discretionary programs, it is the stealth spending spree of automatic entitlement increases that poses the biggest challenge to the fiscal outlook.



“We have to take advantage of what is an opportunity of a lifetime to reform the health care system over a period of time, but make sure that all of the stakeholders are at the table with us in the redesign of a system that needs to fundamentally be redesigned.”

—Donna Shalala, Former Secretary of Health and Human Services

“We have a doubling of the number of seniors coming in over the next 25 years, so we have more people that we have to take care of. The per capita cost is going up...And we have fewer people paying in. So the equation does not work.”

—Former U.S. Senate Majority Leader William H. Frist (R-TN)



One reason why Social Security, Medicare, Medicaid and the other health care entitlements are projected to grow in cost is simply because there will be many more beneficiaries. The share of the population age 65 and older will increase by nearly 80 percent through 2030 while the population age 20-64 will grow by just 10 percent. More beneficiaries means higher spending. It is simple arithmetic. And with the non-elderly population growing much more slowly it means fewer workers paying into Social Security and Medicare through the payroll tax relative to the number of beneficiaries.

One reason for the increased number of beneficiaries for Social Security, Medicare and Medicaid is that people are living longer. That's a good thing, of course. But we have to pay for these good things. When Social Security first began paying benefits life expectancy at birth was below 65, which was the established age of eligibility. Today, life expectancy at birth is above 76 and yet the eligibility age has been lowered to 62 for "early retirement" and is gradually being raised to 67 for full benefit eligibility. Thus we not only have more beneficiaries due to population aging but people are living longer and receiving benefits over a longer period of time, while contributing fewer years of payroll taxes.



"The differences are real across the political spectrum, but compromise is essential. And the one thing we can't afford is gridlock. We can't afford to do nothing, because everything gets worse if we do."

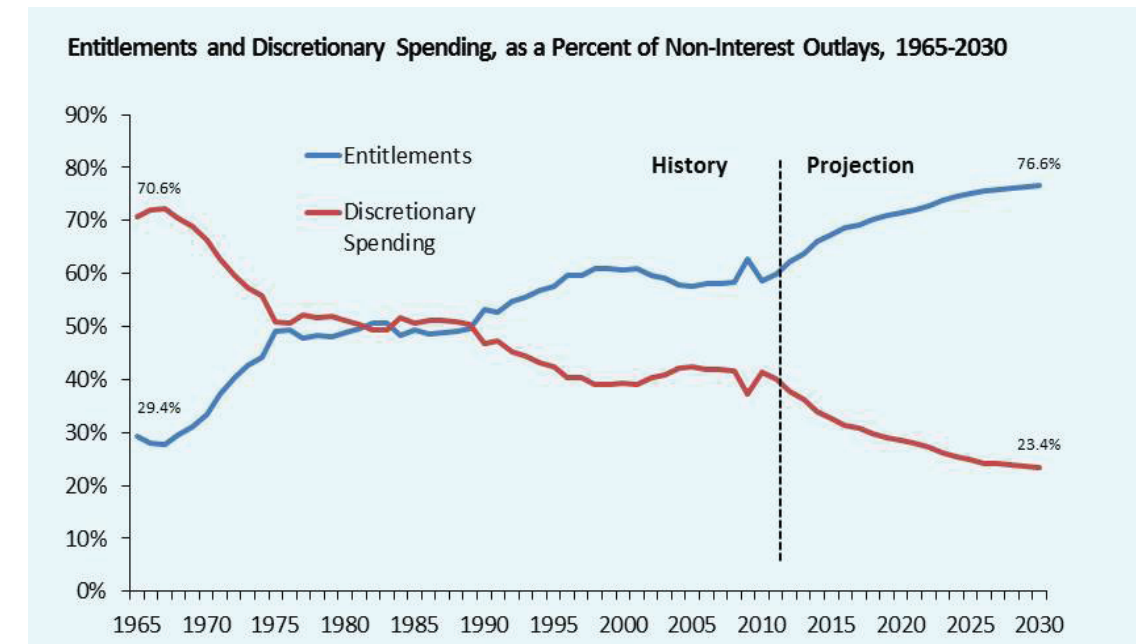
—Alice Rivlin, Former Director of the White House Office of Management and Budget

"The main reason for the explosion of the debt is spending, and the main reason for the increase in spending is the increase in health care spending by the federal government."

—John B. Taylor, Former Under Secretary of the Treasury for International Affairs



ENTITLEMENT SPENDING IS PROJECTED TO INCREASE DRAMATICALLY



Source: CBO historical data and CBO Alternative Fiscal Scenario (CBO, 2012)

Demographic factors are not alone in driving up the cost of entitlements. The second major factor is rising health care costs. The United States currently spends far more per capita on health care than other nations, often with no better, or worse, results. If we cannot find a way to provide health care more efficiently it will be impossible to control federal spending over the long-term.

We're on an unsustainable fiscal path, driven primarily by the rising cost of health care entitlements and to a lesser extent Social Security. These programs are growing because of changing demographics and rising health care costs. The problem is sufficiently large that it is unrealistic to think that we can deal with it all by just cutting other spending or by just raising taxes. We must put everything on the table and arrive at a package of reforms that is big enough to stabilize the debt-to-GDP ratio. And we must act soon to

prevent interest costs from becoming the biggest "entitlement" of them all.

We need a plan that draws on all parts of the budget, including entitlements and taxes, and it needs to be big enough to at least stabilize the debt-to-GDP ratio. The minimum amount of deficit reduction from a realistic baseline is about \$4 trillion dollars. And even that would not be sufficient unless the policies enacted to achieve that level of deficit reduction are capable of producing growing savings over time. Both size and composition matter. So too, does timing. Any plan must be phased in so as not to do harm to the fragile economic recovery. But enacting a plan now with verifiable and growing savings and deficit reduction will spur economic recovery by instilling confidence that the United States is ready, willing, and able to do what it must to get its fiscal house in order. ▶

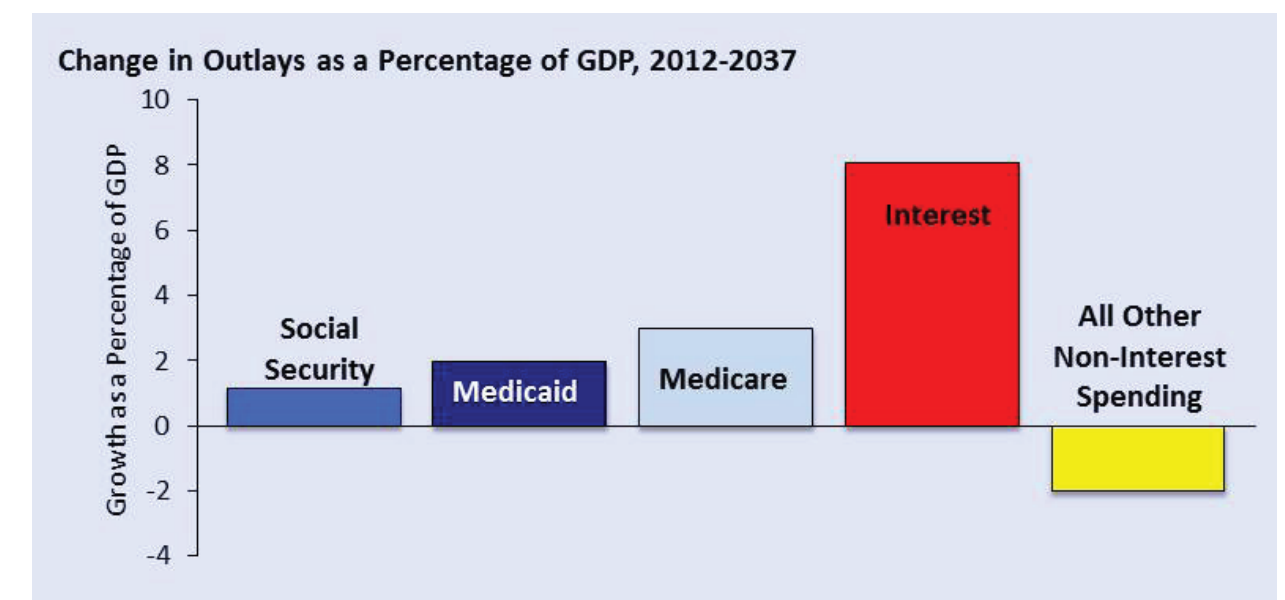
Achieving a Sustainable Fiscal Path

The following five broad principles emerged from the *Strengthening of America—Our Children's Future* forums:

1) The U.S. debt is a ticking time-bomb for our economy.

If we do nothing, we risk a prolonged period of low growth and high interest rates, flagging confidence, and quite possibly inflation, recession, and potentially eroding the dollar as the world's reserve currency. What is happening today in Europe is a cautionary example because when a sovereign debt crisis hits, it can strike overnight. A damaged U.S. economy would dampen global growth, create instability in international markets, and constrain the ability of our government to pursue an independent monetary and fiscal policy. The longer we wait to act preventively, the deeper the hole becomes, and the harsher and more protracted responding measures will have to be. If we are forced to act in response to crisis, the measures required will be far more extreme.

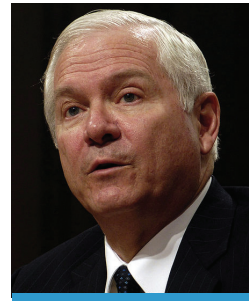
SOURCES OF GROWTH IN THE FEDERAL BUDGET



Source: CBO Alternative Fiscal Scenario (CBO, 2012)

2) The most significant threat to our national security is our debt.

A nation this far out of fiscal balance cannot hope to sustain its superiority from a military perspective or its influence in world affairs. Our inability to address our debt could cause huge and poorly targeted budget reductions in defense and result in a force that is less modern, could go to fewer places, and do less. Pilots will have fewer opportunities to fly and train, soldiers will have fewer bullets in their chamber, ships will stay in port more often, and the armed forces could slowly deteriorate over time. Both allies and adversaries are watching whether we can sustain our footprint in Asia after the “rebalance” and remain influential in a tumultuous Middle East. These commitments become impossible to sustain if we do not put our debt on a sustainable path. Perhaps most importantly, our debt and fiscal position makes diplomacy, development and “preventive defense” less affordable and more difficult. This inevitably increases U.S. and global risks.



—Robert Gates, Former Secretary of Defense

“At some point, financial insolvency at home will turn into strategic insolvency abroad.”

“Poorly targeted cuts virtually guarantee that we would end up with a hollow force, a force unable to conduct training, a force unable to maintain its equipment, and a force unable to fight, a force also unable to readily recover from the ravages of over a decade of war.”

—Michael Mullen, Former Chairman of the Joint Chiefs



“We’re living in a dream world if we think that lenders will continue to finance our growing debt at rock-bottom interest rates.”



—Alfred P. West, Chairman of American Business Conference and CEO of SEI



“We’re holding back on hiring, and we’re holding back on investing. When businesspeople look around the world, we see

all the big democracies in gridlock. And it really just does come down to: Do we still have the political will to be able to act as a great country?”

—David M. Cote, Chairman and CEO of Honeywell

“When you have no confidence in the underlying fiscal structure of your country it’s hard to get excited about putting your own



fiscal capital to work.”

—Navin Thukkaram, COO of Qwiki, Inc.

3) We cannot have economic growth without fiscal stability or fiscal stability without growth.

If you look at any projection of where our economy is or what our debt-to-GDP ratio will be ten years from now, the single most important variable is not what we do about entitlements or what we do about tax reform, but what we do to achieve growth. Achieving growth has to be a crucial part of our economic deliberations. It is a false choice to say that we can either create jobs or reduce the deficit. Confidence is the cheapest form of stimulus, and credible efforts to address fiscal sustainability will make a major contribution to increasing confidence by reducing uncertainty and providing a sense that the future is being planned for and is under control. A sensible tax system and a plan to stabilize the debt will increase economic growth in both the short and long-run.

4) We cannot put our debt on a sustainable path without reductions in the projected cost of entitlement programs, cuts in discretionary spending, and higher revenues.

The main spending drivers of the debt are Medicare and Medicaid and to a lesser extent, Social Security. We know the reasons: an increasing number of seniors and the rising cost of health care. We will double the number of seniors over the next 25 years and their per capita costs are rising. And we have fewer working-age people contributing. The equation no longer works. The simplest way to contain health care spending is to apply a cap, such as GDP plus one percent, but simple caps are not enough with 10,000 new people retiring each day. The delivery system must be addressed if we want to truly keep costs down.

Whatever the size or role of government we think is appropriate, we need to pay for it, which means higher revenue. One possible first step would be to reach agreement on how much revenue is necessary to pay for the government we require. The next step would be to try to raise this revenue through limiting tax expenditures and broadening the tax base. Much of the spending done by the federal government is by allowing deductions, credits, and exclusions in the tax code. The popularity of these expenditures cannot preclude a close examination of each one. They must all be set out with great specificity with respect to how much they cost so that Americans have a clear basis for understanding the substantive effects and political realities.

Reducing tax expenditures is not likely to be the complete answer, however, and politically achievable savings may be less than many plans anticipate. To the extent that base-broadening does not meet revenue needs, a third step will have to include increasing tax rates. The overarching principles must be, first: effectiveness in putting our debt on a sustainable pathway; and second, fairness in assuring that the burden is not born disproportionately by any single income group.

“We’ve got to do something on the revenue side and we’ve got to do something on the spending side—not only discretionary but also entitlements.”

—Former U.S. Representative Bill Gray (D-PA)



“Let’s stop the exercise of saying, I will never support a tax increase; I will never support a touch on Social Security or entitlements. We have to do what we have to do to fix the problem that we created, and that’s the bottom line.”

—Former U.S. Senator Bill Brock (R-TN)



“I know, and many of us know, that with political will we can avoid this because we’ve done it before.”

—Former U.S. Representative Jane Harman (D-CA)



“The solutions are obviously not painless; they are painful. But it just seems to me that a plan that asks Americans to be part of something bigger than themselves, a plan that would give them some confidence about the future for themselves and their kids, is a plan they will embrace.”

—Former Senator Byron Dorgan (D-ND)

5) Solving this problem is achievable if our national leaders are willing to compromise.

Plans to stabilize the debt exist in the public discourse. The bipartisan “Simpson-Bowles” and “Domenici-Rivlin” plans provide useful guidance on how a fiscal sustainability plan should be structured. The main challenge is political dysfunction. Americans must press their elected officials to compromise to set the country on a sustainable fiscal path. There will come a time when we try to kick the can down the road, but we will find that the can will no longer budge. Four trillion dollars is the minimum amount we need to reduce the deficit to stabilize the debt and get it on a downward path as a percentage of GDP. ▶

The Washington Post

Building a Better 'Fiscal Cliff'

By Pete Domenici and Sam Nunn, October 26, 2012

A “grand bargain” of some sort — including spending cuts and higher revenue in the same legislative package — will eventually be needed. In the meantime, quick action is also necessary to establish a more rational default position, one that may not be anyone’s ideal but that both Republicans and Democrats can live with unless and until a grand bargain is reached...

Enacting such a deal means that Democrats have to be willing to consider reforming — over time — Medicare, a key driver of U.S. deficits. Republicans will have to consider raising revenue through reducing tax expenditures, if not through higher rates. Neither will be an easy vote to cast...

Most pundits believe that, rather than go over the cliff, Congress will kick the can down the road...We suggest that Congress should change the “can” before it is kicked. Absent more constructive action, simply postponing when we go over the cliff could hurt business confidence, worry investors and lead to another disruptive debate over raising the debt ceiling.



“The markets don’t care about Republicans or Democrats. They care about their money. And they’re going to ask for more money for their money, and when they do inflation will kick in and interest rates will go up. And the guy that gets hurt the worst is the little guy.”

—Former Senator Alan Simpson (R-WY)

“I’m convinced that if we do this, the future of this country is very, very bright, and we can compete with anybody, with the best and brightest wherever they are. And if we don’t, we’re well on our ways to becoming a second-rate power.”

—Erskine Bowles, Former White House Chief of Staff



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In cooperation with the Campaign to Fix the Debt.

For additional information about *Strengthening of America* or to download audio, video, or transcripts from the forums, please visit: BIPARTISANPOLICY.org, CONCORDCOALITION.org, OR CSIS.org.

