

RED INK RISING

A Call to Action to Stem the Mounting Federal Debt

DECEMBER 2009





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Letter from Co-Chairs of the Peterson-Pew Commission on Budget Reform

We are proud to present this report on behalf of all the members of the Peterson-Pew Commission on Budget Reform. It is the product of a difficult but rewarding year of wrestling with an issue of critical concern — a federal debt that is out of control.

The Commission members share a common concern: the fiscal future we leave to succeeding generations will lower their standards of living. It is our strong belief that we must begin to take action now to prevent that from happening.

This report's recommendations stem from the experience and expertise of the Commission's members. Our plan will be difficult to implement. Our proposed approach will require significant policy changes and raising taxes and cutting spending are always very difficult. But we firmly believe that policymakers will have to do both to turn back the tide of red ink.

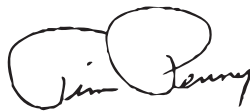
As Congress and the White House determine what process they want to use to meet the nation's fiscal challenges—whether a commission, a task force, the normal legislative structure, or some other process—we look forward to working with policymakers in both parties and believe the ideas in this report will be useful.

In the coming year, the Commission will publish a detailed companion report with additional recommendations on reforming the budget process. That report will propose multiple other budget process tools to help lawmakers reach and maintain a stable level of debt.

On behalf of the entire Commission, we also want to thank the Peter G. Peterson Foundation, The Pew Charitable Trusts, our many consultants, and all the individuals and organizations that regularly advised us. We also thank our superb staff.



Bill Frenzel



Tim Penny



Charlie Stenholm

RED INK RISING: A Call to Action to Stem the Mounting Federal Debt

Executive Summary

A call to action

Over the past year alone, the public debt of the United States rose sharply from 41 to 53 percent of gross domestic product (GDP). Under reasonable assumptions, the debt is projected to grow steadily, reaching 85 percent of GDP by 2018, 100 percent by 2022, and 200 percent in 2038.

However, before the debt reached such high levels, the United States would almost certainly experience a debt-driven crisis—something previously viewed as almost unfathomable in the world’s largest economy. The crisis could unfold gradually or it could happen suddenly, but with great costs either way. The tipping point is impossible to predict, but the United States is already hearing concerns about its fiscal management from some of its largest creditors, and the country is uncomfortably vulnerable to shifts in confidence around the world.

The Peterson-Pew Commission on Budget Reform is calling for Congress and the White House to take immediate action to stem the growing federal debt. Our proposal is crafted both to accommodate the needs of the still-recovering economy, and reflect the tremendous risks posed by the large and expanding debt burden. We recommend that Congress and the White House formulate a fiscal framework that includes:

- A commitment to stabilize the public debt over the medium term;
- Specific policies to stabilize the debt;
- Annual debt targets with an automatic enforcement mechanism to ensure targets are met; and
- A commitment to reduce further the debt level over the longer term.

The looming fiscal crisis

The economic crisis that the United States just experienced resulted in the deterioration of the country’s fiscal metrics as revenue plummeted and spending soared due to the recession’s effects and the government’s response.

The 2009 budget deficit was \$1.4 trillion, almost 10 percent of GDP. The public debt grew 31 percent from \$5.8 trillion to \$7.6 trillion. And the total debt, which includes what the government has borrowed from itself, grew from almost \$10 trillion to \$11.9 trillion.

However, even after the recession abates, its lingering effect, the extension of a number of deficit-financed policies, demographic changes, and growing health care costs will all create an unsustainable fiscal situation where the debt will continue to grow as a share of the economy. Under the Commission’s “fiscal baseline” (Box 1), which assumes the extension of many of the 2001 and 2003 tax cuts and other expiring policies, lower war costs, and discretionary spending that keeps pace with the economy, the United States would see:

- Total government spending—driven by an aging population and rising health care costs—rise from 25 percent of GDP today to 36 percent in 2038.
- Revenue—which fell to below 15 percent of GDP during the recession—grow gradually to 18.5 percent in 2018, surpassing historical averages, but not by nearly enough to keep pace with spending.
- Deficits slip from their current level of 10 percent of GDP to below 6 percent over the next five years but rise to above 16 percent in 2038.

Without a dramatic shift in course, the debt will grow to unprecedented levels, breaking the 200 percent mark in 2038. Well before the debt approaches such startling heights, fears of inflation and a prospective decline in the value of the dollar would cause investors to demand higher interest rates and shift out of U.S. Treasury securities. The excessive debt would also affect citizens in their everyday lives by harming the American standard of living through slower economic growth and dampening wages, and shrinking the government’s ability to reduce taxes, invest, or provide a safety net.

Stabilizing the debt

The Peterson-Pew Commission on Budget Reform knows that fiscal problems of this size cannot be fixed overnight or even in a year. Indeed, rushing the process could harm the economy, choking off the budding recovery. But to buy some breathing room, the United States must show its creditors that it is serious about stabilizing the federal debt over a reasonable timeframe. Both spending cuts and tax increases will be necessary.

The Commission recommends that Congress and the White House follow a six-step plan:

- Step 1:** Commit immediately to stabilize the debt at 60 percent of GDP by 2018;
- Step 2:** Develop a specific and credible debt stabilization package in 2010;
- Step 3:** Begin to phase in policy changes in 2012;
- Step 4:** Review progress annually and implement an enforcement regime to stay on track;
- Step 5:** Stabilize the debt by 2018; and
- Step 6:** Continue to reduce the debt as a share of the economy over the longer term.

1. Commit immediately to stabilize the debt at 60 percent of GDP by 2018.

Congress and the White House should immediately commit to stabilizing the public debt at a reasonable level over a reasonable timeframe: we recommend 60 percent of GDP by 2018. Waiting too long could fail to reassure creditors—one of the primary objectives of acting quickly. The “announcement effect” of such a commitment, if credible, can have positive economic effects by signaling that the United States is serious about reducing its debt.

We believe that the 60 percent goal is the most ambitious yet realistic goal that can be achieved in this timeframe. The 60 percent debt threshold is now an international standard—regularly identified by the European Union (EU) and the International Monetary Fund (IMF) as a reasonable debt target. A more ambitious target could easily prove to be such a heavy political lift that lawmakers would not embrace it or it would not be credible. Given the sig-

nificant risks of high U.S. debt, however, a less aggressive target might be insufficient to reassure markets.

While cutting government spending or raising taxes too early could slow or reverse the economic recovery, other countries have shown that a credible commitment to reducing the debt prior to actual policy changes can improve creditors’ expectations and diminish the risks of a debt-driven crisis. A number of advanced countries including Canada and Sweden offer fiscal success stories (Box 5).

2. Develop a specific and credible debt stabilization package in 2010.

A glide path for getting from today to 2018 is critical. So are the specific policies. Congress and the White House must agree on the necessary reforms and the timing for implementing them. We do not recommend a specific mix but believe that both spending cuts and tax increases will be necessary.

Under the Commission’s fiscal baseline, average annual deficits are projected to be about 6 percent of GDP. To meet the proposed goal, the average deficit would need to shrink to about 2 percent. For illustrative purposes, we propose a glide path that starts gradually with a deficit of 5 percent in 2012 and that requires a deficit of less than 1 percent by 2018. We allow seven years for the plan so that the impact of policy changes made in any single year is not drastic and does not stall the recovery of the economy.

The magnitude of deficit reduction needed to reach the 60 percent goal depends on the level of debt when policymakers start. If no new deficit-financed policies were added to the budget and any extensions of expiring policies were paid for, deficits would average around 3 percent of GDP, instead of 6 percent, and would only need to shrink to around 2 percent to meet the Commission’s goal—clearly a more manageable scenario.

3. Begin to phase in policy changes in 2012.

Given current economic conditions, we recommend waiting to implement the policy changes until 2012. Clearly, policymakers need to closely monitor economic conditions between now and then, but making aggressive changes any earlier could harm the economic recovery, particularly with unemployment reaching a 25-year high

in 2009. However, waiting any longer could undermine the plan's credibility and leave the country reliant on excessively high borrowing for too long with no plan in place to change course. Some policymakers will no doubt try to use the struggling economy as an excuse for delay. Keep in mind however, that *not* putting a plan in place could derail the economic recovery.

4. Review progress annually and implement an enforcement regime to stay on track.

Once a plan is adopted, it will be critical to have a mechanism to ensure that it stays on track. We suggest a broad-based companion enforcement mechanism, or a “debt trigger.” The trigger would take effect if an annual debt target were missed. Any breach of the target would be offset through automatic spending reductions and tax increases.

The Commission recommends that the trigger apply equally to spending and revenue. There would be a broad-based surtax, and all programs, projects, and activities would be subject to this trigger. The trigger should be punitive enough to cause lawmakers to act but realistic enough that it can be pulled as a last resort if policymakers fail to act or select policies that fall short of the goal.

5. Stabilize the debt by 2018.

Reducing the debt to 60 percent of GDP will be no small feat. It will require small changes in the first year from the projected level of 69 percent to 68 percent but, more significantly, will require a dramatic deviation from the current debt path. Preventing that projected path is critical for the United States if it is to avoid the economic risks associated with excessive debt.

But hitting a 60 percent target is, in and of itself, not a sufficient goal. What matters just as much—if not more—is that the debt does not continue to grow as a share of the economy thereafter. This makes deriving a package of revenue increases and spending cuts to bring the debt down to 60 percent even more difficult. It would be easier if policymakers could implement temporary measures, timing shifts, and short-term policies that did not address the major drivers of the budget's growth. This shortsightedness, however, would leave the debt on track to grow again after the medium-term goal was achieved.

To be effective over the longer term, a stabilization package will have to include permanent changes to current policies and must be weighted to control the budget's most problematic areas.

We believe the problem is so large that nearly all areas of the budget will be affected, and certainly both spending and taxes will have to be part of the ultimate package. Reforms in programs that are growing faster than the economy—notably Medicare, Medicaid, Social Security, and certain tax policies—afford the best opportunities for savings and will provide the greatest benefits to longer term debt stability.

6. Continue to reduce the debt as a share of the economy over the longer term.

Though preventing the debt from expanding again over the coming decades will be quite challenging given the demographic and health care cost pressures, we believe that policymakers must, over time, bring the debt down beyond the initial 60 percent target to something closer to the U.S. historical fifty-year average of below 40 percent.

Fiscally-responsible federal policies are necessary so that the government has the fiscal flexibility to respond to crises. Even though the United States had budget deficits when the recent economic and financial crises hit, the relatively low level of debt as a share of the economy gave policymakers the ability to respond quickly and borrow large amounts to respond to those crises without worrying about the federal government's ability to borrow. If the debt level had been at its current level, or where it is projected to grow to, responding to the economic crisis would have been much more challenging.

Implementing reforms that slow the growth of government spending, keep revenue apace with spending, and are conducive to economic growth will be critical to bringing down the debt levels further. Ultimately, this task will almost certainly require more than one package of debt reduction. The Commission hopes that policymakers will monitor the debt to ensure that it stays at a manageable level and does not grow faster than the economy. Ensuring the future fiscal health of the country depends on it.

BOX 1. The Commission's fiscal baseline

The Commission created a baseline scenario to illustrate the path of likely policies and the magnitude of the fiscal challenges the country faces. The Commission's fiscal baseline starts with the standard Congressional Budget Office (CBO) August "current law" baseline, adjusted to reflect actual numbers for 2009. The baseline then incorporates the effects of several tax and spending policies likely to be enacted. In particular, it assumes:

- The renewal of the 2001 and 2003 tax cuts, set to expire in 2010, for families making less than \$250,000 a year and individuals making less than \$200,000.
- A freeze in the estate tax at its 2009 levels, rather than its elimination in 2010 and then a return to pre-2001 levels in 2011 and beyond.
- A continuation of the annual "patch" of AMT that limits its impact on middle and upper-middle income earners.
- A permanent freeze on Medicare physician payment rates, replacing the 21 percent reduction scheduled to occur next year and small subsequent reductions scheduled thereafter.
- A gradual decline in spending on the wars in Iraq and Afghanistan so that troop levels would fall from about 210,000 in 2009 to 75,000 by 2014, with any additional deployments fully-offset within the budget.
- An increase in normal discretionary spending so that it grows at the rate of economic growth rather than inflation.

The Commission uses the fiscal baseline to illustrate the magnitude of the debt reduction policymakers face. It should in no way be taken as an expression of the Commission's support for any or all of the policies included in the baseline. In fact, sticking to "current law" policies would make it far easier to reduce debt levels to 60 percent of GDP.

Comparison of baselines, 2010-2018

| CURRENT LAW BASELINE | | | | | | | | | |
|----------------------|-------|-------|--------|--------|--------|--------|--------|--------|--------|
| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| PERCENTAGE OF GDP | | | | | | | | | |
| Debt | 61 | 64 | 65 | 65 | 65 | 66 | 66 | 67 | 66 |
| Deficit | 9.6 | 6.1 | 3.7 | 3.2 | 3.2 | 3.1 | 3.3 | 3.2 | 3.1 |
| BILLIONS OF DOLLARS | | | | | | | | | |
| Debt | 8,760 | 9,670 | 10,270 | 10,750 | 11,310 | 11,850 | 12,440 | 13,030 | 13,460 |
| Deficit | 1,380 | 920 | 590 | 540 | 560 | 560 | 620 | 630 | 620 |

| COMMISSION'S FISCAL BASELINE | | | | | | | | | |
|------------------------------|-------|-------|--------|--------|--------|--------|--------|--------|--------|
| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| PERCENTAGE OF GDP | | | | | | | | | |
| Debt | 61 | 66 | 69 | 70 | 73 | 76 | 79 | 83 | 85 |
| Deficit | 9.7 | 7.6 | 5.8 | 5.6 | 5.8 | 5.9 | 6.4 | 6.6 | 6.8 |
| BILLIONS OF DOLLARS | | | | | | | | | |
| Debt | 8,780 | 9,910 | 10,820 | 11,690 | 12,700 | 13,740 | 14,910 | 16,160 | 17,350 |
| Deficit | 1,400 | 1,140 | 910 | 920 | 1,000 | 1,060 | 1,200 | 1,300 | 1,380 |

Note: Commission staff used the current law baseline estimates from CBO's *The Budget and Economic Outlook: An Update*, August 2009 and then updated the out-year debt numbers based on 2009 debt data from the Department of the Treasury, *Monthly Statement of Public Debt*.

Source: Congressional Budget Office data and Commission's fiscal baseline.

RED INK RISING: A Call to Action to Stem the Mounting Federal Debt

The Looming Fiscal Crisis

The United States has just had its highest budget deficit since just after World War II, and the government's public debt has increased to a near record high as a share of the economy in the post-war period. In 2009 alone, the public debt rose from \$5.8 trillion (41 percent of GDP) to \$7.6 trillion (53 percent)¹. Much of this increase came from the economic and financial crises, which fueled a dramatic increase in government spending for economic stimulus efforts and financial market interventions, and shrank personal and corporate incomes and thus government revenue.

The economy is expected to recover, but the federal budget may not. Even before the economic downturn, the government was running deficits that were expected to grow as a share of the economy over the longer term. The huge expenses incurred to deal with the recession have exacerbated the growing national debt, making it a more immediate threat to the country's fiscal future. The extension of deficit-financed policies in the medium term, and the aging of the population and growing health care costs over the longer term, mean that our annual deficits will not return to a sustainable path and that federal debt will reach unprecedented levels.

Without preventive action, debt will continue to accumulate, leading to a dangerous fiscal situation. Interest payments will continue to grow, squeezing out important priorities. Under the Commission's "fiscal baseline"—which assumes the extension of many of the 2001 and 2003 tax cuts and other expiring policies, lower war costs, and discretionary spending that keeps pace with the economy (Box 1)—Social Security, Medicare, Medicaid, and net interest combined will exceed total federal revenue by 2027.

Such high borrowing is not sustainable. Deficits and the associated rise in debt may be a necessary one-time response to a major economic recession but if they persist for too long, they can put the economy at risk. An ever-growing debt would likely hurt the American standard of living by fueling inflation, forcing up interest rates, dampening wages, slowing economic growth and job creation, and shrinking the government's ability to cut taxes, invest, or provide a safety net. A hard landing—where higher deficits and debt cause investors to lose confidence in the U.S. economy and rising interest rates choke off the economic growth—is a real possibility.

An ever-growing debt would likely hurt the American standard of living by fueling inflation, forcing up interest rates, dampening wages, slowing economic growth and job creation, and shrinking the government's ability to cut taxes, invest, or provide a safety net.

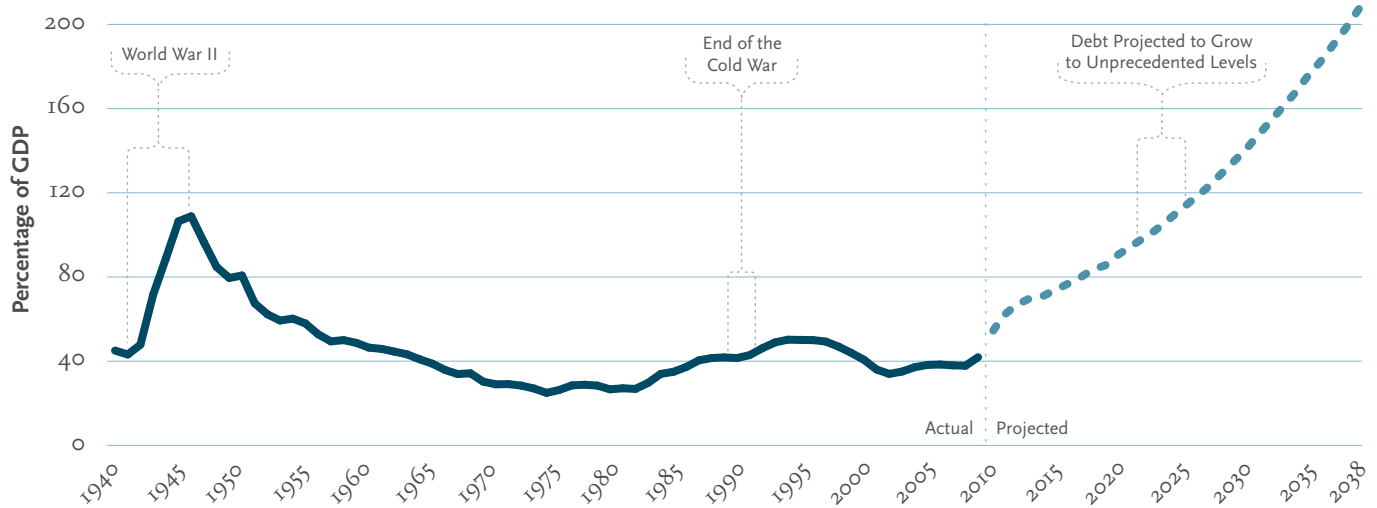
Future debt—a daunting picture

Traditionally, the amount of debt relative to the size of the economy has gone up during times of war and economic crisis (Figure 1). But in times of economic growth, the federal government has run lower annual deficits which allowed the debt to fall back to more sustainable levels. From 1941 (when the debt skyrocketed to finance World War II) to 2008, U.S. debt has averaged 45 percent of GDP. And since 1957, the average has been even lower, at 37 percent.²

1 Staff calculations based on "Monthly Budget Review, Fiscal Year 2009, Congressional Budget Office, November 6, 2009 and Monthly Statement of the Public Debt (MSPD), September, Treasury Direct.

2 Staff calculations using historical debt data from Table 7.1, "Federal Debt at the End of the Year," in *Budget of the United States Government, Fiscal Year 2010, Historical Tables*, Office of Management and Budget, May 2009.

FIGURE 1. Federal debt held by the public, 1940–2038



Source: Table 7.1, “Federal Debt at the End of the Year,” in *Budget of the United States Government, Fiscal Year 2010, Historical Tables*, Office of Management and Budget, May 2009 and the Commission’s debt projection.

Today, the course is very different. The financial crisis and recession have contributed to an extremely large increase in the debt, with revenue plummeting and spending rising for expensive new programs to stimulate the economy and stabilize the financial sector. But instead of a plan to reverse course after the economy improves, the vast majority of policymakers support plans to add more to the debt by extending most or all of the 2001 and 2003 tax cuts, restricting the reach of the alternative minimum tax (AMT), and preventing cuts in physician payments under Medicare’s sustainable growth rate formula, without paying for them, and thus, adding trillions to the debt over the coming decade.

Under the Commission’s fiscal baseline, the public debt is expected to grow to 85 percent of GDP by 2018. Beyond 2018, the situation will deteriorate with the debt surpassing 100 percent of GDP in 2022 and reaching 200 percent in 2038.

The widening gap between spending and revenue will result from the growth in government spending, driven primarily by the aging population and growing health care costs, and a revenue base that grows more slowly. As projected by the Commission’s fiscal baseline, non-interest spending will grow to 22 percent of GDP in 2018 and to 27 percent in 2038. This higher spending would also cause interest payments to grow dramatically, adding nearly 4 percentage points of GDP to spending in 2018 and almost 9 points in 2038.

Revenue is also expected to grow relative to the economy but not by nearly enough to keep pace with projected spending, and the gap between the two will continue to expand over time (Figure 2). Revenue, which recently dropped below 15 percent of GDP due to the recession, is expected to grow to 18.5 percent by 2018 and to continue to grow gradually thereafter. Even if the tax cuts are not extended, revenue is projected to remain below spending indefinitely.

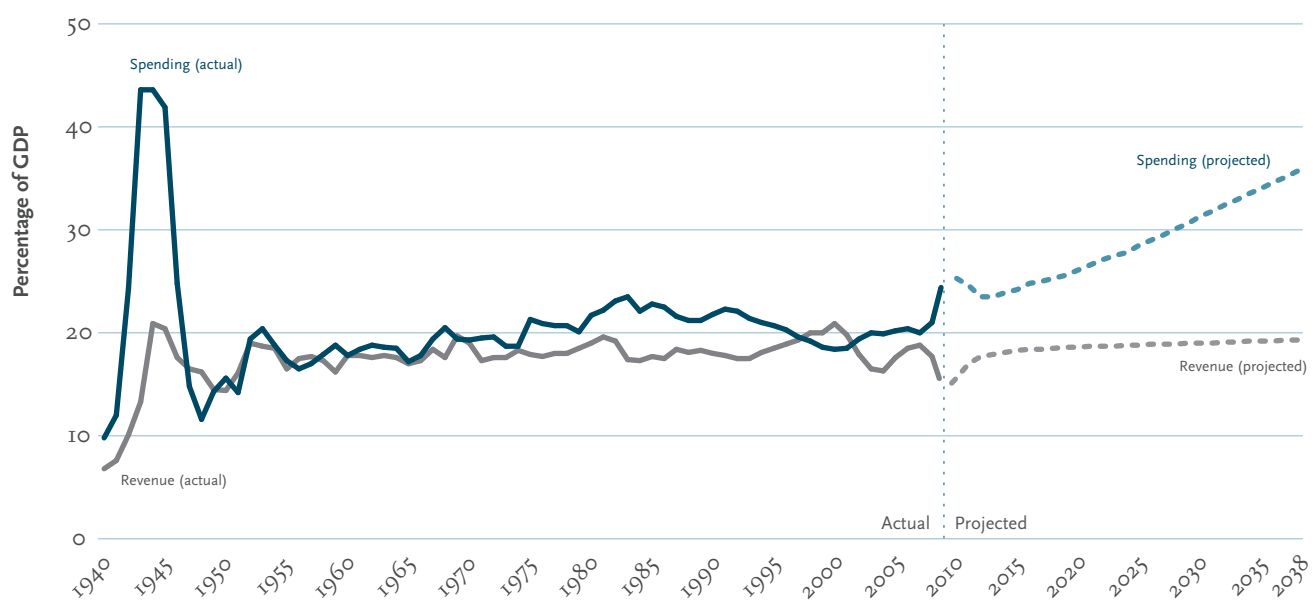
BOX 2. The difference between the deficit and debt

The **deficit** is the difference in a given fiscal year between federal revenue, and spending. The government can have either a deficit or a surplus. In order to finance operations when there is a deficit, the government borrows money by issuing government securities to cover the deficit.

The **debt** is the amount owed to creditors who have financed the government’s borrowing. It does not increase by the exact amount of the deficit, but deficits are the primary factor. The debt can also rise or fall because of changes in the Treasury’s operating cash balance, the exercise of sovereign monetary power, federal credit financing, and federal financial stabilization activities.

The deficit and debt can be expressed both in dollars and as a percentage of GDP. The debt-to-GDP ratio and the debt path, or debt trends over time, are key measures of the debt in comparison to the nation’s total economy, and reflect the nation’s ability to manage its debt.⁵ For this analysis, the Commission uses publicly-held debt, as opposed to gross debt, which includes federal debt held internally by government trust funds to redeem future commitments (Box 4).

FIGURE 2. Spending and revenue, 1940-2038



Source: Table 1.4 “Summary of Receipts, Outlays, and Surpluses or Deficits (-) as Percentages of GDP,” *Budget of the United States Government, Fiscal Year 2010, Historical Tables*, Office of Management and Budget, May 2009.

⁵ For a detailed description of how the government calculates its debt, borrowing needs, and deficits, see chapter 16, “Federal Borrowing and Debt”, and 25, “Budget Systems and Concepts,” in *Budget of the United States Government, Fiscal Year 2010, Analytical Perspectives*, Office of Management and Budget, May 2009.

Once the United States recovers from the recession and its effects, deficits are likely to decline from their high of almost 10 percent of GDP to below 6 percent over the next five years (still well above the historical average of about 2 percent of GDP). They will then rise again as the pres-

ures of the baby boom retirement and health care cost growth bring about record levels of spending for pensions and health care. Within 30 years, deficits will reach unprecedented levels of 16 percent of GDP.

BOX 3. A closer look at the drivers of debt

Mandatory spending. In the coming years and decades, mandatory spending is projected to grow significantly as a share of the economy. The combination of population aging and growing health care costs will lead to an unprecedented expansion of Medicare, Medicaid, and Social Security in particular. Under the Commission's fiscal baseline these three programs will likely grow from less than 8.5 percent of GDP in 2008 to 11 percent by 2018, and 17 percent in 2038.⁶ And since this growth is automatic under the law, active policy change will be required to slow it.

Discretionary spending. Although discretionary spending has declined as a portion of the budget and economy since 1970, it nonetheless threatens to contribute to future spending growth. In theory this area of the budget is easier to monitor and control, since discretionary programs are funded and reviewed as a part of the annual appropriations process. Over the last decade, however, it has grown at roughly the same pace as mandatory spending. While the increase can be partly attributed to defense spending, even domestic spending grew at 6.3 percent, faster than the 5.1 percent average for the economy over that time period.⁷

Revenue. Although revenue is projected to grow in the coming years, this growth will be insufficient to keep pace with spending increases. Currently at around 15 percent of GDP—a post-1950 low caused mainly by the recession—the Commission's fiscal baseline projects revenue will return to around its historical average, reaching 18.5 percent by 2018, and grow somewhat in subsequent years. Population aging and health care cost growth, in addition to putting upward pressure on spending, will shrink the wage base some—the former by shrinking the size of the labor force and the latter by shifting compensation from taxable cash-wages to non-taxed health care benefits. Extending the 2001 and 2003 tax cuts—even only for families making less than \$250,000—will make the gap between spending and revenue far worse over the coming year, adding more than two trillion to the debt over the next decade.⁸

Interest on the debt. The large gap between spending and revenue will require higher levels of borrowing and correspondingly higher interest payments. The growing interest payments create the specter of having to borrow more just to cover interest costs and having interest squeeze out other areas of the budget. Even under current law, interest costs are projected to grow faster than the economy over the next decade and under the Commission's baseline, they will increase from just above 1 percent of GDP now to nearly 4 percent in 2018.

6 See CBO's June 2009 *The Long-Term Budget Outlook* for a detailed description of how changes in the workforce will affect these programs.

7 Staff calculation using historical data from *Budget of the United States Government, Fiscal Year 2010, Historical Tables*, Office of Management and Budget and CBO's *The Long-Term Budget Outlook*, June 2009.

8 Joint Committee on Taxation. "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury," May 2009.

The economic consequences of too much debt

Excessive debt can hurt a country, its citizens, and its economy in many ways. It can harm the economy by pushing up interest rates—something that would be particularly dangerous as we are coming out of a recession. It can slow the growth of wages and keep living standards from increasing by as much as they otherwise would have, leaving the country's citizens worse off. And it deprives the country of the fiscal flexibility to respond to future crises and new national priorities as they arise. With the federal debt about to expand dramatically, the risks of doing nothing are unacceptably high for the American taxpayer. Persistently growing debt levels could lead to many undesirable conditions.

Living standards decline. As debt increases, interest rates are likely to rise since the government will have to pay more to attract capital. This can “crowd out” private investment, and make it more costly to borrow for everything from housing to education to business investments. As higher interest rates choke off investment, productivity growth will fall, wages will rise more slowly (or even fall), and the country's standard of living will suffer.

Interest payments rise and squeeze out other priorities. Greater levels of debt and higher interest rates mean rising interest payments for the government. As interest payments become a larger share of the budget, they squeeze out other important tax and spending priorities. Interest payments can also lead to a dangerous debt spiral whereby the interest payments themselves increase the national debt, compounding over time to worsen the fiscal situation.

As the government relies more on foreign creditors, Americans will see diminished returns from the investments in this country. Even though private savings have risen recently, they will be insufficient to finance all the borrowing demands of the U.S. government and the private sector. In the short term, as the United States has seen over the past decade, foreign savings can make up the difference. But relying on foreign capital means that the interest and dividends from these investments go overseas and it also leaves the United States more dependent on and vulnerable to changes in international lenders' investment preferences.

As international investors become more concerned about U.S. fiscal stability, the dollar may no longer be the foundation of global economic transactions. The United States is currently less vulnerable than many other nations to the full economic and fiscal consequences of high debt because the dollar is the world's reserve currency, and our debt remains popular with investors worldwide as a low-risk investment. Eventually, however, countries may not see American dollars and American debt as so safe and the U.S. may lose the advantages that come with being the reserve currency. The IMF and the United Nations have already begun to investigate a worldwide reserve currency as a potential alternative to the dollar.⁹

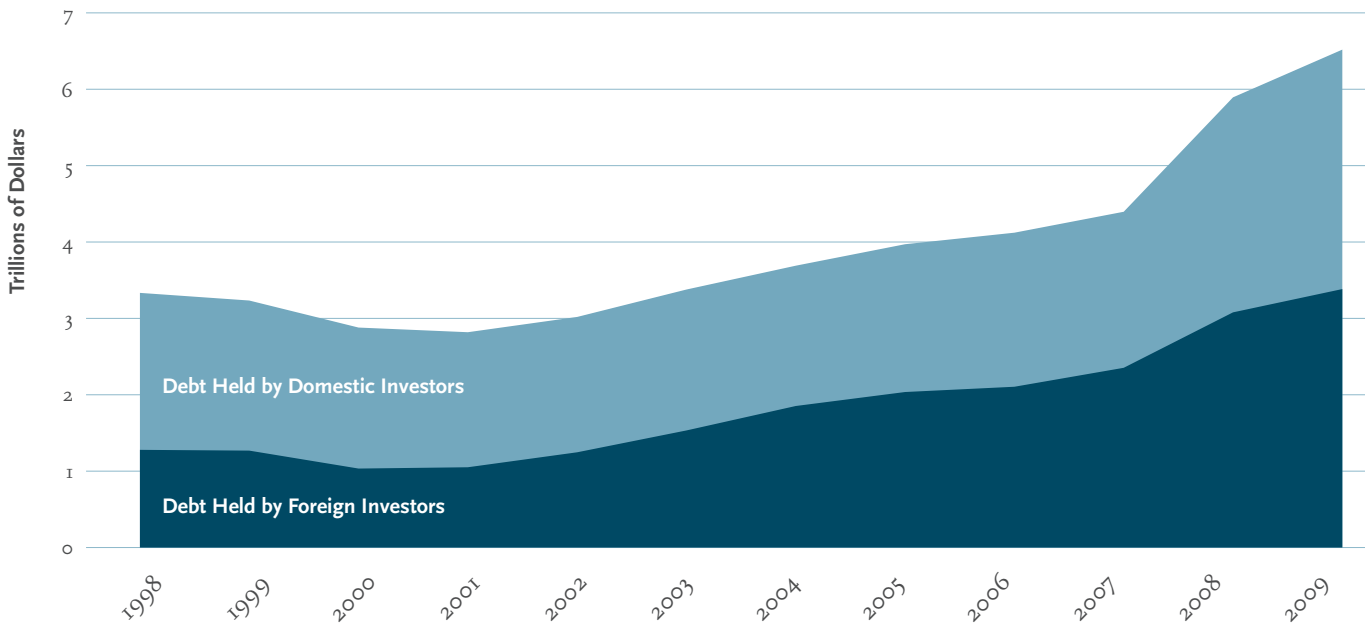
Future generations pay the price. In addition to experiencing lower living standards, future generations will be left with the burden of paying for today's borrowing. This will ultimately mean large tax increases and large spending cuts, and will leave little flexibility for setting future budget priorities.

⁹ Alexander Nicholson. “IMF Says New Reserve Currency to Replace Dollar Is Possible,” *Bloomberg News*, June 6, 2009 and United Nations, *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System*, September 21, 2009.

How much debt can the U. S. economy reasonably sustain? There is no firm answer because of the complex relationship between the economy and the debt. But there is widespread agreement that, if we do nothing, our economic way of life is at risk. Consider the following:

- At 52 percent of GDP, the federal debt is already well above its historical norm. Debt as a share of the economy—one gauge of how much debt the economy can bear—averaged 37 percent during the fifty-year period from 1957 to 2008.
- Without a change in policies, the debt will soar as a percentage of GDP in this generation’s lifetime. In about 15 years, it will exceed the record of 109 percent set in 1946 and continue to grow rapidly.
- The United States has never before experienced debt burdens as high as the current projections. Other countries with huge debt burdens suffered either chronic or acute fiscal rises and, frequently, political crises.
- With the shares of debt held by foreign owners rising to nearly half, a loss of confidence by international creditors could precipitate a financial crisis. As we have seen with many other nations, growing dependence on international financing can make the nation vulnerable to shocks and a vicious spiral of currency declines and spikes in interest rates.
- Whether the debt build up leads to an abrupt, external shock, or a gradual erosion in our economic performance, the growing debt will jeopardize the American living standard and U.S economic leadership.

FIGURE 3. Foreign Ownership of U.S. Debt is Growing



Source: “Table OFS-2.—Estimated Ownership of U.S. Treasury Securities, March 1998-June 2009,” *Treasury Bulletin*, September 2009.

There is little disagreement that the current path is unsustainable. How likely is an economic shock from U.S. growing debt and what might it look like? No one knows for sure. U.S. debt is still attractive for several reasons, including American political stability and a history of economic growth.

However, the United States is now more reliant on overseas investors and central banks than in the past, with foreign holdings now at approximately 50 percent of the total (Figure 3). As the federal debt grows over the next 10 years, especially without a concrete plan to reduce it, foreign creditors may shift their investments to other nations.

Our foreign creditors are already nervous about U.S. debt. In March 2009, Chinese Premier Wen Jiabao expressed concern about U.S. economic and fiscal policies, saying: “We have lent a huge amount of money to the U.S. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried.” And again in November 2009, the premier called for the United States to control its debt: “most importantly, we hope the U.S. will keep its deficit at an appropriate size so that there will be basic stability in the exchange rate and that is conducive to the stability and recovery of the world economy.”¹⁰

This shift could reduce the value of the dollar and force the Treasury to offer higher interest rates to attract borrowers. A rapid sell-off would hurt foreign investors’ portfolios as much as it would hurt the U.S. economy. But over time, foreign owners might stop buying new U.S. Treasury securities.¹¹ While it is unclear whether a crisis would unfold gradually or suddenly, either would come with great costs to both the domestic and global economy.

And change can happen suddenly. In 2008, the credit default swap markets showed how suddenly investor perceptions of the security and stability of Treasury securities can shift. That year, the credit default swap rate for Treasury bills, a measure of investor assumptions about the likelihood of a U.S. default, increased nearly sevenfold. The rate is back to “normal” levels, but this rapid increase shows that the United States is not immune to investor panic.¹² And in October 2009, Moody’s Investor Service warned that the United States may eventually lose the triple A rating on its bonds, if it does not act to reduce its deficits (and its debt) over the next three to four years.¹³

10 “China Slows Purchases of U.S. and Other Bonds,” Keith Bradsher, *New York Times*, April 13, 2009; *Wall Street Journal*, July 29, 2009 “Chinese Convey Concern on Growing U.S. Debt;” “China ‘Worried’ by U.S. Debt” Andy Barr, March 13, 2009, *Politico*; “China’s Leader Says He is ‘Worried’ Over U.S. Treasuries,” *New York Times*, March 14, 2009, Michael Wines, Keith Bradsher and Mark Landler; “China Grows More Picky About Debt,” May 21, 2009. Keith Bradsher, *New York Times*; “Chinese convey concern on Growing US Debt,” Tom Barkley and Deborah Solomon, *Wall Street Journal*, July 29, 2009. For November 2009 quote, Laura Mandaro, “China’s Wen urges U.S. to keep deficit at ‘appropriate size’,” *MarketWatch*, November 8, 2009.

11 James Jackson, “Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal” (Washington, DC: Congressional Research Service, January 14, 2008). Cletus C. Coughlin, Michael R. Pakko and William Poole, “How Dangerous is the U.S. Current Account Deficit?” *The Regional Economist*, April 2006, 8; Steven B. Kamin, Trevor A. Reeve and Nathan Sheets, “U.S. External Adjustment: Is It Disorderly? Is It Unique? Will It Disrupt the Rest of the World?,” Board of Governors of the Federal Reserve System, International Finance Discussion Papers Series Number 892, April 2007.

12 Alan J. Auerbach and William G. Gale, *The Economic Crisis and the Fiscal Crisis: 2009 and Beyond: An Update*, September 2009; *Bloomberg* “U.S. Treasury Credit Default Swaps Increase to Record,” September 9, 2008; *Reuters*, “US Treasury 10-year CDS hits record high,” December 1, 2008. At one point, the rate went up 95 basis points.

13 “Reducing deficit key to U.S. rating: Moody’s,” *Reuters*, October 22, 2009.

Stabilizing The Debt

The Peterson-Pew Commission on Budget Reform believes that establishing a fiscal plan to stabilize the debt over the medium term is critical for averting a fiscal crisis. The Commission recognizes that not all of the country's fiscal problems can be solved overnight or even in a fiscal year—indeed, rushing the process could destabilize a still shaky economy. But to buy breathing room, the United States must show its creditors that it is serious about addressing the nation's unsustainable debt trajectory.

Accordingly, the Commission urges Congress and the White House to adopt a fiscal framework that includes:

- A commitment to stabilize the public debt over a reasonable timeframe;
- Specific policies to stabilize the debt;
- Annual debt targets with automatic enforcement mechanisms to ensure targets are met; and
- A commitment to reduce further the debt level over the longer term.

There are numerous policy combinations that could be implemented to stabilize the debt. The Commission does not support any single set of changes. We do believe, however, that both tax increases and spending cuts will be necessary. The changes needed to stabilize the debt at a reasonable level are large enough—particularly if expiring policies are extended—that it will not be feasible to rely solely on either tax increases or on spending cuts.

The Commission recommends that policymakers commit to the following six-step plan:

- Step 1:** Commit immediately to stabilize the debt at 60 percent of GDP by 2018;
- Step 2:** Develop a specific and credible debt stabilization package in 2010;
- Step 3:** Begin to phase in policy changes in 2012;
- Step 4:** Review progress annually and implement an enforcement regime to stay on track;
- Step 5:** Stabilize the debt by 2018; and
- Step 6:** Continue to reduce the debt as a share of the economy over the longer term.

1. Commit immediately to stabilize the debt at 60 percent of GDP by 2018.

Congress and the White House should immediately commit to stabilizing the public debt at a reasonable level over the medium term. The “announcement effect” of such a commitment, if credible, can have positive economic effects by signaling that the United States is serious about reducing its debt.

BOX 4. Public versus gross debt

The **debt held by the public** is a measure of the total debt held by individuals, corporations, and governments, domestic and foreign. **Gross debt**, on the other hand, also includes what the government has borrowed from itself—mainly from Social Security trust funds which ran large surpluses over much of the last two decades.

Although gross debt better reflects the government's future liabilities, debt held by the public is an important economic measure and is likely to have a greater effect on credit markets. While the money the government borrows from itself has little effect on the capital available for other borrowers, the debt held by the public measures how much the government's borrowing absorbs from the rest of the economy through credit markets.

Accordingly, the Commission uses debt held by the public in this analysis.

While past lessons show that cutting government spending or raising taxes too early can slow an economic recovery, the United States can learn other lessons from our own history and other countries' experiences as well. Announcing a sensible framework for careful debt reduction has been shown to improve creditors' expectations of a country's fiscal management.¹⁴ Improving those expectations can lower investor perceptions of risk and thus the premiums that creditors demand for interest rates paid on U.S. assets. Lower interest rates can, in turn, boost growth and employment—now critical as the economy struggles to regain its footing. In fact, many other countries' debt reduction efforts stimulated their economies and increased economic growth.¹⁵ This announcement—if viewed as credible—can make the goal of debt stabilization easier, since the consequential lower interest rates can both reduce spending on interest payments and increase the size of the economy, relative to what it might have been otherwise.

From a financial perspective, the United States must persuade credit markets that it is serious about debt reduction. Global markets are more likely to embrace a plan if the goal has international credibility.

The Commission proposes a debt stabilization target of 60 percent of GDP by 2018. We take a variety of considerations into account when setting this threshold, including what we believe to be politically achievable, the right balance between economic recovery and fiscal considerations, and the standards used by other industrial nations.

From a financial perspective, the United States must persuade credit markets that it is serious about debt reduction. Global markets are more likely to embrace a plan if the goal has international credibility. The 60 percent debt threshold is now an international standard. In the EU, under the requirements of the Maastricht Treaty and the Growth and Stability Act, EU countries must satisfy a benchmark target of 60 percent of GDP for debt and 3 percent for annual deficits. Likewise, the IMF has singled out the 60 percent debt target as a reasonable benchmark.¹⁶ Given the significant risks of high U.S. debt, a less aggressive target might be insufficient to reassure the markets.

We believe a 60 percent target is the most ambitious and economically sensible target that can reasonably be achieved in this timeframe. Although we would prefer that the debt decline to pre-crisis levels—around 40 percent of GDP—the required precipitous changes could be economically damaging even if they were politically achievable. The Commission believes that ultimately, policymakers should reduce the debt-to-GDP ratio further over time. However, past U.S. fiscal efforts have shown that setting overly ambitious goals greatly reduces the likelihood of success. Lowering the debt too quickly could also hurt the global economy if too many other nations cut back their spending at the same time in similar debt reduction efforts.

14 Christina D Romer, "Lessons from the Great Depression for Economic Recovery in 2009," Talk at the Brookings Institution, March 9, 2009 and Douglas W. Elmendorf, "The Effects of Deficit Reduction Law on Real Interest Rates," Federal Reserve Board, Finance and Economics Discussion Series, 1996.

15 Cottarelli, Carlo and Jose Viñals, "A Strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies," IMF Staff Position Note, September 22, 2009. SPN/09/22.

16 European Commission, *Public Finances in EMU—2009*, May 2009; IMF, *The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis*, March 6, 2009; and Carlo Cottarelli, and Jose Viñals, *A Strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies*, September 22, 2009. IMF's guidelines would require higher-debt nations like the United States to meet higher debt reduction standards, but also allow the savings to be achieved over a longer period

BOX 5. Significant debt reduction is achievable: International success stories

While the U.S. debt problem may seem insurmountable, other countries have succeeded in gaining control of their debt. They successfully addressed their long-term budgetary pressures, increased their budgetary flexibility, and improved their long-term economic growth. Over the past 30 years, the top-ten nations in terms of debt reduction efforts have, on average, reduced their public debt from 84 percent of GDP to 41 percent over 10 or 15 years.

New Zealand

With persistent deficits that exceeded 6 percent of GDP in the 1980s, New Zealand accumulated government debt that was unsustainable as a share of the economy. The country had virtually no economic growth, high inflation, and lost investor confidence, leading to a currency crisis that forced government action in the mid-1980s and again in the early 1990s. It instituted major economic and fiscal reforms to regain foreign investor confidence and increase future budgetary flexibility. The government removed major regulations from the economy, including wage and price controls. The public sector was significantly downsized through spending cuts and privatizations, reducing the number of public employees by half and cutting spending by more than 7 percent of GDP. From 1986 to 2001, the government reduced the debt from 72 percent to 30 percent of GDP.

Canada

Canada also significantly strengthened its economy through tackling its debt burden. The country's combined federal and provincial government debt rose above 100 percent of GDP during the mid-1990s and the fiscal situation worsened due to a sharp rise in interest rates and to growing international investors' concerns about its large debt burden. Although fiscal credibility concerns had steadily grown, the tipping point for Canada came in the aftermath of the Mexican peso crisis in the fall of 1994. The Wall Street Journal suggested that the Canadian dollar could be next. Moody's Investor Service put Canada on a credit watch, and downgraded its debt a few months later. In response, Canada implemented a debt reduction plan and lowered its debt to 63 percent of GDP in 2008. To lower the debt, the government implemented a pay freeze on public employee salaries, eliminated 15 percent of the federal workforce, and made large reductions in subsidies to businesses, such as railways, agricultural industries, and cultural industries.¹⁷ As a result, Canada reduced its vulnerability to interest rate spikes and enhanced its fiscal flexibility.

Sweden

In the 1990s, following a financial crisis and the worst recession in Sweden since the 1930s, Sweden faced a deficit of over 11 percent of GDP in 1993. Soon thereafter, the government enacted a large deficit reduction plan to restore confidence in its currency and enhance its budgetary flexibility. It reduced its subsidies for medical and dental care, indexed certain taxes, and increased contribution rates for the unemployment benefit system. Ultimately, Sweden reduced its debt by establishing a goal to make surpluses equal 2 percent of GDP. By 2004 Sweden was running budget surpluses, and in 2008 the country's debt was 38 percent of GDP.

(continued on following page)

¹⁷ IMF, *Staff Report for the 2009 Article IV Consultation*. April 17, 2009, 14.

(continued from previous page)

Debt reduction in advanced economies (percentage of GDP)

| Country and Period | Starting Debt Ratio | Ending Debt Ratio | Debt Reduction |
|-------------------------|---------------------|-------------------|----------------|
| Ireland (1987-2002) | 109 | 32 | 77 |
| Denmark (1993-2008) | 80 | 22 | 58 |
| Belgium (1993-2007) | 137 | 84 | 53 |
| New Zealand (1986-2001) | 72 | 30 | 42 |
| Canada (1996-2008) | 102 | 63 | 39 |
| Sweden (1996-2008) | 73 | 38 | 35 |
| Iceland (1995-2005) | 59 | 25 | 34 |
| Netherlands (1993-2007) | 79 | 46 | 33 |
| Spain (1996-2007) | 67 | 36 | 31 |
| Norway (1979-1984) | 57 | 35 | 21 |
| Average | 84 | 41 | 42 |

Note: Numbers might not add due to rounding.

Source: IMF, Carlo Cottarelli, and Jose Viñals, *A Strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies*, September 22, 2009, table 1, 18.

Although 60 percent of GDP is a reasonable target based on political, economic, and international factors, ultimately what is most important is that policymakers develop and achieve a clear and widely shared fiscal goal. This will allow policymakers to proceed to the next step of determining how best to achieve that goal and assessing the tradeoffs involved.

2. Develop a specific and credible debt stabilization package in 2010.

Focusing solely on the end goal of debt stability is not enough. A plan must also include a glide path for getting from here to there and the specific policies that achieve the goal. Without a reasonable timetable for phasing in policies and annual debt targets, policymakers may be tempted to backload necessary, but politically difficult, policy changes.

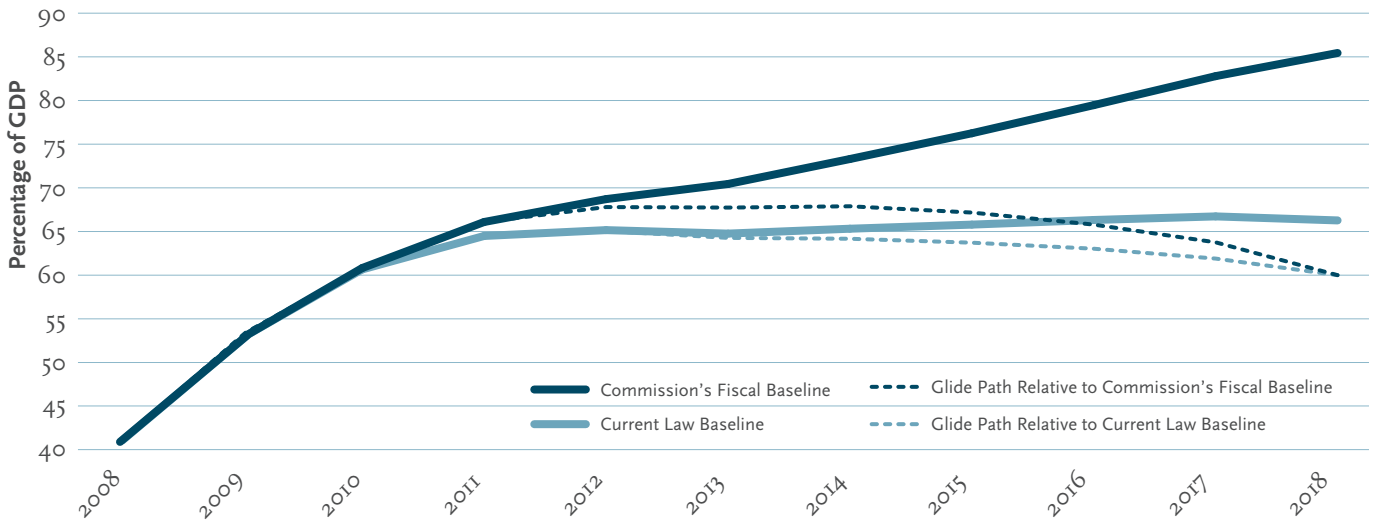
Figure 4 shows the Commission's illustrative glide paths to stabilizing the debt under the Commission's baseline and the current law baseline. The seven-year timeframe allows both

paths to implement changes slowly enough to allow the economic recovery to take hold and grow larger each year, but also quickly enough that savings can compound over the seven-year period. It also shows that achieving the debt stabilization fiscal goal is much harder if the major policies that are slated to expire over the next few years are continued.

In order to stabilize the debt, deficits will have to be lower than currently projected. Figure 5 compares the projected deficits under the Commission's fiscal baseline to possible deficit levels under the illustrative glide path towards stabilization.

Some may assume that in order to reduce the ratio of debt to GDP, the country not only has to bring deficits down, it actually must have surpluses. In fact, the United States can stabilize the debt without surpluses. As long as the debt is growing more slowly than the economy, the ratio will shrink so that small deficits and a growing economy can accomplish the Commission's goal.

FIGURE 4. Illustrative glide paths to stabilizing the debt



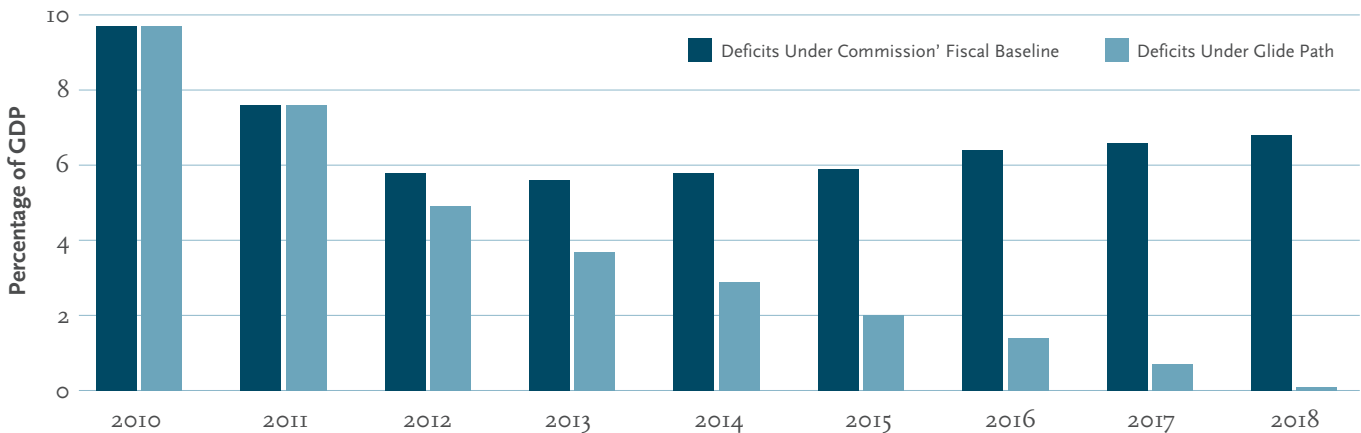
Source: Congressional Budget Office and Commission's fiscal baseline.

The magnitude of deficit reduction needed to reach the 60 percent goal depends on the level of debt when policymakers start. Under the Commission's fiscal baseline, average annual deficits will be about 6 percent of GDP between 2012 and 2018 and would need to shrink to about 2 percent to meet the goal (ranging from 5 percent in the early years to less than 1 percent by 2018). Under current law, deficits would average 3 percent of GDP and they would need to shrink to around 2 percent to meet the goal (ranging from

about 4 percent in the earliest years down to about 1 percent by 2018). The more debt policymakers add before the start of a debt stabilization plan, the greater their burden will be later.

Meeting a 60 percent of GDP target by 2018 will require significant adjustments, and policymakers will have to decide how much should come from spending cuts versus tax increases. We are not recommending a specific mix but in our view, both will be required.

FIGURE 5. Illustrative deficit path compared to Commission's fiscal baseline projections



Source: Commission's fiscal baseline.

Over the longer term, the problem is primarily on the spending side of the budget, resulting mainly from the aging American population and growing health care costs. Though revenue over time is projected to surpass historical averages of above 18 percent—even if all the expiring tax cuts are extended—it will fall well short of projected spending levels.

That does not mean however, that the entire solution has to come from changes to the programs affected by these factors—primarily Social Security, Medicare and Medicaid—or

spending in general. To the contrary, government health and retirement programs will almost certainly have to grow as a share of the economy because of demographic and technological factors, as well as changing preferences.

Nonetheless, the numbers do suggest that since the long-term problem is a spending problem, policymakers should look to reducing spending as a very significant part of any package. The more those reductions are structured and tied to the drivers of spending growth in mandatory programs, the more the changes will help keep the debt stable over the longer term.

BOX 6. Five principles for moving towards a manageable debt level

There are many policy paths that would achieve the desired debt stabilization goal. While we do not advocate any single specific set of policies, we do think that certain principles will be useful in developing the specific plan.

1. Do not use a sluggish economy as an excuse for delaying a plan. While recent deficits may have been necessary to respond to the current economic crisis, the United States must develop a fiscal exit strategy that puts the budget on a sustainable path, keeps the economic recovery on track, and avoids a future fiscal crisis. Excessive delay in crafting and enacting a plan could prove destabilizing to the economy and ultimately derail the recovery. Though policymakers should wait until 2012 to begin to phase in major policy changes, they should commit to stabilizing the debt and develop the specifics of a plan immediately.

2. Put everything on the table. Both spending and revenue must be on the table to have any hope of a “grand bargain” in which all sides have an incentive to negotiate a comprehensive package of reforms. We believe that the scope of the problem is so large that tax increases and spending cuts will have to be part of any final package.

3. Consider the effects of policy changes on economic growth. Not all policy changes are equal. While a strong and growing economy will not be enough to bring the debt to a sustainable level, economic growth will make the task of debt stabilization much easier. Pro-growth policies—such as fundamental tax reform, improving labor force incentives, and protecting productive investment spending—should be given special consideration when crafting a plan. Given that many tax increases and spending cuts will unavoidably depress growth, policymakers should try to minimize those negative effects.

4. Focus on the drivers of program growth. Any package should be weighted towards reforms of the most problematic areas of the budget. Reforms in programs that are growing faster than the economy, such as health and retirement programs, are the most likely to produce compounding savings, which not only help stabilize the debt in the medium term but keep it from growing again over the longer term.

5. Don't make matters worse. Policymakers must consider the fiscal implications of any bill they enact before adopting this framework and should offset new policies added to the budget not part of a debt stabilization package. The extension of a pay-as-you-go requirement and discretionary spending caps can be a modest step in this direction. Policymakers must recognize that the choice to extend current policies in the short term will eventually require much greater changes to reduce the debt.

3. Begin to phase in policy changes in 2012.

Given current economic conditions, we recommend waiting to implement the policy changes until 2012. Making aggressive changes any earlier could harm the economy, particularly when unemployment is expected to remain high after reaching a 25-year high in October 2009 of more than 10 percent and the economy is expected to remain below its potential.¹⁸

However, waiting longer could undermine the plan's credibility and leave the country reliant on excessively high borrowing for too long. Thus far, U.S. borrowing needs have been met by the strong demand for U.S. Treasury securities and (until quite recently) the dollar as a reasonably safe reserve currency during the current economic and financial crises. These conditions could change abruptly—and are more likely to do so if no debt plan is put in place.

In order to reach the target goal of debt stabilization by 2018, annual deficit reductions averaging nearly 4 percent of GDP would be needed if changes started in 2012. (Changes would actually be much smaller in the earliest years, growing significantly each year. Under our illustrative glide path, deficit reduction would be less than 1 percent of GDP in 2012, nearly 4 percent in 2015, and almost 7 percent in 2018.) If changes are not begun until 2014, they would have to be, on average, 5 percent of GDP per year to meet the 2018 goal.

The Commission recognizes policymakers may need to adjust the targets to reflect changes in the economic cycle. If the economy seriously weakens in the future, policymakers might need to adjust the plan to temporarily delay spending reductions or revenue increases. Any delay should be based on objective criteria, such as the official level of unemployment or economic growth. Otherwise, there would be too much opportunity—and temptation—to simply ignore the targets.

4. Review progress annually and implement an enforcement regime to stay on track.

There needs to be a mechanism to help keep any plan on track once it is adopted. Simply pledging to meet certain targets may not reassure financial markets—there have been too many past examples of empty promises and budget gimmickry.

The Commission recommends enacting a “debt trigger,” which would take effect if an annual debt target were missed. Any breach of the target would be offset through automatic spending reductions and tax increases. The Commission recommends that the trigger apply equally to spending and revenue. There would be a broad-based surtax, and all programs, projects, and activities would be subject to this trigger.¹⁹

Past automatic policy changes failed in part because so many programs were exempt from the trigger and it was so easy to bypass the restrictions. A debt trigger should be punitive enough to cause lawmakers to act but realistic enough that it can be enacted as a last resort if policymakers fail to act or select policies fall short of the goal. Using the broadest base possible would prove far more effective in keeping a plan on track since a broader base expands the political consequences of policymakers failing to meet targets, creating an incentive for Congress and the White House to craft their own fiscal policies, rather than relying on a formula to meet their debt targets.

5. Stabilize the debt by 2018.

Reducing the debt to 60 percent of GDP will be no small feat. It will require gradually bringing the debt down from a projected 69 percent in the first year of a stabilization plan. More significantly, it will require a dramatic deviation from the current debt path where the debt is projected to reach 85 percent by 2018. Preventing that increase is critical so that the United States can avoid the economic risks of excessive debt.

¹⁸ Bureau of Labor Statistics, *Employment Situation Summary*, November 6, 2009.

¹⁹ By their very nature, certain spending programs will have to be exempt from a debt trigger but the Commission recommends limiting the scope of those exemptions: interest payments on the debt, certain contractual commitments, international treaty obligations, intragovernmental payments, and constitutionally-mandated requirements.

But hitting a 60 percent target is, in and of itself, not a sufficient goal. What matters just as much—if not more—is that the debt does not continue to grow as a share of the economy thereafter. Deriving a package of tax increases and spending cuts to bring the debt down to 60 percent would be easier if keeping the debt stabilized and preventing its future growth was not important. It could then include temporary measures, timing shifts, and short-term policies that did not address the major drivers of the budget's growth, including health care, retirement programs and certain tax policies.

But hitting a 60 percent target is, in and of itself, not a sufficient goal. What matters just as much—if not more—is that the debt does not continue to grow as a share of the economy thereafter.

The purpose of stabilizing the debt is to reassure creditors and financial markets that the United States can manage its debt and limit its borrowing both in the medium and the long term. Enacting policies where the U.S. debt would grow again after 2018 as a share of the economy may not reassure them. Therefore, any stabilization package must include permanent changes in current policies and must be weighted to control the budget's most problematic areas. We believe that the problem is so large that nearly all areas of the budget will be affected, and certainly both spending and taxes will have to be part of the ultimate plan. But reforms in programs that are growing faster than the economy—notably Medicare, Medicaid, and Social Security—will provide the greatest benefits to long-term debt stability. Given the nature of these programs, many changes will need to be gradual—so that they provide some savings in the medium term but have the greatest impact decades into the future.

6. Continue to reduce the debt as a share of the economy over the longer term.

Though preventing the debt from expanding again over the long-term will be challenging given the demographic and health care cost pressures that exist, we believe that policymakers must bring the debt down below the initial 60 percent target to something closer to the U.S. historical fifty-year average of below 40 percent.

Fiscally-responsible federal policies are necessary so that the government has the fiscal flexibility to respond to crises. Even though the United States had budget deficits when the economic and financial crises hit, the relatively low debt-to-GDP ratio allowed policymakers the ability to respond quickly and borrow large amounts without worrying about the federal government's ability to access funds. If the debt level had been at its current level, or where it is projected to grow to, responding to the economic and financial crises would have been much more challenging.

The United States is likely to face similar crises or needs in the future, which is why returning not just to a stable debt ratio, but also to a lower debt ratio, is prudent. Implementing reforms that slow the growth of spending, keep revenue apace with spending, and are conducive to economic growth will be critical to lowering the debt level even further.

Ultimately, this task will almost certainly require more than one attempt at debt reduction. The Commission expects that policymakers will recognize the importance of debt reduction and not consider their work done after they enact the first package of debt reduction.

Assessing the Commission's proposal

The required debt reduction should be significant but achievable. The 60 percent of GDP goal is ambitious but achievable if policymakers quickly enact permanent structural reforms. Our framework gives policymakers almost two years before any deficit reduction is required and then only requires modest deficit reduction of 1 to 3 percent of GDP in the plan's early years. Given the proposed seven-year time period, there will be time for program beneficiaries and taxpayers to adjust to the changes in advance of when they are phased in.

Reforms should not jeopardize economic recovery. Immediate spending cuts and tax increases might delay or weaken the economy's recovery. The plan puts off any required savings until 2012, when economic recovery should be firmly in place. In the event of a future economic downturn, policymakers could postpone reforms to avoid economic consequences but only under a narrow set of economic conditions. However, policymakers should not use the recent recession as an excuse to avoid the debt challenge, which is why it is important to commit to a time-frame and start date for phasing in changes.

Any automatic enforcement mechanism should include both spending cuts and revenue increases.

The goal of an enforcement mechanism is to be punitive enough to cause lawmakers to act but realistic enough that it can be enacted if necessary as a last resort. Our enforcement mechanism applies across the board to spending programs and revenue alike. Applying automatic changes to both sides of the fiscal ledger will increase the base for savings, lessening the impact on programs and spending, and will require across-the-board sacrifices from program beneficiaries and taxpayers.

The executive branch should not be able to preempt reform by using overly optimistic assumptions.

Past enforcement mechanisms were based on estimates from the executive branch. This allowed the White House to use overly optimistic assumptions for economic growth or generous estimates of recently enacted savings to manipulate the targets. A sensible plan could include options to minimize these budgetary gimmicks such as holding policymakers accountable in the current year from their failure to meet the prior year's targets.

Rules should be strong but flexible. The EU has found that the most effective budget rules are: statutory, simple and transparent, flexible (enough to handle legitimate emergencies), and enforceable.²⁰ Our proposal meets these criteria by imposing a statutory framework, creating a simple goal (60 percent of GDP by 2018), recognizing that adjustments may be required for changing economic conditions, and including an automatic enforcement mechanism.

20 European Commission, *Public Finances in EMU*—2009, May 2009, 91.

Conclusion

There is no question that the United States is on an unsustainable fiscal path. The consequences are serious for public policy, the economy, and the standard of living of the American people. Structural deficits will remain even as the economy recovers from the current deep recession and the debt is on a course to reach levels never experienced in the United States. While it was necessary to ramp up deficit spending to stem the recent sharp decline in the economy, the United States must adopt a plan to stabilize the debt immediately and take the first steps down that path very soon.

History does not provide good comparisons for the magnitude of the explosion in debt we face. Yes, in the immediate aftermath of World War II, the U.S. debt-to-GDP ratio briefly exceeded 100 percent. But any similarities end there. After World War II, the demographics were essentially reversed from today's situation—the U.S. population was much younger, most U.S. debt was held domestically, and the government had a plan to pay back the debt in only a few years.

Today, an ever-growing proportion of debt is held outside U.S. borders. Many fear that, if international markets believe the United States cannot manage its debt, it will be unable to continue such levels of borrowing. And as a result, the American economy will falter. U.S. securities may lose their value as investors flee to alternatives. Further, interest rates on mortgages, car and education loans, and credit cards could rise to unaffordable levels. The cost of doing nothing is high.

Other countries have successfully undertaken fiscal consolidation efforts to reduce their debt. However in many cases, it took a debt crisis or severe international pressure for these nations to act. If policymakers fail to act before a crisis hits, citizens will pay a tremendous economic price.

The Peterson-Pew Commission on Budget Reform believes that policymakers must change the fiscal course to head off such a crisis. This will require policymakers to adopt a path toward sustainable debt and credibly commit to enacting it over the next several years. There is no question that the Commission's plan will require hard choices—significant spending cuts and tax increases will be necessary to shift our fiscal course. And we are under no illusions that any single fiscal framework will fix the country's fiscal problems.

The biggest factor in whether our country will succeed is political will—leaders will need to come together and courageously make the tough choices. Promises not to raise certain taxes or reduce certain benefits only stand in the way of bringing politicians together to develop a realistic plan. Any meaningful effort to address the budget problems will have to be bipartisan, giving both major political parties cover. Our debt should not be our destiny—the time to act is now.

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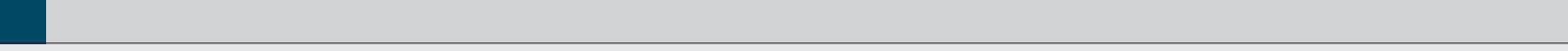
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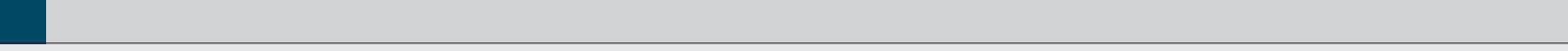


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About the Peterson-Pew Commission on Budget Reform

To modernize an outdated Congressional budget process in light of the daunting economic challenges facing the nation, the Peter G. Peterson Foundation, The Pew Charitable Trusts and the Committee for a Responsible Federal Budget have launched a landmark partnership to build bipartisan consensus for a core set of reforms. The Peterson-Pew Commission on Budget Reform has convened the nation's preeminent experts to make recommendations for how best to improve the nation's fiscal future and how best to strengthen the federal budget process.

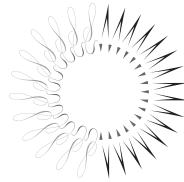
The Commission began its work in January 2009 and will continue to meet until December 2010.



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PETERSON-PEW COMMISSION ON BUDGET REFORM
1899 L Street NW, Suite 400
Washington, DC 20036

