CQ Researcher

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The National Debt

Has it gotten too big?

With the national debt now more than $10 trillion — twice what it was eight years ago — the country faces a dire financial future, some analysts argue. Over the past eight years, the Bush administration has run larger and larger annual deficits, adding to the national debt and restricting the government's ability to respond to a new crisis. Now, with the U.S. and global financial meltdown ushering in a potentially catastrophic economic slowdown, the next president — newly elected Sen. Barack Obama — will be under pressure to use government fiscal policy, such as tax cuts and government spending, to bolster the economy, even though those actions will raise the debt further. Besides wrestling with that dilemma, the new president also must face the question of how to pay for spiraling Social Security, Medicare and Medicaid benefits for the nation's 77 million baby boomers.

The National Debt Clock in New York City registers $10 trillion in October for the first time — twice the amount the U.S. owed when President Bush took office eight years ago.

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THE NATIONAL DEBT

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MANAGING EDITOR: Thomas J. Colin
tcolin@cqpress.com

ASSISTANT MANAGING EDITOR: Kathy Koch
kkoch@cqpress.com

ASSOCIATE EDITOR: Kenneth Jost

STAFF WRITERS: Thomas J. Billitteri, Marcia Clemmitt, Peter Katel

CONTRIBUTING WRITERS: Rachel S. Cox, Sarah Glazer, Alan Greenblatt, Barbara Mantel, Patrick Marshall, Tom Price, Jennifer Weeks

DESIGN/PRODUCTION EDITOR: Olu B. Davis

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EDITORIAL INTERNS: Alexis Irvin, Vyomika Jairam

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The National Debt

By Marcia Clemmitt

The Issues

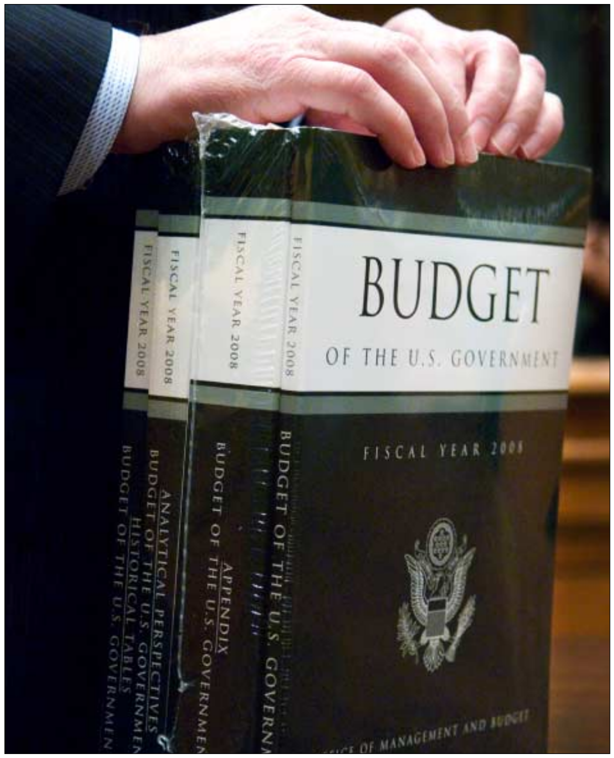
Osama bin Laden is not America's gravest threat, says former Comptroller General David M. Walker.

"The most serious threat to the United States is not someone hiding in a cave in Afghanistan or Pakistan but our own fiscal irresponsibility," Walker told CBS News earlier this year. "We're spending more money than we make. . . . We're charging it to the credit card . . . and expecting our grandchildren to pay for it. And that's absolutely outrageous." [1]

In February, Walker quit his job as head of the Government Accountability Office (GAO) — the nation's auditing agency — to barnstorm the country full time as president of the Peter G. Peterson Foundation. The new organization, founded by investment banker and Nixon administration Secretary of Commerce Peterson, is dedicated to alerting the public to an approaching tidal wave of budget deficits just as waves of retiring baby boomers begin claiming trillions of dollars in Social Security and Medicare benefits.

The sum of deficits year after year — including money raised by selling Treasury securities here and abroad — is the national debt, now more than $10 trillion.

In a year of catastrophic financial news, three milestones stand out. In February, 62-year-old retired Maryland teacher Kathleen Casey-Kirschling became the first baby boomer to receive a Social Security check, ushering in a flood of retirees whose retirement and Medicare benefits will strain federal coffers. [2]



Getty Images/Congressional Quarterly/Scott J. Ferrell

President Bush's $2.9 trillion budget proposal for fiscal 2008 fills four volumes (2,186 pages) and weighs about 10 pounds. In October the annual federal budget deficit hit a record $455 billion. The continuing string of annual budget deficits has pushed the national debt to more than $10 trillion.

In October the annual federal budget deficit hit a record $455 billion, up from the previous record of $413 billion in 2004. The increase alarmed many budget analysts, not only because it continued the recent series of deficits but also because it came before the economy and financial markets nosedived, prompting Congress to approve a $700 billion bailout in October. [3] Also in October the National Debt Clock in New York City's Times Square topped $10 trillion for the first time — double the national debt when President George W. Bush took office eight years ago. [4]

Most analysts agree with Walker that two budget issues especially threaten the nation's future financial health: The recent string of annual federal budget deficits — which have persisted even in economic good times — and skyrocketing health-care costs, which threaten to swamp Medicare, Medicaid and the private health-care system over the next several decades.

"As alarming as the size of our current debt is, it excludes many items, including the gap between future promised and funded Social Security and Medicare benefits, veterans' health care and a range of other commitments and contingencies that the federal government has pledged to support" in the future — thus understating the true magnitude of budget problems, Walker told the Senate Budget Committee in January. [5]

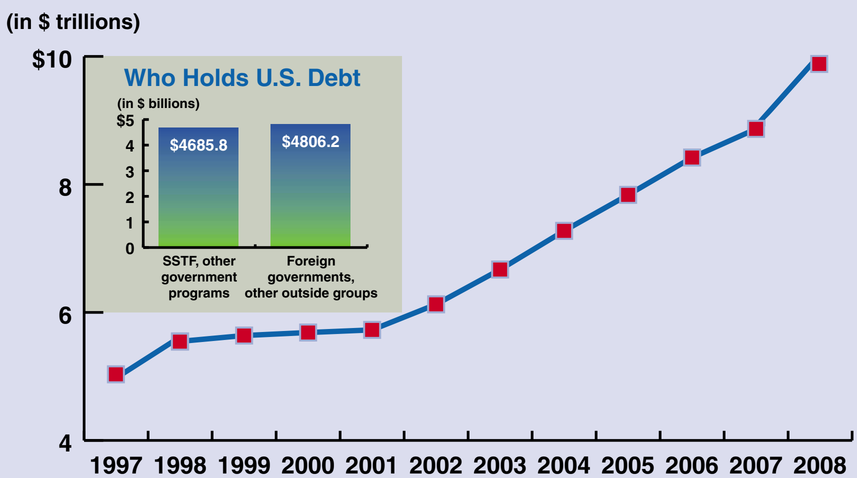
When countries have obligations they couldn't otherwise meet, rather than raise taxes or cut programs to save money, governments that already carry substantial debt burdens have a tendency to simply print more money — called "monetizing" debt. But with more cash available, demand for goods and services swells and prices rise higher in an inflationary cycle, says Herbert I. London, president of the conservative Hudson Institute, a Washington think tank. And when it comes to Social Security and Medicare, "the government is not going to cut these programs," so "monetizing" may prove irresistible, London says.

Much as with any other debt, such as credit-card debt, the national debt matters because the government has to pay interest on it each year, explains Michael Hudson, a research professor of economics at the University of Missouri, Kansas City, and

National Debt Doubled in Last Decade

The total public debt of the United States has steadily increased from $5 trillion in 1997 to $10 trillion this year (line graph). Roughly half the debt is held by the Social Security Trust Fund (SSTF) and other U.S. government programs and half by outside individuals and groups, including foreign governments (inset).

U.S. National Debt 1997-2008



Source: Financial Management Service, Department of the Treasury

president of the Institute for the Study of Long-Term Economic Trends, in Forest Hills, N.Y. If the debt rises too high, interest payments can "crowd out other things" the government might want to do, he says.

"We're already spending twice as much on debt interest as on the Iraq War" — or over $400 billion a year — points out Andrew L. Yarrow, author of the 2008 book *Forgive Us Our Debts: The Intergenerational Dangers of Fiscal Irresponsibility.* [6]

And with foreign central banks now holding a sizable portion of America's debt in the form of Treasury securities, those interest payments don't end up back in Americans' pockets as they did in the past, when "we mostly owed the debt to ourselves," says Linda Bilmes, a professor of public budgeting at Harvard University's John F. Kennedy School of Government and coauthor of *The Three Trillion Dollar War: The True Cost of the Iraq Conflict.* [7] Unlike government spending on items like roads, for example, "interest payments made to the central bank of China" don't help build the nation or the economy, Bilmes says.

The recent practice of running deficits during both good economic times and bad disturbs most economists. In a healthy economy, deficits typically increase during economic downturns — when tax revenues fall — and shrink during boom times.

"But in the mid-2000s the economy grew, but deficits grew too," as Congress continued to spend while giving out tax breaks, says Hashem Dezhbakhsh, a professor of economics at Emory University in Atlanta. "This is a structural deficit," which not only causes the total debt to balloon but indicates that the government isn't behaving conscientiously, he says.

Worse, over the past quarter-century the federal government has run deficits almost every year, even though large, annual Social Security surpluses were borrowed to help shore up federal finances during the entire period.

"The government has used this accounting legerdemain" — borrowing Social Security surpluses to fund programs, including wars and tax cuts — says Yarrow, who is vice president of the nonpartisan, public opinion research group Public Agenda. As baby boomers reach retirement age, those IOUs will come due as Social Security is forced to pay promised benefits. When that happens, the government will have to make some tough choices to cope with the loss of ready cash, he says.

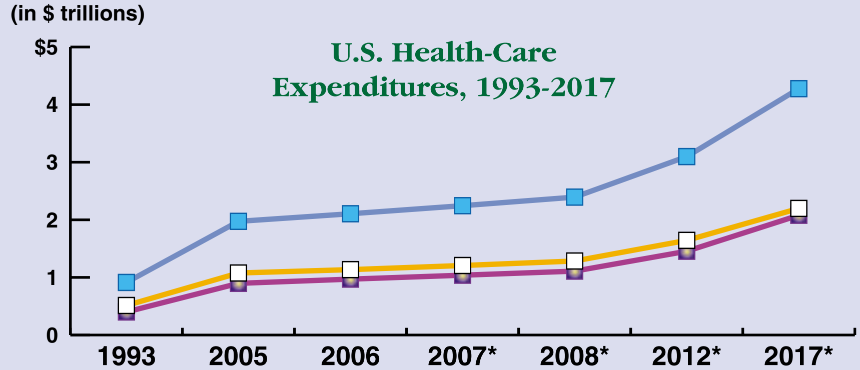
Despite concerns, particularly among skeptical younger Americans who fear Social Security will be broke by the time they retire, most economists say it can survive the fiscal tsunami with only some tweaks. Sometime in the next few decades, Congress will have to either increase Social Security taxes paid by workers and employers or cut the benefits, but the change needn't be drastic, says Roberton Williams, a principal research associate in tax policy at the nonpartisan, mainly center-left-leaning Urban Institute. "We'll probably have to work a little longer or see our benefits cut a little bit," he says.

But the health-care system — Medicare and Medicaid as well as other public and private services — is another matter. Health costs have been rising faster than the rest of the economy for decades — a trend widely seen as unsustainable.

"One hundred percent of the problem" with the nation's fiscal future lies in health care, says Henry J. Aaron, a senior fellow in economics at the Brookings Institution, a centrist think tank. If we solve the health-care problem, "there won't be a long-term fiscal problem," he says.

Rising Health Spending to Boost Debt

National health expenditures are expected to exceed $4 trillion in 2017 — or four times more than the nation spent in 1993, the year the U.S. shifted to managed care. The impact on the national debt is expected to be severe.



* *projected*

Source: Sean Keehan, et al.*, "Health Spending Projections Through 2017: The Baby-Boom Generation Is Coming To Medicare,"* Health Affairs*, February 2008*

The health-care system must be redesigned to offer incentives for providing only the most effective and cost-effective care, "but we don't know yet what 'effective care' is," says James R. Horney, director of fiscal policy at the liberal-leaning Center on Budget and Policy Priorities.

Medicare spending growth rates reflect not only the burgeoning beneficiary population but also health-care costs that are growing faster than the inflation rate, said former Comptroller General Walker. "Total health-care spending," he said, "is absorbing an increasing share of our nation's GDP [gross domestic product]" — the total amount of goods and services the country produces in a year. It has risen from about 8 percent of GDP in 1976 to 16 percent in 2006, and is projected to reach about 20 percent of GDP in 2016 — crowding out other vital spending. [8]

As growing budget deficits and recession threaten to increase the national debt, here are some of the questions being asked:

Is the national debt too big?

The national debt now exceeds $10 trillion — or about 70 percent of the nation's $14.4 trillion gross domestic product. Although some economists find that level of debt alarming, others say it is not overwhelming by international or historical standards.

The debt-to-GDP ratio — which economists say is the most important measurement — "is well within historical limits and still gives the U.S. room to maneuver" today, says Steven Sheffrin, a professor of economics at the University of California-Davis. (*See graph, p. 945.*)

By world standards, America's 70 percent debt-to-GDP ratio is not entirely out of line. Japan's ratio has long been well over 100 percent, and, as of 2007, Belgium, Norway and Israel had debt-to-GDP ratios of 80 percent or higher. In comparison, the ratio in Germany, Canada and France was over 60 percent. [9]

Moreover, the ratio "isn't up appreciably" this year, says the Brookings Institution's Aaron. "We're heading into a deep recession, which will add to deficits, but we're not in a danger zone," he says.

Russell Roberts, a professor of economics at George Mason University in Fairfax, Va., calls the size of the national debt "a bit of a red herring," since citizens will pay for government spending through either current or future taxes. More important, he says, is "whether the money is being spent wisely, whether it's spent on important things."

Furthermore, with the economy facing a deep recession, and financial markets in trouble, most analysts agree that for the time being the United States will run more — though hopefully temporary — deficits in order to stimulate the economy.

Economists normally argue that when a government goes into deficit mode and has to borrow money, it will raise the interest rates it offers on Treasury securities, thus "crowding out" borrowing by private businesses and slowing the economy, says Dean Baker, co-director of the liberal Center for Economic and Policy Research. But in a recession, government borrowing doesn't have that negative effect, since private investors aren't looking to fund new projects anyway, he says.

On the contrary, in a recession "the answer is for the government to spend money," even if that temporarily increases deficits, because the economy needs new demand to begin percolating again, Baker says.

Consumption drives the economy, and "if consumers are confident and keep buying, business will be happy" and the economy will perk up, says Robert E. Wright, a clinical associate professor of economics at New York University's Stern School of Business. "It would be very difficult to pay down the debt" in the next year or so, because the government must spend money in order to help consumers spend and create economy-stimulating demand, he

says, and because tax revenues will fall as the recession continues.

Even organizations that favor debt reduction generally agree that cutting the budget in a recession is not a good idea. In the current climate, "if the federal government had to balance the budget, that would dampen the economy," especially since "a lot of states are at the point where they've having to lay people off and stop projects," says Susan Tanaka, director of citizen education and engagement at the Peterson Foundation. "Our message would be: We're not so much focused on the short term as on the long term" when it comes to budget balancing.

Current circumstances aside, however, many economists worry the debt-to-GDP ratio could be rising to dangerous levels.

In 2006, the World Economic Forum "downgraded the United States from the most-competitive economy in the world to the sixth-most-competitive economy," Senate Budget Committee Chairman Kent Conrad, D-N.D., said last year. Interest payments on the debt were crowding out spending on infrastructure, schools and other investments that could boost productivity, he noted. [10]

A large debt can be dangerous, much as "a fat guy in a small boat" is vulnerable, says Wright. When a big wave comes by, he's more likely to be overturned. Too much debt limits the government's ability to spend big during a crisis, says Wright. For example, "if we'd had a smaller national debt, we might have put up $2 trillion" — rather than $700 billion — in the recent financial-market bailout, he says.

Furthermore, if would-be creditors — such as foreign central banks — begin to worry the United States will have trouble paying back its debts — or will have to pay them back in inflated dollars that have less buying power — then the United States may have to raise its interest rates, which makes future borrowing more expensive, says George Mason's Roberts.

Getty Images/Mark Wilson

Retired Maryland teacher Kathleen Casey-Kirschling, 62, becomes the first baby boomer to file for her Social Security retirement benefits, on Oct. 15, 2007. The national debt will be strained in coming years as millions more boomers sign up to receive retirement and Medicare benefits.

"In the past, despite the debt's size, its economic impact was small," he says, but today it "is getting a little scary."

Interest payments on the debt make up the government's fourth-largest budget item. "So many of the things we want" — from aid to cities to a better air-traffic-control system — "are being stung by cutbacks," says Harvard's Bilmes, because federal dollars are being used to pay interest on the debt.

Many analysts agree that, whether or not the current debt is too high, it is worrisome that the federal government currently spends more than it takes in each year, even when the economy is strong.

"Politicians generally . . . should not have the pleasure of spending (getting votes) without the pain of taxing (losing votes)," wrote public-finance consultant and former Treasury official Francis X. Cavanaugh. "We need that accountability to ensure that the spending is justified — that the taxpayers are willing to pay for it." [11]

Especially during the Bush administration, politicians have come to routinely ignore prudent budgeting by spending and cutting taxes at the same time, many economic analysts say. "[President Ronald] Reagan proved that deficits don't matter," Vice President Dick Cheney reportedly remarked in 2002, when Treasury Secretary Paul O'Neill objected to new tax-cut proposals. [12]

Public opinion encourages politicians to be fiscally careless, says Tanaka, of the Peterson Foundation. "We expect the public sector to do more than we are willing to pay for," and widespread "fear of the T-word" — taxes — means that "lawmakers aren't ever rewarded for being fiscally conservative."

Will Social Security bust the federal budget?

The nation's debt has increased, according to some analysts, because the government has gotten in the habit of paying some of its bills by borrowing money from Social Security surpluses, which have exceeded benefits being paid out since the mid-1980s. But that situation is expected to change after about 2017.

Continued on p. 944

Expert Diagnosis: Rationing Health Care Is Inevitable

America spends twice as much as other developed nations.

When it comes to America's skyrocketing debt, "health care is the big enchilada," says Andrew L. Yarrow, author of the 2008 book *Forgive Us Our Debts: The Intergenerational Dangers of Fiscal Irresponsibility.* America "is spending twice as much as any other developed country" without providing appreciably better care, according to international health statistics, and that spending track will break the bank sooner rather than later. "There has to be systemic reform."

Furthermore, "it's not a matter of making Medicare work better or reducing Medicaid doctor payments," says James R. Horney, director of federal fiscal policy at the liberal-leaning Center on Budget and Policy Priorities. For both publicly and privately insured people, "health-care spending has been growing faster than the economy" overall for decades, "and we don't know what to do," he says.

Getty Images/Congressional Quarterly/Scott J. Ferrell

Robert L. Bixby, Executive Director, Concord Coalition.

Reining in rising costs won't be easy, says Robert L. Bixby, executive director of the Concord Coalition, which advocates for fiscal responsibility. "The kind of thing you hear from politicians are these painless, cost-saving ideas like wellness programs and electronic medical recordkeeping," and "that makes me laugh," since such measures would barely dent the problem, he says.

"No one likes the term 'rationing,' but it is unlikely that we can afford to provide every U.S. citizen with every treatment that has a positive benefit, no matter how small," said Katherine Baicker, a professor of health economics at the Harvard School of Public Health. "The question is what that rationing mechanism will be . . . ability to pay, waiting in line or program rules based on comparative effectiveness." [1]

Data from Medicare tell us that a great deal of health care currently used in the United States may be unnecessary, Peter R. Orszag, director of the nonpartisan Congressional Budget Office, told the House Budget Committee in July.

Even at top university medical centers, he said, the cost per elderly patient during the last six months of life varies by nearly a two-to-one ratio — from $26,330 for the average patient treated by the Mayo Clinic, for example, to $50,522 for a patient at the University of California-Los Angeles, Medical Center. Furthermore, the Mayo Clinic actually scores somewhat higher on quality-of-care measures than UCLA. [2]

Although pinpointing and eliminating the unnecessary care without inadvertently eliminating good care would be difficult, researchers estimate that nearly 30 percent of current health-care costs could be saved by getting high-cost care providers to treat patients the same way that low-cost — but still good-quality — providers do, said Orszag. "That estimate would suggest that nearly 5 percent of [gross domestic product] — or roughly $700 billion each year — goes to health-care spending that cannot be shown to improve health outcomes," he said. [3]

Most countries with national health-care systems, such as the United Kingdom, Canada, the Netherlands and Chile, attempt to gauge the cost-effectiveness of medical care and prioritize what they'll pay for on that basis, usually with some kind of public input on which care should be favored. Most health-policy analysts believe that it's time the United States developed such a system, but the barriers to doing so are steep.

Among the obstacles are the ultra-quick dispersal of new technologies throughout the U.S. health system, including technologies with "limited impact on outcomes," and a "more is better" culture, according to the Institute for Healthcare Improvement in Cambridge, Mass. [4]

A group of public-health analysts from the City University of New York (CUNY) argues that Americans have shown they are ready to make some hard choices.

For example, in a research project called Choosing Health Plans All Together (CHAT) — in which citizens deliberate together about prioritizing scarce health-care funding — all the members of a Minnesota citizens' group said they were willing to accept some cuts to their own health-care benefits to help fund coverage for uninsured children. And a majority said they'd accept benefit reductions to cover uninsured adults. Medicare beneficiaries participating in CHAT were willing to forgo coverage for experimental treatments in exchange for pharmacy, dental and long-term care benefits and to extend coverage to more uninsured people. [5]

Contrary to what many Washington policy makers believe, "Americans understand and are prepared to engage the issues that arise when setting priorities and imposing limits" for health-care programs, the CUNY authors said.

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[1] Katherine Baicker, "Formula for Compromise: Expanding Coverage and Promoting High-Value Care," *Health Affairs*, May/June 2008, p. 661.

[2] Testimony before House Committee on the Budget, July 16, 2008.

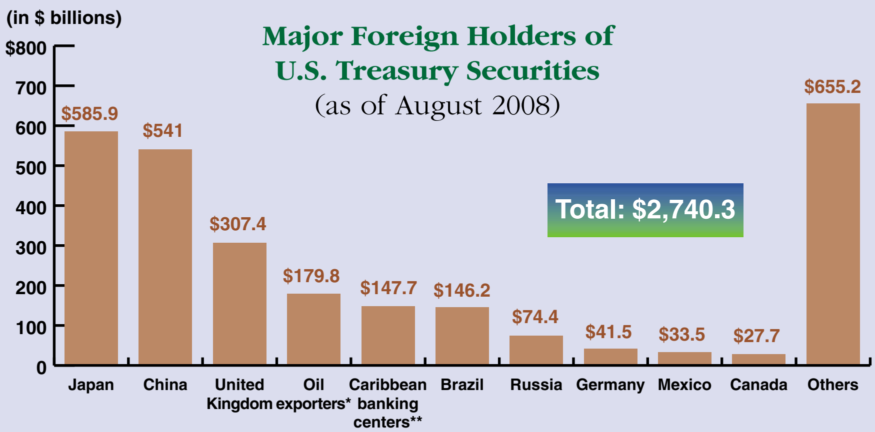
[3] *Ibid.*

[4] Donald M. Berwick, Thomas W. Nolan and John Whittington, "The Triple Aim: Care, Health, and Cost," *Health Affairs*, May/June 2008, p. 761.

[5] Marthe R. Gold, Shoshanna Sofaer and Taryn Siegelberg, "Medicare and Cost-Effectiveness Analysis: Time to Ask the Taxpayers," *Health Affairs*, September/October 2007, p. 1399.

Japan Holds Most U.S. Treasury Securities

Japan holds nearly a quarter of the $2.74 trillion in U.S. Treasury securities held by other nations. Japan, China and the United Kingdom together hold more than half the total.



** Includes Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates, Algeria, Gabon, Libya and Nigeria.*

*** Includes Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama and British Virgin Islands.*

Source: Department of the Treasury

Continued from p. 942

The federal government borrows from Social Security by selling interest-deferred Treasury bonds to the Social Security Administration, which holds them like an IOU. This "intragovernmental" portion of the national debt accounts for about half of the total; the other half — the so-called public portion of the national debt — is held by individuals and organizations outside the U.S. government, including foreign governments.

But in about 2017, when annual Social Security benefit payments are projected to begin exceeding revenues, the Treasury will have to begin paying back some of the deferred interest accumulated on the bonds held by the Social Security Trust Fund. And after 2026, government accountants say, the Social Security System will have to begin asking the government to pay back the principal of the Treasury bonds it holds — a scenario that poses two major debt-related problems.

First, since the government will no longer be able to borrow from Social Security to pay for other priorities, it will either have to raise taxes or cut spending. "When Social Security starts to go into default, we'll be reminded of the IOUs in a very dramatic fashion," says financial analyst Addison Wiggin, who is a coauthor with Walker of the 2008 book, *I.O.U.S.A.: One Nation. Under Stress. In Debt.* Second, many people aren't aware that Social Security funds have been used in place of taxes to shore up the rest of the government for decades, and through "this accounting trick . . . you've been making it sound like the debt is less serious than it is," says Emory University's Dezhbakhsh.

"Today our deficits and debts, relatively speaking, are in pretty good shape, so the government can do what it's doing" — for example, on the financial-markets bailout — with relative ease, says the Peterson Foundation's Tanaka. But when Social Security stops running surpluses, "we will not have the resources" to act so flexibly if crises arise, she says.

And, because of growth in Social Security and Medicare payments, budgetary pressures will be severe "not just on the next president but on the next two or three presidents," says London of the Hudson Institute.

When Social Security can no longer lend its surpluses to the federal government, the government will have to make serious budget adjustments. But that doesn't mean Social Security itself is on wobbly ground, say many economists.

"The policy change necessary to avoid . . . calamities [in Social Security] is not that severe," said Rudolph Penner, an Urban Institute senior fellow and former Congressional Budget Office director. Social Security payroll tax revenues will grow with the economy and will probably be sufficient to give the next generation higher dollar benefits than people get today, though those benefits will represent a smaller proportion of recipients' pre-Social Security income. "They won't get the benefits they're promised, but they will get benefits," he says. "Social Security won't disappear." [13]

By redeeming its Treasury bonds, "Social Security can pay all its promised benefits through the year 2049, and can extend that period for 75 years with "fixes" smaller than those enacted in the 1950s and '80s, says Mark Weisbrot, co-director of the Center for Economic Policy and Research. The idea that Social Security is in danger of going bankrupt is "an urban legend," he says. Promised benefits that won't be covered "amount to less than seven-tenths of 1 percent" of the country's projected future income, "a very small fraction."

"It's close to crazy" to imagine that "at some point in the future the government would just stop paying benefits," says the center's Baker. It's highly unlikely that Congress would "still be building roads and paying for defense

but would stop paying benefits" to millions of voters. "The U.S. government has never defaulted on its bonds in our nation's entire history."

By 2041 the Social Security Trust Fund will have no more Treasury bonds left to redeem, according to Chad Stone, chief economist, and Robert Greenstein, executive director, of the Center on Budget and Policy Priorities. After that, the fund will be able to pay 78 percent of currently promised benefits, dropping gradually to 75 percent in 2082. [14]

Furthermore, future generations may be substantially wealthier than we are today, so "asking them to pay a bit more in taxes would still leave them with a much higher after-tax income and standards of living than current generations enjoy," they added. [15]

While experts continue to disagree over the severity of the Social Security problem, there's universal agreement that rapidly rising health-care costs will force large changes in Medicare and Medicaid in coming decades, not to mention the nation's overall financial picture.

"The share of the economy taken up by health care is large and rising, but once we've said, 'We'll cover you when you're old,' that becomes a promise people rely on," says the Urban Institute's Williams. Basically, we'll need "some way to ration" health care.

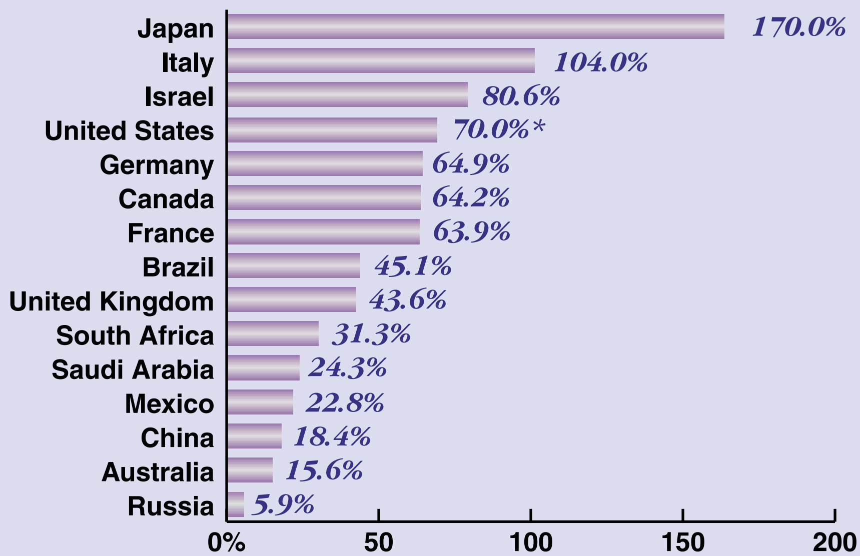
Debate continues between those who say reforming government programs like Medicare is the key to controlling the coming budget tsunami and those who argue that it will also require reining in steeply rising health-care costs for privately insured Americans. [16]

Brian Riedl, lead tax and budget analyst at the conservative Heritage Foundation, says the nation's top three budgetary priorities today are: "first, make sure the current economic downturn is small; second, reform Medicare and Medicaid and Social Security; third, modernize the federal government because the government wastes a lot of money on unimportant things."

U.S. Debt Tracks Other Industrial Nations

America's $10 trillion national debt is more than two-thirds the nation's gross domestic product (GDP). While the percentage is among the highest in the world, it is generally in keeping with the debt-to-GDP ratio of other industrialized nations. Japan's public debt is the highest among first world nations.

Public Debt as a Percentage of Gross Domestic Product
(among selected nations, 2007 estimates)



* 2008

Source: The World Factbook, *Central Intelligence Agency*

But many other commentators caution that trimming spending on Medicare and Medicaid alone won't work. "We have a private health-care system," Baker says. "Medicare and Medicaid are paying almost exclusively for private health care" so unless private-sector costs are reined in, overall costs will continue rising out of control.

Do foreigners hold too much of our national debt?

In the 1940s and '50s, when America was paying off its World War II debt, "most of the bonds were bought by Americans, who had a much higher savings rate" than today, says financial analyst Wiggin.

But over the past decade alone, the national savings rate has declined from an average 4.5 percent of Americans' annual income to 1 percent or less, and foreign capital has financed much more of the debt, said Peter R. Orszag, director of Congress' nonpartisan budget-analysis arm, the Congressional Budget Office. [17] In 2008, foreign central banks and investment funds held more than $2.7 trillion in U.S. Treasury bonds. [18] (*See graph, p. 944.*)

Over the years, many economists have argued that other nations' willingness to invest in U.S. bonds is a win-win situation. "It is a mystery to me why . . . it is regarded as a sign of Japanese strength and American weakness that the Japanese find it more

attractive to invest in the U.S. than Japan," influential Nobel Prize-winning free-market economist Milton Friedman of the University of Chicago said in 1988. "Surely it is precisely the reverse." [19]

America has been able to increase its debt "because a lot of people around the world are happy to hold Treasury bonds," says the Urban Institute's Williams. In recent years, "the Chinese were seeing 10 to 15 percent growth a year" and chose U.S. Treasury bonds over other places to stash their cash, he says.

In addition, foreign central banks' strong demand for U.S. debt has allowed the United States to finance a larger deficit at lower cost because Treasury bond buyers don't have to be enticed with high interest rates, Brad Setser, senior economist for the New York research firm Roubini Global Economics, told the House Budget Committee last year.

"Longstanding concerns that these imbalances will severely damage U.S. economic and financial performance . . . are overblown," Bank of America Chief Economist Mickey D. Levy told the House panel. Foreign investors are attracted by America's rule of law and historic stability and "benefit just as much from their investments in U.S. dollar-denominated assets as the U.S. benefits from the net foreign capital inflows," he said. [20]

"U.S. and global economic growth and standards of living are improved by capital that flows internationally from excess savers," said Levy. "Decades-long worries that foreign investors will abruptly sell their U.S. assets are misplaced. Foreign nations that have accumulated U.S. debt will not shift out of dollars quickly in a way that would jar financial markets unless there is a dramatic shift . . . in U.S. policies perceived to be damaging to U.S. economic or financial performance." [21]

Foreign debt holdings don't expose the country to the risk of foreign governments using "their massive leverage to precipitate a wholesale financial collapse in the United States," as some fear, said Kenneth Rogoff, a professor of economics and public policy at Harvard University. Doing so would "almost certainly backfire," by causing the U.S. dollar to plummet on world markets, dramatically reducing the value of those countries' huge dollar holdings, he said. [22]

Many analysts warn, however, that if the trend of rising annual budget deficits continues, doubts could grow about the economy's strength, and foreign investors might avoid U.S. bonds in the future.

The United States is not just a borrowing nation. It has a long history of lending money to foreign governments as well. "The U.S. net debt position — the gap between what the U.S. has borrowed from the world and what the U.S has lent to the world — has deteriorated dramatically over the past six years," said Setser. "Going forward . . . the United States should not expect foreigners — including foreign governments — to finance the United States on as generous terms as the U.S. has enjoyed over the past few years." [23]

Indeed, Rogoff says, the country's continued dependence on foreign borrowing is a "significant vulnerability" that could leave the United States scrambling if large sums of money were needed to meet some immediate crisis. [24]

"We no longer fund our own government with our personal savings" — by buying Treasury bonds, such as U.S. Savings Bonds — and "if consumption picks up in India, China and Japan, those governments may not have as much money in savings to invest in America," says Wiggin. That would require the United States to offer higher interest on its bonds to attract borrowers, he says, which would make running a deficit much more expensive and potentially force the government to change its fiscal ways.

Developing countries have long faced international demands to reform their economies and governments in line with the priorities of creditor nations like the United States, and that's the risk any country runs if it is perceived as a risky borrower, says author Yarrow at Public Agenda. For the United States, "the shoe could be on the other foot in the not-too-distant future" if large budget deficits and economic woes continue.

Overreliance on a seemingly endless pool of foreign capital also may be lulling the United States into a fiscal stupor, said Setser, with the government unwilling to get its own fiscal house in order and encourage more domestic savings to meet accelerating budget demands that will accompany the baby boomers' retirement. [25] ■

BACKGROUND

Founding Debtors

Almost as long as there have been nations, citizens have argued about how heavily into debt government should go to finance activities ranging from building roads to fighting wars. To get cash, they have three choices: tax their citizens, borrow or print more money. And while few say that debt is always a bad choice, debt skeptics worry that borrowing, because it seems like the easy way out, can lead to careless government fiscal behavior. [26]

Printing money is generally the last resort because it causes inflation — a rise in prices as more money chases goods and services. As prices inflate, the dollar is unable to buy as much as in the past.

That leaves a choice between borrowing and raising taxes. But both are essentially taxes, says George Mason University's Roberts. "Debts are just taxes tomorrow," he says.

Nevertheless, being able to run up debt means that lawmakers can meet

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Chronology

1790s-1920s
The government's budget grows, but national debt increases substantially only in wartime.

1790
Treasury Secretary Alexander Hamilton announces the first national debt tally — $75.5 million.

1919
Government posts its highest annual deficit to date, nearly $13.4 billion.

1930s-1940s
As Depression begins, government tries to keep budget balanced.

1937
Social Security begins providing benefits to a growing elderly population.

1946
Postwar national debt totals about $250 billion, 108.6 percent of gross national product (GNP).

1950s-1970s
National debt keeps growing, but economic growth shrinks the debt-to-GDP ratio, which holds at around 33 percent in the 1970s.

1965
Medicare and Medicaid are created.

1979
Debt reaches $829 billion, 33 percent of gross domestic product.

1980s
Surplus Social Security payments begin to flow into the general budget, masking the actual size of future deficits.

1981-1982
Severe recession helps run up debt.

1983
Short-term Social Security financing crisis prompts Congress to raise the payroll tax and increase the eligibility age to build surpluses to help fund baby boomer retirement.

1985
With annual deficits topping $200 billion, Congress passes the Gramm-Rudman-Hollings law, hoping to wipe out deficits in five years through across-the-board spending cuts.

1986
Interest payments on debt become the biggest federal budget item.

1990s
Bipartisan effort to eliminate deficit leads to surpluses.

1990
Congress passes Budget Enforcement Act, whose "pay-go" rule requires lawmakers to pay for tax cuts or spending increases.

1992
Independent presidential candidate Ross Perot calls attention to the risks of deficits.

1997
Balanced Budget Act cutting Medicare and Medicaid is enacted with bipartisan support.

1998-2001
Government runs first budget surpluses since 1969.

2000s
Tax cuts and spending increases swell the debt.

2000
National debt is $5.7 trillion.

2001
Congress passes President George W. Bush's first round of tax cuts.

2002
Pay-go rule expires.

2003
Tax cuts on dividends and capital gains are enacted.

2006
Federal spending rises from continuing wars in Iraq and Afghanistan and a new Medicare drug benefit, but tax rates are kept low.

2008
First baby boomers begin collecting Social Security benefits. . . . Government reports a record-high deficit of $455 billion. . . . National debt passes $10 trillion. . . . Federal efforts to stem financial-market chaos may add $1 trillion or more to national debt. . . . Economists say government has no choice but to increase debt levels to help end a potentially severe recession.

2010s
Health-care costs are projected to swamp the economy.

2011
First baby boomers become eligible for Medicare.

2017
Health-care costs are projected to equal 20 percent of GDP.

Most Experts Say 'Ignore' the Debt — for Now

Need to stimulate economy called most important consideration.

One thing's for sure over the next year or two: The federal budget will run big deficits, and the national debt will rise steeply.

"The debt is going to go up rather dramatically in the short term in response to this crisis" of financial-market turmoil combined with recession, says Robert L. Bixby, executive director of the Concord Coalition, a grassroots group that advocates for fiscal responsibility.

Remarkably, however, even deficit hawks like Bixby won't call for an immediate halt to deficit spending. That's because, for the first time in memory, a high debt and deficit are occurring simultaneously with a potentially severe economic recession and a near meltdown of the world's financial markets. [1]

Most economists say increasing the deficit and debt are acceptable in the near future to cope with those twin crises.

"I want to make sure that the next president has a sound banking system — and that probably means pouring some money into it," says Bixby. In addition, he favors an economic stimulus plan to help push the economy out of recession.

"During a recession or a downturn, it is good policy to let the government deficit increase and to have an increase in the debt-to-GDP ratio," says Steven Sheffrin, a professor of economics at the University of California-Davis.

The sinking economy began taking its toll on the debt early in 2008, and there's more to come, says Chad Stone, chief economist at the liberal-leaning Center on Budget and Policy Priorities (CBPP). "Early in the year, the debt was already running up from the recession," as tax revenues slowed with the declining economy and claims on programs like food stamps and unemployment insurance rose, he says.

An additional "very rapid run-up of the debt" will occur over the next several months due to ongoing efforts to shore up financial markets, says James R. Horney, CBPP's director of federal fiscal policy. "But that is not quite as bad as it sounds, since some of the money may be used to buy financial assets," such as mortgage-backed securities, which eventually would give taxpayers some return for the money.

Most economists emphasize, however, that deficits, while needed, must be temporary.

"We may decide to do something in the short run" — such as tax cuts or increased government spending — to help shore up the economy, "but we need to ensure that it really is in the short run," says Roberton Williams, a principal research associate in tax policy at the nonpartisan Urban Institute. For example, "if you didn't extend the Bush tax cuts in some form, you'd have a very negative effect on the economy." However, "that doesn't mean 'all for everybody,' " but judiciously allowing some people to keep the lower tax rates while rescinding them for others, he says.

"We should be cautious and not pile on dubious stimulus policies," says Sheffrin. "Temporary tax rebates, as we have recently seen, have limited economic impacts and can be very costly. They should only be used if the economy stumbles badly, and monetary policy" — such as interest-rate cuts to encourage lending — "has reached its limits. So, do let the deficit increase as tax revenues fall, but avoid piling on new programs," he says.

A strong ideological divide exists over whether government should mainly cut taxes on investment or attempt to stimulate spending.

Tax breaks and spending programs aimed at keeping low- and middle-income consumers buying are only a "redistribution of money" from high-income savers to low-income spenders and reduce government revenues without sparking needed

Continued from p. 946

national needs in tough times, Roberts says. "Unlike with an individual" — who can't get a mortgage when unemployed, for example — "the U.S. government can borrow money even during a recession, since the world knows that we can tax our citizens later to pay it back," he says.

Throughout history, many thinkers have been skeptical of large public debts. The British philosopher Adam Smith, author of the 1776 classic *The Wealth of Nations* — the first book on economic theory — argued that the ease of incurring debt compared to imposing taxes could spawn bad national tendencies, including a love for war. Unwilling to fund wars entirely with taxes, 18th-century England borrowed money for several wars. The result, claimed Smith: Citizens who would have become "disgusted" with wars if taxes were raised to pay for them enthusiastically supported the government's military adventures. [27]

Founding Fathers Alexander Hamilton and Thomas Jefferson famously squabbled over whether debts incurred to finance the Revolutionary War and to buy additional territories should be paid off quickly.

Hamilton, the first secretary of the Treasury, advocated debt. "A national debt, if it is not excessive, will be to us a national blessing," he said. "It will be a powerful cement to our union" because citizens who own government bonds will want to see the country stable and prosperous. [28]

Jefferson, the third president, who struggled with personal debt all his life, argued that "the principle of spending money to be paid by posterity . . . is but swindling futurity on a large scale." [29]

Despite their well-known disagreement, both men were fiscally conser-

economic growth, says Brian Riedl, lead tax and budget analyst for the conservative Heritage Foundation. In the 2001 economic downturn, low-income tax cuts such as the increased tax credit for families with children sapped federal revenues more than tax cuts for richer people without boosting "the savings and investment vital to economic growth," he argues.

On the other hand, "the right tax cuts" — such as cutting capital-gains taxes and eliminating the estate tax — "can add substantially to the economy's supply side of productive resources: capital and labor" are economy boosters, he said. [2]

Other economists say that Riedl has it backwards.

In an economic downturn, tax breaks for those who would invest the money won't help because "businesses are not looking to make investments in a slump; they will only make investments" — add on to their plants, hire workers, etc. — "if people are coming into the stores" and buying products, says CBPP's Stone. When unemployment is rising, "you want to prop up aggregate demand" through government spending or assistance to people who will buy, he says.

For example, an expansion of food stamps means that "a local store doesn't have to lay off a worker," so not only the food-stamp recipient but other store employees can spend to keep businesses on their feet, Stone says.

"Down the road, when the economy emerges from the slump," is the time to cut taxes on savings and investment, not today, Stone says.

"It would be good to get some money to state and local governments" to help prevent public-sector layoffs and help states provide services for people hit hard by the downturn, says Dean Baker, co-director of the liberal Center for Economic and Policy Research.

Such government spending and tax cuts for low- and middle-income people have by far the most bang for the buck in turning around a slump, said Mark Zandi, chief economist of the financial research firm Moody's Economy.com. A dollar's worth of federal spending to temporarily expand the food stamp program would increase the annual GDP by $1.73, a nearly 75 percent return on investment, Zandi told the House Committee on Small Business in July. [3]

GDP would rise by $1.64 for each dollar spent on extending unemployment benefits; by $1.59 for increased infrastructure spending; and by $1.36 for general aid to state governments. On the other hand, a $1 cut in corporate tax rates would yield only 30 cents' worth of economic expansion, according to Zandi. [4]

Ironically, though, the recession might actually ease some long-term budget pressure, said Olivia Mitchell, a professor of insurance and risk management at the University of Pennsylvania's Wharton School. With 401(k) retirement stock-market accounts way down and home equity shrinking, "there will be a fair amount of interest in working longer and delaying retirement" among baby boomers, she predicted. [5]

[1] For background, see Kenneth Jost, "Financial Crisis," CQ Researcher, May 9, 2008, pp. 409-432; Thomas J. Billitteri, "Financial Bailout," *CQ Researcher*, Oct. 24. 2008, pp. 865-887; and Kenneth Jost, "Stimulating the Economy," *CQ Researcher*, Jan. 10, 2003, pp. 1-24.

[2] Brian M. Riedl, "Ten Myths About the Bush Tax Cuts," *Heritage Foundation Backgrounder*, Jan. 29. 2007, www.heritage.org.

[3] Mark Zandi, testimony before the House Committee on Small Business, July 24, 2008.

[4] *Ibid*.

[5] Quoted in "Avoiding the Tough Issues: The Candidates on Health Care and Entitlements," *Knowledge @ Wharton*, Oct. 15, 2008, http://knowledge.wharton.upenn.edu.

vative by today's standards, says New York University's Wright. Both wanted small government, and "Hamilton wanted to pay off the debt, too, just more slowly," he says.

Throughout American history, the debt has generally trended up, but the government has repeatedly paid down its large wartime debts quickly.

Overall, the country has been debt-free for only two years, 1834 and 1835, and the debt has gradually grown from $75.5 million in 1790 to around $10.5 trillion today. However, as the debt grew, so did the economy, keeping the important debt-to-GDP ratio relatively low, except in wartime. For example, the debt reached 108.6 percent of GDP in 1946 — right after World War II — but quickly dropped to pre-war levels.

Who Owns the IOUs?

The U.S. national debt consists of interest-paying federal government securities — bonds — sold on the open market to anybody who will buy them, either here or abroad, explains Public Agenda's Yarrow.

In earlier times, including the 1940s and '50s, when America was paying off war debts, the buyers were mostly Americans, who saved at a much higher rate than today and saw bonds as safe and paying reasonably good returns, says financial analyst Wiggin.

Over the years, however, U.S. savings rates have dropped, international trade has increased and the dollar has become the world's chief currency. As foreign governments purchased more U.S. Treasury securities, they came to own a larger and larger portion of U.S. debt, which they held as reserves in their central banks. This change, together with 1983 legislation that created large annual surpluses in the Social Security Trust Fund,

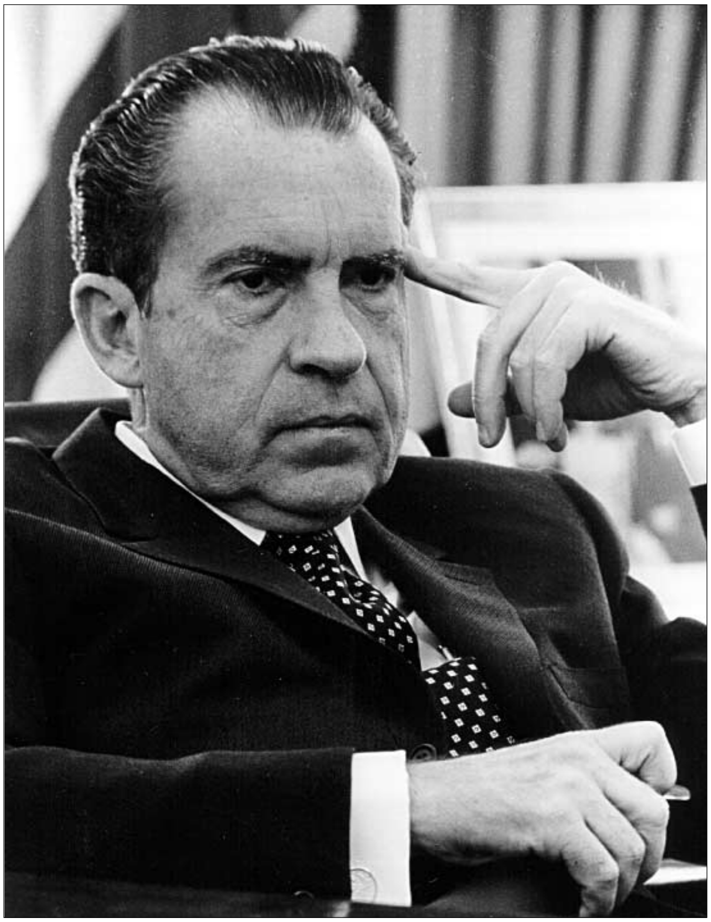
led U.S. policy makers to view rising debt more casually than in the past, economists say.

A series of economic events led to the current high level of foreign investment in U.S. public debt. During the 1950s and '60s, the American government spent heavily on wars in Korea and Vietnam, and other countries took in more U.S. dollars in exchange for their military goods and services than they spent buying U.S.-produced goods. That created a defense-related "balance-of-payments deficit" for the United States, says the University of Missouri's Hudson.

At first, countries could redeem their extra dollars for gold, but in 1971 President Richard M. Nixon removed the dollar from the "gold standard" — the monetary system in which each paper dollar must be backed by a specific amount of gold held in the country's vaults, said Hudson. Once European and Asian central banks could no longer turn in their surplus dollars for gold, they essentially had only one choice — to invest in U.S. Treasury bonds — in other words, to lend money to the American government, he said.

"Central banks don't invest in the stock market, they don't buy real estate and they don't buy companies. They buy government securities because those are the most secure," he said. [30]

As U.S. savings rates were dropping, foreign countries — especially oil producers — were stashing away huge amounts of money, with relatively few good places to invest the money.



Getty Images/National Archives (Feb. 19, 1970)

In 1971 President Richard M. Nixon removed the dollar from the "gold standard" — the monetary system that required each paper dollar to be backed by gold. No longer able to turn in their surplus dollars for gold, European and Asian central banks began investing in U.S. Treasury bonds.

As a result, foreign holdings of U.S. Treasury debt rose rapidly, increasing by nearly 50 percent between 2003 and 2006, according to the Congressional Budget Office (CBO).

To some extent, that's good news, CBO Director Peter R. Orszag told the House Budget Committee last year. "The willingness of foreign investors to buy U.S. debts . . . reflects the attractiveness of the United States as a destination for international investment because of its stable political environment, developed legal institutions, deep and liquid capital market and strong banking and financial systems, among other advantages," he said. [31]

However, the United States — like any other country — cannot continue accumulating debt at a rate faster than its ability to repay it. "At some point foreign investors will become less willing to keep adding to their holdings" of U.S. public debt and other American assets, Orszag said. [32]

Bank of Social Security

Besides skyrocketing foreign-held debt, the federal government since the 1980s has borrowed increasing amounts of money from certain government agencies, mainly the Social Security Trust Fund.

In 1935, when the fund was created, lawmakers understood that the payroll tax that funds Social Security would generate more annual revenues than it was paying out in benefits. The law decreed the excess revenues must be invested in Treasury bonds, which Social Security would later redeem to pay future benefits, just like any other bondholder.

As a result, each year's surplus Social Security revenues become part of the government's general budget, where they help to pay for initiatives, such as wars and tax cuts. And while this intragovernmental debt is counted as part of the total national debt, the annual borrowing from Social Security and other federal trust funds isn't added into the reported annual federal deficit. That potentially confuses the public and hampers lawmakers' efforts to focus the nation's attention on fiscal problems, Senate Budget Committee Chairman Conrad said in January. [33]

Americans Say They'd Help Balance the Budget

But first policy makers have to earn their trust.

Americans say they are ready and willing to help Washington achieve a healthy federal budget, but first policy makers must earn back their trust.

That's pollsters' conclusion after conducting 12 day-long public conversations with randomly chosen citizens around the country. The pollsters concluded that "the main obstacle to building public support for the difficult choices we face" is not "lack of interest" nor "public opposition to tax increases or program cuts." What's holding back progress, rather, is "a deeply felt and pervasive mistrust of government," according to pollsters for several nonprofit organizations pushing for more responsible Washington budgeting, including the Concord Coalition, Heritage Foundation and Brookings Institution. [1]

According to the poll by the San Diego-based public-opinion firm Viewpoint Learning:

- 63 percent of the people interviewed supported limiting Medicare's coverage of experimental treatments and covering only services scientifically proven effective;
- 66 percent supported asking wealthier Medicare recipients to pay more for coverage;
- 84 percent supported asking higher-income people to pay more payroll taxes into Social Security, by raising or eliminating the FICA tax cap;
- 61 percent supported cutting defense spending to reduce deficits; and
- 67 percent supported lowering domestic spending for deficit reduction. [2]

Other groups also are working to engage the public in deliberating budget matters. For example, several online simulation games pit players' wits against red ink as they strive to achieve policy goals while balancing budgets:

- The "NYC Budget Game" lets players tackle a large local budget (www.gothamgazette.com/budgetgame/budgetgame.html);
- The Kentucky State Budget Game invites players to take a crack at the even more complicated budget of an entire state (www.kltprc.net/budgetgame/BUDGAME.HTM);
- Budget Hero, created by American Public Radio, challenges players to confront the daunting policy tradeoffs that face Congress and the president (http://marketplace.publicradio.org/features/budget_hero).

In no case are the choices easy.

Government budgets seem far from citizens' individual concerns, but the questions always affect individuals in the end, says Susan Tanaka, director of citizen education and engagement at the New York City-based Peter G. Peterson Foundation, which promotes fiscal responsibility. If Medicare benefits are trimmed, for example, "people will need to begin saving more" for their retirement needs years in advance, she says.

The question really is, "How much would you personally be willing to contribute to address the problem — you, not other people?" Tanaka says. "How much would you raise your own taxes? What public benefits would you be willing to give up? How much more would you be willing to contribute to your parents' and grandparents' support?"

But one person's sensible solution often sounds hair-raising to someone else.

Postponing retirement to age 65 and beyond would pump more dollars into the Social Security fund and also reduce benefits paid, making it a useful and even "patriotic" step, says Andrew L. Yarrow, author of the 2008 book *Forgive Us Our Debts: The Intergenerational Dangers of Fiscal Irresponsibility.*

Early retirement is a relatively new and fiscally questionable phenomenon, says Yarrow. "When President John F. Kennedy was inaugurated in January 1961, the average retirement age was 66, but then it dropped to 62," paying out benefits to people who, in the past, would probably have been working, Yarrow says.

But when he criticized early retirement as potentially "selfish" in newspaper op-eds, Yarrow, a visiting professor of history at American University, got an earful from other Americans about the idea's flaws.

"Professor Yarrow, perhaps if everyone had a dream job like yours, with three-month vacations, we would be willing to work until we dropped dead," wrote Philadelphia paralegal Patricia Sicilia on the community publishing site Associated Content. But "you can only stand on concrete floors or be subservient support staff to psychotic lawyers . . . for so long," said Sicilia. "We are the only country in the world that expects their people to work until they drop dead! Our vacation and benefits are the worst in the world. And now you want us to work until we're 72 so we can bulk up the economy? Please." [3]

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[1] "Changing Expectations; Americans Deliberate Our Nation's Finances and Future," The Brookings Institution/The Concord Coalition/The Heritage Foundation/Public Agenda/Viewpoint Learning, September 2008, www.viewpointlearning.com/publications/reports/AWW_FINAL-1.pdf.

[2] *Ibid.*

[3] Patricia Sicilia, "Open Letter to Andrew Yarrow, Ph.D., Regarding 'Selfish, Unpatriotic,' Early Retirees," Associated Content Web site, www.associatedcontent.com.

Social Security has faced its own fiscal crises whenever benefits were imminently projected to outrun revenues; each time, Congress restabilized the program by tweaking the benefits and revenue formulas. The last such fix — in 1983 — was especially large and generated huge surpluses that have helped fuel government spending and tax cuts, especially over the last eight years.

"Over the past 20 to 30 years, everybody has been aware that this money would [have to] go back" to Social Security, but the fact played little part in policy makers' actions

because it didn't matter just yet, says Horney at the Center on Budget and Policy Priorities.

"I don't think the '83 reforms were well thought out" from the perspective of what would happen to Social Security's annual surpluses, says Robert L. Bixby, executive director of the nonpartisan Concord Coalition, a grassroots group that advocates fiscal responsibility. Washington "wanted a big fix, just to bring in a lot of money, but there really wasn't a plan for what to do with the extra" income, he says.

As a result, the rest of the government snagged the cash, using it as an easy way to get immediate revenue without raising taxes — or even while cutting them — but not coming completely clean with voters about this fact, says Bixby.

"Maybe we should have had a lower payroll tax" and not run the surpluses, he says. It's very hard for large government funds to actually put away cash for the future, he explains. Hoarded cash becomes worth less over time because of inflation, and governments seldom invest in private markets because they're too risky and because huge governmental sums could influence those markets too much.

The Bush Era

Over the next few decades, the need to reimburse the Social Security Trust Fund and provide Medicare benefits for baby boomers will force the nation to focus, at last, on budget priorities. Unfortunately, many economists say the government has actually become far less budget conscious over the past eight years than before, which will make it harder to cope with future demands.

"Americans generally have become much more comfortable with debt" — both public and private — branding cautious borrowers as "worrywarts who spoil the fun," says the Concord Coalition's Bixby. [34] "I'm not sure when this happened in the private sector, but the lack of concern about budget deficits" on the government side "is fairly recent."

In the 1980s and '90s "lots of the fights in Washington saw both Democrats and Republicans" arguing that federal deficits were too big, he continues. "There were strong disagreements about what exact mix of taxes and spending was the right one," but many in both parties believed fiscal caution was important, Bixby says.

In the late '90s, a booming economy and fiscal prudence by a Democratic president and a Republican Congress led to four years of surpluses. "But then people got lazy and thought that problems had been solved," he says.

In 2000, Vice President Al Gore, running for the presidency, warned that the four annual surpluses — only one of which did not depend on borrowing from the Social Security Trust Fund — should be used to pay down the national debt in preparation for baby boomers' retirement.

But when George W. Bush was elected, he quickly opted for other priorities.

As a recession depressed revenues and the administration pushed tax cuts, "it became a matter of partisan pride" among Republicans — once the party of fervent deficit hawks — "that deficits didn't matter," Bixby says. "The Bush administration has lots to answer for." By insisting that all Republican priorities be enacted, regardless of budgetary effects or opposition, "They encouraged Democrats to do the same.

"Fiscal concern broke down completely during the Bush administration with the totally inconsistent actions of cutting taxes, going to war and adding a prescription drug benefit to Medicare — all at the same time," he continues. "That's the definition of fiscal irresponsibility."

Particularly troubling was funding a war by borrowing, says Harvard's Bilmes. Bush sent his war funding requests to Capitol Hill in the form of "emergency supplemental appropriations," a spending category the law stipulates be used only for new programs that begin midway through a fiscal year and for unforeseen emergencies that require speedy dispersal of funds, Bilmes says.

"All scrutiny is suspended" for emergency supplemental requests, which led to high levels of waste, corruption and incautious spending, she says. For example, soldiers in sand-covered northern Iraq used sandbags manufactured in the United States, shipped to be filled in Kuwait and then shipped over the Iraq-Kuwait border on trucks. "If you tried to think of the most expensive way to provide the sandbags, you probably couldn't even imagine that one," she says. [35]

Besides its immediate costs, the wars in Iraq and Afghanistan also create future government-spending obligations for veterans' health care and replenishing military equipment, she says. "These add to the long-term obligations in Social Security and Medicare," raising future budget demands even higher.

"At the turn of the century, when things were really going good, we had a federal debt of $5 trillion, and now it's doubled," says the Urban Institute's Williams. "Bush said he'd cut taxes and spending, but he only did half the job. We've got this situation because we cut taxes but still spent more."

"You can't grow your way out of the size of deficits we'll have when the baby boomers retire," says Bixby. "People are used to cyclical deficits, but today we have an unprecedented — and growing — structural, not cyclical, deficit" that persists in good economic times as well as bad. ■

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At Issue:

Should Congress reform entitlement programs to solve long-term debt problems?

ALISON ACOSTA FRASER
DIRECTOR, ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, HERITAGE FOUNDATION

FROM TESTIMONY BEFORE HOUSE COMMITTEE ON THE BUDGET, JUNE 24, 2008

YES

The Congressional Budget Office's (CBO) latest analysis projects that — maintaining current tax policy and with tax levels rising just above the historical average of 18.3 percent of GDP — total [federal] spending including interest skyrockets from 20 percent of GDP in 2007 to 75.4 percent in 2082.

Clearly, this is an unsustainable budget path, and it is driven by entitlement spending. The entitlement tsunami is driven by huge increases in future spending on programs for middle-class retirees: Medicare, Medicaid and Social Security. It is not driven by falling tax levels.

Social Security and Medicare have promised $42.9 trillion more in benefits to senior and disabled workers than the programs will be able to pay. Social Security's long-term unfunded obligations are $6.6 trillion; Medicare's are $36.3 trillion.

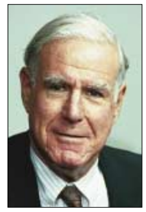
The spending problem is so massive that federal tax rates would have to rise to staggering levels to close the gap. CBO estimates that today's income tax rates would have to more than double. Such tax rates would come at a tremendous cost to the economy.

The [proposed] Safe Commission Act (HR 3654) could break the entitlement logjam. It would create a bipartisan commission to address the "unsustainable imbalance" between federal commitments and revenues while making the budget process give greater emphasis to long-term fiscal issues.

Focusing on slowing the growth in entitlement spending, along with changes to strengthen assistance for the needy, the commission's proposal should appeal to those who worry that surging middle-class entitlement spending will crowd out spending on other priorities.

Public engagement is a vital feature of this commission. It would hold hearings to discuss the entitlement challenge in "town hall"-style meetings across the nation to speak frankly about the fiscal challenge and the tough options for fixing it. This would help to build public acceptance of the need to fix entitlements and support for ultimate plans to modernize the programs. . . .

In today's political environment, it is extremely difficult and uncomfortable for many, if not most, members of Congress to explicitly discuss the colossal fiscal challenge that entitlements present. The highly partisan environment often seeks to push discussions further and further from real action. The end result is that succeeding Congresses merely kick the can down the road. The Safe Commission Act would change these underlying dynamics so that entitlements can be tackled and a huge economic disaster prevented.



HENRY J. AARON
SENIOR FELLOW, THE BROOKINGS INSTITUTION

FROM TESTIMONY BEFORE HOUSE COMMITTEE ON THE BUDGET, JUNE 24, 2008

NO

The premise of HR 3654 [the Safe Commission Act], which would establish a federal budget commission to "reform tax policy and entitlement benefit programs and ensure a sound fiscal future," is correct in part. The United States faces daunting projected fiscal deficits.

However, the bill mischaracterizes the source of these deficits. They derive entirely from projected increases in national health-care spending, affecting private as well as public spending, not from problems peculiar to government health care.

Materially slowing the growth of Medicare and Medicaid apart from general health-system reform is impossible, unless the nation reneges on its commitment to assure the elderly, disabled and poor health care roughly comparable to that available to the rest of the nation.

Nearly all the projected growth of federal budget deficits is traceable to added spending on Medicare and Medicaid. The Congressional Budget Office's projections indicate that apart from the fiscal impact of Medicare and Medicaid, the federal budget will remain in approximate balance through 2050. . . .

Spending on Medicare and Medicaid is driven mostly by forces outside of these programs. The most important is the projected growth of per-person health-care spending. Growth of Medicare spending per person has closely tracked growth of per-person spending on health care in general. Increases in spending per person account for about three-quarters of projected increases in Medicare and Medicaid outlays. Holding growth of per-person spending on Medicare and Medicaid below that for the general population would imply the gradual abandonment of the national commitment to assure the elderly, disabled and poor standard health care.

Growth in the number of enrollees accounts for less than a third of projected spending increases. The only way to offset this source of growth would be a) to increase the age of Medicare eligibility or b) to tighten the already stringent income and asset tests for Medicaid eligibility. Increasing the age of eligibility has a surprisingly small effect because the young elderly are relatively inexpensive. Raising the age from 65 to 67 would reduce spending about 2 percent; raising it to age 70 would reduce spending about 9 percent.

Furthermore, until and unless American workers can be encouraged to retire at later ages, raising the eligibility age would exacerbate an already serious problem — gaps in insurance for those who lose employment-based coverage before they are old enough for Medicare.

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CURRENT SITUATION

Obama and the Budget

With a new president and a new Congress both taking office in January, the budgetary style of the next four years is still unclear. But many budget analysts are pleading for Washington to abandon the deficits-don't-matter philosophy.

Once the current economic downturn abates, "the bottom line on taxes is that they need to cover whatever we're going to spend," says the Concord Coalition's Bixby. "That concept tends to get lost as people look at taxes as a different issue," separate from the benefits government offers. "I think both Sen. Obama and Sen. McCain have been totally unrealistic on taxes, both promising cuts. You have to shake your head and ask, 'How does that make sense?' "

The new president will have to reform both health care and Social Security, says author Yarrow of Public Agenda, but especially health care.

"The next president will be inheriting a fiscal and economic mess of historic proportions — the legacy of President Bush's failed policies — record deficits and record debt," said Senate Budget Committee Chairman Conrad. "It will take years to dig our way out." [36]

An important component of any president's fiscal plan is the ratio between tax revenues and GDP. Historically, that level has hovered at about 18.3 percent in the United States, though it dropped during the Bush administration. Obama's tax plan would bring in revenues estimated at between 18.2 and 18.4 percent of GDP, according to an analysis by the nonpartisan Tax Policy Center jointly run by the Urban Institute and the Brookings Institution. [37]

That's considerably more revenue than would have been garnered by McCain's tax plan — which was "off the charts" low, says Bixby, yielding revenues of only 16 to 17 percent of GDP.

Getty Images/Chip Somodevilla

David M. Walker, then head of the Government Accountability Office, warns the Senate Budget Committee in January that the nation faces a financial crisis because of continuing deficit spending and a flood of impending health-care and other expenses. Walker quit soon afterward to head the new Peter G. Peterson Foundation, which urges Americans to spend less and save more.

Obama proposed several revenue-boosting schemes, including:

- Closing tax loopholes for large corporations;
- Trimming payments to private insurance plans operating in Medicare;
- Allowing the federal government to negotiate with drug companies for lower Medicare prices;
- Withdrawing troops from Iraq; and
- Auctioning permits to companies to emit greenhouse gases as part of an effort to limit overall greenhouse-gas emissions. [38]

Budget balancing would have to come after the economy returns to health, Obama said during his campaign. "We are not going to be able to dig ourselves out of that hole in one or two years," he said. "But if we can get on a path of sustained growth, end the war in Iraq, end some of the special-interest loopholes and earmarks that have been clogging the system, then I think we can return to a path of a balanced budget." [39]

On the surface, Obama sounds weaker on fiscal austerity than McCain, who pledged not to leave office without balancing the federal budget, says Bixby. However, McCain also "insisted that he could do his whole agenda" while bringing in much lower tax revenues and still balancing the budget, which simply wouldn't be possible, Bixby says.

"Obama is probably more realistic," he says, but his spending proposals "still would mean deficits."

Congress and the Budget

The budget path Congress will take also remains unclear.

It wouldn't be surprising if fiscal discipline went by the boards, with Democrats saying, "We want to do our laundry list of items that Bush ignored," says Bixby, warning that trouble is ahead "if we do that by running bigger deficits."

For the past two years, a Republican White House with a veto pen and

a Senate Republican minority with enough votes to filibuster most proposals have fought bitterly over budget issues with the new Democratic congressional majority.

In the past, such "divided government" has been a good thing for fiscal discipline, but not so more recently, according to longtime Washington budget reporter Stan Collender, now managing director at Qorvis Communications. In the late 1990s, "when [President] Bill Clinton and the Republican-controlled Congress fought to a draw," the stalemate halted both large tax cuts and large spending increases, creating rare federal budget surpluses, Collender said. [40]

But not so in the past year and a half, said Collender. The Democratic Congress started out by pledging to apply so-called pay-go rules — requirements that higher spending or tax cuts that increase budget deficits be paid for by slashing spending or increasing taxes — a pay-as-you-go system. However, "the unwillingness of the White House to negotiate with Congress . . . and the inability of Congress to deal with the administration" meant that pay-go wasn't used, said Collender. For example, "spending additions for Iraq and Afghanistan" were slipped past pay-go "classified as 'emergencies,' even though military and other activities began long ago," he said. [41]

Both parties accuse the other of using pay-go only when it suits their purposes.

Beginning in 2001, when Republicans controlled both Congress and the White House, the GOP "weakened the pay-go rule, and look what happened to the deficit afterward," said Senate Budget Chair Conrad, a Democrat. By contrast, the new Democratic majority has proposed spending cuts and revenue increases to pay for programs like tuition loans and children's health care, he said. [42]

But Sen. Judd Gregg, N.H., the highest-ranking Republican on Conrad's panel, accused Democrats of waiving pay-go every time it suited them. Democrats "have either waived or gotten around pay-go on about 12 different occasions, representing billions of dollars to the American taxpayer," he said. "The only thing they intend to use pay-go for is to force taxes to go up." [43]

But some analysts say that forming a task force may just be a way for Congress to delay dealing with the toughest issues. "Commissions never solve complex problems unless members of Congress are prepared to address the underlying source of those problems," says Brookings' Aaron. [45]

"The next president will be inheriting a fiscal and economic mess of historic proportions — the legacy of President Bush's failed policies — record deficits and record debt."

— Sen. Kent Conrad, D-N.D. Chairman, Senate Budget Committee

Exercising fiscal responsibility is virtually impossible in a charged partisan atmosphere, says Bixby. Measures like pay-go "have to have a political consensus behind them," he says. If one party commits, but the other balks — such as by insisting that pay-go apply only to taxes but not to spending, or vice versa — then no such mechanism will work, Bixby says.

Meanwhile, Democrats and Republicans on the House and Senate Budget panels have come together on legislation focused on longer-term budget problems. Two bills (HR 3654 and S 2063) would appoint bipartisan panels to develop legislative proposals for improving the budget outlook as baby boomers begin receiving Social Security, Medicare and Medicaid benefits. (*See "At Issue," p. 953.*)

"It is critical that any solutions to our fiscal challenges be bipartisan and that both political parties are invested in the outcome," making a task force a good place to start, said Conrad and Gregg in a joint statement. [44]

Perhaps the most crucial task for both Congress and the president will be to "gain credibility with the public" so that voters believe they can demand and expect accountability from policy makers, says Emory's Dezhbakhsh. Budget issues require delicate tradeoffs and public willingness to sacrifice that don't exist in an atmosphere of public distrust of Washington, he says.

"This recent episode of the financial-market bailout shows that Americans don't trust the politicians" now, a situation that could doom progress on the even tougher financial matters ahead. ■

OUTLOOK

Look to Health Care

With the debt and deficits rising and the economy and financial system struggling, the country faces

tough fiscal times. After the smoke of the current troubles clears, however, job one for policy makers will be coping with soaring health-care costs.

Helping states and localities through the economic downturn also will take a heavy toll on government revenues. "State and local governments will truly feel constrained in the coming years," says the University of California's Shefrin. "The states are highly impacted by rising health-care costs and other cost-drivers that are straining budgets," he says. Moreover, "the current financial situation will mean that many of the states' favorite budgetary gimmicks, such as securitizing income streams to borrow from the future, will become more problematic. Their program costs will continue to rise, but their revenues will fall."

Until recently, only health economists worried about controlling health costs, but today policy analysts of all kinds see that as job one, says the Urban Institute's Williams. "I keep asking [Congressional Budget Office chief] Peter Orszag when he's going to rename it the Congressional Health Office," he quips.

Unfortunately, "if it were simple" to rein in health costs, "we would have figured it out by now," says Williams. Basically, "we need some way to ration it," he says. "Do I do preventive care," for example? The answer seems simple until "you ask whether you then are obliged to treat all the conditions that you found when you did tests." Figuring out how to sensibly and fairly ration care "is where a lot of effort needs to be concentrated." Health care "is the defining problem of the next 20 years."

"Short of a constitutional amendment to require a balanced budget, there simply has to be concerted action [by Congress and the president] to control Medicare and Medicaid costs," and soon, says Pete Sepp, vice president for policy and communications at the National Taxpayers Union, a nonprofit that advocates for tax cuts and smaller government. "Even small changes could make a lot of difference," he says. "All they've got to do is start."

Creating better public understanding of budget dilemmas is crucial, however, since lawmakers can't propose belt tightening unless citizens understand why fiscal responsibility is needed, says financial analyst Wiggin, the co-author of *I.O.U.S.A.: One Nation. Under Stress. In Debt.*

Currently, "There's an inability for individual lawmakers to bring it up because they get punished immediately [by voters] if they do," he says. That could be the silver lining in the current economic situation.

"Maybe this crisis is just what we need to get our act together." ■

About the Author

Staff writer **Marcia Clemmitt** is a veteran social-policy reporter who previously served as editor in chief of *Medicine & Health* and staff writer for *The Scientist*. She has also been a high-school math and physics teacher. She holds a liberal arts and sciences degree from St. John's College, Annapolis, and a master's degree in English from Georgetown University. Her recent reports include "Regulating Credit Cards," "Climate Change," "Health Care Costs" and "Preventing Memory Loss."

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Center on Budget and Policy Priorities, 820 1st St., N.W., Suite 510, Washington, DC 20001; (202) 408-1080; www.cbpp.org. Liberal-leaning think tank that analyzes the impact of government budget and tax policy on states and localities, the elderly, and low-income and working families.

Committee for Economic Development, 2000 L St., N.W., Suite 700, Washington, DC 20036; (800) 676-7353; www.ced.org. Nonpartisan advocacy organization of business and education leaders that distributes information and policy papers on the budget and other issues.

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