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AMERICA'S FISCAL CHOICES AT A CROSSROAD

The Human Side of the Fiscal Crisis

EXECUTIVE SUMMARY

ANNE VORCE
COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

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America's Fiscal Choices at a Crossroad:
The Human Side of the Fiscal Crisis

Executive Summary

America is at a crossroads. We know that a daunting series of fiscal challenges lie ahead. We know roughly what they are and when they will occur. And we have the chance to address them before they get out of hand. We also know that the economy cannot fully recover or remain strong without addressing these fiscal challenges. If they are left unchecked, we will eventually face a greater crisis, although we can not say with certainty when it will occur or what the tipping point will be.

Yet, policymakers may fail to agree on a plan to right our fiscal course over the next few years. The resulting fiscal stalemate would have high costs and risks for the American people.

To illustrate what is at stake, imagine we can travel through time to the year 2050, when the full effects of the fiscal choices we make as a nation will be readily apparent, for good or for ill. What we would find depends importantly on the choices we make now. This paper will look at alternative fiscal paths for different demographic groups and several special groups in society, based on two reasonably believable fiscal futures:

- **Scenario 1: "Fiscal Gridlock":** Our political leaders do not change course.

- **Scenario 2: "Fiscal Recovery Plan":** A multi-year plan to stabilize and reduce the federal debt as a share of the economy is put in place in the near future.

In our thought experiment, we first trace out broad economic effects that will likely shape people's lives under each scenario. Figure 1 compares macroeconomic conditions that are likely to result from future "policy inaction" versus "policy action". For example, our choice of a particular fiscal course would likely affect economic growth, the path of interest rates, employment creation, income gains, and inflationary pressures, all other things being equal. Moreover, the longer fiscal gridlock lasts, the more likely a fiscal crisis or a crisis with a fiscal dimension becomes, as our creditors lose confidence in our ability to manage our fiscal affairs. Ultimately, one way or another, everyone's standard of living in the near future —and in 2050 and beyond—is at stake.

Fig. 1: Our Fiscal Choices

Scenario One: Fiscal Gridlock	Scenario Two: Fiscal Recovery Plan
Policymakers cannot agree on a plan to get our fiscal house in order, but fiscal change is coming anyway. Battles over fiscal resources will be increasingly common. Eventually, our creditors will lose faith in the government's ability to manage our fiscal affairs. Financial markets will force policymakers to make sudden harsh changes to close our fiscal gap.	*Policymakers hammer out a credible agreement on a multiyear plan to get our fiscal house in order. Ideally, the plan would: kick in when the economy is on stronger footing, set in motion gradual but steady fiscal adjustment, feature "all items on the table" (including both taxes and spending) to spread the burden of adjustment, and shift fiscal resources to boost long-term growth.*
Confidence and the Economic Recovery: Consumer, business and investor confidence will be hurt by ongoing budget battles and expectations that U.S. national debt will continue rising as far as the eye can see. Weak confidence will hurt the struggling economy.	**Confidence and the Economic Recovery:** Less uncertainty and worry will boost consumer, investor, and business confidence, which will help a solid recovery take hold.
Economic Growth and Living Standards: Growth is slower than otherwise from higher interest rates due to investor fears and crowding out effects from our rapidly growing national debt as a share of the economy. With private investment crowded out, living standards for all generations will be lower.	**Economic Growth and Living Standards:** Growth and employment may be weaker initially from fiscal restraint (the effects of higher taxes and lower spending take hold before positive effects kick in), but the future payoff is worth it. Most important, future living standards will be permanently higher because fiscal pressures on the economy and financial sector will diminish to a more manageable level (which will mean lower interest rates and higher investment).
Spending and Fiscal Space: A few programs will take over spending, including interest on our national debt and health care-related spending. With tight budget resources under current tax laws, continuing gridlock will mean greater spending cuts on non-priority programs (including programs that may not be politically important but help the government function). There will less room for maneuver for emergency spending.	**Spending and Fiscal Space:** Done right, fiscal adjustment will prevent spending being taken over by just a few programs. We will also have more fiscal room for maneuver (called "fiscal space"), which is critical in emergencies (whether economic, financial or national security-related).
Likelihood of a Fiscal Crisis: Everyone will experience a fiscal crisis eventually. Extremely large spending cuts and revenue increases in a hurry will be necessary to halt the crisis. In a shock for everyone, there will be no time to adjust.	**Likelihood of a Fiscal Crisis:** We'll probably avoid a fiscal crisis. We will have more scope to cut the spending and raise the taxes we want – not what the financial markets or the International Monetary Fund want. We can phase in our fiscal adjustments gradually so that people and firms can adjust. Effects of painful policies can be better spread.
Fiscal Crisis, Budget Effects and our Future Well-Being: With spending cuts and tax increases suddenly forced upon us in a crisis, we will have no time to prepare tax and spending policies that will also be growth friendly in the long-run. Such dramatic policy shifts may well push the economy into recession and lower the economy's growth path for years to come.	**Fiscal Crisis, Budget Effects and our Future Well-Being:** By making fiscal policy choices on our own terms, we can shift fiscal resources into a strategic growth-friendly budget for the 21st century, to boost living standards — if the fiscal turnaround is done correctly. Lower debt will mean less debt service payments, which will mean more resources available for other public goods and services.

While these economic relationships are well recognized among many experts, most citizens still may not fully appreciate how they would be better or worse off because of their fiscal choices. To help people think far more concretely about how their lives would be shaped if America headed in one fiscal direction but not another, we then took a close look at the impact of the two fiscal futures on each generation's life cycle. We also considered the implications of the two scenarios for special groups in society - the poor, business and innovators. Figure 2 summarizes our findings.

Our conclusions are that if our political leaders do not change course (Scenario 1, the "Fiscal Gridlock" scenario), ordinary people will be worse off in many ways that are important for their well-being:

- Interest rates will normally rise with the advance of the business cycle as the economy gets closer to full employment. In the current recovery, this process is expected to take longer than usual because of the underlying weaknesses of the economy and financial system coming out of the Great Recession. If we have fiscal gridlock, national debt-related pressures in the financial markets will push up interest rates more than normal. Higher interest rates will slow growth and job opportunities. People will have less money. The cost of borrowing will rise for everyone. If companies cannot keep up investment (due to the high cost of borrowing), our standards of living will not change or may even fall over time.

- As a few government programs increasingly take over the budget, the availability of public resources for other purposes will be squeezed. Normal public activity will be affected. Fiscal flexibility in a crisis will be limited.

- A fiscal or other type of crisis with fiscal dimensions will lead to a sudden and large rise in interest rates to stem the outflow of global capital. In addition, because our creditors have lost confidence in our fiscal management, we will no longer be able to borrow at the same terms in global capital markets. Our policymakers will be forced to make immediate fiscal adjustments (usually tax hikes and spending cuts) based on our new, sharply reduced ability to borrow.

Fig. 2: How Different Generations Will Fare under Different Fiscal Paths

Baby Boomers. Age 47-65 now.
While the oldest Boomers have just started to retire, most are still working, saving for retirement plus supporting children and their elderly parents. (At this point in their lives, Boomers are often called the "sandwich generation.") Most Boomers will be better off if our lawmakers start tackling our fiscal problems in the near future through a gradual and credible recovery plan — even though the road will be rocky at times. Most importantly, by putting our budget on a sustainable path, investment and therefore growth will be stronger — which will mean that Boomers and their families will enjoy higher living standards for the rest of their lives. Having stronger basic economic conditions will help people better manage the challenges they face as they and the population age. That said, fiscal restraint would be tough on Boomers (initial effects on growth and employment would likely be negative at a time when they would be in the last years of saving for retirement). However, taking action to reduce the risk of a fiscal crisis is more important. A crisis would mean even more lost job and income opportunities haunting Boomers in retirement. Reducing the risk of a fiscal crisis and changing our debt course will mean that Boomers' savings for retirement could be higher, pension assets will grow more in a healthy economy, and fixed income in retirement will not be eroded (since the temptation for policymakers to inflate their way out of their debt obligations would be gone.) More fiscal resources will be available for Boomer priorities if we take action to close our fiscal gap thoughtfully rather than piecemeal or in the midst of a crisis.

Generation X. Age 35-46 now.
Entering their top professional years at the same time they are trying to raise a family, Generation Xers will be better off if job and income opportunities are not hurt by higher interest rates related to massive government borrowing needs. While it won't be easy for them to weather the initial pain from fiscal adjustment (they need all the take-home pay they can muster, given their financial responsibilities), Generation Xers will be better off in the end when the economy recovers to a higher growth path than it would have been otherwise. Their lifetime standards of living will be higher, too. Plus, the gradual fix of retirement problems in the future (related to solvency of the Social Security program and pension and health benefit promises that are underfunded) will allow them to plan and take steps accordingly. With fiscal policy changes made gradually and deliberately rather than forced in a crisis, Generation Xers will have a better chance at seeing their fiscal priorities related to their children's education, greater investment in employment-boosting innovation, and modernization of transportation infrastructure funded.

Millennials. Age 13- 34 now.
Spanning the high school, college and young professional worlds now, Millennials' lives will be particularly shaped by fiscal issues affecting jobs, income and education. Jobs and income will be hurt by higher interest rates than normal due to national debt-related borrowing pressures in the financial markets. For Millennials just starting out on the work world, a weak job market can mean no job (they have to live off parents or the state) or, at best, a substandard job, which can put them on a subpar job path for the rest of their lives. An added problem is that many Millennials have very large debts related to student loans, which they may not be able to service in the absence of a good — or any — job. (Their credit ratings could be hurt and the public may see a series of defaults.) If the benefits from Social Security and Medicare are not changed, Millennials will have to increase contributions to finance those benefits because the programs will run out of resources due to the aging of the population. To fund currently scheduled benefit levels, Millennials will have to increase their taxes enormously. This burden will sharply reduce takehome pay, which Millennials draw on for everyday life. It will mean that they face a substantially lowered standard of living.Taking the long view, putting our debt on a sustainable path will translate over time into a permanently higher standard of living for Millennials – which will mean better job opportunities, higher incomes, more family resources for housing, transportation, education, less financial pressure and improved basics of life.

Gen-Web. Babies to Age 12 now.
Because the basic payoff of deficit reduction is higher future living standards, the youngest among us — with most of their lives ahead of them — will benefit the most. Also important, today's children will be far better off over their lifetime the sooner we start to fix the financing of programs we know are in trouble. For example, because the Social Security trust fund is projected to be exhausted in 2037 or 2040 (depending on some assumptions), today's children, who will then be the core of our working age population, would be better off if changes to shore up the financing were made gradually and well in advance so they wouldn't be slapped with an emergency surcharge at the last minute to support retirement benefits for their parents — or worse. In the nearer future, their lives will be shaped by fiscal influences on their parents' jobs and income plus any change in budget resources that are targeted at them (such as education). Children caught in a fiscal crisis will be likely to experience a sharp downshift in well being related to negative effects on parents' livelihood at a critical time in their lives. Whether caught in ongoing budget battles or a fiscal crisis, cuts in funding for a host of programs targeted at kids (related to basic nutrition, education, and after-school programs, including athletics) can make a difference in whether they are productive citizens and taxpayers.

Seniors today.
In a world of fiscal gridlock, fiscal resources will increasingly shift at a rapid rate to programs for seniors (including health care) as the population ages. Seniors are also expected to live longer, which means that pressures on fiscal resources will be even higher. While the shift in fiscal resources toward the elderly will benefit Seniors in basic ways, it will likely result in a squeeze on other budget resources that Seniors rely on (such as those affecting personal safety, food safety, public health, and public transportation). Looking at higher interest rates coming from government borrowing pressures in the financial markets, Seniors may at first be happy that the return on their assets is higher (important for those on fixed income), but their well-being will on balance be hurt by a weaker economic environment. Even worse, Seniors will not want to see how policymakers try to manage our fiscal problems by trying to inflate our way out as debt heads above historic levels as a share of GDP. For anyone on a fixed income, inflation is Enemy No. 1. If our fiscal policy path is not changed, the legacy of today's Seniors will be to pass on fiscal burdens to future generations—especially their grandchildren. In a world without fiscal action, poor Seniors will need more public support, because economic weakness (including from a crisis) will reduce help from their families and the budget squeeze will threaten other programs they need.

All generations would be better off if they avoided the effects of fiscal gridlock (Scenario 1):

- **All Generations and Groups.** In a world of fiscal gridlock, everyone will experience a fiscal crisis or a crisis with fiscal dimensions at some point in their lives. America is on a fiscal course that ultimately cannot be sustained. If we do not take pre-emptive action to change course, the financial markets will eventually force us to act when they no longer buy our national debt at a reasonable price—or any price. In a crisis, people see their jobs, income and their livelihoods disappear overnight. Often, they never fully recover.

- **Baby Boomers.** Trying to maximize savings as they approach retirement and, at the same time supporting their elderly parents and possibly their children (who still may not be able to find solid work as our recovery struggles for years to recover from the Great Repression), Boomers will be hurt by national debt-related pressures slowing growth, employment and income. In their retirement years, if our leaders are tempted to try to inflate their way out of our debt problems (that is, they put pressure on the Federal Reserve to permit higher inflation, to lower the value of the debt we must service), Boomers will suffer because their fixed incomes will be eroded by inflation.

- **Generation X.** Entering their top professional years at the same time they are trying to raise a family, Generation X will be hurt if job and income opportunities are weakened by debt-related economic and financial pressures. Down the road, their retirement years will be tougher when growth downshifts (investment has not kept up, because it is crowded out by government borrowing). Pension shortfalls increase as a result.

- **Millennials.** Spanning the high school, college and young professional worlds now, the lives of Millennials will be shaped by fiscal issues affecting jobs, income and education. Jobs and income will be hurt by higher interest rates than normal due to national-debt related borrowing pressures in the financial markets. For Millennials, just starting out in the job world, a weak job market can mean no job (they have to live off parents or the state) or a substandard job, which could mean they will have a lower standard of living over the rest of their lives.

- **Gen-Web (Children).** Debt-related effects on growth, interest rates, jobs and income will hurt parents' jobs and income. Their children will be worse off from household pocketbook effects. Public resources important for children (education, help for the less well-off to make them more productive future citizens—including supplemental nutritional assistance) will likely be squeezed. Looking to the future, the children of today can look forward to a sharply lower standard of living from fiscal gridlock for two reasons. First, because private investment will be crowded out by government borrowing demands, future standards of living will be lower by far than they would be otherwise. Second, because they will be called upon to shoulder the burdens of financing Social Security and Medicare if the basic funding problems are not changed, their future household income will be reduced —by a lot.

The groups we looked at also would be considerably worse off if fiscal gridlock persisted:

- **The Poor and Working Poor.** The poor and working poor, already facing tough living conditions, are particularly vulnerable to any deterioration in the economy, which will reduce limited employment and income opportunities. Debt-related higher interest rates (whether through "crowding out" pressures or a fiscal crisis) will make conditions even worse. Chances are that the fiscal pressures and political battles will mean less safety net resources.

- **Business and Innovators.** As interest rates climb with growing government borrowing and increasing perception among our creditors that buying our debt is a risky proposition, firms will be squeezed when growth slows and business costs rise. In a crisis, where these changes usually happen suddenly, many businesses will not survive. The state of the economy, ability to borrow (including from friends and family or credit cards) will also be critical for innovators. Business (and ultimately everyone's standard of living) cannot thrive without innovation.

As tough as it will be to fix our fiscal problems, failing to fix them will be worse. Though we can not promise that a fiscal fix is pain-free, making the changes before they are forced upon us is far more desirable from the perspective of virtually everyone and the economy as a whole.

The bottom line is that change is coming—whether we like it or not. With national debt heading up toward historic levels even before the inescapable pressures from an aging population start to kick in, it is no wonder people are concerned. America simply cannot afford the debt path it is on.

How long do we have before we should start to get our fiscal house in order? It is hard to pinpoint, but we will enter a period where "business as usual" is no longer possible well before 2020. In fact, we may already be there.

It will make a difference to our future standard of living—whether in 2020 or 2050—if our fiscal actions are taken in a thoughtful, growth-friendly way rather than during an emergency. We still have a window of opportunity to take sensible steps that will maximize jobs, income and other aspects of our quality of life to lay the foundation for a better life.

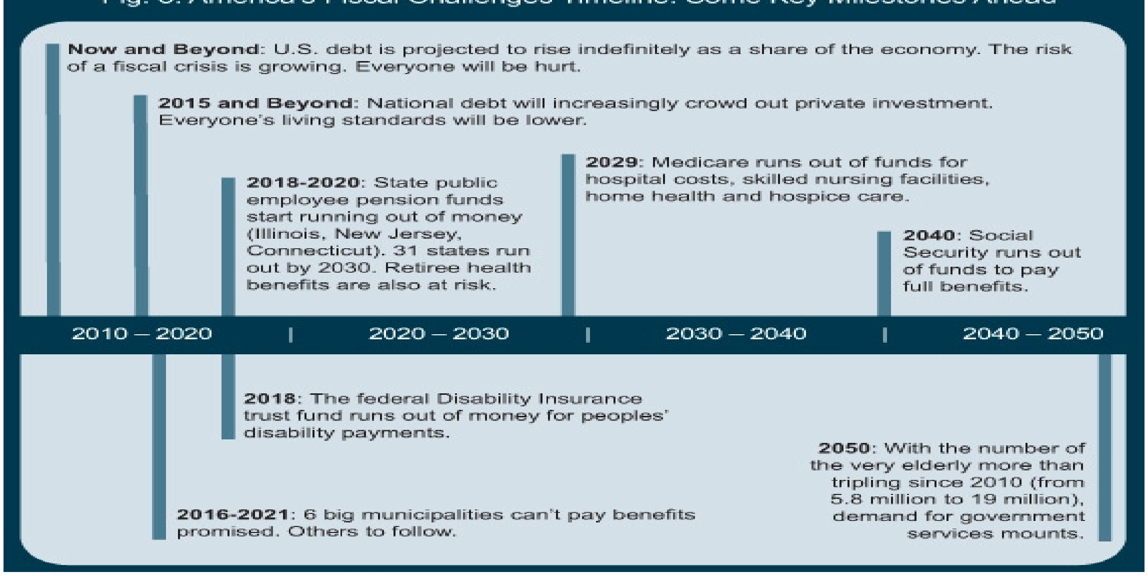
This scenario is not a pipe dream. Governments here and globally have previously taken steps to address daunting fiscal challenges in a growth-friendly way. Those experiences show that it is always worse for a country to have fiscal choices forced upon it by financial market attacks rather than to make sensible policy choices under its own terms.

It is also important that people recognize we are not simply fixing our fiscal problems to fix them, but rather we are getting our fiscal house in order so that we can have a better future—more growth, more jobs and a higher standard of living than we would otherwise have. It is crucial that people have realistic hope that through a strategic, smart and fair plan on how to get out of this mess, they will be better off in the end.

We are at a crossroads. We still have a choice: we can make fiscal changes on our own, wait until the 11th hour to tackle the series of fiscal challenges we face, or wait until changes are forced upon us by the financial markets. If Americans better understood the choices they face, there would be a richer and more informed national conversation about how—not whether—to put our fiscal house in order and what compromises are necessary. Some of the key challenges we face are set out in "America's Fiscal Challenges Timeline" below (Figure 3).

What might break our national political stalemate? How we move forward will depend largely on how ordinary people and our leaders see their choices and act upon them.

Fig. 3: America's Fiscal Challenges Timeline: Some Key Milestones Ahead



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