ESTABLISHING LONG-TERM FICAL SUSTAINABILITY: Daunting Choices and Shared Sacrifice
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ESTABLISHING LONG-TERM FISCAL SUSTAINABILITY:

Daunting Choices and Shared Sacrifice

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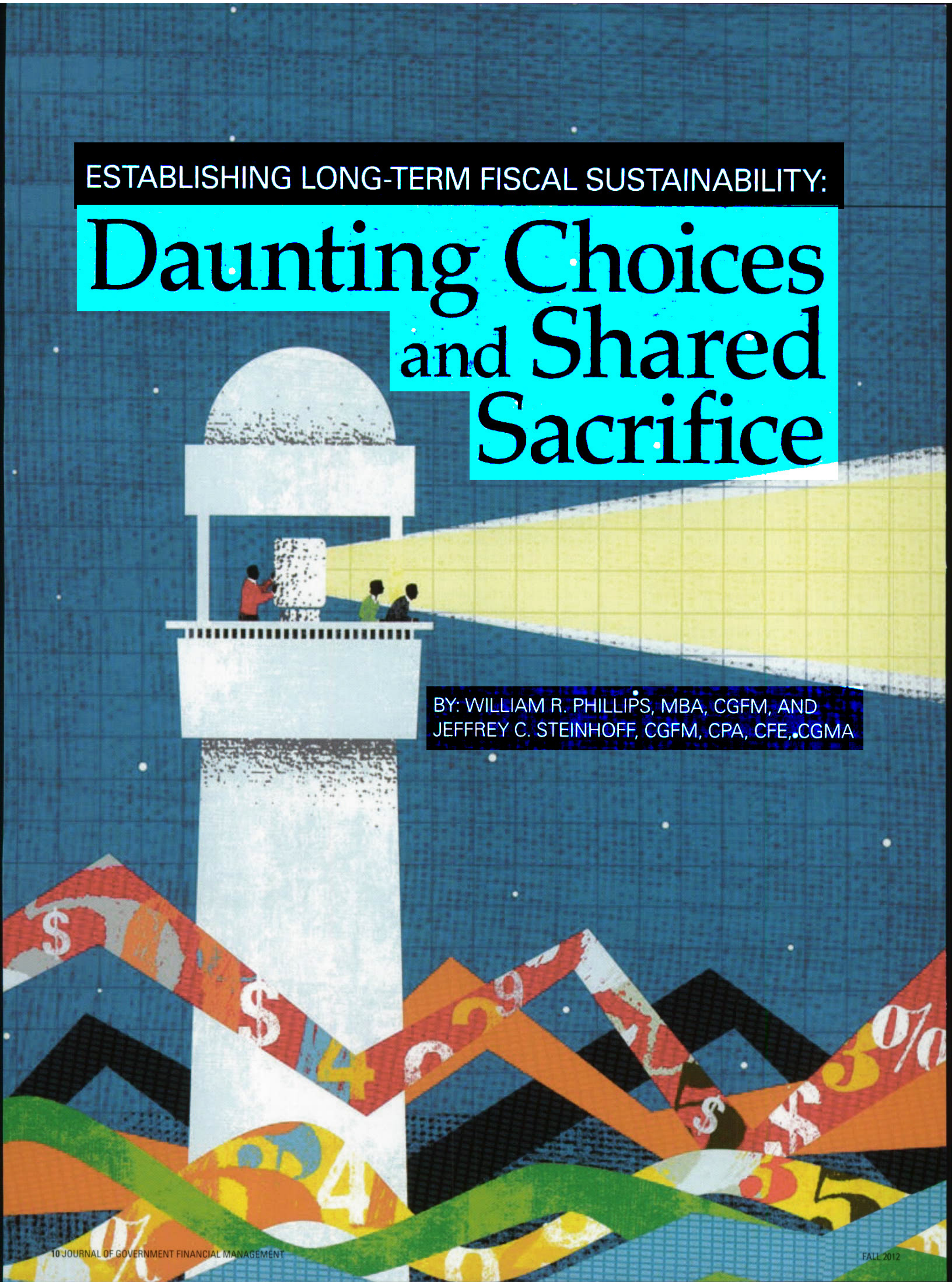


As the nation digs out of one of its deepest recessions, the federal government faces the additional reality of a broadly acknowledged unsustainable long-term fiscal path. To borrow the words of the National Commission on Fiscal Responsibility and Reform (Simpson-Bowles)[1] in its December 2010 report, "The Moment of Truth"[2]:

> ***"... The problem is real. The solution will be painful. There is no easy way out. Everything must be on the table. And Washington must lead."***

In a nutshell, over the past several decades, we have transferred massive debt and fiscal responsibilities to the next generation that simply cannot be met over the long term under current law. It is widely recognized that the problem will not be solved by any one or even a combination of growing the economy, reducing fraud, waste and abuse, wringing out additional administrative efficiencies, or making changes at the margin. We face gut-wrenching policy decisions on spending and revenue alternatives and a candid conversation about our national obligations, priorities and needed resources.

This article explores the federal government's long-term fiscal challenge. It builds upon an earlier AGA *Journal* article, "Attacking the Fiscal Crisis: What the States Have Taught Us About the Way Forward," which examined the stressors facing state governments, explored actions being taken, and offered perspectives on the drivers of successful deficit reduction.[3]

We Face Shared Sacrifice and Increasingly Difficult Choices

Annual deficits have risen to record levels as the federal government has acted to avert a financial meltdown and help revive the economy. These deficits have been adding almost $4 billion daily to the federal debt since the end of fiscal year 2008.[4] To help rein in annual spending, the Congress enacted and the President signed into law the Budget Control Act of 2011 (BCA), which over the next 10 years is expected to reduce *discretionary* spending to levels experienced in the year 2000.[5] The BCA, however, was not intended to address the components of the longer-term structural deficit related to *mandatory* spending or revenues, and one must remember there is always a potential for the BCA's decade-long trajectory to be revisited. This is where much of the challenge lies.

From the preamble of "The Moment of Truth": *"America will not be great if we go broke. Our businesses will not be able to grow and create jobs, and our workers will not be able to compete successfully for jobs in the future without a plan to get this crushing debt burden off our backs ... we share a common belief that America's long-term fiscal gap is unsustainable and, if left unchecked, we will see our children and grandchildren living in a poorer, weaker nation. In the words of Senator Tom Coburn, "We keep kicking the can down the road, and splashing the soup all over our grandchildren."*[6]

And from the Bipartisan Policy Center's Debt Reduction Task Force (Domenici-Rivlin) in its November 2010 report, "Restoring America's Future": *"The federal budget is on a dangerous, unsustainable path. Even after the economy recovers from this deep recession, federal spending is projected to rise faster than revenues and the government will be forced to borrow ever-increasing amounts."*[7]

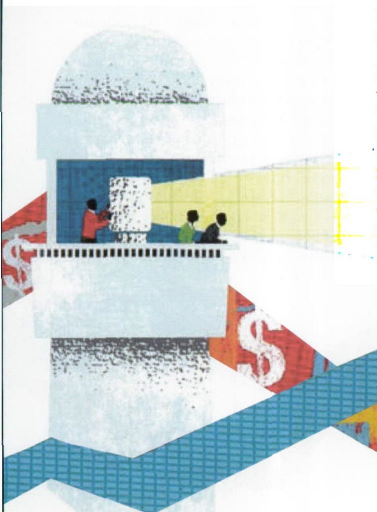
Further to that point, in February 2012, the U.S. Government Accountability Office (GAO) issued an update to its long-term fiscal model.[8] GAO's model simulates federal deficits and debt under different policy assumptions, using data developed by the non-partisan Congressional Budget Office (CBO). GAO's **baseline extended simulation** measures the fiscal impact of current law, extended. It assumes that federal revenue — as a share of the economy — is higher and discretionary spending lower than historical averages. GAO's **alternative simulation** assumes that expiring tax provisions (most notably, the Bush tax cuts) are extended and the alternative minimum tax exemption amount is indexed to inflation through 2022. Also, revenue and discretionary spending are assumed to be at their historical average over the long term.

GAO's alternative simulation showed that, absent policy change, on average over the next 75 years, federal revenue would have to increase by 45 percent *or* non-interest spending would have to be reduced by 32 percent — or some combination therein — just to keep the public debt at the fiscal year-end 2011 level of 68 percent of our nation's gross domestic product (GDP).

In fiscal year 2011, three areas — health care (Medicare and Medicaid), Social Security, and interest on the debt — consumed about 47 percent of total outlays — or 47 cents of every federal dollar spent — and 83 percent of total receipts or revenue.[9] Under GAO's alternative simulation, by 2020 these three areas would almost exceed — and by 2030 *would* exceed — all federal revenues. This means that for everything else — including national defense, homeland security, veterans' benefits, food safety, education, our national parks, and highways — any spending would just add to the existing national debt.

GAO's alternative simulation shows that by 2040, these three areas would represent 73 cents of every dollar spent, and revenues would barely cover net interest on the debt and Social Security. So by 2040, spending for Medicare and Medicaid would essentially also add to the debt. Also, absent action, by 2040, interest on the debt would become the largest component of federal spending under the alternative simulation.

GAO's baseline extended simulation shows a somewhat better, but still precarious fiscal picture. It projects spending for the three areas at over 70 cents of every dollar spent and nearly exceeding all revenues by 2040.



Health Care and Retiree Costs Are Principal Drivers of Long-Term Fiscal Sustainability

We have an aging population that is turning 65 at record rates. The first wave of "baby boomers"[10] turned 65 in 2011 at rate of 7,600 daily, which will grow to a projected 11,400 daily by 2029 with the last wave.[11] People are living longer. As these two baby boomers (one who has already broken the 65 age barrier) will attest, this is great news! But it is also one reason Medicare and Social Security are not sustainable under current law.

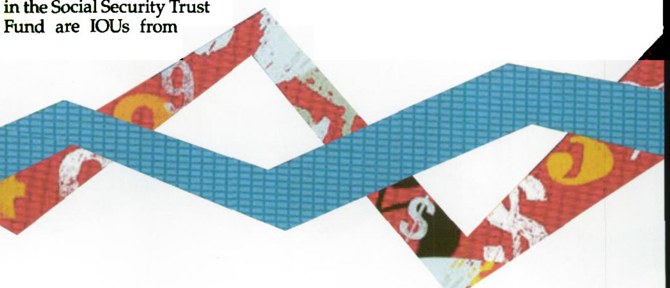
For decades, Medicare ran annual cash surpluses, bringing in more in taxes than disbursed in benefits. These surpluses were invested in Department of the Treasury special issue securities; so in effect, the federal government borrowed from itself. This had the impact of helping finance current federal programs and reducing public borrowing at the time. With the onslaught of baby boomers turning 65 and rising health care costs, Medicare is now cashing in its IOUs from the federal government since it is now running an annual cash deficit. This has the effect of increasing current federal borrowing from the public to finance what will be a mounting bill to pay for the baby boomers. Also, as the annual Medicare cash deficit continues to rise, the Medicare Trust Fund is projected to run out of funds by 2024.[12]

For its part, Social Security also ran large annual surpluses for decades, which similarly masked the magnitude of deficits in other federal spending and reduced public borrowing at the time. Social Security is now running an annual cash deficit to pay for the baby boomers' retirements. Just as with Medicare, the only assets in the Social Security Trust Fund are IOUs from the federal government. The Social Security Trust Fund is projected to run out of funds by 2033.[13]

In "A Message to the Public" on their 2012 Social Security and Medicare Trust Fund annual reports, the Social Security and Medicare Trustees'[14] summed up the situation:

"Both Medicare and Social Security cannot sustain projected long-run program costs under currently scheduled financing, and legislative modifications are necessary to avoid disruptive consequences for beneficiaries and taxpayers. Lawmakers should not delay addressing the long-run financial challenges facing Social Security and Medicare. If they take actions sooner rather than later, more options and more time will be available to phase in changes so that the public has adequate time to prepare. Earlier action will help elected officials minimize the adverse impacts on vulnerable populations, including lower-income workers and people already dependent on program benefits."

Likewise, for state governments, as reported in the most recent "Fiscal Survey of the States[15]," spending on Medicaid — for which the federal government's share of the cost was $275 billion in fiscal year 2011[16] — is expected to consume an increasing share of state budgets and grow more rapidly than state revenue. Also, estimates of the magnitude of underfunded state pension plans range as high as over $4 trillion.[17] So we see a parallel universe of health care and retiree costs at the forefront of long-term fiscal sustainability across all levels of government.



The Federal Government Faces Additional Fiscal Challenges Both Domestically and from Abroad

None of this exists in a vacuum. Consider other factors impacting the federal government's fiscal challenges:

- *The United States is part of a global economy.* The financial stability of other nations can impact our financial well being. The bailout of Greece by the European Union demonstrates the interdependency of the global economy. While the United States faces its own long-term fiscal sustainability challenges, other nations may face even more difficult problems that can have ripple effects on the world economy and exacerbate our challenges.
- *We have a trade deficit.* When we buy more than we sell, the difference — $558 billion in 2011[18] — is financed by more debt, which can weigh upon our economy over the long term.
- *Our national savings rate is lagging.* At 11.6 percent of GDP for 2010, we were substantially below the reported world average of 18.6 percent. China, Germany and the European Union overall were at 54 percent, 22.8 percent and 18.5 percent, respectively.[19] In its 2012 Retirement Confidence Survey, the Employee Benefit Research Institute (EBRI) found that for 60 percent of American workers, the total value of household savings and investments was less than $25,000 (not including the value of their primary residence and any defined benefit plans).[20]
- *We have an aging infrastructure,* with massive investment needs looming on the horizon.
- *State and local government fiscal challenges affect the nation's fiscal health.* The fiscal well-being of state and local governments is critical because all levels of government are inextricably linked. As highlighted in GAO's "State and Local Government's Fiscal Outlook: April 2012 Update"[21]: *"The state and local government sector continues to face near-term and long-term fiscal challenges that grow over time ..."* and *"... add to the nation's overall fiscal challenges."*

The Experience of the States: 10 Drivers of Government Deficit Reduction Initiatives

The earlier AGA *Journal* article, "Attacking the Fiscal Crisis: What States Have Taught Us About the Way Forward" identified 10 drivers that can facilitate meaningful deficit reduction.[22] We will discuss these 10 drivers in the context of the federal government.

1. Strong leaders can drive consensus to make difficult and potentially unpopular choices.

Governors, working with their legislatures, have driven difficult change over the course of the recession. They were motivated by a sense of urgency that resulted in important partnerships that spanned political lines and across constituencies. They did not have the federal government's vast borrowing power or the ability to print money. At the national level, partnerships need to be formed to make the difficult choices required. As Simpson-Bowles observed, *"we cannot put off hard choices any longer."*[23] Solving the fiscal challenge is a joint responsibility of the legislative and executive branches. Bipartisan solutions are needed to establish long-term fiscal sustainability.

2. Decision-makers have a shared and full understanding of the magnitude of the problems, where things stand, the range of options available, realistic trade-offs, time horizons, and the likely impact on fiscal stability and program delivery, both short- and long-term. This is facilitated through reliable, useful and timely financial and program information.

There is no shortage of data pointing to the seriousness and magnitude of the problem and that it will only be exacerbated by the passage of time. While there may not be agreement on solutions, a range of options from credible sources are on the table that can help serve as a foundation for moving forward. Again, what's largely needed at this point is the willingness of officials to work in concert and operationalize some of the proposed options. In the end, this will require compromise and a combination of actions on both the spending and revenue side of the equation.

3. Decisions must be made in the public interest broadly.

There are currently fundamental differences of view as to what this means. Threats of government shutdowns and long periods of continuing resolutions are two tangible indicators of the gulf that now exists. Simpson-Bowles spoke of putting differences aside to forge a plan and reach a principled compromise — *"... we were willing to put our differences aside to forge a plan because our nation will certainly be lost without one."*[24] This will need to seen as a "win-win" and not a "win-lose" proposition to policymakers and executives; otherwise the public loses since the current path is not sustainable and action delayed only makes it more difficult.

4. Partnerships form across a spectrum of interests, between government and its employees, and between government and the business community to formulate meaningful solutions and gain consensus for what may be bold or disruptive change.

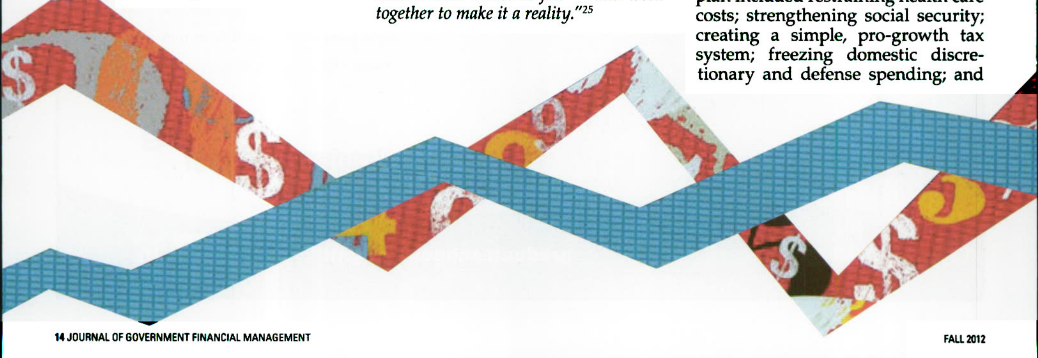
Directly related to the third driver above is that partnerships have not yet formed to the extent that consensus can be gained and meaningful solutions can move forward. The problems are widely-recognized; but agreement ends there. Many states have been able to forge such partnerships. As Domenici-Rivlin concluded, *"... actions needed to bring deficits back to manageable levels are all unpopular. Neither party can take the required actions alone without suffering adverse political consequences. The only hope is for the two parties to come together around a bipartisan plan — which liberals, moderates, and conservatives alike all see as fair — and work together to make it a reality."*[25]

5. The public is fully and openly informed of the nature and severity of the problems, the risks of not taking or delaying action, and the need for shared sacrifice. In the end, government will have to make a case to the public for any substantial change.

A bipartisan plan needs to detail the proposals and how those changes — which will invariably result in some shared sacrifice — will address the root causes of the problems. The case must be clear and convincing. What will be helpful is a unified message on the magnitude of the problem and the rationale for change. Today, it can be challenging to close a post office deemed unaffordable or stop development of a weapons system deemed unneeded or underperforming. Federal deficit spending has many critics, who are understandably concerned about the burden placed on future generations; but the components of spending generally have broad constituencies and vigorous supporters. It must be explained to these constituencies and others that addressing our nation's long-term fiscal sustainability is the necessary imperative.

6. Everything is "on the table," especially given the nature of long-term structural deficits and the opportunity that crisis provides to make broad-based changes that otherwise may be more difficult to achieve.

We have seen that in the proposals to date. For example, Simpson-Bowles included discretionary spending cuts (including defense spending), tax reform, health policies, other mandatory policies, Social Security, and process reform in its six-part plan[26] The Domenici-Rivlin plan included restraining health care costs; strengthening social security; creating a simple, pro-growth tax system; freezing domestic discretionary and defense spending; and



reforming and enforcing the budget process.[27] These proposals offer roadmaps to sound bipartisan solutions; but, once agreed upon, such roadmaps must then also be sustained.

7. Leaders are willing to look at new solutions. Slight tweaking of the status quo is unlikely to create the most successful outcomes. As Albert Einstein said: "We can't solve problems by using the same kind of thinking we used when we created them."

Again, it bears repeating that this is not about nibbling at the edges but looking holistically at programs and the role of government with an eye to structural deficits, affordability and sustainability. GAO reports on government duplication point to areas of possible elimination, consolidation and/or streamlining.[28] And while it is widely recognized that mandatory programs, such as Medicare, Medicaid and Social Security, are fiscally unsustainable in their present form, it is also recognized that there is a deep public need for these programs, especially in times of recession. This will require looking at new ways of doing things as well as revenue alternatives.

8. Gimmicks are avoided, such as shifting payment dates from one year to the next or accelerating revenues. In place of "smoke and mirrors," the magnitude of the problem must be acknowledged and addressed if root causes are to be resolved.

The long-term nature of the problem does not lend itself to short-term patchwork quilts of budget band aids. Bipartisan reform proposals on the table are not focused on gimmicks; rather, the drivers of federal spending.

9. Fiscal performance is continually monitored, and mid-course corrections are taken as needed.

This is an area where the federal chief financial officer (CFO) community can play an increasing role. High performing CFO organizations play an important role in systematically measuring program performance and developing analytical information that helps drive performance and control cost. They provide sophisticated forecasts and alternatives analysis and are at the center of strategic decision making in the "board room." This capability goes far beyond preparing financial statements that receive a "clean" audit opinion and is at the heart of creating greater value. High performing CFO organizations focus on a longer horizon, capture potential impacts of changing external conditions and demographics, and formulate actions necessary to support fiscal sustainability.[29]

10. Technology is fully leveraged to not only reduce costs and improve service, but also to inform the public on results and to encourage feedback and participation.

The continued advances in information technology and the concepts of open government — greater transparency and accountability for spending — provide a means of better informing the public about results and challenges and to eliciting feedback and participation. The expansion of government information portals has provided additional insight to the public on government programs and spending and mechanisms to make their voices heard.

Final Thoughts

There are no easy answers to what will be extremely difficult policy decisions to put the federal government on a sustainable long-term fiscal path. The current fiscal path has been constructed over decades and includes programs near and dear to the hearts and lives of Americans.

Common components of current bipartisan reform proposals include health care, Social Security, discretionary spending (including defense spending) and tax reform, because they are principal drivers of long-term fiscal sustainability. Changes in any one of these areas let alone more than one will require strong bipartisan support and public acceptance of what will undoubtedly require shared sacrifice. While the public may generally understand and be concerned that there is a long-term fiscal problem, many may not yet fully understand the enormous impact of these key components and that the passage of time substantially exacerbates the problem — making delay and later reform even more onerous.

National policymakers face the challenge of developing a strong, bipartisan plan to achieve long-term fiscal sustainability. That conversation would help facilitate an open dialogue with the American people on the components of reform and the need for shared sacrifice. Americans have always been able to rise to big challenges when they understand the stakes and the risks to the well-being of our nation and future generations.

This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP. ■

End Notes

1. President Obama created the bipartisan National Commission on Fiscal Responsibility and Reform to address the nation's fiscal challenges. The Commission was charged with identifying policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run. Co-chaired by former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles, the Commission is commonly referred as Simpson-Bowles.

2. "The Moment of Truth," The National Commission on Fiscal Responsibility and Reform, December 2010

3. "Attacking the Fiscal Crisis: What States Have Taught Us About the Way Forward," by Nancy A. Valley, CGFM, CPA, and Jeffrey C. Steinhoff, CGFM, CPA, CFE, AGA *Journal of Government Financial Management*, Summer 2011

4. Historical Tables, Budget of the U.S. Government Fiscal Year 2013, Table 7.1 – Federal Debt at the End of the Fiscal Year: 1940-2017, U.S. Office of Management and Budget (OMB)

5. The Budget Control Act of 2011 (Public Law 112-25, S. 365, 125 Stat. 239, enacted August 2, 2011)

6. "The Moment of Truth," The National Commission on Fiscal Responsibility and Reform, December 2010

7. "Restoring America's Future," The Debt Reduction Task Force, Bipartisan Policy Center, November 2010. The mission of the bipartisan Debt Reduction Task Force was "to develop a long-term plan to reduce the debt and place our nation on a sustainable fiscal path." Co-chaired by former Senator Pete Domenici and former OMB and CBO Director Alice Rivlin, who also served a member of Simpson-Bowles, the Task Force is commonly referred to as Domenici-Rivlin.

8. "The Federal Government's Long-Term Fiscal Outlook: Spring 2012 Update," GAO-12-521SP, April 2, 2012. Since 1992, GAO has published long-term fiscal simulations showing federal deficits and debt under different sets of policy assumptions – presently under two sets of assumptions: (1) the baseline extended simulation measures the current law, extended and (2) the alternative simulation assumes that expiring tax provisions are extended and the alternative minimum tax exemption amount is indexed to inflation through 2022. GAO regularly updates its simulations using data available from CBO and the Social Security and Medicare Trustees.

9. Historical Tables, Budget of the U.S. Government Fiscal Year 2013, Table 1.1 – Summary of Receipts, Outlays, and Surpluses or Deficits: 1789-2017; Table 8.3 – Percentage Distribution of Outlays by Budget Enforcement Act Category: 1962-2017; and Table 16.1 – Outlays for Health Programs: 1962-2017, OMB

10. The U.S. Census Bureau defines a "baby boomer" as someone who was born during the post-World War II baby boom of 1946 to 1964.

11. "The Federal Government's Long-Term Fiscal Outlook: Spring 2012 Update," GAO-12-521SP, April 2, 2012.

12. "2012 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplemental Medical Insurance Trust Funds," April 23, 2012

13. "2012 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," April 23, 2012

14. "A Summary of the 2012 Annual Reports," Social Security and Medicare Boards of Trustees, Timothy F. Geithner, Secretary of the Treasury, and Managing Trustee; Kathleen Sebelius, Secretary of Health and Human Services, and Trustee; Hilda L. Solis, Secretary of Labor, and Trustee; Michael J. Astrue, Commissioner of Social Security, and Trustee; Charles P. Blahous III, Trustee; and Robert D. Reischauer, Trustee, April 23, 2012

15. "The Fiscal Survey of States, Fall 2011: An Update of State Fiscal Conditions," The National Governors Association and the National Association of State Budget Officers "The Fiscal Survey of States, Fall 201: An Update of State Fiscal Conditions," The Fiscal Survey of States series, started in 1979, presents aggregate and individual data on the states' general fund receipts, expenditures, and balances. The fall 2011 survey was conducted between August and September 2011.

16. Historical Tables, Budget of the U.S. Government Fiscal Year 2013, Table 16.1: Outlays for Health Programs 1962-2017, OMB

17. "State and Local Government Defined Benefit Plans: The Pension Debt Crisis that Threatens America," United States Senate Committee on Finance, A Report by Ranking Member Senator Orrin Hatch (R-Utah), January 2012

18. U.S. Census Bureau, February 10, 2012

19. International Monetary Fund, August 1, 2011; for the United States, Haver Analytics, March 20. 2011

20. Ruth Helman, Craig Copeland, and Jack VanDerhei, "2012 Retirement Confidence Survey: Job Insecurity, Debt Weigh on Retirement Confidence, Savings," EBRI Issue Brief, no. 369, March 2012.

21. "State and Local Government's Fiscal Outlook: April 2012 Update," GAO-12-523SP, April 2, 2012

22. "Attacking the Fiscal Crisis: What States Have Taught Us About the Way Forward," by Nancy A. Valley, CGFM, CPA, and Jeffrey C. Steinhoff, CGFM, CPA, CFE, AGA *Journal of Government Financial Management*, Summer 2011

23. "The Moment of Truth," The National Commission on Fiscal Responsibility and Reform, December 2010

24. "The Moment of Truth," The National Commission on Fiscal Responsibility and Reform, December 2010

25. "Restoring America's Future, The Debt Reduction Task Force, Bipartisan Policy Center, November 2010

26. "The Moment of Truth," The National Commission on Fiscal Responsibility and Reform, December 2010

27. "Restoring America's Future, The Debt Reduction Task Force, Bipartisan Policy Center, November 2010

28. 2012 Annual Report: Opportunities to Reduce Duplication, Overlap and Fragmentation, Achieve Savings, and Enhance Revenue, GAO-12-342SP, February 2012

29. "The KPMG Executive Guide to High Performance in Federal Financial Management," KPMG Government Institute, June 2009

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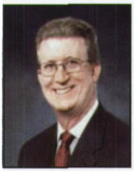

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