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AMERICA'S FISCAL CHOICES AT A CROSSROAD

The Human Side of the Fiscal Crisis

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COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

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Executive Summary

America is at a crossroad. 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 cannot 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 *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.*	**Scenario Two: Fiscal Recovery Plan** *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.

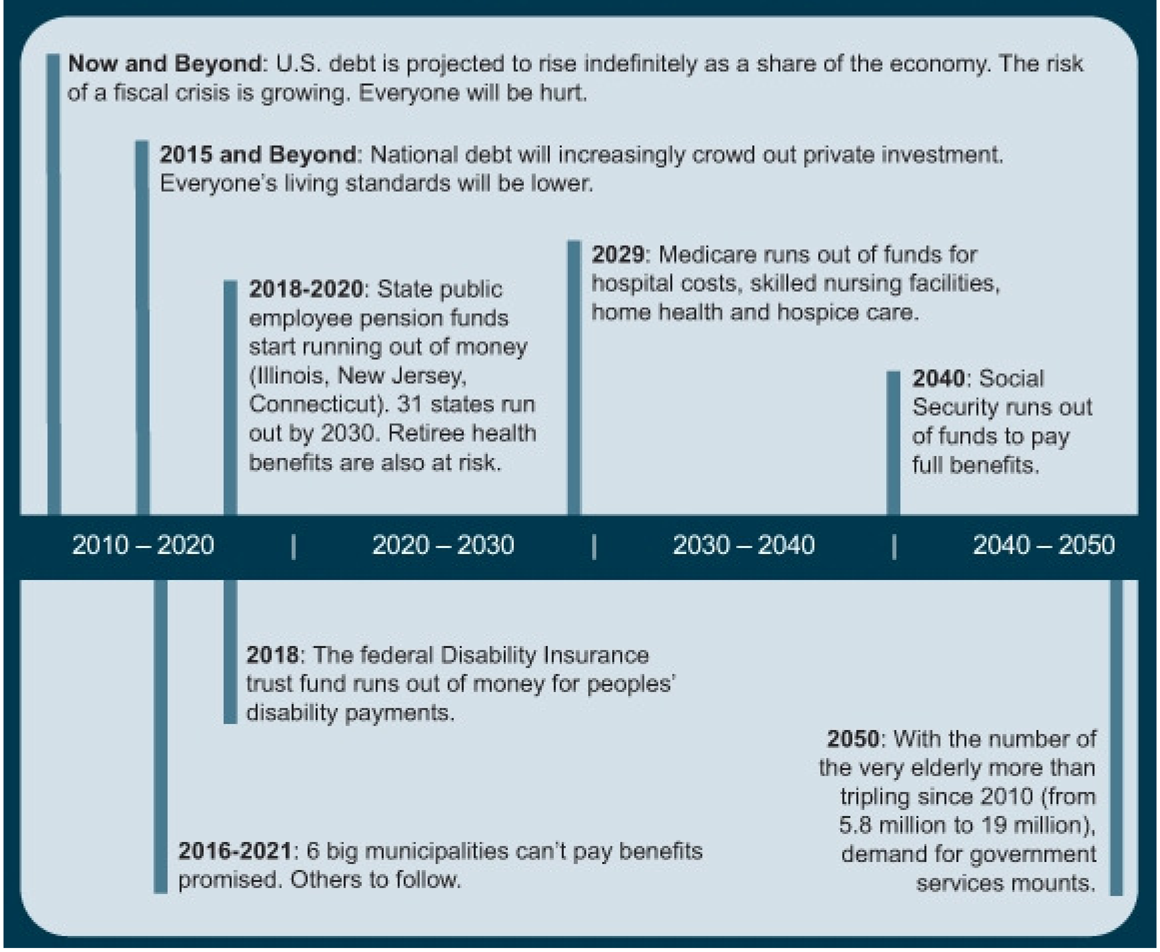
What might break our national political stalemate? How we move forward will depend largely on how ordinary people and our leaders see their choices and act upon them.

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

Introduction

Unlike many other countries, the United States still has a window of opportunity to address its fiscal challenges before they get out of hand. We know that a daunting series of specific fiscal challenges lie ahead and roughly when they will occur (Figure 3). We also know that the economy cannot fully recover and remain strong without addressing these challenges. And we know too that if our problems are left unchecked, we will eventually face a crisis, although we can not say with certainty when it will occur or what the tipping point will be.

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



And yet, policymakers have failed to change course. It is not at all clear when—or whether—we will seize the moment. Looking back from the future in, say, 2050, will we wish we had acted differently?

In an attempt to illustrate what's at stake for all Americans in a more human way than the usual fiscal policy literature, this paper runs a thought experiment.

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. Taking a cue from the Jimmy Stewart movie "It's A Wonderful Life," we consider how people's lives might have been different under two alternative (but reasonably believable) fiscal paths:

- **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.

Chapter One
Our Fiscal Choices and the Economic Back Story

We Must Head off the Coming Storm

Faced with a choice between our two fiscal futures, the preference of many experts is clear: we must take steps to head off the coming storm.

We face an escalating series of fiscal problems. As a share of the economy, our national debt is projected to be close to 70 percent of GDP this year, below its historic high just after World War II (109 percent of GDP) but well above its forty year average (less than 40 percent of GDP). If our lawmakers do not change the nation's fiscal policies, our debt will continue to rise faster than GDP, pausing only briefly in the middle of this decade. At some point, within the lifetime of our youngest generations, the size of our debt will dwarf the economy and interest on that debt will dominate the budget. Experts however agree that we will never reach this point because a fiscal crisis (or a crisis with fiscal dimensions) will occur well before then.

We face increasing risks of a fiscal crisis this decade, although it may not seem imperative to start tackling our problems yet because:

- Global financial markets still turn to *our* debt as a safe haven, not to that of any other government.
- Those markets do not yet insist on being paid a higher interest rate for the risk of buying our debt.
- The worst of our fiscal problems are still down the road.

But we simply do not know how markets will react the longer our problems go unresolved. It is well known that we are entering uncharted fiscal waters. Recent research suggests that when the debt of a country exceeds a certain threshold (measured as a share of GDP), national debt may actually start to harm growth and employment. Our debt is above that threshold.

The benefits of getting ahead of a crisis. Managing our problems in advance is preferable to acting in a moment of crisis. America will be better off if we start to reduce our fiscal imbalances as soon the economy is on stronger footing, rather than waiting until the last minute, when we are forced by the financial markets to make sudden, sharp, and indiscriminate spending cuts and increase taxes in a crisis. Research shows that solving problems sooner rather than later will cost the taxpayer less.

Furthermore, the longer we delay tackling our fiscal challenges, the more our shaky fiscal realities will be reflected in everyday life. We already are experiencing these realities in many different ways: for example, food banks have been overwhelmed in the past few years in part because our public safety nets were not up to the challenges from the Great Recession; and people increasingly face personal risk from a decade of underinvestment in national infrastructure, as reflected by bridge collapses, rail breakdowns, and road surface problems. By doing nothing now, our quality of day-to-day life will continue to slowly deteriorate, while the specter of a worse fiscal crisis will only grow.

The Top 6 Reasons to Adopt a Fiscal Recovery Plan Sooner Rather Than Later

There are six good reasons why we should take fiscal action soon:

- **To lower taxpayer costs from debt service.**
- **To increase confidence among business (job creators), our creditors, and taxpayers. Sustained confidence usually translates into stronger economic performance.**
- **To limit negative effects from higher interest rates.**
- **To make the needed fiscal adjustment more gradual, so that households and businesses can better manage.**
- **To create budgetary room to respond to emergencies and new priorities.**
- **To prevent a fiscal crisis.**

As Federal Reserve Board Chairman Ben Bernanke stated:

"One way or the other, fiscal adjustments sufficient to stabilize the federal budget will certainly occur at some point. The only real question is whether these adjustments will take place through a careful and deliberative process that weighs priorities and gives people plenty of time to adjust to changes in government programs or tax policies, or whether the needed fiscal adjustments will be a rapid and painful response to a looming or actual fiscal crisis. Although the choices and tradeoffs necessary to achieve fiscal sustainability are difficult indeed, surely it is better to make these choices deliberatively and thoughtfully."

Fig. 4: The Basic Case for Fiscal Consolidation: Short term Pain in Return for Future Payoff

Getting our fiscal house in order will have a big payoff by boosting future growth and employment. Our basic standards of living will be higher. But, we must keep in mind that the initial impact of fiscal consolidation is often negative: growth and employment are lowered as government spending is cut, taxes raised and transfer payments reduced. However, past experience suggests that negative effects can be minimized — depending on the specific fiscal measures included and whether other growth friendly non-fiscal policies are adopted at the same time. Gradual — but credible — fiscal adjustment over the medium-run is frequently proposed under current circumstances (a return to normal economic and financial conditions is expected to take longer than usual) so that we can make progress putting our policies on a sustainable path without jeopardizing our struggling recovery.

Chapter Two
How Our Fiscal Choices Could Affect Our Lives: A Close Look at the Generations and Special Groups Under Our Two Scenarios

In this chapter, we take a close look at how our two fiscal scenarios would affect the lives of those in each generation at key points in their lives:

- Baby Boomers
- Generation X
- Millennials
- Gen-Net (Children)
- Seniors

We also look at the effects of our two fiscal futures on two special groups:

- The Poor and the Working Poor
- Business and the Innovators

How would each generation and the two groups fare under each scenario? Looking back from the year 2050, which fiscal path would look better – and why?

Fig. 5: Budget Choices and our Lives: The Basics

How Fiscal Policy Shapes Everyday Life. As dry as they may seem to be, budget issues affect all of our daily lives. For a start, fiscal policies adopted by governments at the local, state and national levels help shape the economic environment that affects our jobs and take-home pay. We count on many public goods and services from defense to unemployment insurance, from retirement for the elderly to highways and bridges for everyone. We count on the government to come up with resources to take care of new challenges threatening our quality of life, from the degradation of our water supply and air we breathe to protection against terrorist attacks. Our children's standards of living are dependent in part to the tax, spending, borrowing, and investment decisions made by the government today.

And fundamentally, we expect government to make life better — not worse; to protect us all — but especially the weak and the vulnerable; to enshrine principles of fairness; and to be transparent and accountable to the American taxpayer.

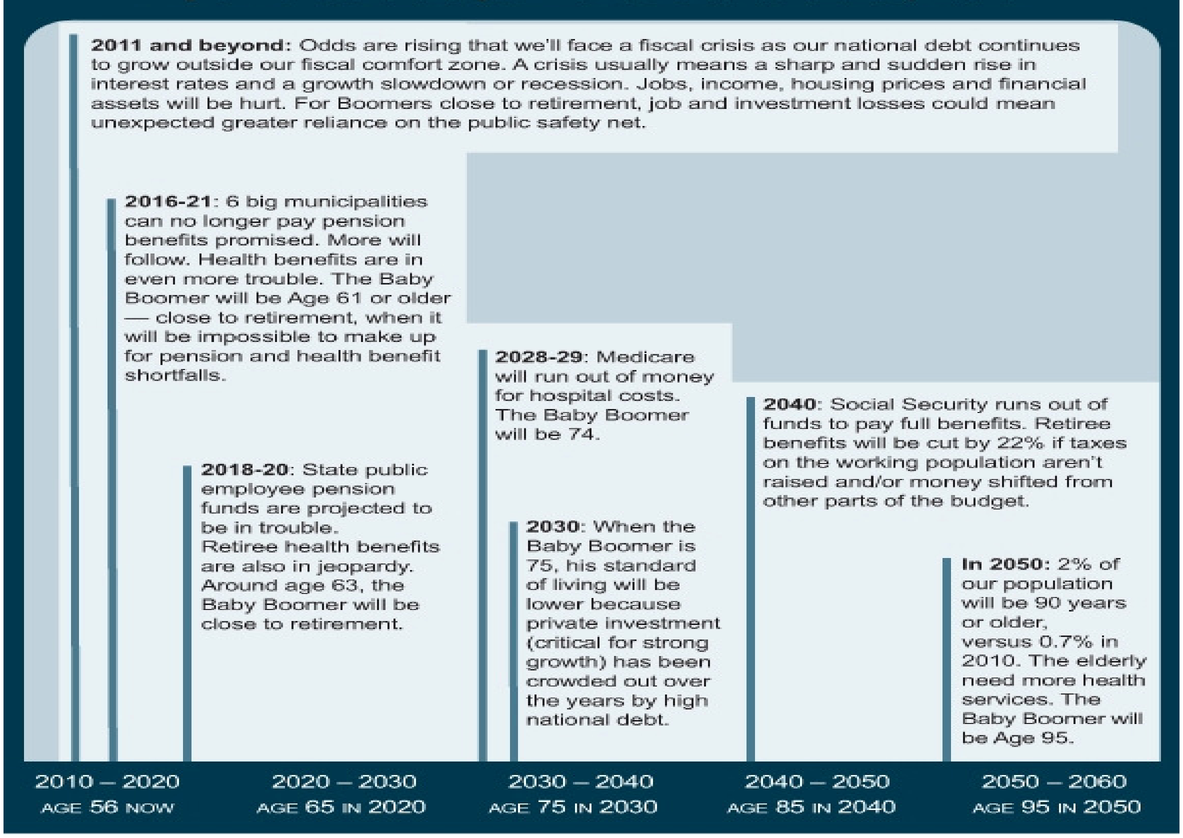
The Baby Boomers
(1946-1964)

John is a 56 year old Baby Boomer. What fiscal issues will matter the most to him? Because he will continue to work longer, fiscal influences on jobs and income will be crucial. (Same for the youngest Boomers, who will be 47 this year.) As he ages, fiscal issues related to savings, pensions and health care will be increasingly important (as they are for the older Boomers, who have already started to retire. The oldest turns 65 this year.) John will try to build his savings (which he should have done earlier). But with elderly parents to support (they didn't save enough for old age either), he will not be able to save enough for retirement without working a lot longer.

How John's Life Will Be Affected by the Fiscal Choices Our Leaders Make

What kind of future does John, our a 56-year-old Baby Boomer, have to look forward to? The timeline in Figure 6 presents a scary picture of some of the fiscal challenges we know that he and other Boomers will face in their lifetimes. What difference would our fiscal choices make in John's life?

Fig. 6: The Fiscal Challenges Timeline for a 56 Year Old Baby Boomer



Fiscal Gridlock (Scenario One)

If our political leaders do not change course, John will suffer through a fiscal crisis—or a crisis with fiscal dimensions—sometime in his lifetime. While the timing or tipping point cannot be predicted with certainty, experts agree that at some point our creditors will refuse to finance national borrowing that is growing faster than our national income indefinitely.

The effects of a fiscal crisis on John's life will be harsh—and sudden. If he is still in the work force when the crisis occurs, John will see job opportunities and income prospects dry up quickly as the dramatic rise in interest rates and immediate fiscal tightening take their toll on the economy. Many firms do not survive these types of sudden shocks. To stay in business, firms will sharply cut expenses, including laying off the most costly (usually the most senior) employees, which could include our Baby Boomer. At a time when John is racing to maximize his retirement savings, being laid off means that he will have a lower standard of living in his senior years. He will have to rely on government safety nets more than he expected.

Even if a fiscal crisis does not occur for awhile, John will still face economic pressures related to our huge and rising national debt. Interest rates will be higher and growth lower throughout the decade and beyond, due to effects from our massive borrowing. Our discouraged Boomer will face a deteriorating job market and worse income prospects over time. An increasing number of Baby Boomers will be forced into early retirement when they cannot find a job. Research suggests that older workers have a harder time than younger ones finding a new job once they are out of work. (We are already seeing this in the aftermath of the Great Recession.) With less income than anticipated in his final working years, John will be less well off for the rest of his life.

Fiscal problems related to pension and health issues will increasingly be the focus of John's life as he accelerates planning and savings for retirement, and then retires. Boomers have several retirement-related fiscal challenges to worry about, including many at state and local levels that could affect the federal budget down the line. Some of these pension crises are expected within the next five years, at a time when John has entered his early 60s and is close to retirement.

Another worry for John will come in 2028–2029, when Medicare will run out of money from the Hospitalization Insurance or HI Fund to pay basic health care costs to health plans and providers, according to the trustees of the fund. John will be in his early 70s and on a fixed income. Many health care plans for public workers at the state and local levels are estimated to be grossly under funded.

One of the most critical fiscal challenges is Social Security funding. After 2040 (2037 if funds are transferred to shore up the Disability Insurance trust fund, as many expect), the Social Security program is projected to run out of funds to pay full benefits. At this point, John will be elderly and on a fixed income, with no possibility of increasing income and savings. Unless considerable resources are shifted from elsewhere in the budget (which will hurt other programs) or taxes are increased significantly for the working population, John, like many Boomers, will suffer a sharp drop in his standard of living. He will have to turn to his children for financial support. Even with this additional support, poverty among seniors will likely rise.

Fiscal Recovery Plan (Scenario Two)

If our policymakers soon put in place a fiscal recovery plan, our 56 year old Baby Boomer will avoid the disruption and economic devastation that usually comes with a fiscal crisis. (When investors see our policymakers taking sensible fiscal action to get taxation and spending gradually back into line, they will be reassured that we have the political will to manage our fiscal affairs.) The longer we wait to solve our fiscal problems, the closer the Boomer will be to retirement, with an ever decreasing number of years to build assets to finance the rest of his life. John will be better able to manage them and to adjust more gradually if our leaders start to tackle them soon rather than to wait until we are in the middle of a crisis.

By putting in place a plan to stabilize and then reduce debt as a share of the economy, policymakers will also sow the seeds of a stronger economy. Government borrowing will not be competing with private investment for capital on the same scale. Interest rates will not rise more than what we might expect during a normal business cycle, as a consequence. With lower interest rates than otherwise, John will see immediate basic benefits for his life, in terms of stronger growth, more jobs and greater income. His standard of living will be higher into the future.

Looking now down the road to the retirement years, putting Social Security and other public programs on a solid financial footing sooner rather than later will allow people to plan and to adjust accordingly. Moreover, adjusting over a long period of time will mean that changes can be smaller because they will be phased in gradually. The longer we wait, the less time we will have to phase in any changes. Particularly as Boomers face retirement or retire, eliminating the uncertainties of key income sources for them as soon as possible would reduce fear and encourage additional savings to plan ahead.

A fiscal recovery program can be realistically expected to have some negative affects on John's life in the short-run, however, depending on the severity of the initial belt tightening. Fiscal consolidation normally slows growth and employment initially, as fiscal resources supporting the economy are withdrawn. John is vulnerable to economic weakness as he prepares for retirement. Eventually the positive economic effects will take over and John's standard of living will be higher for the rest of his life.

Fig. 7: The Fiscal Paths Facing the Baby Boom Generation (1946-1964)
Illustrated for a 56 Year Old in 2011

Life Stage	Fiscal Gridlock	Fiscal Recovery Plan
Jobs and Income Boomers need to support everyday needs but also to build savings as they get closer to retirement.	Jobs and income will be hurt as interest rates rise because our rising high levels of national debt compete with private investment for financial resources, and investors, worried about our ability to manage our fiscal situation, demand higher interest rates for taking on more risk. Boomer children and grandchildren affected too.	Jobs and income will not be hurt by national debt-related increases in interest rates. If our fiscal fix is gradual but credible, jobs and income could be stronger over time even though there would be negative effects at first.
Fiscal Space and Priorities Boomers rely on a wide range of public goods and services. Our government needs enough fiscal space to address new priorities and emergencies.	Rising spending on a few programs will crowd out other priorities. Fiscal space will narrow even more. There will be no room for addressing emergencies (including fiscal shocks) without making our fiscal situation far worse.	By limiting the dominance of a few spending programs, there will be room for other priorities. Once we have more fiscal space, we will have ample room for maneuver to address emergencies and new priorities.
Retirement	Pension and retirement health funding worries will increasingly arise at state, local and federal levels.	Putting public income and health security programs on a solid footing over time will allow people to plan and adjust. Because private assets will grow faster and be larger in a stronger economy, those on fixed income will be better off.
Post Script: Fiscal Crisis .	America's failure to address its long-run fiscal challenges will become increasingly important to investors who buy U.S. debt. The longer we wait, the higher the interest rate they will demand to take a risk buying our debt and the more prone they are to a "sudden stop" where investors stop buying our debt. If our national debt grows as expected, our policy-makers may be tempted to press the Federal Reserve to allow higher inflation, which they think might help the United States to service its debt. But investors buying our debt will react negatively and a financial crisis will probably result. Boomers at every stage of their lives would be worse off if a fiscal crisis occurred. Jobs and income would be hurt (and hurt suddenly and probably severely) if interest rates were raised sharply and suddenly to stop global capital outflows and keep investors buying our debt, which typically occurs in a fiscal crisis. Boomers, whether still working or retiring, would be hurt by sharp government spending cuts and tax increases adopted suddenly to close our fiscal gap in a crisis.	By starting to fix our debt problems in a credible way, we will prevent interest rates from rising more than normally as the business cycle matures. We will also lower the risk that investors will reduce or stop buying our debt. We will avoid temptation to try to wiggle out of our debt problems by accommodating more inflation (thus reducing the value of the debt service we must pay). We are considerably better off making fiscal adjustments on our terms rather than making them in a hurry to bring a fiscal crisis to a halt. Boomers would be better off.

Generation X
(1965-1976)

Turning 41 this year, Generation X member Kate is entering her most productive years. Among the most critical fiscal issues for her are those affecting family and career. Fiscal conditions for education will also shape her family's future. Retirement issues will be more important down the line (including the retirement situation faced by her parents, who will be living longer than previous generations). As she ages, the well being of her children and grandchildren and her legacy to them will become an even higher priority.

How Kate's Life Will Be Affected by the Fiscal Choices Our Leaders Make

Kate's fiscal timeline (Figure 8) illustrates some of the fiscal challenges that will keep her awake at night, in a world without a fiscal fix.

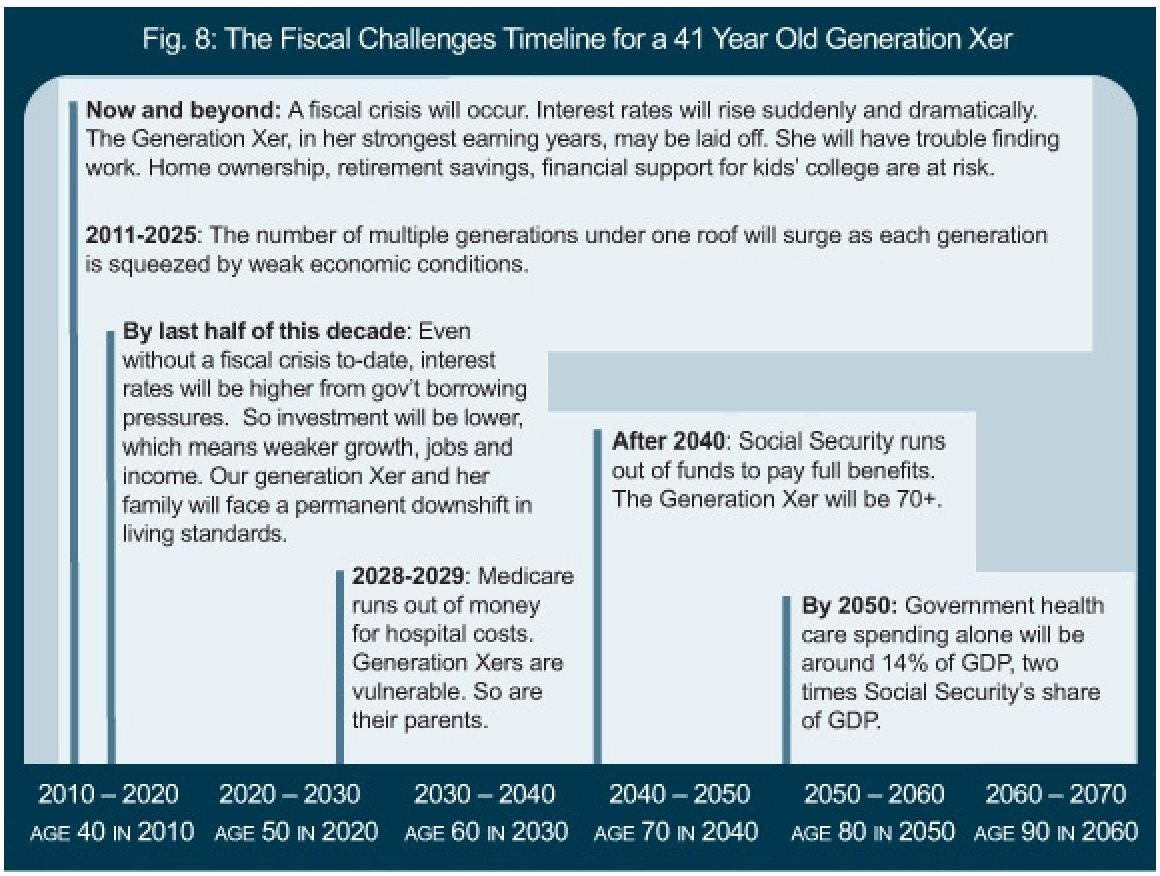


Fig. 8: The Fiscal Challenges Timeline for a 41 Year Old Generation Xer

Looking back from the year 2050, when she is 80, how will Kate see the choices our leaders are making now?

Fiscal Gridlock (Scenario One)

Fiscal gridlock means that our national debt will continue to increase as a share of the economy as far as the eye can see. Debt-related effects will affect Kate's life in various ways:

- She will be particularly concerned about having a job—one with enough take-home pay to support her family or simply herself. The state of the job market will be critical, and it will be affected by the fiscal policy landscape. Growth over the decade and beyond will be weakened by interest rate effects from our huge borrowing needs. Jobs will be harder to find and income will be under pressure.

- Moreover, Kate will increasingly worry that her livelihood is at risk from a fiscal crisis. The timing of a fiscal crisis is uncertain, but she will most definitely go through a fiscal crisis at some point in her life.

- The state of the housing market (including the level of interest rates and tax policy) is critical for our Generation Xer and her young family. She may have to delay housing purchases or downsize expectations, if jobs and income prospects are poor and interest rates are high, driven importantly by national debt pressures.

- Kate's budget priorities will probably be squeezed as a few programs and debt service increasingly take over spending. Kate drives a lot (to and from work, taking the kids to school, afterschool and weekend activities). If roads are not well maintained, infrastructure is not modernized, and public transit not improved, being stuck in traffic will continue to dominate everyone's life, bringing with it road rage, accidents, and other hazards. On average, drivers now waste many hours daily sitting in traffic.

- Social Security is projected to exhaust its trust fund financing and cut benefits sharply in 2040 (2037, if funds are shifted to the Disability Insurance Trust Fund, projected to be exhausted earlier). If our leaders wait until shortly before the projected exhaustion date, Kate will be 70 and retired, when she is unable to make up for the income loss. As Generation Xers age, their generation will become increasingly concerned about budget programs supporting health and personal security.

Fiscal Recovery Plan (Scenario 2):

Kate, our Generation Xer, will be better off if we start to get our budget problems under control sooner rather than later. However, the benefits from deficit reduction will not show up immediately. Fiscal consolidation will set in motion various economic and financial effects that kick in at different points. The payoff comes increasingly over time:

- Fiscal tightening is usually contractionary at first, because the initial negative effects outweigh the positive effects, which work through as our fiscal position improves. Growth and employment will slow as spending is cut, taxes are raised, and transfer payments are reduced. Because Kate and her family will face weaker economic conditions initially, it will be harder for them to see the benefits of fiscal consolidation. How long growth remains weak will depend on how large and concentrated the fiscal adjustment efforts are.

- After the initial negative impact, fiscal adjustment will increasingly have a positive impact on growth as it leads to lower interest rates. If financial markets decide debt reduction efforts are serious, long-term interest rates will come down because investors think that the risks from buying our debt have been reduced.

- As we stabilize and then reduce debt as a share of the economy over the next few years and beyond, interest rates will be lower because of reduced credit market pressures from government borrowing. Investment will not be crowded out by the high interest rates that would have resulted otherwise. With a higher investment path, growth and living standards will be higher over time.

- Higher growth over the decade will boost jobs and income, which will help Kate support her family and prepare for her retirement years, too. Lower interest rates will help her finance her house, her car, and her kids' education.

- As a taxpayer, she will see lower costs from debt service resulting from less debt and lower interest rates than otherwise. More money may be available for some of her priorities as a consequence.

- If Social Security and other programs benefiting the elderly are put on a sounder footing well in advance, Kate can better plan for her own retirement and anticipate additional resources needed to support her parents.

- By eliminating the certainty of a fiscal crisis, Kate has a lower risk that her job will suddenly disappear because a sharp rise in interest rates devastates the business community. Severe cuts in public services will also be avoided.

Fig. 9: The Fiscal Paths Facing Generation X (1965-1976) *Illustrated for a 41 Year Old in 2011*		
Life Stage	**Fiscal Gridlock**	**Fiscal Recovery Plan**
Family and Career	As rising high levels of national debt compete with private investment for financial resources, interest rates rise more than normal in a business cycle. Plus, investors, worried about our ability to manage our fiscal situation, demand higher interest rates for taking on risk by continuing to buy our debt. Job prospects, income, and affordability for housing and other big ticket items will be hurt by high and rising interest rates.	Initially, fiscal consolidation will weaken the economy, which will affect growth, jobs and income. Typically negative impact at first can be offset by other growth-friendly measures. Over time, though, there will be an increasing payoff. If our fiscal fix is gradual but credible, jobs and income could be stronger than if fiscal gridlock persists. Jobs and income will not be hurt by national debt-related increases in interest rates as the decade progresses. Beyond, the Generation Xer will have a higher standard of living in the future, which will also benefit her family.
Fiscal Space and Priorities	With no change in our fiscal path, there will be limited fiscal space to take budget action in case of an emergency (examples from the past: greater homeland security spending after 9/11; resources to stabilize the deteriorating economy when the subprime housing shock hit). Plus, for everyday life, fiscal resources available for many programs other than just a few will diminish. Programs related to Generation X priorities, such as education (good public schools, kids' college) and infrastructure (for the daily commute, transport of the kids and grandparents) are likely to suffer. Health care (with high family expenses) will absorb an increasing share of household spending, unless costs are brought under better control.	The increase in future fiscal space as we are getting our fiscal house may mean that more fiscal resources for Generation X key priorities (education, infrastructure modernization) are available (depending on political agreements over priorities) once fiscal adjustments are over. Fiscal space will mean that we have room for maneuver to take action in an emergency.
Retirement	When its members reach retirement age, Generation X will no longer have full health benefits and retirement income because the funds will be exhausted.	Because we know about the exhaustion of full retirement and health benefit funds now, changes made soon to put benefits on more solid footing will allow people to plan to take any changes into account and will eliminate fear and uncertainty for people looking ahead to their retirement years.
Post Script: A Fiscal Crisis	A fiscal crisis usually comes with a sudden sharp increase in interest rates, as we try to pay investors to continue buying our debt – not to go elsewhere. Then, since we are having trouble borrowing money from global capital markets, we have to reduce our borrowing needs immediately and significantly by usually severe spending cuts and large and immediate tax increases. These series of events will hurt any generation, but will devastate Generation X and his or her family, in mid-career. It often takes years for jobs and income lost to recover from these types of crises — if they ever do. Many people will have lost their highest earning years, savings opportunities for retirement. Effects on their families will be devastating.	Preventing a fiscal crisis through more gradual fiscal downsizing would allow people to manage and adjust in a way that wouldn't destroy their human capital, their careers and put pressure on their families.

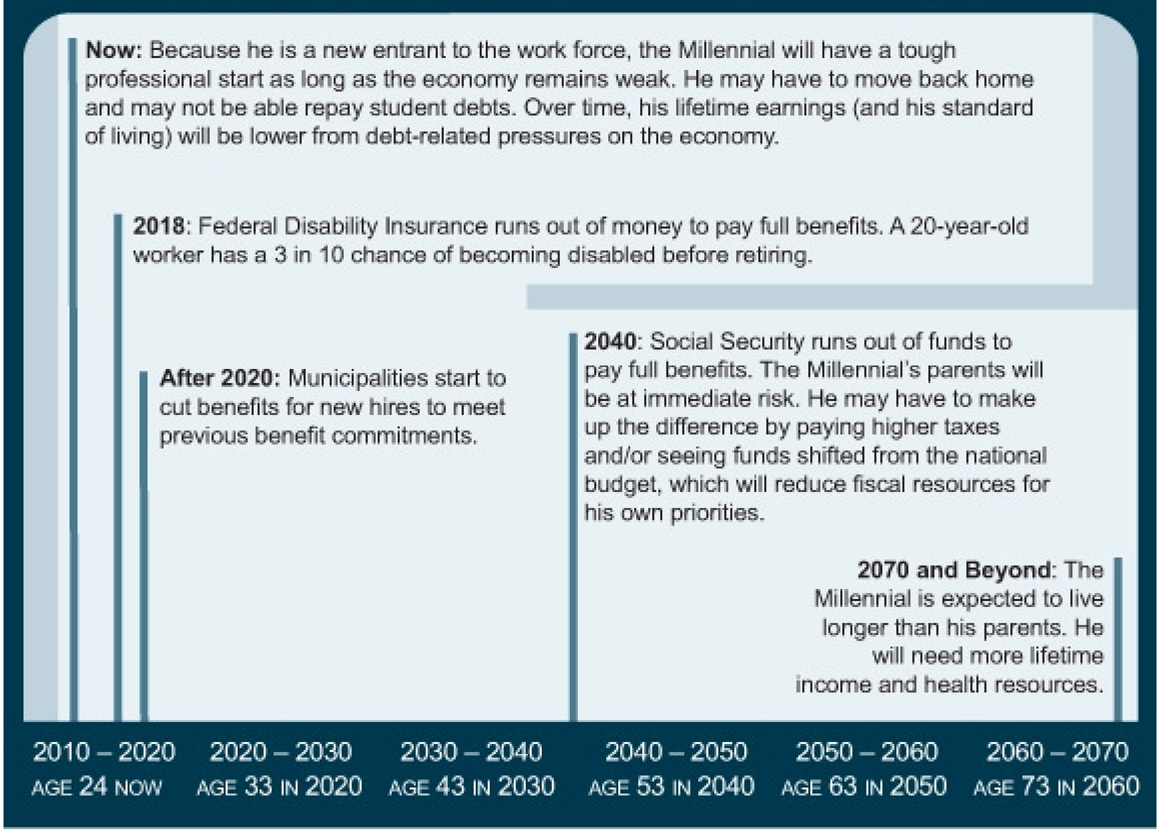
The Millennials
(1977-1998)

Nick is 24, in the middle of a generation that spans the young professional, college, and high school student worlds. He graduated from college fairly recently. However, with the economy still struggling to recover from the Great Recession, he has not been able to find the work he had expected. Because he does not come from a wealthy family but attended an expensive college, he graduated with large student loan debts. Without a well-paying job, he will not be able to continuing paying off his loans and default is a real risk. In the near future, Nick's life will be particularly shaped by fiscal issues affecting jobs, income, and education. Over time however, he will be increasingly worried about the burdens he will have to shoulder to finance programs for senior citizens—at the expense of priorities for his own life.

How Nick's Life Will Be Affected by the Fiscal Choices Our Leaders Make

As Figure 10 illustrates, Nick will face a series of major fiscal challenges over his life. When he is close to retirement, will he think that our leaders made the right fiscal decisions this decade?

Fig. 10: The Fiscal Challenges Timeline for a 24 Year Old Millennial



Fiscal Gridlock (Scenario One)

Just starting out in the working world, the job climate will matter to Nick. Higher interest rates resulting from the impact of the rising national debt on the economy or a fiscal crisis will limit job availability for new entrants to the workforce. With limited job prospects and income, he will be forced to rely on his parents for resources and may have to move back home until he can afford a place of his own. Nick may even have to postpone car purchases until he gets a steady job or interest rates are lower. He—and other Millennials—may increasingly delay marriage until they get more financially on their feet. Delays in normal life cycle passages will follow Nick for the rest of his life. For example, getting professionally established later in life will hurt lifetime earnings.

Health. Like all other citizens, the Millennial Generation faces fiscal challenges related to the exhaustion of funds for federal Disability Insurance and state and local health benefits. Most people do not like to think about disability. But the chances of becoming disabled at a relatively young age probably are greater than most people realize: research shows that a 20-year-old worker has a 3-in-10 chance of becoming disabled before reaching retirement age. Later in life, unless the U.S. health care system improves, Nick will not have adequate coverage or resources to guarantee decent health care for himself, his parents, and his kids.

Retirement: After 2040, Social Security runs out of funds to pay full benefits. Nick's parents will be at immediate risk, and he may have to make up the difference at a time when he should be saving for his own retirement. Burdened by his parents' need for resources (and expected to live a lot longer than his parents), he will need supplemental income and health care assistance to achieve a decent quality of life, but sufficient fiscal resources will not be available.

Fiscal Recovery Plan (Scenario Two)

The benefits of adopting a fiscal recovery plan may not seem at all obvious to 24 year old Nick initially—to say the least. At first, he can expect that fiscal tightening will lower growth and reduce his job opportunities. He will not earn what he had expected or hoped. How long these conditions will last will depend importantly on how front-loaded tax and spending measures are. At a time when Nick is just getting started professionally (and has large student loans to repay), this is not good news to him. He will be discouraged by his prospects.

However, things will improve for him—maybe more quickly than he expects, depending in part on how seriously financial markets take our leaders' fiscal recovery program. As policymakers reduce government borrowing and show that the United States is capable of managing its fiscal affairs sensibly, interest rates will be lower, which will boost growth and investment. Over time, stronger growth and investment will translate into a higher standard of living for Nick and his family. If our leaders make sure that they increase high quality investment (often defined as investment in infrastructure and human capital, including education), he could be even better off.

If the series of fiscal challenges related to health care and aging pressures are tackled, potential crises will be headed off. Moreover, our Millennial and his family will benefit directly and obviously if our basic programs for seniors are fixed well in advance, so that he, still in the working world at that point, does not have to pay higher taxes or accept a shift of resources from general budget funds to support these programs without change. His take-home pay will not be cut drastically so that existing benefits can continue in these programs.

Fig. 11: The Fiscal Paths Facing the Millennial Generation (1977-1998)

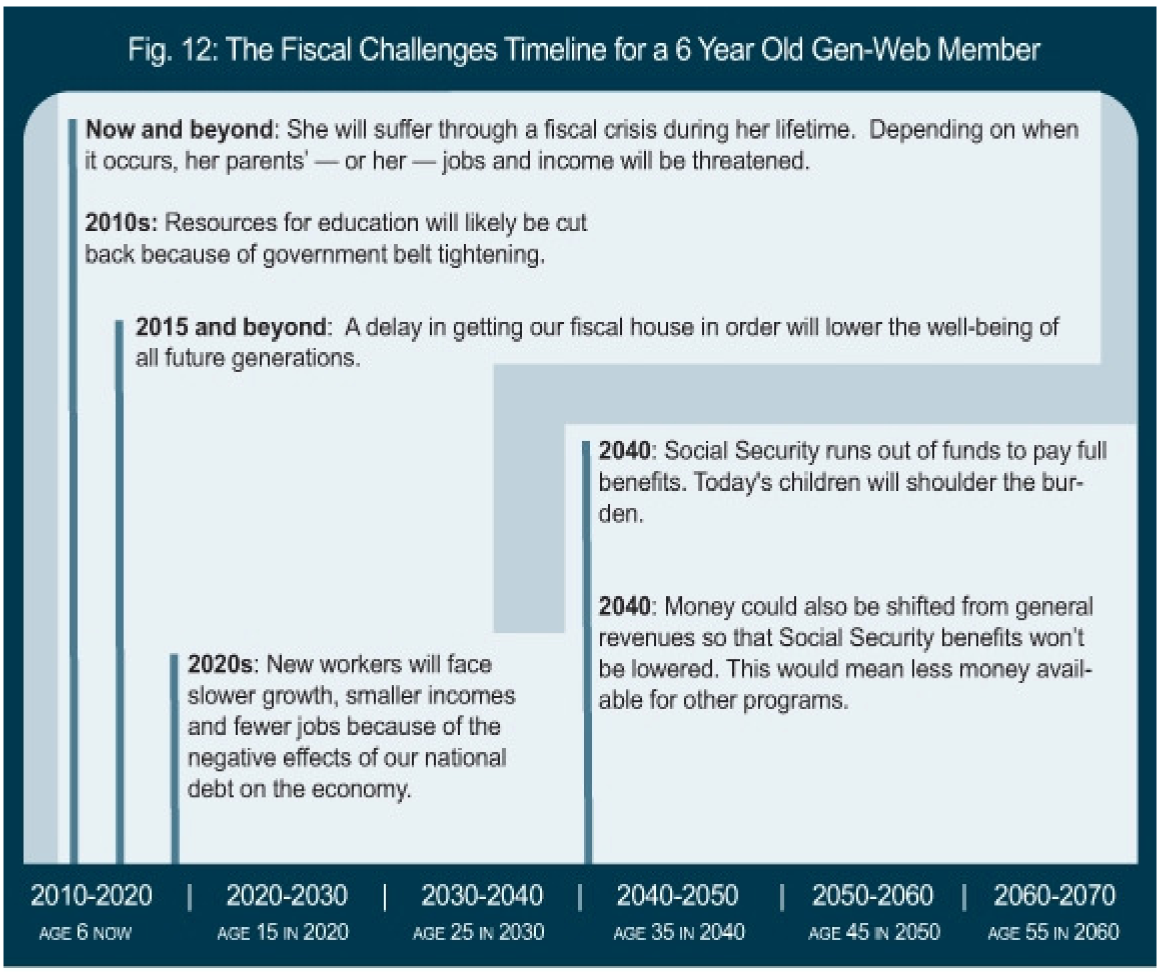
Illustrated for a 24 Year Old

Life Stage	Fiscal Gridlock	Fiscal Recovery Plan
Jobs and Income	The 24 year old Millennial, a new entrant into the job market now and in the near future, will have a tougher time than most of us. Employers will not add new employees as usual because business will be hurt by higher interest rates, pushed up by our national debt. His career will be delayed, income will be lower, and he will need to rely on his parents for housing and financial support. Lifetime earnings will be lower.	Initially, the Millennial will face weaker economic conditions from fiscal adjustment, with the degree of weakness depending on how drastic measures are. Initial negative effects on jobs and income from deficit reduction will subside and positive economic effects will increase over time. With investment and growth stronger, his lifelong living standards will be higher.
Fiscal Space and Priorities	Education at all levels will be crucial for the Millennial. Education finance will be more expensive because of national debt-related higher interest rates. Government support for education may be squeezed by fiscal pressures.	Education finance will be less costly. Plus, if education is recognized as a priority for our long-term growth agenda (to build human capital), the Millennial will be better off over time.
Retirement	The Millennial will be close to retirement when the Social Security trust fund is projected to be exhausted. Without an earlier fix, full benefits will no longer be possible — unless the Millennial (and younger workers) are hit with a sharply higher tax bill or funds are transferred from the national budget (which takes away money for his own priorities).	If problems with Social Security and other retirement-related funds are tackled sooner rather than later, gradual adjustment and planning can make life a lot easier and certain for the Millennial.
Post Script: A Fiscal Crisis	Job and income prospects for the Millennial will be even worse when the fiscal crisis occurs. Interest rates will be higher and will increase more suddenly than under simple fiscal gridlock. Growth will slow down — or a recession may occur. Businesses will close. Jobs will dry up. Careers will be delayed or even damaged.	If the Millennial can avoid a fiscal crisis, the normal progression of his life (including his career) will not be interrupted and his lifetime earnings will be higher.

Gen-Web
(1999 – now)

Keisha, our child of the Internet Generation, is 6, just starting school and with most of her life ahead of her. Her generation will benefit the most from the boost in future living standards that usually comes from fiscal consolidation. During her childhood, fiscal influences on her parents' work and income and on education will be very important. When she enters the professional world, the impact of fiscal policies on her workaday world as a new entrant will matter. However, If funding issues for Social Security are still not solved by the time its trust fund is projected to be exhausted, our Gen-Web member may well be hit with sharply higher taxes to fund full benefits for her parents at a time when she needs even higher take-home pay to support her own family.

How Keisha's Life Will Be Affected by the Fiscal Choices Our Leaders Make



Fiscal Gridlock (Scenario One)

In a world of fiscal gridlock, the future looks bleak for the youngest among us. (Figure 12) Today's children will grow up in a tough world of fiscal austerity, as budgetary pressures will increasingly limit resources. At the same time, fiscal effects on economic conditions will hurt job and income prospects for her parents.

Our 6-year-old will go through a fiscal crisis at some point in her life. If a crisis occurs when Keisha is still a child, it will primarily affect her through the impact on her parents' jobs and income. If it occurs later, it will affect her directly by diminishing her job and income opportunities. In either case, Keisha's lifelong standard of living will be lower – perhaps even lower than her grandparents'.

Waiting until the last minute to address the exhaustion of the Social Security trust fund will have a tough impact on the Gen-Web member. As 2040 approaches (the projected date of exhaustion for the trust fund), Keisha will be nearing 40, when she will be juggling payments on a house or apartment and a car, and supporting herself or a family—possibly with more family members on the way. If our lawmakers decide to continue providing full benefits to Social Security recipients around that time, she (as a member of the working population) will be hit immediately by a large increase in taxes, so that benefits can continue to be financed. If our lawmakers decide instead to reduce Social Security benefits, our Gen-Web member may have to step in to provide additional financial support to her parents. If our lawmakers decide to finance Social Security by shifting resources from general revenues, budget resources for many needed government programs will be squeezed. None of these solutions will be easy for Keisha.

Fiscal Recovery Plan (Scenario Two)

Children will see similar benefits from "smart" fiscal consolidation as the Millennial Generation—but even more so. With improved U.S. fiscal management and a budget that better targets the competitive realities of the 21st century, underlying growth will end up being stronger than it would have been from changes made during a crisis.

By preventing a slowdown of potential growth (or by raising it), we will give the children of today and the future greater opportunity, wealth, and thus living standards. A great emphasis on education as part of smart fiscal policy will contribute significantly.

With the creation of more fiscal space, we will have the possibility to invest more in children from an early age, which has been found to have a huge payoff.

Fig. 13: The Fiscal Paths Facing Gen-Web

Illustrated for a 6 Year Old

Life Stage	Fiscal Gridlock	Fix our Fiscal Problems
Children's Basic Needs: Income, Housing, Nutrition, Education	Children's basic needs will be hurt by rising interest rates related to our large national debt: as parents' jobs and income are lowered, children will be affected through household pocketbook effects.	Children's basic needs will be better addressed in an economy where our fiscal problems are tackled, which will limit the negative effects on household pocketbook matters from national debt-related increases in interest rates.
Fiscal Priorities and Fiscal Space	Public resources for less well-off children will be lowered as a handful of programs considered higher priorities push out spending in other areas. Public resources for education will be hurt. Public and private funds cannot keep up with population growth.	If fiscal consolidation is done thoughtfully, there can be room for recognizing that fiscal resources for investing in human capital for America's future (education, nutrition) is a priority for our competitiveness and resources can be shifted in that direction.
Adult Life and Living Standards	If there is fiscal gridlock, US living standards will probably not be kept up.	Living standards can be sustained or improved, if priority is given to grow-friendly investments as we get our fiscal house in order.
Retirement	Looking to the distant future, children should expect to face a large cut in retirement benefits and/or a large increase in taxes if our public retirement programs are not fixed before they are exhausted. Unlike the Baby Boomers, the Social Security benefits of today's children at retirement will probably not be financed by a very large group, as population growth is not expected to surge.	With our population shifts, reduction in retirement benefits and any necessary changes in financing can be more gradual. As they become adults and enter the work world, today's children will be able to better plan and manage their future over time.
Post Script: Fiscal Crisis	A fiscal crisis will accelerate tough trends emerging with fiscal gridlock: more children will be left behind and more immediately as a crisis forces interest rates to jump dramatically and policymakers to take immediate fiscal actions to stem capital outflows. Sharp cuts in public programs will hurt the most vulnerable.	By avoiding a fiscal crisis and the quick negative effects that generally accompany it, today's children will be better off.

Senior Citizens

Edna is 75 years old now. Reliant on a fixed income from her savings and pensions, she is vulnerable to deteriorating economic condition, inflation and a cut-back in income. Having sufficient income and health benefits to cover her circumstances and emergencies is critical. Services (especially health-related) have become increasingly important. Personal security issues are important. The well being of her kids and grandkids is very important, as is her legacy to them.

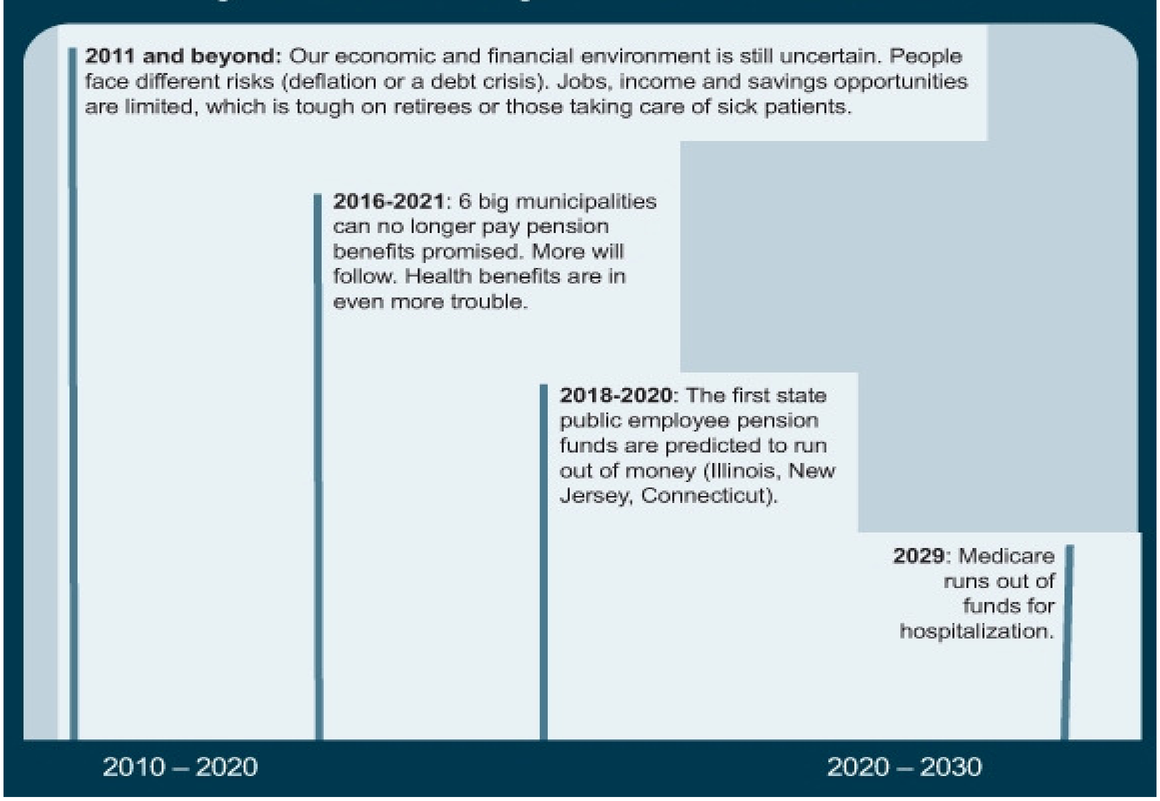


Fig. 14: The Fiscal Challenges Timeline for a 75 Year Old Senior

Fiscal Gridlock (Scenario 1)

Income and Health. Without a change in fiscal policy, senior citizens will face cuts of about 25 percent in Social Security benefits when its trust funds run out, according to program trustees (2037 if funds had been shifted earlier to shore up the disability insurance trust fund). Similar issues will arise for Medicare. If funds are diverted from other programs or taxes increased on younger citizens still in the working world, and no change in benefits or eligibility are made, working Americans will bear a large burden to fund the older generation's basic safety net. Many experts point out that making gradual and limited changes in the programs long before the trust fund crisis occurs will help people adjust to the changes and will spread the burden more fairly among generations.

Other priorities may face cutbacks. Seniors may face under-funding for other resources they rely on, if new fiscal realities dictate sharp and immediate budget cutbacks. However, in our national fiscal conversation, we still have a window of opportunity to make sensible fiscal changes that protect priority programs. For instance, research shows that people over 50 (and children) are particularly susceptible to pandemics, food-borne illnesses (such as salmonella, listeria, and E-coli), and air pollution (experts think that air pollution has increased hospitalization for asthma and other respiratory illness among seniors). Programs to inspect food sources abroad and resources for food inspectors and food-worker education are already under-funded.

Fiscal Recovery Plan (Scenario 2):

The sooner our leaders start to tackle Social Security and Medicare funding challenges, the better off senior citizens will be because they will be able to plan their retirement options as far in advance as possible. Seniors will also be better off from fiscal consolidation because there will be more fiscal room for maneuver. This means that adjustment to any unexpected events in the future can be gradual, not sudden.

Fig. 15: The Fiscal Paths Facing Seniors

Illustrated for a 75 Year Old

Life Stage	Fiscal Gridlock	Fiscal Recovery Plan
Retirement	Today's senior citizens do not face a crisis in their income and health benefits funded by the federal government. With pension and health issues the most important for senior citizens, funding for full Social Security and Medicare benefits is not at risk for awhile (projected 2037 for Social Security or 2028 for Medicare).	Fixing our fiscal problems gradually but comprehensively could help ease the massive income transfer from the younger generations to senior citizens. If done gradually, over a long period of time and well in advance, fixing our Social Security program funding would not affect today's senior citizens.
Fiscal Priorities and Fiscal Space	Fiscal gridlock could hurt many seniors if (through political disagreement or belt tightening), the government could not provide sufficient resources for senior needs in priority areas such as safety (anti-crime efforts), health, and transportation.	A stronger economy (when interest rates aren't pushed up by fiscal gridlock) and more fiscal room for maneuver would help us better provide for senior priorities.
Post Script: Fiscal Crisis	A fiscal crisis could harm today's seniors. To restore US fiscal credibility to financial markets yet to avoid severe cuts to a small part of the budget, policymakers would be under pressure to cut as many government programs as they can. While there would be an attempt to protect programs important to senior citizens (especially the most vulnerable), financial pressures might lead to cuts in many areas.	It is always better — especially for the mist vulnerable in society — to avoid a crisis and to manage change gradually.

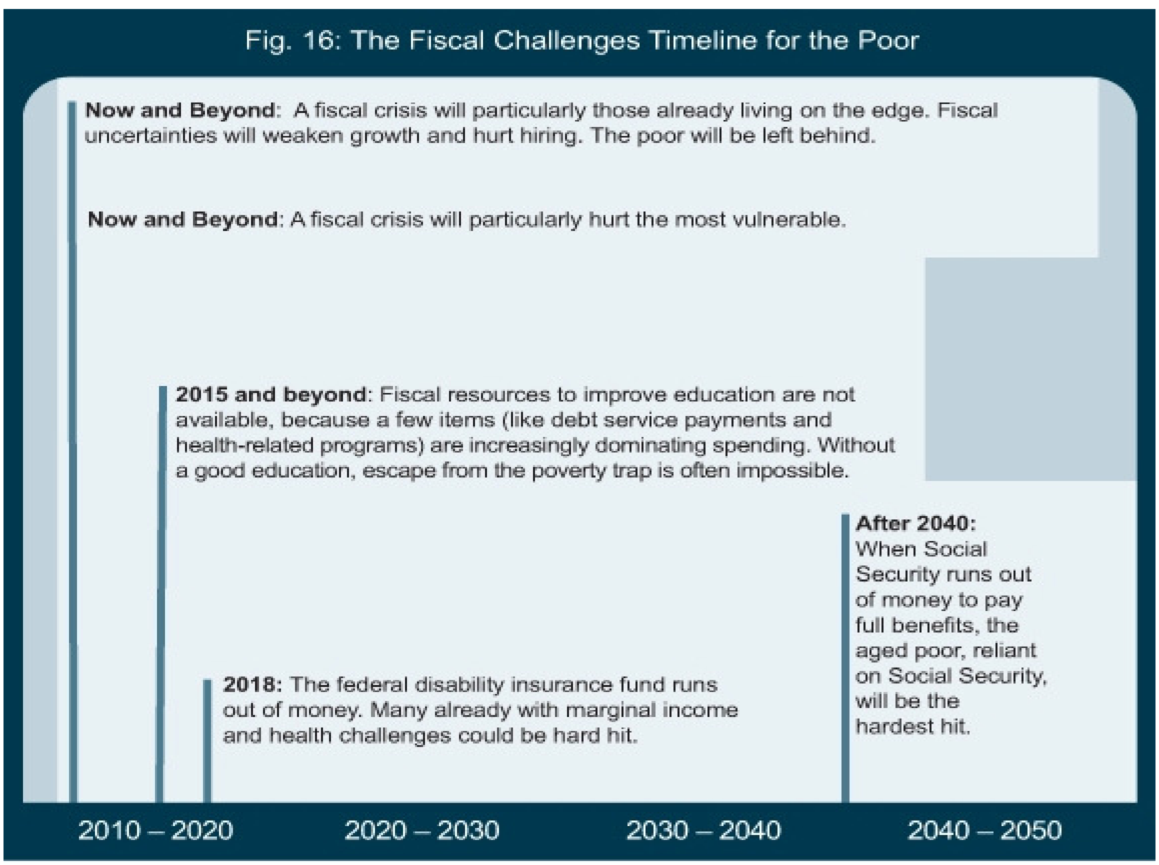
THE EFFECTS OF OUR FISCAL CHOICES ON SPECIAL GROUPS

Our fiscal choices will also have important effects on special groups. We take a closer look at the poor and business. While they do not have fiscal challenges as predictable as the generations, their future paths can be more closely explored under the two alternative fiscal futures.

The Poor and the Working Poor

The poor are particularly vulnerable to further deterioration in the economy, which will reduce employment and income opportunities. Fiscal pressures from our large and rising debt will hurt the economy. The fiscal battles which lie ahead may mean less safety net resources and lower political support for the poor. With worsening income distribution due to several reasons (including effects of technology and trade), solutions to increase opportunities targeted at this population are challenging. Funding for education, critical to helping people advance, may be limited.

How the Poor and Working Poor Will Be Affected by the Fiscal Choices Our Leaders Make



Fiscal Gridlock (Scenario 1)

If our fiscal situation continues to deteriorate, the poor and working poor, already living close to the edge, will be hurt by the negative effects of large and rising debt on the economy (jobs and income will be hurt), but also in other ways, including:

- Affordable, decent housing will be even less available, as higher interest rates limit affordability for many people and budget pressures could likely mean a further cutback in resources for public housing. Public funding for preschool programs could be at risk with budget resources under pressure. Studies have shown that the payoff for investment in early childhood education is considerable.

- Limited fiscal resources will squeeze spending on higher education. Poverty can be reduced through decent education. According to the Bureau of Labor Statistics, 2009 weekly earnings for workers with less than a high school diploma were $454, compared to $1,137 for workers who had gone to college and beyond. However, many people cannot afford higher education without financial help, including assistance provided by the government. The importance of federal assistance for education is underscored by the fact that 80 percent of low-income undergraduates in the 2007–08 academic year had federal government grants.

- Fairness issues will rise to the fore even more, as citizens will increasingly be divided between those who can afford to pay for what used to be public goods and those who cannot.

- With income inequality increasing, the lack of public resources for kids will widen the gulf between haves and have-nots. Commonly accepted public goods and services (which many had counted on to lift them out of poverty) will be diminished. Poverty among the nation's children—already at one of the highest rates among the richest nations—will rise even more in the absence of public resources to provide opportunity. Meeting the nutritional, personal safety, and education needs of our children will be key factors in determining their lifetime success.

Fiscal Recovery Plan (Scenario Two):

If done properly, as we put a fiscal consolidation plan in place, we will need to protect the most vulnerable among us. With negative effects to be expected at first, those living on the edge already will need additional resources for support. As part of restoring our fiscal balances, we may be well-advised to shift fiscal resources to priorities which are known to increase human capital. For example, research shows that better education (including for the very young) will translate into higher income over people's lifetimes, will reduce crime, and could help improve health outcomes.

Fig. 17: The Fiscal Paths Faced by the Poor

Life Stage	Fiscal Gridlock	Fiscal Recovery Plan
Basics: Interest Rates and Growth	Fiscal gridlock will mean that interest rates are higher than they would be otherwise. Worse job prospects will hurt many low wage and unskilled workers plus new entrants to the job market (including recent school graduates, many of whom have huge student loans) Fiscal gridlock will probably also mean the inability to agree on providing additional fiscal resources if the economy weakens again.	While things will remain tough, the poor and working poor will be better off if our fiscal problems can be fixed in ways that keep the economy on track and that do not take away resources they need for support.
Fiscal Priorities and Fiscal Space	Resources for the poor and working poor will be squeezed. This will be particularly a problem for those trying to escape poverty by getting more education	Resources boosting human capital (like education) could be more available over time, so that people would have a better chance to escape poverty.
Post Script: A Fiscal Crisis	A fiscal crisis could mean that job opportunities for those previously considered the poor and working poor will disappear because they will be displaced by the new poor, laid off from their jobs and probably more highly skilled. Slower growth and sharply higher interest rates will also limit opportunities available.	Avoiding a fiscal crisis would be a good thing.

Fig. 18: Who are the Poor?

In 2008, 19 percent of children (under 18) were below the poverty level, more than any other group, although the group aged 18–24 was not far behind (18.4%). The overall poverty rate for senior citizens (8.4 percent for those aged 65–74 and 11.2 percent for those 75 and older) was considerably lower, according to the Census Bureau. However, there remains a considerable group of poor elderly.

Businesses and Innovators

Business cannot thrive without innovation. Both businesses and innovators have very strong reasons to keep the United States on a healthy growth path, including minimizing the risk of a crisis. Fiscal policy plays an important role in shaping the business and innovation landscape, although other policies are key as well. For companies and innovators, low interest rates, strong low inflation growth, competitive tax rates, reasonable access to finance, and open markets in the US and around the world are important. Education is critical for innovation to thrive, and fiscal policy plays a role.

How Business and Innovators Will Be Affected by the Fiscal Choices Our Leaders Make

Fig. 19: The Fiscal Challenges Timeline for Business and Innovators

Fiscal Gridlock (Scenario One)

Businesses will be worse off if we do not correct our fiscal course under our own terms soon:

- Unless the United States starts reducing its fiscal imbalances, businesses will increasingly face higher interest rates, as massive government borrowing and private investment compete for capital and the buyers of U.S. government debt insist on higher interest rates for the increasing risk of holding U.S. debt. A fiscal crisis would have effects along these lines, although change would most likely come in the form of a sudden shock, which would be harder for businesses to survive.

- If interest rates are higher, the economy will downshift—and the impact could be dramatic in the case of a crisis. Firms' profits and profit margins are reduced by consumers' inability to buy their products (especially big-ticket items like cars and washing machines, which are often only affordable through consumer finance). The health of companies' balance sheets—including their need to finance inventory purchases or other necessary expenses—also depends on borrowing capacity and the cost of borrowing. Many firms (including farmers) do not sustain deep pockets or rainy-day reserves and so are vulnerable to sudden shifts. Companies may have to lay off old employees (who may be more expensive) even though the loss of experience (human capital) could hurt the company. They may not hire as many—or any—new employees. To rebuild their businesses, they may hire more part-time workers, who will have lower pay and minimal or no benefits.

- Fiscal pressures will diminish public resources available for business. There may not be sufficient resources to pay for the modernization of U.S. infrastructure with adding to our debt burden, which would, for example, help companies transport goods efficiently or offer services efficiently through the Internet.

- Policymakers may be reluctant to give growth-friendly tax breaks to innovators. While it is often difficult to get these policies right, failure to address the issues in a serious way could stifle new sources of basic growth that drive business formation.

- Public investment in human capital and new priorities, such as environmental products, may be limited by the lack of fiscal space available.

Fiscal Recovery Plan (Scenario Two)

With interest rates and growth key, business and innovators will be better off in the aftermath of a fiscal turnaround that features shifts from inefficient and outdated measures to pro-growth policies.

Then, with debt reduced as a share of the economy, there will be more room for maneuver to put in place growth friendly policies that will ultimately boost underlying growth.

Because businesses also prefer to plan, putting in motion a well-crafted and reasonable fiscal plan will eliminate unnecessary uncertainties. Businesses will go bankrupt very quickly in a fiscal crisis, as we have seen elsewhere.

Innovators and America's Competitiveness. Americans need to make sure we continue to support innovation to sustain growth, particularly at a time when an increasing portion of our population will not be working and needs greater public resources. However, our ability to innovate could be seriously compromised by a delay in fiscal consolidation.

Thoughtful modernization to tackle our fiscal imbalances could help. Most critically, we may be well-advised to provide resources for education and other areas supporting human capital development. Without public support in these areas, we probably will not have new sources of growth, as we did in the 1990s. When growth slows, standards of living decline (measured by income growth).

In this regard, American competitiveness is also a big concern, and education of the workforce is thought to play a major role. In the most recent major international comparison, American students had a lower science literacy score than students from the world's major countries, on average. The Census Bureau reports that nearly two-thirds of all Americans over the age of 25 do not have a college degree of some sort.

Education is one of the most important fiscal challenges facing businesses and innovators, who absolutely need a well-educated labor force to maintain global competitiveness. The education system is already failing many young people, and a continuing squeeze in fiscal resources will make the current situation even worse.

While many kids get a good education, there is another side. Now, around 1.3 million students drop out of high school annually. The dropouts are more likely to face lower lifetime earnings and longer periods of unemployment, to need higher government assistance for longer periods, and to have a higher risk of going to prison than those who have graduated.

Lower lifetime earnings will in turn mean lower budget revenue for all levels of government. Longer periods of unemployment, greater government assistance, and increased likelihood of imprisonment all have fiscal costs. Furthermore, there is a basic loss of potential skill and talent (human capital).

While the causes and solutions to our public education problems are complex, many experts think that additional targeted public funding (including at the federal level) could, along with other changes, improve outcomes. With fiscal pressures rife throughout all levels of government, new resources will not be readily available.

Fig. 20: The Fiscal Paths Facing Business and Innovators

Life Stage	Fiscal Gridlock	Fiscal Recovery Plan
Basics: Interest Rates and Growth	Debt-related higher interest rates than normal as the economy recovers will hurt jobs and income, which will lower consumer purchases of goods and services. Businesses will see their earnings suffer and over time may not be able to survive. Businesses need access to affordable credit, to finance inventories, to keep income steady in seasonal ebbs and flows, to invest to modernize and keep competitive, and to expand. With interest rates higher than normal, businesses will be hurt by credit costs. Innovators will also be affected here, since their ability to innovate and get return is linked to access to affordable credit, to be able to innovate until an idea can be brought to market. We have seen this in the internet businesses, drug companies, more recently environmental businesses.	If our fiscal problems were fixed in a credible way that allowed for gradual adjustment and yet paid attention to basic factors that promote future growth, businesses would face an environment in which they could continue to invest and grow, which is good for jobs and income throughout America. If interest rates were not pushed up more than normally by our large and increasing appetite for borrowing, businesses would have an easier time with affordable credit. Innovators would also be better off with greater access to affordable credit. Both businesses and innovators would be able to plan and manage better, if fiscal policy were not out of control.
Fiscal Priorities and Fiscal Space	Businesses rely on having enough good employees. Innovation is associated with a strong educational background. Devoting resources to improve human capital (including spending on education) is very important here. With fiscal gridlock, the room to support these priorities will increasingly narrow.	Priorities like boosting human capital could be emphasized once we had more fiscal room from shifting fiscal resources from unproductive and outdated policies.
Post Script: A Fiscal Crisis	A fiscal crisis would intensify the types of problems that would have emerged with fiscal gridlock: a sudden and sharp rise in interest rates would hurt firms' business and their ability to afford credit. The suddenness of the crisis would limit the time and resources firms have to adjust and many would not survive. Resources for innovation would diminish—probably all of a sudden.	Business and innovators do not want to get caught in a fiscal crisis.

Conclusion: The Benefits of Fiscal Action

The U.S. fiscal house is in trouble. Even now, our government cannot provide goods and services to the American public at current tax levels without resorting to heavy borrowing. The situation will only get worse in the future, as the average age of our population increases from the double whammy of lower birthrates and the retirement of the Baby Boom generation. The aging population will need more government services but, at the same time, tax contributions won't keep pace with spending, because growth of the working-age population will slow. For programs like Social Security, which will have to depend on a lower number of workers making contributions for a larger number of retirees, the aging of the population has real consequences. How long do we have to fix these problems (or issues)?

In recent months, jockeying for political power in Washington (and around the country) to "win" the best deal possible remains the name of the game. Compromise is not mentioned enough. Many policymakers and the public seem to think that we still have time, that this fiscal "business as usual" can continue for a while.

In fact, with the United States running record high budget deficits, national debt at its highest point as a share of the economy in peacetime, and the Baby Boomers starting to retire, we can say with full confidence that fiscal business as usual is over.

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.

Basic public goods and services from all levels of government that people count on are at risk, not only for the groups they directly affect but with likely ripple effects through all generations and regions. Most people may not fully understand that the degradation of government goods and services that they experience reflects poor fiscal management by our political leaders—and that it can be improved.

And we are increasingly at risk for a fiscal crisis. Looking ahead, will we wait until change is forced upon us, or will we rise to the occasion sooner rather than later and take steps to tackle our challenges head on? Are Americans better off doing nothing to alter our fiscal future, or should we try to figure out a fair—and—sensible plan to manage the inevitable change?

It is better to address our fiscal problems sooner rather than later—and under our own terms, rather than under pressure from the financial markets. It will make a difference to our future standard of living if our fiscal actions are taken in a thoughtful, growth-friendly way rather than in an emergency in response to, for example, a run on the dollar (one of the possible ways a fiscal crisis could unfold). 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. Others' experiences show that it is always worse for a country (or state or municipality) to have fiscal choices forced upon it by financial market attacks rather than making more sensible policy choices on its own terms (Figure 21).

Fig. 21: Fiscal Turnarounds in Canada and New York: Lessons for the United States

Canada (1994-1998). Canada provides a good example of how it is better not to be forced to take fiscal consolidation steps in a crisis because of the harsh changes that must be made, but also how fiscal turnarounds, once they take place and are sustained, can have a silver lining.

Canada's national debt mounted up for years as it did not make the hard choices necessary to get its spending and revenues into balance. In the aftermath of the Mexican peso crisis, the Canadian dollar was seen vulnerable to attack by financial markets. In this environment, the credit ratings agency Moodys put Canada on a credit watch. Markets reacted negatively: the Canadian dollar slid against the US dollar and investors sold Canadian bonds. Moodys downgraded Canada's debt a few months later, and the Prime Minister warned that Canada's creditors and the International Monetary Fund might have to impose conditions to rescue the economy (not unlike what is happening in Ireland now).

On the verge of a worsening fiscal crisis, Canada finally took tough budget steps. Supported by other economic policies (at the time a strong anti-inflation program was put in place) and strong export growth (due to world economic recovery), Canada shifted from chronic fiscal deficits to fiscal surpluses and sharply lowered its debt-to-GDP ratio. Because it then went on to sustain its turnaround, it had more room for maneuver than most countries to respond to the shock from the subprime crisis over the past few years. Also, because it had finally taken the earlier steps, it may not have the credibility problems that the US will have to establish its fiscal management credentials.

New York City. New York City came very close to bankruptcy and default in 1975. Its severe financial problems were the culmination of years of borrowing to finance chronic budget deficits. To avoid the state's balanced budget requirements, the city had used accounting gimmicks for years. By 1975, it did not have enough money to pay operating costs. Forced into a corner by its financial market creditors (with worry about one of the world's financial center also coming from abroad), New York turned to the federal and state governments for assistance. Severe conditions were put on the city as the price of assistance. Drastic cuts in city services and increased fees (including for a subway ticket) were put into place. It took New York several years to restore its credibility in financial circles so it did not have access to private credit markets for awhile. In the meantime, city residents experienced tough austerity conditions as New York tightened its budget belt to return to fiscal health.

As we all try to come to grips with our fiscal future, it will be all too easy for interest groups and personalities to try to game the system to their own advantage. Political stalemate, however, is not to anyone's advantage, because time is not on our side. And politically, it is crucial that a solution is widely perceived as fair—that is, the burden of tough changes must be shared.

It is also important that people recognize that we are not simply fixing our fiscal problems to fix them, but rather we are reducing our fiscal imbalances so that we can have a better future—more growth, more jobs, and a better quality of life than we would otherwise have. It is crucial that people have realistic hope that through a strategic, smart, and fair plan for how to get out of this mess, we will see a better future.

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.

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 solve our fiscal problems and the compromises that are necessary.

As tough as it will be to fix our fiscal problems, failing to fix them on our own terms will be worse.

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