STATE OF THE UNION’S FINANCES: FACTS AT A GLANCE

$56.4 TRILLION
CURRENT LIABILITIES AND UNFUNDED PROMISES
OF THE UNITED STATES GOVERNMENT

$36.3 TRILLION
Promised Medicare benefits not covered
by taxes and other contributions

$6.3 TRILLION
Promised Social Security benefits not
covered by taxes and other contributions

$6.6 TRILLION
Promised Social Security benefits not
covered by taxes and other contributions

$13.5 TRILLION
Other federal liabilities

$483,000
for each American household

$51.5 TRILLION: Total household net worth (Q4 2008)
$50,233: Median income per household (2007)

$11 TRILLION
CURRENT NATIONAL DEBT

$6.8 TRILLION
Held by the public

50%
Portion of the budget spent on
Social Security, Medicare, Medicaid
and net interest in 2008

49%
of debt held by the public is currently
held by foreign countries

$1.7 TRILLION
PROJECTED 2009 DEFICIT
The largest as a share of GDP since World War II

Hon. Peter G. Peterson
Chairman of the Board

Hon. David M. Walker
President and CEO

Our Fellow Americans,
We are seeing the heavy price the country pays when institutions and individuals
don’t take steps to fix large, known and growing problems. Our elected and
 corporates waited for a crisis to hit before they moved to act in connection
with the mortgage-related sub-prime crisis. We cannot afford to let the same
thing happen with our nation’s finances, because the adverse consequences
would be much worse.

The facts are clear and compelling—the federal government’s financial condition
is worse than advertised, and we are on an imprudent, irresponsible and immoral
path. Washington policymakers are mortgaging the future of our country,
while reducing the relative level of investments in their future. We are also becoming increasingly reliant on foreign
lenders to finance our nation’s debt. If trillion dollar-plus recurring deficits don’t
wake us up, we’re not sure what will. Federal elected officials need to make
tough choices sooner rather than later because time is not currently on our side.

What do we as a country need to do? Yes, we need to take steps to turn our
economy around and address our current credit crunch and other immediate
challenges. We also need to put a process in place that will engage the American
people and support elected officials as they make tough but necessary choices
about entitlements, health care, tax and other issues, and put our country on a
more prudent and sustainable fiscal path. This guide is intended to help inform
you of the nature and seriousness of our nation’s true financial condition and
large and growing fiscal challenge. On pages 22-25, you will find a description
of what’s at stake, a proposed path forward, and a series of actions you can take.
We the people must hold current and prospective elected officials accountable
for taking steps that will help to ensure that our collective future is better than
our past. The time for action is now!
Arguably, we are already getting a taste of what that future will be like. Since the middle of 2007, problems in the U.S. housing sector have illustrated what happens when lenders lose confidence in borrowers. The economic difficulties of smaller countries like Iceland and Hungary show what happens when no one wants to lend a nation money. If our ability to manage our nation’s fiscal affairs is called into question, we are likely to face even more severe economic challenges, including sharply higher interest rates, further downward pressure on the dollar, higher prices for oil, food and other necessities, and greater unemployment.

Our current national debt of $11 trillion is cause enough for concern, but that figure does not account for the gap between future promised and funded Social Security and Medicare benefits, as well as a range of other commitments and contingencies the federal government has pledged to support. A full accounting of those exposures shows that the federal government is in a $56 trillion-plus hole!

Known demographic trends and skyrocketing health care costs are the crux of the problem. Most of the 77 million post-World War II baby boomers (representing one-fourth of the U.S. population) are still working, but some are beginning to retire. As boomers retire, federal spending for Social Security and especially Medicare, given rapidly rising health care costs, will grow dramatically. As they do, younger workers—our children and grandchildren—will ultimately have to foot the bills.

To lighten their load, we must mend our fiscally irresponsible ways, change current federal programs and tax policies, and create a climate that is more favorable to future economic growth and good government. If we do nothing, the budget will have little room to address emerging national priorities and real emergencies in the coming years.

What needs to be done? Simply stated, our elected officials must start to close the gap between spending and revenues that results primarily from large and growing unfunded promises for Medicare and Social Security. Projections show that by 2028, revenues of about 18 percent of GDP—the level we are used to—will not even cover net interest, Social Security, Medicare and Medicaid. The federal government will have to borrow to pay for all other activities including education, national defense and homeland security. Otherwise, we will have to do without those other programs.
THE FEDERAL BUDGET

THE FEDERAL BUDGET is a key instrument in federal policymaking. Through the annual budget process, the Congress and the President determine national priorities and allocate resources among the many federal programs. They also decide how to finance those decisions, primarily through collecting resources from individuals and businesses through taxes and borrowing from domestic and international lenders.

During the past 50 years, we’ve balanced the federal budget only six times. When you exclude the Social Security surplus, we’ve only balanced the budget once (in 2000) over the same period. Over the same 50-year span, we have run average annual budget deficits of over 2 percent of our nation’s economy. More alarming is the fact the projections of current policy show a sharply widening gap between spending and revenues. And that means a continuing trend of budget deficits and growing national debt.

Without reform, federal deficits and debt levels will rise so high relative to GDP that they will threaten our economic strength, our international status, our standard of living, and eventually, our national security and domestic tranquility.

DEFICITS PAST, PRESENT, AND PROJECTED

The deficit is the difference between the amount of money the government spends and the amount it raises in revenues each year. If the government spends less than it collects in revenue, then it runs a surplus—the opposite of a deficit.

Over the last 40 years, the federal government’s average annual spending has exceeded revenues, resulting in an average deficit of about 2.4 percent of GDP. Given the federal government’s stimulus and financial stabilization efforts during the recent financial crisis, deficits are projected to rise.

For example, in 2008, the federal government ran a budget deficit of $459 billion. For 2009, the Congressional Budget Office (CBO) projects a deficit of $1.7 trillion—the largest as a percentage of GDP since WWII. If this situation were only temporary, it would be manageable. But huge deficits are projected to continue in the near-term, and, even more importantly, current projections of spending and revenue show that deficits could reach as high as 23 percent of GDP over the next 40 years.

Why is this a problem? Given our AAA credit rating and the fact that the dollar is a global reserve currency, lenders, both domestic and foreign, have thus far been willing to finance our national debt. However, in light of projected deficit and debt burdens, this may change. For example, in March 2009, Chinese premier Wen Jiabao publicly expressed his concern regarding the creditworthiness of the U.S. government.

FEDERAL SPENDING AND REVENUES (% OF GDP)

FEDERAL DEFICITS (% OF GDP)

SOURCES: PGPF calculations based on OMB, CBO, GAO. See endnote.
ESCALATING NATIONAL DEBT

The debt is the cumulative total of all our previous deficits and surpluses and other financial transactions. Total debt comprises intergovernmental debt—Treasury securities held by federal “trust funds” and other accounts—and debt held by the public, which includes both domestic and foreign lenders. In short, it is the total amount we have borrowed, minus what we have paid back. Our national debt has doubled in the past decade, rising from about $5.5 trillion in 1998 to over $11 trillion as of March 2009. As deficits escalate and federal debt grows, interest costs increase, and, in some cases, get added to the outstanding debt. The result? Absent reforms, within a little more than 25 years, interest will become the largest single expenditure in the federal budget. The federal government will be increasingly forced to forego investment opportunities that could strengthen the nation’s future social and economic well-being. This is already happening, but it will get much worse without a change of course.

To finance deficits and our debt, the Treasury issues marketable securities to the public (e.g., state and local governments, banks, individuals, mutual funds and foreign investors) to finance deficits. Because of America’s low rate of saving (an average of less than 2 percent of personal income over the past 10 years), the federal government has become increasingly dependent on foreign lenders.

As of January 2009, foreign investors owned 49 percent of debt held by the public, up from 18 percent in 1990 and from virtually zero in 1946. Among our top foreign lenders are countries whose national interests are not always in line with our own.

CHANGING COMPOSITION OF SPENDING

Federal spending is divided into five major components: net interest, Social Security, Medicare and Medicaid, national defense, and everything else.

Since the 1960s, the decline in defense spending as a share of the budget and as a share of GDP has been offset by the growth in the major entitlements (Social Security, Medicare and Medicaid) and other mandatory spending (agriculture subsidies, unemployment benefits, student loans, and civilian and military pensions and health benefits). In 2008, defense was 21 percent of the budget including the cost of operations in Iraq and Afghanistan and the war on terrorism.
By 2008, only 38 percent of the budget (including defense) was considered “discretionary” and funded through annual appropriation decisions, while 62 percent consisted of entitlement programs and other mandatory spending (including net interest). Of the major functions that the nation’s Founding Fathers envisioned for the federal government (for example, national defense, foreign policy, and the federal judiciary), a vast majority are in the shrinking discretionary portion of the budget.

As entitlements and net interest grow, discretionary spending gets squeezed. Defense becomes a first priority when national security threats arise. But non-defense programs, which include activities related to children, transportation infrastructure, education, training and research that should promote future economic growth and prosperity, are now under increasing funding pressure, despite some temporary increases in funding included in recent stimulus bills. These programs represent opportunities that could be pursued if there is more room in the budget to do so.
THE FEDERAL BUDGET

SHORTCOMINGS OF THE BUDGET AND BUDGET PROCESS

The federal budget should serve as the fiscal roadmap for federal policymaking. However, the budget and its related process have major weaknesses when it comes to both understanding and managing the finances of the United States government.

The annual budget process focuses on the immediate budget year and largely discounts the future implications of current decisions. Decision-makers do not devote the same level of scrutiny to future impacts as they do to current costs.

Children can’t vote, and younger people are typically less involved in the political process than other segments of eligible voters. As a result, the potential political gain from immediate increases in spending or reductions in taxes outweighs the eventual economic benefits of more politically costly but fiscally responsible choices.

The budget is mainly cash-based and thus ignores future costs that are likely to result from various activities of the federal government. Some of those costs reflect federal liabilities and legal obligations. Others are contingent upon future events. Still others relate to public expectations and current promises of future federal benefits, including Social Security and Medicare.

The federal government does not have a comprehensive and integrated strategic framework. It also lacks an overarching blueprint for governing federal finances. The President proposes a budget, and the Congress enacts the budget using its own processes. However, the two branches of government do not formally agree to a single financial plan that sets overall priorities, identifies their fiscal policy goals and metrics, and provides a plan to achieve those targets. As a result, voters lack adequate benchmarks against which to measure progress and hold elected officials accountable.

Furthermore, unlike most private businesses and state and local governments, the federal government does not engage in a comprehensive effort to identify and budget its physical capital requirements separately from its normal operating costs.

REVENUES

On the revenue side of the budget, in 2008 the federal government collected almost 81 percent of its total receipts through individual income taxes (45 percent) and social insurance payroll taxes (36 percent).

Income taxes are progressive: higher income earners are taxed at higher marginal rates. Most recently available data show that the top 20 percent of households paid 86 percent of individual income taxes, while the bottom 20 percent received tax credits in excess of taxes due equal to 3 percent of total individual income taxes paid by everyone else.

Payroll taxes, which are dedicated to Social Security, Medicare and unemployment insurance, are regressive. Everyone pays the same rate on wage income up to any applicable limit. Due to the annually-adjusted ceiling on taxable earnings for Social Security ($106,800 in 2009), higher income earners pay a lower share of their wage earnings in payroll taxes than do lower wage earners. Households in the bottom 80 percent of the income distribution pay more in payroll taxes than they do in income taxes.

Corporate income taxes and excise taxes, which are levied against specific goods and services including tobacco, alcohol, and motor fuels, have fallen as a share of total revenues. Directly or indirectly, individuals pay those taxes.

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AN UNSUSTAINABLE FISCAL TRAJECTORY

Long-term projections for the federal budget start with current policies, and then factor in expected changes in demographics and economic conditions. Under almost any scenario, the trajectory of current fiscal policy is cause for great concern. As alarming as the size of our current debt is, it excludes many items, including the gap between future promised and funded Medicare and Social Security benefits, and a range of other commitments and contingencies the federal government has pledged to support. Moreover, given skyrocketing health care costs, current projections may even be too conservative.

### 2008 MAJOR FISCAL EXPOSURES

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<td><strong>Explicit Liabilities</strong></td>
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<tr>
<td>Publicly-held debt</td>
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<tr>
<td>Military &amp; civilian pensions &amp; retiree health benefits</td>
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<tr>
<td>Other</td>
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<td><strong>Commitments &amp; Contingencies</strong></td>
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<td><strong>Implicit Exposures: Future Benefits</strong></td>
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<td>Medicare SMI (outpatient)</td>
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<td>Medicare prescription drug</td>
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<td>Social Security</td>
<td>6.6</td>
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<tr>
<td><strong>Total</strong></td>
<td>$56.4 T</td>
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Note: Estimates for Social Security and Medicare are at present value as of January 1, 2008. Figures for implicit exposures are in excess of revenues dedicated to trust funds, e.g. through Social Security taxes.
AN UNSUSTAINABLE FISCAL TRAJECTORY

MAJOR FISCAL EXPOSURES

The term “fiscal exposures” measures a range of federal liabilities, programs and activities which, based on current law, will require federal resources at a future date. A complete accounting of the current major fiscal exposures provides a fuller and fairer picture of the deteriorating condition of federal finances. As the preceding table shows, the federal government was in a **$56 trillion-plus** hole as of September 30, 2008 and the hole gets deeper by $2-3 trillion per year, even with a balanced federal budget.

Some exposures are explicit and known liabilities that the federal government is legally obligated to fulfill. Commitments and contingencies represent contractual requirements that the federal government is expected to fulfill when or if specified conditions are met.

The largest category of exposures contains the growing unfunded promises for Social Security and Medicare benefits for current and future beneficiaries. Although people rely on the promise of those benefits, the Congress and the President can—and at times do—change the programs in ways that increase or decrease the value of expected benefits, and thus alter the size of the implicit exposure. For example, in the past, policymakers have increased payroll tax contributions, increased the retirement eligibility age, changed cost-of-living adjustments, and increased beneficiary premiums applicable to such programs. In addition, the U.S. Supreme Court has ruled that the benefits under these programs can be changed at any time through legislation.

The dollar figures used when discussing the federal budget are almost too large to comprehend. To translate the estimated $56.4 trillion in major fiscal exposures—our federal fiscal hole—into a more understandable number, the burden as of September 30, 2008, was equivalent to:

- **$184,000** per person living in the U.S.
- **$435,000** per full-time worker
- **$483,000** per household

“We should avoid ungenerously throwing upon posterity the burden we ourselves ought to bear.”

*George Washington - 1796*
AN UNSUSTAINABLE FISCAL TRAJECTORY

UNFUNDED PROMISES: SOCIAL SECURITY AND MEDICARE

Over 40 percent of the current federal budget is devoted to Social Security, Medicare, and Medicaid. Because these programs provide significant benefits to older people, that percentage will grow as the population ages and health care costs increase.

For every dollar that the federal government spends on children’s education, health care, income support, and other programs that help parents meet their children’s basic needs, it spends more than 4 dollars on behalf of older Americans (i.e., those age 65 and over). If current policies continue, that gap will grow, placing additional pressure on these future-focused activities that can represent investment in a better tomorrow.

Main Entitlement Programs’ Uncertain Financial Future

Measures of the fiscal burden stemming from Social Security and Medicare can be found in the annual reports of the Social Security and Medicare Trustees. For example, the 2008 reports indicate that an immediate 14 percent increase in payroll taxes (from 12.4 to 14.1 percent of taxable earnings), a 12 percent cut in benefits, or a combination of the two would be required to bring Social Security into actuarial balance for the next 75 years.

Future costs associated with Medicare are much higher relative to Social Security. Actuarial projections for Medicare are less informative because its dedicated receipts do not come close to meeting its expenses. A better indication of Medicare’s potential drain on future federal resources is how much general revenue will be required to pay for scheduled benefits. As Medicare costs grow from 2.7 percent of GDP in 2007 to 8.4 percent in 2050, the general revenue share of Medicare’s income would rise from 40 percent to 57 percent. Even that projection is optimistic, however, because it reflects unrealistically low physician payments rates that are contained in current law.

Social Security Faces Demographic Pressures

On average, more than 10,000 baby boomers will become eligible for Social Security benefits each day over the next two decades. Moreover, not only will the retiree ranks swell as large numbers of baby boomers leave the workforce, but new retirees are also expected to live longer and collect more benefits than current retirees. With fewer births, longer lives, and longer periods spent in retirement, there are fewer workers whose taxes can support those who retire. This has placed burdens on younger workers, who will end up bearing the brunt of future taxes.
Rising Costs Threaten Medicare and Medicaid

Medicare, which provides health insurance to people age 65 and older, and Medicaid, the largest third-party payer of long-term nursing home care, will also be subject to even higher rates of growth. Medicare and Medicaid insured about 85 million people, 28 percent of the population, in 2008. While some Medicare and Medicaid program reforms are needed, absent solutions to our overall health care challenge, it will be very difficult to keep Medicare and Medicaid cost growth in check without severely affecting beneficiaries’ health care services.

The federal government’s role in health care financing has been expanding. In the last 20 years, health care programs’ share of the budget has doubled, reaching about 25 percent ($747 billion) of total spending in 2008. In addition, the federal government subsidizes private health insurance through the tax code to the tune of over $260 billion in annual tax expenditures.

The federal government pays for one-third of the nation’s medical bills. Since 1965, when Medicare began, the federal share has tripled. Over the last 40 years, many costs that individuals used to pay out-of-pocket have been transferred to the federal budget.

Critical Need for Controlling Health Care Costs

Health care costs are growing faster than the population, the prices of other goods and services, and the nation’s overall economy. Health care as a share of GDP has doubled since 1975. Moreover, inflation-adjusted health care costs per person are projected to rise to over $30,000 within 40 years! While the budgets of households, businesses and government are all under pressure, health care cost growth affects the federal budget in two ways: it increases the cost of federal health programs; and it stimulates greater demand for further expansions of the federal government’s responsibility for paying for health care. We must do more to control costs since they represent the biggest single threat to our collective financial future.

Politicians and the public may want the government to provide more benefits. However, the government has already promised more in health benefits than it can realistically afford to deliver, given current projections. In addition, it is important to remember that transferring costs to the federal government does not make those costs disappear. For example, the recent enactment of the Medicare drug benefit added about $8 trillion in federal fiscal exposures. When responsibilities are added to the budget without adequate financing, it only serves to further mortgage the future of our country, children and grandchildren.
WHAT’S AT STAKE?

NO MATTER WHAT lens is used, the outlook for the federal budget, the national economy and the burdens that are likely to be imposed on future generations is not good and is getting worse with the passage of time.

Today’s policies and programs lay claim to future resources. Absent reforms, tomorrow’s policymakers will find that they have little flexibility to address emerging needs. If resources are spread too thinly, government will become increasingly ineffective and unresponsive. Additionally, federal tax levels could more than double over time, absent reform of existing federal spending programs and tax policies.

Federal deficits reduce national saving, displace potentially productive private investment and hamper economic growth. Furthermore, our increasing indebtedness to foreign lenders, who cannot be counted on to be always willing to finance our deficits, is a high-risk strategy that is not in our nation’s longer-term interest. For example, interest payments on foreign-held debt go abroad instead of providing income to U.S. residents and feeding into our economy.

The well-being of our key social safety net programs and those who depend on them are in jeopardy. Preserving these programs without passing the buck to future generations becomes more difficult each day we and our leaders wait to take action.

If we do not take corrective action soon, we will be admitting defeat and leaving it to our children and grandchildren to clean up our fiscal mess. They already face a more competitive and uncertain world. Our failure to make appropriate program and policy changes would be both irresponsible and unfair to them.

MOVING FORWARD

Implement

statutory budget controls that address discretionary and mandatory spending as well as tax preferences both in the short term and over time

Pursue

comprehensive tax reform that makes the system more streamlined, understandable, equitable and competitive while also generating adequate revenues

Review

re-prioritize and re-engineer the base of the federal government to focus on the future and generate real results

Achieve

Social Security reform that makes the program solvent, sustainable, secure and more savings-oriented

Reduce

the rate of increase in health care costs and more effectively target related taxpayer subsidies and tax preferences

Pursue

comprehensive health care reform that addresses coverage, cost, quality and personal responsibility

Ensure

that we have processes that will enable us to achieve the above objectives within a reasonable period of time
WHAT CAN WE DO?

AS CITIZENS

• Register to vote.
• Become informed about the key issues facing our country and society.
• Demand that Washington policymakers begin to address these issues, and that candidates for federal office disclose their proposed solutions.
• Rethink our priorities. We should focus on critical societal needs, and on programs and policies that work and create a better future. In addition, we should not assign responsibilities to the government that we are not willing to pay for in taxes.
• Recognize that there are no easy answers. Economic growth is essential, but we cannot grow our way out of problems caused when programs are scheduled to grow faster than the economy.
• Build a consensus in favor of constructive and responsible change by building and sharing awareness of the fiscal challenge, the need for timely action and the cost of inaction.
  • Hold elected officials accountable for acting on large, known, and growing key challenges and delivering on their promises.
  • Join with other citizens to broaden public knowledge about our fiscal challenges and support civic groups that are working to address them.

AS INDIVIDUALS

• Establish a personal budget and stick to it.
• Formulate a financial plan that considers the following questions:
  • What are my short- and long-term personal financial objectives?
  • What major milestones do I need to prepare for (e.g., education, family, retirement)?
  • When do I see myself retiring? Have I considered that for each year I delay my retirement, I can substantially increase my retirement income for the rest of my life?
• Put that personal financial plan into immediate action.
• Become more responsible in decisions to spend and use credit, save for the future and invest savings wisely.
• Teach children the importance of planning, saving, budgeting, investing, and making responsible use of credit.
• Invest wisely not just in different types of real and financial assets, but also in my family’s knowledge and education.
Historical debt-to-GDP estimates are based on debt as recorded by the U.S. Department of the Treasury paired with GDP estimates through 1928 from the Institute for the Measurement of Worth and GDP values 1929-1939 and 2008 from the Bureau of Economic Analysis (BEA)’s National Economic Accounts. The debt-to-GDP ratio for 1940-2007 is from the Office of Management and Budget (OMB) FY 2009 Historical Tables. Historical spending, revenue and deficit data are also based on OMB data.

Projections of debt-to-GDP are based on the Congressional Budget Office (CBO)’s Preliminary Analysis of the President’s Budget and an Update of CBO’s Budget and Economic Outlook (March 2009); CBO’s Budget and Economic Outlook: Fiscal Years 2009-2019 (Jan. 2009); and the alternative simulation contained in the U.S. Government Accountability Office (GAO)’s The Nation’s Long-Term Fiscal Outlook: September 2008 Update (Nov. 2008).

Projections for spending, revenues, deficits and total debt are PGPF compilations from CBO and GAO data. The major assumptions underlying GAO’s alternative fiscal scenario simulation are that: (1) discretionary spending grows at the same rate as the economy after 2008; (2) the Alternative Minimum Tax exemption is retained at the 2007 level through 2018, following which federal revenue returns to its historical level of 18.3 percent of GDP plus expected revenue from deferred taxes (i.e., taxes on withdrawals from retirement savings accounts); and that (3) Medicare spending is based on the Trustees’ 2007 projections adjusted to reflect the assumption that physician payments are not reduced as specified under current law.
ABOUT THE PETER G. PETERSON FOUNDATION
Since its launch in July 2008, the Peter G. Peterson Foundation has devoted its resources to raising awareness of, and seeking solutions to the fiscal challenges posed by the rising costs of health care and retirement and a near-zero household savings rate. To address these challenges successfully, the nonpartisan Foundation works to bring Americans together to find sensible, long-term solutions that transcend age, party lines and ideological divides.

THE CRITICALLY ACCLAIMED feature documentary I.O.U.S.A. tells the story of the rapidly growing national debt and its consequences for the U.S. economy. Hailed by Reuters as being “to the U.S. Economy what AN INCONVENIENT TRUTH was to the environment,” the film is available online and in stores nationwide (April 2009) and continues its tour of college and university campuses across the country.