Chapter Two
Understanding the Federal Government's Long-Term Cost Drivers

By David M. Walker

Understanding the Federal Government's Long-Term Cost Drivers

In order to restore fiscal sanity, achieve strong and sustainable economic growth, maintain America's position in the world, preserve our national security, ensure a sound social safety net, and continue to improve our standard of living at home, many transformational changes need to occur in the federal government. These needed reforms must consider every major area of government's organizational structure, operational practices, spending programs, tax policies, and regulatory approaches. Simply stated, government has grown too big, promised too much, and waited too long to restructure. The time has come to make it more future-focused, results-oriented, responsive, affordable, and sustainable for the 21st century.

As we look to the future, we must understand that the size of government is based on the level of total federal spending, not the level of taxation. The federal government has grown from two percent of the U.S. economy in 1800 to about 24 percent today and is projected to rise to about 37 percent by 2040, absent a change in course. Without reforms, this growth will drive larger deficits and mounting debt burdens that will, in the long run, ultimately result in higher taxes and a weaker country. There truly is no such thing as a free lunch.

As we seek to restore fiscal sanity, a key dimension involves how best to address the key cost drivers in government. In examining this question, it's important to understand that government-related costs come in many forms, all of which are in need of fundamental reexamination. For example, most people think of government spending as the cost of direct spending programs. These are indeed the largest category of cost and they amounted to about $3.6 trillion for the fiscal year that ended on September 30, 2011. However, there are other government-related costs that are very real and must also be reviewed and re-engineered.

The second largest government cost is tax expenditures. These comprise the revenue that is foregone due to the various deductions, exemptions, credits, exclusions, and other tax incentives in the Internal Revenue Code. Collectively, they amounted to about $1.3 trillion for the fiscal year that ended on September 30, 2011.[1] However, unlike direct spending, these amounts are not budgeted or appropriated annually, they do not appear in the federal government's financial statements, and they are not periodically reviewed or re-authorized. In essence, they represent back-door and off-the-books spending that should be reexamined just as closely as direct spending programs are.

There are other forms of government activities that ultimately result in varying levels of direct government spending. For example, the federal government issues guarantees of various loans (e.g., Fannie Mae, Freddie Mac, Sallie

Mae) and engages in various periodic bailout efforts that can result in huge costs to taxpayers. Furthermore, periodic military engagements and natural disaster responses, largely unbudgeted for on an annual basis, can serve to mushroom annual deficits and debt accumulations.

While the above costs are generally easier to identify and estimate, there is another type of hidden government costs that is very important. These costs are borne directly by the economy and by consumers as a whole, and they impact federal government revenues and spending levels by amounts that are difficult to predict. Specifically, these represent the cost of over-regulation, or unclear regulation, and the absence of a reasonable degree of certainty in connection with future tax laws and regulatory policies.

Future Spending Commitments Are Key Cost Drivers

Let's review the various types of spending in more detail. In the case of direct federal spending, there are two types:

- **Discretionary:** Discretionary spending is set each year by the Congress. It includes all of the express and enumerated roles outlined for the federal government under the Constitution (e.g., defense, foreign policy, federal judicial system, Congress, executive offices of the President) and all major federal investments (e.g., research and development, critical infrastructure, education) designed to help create a better future. Despite encompassing all this, discretionary spending represented less than 40 percent of total direct federal spending in fiscal year 2011—down from over 60 percent 40 years ago and continuing to decline.
- **Mandatory:** Mandatory spending involves the cost of certain federal government programs and policies that provide for specific benefits by law and for which there is not an annual limit imposed. This includes such items as Medicare, Medicaid, Social Security, farm subsidies, and interest on the federal debt. In fiscal year 2011, mandatory spending was over 60 percent of federal spending and growing at a much faster rate than discretionary spending. Mandatory spending is in essence spending on auto-pilot.

While there is considerable public concern regarding recent trillion-dollar-plus annual deficits and our mounting federal debt burdens, these are not our biggest challenges. Our greatest challenge relates to the tens of trillions of dollars in unfunded Medicare, Social Security, and other obligations that will result in much higher deficit and debt levels over time, absent a change in course. As of September 30, 2011, based on reasonable assumptions, total federal liabilities and unfunded obligations totaled over $65 trillion. This amounts to about $200,000 per person and over $550,000 per household, and these amounts are growing rapidly.

The truth is our fiscal challenge is so great that we cannot just grow, inflate, tax, or cut our way to a better future. Elected officials need to be honest with the American people and start making tough choices if we want America to stay great and for our future to be better than our past. After all, the U.S. is not exempt from the laws of prudent finance, and we will have a debt crisis if we do not wake up and start to act soon. And if the U.S. has a domestic debt crisis, it will be felt around the world, and no one will be able to hide. Unfortunately, the poor and the vulnerable would likely feel the worst effects.

How the U.S. Compares with Other Nations

How do our fiscal position and outlook compare with those of other major nations? The first-ever Sovereign Fiscal Responsibility Index (SFRI) of 34 major nations was created in 2011 by the Comeback America Initiative (CAI) and several Stanford master's degree students. The SFRI, which is a fiscal fitness index of sorts, ranked Australia number one in the world, Greece last at number 34, and the U.S. at an embarrassing number 28—down sharply in the past 10 years. The U.S. is in a bad neighborhood on the list and it must take dramatic steps to restore fiscal sanity.[2]

There is some good news. Several of the top-rated countries in the SFRI, including the top three—Australia, New Zealand, and Sweden, respectively—faced serious challenges in the 1990s. They rose to the challenge and made tough choices and now they rank highly. In addition, if the President and the Congress were able to work together and pass a comprehensive fiscal reform with the same bottom-line fiscal impact as the National Commission on Fiscal Responsibility and Reform (also known as the Bowles-Simpson Debt Commission), the U.S. would rank number eight in the world and would achieve fiscal sustainability for many decades into the future. So why haven't they? Because the biggest deficits the U.S. has are our truth, trust, and leadership deficits.

Yes, we can avoid a debt crisis. However, to do so, we will need to enact budget reforms and re-impose tough budget controls, reform existing social insurance and other mandatory spending programs, reduce defense and other discretionary spending, and engage in comprehensive tax reform. The sooner we get started, the better, because time and the power of compounding are currently working against us.

As we look to the future, we must recognize that the major individual cost drivers of our future fiscal imbalances are health care, tax preferences, and interest costs. Putting our finances in order will require a range of tough choices designed to address these and other federal finance issues.

The debt-ceiling increase bill of August 2011 included a provision that created a so-called Super Committee with the purpose of recommending

The Government's Credit Rating

By Glen C. Gram

In 2011, Standard and Poor (S&P) downgraded the U.S. federal government's credit rating. Two other rating agencies, Moody and Fitch, placed a watch on the U.S. government's fiscal condition in 2011 and will reassess their ratings in 2012.

S&P, Moody, and Fitch are the most influential credit rating agencies and a downgrade by one or all of them could jeopardize public confidence in the United States and discourage investors from buying U.S. debt. This, in turn, would increase borrowing costs for both the U.S. government and consumers.

In August 2011, the U.S. lost its top-tier AAA credit rating from Standard and Poor because of concerns about the U.S. government's budget deficit and rising debt burden. The downgrade to AA-plus, the first U.S. S&P downgrade since 1941, is a result of S&P's view that the U.S. fiscal consolidation plan fell short of what S&P considered necessary to stabilize the government's medium-term debt dynamics.[3]

Moody[4] and Fitch[5] downgrades of U.S. AAA credit ratings may occur in 2012. Both credit agencies have already placed a negative outlook on the U.S. due to the inability of the Super Committee to reach an agreement in November 2011. Even though Moody and Fitch indicated that this did not merit a downgrade because the inaction of the Super Committee will still trigger $1.2 trillion in automatic spending cuts, this does not mean the U.S outlook is regarded as safe by any means. A negative outlook indicates the possibility that these credit agencies could downgrade the country's sovereign credit rating within the next year or two.

The ratings and outlooks of these three agencies have placed pressure on federal policymakers to formulate and execute a credible plan to reduce the budget deficit after next year's elections. It is no longer unimaginable that the federal government could lose its AAA credit rating. The U.S. is not alone. The credit ratings of other countries, such as Britain, France, and Germany, are also at risk and in some cases have already been downgraded.[6] Drastic actions will be required in many countries to pursue rapid fiscal improvements.

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at least $1.2–$1.5 trillion in spending cuts over the next 10 years. The Super Committee turned out to be a "super failure" and did not make any recommendations. As a result, automatic spending reductions are now scheduled for 2013, amounting to about $1.2 trillion over a 10-year period. There are, however, members of Congress who want to reduce and/or reallocate these scheduled reductions.

In any event, the Super Committee was only going to be a first step in a long and difficult road to restore fiscal sanity. Ultimately, the Congress and the President need to work together to make a range of tough choices to restore fiscal sanity and avoid a U.S. debt crisis. Given the size, scope, and nature of our challenge, everything needs to be on the table, and the President and congressional leaders from both political parties be at the table in order to get the job done. It will involve taking steps designed to return to the principles and values that made America great. These include limited but effective government, individual liberty and opportunity, personal responsibility and accountability, rule of law and equal justice under the law, fiscal responsibility, and intergenerational equity.

Comprehensive, Fundamental Reassessment Needed

Returning to the above principles and values will require a comprehensive and fundamental reassessment of what the federal government should do, how it should do it, who should do it, and how it should best finance its activities. This will include enacting budget controls and process reforms, Social Security reform, comprehensive Medicare, Medicaid, and health care reforms, reducing defense and other spending, and passing comprehensive tax reform that makes our system simpler, fairer, and more competitive while also generating enough revenues to pay our bills and deliver on the promises that the federal government intends to keep. It will involve a multi-step transformational reform process over many years, designed to make the federal government more future-focused, results-oriented, affordable, accountable, and sustainable.[7]

Finally, as noted previously, tax and regulatory policies must be focused on to improve their certainty, simplicity, and stability. Current tax and regulatory policies are far too voluminous and complex. There is also significant uncertainty regarding what longer-term tax and regulatory policies will be. This uncertainty has a very real but hard-to-calculate adverse impact on economic growth and employment levels. Both of these factors must be addressed in order to improve U.S. competitiveness. We must also take steps to increase exports from our small and medium-sized businesses. After all, it is this portion of the private sector that represents the engine of innovation, growth, and job creation in America. Other countries' governments partner with businesses to promote domestic investments and to promote exports, and the U.S. government should too.

Public confidence in the Congress and the President has recently reached an all-time low. Americans and other individuals around the world are watching and waiting to see if America will take steps to begin to put its finances in order and defuse its ticking debt bomb. For the sake of our country, our children and our grandchildren, let's hope that our elected officials act accordingly. In the interim, if you want to do your part, take the quick Fiscal IQ quiz, at www.fiscaliq.net, and encourage others to do the same.

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Notes

1. Donald B. Marron, "How Large Are Tax Expenditures?" in "Tax Facts," a biweekly column in *Tax Notes,* Tax Policy Center, March 28, 2011, p. 1597. (http://taxpolicycenter.org/UploadedPDF/1001526-Expenditure-Estimates.pdf)
2. Find out more about the index at www.tcaii.org.
3. Walter Brandimarte and Daniel Bases, "United States Loses Prized AAA Credit Rating from S&P," Reuters, August 6, 2011. (http://www.reuters.com/article/2011/08/06/us-usa-debt-downgrade-idUSTRE7746VF20110806) and Nikola G Swann, John Chambers, and David T. Beers, "Research Update: United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative," Standard & Poor's, August 5, 2011. (http://www.washingtonpost.com/wp-srv/politics/documents/spratingreport_080611.pdf)
4. Martin Crutsinger, Associated Press, "Moody's Warns U.S. Not to Back Off Automatic Deficit Cuts," *USA Today,* November 23, 2011. (http://www.usatoday.com/money/economy/gdp/story/2011-11-23/Moodys-US-credit-rating/51375040/1)
5. John Detrixhe, "U.S. Faces Fitch AAA Downgrade By End of 2013 Unless Deficit Cuts Made," Bloomberg, December 21, 2011. (http://www.bloomberg.com/news/print/2011-12-21/u-s-faces-fitch-aaa-downgrade-by-end-of-2013-unless-deficit-cuts-are-made.html)
6. "S&P Lowers Credit Ratings of France, 8 Other Eurozone Countries," *Los Angeles Times,* January 14, 2012. (http://articles.latimes.com/2012/jan/14/business/la-fi-europe-downgrade-20120114)
7. To get a better sense of how that can be accomplished, see CAI's "Restoring Fiscal Sanity Report" at www.tcaii.org.