The background features a large circular graphic composed of three overlapping circles in shades of green and teal. Behind this graphic is a faint, light-colored image of a budget table with columns for years (1997, 1998, 1999, 2000, 2001, 2002) and various numerical values.

A Citizens'
Solutions Guide

The Federal Budget

PREPARED BY PUBLIC AGENDA | MAY 2012

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Where Things Stand

Not a lot gets done in life without money, and that's as true for the federal government as for anyone else. How the government raises and spends our money is an expression of our priorities as a nation. It also has huge implications for the health of the economy, which makes it especially critical as the nation continues to struggle out of the economic problems that began in the financial crisis of 2008.

Yet there's another reason why the federal budget is important this election year: it's heading for trouble. The government's own budget agencies all use the same word to describe the situation: "unsustainable." While we're nowhere near the kind of budget problems that have plagued European nations over the past two years, Europe's debt struggles are a useful reminder of what can happen to countries that mismanage their money.

Over the past two years, we've seen Washington strain when dealing with the budget. We've had a presidential commission, a congressional "supercommittee," and a series of showdowns that carried the risk of shutting down the government or even defaulting on the government's obligations. None of them have produced a real solution. Most policy experts don't expect the country to make much progress addressing this issue until after the 2012 elections; but after that, many say we won't be able to ignore this problem forever.

The good news is that the experts agree that there are plenty of answers out there – if we're willing to accept them. There are practical solutions to our fiscal problems whether you're a liberal, a conservative or a moderate. The trick is acknowledging and accepting the tradeoffs needed to make any of those solutions work.

Five Things You Need to Know About the Deficit and the Debt

- **A deficit happens when the government spends more than it takes in during a given year.** This has pretty much been our default setting: the federal government has run a deficit for 36 out of the past 40 years. In 2011, we came up \$1.3 trillion short for a \$3.6 trillion federal budget.
- **When the government runs a deficit, it borrows to cover the difference.** When you buy a Treasury bond, this is what you're doing: loaning money to the U.S. government.
- **The national debt is the total amount the government has borrowed.** Every time we run a deficit, we're adding to the national debt, now well past \$15.5 trillion. There are two types of debt you'll hear policy types talk about.
- **"Debt held by the public" means money the government owes to others,** which means the Treasury bonds that you, banks and foreign investors can buy. In April 2012, this debt stood at about \$10.8 trillion. Economists focus on this kind of debt because it has an impact on the broader economy. Properly managed, some public debt can benefit the economy. If public debt becomes too big, however, the risk is that it "crowds out" other investment; in other words, so much money is going into government borrowing that there isn't enough for business loans, mortgages and so on.

- **“Gross debt” is everything the government owes: the public debt plus what the government owes itself.** Maybe you didn’t know that one part of the government can owe money to another part, but it’s pretty routine. All told, “intergovernmental debt” was about \$4.7 trillion in April 2012. The best-known examples are the Social Security and Medicare trust funds, which is the money the government has borrowed from these programs over the years and must pay back. This kind of debt doesn’t affect the overall economy in the same way as debt held by the public, but the money to pay for Social Security and Medicare for the huge baby boom generation will have to come from somewhere. That means the government will have to shift money from

other areas to repay these trust funds, potentially squeezing other priorities.

Money Comes, Money Goes

The federal government is an enormous enterprise, spending \$3.6 trillion in 2011. And yet for all its size and scope, the federal government spends two-thirds of its money on just five things: Social Security, defense, Medicare, Medicaid, and interest on the national debt. Everything else the federal government does, from office supplies to the space program, only takes up a third of the budget.

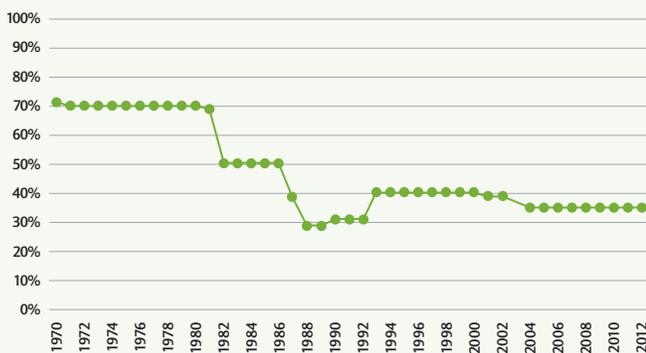
The other key point about federal spending is the difference between “mandatory” and “discretionary” spending. Mandatory programs are required by law, and that includes four

out of the five big-ticket items (with the exception of defense). Discretionary spending includes a wide range of important items like education and the environment, but Congress can spend as much or as little as it wants every year. When politicians talk about cutting “non-defense discretionary spending,” they’re talking about that one-third of the budget.

On the tax side, if you look at the Revenue Sources chart, you’ll see that most of the government’s revenue is coming from the payroll deductions in your paycheck, both in terms of the income tax that’s withheld and the payroll taxes that support Social Security and Medicare. When it comes to national tax revenue, corporate taxes and other sources of revenue make up relatively small portions of the whole.

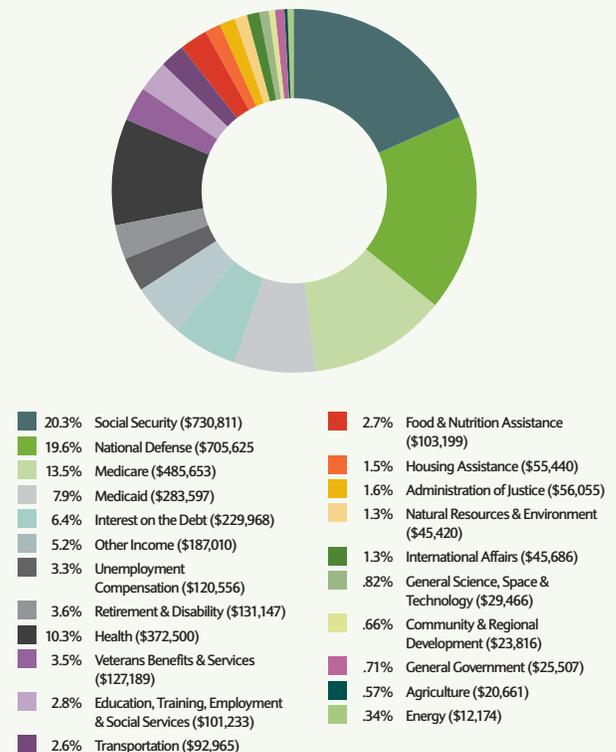
Top Federal Tax Rates

Highest marginal individual income tax rate, 1970–2012. (Source: “Historical Individual Income Tax Parameters,” January 2012, Tax Policy Center).



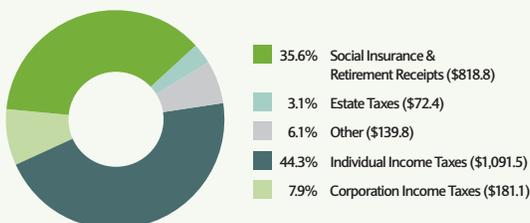
Federal Budget Expenditures

Federal outlays by source, in billions, fiscal year 2011. (Note: Energy spending equaled less than one percent of the budget. Federal outlays totaled \$3.6 trillion in 2011. Source: “Budget of the United States Government: Fiscal Year 2011,” February 2012, Office of Management and Budget.



Federal Budget: Revenue Sources

Federal receipts by source, in billions, fiscal year 2011. (Note: Social insurance and retirement receipts include Social Security and Medicare taxes and unemployment insurance. “Other” includes estate and gift taxes and customs and duties fees.) Federal receipts totaled \$2.3 trillion in 2011. Source: “Budget of the United States Government: Fiscal Year 2013,” February 2012, Office Management and Budget.



The Long and the Short of It

Many economists argue that deficits are natural and even beneficial in bad economic times. When people are out of work and businesses are losing money, they pay fewer taxes, and that means the government's wallet comes up short as well. Meanwhile, the demands on the government grow. More people need unemployment benefits and other kinds of social services.

Plus, in hard times the government usually takes steps to boost the economy, such as cutting taxes or spending money to create jobs (building public works projects, for example). That's the philosophy behind the "stimulus" package enacted in 2009, and in the bipartisan decision in 2010 to extend the Bush tax cuts for another two years.

So, if this was simply a question of going through hard times, there might not be a problem. But the U.S. government routinely doesn't take in enough money to cover expenses. And the projections are that this is going to get worse, rather than better, because of two long-term trends: an aging population and rising health care costs.

As the 78 million baby boomers retire, there will be more people getting benefits from Social Security and Medicare, and fewer people paying in. And since health care costs are consistently rising faster than inflation, Medicare and Medicaid benefits are getting more costly to provide. Since Medicare has both rising health care costs and an increasing number of recipients as the baby boomers retire, it's going to end up being the toughest problem to solve.

Both Social Security and Medicare do have "trust funds" designed to ensure that recipients get their benefits, with Medicare able to draw on its funds until 2024 and Social Security until 2033. But we'll still feel the budget pressure. Since the government used the money in the trust funds for current expenses, it will need to shift money from elsewhere in the budget to repay them.

Finally, if we don't either raise taxes or cut other spending to deal with these trends, we'll end up paying for them the way we deal with deficits now: by borrowing the money. That means that the national debt will rise, and interest payments will take up an even greater portion of the budget.

Where Do We Go From Here?

How bad our fiscal situation gets will largely be determined by how we respond to it. For example, the nonpartisan Congressional Budget Office estimates that our total deficits over the next 10 years could be anywhere from \$2.8 trillion to \$10.7 trillion. The lower figure assumes Congress allows several things to happen, as planned, including:

- Allowing the Bush tax cuts to expire at the end of 2012.
- Letting more than \$1 trillion in automatic spending cuts occur as part of a budget deal reached last year.
- Permitting the health care reform law's process for controlling health care costs to proceed as planned, including cuts in Medicare payments to doctors and hospitals.

There's a very good chance, however, that none of these things will happen at all. Both Republicans in Congress and President Obama have called for the Bush tax cuts to be extended (the Republicans for everyone, President Obama for anyone making less than \$250,000 a year). The automatic spending cuts face resistance in both parties because of the impact they would have on defense and social programs. And the health care law is highly controversial and facing a constitutional challenge.

There are lots of issues to weigh here. The economy is still struggling to climb out of the Great Recession, and federal budget decisions can either help move it forward or hold it back. Controlling health care costs is crucial for managing the budget, but that has implications for millions of patients. On the other hand, you can't wait until the last minute to solve a debt problem. Debt builds up over time, and the longer you wait to deal with it, the more painful the solutions become. If we start phasing in tax increases or spending cuts over the next few years, they'll be less dramatic than if we wait until a crisis actually hits. And as nations like Spain, Italy, Greece and Ireland have found, a debt crisis – when lenders decide a government isn't a good risk, and either refuse to lend or demand much higher interest rates – can happen staggeringly fast.

That's the fundamental question about the budget: it's not just about making the numbers add up. It's about assessing values, setting priorities and making tradeoffs. It's about weighing what we're willing to pay and what we want to happen to the economy and in the broader society. These are choices that belong to all of us, not just politicians and bankers. And these choices are too important to be made by default.

Approach One

Make Long-term Investments and Raise Revenue to Cover the Cost

Focus federal spending on the long-term needs of our economy — like better roads and bridges, better science and math education and faster and more secure Internet connectivity — and raise revenue to cover what we spend.

We've tried to borrow our way to prosperity, but we can't keep that up forever. In fact, income taxes are at historically low levels and our tax code is full of loopholes that keep wealthier people and corporations from paying their fair share. Meanwhile our educational system and our national infrastructure

are in dire need of improvement, and if we don't fix them our economy will suffer in the long term. We need to be willing to raise the money for what we want, and we need to spend it on investments that provide a better foundation for our economy.

This should be done by:

- Letting all or at least some of the Bush tax cuts expire to help reduce the deficit.
- Simplifying our tax system, eliminating tax breaks and tax expenditures that cost the government money and let upper-income people and corporations off the hook.
- Focusing our spending on investments for the future, such as upgrading our roads, bridges and electrical grid, as well as improving education.
- Passing “pay-as-you-go” legislation, meaning that if a spending bill is passed, it must be offset by either a spending cut someplace else in the budget or a raise in taxes to cover the new expenses.

Arguments for:

- Our infrastructure is aging, and this undermines our prosperity. If we don't keep it up to date we'll pay the price later. Plus, rebuilding roads, bridges and our electricity grid will provide needed jobs now.
- It's time to raise taxes to stop the flow of red ink. That's what we did in 1990, and combined with spending cuts, that's what led to the budget surpluses of the late 1990s. Since most government spending is on Medicare, Social Security and defense — programs that are both necessary and popular — trying to solve our budget problems through spending cuts alone will be destructive and counterproductive. Social Security can wait. Even after 2033, it will have enough incoming revenues to pay more than 70 percent of promised benefits.
- Our tax code is too complicated, to the point where billionaires can pay a lower tax rate than their personal assistants. We need to make sure everyone pays their fair share.

Arguments against:

- This is the worst time to raise taxes. We need to worry about economic recovery first, especially when the economy is still weak. Taking money out of people's pockets won't help the economy grow.
- Raising taxes just gives the government more money to waste. Why should taxpayers dig into their pockets while the budget is still fat with earmarks and unexamined billions in the defense budget?
- Unless we get a grip on the entitlements, particularly Medicare, we'll never have our finances under control.
- Our fiscal problems are so big that even “soaking the rich” won't raise enough money to solve them. We're going to need to make real cuts to control the problem.

Approach Two

Focus on Social Security and Medicare

Immediately focus on Social Security and Medicare, including raising taxes and fees to recipients and trimming benefits for recipients down the road.

Unless we act now, Social Security and especially Medicare will end up both breaking the budget and failing to serve the elderly when the baby boomers retire en masse. The long-term trends of rising health care costs and an aging population are the real budget problem, not our short-term deficits, which are mostly caused by the struggling economy. We shouldn't change the rules for people who are already retired (or about to be), but we really have to make some changes or the programs will become unaffordable. The sooner we tackle this, the less traumatic it will be for all Americans.

Arguments for:

- Now is the best time to reform these programs, while many of the baby boomers are still working and the number of seniors covered is relatively small.
- Health care costs are rising at twice the rate of inflation, and that means there's no way the government can keep up with the costs of Medicare and Medicaid. Unless we take strong measures on health care, we'll never control our budget problems.
- Social Security was conceived as a safety net. Reforms will keep the program financially sound so it can be there for future generations. Social Security should not provide extra income to affluent seniors who are fortunate enough to have very comfortable retirements.
- Baby boomers are living and working longer, and are in better health than when the entitlement programs began. Social Security is based on outmoded assumptions about who's considered elderly. Why should people be encouraged to retire in their early and mid-60s, especially considering the higher life expectancy?

This should be done by:

- Reducing Social Security benefits for wealthy retirees and setting higher fees and co-payments for higher income retirees on Medicare. These programs should provide security for middle-income and lower-income people – not extra spending money for affluent seniors.
- Raising the cap on Social Security taxes. Right now, payroll taxes are only collected on incomes up to \$110,000 per year. That means that workers who make \$200,000 and \$300,000 a year are paying the same taxes as people who earn much less.
- Gradually pushing back the retirement age and phasing out the policy that lets people start collecting benefits at a lower rate at age 62. When Social Security began in 1935, life expectancy was just under 62. Now, a child born in 2007 can expect to live to nearly 78.
- Enact tough restrictions on health care spending, including limiting payment to doctors and hospitals, discouraging tests and procedures that aren't proven to be effective, cutting waste and making other basic changes to our health care system.

Arguments against:

- We promised income and health security to the elderly, and we shouldn't balance the budget on their backs – especially since elected officials borrowed from the Social Security Trust Fund to cover their routine deficit spending.
- If we make wealthier Americans pay higher taxes for Social Security and we reduce the benefits they receive from the program, they may stop supporting it altogether. Social Security needs broad political support.
- We need a far more fundamental reform of the health care system. Cutting Medicare will hurt seniors without solving the real, underlying problems.

Approach Three

Keep taxes low and reduce the size of government

Keep taxes as low as possible, but reduce the size of government by making major cuts in all areas, including popular ones such as defense, health care, education and higher education.

Federal spending has mushroomed since the 1970s, and government programs are rife with waste and mismanagement. Raising taxes to cover federal spending will just give government more of our hard-earned dollars to spend wastefully. Plus, keeping taxes low helps spur economic growth and allows Americans to keep more of their own money.

This should be done by:

- Extending the Bush tax cuts and reducing taxes on businesses – they are the engine of our economy.
- Cutting growth in government programs and carving out the waste and extra costs, such as outside contractors who charge the government billions of dollars each year.
- Eliminating earmarks and other “pork barrel” add-ons to legislation that allow members of Congress to slip in funding for their pet projects without a vote.
- Shifting more domestic policy responsibilities – areas like Medicaid and education – to states.
- Having the private sector take on tasks like air traffic control and safety inspections. It can handle them more efficiently and at a lower cost.

Arguments for:

- By focusing on cutting waste, we'll have a leaner budget to work with that will save money in the long run.
- Increasing taxes would be the worst thing to do when the economy is struggling, putting an additional burden on businesses and reducing jobs.
- The government should focus on truly national concerns, such as foreign relations and defense. The federal government doesn't need to focus its time, or dollars, on the business of health care or education.

Arguments against:

- Ending earmarks and pork-barrel spending is important, but it doesn't help that much when it comes to balancing the budget. Earmarks cost about \$3 billion dollars in 2012. Meanwhile, the 2012 deficit is projected to be well over \$1 trillion.
- Over two-thirds of the budget goes to just five areas: defense, Social Security, Medicare, Medicaid and interest on the debt. The first four are broadly supported, and making cuts there will be extremely difficult politically. We have no choice in paying interest on the debt.
- Taxes are at historically low levels, and job creation has been lagging. Plus, the benefits of the last round of tax cuts have gone disproportionately to very wealthy Americans. This plan means cutting government spending on health care and education to benefit the country's more affluent taxpayers.

Resources to learn (and do!) more:

The Budget:

“The President’s Budget for Fiscal Year 2013,”
The Office of Management and Budget
www.whitehouse.gov/omb/budget

Understanding the Budget and Our Fiscal Future:

***Where Does the Money Go?*, Scott Bittle and Jean Johnson:** Published by HarperCollins and updated in 2011, this book is a guide for citizens to understand and decipher the country’s budget woes.
www.publicagenda.org/wheredoesthemoneygo

“The Federal Government’s Long-Term Fiscal Outlook,”
Spring 2012 update, U.S. Government Accountability
Office: The most recent financial outlook from the government’s auditors, the independent Government Accountability Office, with charts to help understand the data.
www.gao.gov/special.pubs/longterm/fed

“A Message to the Public: A Summary of the 2012 Annual
Reports,” Social Security and Medicare Boards of Trustees:
The most recent Social Security and Medicare Trustees Reports, distilled.
www.ssa.gov/oact/TRSUM/index.html

“A Citizen’s Guide to the 2011 Financial Report of the
United States Government,” Department of the Treasury:
The annual financial report is pretty dense, but this Citizen’s Guide chapter will help orient you to the data and numbers.
www.fms.treas.gov/fr/index.html

“U.S. Federal Budget Infographic,” Congressional Budget
Office: A nifty infographic that shows how and where the government is spending money, as well as deficits and debt over time.

www.cbo.gov/publication/42636

“Federal Debt and the Risk of a Fiscal Crisis,” The
Congressional Budget Office: Things you need to know about how the national debt could hurt us.
www.cbo.gov/publication/21625

Fiscal Plans:

“Federal Deficit Reduction Plan Comparison Tool,”
Committee for a Responsible Federal Budget:
An interactive tool to compare the various fiscal plans that have emerged.

www.crfb.org/compare

“The Solutions Initiative,” Peter G. Peterson Foundation:
Six plans from organizations representing a wide scope of the political landscape.

www.pgpf.org/solutionsinitiative

Tools to Act and Interact:

“A Nation in Debt: How Can We Pay the Bills?,” National
Issues Forums: Interested in having a conversation about the federal budget with friends, colleagues, students or community members? This resource will help guide a deliberative, even-handed and solutions-oriented discussion on the topic.

www.nifi.org/detail.aspx?catID=11496&itemID=11502

“Budget Hero,” American Marketplace: Try your hand at balancing the budget.

www.marketplace.org/topics/economy/budget-hero

About the Citizen’s Solutions Guides:

Public Agenda’s Citizen’s Solutions Guides are nonpartisan, unbiased resources to help you think through a difficult issue in alternative ways, weighing and evaluating values, priorities, pros, cons and tradeoffs. The Guides can also be used as discussion starters for community and group conversations and in classes. Note that the Citizen’s Solutions Guides are meant to help people start thinking and talking about an issue in productive ways — they are not meant to rigidly restrict thinking or dialogue. The perspectives described are not the only ways of dealing with the problem, nor are the viewpoints mutually exclusive in every respect. You can mix and match from different perspectives, or add additional related ideas.

For more information on the sources for this material, please refer to the Citizen’s Solutions Guides online at <http://www.publicagenda.org/pages/citizens-solutions-guides>

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