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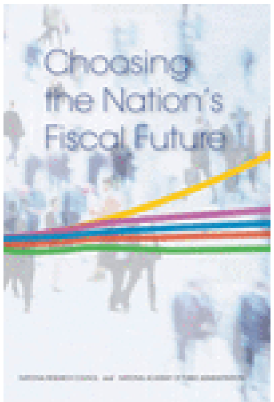


## Choosing the Nation's Fiscal Future

Committee on the Fiscal Future of the United States; National Research Council and National Academy of Public Administration

ISBN: 978-0-309-14723-1, 268 pages, 6 x 9, paperback (2010)



*A mismatch between the federal government's revenues and spending, now and in the foreseeable future, requires heavy borrowing, leading to a large and increasing federal debt. That increasing debt raises a serious challenge to all of the goals that various people expect their government to pursue. It also raises questions about the nation's future wealth and whether too much debt could lead to higher interest rates and even to loss of confidence in the nation's long-term ability and commitment to honor its obligations. Many analysts have concluded that the trajectory of the federal budget set by current policies cannot be sustained. In light of these projections, Choosing the Nation's Fiscal Future assesses the options and possibilities for a sustainable federal budget. This comprehensive book considers a range of policy changes that could help put the budget on a sustainable path: reforms to reduce the rate of growth in spending for Medicare and Medicaid; options to reduce the growth rate of Social Security benefits or raise payroll taxes; and changes in many other government spending programs and tax policies. The book also examines how the federal budget process could be revised to be more far sighted and to hold leaders accountable for responsible stewardship of the nation's fiscal future.Choosing the Nation's Fiscal Future will provide readers with a practical framework to assess budget proposals for their consistency with long-term fiscal stability. It will help them assess what policy changes they want, consistent with their own values and their views of the proper role of the government and within the constraints of a responsible national budget. It will show how the perhaps difficult but possible policy changes could be combined to produce a wide range of budget scenarios to bring revenues and spending into alignment for the long-term. This book will be uniquely valuable to everyone concerned about the current and projected fiscal health of the nation.*

# Summary

The federal government is currently spending far more than it collects in revenues, and if current policies are continued, will do so for the foreseeable future. Over the long term, three major programs—Medicare, Medicaid, and Social Security—account for the projected faster growth in federal spending relative to revenues. No reasonably foreseeable rate of economic growth would overcome this structural deficit. Thus, any efforts to rein in future deficits must entail either large increases in taxes to support these programs or major restraints on their growth—or some combination of the two. The good news is that the nation now has many options to change course and put the federal budget on a different path. Taking steps soon to stabilize the nation's fiscal future will be less costly and difficult than acting later.

The Committee on the Fiscal Future of the United States was established under the auspices of the National Academy of Sciences and the National Academy of Public Administration, supported by the John D. and Catherine T. MacArthur Foundation, to carry out a comprehensive study leading to a set of plausible scenarios for the federal budget, to put it on a path toward a stable fiscal future. Members of the committee have quite varied backgrounds and perspectives on the budget. We disagree on many policy matters; but we are unanimous that forceful, even painful, action must be taken soon to alter the nation's fiscal course.

Without such action, the long-term mismatch between expected revenues and the estimated costs of government policies and programs will continue to require the government to borrow heavily. If remedial action is postponed for even a few years, a large and increasing federal debt

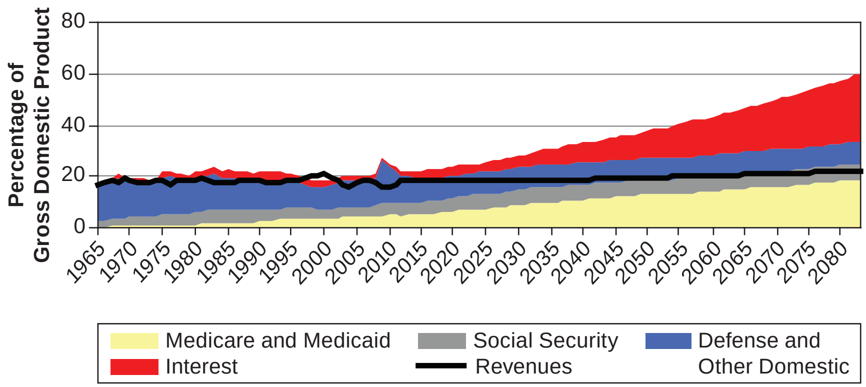


**FIGURE S-1** The long-run budget outlook.

will inevitably limit the nation's future wealth by reducing the growth of capital stock and of the economy. It will also increase the nation's liabilities to investors abroad, who currently hold about one-half of the federal government's debt. If policies do not change, a large and increasing debt will expand the portion of the budget required to pay interest on the debt, especially if interest rates rise, and thereby reduce the resources available for all other government activities. Increasing debt also may contribute to a loss of international and domestic investor confidence in the nation's economy, which would, in turn, lead to even higher interest rates, lower domestic investment, and a falling dollar.

As shown in Figure S-1, the current trajectory of the federal budget cannot be sustained. Without a course change, the nation faces the risk of a disruptive fiscal crisis, a risk that increases each year that action to address the growing structural deficit is delayed. With delay, the available options become more extreme and therefore more difficult, and even more pain is shifted to future generations.

In the next year or two, large deficits and more borrowing are unavoidable given the severity of the economic downturn. However, action ought to begin soon thereafter—the committee believes that fiscal 2012 (which begins October 1, 2011) is a reasonable time to start—to first slow the rapid increase of the federal debt relative to the economy and then, over several years, reduce it to a more desirable level.

A first step toward dealing with the country's fiscal challenge is to specify a concrete test that can help to assess whether any budget is moving toward sustainability in a prudent manner. There are a variety of ways to measure fiscal prudence and numerous targets and time paths that could be connected to various measures. In order to design plausible scenarios to illustrate the implications of future policy choices, the committee selected a widely used metric as a reasonable (albeit not the only possible) indicator of fiscal prudence: the size of the government's debt as a percentage of the nation's gross domestic product (GDP). The key concern undergirding the committee's analysis is that under a continuation of current policies this ratio would continue to rise in the years ahead, with potentially harmful effects on current and future generations.

There is no magic number for the ratio of government debt to GDP; a smaller debt is always more manageable and gives a nation more ability to absorb unexpected shocks. A higher debt limits its choices and flexibility. The committee believes that the debt that will result if the United States continues with current tax and spending policies will be at a level that poses too great a risk to the economic welfare of the current generation and would impose an unfair and crushing burden on future generations. (The debt, which was about 40 percent of GDP just 2 years ago, is now above 50 percent and rising rapidly.) This is a judgment based on the committee's deliberations over the best available data, literature, understanding of economic policy and history, and analysis of possible scenarios. Given the additional risk of carrying a higher debt burden, the committee believes that the growth in this ratio must soon be limited, as shown in Figure S-2.

More specifically, the committee believes that some combination of revenue increases and spending restraints should be implemented soon to constrain the growth of federal debt as a percentage of GDP within a decade to a level that provides an appropriate balance between the risks as-

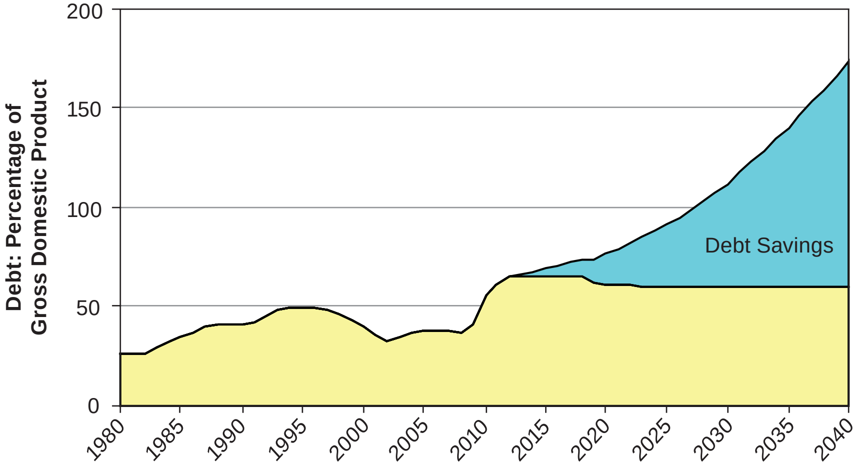


**FIGURE S-2** Debt savings from stabilizing the debt-to-GDP ratio in 12 years.

sociated with a higher ratio and the additional difficulties of implementing policies that would be consistent with a lower ratio. The committee judged that a debt of 60 percent of GDP reflects an appropriate balance and is an achievable target within a decade—and is therefore useful to guide policy choices that will ultimately be made by elected leaders. This is a different ratio than the committee would have likely proposed under different circumstances. Indeed, it will surely be seen by some as too high and by others as too low. But the committee believes it is the lowest ratio that is practical given the fiscal outlook. A higher debt burden would leave the nation less able to cope with unforeseeable but inevitable shocks—such as international crises or natural disasters—requiring a vigorous federal response. It would put the nation closer to a point from which no politically credible path to sustainability could be constructed. Moreover, stabilizing the debt at a higher ratio implies a higher deficit, a greater draw on the nation's saving or more foreign borrowing, which will have a negative impact on future living standards. On the other side, a lower ratio would imply even more painful changes in tax and spending policies.

The rapid growth of federal spending for health care is the largest contributor to the nation's long-term fiscal challenge. Any reasonable path to fiscal sustainability will have to include reforms to reduce the growth rates of Medicare and Medicaid. The challenge posed by Social Security is far less problematic, but still substantial. Options for putting it on a sound fiscal footing range from sizable reductions in currently projected benefit growth to sizable increases in payroll taxes, with many possible intermediate combinations. Spending growth in many other areas of federal activity can be moderated, in part by curtailing or reforming less effective programs. Options that raise taxes substantially include significant reforms to make the tax system fairer and more efficient and include the introduction of new taxes on consumption.

These and other policy changes can be combined to produce a wide range of budget paths or scenarios that would bring revenues and spending into close alignment over the long term and to stabilize the nation's debt burden. The committee's different scenarios are intended as an illustrative, but by no means definitive or exhaustive, set of trajectories toward a sustainable fiscal future. The committee offers four representative scenarios that illustrate a wide range of available policy choices. Any of these paths would yield growing debt savings relative to current policies and stabilize the debt at 60 percent of GDP. To achieve this, the budget does not have to be balanced or in surplus. In fact, once the target debt ratio is reached, average deficits could be as high as 2 to 3 percent of GDP without debt growing faster than GDP.

The four illustrative paths show that many policy choices are available if action is taken soon. However, none of them is easy. If the choice is to continue all government programs at a level consistent with current policies, both spending and revenues would have to rise dramatically to prevent an ever-rising debt in relation to GDP. Given the inefficiency of the present tax structure, it would almost certainly also be necessary to change how revenue is collected. If, instead, the choice is to keep the federal government's share of the economy close to the level of the past several decades, the government would have to scale back what it does, and extremely difficult choices would have to be made about what social goals to pursue less vigorously and what programs to end.

Figure S-3 compares the committee's four illustrative paths.

1. *Low spending and revenue:* revenues are held near their recent average level of 18 to 19 percent of GDP, and spending is 2 to 3 percentage points higher than revenues. This path would require sharp reductions in projected growth rates for health and retirement programs, as well as reductions in the proportion of the economy's resources available for all other federal responsibilities.
2. *High spending and revenue:* spending and revenues are increased substantially, with spending eventually reaching one-third of GDP. Because this spending level is still less than under a continuation of current policies, it would require an eventual reduction in the rate of growth of health spending. It would, however, accommodate the spending needed to maintain currently scheduled Social Security benefits. And it would allow spending on all other federal programs to be higher than the level implied by current policies.

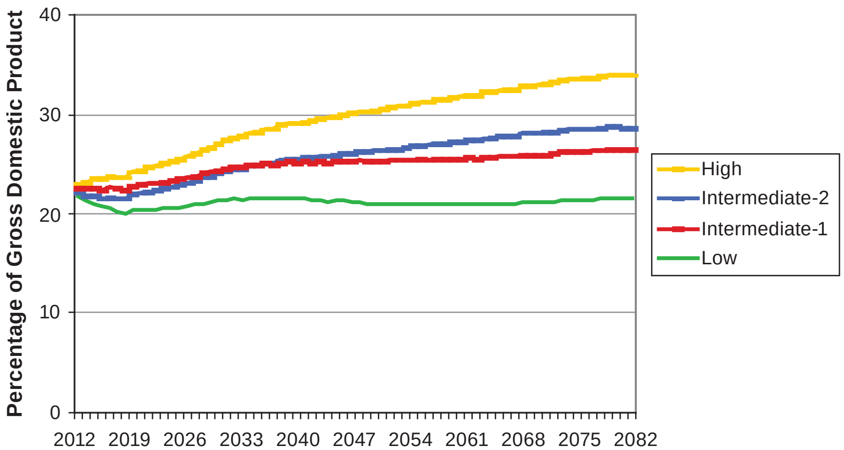


**FIGURE S-3** Projected federal spending under the committee's four scenarios.

3. *Intermediate path 1:* spending and revenues rise gradually to about one-fourth of GDP and spending on the elderly population would be constrained to support only modest expansion of other federal spending. The growth rates for Social Security, Medicare, and Medicaid would be slower than under current policies. This path reflects the view that the federal government should make selective new public investments to promote economic growth, preserve the environment, and build for the future.
4. *Intermediate path 2:* spending and revenues would eventually rise to a little more than one-fourth of GDP. Spending growth for health and retirement benefits for the elderly population would be slowed but less constrained than in the intermediate-1 path. Spending for other federal responsibilities would be reduced. This path reflects the view that the government's implicit promises for the elderly are a higher priority than other spending.

The scenarios demonstrate that it is indeed possible to reduce the risk of financial disruption and put the budget on a sustainable course using the illustrative debt target of 60 percent of GDP and timeline to reach it. The choice of the starting date and timeline, as with the level of the target, will ultimately be a decision of elected leaders, taking into account the best information available to them when they must make budget choices.

The committee recognizes that this task is extremely difficult: the pain, whether cutting the growth of spending, increasing taxes, or both, must begin very soon, while the gain of avoiding a fiscal train wreck and its consequences is in the future and of uncertain magnitude. Although it may be natural to want to delay action, the committee has concluded that doing so would be costly and possibly perilous. With delay, revenues would have to be raised even higher or spending reduced even more to bring the debt to a prudent level while also incurring higher interest payments. With delay, also, the risk grows that the nation's creditors—especially, those abroad—will conclude that the United States has no plan to restore fiscal stability and will therefore demand higher interest rates or make other tough economic demands. The margin for error then would be smaller, and the options for corrective action even more painful than they are today.

The committee recognizes that fiscal sustainability cannot be achieved without major near-term policy changes, particularly forceful actions to slow the growth of spending in Medicare and Medicaid. Because of the difficulty of such changes, the committee proposes that elected leaders annually assess the country's progress and develop concrete proposals to place the budget on a sustainable path. To do so, the committee offers a framework that everyone can use to evaluate any proposed federal budget. Our framework of six tests can be used to hold leaders accountable for their proposed budgets:

1. Does the proposed budget include policy actions that start to reduce the deficit in the near future in order to reduce short-term borrowing and long-term interest costs?
2. Does the proposed budget put the government on a path to reduce the federal debt within a decade to a sustainable percentage of GDP? Given the fiscal outlook and the committee's analysis of the many factors that affect economic outcomes, the committee believes that the lowest ratio that is economically manageable within a decade, as well as practically and politically feasible, is 60 percent.
3. Does the proposed budget align revenues and spending closely over the long term?
4. Does the proposed budget restrain health care cost growth and introduce changes now in the major entitlement programs and in other spending and tax policies that will have cumulative beneficial fiscal effects over time?
5. Does the budget include spending and revenue policies that are cost-effective and promote more efficient use of resources in both the public and private sectors?
6. Does the federal budget reflect a realistic assessment of the fiscal problems facing state and local governments?

The President and Congress share accountability for putting and keeping the federal budget on a sustainable path. The Office of Management and Budget and the Congressional Budget Office—as well as private organizations—can make major contributions to the needed reassessment of the nation's fiscal course by regularly publishing projections of the long-term effects of the President's budget and of major alternatives. Those projections can be used to assess the extent to which proposals are sustainable by the tests above.

The current federal budget process does not favor forward-looking assessment and management of the nation's fiscal position. The committee finds that the present process gives too much weight to the interests of the current generation and too little weight to the interests of future generations. If the process is an obstacle to prompt correct action, then the first step in dealing with the fiscal challenge is to reform it.

The committee favors reforming the budget process to make it more far sighted and to establish a new regime of responsible budget stewardship. Under this new regime, leaders will be better prepared to take the political actions necessary to fairly represent the interests of the nation's children and grandchildren and to avoid the potentially serious consequences of continuing on the present path.

If action is taken soon, the country has a wide choice of options to help achieve fiscal sustainability. All are difficult; but if action is postponed, the options will be fewer and the choices will be even more difficult. With delay, the risk of a disruptive fiscal crisis will grow, and the standard of living experienced by everyone's grandchildren is likely to be lower than it is for people today.

The challenges are formidable, but not impossible. If the nation accepts sacrifices in the short run, it will be much stronger, safer, and more prosperous in the long run.

# Choosing the Nation's Fiscal Future

Committee on the Fiscal Future of the United States
Division of Behavioral and Social Sciences and Education

NATIONAL RESEARCH COUNCIL *and* NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

THE NATIONAL ACADEMIES PRESS
Washington, D.C.
**www.nap.edu**

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NOTICE: The project that is the subject of this report was approved by the Governing Board of the National Research Council, whose members are drawn from the councils of the National Academy of Sciences, the National Academy of Engineering, and the Institute of Medicine. The members of the committee responsible for the report were chosen for their special competences and with regard for appropriate balance.

This study was supported by Grant No. 07-90771-000-HCD to the National Academy of Sciences and Grant No. 07-90771-001-HCD to the National Academy of Public Administration from the John D. and Catherine T. MacArthur Foundation. Any opinions, findings, conclusions, or recommendations expressed in this publication are those of the author(s) and do not necessarily reflect the views of the organizations or agencies that provided support for the project.

International Standard Book Number-13: 978-0-309-14723-1
International Standard Book Number-10: 0-309-14723-9
Library of Congress Control Number: 2009943505

Additional copies of this report are available from the National Academies Press, 500 Fifth Street, N.W., Lockbox 285, Washington, DC 20055; (800) 624-6242 or (202) 334-3313 (in the Washington metropolitan area); Internet, http://www.nap.edu.



Printed in the United States of America

Suggested citation: National Research Council and National Academy of Public Administration. (2010). *Choosing the Nation's Fiscal Future*. Committee on the Fiscal Future of the United States. Washington, DC: The National Academies Press.

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**Kathy A. Ruffing**, *Senior Program Officer* (March-November 2008)
**Malay Majmundar**, *Senior Program Associate*
**Danielle Johnson Bland**, *Senior Program Assistant*

# Foreword

This report represents the outcome of a joint and shared effort between our two organizations: the National Academy of Public Administration (NAPA) and the National Academy of Sciences (NAS). In their respective spheres, these two institutions play important roles by bringing to bear expert advice on some of the most significant challenges facing our nation.

At the request of and with the support of the John D. and Catherine T. MacArthur Foundation and using procedures of the National Research Council, NAS and NAPA jointly undertook a 2-year study of the long-term fiscal challenge facing the United States. The work was performed by a stellar committee representing a diversity of disciplines and practices, a wealth of experience with the federal budget and various public policies, and a wide range of political and policy views. The committee has worked in harmony and forged a strong consensus under the leadership of its co-chairs, John Palmer and Rudy Penner. We thank them for their leadership and the entire committee for their extraordinary efforts.

No one reading this report can avoid being struck by the magnitude of the long-term budget challenge facing the federal government. Other studies have called attention to this challenge in similar terms. Uniquely, however, this study provides a framework that leaders and others can use to systematically consider a range of choices to put the federal budget on a sustainable course.

This report neither presumes nor recommends a particular path to a stable fiscal future. In a democracy, it is not the role of experts from outside the government to decide important policy questions, especially questions of this magnitude. That is the task of political leaders. And voters have the responsibility to engage in the issues, elect officials who understand the challenges, and then hold them accountable for acting responsibly.

As a group of experts, the committee is providing the basis for making policy decisions and their professional judgment about the key issues for our fiscal future. It acknowledges the differences in values and perspectives that must be reconciled in order to reach agreement. It illustrates the range, as well as the difficulty, of the policy choices that have to be faced. It also offers a set of analytical tools for weighing those choices, including practical tests that can be applied to budget proposals to determine their fiscal prudence.

Much is at stake. If we as a nation do not grapple promptly and wisely with the changes needed to put the federal budget on a sustainable course, all of us will find that the public goals we most value are at risk. This report will have served its purpose if its insights and analytical framework are widely used to support serious discussion of this most urgent question. We hope that it will receive the widest possible attention.

Ralph J. Cicerone
*President*
National Academy of Sciences
*Chair*
National Research Council

Jennifer L. Dorn
*President and Chief Executive Officer*
National Academy of
Public Administration

# Acknowledgments

This study is the product of the generous support, hard work, and dedication of many organizations and individuals. The officers and staff of the John D. and Catherine T. MacArthur Foundation originated the idea for the study and provided its funding. They maintained strong support and interest throughout the course of the work.

Jennifer Dorn, president and chief executive officer of the National Academy of Public Administration; Lois Fu, senior adviser to the president of the National Academy of Public Administration; Michael Feuer, executive director of the Division of Behavioral and Social Sciences and Education (DBASSE) at the National Research Council (NRC); and Jane Ross, director of DBASSE's Center for Economic, Governance, and International Studies provided leadership in the development of the study and continued support through the study process.

We owe special thanks to our fellow committee members, who gave long hours to this project, providing not only in-depth analyses, but also drafts—and repeated redrafts—of text for the report. The members hold a broad range of views on topics related to this study, and they used those differences to explore a very wide range of policy ideas and to draft a report that would be useful to individuals and groups with diverse beliefs and priorities.

A great deal of the success of this project is due to its excellent staff, who performed innumerable analyses and produced many drafts of the report. We are especially indebted to our study director, Steve Redburn, who managed the overall work of the panel, led a complex set of analytic activities, and helped us to meet our deadlines. The fast pace of the work and the outstanding quality of the final product are due to an important extent also to the work of Mark Menchik, Malay Majmundar, Kathy Ruffing, and Danielle Bland. Eugenia Grohman, associate executive director of DBASSE, shared her extensive experience at critical points in the study process, especially in editing the manuscript.

Staff members of the Social Security Administration's Office of the Chief Actuary provided cost estimates on various proposals contained in the report's illustrative scenarios and reviewed text for completeness and accuracy. The Urban Institute-Brookings Institution Tax Policy Center contributed to the detailed analysis in the report by producing simulations of tax changes that were part of several illustrative scenarios. Barry Anderson and his colleagues in the Budgeting and Public Expenditures Division of the Public Governance and Territorial Development Directorate of the Organisation for Economic Co-operation and Development produced a study of the international experience with long-term budgeting.

This report has been reviewed in draft form by individuals chosen for their diverse perspectives and technical expertise, in accordance with procedures approved by the Report Review Committee of the NRC. The purpose of this independent review is to provide candid and critical comments that will assist the institution in making the published report as sound as possible and to ensure that the report meets institutional standards for objectivity, evidence, and responsiveness to the study charge. The review comments and draft manuscript remain confidential to protect the integrity of the deliberative process.

We thank the following individuals for their participation in the review of this report: Henry J. Aaron, Economic Studies Program, Brookings Institution, Washington, DC; Robert Greenstein, Center on Budget and Policy Priorities, Washington, DC; Edwin L. Harper, Public Affairs/Government Relations, Assurant, Inc., Washington, DC; Ron Haskins, Brookings Institution, Washington, DC; Peter S. Heller, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University; James R. Horney, Center on Budget and Policy Priorities, Washington, DC; Philip G. Joyce, George Washington University; Lawrence S. Lewin, Executive Consultant, Chevy Chase, MD; Alicia H. Munnell, Carroll School of Management, Boston College; William Nordhaus, Department of Economics, Yale University; Marilyn Rubin, Department of Public Management, John Jay College of Criminal Justice; John B. Shoven, Department of Economics, Stanford University; and Theda Skocpol, Department of Government, Harvard University.

Although the reviewers listed above have provided many constructive comments and suggestions, they were not asked to endorse the conclusions or recommendations nor did they see the final draft of the report before its release. The review of this report was overseen by Charles F. Manski, Department of Economics, Northwestern University, and M. Granger Morgan, Department of Engineering and Public Policy, Carnegie Mellon University. Responsibility for the final content of this report, however, rests entirely with the authoring committee and the institutions.

John L. Palmer and Rudolph G. Penner, *Cochairs*
Committee on the Fiscal Future of the United States

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## Appendixes

**Appendixes A through G are not printed in this book; they can be found online at http://www.nap.edu/catalog.php?record_id=12808.**

# Figures, Tables, and Boxes

## FIGURES

## TABLES



## BOXES