Chapter 2

Budget and the Economy

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INTRODUCTION

Budgets play multiple roles as policymaking tools: They allocate resources to public purposes; they establish and reflect the government’s priorities; and they distribute income through the government’s power to tax and spend. In addition, the federal budget constitutes one-fifth of the economy and thus plays an important role in promoting economic stability and growth.

Decisions made during each budget cycle not only affect current spending but also shape the government’s ability to address future demands.

Many economists and other experts say the federal budget is on an unsustainable path of large and growing deficits, a soaring national debt and unaddressed future financial obligations. Yet a few years ago the budget was in surplus, and it seemed possible that federal debt would be retired. But after a recession and the 2001 and 2003 tax cuts, record deficits reemerged, reaching $455 billion in fiscal year 2008. Indeed, the deficits would be much larger if Social Security were excluded from the calculation. Furthermore, January 2009 projections by the Congressional Budget Office (CBO) of net deficits of $3.1 trillion over the next decade show an alarming reversal from the CBO’s January 2008 projection of a small net surplus of $300 billion. The projected deficit for 2009 is well over one trillion dollars, and could rise much higher depending on the size of the stimulus and recovery legislation enacted in 2009. Both the January and September CBO estimates assumed that the tax legislation currently in place will expire after 2010 as scheduled, resulting in a sharp increase in revenues. It is, however, more likely that some of the tax cuts will be extended permanently. Hence, future federal budget deficits could be much larger than the CBO projections, not only in absolute dollars but also relative to the size of the economy. Clearly, long-term fiscal imbalances and continued large-scale deficit spending threaten the fiscal health of the federal government as well as that of the nation.

Reducing the federal deficit to a manageable level while ensuring an adequate revenue stream to support important programs and vulnerable Americans must be a top policymaking priority.

Deficits pressure governments to cut spending. Continuing high allocations for defense spending, the rising interest costs for servicing the federal debt, and increases in health care costs will likely increase pressure to cut federal social programs that serve the poor, the disabled, and the elderly, and limit the investments in human and physical capital needed to maintain economic growth and global competitiveness. Large and persistent budget deficits also make it difficult for government to meet its future obligations to Social Security and Medicare and repay its debt to the Social Security Trust Fund. Large deficits absorb capital, drive up interest rates, and discourage the investment that spurs economic growth. With slower growth, revenues from both income and payroll taxes grow more slowly.

At the state level, where most governments are precluded from running deficits, policymakers face the task of achieving budget balance during every budget cycle. Their challenge is heightened as recessions reduce state and local government revenues while increasing necessary expenditures for vulnerable populations and the unemployed.
AARP PRINCIPLES

Growth and stability—Budget policy at the federal, state, and local levels should promote economic growth and stability.

Fiscal balance—The federal government cannot continue on its present path of large-scale deficit spending and must strive for long-term fiscal balance. This need to reduce long-term fiscal imbalances, however, should be tempered by the occasional need for short-term fiscal stimuli, emergency spending, and long-term investment.

Revenue adequacy—Revenues should be adequate to fund national priorities, including investments in education, infrastructure, and programs to assist vulnerable populations.

Shared benefits and burdens—The benefits of economic prosperity and public programs, and the burden of providing such programs, should be shared equitably across income groups and generations.

Minimize unfunded mandates—Federal and state budget policymakers should keep in mind how their decisions will affect other levels of government.

Prudent practices—Federal and state policymakers should adopt and respect prudent budgeting practices that ensure accountability, transparency, and fairness.
PURSUING BUDGET BALANCE

Because reducing the federal budget deficit to a manageable level is a high priority, the administration and Congress face the challenge of adopting fiscal policies that cut the deficit without placing at risk the essential services and programs that serve vulnerable populations. Restoring budget balance requires difficult choices among competing interests and priorities and efficient management and accounting for all federal expenditures, international and domestic.

Addressing both the revenue and spending sides of the budget is essential to achieving budget balance. Ensuring adequate revenues may require that policymakers reexamine tax cuts adopted during times of fiscal plenty, because they erode the revenue base and worsen fiscal difficulties when the economy weakens.

Controlling spending is also an essential component of maintaining fiscal discipline. However, efforts to cut spending have the potential to disproportionately hurt vulnerable populations.

During recessions, rainy-day funds that states and local governments accumulated during good economic times can cushion against drops in spending on needed programs. But these funds must be replenished when the economy is again strong.

To preserve essential services in a downturn, states often need to find new sources of revenue just when family budgets are stretched thin. When revenue-increasing measures that are temporary or inherently unstable or declining (such as taxes on tobacco, alcohol and gambling) become tied to vital programs, those programs are jeopardized.

### PURSUING BUDGET BALANCE: Policy

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<thead>
<tr>
<th>Area</th>
<th>Level</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>Rainy-day funds</td>
<td>State</td>
<td>When economic conditions permit, states should accumulate budget reserves of at least 5 percent of total general fund expenditures in separate rainy-day funds, protected against raids for nonessential purposes, to help maintain services during recessions. The use of rainy-day funds should be restricted to times when revenues, adjusted for inflation, actually decline.</td>
</tr>
<tr>
<td>Budget surpluses</td>
<td>Federal-State</td>
<td>Proposals to spend new or unexpected revenues or refund them to citizens in the form of tax cuts should be considered cautiously, since budget projections can change radically within a short time.</td>
</tr>
<tr>
<td>Revenue sources</td>
<td>State</td>
<td>States should not formally tie essential spending programs to unstable revenue sources.</td>
</tr>
<tr>
<td>Cuts to avoid</td>
<td>Federal-State</td>
<td>Deficit-reduction efforts should avoid cuts in programs that serve low- and moderate-income populations.</td>
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</table>

ENTITLEMENT SPENDING AND THE FEDERAL BUDGET

More than 350 federal programs are referred to as entitlements. They make payments to eligible recipients who apply for them—usually individuals but sometimes businesses, nonprofit institutions, or state and local governments. The term “entitlement” refers to the facts that recipients are eligible for benefits, as established in law, because they meet specific criteria, and that Congress is usually not required to appropriate funds annually for the benefits to be paid. Federal entitlement programs include Social Security, Medicare and Medicaid, veterans’ benefits, federal employee and military retirement plans, unemployment compensation, food stamps, and the agricultural price support program.

Entitlement and other mandatory spending, as defined by the Congressional Budget Office, totaled about $1.6 trillion in fiscal year (FY) 2008, net of offsetting receipts, or about 54 percent of all federal spending, representing approximately 10.9 percent of gross domestic product (GDP)—a figure comparable with levels reached in the early 1980s and projected to rise to about 12 percent of GDP over the next decade.
Entitlement spending, especially for Social Security and Medicare, is not the chief source of the nation’s future budget challenges. Although many experts have projected a dire long-term economic outlook due to the retirement of baby boomers and increased longevity, changing demographics are not the primary cause of our fiscal dilemma. Rather, it is the health care system, which delivers too little care and costs too much.

Over the past 30 years, total federal spending on entitlements has not grown as a share of the overall economy. The growth in entitlements relative to the economy has occurred only in the health area—Medicare and Medicaid—which have doubled in size relative to GDP since the early 1980s (Figure 2-1). But the growth in health entitlements is merely a symptom of the inability to contain costs within our total health care system.

![Figure 2-1](image_url)

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Tax expenditures—provisions in the tax code that confer benefits on certain taxpayers—are often considered entitlements since receiving them is based on meeting certain eligibility criteria and does not rely on an annual congressional appropriation. Three of the largest of these, totaling $321 billion in FY 2008, are deferral of taxes on employer-provided pension and 401(k) plans, the deductibility of home mortgage interest, and the exclusion of employer contributions for medical insurance (see Chapter 3, Taxation, for further discussion of tax expenditures).

Entitlement benefits are much more equally distributed than those from tax expenditures, which go mostly to high-income people. About half of the benefits from major entitlement programs go to people in the bottom half of the income distribution, but about half of all tax benefits from major tax expenditures go to people in the top 10 percent of the income distribution.

Entitlement spending cuts have been proposed as the most important way to reduce the long-term federal deficit and restore fiscal discipline. However, an entitlement-spending cap would seriously weaken Medicare, Medicaid, and other programs because it does not address the underlying problem of health care costs growing faster than GDP.

Although the aging of the baby boomers and the increased longevity of Americans generally present real financial and social challenges, they can be countered with policies to control health care costs, ensure the solvency of Social Security, increase retirement savings, make it possible for people to work longer, restore and strengthen the depleted federal revenue base, and vigorously promote economic growth.
## Entitlement Spending and the Federal Budget: Policy

<table>
<thead>
<tr>
<th>Entitlement spending</th>
<th>Federal</th>
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<tbody>
<tr>
<td>Efforts to reform entitlement spending should:</td>
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<tr>
<td>• recognize that the primary cause of the projected growth in entitlement spending is continuing increases in health care costs and not increased benefits or the aging of Americans;</td>
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<td>• insist that commissions or other bodies charged with recommending legislation or other measures to reduce future deficits be balanced in composition, conduct fair and transparent deliberations that give adequate time to all sides, and have a mandate to examine both tax expenditures and direct spending;</td>
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<td>• reject across-the-board cuts in entitlement spending; and</td>
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<td>• subject the creation or expansion of tax expenditures to at least the same scrutiny as the limitation or elimination of entitlement spending.</td>
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### Social Security and the Budget

Because Social Security has its own dedicated funding source and a sizable reserve, legislation adopted in 1990 separated Social Security revenues, spending on benefits, and the accumulated surpluses in the Social Security trust funds from the rest of the federal budget. (The program’s administrative costs remain “on budget.”). Presenting a “unified” budget that includes Social Security ends up misrepresenting the balance in the budget’s non–Social Security portion.

Current law requires that Social Security funds be dedicated exclusively to the program’s obligations and that any funds not needed to pay benefits immediately be invested in US Treasury bonds, which the government guarantees. When Social Security has a surplus, the Treasury borrows Social Security funds rather than borrowing from the public. Although the Treasury may use the borrowed funds for many purposes, the trust funds receive interest on all dollars lent. When Social Security presents the bonds to the Treasury for payment, the funds are used only to pay benefits to eligible beneficiaries. These transactions affect neither the solvency nor the size of the trust funds.

If the non–Social Security portion of the budget is in surplus, it is easier to repay the funds borrowed from the trust funds.

The Social Security Administration (SSA) faces a number of significant challenges to maintaining the quality of service. SSA needs employees who can respond to a multilingual and culturally diverse population of applicants and beneficiaries, as well as new hires to replace the large group of employees who are scheduled to retire in the next five years. The agency has also been unable to reduce the backlog of both disability applications and continuing disability reviews.

Efforts to deal with SSA’s service problems, however, are hampered by insufficient funds. Although SSA’s administrative expenses are paid from the trust funds, Congress has not provided sufficient funds in recent years because the agency’s administrative expenses have been included as part of the non–Social Security spending that is subject to caps and across-the-board cuts. This means SSA’s funding has been artificially low in order to comply with spending targets unrelated to Social Security.

### Social Security and the Budget: Policy

<table>
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<tr>
<th>Social Security treatment</th>
<th>Federal</th>
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<tr>
<td>The Social Security trust funds represent a compact among generations and should continue to be spent only for purposes that reflect the spirit of this compact.</td>
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</table>
The costs of some proposed changes to Social Security, such as those that would finance private accounts with general revenue transfers, could affect the non–Social Security budget. Therefore, they must be recognized and accounted for in a clear and transparent way. Changes to Social Security should not be made for the purpose of reducing the unified budget deficit.

Funding

AARP supports exempting Social Security’s administrative costs from limitations on discretionary appropriations in the federal budget. AARP supports allocating sufficient funding to strengthen the administrative capacity of the Social Security Administration so it can better meet the needs of applicants and beneficiaries.

### BLOCK GRANTS AND UNFUNDED MANDATES

The federal government provides states with block grants in several discretionary spending areas, and states frequently pass block grants to local governments, either with or without additional state funds. Block grants have a long tradition in intergovernmental relations but have become more common in recent years. Block grants can be a good way to ensure that people who are familiar with the needs of the population being served make decisions about service delivery. However, block grants can be problematic if they supplant funds that had previously been spent by state and local governments, if there are not adequate controls to ensure quality, if sufficient resources are not given to accomplish the assigned task, or if they result in lower funding levels over time.

For example, the federal government has established several programs for the states to operate, with the understanding that it would provide the funding. Yet sufficient funding has not materialized for some programs, including Temporary Assistance for Needy Families (the successor to welfare, or Aid to Families with Dependent Children), the No Child Left Behind Act (education reform), the Homeland Security Act (antiterrorism efforts, in which states and localities are the nation’s first line of defense), and the Help America Vote Act (election reform, aimed at replacing obsolete voting equipment and making polling places more accessible for people with disabilities).

Unfunded mandates occur when lower levels of government are required to adopt and implement policies but do not receive adequate resources to accomplish the task. Such mandates allow the higher level of government to give the appearance of addressing pressing needs without devoting the money required to do the job.

### BLOCK GRANTS AND UNFUNDED MANDATES: Policy

<table>
<thead>
<tr>
<th>Unfunded mandates</th>
<th>Federal State</th>
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<td>When a higher level of government determines that a lower level should perform a necessary function, adequate resources must be made available to accomplish the task. Passing responsibilities down to lower levels of government should be undertaken primarily to place services closer to the people being served and to maximize administrative efficiencies, not as a way to reduce costs.</td>
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<tr>
<th>Block grants</th>
<th>State</th>
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<tr>
<td>Services should be implemented and operated by the level of government most appropriate to deliver them. When a block grant is deemed appropriate:</td>
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<tr>
<td>• States should at a minimum maintain their current funding commitments.</td>
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### Block grants (cont’d.)

**STATE**

- Funding formulas should accommodate changes in demographics and inflation to meet the needs of benefit recipients.
- Discretionary decisions about the use of block grant allocations should be made in the open and with input from affected stakeholders. Adequate advance notice, open hearings at the local level, and accurate, timely information are essential to the process.
- Allocation decisions should reflect localities’ needs and ability to raise revenues and should accommodate variations in service-delivery cost.

### BUDGET PROCESS AND REFORMS

Over the years federal and state governments have tried to change budget rules to control government spending and impose fiscal discipline. Some of these proposals have the potential to erode democratic processes and institutions and eliminate the flexibility that governments need to address changing economic and political circumstances.

**Discretionary spending caps and PAYGO**—Until 2002 there were two enforcement mechanisms in place to limit the ability of both Congress and the president to increase budget deficits or decrease budget surpluses: caps on discretionary appropriations and the pay-as-you-go (PAYGO) rules, which required that entitlement spending increases or tax cuts be offset by corresponding changes elsewhere in entitlement spending or taxes. These rules were adopted in 1990 and modified in 1993 and 1997. Modified PAYGO rules were adopted by both the House and Senate during the 110th Congress.

While the caps and rules were effective when the president and Congress agreed on the overall budgetary framework, they caused evasion of and frustration with the process when no overall agreement could be reached.

The discretionary appropriations caps, for example, frequently proved to be unrealistically low in light of subsequent congressional or presidential action. Consequently, lawmakers struggled to find ways of spending more while technically staying within the caps. At other times Congress enacted across-the-board cuts to keep spending below the caps. This reduced funding for programs critical to vulnerable groups, especially people with low incomes.

**Line-item veto and enhanced rescission power**—In 1996 Congress created the line-item veto, allowing the president to cancel appropriations, new spending, and some tax benefits. While the president had to notify Congress of his actions, the items that were vetoed were permanently cancelled unless Congress voted to disapprove the measure within a limited period of time. Because disapproval legislation could be vetoed, stopping a presidential cancellation in reality required a two-thirds majority vote. In 1998 the Supreme Court ruled the line-item veto unconstitutional.

While supporters of the line-item veto claim that it would reduce the number of special-interest provisions and help control spending, other budget experts note that the savings from such vetoes would be small and the tool would be rarely used. Opponents are also concerned that too much power might be given to the executive branch and that spending and tax breaks would not be equally protected.

Enhanced presidential rescission power has also been proposed. This would not permit the president to cancel spending or tax items without congressional approval. Rather, he could identify appropriations, entitlements, or tax provisions that he wished to strike from newly passed bills and send the bills back to Congress to be considered under an expedited procedure. The provisions could be deleted from the bills only if Congress approved.

**Balanced budget amendment**—The current outlook for large and continuing budget deficits may again generate some support for a constitutional amendment to balance the federal budget.

A constitutional amendment is not necessary to balance the federal budget. To be enforceable, a constitutional amendment would shift the power to tax and spend from elected officials to an unelected judiciary. Such a change would weaken the
accountability of Congress and the president for fiscal decisions and could lead to a constitutional conflict between the courts on one side and Congress and the president on the other. As a practical matter a strict constitutional requirement for a balanced budget would limit the government's ability to respond to changes in the economy and to national emergencies.

While supporters claim that a balanced budget amendment would mirror the balanced budget requirements in many states, the structure of state requirements differs from proposals that Congress has considered. In particular, “budget balance” in the states generally relates only to their general fund (about 50 percent to 60 percent of the total budget in most states) and not to the total budget, including capital spending. So “balance” in state budgets does not automatically mean that current revenues equal current spending.

All states except Vermont have statutory or constitutional provisions requiring a balanced budget, and thus any decision affecting revenues or expenditures requires a value judgment on the merit of the expenditure and need for the revenue. State revenues and expenditure levels vary not only by action of the legislature but also because of growth or decline in the economy, changes in price and wage levels, federal legislation, disasters, and myriad other foreseeable and unforeseeable factors.

Supermajority requirements—Some states require more than a simple majority of legislators to raise taxes but not to cut taxes or spending. For example some states require that at least two-thirds of legislators approve bills to increase taxes, but require only a simple majority to pass a tax or spending cut. This is problematic because it tilts budget-balancing activities toward spending cuts, which disproportionately hurt lower-income and vulnerable populations while protecting tax expenditures, which disproportionately benefit higher-income people. In addition these requirements make it harder to finance programs for which only a majority vote is required.

Ballot initiatives and TABOR—In recent years taxing and spending questions increasingly have been put on state ballots, and thus voters must decide on highly complex fiscal issues that are often simplistically formulated. This is part of a general trend, especially pronounced in western states but spreading, toward governing via initiatives and referenda rather than legislation.

Beginning in 2005, Taxpayer Bill of Rights (TABOR) initiatives emerged in about half the states. TABOR would place rigid constitutional limits on state (and sometimes local) government revenues and expenditures based on a formula of inflation plus population growth. This formula does not allow for the fact that the fastest-growing demographic groups—the elderly, the disabled, and the prison population—are the most expensive to serve; nor does it take into account states’ need to deal with natural disasters, acts of terrorism, or sudden increases in costs imposed by the federal government.

TABOR has passed only in Colorado, where it caused serious economic disruptions and was rolled back by voters for a five-year period in November 2005. Such initiatives are often backed by out-of-state groups portraying the effort as part of a citizens’ grassroots movement. Supporters are dedicated to shrinking government and privatizing most of its primary functions, and although proponents have failed to get TABOR on the ballot in all but a handful of states, where it has so far failed, it will be an issue for the states for the indefinite future.

The push for such initiatives poses a threat to representative democracy. State budgets should be negotiated documents that reflect the values of the state in light of projected revenues and expenditures. Such negotiation must be done by legislators annually; in fact that is the essence of the duty for which they are elected. That duty is undermined if it is constrained by constitutional mandates that specify the maximum or minimum revenue or expenditure amounts, either in general or from particular sources or for particular purposes.

<table>
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<tr>
<th>BUDGET PROCESS AND REFORMS: Policy</th>
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<tr>
<td><strong>Line-item veto</strong></td>
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</table>
## Balanced budget amendment

**Federal**

AARP opposes a balanced budget amendment to the US Constitution because it would endanger the nation’s economic health by limiting the government’s ability to address economic and political changes and invest in our nation’s future. States should reject any balanced budget amendment that Congress refers to them for ratification.

## Spending caps

**Federal**

If Congress imposes discretionary spending caps, they should be set at a realistic level to avoid placing unnecessary burdens on programs serving low-income people. The administrative funding of Social Security should not be included under such caps.

## Pay-as-you-go (PAYGO) rules

**Federal**

AARP supports effective and balanced rules for fiscal discipline. For example, both mandatory spending and revenues should be subject to PAYGO rules.

## Supermajorities

**State**

AARP opposes supermajority voting requirements for budgetary or tax matters.

## Tax and expenditure limits

**State**

AARP generally opposes tax and expenditure limits. Taxpayer Bill of Rights initiatives are the worst example of proposals that would virtually eliminate needed fiscal flexibility.

If states and localities have tax and expenditure limits, whether statutory or constitutional, they should contain:

- a sunset provision, perhaps of a ten-year duration;
- a single base year from which all future annual increases would be calculated;
- annual increases based on population growth or a similar measure of service load, on inflation and on changes in economic activity;
- a requirement that excess revenue be used first to bring rainy-day funds to adequate percentages of general fund expenditures; and
- a procedure for refunding surplus revenue, as nearly as possible, to those who paid it.

The government should not limit its ability to address future economic and political changes and the need for investments. There should be a bias against any effort to limit the government’s flexibility in taxing and spending. Any such decisions should have a compelling justification.

Except for general obligation bond issues, states should not refer tax and spending matters to the electorate for decision.

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### TAKINGS

An issue of growing importance in the states is “takings,” which occurs when the government takes possession of private property for some higher-priority public use. Under the Fifth and Fourteenth Amendments to the US Constitution, people are entitled to compensation from the government when it takes their property.

Currently, however, some property rights groups are promoting new state and federal takings laws that would entitle property owners to government compensation when a law, regulation or local ordinance causes a reduction in property value. These are known as “regulatory takings.” An example is a state wetlands law that prevents landowners from
developing their property. Such regulatory takings laws could adversely affect the protection of human health, livable housing, public safety, the environment, civil rights, worker safety, and other related concerns. In addition, these laws could have huge budgetary impacts. Many state legislatures have also considered takings legislation, and about half the states have adopted some form of legislation on the subject.

There are two main categories of regulatory takings proposals: “red tape” and “compensation.” Red-tape laws require the state attorney general or government departments to thoroughly assess the impact of a proposed regulation on private property. Compensation laws require a government agency to pay a landowner for any reduction in property value caused by government regulation. These laws can have huge state or local budgetary impacts. Six states (Arizona, Florida, Louisiana, Mississippi, Oregon, and Texas) have compensation laws. Oregon voters scaled back the compensation requirements of that state’s takings law in 2008. Experience with the earlier Oregon law shows that in most cases government cannot afford to pay compensation and that these laws can effectively shut down planning, zoning, and regulatory activities that seek to protect public health and safety and quality of life.

At the federal level takings legislation was a central feature of the Contract with America in the 104th Congress, and some version of this legislation has been considered, but not adopted, in almost every subsequent Congress. (See Chapter 9, Livable Communities: Land Use—Community Redevelopment, Eminent domain.)

<table>
<thead>
<tr>
<th>TAKINGS: Policy</th>
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<tbody>
<tr>
<td>Regulatory takings</td>
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<tr>
<td>Governments should avoid enacting regulatory takings laws that do not entail actual taking of property but merely have effects on property values. Such laws and associated regulations could seriously affect governments’ ability to protect human health, create livable communities, ensure public safety, preserve the environment, enhance civil rights and worker safety, and deal effectively with other related concerns.</td>
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**ECONOMIC STIMULUS AND RELIEF DURING ECONOMIC CRISIS**

Policymakers may consider measures to stimulate the economy or relieve hardships under the extraordinary circumstances created by the economic crisis beginning in 2008. These measures—and indeed any comprehensive piece of legislation—may include proposals that fall outside of or conflict with existing AARP policy. In those cases, AARP will evaluate the overall impact of the proposals in light of the association’s overall mission and priorities.

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<th>ECONOMIC STIMULUS AND RELIEF DURING ECONOMIC CRISIS: Policy</th>
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<td>Crisis priorities</td>
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<td>Financial security in retirement and health security for all</td>
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<td>Transparency and accountability to protect public funds</td>
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<tr>
<td>Consumer protection and the prevention of fraud and deceptive practices</td>
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<tr>
<td>Investments in livable communities</td>
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<tr>
<td>Help for those most in need</td>
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<tr>
<td>Long-term investments that benefit all ages</td>
</tr>
<tr>
<td>Long-term stability of the economy and of important programs</td>
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<tr>
<td>Stimulus criteria</td>
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<tr>
<td>Proposals to stimulate the economy should be evaluated according to the timeliness with which they can be implemented and the degree to which they are likely to boost the economy. Preference should be given to measures that are temporary, that involve investments that</td>
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<tr>
<td>Stimulus criteria (cont’d.)</td>
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<tr>
<td>Relief criteria</td>
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