THIRD WAY

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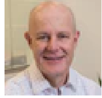
Growth, Not Greece: A Growth-Focused Deficit Reduction Agenda



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It took America 193 years to run up its first trillion dollars of debt; it took us 10 months to run up our most recent. [1]

Today, the government spends three dollars for every two dollars it raises. For the second year in a row, the deficit exceeds one trillion dollars. But as worrisome as the budget explosion is today, the years ahead are most alarming. The deficit going forward is structural, not cyclical—an aging population that consumes taxpayer dollars is growing far faster than a working age population that provides most of the tax revenue. [2]

The deficit will prevent America from achieving the vibrant economic growth, middle class living standards, and secure safety net that we have come to expect. Our deficit will eventually overwhelm the economy. Government spending on consumption will swamp investment spending necessary for future growth. The nation needs a deficit reduction strategy that places long-term U.S. economic growth as the single most important objective in getting our debt under control.

This memo represents Third Way's opening contributions to the budget debate. Section I describes the economic imperative for action on the budget—both reducing our annual deficits and shifting our budget from one dominated by consumption to one that is balanced with investment spending. Section II dissects the current political stalemate and how the budget debate has become a Rorschach test for the left and the right. Section III lays out the rationale and the core elements of a deficit reduction agenda—one that is singularly focused on achieving long-term, robust economic growth for America. Over the course of the next few months, we will be releasing several dozen detailed policy proposals to

help restore fiscal balance and generate economic growth for the country.

Section I

The Economic Imperative for a Fiscal Makeover

For much of the 20th century, the United States was a production giant. We produced much of the world's goods; we led in innovation; our service sector exploded; our productivity soared, our middle class became the envy of the world, and we became, unquestionably, the most powerful economy on earth. Slowly, however, we became a consumption giant. We now power the world's economy as much by what we consume as what we make. We've become, in the words of Senator Charles Schumer, "the kid with the cake mustache on his face."

As Americans have become monster consumers, so too has the government. Consider that between 1981 and 2010, the nation added $7.6 trillion dollars to the national debt. During those three decades, the economy grew by 378%, government revenues by only 261%, and government spending spiked by 449%. [3]

> ***"The current budget is not one of a great and growing nation, but the budget of a once-great and now-stagnating nation."***

In 1990, forty-four cents of every federal dollar was spent on the pure consumption line items of Medicare, Medicaid, Social Security, and interest on the debt. In 2030, sixty-eight cents of every federal dollar will go to those four budget items. [4] By 2020, the cumulative debt of the nation is expected to reach the level of Greece's indebtedness relative to the size of its economy. By 2024, U.S. debt is expected to equal U.S. economic output—meaning that we will owe as

much to creditors as we produce in a given year. By 2037, U.S. debt will be twice the size of our entire economy. [5]

In part, as a consequence of our mounting debt and the crowding out of public investment in favor of entitlement spending, we are projected to average 2.0% real GDP growth —more than a full point less than the growth America experienced from 1975 to 2005. [6]

The predictions of Nostradamus? No, these are the down-the-line estimates of the non-partisan Congressional Budget Office. And this may be a rosy scenario. The CBO assumes that there will be no economic shocks to the system caused by our mounting debt or any other economic calamity. To underscore the seriousness of these projections, CBO assumes that the top two marginal tax rates are at the revenue-producing Clinton level, not budget-busting Bush rates.

These projections are the result of two powerful demographic trends: the corrosive rise of health care costs and the aging of the population. Looking forward, health care spending is expected to rise by 5% per year for each person in the nation, or more than twice the rate of inflation. [7] Over the next two decades, the tax-paying base of America, those between the ages of 25 and 59, is expected to grow by only 8%; the tax-consuming base, those over 70, is expected to rise by more than 80%. By way of comparison, the working age population increased by 23% between 1980 and 2000, or three times the rate of the next two decades; and the over 70 segment increased by 43%, less than half of what is to come by 2030. [8]

If we do not change course, this new budget math leaves us without nearly enough resources to invest in the nation's infrastructure, research, education, technology, or to defend ourselves. In 2030, this consumption-dominated budget is projected to be $3 trillion in arrears in that one year alone.

To say this is unsustainable fails to convey the key point. This is a budget of a country that will not be able to afford to defend itself, invest in itself, or fund itself. It is not the budget

of a great and growing nation, but the budget of a once-great and now-stagnating nation.

Section II

The Political Stalemate

As the budget crisis looms, the deficit has become a Rorschach test for ideologies. And discouragingly—if not predictably—both progressives and conservatives are now using the deficit debate as a way to re-state and advance their often outdated orthodoxies about government spending and taxes.

Soak the Rich

On the left, leading intellectual and activist voices have said that we don't have a spending problem (except for defense, of course). Even a minor reduction in spending, such as the freeze on overall discretionary spending proposed by President Obama, is taken as an affront. Former Labor Secretary Robert Reich called the Obama plan "another win for Wall Street, and another loss for Main." [9] U.C. Berkeley economist Brad DeLong labeled it "fundamental unseriousness… that will do short-term harm to the economy." [10] Behind the outrage is the implausible notion that there isn't any domestic discretionary spending that is wasteful, not completely necessary, or in need of reform.

But that is a walk in the park compared to entitlements where there is complete denial. *The New York Times* columnist Paul Krugman went so far as to argue that the Social Security crisis is fabricated. "The program won't have to turn to Congress for help or cut benefits until or unless the trust fund is exhausted, which the program's actuaries don't expect to happen until 2037–*and there's a significant chance, according to their estimates, that that day will never come* [emphasis added]," wrote Krugman in August. [11] Among the major assumptions behind the optimistic scenario Krugman relies upon is an increase in the U.S. birth rate to levels not seen in America since 1970 and one akin to those of developing

nations like El Salvador, Jamaica, and Colombia.[12] Another assumption—the progress in Americans' life expectancies suddenly and inexplicably stalls to levels not seen since before World War II.[13]

> ***"We hold the view that a government for the many should be funded by the many."***

On the progressive side, the main thrust of budget solutions has been to increase taxes on the rich and corporations. We agree that there is room to increase taxes on wealthy Americans. But we are kidding ourselves to believe that the budget shortfall can come near to closing through taxation on high earners. Only 4% of American families have taxable incomes of greater than $200,000.[14] Less than one percent have taxable incomes above $500,000.

When the repeal of the Bush tax cuts on those earning above $250,000 are coupled with the tax increases on upper income earners to fund portions of health care reform and the likely increase in FICA taxes that may occur as part of a plan to shore up Social Security and Medicare—we are approaching the limits of taxation before it becomes self-defeating and confiscatory, even on the wealthy. We hold the view that a government for the many should be funded by the many.

Corporate taxes also provide opportunities for new revenue by eliminating loopholes and special provisions in the tax code. However, raising the corporate tax rate—already among the highest in the world—would retard growth and probably not accomplish any of those goals and would, therefore, not likely result in as much government revenue as hoped. The tax system must encourage U.S. growth, business formation, domestic employment, and exports.

Starve the Beast

Not to be outdone are powerful conservative voices on the right who have retreated to the same solution on the deficit

that they've run to on every other economic issue: tax cuts. Never mind that only ten years ago, President George W. Bush and a Republican Congress pushed through a major tax cut that wiped out a budget surplus that was paying down old debt and instead produced a plan that added more than one trillion dollars in newly minted American debt. Despite having run this failed tax cut-deficit experiment twice in the last thirty years, very few conservatives—if any—have taken tax cuts off the table as a means of reducing the deficit. In fact, Senate Minority Leader Mitch McConnell this month unveiled a new tax cut package that, according to the Congressional Budget Office, would add $3.9 trillion to the national debt—doubling the cumulative public debt tallied by the nation between 1789 and 2003. The total size of the package is more than four times that of the Obama health care plan, according to *The Washington Post*. [15] "We have a spending problem. We spend too much. We don't have a taxing problem. We don't tax too little," said McConnell. [16]

But on spending it is all sizzle and no steak. Only a handful of conservatives have proposed actual spending cuts in league with the size of the deficit problem or that matches their multi-decade rhetorical assault on the evils of government. Former Vice President Dick Cheney famously said "deficits don't matter." And under President George W. Bush, government spending grew by 89%, faster than the rate of government growth under Democrats Bill Clinton, and the combined Kennedy-Johnson years. [17] This month, House Republicans unveiled their "Pledge for America," a governing doctrine should they take control of the House in November. On spending, it might as well be called "Dodge for America," as Republicans dodged every tough and not-so-tough spending decision. "Small in its ambition," was how *Washington Post* columnist Dana Milbank accurately described it.

The one exception is Republican Wisconsin Representative Paul Ryan. Whether or not one agrees with the particulars of his balanced budget plan (and Third Way does not), at least, in the words of Ezra Klein of *The Washington Post*, "you have

to give him credit for stepping up to the chalkboard.”[18] A meager 13 of his congressional colleagues have signed on to it.

> ***"Indiscriminate cuts, as conservatives are once again threatening, would cook the goose that lays the golden eggs."***

For several decades, the conservative argument on the budget has been to “starve the beast.” Once in power, however, governing conservatives have rarely followed through on this promise (government spending under President George W. Bush and his Republican Congress outstripped that of most other former presidents). And although conservatives have failed to come to terms with them, government safety nets have been a quiet, but key part of America’s success story. Social Security and Medicare gave people economic assuredness and independence in their old age which freed them to take risks, start a business, and invest in their children’s education during their working years.

Equally important have been massive investments essential to America’s growth—land grant universities, the GI bill, interstate highway system, National Institutes of Health, the space program, Erie Canal, railroads, DARPA, Panama Canal, a civil justice infrastructure, patent protection, Pell Grants, student loans, the Hoover Dam, and, of course, the internet. Indiscriminate cuts, as conservatives are once again threatening, would cook the goose that lays the golden eggs.

In normal times, this rigid ideological debate would simply be another amusing Washington sideshow, but the structural deficit is among the most serious long term impediments to America’s economic growth. No country could conceivably succeed to the level we expect for America with massive yearly deficits, mountainous total debt, and a budget so overwhelmed by entitlements that our children will have to

settle for budget leftovers. And as for future taxes, Isabel Sawhill of the Brookings Institution said it best, “The higher tax rates that unreformed entitlements will demand in the future will be even more unpopular than making the needed reforms now.” [19]

Section III

A Growth-Focused Deficit Reduction Agenda

Is there a path to fiscal responsibility? There is. It is not an easy path, but there is a promising one that could unite many on the left and right.

And act we must. The public simply demands political leaders to step up. Four of five Americans see the debt as an extremely serious or very serious threat to the nation’s well-being. That is the same threat level they assign to terrorism and health care costs. [20] In addition, 59% of Americans hold the view that the nation is losing our global leadership to China and other countries that hold our debt, instead of seeing America as the world’s strongest and most influential country. [21]

> ***"Fiscal responsibility cannot simply be an accounting exercise, because not all deficit reduction ideas are created equal."***

But fiscal responsibility cannot simply be an accounting exercise, because not all deficit reduction ideas are created equal. A reduction in federal research dollars to fund innovations in energy may satisfy an accountant worried about budget targets, but could greatly impede growth that is essential to our living standards and future budget revenue.

Thus, fiscal responsibility must be centered around a single organizing principle: *enduring, robust, sustainable economic growth*. It is about developing the right long-term budget

strategy for America that balances our needs to protect the vulnerable with the necessity to invest in the future while living within our means.

Over the course of the next few months, Third Way will be releasing specific policy proposals to accomplish this singular goal: *economic growth*.

As one of the central elements of a healthy and growing economy, we believe that the yawning gap between spending and revenue must close significantly. Many economists argue that a deficit of 3% or less of GDP is manageable. We agree that some level of deficit spending is acceptable and in some cases advisable, and that 3% is in the ballpark of the outer limit of reasonable deficit spending in normal times.

In addition, we believe that the composition of the federal budget must change. We have an aging population that will require more government resources than at any time in our history. That is an unalterable fact. We will spend more on the elderly—in absolute terms, in real terms, as a percentage of our GDP, as a proportion of our budget—than ever before. But we cannot leave entitlement spending on autopilot, we cannot spend unlimited amounts on the aged, and we cannot neglect investments in young people, new infrastructure, and fresh innovations that are the basis of economic growth.

What follows are the core components of a Growth-Focused Deficit Reduction Agenda with thumbnail sketches of Third Way policy ideas. In total, these ideas will close the long-term budget gap by trillions of dollars. These ideas do not represent the totality of solutions to restore fiscal responsibility; rather they are the ideas that we believe are the foundation for deficit reduction that fosters economic growth instead of impeding it.

The Five Core Elements to a Growth-Oriented Deficit Reduction Plan

1. Government Goes First

With public trust in government so low and with the necessity to pare spending in popular entitlement programs

like Social Security and Medicare, the first core element of a growth-focused deficit reduction agenda is a “me first” strategy on the federal budget. Congress and the federal government must take the first significant cut, and by this we don’t mean symbolic measures like freezing congressional pay or cutting congressional and White House staff. Taking the first real cut would demonstrate to a skeptical public that we take seriously their concerns about an overly large federal workforce. It would show that there are no sacred cows in this debate. And it would prove that Congress can cut spending without impeding economic growth. Among the Government Goes First ideas that we are releasing this week:

- **Pension reform**: A quirk in the 1986 law creating the federal employee retirement system (FERS) means that for every one dollar an employee contributes to his or her pension, the federal government puts in fourteen dollars. Federal employees already enjoy one of the most generous retirements in America through Social Security, FERS, and voluntary contributions into the Thrift Savings Plan. Requiring employees and the federal government to contribute equally to the plan would save more than $270 billion over twenty years.

- **Earmark reform**: The dirty little secret about earmarks is that even when they are eliminated through amendments, federal spending is not reduced. We propose an Earmark Reduction Savings Account in each appropriations bill. Cuts to earmarks would be channeled into these accounts with resulting reductions in 302b allocations and discretionary caps.

- **Biennial Budgeting**: Instead of racing each year to fund 12 spending bills, Congress would appropriate one year and conduct oversight and make recommendations for cuts in the subsequent year. This would put oversight and budget cutting on the same par as adding spending for appropriators.

- **Taxpayer Right to Know**: Because an educated consumer is our best customer, taxpayers would receive an exact accounting of where their tax dollars were spent—to the penny. Consumers know exactly what's in a 75-cent candy bar and receive nothing about their $5,400 tax bill.

2. Preserving and Extending Social Security

In 2014, payroll taxes won't cover Social Security payments. In 2024, total income for Social Security will be less than total outlays. In 2034, Social Security will take in $500 billion less than it pays out. In 2044, the Social Security Trust Fund will be $7.8 trillion in arrears having run out of assets 7 years prior. In that year, senior citizens will receive 70-cents on the dollar for the benefits they've earned. [22]

If we don't tackle Social Security now, what is likely to occur is that instead of foregoing benefits, in the future working age Americans and their employers will pay far higher taxes to fund the retirement of a growing population of senior citizens. That enormous tax burden on workers and employers will have a devastating impact on growth.

- **Saving Social Security**: Our forthcoming plan eliminates the Social Security shortfall through 2085 through gradual and reasonable measures of shared responsibility.

3. Bending the Curve on Health Care Costs

The federal government currently spends more on health care than any other budget item including Social Security. By 2022, health care will consume the funding for one-third of all government programs, crowding out necessary growth investments. [23] Even after the passage of the 2010 health care bill, there is still enormous excess and waste in our health care system. Health care inflation is still expected to be more than double that of normal inflation. [24] Rising health care costs will hurt U.S. companies who must compete against companies in other counties with lower health care costs. Employers and employees will be spending $10,211 on average for each person's health care coverage by 2024,

which is nearly double what it costs today.[25] The following policy ideas will further bend the cost curve:

- **Restraining Medical inflation**: Our forthcoming set of ideas will finish the job on health care cost containment begun under the Obama plan through system reforms that pay doctors for the quality of care, not the quantity; initiates medical malpractice changes; adds a health insurance exchange for Medicare; transforms end-of-life care; and provides incentives to keep health insurance premiums from excessive increases.

4. Eliminating Government Giveaways

Much of what the government does and encourages is necessary and important, but too much of what the government does and encourages is superfluous, wasteful, and harmful to growth. We can no longer afford to carry programs that don't work, subsidies that inhibit innovation, and tax expenditures that do nothing for the economy other than play favorites.

- **Reining in Government Giveaways**: Our forthcoming ideas include the elimination of the Bush tax cuts on those earning above $250,000; a three-year freeze on discretionary spending; a three-year freeze on non-Iraq, non-Afghanistan military spending; elimination of certain rifle-shot tax breaks and tax expenditures; elimination of certain dirty energy incentives; and reduction of certain agriculture subsidies

5. Re-balancing Investments in the Budget

As important as it is to cut, it is also essential to invest in future growth. The government has a critical role to play in spurring research, innovation, domestic manufacturing, and education. When our nation was at its strongest, public investments led to enormous growth. For America to lead the world, public investment must be a partner in future growth. And that means restoring a better balance between government consumption and government investment.

- **New Investment Spending**: Our forthcoming ideas include a National infrastructure bank; college tuition tax credits; manufacturing tax breaks; National Institutes of Energy; export promotion; K-12 education investments; high-skilled immigration retention; and Regional Innovation Clusters.

Conclusion

The public is serious about the deficit and at the same time they are profoundly confused about what it would take to contain it. In our own polling, we found that Americans were highly deficit-sensitive. For example, when we asked whether Congress should "cut taxes on the middle class" or "cut government spending and reduce the deficit," the deficit option won by 33-points. [26]

But they believe that the culprit is government waste. Only 21% agreed with the statement, "If we're serious about reducing the deficit, we have to reform Social Security and Medicare." And even fewer, 17%, agreed that a serious deficit reduction plan would include tax increases. [27] This is one of the reasons we believe that a "me first" strategy in which the government takes the first cut is so important.

America is a nation of optimists. In an August poll, 76% still described their household finances as good, very good, or excellent. [28] 71% said they were better off financially than the average American. [29] And 58% said "America will bounce back" from the recession. [30]

But behind that optimism is profound concern about the future. 56% of voters said "America is losing its global leadership as China and other developing countries grow their economies and hold more of our debt." [31] What Americans want is for the country to be strong and remain the economic leader of the world and they are correct that a deeply indebted nation cannot be. We cannot continue to lead and be the kid with cake mustache on his face.

America led the world in the 20th century. We were the economic giant and we remain on top today. But our position is precarious. That is something that Democrats and Republicans in Washington can agree upon, as do the American people. The steps that we take today—to tame the deficit, restore the balance between consumption and investment spending, and promote a policy of growth—will ensure that America remains the leader in the 21st century.

TOPICS

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END NOTES

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