THIRD WAY

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Six Facts About a Grand Bargain

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As the lame duck begins, President Obama will begin his push for a grand bargain to reduce our long-term debt and avert the fiscal cliff. But opponents of a balanced deal are already planting their flags, not just on the Republican side, but also on the left of the Democratic Party.

A coalition of labor and senior groups has announced a campaign against any changes to Medicare or Social Security. Like the right-wing, Grover Norquist-led campaign against any new revenue, the newest anti-bargain coalition has arguments that don't hold up. Here, we take a sober look at the facts underlying the president's support for a grand bargain.

Claim #1: The deficit is not a real economic problem.

FACT: Our current fiscal path, unchanged, guarantees higher interest rates and lower economic growth.

In the last eight years, U.S. public debt has doubled, from 36% to 72% of GDP.[1] That's a level many economists consider unhealthy over a sustained period

We've had debt this high before, during World War II, but the nature of today's debt is different. In the post-war decade, foreign governments and investors held 5% of U.S. debt. Last year, foreigners held 46% of U.S. debt.[2] Foreign-held debt constrains U.S. influence with competitors like China—which holds much of our debt—and it means our costly interest payments go overseas, rather than staying in the domestic economy.

Even after the economy returns to full capacity, the debt problem will worsen. In six years, the share of our economy needed for debt payments will be double today's.[3] That's largely because economy-wide interest rates are expected to rise from their historically low level. Worse, interest rates on U.S. Treasury bonds, in particular, could rise further if investors begin to perceive them as less secure. When this happens, our economy will slow. Should it slow to a recession, the government won't have the cheap credit needed to borrow and stimulate our way out. This time, our only option will be painful austerity. We've seen what this has done to Europe both in terms of jobs and their safety net.

Claim #2: Social Security and Medicare don't contribute to the deficit.

FACT: Social Security and Medicare's fiscal shortfalls directly contribute to the deficit problem.

The Medicare and Social Security trust funds have enough money to pay out benefits for many years, but their fiscal foundation is unstable. In 2008, Medicare began to spend more than in takes in. Social Security will do the same in 2015.[4] Over the next two decades, the trust funds will run out of money as they struggle to keep up with the baby boomers' retirement. The Medicare trust fund will go broke in 2024 and Social Security nine years later.[5] As they draw down their trust funds, the money to repay them has to come from somewhere: higher taxes, less spending, or more borrowing. More borrowing for ever-growing deficits is the current course as projected by the Congressional Budget Office

Medicare and Social Security are stretched for well-established reasons. First, retirees take out more than they put into the programs. An average-income, newly retired couple, for example, will take out 38% more than they contributed to these programs.[6] Second, our population is getting older and living longer. Over the next 40 years, the number of retirees will double, and their benefits will increase by 85% in inflation-adjusted dollars. But the number of taxpayers—those who must foot the bill for all of these costs

—will increase by only one-third.[7] Add to these rising health costs, and there are plenty of challenges to address.

The problems facing Social Security and Medicare are not so great that they require a radical overhaul involving privatization, vouchers, or across-the-board benefits-cuts. Instead, course corrections taken now can preserve these programs for future generations.

Claim #3: A grand bargain "betrays" voters.

FACT: Large majorities of voters support the core principles of a grand bargain.

Voters routinely express that the deficit, along with jobs, is a top economic priority. In an October poll by Kaiser Health, 75% of respondents said that the federal budget deficit would be "extremely important" or "very important" in their vote for president.[8] Furthermore, 81% of voters asked in a 2011 poll said that without changes, Social Security is headed for a crisis.[9]

Voters support policies that fix Medicare and Social Security, because they are acutely aware that these programs face insolvency if left unaddressed. According to recent Third Way focus groups, both Democratic and Independent voters overwhelmingly express a dim view of Social Security and Medicare's financial prospects. They worry that, without changes, these programs will not be available for future retirees

The reelection of the president provides a mandate for core elements he seeks in a grand bargain: higher taxes on the wealthy and sensible savings from entitlement programs. Voters don't want entitlement benefits slashed, but they recognize that modest changes are necessary for the longevity of Medicare and Social Security.

Claim #4: A grand bargain means austerity.

FACT: A grand bargain is the best alternative to austerity.

Opponents of a grand bargain frame it as needless, self-imposed austerity. What they often neglect is that ***the U.S. economy is headed for austerity now—unless we forge a grand bargain***. Without bipartisan action, the automatic tax increases and spending cuts would throw the economy into recession. A grand bargain based on the principles President Obama supports would *reduce* the amount of deficit savings on the books, recoup a *smaller* amount of savings in a more reasonable way, and push that savings into future years so as *not* to impede recovery.

The alternative to a grand bargain is a fight in Congress without any progress, much like the debt ceiling debacle of 2011. Only this time, the threat of default would be joined by the double threat of sequestration and tax hikes on the middle class

Even if the president were to emerge from the fight to kick all three cans down the road, as opponents of a bargain seem to advocate, the economy would suffer. Ratings agencies would honor their word and downgrade U.S. Treasuries, again. Worse, we'd send the message that even at the most opportune moment—the beginning of a second presidential term coinciding with a deep and treacherous fiscal cliff—our political system can't take on the debt. If that political failure continues, we'll be more likely to encounter real austerity, the kind necessitated by a European-style debt crisis

Claim #5: Taxing the rich is enough to resolve deficits.

FACT: Leaving Social Security and Medicare untouched guarantees middle class tax hikes, because no plausible tax increase on the wealthy, alone, can stop deficit growth.

Returning tax rates on the wealthy to Clinton-era levels can and should make up a sizable portion of a grand bargain. ***But***

only raising taxes on the wealthy cannot deliver the revenue needed to solve long-term deficits

Many Democrats now support eliminating the Bush tax cuts for the wealthy: return top rates on personal income to 36% and 39.6%, restore the estate tax, and raise rates on capital gains. Even if Democrats went well beyond these levels, pushing the top rate to 50% and the capital gains rate near 40%, revenue alone can't solve the deficit. A plan like this one would allow annual deficits in 2040 to exceed $3 trillion, in today's dollars, and the federal debt, as a share of the economy, would be twice the size of today's debt. [10]

In reality, a taxes-only approach to the deficit would necessitate large tax increases on the middle class. For example, a deficit plan by former IMF economist Simon Johnson and coauthor James Kwak includes only minor changes to entitlement programs but calls for numerous tax increases, many of which fall directly on the middle class. Their plan raises the rates of the Social Security payroll tax, the Medicare payroll tax, the gas tax, and the capital gains tax. It slashes a big middle class deduction and exemption, for mortgage interest and employer-sponsored health insurance. It also adds a new carbon tax and value-added tax. [11]

As the Johnson and Kwak plan shows, containing long-term deficits predominantly with tax increases is theoretically possible, but doing so would demand burdensome tax increases on the wealthy and middle class alike.

Claim #6: President Obama promised not to touch Medicare and Social Security.

FACT: The president has repeatedly endorsed a deal that includes reasonable savings to make Social Security and Medicare stable for future generations.

President Obama has been entirely consistent on the deficit and entitlements. He proposes to cut deficits by $4 trillion, over ten years, "in a balanced way." There is no question as to what balance means to the president. In the midst of the 2011 debt ceiling negotiations, Obama said, “Despite what some in my own party have argued, I believe that we need to make some modest adjustments to programs like Medicare to ensure that they’re still around for future generations.” [12]

The president has maintained that position throughout the presidential campaign. In the first presidential debate alone, he referred to “balanced” deficit reduction seven separate times. And the transcript of his *Des Moines Register* interview is clear: “I am absolutely confident that we can get what the equivalent of the grand bargain that essentially I’ve been offering to the Republicans for a very long time, which is $2.50 worth of cuts for every dollar in spending, and work to reduce the costs of our health care programs.” [13]

END NOTES

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