



A Joint Project of The Century Foundation and Dēmos

## THE HIGH ROAD TO FISCAL REFORM

A very misleading story about huge risks of “unfunded liabilities” damaging future generations has dominated the public debate about how to think about budget priorities. This set of claims confuses the disparate issues of how we should provide adequate social insurance for young and old with issues of fiscal responsibility and reform.

As the nation confronts the largest economic crisis since the Great Depression, we believe it is time for a reasoned and balanced dialogue about the state of our nation’s finances and our fiscal future. During this period of great anxiety, uncertainty, and confusion, the public debate would benefit from perspective that informs Americans rather than compounds their fears. Full-page advertisements in newspapers depicting an ominous iceberg close at hand, for example, are not constructive in promoting reasoned responses to the genuine but manageable challenges confronting the United States.

Organizations including the Peterson Foundation, the Heritage Foundation and the Brookings Institution have joined in promoting a skewed and narrowed definition of the problems, which, while stating that all options should be on the table, defines the choices in ways that move toward lowered social investment for ordinary citizens and public needs, usually described as “entitlement reform”. For instance, a statement put out on February 19 on President Obama’s Fiscal Summit called for “a degree of sacrifice impossible under the existing policy process.”

Steering the debate toward the high road requires disentangling three distinct challenges facing the nation:

1. Addressing the very real threat of continued economic decline by investing in our nation’s social and physical infrastructure;
2. Reducing the nation’s long-term debt trajectory through responsible tax reforms and changes in spending priorities; and
3. Preserving our nation’s system of social insurance, including Social Security, Medicare and Medicaid.

This paper briefly maps out an overview of the fiscal landscape that in important ways differs from the more alarming picture that has come to dominate the debate:

## **PERSPECTIVE ON FEDERAL DEFICITS AND GOVERNMENT SPENDING**

First, should we have rough fiscal balance over the business cycle? Most economists would say that, except in emergencies such as the current financial collapse, moderate deficits of 1 percent or 2 percent of GDP, are sustainable indefinitely, as long as the economy is growing faster than the debt so that the debt-to-GDP ratio is stable or declining.

Second, what share of GDP should public outlays consume? It is possible that America's well-being, especially the well-being of the young, requires increased social investment—in education, training, early childhood education, child care, and affordable housing. But we can still have responsible fiscal policy by balancing social outlays with revenues at a higher fraction of GDP. This is an option that has been overlooked in the debate, which up to this point has largely conflated lower spending with fiscal balance.

At the heart of our argument is that there is more than one road to an economy of shared prosperity and opportunity. The high road recognizes the need for sustained investments in education, energy alternatives, infrastructure and health care. The low road approach represents a status quo on tax policy and drastic spending cuts in social insurance.

The reality is that it is not necessary to choose between adequate social investment and fiscal prudence. We can have both if we finance the costs of well designed and comprehensive social insurance, and reform our health system. The federal government currently spends about 20 percent of GDP. And due to tax cuts of the Reagan and Bush eras, the pre-recession federal revenues totaled about 16-17 percent of GDP, leaving deficits of 3 to 4 percent. These deficits will sharply rise during the recession.

When the recession ends, we need both a sustained increase in public outlay to meet unmet social needs, and a budget that is close to balance. A good target for the long term would be federal outlays of about 25 percent of GDP, to finance investment in early childhood, a conversion to a green economy, and other needed social investments. Federal revenues should be about 23-24 percent of GDP. That, of course, would require additional taxes. Good candidates for increased revenues would be a restoration of pre-Bush tax rates on the upper brackets, improved tax enforcement directed at tax evasion by the very wealthiest, as well as a small transfer tax on financial transactions. The details will be the subject of a future publication.

## **THE PUBLIC DEBT**

The true figure for debt—that is, on which actual interest is paid by taxpayers—is the public debt held by the public, estimated as of February 2009 to be about \$6.64 trillion dollars. This is the figure put out by the [U.S. Treasury Public Debt Web site](#).

The Treasury Department's figure for public debt is just over 40 percent of GDP, which is a far smaller portion than at any time during the quarter-century after World War II, a period of record economic boom.

The most important measure of the real debt burden is the ratio of public debt to GDP. The debt ballooned during World War II, when we huge annual deficits in order to re-arm America and

defeat the Axis powers. Among the virtuous side effects of all that public spending were the recapitalization of American industry, the retraining and re-employment of tens of millions of workers, and massive investments in science and technology. All those investments bought a much more productive economy, and fueled the great postwar boom—a period not only when the economy grew at an annual rate averaging 3.8 percent a year for three decades, but also when Americans across the income spectrum prospered while economic inequality remained relatively modest. If public debt were crippling per se, the postwar boom could not have happened

The comparison to today's situation is instructive. The debt-to-GDP ratio was about 120 percent of GDP at the war's end. But within three decades, it had come down to a low of less than 25 percent of GDP, because during the boom years the deficits were moderate, and the economy grew much faster than the debt.

Today, the most urgent need is to prevent a second Great Depression, not to make fanciful debt projections for 2050. *The single most important factor affecting the debt load in 2050 is the health of the real economy.* If it takes deficit spending of 10 percent or even 15 percent of GDP per year for two years to put the economy back on the path to steady growth, that will be far more of a service to our children than having them inherit a prolonged depression. If the public debt increases to, say, 70 percent of GDP by 2011 as part of a necessary recovery program, the debt ratio can then come down to something more normal once growth returns, just as it did after World War II.

## **SOCIAL SECURITY**

The Social Security program faces a relatively small seventy-five-year budget shortfall, currently estimated by the Congressional Budget Office at 0.38 percent of GDP. The shortfall figure is so small and the margin of error so large that the program is effectively close to balance. The economic assumptions used to produce that figure include a low rate of GDP growth, and slow wage growth. If wage growth were to return to the postwar trend relative to productivity growth, Social Security would be in perpetual surplus. Even if it turns out that the projected deficit is real, very small modifications in the system's tax collections or payout formulas could return the system to surplus. Social Security is not in crisis, and relatively minor adjustments to the payroll tax, would ensure the program's long-term fiscal soundness and benefits for future generations.

## **MEDICARE AND MEDICAID**

The fiscal challenges facing Medicare are indeed serious. Medicare will go into deficit within a decade if nothing is done; but Medicare's cost inflation is a reflection of the extreme inefficiency of the larger health system of which it is a part (since 2000, Medicare's inflation rate actually has been lower than the private parts of the system). If we do not convert the larger health system to universal health insurance, while making structural reforms needed to contain health care inflation, Medicare is on a relentless path to reduced benefits. Absent comprehensive health reform and universal insurance, Congress will be forced to shift more and more costs to individual subscribers. This has huge social-class implications, since more affluent retired people will be able to supplement barebones coverage with private resources, while ordinary Americans will not. How to achieve universal coverage, as decent health policy and as a more efficient use of scarce resources,

must be the subject of an urgent national debate. But far too much of our current debate centers around an “entitlements crisis” which doesn’t exist. The crisis we face is a health care crisis.

## **BEING RESPONSIBLE TO OUR CHILDREN**

One of the key strands of the fiscal conservatives claims is that the national debt will result in lower living standards for future generations, or more recently, that the recovery package amounts to “generational theft.” We believe both of these claims are patently false, and diminish attention away from the real challenges facing today’s young people to political footballs.

First, the living standards of our children are a function of two variables: whether we can get the economy back on a path toward high growth, and whether we can provide the social investments necessary so that our children can become productive citizens and workers. To sacrifice necessary social outlays on the altar of budget balancing is almost guaranteed to prevent economic recovery and to reduce further the needed investments that young Americans are already being denied.

Consider life from the perspective of twenty-five-year-old Americans. For a great many of those young citizens, their living standards are already below those that their parents enjoyed at that age, and the reasons have nothing to do with the national debt—and everything to do with stingy social policies and wage-inequality. Young adults face a very steep path of entry into the middle class—high costs of housing, of health care, debts incurred to pay for college, expensive child care. Looking forward, they face diminished pension coverage. These are costs to the young and reductions in their living standards right now, not in 2050.

## **CONCLUSION**

We seek an honest debate about our economic future—one that addresses the real and very distinct challenges confronting us today. All too often this debate has been framed as an entitlements crisis or a problem of unfunded liabilities that are leading America down a path of economic destruction. We believe this is the wrong debate. The real debate is about what kind of social investment we need to ensure our nation advances in the 21<sup>st</sup> century, and identifying responsible and sustainable mechanisms to pay for it.

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