

**PROGRESSIVE REVENUE AS THE ALTERNATIVE  
TO CAPS, COMMISSIONS, AND CUTS**

**Robert Kuttner**  
**Co-Editor, The American Prospect**

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*Abstract.* Americans are simultaneously debating three distinct questions. What is the best strategy for economic recovery from a severe downturn? What level and form of social investment is desirable over the long term? What fiscal policy can produce a sustainable level of annual deficits and accumulated public debt. Opponents of social investment believe they have a single answer to all three questions: deep cuts in social outlay. But a better alternative strategy to reconcile the need for adequate short and long term public investment is to make the case for enhanced progressive taxation

ROBERT KUTTNER is co-founder and co-editor of The American Prospect and a senior fellow at Demos. He is author of nine books, including most recently *A Presidency in Peril*, to be published by Chelsea Green in March 2010. His best known previous works include *Everything for Sale*, *The Squandering of America*, and *Obama's Challenge*. He has taught at Brandeis, The University of Massachusetts, Boston University, and Harvard's Institute of Politics. His previous positions include national staff writer on the Washington Post and chief investigator of the U.S. Senate Banking Committee.

American politicians and pundits are embroiled in ongoing debates about three critical questions: What kinds and levels of public spending do we need to spur recovery from deep recession and high unemployment? What level of social investment do we need over the long term? And what are we to do about the escalating long-term deficits bequeathed to us by eight years of big tax cuts for the rich and off-budget spending on foreign wars? Each is a vital question, but they need to be disentangled.

Unfortunately, opponents of social investment are deliberately mixing up the issues, and using the coincidence of these debates to pursue longstanding strategies to slash the American social security state and cut off discussion of a strong role for government and building the nation's future. We must challenge the current conventional wisdom to clear the way for clear thinking about better paths forward in paying for the government investments America needs.

### **What Path to Prosperity?**

The dominant narrative holds that today's deficit levels are unsustainable and that the necessary remedy is a set of extraordinary procedural measures aimed at reducing public outlays over the long run. That premise, of course, leaves out the possibility of significant revenue increases to maintain and expand public spending, both as a recovery measure and over the long term. If anything, the level of social investments of all kinds in the US is inadequate, and needs to be enhanced—both to promote social balance and to increase productivity and growth.

We rank 26<sup>th</sup> among 30 wealthy nations in our social spending.<sup>1</sup> Entire categories of social investment such as early childhood education and active labor market policy are only rudimentary in the US. Other categories of social outlay, such as unemployment compensation and pension systems, have much income lower replacement ratios than those of other wealthy nations. In addition, our investment in basic infrastructure as well as advanced systems such as high-speed rail and a modern electricity and telecommunications grid has not kept pace with the need.

This challenge has both a short-term and long-term dimension. During the current downturn, we need additional public spending for macroeconomic stimulus, direct job-creation, and emergency replacement of lost revenues for states and localities. And over the long term, we need to enhance public investment and systems of social insurance. There is an available path that combines faster recovery from recession, increased social outlay, higher growth, more equitable income distribution and long run fiscal balance.

But this is a distinctly minority view. Paradoxically, a crisis that should have discredited laissez-faire economic policies and revived support for activist government is being used politically to advance more constraints on government. The current deficit, despite its origins in the libertarian regulatory policies that invited financial collapse, has been a windfall to conservative groups using fiscal concerns to weaken Social Security and Medicare. So the several issues that need to be unpacked are these:

**\*Recovery Strategy.** How large a deficit is sensible in the current downturn, and how does deficit spending fit into the recovery strategy? What are the priorities for public spending to move the economy back towards full employment?

**\*A Path to Fiscal Sustainability.** What is the proper trajectory of deficit reduction once strong growth returns and joblessness is reduced to an acceptable level? What should the deficit average over the business cycle, and what public debt level is sustainable over the long term?

**\*Adequate Social Outlay.** What overall level of federal outlay is desirable? Which social investments need to be expanded?

**\*Paying For It.** Which new or increased revenue sources make political and economic sense to allow us to pay for these new outlays consistent with a sustainable budgetary policy?

**\*Strengthening Social Insurance.** What is a sensible strategy for shoring up Social Security and Medicare, which have become the poster-children for the story that entitlements are out of control and will wreck the economy? Which entitlement programs need to be expanded, reconfigured, or newly created?

Concern about the deficit per se is crowding out the real debate that we need to have. Much of the elite press and many voices from centrist and conservative think tanks contend that the economy faces such a severe deficit crisis that it needs extraordinary measures, such as an extra-legislative deficit commission, a mandatory spending freeze, and caps on entitlement spending, or all three.<sup>2</sup> The Obama Administration been swayed by this thinking. The president's recent budget for fiscal year 2011 proposed a three-year freeze in discretionary domestic spending to begin in October 2010, (just when unemployment is projected to peak) and President Obama also announced that he would

create by executive order a bipartisan commission on deficit-reduction of the sort that narrowly failed to win enactment in the Senate in late January.<sup>3</sup>

Standard economic analysis would suggest that the most expeditious fiscal strategy to reduce deficits and the national debt in the long run is to restore economic growth rates. Then, deficits can be cut to a level that reduces the ratio of debt to Gross Domestic Product over time. In the short run, this course requires a paradox of increased deficit spending.

This kind of process occurred, somewhat serendipitously, during and after World War II, when the national emergency pushed deficits to the range of 28-30 percent of GDP, compared to the New Deal deficits of 4-6 percent which were insufficient to end the Great Depression. That extraordinary wartime deficit spending, however, recapitalized American industry, invested massively in science and technology, retrained and re-employed American workers, and restored consumer purchasing power and private business investment. 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 declined.

Despite a national debt of about 120 percent of GNP at the war's end, the stimulus of war powered a 25-year boom. If public debt were crippling per se, the postwar boom could not have happened. During the postwar boom, deficits were in the 1 to 2 range, the economy grew at a much faster rate than the debt, so that by the 1970s the debt was below 30 percent of GDP. This is a far more attractive path to recovery than an austerity policy.

Pursuing budget balance prematurely in an economic downturn, as Roosevelt did in 1937, only prolongs and deepens recession. That, in turn, makes the national debt weigh more heavily on the real economy. Austerity policies also deprive the economy of needed public outlays that can enhance growth, such as investment in human and physical capital.

In short, the preferred strategy of recovery, growth, and fiscal management entails somewhat larger public spending and deficits for a year or two more, and then a gradual increase in taxes to bring the budget close to balance over the business cycle without sacrificing needed public outlay. Politically, the challenge is to chart this path, explain it to voters, and identify the new revenue sources that will be broadly acceptable. This will require presidential leadership, scholarly analysis, and political organizing to counter the immense influence of the deficit-alarm camp.

### **A Progressive Recovery Strategy**

The risk of the current recovery strategy, Democrat or Republican, is that it will aim too low. The recession is technically over, with positive GDP growth having resumed for two consecutive quarters. However the overhang of high unemployment is projected to continue well into this decade. The administration's own projections assume average job creation this year of just 95,000 new jobs per month, when the economy needs about 150,000 jobs per month just to keep up with population and labor-force growth.

Counting the 8.6 million jobs actually lost since the recession began plus the jobs needed to accommodate normal population growth, in February 2010 there is a jobs gap

of 11 million. To get back to a pre-recession unemployment rate by 2013, the economy has to create 400,000 jobs every month for the next four years, and at this writing we are still losing jobs.<sup>4</sup>

After a modest gain in November, the economy shed another 85,000 jobs in December 2009, while the measured labor force shrank by 661,000. Had these workers not dropped out, the official rate would have been 10.4 percent. The economy has lost more than 8.6 million jobs since December 2007.<sup>5</sup> In January, the BLS released technical revisions, calculating that its preliminary calculations had under-counted job losses by over a million workers since the recession began. The employed share of US population fell to 58.2 percent, a twenty-seven-year low, and a decline of 4.5 percentage points since December 2007.<sup>6</sup> As a January report from the Economic Policy Institute observed:

Given population growth from December 2007 to December 2009, we would have expected the labor force to *increase* by around 2.8 million over this period. This means that there are now roughly 3.6 million “missing workers,” that is, workers who dropped out of (or never entered) the labor force during the downturn. When the recovery begins to take hold and these missing workers start entering or reentering the workforce in search of jobs, it will put strong upward pressure on the unemployment rate.<sup>7</sup>

If we count people who want full-time jobs but are involuntarily working part-time, the unemployment rate is above 17 percent. The typical unemployed worker is now out of work for over twenty weeks. The “long-term unemployed”—those who have been unemployed for six months or more—was 41 percent of the total in January 2010, the highest since the Great Depression. During the entire postwar era, the share of long-term unemployed had not previously risen above 26.0 percent. At this writing, there are 6.3 unemployed workers for every job opening, and that number has been worsening in

recent months. As pockets of economic activity have picked up, employers have met the demand mainly by increasing workers' hours or by hiring temps, not by adding permanent jobs. All of this increases insecurity and puts downward pressure on wages, as desperate people are willing to work for less money.

In December, the House narrowly passed a \$154 billion spending program, for unemployment compensation, fiscal relief to the states and job creation. The senate counterpart, proposed by a bipartisan group led by Finance Chair Max Baucus and the committee Ranking Republican, Charles Grassley, is just \$85 billion, mostly in tax cuts. The Administration budget for 2011 proposes a total of \$266 billion in recovery measures, about 76 billion of which is in tax cuts.<sup>8</sup>

All of this is at far too small a scale. According to the Center on Budget and Policy Priorities, state and local governments have a revenue gap of \$142 billion for FY 2011, on top of a shortfall of \$125 billion this year.<sup>9</sup> The gap would be much larger if most states had not raised taxes, which is of course fiscally contractionary. So the total cut in public outlay by the states exceeds the proposed increases in tax cuts or spending increases by the Obama Administration, leaving government as a whole providing net negative economic stimulus.

In addition, the American Recovery and Reinvestment Act, the administration's February 2009 \$787 billion stimulus package, is already starting to peter out. Though billed as a two-year program, the funds were actually spent over three fiscal years, meaning that the gross stimulus was well under 2 percent of GDP per year. And netted out against some \$466 billion in state and local cuts or tax increases during the same three fiscal years, the net government stimulus was well under 1 percent of GDP.

According to the Center on Budget and Policy Priorities, by the beginning of 2010 forty-three states had cut services to residents and thirty states had raised taxes. At least twenty-one states had cut low-income health insurance or reduced access to health care; twenty-two states and the District of Columbia were cutting medical, rehabilitative, and home-care services for low-income people who are elderly or disabled. At least twenty-four states were cutting funds for K–12 schooling, early education, and child care, and thirty-two cut support for public colleges and universities.<sup>10</sup>

Many of the specific program categories of the Recovery Act did produce significant increases in long-term public and social investment. For example, \$44.5 billion went to school districts for repairs, construction, modernization, and to prevent layoffs (there were at least 40,000 teacher layoffs despite this aid.) Deferred maintenance in highway and bridge projects received \$27.5 billion. Basic water and sewer modernization projects got \$6 billion. High speed rail received \$8 billion, and another \$8.2 billion went to other public mass transit projects. Broadband and high speed internet got \$7.2 billion. Several billion more, via various programs, went to green energy. Head Start and Early Head Start received \$2.1 billion (increasing the fraction of eligible children who will be served by Early Head Start from three percent to six percent.)<sup>11</sup>

By their very nature, most of these are long term projects and long term needs, not one-shots. But even the Administration budget does not propose continuing this level of support for most of these expanded program categories once the spending of the Recovery Act expires in Fiscal Year 2011.

To produce the kind of job growth that the economy requires, as well as to continue these long-deferred public investments, we need increased public outlays of at

least \$500 billion during each of the next two fiscal years. States should restore public services to pre-recession levels, with emergency federal revenue sharing. The outlays of the February 2009 Recovery Act should be at least maintained. In addition, the Federal government should add a program of direct job creation. For the most part, spending increases are more efficient than tax cuts, because recipients of tax cuts often use the money to pay down debt rather than to maintain or increase consumer spending.

In the absence of tax increases, which are generally counter-productive during a depressed economy, this level of increased federal outlay would increase the deficit by about three percentage points in each of the next two years. However that gross figure is misleading. By putting the economy on a higher growth path, these expenditures would produce increased offsetting revenues without raising tax rates. There is also a strong case that raising taxes on the very highest income brackets, such as the top 1 percent, are not contractionary since most of their income is not spent. The net increase in the deficit, factoring in higher employment and revenues, would likely be far less than three percentage points.

But because of generalized deficit-phobia, this level of outlay is not on the table. The most expansive mainstream proposal is a plan released by the Economic Policy Institute in January, which calls for a \$406 billion program of fiscal relief, tax credits, extended unemployment benefits, and direct public service employment to create 4.6 million jobs. As EPI ruefully acknowledges, even this proposal would be sufficient to produce barely half the jobs that the economy needs to get back to pre-recession unemployment rates by 2013.

## **A Path to Shared Prosperity and Fiscal Sustainability**

The Congressional Budget Office's most recent estimate (January 28, 2010) projects that the deficit for 2010 will be 9.2 percent of GDP assuming no change in current law or program activities.<sup>12</sup> That, however, is unrealistic because the Bush tax cuts sunset in 2010, but there is no political support in either party for raising taxes in the bottom 98 percent. Retaining the Bush tax cuts for those with incomes under \$250,000 (the Obama proposal) has revenue costs of over \$200 billion a year compared to the CBO baseline, and the Administration proposes more than a trillion dollars of other tax cuts over a decade.

The Administration's own budget allows the Bush tax-cuts to sunset in 2010 for all but the top two percent of the income distribution. The combination of modest spending increases, a freeze in most domestic discretionary spending, and additional tax cuts, leaves the following trajectory of deficits, growth, and unemployment:

### **Basic Fiscal and Economic Data, 2010-2020**

Fiscal Year	Deficit-to-GDP ratio	Debt-to-GDP	Revenues/GDP	Outlays/GDP	GDP Growth	Unemp. Rate
2010	10.6	63.6	14.8	25.4	3.0	10.0
2011	8.3	68.6	16.8	25.1	4.3	9.2
2012	5.1	70.8	18.1	23.2	4.3	8.2
2013	4.2	71.7	18.6	22.8	4.2	7.3
2014	3.9	72.2	19.0	22.9	3.9	6.5
2015	3.9	72.9	18.9	22.9	3.4	5.9
2016	3.9	73.6	19.3	23.1	3.1	5.5
2017	3.7	74.2	19.4	23.1	2.7	5.3

2018	3.7	74.9	19.5	23.0	2.6	5.2
2019	3.9	75.9	19.5	23.7	2.5	5.2
2010	4.2	77.2	19.6	23.7	2.5	5.2

Source: President’s Budget for 2011, Tables S-1 and S-13<sup>13</sup>

Several aspects of this set of projections invite closer analysis. First, the proposed decline in the rate of unemployment is far too slow. With this path, unemployment is still at over 8 percent when the president runs for re-election! And it doesn’t fall below 7 percent until 2014. Even in the second half of this decade, it stays well above the 4 percent that most economists consider effectively full employment, meaning fairly loose labor markets and little pressure to have wage increases match productivity gains, of the sort that we briefly saw during the last period of full employment in the late 1990s.

Secondly, GDP growth gradually falters from a not very impressive recovery peak of just over 4 percent to around 2.5 percent by decade’s end. Both numbers are too low. In past strong recoveries, annual growth rates exceeded 5 percent in peak years, and during periods of prolonged expansion, the annual growth rate was well in excess of 3 percent.

Third, the proposed trajectory of government spending gradually declines from a recession peak of 25.4 percent this year to about 23.5 percent in the second half of the decade. Elsewhere in the budget, we learn that most of the three percentage point increase over the historic trend of about 20.6 percent is increased spending on health care and Social Security. The budget assumes enactment of some versions of the Obama health plan, but no further fundamental reforms.

Fourth, the proposed annual deficit averaging about four percentage points of GDP after 2014 is too large, but not frighteningly so. The all-important debt-to-GDP ratio very slowly keeps creeping up from 70.8 percent in 2012 to 77.2 percent in 2020. As noted, the prior peak, just after World War II was over 120 percent.

As I suggest in this paper, the best solution on the spending side of the equation is to target federal outlay at about 26 percent of GDP, so that we can build the systems of public investment needed by the economy and the society. In current dollars, that would permit about \$450 in additional annual spending on adequate systems of social insurance and public investment. It would allow the basic and advanced infrastructure outlays of the Recovery Act to be continued and expanded, rather than cut short after 2011. These addition outlays could also finance adequate investment in an active labor market policy. With more fundamental reform of the health system, additional public resources could be freed for other needs.

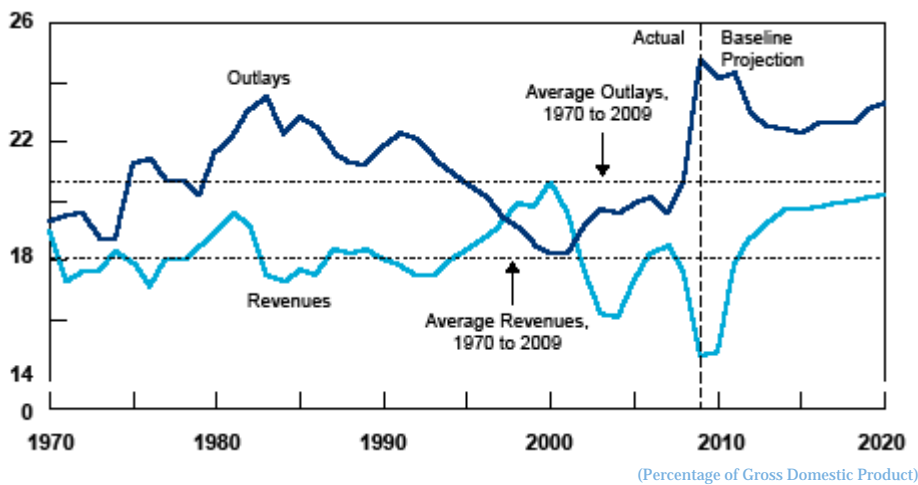
Then on the revenue side, we should increase total revenues to about 24 percent of GDP, leaving a typical annual deficit of 2 percentage points averaged over the business cycle (less in boom years, more in recessions). The increased investment in human and physical capital will produce somewhat higher growth rates. Assuming growth rates in excess of 3 percent, the debt-to-GDP ratio then peaks at around 80 percent and gradually declines.

This strategy requires increased revenues of about 4 percentage points over the Obama Administration's projections. In current dollars, that's just under \$600 billion a year. Below, this paper describes politically and economically feasible ways of getting those increased revenues, while generally holding harmless the bottom 97 or 98 percent

of the income distribution. This is not as difficult as it might seem, because the Administration's ten year projection includes \$2.562 trillion in tax cuts in excess of the CBO baseline (which assumes that all the Bush tax cuts sunset in 2010.) Some of these proposed tax cuts, such as not raising taxes on taxpayers earning under \$250,000, are both economically sensible and politically necessary, but close of \$100 billion a year in the Administration's other proposed tax cuts can be questioned both as politics and as policy.

Historically, the average revenues between 1970 and 2009 were about 18 percent of GDP, according to the CBO. Average outlays, as noted, were about 20.4 percent, so the deficit averaged 2.4 percentage points. However, this period lumps together the Bush and Reagan years, when deficits were unsustainably high with the Clinton years when deficits were declining or the budget was briefly in surplus. Before the Reagan presidency, annual deficits averaged well below 2 percent, allowing a rapid decline in the debt-to-GDP ratio in the three decades after World War II.

### Revenues and Outlays Relative to GDP, 1970-2000



Source: Congressional Budget Office

Though President Obama's critics have faulted the Administration for going on a spending binge, the deficit was already projected to exceed 9 percent of GDP at the time the Administration took office and those projections understated the depth of the recession. Most of the imbalance in the budget is due to the recession itself, which reduces revenues and triggers increased public outlays via automatic stabilizers such as unemployment compensation and other safety-net measures.

According to an analysis by the Center on Budget and Policy Priorities, over 80 percent of the increased deficits beginning in 2009 are the result of three factors that antedate Obama: the Bush tax cuts; the Bush military build-up; and the lost revenues resulting from the recession itself, which in turn can be attributed to extreme financial deregulation and lack of enforcement of the financial regulations that remained.

Just two policies dating from the Bush Administration — tax cuts and the wars in Iraq and Afghanistan — accounted for over \$500 billion of the deficit in 2009 and *\$7.1 trillion* in 2009 through 2019, including the associated debt-service costs. These impacts easily dwarf the stimulus and financial rescues. Furthermore, unlike those temporary costs, these inherited policies (especially the tax cuts) do not fade away as the economy recovers.<sup>14</sup>

For the years 2001 through 2008, CBPP calculated that 49 percent of the increased deficit was the result of tax cuts and another 34 percent increases in military spending.<sup>15</sup>

A similar analysis of CBO budget statistics by reporter David Leonhardt for the New York Times concluded that about 37 percent of the deficit that Obama inherited was the result of reduced revenues from the recession and another 33 percent was Bush spending increases, mainly on the military and the privatized Medicare drug program. Just 7 percent was the result of the Recovery Act, and 3 percent from all of Obama's other domestic spending.<sup>16</sup>

## **Fiscal Scaremongering**

Over the past three decades, fiscal conservatism has undergone a peculiar political odyssey. Before 1980, most political conservatives were also budgetary conservatives. In the Reagan era, with the advent of supply side economics, the conservative strategy shifted. The stated theory was that tax cuts would stimulate growth and hence revenue. But in practice the idea was to create large deficits with the tax cuts, and then use fiscal imbalance as a basis for reductions in domestic spending.

During the 1980s and 1990s, Democrats became the fiscally more conservative party, promoting tax increases and agreeing to spending cuts they really didn't want in order to demonstrate their fiscal rectitude. In the 3-way election of 1992, H. Ross Perot used large deficits as a surrogate for the broad proposition that government was out of control. The deficit became a proxy for generalized distrust of government.

Under Clinton, conversely, deficit reduction became the emblem of public virtue. But under George W. Bush, as under Reagan, the premise was that most voters didn't really care about deficits as long as they got prosperity and national security. Though Clinton put the budget briefly in surplus, it took Bush only a few years to get the deficit right back to the level it had been under Reagan—in excess of 4 percent of GDP.

A politics of chronic deficits, however, was a political windfall for a very different sort of conservative—critics of social insurance. For a quarter century, the private-equity billionaire Peter G. Peterson and his allies have been warning that excess spending on entitlements would crash the American economy. In the course of four books, all variations on the same argument, he has sounded increasingly dire in his predictions that accumulated public debt, visible and invisible, would produce economic

collapse. His warnings did not abate even in the late 1990s, when endless budget surpluses were projected.

The prime culprit, in this analysis, is “unfunded liabilities” of over \$50 trillion dollars, most notably Social Security and Medicare, plus more the \$13 billion of explicit government debt. This imbalance will supposedly drain money away from all other public needs, cause financial markets to lose confidence in the ability of the U.S. government to pay its debts, erode the value of the dollar, raise interest rates, and require a doubling of the tax load.

When an actual financial collapse materialized, of course, it had nothing to do with social insurance or unfunded liabilities or projections of long term public debts -- and everything to do with financial deregulation. Peterson cashed in his stake in the Blackstone Group, which went public in 2007, walking away with well over \$1 billion, just before the sky really did come crashing down. Indeed, in the wake of this economic collapse, it is programs such as Social Security, Medicare, and Medicaid that have proven to be the last line of defense for millions of Americans confronting hardship. Privatized forms of retirement income are pro-cyclical. Just when people needed them most, they lost value along with the rest of the economy. Only public social insurance remained reliably counter-cyclical.

Peterson is devoting over a billion dollars to institutionalize his message about the importance of cutting social programs, through the Peter G. Peterson Foundation. The foundation was established in early 2008 and is headed by David Walker, the former U.S. Comptroller General. Peterson’s foundation is at the center of a network of fiscal conservatives who include the Concord Coalition, a major program at the New America

Foundation, a joint Brookings-Heritage Fiscal Seminar, another joint program with the Pew Charitable Trusts, the Washington Committee for a Responsible Budget, and the Hamilton Project at the Brookings Institution.

The Peterson Foundation has produced a pseudo-documentary, “I.O.U.S.A.,” that has been broadcast on public TV, and created campus affiliates to spread the message that programs for the elderly are bankrupting the country at the expense of the young. Peterson’s latest venture is an online newspaper called Fiscal Times, which offers supposedly fair and balanced commentary to news media, and has a content partnership with the Washington Post. The maiden Fiscal Times article published by the Post, in its news pages, and generated huge controversy, because the piece was so patently slanted towards the Peterson interpretation of the nation’s fiscal challenges.<sup>17</sup>

The Foundation has reached out to liberals as well as conservatives, trying to broker a grand bargain in which entitlements are capped but taxes also are “on the table,” and money is somehow found for new social investment. The mechanism by which this bargain would be achieved is an extra-legislative budget commission, with extraordinary powers to devise a budget plan that both houses of Congress would have to vote up or down, with very limited debate or power to amend. The practical political problem is that Republicans have been unwilling to embrace any grand bargain that might include new taxes.

Criticisms of the commission idea boil down to two. First, it is an unwarranted end-run around normal legislative procedure. The constitution vests the power of the purse in a democratically elected Congress, not in an elite body that would be insulated from public deliberation and debate. The second objection is substantive. The

commission's sponsors hope that it would recommend caps on social insurance that would never be approved through the normal legislative process.

Senate supporters of the commission hoped to add it to must-pass legislation to increase the national debt. But on January 26 they fell short of the 60 votes needed to vote cloture, by a vote of 53-45, mainly because Republicans were reluctant to be identified with any vehicle that might raise taxes. The Senate Finance Committee Chair, Max Baucus, ordinarily something of a fiscal conservative, resented the jurisdictional encroachment. He declared that the bill's sponsors had "painted a big red bull's-eye on Social Security," adding, "Their commission is a Social Security-cutting machine."<sup>18</sup> Yet President Obama, seeking badges of fiscal prudence, has rescued this idea from the political graveyard, by embracing a presidential version of the same commission idea, along with a short term three-year budget freeze (which affects only discretionary domestic spending, and excludes Social Security, Medicare, national defense, homeland security, and veterans' benefits.)

This presidential strategy seems a blunder, in several respects. First, at a time when unemployment is still above ten percent, the president has placed deficit-reduction ahead of job creation, both symbolically and in his proposed 2011 budget. The anti-recession portions of the program announced in his State of the Union Address are puny. They will provide neither substantive nor symbolic impetus for a strong recovery program for the middle and working class.

Second, the proposed freeze is not convincing even in its own terms. The Wall Street Journal headline for January 29, captured its gimmicky weakness perfectly:  
**BUDGET FREEZE IS PROPOSED**

*White House Plan Applies to Only 17 % of Spending; Small Impact on Deficit.*<sup>19</sup>

Third, by paying lip service to deficit-phobia but not delivering much of substance, President Obama only reinforces the argument of the deficit hawks like Peterson that entitlements are a menace and that an extraordinary remedy such as a deficit commission is needed because politicians are not taking the supposed crisis seriously.

What is desperately required is political leadership pointing out that it is possible to be both fiscally responsible and to adequately finance both the needs of the immediate recovery and long term social investment. But the deficit scare-mongering has become the conventional wisdom to such an extent that many Democrats have embraced it and even a progressive administration feels compelled to give this view some deference.

### **Entitlements and the Debt Crisis**

The Peterson Foundation's central claim of over \$50 billion in unfunded liabilities is arrived at by miscounting apples and oranges. The only true figure for debt—that is, debt on which actual interest is paid by taxpayers—is the public debt held by the public, estimated as of January 12, 2009, according to the Treasury, is \$7,781,352,915,790.80.<sup>20</sup>

The Treasury Department's figure for public debt is about 54 percent of GDP, a far smaller portion of GDP than at any time during the quarter-century after World War II, a period of record economic boom. The rest of the Peterson Foundation's fanciful arithmetic is derived by adding debt that one government agency owes to another (another roughly \$4.5 billion) as well as the projected seventy-five-year deficits for Social Security, Medicare, and Medicaid, using worst-case scenarios. About four-fifth of this projection is Medicare.

The fiscal categories from which these sums are taken are vastly different from one another, and it does a public disservice to lump them together. Each category of “debt” presents its own unique public policy challenge, and each challenge requires a different approach.

**Social Security.** The Social Security program faces a relatively small seventy-five-year budget shortfall, currently estimated by the Congressional Budget Office at 0.49 percent of GDP.<sup>21</sup> 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 income or payouts could return the system to surplus. So the alarmism is wildly exaggerated. Because of changes in the Social Security program in 1983, the lifetime replacement ratio is already declining.<sup>22</sup> If anything, pension policy in the US needs to increase the security of retirement income, not reduce it further.

**Medicare and Medicaid.** The fiscal challenges facing Medicare are another story entirely. 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 slightly 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.

Republicans let the cat out of the bag when Rep. Paul Ryan, a six-term congressman from Wisconsin, proposed a program to convert Medicare into a voucher.<sup>23</sup> Elderly people would get a fixed sum and use it to buy whatever private insurance they could afford. The proposal has divided the Congressional Republican Party. This approach, inevitable in the absence of basic structural reforms to the health system, has huge social-class implications. 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 the Peterson Foundation does not address that topic, it only asserts the need to cap costs.

By the same token, the Obama reform program only partially addresses the deeper sources of long term medical cost inflation. While all societies have had to deal with an aging population and costly advances in medical technology, ours has uniquely high health care costs and a higher than average rate of cost increases mainly because of the commercial domination of our system. That reality, in turn, leads to a seeking of profit centers (which are someone else's cost centers) rather than the most cost-effective use of medical outlays. More than thirty years of private sector solutions, such as the use of HMOs and incentive compensation for physicians has not been able to alter this dynamic. And with the Obama plan reliant mainly on private, for profit insurers, it is not likely that the latest reform proposals will fundamentally alter the cost curve either, except at the expense of care.

The US now spends 17 percent of GDP on health care, and nearly 60 percent of that is already contributed by some level of government. (The official CBO figures place the figure at just over 50 percent, but their computations exclude the employer contribution of federal, state and local contributions to the coverage of public employees and their families.) The average OECD country spends about 9 percent of its GDP on health care and covers everybody.<sup>24</sup> We already spend about 9 percent of GDP socially, but because of the private domination of the system we leave some 50 million people without insurance and cover the remaining 85 percent with great inefficiency. If employer premiums to private insurers were shifted to Medicare-for-all and employers who refused to provide coverage were taxed, we could gain the cost-efficiencies of a single-payer system and cover everyone with out much additional cost to the public fisc except transitionally. And we could restrain Medicare's inflation rate far more effectively than we would by retaining Medicare as an island of single-payer coverage in a sea of fragmented commercial insurance.

**Being Responsible to Our Children.** The Peterson Foundation uses the young as poster children for its storyline. Supposedly, if we do not act, the next generation will suffer lower living standards than their parents. Allegedly, "our" profligacy is condemning our children and grandchildren to debtors' prison. That claim needs a closer look.

First, the living standards of our children are a function of three variables: whether we can get the economy back on a path toward high growth; whether we can provide the social investments necessary so that our children can become productive citizens and workers; and whether social investments are adequate to improve the life chances of children who do not start out with affluent parents. To sacrifice necessary

social outlays on the altar of budget balancing is almost guaranteed to prevent full 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, the financial collapse, and persistent income 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 the consequences of the weight of the public debt in 2030.

Through some sort of alchemy, the Peterson Foundation contends that, if we cut social insurance for retired people, we could increase outlays on the young. But their use of that argument is ironic—for the most part, the opponents of adequate social insurance for the elderly usually oppose increased social investment for the young as well. Compared to other advanced nations, the United States has a very threadbare system of social insurance generally. The need is to extend it to the whole life course, not to take it away from the one group that has fairly decent benefits, the elderly.

As a consequence of the financial collapse—the result of market-fundamentalist policies promoted by Wall Street in the narrow self-interest of financial elites—retired people are now even more heavily dependent on Social Security and Medicare, as 401(k) plans have lost trillions of dollars. Medicare benefits already have been reduced or cost-

shifted to subscribers, and most Americans cannot afford to buy comprehensive supplemental insurance of pay out of pocket. It would be ironic in the extreme if the casualties of Wall Street dominance of public policy served as the pretext for a successful assault on Social Security and Medicare. In effect, the message to middle America is that due to the financial crisis, you have lost wages, retirement savings, and home equity. Now, you must pay again through reduced social insurance benefits and perhaps increased taxes as well. It is astonishing that anyone would think this defensible economics or politics.

**What Do You Mean, “We”?** In an old joke from the 1950s, the Lone Ranger says to his faithful Indian companion, Tonto, “We are surrounded by Indians.” To which Tonto replies, “What do you mean, ‘we’?” The Peterson Foundation is very cavalier in its broad use of the generic “we.” As in, “*we* are leaving our children saddled with debt,” or “*we* are spending too much to subsidize the retirement of the affluent.” Tonto had it right—“What do you mean, ‘we’”?

The fact is that the current generation is not an undifferentiated “we,” nor is the next one. The real dividing line in America is not old versus young but rich versus poor. As the income distribution has become extremely more unequal, some middle aged and older people are fabulously wealthy. Their children will be financially secure, thanks to private inheritances. Others in both generations barely get by, and are dependent on social outlays for minimally decent standards as well as decent life chances. If we slash social insurance, the children and grandchildren of investment bankers will not suffer. But others will.

At bottom, the mission of the budget hawks is an attack on decent social outlay masquerading as a high-minded concern for fiscal balance. But there is more than one road to a responsible budget, and more than one road to an economy of shared prosperity and opportunity.

### **Progressive Sources of Revenue and Outlay**

My contention is that we need at least \$500 billion of additional spending per year in 2010 and 2011. Some of that money should be short term fiscal relief for the states and public works employment. Some of it can be a down payment on permanent, counter-cyclical infrastructure spending. And some can fill in the gaps in our system of social insurance, such as universal pre-kindergarten and the upgrading of all human service jobs so that they pay a living wage. We could also fashion a more comprehensive active labor market policy.

Once recovery comes, much of this short-term stimulus spending should be converted to a permanent increase in public investment, financed mostly by increased revenues rather than deficits. These outlays will make America a more productive society as well as a more just one. This paper is not the place for a comprehensive blueprint of how to complete a very fragmented welfare state, but it can lay out plausible sources of revenue.

With this strategy, revenues would stabilize at about 24 percent of GDP, and outlays would stabilize at about 26 percent. The baseline Obama budget noted in the chart above calls for revenues averaging 19.5 percent of GDP in the second half of this decade. So we need an additional 4.5 percentage points of GDP per year in revenues, or

about \$650 billion in current dollars, beginning in 2012. The exception to the rule that says never to increase taxes in a recession is the increases on top two percent of the income distribution proposed in the Obama budget, which could take effect in 2011. The deficit would still be amply large to provide macro-economic stimulus, while the revenues would be used to finance public outlays that enhance employment and productivity.

Here is a list of possible revenue sources, totaling roughly \$760 billion. I am excluding a value-added tax, as distributively regressive and neither wise nor necessary. At some future time, I would not exclude adding a progressive VAT if its purpose were to underwrite distributively egalitarian social investments. But there are plenty of progressive revenue sources that should be utilized first.

\*Pass a Tobin Tax of 0.25 percent on all financial transactions. The benefits of a tax on financial transactions are multiple. First, the tax discourages very short term purely speculative trading such as speculating in foreign exchange movements, and credit default swaps. This is the province of financial insiders. Long term investment is rewarded. On a long term investment, a transfer tax of a quarter or half a point is hardly felt. But for a trader who makes several hundreds such transactions every day the costs add up. An alternative is to vary the rate, depending on how long the asset is held. The tax could be half a point on very short term trades where the asset is held less than a week, a quarter point on investments held for less than six months, and zero for longer term investments. In addition to promoting real as opposed to speculative investments, a

Tobin Tax could generate serious revenues, virtually all of the money coming from the upper brackets. Revenues: About \$150 billion a year.

\*Enact the Levin-Doggett “Tax-Haven Abuse Act”. Senator Carl Levin’s Permanent Subcommittee on Investigations has conducted extensive hearings the use of offshore tax havens to avoid taxes owed in the US. Among other provisions, the measure would treat foreign corporations managed and controlled in the United States as domestic corporations for income tax purposes, and would close other loopholes that enable various forms of tax evasion using shell companies based offshore. The Treasury estimates that the Levin-Doggett Bill would bring in at least \$100 billion a year and as much as \$130 billion, virtually all of it from tax-evading corporations and very high income individuals using sophisticated gimmicks to book income offshore in havens with no taxes and no tax treaties with the United States. The Government Accountability Office found that 18,857 U.S. companies maintained an office of record in a single building in the Caymans, which in reality has a single occupant, the law firm Maples and Calder.<sup>25</sup> Morgan Stanley has 158 subsidiaries in the Cayman Islands, which are the location of choice for hedge funds. Revenues: At least \$100 billion a year.

\*Close the Bush-era loophole on deferral of foreign source dividend income. US companies pay tax on worldwide income, but they don’t owe tax on income earned through their foreign subsidiaries until it is repatriated. This is called deferral. Obama in the campaign promised to close this loophole when he talked about curbing the tax incentive to shift jobs overseas. Rules dating to 1962 allowed this kind of indefinite deferral of taxes owed only when a subsidiary is based in a foreign jurisdiction with tax

levels comparable to those in the US. But these rules were weakened by regulation in 1997; and in the 2006 the Republicans, in anticipation of the Democratic takeover of Congress, passed a law putting the 1997 loopholes into the tax code. The loophole allows foreign subsidiaries to make payments to one another without triggering US tax. This means that you can pay royalties and interest from France or Germany (high tax countries) to countries such as Ireland (low tax) and escape U.S. taxation entirely. Revenues: About \$50 billion a year.

\*Eliminate the deductibility of interest payments in all corporate mergers and acquisitions. One of the most destructive practices of financial engineers is the use of private equity companies to take over healthy operating companies almost entirely by debt financing. The debt then becomes a burden on the operating company. Typically, the private equity owners pay themselves exorbitant dividends, while squeezing the operating company with layoffs, abandoned pension and health benefits, and offshoring. Hundreds of bankruptcies of viable companies have resulted from these practices. What makes this financial strategy possible is the tax-deductibility of debt financing. Basically, money goes from the Treasury in the pockets of leveraged-buyout artists at so called private equity companies, which in fact seldom contribute net equity—they should be renamed private debt companies. Closing this loophole would end a destructive abuse and produce serious revenue gains. Revenues: about \$50 billion a year.

\*Reduce Tax Expenditures. According to Citizens for Tax Justice, the cost of tax loopholes to the Treasury in 2008 actually exceeded the total cost of direct discretionary

outlays. Direct spending was about \$1.16 trillion, while tax expenditures were over \$1.2 trillion. With the exception of the child tax credit and the earned income tax credit, most tax expenditures are regressive and are typically narrow interest provisions slipped into tax legislation. A serious review of special interest tax loopholes is overdue. Revenues: At least \$100 billion a year.<sup>26</sup>

\*Enact a 5% surtax on incomes of over \$1 million. The top 0.1 percent now earn more money than the bottom 50 percent of Americans. During the Bush years, the wealthiest 400 people in our country saw their wealth increase by \$670 billion. A surtax on incomes over a million dollars was included in the House draft of the health reform bill. But with a health reform closer to a single payer or Medicare-for-All model, the coverage of the uninsured would more than pay for itself over a decade through improved efficiencies and this proposed tax could be used for general revenue. Revenues: \$80 billion a year.

\*Raise the tax on short term capital gains. Until the Reagan era, the rule on capital gains taxes was that short term capital gains were treated as ordinary income, while capital gains on investments held more than six months got a 50 percent reduction in the rate. Over time, the rate on capital gains was steadily reduced, and the favorable treatment for long-term investments was eliminated. The rule that short term capital gains are taxed as ordinary income should be restored. Revenues: \$80 billion a year.

\*Restore higher rates on corporate income taxes. Since the late 1970s, corporate income tax rates have come steadily down. Today, many large corporations use loopholes to

avoid taxation entirely, and the effective tax rate on corporate profits is about 25 percent, or about 300 billion on \$1.2 trillion of annual corporate profits. A slight increase in the rate combined with closing of narrow-interest loopholes could yield \$50 billion a year.

\*Shift tax enforcement targeting in the direction of high-income tax-avoidance partnerships, away from its current emphasis on innocent or technical violations of low income taxpayers who take the earned income tax credit. In the Bush era, enforcement resources were diverted from audits of high-income taxpayers who use complex partnerships to avoid taxes, sometimes illegally. Instead, more audits were done on people who use the EITC. Better targeted tax enforcement could increase revenues by \$100 billion every year.

Total Annual Revenue: At least \$750 billion

### **Progressive Economics as Good Politics**

Every one of these proposed new taxes would fall exclusively on the wealthy, and nearly all of them would fall on the mega-wealthy—people with earnings of over a million dollars a year. So this strategy produces not only extensive new revenues but a viable politics.

It almost goes without saying that a program that combines increased social investment, fiscal soundness, and expanded progressive tax revenue files in the face of both fiscal and political conventional wisdom. Seemingly, a period of economic distress is no time to call for costly new social outlay. But the New Deal experience proves the opposite. And President Obama is in trouble with voters not for attempting too much but for delivering too little. Seemingly, too, ordinary Americans would resist new taxes even on the very wealthy because Americans are said to “identify up.” But the cure for this is also presidential leadership and political organizing. New taxes on the wealthy could be a big political winner if they were combined with real, tangible benefits for the middle and working class--as opposed to the token middle class benefits of the Obama State of the Union address, or the even thinner voter satisfaction of fiscal discipline.

A program such as this requires political imagination and leadership, both from the very top and from a progressive movement at all levels. The virtue of thinking big, and offering new valued benefits to tens of millions of Americans paid for by the super-rich could re-introduce a salutary whiff of social class. And it could demonstrate that progressives have a path to fiscal sustainability that is every bit as sound as the Peterson path, but that ours is more consistent with higher economic growth as well as social decency.

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