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Grow Up, Guys!

By GENE EPSTEIN

While the President and GOP sling mud at each other, the debt crisis is growing. Barron's offers some tough—but necessary—ways to alleviate it.

Deficit denial seems permanently out of season. The ocean of red ink threatening to capsize America's ship of state has generated much talk in Washington and even a little action on Wall Street.

After President Obama's 10-year budget plan, submitted in February, didn't even meet the deficit-cutting targets recommended by his own Bowles-Simpson Commission, the Republicans responded with their own plan. Rep. Paul Ryan, the House Budget Committee chairman, last month proposed ambitious spending cuts totaling $6 trillion over 10 years. Parts of his proposal were specific; others were not.

The president countered in an April 13 speech that effectively repudiated his own budget. Obama proposed $4 trillion in debt reduction over 12 years—6½ years longer than he would be in office, if re-elected—based on tax hikes and spending cuts.

The details of his spending reductions were so vague, however, that even his own Office of Management and Budget hasn't elaborated on the chief executive's new ideas.

Meanwhile, a bipartisan "gang of six" senators is working on yet another proposal, to be a compromise between Obama's and Ryan's proposals. But only a plan as stringent as the Wisconsin Republican's can alleviate the crisis. And even his blueprint probably needs reinforcement, in the form of some Obama-proposed taxes and *Barron's* cuts that would augment Ryan's.

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The Obama solution calls, in part, for higher taxes on the rich.

On Wall Street, Standard & Poor's—the same S&P whose wildly bullish securities ratings helped fuel the 2008 financial debacle—roiled the markets on April 18 by lowering the outlook for U.S. Treasury debt to Negative from Stable. Unfortunately, this time, the firm's judgment looks realistic.

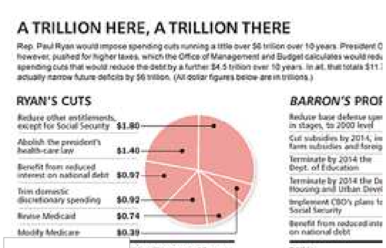
Maybe S&P's credit analysts had just finished reading a chilling "Issue Brief" published last year by the bipartisan Congressional Budget Office called "Federal Debt and the Risk of a Fiscal Crisis." The CBO warned that "a growing level of federal debt would...increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget...." The result: The government would "lose its ability to borrow at affordable rates."

What alarms the CBO is that federal debt is growing faster than nominal gross domestic product. At $10.4 trillion, that debt now equals more than 66% of nominal GDP, up from around 33% in 2000 and higher than it ever has been, except during and immediately following World War II. And the CBO's "baseline projection" has the figure hitting 75% over the next 10 years...and then continuing to climb.

Worse, about 47% of U.S. debt is now held by foreigners, up from 31% in 2000. The mix of foreign ownership has also changed dramatically. China has quickly become America's largest foreign creditor, holding nearly $1.2 trillion worth of U.S. debt, or more than 10% of the total, up from just $60 billion in 2000. And that share is likely to keep rising.

However scary the prospects, not even Ryan proposes actually achieving a balanced budget in 10 years, even though as recently as the late 1990s, balanced budgets were attainable. A radical proposal to achieve a balanced budget, without tax hikes, can be found in "A Plan to Cut Spending and Balance the Federal Budget," by Chris Edwards, the Cato Institute's editor of **DownsizingGovernment.org.**

Barron's used some of his key ideas in crafting a fiscal plan that makes its peace with the "new normal" by permitting deficits to persist. It would allow the debt level to grow, but at a rate no faster than that of nominal GDP. Thus, in 2021, the debt would equal a little over 66% of GDP, as it does now.



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Ryan's plan claims to achieve that objective, also without tax increases. On the tax side, the aim would be to remain revenue-neutral for all income brackets. The congressman would, however, simplify the tax code, making it possible to downsize the Internal Revenue Service (and maybe aiding the private sector by letting individuals and companies fire a lot of tax lawyers and accountants.)

The full burden of debt reduction, then, would be on spending cuts—$6.2 trillion over 10 years. Uncle Sam would still be in the red every year. Ryan's figures show debt as a percentage of GDP continuing to rise for a while. But he sees it slipping back to 66% or so by 2021.

Ryan's plan would be more assured of working if it incorporated aspects of the Obama and *Barron's* proposals. For one thing, it's sometimes short on specifics, raising doubts about whether all the envisioned spending cuts would materialize. One example: $920 billion in savings is supposed to come from cuts in domestic discretionary programs, but what would actually be chopped isn't spelled out.

In addition, Ryan claims that with actual spending cuts over 10 years totaling $5.25 trillion, Washington's interest tab on its borrowings would fall by $970 billion during the same period. But that imposing figure is very sensitive to the cuts' timing. At an assumed interest rate of 4%, a $100 billion reduction in 2012 saves $4 billion annually over the 10 years. But a $100 billion cut saves only half as much, if imposed in 2017.

Ryan's proposals also face one huge hurdle: Implementing all of them might not be politically feasible. True, the reinforcements to his plan that we suggest below, from Obama and from *Barron's*, might suffer similar challenges. But they do add a potential $4.5 trillion in spending cuts (*Barron's*) plus $1 trillion in tax hikes (Obama) to the $6 trillion in spending cuts that Ryan proposes.

If $6 trillion in combined revenue increases and outlay reductions is needed to keep the deficit at two-thirds of GDP, the chances of reaching that goal are greatly bolstered by expanding the menu of choices by several trillion more dollars. And if, by some miracle, all of the proposed remedies were implemented, the country would benefit more.

Following are some of the highlights–or lowlights, depending on your point-of-view–of the Ryan, Obama and *Barron's* proposals.

Ryan's Plan

The House Budget Committee chief's most controversial proposals focus on government-funded medical care.

He'd replace the current **Medicare** system with one under which Washington would issue vouchers (called "premium support payments") that senior citizens would use to buy private insurance on an exchange set up expressly for that purpose. The vouchers' dollar value would be based on the beneficiary's income and health. The richer and the healthier would get less.

Ryan would also change **Medicaid**, the federal/state program that provides health coverage for the poor. He'd convert the federal share of its funding into block grants for the states. The grants' value would be adjusted annually to reflect changes in each state's Medicaid-eligible population and the consumer price index.

Even more controversially, Ryan would effectively repeal the **New Health-Care Bill** signed into law by Obama last year.

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Rep. Paul Ryan has taken aim at spending.

Ironically, the Republican congressman has received plenty of criticism for not being radical enough to reduce the cost of government-funded medical care.

Others have criticized him for being too hard on those least able to afford health care. For example, regarding the block grants for Medicaid, the CBO observed that while "the approach would make Medicaid more predictable from a federal perspective...it would lead to greater uncertainty for states as to whether the federal contribution would be sufficient during periods of economic weakness." The Cato Institute's Chris Edwards counters that the welfare reform bill President Clinton signed into law in 1996 also involved fixed block grants to the states, and gave the states more flexibility in making reforms and cutting costs. With a similar block-grant structure, states would find a way to allocate the money effectively to the poor who need medical aid, Edwards contends. In contrast, under the current Medicaid program, states draw more money from Washington automatically. That practically reverses the incentives.

More to the point, the idea that government-run medical care ultimately helps the disadvantaged is open to question. When government allocates any scarce resource, bureaucracies dominate. Because bureaucracies inflate costs and deflate the value of whatever is produced, the poor suffer. Meanwhile, richer folk use their political clout and savvy to game the system, and their wealth to seek private-sector solutions.

While he acknowledges these problems, Obama's solution, in the grand Washington tradition, has been to—what else?—hire more bureaucrats. Witness his Independent Payment Advisory Board, a 15-member group of experts due to be appointed in 2012 to six-year terms. They will have the power to ration health care for seniors via fiat pricing. As costs continue to rise, such rationing will become even more draconian.

To those who charge that proposals like Ryan's would destroy the health-care system, one answer is that it is already in the process of self-destructing. Perhaps industrial economies have been marching in the wrong direction with the deeply flawed notion that markets cannot deliver medical care to the masses and that government must run things. Food is even more essential to survival, and yet luckily, the world has learned that when government runs the farms, the masses often go hungry.

***Barron's* Proposals**

Probably the most controversial *Barron's* proposal is a $1.6 trillion 10-year cut in **Base Military Spending**—not mentioned in Ryan's proposals–which would reduce it to its inflation-adjusted 2000 level. Just as cuts in government-funded medical care appear to some like victimizing the poor, cuts in military spending appear to others like victimizing the troops.

Few perceptions could be more misleading. Just read the long letter sent last year to Erskine Bowles of Obama's Bowles-Simpson Commission, signed by eight men with military backgrounds, including four retired military officers. An even better start would be to sample the 10 essays by some of the same men in a recently published book called *The Pentagon Labyrinth*.

Both the letter and book paint a portrait of bureaucracy run amok. Like all government agencies and public corporations, the Pentagon is legally required to submit to a yearly audit that connects its spending to its allocations. But in defiance of the law and the Constitution (Article I, Section 9), the Pentagon has never been audited. Therefore, the authors assert in their letter, it "cannot track the money it spends...does not know if it has paid contractors once, twice, or not at all...[and] does not even know how many contractors it has, how many they employ, and what they are doing."

Given the Pentagon's freedom to operate without financial accountability, it keeps requisitioning ever more complex weapons that cost "three to ten times more to buy and operate" than those being replaced. This complexity, the authors argue, actually makes our troops less effective. Its aim is to justify ever-rising bills from the contractors, not give our Army, Navy, Marines and Air Force an edge. The overriding need, then, is for the Pentagon to be audited to find out how it does spend taxpayers' money.

Winslow T. Wheeler of the Center for Defense Information, a nonprofit, nonpartisan research organization in Washington, has suggested the reasonable goal, which *Barron's* favors, of trimming, in phases, base military spending to the 2000 level (adjusted for inflation). Thereafter, he'd let military outlays grow at the rate of inflation. (Base spending doesn't include the allocations for the wars in Afghanistan and Iraq.)

A 2000-level budget would still be much larger than the highest estimates for the combined current military spending of any country or group that realistically could be America's enemy, including China, Russia, Iran, North Korea, Cuba and al Qaeda. Even that calculation assumes that all these forces would be united against America in a future conflict. It also assumes that if, say, China or North Korea threatened military aggression, the countries most directly affected, like South Korea and Japan, wouldn't have sufficient military defenses of their own.

An American soldier stationed in Germany circa 1970 recalls that American tourists, encountering a G.I. in uniform, were surprised. A few thought the U.S. had pulled out of Europe in 1946, after winning World War II. In 1970, there was at least a Soviet threat. Imagine how shocked these folks would be to realize that, with the U.S.S.R. gone, the U.S. is still spending $6.8 billion a year to keep troops in Germany. And a combined $8.2 billion annually to station troops in Japan, Italy and the U.K.

"[T]here is a path," write Wheeler and his colleagues, "that meets the goals of deficit reduction and strengthens real national defense." Following their suggestions would put the country on that path.

If cutting military spending is controversial, it's less so than suggesting curbs on **Social Security**–the "third rail" of American politics, which can inflict political death on any public official who touches it. Maybe that's why Ryan left it virtually alone. The late free-market economist Milton Friedman termed Social Security a regressive tax that falls on the first dollar of wages, combined with a pension plan favoring the better-off. Accordingly, Friedman marveled that it still had the status of a sacred cow.

Friedman wanted to abolish the system and turn it into a minimum guaranteed income plan for the elderly poor, in the form a negative income tax; benefits would decline as income rose. Over the long run, such a radical reform would be a huge cost-saver, although phasing it in would be complicated. As a substitute for this more radical plan, figures provided here combine the CBO's various proposals for reducing the costs of the system over the next 10 years, including one that involves means-testing and raising the eligibility age because people are living longer.

Another sacred cow—no pun intended—is **Farm Subsidies**. It's hard to get any nonfarm state legislator to defend this giveaway with a straight face. But the subsidies still exist, to the annual tune of about $29.5 billion. Eliminate these by 2014, and the savings amounts to nearly $250 billion over the following eight years.

Lots of money also would be saved by terminating the **Department of Education** and the **Department of Housing and Urban Development**.

As Cato's Chris Edwards points out, of all things former President Bush might have been doing on the morning of 9/11, reading a book aloud to school kids in Florida was symbolically the least appropriate. Schooling is not the business of the federal government. The Department of Education, created in 1980, was one of Jimmy Carter's worst ideas, and should have been abolished by Ronald Reagan, who spoke of doing so, but didn't.

As for the Department of Housing and Urban Development, nothing very good comes from government involvement in the housing market. HUD was a major contributor to the housing bubble, which battered the U.S. economy and disproportionately hurt the poor. For background, read *The Housing Boom and Bust*, by economist Thomas Sowell.

Obama's Tax Hikes

The Office of Management and Budget claims that Uncle Sam would raise an additional $1 trillion over 10 years by boosting rates on people in the top two income-tax brackets and by increasing the estate tax. This number also is probably inflated.

There might not be any problem getting salaried people to pay up. But negative effects on the incentives of small and medium-size businesses and venture capitalists might greatly diminish hoped-for revenue. As William Dunkelberg, chief economist of the National Federation of Independent Business, remarks, "Anything you tax, you get less of. Fact of life." Not surprisingly, the NFIB is opposed to the tax hikes. But there is little question that such higher taxes would yield additional revenue at a time when more is needed.

One thing that unites Obama and Ryan is a reluctance to hike taxes on anyone else, especially the middle class. But unless agreement can be reached on cutting federal expenses, higher taxes across the board will be necessary, sooner or later. And in order to avoid a fiscal crisis, better sooner than later.

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