



HPSinsight

THE PATH FORWARD
Political Solutions for the
Economy

21.23	+0.22	18.2801	4.28	-8.00
20.54	+0.22	18.2801	535.34	+9.00
72.20	+0.21	18.2801	21.23	+0.00
2,322.00	+0.12	18.2801	20.34	+0.00
2.96	+0.23	18.2801	72.20	+0.00
21.03	-0.24	18.2801	5,322.00	+3.00
226.27	-0.23	18.2801	3.00	+9.00
226.15	+0.02	18.2801	23.03	+3.00
38.23	+0.24	18.2801	235.27	+7.00
4.83	+0.00	18.2801	925.10	+3.00
46.02	-0.22	18.2801	35.23	+0.00
47.35	-0.26	18.2801	4.23	+0.00
74.22	-0.21	18.2801	46.02	+3.00
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2.86	+0.22	18.2801	74.22	+3.00
212.83	+0.09	18.2801	23.33	+2.00
90.20	-0.25	18.2801	2.46	+0.00
8.21	+0.24	18.2801	332.45	+9.00
122.09	+0.00	18.2801	56.39	+2.00
33.83	+0.22	18.2801	4.21	+3.00
37.92	-0.23	18.2801	152.09	+0.00
23.33	-0.21	18.2801	33.33	+0.00
63.96	+0.26	18.2801	57.92	+2.00
72.12	+0.22	18.2801	23.33	+2.00
655.22	-0.21	18.2801	532.95	+2.00
8,212.30	+0.22	18.2801	73.12	+3.00
1.80	+0.22	18.2801	533.22	+1.00
52.12	+0.09	18.2801	2,212.30	+3.00
63.96	+0.22	18.2801	3.00	+0.00
234.22	+0.22	18.2801	53.12	+9.00
2.22	+0.21	18.2801	65.96	+2.00
26.13	+0.21	18.2801	254.22	+9.00
74.75	+0.22	18.2801		
50.43	+0.10	18.2801		
76.42	+0.23	18.2801		
1120.22	+0.23	18.2801		
25.52	+0.24	18.2801		
925.10	+0.00	18.2801		
18.23	+0.23	18.2801		
8.23	-0.23	18.2801		
46.92	-0.21	18.2801		
42.35	-0.26	18.2801		
78.32	+0.22	18.2801		
180.22	+0.21	18.2801		



Executive Summary

As difficult as it has been to coax the economy back to strong growth, the political solution to both short and long term issues has been even more elusive. In this report, we have tried to diagnose the causes of gridlock and identify a potential path forward. We find:

- Long-term deficit reform focusing on entitlements is the only way to create any appetite for significant near-term actions to boost the economy, beyond those changes that cost nothing.
- Democrats are unwilling to make major changes to entitlement programs without increased taxes on the rich so that the deficit reduction is shared more broadly.
- Republicans are unwilling to entertain higher taxes of any kind because the problem is caused by spending. They view higher taxes as a slippery slope that will not fundamentally fix the problem, will result in more tax hikes in the future, will permanently enlarge government, and ultimately undermine the dynamic character of the American economy.
- Because of these twin concerns, we believe successful negotiations on deficits and entitlements must start by agreeing to a long-term goal for tax revenue as a percentage of GDP, followed by a separate discussion of how that revenue is raised and spent, thus addressing the primary fears of both Democrats and Republicans and narrowing the set of policy choices on entitlements.

Introduction

We are three years into an historic economic slump and no policy out of Washington during that time has successfully addressed the full extent of the problem. Whatever the impact has been (positive or negative) from the extraordinary efforts of the Federal Reserve, the President's stimulus, and various other actions, it is undeniable to say that despite all the good-faith efforts, our economic challenges continue.

This report is the final in a series of three intended to jumpstart a discussion of the economic policy path forward in conjunction with the return of Congress from summer recess, the President's joint address to Congress on the economy and the first meeting of the Joint Select Committee on Deficit Reduction.

In the first report, we worked to outline in a digestible form a view of the major cause of our extended economic slump. In the second report we looked at the major policy choices that exist to address our current problems and the challenges they present. In this final report, we outline a potential political path toward real action on the economy.

This report has been prepared independently by Hamilton Place Strategies with the invaluable efforts of Ashley Smith and Russell Grote. No third party funded this work and our conclusions are our own. The analysis here has been conducted simply to further a public dialogue on the political and economic choices facing the country.

Hamilton Place Strategies



Matt McDonald
Partner

The political dynamics

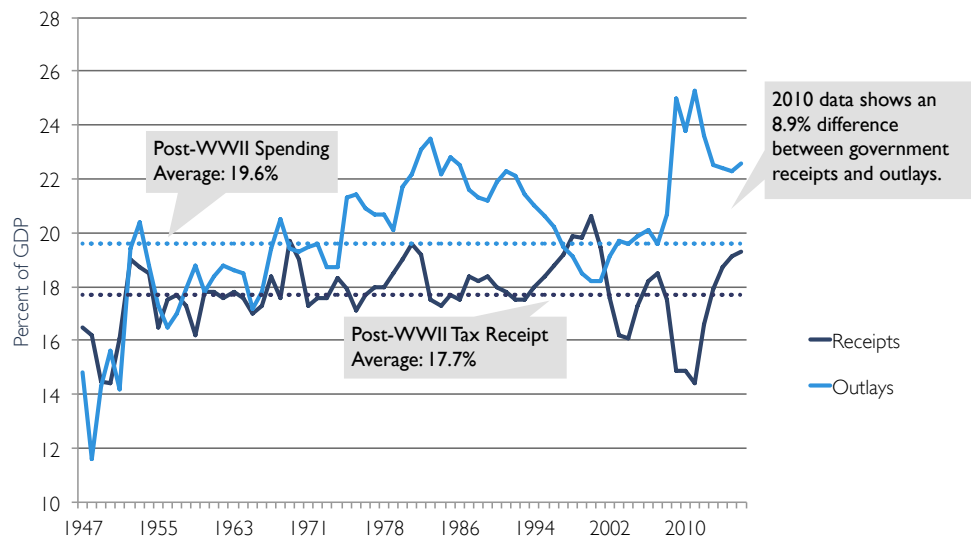
Anyone watching the debt ceiling debate this summer will have a sense of how difficult the political dynamic in Washington has become. In fairness, part of the reason the parties are bickering over the path forward is because the problems we face are huge: massive joblessness and overwhelming long term deficits. But what is the underlying concern of the parties that is driving this dysfunction?

For Democrats, they need a victory in the form of higher taxes on the rich. They lost the battle for higher taxes during the lame duck session and they lost again during the debt ceiling fight. They will be absolutely unwilling to engage in major long-term deficit reform without some form of new revenues. They will not balance the budget “on the back of the poor.”

For Republicans, they see the deficit problems as driven by spending, not a lack of tax revenue. (See Exhibit I) They are unwilling to entertain higher taxes, not because they feel a particular need to protect the rich, but because they see a slippery slope before them that will transform the American economy into something unrecognizable.

Exhibit I

RECENT HISTORY SHOWS GROWING DEFICITS



Note: Graph includes government receipt and outlay forecasts from 2011 to 2016.
Source: Office of Management and Budget

To understand the latter position better, consider the trend of taxation going forward. In President Obama’s April proposal for a grand bargain, he initially suggested a mix of \$3 in cuts for every \$1 in new taxes. If the President’s 3 to 1 ratio were to be extended until the medium-term (2035) budget was balanced,

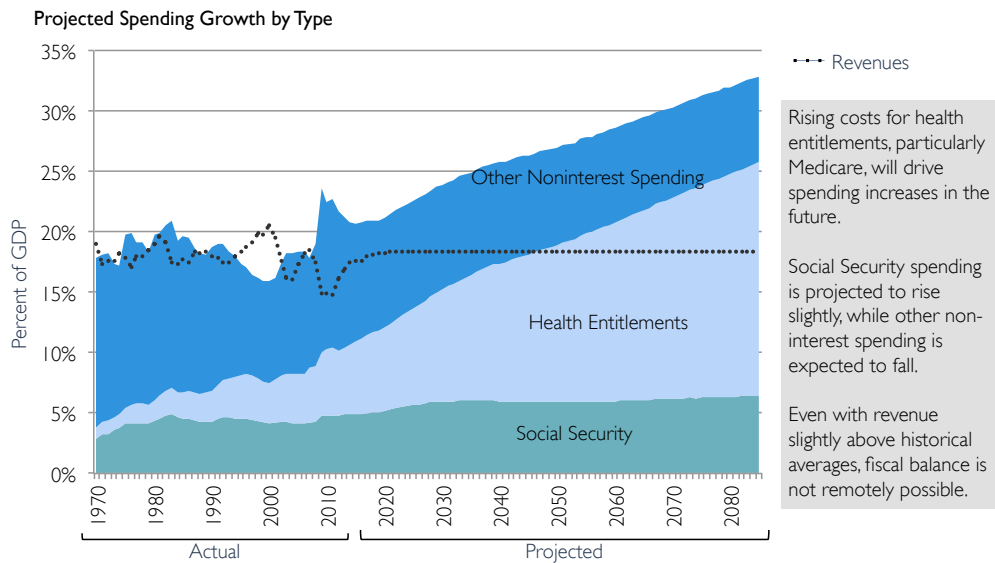
If the President's 3 to 1 ratio were to be extended until the medium-term (2035) budget was balanced, tax revenue would rise to 22 percent of GDP, a level never before seen ...

tax revenue would rise to 22 percent of GDP, a level never before seen, representing a 20 percent increase in taxes (dependent on the timing of the deal).¹ For a \$2 in cuts to \$1 in taxes ratio proposed by the President this week, tax revenue would be above 23 percent of GDP, a 28 percent increase in taxes over the medium-term projection of 18 percent.

It helps to look at history to fully understand the context of these taxation and spending levels. The US has collected an average of 17.7 percent of GDP in tax revenues at the federal level in the Post-WWII era. We have been able to maintain low federal taxes because we have only spent an average of 19.6 percent of GDP in the same period. (This of course does not account for state and local taxation and spending.) However, recently we have run higher federal deficits due to the economic crisis and policies enacted to combat it. More importantly, in the long-term, the Congressional Budget Office expects primary spending (total non-interest spending) to rise above 30 percent of GDP.

Exhibit 2

THE CURRENT LEVEL OF ENTITLEMENT GROWTH IS UNSUSTAINABLE



Source: CBO Long-Term Budget Outlook 2011, Alternative Fiscal Scenario

¹ 20 percent increase from CBO Alternative Fiscal Scenario medium-term projection for revenues of 18.4 percent of GDP.

The driver of this increase is primarily entitlements. Health care costs are expected to quadruple and Social Security will rise from 4.8 percent of GDP to 6.1 percent. Most of the near-term increases are due to an aging population. Ultimately, these large increases in entitlement spending are unsustainable given current revenue projections of 18.4 percent of GDP. (See Exhibit 2)

As described above, piecemeal attempts to address the deficit have failed as Republicans fear the slippery slope of high taxes and Democrats require tax hikes before entitlement reform. Discussions this week of tax hikes for millionaires are the perfect example of this political theater. They ignore the underlying dynamic described above, and are unhelpful to actually achieving an agreement. In this context, Washington has turned to committees such as the Gang of Six and the Bowles-Simpson Commission to break the political impasse with Grand Bargain proposals. The latest has been the Joint Select Committee on Deficit Reduction. To date, these strategies have failed.

Exhibit 3

ANY ACTION IS COMPLICATED BY POLITICAL GRIDLOCK IN WASHINGTON

Democrats

- Resistant to tackling entitlement reform
- Supportive of tax increases, particularly for the wealthiest Americans

Must be willing to look at entitlement reform and understand that tax increases cannot provide the solution.

Republicans

- Open to entitlement reform
- Unwilling to support tax increases across the board,

Must be open to higher overall tax levels, if given safeguards to retain our overall low-tax economic strategy.

Political gridlock in Washington over taxes and entitlements has made it nearly impossible to come to an agreement over how to tackle our debt problem.

Democrats and Republicans need to agree on a *long-term* solution in order to create political space for short-term solutions to the economy.

The Bowles-Simpson plan set revenue caps, but tied them to detailed tax and entitlement reforms that ultimately reduced the plan's popularity and viability. Gutting tax expenditures, legislating more serious entitlement reforms, and addressing the sensitive budget of the Defense Department are politically challenging, as many dueling stakeholders are involved. The political fight over these issues can easily doom reform.

Recommendations for a path forward

Washington needs to agree on how much to spend – then they can have a fight about how to get it and spend it.

Given the political context above, our recommendation is that instead of an ad hoc, piecemeal approach or a Grand Bargain full of specific reforms, Washington should look at reform sequentially. Detach revenue caps from the specific details of spending cuts and entitlement reform. Washington needs to agree on how much to spend – then they can have a fight about how to get it and spend it. By first setting an incrementally higher revenue target in principle and capping it, Democrats would get the short-term victory they need on revenues while Republicans fears of a slippery slope will be assuaged. The result would be a concrete revenue ceiling to guide future discussion over spending cuts, entitlements and tax reform and more political space for short-term action to combat the crisis. An agreement in principle only would ensure that Republicans don't feel they are giving up on taxes before they get concessions on spending reforms.

Without being prescriptive as to the right level, there have been a series of previous revenue cap proposals. The Roadmap for America, Paul Ryan's budget plan, set revenue levels at 19 percent of GDP. The bi-partisan Bowles-Simpson Commission set a cap at 21 percent of GDP. The Progressive Caucus put forth a plan that raised 22.3 percent of revenues. Historically, the most the United States has ever collected in revenues was just over 20 percent of GDP in 2000 during the height of the dot-com bubble. The post-WWII average has been 17.7 percent. Whatever revenue cap is decided, there will be no political gain unless the cap is credible.

A tax law that can be overturned by a simple majority would not alleviate Republican fears because future Congresses could easily raise the cap. Therefore, policymakers should discuss different override rules to ensure the credibility of the cap such as a super majority vote in both chambers, a public referendum and a Constitutional amendment. With a credible cap, policymakers can once again focus on the current economic challenges.

Conclusion

As we reflect on the economic crisis and its aftermath over the past three years, it is striking the amount of policy and regulatory activity that has occurred, and equally striking is its apparent inability to restart strong growth. Consider the host of policies that were implemented during the first two years of the crisis when the President enjoyed supermajorities in both houses of Congress: the stimulus, new housing policies, Dodd-Frank, unemployment extensions, Cash 4 Clunkers, payroll tax cuts, Build America Bonds, hiring tax credits, 1st-time

homebuyer tax credits, Lilly Ledbetter Fair Pay Act, credit card reform, extension of Bush-era tax rates and others, not to mention healthcare reform.

Unfortunately, this raft of new policies has not resulted in sufficient growth, in part because they have done a poor job of addressing the fundamental problems outlined in part one of this report.

It is unclear at this point whether there is political will left in Washington to change direction or if policymakers will be looking to position for the 2012 election and simply run out the clock with hopes of a fresh start (one way or another) in 2013. The President's latest jobs plan is similar to his previous proposals and parts are likely to pass, but unlikely to have the desired impact on the economy.

What progress can be made over the coming year on economic policy remains to be seen. But we must begin to shift the political dynamics as outlined in this report so that after the political season has passed, substantial progress can begin on the long- and short-term issues facing our economy. We cannot afford another three years of slow growth for the U.S. economy.

About Hamilton Place Strategies

Hamilton Place Strategies is a policy and communications consulting firm based in Washington. As a firm, our focus and expertise lie at the intersection of government, business and media. Our deep experiences on all of these dimensions allow us to serve industry leaders seeking to navigate the paths between Washington and the private sector.

HPS works with clients on a host of challenges, from crisis management and reputation building to policy analysis and business strategy. Our support includes outside advisory, as well as transformational work to directly improve client capabilities.

Our collective prior work entails decades of experience at the highest levels of government, business and communications, including work in Congress, the White House, the Office of Management and Budget, the Treasury Department, the Financial Crisis Inquiry Commission, Presidential campaigns as well as management consulting.



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