Grand *Bargain*

Time for a second famous American dinner party.

BY RONALD MCKINNON

The recent spectacle of the two major political parties in the United States being unable to agree on any action that would close the gaping federal fiscal deficit—more than 9 percent of GNP—is both unedifying and bewildering. In past decades, similarly tense political disputes over actual or projected fiscal deficits, if left unresolved, have induced sharp increases in interest rates that have focused the minds of politicians worried about a credit crunch. But now with the Federal Reserve keeping short-term interest rates close to zero, and central banks in emerging markets and the Fed itself buying huge amounts of longer-term U.S. Treasury bonds, interest rates have not risen. This crucial source of market discipline on fiscal behavior has been euthanized.

Setting an artificial deadline to force Congress to raise the limit of $14.5 trillion on the outstanding federal debt or risk being censured by the electorate for severe disruption of federal payment obligations cannot lead to anything better than a short-run palliative. Far better for the two parties to agree on the basic principles of a "grand bargain" on fiscal reform, and then leave enough time for careful consideration of its legislative and administrative implementation.

In 2011, the philosophical differences between the two sides are so great that any successful grand bargain must force each side to give up a cherished belief—but a belief that is damaging the economy and harms the general welfare. There must be blood on the ground, as the more extreme supporters on either side are outraged

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when the bargain is concluded so that the economy can improve.

Perhaps a look back to the late eighteenth century could provide impetus for such a grand bargain. After the Revolutionary War, in 1790 the fledgling U.S. government also faced paralyzing gridlock between two major protagonists over a huge, seemingly unsustainable, debt problem that threatened the future creditworthiness of the new republic. During the war, the taxing ability of most of the individual states eroded. But to support George Washington's Continental Army and cover ordinary government expenditures, many states, particularly in the North, borrowed by issuing paper notes. By 1790, most of these notes were threatened by default. Speculators had purchased many from their original owners, such as war veterans, at steep discounts. To establish confidence in the nation's near-moribund financial markets, the first Secretary of the Treasury, Alexander Hamilton, proposed a one-time assumption of the state debts by the new federal government.

However, unlike their less provident northern neighbors, the Southern states, notably Virginia and Georgia, were not threatened with debt default and opposed federal assumption. Their residents were also concerned that federal purchases of discounted state debts at 100 cents on the dollar, as Hamilton proposed, would unjustly enrich the speculators. Thus, early in 1790, the first Congress failed to pass Hamilton's assumption bill—to the detriment of the country's national and foreign credit standing.

More or less accidentally on June 20, 1790, Thomas Jefferson met a very despondent and haggard-looking Hamilton, whom he invited to dinner the next day. This invitation was later extended to a few other notables such as James Madison. The result was the most famous dinner party in American history. The deadlock was miraculously resolved by each side relenting and giving up long-held positions to satisfy the other. The now familiar outcome was that Jefferson, with Madison not opposing, agreed to the federal government's one-time assumption of the states' debts (largely the result of the common war effort); while Hamilton, along with other Northerners, agreed to move the capital of the new Republic to the banks of the Potomac in ten years' time. (In the interim, the capital was to be in Philadelphia, where Congress had been lodged.)

When news of the deal broke, both sides were outraged. New Yorkers, whom Hamilton was supposed to be representing, were particularly upset because the new capital was not in the nation's commercial capital. Rural folk everywhere, including gentlemen farmers in Virginia and Georgia, were outraged by what they saw as a sellout to the moneyed interests of "Wall Street." Nevertheless, the Assumption Bill passed later in 1790, and resulted in an immediate tonic for the ailing economy and public credit.

Under Hamilton's follow-up measures, a market for U.S. Treasury bonds was created to provide federal funds for the assumption, while new sources of tax revenue from the customs (tariffs) and excises (whiskey) were set up to service the interest costs on newly issued U.S. Treasury bonds. The First Bank of the United States (another Hamilton creation) required the new owners to use U.S. Treasury bonds for paid-in capital; and, starting in Philadelphia in December 1791, began branching into several states for accepting deposits and making short-term loans, largely for commercial credit. Thus did the assumption deal not only save the Union but also buoyed the financial system and the national economy.

Without a modern-day Alexander Hamilton, would such a deal for resolving today's political impasse and debt overhang be possible? What major reciprocal sacrifices could be made that would resolve the political deadlock and greatly benefit the economy? Suppose Barack Obama threw a dinner party and invited a few key principals from each side. What should be on the menu?

Unfortunately, none of the Democratic or Republican plans put forward so far—some in great haste before the approaching deadline—have addressed two crucial problems. These could be the basis for a grand political bargain in the Hamilton-Jefferson tradition.

The first omission is the U.S. trade deficit, currently 4.4 percent of GDP, which is linked both to high fiscal deficits and to very low personal saving rates. Since 1971, the Congressional Budget Office has shown that tax revenues have averaged about 18 percent of GDP, while expenditures are about 21 percent. But from 2009 to 2011, expenditures have surged to nearly 24 percent, and the CBO projects that under current laws, they will stay at 24 percent

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until 2021. With tax revenues at 18 percent, this longstanding gap between revenue and expenditures would be filled, as it has been, by borrowing from foreigners. The result is continuing trade deficits of 4 percent to 5 percent of GDP.

Does this continued huge buildup of indebtedness to foreigners matter? Alone among debtor countries, the United States can borrow internationally in its own currency—if only because most of world is on the international dollar standard. However, at some point the huge debt overhang will undermine confidence in the dollar with the risk of a debilitating credit crunch as foreigners stop lending to the United States. Although often predicted, it hasn't happened yet.

Dollar crash aside, a more immediate ongoing consequence of the continued U.S. trade (saving) deficit is further deindustrialization. The high-saving newly industrializing economies of East Asia run trade surpluses in manufactures to effect their saving transfer to the saving-deficient United States. Thus, job losses in U.S. manufacturing are accentuated by U.S. fiscal deficits—and President Obama's vow to double U.S. exports in five years is undermined.

The second omission is the declining international competitiveness of the American economy from the supply side. While having many facets, the most visible is the exploding costs of private medical care paid by employers and employees, while making public programs such Medicare and Medicaid unsustainable. Since 1985, enrollee costs in Medicare have been rising 1.7 percentage points faster than per capita GDP and recent enrollment in Medicaid has been exploding. The President's Patient Protection and Affordable Care Act of 2010 could accentuate these trends. Together with Social Security, which is more easily fixed by raising the retirement age, costs of these three programs are growing so fast that, under present laws, they will eventually fully exhaust traditional tax revenue of 18 percent of GDP—leaving no room for other tax-financed government expenditures!

Burdensome litigation differentiates the American economy from its more nimble international competitors in East Asia and even Europe—particularly Germany. Spending on legal services grew from just 0.4 percent of America's GDP in 1978 to 1.8 percent in 2003, before slowing in the economic downturn after 2006. In the United States, litigants find it far too easy to file suit for any number of reasons—whether against new industrial development including mining and mineral extraction, labor market discrimination, or medical malpractice—without having to cover the social costs from filing the suit. In particular, healthcare is significantly affected by the high costs of medical malpractice insurance—which further induces redundant but expensive "defensive" medicine to avoid such suits. The threat of litigation hampers the existence of low-cost public clinics for keeping the poor out of hospital emergency rooms.

So we have massive political gridlock. On the one hand, Republicans are unwilling to consider any measures that raise tax revenue—let alone moving the federal government tax take from 18 percent to, say, the 23 percent of GDP necessary to eliminate the trade deficit. In their eyes, even income tax reforms that are narrowly conceived to plug loopholes must be "revenue neutral" and offset by reduced tax rates.

On the other hand, Democrats are in thrall to trial lawyers, who collectively are big contributors in terms of money and personnel to their political war chests. Early on in the debate on health care, President Obama made a modest proposal that medical malpractice awards be capped to better reflect actual damages, but that was shot down by his own supporters. Currently, his own Patient Protection and Affordable Care Act contains no constraints on "excessive" litigation.

So for our twenty-first-century dinner party to resolve the political deadlock, we have the outline of major—but reciprocal—political sacrifices that would also greatly benefit the economy.

First, the Republicans must recognize that their stand on no new net taxes has become ridiculous. U.S. tax revenue as share of GDP is less than that of the other industrial countries, all of which have much less onerous defense establishments, and that of many emerging markets. (One of China's little-heralded but great strengths were tax reforms in 1994–95 that eventually enabled the share of revenue in GDP to rise from 11 percent in 1995 to 21 percent in 2011.)

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The Republican anti-tax establishment is right to decry very high marginal income tax rates that damage work incentives and typically raise little if any net revenue. Instead, the Republicans and Democrats together should embrace "flat" but moderate rates of income taxes that eliminate exemptions and do raise revenue. Also on the table could be some form of broad-based value-added tax that reaches all consumption (no exemptions) in the economy. Without causing indigestion, the dinner guests could pledge to raise tax revenue to some nice clean number, such as 23 percent of GDP.

But any such pledge to raise tax revenues must be accompanied by specific constraints on all major government spending programs—including healthcare. The tax increase must be a vehicle for pure deficit reduction and not one for funding new government spending. Only then could the participants be assured that the trade deficit would eventually fall in tandem with the fiscal deficit.

What sacrificial lamb could the Democrats possibly offer sufficient to nudge the Republicans to accept the principle that tax revenues should rise to 23 percent of GDP without parallel increases in expenditures? General tort reform that dramatically reduces the volume and scope for litigation over most segments of American economic and political life, but particularly in the area of medical malpractice, would certainly get their attention. The relationship between federal and state laws is complex and has to be rationalized. But acceptance of general principles of tort reform would be more straightforward:

- A strong form of the English rule (which prevails in most other countries) where a losing plaintiff pays the full costs of defending against the suit, covering people suing each other, or suing hospitals or schools, or governments suing people, or firms suing employees or each other, and so on.
- No joint and several liability, so that litigants can't single out marginal defenders with deep pockets.
- No punitive damage awards beyond actual damages to the plaintiff.
- As is common elsewhere, no juries for civil cases, such as medical malpractice.

Such a radical restructuring of the U.S. legal system would take many years, and might require a modern-day Alexander Hamilton to shepherd it through. (Hamilton himself was an excellent lawyer in helping to establish important principles in American law.) But at President Obama's dinner party, a good-faith agreement on the principles of legal reform to match the agreement on tax reforms *cum* expenditure constraints is devoutly to be wished—even though the details would have to be worked out subsequently. Then the United States could again become a robust international competitor without neither a saving deficiency nor a trade deficit. ◆