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COMMENTARY

The Great Entitlement Raid

Amitai Etzioni

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Abstract To bail out the banks, and more generally Wall Street, and as a result of their profiteering, the nation faces a great deficit. It is premature to deal with it, but when the time comes, it should not be closed by scaling back social programs and entitlements. Such a way to deal with the deficit would in effect amount to a two-step major wealth transfer from the most vulnerable Americans to the most endowed. (First the funds were given to Wall Street; next they will be taken from the poor and working-class Americans, to cover the shortfalls). There are other sources for reducing government expenditures and for new revenues.

Keywords Banks · Bailout · Deficits · Social spending

In January 1981, shortly after I left my post in the Carter White House following Reagan's victory, I was invited to a White House staff meeting. It seemed that the new administration had not deleted my name from the invitee list. During the meeting, Murray Weidenbaum, soon to become Chairman of the President's Council of Economic Advisors, stated that the new administration would generate such a deficit that if the Democrats ever made it back into office, they would be unable to spend much on their favorite social programs. This turned out to be far from an idle threat or wishful thinking. While berating the Democrats about their propensity to spend and cause deficits—a major theme of the Reagan election campaign and administration—Reagan created a huge deficit. When Clinton came to the White House, he took the call to curb deficits to heart, capped social programs for 5 years, and turned the GOP-Reagan deficit into a surplus. George W. Bush followed, and true to the GOP-Reagan form, he too shed crocodile tears about deficits—but not only spent the Clinton surplus, he also increased the deficit even more than Reagan did, leaving in his wake a 1.4 trillion dollar deficit (Congressional Budget Office, "Historical Budget Data," http://www.cbo.gov/ftpdocs/108xx/doc10871/AppendixF.shtml#1096834).

I naively thought that President Obama, facing the same criticisms from the right, the same attempt to use the deficit as a political tool to gut social spending—especially uncalled for during a deep and lasting recession—would heed the lesson of his Democratic predecessors. I expected Obama to be against deficits in principle, but not to allow such proclamations to stand in the way of whatever must be done. Instead, Obama capped social outlays by instituting a freeze on discretionary spending, which includes funding for the Departments of Education, Justice, Interior, Commerce, Agriculture, and the Environmental Protection Agency. In addition, Obama set up a commission that is to recommend other measures to cut the deficit, which swelled largely because deregulation during the previous administration left the US in a financial meltdown. If it was not for the costs of the bailouts and stimulus, the losses of revenue due to lower economic activity, and increases in outlay for unemployment—all caused by the Great Recession—the United States deficit would be rather small, as measured by percent of GDP (the proper way to assess such deficits).

Given that the GOP is adamantly against raising taxes in any way or form and that the Democrats fear being tagged as big spenders, and given Obama's strong propensity to compromise in order to find a middle ground—often far from the middle in practice—I predict that the National Commission on Fiscal Responsibility and Reform will come up with suggestions that, in effect, will call for major cuts in social programs—above all, in Medicaid and Medicare, as well as in Social Security benefits—and rather minor tax increases, possibly in the form of a rather regressive VAT. Moreover, the implementation of these policies, when combined with measures that are already in

A. Etzioni (✉)
The George Washington University,
1922 F St. NW, Room 413,
Washington, DC 20052, USA
e-mail: etzioni@gwu.edu

place, I will show shortly, will lead to a huge wealth transfer from the more vulnerable Americans to the most affluent ones, a very sad legacy for a Democratic administration and President Obama. Moreover, these moves will not protect Democrats from GOP attacks. However much the deficit is reduced, the Republicans will insist that it is too large and that more cuts in social programs are needed.

How Bad Are Deficits and When?

Before I point to the great wealth transfer and to alternative ways to curb deficit—a word about the detrimental effects of this notorious economic malaise. Few nonpartisan economists doubt that what we now need (as these lines are written in February 2010) is a greater deficit. Increased public spending is needed to help ensure that the economy—whose recovery so far is weak and fragile—will be sustained. More robust growth is required so that millions of unemployed people can find work (a moral commitment which has many economic benefits for all). Note that the statistic cited by the media, that one in ten Americans is out of work, vastly understates the problem, as this figure counts only those who actively seek work. Estimates suggest that at least another 7% of Americans are unemployed but have stopped looking for work, and others work significantly fewer hours than they need to make ends meet. Almost one out of every five Americans is unemployed or underemployed, and most have families who share their economic and psychological suffering. Given that when people are out of work, they purchase little and find it difficult to keep paying off their loans and mortgages, it is easy to see how their condition affects all the other parts of the economy. For the same reasons, returning them to work is not only the right thing to do, but the best way to restore the economy to good health, rather than, say, improving the take-home of shareholders, bankers, and executives, who spend only small parts of their income and invest much of the rest overseas. Also, few doubt that the best way to reduce the deficit is to return the economy to a higher growth pathway. Curbs on spending now are sure to undermine the economic recovery; so is voting against major jobs bills because of the fear of swelling the deficit.

Indeed, at this stage of economic recovery, mere discussions by policymakers of what must be done to lower the deficit scare investors and businesses. This was highlighted when the Federal Reserve raised its discount rate in February 2010 for the first time since the start of the Great Recession, leading to a worldwide panic by investors. (Despite the fact that raising the discount rate from its extraordinarily low level had few objective consequences, it was viewed as the first sign that the Fed was beginning to be more concerned with inflation than deflation, more with deficits than with growth.) Note that what needs to be done when we are ready to tackle the deficit is not a big mystery and requires no lengthy preparation, as far as the Fed is concerned. In short, there is no need to focus on deficit reduction now, when more stimulus is needed.

A progressive colleague, well aware of the case I just laid out, argued that while all this is true, the problem Democrats face is that it is difficult to sell the American public on the Keynesian notion that the deficit is good at present, but will become bad in the future. I wonder: Can Americans not understand that in the winter you do not turn on your air conditioning to further cool things down, but you realize that you are sure to need it when things heat up in the summer to follow?

I should add that the precept that a given level of deficit is acceptable, while another is tolerable, and some other specific level is detrimental, is far from proven. George Soros has been predicting that the sky will fall because of the level of our deficit and debt since 1984. Pete Peterson has been claiming for decades that we must cut our social benefits or the deficit will kill us. But it was Wall Street that caused the economic nosedive, not Social Security or even Medicare. Moreover, the true economic impact of budget deficits is not fully understood. "The conventional wisdom is that a large budget deficit is a source of economic instability. Empirical research, however, does not conclusively support this conventional wisdom; results are mixed and controversial across countries, data and methodologies," according to Yaya Keho, writing for the *European Journal of Economics, Finance, and Administrative Sciences.* In late 2009, Japan's GDP rose at an annual rate of 4.8%, despite a record budget deficit of 8% of GDP.

Also, the international economic situation affects which levels of deficit and debt are problematic—and when. For instance, the ability of the governments of Greece, Spain, Italy—and possibly even the United Kingdom—to finance their deficits became endangered in 2010. Oddly, as a result of the EU crisis, the United States find itself in a much better position for the near future. The notion that the euro may replace the dollar as the global currency, and that nations that finance our debt will sell their US treasuries and purchase instead EU bonds, is so yesterday. The dollar—and U.S. treasuries—maintain their status as the international haven (other than for the nutty gold bugs), and hence, the United States is unlikely to have difficulties financing its debt for the next years. In short, the preoccupation with the deficit now is ill-timed, premature, and damaging.

Lessons from Game Theory

Game theory has long studied the situations in which one intransigent, ideologically-determined party acting irratio-

nally faces another that acts reasonably and responsibly. In such conflicts, the first party takes the second party to the cleaners. The correct posture for the second party in such circumstances is to act equally adamantly, until the intransigent party sees that its posture no longer pays and it is willing to sit down and have a reasonable give-and-take. Currently, we face a GOP that is acting in a very ideological and unreasonable manner. This posture is struck not just by the Tea Party and those who seek to incur its favor, but by most of the GOP leaders and Congress members. Thus, the GOP claims that however terrible the deficit is (in its eyes), it will not support any tax increases and demands instead cuts in social spending. If all its various demands are met, GOP Congressional leaders hint, they may, possibly, support a VAT. This position is further amplified by conservative think tanks such as the American Enterprise Institute and the Heritage Foundation, and promoted by the billionaire Pete Peterson and diehard ideologues such as David Walker, the editorial pages of the *Wall Street Journal*, the *National Review*, and conservative TV and radio hosts, all of whom have next to no liberal counterparts!

In contrast, we find on the Democratic side not just many deficit hawks and anti-tax zealots, but also leading and renowned economists, such as Alice Rivlin (Director of the Office of Management and Budget under Clinton and a Senior Fellow at Brookings), Robert D. Reischauer (former Director of the Congressional Budget Office and President of the Urban Institute), and Isabel Sawhill (former Associate Director of the OMB under Clinton and a Senior Fellow at Brookings), who argue that we must curtail benefits, including Medicare, Medicaid, and even Social Security. All three have considerable influence in Democratic circles and on the hill. Furthermore, Rivlin is a member of the president's deficit commission. These are the reasons I predict that when Democrats and Republicans meet in the president's commission, with the blessed exception of Andy Stern and maybe one or two others, they will tilt heavily toward recommending major cuts in social expenditures and will not have the majority needed to recommend raising taxes significantly. Instead, the Democrats should start the give-and-take with some strong claims of their own. I cannot stress enough that the suggested moves below are both justified in their own right and would lead to a more just and balanced policy mix.

First of all, Democrats should declare from the get-go that while President Obama announced that "everything" was on the table, from their viewpoint, means testing Medicare and using private retirement accounts to replace all or even part of Social Security are off the table. Many progressives have ambivalent feelings about these two major social programs, in part because they tilt national spending toward senior citizens instead of channeling more resources to children, and in part because they believe that Social Security will go bust before young Americans will live to collect. However, Democrats should recall that both programs, while they have the structure of universal programs—they tax all and pay to all—include important wealth transfer elements. Thus, large families (usually of poorer class or minorities) collect more social security than smaller ones, but pay less into it. Medicare covers 45 million elderly or disabled Americans, half of whom live at or below 200% of the federal poverty line. Social Security is credited with lifting 11.4 million elderly Americans out of poverty, more than all the other government anti-poverty programs together. Medicare helped reduce the poverty rate among the elderly from 33% to 14%. Furthermore, means testing is a sure way to destroy the political support for these programs, as those with the most political clout will not collect benefits and hence will oppose paying for them. Private Social Security accounts will siphon off a good part of their yield to Wall Street. (529 college savings plans provide an example of this type of loss. Many 529 plans are conducted through brokers, who take up to 5.75% of investments as commissions, in addition to charging hidden fees.) If Social Security is to invest in stocks, it should be done on a collective level by the Social Security Administration, not by individuals.

One can find savings in Medicare; for instance, by allowing it to negotiate drug prices. The National Committee to Preserve Social Security and Medicare reports that, "Allowing the Secretary [of HHS] to negotiate drug prices has the potential to save…up to $24 billion annually." Savings can also be found by cutting payments to Medicare Advantage—a program that subsidizes private health care plans, profiting insurance companies while doing little to improve care or coverage—by $123–156 billion over 10 years. Greater savings can be made by capitation instead of paying for each procedure, and, above all, by reimbursing only for services that have been proven safe and effective. Social Security can be made whole by relatively minor adjustments in its makeup.

Sizable pots of money can be found elsewhere. I list next just a few to illustrate the approach, rather than attempt to flesh it out here. One proposed cap-and-trade system has been estimated to generate as much as $1.9 trillion in revenue between 2012 and 2019. An alternative—an emissions tax of $10 per ton of carbon content could generate $50 billion a year. Eliminating subsidies could save as much as $200 billion over 10 years. (The Obama budget proposal only saves $2.5 billion over 10 years.) Thomas Hazlett, former chief economist of the FCC, has calculated the government could make at least $100 billion by auctioning off frequencies of the radio spectrum.

Another place one can find billions of dollars is the commitment we made to spend funds on Afghanistan. We

have already spent $299 billion on the war there, and estimates project that costs will rise to over $1 trillion. If instead we note that less than 100 Al Qaeda members are left in Afghanistan, and the Taliban seem willing to agree to not harbor them if we let them be, we can deal with the remaining Afghan terrorists the way we deal with those in Yemen and Somalia, without almost one hundred thousand boots on the ground and the often-overlooked similar number of private contractors. (This is what Vice President Biden suggested, although he was overruled. This position should be reconsidered.) Those keen to "reconstruct" Afghanistan should note that we have not found a way to prevent most of the funds we provide from ending up in the Dubai bank accounts of corrupt Afghan leaders and drug dealers.

The Pentagon budget could generate substantial savings. Canceling the production of redundant or unnecessary ships and planes, including DDG-1000 destroyers, SSN-744 Virginia Class submarines, F-35 Joint Strike Fighters, V-22 Ospreys, and C-17 cargo planes would save a combined $18.6 billion. And reducing our nuclear arsenal, following an agreement with Russia to instate the same cut, would save $13 billion.

Another sizable contribution to reducing the deficit can be collected from windfall profit taxes on the banks, as they are recovering from the crisis they brought on themselves. The banks have been bailed out by the Fed, which allowed them to take out loans with no or very little interest (0.25%) and loan the funds out at prevailing rates. While the total amount of the loans is difficult to estimate, at one point there were $110.7 billion in such loans on the Federal Reserve balance sheet. The reason, we are told, that these low interest loans had to be made is that the banks' financial assets were dangerously low and if we did not shore them up, the banks would be unable to make loans essential for the functioning of the economy. There were other ways this could have been achieved. For instance, I suggested on September 23, 2008, that each household be issued a coupon by the government that could be cashed in only to pay off a mortgage. These coupons could be traded so that those households with no mortgages could sell them to others. All these funds would also have ended up in the banks, and shored them up, in the process reducing the toxic assets and easing the burdens on homeowners and other Americans. (To make the coupons more progressive, they should be considered taxable income.) Another approach, suggested by Joseph Stiglitz, was for the government to make low-interest loans to homeowners struggling with mortgage payments instead of to banks. However, this is water under the bridge that cannot be recaptured. However, as the banks return to good health, the public can retrieve parts of the huge handout given to them by taxing the effortless windfall profits they made as a result of the federal, practically interest-free, loans just the way we imposed such a tax on oil companies after OPEC suddenly raised the price of oil and American corporate income rose drastically without any new expenses. (The tax was projected to generate $393 billion in revenue, which in today's dollars would amount to $720 billion.) Even if none of these sources of revenue is part of the final deficit reduction measures to be employed when the time comes, raising them would provide some counter-moves to the GOP's opening position of taking it mostly out of social spending.

Also, rather than using the president's commission to help Obama walk away from his pre-election commitment to raise taxes only on those who earn $250,000 or more, the Democratic Party should be at least as adamant about this position as the GOP is about exempting billionaires from the estate tax.

Only a heartless cynic would advocate cutting the funds that keep millions of elderly Americans who have worked all their lives out of poverty and that provide health insurance to the poor, the old, and the disabled, and transferring them to banks that shell out billions in bonuses to some of the richest Americans. But this is, in effect, where we are headed in a two-step process that makes the huge wealth transfer from the most vulnerable members of society to the elites much less visible. We first granted trillions to the financial institutions because otherwise the whole economy might have collapsed as it did during the Great Depression. We are now moving toward dealing with the resulting deficit by taking the needed funds largely out of social spending and entitlement programs. However, there are ways to reduce the deficit—when the time is right—and recapture some of the funds given to the financial sector, once it is functioning again. And there are still other ways to shore up the social programs and cut the benefits monopolized by the rich.

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Amitai Etzioni is a University Professor at The George Washington University. He is the author most recently of *New Common Ground*. In 2009, he was awarded the Meister Eckhart Prize, previously award to Amartya Sen, Claude Levi-Strauss, and Richard Rorty. He served as the president of the American Sociological Association.