Obama's Central Drama

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Faced with a collapsing banking system and worsening recession, the United States has embarked on a 'borrow and spend' binge of mind-boggling proportions. That may seem ironic, considering that living beyond our means is what got us into this mess in the first place. Nonetheless, President Obama probably has no alternative than to prescribe a 'hair of the dog that bit you' for America's prostrate economy.

That, however, is only the first act of what is likely to be the central drama of the Obama presidency. The second – assuring the nation's long-term fiscal stability – will be just as important, but a much tougher sell politically. That's because it entails reform of America's biggest and most popular social insurance systems: Social Security and Medicare.

The numbers are stratospheric. Even before counting Obama's $787 billion stimulus plan, this year's budget deficit is projected at $1.3 trillion. That is more than 9 percent of GDP, the biggest peacetime deficit ever. In all, the gap between federal income and spending could reach $2 trillion for the year, atop the $10 trillion national debt Obama inherited from his profligate predecessor.

These record-shattering deficits also compound America's long-term fiscal crisis. The United States is a rapidly aging society in which health care costs have been growing faster than the economy for three decades. With roughly 4 million baby boomers reaching the legal retirement age each year, the costs of America's big entitlement programs, Social Security, Medicare and Medicaid, are fast becoming unsustainable. According to government actuaries, Social Security and Medicare are underfunded to the tune of over $40 trillion.

This massive overhang of public debt clouds U.S. economic prospects, both now and in the future. Financing it means imposing a stringent austerity regime on Americans or, more likely, borrowing even more heavily from others, especially the Chinese, who already hold $600 billion in U.S. Treasury bills. The flood of foreign loans, coupled with today's near-zero interest rates, could lead to new asset bubbles, setting the stage for future financial panics. Our overseas bankers might lose confidence in America's fiscal stability and start dumping dollars. The

Federal Reserve might raise interest rates, at the risk of delaying economic recovery, or simply let inflation whittle away at our mountainous debts. In short, it will be painful to put the United States on a sustainable fiscal course, but the alternatives are worse.

For President Obama, it all adds up to a decidedly mixed economic message. First, he's asking the public to back an unprecedented fiscal surge to bail out homeowners and banks, and to keep the recession from turning into a depression. At the same time, he needs to spell out a fiscal 'exit strategy' – a plan to pivot sharply from prodigality to restraint once the economy starts growing again.

And in fact, Obama has taken an increasingly tough line on fiscal discipline since his inaugural just a month ago. 'We cannot and will not sustain deficits like these without end. Contrary to the prevailing wisdom in Washington these past few years, we cannot simply spend as we please and defer the consequences to the next budget, the next administration or the next generation,' he declared at last week's 'fiscal responsibility summit' at the White House.

A few days later, Obama unveiled his first budget, which promises to cut the federal deficit in half over the next four years. The administration proposes to phase out the Bush tax cuts for wealthy people, raise taxes on businesses and cut spending on the wars in Iraq and Afghanistan.

That's a start, but will it be enough to get spiralling deficits under control? With the situation in Afghanistan deteriorating rapidly, it may prove harder to wind down war spending than White House budgeteers hope. And while Democrats love the idea of killing Bush's tax cuts and reaping a peace dividend, they are going to have to sacrifice too to put the nation's fiscal house in order.

A bipartisan group of Washington fiscal hawks (which includes me) has urged the president to go farther, by adopting strict budget caps and 'paygo' rules that require that any spending increase be offset by cuts or tax hikes elsewhere. These action-forcing devices would not kick in until the economy starts growing.

In addition to federal spending, America's Swiss cheese tax code also needs a thorough scrubbing. The Progressive Policy Institute has called for a military base-closing style commission to cut or reduce $900 billion in federal tax 'expenditures' – otherwise known as corporate welfare.

This still leaves the long-term crisis. To his credit, Obama has declared himself 'willing to spend political capital' to reform Medicare, Medicaid and Social Security. What that means in practice, however, is vague.

At the summit, White House budget chief Peter Orszag argued that slowing the growth rate of health care costs is the key to long-term fiscal stability. 'Health care reform is entitlement reform,' he declared. A more efficient health care system is desirable for all sorts of reasons, but U.S. policy makers are a long way from consensus on how to break the back of medical inflation.

Health care reform, however, is not Social Security reform. Social Security's funding gap is relatively modest ('only' about $4.3 trillion). It's easier to fix, but too many progressives are either in denial about the need to fix it, or have rejected any fixes that restrain future benefit growth. Any plausible political deal for ensuring Social Security's solvency, however, will have to combine tax and spending changes.

Obama hasn't yet specified how he'll modernise the big entitlements. But stay tuned: that debate is likely to be the main event of his presidency.

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