Insight

Reform Entitlements or Go Home

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Despite the hand-wringing by the usual tut-tutting journalists and administration friends (but I repeat myself), there's about as much chance that the U.S. will default on its bonds as there is of Columbo remaining stumped at the end of an episode.

No one on Wall Street thinks that U.S. bondholders will be forced to take a haircut in the near term, and that's all that really matters to the market — hence its collective yawn at the impasse in negotiations. Even if the credit rating agencies did downgrade our bonds, it would have as much impact on markets as the U.S. News and World Report leaving Harvard off its list of top schools would have on Harvard's enrollment.

The real question should be whether the ultimate agreement will produce meaningful reductions in entitlements, and it looks like this may not happen. While House Speaker John Boehner's plan calls for a commission to propose reforms to Social Security, Medicare and Medicaid that would be used to pay for the second installment of the debt limit increase in early 2012, Senate Majority Leader Harry Reid has stated emphatically that he and his Democratic colleagues could not countenance changes to these programs.

Ultimately, any debt-reduction deal that doesn't involve some kind of commitment to controlling the growth of entitlements is useless, if not completely fraudulent. Discretionary spending caps can be broken by subsequent Congresses and most likely will be. There are plenty of tax expenditures that deserve to be killed, but killing them outside of the context of major tax reform will decrease the pressure for such reform. And nothing we do in the next two years will do more to create economic growth than genuine tax reform that lowers rates on small businesses and corporations while eliminating the special tax credits, deductions and exemptions that Congress uses to direct funds for political — not economic — purposes.

Slowing the growth of entitlements would not only represent a real step towards reducing our gargantuan debt, it would also cheer financial markets. Entitlement spending currently makes up 60 percent of the budget, a proportion that is growing rapidly with the aging of the baby boomers and advances in longevity for the over-65 set. Social Security already runs an annual deficit and soon Medicare will too.

Tweaking the way we index Social Security benefits, moving to progressive indexation for initial benefits and/or indexing benefits for longevity are steps we could implement fairly easily that would reduce short-term spending but yield gigantic savings 10 or 20 years from now. Most of the proposed Medicare changes also have relatively small short-term savings that grow smartly over time: For instance, the Ryan plan that senior groups are fulminating against would affect no one over 54 years of age, a detail lost on most of the agitators.

It is this relatively small short-term benefit — and a near-certain accompanying political hit — that makes Republicans less than enthusiastic about including entitlement reform in the debt ceiling negotiations. Every member of Congress from a marginal district would no doubt be demagogued for the next 15 months for their roles in “destroying” Social Security and Medicare.

But we need to rein in entitlement spending now, because it is difficult to conceive of another situation in the next few years where it would again be possible to do so. The 2012 election will produce either an emboldened Obama who’ll have returned to office by attacking Republicans for daring to reform entitlements or a Republican facing a large Democratic Senate minority determined to see him fail — and with the power to deny him any legislative victories. If we wait until after the 2016 election to reform entitlements, we’ll have to exempt baby boomers — who are driving the massive growth in entitlement spending — from the reforms.

The inexorable increase in entitlement costs *will* bring about an existential fiscal crisis if something isn’t done. That is what financial markets fear the most. As should the rest of us.

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