

The Bargain

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Executive Summary

In July 2011, President Obama and Speaker Boehner nearly reached an historic budget agreement. The deal would not have answered all of our economic woes, but it would have been the biggest and boldest economic plan since 1993. It would have begun addressing challenges that pre-dated this recession and set a precedent for progress in this era of intense political polarization. But the deal, as we know, broke down, and the Speaker has subsequently taken it off the table.

Only with a series of grand bargains will America find the additional one point of growth needed to save the middle class.

In this paper, we posit that absent a series of grand bargains modeled on what the President and Speaker sought to achieve, America's sixty-year span of automatic, robust economic growth will draw to a close. We argue that these bipartisan grand bargains—on the deficit, entitlements, education, investment, immigration, trade, and taxes—must aim to modernize a middle-aged U.S. economy struggling to keep up with younger and leaner international competition.

After World War II, our growth was so consistently reliable and dynamic that many Americans took growth and rising living standards for granted. To be sure, liberals and conservatives viewed the causes of post-war growth through very different ideological lenses. But, with Europe playing catch-up, the Soviet Union built on a sham economic model, and Asia not yet providing stiff competition, America could count on solid economic growth—averaging a healthy 3.3% annual bump between 1947 and 2008.

In Section I of this paper, we warn of a confluence of long-term growth forecasts from mainstream economists of around 2.3% per year—a level that is significantly below American growth levels of previous decades. If these forecasts are accurate, America's feeble long-term growth would have a potentially devastating impact on America's middle class. We note that these economic projections are uniform because they are typically based on the assumption that public policies maintain the status quo and Washington fails to make the choices needed to ensure that we thrive in a new century.

Also in this section, we are the first to quantify what this slower growth would mean for the economy and middle class Americans. We calculate the impact of this one percent growth

deficit, laying out the stark details of what it means for wages, job creation, wealth accumulation, living standards, the safety net, and America's international strength.

In Section II, we provide a roadmap for a series of bipartisan grand bargains which, taken together, would modernize our economy for a new and fierce era of global economic competition. While liberals traditionally focus on economic security and conservatives on economic freedom, this bipartisan framework is intended to maximize economic opportunity and boost post-recovery growth from an anemic 2.3% to a robust 3.3% in a sustainable, broadly beneficial, non-inflationary way.

Our agenda presumes that what is missing most is not an exhaustive list of public policy ideas but a common framework in which to forge a set of grand economic bargains. Thus, our growth plan asks first and foremost for both congressional Republicans and Democrats to update their ideas and orthodoxies for a new century, and it offers a path to compromise that does not forsake core party values. Absent such a set of policy compacts in which both sides recede from their rigid ideological positions, neither party will be able to deliver on the one imperative that is non-negotiable for American voters in any era: sustained, robust growth.

A brief summary of our findings and agenda are as follows.

Section I: Defaulting On Growth

FINDING #1:

The U.S. "Default Growth Rate" will be 2.3% over the coming decades.

Mainstream economists now project substantially lower post-recovery growth for the United States compared to previous generations in the nation's modern history. The Congressional Budget Office predicts 2.3% annual, post-recovery growth for America, assuming that public policies default to the current path. This rate of growth is a full point less than the annual growth America enjoyed in the 60 years following the conclusion of World War II.

Consensus projections of America's slower growth are driven by a number of trends, most notably America's aging population and the absence of an aggressive policy response to America's economic challenges, including long-term federal budget deficits, an outdated infrastructure, an overly complex tax code, and a leveling off of educational attainment.

FINDING #2:

Adding one point to sustainable growth offers immense benefits for America and the middle class.

Increasing America's long-term growth by one percent would make a tremendous difference to our nation, our place in the world, and to the lives of average Americans. A Third Way economic analysis performed by Steve East, senior economist at Height Securities, LLC, finds that increasing our projected, post-recovery growth by one-point starting in 2018 would add:

- \$901 billion in new, real economic output in 2022 and \$2.877 trillion in new output in 2030.¹
- \$792 billion in additional personal income in 2022 and \$2.530 trillion in 2030.²
- \$233 billion in lower deficit levels in 2022 (simply through higher revenue) and \$866 billion in new revenue in 2030 alone.³
- Nearly 2 million additional jobs by 2022 and roughly 5.3 million new jobs in 2030.⁴

Ultimately, this one point means average incomes for Americans that are several thousand dollars higher; a middle class that is on a trajectory toward success rather than one in search of an elusive economic security; and the difference between a nation's economy that is surpassed by China in two decades, and one that is larger than China's through the middle of the century and, perhaps, beyond.

Section II: The Bargain

In Section II, we offer a framework for a series of bargains which aims to boost economic activity to a sustainable and non-inflationary 3.3% level—a point above current long-term growth projections and the historic average for the U.S. from 1947 to 2008.

Our recommended bargain includes seven broad categories of policies in which the U.S. must modernize our ideas if we are to win the 21st century economic race. In each of the seven policy areas we call on progressives and conservatives to puncture their ideological balloons and break free of the stale orthodoxies that limit both parties. We note that our proposed solutions are not without controversy, but also that Congress' avoidance of choices and its rigid adherence to party doctrines has yielded its most dismal public approval in history. Thus, the path we are on does not work economically or politically.

1. Re-Balance our budget.

Democrats must accept a substantial reduction in our long-range federal deficits that is based significantly on entitlement reforms. Democrats must accept reconfiguring the budget so that, in relative terms, the amount of spending on health care and income supports is reduced compared to public investments.

Republicans must accept selected tax increases that meaningfully narrow the gulf between spending and revenue. Republicans must accept that investments in young people, emerging industries, new ideas, breakthrough research, old roads, and new broadband are important and must increase.

2. Become an export giant.

Democrats must accept that expanding U.S. exports comes primarily through aggressive new trade measures like the Trans Pacific Partnership.

Republicans must accept that more must be spent on enforcing unfair trade practices and on displaced workers who need help and training due to their exposure to trade.

3. Reform corporate taxes and business regulations.

Democrats must accept that a simpler tax code with a low corporate rate and a streamlined regulatory regime that helps businesses grow is good for America.

Republicans must accept that corporate tax reform will not add to the deficit and that regulatory agencies must be fully staffed to prevent corporate abuse.

4. Increase the productivity and educational attainment of the American workforce.

Republicans must accept that we need further investments in education and there must be a federal role in raising performance among students and schools.

Democrats must accept that education funding comes with a commitment to reform that puts student performance above all else.

5. Become a global magnet for talent.

Republicans must accept that the United States must increase legal immigration levels and use immigration policy to become a global magnet for talent.

Democrats must accept that legislation must tilt future immigration flows into the country decidedly in the direction of skills and education.

6. Improve infrastructure.

Republicans must accept increased funding and innovative financing for new investments in projects that move people, products, ideas, and power better, faster, and cheaper than the rest of the world.

Democrats must accept that chronic cost overruns have to end and must submit to contracting reform to reduce waste and encourage economically beneficial projects only.

7. Spur breakthrough innovation.

Republicans must accept a sustained and generous commitment to public sector-led investments in pure research, energy innovation, science, and technology to lead the knowledge economy of the 21st century.

Democrats must accept that breakthrough innovations are virtually meaningless without large, vibrant, and innovative private sector-led capital markets to seek out, finance, and promote new ideas.

America's economic problems did not commence with the collapse of Lehman Brothers and the onset of the Great Recession. For several decades, globalization and the advance of technology have put ample stress on America's economy and its middle class. Thanks to leadership from President Obama and some in Congress, America is now well on the road to recovery. But, our future growth projection pales in comparison to our past growth. Sticking with our rigid orthodoxies will not alter this trajectory. It is necessary to set aside old battles and obsolete ideas to secure future growth and prosperity.

We know it is a tall order, but it is not impossible even in today's toxic political environment. The President and the Speaker came within a whisker of making a "grand bargain" agreement that would have made a down payment on America's future. A second opportunity will come again with the expiration of the Bush tax cuts and the onset of sequestration. But the cost of doing nothing—of defaulting on the big choices and continuing to patch as we go—has serious consequences. It could shave a point off U.S. long-term economic growth. This one point makes all the difference in the world.

SECTION 1: Defaulting on Growth

Growth just happened.

The 60 years preceding the Great Recession was an era of strong economic growth for the United States. Although there were occasional recessions and booms, there was amazing constancy to growth over the six decades following World War II.⁵ From 1947 to 2008, real U.S. GDP grew at an average rate of 3.3% per year.⁶ This robust growth was so consistent that Americans could be forgiven for assuming that it was virtually automatic.

To be sure, there were clearly important—if not always fully appreciated—causes for America’s superior economic performance following World War II. The United States faced weakened competition in the global economy. In the war’s aftermath, America produced half of the world’s GNP, ran large export surpluses, and could afford to spend billions to help rebuild economies throughout the world.⁷

Our population was young and expanding with the Baby Boom generation significantly contributing to America’s economic output by bolstering the number of American consumers and, eventually, the ranks of American workers.⁸ Pent-up demand after the war coupled with high personal savings led to massive purchases of durable goods like appliances, cars, and housing.⁹

America’s political system, with its emphasis on the rule of law, property rights, economic freedom, and entrepreneurship fostered a dynamic ecosystem that promoted growth and prosperity.¹⁰ The nation’s robust capital markets and well-functioning financial institutions provided both the confidence and capital needed for strong economic growth.

It is also true that government made many wise decisions. Education benefits created under the GI Bill, for example, added hundreds of thousands of engineers, teachers, scientists, and other professionals to the American economy. The Interstate Highway System in the 1950s and 1960s had far-reaching effects in promoting growth.

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Federal support for research and government purchases of breakthrough products played a decisive role in many of the technological innovations that have been responsible for strong growth over the past 60 years. The government's need for cutting-edge microprocessors for its space and missile programs in the 1960s enabled companies to ramp up the efficient and large-scale production that ultimately made computer chips the backbone of the computer revolution that powers the modern economy.¹¹

In addition, relatively prudent fiscal and regulatory policies helped create a fruitful environment for economic growth. Taxes were cut from their high wartime rates and, despite much bickering, a bipartisan consensus on the balance between spending and revenue existed. On just 22 of 64 occasions between 1947 and 2010 did yearly budget deficits exceed 3.3% of gross domestic product (our average post-war growth).¹²

But that was yesterday's world. If you look at America today, very few of the factors that brought us consistent, robust growth are fully present now.

We don't compete alone in the world market; we are merely the largest of several dominant players. We are not a demographically young country full of vigor; we are a middle-aged country with love handles. Our infrastructure is inadequate to meet the demands of a new century. The bipartisan consensus to live within our means has long broken down. Much of our spending does not create economic growth, with the bulk of new spending providing support to a deserving, but less economically productive, elderly population as opposed to funding investments in the future.

In short, many of the economic factors that made America the most successful nation in the 20th century are diminished today, putting growth in jeopardy.

FINDING #1:

The U.S. "default growth rate" will be 2.3% from 2018-2030.

According to the Congressional Budget Office (CBO), the United States will average growth rates of 2.3% once the United States is fully recovered from the Great Recession post-2017. That is a full point less than the previous six decades of growth.

The CBO forecast is not an outlier.

- The Conference Board forecasts 2.3% annual growth from 2017 to 2025.¹³
- The Organisation of Economic and Co-operative Development (OECD) predicts 2.4% U.S. growth from 2018 to 2030, with growth declining to 2.1% thereafter.¹⁴
- An analysis by the National Bureau of Economic Research (NBER) foresees real GDP growth through 2027 at 2.4%.¹⁵
- Goldman Sachs has forecast real GDP growth for the 2015-2050 period of 2.5% and PriceWaterhouseCoopers has forecast U.S. growth of 2.4% through 2050.¹⁶

- The Office of Management and Budget (OMB) has forecast that real GDP will grow at an annual average rate of 2.5% by 2018-2021, according to the FY2012 budget.¹⁷
- The Blue Chip Consensus—an average of 50 private sector economic forecasts—projects annual growth rates averaging 2.5% for 2018-2021.¹⁸

Why are these forecasts so consistent? They all use roughly the same metrics of growth if America continues on its course, avoiding major deals on the budget, taxes, spending, immigration, public investments, and workforce improvements. Thus, this is what happens to our economy if we muddle on and make minor patches as we go, defaulting on the major choices we need to make.

- **Demographics:** Nearly all of America’s economic growth is created by people who are in their prime working years—generally considered to be between the ages of 25 and 64. Younger people create future economic growth while older people consume government services and generally create little economic growth. From 2010 to 2040, the number of elderly people is expected to double, while the working age population will increase by only one-sixth.¹⁹ The median age of the population was 30 in 1980; it’s 37 today and will be 39 in 2030.²⁰ Without changes in birth rates or immigration, this alone means leaner economic growth.

Population Age ²¹	2010	2040
25-64	164M	193M (+18%)
65+	40M	81M (+102%)

- **Productivity:** College attainment in the U.S. has slipped relative to our international competitors in recent decades—particularly among men. Three-fifths of today’s 25 to 34-year olds lack any post-secondary two- or four-year degree.²² Economists across the ideological spectrum are in general agreement that under-performing educational attainment will be a drag on future growth. This is just one piece of the productivity shortfall.
- **Private Capital:** Large projected budget deficits, most mainstream economists agree, will eventually lift interest rates and crowd out capital needed to invest in new businesses, business expansion, and public investments that lead to growth. According to the International Monetary Fund, economic growth in industrialized countries falls by 0.15% for every 10% increase in the share of national debt to the size of the overall economy. With the U.S. ratio of debt to GDP projected to increase from 40% in 2008 to 86% in 2020, this would mean a reduction in U.S. GDP growth by more than two-thirds of a point under the IMF standard.²³

Taken together, these and other factors are the reason why there is such a consensus of growth predictions in the 2.3% range.

FINDING #2:

Adding one point of sustainable growth offers immense benefits for America and the middle class.

Economist Steve East analyzed the CBO’s projected post-recovery rate (which averages 2.3% between 2018 and 2030) and compared it to the U.S. economy if it were to grow at a 3.3% average rate over the same period.* According to East’s analysis, increasing our projected growth by one point starting in 2018 would add nearly \$1 trillion in new, real economic output in 2022. In 2030, that extra point would create almost \$3 trillion in new output as well as millions of new jobs and hundreds of billions in added wages.^{24 †}

What does a one point difference in growth mean?

As it turns out, it means all the difference in the world.

If the economy were to grow at the long-term average of 3.3% instead of 2.3%...

What would one point mean for the U.S. economy?	
<p>By 2022—one point adds nearly \$1 trillion to the U.S. economy.</p> <ul style="list-style-type: none">• Under the projected growth scenario, the total value of the U.S. economy would be \$18.1 trillion in 2022 in real 2005 dollars.²⁵• Adding a point to the projected growth rate puts the total value of the U.S. economy at \$19 trillion in 2022—a difference of \$901 billion in inflation-adjusted dollars.²⁶	<p>By 2030—one point adds nearly \$3 trillion to the U.S. economy.</p> <ul style="list-style-type: none">• Under the projected 2.3% growth scenario, the total value of the U.S. economy would be \$21.3 trillion in 2030 in real 2005 dollars.²⁷• Under a 3.3% growth scenario, the total value of the U.S. economy would be \$24.2 trillion in 2030—a difference of \$2.877 trillion in inflation-adjusted dollars.²⁸

* Steve East performed this analysis at the request of Third Way. The information has been obtained from sources which Height Securities, LLC believes to be reliable; however, the information contained herein is not an offer to purchase or sell any security.

† In the East analysis, this extra point in growth would need to be sustainable and non-inflationary. Thus, it assumes that America would make the policy changes necessary to allow the country to grow an extra point without overheating the economy. These measures are discussed in the final section of the paper.

What would one point mean for personal income?

By 2022—one point adds nearly \$800 billion in new personal income.

- Under the projected growth scenario, Americans would be expected to earn \$15.9 trillion in personal income in 2022 in real 2005 dollars.²⁹
- Adding a point to the projected growth rate would see Americans earn \$16.7 trillion in personal income in 2022—an increase of \$792 billion in inflation-adjusted dollars.³⁰

By 2030—one point adds more than \$2.5 trillion in new personal income.

- Under the projected 2.3% growth scenario, Americans would be expected to earn \$18.7 trillion in personal income in 2030 in real 2005 dollars.³¹
- Under a 3.3% growth scenario, Americans would be expected to earn \$21.3 trillion in personal income in 2030—an increase of \$2.53 trillion in inflation-adjusted dollars.³²

What would one point mean for jobs growth?‡

By 2022—one point adds nearly 2 million jobs.

- Under the projected growth scenario, the United States would employ 156.7 million Americans in 2022.³³
- Adding a point to projected growth would see the United States employing 158.7 million Americans in 2022—an increase of 1.958 million jobs.³⁴

By 2030—one point adds more than 5.3 million jobs.

- Under the projected 2.3% growth scenario, the United States would employ 162.7 million Americans in 2030.³⁵
- Under a 3.3% growth scenario, the United States would employ 168 million Americans in 2030—an increase of 5.340 million jobs.³⁶

What would one point mean for deficits?

By 2022—one point adds more than \$600 billion in total new revenue, over \$200 billion in new revenue in 2022 alone.

- Under the projected growth scenario, the federal Treasury would receive \$4.692 trillion in revenue in nominal dollars in 2022.³⁷
- Adding a point to projected growth would have the federal Treasury receiving \$4.925 trillion in revenue in nominal dollars in 2021—an increase of \$233 billion.³⁸ Over the entire period, higher growth would bring in \$653 billion in additional revenue.³⁹

By 2030—one point adds more than \$5 trillion in total new revenue, nearly \$900 billion in new revenue in 2030 alone.

- Under the projected 2.3% growth scenario, the federal Treasury would receive \$6.419 trillion in revenue in nominal dollars in 2030.⁴⁰
- Under a 3.3% growth scenario, the federal Treasury would receive \$7.285 trillion in revenue in nominal dollars in 2030—an increase of \$866 billion.⁴¹ Over the entire period, higher growth would bring in a total of \$5.120 trillion in additional revenue.⁴²

‡ Calculations are based on the Bureau of Labor Statistics Household Survey and reflects estimates of total employment in the United States.

Ultimately, a one-point increase in growth means average incomes for Americans that are several thousand dollars higher, a middle class that is on a trajectory toward success rather than in search of economic security, and the difference between a nation's economy that is surpassed by China in two decades, and one that is larger than China's through the middle of the century and, perhaps, beyond.

SECTION II: The Bargain

Lower growth is a forecast, not a destiny.

In this section, we lay out the contours of a plan to put America on top and to achieve long term, sustainable, non-inflationary economic growth of 3.3% over the coming decades. This is a one-point bump from current projections and is the growth level the country experienced over the sixty years following World War II. It is designed to not only increase growth, but to see that it is widely shared with a middle class that has a greater opportunity to succeed.

There are many plans sitting on the shelves at think tanks and policy organizations spanning the ideological spectrum. The problem we face as a nation is not a lack of concrete policy plans. What is missing is a serious and sustained attempt—by the left and the right—to transcend the constraints of their respective positions and build an intellectual framework that would achieve many of their main objectives while giving some reasonable ground to their political opponents.

This agenda is a deliberate departure from the prevailing ideologies and orthodoxies of both sides. We highlight the limitations of these ideologies as it pertains to hardened policy positions that are certain to inhibit future growth. We recommend new approaches for bipartisan agreement to ensure American economic might. And we believe agreeing to do the “gives” described in our growth plan is not only a prerequisite to working out the policy details, but it is a step that cannot be skipped over if we want a new era of economic growth.

Our aim and hope with this paper is to reach both parties and challenge them to use their respective bully pulpits to not just vigorously defend their own well-established positions, but to ask for a public mandate for the orthodoxy-challenging set of bargains outlined in this section.

Not every moment is ripe for political compromise. But, the need to forge an agreement in America is so great and the fatigue over the partisan battles of the past so pronounced, we hope this growth agenda fosters new thinking in the spirit of bold compromise—the kind of compromise necessary to renew our economy for the dawning era of global economic competition.

If the world economy were the Olympics, less than one-third of Americans believe that the United States would win the gold medal in ten years.⁴³

1. Re-balance our budget.

Each day in 2010, 6,670 Americans celebrated their 65th birthday. In 2020, 9,654 Americans will turn 65 every day. Each day in 2010, 11,712 Americans turned 25. In 2020, 12,253 will turn 25 every day.⁴³ The ratio of new 25-year olds to new 65-year olds will go from 50 to 28 in 2010 to 50 to 39 in 2020. This is as close to an unalterable truth as it gets. And the ramifications are inescapable as government retirement and health benefits grow faster than general inflation, and often as fast or faster than wages.

Entering Work and Entering Retirement: Number Reaching 25th and 65th Birthday Each Day⁴⁵

Year	25 th Birthdays	65 th Birthdays	Ratio of 25 to 65 yr olds
1990	11,691/day	5,823/day	5 : 2.5
2000	10,620	5,921	5 : 2.8
2010	11,712	6,670	5 : 2.8
2020	12,253	9,654	5 : 3.9
2030	12,499	10,948	5 : 4.4

By 2030, the federal government will spend 69 cents of every government dollar on Medicare, Medicaid, Social Security, and interest on the debt; that's up from 46 cents in 1990.⁴⁶ By 2035, spending on Medicare, Medicaid, Social Security and net interest payments will equal 25% of U.S. gross domestic product—a greater share of GDP than all government spending combined in 2010.⁴⁷

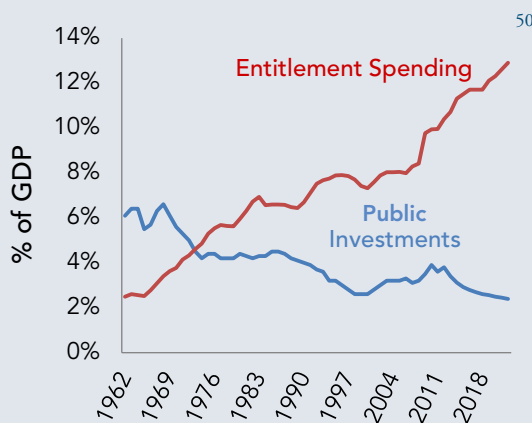
It is why progressive health care expert Ezekial Emanuel wrote this spring that “if nothing is done about entitlement spending, and if our current tax breaks continue, then by 2025, tax revenue will be able to pay for Medicare, Medicaid, Social Security, interest on the debt and nothing else. The rest—defense, medical research, highways, education, energy—will have to be financed by deficits.”⁴⁸

It is why economists like Robert Rodriguez, CEO of money-management at First Pacific Advisors, says, “If we don't start on a fiscal restructuring in this country by the end of next year, it is quite likely that between 2014 and 2016 we could experience something as big as Europe is going through today.”⁴⁹

These two problems—huge annual deficits and a massive shift of government spending toward consumption and away from investment—are among the most pressing constraints on long-term economic growth for America.



Democrats must accept that without a meaningful reduction in our long-range spending on the principal entitlements for the elderly of Medicare, Medicaid, and Social Security, the working age middle class of the future will be saddled by a withering tax and deficit burden. They must accept that there is no realistic path to shoring up Social Security and financing ever-increasing expenditures for Medicare and Medicaid by simply taxing the wealthy. They must also accept that, absent entitlement reforms that pare spending on Medicare, Medicaid, Social Security, as well as federal pensions, there will be little room to spend on infrastructure, education, research, housing aid, overseas food aid, and public safety. In relative terms, Democrats must accept that we must reduce federal consumption spending on health care and income supports to make room for new public investments in growth areas.



There are several workable plans that solve the Social Security solvency problem with modest, gradual changes that trim benefits and increase flows into the Trust Fund. We have one of them.

There are various ideas that we and others have proposed to reduce Medicare and Medicaid outlays through discreet measures that do not alter the guaranteed nature of health care to the elderly and poor and that increase quality—creating exchanges for Medicare and Medicaid, ending first dollar

coverage for Medigap policies, better managing of end of life care, a medical inflation fee, medical malpractice reform, among others.



Republicans must accept that, in a complex and global world in which the United States faces existential national security challenges, glaring public investment needs, and an aging population that is expensive to care for adequately, we cannot remotely afford their “all or nothing” approach to fiscal responsibility. They must accept that increased tax revenue is part of any serious budget deal that brings deficits to a reasonable level. Selected tax increases must meaningfully narrow the gulf between spending and revenue because a cuts-only approach is economically harmful and not politically achievable. They must also accept that not all government spending is bad and that investments in young people, emerging industries, new ideas, breakthrough research, old roads, and new broadband are worthy and should increase.

Some ideas that Republicans must abandon are the preservation of the Bush tax cuts for those earning more than \$250,000, opposition to the use of chain-weighted CPI across all government programs including tax brackets, and steadfast support for even the most narrowly tailored tax loopholes and expenditures. Republicans must also accept an increase in domestic discretionary caps dedicated only to growth investments.

2. Become an export giant.

America is first in consumption and last in exports.

Exports generate only 13% of U.S. economic activity, compared to 47% for Germany, 30% for China, 27% for Italy, and 30% for the United Kingdom.⁵¹ Among the twelve largest economies, the U.S. ranks last in the ratio of economic output that is derived by exports. We export only half as much of our manufacturing production as the world average.⁵² Since 2000, the United States' share of the Asian export market has declined by 43%.⁵³

Over the next five years, a staggering 87% of all global growth will take place outside of the United States.⁵⁴ By 2022, the major Asian economies alone will import \$10 trillion in goods per year.⁵⁵ By 2030, the world will have an estimated 2 billion new middle class consumers.⁵⁶ America should set a goal to increase exports so that they double to 25% of GDP by 2025.

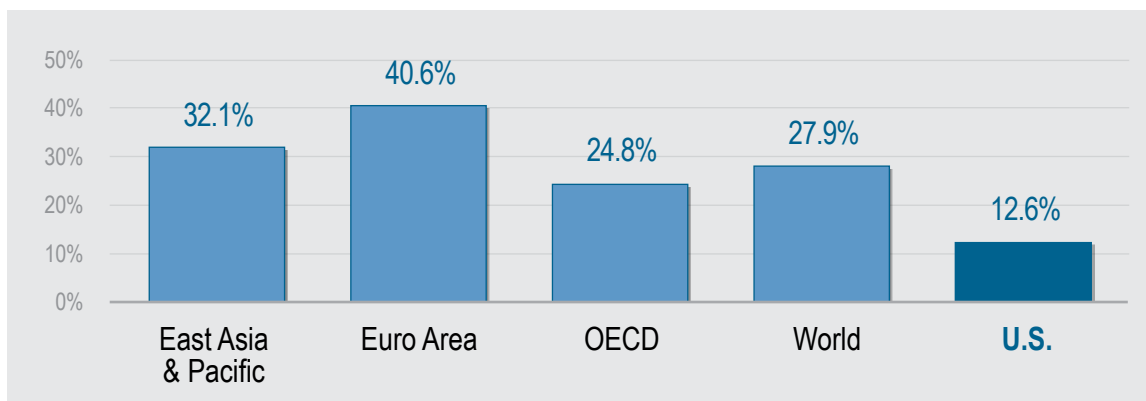


Democrats must accept that America's future economic growth hinges almost entirely on our engagement with overseas trading partners. Expanding U.S. exports is contingent upon trade agreements. In the 17 countries in which the United States has bilateral trade agreements, we have a manufacturing trade surplus—in contrast to our massive manufacturing deficit in countries where we don't have an agreement.⁵⁷ Our biggest trade deficit is with China—a country with which we have no agreement.

Democrats must also accept that there is value in imports that goes beyond consumers' ability to purchase inexpensive goods. There are entire industries and millions of jobs that are related to transporting, selling, and assembling imports. Part of our trade deficit has little to do with unfair practices abroad, but the unwillingness of American business and labor to agree to a modern cost structure (particularly as it pertains to non-wage benefits) that allow us to compete on price.

Some ideas Democrats should support include the conclusion of a trans-Pacific trade pact that addresses tariff and non-tariff barriers to regional trade and creates a new architecture for high-standard trade agreements; an international services agreement that helps open export markets for financial products, insurance, and other services; renewed efforts to reduce health care costs for employers, such as the Cadillac tax on high cost plans; and a continued ratcheting down of formal and informal trade barriers on all sides of the border.

Exports of Goods and Services (as a % of GDP, 2010)⁵⁸





Republicans must accept that even the most Schumpeterian economist knows that trade will create winners and losers in the United States. Disruption through creative destruction accelerated through global trade has very real costs despite the important net benefits it creates for society. They must accept that we are in an especially dynamic period of global transition in which enormous labor economies that were previously outside of the free market world are now inside and have created a glut of low-cost labor.

Helping people cope and come through this disruption should not be a grudging concession to win a couple of trade deals, but a national priority to make trade work better for more Americans. They must accept that more must be spent on enforcing unfair trade practices, helping U.S. businesses navigate international markets, and promoting American products. In an earlier [Third Way report](#), we identified 8 specific trade barriers that America must force China to address beyond currency. Nearly every export problem—dealing with standards, quotas, intellectual property theft, and non-tariff barriers—is at its worst in China and none can be solved without greater resources devoted to [rules-based trade](#).

Some ideas Republicans should embrace include full support for Trade Assistance Act efforts for displaced workers; support for continuing education for adults; aggressive funding of the President's new Interagency Trade Enforcement Center as well as other enforcement efforts across industrial sectors; and new investments in effective export promotion programs modeled on Germany's successful system.⁵⁹

3. Reform corporate taxes and business regulations.

Our tax code was last reformed in 1986—when China was red and the Internet didn't exist. Since then, our tax laws have undergone more than 15,000 piecemeal changes.⁶⁰ The 1997 Budget Act alone added 285 sections to the code.⁶¹ Over the last ten years, changes to the code have averaged more than one per day, with 579 in 2010 alone.⁶² Today, its length has doubled to exceed 3.8 million words⁶³ and 11,045 pages.⁶⁴

Much of this growth has come in the form of tax expenditures. Since the 1986 reform, 159 new tax expenditures have been signed into law.⁶⁵ Though the 1986 reform reduced the value of expenditures from almost 9% of GDP to 6%, by 2003, the value of expenditures had crept back up to 8% of GDP.⁶⁶ In 2010, tax expenditures made up almost a quarter of all federal spending.⁶⁷ Today, the 250-plus tax expenditures on the books⁶⁸ ring up at a price of more than \$1.1 trillion.⁶⁹

The bottom line is that our corporate tax code is meant for a different era, with rates too high, loopholes too abundant, and a code so complicated that we are at a disadvantage to international competitors.



Democrats must accept that private sector job growth is the linchpin of American economic success, and a simpler tax code with a low rate and a streamlined regulatory regime that helps businesses grow is good for America. While start-ups and small businesses are the seedlings of future job growth, one-fourth of U.S. labor works at a firm that employs more than 10,000 people. And the dream of nearly every small business and start-up is to be a contractor for a large and successful firm.

They must realize that while we want businesses to start and expand in America, there are legitimate reasons for businesses to expand and open facilities overseas; overseas operations that create profits for U.S. corporations have benefits to Americans as well. And though business must absolutely be regulated to prevent abuses, people don't hate their employers and don't see themselves as victims of arbitrary and capricious work rules and bosses.

Ideas that Democrats should embrace include revenue-neutral corporate tax reform that lowers the rate and broadens the base; a sensible transition toward a more territorial international tax system; and a top-to-bottom review of business regulations to end redundancies, red tape, and economically harmful rules.



Republicans must accept that capitalism and free markets are theories, not theologies. Markets are, as economist John McMillan says, "not an end in itself but an imperfect means to raising living standards."⁷⁰ Thus, they must accept that there is an appropriate tax and regulatory role for government with regard to business. Unbridled business success does not automatically spell American success. The fundamental purpose of business and financial institutions is to provide value to customers from which profits flow. The role of government isn't just to help businesses succeed, but to help them succeed here. New businesses and nascent industries often need government help to reach adulthood.

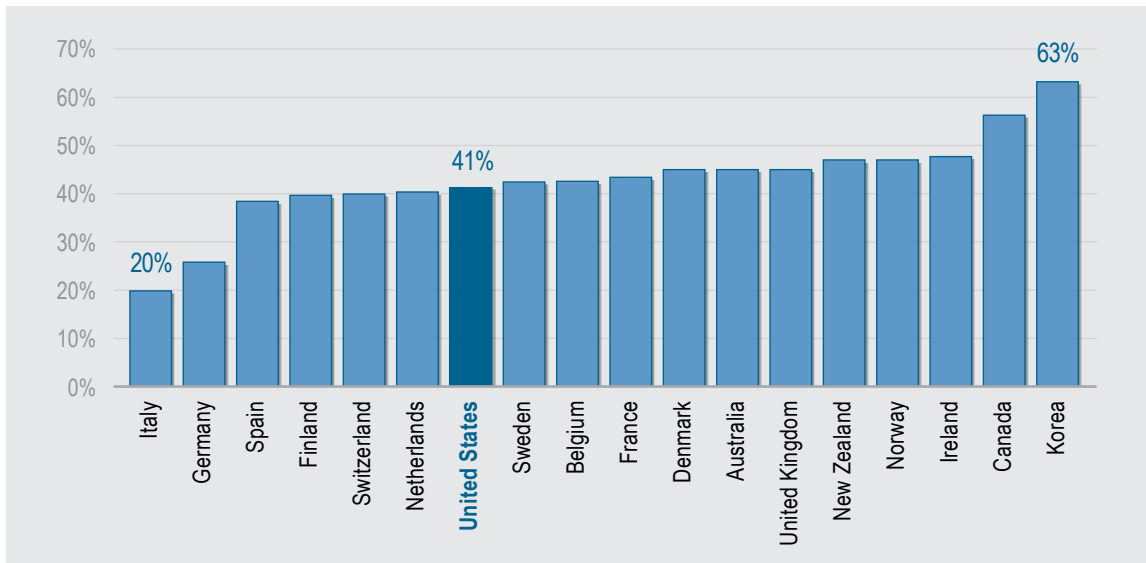
Republicans should embrace (like Democrats) corporate tax reform that does not add to the deficit and lowers the rate and broadens the base; selected broad-based tax breaks that promote research, business formation, and American production; and full funding and balanced regulations for regulatory watchdog agencies from the EPA to the SEC.

4. Boost the productivity and educational attainment of the American workforce.

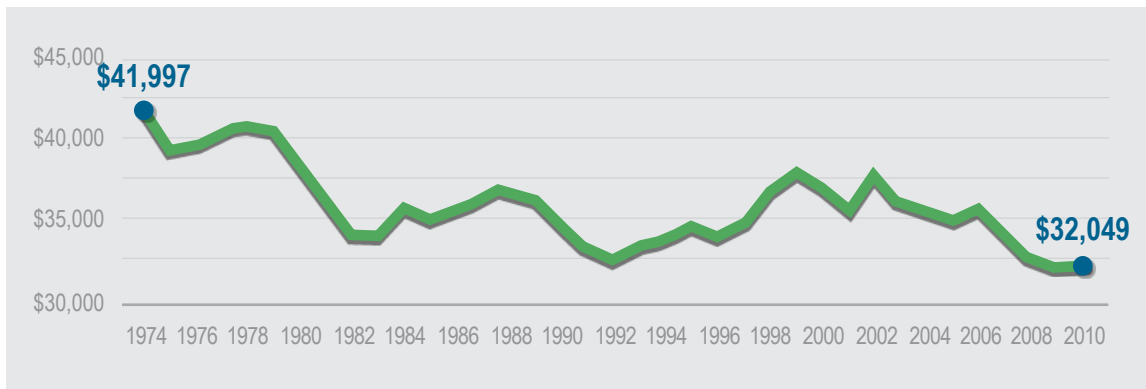
Today, only two of five young adults have attained at least a two-year post-secondary degree. This relegates more than half of young Americans to a life of economic insecurity. For men, in particular, the lack of a college or associates degree has meant declining real wages. For men with only a high school degree, their peak earnings year in inflation-adjusted dollars was 1974.⁷¹ This 38-year trend of declining wages—which is also a proxy for the amount of economic growth this cohort creates—will not change.

Since 1975, college graduation rates among U.S. men have barely increased (though women have made steady gains).⁷² America ranks 12th among OECD nations in the number of 25 to 34-year olds that hold a post-secondary degree. To show how far we've fallen, among those between 55 and 64, America ranks fourth.⁷³

Percentage of 25-34 Year Old Population Who Have Attained Post-Secondary Education, by Country⁷⁴



**Mean Earnings of Male High School Graduates 1974-2010⁷⁵
(constant 2010 dollars)**



This is not merely a low-income school problem. In a 2011 *Third Way report*, we found that only three of ten graduates from high schools in middle class communities earn a four-year degree by age 26.⁷⁶

A Georgetown University study by Anthony Carnevale and Stephen Rose urges America to set a goal of adding 20 million post-secondary educated workers to the workforce by 2025. That would be an increase of 12 million college, associate, and graduate level Americans than expected if we do nothing. According to the authors, this alone would boost GDP by \$500 billion per year.⁷⁷

To increase the productivity of the labor force and maximize economic opportunity for Americans, we set a goal of increasing the number of future 25 to 34-year olds with an associate degree or higher from 40% to 60% by 2025.



Republicans must accept that the path to a successful workforce runs through public schools. They must accept that public schools are attended by seven of eight children and that private schools will always represent a minority of students.⁷⁸ They must accept further investments in education.

There is a federal role in increasing standards of achievement in public education and that increasing educational attainment is a national priority. The federal government has an interest in making college education available and affordable to middle class families and to help make continuing education a viable and productive option for those who have already entered the workforce.

Republicans should support increased federal aid to middle-income public schools; better coordination of high school curriculum with college and technical school requirements; a federal role in evaluating objective measures of success or failure of public schools, as well as colleges and universities; preservation and expansion of existing college tax credits; and additional resources for individuals in the workforce who seek to further their career through education.



Democrats must accept that education funding comes with a commitment to reform that puts student performance above all else. They must accept that it is virtually impossible to reform and improve education without restructuring the way teachers are hired, promoted, and dismissed. No business could improve under such a structure; schools are no exception. A high school degree should no longer be considered a benchmark of success for a school system, rather completing a two- or four-year degree must become the new standard. Schools should be measured on the number of students who earn post-secondary degrees, not on diplomas. Curriculum must be reformed to not only raise test scores, but to also prepare students to succeed in a modern work environment. Far more must be expected of parents to prepare children for school and to make the home a learning environment.

Democrats should support school reforms to increase competition and performance within public schools; merit-based performance measures to attract, retain, promote, and dismiss teachers; charter models and incentives for public schools; a restructuring of teacher contracts to lower the cost of non-wage benefits; and measures to promote parental responsibility.

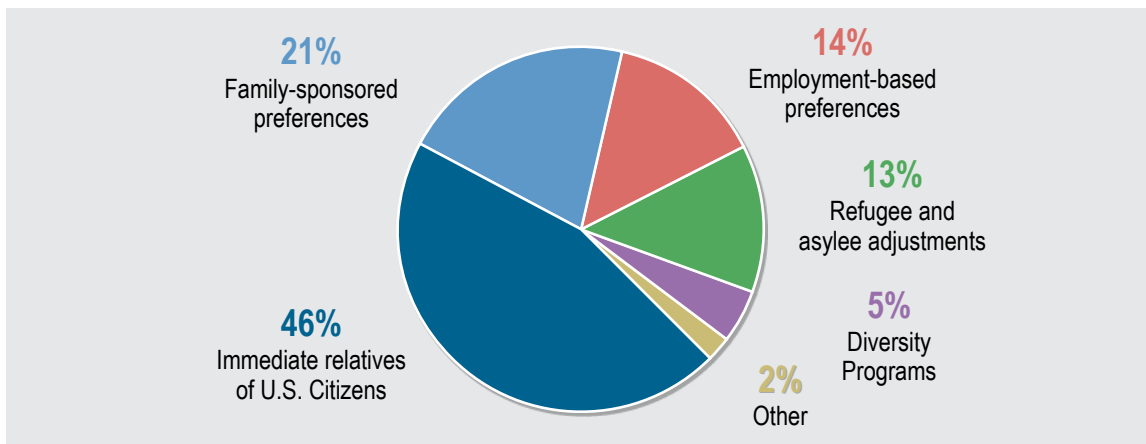
5. Become a global magnet for talent.

For sixty years, the Society for Science & the Public has held a nationwide high school science competition. It is the nation's oldest and, arguably, most prestigious pre-college science award. Each year they bring together the finalists for an award ceremony in Washington, DC. Of the 40 finalists for 2012, 13 of these high school students were born outside of the United States. Many of the rest are the sons and daughters of first-generation immigrants.

From 1900 to 2000, the U.S. became home to 47.2 million legal immigrants—far more than any other country. During the same period, the U.S. economy grew nearly 25-fold, we won two World Wars and a Cold War, and our middle class became the envy of the world.⁷⁹

Immigrants—whether it was Albert Einstein, Andrew Carnegie, or millions of factory workers, farmhands, cooks, and construction workers—were a huge part of America’s 20th century success story. Today, we are an increasingly service, knowledge, and innovation led economy. Even our manufacturing jobs require a great deal more skill. To maintain our global dominance and strengthen our economy, U.S. immigration policy must not only increase its current levels of legal immigration, but it must also be restructured to attract foreign-born intellectual capital to facilitate innovation and job creation.

Persons Obtaining Permanent Legal Resident Status in U.S. by Major Class of Admission (2009)⁸⁰



Republicans must accept that our current level of legal immigration is not sufficient to make up for our modest native birthrates or to create enough economic activity to afford the retirement of the Baby Boom. They must accept that deportation of 11 million undocumented immigrants is expensive and impractical, and that efforts to keep them outside of the legal structure of employment are counterproductive for the economy.

Policies Republicans should embrace include increasing the level of legal immigration by at least 100,000 per year; allowing undocumented immigrants who came here as children to earn citizenship through educational attainment; providing an avenue for other undocumented immigrants to attain permanent legal status; and recruiting and retaining high-skilled immigrants who come to our colleges and universities through pathways to citizenship.



Democrats must accept that perpetually allowing illegal immigrants to earn citizenship only encourages more illegal immigration. They must accept that citizenship is not a commodity but a treasured credential. Our current legal immigration system is tilted too heavily toward family migration and not skills. U.S. immigration policy should be designed, first and foremost, to solve America’s economic needs.

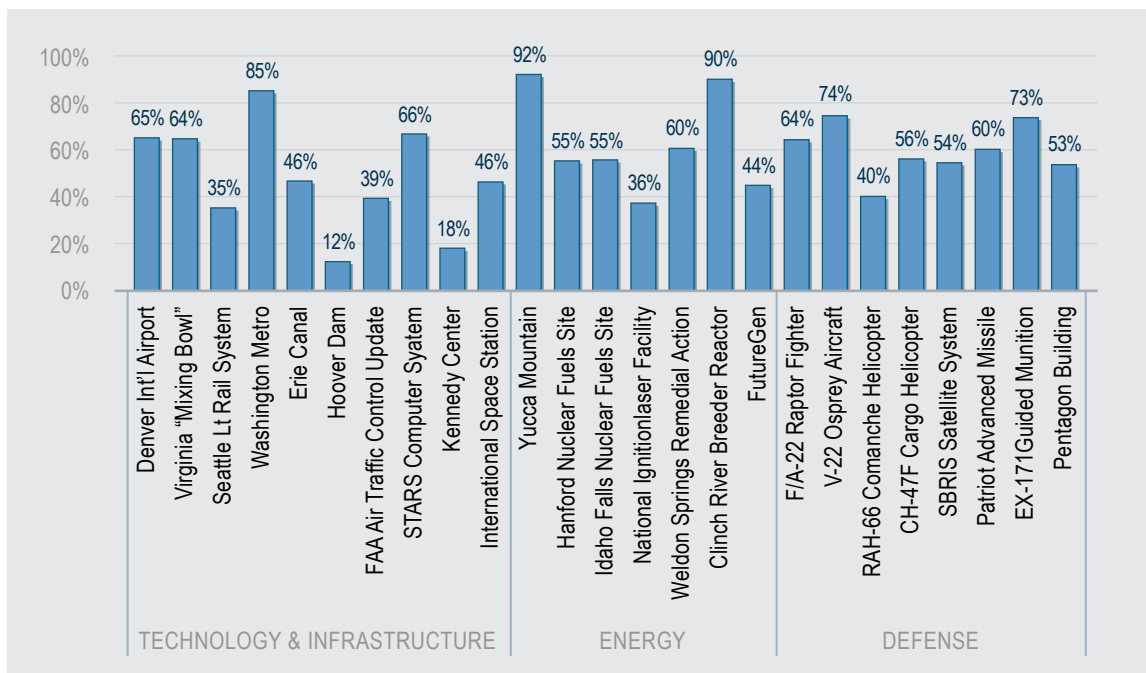
Policies Democrats should embrace include a more skills-based immigration policy by reserving all new immigration slots for high-skilled entrants; curtailing some future family-based immigration; and accepting permanent legality that is short of citizenship for much of the 11 million.

6. Improve infrastructure.

In the 1820s, New York's construction of the Erie Canal brought the price of shipping flour from Buffalo to New York City from \$120 to \$6 per ton.⁸¹ The nation's highway infrastructure was directly responsible for fully one quarter of the increase in U.S. productivity between 1950 and 1989.⁸²

China's latest Five-Year Plan allocates \$1 trillion for investment in high-speed rail, water, electrical infrastructure, and highways.⁸³ Meanwhile, our spending on transportation and water infrastructure has declined from a peak of 3.1% of GDP in 1963 to 2.4% of GDP in 2007.⁸⁴ The physical infrastructure that vaulted the United States to global economic power—including our roads, bridges, rail, aviation, and waterways—has slipped into a state of serious disrepair,⁸⁵ earning a grade of "D" from the American Society of Civil Engineers.⁸⁶ America's inadequate infrastructure is a drag on our economy and a serious impediment to our international competitiveness⁸⁷ and future growth.⁸⁸

Cost Overruns for Selected U.S. Public Works and Defense Projects⁸⁹





Republicans must accept the correlation between public investment and private sector growth. They should accept substantially higher funding and innovative financing for new investments that move people, products, ideas, and power better, faster, and cheaper than the rest of the world. They must accept that to grow, we have to invest in cutting-edge infrastructure—including broadband, smart electric grids, intelligent logistics, and satellite-based air traffic management.⁹⁰ Our funding mechanisms for infrastructure projects are becoming as obsolete as the buggy whip.

Ideas Republicans should embrace include higher spending on capital budget items like highways, broadband construction, and power grid improvement; leveraging public spending with private capital through such financing structures as a National Infrastructure Bank; and an increase in the revenue stream that funds infrastructure projects through a modest carbon tax, or some other revenue generating measure.



Democrats must accept that the typical federal highway project comes in nearly 30% over budget,⁹¹ which represents awful stewardship of taxpayer dollars. They must accept that infrastructure projects must be awarded for economic reasons, not constituent reasons.

Ideas Democrats should embrace include contracting reform so that contractors and government are in agreement on who bears the burden of cost overruns; additional reforms to eliminate moral hazards in lowest-priced bidding; requiring complete project designs before a contract to build is awarded; and innovative financing measures like independently funded toll roads.

7. Spur breakthrough innovation.

It is quite possible that the Internet would not exist were it not for the United States government. In the 1960s, innovators at the Defense Advanced Projects Research Agency (DARPA) and several universities experimented with the idea of connecting computer networks in disparate places. Simultaneously, the National Science Foundation was teaming with universities to connect their own computer networks.⁹² Their discoveries gave birth to the Internet, which now adds as much as \$2 trillion annually to the U.S. GDP—over one-seventh of our overall economy and more than \$6,500 per person.⁹³

But we are slipping. While we once led the world in broadband, average broadband speeds in 15 countries are now faster than ours. Foreign firms are now world leaders in areas that we pioneered, including solar and wind energy technologies, robotics, and batteries.⁹⁴ In surveys of innovation competitiveness, America ranked sixth out of 40 leading industrialized countries—not bad. But in a survey of the rate of change in innovation capacity over the last decade, we ranked 40th—dead last.⁹⁵ To achieve higher rates of long-term economic growth, the United States must renew its commitment to the power of innovation.



Republicans must accept a sustained and generous commitment to public sector-led investments in pure research, energy innovation, science, and technology so that America leads the knowledge economy of the 21st Century. They must accept that science is valued and that scientific research should be shielded as much as possible from the culture or climate wars. They should acknowledge that not all public investments work out.

Ideas Republicans should embrace include higher funding for the National Science Foundation, NASA, and other select research agencies; creating “entrepreneur” visas to allow individuals with exceptional talent and breakthrough entrepreneurial ideas to emigrate to the U.S.; and making the federal government a market for innovative technologies by, for example, expanding the Defense Department’s Operational Energy project that moves the military from traditional to alternative energy—reducing the huge cost of fuel in both dollars and mortality in the field of battle.⁹⁶



Democrats must accept that breakthrough innovations only lead to enormous opportunities when healthy capital markets are able to finance new ideas to make them grow. There is nothing wrong when corporations make “enormous profits.” Capital markets are as important to the development of new ideas as oxygen is to the bloodstream.

Ideas include relaxing Sarbanes-Oxley rules for small IPOs; allowing for crowd-sourcing to let start-ups raise capital from small and medium investors; continuing favorable tax rates for venture capital and other investments that finance the growth of ideas and business; providing certainty in financial markets regulation; and consolidating all energy research into a National Institutes on Energy modeled after NIH.⁹⁷

Conclusion: A Now or Never Moment

Robert Kagan wrote that “the American system, for all its often stultifying qualities, has also shown a greater capacity to adapt and recover from difficulties than many other nations.”⁹⁸ America still has inherent advantages that are the envy of the world. An innovative population that is renewed each generation through immigration; world-class universities; a legal system that guarantees the fruits of one’s labor and inventions; top-flight capital markets; a business environment that allows for failure; relative equal opportunity for all genders and races; abundant natural resources; and by-and-large, a political system that works when it absolutely has to.

On December 31, 2012, the Bush tax cuts expire. On the following day, sequestration begins. And somewhere within weeks of this time, the U.S. will reach another debt ceiling limit. It’s the triple-witching hour of fiscal deadlines and expirations. This is the next moment where our political system absolutely has to work to create the first of several grand bargain agreements to put the country on a path to sustained, robust growth.

Voters instinctively get that we must change our path. In our own polling, we found that Americans believe that future economic activity will mostly be created elsewhere, not here. They do not believe that the United States will have the strongest economy in the world decades down the road. They believe the American Dream will be more difficult to achieve for coming generations. They are highly deficit sensitive and nearly all believe that Social Security and Medicare are on a path to insolvency without major reforms.⁹⁹ These sentiments are surely behind the public polling that consistently shows approval of Congress hovering near ten percent.

Moreover, the era of decades-long, one-party rule is likely over. The Presidency, once the providence of Republicans, now is routinely won by Democrats. The Congress, and particularly the House, once the refuge of Democrats, now routinely flips. If progressives and conservatives are waiting for a sustained period in which one party controls all and is able to ram through a wish-list agenda, be prepared for a very long wait.

The good news: we only need one more point of economic growth to ensure that the 21st Century is as robust for America as the 20th. We see this moment as a time to return to what government once did well: seek consensus and begin to create a far-reaching agenda that will solve America’s most pressing long-term problem—our slow growth.

Methodology and Assumptions Underlying Our Economic Projections

Real GDP

All of the hypothetical future economic projections contained in this paper ultimately derive from assumptions regarding what the annualized levels of real (and nominal) GDP will be under two different scenarios: a base case scenario, and an alternative scenario in which the growth rate of real GDP is one percentage point faster than in the base case.

The base case scenario begins with the actual level of real GDP as of 2Q 2012 (as recorded by the U.S. Bureau of Economic Analysis in its August 29, 2012 release of GDP statistics). The annualized levels of real GDP in the base case scenario are calculated as follows. The annualized levels of real GDP in 3Q 2012 and 4Q 2012 are the levels published by the CBO in its August 2012 report, *An Update to the Budget and Economic Outlook: Fiscal Years 2012–2022*. The annualized levels of real GDP from 1Q 2013 through 4Q 2030 are derived by applying growth rates implied by the projections of the annualized levels of real GDP contained in the CBO’s June 2012 report, *The 2012 Long-term Budget Outlook*.

The alternative scenario for real GDP is the same as the base case scenario through 4Q 2017. From 1Q 2018 through 4Q 2030 real GDP is assumed to increase at a 1% faster pace than in the base case scenario.

Nominal GDP

The base case scenario begins with the actual level of nominal GDP as of 2Q 2012 (as recorded by the U.S. Bureau of Economic Analysis in its August 29, 2012, release of GDP statistics). The annualized level of nominal GDP in 3Q 2012 and 4Q 2012 is the level projected by the CBO in its August 2012 report, *An Update to the Budget and Economic Outlook: Fiscal Years 2012–2022*. From 1Q 2013 through 4Q 2030 the assumed annualized level of nominal GDP is calculated from the base case scenario for real GDP by applying the assumed level of the GDP price deflator (see “GDP Price Deflator” below).

The alternative scenario for the level of nominal GDP from 2Q 2012 through 4Q 2017 is the same in the alternative scenario as in the base case scenario for nominal GDP. From 1Q 2018 forward the annualized level of nominal GDP in the alternative scenario is calculated from the level of real GDP in the alternative scenario using the assumed level of the GDP price deflator (see “GDP Price Deflator” below).

GDP Price Deflator

The GDP price deflator calculations use the actual level of the GDP price deflator as 2Q 2012 (as recorded by the U.S. Bureau of Economic Analysis in its August 29, 2012 release of GDP statistics) as a starting point. From 3Q 2012 through 4Q 2022 the GDP price deflator is that which is implied by the difference between the annualized levels of potential real GDP and potential nominal GDP contained in the CBO’s August 2012 report, *An Update to the Budget*

and *Economic Outlook: Fiscal years 2012–2022*. From 1Q 2023 through 4Q 2030 the GDP price deflator is assumed to increase at a +1.90% annualized rate.

Federal Revenues

Federal revenues in both the base case and alternative scenarios are calculated as a percentage of nominal GDP. The percentage rates applied to nominal GDP in both scenarios are those shown in “Summary Data for the Extended Alternative Fiscal Scenario” in the CBO’s June 2012 report, *The 2012 Long-Term Budget Outlook*.

Nominal Personal Income

Personal income in both the base case and alternative scenarios are calculated as a percentage of nominal GDP. The percentage rates applied to nominal GDP in both scenarios are those calculated from the CBO’s August 2012 Baseline Forecast data for nominal GDP and personal income found in the CBO’s August 2012 report, *An Update to the Budget and Economic Outlook: Fiscal years 2012–2022*.

Real Personal Income

Real personal income is calculated by deflating nominal personal income by the assumed PCE price index. The PCE price index calculations use the actual level of the PCE Price Index as of 2Q 2012 (as recorded by the U.S. Bureau of Economic Analysis in its August 29, 2012 release of GDP statistics) as a starting point. From 3Q 2012 through 4Q 2022 the assumed PCE price index is the CBO forecast for the PCE price index as contained in the CBO’s August 2012 report, *An Update to the Budget and Economic Outlook: Fiscal Years 2012–2022*. From 1Q 2023 through 4Q 2030 the PCE price index is assumed to increase at a +1.90% annualized rate.

Employment

All employment projections refer to the total number of people employed as measured by the Bureau of Labor Statistics’ Household Survey (note that this is different from the nonfarm payrolls statistic contained in the BLS’s Establishment Survey).

The base case scenario: Through 4Q 2022 the level of employment is that projected by the CBO in its August 2012 report, *An Update to the Budget and Economic Outlook: Fiscal years 2012–2022*. From 1Q 2023 through 4Q 2030 employment is assumed to increase at a +0.4672% annualized pace (which is the CBO’s projection for the pace of potential labor force growth from 2018 through 2022; please see Table 2-3 in “Key Assumptions in Projecting Potential GDP” Excel file associated with the CBO’s August 2012 report, *An Update to the Budget and Economic Outlook: Fiscal Years 2012–2022*).

The alternative scenario: Through 4Q 2017 the level of employment is the same as in the base case scenario. Starting in 1Q 2018 the annualized growth rate of employment is assumed to be +0.25% faster than in the base scenario.

Rationale: In this paper we speculate as to what various economic variables would look like in the future if, starting in 1Q 2018, real GDP increases at a pace that is 1% faster than what is

generally assumed to be the case. In order to posit a future in which actual real GDP increases at a 1% faster pace while the pace of inflation remains at the desired pace, one must also posit a future in which the *potential* pace of real GDP growth is 1% faster. With a starting point at which the real GDP output gap is zero, or is of negligible size, if the actual pace of real GDP growth significantly outstripped the growth rate of potential real GDP, a positive output gap would develop and become increasingly larger with the passage of time. This would (per generally accepted economic theory) result in acceleration in the pace of inflation.

The potential growth rate of real GDP equals the sum of the pace of labor force growth and the pace of productivity growth. In this paper we assume that the pace of real GDP growth is increased by 1.00% in the alternative scenario via a 0.25% increase in the pace of labor force growth and a 0.75% increase in the pace of productivity growth. Thus, our hypothetical assumption that the labor force, *and* actual employment, increases at a 0.25% faster pace in the alternative scenario.

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- 10 Dan Richards, "Paul Romer: What Drives Economic Growth?" Newsletter, Advisor Perspectives, March 16, 2010. Accessed April 8, 2011. Available at: http://www.advisorperspectives.com/newsletters10/pdfs/Paul_Romer-What_Drives_Economic_Growth.pdf; See also "Rule of Law and Economic Growth," *International Economic Trends*, The Federal Reserve Bank of Dallas, August 2004. Accessed April 8, 2011. Available at: <http://research.stlouisfed.org/publications/iet/20040801/cover.pdf>; See also Gordon, *An Empire of Wealth*, pp. xv-xvii.
- 11 In the 1960s, while the U.S. businesses continued to use less advanced hardware, NASA and DoD bought hundreds of thousands of innovative computer chips—virtually every microprocessor that U.S. companies could produce. These massive purchases rapidly drove down prices. For instance, in the span of only a few years, the price of a processor used extensively in the Apollo lunar program fell from \$1000 to less than \$30. See "Case Studies in American Innovation: A New Look At Government Involvement in Technological Development," The Breakthrough Institute, April 2009, pp. 8-9. Accessed July 23, 2012. Available at: http://thebreakthrough.org/blog/2009/04/breakthrough_report_case_studi.shtml; See also "The Birth of the Microchip," Longview Institute. Accessed July 23, 2012. Available at: <http://www.longviewinstitute.org/projects/marketfundamentalism/microchip>.
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- 13 "Comparison of Base Scenario with Optimistic and Pessimistic Scenarios, 2012-2025," Table, The Conference Board, Global Economic Outlook 2012. Accessed July 23, 2012. Available at: <http://www.conference-board.org/data/globaloutlook.cfm>.
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- 18 Ibid. Table 2-2. Comparison of Economic Assumptions, p. 18.

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26 Ibid.

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30 Ibid.

31 Ibid.

32 Ibid.

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34 Ibid.

35 Ibid.

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37 Ibid. (The analysis uses the CBO baseline budget.)

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