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Slugging It Out, Inside Obama's Mind

By N. GREGORY MANKIW

THROUGHOUT Washington, policy makers are debating how to avoid hitting a wall on Jan. 1, when large and abrupt tax increases and spending cuts will take effect automatically unless Congress acts. The debate is perhaps no more fervent than it is inside the head of our newly re-elected president, who must now decide what kind of policy leader he will become, both in this confrontation and throughout his second term.

Here is the dialogue, as I imagine it, between the two policy wonks — the Moderate Obama and the Liberal Obama — struggling for control of the president's soul.

THE MODERATE OBAMA: I am sure glad the election is behind us. I was really getting tired of giving all those platitudinous campaign speeches.

THE LIBERAL OBAMA: Yeah, me too.

MOD: ... and beating up on Bain Capital.

LIB: Actually, I enjoyed that. It's fun to make the plutocrats squirm.

MOD: The good news for the nation is that we can now resolve the budget impasse quickly and avoid the fiscal cliff.

LIB: Really? I don't see how.

MOD: Didn't you listen to Speaker Boehner's press conference the other day? He's finally conceded the need for more tax revenue. He is ready to throw Grover Norquist's tax pledge under the bus.

LIB: You think Boehner is ready to raise income tax rates for the rich? I don't think so.

MOD: Well, sure, he won't agree to increase tax rates, but he is ready to increase tax revenue by broadening the tax base. As long as the rich pay more, I don't care how we do it.

LIB: We tried negotiating this back in 2011, and nothing came of it. What's new here?

MOD: The election is over. The Republicans are ready to make a deal.

LIB: I'm not sure I believe that. But let's say it's true. Can we raise enough money that way?

MOD: According to the Tax Policy Center, if we cap itemized deductions at $50,000 and keep tax rates as they are today, we'd raise $749 billion in tax revenue over 10 years. And 96.2 percent of the extra revenue would come from the top fifth of taxpayers, with 79.9 percent from the top 1 percent.

LIB: I have a couple of concerns about that.

MOD: What?

LIB: First, if you limit deductions, people in high-tax states will be hit particularly hard, because state and local taxes are deductible.

MOD: Isn't that fair? I don't see why states and towns that choose to have very high taxes should be subsidized by everyone else.

LIB: These states generally have liberal agendas, which I want to encourage, not penalize. And many of them, like New York and California, vote Democratic. After they helped us win such a great victory, I don't think we should be asking our allies to bear a disproportionate share of the burden.

MOD: O.K., what's your other concern?

LIB: I don't think that $749 billion is enough revenue to solve the long-term fiscal problem.

MOD: By itself, it won't solve the problem. We'll need to combine it with reforms on the spending side. Maybe we should gradually but significantly increase the ages of eligibility for Social Security and Medicare.

LIB: Our signature achievement in the first term was to make the social safety net more generous with Obamacare. (I've really come to like that term.) I don't want to devote our second term to undermining the safety net by making Social Security and Medicare less generous.

MOD: But we promised a balanced approach. That meant raising taxes on the rich, together with substantial reductions in government spending.

LIB: We should start by cutting military spending.

MOD: Maybe, but that's not the main source of our long-term fiscal imbalance. Spending on entitlements is.

LIB: Then why don't we focus on bending the cost curve for health care?

MOD: Sure, everyone would like to pay less for health care without reducing its availability or quality. But it's not so easy.

LIB: We have lots of great ideas: increased preventive care, greater reliance on health information technology, more research on the cost effectiveness of alternative procedures.

MOD: That all sounds good, but it ultimately might not amount to very much savings. I am afraid that you're being tempted by wishful thinking.

LIB: We've barely started. Look at Europe. They have a more robust social safety net than we do.

MOD: True, but they pay for it by taxing the middle class more heavily. They impose a value-added tax, for example. We just promised that we wouldn't raise middle-class taxes. Besides, Europe's fiscal picture doesn't look very pretty, either.

LIB: Then we'll just have to raise taxes on the rich even more.

MOD: What are you proposing?

LIB: We can both broaden the base and raise the top tax rates. The economist Peter Diamond, whom we tried to appoint to the Federal Reserve, has calculations suggesting that the top tax rate should be 73 percent. That is close to the 75 percent rate that President Hollande of France is now pursuing.

MOD: Are you nuts? I don't want to become France.

LIB: We don't have to go that far, but we can go higher than where we are now. California just created a new tax rate for married couples earning more than $1 million a year and singles earning more than $500,000. Maybe the federal government should do the same thing.

MOD: California is not exactly a role model for sound fiscal policy.

LIB: True, the state has had its problems. But it is now coming to grips with them, in a progressive way.

MOD: Let's face facts: It's impossible to resolve our fiscal imbalance just by taxing the rich more. The gap between spending and revenue is too big. If we are going to avoid much higher middle-class taxes, we need fundamental entitlement reform. Also, we need to keep Speaker Boehner on board. Even if he wanted to, he could never get the House Republicans to agree to a tax increase as large as you want.

LIB: We've got leverage now. If the House doesn't cave, we can threaten to go over the cliff. The economy would most likely head into another recession, but we could blame it on the Republicans. That prospect should scare them into line.

MOD: Are you really sure that's the mandate we got from the election?