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How to Get That AAA Rating Back

Reagan inherited economic problems and fixed them. Obama's strategy is to blame Bush and Standard & Poor's.

By ROBERT J. BARRO

Ronald Reagan and Barack Obama have at least one similarity. They both were confronted by great economic challenges when they became president.

Mr. Reagan's immediate challenge was that inflation and interest rates were out of control. He met this great test by allying with the Federal Reserve chairman, Paul Volcker, in accomplishing a return to price stability, even through the 1982 recession when the unemployment rate hit 10.8%.

Reagan's success is not in doubt. Inflation and interest rates were reduced dramatically, and the recovery from the end of 1982 to the end of 1988 was strong and long with an average growth rate of real GDP of 4.6% per year. Moreover, Reagan focused on implementing good economic policies, not on blaming his incompetent predecessor for the terrible economy he had inherited.

Mr. Obama was equally in position to get credit for turning around a perilous economic situation that had been left by a weak predecessor. But he has pursued an array of poor economic policies, featuring the grand Keynesian experiment of sharply raising federal spending and the public debt. The results have been terrible and now, two and a half years into his administration, Mr. Obama is still blaming George W. Bush for all the problems.

Friday's downgrade of the U.S. credit rating by Standard & Poor's should have been a wake-up call to the administration. S&P is saying, accurately, that there is no coherent long-term plan in place to deal with the U.S. government's fiscal deficits.

The U.S. Treasury could have responded in two ways. First, it could have taken the downgrade as useful information and then focused on how to perform better to earn back a AAA rating. Instead, it chose to attack the rating agency as incompetent and not credible. In this respect, U.S. officials were almost as bad as Italian Prime Minister Silvio Berlusconi, who responded to warnings from S&P and Moody's about Italian government debt by launching police raids on the offices of the rating agencies in Milan last week. The U.S. Treasury's response also reminds me of Lehman Brothers blaming its financial problems in the summer of 2008 on evil financial analysts and short-sellers.

The way for the U.S. government to earn back a AAA rating is to enact a meaningful medium- and long-term plan for addressing the nation's fiscal problems. I have sketched a five-point plan that builds on ideas from the excellent 2010 report of the president's deficit commission.

First, make structural reforms to the main entitlement programs, starting with increases in ages of eligibility and a shift to an economically appropriate indexing formula. Second, lower the structure of marginal tax rates in the individual income tax. Third, in the spirit of Reagan's 1986 tax reform, pay for the rate cuts by gradually phasing out the main tax-expenditure items, including preferences for home-mortgage interest, state and local income taxes, and employee fringe benefits—not to mention eliminating ethanol subsidies. Fourth, permanently eliminate corporate and estate taxes, levies that are inefficient and raise little money.

Fifth, introduce a broad-based expenditure tax, such as a value-added tax (VAT), with a rate around 10%. The VAT's appeal to liberals can be enhanced, with some loss of economic efficiency, by exempting items such as food and housing.

I recognize that a VAT is anathema to many conservatives because it gives the government an added claim on revenues. My defense is that a VAT makes sense as part of a larger package that includes the other four points.

The loss of the U.S. government's AAA rating is a great symbolic blow, one that would cause great anguish to our first Treasury secretary, Alexander Hamilton. Frankly, the only respectable reaction by our current Treasury secretary is to fall on his sword. Then again, "the buck stops here" suggests that an even more appropriate resignation would come from our chief executive, who, by the way, is no Ronald Reagan.

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