

THE BROOKINGS INSTITUTION

"RESTORING FISCAL SANITY:  
HOW TO BALANCE THE BUDGET"

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Tuesday, January 13, 2004

Falk Auditorium  
1775 Massachusetts Avenue, N.W.  
Washington, D.C. 20036

[TRANSCRIPT PREPARED FROM A TAPE RECORDING.]

**INTRODUCTION:**

STROBE TALBOTT  
President, The Brookings Institution

**PANEL 1:**

ALICE RIVLIN  
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ISABEL V. SAWHILL  
Vice President and Director, Economic Studies Program, The Brookings Institution

## PROCEEDINGS

MR. TALBOTT: [In progress.] --in the front and a couple in the middle over here. So those of you who are standing are welcome to come up front.

I'm Strobe Talbott, and I'd like to welcome all of you to The Brookings Institution for this event this afternoon and thank all of you for coming out. The purpose of this event is to share with all of you the results and some commentary on an important project that we've had underway here at Brookings. I'd especially like to thank the Casey Foundation for its support of this project.

We're releasing today a report called, "Restoring Fiscal Sanity: How to Balance the Budget," and I think it's an indication of interest in that topic that so many of you are here.

There are few issues that are more crucial to the future of this country, and I would say that also have as much implication for America's leadership and the rest of the world, as the U.S. government's fiscal policy. After a brief period of surpluses at the end of the last century, the federal government is now projected to run deficits in the neighborhood of half a trillion dollars annually over much of the next decade. The reason? Rising expenditures, especially for Medicare, Medicaid and Social Security as the baby boomers retire, and falling revenues related to the recent tax cuts.

At the same time, there's a good deal of concern about neglect for certain key areas, such as health care, education, the environment and low-wage workers and their children.

In short, the United States faces some crucial choices. And posing choices in a way that citizens can understand and that public officials find constructive is the essence of what we do here at Brookings. It goes to the very slogan of Brookings, which is, "Independent research shaping the future."

The report today is led--the effort to produce the report has been led by Alice Rivlin and Belle Sawhill, with contributions from a number of Brookings scholars with extensive knowledge and experience on fiscal issues: Henry Aaron, Lael Brainard, Bill Gale, Ron Haskins, Mike O'Hanlon, Peter Orszag and Charles Schultze.

Alice and Belle will begin by providing an overview of the book that they have produced, laying out the magnitude and the implications of the deficit and then outlining some alternative approaches.

We'll then have a discussion, which will consist of a panel of people with extensive experience and expertise on fiscal matters. They include two former directors of the Congressional Budget Office, Dan Crippen and Bob Reischauer; a former chairman of the House Appropriations Committee, and I might add a Brookings trustee,

John Porter; and the former secretary of the Treasury, Bob Rubin, who is also an author, I might add. And, Bob, authors are always welcome around here.

We'll end with a discussion among most of the authors of the book. That will be moderated by Hank Aaron, and there will be time for give and take with the audience as well.

Let me now turn the podium over to Alice.

MS. RIVLIN: Thank you, Strobe, and welcome to this discussion.

This book is about how to balance the budget. We think its significance in the current fiscal debate is that it actually tries to answer the question: If you wanted to balance the budget in 10 years, how could you do it? What specific spending cuts and/or revenue increases would have to be enacted to eliminate the deficit by 2014?

Now, we don't expect everybody to buy our particular answers. Indeed, we'd be delighted if this book sparked a vigorous debate and lots of counterproposals. Our hope is to move the discussion from "should we try to balance the budget?" to "how should we balance the budget?"

We actually have three plans for eliminating the deficit over the next decade. Before Belle tells you a little bit about them, I'm going to talk about how we see the budget outlook, why we think getting to balance is important and what we mean by it.

First, the deficit outlook. The deficit for the current year is now expected to be, in Secretary Snow's words, in the range of \$500 billion. That's about 4.4 percent of GDP. None of us is worried about the consequences for the economy of a large budget deficit this year. The economy is recovering, but labor markets are still very soft, and inflation is nonexistent.

What we are worried about is that these deficits are not temporary. They will remain around 3.5 percent of GDP, even if the economy grows at 3 percent a year for a whole decade.

The top line in Figure 1.4, which is from the manuscript, shows the Congressional Budget Office's latest projection, made last August. And it does, indeed, get back to balance in 2011, but those numbers assume that the tax cuts sunset, that the tax code goes back to its pre-2001 rates and provisions when scheduled to do so in the law. The administration opposes this and wants to make the tax cuts permanent.

The CBO numbers also assume that the Congress fails to reform the alternative minimum tax. The projections were made before the Medicare expansion bill passed, and they assume that discretionary spending grows only at the rate of inflation.

The middle line shows our adjusted projection. That assumes that the tax cuts are made permanent, that the alternative minimum tax is reformed to hold constant the number of taxpayers subject to it, the discretionary spending per capita grows with inflation, and we added the Medicare prescription drug benefit.

In the adjusted projection, you will see, the deficit does not decline. It's a structural deficit. It stays around 3 percent, 3.5 percent of GDP.

So far, we've been talking about the overall budget, so-called unified budget, which includes the surpluses in the retirement accounts; the surplus in Social Security, and Medicare, and Federal Employee Retirement, which offset the deficits in the rest of the budget. These surpluses will disappear as the baby boom generation retires. That's what they're for.

With the looming demographic pressure on the budget in the decade after the next one, we think it's appropriate to achieve budget balance without relying on those temporary surpluses. But if you do that, you're now talking continuing deficits between 5 and 6 percent of GDP. For those who don't like to think in percents of GDP, but who like to think in terms of dollars, we offer another chart from which you can see that by 2014, 10 years from now, the deficits will be \$687--it is projected to be \$687 billion, if you include the surpluses in the retirement accounts, and over a trillion without those retirement surpluses.

Now, projections are very uncertain. Reality could be worse than these projections or it could be better, for a lot of different reasons. But could we grow out of this deficit? Not likely. To get to balance in the unified budget, that is, counting those Social Security, et cetera, surpluses, we'd have to have 4-percent growth every year over a whole decade. Now, we've had 4-percent growth for the end of the 1990s, but having it for a whole decade is a stretch.

Do deficits matter? We think large, sustained deficits matter very much--that's why we wrote the book--especially now. Why especially now? Because the demographics are going to shift against us, nothing uncertain about that. And this will increase the ratio of retirees to working folks dramatically. No matter how we finance the cost of retirement, it will be easier to carry the retirement costs and the health care costs of the retirees if we grow the GDP, and sustained deficits are bad for long-term growth.

Deficits put upward pressure on interest rates. When the economy is at full employment, more government borrowing actually has two effects: It puts upward pressure on interest rates, and it attracts capital flowing in from overseas.

The best estimate that our folks could make of the interest rate effect is about 30 to 60 basis points for each percent of GDP of deficit. Now, that doesn't sound like very much, but it means that sustained deficits, in the range of 3.5 percent of GDP, are likely to raise long-term interest rates 1 or 2 percentage points, and that translates

into lower capital expenditures, lower productivity growth, lower GDP. We estimate that it means about \$1,800 less income per household in 2014.

Higher interest rates also affect households directly, not just through their income, but if they have mortgages or other consumer loans. Interest rate increases of that magnitude could mean \$2,000 a year in additional interest costs for a household with a \$250,000 mortgage.

Moreover, adding \$5 trillion to the debt, plus the higher interest rates, increases the cost of carrying that debt to the federal government itself--the interest that has to be paid every year. We estimate that that would come to about \$3,000 per person by 2014. And interest on the debt has to be paid first before you do anything else. It tends to crowd out funding for other services.

Growth and interest rate effects are mitigated by borrowing from abroad, but that has long-run costs too. Paying interest, and dividends, and profits to foreigners leaves less of our income for Americans to enjoy. Large current account deficits, which we are now running, put downward pressure on the dollar, and we are already seeing that. This can contribute to inflation and lower standards of living, even if the fall is gradual.

But foreigners might lose confidence in the United States as a place to put their money. We could have a sudden flight from the dollar, a spike in interest rates, even a financial crisis. The chances of that may be small, but we shouldn't take the chance. We need the insurance.

And, finally, large deficits and growing debt simply shift the current costs of government to future generations. It's a particularly bad time to do this now, in view of the demographic bulge.

So what's our goal? One could have lots of alternative goals. We considered two:

First, getting to balance in the overall budget, that is, counting the Social Security and Medicare surpluses, in 10 years or the more demanding goal of balancing the budget without relying on those retirement surpluses, and we chose the easier course to balance the overall budget over 10 years. As Belle will tell you, it proved hard enough.

Doing that will require \$534 billion in either spending cuts or revenue increases. If we can cut that much from the budget on these projections, then we would save enough in interest costs to reduce the total deficit by the \$687 billion that we estimate it will be in 2014.

Now, Belle is going to tell you how we propose to do that.

MS. SAWHILL: Well, I hope Alice has convinced you that this is a very serious problem, and my job now is to talk about how we might deal with it. And as she's told you, we talk in this book about three different plans:

The first one we call the smaller government plan. It relies primarily on spending cuts to get to balance in 2014;

The second we call the larger government plan, and it relies almost exclusively on higher revenues to get to balance in the same year;

And the final we call the better government plan. It keeps government about the same size as it is now as a share of the economy, but it reallocates spending in ways that the authors of this book think would make a government more effective and, thus, a better government.

I want to move now to a summary of the three plans and the numbers associated with each, and start with the smaller government plan.

This plan cuts spending, as you can see, by about \$400 billion a year. It does this by scaling back subsidies for business and agriculture, devolving a lot of responsibility to states for everything from education and training to housing and the environment, and by making a variety of other cuts in domestic programs.

But even after all of these draconian cuts, we still have to raise revenues in this smaller government plan. The reason is that we have not been able to find anyone who has suggested other areas that could be cut. We feel we've gone to the bone, but as Alice said at the beginning, we would welcome further thoughts about that.

We, therefore, raise taxes very modestly by doing such things as investing more in the IRS so that there can be better enforcement of existing tax laws, something that the Treasury Department issued a release about today and evidently is planning to do.

The larger government plan bears some resemblance to what many of the Democratic presidential candidates are talking about. It's a kind of synthesis of what we've been hearing from the campaign trail. It makes some modest spending cuts, especially in defense, but these are more than offset by new spending on health, education, assistance to the states, the safety net, and other programs that advocates of a more activist government tend to favor.

The net result is about \$100 billion in additional spending in this plan. That, together with the need to close the fiscal gap, requires over \$600 billion in additional revenues. So we put together a revenue package that we think illustrates how you might raise those revenues, but we didn't feel that you could get there simply by changing tax rates in the current law or reversing all of the tax changes that were made in 2001, 2002 and 2003. So we suggest that a new value-added tax be a part of the

package, and we impose it at a 2-percent rate pretty much across the board, with some exceptions.

The better government plan, finally. It's a little bit complicated. It contains some new spending--\$41 billion, specifically--but also a lot of spending cuts--\$60 billion in defense and \$115 billion in nondefense programs, for a total in spending cuts of \$175 billion. Even so, it still has to rely heavily on revenue increases of \$400 billion to get to balance.

But rather than dwell on these numbers, let me describe the key elements of the better government plan.

First of all, we fund some high-priority initiatives, as you can see listed here on Table 8;

We increase international assistance because we think soft power is as important as hard power in the kind of global environment we now live in.

We increase funding for homeland security, and we have a whole book that we've written on that topic. And although we think much has been done to improve it, we think more needs to still be done.

We fund programs for low-income working families, especially child care and health care, better than they're funded now.

We more fully fund the No Child Left Behind legislation, particularly paying attention to teacher training.

With respect to the environment, although we don't spend any new money on the spending side of the budget, we do think that it's important to get the price of energy right through either energy taxes or a system of auctionable and tradable permits. So we have some options to do that in the book.

We make a lot of selective cuts, very selective cuts in domestic programs and in defense. Charlie Schultze was in charge of domestic spending cuts. He can tell you much more about them. The defense savings come primarily from assuming that we will no longer be worrying about war and reconstruction in Iraq by 2014 and also by some perhaps optimistic assumptions about burden sharing with our allies.

We also make a few selective savings in Social Security and Medicare, which, as you've heard, are growing very rapidly. We don't feel you can make big changes there because--you know, fundamental reforms of these programs are very badly needed, but they are unlikely to affect spending very much over the next decade because it wouldn't be desirable to change benefits for people who are already retired or about to retire.

Having gone through all of that, we still have to raise some revenues. That cannot be avoided. The reason is because revenues, as a proportion of GDP, has shrunk so much in the last few years.

How do we raise the needed revenues? Again, there are lots of possibilities here, but we illustrate one that increases the top four rates; that is, the rates in the income tax system that are above 15 percent; we raise the earnings ceilings for Social Security payroll taxes from about \$88,000, where it is now, to \$130,000; we repealed the lower tax rates on dividends and capital gains that were enacted in 2003; and we retained the estate tax, although with a larger exemption, and we make a few other changes that are detailed in the book.

Having done all of that, we realize this would be extremely difficult to enact politically and that it would help if we had better budget process rules to help guide the process and to give members of Congress some reasons to say no to additional tax cuts and additional spending increases, and so we outline for you here the kind of budget rules that we think are necessary.

Well, I've only scratched the surface, and I've run out of time or more than run out of time. You can access the entire book, including this PowerPoint and the Executive Summary, at this website.

I just want to make a couple of concluding comments and emphasize three points that I think stand out, having gone through this exercise:

The first is that you can't get from where we are to balance without new revenues. Anyone who says that you can should be asked to show specifically how that could be done.

Second, that doesn't mean that spending can't or shouldn't be cut. We identify a total of \$175 billion a year in cuts in the better government plan, and we believe, if they are used in the right way--and I emphasize being used in the right way--this would actually make government more effective than it is now.

However, all of these actions are likely to be extremely unpopular, so the public very much needs to be convinced that deficits are sapping our national strength and undermining their own and their children's well-being, otherwise there will be no incentive for their elected representatives to do anything about the problem.

Let me stop there and turn this over to the next panel.