

THE BROOKINGS INSTITUTION

"RESTORING FISCAL SANITY:
HOW TO BALANCE THE BUDGET"

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PANEL 3:

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QUESTION & ANSWER SESSION

PROCEEDINGS

MR. AARON: --this project on the budget deficit. So it's altogether fitting and proper that we have a time deficit, running a bit behind schedule.

Alice Rivlin and Isabel Sawhill began the afternoon by giving us an overview of the project and the general reasons why addressing the budget deficit is so important. The members of the second panel tried to explain the stakes in deficit reduction, which, in Bob Rubin's terms, were nothing less than the future stability and growth of the U.S. economy.

This final session is going to get quite specific. The distinguishing feature of this project is its insistence that to be serious about the budget deficit, you have to get specific. When it comes to dealing with the budget deficit, high-flown generalities just won't cut it.

You have to pinpoint which programs will be cut, and how much, and which taxes will be increased, and how much, and that is what the authors of this project have done. We have five of them here on the platform, six if you count me. Here's how this session is going to work. I'm going to ask each of the five members of the panel a question or two to jump start the discussion. They will respond in I hope not more than four minutes, given our time deficit. I hope that whoever is sitting in the front row flashing signs at the speakers will help us out on that.

Then, we're going to open the questioning and the comments to the floor. Time is short, so I would ask you to state your name and be brief, as were the questioners in the preceding session.

I'm going to give the first question to Ron Haskins, who was responsible for putting together the small government program that is in the budget book. Ron has extensive experience on the Hill, having worked on welfare reform legislation that passed in the late 1990s--I think probably he is more responsible than any nonelected official for the shape of that legislation. He has been working with Isabel Sawhill on a project, "Welfare Reform and Beyond," and is a senior fellow here.

One of the more striking characteristics of the small government program is that even that program has \$130 billion in tax increases in the year 2014. It didn't rely entirely on spending cuts.

The question I would have is a combination of politics and policy. Do you think there is any likelihood that people who are sympathetic, philosophically, with the small government program would be willing to buy a program with tax increases of that size?

MR. HASKINS: First of all, the most interesting part of this project for me was going through the budget and trying to find rational, even irrational, cuts that

would add up to what amounted to almost \$550 billion, because that's, under our rules, what it would take reach zero deficit in 2014.

And we did that. We went through all of the CBO documents. We got a very nice hand from the Cato Institute--Bill Niskanen is here--and found about \$130 billion in so-called corporate welfare. We found a lot of money by devolving responsibility to the local and state government, which is something Republicans like to do a lot. And we even cut entitlements by over almost \$80 billion.

And yet when we got through with that, Washington was completely devastated. There are no toilets at HUD any more.

[Laughter.]

MR. HASKINS: There is virtually no Department of Education any more, which some people would regard as an advantage, and yet we were short. So we decided that it made more sense, politically, to have some tax increases, and so we tried to go through and take tax increases that did not disturb the 2001, 2002, 2003 tax cuts, that did not change the tax brackets, and yet were tax proposals that had some credibility because they had been suggested by the Congressional Budget Office in that Budget Options book or because one or more members of Congress had proposed them.

So, now, this brings us to the last question, which was posed in the previous panel, and that is, is it plausible to think that President Bush, and Republicans currently in Congress, would support tax increases as part of a budget deal? And the answer is, no.

[Laughter.]

MR. AARON: Full stop.

MR. HASKINS: Yes.

MR. AARON: We'll come back to that, I suspect.

[Laughter.]

MR. AARON: The person who was responsible for putting together what we called the better government program was Charles Schultze, who served as director of what was then called the Bureau of the Budget, and then was chair of the Council of Economic Advisers, and who is the father of the lengthy series of studies referred to in the prior panel entitled, "Setting National Priorities," which is the precursor for this effort.

That better government program had a lot of spending cuts in it, but it didn't have as many, as in the small government program. Could you give us some idea

of what principles guided the deletions and the selections, and maybe give us an example or two to illustrate those principles.

MR. SCHULTZE: I just wanted to start by saying I'm proud to be here, not as a big government man or a small government man, but a better government man.

[Laughter.]

MR. SCHULTZE: And that made the job a lot easier. I also want you to know that my first year as budget director, with a little help from "which shell is the pea under," we kept annual spending in that year under \$100 billion. So I should be with the small government program.

Let me talk about the better government budget cuts. In selecting what to cut and not to cut, we used a number of different criteria. Some of them stem from an economic view about the kinds of things that the federal government ought to do and what should be left to the private sector.

For example, in the better government plan, we propose increasing the incentives for the private sector to undertake environmentally friendly research and development through imposing a modest carbon tax, backed up by auctioning off tradable emission rights. Simultaneously, we propose eliminating the Department of Energy's applied research program and fossil fuels and renewable sources, since the private sector is much better qualified to select and carry out applied projects than is the federal government, which has a poor record in this regard.

On the other hand, we kept intact the funding for the Department's general and basic energy programs. It's hard for the private sector to capture the returns from basic research. And without federal government support, it will be underfunded.

Another example, state and local grants. The smaller government program eliminates, by 2014, some \$123 billion of annual discretionary spending that it argues should be the function of state and local governments. And that includes all federal grants for elementary and secondary education, housing and urban development, manpower training and the administration of justice.

In the better government plan, our criteria substantially narrowed the field of cuts, but still allowed for some \$17 billion in reductions among grant programs in the year 2014. For example, with very few exceptions, we didn't cut grants designed principally to assist the poor and the disadvantaged. We also exempted grant programs aimed at high-priority national objectives.

And so, for example, again, while we eliminated or cut some categorical federal grants to education, we didn't touch the large grants to disadvantaged schools nor a number of others that fund the No Child Left Behind program. So, in effect, we were

easy on the poor, and we picked out some that appear to be major national objectives and cut around those, not in them.

As another obvious criterion, we decided to cut back or eliminate investment in research programs that delivered national benefits significantly less than their costs. And what I consider to be a prime example is human space flight. We propose phasing it out. Essentially, that consists of the shuttle program and the international space station, and give me just a couple of minutes on that.

The original objective of the space program--of the space shuttle--when first planned, was an inexpensive way for delivering many scientific military and commercial missions. The original plan was going to have 25 to 60 flights a year. But the enormous complexity, costs and payload limitations imposed by the necessity to provide for human beings in space sharply reduced its attractiveness to potential clients.

The Air Force was to be a big player, but it has dropped out as a major user. So have potential commercial users. The really important scientific missions are now carried out with unmanned vehicles. The 25 to 60 flights dropped to 8, and then to 5 a year, and most of those go to the international space station just to build and supply it.

One long-time NASA historian, now a history professor at Duke, captured it pretty well. "Any scientific mission you can identify to do in space, you can design and build an unmanned spacecraft do it more effectively, more economically and more safely." The scientific work done on the shuttle is not of major importance.

Real quickly, what about the new proposal of President Bush to build a permanent manned base on the moon and send astronauts to Mars? We don't know the details, so it's hard to get a ballpark even on the cost, but sometime ago President Bush, Sr., proposed a moon and Mars mission. NASA published cost estimates, some of which foresaw costs that, in today's dollars, amounted to over \$25 billion a year for 20 years. The sticker shock doomed that program.

Given the history of such estimates, the costs would almost surely be much higher. And what national purpose does all of it serve? The main purpose of establishing a human-inhabited moon colony and then a manned mission to Mars can't be scientific knowledge. A huge fraction of the costs will have to go simply to support human life, and the cost per unit of genuine scientific achievement would be enormous.

As far as I can tell, what this would be is a modern equivalent of the old Roman "bread and circuses" without the bread.

[Laughter.]

MR. AARON: But what do you really think, Charlie?

[Laughter.]

MR. SCHULTZE: If you want to know--

MR. AARON: No--

MR. SCHULTZE: Years divisible by four is good for these sorts of things.

MR. AARON: Lael Brainard and Michael O'Hanlon co-authored the chapter on National Defense and International Security. Michael is not here. Lael is. Lael was Deputy Director of the National Economic Council in the Clinton administration. She has been a senior fellow here at The Brookings Institution for some years since.

And I think it would fill a gap in the discussion so far if we did talk a bit about national defense. We live in a pretty dangerous world, what with Iraq, and al Qaeda and North Korea. Yet two of the three programs in this volume call for a cut in national defense of about \$60 billion from the projected baseline. Does that make sense?

MS. BRAINARD: In fact, the better government scenario, lays out what it takes to achieve a strong national security in the context of fiscal responsibility, which I like to think of as a Brookings hallmark. It's premised on the strong belief that at this moment, when the United States is confronting new threats that could prove as sustained as the totalitarian challenges of the last century, we can't afford to shortchange America's security.

Indeed, we look at homeland security, foreign affairs and diplomacy and defense as a unified national security budget and argues for increases, in real terms, for all three elements.

The better government plan provides a scenario in which overall national security spending grows 1.5 percent per year, in real terms, but still gets \$40 billion in savings below the CBO baseline projection of \$737 billion out in 2014.

How does it do that? Well, partly by reallocation. It provides a very large increase of resources in both homeland security and in soft power encompassing American foreign aid, and diplomacy abroad, to address challenges ranging from radical extremism to killer diseases, like HIV/AIDS, uneven globalization, and states that fail their own people.

It also argues for the creation of a more substantial standing civilian capacity for post-conflict reconstruction and complex emergencies to take the burden partially off the military, recognizing that we have engaged in six or seven of these kinds of nation-building exercises in the last 15 years alone and that this is something that we cannot afford not to prepare for looking towards the future.

In terms of the defense budget, it provides for growth from the current level of about \$407 billion to \$589 billion 10 years out. That's about 1-percent growth, in real terms, annually. Nonetheless, we get \$60- billion savings in that one account alone, relative to the CBO baseline.

How do we do it? Well, partially we get a big benefit from a very important assumption, which is that we're out of Iraq and Afghanistan by that time. That is an absolutely critical assumption. It also makes some other fairly heroic assumptions.

One is that we are not engaged in any other new major overseas' commitments at that time, that the United States makes very smart and economical choices about weapons modernization and figures out how to save money in defense support activities through privatization and other mechanisms, not something we've done so well on previously, and that allies pick up a larger share of the collective cost of our security.

If we don't make those assumptions, Mike O'Hanlon would point out strenuously if he were here, the defense budget could easily exceed \$650 billion and even reach \$700 billion.

The message to take away from this exercise is not, hey, look, we can get to a balanced budget in 2014, and this is going to be easy. If you look just over the last three years, the unified national security budget has actually grown by \$200 billion above what was anticipated by the administration in FY 2000. It's been an enormous contributor to the expansion of federal spending.

This is an area where we have a very difficult time predicting what the contingencies are going to be even a few years out, so it tells you that, even under fairly optimistic assumptions, it's going to be very difficult to achieve these goals in 2014. To the extent that we need to build in cushion, this is one of those critical areas that we might want to have that cushion.

MR. AARON: Thank you very much, Lael.

Peter Orszag and I worked on a chapter on the Big Three entitlements-- Social Security, Medicare and Medicaid. This is the area where Dan Crippen emphasized, along, I might say, with many others, that the long-run budget problem is concentrated.

Still, in our chapter, we used cuts in the entitlement programs, those Big Three entitlement programs for only about a quarter of all of the spending cuts that are listed and about 10 percent of the job of closing the overall budget deficit. Many people might say that we have dodged the issue.

Peter, what would you tell them?

MR. ORSZAG: Well, did we?

[Laughter.]

MR. ORSZAG: No. The focus of this book is balancing the unified budget by 2014. That is clearly not sufficient to address the whole long-term problem facing the nation, as given the significant costs associated with the retirement of the baby boomers after 2014, but it would be a solid first step in the right direction.

Also, those long-term deficits are one of the key motivations for balancing the budget by 2014--the unified budget by 2014. Balancing the budget by 2014, in other words, ahead of the bulk of the cost of the baby boomers, would help better prepare the economy and the federal budget for the costs that will be associated with the baby boomers' retirement through Social Security, Medicare and Medicaid.

So the book does not pretend to address the longer-term problems facing those entitlement programs, all of which are enormously complicated. We, after all, tried to keep this book to under 100 pages and barely succeeded. However, Brookings scholars, in different forums, have tried to address those longer-term problems in separate volumes. Most recently a book that I wrote with Peter Diamond of MIT on "Saving Social Security," offered one possible way to address the long-term problem in that program.

But I think the key thing is that whatever one's views are about the right way of addressing Social Security, Medicare and Medicaid problems over the long term, almost everyone--not everyone--but almost every analyst would agree that we should do the changes in a gradual way to avoid abrupt tax increases or benefit cuts. And what that necessarily requires is that the cost savings over the next 10 years are relatively modest.

So the bottom line is we want to start sooner--and, in fact, we need to start sooner--in order to address the long-term problems facing these programs without abrupt changes, but the gradual changes that most people think would be warranted as sound reform mean that we don't save that much money over the 10-year budget window. Let me give you an example.

The President's Commission to Strengthen Social Security adopted the principle that those 55 and over, at the time of Social Security reform, should be held harmless. Their benefits should not be changed. Those 54 and younger, in 2004, don't become eligible for Social Security retirement benefits until 2012 and thereafter, and they also account for only 5 percent of the total benefits paid between 2005 and 2014.

That means that if you are going to hold the current retirees and near retirees harmless from the changes, there's not a lot that you're going to get in the budget window that we're looking at.

Nonetheless, entitlement reform can contribute something to budget balance over the next 10 years, and we discuss various options in which those longer-term reforms that would be sensible structurally can feed in and help to address the shorter-term budget problems, including possible changes to the index that is used for Social Security costs of living adjustments, including changes to the Part B premium under the Medicare program, including changes to the disproportionate share hospital program and teaching hospital programs under Medicare, and others. So, in the volume, you do see some savings that are coming from the entitlement programs.

In my remaining 45 seconds, I just want to hit one point, which is that sometimes one gets the sense that there is a fiscal crisis being created on purpose in order to force long-term entitlement reform. And in the paper that was mentioned before with Bob Rubin and Alan Sinai, we addressed this possibility and argue that it's a very risky proposition, in large part because there's no guarantee that it will work.

It's too easy for those who would be adversely affected by long-term entitlement reform to point to the tax cuts or spending increases that created the short-term fiscal crisis and say, but for those, we wouldn't need to undertake the painful steps that are part of long-term entitlement reform. And if you get a political impasse as a result, you wind up with the sorts of fiscal disarray that Bob Rubin spoke about on the panel earlier.

So, in our opinion, re-establishing an environment of fiscal discipline over the medium term, reaching balance by 2014 on the unified budget being a good example of that, could actually help long-term entitlement reform, rather than hurt it. And, again, sensible long-term entitlement reform should begin earlier, rather than later, so that the changes can be gradual. You'll get some saving, but it won't be monumental, over the next 10 years.

MR. AARON: Thanks very much, Peter.

The last section of the book that we're going to review before we open the floor to you for questions is the chapter that concerns tax policy. Perhaps the most successful start-up in recent Brookings history, I think, has been a Tax Policy Center that Peter Orszag and Bill Gale are co-directors of, in collaboration with colleagues at The Urban Institute.

This center has become, instantly, a source of highly reliable information, and there is a website connected to the Brookings and the Urban Institute sites. They are two of three authors who worked on the chapter on tax policy for this book. All of the options have some revenue increases.

Unlike the rest of the book, this chapter does not present programs for action so much as it presents a menu of possible ways of increasing revenues.

It includes a large list, but it doesn't raise the possibility of sweeping or fundamental tax reform, a topic that has been discussed so widely and for so long.

Bill, why did we shy away from that, and why did we include the items we did?

MR. GALE: Thank you. I have four points to make in response to the question, and I'm going to answer the question in the second of the points.

What we did in the tax chapter was look at several different tax options in the spirit of the CBO volume that looks at deficit reduction options. We looked at repealing some or all of the recently enacted tax cuts or what amounts to the same thing in the long term, letting them expire. That was one set of options.

The second set of options was a variety of what you might call smaller tax increases: sin taxes, adjustments in enforcement, adjustments to the way the tax system is indexed, some adjustments to the payroll tax, some relatively minor base-broadening initiatives.

The third category was to look at new taxes. Here we focused on a carbon trading permit system and a value-added tax. I think a couple of lessons come out of all of this.

The main one is, sort of the "Willy Sutton Theory of Tax Changes": that is, the real money is in letting the existing tax cuts expire or partially repealing them or in enacting a value-added tax. If we repeal or let expire the portions of the last three tax cuts that do not affect middle-income taxpayers, we'd save about 2 percent of GDP in revenues, on an annual basis, by 2014.

Likewise, if we had a 5-percent value-added tax that excluded religion, education, health care and small business, we would raise another 2 percent of GDP in 2014. To put that a different way, if we had a value-added tax of 8.5 percent, we could finance the whole 2014 budget shortfall.

Now, those are meant to be illustrative numbers. In the chapter, we put together different packages, but we don't come down and say, "We prefer X, Y and Z," but if you can do arithmetic, you can make the choices yourself.

The second point I want to make has to do with fundamental tax reform. We did not propose a flat tax or a sales tax or a USA tax or anything like that. We did, though, do a lot more than just bow in the direction of tax reform.

One point is all of the plans contain a fully reformed alternative minimum tax that basically solves the AMT problem. For those of you who are not aware of the AMT, it's basically growing like kudzu and will take over the whole income tax in the next decade if we don't do something about it. So all of our plans include a substantial

adjustment to keep the number of AMT taxpayers down around two or three million households.

The other thing is we do consider value-added tax as an add-on to the existing system, not as a replacement. Certainly if you're thinking about fundamental tax reforms in the long term that will raise revenue, the value-added tax is at the top of the list as a candidate.

Now, I want to make two more points, and one that has to do with what Ron Haskins said. I agree there is no way that President Bush and a Republican Congress will raise taxes. So why talk about taxes as part of the solution at all? Well, there's an asterisk to the point that they won't raise taxes, and that is they won't raise taxes relative to current law. The adjusted baseline that we use has over \$550 billion in tax cuts in 2014 relative to current law.

What that means is that our small government plan, which was described as having a \$130-billion tax increase, really has a \$400 billion tax cut relative to current law.

The better government plan, the middle plan, which has a \$400 billion tax increase relative to the adjusted baseline, is really a \$150-billion tax cut, relative to current law.

So there's ample room to "raise taxes" relative to the adjusted baseline, even without going above current law. And that's really important because over 200 House members have signed the "No New Taxes" pledge. I think 37 Senators have signed the "No New Taxes" pledge, and one chief executive of the United States has signed the "No New Taxes" pledge.

So raising taxes relative to current law is going to be a very difficult constraint to overcome if the Republicans stay in power, but that still leaves plenty of room to raise taxes relative to the adjusted baseline.

The last point I want to make has to do with the role of taxes in the long-term situation. Everyone agrees that Social Security, Medicare and Medicaid are a big part of the long-term fiscal problem. The point you should be aware of, though, is the tax cuts, which expire at the end of the decade, are an equally large part of the long-term fiscal problem.

Letting all of them expire gives you about 2.5 percent of GDP in revenues. Over 75 years, that is about equal to the shortfall in the Social Security and Medicare trust funds. So tax policy changes that look like pretty basic have long-term effects that are equal to the whole 75-year actuarial shortfall in the two biggest entitlement programs. So don't leave tax policy out of the long-term fiscal problem.

MR. AARON: Thanks to the panel, and now the questions are up to you. Please state your name, a brief question and the name of the person on the panel to whom you wish to direct it.

There's a lady in a--I'm color blind--but I think a red suit there.

QUESTION: Sara Watson with the Pew Charitable Trusts. This is for Mr. Schultze and perhaps Mr. Haskins as well.

There are some domestic policy programs, in particular, high-quality early education, that lots of data have shown have benefits that outweigh the costs. I am wondering if you believe that research and, if so, are you willing to put investments in a budget that reflect the expectation that these types of programs would result in lower government expenditures over time because of the benefits that they provide?

MR. SCHULTZE: Well, in the area that you're talking about, which is essentially domestic spending outside of the big entitlement programs, we have put in, it's not a big amount of money, but it's \$20 billion a year, as of 2014, for high-priority programs, among which are programs to improve the educational system, to improve educational attainment, et cetera, et cetera, et cetera.

Now, whether that would be particularly the programs you're talking about is another question, and at that level, we didn't pick and choose. We did--what's the word I want--explicitly provide for additional funding for the No Child Left Behind initiative, but I must say, at this stage, we didn't go into greater detail of doing it.

MS. SAWHILL: And pre-K.

MR. SCHULTZE: Pardon?

MS. SAWHILL: And pre-K.

MR. SCHULTZE: And for pre-kindergarten, that's correct. And for pre-K education. Thank you, Isabel. In fact, since Isabel did it--

MR. HASKINS: So the point is that the better government plan did anticipate investments in pre-school programs precisely in accord with your question.

My answer is, first of all, I think that the small-scale programs, like Abecedarian, Perry Preschool and a few others, have demonstrated that you could produce benefits that exceed costs. But the larger-scale programs, and especially national Head Start, and as you probably know, by next year we'll have the results of a national study, and I predict they will not show those kind of benefits will exceed costs.

However--forsaking my Republican commitments--the problem of the gap in education between poor kids and wealthier kids, particularly minority kids, is so

great, and the problem is so important, that I nonetheless would invest money in preschool programs because we do have some good data. We know it's possible, and especially if we could figure out ways to combine it with the money we already have in child care and with Head Start, I think there's at least a chance that we could close the gap before the kids come to public schools. And if we don't close that gap, I don't think the public schools will ever be able to do it. So I would make room for it and, indeed, the better government plan does.

MR. AARON: The gentleman with the blue sweater, I think.

QUESTION: Black, actually, but I had to look.

[Laughter.]

QUESTION: This is arguably--

MR. AARON: Name, please--name and affiliation.

QUESTION: Gary Mitchell from the Mitchell Report.

--arguably a question for the prior panel and/or the editors, but let me frame it anyway, if I may.

"Restoring Fiscal Sanity" is an economic document with three strategic options, but achieving fiscal sanity is really a political challenge. And my question is, is there an opportunity in this process somewhere, looking forward, to consider political and sort of strategic communications options for getting this job done, since that's ultimately--I think as Congressman Porter suggested--that's ultimately how this all gets done?

MR. AARON: Alice, do you want to come up and speak to that?

MS. RIVLIN: Well, I think the questioner's point is obviously right. None of this happens unless the public is aroused, and the public can be aroused in two ways, some of which we've talked about. One is being convinced, through a major media effort; the other is a crisis. And I don't know which is the most likely to happen, but my hope is that we do get some political leadership willing to put out the effort to convince the public that this is important.

MR. AARON: Thank you, Alice.

I want to just say one thing about that. It seems to me that the media do play an absolutely critical role here. It's about time that the media stop being quite so soft and pliant before elected leaders and would-be elected leaders from both political parties. I think the distinguishing characteristic of the budget problem that we're talking about is that we're getting lousy leadership from both parties.

Yes, sir. The gentleman--

QUESTION: Howard Rolston, temporarily retired.

[Laughter.]

QUESTION: My question has to do with devolution to the states and what that would actually gain. It assumes that states would show fiscal discipline because they need to balance their budgets, but I think what we've seen over the past four or five years is that they're pretty good at, in effect, deficit spending and putting off current cost to pay for them in the future.

So what kind of assumptions did you make on these devolution cuts, in terms of what state behavior would be?

MR. HASKINS: The answer is straightforward. We made no assumptions about what they would do, but clearly the implication of the devolution proposal, which is about \$150 billion, \$140 billion, is that the states would be responsible for education, environment, education and training, a whole raft of responsibilities that have now been claimed at the federal level.

As you know very well, in Republican philosophy, this is an appropriate thing; that Republicans traditionally have felt that, beginning with the New Deal, and especially with the war on poverty, that the federal government absorbed responsibilities that should have been properly the preserve of states and localities. You're shaking your head. I guess you're not a Republican, but--

QUESTION: [Inaudible.]

MR. AARON: I think we're going to have to avoid the side discussions away from the microphone. We've heard the answer.

We'll take two more questions, and then we're going to have to break this up.

The young man in the suit there.

[Laughter.]

QUESTION: My mom is waiting outside, so I'll try to be quick.

[Laughter.]

QUESTION: I'm Brian Riedl from the Heritage Foundation. I have a question about the tax policy assumptions.

With the revenue assumptions of the president's tax cut, what percent feedback effect did you calculate would recover revenue from increased economic activity, given the fact that the tax cuts get so large that certainly even a small percentage of feedback effect from increased revenue could recover a proportion of it? I'm just wondering what calculations, what percentage, approximately, you assumed.

Thank you.

MR. AARON: I think it's safe to say that both of the respondents can say they're glad you asked that question.

Go ahead.

MR. ORSZAG: Two answers to the question.

First, in doing the estimates, we tried to replicate the Joint Tax Committee numbers using the Tax Policy Center model. That required some microeconomic behavioral response, but we did not take into account macroeconomic behavioral responses, and let me just say a quick comment on that.

The macroeconomic studies that have been done of the 2001 and 2003 tax cuts, which were deficit finance, reflect the interplay between two effects: possibly modest, but positive, effects from reduced marginal tax rates, which boost economic activities, and then the negative effects from higher budget deficits.

When people try to take both effects into account, the Joint Committee on Taxation, researchers at Berkeley, here at Brookings, at the Federal Reserve and elsewhere, have suggested, if anything, the effect is negative. So those who try to say that, over the long term, the feedback effects--

And that, by the way, is only taking into account the conventional analysis of budget deficits, let alone the things that Bob Rubin talked about, where you have even larger effects.

I don't know if Bill has anything else to add.

MR. AARON: Bill does not. We want to move on.

[Laughter.]

MR. AARON: You had your hand up, Bill Niskanen, from Cato, and you will get the last question.

QUESTION: Rare for Cato to have the last word.

I'm amazed that you couldn't find more than \$60 billion of savings in the defense budget, doubly amazed that there are no defense cuts in the smaller government option, and absolutely dismayed that not one of you mentioned the Constitution as having any relevance to what the federal government ought to do and should not do.

MR. HASKINS: Let me say something about the defense cuts. I entirely agree with you, and, in fact, in retrospect, I wish I had said that it would be possible, under the smaller government plan, to get the \$100-and-almost-40 billion that we need. So you could do the entire thing with cuts if you cut the defense budget.

But we made the assumption in the beginning that there would be very few conservatives that would support cuts in defense, and we were trying to make it somewhat plausible. I can tell by your question that you regard that as a mistake, but that was an assumption we made, and we were determined to do it without cuts in defense or homeland security.

So that's the answer. It might have been a mistake to make that assumption.

MS. BRAINARD: Just on the issue of the better government plan and why it wouldn't cut defense by more than what is assumed now, which is real growth of about 1 percent per year, I think Mike O'Hanlon, who is an expert on these issues, thought that that was not only politically unrealistic, but also, from a policy perspective, unwise, for several reasons.

One, we are in a new world where national security is not going to go away as a top priority on the national agenda. We are involved in a long-term war on terrorism. If anything, people are not calling for cuts in the Armed Services right now, but rather for expansions.

The spending projections we made depend centrally on our allies abroad taking a greater share of the burdens. And let's not forget that our allies are not particularly inclined to do that, given their own fiscal circumstances.

Third, the Defense Department has been asked to shoulder an increased burden in the area of homeland security, which we factor in here.

Fourth, the procurement holiday, which Mike refers to in the chapter on national security, is over, and so weapons modernization is essential going forward.

So in fact the better government plan is quite an optimistic set of assumptions about what one might be able to achieve in the 2014 time frame.

MR. AARON: I want to thank you all for your attention and your participation.

[Applause.]

MR. AARON: The message of this day I think is simple and clear. It is, that is that irresponsible budget policy, if allowed to continue over the long run, seriously threatens the well-being of the United States of America. Current economic policy may be grievously misguided, but so far the damage is limited. We can still get the economic train back on the tracks with major, but not Herculean effort. But as a number of the speakers have emphasized, time is not on our side.

We also want to stress that this is not a debate about small government versus large government. It's possible to be a fiscally prudent conservative or a fiscally prudent liberal, but it is not possible to be both fiscally undisciplined and a responsible steward of this nation's future.

Again, thank you very much. I believe refreshments are available across the hall.

[Applause.]

[Whereupon, the proceedings were concluded.]