BROOKINGS INSTITUTION

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Moderator Ladies and gentlemen, thank you for standing by and welcome to the Bush's New Economic Staff conference call. At this time all participants are in a listen-only mode. Later we will conduct a question and answer session, and instructions will be given at that time. As a reminder, this conference is being recorded.

I would now like to turn the conference over to our host, our guest scholar, Bill Frenzel. Please go ahead.

B. Frenzel Bill Gale and I are going to open with very short presentations and then we'll be grateful to you for placing the smart questions to bring up the things that are perhaps really important to you. I'd simply like to say that the three new members of the team, that is Mr. Snow, Mr. Freedman, and Mr. Donaldson, are first class people of high achievement in the business world. It seems to me from a political standpoint that Mr. Snow has no trouble with confirmation. I suspect that questions will be raised of Mr. Donaldson, but I also believe he will be confirmed promptly.

These three men join a staff already in place, which includes the Secretary of Commerce Evans, Budget Director Daniels, CEA Chairman Hubbard, and then of course the outsider, but maybe taller than any of them, Alan Greenspan. The budget and tax policies of the administration are probably pretty well defined at this time, although they haven't been presented. The new members will help to add form to the skeleton, but a lot of their decisions have been already made and they will be I'm sure polishing up the details.

The change of the guard was done a little bit clumsily in my judgment, but represents the administration's way of telling the American public that the intention is to spend more time worrying about the economy this year and using the new faces to present the new budget and tax programs. There will be a tax program. I'll leave that discussion more to Bill. We don't know its form. We can only suspect it, but we have been advised to expect a substantial tax cut program, because of worrying about the economy.

With that, I'd like to pass the baton to Bill Gale.

B. Gale I will be equally brief. I have much less to say about the individuals involved. I don't know any of them. All I can tell you is what I read in the papers that it's somewhat surprising that they are as moderate or have been as moderate in the past as they seem to have been given the penchant in the administration right now for tax cuts. In terms of what's on the economic agenda, the tax cut agenda; a number of proposals are still floating around.

It's really important at the beginning to try to figure out why it is that we're actually talking about tax cuts right now. If the answer is to stimulate the economy, most of the proposals under discussion would be at best weak stimulus and at worst would work in the wrong direction. If it's not stimulus, what is it? The whole discussion right now has been fairly muddled and there are probably half a dozen major ideas floating around, but none of them are good ideas until or unless we figure out why it is we're cutting taxes.

Let me just stop there. It's time to turn it over to questions.

Moderator Our first question will be from the line of Jonathan Weissman, *Washington Post*. Please go ahead.

J. Weissman I understand that you generally have not supported tax cuts as stimulus. The administration appears to be leaning toward investment side tax cuts on the assumption or the understanding that the business investment has continued to lag. Why do you say that at least another round of bonus depreciation allowances would not have any impact?

B. Gale Investment is lagging right now, because there's a very high level of unused capacity in the economy. It's close to the highest level in 20 years. It's hard to see why businesses are going to buy new things when they're not using the things that they currently use. Investment has been lagging in the last year to even though we had a stimulus package, even though we had this 30% expensing, that alone was supposed to boost investment or why did we do it? On top of that we have very low long-term interest rates and very low inflation rates right now, both of which independently served to reduce the cost of investment even with no change in tax policy.

If you look at the actual cost of investment right now, it's gone way down over the last couple of years. That has not proven to be an effective stimulus precisely because there is so much unused capacity. I don't think that if we provided more depreciation bonuses that that would necessarily do anything. What it would do would be to give firm subsidies for the investments they were going to do anyway, but that's not an investment stimulus. I doubt seriously that it would get firms to be investing more, because they already have unused plant and equipment.

J. Weissman A lot of the administration folks that we've been talking to say that these are not supposed to be tax cuts necessarily to prompt investment now or even to stimulate the economy. They said that these are good tax cuts, good policy on their own. Would you agree with that?

B. Gale If you want to turn to longer-term forms of tax structure there are definitely issues to debate, but the administration has taken a very one sided view, in fact a very economically unsound view of what a good tax structure would look like. For example, we allow firms to deduct their interest payments. In combination with overly generous depreciation deductions that can make the effective tax rate on new investments negative. That happened in the early '80s. That was one of the problems with the '81 Tax Cut Act was that the provisions were so generous that the firm actually got more in deductions from an investment than it actually paid in taxes and so the effective tax rate was negative.

What I'm trying to say is you don't want to design the depreciation provisions independent of the interest provisions. The administration doesn't seem to me to be talking very carefully about that. It seems to me they're just saying more investment is good so let's do anything we can to subsidies more investment. That's not a fundamental notion of good tax policy. Another example of this where they try to pull the tax structure trump card has to do with the taxation of dividends. I'd be perfectly in favor of the following policy. Shut down corporate shelters, shut down corporate subsidies, what used to be called the corporate welfare payments and use that revenue to reduce the double tax on dividends.

That would be a proposal that was roughly revenue neutral, roughly distributional neutral, and improved the structure of the tax system. But if you just cut dividend taxes, then you haven't done anything to shut down the loopholes and the inefficiencies in the rest of the corporate tax. Instead you've just provided yet another tax cut for wealthy households. I'd be in favor of and always have been in favor of reforms that make the tax system simpler, more equitable, more efficient, but they're using that as a cover to push what are essentially tax cuts for the rich.

B. Frenzel I unsurprisingly have a slightly different slant on this than Bill does, although I yield to his superior knowledge of the study of taxation. Question of whether people are going to buy new equipment or not at least partially hinges on the fact the some of the new equipment is different and is more efficient. It enables them to produce better stuff and so I do not take the position that if they're not using their old stuff they won't buy new stuff. There is a good case to be made that we can stimulate some business spending, which has been one of the worrisome parts of this less strong than desired recovery.

B. Gale Let me just add one more thing on that. There is an economic literature that shows that investment incentives stimulate investment controlling for a variety of other factors. I'm fully aware of that literature. I'm not rejecting that literature at all. All I'm saying is that literature does not look at the question. I literally know of no paper that looks at the question of whether investment incentives work during downturns in business cycles. That is the literature looks at the average affect over the business cycle.

J. Weissman But are we in a downturn?

B. Gale It depends on a lot whether you get positive result on average, because investment incentives always work positively or whether it's that they work very well in boom time. It's when demand is already tight. But they work very poorly in flat times. I don't want to take any metaphysical stand on whether we're in a downturn or a slope period. The thing that is a fact is that capacity utilization is flat right now and so that is what I would focus on, not whether the economy is ticking up slowly or ticking down slowly.

J. Weissman What about accelerating rate cuts? Do you believe that there is a need to get some more money into the hands of consumers?

B. Frenzel I think that one of the items under consideration might be to take what we call a middle bracket, which is due to phase in I think in 2006, a reduction of 25%, and escalate that. There's some talk about that. Depending on what the rest of the package looks like, it seems to me that's the most likely element of individual income tax other than the dividend question, which Bill Gale referred to earlier. That is a possibility and I wouldn't know unless I saw the whole package whether I liked that or not, but it has possibilities and could be included.

B. Gale The general category of tax cuts here is immediate income tax cuts and accomplished by accelerating the 2004 cuts to 2003 or the 2006 cuts to 2003. There's a debate about this in the economics profession, but generally people think that high income households save at higher rates than low income households and therefore that a dollar that flips into the hands of low income household is more likely to be used on current spending than the same dollar going to a high income household.

That's important, because accelerating the 2004 or 2006 income tax rate cuts to 2003 would basically have no affect on the bottom 60% of the income distribution. The average tax cut would be zero in the bottom two quintiles and one dollar in the third quintile. It would be stuff that's targeted very much toward upper income households. The top one percent would get 43% of the tax cut even though they pay a smaller share of federal taxes than that.

J. Weissman Bill, could you repeat those numbers? Average tax cut would be zero in the bottom two quintiles.

B. Gale And one dollar in the middle quintile and $48 in the fourth quintile. It's pretty much all concentrated in the top and the top one percent would get 43% of the benefits.

B. Frenzel Is this for that 25% bracket?

B. Gale This is for accelerating the 2004 income tax rate cuts to 2003.

B. Frenzel I was talking really about only one bracket.

B. Gale It's still true that there'd be no benefit for the bottom 60%.

B. Frenzel Which don't pay very much taxes.

B. Gale I know, but if you're looking at a stimulus proposal, if you give Bill Gates back $100 do you think his spending is going to go up by $100? It's doubtful. If you give middle and low income household $100 it's much more likely that they're going to spend a substantial share of it. My point is if they're going to do something like this, a one-time thing aimed at getting money in people's hands, it would make much more sense either to accelerate the expansion of the 10% bracket or accelerate the expansion in the child credit or do a payroll tax cut. I'm not a big fan of any of those policies, but all of them would be more stimulative, would have a bigger bang to the buck than accelerating the income tax rate cuts. The reason is that all of them hit lower in the income distribution.

Moderator For our next question we go to the line of Ed Andrews, *New York Times*. Please go ahead.

E. Andrews First, what is your own sense of where the economy is actually going? We have it seems to me very mixed data, but it's an important question obviously if indeed the economy is on a slow track to recovery anyhow. The second question quite different is what do you expect, do you have any thoughts on the role that the National Economic Council is going to play in all of this? This is kind of a new operation. Robin Rubin was the first one to do it. Is it going to plan an important role in the way the White House is actually organizing and pushing things, or do you think the lead role will be more treasury or Glen Hopper … or something like that?

B. Gale I'll actually take a crack at the second one first. The NEC came to existence with Robert Rubin and it's really changed its style with each of its directors. As we went from Rubin to Tyson to Gene Sperling in the

Clinton administration the NEC became more active actually in formulating policy under Sperling's tenure, whereas under Rubin's tenure it was more of a clearinghouse and making sure that everyone got a chance to make their case. Under Larry Lindsey it was probably much more like it was under Sperling where the NEC director was directly advocating a set of policies in the internal debates.

Now I would guess that Freedman would move back more towards the Rubin model and would be much more of the honest broker type whose job is to make sure the President hears all the voices and has enough information to make a decision. That's just a guess, but it stems from the fact that Freedman is a newcomer and there are already strong forces in the administration that are trying to jockey for position. It seems very evident that what the administration needs is someone to channel all this and focus it and reduce the backbiting rather than increase it. I would guess he'd be much more in the Rubin mode and that he will serve to make policy flow much more smoothly.

Now on terms of this question about how the economy is doing, I'm going to retreat to my previous answer, which is it's clear that things are moving slowly. Whether that means they're moving slowly up or slowly down I don't think is fundamentally that important. The difference between half a percent and plus a half a percent is just as big as the difference between plus one and plus two. That just happens the first difference … zero. I refer to economic doldrums of sort, but I don't know if that means we're in a recession or we're in an economy that's strong, but not strong enough, as the White House likes to say.

B. Frenzel I'd like to support Bill Gale's answer to that first question. I believe that Freedman is a good solid guy, but he comes from the outside. He wasn't along the original campaigners. He competes with people who have been around the President for a while and so I would expect him to play a role more like Rubin played in the first couple of years of the Clinton presidency. With respect to the economy, the numbers are telling us that the economy is going up. It isn't going up as fast as it usually goes up when we come out of the recession we think we're coming out of, but clearly it is moving up somewhat.

E. Andrews To what extend to you and particularly interested here in Mr. Frenzel here as a Republican, to what extent do you think that Mr. Snow will provide the administration with that added credibility, marketing ability, or whatever that apparently Mr. O'Neill lacked? Is he going to project a sense of a steady hand at the tiller and give the President the force he needs to get his agenda through?

B. Frenzel The proof of the pudding is always in the eating and the people who come to Washington looking like the best sometimes aren't the best and vise versa, but with Snow the background is fairly strong. He has been in Washington heavily involved with the roundtable and the conference board and with his railroad. He is well acquainted with the old timers in the Congress. His Washington experience is much more recent than Mr. O'Neill's was.

You remember Mr. O'Neill was also a strong Washington player, particularly over at OMB, but his tenure has judged as less successful. Snow will be much stronger, but we're going to have to wait to see how that's going to work. He of course also in addition to being a spokesman and the steady hand on the tiller for the administration, he has to be our face to the world as well and has to work very closely with Alan Greenspan. These things will have to be awaited, but it looks to me like he has the right kind of ability to do both jobs.

Moderator For our next question we go to the line of Marchin Crepsinger, *Associated Press*. Please go ahead.

M. Crutsinger I was wondering if you could talk a little bit about how you think that this tax cut battle will evolve going forward. We seem to be hearing a lot from the administration on the business side of it, the investor side of it, the accelerating of the rate cuts, which you say would benefit the wealthy. We're not hearing the kinds of things that the Democrats seem to be looking for, which would be maybe a payroll tax holiday of some part. Are they leaving that out, because they know there's going to be some sort of compromise package that eventually ends up? How do you expect them to roll this out and could you forecast the chances of success, and at what level? Are we $300 billion over ten years or does this get out of hand and go larger?

B. Gale Whatever they do they're going to call it a stimulus package, but I don't think that it's known what they're going to do yet. Just doing something they'll declare it a success. That's in answer to your last question, will it be a success. There are a couple of agendas floating around here. One is to stimulate the economy. Another is to enact long-term structural improvements in the economy and a third is simply to cut taxes as much as you can however you can, finding the weakest link in the tax chain and cutting there.

My impression of what the administration is doing is that they're either saying that they're doing stimulus or they're saying that they're trying to do long-term structural reform. But if you look at what they're actually doing, they're basically probing for weak spots in trying to cut taxes as much as possible without particular regard to things like whether it would actually stimulate or as I mentioned in the discussion with Jonathan Weissman about whether they get the tax structure quite right.

They're bowing in the direction of both of those objectives, but if you look at the proposals closely that's not what they're doing. What they're doing is trying to cut taxes and that's consistent with the long-term agenda that tries to starve the federal government of as much resources as it can. My impression is that that's what they're doing and therefore whatever they can get they'll think of as a success. In terms of what it will actually be, I think they're not mentioning payroll taxes for the precise reason that you mentioned. Why should they be for it if the Democrats are already for it? They'll hold out for the biggest tax cut they can get.

Hubbard in particular has been pooh-poohing the notion that fiscal discipline matters, calling the notion that deficits affect the interest rates nonsense, saying that there is no evidence. That's all an effort to provide an intellectual support for as big a tax cut as possible. I also think that it's fundamentally wrong and we'll be talking on Tuesday at Brookings about that, but it's clear to me that they're just trying to push the chairs aside and for as big a tax cut as they can get. Although they have preferences about where they get it, they'll take what they can get.

B. Frenzel I believe there are a variety of purposes at work here. Of course $300 billion over ten years sounds like a big number, but it's really a drop in the bucket if you annualize it. The question is where do you go for those business tax cuts and those rate cuts that you want to be effective now or whether you're talking about permanentizing tax cuts, which you're really talking pretty long-term at that point? I understand some Democrat members of Congress met by phone yesterday talking about payroll tax holiday and suggesting that might be one of the things that come into their scheme.

The White House is very aware that the Congress is going to have some ideas of its own and while I think it cam rely on Republicans to pretty much hold the line, there will be changes and the White House knows that. That will have something to do with the way they structure their proposal. They're going to talk first about the economic stimulus portion of it or maybe serve that portion up alone at first, because that's where they sense they have the easiest time. Judging from the success of the past two years, one would guess that what they send up is likely to be accepted or at least most of it is likely to be accepted.

M. Crutsinger Mr. Frenzel, you said that they pushed the economic stimulus portion of the plan first; because they think they can get the most success there. But wouldn't some people argue that there really isn't much quick acting stimulus in the things they're talking about? Most of it is stuff that would roll out much later.

B. Frenzel You heard Bill and I expressing quite different opinions about expensing. Our opinions would be different about reduction of taxes on dividends and double taxation. Rate cuts would also come into the rather immediate stimulus considerations. You can construct a tax bill pretty easily that at least I would consider stimulative. Now the Gale position that some of these incentives are not incentives at all and only rewards for doing what people would normally do has truth to it and sometimes the best plans we make don't work out the way we want them to, but you can structure a tax bill to put some if not immediate, at least short-term tax incentives, into the code and expect that it'll be passed pretty promptly.

Moderator For our next question we go to the line of Jim Tiltman, *News Day.* Please go ahead.

J. Tiltman In your models to what extent is any federal tax cut mitigated by the increased state and local taxes that are going to be necessary this year?

B. Gale That's a crucial, crucial issue. As I think everyone knows the states constitutions have them operate under balanced budget rules. When there's a recession or a downturn state revenues falls and state spending rises for natural cyclical reasons. That gets their budget out of balance. That means they have to raise taxes or cut spending, and they have to raise taxes more and cut spending more the worse the downturn is. Notice that that's exactly the wrong response from the point of view of the economy as a whole. They need to do that to get their budgets back in order, but in terms of the general stimulus, the general effect on the economy, it's a negative stimulus.

The estimates put that in the order of $30 to $50 billion over the last year or two and that's working to hurt the economy right now. One of the things the federal government could do would be to help out the states and that would have a couple of benefits. One, it would be directly stimulative, because it would offset either a spending cut or a tax increase that the states would otherwise have to make. The second thing is that it would do things like when you look at what states are cutting; it's things like education programs, some health programs, some infrastructure investment.

Those are things that from a long-term perspective are not a good idea to cut. Helping the states could not only help in the short run, but could help in the long run, too. The other thing to add on this is that part of the states problems are due to increased federal mandates or federal burdens. A mandate is a technical term. They're going to have more coming down the pike in terms of homeland security, so there is a strong case on all sorts of grounds, long-term economic, short-term economic, social policy, security policy for the federal government to be pushing support to the states.

B. Frenzel I would say that it is unlikely that the federal government is going to talk about any of the programs that we used to call revenue sharing. Congress is pretty tough on keeping its own money where it is and therefore I suspect the best thing that we can do for the states given the situation we're in now is to have the economy react positively to stimulus and crank up the tax receipts that are available to the states. Pretty clearly the governors who got elected this year drew the short straw. They're going to have real troubles no questions about it.

J. Tiltman Quantitively if the economy has to absorb increased taxes of $30 to $50 billion in state taxes it's going to take a huge federal cut to have any stimulative effect, isn't it?

B. Frenzel It would take a good-sized federal cit to offset it. Since you have suggested the states are going to do this anyway, if they do it will certainly have a deleterious affect on the economy and it would be an additional reason for the Feds to cut taxes.

B. Gale Let me be clear, this is as an alternative to cit taxes. If the Feds supply the funding the states wouldn't have to do this is the point. It's not that they're going to do it regardless of whether the Feds supply funding. The whole point of the federal government providing support would be precisely so the states wouldn't have to do that anymore. It could in fact restore the programs.

J. Tiltman The question I'm trying to ask is isn't it going to take an even larger federal tax cut than we've envisioned to overcome the weight of the tax increases from the state level programs?

B. Frenzel Yes. Except I don't know what size of tax cut you've envisioned, because all I've heard is the vague statement of $300 billion over ten years, but I have not seen any hard numbers.

J. Tiltman But if you do your math that's $30 billion a year, which is equal to the increased state taxes they have to impose.

B. Frenzel To be sure and that's a good reason why the $300 billion if that's going to be the number and I don't suggest necessarily that it is needs to be front end loaded.

B. Gale Let me clear. There are two issues. One is how big the stimulus is and the second is what it consists of. The point I was trying to make is that if the states are cutting back on this kind of spending, on their spending and they're raising taxes, then the dollar given to the states is a dollar of stimulus, because it stops them from doing. It stops them from having to do that. It's 100% stimulus. Any other stimulus gets diluted and some of it by large amount, because people aren't going to spend all of it.

The rebate for example in 2001, the estimate suggested that people over the course of the first six of nine months spent about a third of it. One of the advantages of supporting the states is that it would be a direct one to one bonus, a stimulus. Even with investment subsidies for example, let's say they increased investment 5%, which would be gigantic. That still means that $20 out of every $21 of that subsidy is going to investment that would've occurred anyway. That's not such a good stimulus.

Moderator For our next question we go to the line of Andrew Caselle, *Philadelphia Enquirer*. Please go ahead.

A. Caselle I wonder if you could go back to the point about corporate welfare versus double taxation dividends. What specific loopholes do you think could be gotten rid of to fund that? In dealing with the double taxation question, could you go through the merits of doing that at the corporate end versus at the individual end?

B. Gale Let me start with the second one first. That's a tricky thing. The statement that you commonly hear is that dividends are taxes twice, once at the corporate level, once at the individual level. It turns out that that's true for about half of dividends and it's not true for the other half. Dividends are taxes one and a half times. To put it differently, half of them are not taxed at the individual level. The reason that matters for this discussion is that if you exempt dividends at the individual level you're only exempting half of them, because the other half are already exempt. In some sense it costs less to exempt at the individual level.

Combating that on the other hand is that in order for firms to actually pay more dividends it may be the case that they have to see an effect of that on the bottom line of their financial forms. To put it differently, firms aren't always happy with the notion that although their taxes don't go down, their shareholder's taxes do. They're happy for their shareholders, but their first priority is to get their own taxes down. If the dividend were provided at the firm level such that an increased dividend payment generated a deduction, which then increased the firm's bottom line profits, that might make firms more responsive to the change in the tax treatment, but of course that would be more expensive.

Those are the tradeoffs that are involved in doing the exemption at the individual or the corporate level. If you just did that, if you just cut dividend taxes at one level or the other, you'd be providing win/fall gains to shareholders for no purpose whatsoever. There is no reason to subsidize somebody now on the basis of what they did ten years ago.

The reason I say it's a win/fall gain is because when people bought the stock in 1995 or 1990 or 1950 they paid a lower price for it than they otherwise would have if there had not been double taxation of dividends. Just cutting the dividend tax is not such a bright thing to do. It would make much more sense to use this as an opportunity to clean up a bunch of the problems in the corporate tax, which involve the fact that different assets are taxed at different rates, different types of investment.

There are subsidies for different types of investment. There is what I'm guessing but cannot prove is a pretty serious corporate sheltering problem with offshore entities and I'm prepared to say whatever revenue we can generate from closing down shelters and broadening the corporate tax base should be used to reduce the double tax on dividends. That would be a vast improvement over the current system, but just cutting out the tax and leaving all the loopholes and shelters in there is what you would do if your agenda is just to cut taxes as much as you can. That was the distinction I was trying to draw before.

B. Frenzel Bill is right. It's a very complicated situation and you really have to know what is being suggested and whether if any there are tradeoffs. For instance, there is some stuff rattling around that says you ought to take the dividend taxation down to the level of capital gains. There are a number of other proposals. We can talk about them in the abstract, but it's a lot better to see what the proposal is before we decide whether we like it.

A. Caselle You mentioned Mr. Hubbard and his pooh-poohing of deficits. I really haven't seen anybody take that on. What is the answer there?

B. Gale It's a fairly lengthy answer. I will abridge it dramatically and say that we're going to have a presentation at Brookings Tuesday at noon to toll out a study that was just completed. The basic critique is it has two components. One is that the focus on interest rates is a little misplaced. The real focus should be the effects of deficits on future national income.

There is no debate that an increased budget deficit by reducing national savings reduces future national income.

Every single macro economic textbook in the world will tell you that, except the one by Robert Barrow, but Barrow's notion is that if there is a bigger deficit people will increase their saving by the same amount, but dozens of studies reject that hypothesis. The basic point is that borrowing more now we're mortgaging against our future income, which is true for an individual as well as a country. Therefore we need to pay it back. That's point one. Point two is how does that reduction in future national income occur? There are two ways it can happen. One is you can get massive capital inflows from overseas. If the economy saves less, but we still want to do our investment, we have to borrow from other countries.

If we do that, then our gross domestic product doesn't fall. That is the amount of stuff that is produced in the United States doesn't fall, but it's still true that our national income falls, because of that same amount of produce we owe more of it to foreigners than we otherwise would. If there is a sufficiently massive inflow of capital from overseas, then there's no increase in interest rates, but there's still a reduction in future national income. If there's not a sufficiently massive inflow of foreign capital, then there's an increase in interest rates, because the supply of funds has gone down relative to the demand for funds.

That increase in interest rates serves to equate supply and demand for funds. That's the general point. Even if there is not an interest rate effect there is an impact on national income that every single macro textbook in the world except Barrow would show you. Now turning to the evidence, what a lot of people have done is looked at current deficits to see if they affect interest rates. There is not a whole lot of action there, but it remains true nevertheless that the studies that have looked at how expected future deficits affect current interest rates find effects.

The right way to look at deficits is to say ask and financial markets are forward-looking, so you want to do two things. One is look at expected future deficits and the second is look at not just the level of interest rates, but the difference between long-term and short-term interest rates. The reason you want to look at the difference is that interest rates are affected by thousands of things. No one is claiming that deficits are the only thing that effect interest rates. Hubbard when he presents says it's clear that interest rates and deficits don't move in lockstep. That's true. No one ever claimed that they did. No one ever claimed that deficits explain 100% of the variation in interest rates.

What people claim and what we find to be true is that increases in expected future budget deficits cause increases in current interest rates. Almost every study that's looked at expected future deficits finds a positive effect on the differential between current long-term and current short-term interest rates. For example, people will say how can the increase in future deficits matter when mortgage rates are so low that everyone's refinancing.

The answer is that the Federal Reserve has reduced short-term interest rates by over five percentage points in the last couple of years. Long-term interest rates have come down because of that, although they've gone up relative to short-term rates, in our view because of the deficit. From January 2001 to January 2002 the differential between short and long-term rates went up dramatically even though both of them were coming down. You need to look at expected future deficits and you need to look at their impact on long-term rates relative to short-term rates to get a meaningful answer.

A. Caselle Do you think that's going to be a compelling argument against somebody who just says don't worry, cut taxes?

B. Gale It's a correct argument. If you're asking me is a Senator or a Representative who is a member of the Republic party and pledged to tax cuts and has constituents that want tax cuts, is he going to be compelled by this. I don't know, but my job is to get the facts out. I don't control how they vote.

B. Frenzel I need to add one other thought and that is that that's not the only alternative. It is still possible that you can cut government expenses. I suggest that it's a low probability looking at the Congress and looking at the difficulties we perceive at the moment, but I don't think we should ever wave it out of the question.

B. Gale I wasn't. I was talking about increase in deficits, not just tax cuts.

B. Frenzel I wasn't referring to your answer. I was referring to his question.

B. Gale Before we go to the next question, I need to cut out in about four minutes.

Moderator For our next question we go to the line of Peter Gozlin from *LA Times*. Please go ahead.

P. Gosselin This is to Bill Frenzel. The administration, I guess this is mostly Carol Rouve, has been reassuring conservative advocates that these guys, Freedman in particular, would be the marketing department for the President's agenda. I want to tap your historical knowledge. Is there an example going all the way back to maybe Eisenhower in the post war period where there wasn't somewhere in the administration a strong quasi-independent voice for what makes economic sense and what doesn't, what makes budgetary sense and what doesn't. If these guys truly live up to that description, will this be an unusual arrangement?

B. Frenzel In every administration there have been folks who have stood up for what they believed were good, honest, and true economic concepts. I can remember a couple of heads of CEA being allowed to resign when their advice or their comments seemed to be out of step with those of the administration. These men that have been selected here may be the spokespeople and the salesmen, but I don't think they're going to abandon their wits if they see something that doesn't look to be right.

They're going to have a hand in shaping the policy. I agree with Bill Gale's earlier statement. Because they're latecomers and the policy at least for the short-term is pretty well made they may have less effect, but down the line they will have an effect and I don't necessarily believe they're going to take on the administration, but they will certainly try to keep the administration on what they perceive the straight and narrow.

Moderator We have a question from Patty Moore, *Tax Notes*. Please go ahead.

P. Moore Just to follow-up on that last question, what do you think that the new members will offer in that respect of long-term budget and tax policy? What do you think they will bring to the table?

B. Gale Patty, if you want to just call me after this and I'll talk to you about it more. I have to bolt for this other conference call.

B. Frenzel My answer to that is that I don't have any way of knowing that immediately. All I can say is that like a lot of other people who've come to Washington they seem to be sensible people. I would expect them to deliver sensible advise to the President, but I can't really draw specifics at this point.

Moderator Mr. Frenzel, are you taking any more questions at this time?

B. Frenzel If there are any out there.

Moderator At this point we don't have any other questions in the queue.

B. Frenzel Let's close up.

Moderator Ladies and gentlemen, this conference will be available for replay after 3:00 p.m. today until midnight on December 14, 2002. You may access the AT&T Teleconference Replay System at any time by dialing 1-800-475-6701 and using the code of 665611. International participants please use 320-365-3844. That does conclude our conference for today. Thank you for your participation and for using AT&T Executive Teleconference. You may now disconnect.