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DO BUDGET DEFICITS MATTER?

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Moderator:

ALICE M. RIVLIN
Director, Greater Washington Research Program and Senior Fellow, Economic Studies

Panelists:

ERIC M. ENGEN
Resident Scholar, American Enterprise Institute

WILLIAM G. GALE
Senior Fellow, Economic Studies, and the Arjay and Frances Fearing Miller Chair, The Brookings Institution; Co-Director, Tax Policy Center

Professional Word Processing & Transcribing
(801) 942-7044

RUDOLPH G. PENNER
Senior Fellow and the Arjay and Frances Miller Chair, Urban Institute; Former Director, Congressional Budget Office (1983-87)

CHARLES L. SCHULTZE
Senior Fellow Emeritus, Economic Studies

DO BUDGET DEFICITS MATTER?

MS. ALICE M. RIVLIN: Good morning. I'm Alice Rivlin. I am delighted to welcome you to this panel on "Do Deficits Matter?" I won't say I'm delighted to be talking about that subject again. I had hoped we had put it behind us in the '90s and that everybody was quite comfortable with this subject, and here we are again.

I'm tempted to say the answer to this question is yes, and you can all go have a cup of coffee and go home, but economists don't work that way. It is in fact I think a singularly difficult subject to get across to the lay public and even sometimes to sophisticated audiences like this one because the deficit question leads economists into saying things like well, they matter in the long run but not in the short run, it's a hard thing for most people to grasp. And do they raise interest rates? Well yes, but sometimes they don't. So it is a complicated and difficult subject.

But to elucidate this matter this morning we have a set of very articulate and knowledgeable people with budget experience and we are going to start with Bill Gale who is an economist versed in budget and tax and is a Senior Fellow here at the Brookings Institution.

Bill?

MR. WILLIAM G. GALE: Thanks very much.

My presentation has the very imaginative title of "Do Deficits Matter?" At least I'll be the first person to have this title. I guess I should add a sub-title to that, "If so, why?" I agree with Alice, the answer is yes but I think it's as least as important to think about the why part as the simple yes or no part.

Next slide.

The basic issue can be described in what are called accounting identities. These are just definitions. They're central to the way economists structure and frame the world.

The amount that a country saves can be decomposed into the amount that the public sector saves and the amount that the private sector saves. This is a little bit of an artificial decomposition, of course, because we all are both the private sector and the public sector.

I remember a talk show around 1988 or so where one of the candidates said this is a really important issue but the American people shouldn't have to pay for this, the government should pay for it. The commentator sort of stared at him dumbfoundedly and said yeah, but aren't

they the same? The answer is yes.

So national saving is the sum of private saving and public saving. Private saving occurs when people's income exceeds their expenditures. Public saving occurs when the government's tax revenue exceeds its expenditures.

The reason national saving is important is that by definition it funds what we'll call national investment. National investment is either domestic investment, that is investment here in the United States, or it's net foreign investment. I want to be clear, this is net foreign investment by American households. So it's the amount we invest overseas minus what other countries invest here.

For example, if we invest more overseas our net foreign investment goes up. If they invest more here and we don't change, then our net foreign investment falls.

So every dollar of national saving has to finance, by definition, a dollar of national investment, whether it's domestic investment or net foreign investment.

These identities are pretty simple. . But they have two relevant points to make. One is that if the budget deficit goes up-- a budget deficit is a reduction in public saving-- or the budget surplus falls, the government saves less. IIf that happens, national saving falls unless private saving rises by the full amount of the reduction in public saving. This sounds more complicated than it is. If the government saves $100 billion less, national saving falls unless the private sector saves $100 billion more.

The second step is that if national saving falls, that has to turn into a reduction in national investment. By definition, national saving and national investment are equal to each other.

Those are identities. But Who cares?

The substance relates to the point that Alice mentioned. We often say that deficits don't matter in the short run, they do matter in the long run. These identities can help explain why that is. I think it's actually not that they don't matter in the short run, it's that they matter in a different way in the short run.

Say you have an economy, like we currently have, with underutilized capacity. That is a slow-growing or slack economy. In an economy like that, reducing national saving, which is what the evidence suggests budget deficits do, increases the amount of output that is spent. It increases expenditures. That's a good thing in a slack economy. That boosts aggregate demand, it helps the economy return to a full employment growth path.

So in the short run, in a slack economy the deficit can have beneficial effects. In the long run, though, in a full employment economy, a reduction in national saving turns into a reduction in national investment which then, other things equal, reduces the capital stock owned by Americans and hence reduces our future national income.

This is not that complicated and I want to use a family example for you.

Think of a family in which the the main breadwinner has lost his or her job and is looking for work. They're in a slow-down right now. It makes perfect sense for them to reduce their savings, for them to borrow more to tide themselves over the hard times. That's the equivalent of the beneficial effects of deficits in a short-run slack economy.

But now think of that same family saving for retirement. Saving for the long run. If they spend more than they earn every year for the next 20 years, they're in big trouble when it comes to retirement, because they haven't saved anything. That is, in the long run, persistent reductions in saving come back to bite them and they pay the price for that in terms of reduced income in retirement if they save less.

So it's perfectly consistent to say that borrowing can be beneficial in the short run, but sustained systematic borrowing can impose costs in the long run.

So far I have not mentioned interest rates, but I do want to show you how interest rates fit into this picture. The basic story so far is that deficits reduce national saving, that reduces national investment by definition, and that reduces the future national income of American households.

The question is when national saving goes down, How do national saving and national investment become equal again?

There's two ways that can happen. One is that interest rates rise. That would reduce domestic investment. The other is that you can get capital in-flows from overseas. That is, although we're not saving enough to finance our investment, other countries might lend us the funds. Either way, regardless of whether interest rates go up or not, you get the reduction in national saving..

So my view is that the effect of deficits on interest rates is a little bit of a red herring and that even if deficits don't affect interest rates, there's still an impact on national saving and that's the problem, that's the long term economic problem.

Think back to the family again, as a way to think about this. A family that never saves, that continually borrows a lot of money, might find that its credit card interest rate goes up. It

might find that it's become a bad credit risk and therefore it has to pay a higher interest rate. But even if it doesn't, even if its interest rate doesn't go up, it's still true that the act of not saving all its life means it has no income in retirement. So the channel that deficits reduce national saving which reduces future national income still holds. It's in place regardless of whether deficits raise interest rates or not.

This slide, which is in the back of one of the papers outside, basically tries to summarize these points. The main point is that the key issue is up at Point A. That is, what happens to private saving when public saving falls? If private saving rises by less than 100 percent of the decline in public saving, national saving has to fall and future national income has to fall.

Whether interest rates rise or not is down around Point C, and it's an interesting question but it's not central to the debate about national saving and future income.

Let me close with an example. This example is based on the experience of the last two years. This is a real-world example, it's not a hypothetical worst case scenario. This is actually what has happened the last two years.

Over the last two years the surplus estimated for the 2002-2011 period has fallen by $6 trillion according to CBO. If you assume that private saving rises by about 30 percent of that decline, which is a number based on a variety of econometric pieces of evidence, that implies that the capital stock owned by Americans will be $4.2 trillion lower in 2012 than if that deterioration had not occurred.

Now capital earns a rate of return. Using a conservative estimate of a six percent rate of return, the decline in capital turns into a reduction, by 2012, in annual future national income of about $2100 for every household in the country, or $800 per person.

That effect--reduced national saving reduces national investment, which then reduces future capital income--occurs regardless of whether interest rates go up or not.

The last point I want to make is that so far I've been talking about deficits in isolation. If you want to look at the effect of a policy that creates a deficit you need to look at the direct and indirect effects of the policy. For example, the 2001 tax cut will increase labor supply and investment directly by cutting marginal tax rates, but it's going to reduce national income through its effect on the budget deficit.

The net effect of the tax cut is uncertain because these effects work in opposite directions. at Several studies suggest that in the long run the net effect will prove negative, precisely because the constant gnawing away at national savings undercuts the future national income of the country.

So it's important to distinguish between the deficit holding everything else equal and the net effects of policies that create the budget deficit, but I'm sure we'll talk about that more in the additional time.

Thank you very much.

MS. RIVLIN: Thank you very much, Bill. Now we will hear from Eric Engen. Eric is a resident scholar at the American Enterprise Institute. He's been there only a relatively short time. He had a long distinguished career at the Federal Reserve in the Division of Research and Statistics and he's an expert on budget, social security, pensions, and related issues.

MR. ERIC M. ENGEN: Thank you, Alice. Thank you Bill and Brookings for inviting me here.

I have the same unimaginative title as Bill. The main points I want to make are in the context of, as Bill asked for this forum to be, an academic discussion of deficits so I want to take a big picture view of what I think policymakers and economists should be thinking about and also as well try to give a reflection of some of the debate within the economic profession on the effects of deficits.

The first is that in my view oftentimes the conversation or debate about deficits is too narrowly focused in that it looks just at deficits. But deficits actually are the result of both spending and tax policy. We look at governments, spending very importantly is determined by how much, and oftentimes if you peel back all the layers of discussions about deficits or discussions about all kinds of other types of policies at the core is an issue of what is an appropriate size of government. So I think we need to when we're talking about deficits peel that layer back also.

As well, what's important in terms of spending is what we're spending it on. Is it investments that will pay off in the future or is it just for current consumption or is it just transfer payments that an individual will consume privately?

As well, we need to look at the effects of taxes on the economy as Bill noted. There's both a private effect of taxes in terms of their effect on capital formation and labor markets, in addition to the effects of taxes on deficits.

Now deficits are oftentimes viewed as a summary measure for fiscal policy, and as you'll see, I'll conclude they are important, but it does not describe many of the effects of fiscal policy.

To provide an example, although I feel that deficits matter I would be much more

concerned about a balanced budget where taxes and spending are both 70 percent of GDP as opposed to say half a percent of GDP deficit where taxes and spending are closer to say 20 percent of GDP. I think the effects on the economy would be markedly different in those cases and they would be more accurately described by the level of spending and taxes than the level of deficits.

Also when we talk about the deficit, the conventional measure that we use and the one that is most typically used in empirical work is the conventional measure that's reported by CBO or OMB, that's simply spending minus taxes, usually include both the on and off budget components.

But if you look at the academic literature, this appropriate measure of the deficit is much less settled. There are a lot of proposed adjustments that there's very sound economic rationale for making some of these adjustments. Some of these adjustments matter a lot, some matter less, but they can all at various times, depending on conditions in the economy, be very important.

One is the business cycle, or to use what CBO calls their standardized budget balance. That is pull out the cyclical effects. That is the effects of the macro-economy as it goes through expansions and recessions, out of the deficit. In other words, in a sense smooth the deficits or surpluses out to solely reflect the underlying policy -- that's the idea -- rather than the swings that are caused by business cycles. This can be very important in empirical analysis. Estimates of, for example, the effects of deficits on interest rates can differ quite widely if you use an adjusted deficit measure as opposed to using one that is unadjusted.

Inflation is low these days so we don't tend to talk about inflation as much, but certainly when we're looking historically at the effects of the deficits there have been times when inflation was quite large and adjustments that people make for inflation can actually swing deficits in earlier periods, in the late '70s, early '80s, from deficits actually to surpluses. Whether we should use debt measures that are just par value, which is the current convention, adjusting them essentially for interest rate changes, marking them to a market value, is another issue.

Capital budgeting. We don't use a capital budget in the federal budget. What the measure of a deficit is can matter quite widely whether we use a capital budget or not.

One of the issues discussed in Bill and Peter's paper is the issue of whether we just use a measure of the current deficit or expected deficit.

What do we do about things that aren't on the government's books in terms of conventional deficits, the implicit liabilities, particularly of Social Security and Medicare? Or just looking at the explicit liabilities, do those matter?

These are all-important adjustments and have very important effects on how we view the effects of deficits. And indeed, I'm just going to put it up for completeness, some such as Larry Katlikov, Allen Auerbach, have suggested that well deficits may be almost meaningless because the definitions of taxes and spending are not clearly defined so they propose an alternative called generational accounts.

So one of the things I want to bring out is that in the academic literature what is even just the measure of the deficit is not a settled issue.

Let's step beyond that measurement issue. What is the basic theory that economists bring to the table in terms of how deficits may affect the economy? In the short run, as Bill outlined so I won't spend too much time on it, deficits can be either helpful or at least not harmful, particularly in a time period following a recession and as well, many economists would state that war time is also a time that you might want to, or be willing to run a deficit given that the benefits and terms of political and economic stability, lasts out into the future.

I won't say necessarily that all economists agree on this. I've learned my lesson the hard way many times. All economists don't agree on anything. But I do think that the current crux of the debate right now is not necessarily on the short-run effects, instead it's on the longer-run effects.

The traditional view is one that government deficits, what they tend to do, the theory is that in the capital markets or in the market for loanable funds they tend to raise interest rates and crowd out private investment.

An important feature of that traditional view is that investment, private investment is responsive to the cost of capital, and that's an important feature of that traditional view because, you need to keep that in mind because some people argue that say investment is not responsive to changes in the cost of capital driven by tax policy, but then on the other hand argue that investment is responsive to changes in the cost of capital driven by interest rates. You can't have it both ways.

If we do feel that the traditional view holds, then that does have an underlying premise that investment must be responsive to the cost of capital.

There are other types of, I view them as variants of the traditional view. Some people view them as completely different types of models of how deficits view the economy, but I think you can actually subsume them within the traditional view. Under these conditions, deficits may have no effect on interest rates private investment.

The first is the Riccardian equivalent proposition, and that is the idea is that people know

that over a long period of time if say taxes are cut now, that they're going to have to raise them in the future so what households do is save more now in order to pay that tax burden in the future.

Under the pure Riccardian equivalents for that tax-reducing deficit, that private saving completely offsets the reduction in public saving, thus interest rates don't change, private investment doesn't change, the capital stock in the economy does not change.

One key important thing in that, even in that view, is it depends on what causes the deficit. Even in the Riccardian view, an increase in spending that causes the deficit changes interest rates and changes investment. So one thing to be clear, the Riccardian equivalent view doesn't say that under all cases a deficit doesn't affect interest rates and investment. Even in that view it can.

Another important variant of the traditional view is that actually the responsiveness to interest rates may not be as large as we may think because the U.S. operates, increasingly so, in a large, global, capital market. And the main point here is given our historical deficits they tend to be small, thus they have little or no effect on interest rates and that borrowing comes in from foreign savers. The capital is still here in the U.S., although the owners of it are foreigners.

My view is that in a sense it's an empirical question, what is the most important here? I think if you look at the academic literature there is no clear-cut acceptance of any one of these particular views or variants of these views on the theory. So it comes down to then what is the evidence?

So here looking at the evidence there are I think two primary ways that economists tend to do it. One is using econometrics where you try to statistically identify the effect of deficits on interest rates.

The problem with this is, in this particular case, is that the deficit and interest rates are both highly endogenous variables. What economists mean by this is they're both affected by a whole bunch of things in the economy at the same time. So things such as economic growth, unemployment rates, rates of productivity, all of these things in the economy that affect on the one hand interest rates, they also affect deficits. So the problem is finding ways to statistically identify the effect just of deficits on interest rates as opposed to correlations that are potentially caused by their both being related to all these various factors in the economy at the same time.

When you then go to the empirical evidence the estimates vary widely. Indeed you can find empirical studies that come to the conclusions that deficits have no effect on interest rates, that deficits have positive effect on interest rates, that deficits have negative effect on interest rates.

You then want to look into those studies a little bit harder and say okay, is this a good study, is it a solid study, what mistakes have they made, what are the various things? My interpretation and my reading of it is that this is still a very unsettled point. I'll come back to this in the conclusions here, but what I want to say here is by saying that it's unsettled, that doesn't mean I'm necessarily saying the effect is zero or the effect is negative or a particular positive amount. My view is that it's unsettled because the estimates vary so widely.

A second way is that macroeconomic models are used. These are macroeconomic models that are typically used for economic forecasts, we use them at the Federal Reserve Board, they're used by private forecasters such as macro advisors, other organizations such as the IMF and others, both public and private, use macroeconomic models.

The issues here, whereas the estimates tend to be more on the positive side, the deficits increase interest rates, the estimates vary widely because it matters what the underlying structure is. And many times you can, it's not settled what that underlying structure is. Well, there's a thing called the Lucas Critique that, particularly when you're changing policy your parameter estimates in these macroeconomic models actually tend to change, so there's still, I view, a lot of uncertainty in terms of these macroeconomic models, what they imply.

For example, a one percentage point of GDP increase in deficits over a ten year period is estimated in different models to affect interest rates anywhere from 20 basis points to well over 200 basis points. That certainly doesn't point to a consensus.

As well, another point I think that's important in terms of looking at the evidence is that there's been a lot of tests on whether Riccardian equivalents or implications of Riccardian equivalents or assumptions of Riccardian equivalents, and whether international capital mobility, whether they hold perfectly. Whether capital markets are perfectly mobile or whether Riccardian equivalents hold perfectly.

My view on this is they do not have to hold perfectly in order to have important effects in terms of the impacts of deficits on interest rates, on investment in other parts of the economy.

I think in the introductory paper, chapter of the Economic Handbook of Monetary Policy the government debt chapter written by Doug Elmendorf and Greg Mancue, they say at the very beginning I think the view that summarizes my view of the academic view on deficits, and that is it shouldn't be a surprise to learn macroeconomists are divided on this answer.

So what do we do? I think in a sense what economists tend to do at the end of the day is kind of go with your gut, go with what seems to make the most sense.

So that said, here are my particular conclusions. Yes, deficits do matter. All else equal, certainly no deficits are better, but typically all else is not equal. In fact in almost all cases all else will not necessarily be equal. In particular, different deficit policies are usually associated with different policies for tax and spending.

My view of reading through the econometric evidence is that the magnitude, which is even more important I think than whether it's zero or not zero. Indeed you can read papers that go through all these econometric exercises and at the end all they report is whether the coefficient is statistically different from zero but they don't even report a magnitude.

The interesting question, the effect of the magnitude on interest rates I think has still not been clearly established by the empirical literature.

One of the reasons why is that the economy and other related factors oftentimes are the most important thing in affecting both the deficit and the interest rates, so it's a very difficult thing to tease out.

As well, and moving back to this issue that the deficit is not a single summary measure, is the economic effects of government borrowing depend on what is financed by the borrowing. To use Bill's examples of a household, a household borrowing to finance education, or a household borrowing in order to finance a house, that has different implications than a household borrowing to finance a Caribbean vacation. And so I think we need to keep that in mind in terms of looking at the effects of government deficits from a public perspective.

To me I think one of the important things is that deficits are a signal that the benefits of spending are less than the cost of taxes. We don't want to raise taxes enough to cover that spending. Or a way to interpret this is that spending is too high. This was a view that if you go back to Musgrave, to Wixel, to other earlier economists, that their view was that deficits were a signal of fiscal irresponsibility and spending was too high. So that's why I want to, on my final note, if you can flip to the last side --

Correctly so. We focus on long term fiscal imbalances and we need to be concerned about those. But when I look at those, this is a graph that has projections of outlays and revenues as a percentage of GDP done by the CBO. What I view is that that is a spending problem. We have spending projected to explode as baby boomers retire both in terms of retirement and health benefits. It's not necessarily a revenue problem. Where I view it would be a revenue problem is if we tried to raise revenues to twice the level of what they currently are relative to GDP to try to close that gap.

Thank you.

MS. RIVLIN: Thanks very much, Eric. We guaranteed you some controversy, clearly

we're going to have some.

Next we get to hear from Rudy Penner. Rudy is an economist with many scars of the budget battles. He was the Director of the Congressional Budget Office. He has been in the private sector. He is now at the Urban Institute.

Rudy?

MR. RUDOLPH G. PENNER: Thank you very much, Alice. I kind of suspected that everyone on this panel would say that deficits do matter so I thought I'd speculate a little bit on how much they might matter. It will be no surprise that an economist would say it all depends on all sorts of things.

Previous speakers have talked about the possible effects on aggregate demand. They've talked about what a deficit might be used to finance. Obviously if it's used to finance a high-yielding government investment it's beneficial to growth, but government has a lot of trouble finding high-yielding investments. And we've talked about the implications of some of the deficit being financed by in-flows of capital from abroad. I'd like to expand on that point a little bit because I think there are subtleties there that are important.

Bill noted very clearly that whether a deficit is financed by in-flows of foreign capital or by reducing American physical capital investment doesn't matter that much to national wealth or future income because if it's financed by foreigners obviously they will eventually have more of a claim on our production.

However, the effects are quite different and it's useful to distinguish between gross domestic product which is a measure of total production in the United States and gross national product which is a measure of our income. And whether or not U.S. production is influenced depends very crucially on whether the deficit is financed from abroad.

So if it were all financed from abroad and no reduction in physical capital would occur, then U.S. production would not be influenced and the important aspect of that is that U.S. wages would not be influenced in that case.

There is a lot of disagreement, as Eric noted, but I think the typical econometric model would suggest that somewhere between 30 and 50 percent of any deficit increase is probably financed by increased capital in-flows.

Let us focus on that part of the deficit that is financed by reducing American physical

capital formation. How important is that? Well, I think very obviously it depends on what kind of theory of economic growth you have. A very common kind of growth model looks at the course of GDP through history and relates that to physical changes in the capital stock and in the labor supply as measured by number of hours of employment. When you do that you end up with a huge residual that's not explained.

The late Edward Dennison here at Brookings spent much of his career trying to decompose that residual, and very obviously a very large part of it is technological change which allows you to use the capital stock and labor more efficiently, but some of it, well a lot of it too is the education and experience of the labor force, and Dennison got down to the real fine tuning. He even talked about crime rates and their possible effects on growth and so on.

But when you look at growth this way, physical capital doesn't become very important. Therefore, deficit policy becomes less important than in certain other theories of economic growth.

A very common alternative theory that makes physical capital formation and deficit policy more important is to argue that investment, physical investment is necessary to implement technological change; or in economist jargon, technology tends to be embodied in the capital stock.

Then much of this previously unexplained residual is explained by physical capital. Physical capital formation becomes much more important and deficits matter a great deal more.

Now interestingly Dennison himself argued that this was not a very important issue, that at the margin investment was not necessary to implement technological change, that maybe the first kind of investment you observe might be, but the whole argument is at the margin. But I really never thought that Dennison produced very convincing empirical evidence on this point.

There is a theory that would give capital formation even more importance and that is the so-called new theory of economic growth, although I think I learned the new theory of economics growth 40 years ago from the very best economic teacher I ever had, which was Simon Tuzna. But basically the argument is that economic growth creates conditions that are conducive to fostering even more growth. Then a rise in physical capital may have a small effect on growth initially, but a much bigger effect, that spurt of growth has a much bigger effect in the long run.

In Kuznits' formulation the technological advances that initiated the industrial revolution were based on sophisticated science. We've all heard the myth of James Watt watching his mother's teapot kettle lid bounce up and down, but as Kuznits pointed out, Watt was in fact an accomplished scientist. And in any event, Kuznits argued that the initial birth of burst of growth

provided the resources to do even more science which led to more technological change and therefore more growth.

Admittedly, modern economists looking at recent economic history have not found much empirical evidence to favor this new theory but I find it intuitively appealing and it makes physical capital formation much more important and therefore deficits much more important.

Just as it's very possible to demean the importance of deficits it has to be pointed out that it's also very possible to exaggerate their importance as well. And in particular there was some discussion in those heady days when we forecast surpluses and talked of repaying the full national debt that somehow this would help us enormously in dealing with the demographic changes that are going to cause that huge growth of spending that was in Eric's last chart.

I think in fact no matter how you do the arithmetic and what theory of economic growth you have, either balancing the budget or going further and paying off the whole debt, well, it helps a little obviously, but it doesn't help a lot. There are two reasons it doesn't help a lot. First of all, the problem is so immense. You're talking about Social Security, Medicare and Medicaid, depending on your projections consuming five, six, seven percent or more of the GDP by 2030. Another reason it doesn't help a lot is because of the basic structure of the programs that are causing the problem.

If you grow more you find that Social Security benefits are indexed to wages so the cost of the [promise] goes up. It helps a little bit because after people retire they're only indexed to the CPI but it helps a very little bit. And we at the Urban Institute quite awhile ago when we were still projecting surpluses and we were discussing now obsolete notions like the lockbox, we did look in a common growth model at the difference between just balancing the budget and balancing the budget outside the Social Security surplus and really found that it changed the ratio of Social Security benefits to GDP out there by only a very trivial amount. And I would argue, but I don't have time, that Medicare itself is also, the costs of Medicare are also affected by the rate of economic growth. That those costs rise more rapidly in a more rapidly growing economy.

So there's no magic in aggregate fiscal policy here. There's no substitute I think for radical reforms of those programs, either with huge tax increases that seem quite implausible, or with quite substantial benefit reductions relative to the income out in 2030.

There's no reason, I noted that the benefit promises depend on growth. There's no reason, it would be easy to afford the absolute real level of benefits we give old people today, it would be easy to afford medical care based on today's technology as opposed to the promise to provide people with whatever technology they would like in the future.

I thought I'd say a few words on the possibility that large deficits would provoke hyper-

inflation because as the debt explodes there is a great temptation to finance deficits, to print money as opposed to finance them by borrowing. But given the time and given that this is really a remote possibility in the United States today with a debt of only a third of the GDP, the Mastrich Rules define irresponsible debt policy as something over 60 percent of the GDP, so you can see the United States is in very good shape in that regard. So maybe I'll leave that for the discussion if anybody's interested.

Thank you.

MS. RIVLIN: Thanks very much, Rudy.

Now may I call on Charles Schultze, former OMB Director, former CEA Chair, and a Senior Fellow Emeritus at the Brookings Institution.

MR. CHARLES L. SCHULTZE: Thank you, Alice.

I did notice that Senior Emeritus is a kind of dubious title. Emeritus, you know, is from the Latin. E or X meaning more or less outside of, and meritus meaning merit, so it's not a great title. [Laughter]

What I want to do is talk mainly about the long term effects of budget deficits and tax cuts and how this relates to the longer term prospects for the federal budget.

In the first place, as Eric Engen pointed out in discussing the economics of long term budget deficit, it's important to consider exactly what deficit it is that we're talking about. I just want to refer not to one of the many variants that Eric laid out, but to one. Let me start with the unified budget which includes all of the federal government's revenues from and all of its payments to the rest of the economy. In particular, it combines and consolidates the revenues and expenditures of the Social Security and Medicare trust fund with the revenues and expenditures of the government's regular operating budget.

The CBO has just released its projection of budget outcomes over the next ten years, assuming current tax laws, expenditure policies, and the President's new proposals for changes in those laws and policies. On that basis, the CBO projects a cumulative deficit of $1.8 trillion over the next ten years in the unified budget. This does not include any costs for war and post-war activities in Iraq, nor does it cover several other likely budget contingencies that are almost pretty sure to show up in the next few years.

That $1.8 trillion cumulative deficit in the unified budget is made up of two off-setting

components: a surplus of almost $3 trillion in the Social Security and Medicare trust fund. More than offset by a $4.7 trillion deficit over the next ten years in the federal operating budget which is everything outside of Social Security. The fairly steady $450-plus billion a year deficit for ten years, about three percent of GDP over those ten years.

As you know, starting around the year 2015 as the ratio of retirees to workers begins to mount rapidly, expenditures for Social Security and Medicare benefits will begin to exceed incoming revenues from the currently scheduled tax rates, and the potential gap will grow sharply thereafter. Some combination of benefit cuts and efficiency-inducing reforms in Medicare may be able to reduce the burden on the coming working generation, but with any realistic assessment of the possibility -- politically, ideologically, practically, a major burden is still going to remain.

The total accumulation of surpluses in Social Security and Medicare trust funds which will amount to some $4.75 trillion by the year 2015 when the problem really starts showing up, that accumulation together with the interest on the Treasury securities and the trust fund are meant to provide a means by which the current working generation can pay for at least a modest fraction of the additional costs which their growing numbers are going to impose on society.

But to accomplish that end it's essential that the accumulating surpluses in the trust fund be used to retire debt. A large fraction, let's say 70 percent to three-quarters of the funds made available by debt retirement end up, as Bill Gale has indicated, as an increase in national savings with a corresponding increase in the capital, foreign and domestic, owned by Americans. This would generate a rise in the future level of national income out of which Social Security and Medicare benefits will be paid. In this way the burden on future workers will be correspondingly reduced. Again I remind you it's a modest fraction of the burden, but at least it is some contribution of this generation to its own retirement. Added on, if you will, to what's basically a pay as you go system.

But if the operating budget of the federal government runs deficits over the next 10 to 15 years the surpluses in those trust funds will be used to finance those deficits rather than to buy back outstanding federal debt. As a consequence, the process by which the accumulation of trust fund surpluses could ease the burden of rising Social Security and Medicare costs on subsequent generations will be aborted.

The proponents of tax cuts, deficit financed tax cuts, argue that to the extent deficits in the operating budget are incurred in the process of carrying out a growth-oriented tax cut, national income will be increased thereby achieving the macroeconomic goal of the trust fund surplus. In effect this argument proposes the novel proposition that the trust fund surpluses can best be invested not in repurchasing and retiring of public debt, but the deficit financed tax cut.

Now most mainstream economists would agree with both of the following propositions, and I think everybody here today falls in that category. Number one, in years of high employment budget deficits depress national saving and thereby reduce national income. Proposition two, tax cuts can provide increased incentives for work and saving that will raise national income.

There's room for disagreement about the relative magnitudes in the short and medium run. My own judgment in that the negative effects of deficit financing in reducing national income will offset and probably more than offset the positive incentive effects of the tax cut, but you'll get substantial disagreement around that.

I would, however, argue that if we look ahead to the long run, the positive effect of the tax cuts will clearly be outweighed by the negative effects of the deficit used to finance them. Even before the recent and proposed tax cuts, that is before the tax cuts of the year 2001, before their extensions and other tax cuts that are now being proposed by President Bush, even before then, several studies including one by the CBO and one by Auerbach, Gale and Orszag, had shown that the federal budget was not on a feasible, long-run trajectory. Without changes in tax or expenditure policies the ratio of public debt to GDP would continue to grow indefinitely and eventually explode.

With the 2001 tax cuts, with its provisions extended, the fiscal gap is clearly even larger. In other words under current conditions deficit-financed tax cuts must ultimately be offset by tax increases which would in turn reverse some or all of the initial positive effects on national income.

Since in the mean time the budget deficits would have depressed national saving through the channels that Bill Gale spelled out, the ultimate net result would be a decrease in the stock of capital owned by the nation's citizens, and therefore in national income, made worse by the increased interest bill for the public debt that was accumulated in the interim.

Conceptually the rising debt-to-income ratio could be stabilized by cutting federal spending rather than by reversing the tax cut. As Eric Engen has pointed out, the big fiscal gap in the future arises principally from growing Medicare and Social Security spending, and therefore it's a spending problem. But in fact I don't think that's the way to look at it.

As I said before the recent large tax cuts were introduced, this problem, the fiscal gap in the future was there. There's a political, ideological decision to be made by the country as to how to close that gap principally between Medicare and Social Security spending on the one hand, and revenues on the other, and that's going not be a major decision to be undertaken.

But then on top of that we add about $3 trillion -- if the President's proposals are passed

this year -- about $3 trillion over the next ten years in deficit-financed tax cuts. I don't think it's reasonable to assume that still further cuts in Medicare and Social Security spending should be made to deal with the fiscal gap caused by these tax cuts. So therefore if you're thinking of spending cuts to close the fiscal gap caused by the deficit financing, you've got to think of other spending cuts. I just don't think it's reasonable politically or any other way to suggest that the tax cuts should be the reason to be even tougher on cutting Medicare and Social Security spending.

In that case, that's really a thin reed to lean on, namely that the fiscal gap caused by these tax cuts will be made up by spending cuts. If we could count on eventual cuts in government spending to stabilize the public debt, why was government spending not cut in the first place thereby avoiding the need for the deficit financing.

There's no reason to believe that what we couldn't count on in the past will somehow become available to do the bulk of the job in the future. In that case the analysis of the comparative impact of fiscal deficits, of deficit-financed tax cuts on the one hand and what we do to close that gap comes down to in effect reversing one way or the other at some stage in the future those tax cuts so that the positive benefit washes out basically and what we're left with is the cumulative negative impact of the intervening deficits depressing national saving, national investment and national income.

So in the short and medium run deficits do matter, and in the long run they matter quite a bit.

Thank you.

MS. RIVLIN: Let me invite all the panelists to come up and we'll have a discussion among them and then we'll throw this open to questions.

I'd like to start the discussion off by coming back to the sort of practical problem of the moment and get each of you to think what your short answer is to the new congressperson who comes to you and says I've just been elected but I hope to be here for awhile, and I'd really like to vote for all these tax cuts. I think my constituents would appreciate it. But my constituents are also pressing me for some spending increases. They want prescription drugs, they want better education, they want a whole bunch of other things that are possible spending increase. Should I worry about these long-run deficits, or should I not? I'd like to be around in ten years. If I do what my constituents want right now will I be in bad shape in ten years?

MR. ENGEN Certainly I think as the conclusions in my presentation said yes, deficits do matter. So I think clearly any policymaker right now in terms of looking at the budget needs to make the type of decisions that are hard ones, and that is all else equal, people like tax cuts; and all else equal, people like spending increases. But government, just as the rest of us at home or in

a business, we face budget constraints. So they have to make those tradeoffs. We can't look out into the future and say we're going to ignore this.

So it requires making tradeoffs, what do we think is better for the economy? A dividend tax relief that costs in the neighborhood of $400 billion over the next ten years, or prescription drug benefit adding onto a Medicare system that's already financially imbalanced that's about $400 billion or more over the next ten years. That's tradeoffs they're going to have to make and the fiscally responsible thing to do is to make those tradeoffs up front.

MR. PENNER: I think that the American people generally recognize the fundamental point that government is subjected to the same kind of budget constraints in the longer run as is the individual household or a business, and indeed I would argue that the notion the budget should be balanced regardless of the definition of the budget has been a very strong force in the United States for more than the 200 years of our fiscal history.

I don't think it's an impossible sell. We in Washington seldom talk to real people but I have had occasion recently to be in the countryside a little bit and I do feel people genuinely disturbed, a wide variety of people, many of them Republicans, quite disturbed about the deficit and the President's budget. So I don't think it's as politically implausible as your question implied, Alice, that they'd be willing to give up some of these tax cuts in order to have what some of us would call for more responsible fiscal policy.

MR. GALE I would emphasize three different time horizons in thinking about the budget deficit. Over the next two years with the economy moving slowly, budget deficits are not that big a deal, they can help in the short run. And if we had surpluses rising and extending indefinitely into the future, a short term budget deficit would be of no concern whatsoever.

The second time period to think about is the long term, which is , say, ten years and beyond. There, we all agree we see increasingly large deficits that snowball over time. That means the critical time period is the medium term, that is to say, years three to ten from now. if we had surpluses starting from year ten on, the next years three to ten wouldn't manage that much because we're sort of headed to nirvana anyway.

But the fact is we're headed in the other direction and we have a ten-year window to deal with that before the problem gets much more difficult. So if we're going to squander resources in the next ten years, it better be for something that really has a big payoff in terms of making the economy grow.

MR. SCHULTZE: I spent the first half of my professional life saying don't worry too much about deficits. This was in the time when the fundamental definition of a conservative was deficits are always bad.

MS. RIVLIN: You haven't changed, the definitions have.

MR. SCHULTZE: -- changed some things.

First I agree with Rudy, there are two aspects of this. There is the intellectual problem of what the deficits mean, what their impact on the economy is. As Bill has said, the really large problem is not the immediate timeframe, it's looking much further out. It's fundamentally a question of intergenerational transfers. What do we really owe succeeding generations? And it's far enough ahead that it's very difficult to make it zing in political conversation -- What are you for, Senator? What are you going to do for the country? Well, I'm going to make sure that 25 years from now our actions today are not doing something bad for the economy. Thank you. Next candidate.

So Rudy I think, let me add one more thing to this. It's also clear that in the short run, during periods of recession, in periods where there's any great big bulge in expenditures that we're pretty sure is temporary and want to smooth over, in all those cases deficits are a good thing. Hence we have to make a choice between setting up rules that are probably excessively difficult when it comes to deficits, but as ways to discipline ourselves, or to have to rely upon fairly, as I say, academic and conceptual problems about the intergenerational impact of deficits which I don't think is going to work. So I end up with Rudy saying we need better practical current rules to try to keep down deficits in the current period as the practical way of enforcing what it's impractical to enforce solely by appealing to large conceptual ideas.

MR. PENNER: Can I just make a point on the short run versus the longer run? I think I feel that's less important than my fellow colleagues. I think the distinguishing thing about our fight against deficits in the 1980s and the 1990s was that we were very willing to forego the notion of countercyclical fiscal policy. We passed [TEFRA] in almost the depths of the recession. This was a major tax increase in response to Reagan's tax cuts. We passed that in 1982 when the economy was quite in the doldrums. We had a huge deficit reduction package in 1990 during a recession. We had another one in '93 when, in retrospect we see the economy was recovering, but we didn't really know it for sure there.

I think it's very hard to have fiscal discipline and countercyclical policy because you can always make an excuse -- the economy is weak and we need deficits in the short run. But if you really get serious I don't think there is a place for countercyclical policy on the fiscal side.

MR. SCHULTZE: Tongue in cheek, partly tongue in cheek, maybe we ought to go back to the days with no indexing of the federal tax system and fairly significant inflation because what happens in that case is the basic economic system itself is going to generate tendencies towards large surpluses which everybody who wants a tax cut then has a way to enact a tax cut

and brag about it, and in the long run it kind of evens out.

It is very difficult now, at least I think, to deal with fiscal policy in a world in which roughly speaking if you don't do anything revenues stay the same fraction as GDP. We don't have that advantage. So Rudy's got a point. It's just very difficult to use deficits for countercyclical policy these days, I think in part simply because we've made the tax system more rational and better in one sense but maybe a little bit more difficult in others.

MR. PENNER: And the benefit system.

MR. SCHULTZE: Yeah, okay. Agreed.

MS. RIVLIN: I want to come back to Eric's graph of the rising expenditures and the steady revenues. And explain why you think rising future expenditures are evidence that we haven't, that we don't want to pay for those and therefore is a spending problem.

I can imagine buying the argument if you were talking about current expenditures but here you're talking about things that haven't happened yet, and people may not believe are really going to impact them and have not made up their mind whether they really want, don't realize they have this choice between the expenditures that fall inexorably out of the demographic changes and the taxes.

MR. ENGEN: To the degree that people realize the long-term imbalancing of Social Security and Medicare and whether they don't, it's hard to quantify that. I do think people have a sense of that imbalance and in some cases they're more pessimistic even than the numbers suggest. We have polls where there's many people that say they expect nothing from Social Security because it's going to be broke and not going to be able to pay any benefits into the future. Whereas if you look at the numbers --

MS. RIVLIN: They aren't acting as though they thought that though, by private savings.

MR. ENGEN: Where if you look at the numbers, if we cut benefits by 30 percent, certainly a big cut, that would balance given current law benefits and revenues approximately, so I don't think people are completely unaware of that.

I guess my point is that the economy would be in a very different place if what we choose to do is to let medical and retirement benefits grow along with the other spending to 40 percent of GDP and we raise taxes twice the level that they are now at the federal government level, to about 20 percent, than if we do the opposite, that is reign in that spending.

I think there you could set up two scenarios. Zero deficit where you balance it, but the

effects on the economy would be dramatically different and I think they'd be much more detrimental if what we're trying to do is raise revenue up to that spending line, rather than pushing spending down to the tax line.

MR. PENNER: I think there's much confusion about what the word cut means here. We have indexed Social Security in a way that promises ever-increasing standards of living for the elderly as the rest of the economy grows. We have created Medicare that promises people to cover the costs of improved technology forever. But I think when people talk about Social Security cuts or Medicare cuts, especially the demagogues, it makes it really seem like it's a cut in today's standards of living for the elderly, and the elderly naturally fear hearing the demagoguery that they'll be soon eating dog food.

The fundamental point is that there's really no problem in maintaining the elderly at today's absolute standard of living. The problem is what the system promises, that the replacement rate is constant, that we forever increase their standard of living as wages go up.

MS. RIVLIN: It might be a problem of saying we'll only give you 1950s medicine today, which is what it seems to me is implied in your --

MR. PENNER: No, no. I don't think so. I think what I'm saying is we'll give you 2003 medicine forever. We can afford that, I'm quite sure.

MS. RIVLIN: I'm saying in 2050 that may not seem like the acceptable thing.

MR. GALE: That was one of my points. In addition, if you told people now that your retirement benefit replaces 20 percent of average wages in 1950 in real terms, they might not consider that such a great deal given that they paid into the system their whole life. But if we freeze real benefits, that's in effect what we'd be saying to them in 2053: your retirement benefits now are replacing a reasonable share of 2003 wages but not of the wages you earned over the course of your lifetime.

MR. PENNER: The point is they're not paying enough into the system to finance it.

MR. GALE: That's the other point I wanted to get to. If A is bigger than B, it does not mean that by definition the problem is that A is too high. It might be that B is too low. To say that because we have a deficit, it's therefore a spending problem, therefore we spent too much, implies that when we had a surplus a few years ago that means the problem was we were spending too little. It's sort of like asking which part of the scissors does the cutting. There's an imbalance between taxes and spending. We have to resolve it. The fact that it's spending that's going up doesn't mean that by definition it's a spending problem. The problem is the imbalance.

Congress has promised these benefits to the American people and Congress has legislated tax rules and there's an inconsistency between those two sets of promises. But that doesn't make it by definition a spending problem.

MR. SCHULTZE: Number one, the big problem isn't Social Security, what it would take to "fix" the Social Security system. It isn't that large and you can debate how much you want to do it on the tax side and what you would do on the benefit side. The big problem is Medicare, and not in the trust fund part, but in Medicaid as well. I would agree in one sense with Rudy, in fact I think we're going to have to have some form of rationing medical care. Now by rationing all I mean is some way in which apart from pure income we're going to determine some limits on what's available.

What you can't do is say okay, that's great for the elderly only, and therefore I don't see how we can deal with this problem solely in terms of Medicare itself. It's going to have to be, I hate to sound like Hillary Clinton, but it's going to have to be a relatively thorough look and some major changes in the broad system of medical care itself. I don't think it can be looked at just as a problem for the elderly.

MR. ENGEN: Certainly I would agree with Charlie. You look at the Medicare problem, actually a combination Medicare and the Medicaid programs, those resources devoted to the elderly, that's a bigger problem than Social Security, clearly.

I guess, though, in looking at not just the few years of surplus in the late '90s but looking at the broad picture, my view is there tends to be a deficit bias in policymaking. I think if you look over the long term federal budget of the last number of decades it's much more likely that we run deficits, than we run surpluses. Indeed the late '90s, if you take the cyclically adjusted deficit, it was only in surplus for two years. If you actually take out the effects of the booming stock market that many people agree is not something that was sustainable, you can see where in my view that surplus, that kind of surplus was more of a hiccup, a bump in the road that is not reflective of the longer-term problem of a deficit bias. I think that's where when we then come down to sort of balancing that spending and taxes. Certainly Bill's right. It's both sides of the trigger.

The only point I want to make is I view that the impact on the economy, on standards of living, would be much different if we have a federal government's role in the economy that's 40 percent as opposed to a federal government's role in the economy based on recent historical levels of about 20 percent of GDP.

MR. GALE: This relates to both a deficit issue and the current debate. I think Eric's right, that we did not really have a surplus in the late '90s and early 2000, 2001. Measured by any conventional standards, as Charlie mentioned in the paper I did, we had a long-term deficit.

But then we came along and dug the deficit hole much deeper, the long-term deficit hole much deeper, with the 2001 tax cut and with the proposal to extend it.

If you extend the 2001 tax cut permanently you're cutting taxes by an amount of money that is basically enough money to fix the Social Security problem over the next 75 years and almost all the Medicare problem over the next 75 years.

So it's not the case necessarily that there's some inexorable problem that can't be fixed out there. It is the case that policymakers are making decisions right now and in the last year or two that have gigantic implications for the long-term fiscal stance of the government.

MS. RIVLIN: Questions?

QUESTION: Al Goyburu, Heritage Foundation.

What should be the role in examining long-term interest rates in deciding whether the federal government should pursue a deficit or surplus policy? All other things being equal, should the federal government view spending or tax-cutting decisions differently if long-term interest rates were say nine percent as opposed to three?

MR. PENNER: I'm not sure how subtle you're being here with that.

The ultimate danger of deficits occur when the debt explodes relative to our income and the interest bill rises very rapidly, and there is a mathematical formula that suggests the explosion occurs much more rapidly if the rate of interest is higher than the rate of economic growth. I'm not sure if that's the sort of thing you're getting at, but if it is then that's a big worry.

MR. GALE The real cost of the deficit is a reduction in national saving, and that occurs regardless of the level of the interest rate. As long as private and government rates are aligned--that is, as long as low rates of return in the public sector imply low rates of return in the private sector, there's no issue here due to the level of interest rates.

QUESTION: Wouldn't the cost of carrying the new debt change as long term interest rates change, though?

MR. PENNER: Yeah, that's related to my point.

MR. GALE But there's still the cost in terms of national savings which is the fundamental cost. The point is that if interest rates are low, national saving, whether it's private or public, is generating a low return. If for some reason, the difference between public and private returns has gotten bigger, then that is a reason not to run deficits, since the induced reduction in private investment would have a bigger cost.

MR. SCHULTZE: This is saying the same thing, but the higher the set of long-term interest rates, particularly if you expect them to prevail for a long time, the more costly it is to run a big deficit not so much in terms of debt service per se, but in terms of that implies that the marginal product of capital is quite high and when you're foregoing saving you're foregoing a particularly large increment to your national income. So in that sense the deficit is in that sense more expensive.

MR. ENGEN Rudy made the main point and that's certainly the correct one. The cost of servicing the debt is the higher interest rate you have. That's obvious. But the other one he just touched on and I'd like to emphasize its importance is the relationship between the interest rate and the rate of economic growth. We have had time periods where the rate of economic growth [inaudible] interest rates, that reduces the burden of the debt relative to GDP.

Over the long term that doesn't tend to hold, but it is important particularly if you're looking at certain time spans, not only what the level is of the interest rate but also its relationship with the rate of economic growth.

QUESTION: Stanley Coburn, CATO Institute.

I'd like to bring in an international dimension because the U.S. budget deficits are not isolated. You have budget deficits in Japan, China, France, Germany, I could go on. What are the implications of all the major economies running huge budget deficits simultaneously?

MR. ENGEN: It makes it difficult to argue that if we run a deficit here it's going to be financed simply by capital in-flows because everyone else is competing for those same capital in-flows.

MR. PENNER: I would argue further there's an enormous difference between the Japanese fiscal policy and American. The Japanese situation is terrifying to me, with debt marching towards 150 percent of GDP, no hope of a budget balance excluding interest for ten years or so. It is difficult for me to understand how they're going to avoid an outright debt explosion, whereas our fiscal policy is eminently responsible by comparison. And they have a more difficult aging problem.

MR. ENGEN If I could add on that, the aging problem is not only worse for Japan but it certainly is for Europe. I think everyone up here agrees that it's the aging implications for our budget that are the important one over the long term, even if there's disagreement on how to close that.

Our fiscal imbalance situation over the long run looks pretty good relative to particularly Europe and Japan as well, given that their demographics have a much bigger negative impact on their fiscal balances.

QUESTION: Ed Keene with the G7 Group.

I'd like to ask all the panelists to discuss the economic implications of the reemergence of a budget deficit at a time when the United States already has had fairly substantial trade and current account deficits. What are the economic implications of that particularly in terms of our ability to attract foreign capital?

MR. SCHULTZE: Let me take a start at it. At least for the immediately foreseeable future I'm not worried about our ability to attract foreign capital to finance our growing current account deficit, but it does lead into another point which is there's a cost to budget deficits that we haven't talked about which is to the extent they are financed by very substantial current account deficits, the in-flow of capital, you then have to begin to worry about stabilizing that external debt relative to GDP and as that debt expands a larger and larger amount of the trade deficit has to be -- You've got to start working towards the position where you can get a trade surplus to pay the increasing interest and other capital income flows to finance our deficit.

So as you look out into the future and if you continue to have very large rising current account deficits, you've got to worry about q system in which the value of the dollar is going to have to decline, need not be disorderly, but is going to have to decline and the terms of the trade that are more against us as the cost of paying that off. We're seeing the dollar decline now, but over the longer term that can be a problem and an indirect cost of the budget deficits that help create the current account deficits.

MR. PENNER: I guess I'm a little bit more concerned than Charlie about the immediate future. As he says, the dollar has already declined a lot. The increase in the budget deficit makes us more dependent on our foreign capital in-flows. One of the only ways of inducting those is to let the dollar deteriorate, making our assets cheaper to foreign investors. I guess I'm somewhat surprised there has not been more concern about the recent falling of the dollar which is pretty substantial, after all. But as Charlie noted, it has proceeded in a very orderly way. So I think that has helped a lot, but that orderly decline could very easily become a rout, it seems to me.

MR. SCHULTZE: The only problem is given the state of the major financial capitals, at least Europe and Japan, we're up even investor money.

MR. PENNER: But I think the market [inaudible] of the dollar is going down.

MR. SCHULTZE: I think the market to worry about Iraq, but I'm --

My only point is, whatever the problem is about attracting foreign capital to finance the deficit, just like the fiscal gap you can't keep on doing it forever, and ultimately it's going to have to be a decline in the dollar to produce not only a turn-around in the trade deficit, but a trade surplus in order to earn the income to pay off the huge accumulation of debt.

America's net foreign position has gone from roughly a balance of the assets owned and assets owed to a $2-plus trillion deficit in the period of six years. That trajectory can't keep up.

QUESTION: Bill Ferguson, Grinnell College.

About ten years ago, 12 years ago when this issue was hot the last time around there was a nice little book published which several of you have probably seen called "The Debt [Invested] Debate". I believe it was edited by Allen Blinder, at least he wrote the last essay in it. It went through some of the accounting arguments, talking about the question of adjusting for inflation, adjusting for capital accounting as opposed to consumption accounting and so forth. And there were both sides. Gramlick argued basically that the deficit is a problem. Eisner argued no, you can adjust the accounting and so forth. And Blinder basically said while he was sympathetic to a lot of the accounting adjustments, what really mattered was what the change was, and if you measure it consistently, it doesn't matter which accounting convention you use, but if you start in 1980 and go to 1992 there's a tremendous rise in the deficit.

It seems to me that an exactly analogous argument could be made right now. In other words, in 2001, the CBO projected enormous surpluses and part of the justification for the large tax cuts in 2001 was that we don't know what to do with the surpluses anyway so let's cut taxes and trim down these excessive surpluses.

Now what we find is that those estimates have been radically revised. The estimated surplus what, down about $6 trillion. That's a pretty big change. And we could go through some accounting and talk about well, these deficits are going to actually be closer to balance if we take into account capital expenditure and so on and so forth. But of course if we did those same adjustments for the 2001 figure the surpluses would have been much larger.

So we still would have seen a net effect, my guess, obviously I haven't done the math here, of something like a $6 trillion decline.

So the question the is, isn't the change from 2001 to now significant and worrisome, independent of the particular accounting issue convention used?

MR. SCHULTZE: Absolutely yes.

MR. GALE: There is a reason to be concerned about the accounting convention itself because it tells you where we're headed. But basically where we're headed is toward more retirees, increasing life span, increasing health care costs, and regardless of accounting convention, the fiscal stance is going down the tube in the future.

Your point though is that, even if we didn't know the exact fiscal stance , we do know that it deteriorated substantially the last two years. I think that's fundamentally right.

MS. RIVLIN: We've run over the time. Let's take one more question then we'll wrap it up.

QUESTION: Thank you. [Inaudible] Embassy of [inaudible].

If the deficits matter, I have a question on the policy implications. In the '90s you had the pay [growth] and you had the caps and now there's been talk about increased use of [inaudible] and trigger mechanisms. I'd just like to hear the panel's view on should Congress implement something in those lines again now? Or do you have other ideas that could get us back to a balance? Also maybe your view on how likely it is to be able to implement anything like that.

MS. RIVLIN: My view is that they should implement a new budget process that has some disciplinary mechanisms in them. And certainly the caps on discretionary spending while often dilated were a disciplinary device for fitting things under the cap, as was the [Pago] rule on taxes and entitlements.

MR. GALE What the Administration wants to do is apply a PAYGO rule on spending but not have it apply to tax cuts. They're defining the problem solely as a spending issue.

I think one reason the budget rules worked in the '90s was because they linked spending and taxes. It didn't say you can do whatever you want on the tax side but you have to limit spending.

So I think that if they impose rules, they should include tax cuts as well as spending increases in those rules.

MR. PENNER: I think in general terms not a sufficient amount of attention has been paid to what I would call the collapse of the congressional budget process. Not only have the [Pago] and caps expired they couldn't even pass the budget last year which is a rule that's on the books that they should. And you had appropriations just completed for fiscal 2003 which I think is just totally inexcusable. So the system I think is in a state of chaos in the Congress, and I'm not sure how you put Humpty Dumpty together again, frankly because it may not be in anybody's interest at this moment to do so. But for us outside budget [WASPs], I think we really, I feel that

a more disciplined process is desperately needed.

MR. GALE Rudy has a great saying that it took me several years to fully understand. But with regard to the budget he said: "the process is not the problem, the problem is the problem."

The problem is how to balance and juggle all of the wants of the various constituencies in current and future generations and of the dueling parties, etc. It's really true in the sense that they can break any rule that they make. So we can sit here and say yeah, they should have rules, but if they don't feel like following their rules, they'll just waive them.

MS. RIVLIN: But rules do help impose some discipline.

MR. PENNER: Even I don't disagree. [Laughter]

MS. RIVLIN: On that note let me thank all of our panelists and the audience, and bring this to a close.

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