THE BROOKINGS INSTITUTION

"RESTORING FISCAL SANITY: HOW TO BALANCE THE BUDGET"

3:30 p.m. - 5:30 p.m.
Tuesday, January 13, 2004

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

[TRANSCRIPT PREPARED FROM A TAPE RECORDING.]

INTRODUCTION:

STROBE TALBOTT
President, The Brookings Institution

PANEL 1:

ALICE RIVLIN
Senior Fellow and Director, Greater Washington Research Program,
The Brookings Institution

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

P R O C E E D I N G S

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

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

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

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

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

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

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

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

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

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

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

Let me now turn the podium over to Alice.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

THE BROOKINGS INSTITUTION

"RESTORING FISCAL SANITY: HOW TO BALANCE THE BUDGET"

3:30 p.m. - 5:30 p.m.
Tuesday, January 13, 2004

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

[TRANSCRIPT PREPARED FROM A TAPE RECORDING.]

PANEL 2:

MODERATOR:

RON HASKINS
Senior Fellow, Economic Studies, Brookings

PANELISTS:

ROBERT E. RUBIN,
Director and Chairman of the Executive Committee, Citigroup

JOHN EDWARD PORTER
Partner, Hogan & Hartson, LLP

ROBERT D. REISCHAUER
President, Urban Institute

DAN L. CRIPPEN
Former Director, Congressional Budget Office

QUESTION AND ANSWER SESSION

P R O C E E D I N G S

MR. HASKINS: Thank you for coming. Now, we get to pose some questions of, I would say, a fairly decent panel to respond to these issues.

[Laughter.]

MR. HASKINS: We have a tradition here at Brookings that we include lots of biographical information in your packets, and we give very short introductions. This is primarily because, on rare occasions, we have Republicans who introduce Democrats, and they might get carried away, so we want to make sure that doesn't happen.

So, in this order, we're going to begin with Bob Rubin. Bob Rubin is a former Secretary of Treasury and the Co-Chairman of Goldman Sachs, and he is currently the Director and Chairman of Citigroup;

John Porter, on my left, is a former Congressman from Illinois, but more to the point, he was the Chairman of the Labor and Health and Human Resources Subcommittee of the Appropriations Committee, one of the cardinals, so to speak. He is currently a partner in Hogan & Hartson here in Washington, D.C.;

Bob Reischauer, who is also a former Director of the Congressional Budget Office and, equally important, a former senior fellow here at Brookings, and he is now President of the Urban Institute;

And, last, Dan Crippen on my right here, who is also a former Director of the Congressional Budget Office, and he was a founding partner in the Duberstein Group. He is now a private consultant.

Here is our procedure. Each of the panelists is going to have seven minutes. They can either use the podium or stay seated, and upon the conclusion of those seven minutes of comments, I'm going to pose some dastardly questions, and then we'll have about 30 seconds left for audience participation.

[Laughter.]

MR. HASKINS: So that's our plan, and we're going to begin with Robert Rubin.

MR. RUBIN: Thank you.

I will follow up on what Alice and Bell had to say and, to some extent, my comments will relate to theirs and, to some extent, it may go off a bit into a slightly different direction.

If you look at virtually all mainstream economists, I think it's fair to say that they would hold that there is a significant relationship between long-term deficits and interest rates.

At the American Economic Association meeting of a week ago past Sunday, Alan Sinai, of Decision Economics, Inc.; Peter Orszag of Brookings; and I presented a paper, with Peter being our presenter, that was entitled, "Sustained Budget Deficits: Longer Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray."

And what it did was to discuss the conventional analysis of the effects of long-run deficits and then, recognizing that those conventional effects are indeed serious, went on to discuss the potential for exceeding those conventional effects.

Today's conference relates to that analysis, and you heard Alice I think present it exceedingly well, and then goes beyond that to discuss some possible responses to what is now a horrendous long-term fiscal situation. And if nothing else, it seems to me, as Alice said, this should provoke debate, and it does demonstrate how difficult, both substantively and politically, dealing with the deep hole that we are now in will be.

I'm not going to repeat here the paper that we presented a week ago this past Sunday, but let me just briefly list the effects in summary form.

The first is the conventional analysis, which Alice referred to, which is that the government demand for capital crowds out private sector demand. That, in turn, reduces private sector investment and reduces productivity, which reduces growth over time. And of course the intermediating factor to bring equilibrium back is higher rates, which can also adversely affect demand, reducing consumption and reducing investment.

Beyond that, there are the effects that go beyond this conventional analysis, and in my judgment, at least, I think those effects have the potential of being far more serious, and far more severe, and should be far more troubling.

I worked in markets for 26 years before I went into the government. It's the world that I've been part of my entire adult life. I think that when you face the kind of deficits that we face today, what you have is a serious risk that at some point the markets may begin to believe that the government is going to resort to inflation, rather than fiscal discipline, to deal with debts and to deal with fiscal deficits.

And reacting to that, the markets will begin to demand a sharp increase in interest rates, over and above that projected through conventional analysis in order to compensate for that risk of resorting to inflation.

Secondly, I think there is also a risk--and Alice alluded to this--that the international markets could lose confidence in our currency because of our long-term fiscal regime and also because of our large current account deficits, which, as you all know, are partly a function, again, of our fiscal ill discipline.

As a consequence, there is the risk that, in addition to the gradual kind of adjustment in our currency that you might have expected because of our large current account deficit, there is the risk that the international markets will begin to demand sharply higher interest rates in order to compensate for the risks, both currency risks and interest rate risks that I've just mentioned.

There is also the risk that they will become reluctant to engage in the rollover of the very large amounts of U.S. dollar-denominated Treasury debt now held abroad, except, again, at much higher interest rates.

Another item in the list of nonconventional effects. As happened in the early 1990s, the deficits could come to be seen as evidence of a more general inability of our society to deal with its economic issues, and as a consequence, could begin to undermine business and consumer confidence more generally, which I believe is what happened in the early '90s.

Furthermore, all of these effects could happen together, and any one of them individually could create serious additional problems over and above the conventional analysis. Put them all together, and you could have a very severe set of effects.

There are various models that attempt to quantify the conventional kinds of effects. I don't think there is any way to reasonably get at trying to quantify these nonconventional effects, and that, unfortunately, makes it much more difficult to convey them in a public domain and to create what I think would be a totally appropriate, terribly troubled public reaction, which in turn could help feed our political process. But in my judgment, there is no question that the risks are severe and need to be taken with great seriousness.

As Ball and Mankiew said in a 1995 paper warning of a similar set of effects, and I now quote, "We don't want to see what this means in a G7 economy."

All of these effects or risks, rather, exacerbated by the beginning of the retirement of the baby boomers the latter part of this decade, which will increase the deficits with every passing year.

We are also now a large debtor nation, so that foreign capital sources are heavily weighted toward the dollar and also have to make decisions on rollovers on a constant basis. That increases the level of confidence that we need to have abroad in our fiscal regime.

And, finally, as the investment banking firm of Goldman Sachs & Company said, I think it was a couple of months ago, in the first sentence of a recent report, and I quote, "The United States budget is out of control."

On this last point, the 2001 and 2003 tax cuts, assuming the tax cuts are made permanent, as the advocates propose, and assuming the debt service would cost about $3 trillion over the next 10 years, if you take the deterioration in our projected fiscal position, since the CBO projections of January of 2001, that deterioration is about $9 trillion. It is actually $11 trillion, but if you adjust for various methodological issues, it's a deterioration of about $9 trillion. That $3 trillion is directly responsible for one-third of it.

And I think there's an indirect effect which may be even more important, which is I think once you have those very large tax cuts, particularly that favor the most affluent, it is very hard--I think it has proved to be impossible, actually--to maintain the always fragile political coalescence around fiscal discipline.

The timing of these effects is impossible to predict. As long as there is relatively little demand for private investment, I believe, from all of my experience in markets, that you will have, as you indeed have had over the last two years, low interest rates. The problem is, once you have strong demand, strong private-sector demand for investment, that will collide with the deficits. And then at some point I don't think there is any question that the markets will look forward to the unsound fiscal conditions now projected and that you will begin to have, and in very large measure will have, the kinds of effects that I've just described, and the risks will become a reality.

Let me conclude by saying that repairing the politics or, rather, the politics of repairing the deep--

[Laughter.]

MR. RUBIN: It comes out the same way. Either way, it doesn't matter. This is tough is the point, I suppose.

[Laughter.]

MR. RUBIN: Repairing this fiscal mess, to use a technical term, is exceedingly difficult, but in my judgment, our future absolutely depends on meeting the challenge. Moreover, the longer we wait, the deeper the hole.

Moreover, the claim that this can be made on the spending side alone seems to me simply lacks credibility.

Number one, if you look at what's happened over the last three years, the large increase in discretionary spending and now a prescription drug benefit, with no means to pay for it, it seems to me it suggests the political system simply won't do it, and, secondly, given what the American people want government to do, including defense, Social Security, Medicare and all of the rest, it doesn't make sense to think that that's going to happen.

I think this conference contributes enormously to the public debate by putting forth realistic options that can be debated. I don't think there's any question that what is going to be required is both an increase in revenues and real spending discipline. It is very easy politically to reduce taxes, it is very easy politically to increase spending and let somebody else worry about the consequences down the road. What is hard is to put in place fiscal discipline, but I think it is absolutely critical with respect to economic future.

Thank you.

[Applause.]

MR. HASKINS: Thank you, Bob.

John Porter?

MR. PORTER: Good afternoon. Each of us has seven minutes, and I don't think I can talk as fast as Secretary Rubin talked. I'll do the best I can.

As a former member of Congress and as an appropriator, I am suspect, and particularly in the midst of this large group of economists. But let me tell you, for just a second or two, about my own bona fides. I will probably be remembered as the chairman of the subcommittee for my effort to double funding for the National Institutes of Health over five years. I did that, though, in a growing economy, with surpluses as far as the eye can see, no terrorism and no war.

During the 1980s and 1990s, I was cited by the Concord Coalition and Citizens Against Government Waste repeatedly as the most conservative member of the House or tied for the most conservative or among the most conservative, and I voted to cut and restrain the rate of increase in most every account where I had the opportunity to do so.

I created a group called SEND--Students to End National Deficits. I thought the problem was that serious. I worked to try to solve it.

Bill Frenzel and I--Bill was a member from Minnesota, and he's now a scholar here at Brookings--he and I offered our own budgets for about five years in a row. Our high-water mark was 65 votes out of 435. He was Don Quixote and I was Sancho.

[Laughter.]

MR. PORTER: As chairman of the committee, my first task was to cut $9 billion out of $70 billion of discretionary spending in my subcommittee. I did that. It was very difficult to do. The scary thing today is that that discretionary budget, just nine years later, is $140- or approaching $140 billion.

The Brookings' effort, it seems to me, is important because it tells us the magnitude of the problem. You can't solve this no matter what philosophy you have without some tax increases or revenue increases. You can't solve the problem without severe spending cuts. That's also a shock. The problem is a serious one, and it must be addressed.

Every member is for balanced budgets. We like to balance them on the other guy's priorities. Members vote to cut defense spending. Other members vote to cut social spending. Very few vote to make both [types of cuts], contribute to the solution to the problem. That's why the three scenarios, in my mind, are important. It tells us the seriousness. It will stimulate discussion and gain interest, and hopefully it will stimulate debate and get some action on a very, very serious problem for our country.

The first step it seems to me is to get critical mass around admitting that we have a serious deficit problem. The party out of power is always concerned. In my first 15 years, we, as Republicans, harped incessantly on the deficits that the Democrats were, of course, creating. Now that Republicans are in power, deficits don't seem so important to us any more. I think we are in denial. I suspect we will be in denial until after the election. The important question is what will be done in early 2005 to come to grips with this serious problem for America.

When Congress and the White House are in control of the same party, and that's likely to be true for a long time to come, Congress is unlikely to lead on the deficit issue. Yes, Congress can raise the issue, can put pressure on the issue, but the president must lead. The president must lead.

Unfortunately, we're going to hear from the president a week from today telling us that we should go to the moon with the new space station and to Mars with a manned exploration, costing some $500 billion. That money, I understand, some of it is going to be--the first year--is going to be in the budget. It's a message to the American people that we can afford anything, anything. I think it's likely to go away after the election, but it is the wrong message to send that we can afford anything. We definitely cannot.

Also, we're going to hear the message, and we've heard it before, to make the tax cuts permanent. I have to tell you I represented one of the most affluent districts in America, and as I went through my district asking about tax cuts, people would say to me, "I don't need my taxes cut. We need to solve the problems of this country. Don't talk about a tax cut." If I were still there, I would have voted, no, on the tax cuts. I think both messages may be, from the White House, may be good politics, but I don't think, frankly, they are good policy.

It's difficult to get the public to focus on deficits and the debt. Unless the public feels that it affects them directly and personally, they don't focus on it. And the party in power always, whether it's Republicans or Democrats, wants to insulate people from feeling it personally and directly.

In addition, we've had large deficits, large surpluses, large deficits again. People suspect the projections. And Republicans, we do think our policies will bring about extraordinary economic growth and that the problem will dissolve, and I certainly hope that we are right. But, as a fiscal conservative, frankly, I wish that conservatives would act conservative, assume the worst and bring about some real change to address this serious problem.

The book and Brookings' effort on process, I think is a very important chapter, and I would commend that one to you. The budget process, in my mind, is a farce. Members of Congress vote for a budget that restrains spending and then refuse to vote for the bills that make that budget stick. The only way to make the budget stick is for Republicans and Democrats, together, to agree on an overall spending number, to agree on allocations and to shape the bills in a bipartisan manner. Anything less will never get you into balance, in my judgment, and we need to get back to a serious measure of bipartisanship in addressing this problem for our country.

The president, we can say, can use his veto. The difficulty is that every president wants something from the Congress, and you need a president, if you're going to work it only that way, that wants only one thing from the Congress, and that is balanced budgets. I've never seen a president that wanted just that one thing.

Bill Frenzel and I proposed to freeze spending by function. That would mean by appropriations subcommittee allocations--not to freeze programs, but to choose priorities within an allocation, and that of course is the very job that appropriators have. Some years, we proposed a hard freeze, other years a soft freeze. What the message was is restrain the rate of increase, choose priorities. That's the way to address this problem, and I think it's a way to address it that if we can get the critical mass, it can work to solve this problem.

One final thought I have, and I realize I've run out of time, in my judgment, major reform of any type in this country is virtually impossible. We have

entrenched sophisticated, well-financed, politically savvy lobbies protecting most everything.

And the most important reform of all that can address many of the problems that our country has is campaign finance reform, public financing of campaigns. I didn't used to believe this, but as time went on, I came to believe that the only way to address serious problems, to get serious reform, is to get the public financing of our campaigns. The party in power, whichever party it is, is always against it, but that strikes me as the most important reform of all.

Thank you for listening to me.

[Applause.]

MR. HASKINS: Bob Reischauer.

MR. REISCHAUER: It's always a pleasure to return to Brookings, even if the topic that we're talking about isn't exactly pleasurable. But it's an unusual pleasure to be part of a panel which is characterized by Ron Haskins as "decent."

[Laughter.]

MR. REISCHAUER: And so I must raise [the point] that three decent people can outweigh one indecent participant.

[Laughter.]

MR. REISCHAUER: The nation's fiscal situation has come full circle in three short years, having attained the state of fiscal grace between 1998 and 2001, when we ran surpluses. We're now deep in the slow of despond, despairing that we see nothing but large and growing deficits as far as the eye can see and no apparent way to deal with them.

I think Brookings, in this effort, should be commended because I think this effort will first draw attention to the seriousness of the problem; second, underscore the costs associated with inaction; and, third, present policy makers and the public with three approaches that could solve this problem if we had the political will.

It's tempting for many of us who have lived through the past few decades to look back at the experience from 1982 to 1998 and say, well, we've been here before. We were in deep despair. We thought there was no way out of it. Bob Reischauer was willing to bet you a considerable amount of money that he would never live in an era of unified budget surpluses, let alone on-budget surpluses, and yet we did the impossible somehow. And if we could do it in the past, why can't we do it again?

And for that reason, I thought it might be useful, before this group, just to tick off some of the lessons that we learned during this past 20-year period and reflect on how they might apply to the situation that we face now.

The first of those lessons is that you need a widespread bipartisan consensus that deficits are a problem and a sufficiently serious problem that the pain related to solutions is worth enduring. And it took a long time to develop that consensus in this country, basically, a decade during the 1980s, before we were really convinced that that was the thing to do, and it was a bipartisan feeling.

The real question I have, arising from that experience is, will this substitute for Ross Perot?

[Laughter.]

MR. REISCHAUER: Because one cannot underestimate the role that he played in that effort.

The second lesson that we learned during that period was that process is not a substitute for political will and resolve; that process can reinforce political decisions, but it can't force them. We had an unhappy experience with the Gramm-Rudman-Hollings procedures, and there will be a temptation, over the course of the next couple of years, to turn to a balanced budget amendment or some other process gimmick and say the process will make us do the right thing, but processes can't.

The third lesson from that era is that successful deficit reduction efforts involve multi-year decisions, that you can't do them one year at a time. The immediate will always drive out the long run. The pain and suffering from what is facing us today will always trump the long-run benefits that might arise from deficit reduction.

The fourth lesson that we learned during this period is that the fiscal diet must be a balanced diet. It has to include all food groups. It has to have taxes, it has to have discretionary spending, both defense and nondefense spending, it has to have entitlements, both middle class entitlements and means tested entitlements. And here I applaud the Brookings' three options, all of which include tax cuts, some of which include all of the other food groups.

The fifth lesson that I think we can draw from the experience of the last 20 years is hair shirts don't work. By "hair shirts" I mean budget deficit reduction policies in which we say there will be no increases in spending, there will be no tax cuts. Every one of the multi-year efforts, and in fact every one of the annual OBRAs that we passed during that period, had little bits and pieces of spending increases or tax cuts to appease one group or another. They were more symbolic than substantive, but they helped the bitter pill go down.

The final lesson that we learned from the last 20 years is that it pays to be lucky, and you cannot underestimate the good fortune that we had during the decade of the 1990s. Let me just remind you of how lucky we were.

The evil empire fell apart in 1989, and it fell apart in a benign way, and that allowed us to reduce defense spending by 25 percent or so in real terms. In fact, it compelled us to do that. We were lucky in the sense that health spending, having risen inexorably over the previous 15 years, suddenly slowed down to a crawl in the mid 1990s. We were lucky in the sense that we had the longest sustained economic expansion in American economic history. We were lucky in the sense that stock values, equity values in the United States exploded far more than could be rationalized by the good economic news that we had.

And, finally, we were lucky because in the last half of the 1990s, we had divided government, and with divided government comes gridlock; that had Bill Clinton and the Democrats got what they wanted, we would have had surpluses; had the Republicans gotten what they wanted, we would not have had surpluses. Neither got what they wanted, and the American people got what they deserved, which was a surplus.

[Applause.]

MR. HASKINS: Dan Crippen.

MR. CRIPPEN: I want to, before we're through--before I get through--do a little review of history of where we were, how we got to where we are now and where we might be going. Some of you have seen me do this before or, as Robin Williams says in a parody of Walter Cronkite--my apologies to both--"What it is, what it was, and what it will be."

Before I do that, I want to talk just a minute about baselines because we have avoided that discussion so far, and it's an interesting one I think we can't avoid. Clearly, the authors of this report, and many others, have chosen a baseline that they think to be reasonable, and I'm not here to disagree with their sense of reasonableness, but I will say that when you depart from a baseline of current law such as that CBO is required to use, you are left in a position of having to make judgments about future political outcomes, and I'm not sure how good we are at that, frankly.

As economists making political predictions, I'm not sure we're any better at that than we are at making economic predictions, and our record speaks for itself on that score.

As I told Congressman Porter, my father reminds me very often about what Will Rogers said about economists; namely, you can ask an economist his opinion about almost anything, and he's as likely to be right as the next man.

[Laughter.]

MR. CRIPPEN: All of that is to say I'm not sure what baseline I would choose if I were going to depart from the safe haven of a CBO-like current law baseline. I certainly would agree with some of the observations on AMT and perhaps even on some of the extension of tax cuts, but it's not clear where we end up. There are going to be Medicare policy changes along the way. It's not clear to me they're all going to be on the upside. Indeed, we have had increases in taxes and reductions in spending along the way in the past, in part because of the deficit outlook and, in part, for policy reasons.

So I don't know where we're going to be 10 years from now, and once you leave the current law baseline, I find it hard to say exactly where we're going to be. And maybe that's why, frankly, the current bond markets seem to be relatively sanguine about this outlook. Presumably, they have this information. Your former colleagues at Goldman Sachs certainly have it. And if they don't have this information, I want you, Mr. Secretary, to help me short the market as quickly as possible.

[Laughter.]

MR. CRIPPEN: If we know something they don't know, I want to take advantage of that.

But my guess is they're a little sanguine because they don't expect this outcome either. Why they don't expect this outcome, that is, the outcome we're looking at today, because of more responsible policy or economic growth or other reasons, I don't know, but apparently they don't yet or aren't yet convinced that the outcome we foresee is one that is inevitable.

There are many things that can change between now and the next 10 years, including the economy itself, changes in immigration policy, other things that would change this whole outlook. So I'm not convinced what baseline is correct. I am persuaded that perhaps there are things that are going to happen along the line that we should be cognizant of, but to be precise about that is about as good as being precise about the baseline itself.

With that said, let me do a quick review of history. I think it's important to let us know how we got here and where we might be headed.

This first graph is just a decomposition of CBO's outlook for 1997, which was essentially that deficits are going to go on forever--$200 billion or greater. What happened then, in order to give us the outlook that actually produced some surpluses, were some legislation we all know about, which is the dark-blue wedges here, but they were relatively modest to the overall change in the outlook.

One would say, however, they're not unrelated to what happened, and I'm sure the secretary would as well, not unrelated to what may have happened to the

economy, but at the same time much of this change in outlook and, indeed, the actual surpluses we experienced, were due to changes in economics and other underlying economic factors.

As Bob said, we were very lucky along the way. Much of the change in the economic outlook helped us produce more revenues and, indeed, that level of economic growth produced even more revenues than we would have expected, in part, because of the stock market and the expansion of the capital gains receipts.

But if we look now at what happened, this outlook--the next slide--where we were predicting surpluses, you can see again the decomposition of where the surpluses went. The bottom line is the current CBO baseline. Again, we can talk about whether that's the right one or not. It probably is going to be somewhat lower, and this quirk over here on the right is assuming that the Bush tax cuts go away.

But, nonetheless, you can see that there are other components to how we got from surpluses to spending that are very--or to deficits that are very important; the economy being the largest one, certainly in the short run. But even over the longer run, the tax cuts are not the single most important thing that has caused a deterioration. Spending, in and of itself, is larger. That's not to say that we should have tax cuts or these should remain, but we need to be mindful I think, as we go forward, how we got from an outlook of surpluses to one of the dire deficits that we're looking at today.

The last slide--and all of you who know me will not be surprised to see this--is simply a look at one possible outcome of what's going to happen in the near future, but beyond the 10-year window the authors are looking at here today, and that is my generation's retirement. We all know the familiar discussion--part of the discussion is in the report, of course--on how much particularly Medicare and Medicaid will grow.

And in this view of the world, no matter where you think the exact number comes out, there are really only a couple of moving parts. Indeed, in this case, it's the increase in health care costs that drive this outlook. Social Security, in and of itself, is not growing even as fast as the economy--on a per capita basis as fast as the economy here. So it's mostly the increase in health care costs.

And given this view of the world, the other variable that's important, of course, if you're looking at fiscal discipline and balanced budget, is the level of taxation. So those are the two pieces that really will adhere a fiscal discipline to this outlook, and it will be obviously very significant tax increases if one looks at those as being the solution.

Indeed, in the report, the authors said that there isn't much one can do with Medicare and not much one should do with Medicaid. And so we're left, I think, in the long run, with a need to talk about what we're going to do for tax policy when my generation retires.

So we definitely need to expand our horizon beyond this 10 years--I would argue to the 25- or 30-year mark. During that time when my generation retires, as many of you know, we'll double the number of recipients from 40 million to 80 million. We can't grow out of the problem, as the authors of the report have said. And I would suggest an important criteria for judging any of these plans or other plans would be what effect does it have on this 25- or 30-year outlook.

There were, in the report, some suggestions for Social Security changes, which would help some, and modest changes in Medicare, but it wouldn't change this spending outlook much at all.

What that leaves you, then, as I said, is I think the level of taxes, and we need to start a debate about that quite soon, about how we're going to pay for the impending retirement of my generation. So the outlook is even worse, in some ways, than what the authors said.

However, I do want to say, as some of my colleagues have, this is a terrific effort, and most of you are too young to remember, it's a continuing effort of Brookings on looking at budget options and priorities. The old version, the old series of, "Setting National Priorities," of Brookings' volumes are still worth reading even today.

And one of my measures of, "Is this a serious effort or is it being taken seriously," is does C-SPAN show up. I've found I've had a very hard time getting C-SPAN to cover budget hearings or budget meetings. And so the fact that they're here I think suggests quite strongly not that only is this a terrific effort, it's one that is being taken quite seriously and will be seen by a lot of people.

Thank you.

[Applause.]

MR. HASKINS: Dan, I'd like to correct one obvious flaw in your comments. From the looks of this audience, there are plenty of people here who are old enough to remember things that even happened in the '50s, so--

MR. CRIPPEN: Only on the panel.

MR. HASKINS : No, no, out there too. There's a lot of snow out in that-

[Laughter.]

MR. HASKINS: So we get to ask some questions now, and I'd like to emphasize to the panelists that it's important to try to give short answers so we can ask lots of questions and every panelist can have a chance to answer the questions.

The first and obvious question is what's the big deal? The thesis of this project is that we are in a crisis and that if we don't do something, there will be one or more of five consequences: slower growth, increased borrowing costs, indebtedness to foreigners, increased interest payments in the federal budget, and passing the bill to our kids.

So, panelists, are these real threats? And when would you anticipate they will begin to occur?

Why don't we start with you, Bob, because you have a microphone. In Washington, it's always good to have a microphone.

MR. RUBIN: Well, it depends what you say.

[Laughter.]

MR. HASKINS: I was fully confident you would know what to say.

MR. REISCHAUER: Ask his successor at Treasury if that's true.

MR. RUBIN: My successor was Larry Summers. I think my successor would be fine.

[Laughter.]

MR. HASKINS: It applies to him too.

MR. RUBIN: My successor is in good shape. We're getting to a different subject.

MR. RUBIN: On the question you asked, no, look, I think all of these are serious problems, and I think the real problem is that all of us can come together, and we can have an unholy mess potentially, and I think all of us have addressed that in different ways, and I think that the time to address it is now.

As to why the markets don't reflect it, I've lived with markets all my life. Markets have a way of focusing on the here and now. I spend tons of time with people right now involved in all kinds of trading activities. And if you ask them are they concerned about it, they'll say, yes. If you ask them are they factoring into their current judgments about their activities in bonds, and stocks, and the rest, and the answer is pretty much, no.

MR. HASKINS: But when would you anticipate--there are a whole range of consequences--

MR. RUBIN: Oh, when it will happen?

MR. HASKINS: Yes, is it going to be tomorrow? Is it going to be--

MR. RUBIN: Oh, I think it'll happen when it occurs.

[Laughter.]

MR. HASKINS: You've been in Washington before, huh?

MR. REISCHAUER: If not before.

[Laughter.]

MR. RUBIN: No, I don't think before. I think actually when it occurs.

No, I don't know. I don't think there's any way to predict when it will happen. Look, in the '80s, people were worried about this for a long time, and I think realistically worried, and we didn't start to have a real slow-down until '89, as you remember. And if you look at what happened with interest rates, the economy slowed down, interest rates didn't come down the way you would have expected, and it all became a very difficult situation, but it took quite a while for it to evolve.

MR. HASKINS: Well, as the other panelists answer this, I mean, I think several people have commented, and it's obvious, that part of the goal of this project is to bring the importance of this issue to people's attention. And if we say to the American people, "Oh, my gosh, there are five horrible consequences, and they will occur someday," I mean, that's not exactly a rousing call. So it is a crucial issue, even though we can't predict, with any exactitude. I mean, I'll--Bob?

MR. REISCHAUER: We'll get worried about this as a people when there appears to be adverse economic developments, whether those adverse economic developments are, in any real sense, associated with the build-up of debt and the size of deficits. And that's what happened during the 1980s and the 1990s. It wasn't necessarily that, in an economic seminar, that somebody would tie, you know, slow productivity growth, whatever our malaise was to the fiscal situation, but in the popular mind, that occurred, and it will happen again, whether it's the collapse of the dollar or whatever.

MR. CRIPPEN: And as you said, Bob, that without Ross Perot, it's not clear what would have happened and when. And so, to the extent this becomes a political phenomena that pushes the Congress and the president into doing something, it will depend upon the development of it as a political issue, much more potently than I think it has so far.

MR. RUBIN: Yes, I do think, Dan, at some point you are highly likely--but it may be well off in time or it may not be--highly likely to see exceedingly sharp

impacts on interest rates, and I think, Bob, people will tie that, at least my guess will be, both substantively and politically tie that to fiscal conditions.

MR. HASKINS: We have a number of people on this panel who have had the opportunity to advise presidents or to advise senior members of Congress. Next week is a State of the Union address. Imagine that you were in a position to advise the president or advise senior of members of Congress. I assume that everybody, possibly, except Dan, would say we are, in fact, either in a crisis or about to be in a crisis, and here is what you should do now.

What is it that you would tell them to do?

MR. CRIPPEN : I mean, frankly, it's not that I don't think we might be--I think we're in a long-term crisis. It's not today or tomorrow perhaps, especially given the state of the economy, but it's something that we are going to have to address soon. And this kind of effort, while it's aimed at looking at the 10-year budget, is critically important to bringing us one step closer to at least getting into the next decade and beginning to deal with that issue.

Whether or not you want to stay employed by this president is another question, but--

[Laughter.]

MR. CRIPPEN: But, for me, it is that issue that's most important, and it's going to take, as Congressman Porter said, presidential leadership to do anything about whether it's the short term or the long term. And, for me, that would mean probably Medicare reform and, secondarily, maybe Social Security reform, but more importantly Medicare, health care reform of some kind, and in an election year, is that what the president--would you advise a president to do that is an open question.

MR. HASKINS: And what about tax cuts?

MR. CRIPPEN: I wouldn't call for more tax cuts, but that's what I mean. I mean, as I said, I'm not employed there, and probably wouldn't be, but--

MR. HASKINS: No, you won't now, for sure.

[Laughter.]

MR. PORTER: Let me comment on it.

MR. HASKINS: Yes, go ahead.

MR. PORTER: I think, if the president would simply put a good, strong paragraph in a speech that will cover practically everything and say this is a serious

problem that his administration is going to address and will have specific proposals when they work it through, just something to put a mark on the need to address this, I don't sit here and expect him to put it in a major place in an election year, and neither does anybody else. But recognizing that it's a serious problem and that the administration intends to do important things about it, and is reviewing it and going to address it in the near future, I think would do a lot to get people focused on the seriousness of the problem to the American people.

MR. RUBIN: Could I ask you a question, John? But how would he reconcile that, with advocating that the tax cuts be made permanent?

MR. PORTER: Well, I just said I think he ought to not make the tax cuts permanent, and I think we ought to not plan to go to the moon or Mars with manned exploration. So I don't think you can reconcile it.

MR. HASKINS: I wish I weren't sitting next to John Porter to point this out, but it's pretty obvious that the most important thing that's happened so far today is that a very senior member of Congress specifically said that we should not extend the tax cuts. So that's quite a remarkable thing.

MR. PORTER: Well, I'm no longer in office, so it's an easy thing for me to say.

[Laughter.]

MR. HASKINS: Well, no, but you still have friends in the House--

MR. REISCHAUER I don't think you'll be re-elected.

[Laughter.]

MR. HASKINS: Here is what I have heard repeatedly. Some of the rest of you may have heard this same thing.

"Relax. This is not that big a deal. First of all, we're going to trim spending. We're going to control the growth of spending. We're going to slow it down, and then we're going to grow out of this deficit." Is that a realistic prescription?

MR. CRIPPEN: No. I mean, as the authors quite aptly point out in the report, you can't grow out of the deficit, and you're not going to restrain, politically or otherwise, spending.

The issue, again, and certainly in the long run, is not domestic discretionary spending, which is what most people are talking about. It is Medicare, Medicaid, Social Security, and the level of taxation. And once you get past those discussions, there isn't a lot left, in this long-term outlook at least, to argue about.

MR. PORTER: I thought--

MR. HASKINS: Republicans are dominating. This is what we planned.

[Laughter.]

MR. PORTER: Dan, I thought that the report had said that over the 10-year period, if growth rates were 4 percent per year for the entire 10-year term that the problem would go away, although not the long-term problem, and I think every American hopes that the growth rate is 5 percent.

The difficulty is, is that the historical rate is at 3 percent, and not too many--and I'm certainly not an economist--but not too many economists think that it's likely that we will have an increase to 4 percent over that long a period of time. I'd like to know what these economists think about the possibility of our doing that.

MR. HASKINS: That's a good point. So the claim is that if we could grow at 4 percent a year for a decade, everything would be fine. Is that realistic? That's his question.

MR. REISCHAUER: Are you asking me--oh, is it realistic?

MR. HASKINS: Yes.

MR. REISCHAUER: No. I mean, is it possible? Yes. Should we predicate our budget policy on that assumption? No. As the book points out, very cogently, it's easier to go in one direction than the other if you're wrong. If it turns out that growth is faster than projected, the deficit is coming down faster than expected because of the cuts that are in place and the rapid economic growth, we certainly can find our way to stopping the cuts or stopping the tax increases. But if we get halfway through the next decade and we find that growth is really 2 percent, then, we're really in trouble.

MR. RUBIN: I think there's another problem as well, which it seemed to me that the general thrust here was that having these very large deficits, instead of promoting growth, is most likely to undermine growth.

So whatever you might have thought the projected rate of growth would be, and I think Goldman Sachs projected a 10-year deficit of $5.5 trillion, and I think they were using growth of 3.1 percent--I've forgotten--but something like that. But it seems to me that the very deficits that you're trying to deal with are themselves undermining of the growth that some people are claiming will solve the problem.

MR. HASKINS: Moderators are not supposed to participate, but I think, as a matter of logic, it would be good to point out that the consequences of being wrong

and having solved the problem too much, as opposed to the consequences of being wrong and not having addressed the problem are quite radically different. So that's another thing I think people would have to consider in making a decision.

Let me ask one more question of the panel before we turn it over to the audience, and let me be bipartisan about this.

Some of us remember, in 1995, 1996, Republicans shut down the government twice over a budget deficit, and they were insisting that the president come up with a 7-year plan that would balance the budget using CBO scoring, and when he didn't meet those specifications, Republicans closed the government. And if some of you might go back and read the rhetoric at that time, the future of the nation and our children was at stake. This was the most important thing in several decades. We had to balance the budget.

And now here we are again, in 2004, in a situation very similar to the situation in the mid 1990s, except that we're much closer to the problem that Dan has emphasized, which is the retirement of the baby boomers, and where is the outrage? Where's the concern? What happened? How can you explain this? I am truly perplexed.

[Laughter.]

MR. PORTER: I'd sort of like to leave him perplexed.

[Laughter.]

MR. PORTER: I think one thing that I mentioned in my remarks is true, and that is that we have had, up until the last few years, surpluses for a while, and we had deficits for a long, long while prior to that time that never did get brought under final control. So I think it's a reasonably recent phenomenon to have deficits that we've had for the last couple years, and we're again dealing with projections for the next 10 years, and as I said before, I think people, given the history of things, don't really believe necessarily the projections, and there needs to be a longer historical context before you can get that critical mass.

MR. REISCHAUER: To what John has said, I would add two other factors.

First and foremost, probably, is that there have been a few diverting issues--war in Afghanistan and Iraq, 9/11--and a slowdown in the economy, combined with a collapse of equity markets. So people have been focusing on that.

In addition to that, as opposed to the mid 1990s, certain dimensions of our economy for the employed population have been performing very, very well. It's cheaper to buy a house, I mean, mortgage interest rates are at an all-time low, and have

been for a long period, and inflation has been very much under control, and so it's very hard to translate this abstract notion of the government is spending too much beyond its means into what are some adverse consequences for me sitting at my kitchen table, except if I'm unemployed, and if I'm unemployed, you're saying to yourself, more tax cuts, more government spending, do something to stimulate the economy in the old-fashioned way.

MR. HASKINS: Okay. Audience participation. Let me remind you that everybody else in this room, except whoever asks the question, would rather hear from the panelists than from you. So please ask short questions.

MR. CRIPPEN: Don't be so sure.

[Laughter.]

MR. HASKINS: Who has a question? In the back there. They'll bring you a microphone. Tell us your name and ask the question.

QUESTION: Lisa August with OMB.

What role do you think the Federal Reserve should play; that is, should it be active or neutral?

MR. HASKINS : Dan? Somebody?

[Laughter.]

MR. CRIPPEN: Well, I'm not quite sure what you mean by active. I think the Federal Reserve is going to play an accommodating role here with the economy, at least if you believe the public statements and those who tea-leaf Greenspan better than I do, they're certainly going to be neutral to promoting economic growth and lower interest rates for the next year or so.

I think your question was normative, what should they do, and in the long run, the best thing they could do is whatever it takes to keep inflation low, but, I mean, that's kind of a naive statement. So I'm not quite sure how to answer your question.

MR. HASKINS: Does anybody else want to add anything to that?

[No response.]

MR. HASKINS : Next question. Follow her example. That was nice and short. Yes, right behind you.

QUESTION: Hi. Bud Newman with BNA's Daily Tax Report.

For the purpose of the question, can we assume, just for a moment, that President Bush is re-elected and Republicans control Congress after the next election. Do any of you on the panel believe that under that scenario that President Bush would ever put forward or the Republican Congress would ever pass a deficit reduction package that included revenues, tax increases of the kind that were described in the report? Do you think that will ever happen?

MR. HASKINS: Excellent question.

Dan, especially, and John Porter. John, you can go first.

MR. PORTER: I think, if the problem is perceived as severe, as we think it is, and if the situation in Iraq improves, and the terrorism threat recedes somewhat, I think that the president might well propose some way of addressing the problem.

I think elections have ways of really distorting what people believe in their hearts about addressing problems, and when the election goes away, I think there's a real chance to address things in a very real way. So, yeah, I'm hopeful that that might happen if we find ourselves in that situation.

MR. CRIPPEN: I guess I'd say roughly the same thing. I mean, remember--and, Bud, I'm sure you do--that Reagan, after '81, subsequently endorsed or otherwise acquiesced to something like 11 tax increases, and most of them in trade for other things he wanted--spending reduction and other policies. So, if Reagan can do it, maybe Bush could, too, and particularly if there's something else that's important to him involved, whether it's entitlement reform or something else that I'd like him to address. So I think it's possible that he would.

MR. REISCHAUER: But if the dollar collapsed and interest rates spiked, there would be a "eureka moment" in the White House.

MR. PORTER: Well, and one thing is very much different, and that is that the Congress and the president, as you assumed, would remain in control. And when you're in control of the entire government, you become the responsible party. And if you don't address problems that affect people, you're going to pay the political price for it, and I think that whatever party is in control doesn't want that to happen.

MR. HASKINS: Bob, do you want to add anything to this?

MR. RUBIN: They don't consult me, so I don't--

[Laughter.]

MR. HASKINS: They soon will, though, Bob.

MR. RUBIN: I think that's probably unlikely, but in any event--

MR. HASKINS: One more question from the audience. In the back.

QUESTION: Hi. Robert Sherretta with International Investor.

Particularly for Mr. Rubin, although any of you. You mentioned that Wall Street has a short-term focus. We spoke to Mr. Jagadeesh Gokhale about six months ago.

MR. RUBIN: To who?

QUESTION: Jagadeesh Gokhale. He's a co-author of "Fiscal and Generational Imbalances." He has a report out on that, to that effect. His argument is that in about 2008 a flash point occurs in terms of the surpluses turning into deficits in Treasury obligations. Do you think foreign investment will react prior to that kind of flash point?

MR. RUBIN: I think it's impossible to know when markets are going to react. I think one of the problems is that if markets don't react for a while or at least don't react in a very major way, that people may be lulled or there may be a tendency to get lulled into some kind of complacency which I think, to some extent, we have now on these issues.

As I said in my remarks, I think the probability of these kinds of effects happening is exceedingly high. The timing I think is simply unpredictable. Markets do tend to have a short-term focus, and it may be that it will happen in the nearer term, but it may be it will take quite some time.

But the fact that it takes quite some time doesn't mean any the less that it's likely to happen, and I think it has the disadvantage of carrying this on longer, making the hole deeper, and lulling us into a kind of complacency, rather than causing us, as Bob Reischauer suggested, to actually deal with it. But I don't think there's any way to predict when these things are going to happen.

MR. HASKINS: Does anybody want to add to that?

[No response.]

MR. HASKINS: Well, join me in thanking this panel and thank the audience for great questions.

[Applause.]

THE BROOKINGS INSTITUTION

"RESTORING FISCAL SANITY: HOW TO BALANCE THE BUDGET"

3:30 p.m. - 5:30 p.m.
Tuesday, January 13, 2004

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

[TRANSCRIPT PREPARED FROM A TAPE RECORDING.]

PANEL 3:

MODERATOR:

HENRY J. AARON
Senior Fellow, Economic Studies, The Brookings Institution

PANELISTS:

LAEL BRAINARD
Senior Fellow, Economic and Foreign Policy Studies, The Brookings Institution;
The New Century Chair

WILLIAM G. GALE
Senior Fellow and Deputy Director, Economic Studies, Brookings;
Co-Director, Urban-Brookings Tax Policy Center

RON HASKINS
Senior Fellow, Economic Studies, The Brookings Institution

PETER R. ORSZAG
Joseph A. Pechman Senior Fellow, Economic Studies,
The Brookings Institution

CHARLES SCHULTZE
Senior Fellow Emeritus, Economic Studies
The Brookings Institution

QUESTION & ANSWER SESSION

P R O C E E D I N G S

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

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

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

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

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

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

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

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

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

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

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

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

[Laughter.]

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

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

[Laughter.]

MR. AARON: Full stop.

MR. HASKINS: Yes.

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

[Laughter.]

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

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

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

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

[Laughter.]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[Laughter.]

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

[Laughter.]

MR. SCHULTZE: If you want to know--

MR. AARON: No--

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MR. AARON: Thank you very much, Lael.

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

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

Peter, what would you tell them?

MR. ORSZAG: Well, did we?

[Laughter.]

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

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

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

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

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

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

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

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

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

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

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

MR. AARON: Thanks very much, Peter.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MS. SAWHILL: And pre-K.

MR. SCHULTZE: Pardon?

MS. SAWHILL: And pre-K.

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

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

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

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

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

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

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

[Laughter.]

QUESTION: This is arguably--

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

QUESTION: Gary Mitchell from the Mitchell Report.

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

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

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

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

MR. AARON: Thank you, Alice.

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

Yes, sir. The gentleman--

QUESTION: Howard Rolston, temporarily retired.

[Laughter.]

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

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

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

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

QUESTION: [Inaudible.]

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

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

The young man in the suit there.

[Laughter.]

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

[Laughter.]

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

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

Thank you.

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

Go ahead.

MR. ORSZAG: Two answers to the question.

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

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

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

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

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

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

[Laughter.]

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

QUESTION: Rare for Cato to have the last word.

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

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

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

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

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

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

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

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

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

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

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

[Applause.]

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

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

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

[Applause.]

[Whereupon, the proceedings were concluded.]