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THE PRESIDENT'S BUDGET AND THE LONG-TERM FISCAL OUTLOOK

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C O N T E N T S

Panel I: Domestic and International Implications

Moderator: [Both panels.]

RON HASKINS, Senior Fellow
The Brookings Institution

Presentations:

JAMES CAPRETTA, Visiting Fellow
The Brookings Institution

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

LAEL BRAINARD, Vice President and Director,
Global Economy and Development Center
The Brookings Institution

PHILLIP L. SWAGEL, Resident Scholar
American Enterprise Institute

ALICE RIVLIN, Senior Fellow
The Brookings Institution

Panel II: Political and Business Perspectives on the Budget

Presentations:

PETE PETERSON, Senior Chairman
The Blackstone Group

CHARLES KOLB, President
Committee for Electronic Development

THOMAS HEALEY, Chairman
Healey Development

P R O C E E D I N G S

MR. HASKINS: Welcome to Brookings. My name is Ron Haskins. I'm a Senior Fellow here, and also Senior Consultant at the Annie E. Casey Foundation, and I'd like to welcome you to our event on the President's 2007 Budget.

I'd like to begin by pointing out that this week when the President was in New Hampshire defending his budget, he said that he was trying to bring fiscal sanity to Washington. I'd like to call your attention to this fine little volume here by Alice Rivlin and Isabel Sawhill called Restoring Fiscal Sanity. So I'm now prepared to announce that the President who is notoriously early to bed is actually up there reading Brookings' Fiscal Sanity. This does not, however, account for his position on tax cuts, so we should be clear about that.

Let me just say a few things by way of background for the President's budget. He is proposing to spend about $2.7 billion next year and to collect about $2.3 billion in revenue, assuming that the tax cuts are made permanent, and this leaves a deficit of about $400 billion, or 3.2 percent of GDP. The President says that the deficit will fall in subsequent years, and according to OMB it will be below 2 percent of GDP in every year between 2008 and 2011. As many of you already know, there have been a number of prominent folks who have disputed these figures because they say that the costs of the war, flood insurance, and the alternative minimum tax after 2006 are not included in the President's figures, so they think that they're questionable.

Broadly speaking, the President increases spending on defense and homeland security while reducing taxes, and by contrast, he proposes budget cuts including ending 141 programs, imposing serious constraints on domestic discretionary spending, and on both Medicare and Medicaid.

Finally, by way of introduction, let me say that the President's budget is nothing more than a proposal. Congress will have its own budget, and the early indications are that the Congress is already questioning several of the major elements of the President's proposal, so this should be an extremely interesting winter and spring up on Capitol Hill as the Congress tries to establish its own budget.

To discuss all these matters, we have a very distinguished panel here. Let me say a word about how we plan to proceed. We have two panels. The panelists on each panel will speak for 7 minutes and then I will ask them some questions, and then we'll give the audience an opportunity to ask questions. Our introductions, as always, will be very brief. You have biographical information available on all of the speakers. And I'd like to point out to the speakers that we have a timekeeper right here in the front row and we have newly installed trap doors up here, so when 7 minutes hits you get about 3 seconds and then the trap door opens and away you go.

On our first panel is Jim Capretta who is in the middle here. That's where he wants to be is in the middle. Jim is a former OMB official in the Bush administration, and now he's a Visiting Fellow at Brookings.

Isabel Sawhill to my left is also a former senior official at OMB. In fact, she and Jim held basically the same position in different administrations, Isabel was in the Clinton administration, and she is now a Senior Fellow at Brookings and also the Vice President of our Economics Studies Division.

All the way on the right down there is Lael Brainard. She was a senior official working on international economics in the Clinton administration. She is now a Senior Fellow and also a Vice President and Director of our Global Economy Development Center at Brookings.

Then to my immediate right is Phil Swagel. He is a former Chief of Staff at the Council of Economic Advisers in the Bush administration, and he is now a Fellow at the American Enterprise Institute.

Finally, Alice Rivlin on my far left, who is the only person living or dead who headed both the CBO and the OMB, and she is now a Senior Fellow in the Bush—[Laughter.]

At Brookings. I'm sorry. I didn't mean to promote her like that.

So we're going to begin this politically balanced panel with Jim Capretta and then proceed in the order in which the people were introduced. Jim?

MR. CAPRETTA: Thank you very much, Ron. It's certainly a pleasure to be here.

I want to start just by orienting ourselves around where we stand right now in 2006 because all the discussion about the budget, it's usually a little difficult to keep score. It's good to remember that the deficit in fiscal year 2005 was 2.6 percent of GDP that was down from 3.6 percent of GDP in 2004, so we had a percentage point drop in the deficit over that 1-year period. The reason the deficit dropped was that revenues came in very strong in 2005. They drew 14.5 percent in 2005 compared to 2004. That was the fastest revenue growth in more than two decades. No doubt that revenues were at a very low level in 2002, 2003, 2004, for a variety of reasons, but at least in 2005 they showed a strong rebound.

We're one-third into fiscal year 2006 through January, and CBO projects for the full year that we'll have a deficit of about $355 billion in fiscal year 2006. That's their current estimate. That's about 2.7 percent of GDP, so it would rise under their current estimate from where it was last year. That does include the assumption that we're going to have another supplemental essentially for defense and for flood insurance, but it does not include the potential revenue loss from an initial tax cut that may actually be examined and approved by Congress. That tax loss may be in the range of $15 billion in fiscal year 2006.

When you look at it in total, to be able to hit the numbers CBO is talking about, about 355, but you look at the actual revenues through the first third of the year, revenues have grown at a pace of about 10.4 percent through the first 4 months. They assume over the full year that revenues will grow at about 7.4 percent. So during the last two-thirds of the year there would have to be a pretty substantial slowdown in revenue growth which could happen. The big revenue months are still ahead, we're only about one-third into the revenue take for the year, but at least so far the revenue growth that we saw in 2005 has moderated somewhat, but it's still by any measure at a pretty healthy pace. So there is some small and modest reason to think that the revenue side may actually be a little bit better than we're currently projecting, at least in 2006. That is not to say that in 2007 and beyond it's not going to be where CBO and OMB actually assume it will be which is a slowdown from these rapid growth rates.

My main point here is that when the economy is in the fat part of the business cycle as it is right now, that's when you can get some deficit reduction and it is the moment to really emphasize deficit reduction and to do everything we can to keep the economy going as it is, but also to, as the economy is doing well, do everything possible on the spending restraint side. It's worth noting that states are also experiencing strong revenue growth, at least in most parts of the country at the moment.

Looking at the 2007 budget, for those of us who have been working on these budgets—I worked on the first four in the Bush administration—there are a lot of familiar themes here. The President in some ways is kind of predictable. He says what his priorities are and then they pretty well get carried out in his fiscal policy. His priority is spending whatever it takes to prevail and be successful in Iraq and wage the war on terror globally, and they emphasize that in the budget again with a pretty healthy increase in even the normal rate of spending for the Defense Department. Spending authority would be up 6.9 percent in 2007 compared to 2006, and that doesn't include the supplementals for Iraq and Afghanistan.

Homeland security again gets a pretty sizable increase. Spending authority would go up especially relative to the rest of the budget 3.3 percent in 2007 compared to 2006. He does propose as he has in every budget since 2003 to extend the tax cuts on a permanent basis, and he emphasized that just again the other day.

Then everywhere else in the budget it's restraint. This is similar to pretty much every budget he's submitted for the last 4 years. He proposes to hold non-defense, non-homeland security spending below an absolute freeze. He would take it down .5 percentage points. And he proposes another round of mandatory spending reforms, saving about $65 billion over 5 years. That's on top of the roughly $40 billion that he just signed into law. He's slowly but surely trying to restrain those portions of the budget that he hasn't put a high priority on in fairly targeted ways.

One theme I think that has emerged through all of this is that for people in fiscal policy, there's a certain amount of benefit from certainty in the trajectory of the budgets going forward. Taking uncertainty out of the fiscal projections actually probably does have some beneficial effects on the markets and observers of where we are.

This President has not engaged in an effort to try to build some kind of framework with the Congress that would last over a multiyear period. He's proposing this pretty much one year at a time. He puts his agenda out there, he negotiates it, he talks about a half a loaf at the end with the Congress especially on the spending restraint side, and then he tries again the next year. I think that's a pattern we've seen now for the last couple of years, and that's a pattern I expect to see even in the next budgets that he submits before his term expires.

I think my time is just about out. One last point here. The Congress is going to have a hard time accepting a lot of cuts that are in the current budget, but I think even if that's the case, the stage is set for another round of deficit reduction. If they don't like what's in the budget, the President proposes, they dispose, and I think it will be difficult to just avoid a deficit reduction exercise altogether.

MR. HASKINS: Belle Sawhill?

MS. SAWHILL: I certainly agree with Jim that this budget is consistent with the President's priorities. I think what I would add though is that he hasn't put much priority on reducing the deficit. First of all, his goal, which is to reduce the deficit in half by 2009 relative to 2004 as a portion of GDP, isn't a very ambitious goal. But even if it were and even if we could achieve it, which is quite unlikely at this point, if you look through this year's budget and you actually look at his policy proposals whether on the spending front or on the tax front, they don't do anything to get us any closer to his own goal. In fact, there was a page that is normally published as part of the budget and it was left out this year that shows that his own proposals, the administration's own proposals, will actually increase the deficit by about $229 billion over the next 5 years. After 2009, things get much, much because the Baby Boomers begin to retire and the entitlement programs grow rapidly, and I think Alice and Phil will probably say more about that.

Moving from what the administration has proposed to what Congress is likely to do, Jim is certainly right that there is some restraint in some spending programs in this year's budget, but many of those proposals repeat what has been proposed in previous budgets. Congress has projected many of those proposals in the past, and it's not likely that they're going to do things this year that they haven't done last year or the year before particularly when you remember that this year is an election year.

Congress, as most of you know, has just enacted a spending bill that would cut spending by $40 billion over 5 years. The bill was a real squeaker. The Vice President had to cast a tie-breaking vote in the Senate. Thirteen Republicans in the House voted against it. It barely got through there. The cuts that they managed with great difficulty to make are very small. They are three-tenths of 1 percent of total federal spending. So I don't think we can be terribly optimistic at this point about prospects for restoring fiscal sanity.

The problem, of course, is politics. Our current politics are simply not well aligned to make progress in getting the deficit under control, and given this lack of political courage, you might ask, what should we do? It's not clear that there's anything that can be done, but I have floated an idea recently that I'd like to share with you in brief. That is that we set some kind of a goal, it could be the goal of reducing the deficit in half by 2009 or any other goal that one could come up with, and then we call for a temporary suspension of the indexing of both benefit programs and taxes until that goal is achieved. I would include an exception for programs targeted to the poor, but otherwise this would be very much across the board, it would affect everybody's income taxes, and it would affect benefits like Social Security benefits that reach a large number of people. So both working-age people who pay income taxes and the retired would be affected.

The rationale for doing this is as follows. First of all, it does require broad-based sacrifice. Instead of pitting one group against another, it would say we've got to all tighten our belts a little bit, and it would do so in a way that is fair and affordable to any individual family and relatively easy to administer. It would in effect be asking everyone to sacrifice a little to pay for homeland security, for the war in Iraq, and for rebuilding after Katrina. And it would give the public, because they would be affected in their pocketbooks, some concrete reason to not think about the deficit as an abstraction anymore and to hold their elected official accountable for making progress because the guideline here would be that once we made progress towards the deficit, we could again allow people's benefits or taxes to be adjusted for inflation.

I think it would also take the pressure off of discretionary spending, non-security discretionary spending, which is now only about 16 percent of the total budget, and where all of our efforts have been concentrated and which is mainly affecting more vulnerable populations where if we continue to just cut that one small part of the budget, it would be good for that reason as well. Finally, it would actually accomplish quite a lot, much more than we've been able to accomplish through any of the steps that have been taken recently. Over a 3-year period, a very rough estimate is that it would save at least $100 billion, so it would not only call for a broad-based sacrifice that wouldn't hurt any family unduly, but it would actually make a serious dent in the deficit.

Do I think it would be easy to get Congress to enact such a proposal? No. They haven't shown a lot of political courage and this would be contentious, but it might be easier than the kind of major structural reforms that we're eventually going to need both on the entitlement front and in the revenue area in order to deal with the long-term fiscal situation that you'll more about later. And I don't expect those fundamental reforms to happen much before 2009 or 2010 because I think we're going to need a whole new political environment in order to have them be put in place, and this would at least put a major finger in the dike in the interim and give elected officials a reason to be more disciplined. So I'll leave it at that.

MR. HASKINS: Lael?

MS. BRAINARD: I was asked to talk a little bit about why we should care about the size of the budget. A lot of people would say interest rates have remained relatively low, growth has remained relatively good, so what is it exactly that you folks are worried about?

In the State of the Union, people really sat up and took notice when President Bush for the first time said the nation has a problem, we're addicted to foreign oil. What he didn't say, but is equally true, is the nation has a problem; we're addicted to foreign capital. The reason that so far we really haven't had to pay for any of this consumption is because essentially our consumption is being financed by foreigners. In the immediate-term, I think a lot of people would come back and say this is a great deal for us. The Chinese are willing in particular to finance our deficit and to finance our purchases from them, so what exactly is the problem here? If you look at our foreign borrowing over the last few years, it has gone up extremely sharply in a very short period of time so that last year we were borrowing close to 6 percent of our income from foreigners. We have borrowed heavily in the past. If you think about the 1980s in particular, it was a period of some run-up in our debt.

What's different now is that at that time we were net creditors and we went into this and are now increasingly net debtors to the rest of the world. Moreover, we are net debtors and with accumulating IOUs to the rest of the world at a time when we're about to retire which is really what we should be saving for.

If you look at the debt trajectory, it went from about 14 percent of GDP to now over a quarter in about 4 or 5 years' time. If you look at Argentina and Brazil on the brink of their financial crises a few years ago, their debt to GDP ratios were 18 and 33 percent, respectively. So we're sitting right comfortably in the middle of that range, and it is a very awkward place for us to be. If you think about the historical fact that it's very hard to think of an example of a hegemonic power, a global superpower, that's actually a net consumer of capital in world markets, the British model was exactly the reverse.

There is a strong argument to be made on the "don't worry, be happy" side, and in fact we've gotten very lucky. All of the things that you would want to go our way have gone. Valuation changes have gone our way so that our debt has not accumulated as quickly as you would be worried. But if you look at who's holding the debt and what type of debt they're holding, you should worry.

If you look back in about 2000, the majority of what foreigners were investing it was productive capacity in this country, and they were mostly private investors. There's been a very sharp shift in the composition of our external liabilities, so if you look at it, that most of the net holdings are now official securities, that is to say, treasury securities, being held by official foreign entities, that is to say central banks mostly in Asia. If you look at treasury securities, 55 percent are now held by foreigners, many of those by Asians. What are the dangers? I think we all know the hard-landing story, that is, there's a rush to the exit. People dump our securities. The Fed is forced to sharply raise interest rates, the recovery is sharply curtained, and financial markets are kind of a wild ride at least for a short period of time.

The alternative though is not that attractive. Most people think that the probabilities are all more in line with a soft-landing story, but even that is a story about delaying the pain. It is also risky, but it's much subtler and may be in more dangerous ways. Nouriel Roubini and Brad Setzer have projected out our current account deficits and have essentially said that we're on track to have 8 percent of GDP current account deficits with net debt on track to reach 50 percent of GDP not in 10 years, but in 2 years. So if we awake to this issue late, if our foreign partners continue to indulge this consumption binge, over time we're going to be spending more and more of our export earnings essentially paying back IOUs, and that will also be true of our government deficit. The next time we confront a Hurricane Katrina or the need to invade a hostile state, we'll have that smaller degree of freedom.

The other story line for the "don't worry, be happy" crowd is it's mutually assured deterrence. The Chinese can't dump all of their securities, it's very difficult to find a good alternative, and they have pretty strong interests in ensuring that financial markets remain relatively stable given their own interest in selling to the rest of the world. That's true, but financial markets are actually markets, and there are a lot of players in financial markets and as we have seen just in the last few days, rumors can move markets and you don't really need a big concerted official move to do that.

The final piece of this is, why the government deficit? The reality is that our savings rate as a nation has dropped to something like 1 percent of GDP. Contrast this with China at 40 percent of GDP. The only piece that we really have a handle on in terms of policy levers is the government piece and that is why that single lever bulks so large whenever discussions of reducing our reliance on foreign capital come into play.

MR. HASKINS: Phil Swagel?

MR. SWAGEL: Thanks very much. I'll touch briefly on a couple of things in the budget on the near-term side, and then talk about entitlements, taxes and the long-term fiscal situation. Maybe I'll just touch quickly on two things in the budget. I could talk a lot more, but I'll just hit two things.

One is that it's good in my mind that the budget does take on Medicare and does focus on health care and continues the conversation on Social Security even if in somewhat muted tones. The Medicare changes are modest as Jim pointed out, but at least they break the ice which matters since, as we all know, Medicare is such a much larger unfunded liability than Social Security and will hit us before Social Security.

A large part of the changes proposed to Medicare are effectively to reduce net benefits going to the rich, and this echoes President Bush's proposal last year for Social Security solvency which involved slowing benefit growth for the rich. I think if someone wanted to say what's President Bush's structure for addressing long-term entitlements, it's a very progressive one; it's to reduce net benefits going to the rich.

It's easy to attack any cut, so it's a good sign that cuts are being put on the table knowing that these are an easy target for criticism, and we'll see what happens. If we can't make progress and progressive changes now, it's going to be hard to tackle the fiscal challenge of entitlements.

On the health care, the proposals in the budget I think likewise have the potential to make progress on some important economic challenges for the nation. They're not perfect, but they're a step in the right direction. As has been discussed by many people, the level of the playing field between buying health insurance at work or outside of work and help further the trend away from third-party payer insurance, and this will hopefully get at some of the incentives for increased utilization of health care services that do not correspond to gains in health care outcomes.

There is a sense in which the HSA proposals are taking a tax break that the rich already get and making it accessible to everyone else, taking a tax break for the rich and making that tax break accessible to the poor, the unemployed and people who don't get insurance through their jobs. At the same time, a refundable tax credit will help poor people afford insurance, while new proposals will allow policies to be more portable. Research at the Fed here in Washington has found that the change in pensions from defined benefits to defined contributions was driven by workers' preferences for more portable benefits, and this suggests to me that portable health care could become a desirable benefit as well.

Let me switch and turn quickly to the big picture. The fiscal situation is unsustainable. There is a long-term structural financing gap. I'd like to point out though that this was true in 1998. The fiscal situation was unsustainable in 1998, it was unsustainable in 1999, and it was unsustainable in 2000, even when the federal government was running very welcome fiscal surpluses. That's because in those years we still knew that the fiscal situation was unsustainable because of entitlements.

The gap has gotten bigger since then especially because of the Medicare Drug Benefit, but my sense is that much of the criticism of that drug bill when it was being discussed was that it wasn't generous enough. Fortunately, the deficit is sustainable for now because of our large capital account surplus representing the resources that foreigners willingly supply to fund investment in the United States.

I also don't see much of a capital account reversal in the foreseeable future, and also look to market participants as being with me on this one since, otherwise, interest rates would much higher and would have risen much more with our mounting long-term deficits.

In thinking about how to address the fiscal gap, I think it's important to keep in mind the source of the problem. Here I'm not talking about the short-run. I'm not much interested in the calculations of what's contributed to the deficit between 5 years ago and today. I have in mind the long-term fiscal danger. Here I think it's important to focus on the tax cuts and entitlements. The 2001 and 2003 tax cuts together equal about 2 percentage points of GDP every year. Entitlement spending is set to rise by an additional 10 percentage points of GDP over the next 30 years and by 20 percentage points in total over the next 75 or so years.

I realize that many people focus on the tax cuts when they start talking about the fiscal situation, and to me this is like saying we just really need to get a running head start to jump across the Grand Canyon. Either way we're not going to make it. At the same time, it's important to keep in mind that the tax cuts do a lot of good, particularly the provisions regarding dividends and capital gains that lure the cost of capital to firms and that partly remove the tax disincentive against saving arising from the double taxation of capital income.

I wonder sometimes even if the focus on tax cuts is counterproductive, if it prevents having a two-sided discussion on entitlement spending. I realize there is vast disagreement on tax cuts, but really what I see is almost complete agreement on the need to address entitlement spending regardless of whatever else happens with taxes. There is no way we're going to be able to raise taxes enough to deal with the problem, so we have to do something on entitlement spending as well.

So I would say let's get started where there is agreement, and the President's approach as I said before is to lower benefits going to the rich. It seems like that should at least be a basis for discussion, not necessarily agreement, but the basis for discussion. There is a natural skepticism of commissions, but perhaps the President's proposal for another one on entitlements is the way to get this conversation started.

Market participants in my mind believe that we will tackle our long-term fiscal problem, since, otherwise, of course, interest rates would be much higher since the fiscal situation currently stated is unsustainable. The markets don't know how we'll do it, we don't know ourselves, but they trust that we will get there. And hopefully this year's budget with taking on the entitlements yet again will get us started on the main issue of the fiscal pressures arising from entitlements.

MR. HASKINS: Alice Rivlin, try to find something to disagree with in that presentation.

MS. RIVLIN: I actually agree with much of it, although I would put it in slightly different terms.

You've heard a good deal this morning and over the last few days about what the budget proposes and the priorities that it reflects. It clearly reflects an increased priority to defense and homeland security, although it doesn't fully fund those things, either the obligations in Iraq and Afghanistan, or the rising cost of the force structure that we think we need to deal with the dangers in the world. And it proposes tight control on most domestic spending especially after 2007. There is a high risk as others have pointed out that this won't happen. If it is to happen, the administration has got to bargain and to use the veto power. And as the Clinton administration found out in the first couple of years, it's hard to bargain with your own team, especially when an election is coming up, and an election is always coming up, and this administration has not shown itself willing to bargain with its own team.

But I want to say a word about what the budget does not do, and let me put it this way. I think it does not recognize the squeeze that medical care is putting on the budget and will continue to put. I chose those words carefully. This problem is sometimes described as the long-run problem. It's not a long-run problem. It's already happening. It's been happening for quite some time. Spending for Medicare and Medicaid per capita has been rising faster, considerably faster, about 2.5 percentage points faster, than the GDP for a very long time, and we don't have a current way of reducing that gap between the rise in medical care spending in these programs and everywhere else in the economy that would reduce that excess growth of medical care spending over the growth of our economy. Maybe we could get it down from 2.5 to 2 or 1-1/2, but the basic problem is that demand for medical care is rising faster than our economy is growing, and it's likely to stay there.

So I think it is misleading to call this the long-run problem since we've had it for a while, but we've had a way of solving it. The way of solving it was squeeze down everything else the government does. We used to spend a lot higher percentage of our GDP on defense than we do now, and I think we no longer think that we can squeeze that any further, indeed, that it maybe have to go up, and we have squeezed down as a percent of GDP the rest of government spending as well.

I think it's also perhaps misleading to call this either the Baby Boom problem or the entitlement problem because, not that those aren't part of the problem, but when you hear the Baby Boom problem or the retirement problem or problems of promises made to the elderly, or other phrases of that general nature, what an awful lot of people think is ah-ha, it's Social Security because that's what we know most about as a retirement program, and it's temporary because those Baby Boomers are going to retire and then this problem will presumably be behind us, it'll take a while, but we'll get there.

With respect to Social Security, that's largely true. Social Security, if we paid all of the benefits that we have promised under the current law, would rise as the Baby Boomers retire from about 4 percent of the GDP to about 6 percent of the GDP, and then it kind of levels out because the thing that's pushing it up subsides. The only thing you have left is increasing longevity, and that's pretty slow, so that Social Security illustrates the problem of the Baby Boomers, but Medicare and Medicaid really don't.

The problem is seriously exacerbated by the fact that the Baby Boom generation will retire and that the federal government happens to concentrate its spending on programs for the elderly, especially Medicare, and the long-term care of Medicaid, so that does create a problem, but that's not what is driving primarily the increasing costs. It's the fact that all of us are spending more each year on medical care because Medicare care is better and the costs of it are rising, and if you have some component of your economy that's rising faster than the rest, you got to figure out what to do about that, and this budget does not really face up to that problem or resolve it.

That's a lot to ask of a budget. A budget generally reflects the shorter-term implications of policies that have been decided or on which there is some kind of consensus, or at least a consensus within an administration, and we don't have a consensus on what to do about this problem. I think the budget takes some small steps in the direction of recognizing it, to come back to Social Security which is not a big part of the problem. There are some modest reductions in Social Security benefits and another nod in the direction of individual accounts, but they don't represent a serious facing up to the Social Security underfunding problem and don't seem to represent a new effort to cut a deal on this.

And the question of what happens in medical care is I think arguable. On the one hand, there is a nod in the direction of reducing the ongoing costs, the rising costs of Medicare in the direction of increasing the means testing of the premium by getting rid of the indexing.

There's another interesting approach which resembles somewhat Belle's proposal on Medicare which is a proposal for an automatic sequester, if you will, or an automatic passing on of the cost of Medicare gets over 45 percent being paid by general revenues, then the administration is proposing an automatic cut in provider payments, a small one, but one that would continue until the problem was fixed. And it's kind of a Belle Sawhill sort of this may not be a very good idea, but if we make it automatic, somebody will pay attention and the thing will get fixed.

MR. HASKINS: Alice, can you wind up, please?

MS. RIVLIN: The other thing is health savings accounts, and I think we need to come back to that because one can argue either that it controls costs or that it doesn't, and the jury is still out.

MR. HASKINS: Let's begin with the obvious question. Several panelists have referred to it, and the obvious question is, will the President get the cuts that he's asking for? Then the second question is, will the tax cuts be made permanent? Are the votes there to do it?

MS. SAWHILL: If I can take a first crack there, I think one of the things we need to emphasize is that although Congress has just passed this spending bill that reduces spending by $40 billion that I mentioned earlier, they're about to probably pass a second bill that will reduce taxes by $70 billion, so the next effect over the 5 years will be actually to increase the budget. That bill which is going to conference now, the tax reduction bill, does attempt to make the tax cuts permanent, but there's a major dispute between the Senate and the House. This is not a dispute between Democrats and Republicans, this is a dispute within the Republican Party between those in the Senate who want that bill to focus on fixing the alternative minimum tax which is going to begin to affect a lot of middle-class families, and people in the House who prefer to give priority to extending for two more years the reduction in rates on capital gains and dividends. I think it's going to be very hard for them to come to a compromise in which of those two major proposals to put through an expedited process called reconciliation that needs to be worked out in conference.

MR. HASKINS: What about this year's tax cuts and spending cuts? What you just talked about is an introduction to essentially business left over from last year, and now we've got—

MS. SAWHILL: I'd welcome other people's thoughts, but I think what I said earlier was that I don't see Congress being able to cut spending very much more. The low-hanging fruit has already been plucked in terms of spending cuts. I think Phil was right, and Alice alluded to this as well, that there are some further proposals on Medicare, for example, that Congress can look at, but this is very contentious particularly in an election year. Given the difficulty they had enacted those cuts this year, I think going forward it's going to be extremely difficult for them to do more. But Alice, as did Phil, pointed to several proposals that certainly Congress should seriously look at.

MR. HASKINS: Jim, what do you think?

MR. CAPRETTA: On the spending cuts side, I guess I would look at the dynamic that played out in calendar year 2005, playing out again this year in maybe delayed fashion. I could see them actually delaying most of the tough votes until after the election, but they did a somewhat similar thing this year.

MR. HASKINS: So he would get half of what he asked for.

MR. CAPRETTA: He's not going to get all that he's asked for, but he'll get some.

On the tax cut question I'm not sure how this dynamic is going to play out, but one thing to note is that in the 2004 campaign, the question of extending the tax cuts was very much front and center, of course, and Senator Kerry at the end of the day as part of his platform wanted to extend the tax cuts just for people with incomes below $200,000 a year. That's sort of where he came out. That was a pretty big extension of the tax cuts. Assuming what's the base line as sort of the question, how much of this is going to go forward on a permanent basis, there could be another deal eventually, but absent that, it's hard to imagine the political system going back to just where the taxes were before tax cuts. I don't think even many of the Democratic side want to have that sizable of a tax placed on people in the lower brackets.

MR. HASKINS: But are you also saying that it would be less than making the full tax cut permanent of 2001-2003?

MR. CAPRETTA: The question is on political leverage at this point, and it's hard to tell. I don't think they'll get it this year, no.

MR. HASKINS: Phil?

MR. SWAGEL: I don't have really anything else to add on that.

MS. RIVLIN: I think they'll kick it down the road.

MR. HASKINS: Which means they'll delay it until after the election?

MS. RIVLIN: That they won't do anything very major before the election, and particularly since the President is proposing kicking AMT down the road, that that's the easy thing to do and they'll do it.

MR. HASKINS: What about the cuts in spending?

MS. RIVLIN: He'll get part of them, but I don't think all of them, and the drastic ones that really contribute to halving the deficit by 2009 come after 2007 anyway.

MS. SAWHILL: There are a lot of cuts in the budget, things like eliminating the lump-sum death benefit and Social Security, raising airplane ticket fees, a whole lot of other cuts that I don't think anybody believes can happen politically.

MR. HASKINS: So I think we're all agreed that he'll get some of his cuts, but nothing like the full everything that he's asking for. In fact, many of them, as people probably know, have already been on the plate for several years and have not passed.

If we stand back and look at the President's entire budget and something like his strategy, and this is consistent pretty much with what Phil said as well, the idea is to keep discretionary spending below the rate of inflation, propose actual cuts on non-defense, non-security discretionary spending, to eliminate many ineffective programs or duplicate other programs, and then to reduce spending on two of the most rapidly growing entitlements, Medicaid and Medicare. Were it not for the tax cuts, would this be a reasonable strategy, do you think, to at least make a down payment on the budget?

MS. RIVLIN: I don't think it's a very good one because the squeezing down on discretionary spending I think I agree with Belle, unless you have a serious strategy for what the government is going to do and what the government is not going to do, just squeezing everything down a little bit each year gets increasingly difficult because resistance builds. And as I said, I don't think we've got a strategy on the medical care programs yet.

MR. HASKINS: But at least the savings are $36 billion, and in Medicare it's at least a start, or don't you think it is?

MS. RIVLIN: It's a start. I don't think it's a very good start but, yeah, sure, it's a start.

MS. SAWHILL: I certainly agree with what Phil said about the appropriateness of beginning to charge the more affluent seniors a bit more for Medicare Part B for the doctor part of Medicare, and they are trying to do that. I think that's a sensible thing to do and we're going to see more of that in the future.

MR. HASKINS: Phil?

MR. SWAGEL: I was going to say in my mind the real action is on the long-run, and what I mean by the long-run is that these are problems that we can solve gradually and that that's what makes it a long-run. The problem is, even if do face it today, and I think the short-run is pretty hopeless, no one really wants to make serious cuts in the short-run, so that's why I just talk mainly about the long-run.

MR. HASKINS: Lael?

MS. BRAINARD: I would like to contrast the current moment with politics surrounding budgets starting with Gramm-Rudman-Hollings and then going into the major Budget Act of 1993.

We're just not in the same universe right now. What is required to have a really strong push where lots of difficult political choices are truly on the table is a complete mindset shift about how important this is, and I don't see that at the moment. I don't see it in the polling; I don't see it in the run-up to the elections. I certainly didn't see it in 2004. I think one of the questions is, is it a public education effort? What will it take to get the kind of appetite for serious political compromise to start to effect political calculations? But I would just say I don't see it at the moment.

MR. HASKINS: Let me take that a little bit further. Belle and I actually did some research on this. We called 20 former members of Congress and senior budget officials and senior staffers on the Hill and we asked them about what it takes. All of these people had participated in some of the grand compromises of the past, the Social Security—of 1983, the tax reform of 1986, and then the budget deals of 1990, 1993, and 1997. There was quite a bit of agreement, in fact, in some of these cases unanimous, that four factors were really crucial, and this goes right to your point, Lael. First of all, presidential leadership. You couldn't do it without strong presidential leadership. Secondly, had to be bipartisan. Neither party could make a lot of progress on its own. Third, everything had to be on the table, taxes, spending, the works. And fourth, you had to have an aroused public. Now to make your point, we don't have of those four right now. So what I'd like to ask the members of the panel is, when do we get those, how do we get those, what can we do to create the background in which serious discussion of fixing the deficit and enduring the pain would be possible?

MS. SAWHILL: One of the things I think we need for the business community to get more engaged, and I bring that up because I'm hoping that the next panel and Pete Peterson and others, Charlie Kolb, will address that. Pete has written some wonderfully challenging commentary to his colleagues in the business community. This goes back to the fact that we haven't seen much reaction in financial markets so far for some of the reasons that were discussed earlier and that may be why they are not weighing in. One could also cynically suggest they're not weighing in because these are their friends that are in the White House, but I'll wait to see what the next panel wants to say about that.

MR. HASKINS: Alice?

MS. RIVLIN: I think we may need a crisis or a perceived crisis. Lael provided a scenario or two for a currency crisis, a spike in interest rates, fallen markets. It could be that. It doesn't have to be terribly serious. The 1987 stock market crash which probably had very little to do with the budget was perceived as budget-driven and had a lot of positive effect on the consensus.

But the other candidate for crisis is medical care. I think there is a rising feeling that something has to be done to curb the rising spending on medical care, and if we can do that in the name of crisis, we've done most of the long-run job.

MR. HASKINS: There's already a loud voice from Detroit on that issue, right?

MS. RIVLIN: Yes. Sure.

MR. HASKINS: Medical care is bankrupting the auto makers. Does anybody else want to add to this?

Let me end my questions with more kind of an academic question. At least word has it, and I think we're going to look into this more carefully at Brookings in the near future, that there was something devised at OMB, I believe it's pretty much bipartisan, it's called PART, and that's called the Program Assessment Rating Tool. The idea is to make sure that all of these thousands and thousands and thousands of federal or federal and state programs, that they have clear goals and that there is evidence that they achieve their objectives.

I'm personally aware of a number of times when OMB has looked at all the numbers and consulted with the agencies and they decided this program doesn't work, we're going to kill it, or we're going to substantially cut it back. A notorious example is the 21st Century Schools which caused a huge problem, and we had a big event here at Brookings, and Congress totally ignored the President's recommendation and went ahead and fully funded it largely because Arnold Schwarzenegger visited down and said what a fine program this is.

But my question is, do you think that this could actually play a role, that there could actually be a mechanism that OMB and the agencies work out that programs don't work, and we all know that a lot of programs don't work, and use that as a rationale for seriously cutting back on government spending?

MS. RIVLIN: I'm very skeptical. The list in the President's budget includes a lot of programs that we came to that conclusion about in the Clinton administration. Some of them have wonderful sounding names. Safe and Drug Free Schools was one of our candidates for elimination. It's one of the Bush administration's. It's still there. And I think it's very hard to get rid of programs just on he grounds that they "don't work."

MR. HASKINS: Jim, do you agree with that, that all those bright people up there in Congress and they are confronted with very strong evidence that a program doesn't work and they keep it going? Could that really happen?

MR. CAPRETTA: I don't think I'll answer that direct question. [Laughter.]

MR. HASKINS: You should be up on the Hill.

MR. CAPRETTA: First of all, I think the effort is very good. I think the systematizing the process of examining programs and putting it in a very transparent way and making it public can only help the discussion. One of the big problems with the federal government is lack of data, that if you want to know how a program is doing, usually you need some data and that you'd be surprised at how many programs have literally no data. So the process of trying to force some accountability on the taxpayer's dollars I think is tremendously useful.

I do agree a little bit with Alice that it's an uphill fight, but last year I think it was the first of this President's budgets where you saw the appropriations process produce more than a small amount of the proposed cuts. It was $5 or $6 billion worth of cuts. He proposed I think more than ten, so he didn't get all of what he wanted, but he started to get some. Can he sustain that and balance the budget on it? No. But will it force programs to perform better and be more accountable? Absolutely. The general reaction usually is not that the program does, but it finds a way to get a little bit better. That doesn't necessarily save us money, but I think it helps the country.

MR. HASKINS: Does anybody want to add anything there?

MS. RIVLIN: I'd like to correct the record that I fully agree with Jim that we shouldn't stop trying.

MS. BRAINARD: I think performance measures are a good thing in general. I think Alice's comments earlier, and Belle has pointed out, there is only so much to squeeze in discretionary especially when you take defense and homeland security off the table. So to fool ourselves into thinking that somehow that's the answer, I think, again, it's a sort of non-answer to the question.

The answer has to be broader, and my guess is that the politics of some of this requires something that's automatic. I will simply say that several of us on the panel—

[End Tape 1 Side A. Begin Tape 1 Side B.]

MS. BRAINARD: [In progress] —the discipline of requiring that we find offsets for any spending increases we proposed and several of us did not live with that, and I think our lives were just very different. And it's some of those very basic rules, disciplines, which are unpleasant, but at the end of the day tend to produce results even when you're sitting there and chafing under the discipline that they impose.

MS. SAWHILL: One final comment about this. We tend to forget that the defense budget needs to be scrubbed as well. I've been on several meetings recently with Doug Holtz-Eakin, the former Director of the Congressional Budget Office. He makes this point strongly nowadays that we are giving defense for obvious political reasons right now, and reasons of national security, a kind of a pass.

MR. HASKINS: It is the case though that the President did propose some cuts in defense, right? Overall it's a net increase, but there are some cuts within defense, I believe.

MR. SWAGEL: There's a really nice paper on the Brookings website now by Barry Bosworth talking about achieving surpluses in the latter half of the 1990s. He writes, "In effect, the budget benefited from an extraordinary run of good luck, not policy change." So there is I think a sense in which what we need to do now is a change.

MR. HASKINS: We need to get good luck somewhere?

MS. RIVLIN: I can't leave that unchallenged. We certainly had a very strong economy. But if you look at the numbers on the growth in spending until the surpluses appeared, the growth in spending was extraordinarily low and it was low for the reason that Lael said, that we were working under those awful, horrible spending caps and PAYGO rules and we couldn't find a way to pay for the things we wanted to do.

MR. HASKINS: This raises an issue. Let's talk one second about this. This is something I can understand. President Clinton, excuse me, Republicans, had more budget discipline than certainly any Democratic President, and he was working with a Republican Congress which was ferocious about balancing the budget and cutting spending, and the two of them together actually achieved something.

MS. RIVLIN: Right.

MR. HASKINS: Some if it happened before Republicans took over in 1994, but nonetheless, if you look at the spending restraint in the Clinton administration, it's greater than at any other time. It was a bipartisan achievement. Why do people object to it? I don't understand that.

MS. RIVLIN: I don't know. We don't either. It was a lot of hard bargaining and the hard bargaining started, some of it before 1995, but mostly it started in 1995. It was we've got to get the deficit down. You want to do it one way; we want to do it another, let's cut a deal.

MR. HASKINS: Jim, do you agree with that, that it was really bipartisan?

MR. CAPRETTA: Like the other question you asked, Ron, I'm not going to answer that direct question. What I'd like to do is point out is that I think the record would show the largest bipartisan deficit reduction package, the one that set in motion really what happened in 1993 and 1997, was 1990.

MS. RIVLIN: Right.

MR. CAPRETTA: It was truly painful. We were all involved.

MR. HASKINS: 1993 was only painful for half of us, right?

MR. CAPRETTA: 1993 was a one-party deal.

MR. HASKINS: Yes.

MR. CAPRETTA: Just like the 2001 and 2003 tax cuts were. I guess my point is, basically, that a lot of the beneficial fiscal policy that was set in motion through the 1990s really did start with 1990. Granted, a lot of it got extended a built upon in 1993 and 1997, but the 1990 deal was a landmark deal.

MR. HASKINS: We can grant that it was a landmark deal, but I don't see why anybody wouldn't look at the facts at what happened and they couldn't possibly conclude anything except that President Clinton was serious about cutting the deficit, Republicans were equally serious about cutting the budget, Republicans put tons of proposals on the table, Clinton accepted some of them and we had the lowest rise of spending at any time since before 1965 for sure; bipartisan.

Now we've arrived at the time for questions from the audience. When you ask a question, remember that it's a question. We don't want any long statements. Tell us your name and organization and ask a concise question. You can direct to the entire panel or to any one of the panelists.

MR. GREENE: I'm David Greene from National Public Radio. I just wanted see if you could expand a little bit when you were talking about the proposed programmatic cuts to discretionary programs. When it comes to President Bush and other presidents, is this more about sending a message to the programs, the managers, and sending a message to the public about the willingness to at least challenge and propose some cuts than it is about actually saving a whole lot of money?

MR. HASKINS: Belle, you're shaking your head.

MS. SAWHILL: My answer would be it is mostly symbolic.

MR. HASKINS: Another explanation, I think, see if you agree with this, is that it might be easier to cut domestic discretionary certainly than defense and then homeland security and then entitlements. Would that also play a role?

MR. CAPRETTA: Well, certainly you have to appropriate these programs every year, so they're always under review and you have to decide every year what level generally you want to spend on them. And if it's the view of the leadership of the administration that it's a lower priority or not money well spent, I think they will continue to propose it for cuts and terminations. Even if it forces some dislocation in the Congress and the appropriations process, if they don't want that cut, what cut do they want? There's some of that.

But I think I disagree a little bit with Belle. I think last year they pushed and pushed and pushed and got a portion of what they proposed. They actually did get some cuts that they suggested, and I think they think they'll get a portion of them again. That's how they operate. They'll go up to the Hill and they'll take a third of the loaf if they can. But it has probably the beneficial effect of also forcing reform where they think it might be reformed as well.

MR. HASKINS: There is one flaw though, and let's get the panel reaction from this, and that is that discretionary is about a sixth of the budget and we've squeezed it at lot as Bell has already pointed out.

MS. SAWHILL: Non-defense discretionary.

MR. HASKINS: Non-defense discretionary. And I think Maya MacGuineas said this week, if you have a structural problem with your house, it's a lot easier to mow the grass, but it's not going to fix the house, and that's approximately the situation we have here. It's really tough to tackle entitlements. Isn't that part of the problem as well? This strategy is clearly limited. You can only get so much.

MS. SAWHILL: That's right, but let me modify what I said earlier or elaborate and partially agree with what Jim is saying here. If you do have a hard freeze and you can achieve it politically, it does save quite a lot of money. The administration not only has a hard freeze, they're going below a hard freeze, and that takes courage. So I don't want to in any way detract from the fact that that's a reasonable thing to have proposed. Whether it will happen is a whole 'nother matter, and whether it will make a big dent for the reasons Ron is suggesting is also another matter, but we shouldn't be overly critical of it.

MR. SCHOETTLE: My name is Pete Schoettle. I'm from Brookings and I have a two-part question. The first relates to the issue of strategy and cuts. At the end of last year, the tax bill cut 1 percent across the board on federal agencies, exempting defense, and to me that's the total absence of leadership and strategy, just everybody cut, no correlation of cuts to pars, good agencies don't get hit, bad agencies get hit more, et cetera, just across the board. Where is the strategy in that?

The second question is, there has been no mention at all of the drastic shrinking of revenue from corporate taxation and the increase in personal income taxes. What impact does that have on the economy and the budget? Back in the 1950s, corporate tax rates were significantly higher. What's wrong with slightly raising those?

MR. HASKINS: Let's deal with the first one. What do you think about a 1 percent or some across the board cut? Is that a failure of leadership?

MS. RIVLIN: I think it's a failure of imagination, but it may be the only thing you can do. It does force programs to be as efficient as they can, and it's susceptible to the argument, 1 percent isn't very much, anybody could find 1 percent somewhere. So it's an easy way out, but it's better than nothing.

MR. HASKINS: Jim?

MR. CAPRETTA: I knew you were going to pick me. I generally agree with the sentiment of the question. I really prefer picking and choosing. But as long as it's not much above 1 percent, you can probably handle it every few years and do one of these things, but you don't want it to be part of the regular budget process, that's for sure.

MR. HASKINS: The second part of the question? Can you talk a little bit about that?

MR. SWAGEL: Our current tax is in some sense a hybrid between an income tax and a consumption tax. There has been a decades-long movement in the direction of a consumption tax, so not taxing the return to saving as we've expanded savings vehicles and IRAs and 401(k)s and things like that the President has again proposed what's called the LSA or RSA expanded savings vehicles and that would take us further in the direction of a consumption tax.

My sense is that academic economists are generally in favor of moving toward a consumption tax. So what might in some sense optically look like a bad thing, with the change in the composition of tax revenues might actually fit well with the academic consensus of what should be the composition of revenues. That doesn't mean politically it's the right thing or a good thing or an easy thing, but at least from an academic perspective it is probably a reasonable thing.

MR. HASKINS: Alice Rivlin?

MS. RIVLIN: I agree with that, but even if you don't put it on the basis of moving toward a consumption tax, I think most purists about taxation would say we ought to integrate the corporate and the individual tax so that individuals bear the burden in an explicit way rather than taxing corporations and then that gets shifted to whoever, employees, shareholders and dividend people and whatever, but it would be better to integrate the whole thing and tax it once.

MR. HASKINS: Would you say it's necessarily a flaw if you just optically, to use Phil's term, that corporate income tax goes down and individual income tax goes up?

MS. RIVLIN: That's the implication of what I'm saying, is we're moving in the direction not very well of integrating the corporate and the personal tax.

MS. SAWHILL: Here's one other point that might be worth making here which is there has been a lot of talk about the fact that there has been a revenue surge just recently. Josh Bolten likes to talk about that a lot and uses it as evidence that the supply side of these tax cuts is working. I think what sometimes gets lost in that conversation is the fact that we had a bonus depreciation provision, we also had a one-time holiday for corporations that were repatriating their earnings from abroad, so of course corporations cashed in on that. That's been one of the major drivers of this revenue surge, and that I think often doesn't get mentioned.

MR. HASKINS: Another question?

MS. WAYMAN: I'm Carol Wayman with CFED, the Corporation for Enterprise Development, and I have a question, but first a comment. I wanted to challenge the Performance Assessment Rating Tool comments that were made. OMB's initiative is an OMB initiative. It's not bipartisan. It doesn't have a lot of congressional support. And a number of the criteria are completely inappropriate for the program. For example, community development financial institutions was found adequate and one of the problems that OMB referred to is that it's duplicative with a few state programs and the CRA, Community Reinvestment Act which is completely inappropriate. We had the same problem with rental housing programs where they said this is duplicative because we have vouchers, but you can't finance, you can't supply affordable housing on vouchers. Year to year there is not enough of a financial commitment for banks.

My question is, where do you see the budget focused on economic growth in low-income areas? What do you see the President promoting economic growth in low-income areas, especially since a number of the programs that have done that have been eliminated in his budget for as Ms. Sawhill mentioned 2 or 3 years now?

MS. SAWHILL: I don't see an emphasis in this budget on that priority and haven't seen one for several years.

MR. SWAGEL: To me this is an issue that goes beyond the budget. One thing that we've seen in the last couple of years is that the share of income going to labor has declined markedly. It was elevated in the late 1990s but it has since declined, and this is probably connected to the phenomenon I think you're referring to, and obviously the share of income going to owners of capital has gone up.

Another way of saying the exact same thing is to say that productivity growth was very strong over the last 5 years, but wage growth has not been nearly as strong. So what's going on? Historically, when productivity growth has increased, wage growth has followed, but with a lag. So when productivity growth sped up in 1995, wage growth sped up really in earnest in 1997, so there was about a year and a half or 2-year lag. The lag this cycle is much longer. It's essentially the strongest relationship in economics that wages equal productivity or wage growth equals productivity growth. That tells us that wage growth will go up and that low-income earners will finally see the fruits of their increased productivity growth. I can't tell you when, but I suspect that will happen regardless of what happens in the budget.

MR. HASKINS: Her question is, where are the policies that are going to make it happen faster or more or whatever?

MR. SWAGEL: You're going to hate my answer. I know you're going to hate my answer. When economists look at capital taxes they say that the burden of capital taxes in the long-run, so over time, falls on workers. So you lower capital taxes, that looks like it helps owners of stock, but over time we find that savings goes up, investment goes up, and that raises labor productivity, and as I said before, wages follow. So over time, and if you want to be real academic, you'd say that all the gains from capital tax cuts go to workers and workers bear the entire burden of capital taxes. So it's completely the opposite of what you might expect. That's the policy I'd say.

MR. HASKINS: The answer in short is, if you want to help low-income workers, make the President's tax cuts permanent?

MR. SWAGEL: That's it.

MS. RIVLIN: I didn't think was the question though.

[Laughter.]

She spoke about low-income areas, and the kind of place-specific programs that were emphasized in Clinton administration as in community development and financial institutions have not been emphasized in this one.

MR. HASKINS: Going back to the PART, do you think there's evidence that the Clinton emphasis on place was successful?

MS. RIVLIN: I think there is evidence that, yes, I do, that well-managed investment in low-income areas including right here in this city by CDFRs pays off.

MR. HASKINS: One more question.

MR. CAPRETTA: Your observation that it's OMB driven and not bipartisan, I would agree that it was OMB driven. Certainly they started the process in OMB as part of another effort to look at government performance in a systematic way. There is probably no other place in the Executive Branch that could generate that, so it's sort of a logical place to start. It would be much better if it were bipartisan in the sense that the Congress, both parties, adopted it or some system as part of their review. That's got to be the next step, to integrate particularly the Subcommittees on Appropriations into it and have them vest themselves in it so that everyone has the same language.

Short of that, it's probably still worth the effort. It is shared and supposedly worked out with the agencies, although maybe the leverage is a little bit one-sided.

MR. SWAGEL: Just about the area-based programs, it is, I think, fair to say there is a divide within the administration and this is reflected in the policies. Some people say that we want policies that are really attached to individuals and that if migration is part of a response to events, declines in Michigan or housing shortage, whatever, that you don't want place-specific, you want individual-specific, whereas there are many people who want more place-specific. There has been a mixed bag. There has been the Gulf Zone, Opportunity Zone, during the campaign there was a big Opportunity Zone, so there has been some but I think there is somewhat of a divide.

MS. SAWHILL: I would say there's a divide in Democratic administrations as well in exactly the same, place versus people, which is the better strategy, and you shouldn't be theological about it, but it's an ongoing debate.

MR. HASKINS: One more question. Yes, right here.

MR. ZUDIF: I'm Nidid Zudif [ph] for the Threat Council [?] and my question has to do with the forecast about economic growth for the United States. I think that since we agree to make this budget strategy sustainable, economic growth will have to catch up, especially if President Bush will make his tax cuts permanent.

It seems to me that forecasts on economic growth sometimes rely on a gamble. I don't see exactly how he's so sure that economic growth will catch up to a necessary extent. The panelists correctly pointed out that foreign borrowing mainly finances consumption in the United States and not investment, and the savings rate does not catch up. The investment rate does not catch up either, and the manufacturing base in the United States has dramatically shrunk in the last years. The service sector is doing pretty well, this is true, but in the world markets, the service sectors are not integrated so I don't see where the great revenue could come from that sector.

MR. HASKINS: I think Belle knows the answer to that question.

MR. SAWHILL: Well, I don't think I have any monopoly on it. I don't think any of us really knows the answer because as you're pointing out, any economic growth forecast is going to be based on assumptions, guesses, informed guesses. You seem to be implying that it would be hard for us to continue to grow in the United States given some of the structural changes that have occurred. I don't think that's the case at all and I think there are always new areas that we can move into.

We have not talked about the administration's focus on a Competitiveness Initiative, improving education particularly in math and science, and having more emphasis on research and development. I think we do need that to continue to grow. I'm not sure that all of the government efforts in those areas are effective. There are lots of questions about the R&D tax credit, for example, which is the biggest part of that package.

But I think we are going to continue to grow, but not every year. We're going to have a business cycle that hasn't been eliminated, and economic growth is in no way going to solve this deficit problem, particularly if you look out over say a 10-year period or longer.

MR. HASKINS: Do you want to add anything?

MS. RIVLIN: I'm pretty optimistic about economic growth and I don't think it depends on manufacturing. Productivity growth has been faster and that is very encouraging. It hasn't reached low-income workers as well as it should, but basically this economy has a lot of encouraging signs.

MR. HASKINS: Lael?

MS. BRAINARD: The piece that you mentioned in manufacturing is very relevant. Traditionally, the way people pay off their external liabilities is through exports. Traditionally, a much greater share of trade is manufacturing and that's why people make that connection between our mounting foreign borrowing and the need for our manufacturing sector to really kick up and become more of a net exporter, although the services sector is increasingly integrated and we've seen consistent although somewhat smaller surpluses on that side.

But that also relates to this broader theme which is competitiveness. We asked earlier what kinds of forces could get a broader constituency in this country worried about our savings rate, our investment and our dependence on foreign capital, our fiscal profligacy. If you look back to the late 1980s, there was a raging competitiveness debate here and concerns about losing our place in the international economy relative to some of our competitors. So one question is, is the business community really going to get a little bit more seized with the urgency of this in the months and years ahead, maybe with health care driving it as we've seen now in the GM/Ford story. But the big question mark there is could we see a resurgence of the competitiveness debate maybe giving us a little bit more of a political impetus to the deficit-reduction story.

MR. HASKINS: Please join me in thanking the members of the panel.

[Applause.]

MR. HASKINS: Stay in your seats. We're just going to switch very quickly to the second panel and begin again.

[Break.]

MR. HASKINS: On the second panel we obviously have invited prominent business people with business backgrounds and also in every case, backgrounds in politics. Let me briefly introduce the panelists.

Pete Peterson is a former senior adviser to President Nixon. He has had a long career in business. He is now Senior Chairman and Co-Founder of the Blackstone Group, and he is also Chairman of the Council on Foreign Relations. We normally don't do this at Brookings, but Pete has offered me a little sum on the side if I would please notice and bring your attention to the fact that he, and I'm supposed to do this nonchalantly, is the author of Running on Empty, and Gray Dawn. I of course refused his offer. Next on Pete's left is Charles Kolb who is a former senior adviser to Bush the elder, and he is now head of the

Committee for Economic Development. And on my right is Thomas Healey, former Assistant Secretary at the Department of the Treasury, and for the last 20 years he's been at Goldman Sachs where he is now a Senior Director.

Our rules will be the same. Each panelist will have 7 minutes. There will be a timekeeper here in the front row. Then I will pose a couple of questions, and then we'll open it up to the audience. We'll start with Pete Peterson.

MR. PETERSON: There was a reason I asked you to refer to my books. I desperately need the sales, and all these meetings always require a little levity it seems to me. [Laughter.]

Anybody in business that's presumptuous enough to write books ought to be prepared for some serious roasting. In my case, my favorite roaster is Ted Sorensen who about Gray Dawn said, Gray Dawn is a book that once you put it down, you won't be able to pick it up. And about Running on Empty, he said, "Pete, when I read the title, I had assumed it was an autobiography." [Laughter.]

Generally, I'm struck by the broad agreement that our long-term situation is unsustainable. I've been speaking lately in terms of tri-deficits and why I think they're related. The budget deficit is number one. There is certainly a lot of agreement that the long-term fiscal outlook energized by the entitlements is clearly unsustainable. When you think of $40 or $70 trillion dollars of unfunded liabilities, depending on how you count them, and look at the net worth of the entire economy at $40-some-trillion, that's one definition. When you hear the Social Security Administration say that payroll taxes for my kids and so forth would have to double to take care of Social Security and Medicare, I would think we would all agree that's unthinkable morally, politically, economically, and certainly unsustainable.

The second of the deficits, of course, that we've had references to is the current account deficit. It seems to be racing towards 7 percent of the GDP, and virtually every estimate that I've seen suggests it's going to go higher. As one of our earlier speakers indicated, if you want to think about unsustainability, just think of projecting 7 to 8 percent of the GDP in terms of our foreign debt service and that ought to be enough to wake us up to the implications.

While there is growing agreement, I think, on the unsustainability of current account deficits, there is a lot of debate that I hear both on whether it's a hard landing or a soft landing, but in particular, the timing. This is being made extraordinarily difficult by utterly unprecedented flows of foreign capital from high savings emerging markets, now the petro dollars, and they now own about half of our treasury bills, the official institutions do. But some of these foreign governments are not motivated by the typical risk-reward, risk-adjusted returns. They're obviously motivated by a desire for export jobs. In Davos it was interesting to observe that the Chinese were putting out the word that you don't need to worry because we have to have 24 million jobs a year and we desperately need it and we'd be self-destructive to stop lending you money, but that ignores what this country looks like after 10 years or so of these debts.

The third deficit that I talk about is the savings deficit. The rhetoric is virtually unanimous that we have to increase our savings rate. The personal savings rate, as many of you know, has utterly plummeted from about 8 percent of disposable income a dozen year ago to a minus number.

But as impressed as I am with the unanimity on the scale of these problems and as impressed as I am that we speak at conferences like this on the general structure of the solutions, I'm not terribly impressed with the answers in terms of what they are and how practical we are. Social Security as we've discussed and I needn't belabor is a far, far simpler problem to solve in my view than Medicare which is about 5 or 6 times bigger fiscally, and I think 100 times bigger politically and economically.

Let's look at some of the issues here on health care which we haven't spent much time talking about. It's very hard it seems to me in the medical field because we're dealing with psychological issues to understand or even estimate what the cost savings are going to be from doing various activities unless you cap health care costs which almost no one is talking about. I wonder if this suggests that one of the things we might want to think about is launching at least a large-scale set of experiments in which we take some of the proposals and try to get a better understanding of not only what is the cost reduction that emerges but also what are the health outcomes.

Let me illustrate some of the really difficult problems it seems to me on health care. We spend much more on the last few months of life I think than any country in the world. Other countries, like Great Britain for example, when you have a de minimis quality of life stroke patient, the neurologist sends them to the general practitioner who sends them home and they die what used to be called the old man's death. To show you the difficult problem politically in this country, I was dumb enough to advise Dick Lamm who's running for Senator in Colorado that perhaps he ought to take the modest step of proposing living wills. He lost the election by a huge margin, and his opponent referred to him as Dr. Death. We now have unbelievable variations that wouldn't be tolerated for a moment in the business sector that emphasizes best practices. There are some regions that have 6 times the back operations that other regions do. There are areas that have 6 times the prostate removals that other areas do. Am I to assume that the backs or the prostates are different in this region? Or that this is the result of a unique, open-ended health care system with enormous decision-making power in the hands of doctors? How then do we get closer to some notion of best practices? And, indeed, in our political system, how do we implement such a program of more best practices?

There is the general issue of rationing, because I, for all of the talk about information technology and so forth, find it hard to believe given the magnitude of this problem that we're not going to have some people give up some medical benefit that has some effect. Yet, as we even think about rationing, I remind you of what happened in the State of Oregon, if you've forgotten that. The state was going broke with Medicaid and they decided to set up a communitarian approach of lawyers, doctors, CEOs, labor unions, et cetera. These fine people took over 7,000 diagnostic-related groups that describe what happens in hospitals and they actually ranked them, and they said below a certain number if we run out of money we're not going to do it. The Bush-run White House said, oh my God, these people are talking about rationing. My reaction is, hello?

Next, what about this issue of savings? We desperately need some practical ideas on savings incentives or approaches that would really work. A number of years ago I was asked by the White House and the Congress to explore the current savings tax incentives, and I had a couple of Brookings people there, conservatives, liberals, et cetera. They were unanimous in the view, as I recall, that the effect of tax incentives is both limited and ambiguous. Among the reasons for that is that the people who use the 401(k)s and so forth would have saved anyway, and you have the cost of the tax incentive that reduces the increase in savings. So we have to confront the real problem of how do we increase private savings in this country.

I've been a Republican all my life, but I've come to the reluctant conclusion that we are so borrowing- and consumption-obsessed in this country for reasons that are subject of another speech, that I think we're going to have to seriously consider a mandatory program very much like Singapore, Chile or Australia.

There is one other issue on which I think we need some ideas from think tanks like this organization.

MR. HASKINS: Pete, can you wrap up?

MR. PETERSON: I will. This is my last point. Imagine for the moment that we were successful. Imagine for the moment that we got our budget under control. Imagine for the moment that we increase savings. That would imply less consumption, it would imply fewer imports, and it would imply more exports. But we've now constructed a global economy that dysfunctionally depends on, as Fred Burkston put it, a new version of supply side where they supply the goods and they supply the money. It's clear to me there is no solution to this issue globally unless other economies stimulate their own economies in a very significant way and we get away from this dysfunctional system we have now.

I haven't heard much talk, frankly, about how do we do that, what is the negotiating approach, what are the levers, what the sticks, what are the carrots, and that's still another issue on which I think we need ideas from places like Brookings. Thank you.

MR. HASKINS: Thank you. Charles Kolb?

MR. KOLB: Ron, thank you. It's an honor to be here today and also on this panel with Pete Peterson who is CED's longest-serving trustee.

MR. PETERSON: Incidentally, I'm a big financial contributor so that you understand the validity of that comment.

MR. KOLB: He didn't ask me to say that, but the fact is that Pete is CED's longest-serving trustee. I'll make some comments about some of Pete's other remarks in what I have to say, but he's also been a national leader on these issues certainly with his work at the Concord Coalition and we've been pleased to partner with Concord, Brookings and Heritage and others to try and take what Bob Bixby calls our fiscal wake-up call around the country.

I want to take a slightly different approach. As I listened to the first panel, I found myself thinking, "where is Nancy Reagan when we really need her now?" Why do I say that? Because remember, Nancy Reagan's approach to drug policy and to drug addiction was, just say no, and we are an addicted society. I heard that word at least twice in the discussion. I remember John McCain said that the politicians were addicted to soft money, George W. Bush has said that the country is addicted to oil, and Lael Brainard said that the country or the capital markets are addicted to foreign capital. Belle referred to the need for a new political environment, and if we're learned anything about addicts and addiction, it's very simple, they do not, cannot, will not, cure themselves. There needs to be some sort of external jolt, restraint, to get the system to change. And I'm more interested in asking and hopefully trying to answer the question, how do you get the change to occur?

My comment on the budget, and Pete, I, too, have been a life-long Republican serving under Bush I and Reagan, and my first job was at OMB. But when I look at this budget, I would describe it as beside the point and irrelevant. What I mean by that is that the budget does not address the major programmatic, structural, investment-related issues that this country has to face. We touched on the deficit and the fiscal imbalance, the triple deficit that Pete refers to in terms of national savings, the budget, and the trade imbalance. It doesn't address the big issue that the first panel alluded to, and that is health care reform, particularly Medicare and Medicaid. It doesn't deal with the major demographic issues, parts of which include Social Security, health care and pensions. It doesn't deal with tax reform, the AMT, it doesn't focus on fixing Social Security. It does a little bit of tinkering with the declining public school system, some tinkering with competition and

R&D and innovation, and very little in terms of environmental sustainability, and that's why I say it's irrelevant.

At some point I do think the business community will wake up and realize that it will be affected adversely by our collective failure to address these issues. There will either by higher interest rates, there will be a declining or collapsing dollar, or there will be serious adverse impact on people and communities around the country. We're starting to see it in New Orleans, but just imagine if the health care system, either the public system and/or private system actually fail to address the needs of real people.

How do you get change? I want to commend Pete for an article that he wrote that he didn't get a royalty for I suspect.

MR. PETERSON: Certainly from the business community.

MR. KOLB: In July 2004, Pete wrote a very important article in the Outlook section of The Washington Post, the title of which was, Where Are the Business Patriots? Where Are the CEOs Speaking Out on This Issue? Pete did a reprise of that article I believe for Newsweek about a year later, and that was followed by similar articles by Tom Friedman in The New York Times, Matt Miller in The New York Times, asking Where Are the CEOs Speaking Out on Health Care, Jeff Garten, then the Dean of the Yale Management School had a similar piece, and then of course, Ian Davis, the worldwide chief of McKinsey had a very important three-page article in The Economist, again, urging business leaders to get involved. In a month or two you'll see a new book by Dan Yankelovich which basically spells out reasons why the business community can help itself by getting actively engaged around public policy issues.

At CED for 63 or 64 years now, that's in essence that we've been trying to do, and I will have to tell you candidly, in the current environment it is not an easy job. Part of that environment has to do with the nature of corporate America itself. People who run companies now face different time constraints, different pressures than they did 40 or 60 years ago when some of our founding trustees helped develop the Marshall Plan. But I am optimistic, nonetheless, because what we try to do is to get enough corporate leaders in this country to speak out on issues.

The other thing I would point out is the environment in this town, quite frankly, over the last 4 or 5 years has not been conducive to soliciting the active views of CEOs and corporate leaders except, of course, in the context of lobbying or getting a tax break or getting some other type of regulatory reform. The environment has been, if you question what's going on or you speak out against it, you're likely to be shut out, and that is part of the problem.

We've had some modest success at the Committee for Economic Development, and as Pete and Ron and others know, we were the leading business group to get involved in campaign finance reform and I think helped to do some good there. We helped end the addiction to soft money; we didn't deal with everything. But let me just make an advertisement for two things that we are going to do, and it's a bit risky, but I think they're important. The two issues that we're about to take on are health care and fixing Washington, or as we call it, Making Washington Work. It started out with a reference to dysfunctionality. The actual title is now Making Washington Work.

On health care, about 3 years ago we published a report really trying to find ways to shore up the employer-sponsored system. We've now reached the conclusion that that's not doable and we need to think about what happens if that system collapses, and we need to think and move beyond the employer-sponsored system. So we're launching a project over the next year really with the leadership of Alain Enthoven at Stanford and others to help think this through.

The second issue is the most important issue, and that is if you want to make progress on all of these other issues, we simply have to fix the political environment and the structure that we are in now. We are going to look at issues about the ongoing role of money in politics and, frankly, even with campaign finance reform, if you look at the way PAC money is deployed in town, it's basically buying access, it's buying influence. There is no other way to look at it. So we're going to look at issues like revolving door ethics in government, redistricting and other practices. But the goal here ultimately is to answer Pete's question. The goal here is to help establish politically, reestablish, a vital center which used to exist in this country and in this town, and also to try and force, forge, stimulate a return to classic American pragmatism, to bring people together to try and deal with these issues. I don't think this is naive, I admit it's optimistic, but I don't think we have any other choice. And our experience has been that if you can get a significant segment of the business community involved, the politicians will listen and the people will listen.

I go back and ask, why did campaign finance reform work? I remember 7 years ago people told me CED is crazy to get involved in this. It's not going to go anywhere. It's never going to change. Well, it did. Why did it change? Really, three points. One, there was national leadership. Whether you like him or not, John McCain made this issue central to why he wanted to be President. Second, there were a number of groups, organizations, that for 15 or more years had actually worked in the field on this issue so that they were ready when the third event occurred. The third event was Enron and the corporate scandals which made it very clear to people why the money in politics issue mattered for them.

Lael Brainard and others referred to the possibility of some sort of external shock. It may be something like that which is required to get the system moving, but we're going to try at CED. We have no choice. It's what we've been doing for 60 years, and we're going to make it happen again. Thank you.

MR. HASKINS: Thank you. Tom Healey?

MR. HEALEY: I'm going to move a little more micro, which has nothing to do with my agreement with all the very constructive things that have been said. I was going to focus on pensions, and if I in particular, if I can offer up two headlines, number one, the United States defined benefits system is going out of business and almost no one is noticing. Second, the PBGC which guarantees the pension promises of that system is bankrupt and, again, no one is really noticing. The implications of these, we talked about savings rates, this has been the principal savings device in the United States in the last 50 years, and it is changing radically in the next five.

Number one, the U.S. Defined Benefits System. It covers 34 million employees, it's $3-plus-trillion, it is the envy of the world, and it is going out of business. It's not just sick companies, it's not just steel and airlines and autos, it's also healthy. Within the last 30 days, IBM and Verizon have both frozen their pension plans for both new workers and for adding benefits to existing workers. Verizon is not a sick pension plan. It's actually 105 percent funded. Verizon is a healthy earning company. They actually earned 20 percent more last year than they did the year before. But they have stopped their defined benefit pension plan.

There are four causes for this, at least four, but four big ones. Two are demographic, the Baby Boomers approaching retirement, meaning that the cash drain on pension plans is going to accelerate. Second is retirees are living longer, and some of the demographics estimates the actuaries made actually have caused the funds to be underestimated what's needed.

The other two drivers are economic, 3 years of market losses after the bubble in 2000 dramatically hurt assets, and the net of that is that in aggregate, corporate pension funds are about $450 billion underfunded. But the fourth driver is interest rates which are at a 40-year low, and the way pension math works, you present value the liabilities and with low interest rates it magnifies the impact of that, but it shows that way on corporate balance sheets.

There are also two immediate pressures that are serving as catalysts for closing plans. One is proposed accounting changes which are actually going to improve the accuracy of pension accounting, but it also increases the volatility of earnings because changes in the pension assets are going to go very quickly through the income statement. CEOs don't want that, CFOs don't want that, stockholders don't want that, so that's a reason to change. And this is the segue into my next point, the proposed increases in the PBGC premiums and the pension funding requirements which are desperately needed are putting pressure on corporate balance sheets and, therefore, the corporations are throwing up their hands and saying we're going to switch to a DC system so that the liability isn't on the stockholders, it's on the workers. How significant is this? Do we care? Should we care? I've seen projections that there will be literally no major corporation that has a defined benefit plan that is live for new workers or increasing benefits within 5 years. As stunning as that result is, it's not implausible.

Headline number two, the PBGC, the Pension Benefit Guarantee Corporation, which guarantees these promises when companies go bankrupt, the PBGC is bankrupt. It's currently $23 billion underfunded. The good news is it's not out of cash, but it's underfunded. Policy makers are aware of this problem, but the solutions proposed are, I don't know what's smaller than a Band-Aid, but if you can come up with a word smaller than a Band-Aid, that's appropriate. There is pension legislation that's gone through both the House and the Senate. It is described as the biggest pension bill since ERISA. That's hard to imagine because it has so little impact even though it's been so controversial.

Let me give you a sense of the dimension of the problems. At the end of the fiscal year last year for the PBGC, it's $23 billion underfunded. The CBO projects that in 10 years, that $23 billion will be $86 billion, and in 20 years, $141 billion. To my mind, that feels like the same size of bailout, because eventually it will have to be bailed out by the taxpayer, as the S&L problems 15 years ago. We know it's there. It's very predictable. It may run out of money in 20 years or 21 years, and I can't tell you exactly which year, but actuarially it's going to happen, and if we don't fix it now, it's just going to get bigger as those numbers show. The proposed fixes are tiny, changing the premium from $19 to $30 an employee is the core of the current premium change that the House and the Senate have agreed on. The CBO estimates say that in order to get it into balance, not $30 an employee is needed, but $123 an employee.

The reality is that that's never going to happen. Why is it so hard to get a real solution? One, you have an unusual coalition. Both employers and employees don't want to increase the premium, employers because they don't want to make the payments, employees because they know that if you increase that premium too much, employers are going to stop their defined benefit plans and that's bad for workers. So you have this vicious cycle of everybody trying to stop reality and ignore reality. So it's easy for Congress to improve a Band-Aid that avoids the tough medicine and everybody goes home and says something has been done about it and it's going to be 20 years before they run out of money, because they have $55 billion in assets and we would calmly pass that problem all off to both another generation of taxpayers and another generation of Senators and Representatives.

I'd like to conclude, and this will tie back I think into the other comments, on something I call the dilemma of good policy implementation. Whether it's the PBGC where you know there's a problem but there's no will to fix it, or Social Security or Medicare, these are real problems, they are there, they are analyzable, but because they're not broke, Social Security doesn't go broke for another 30 years, Medicare for another 15 years, you can put it off without seeming to be any problem. But delay is just going to make it worse. That's inherent in financial problems and compound mathematics. And I think to go back to the earlier comments, how do you create a will of the Congress and the people and the business community to address these problems realistically is a great, great challenge in a city which is focused on avoiding short-term pain.

MR. HASKINS: Let's start the questioning by going back to the article in the Outlook section of The Post that Charlie mentioned a few minutes ago. The thesis of the article was very straightforward, it said business leaders are not stepping up. That was 18 months or so ago. Are they stepping up now? Is there evidence that the business community is more committed to doing something about the deficit?

MR. PETERSON: The brief answer is no, I don't think they are.

MR. HASKINS: So what should we do?

MR. PETERSON: Well, first we probably ought to understand a little bit, and Chuck knows more about this than I do, of what some of the reasons might be. Because it is true that in previous times, certainly in the post-War period, where this country had some major macro issues like the fact that the rest of the world was in ashes and we had this huge production facility in this country, and it was in our longer-term interests that the Marshall Plan be put into effect. When this set of about a half-dozen or so outstanding leaders got together, they saw that their own enlightened self-interest and the strength of the economy depended on a solution and when they started the public-supported Marshall Plan was I think 14 percent, and by the time they got done with the national campaign, it passed.

I'm interested that in the 1990s, Bob Rubin called me one day and said, Pete, you in times past have organized business groups. Do you think you could get a major business group organized around the idea of balancing the budget? Alice will remember this. I got three Democratic CEOs and two Republicans to join me and before long we had about 200 or 300 CEOs. I found myself in the Oval Office talking to President Clinton about this and he was very impressed with the support and so forth. So the question might be asked, what was different about then and now? That was only about 10 years ago that this happened.

Among the reasons I think is, Chuck is right, the global economy is getting far more demanding and CEOs are racing around the world and they don't have perhaps the time that others had. There is the whole executive compensation issue and the enormous incentives to focus on the short-term because most CEOs are only around about 5 years now and their options cash in and they want to focus on making it while they can.

But I think there's also another reason. There is a difference between the Clinton administration and the current administration, and that was Democratic and this is Republican. So the businessmen I think who are largely Republicans felt comfortable or more comfortable in implicitly criticizing than is true at the present time. What is it going to take to wake them up? I'm planning to sit down with the heads of some of the leading business organizations to be sure they understand what the risks are here of these totally unsustainable deficits that we're now facing. I'm particularly concerned about the current account situation.

Secondly, on the subject of an entitlement commission, I was on one of those commissions. Alice may remember. It was President Clinton's Commission on Entitlements that Bob Kerrey and Jack Danforth co-chaired. I don't think that's the kind of commission we need at this point because that one was kind of a bit under duress I would say, Alice, in which Bob Kerrey in order to support the Clinton plan, and his vote was needed, insisted on setting up an entitlement commission. I don't think that kind of commission set up under those purposes is going to work.

I've tried to think and have even mentioned to the President in the White House what kind of a commission might work in the current context. I think I've gotten some encouragement from the 9/11

Commission which had some totally devoted co-chairmen, highly credible, who were willing to invest enormous amounts of time not only in coming up with the recommendations, but awakening the country.

MR. HASKINS: Pete, here's a big problem with a commission. Can you imagine the Bush administration allowing a commission that would seriously put tax increases on the table?

MR. PETERSON: Just hear me out on this. I think the composition of that commission is extremely important. I may lose Alan Greenspan's friendship for suggesting this, but I think a commission chaired by Alan Greenspan to start with if you want something specific, and with people like Paul Volker, Sam Nunn and Bob Rubin, and people of unquestioned integrity and experience, that kind of group might perform a very important function which is to awaken the country on what the risks are here.

[End Tape 1 Side B. Begin Tape 2 Side A.]

MR. PETERSON: [In progress] —get the answers, but the questions aren't being raised at the present time. We have this critical issue of competitiveness that everybody is now talking about. Let's get serious for a moment. One of the reasons I want to see health care costs get under control is we desperately need the resources for education, for research and for development. But, hell, if we're going to be spending 20 percent of our GDP on health care, that that's much less resources. What's happened with the federal budget? Alice and Isabel would know more than I. But it wasn't too many years ago that 5 percent of the budget went into non-defense basic research and development that was a very important part of major innovation that came about. I think it's down to 2 percent or something at this point.

MR. HASKINS: Let me take a little bit different direction here about what a commission, maybe we're going to have one, but I just think it's very difficult to imagine a Bush administration blessing a commission that has the authority to put taxes on the table, but let's stay with this issue of taxes. I mentioned previously that Belle and I did this work where we talked to people who have been involved in deals in the past and there was unanimous agreement that you're never going to get a deal unless taxes are on the table. Well, taxes are not on the table, so here's the question. What would happen if a big delegation like the one you just described a minute ago of 50 major business leaders went to the President and said, taxes have to be part of the solution? Can you imagine something like that happening? Do people in the business community say this to the President? Or does on this panel disagree that we can do it all on the spending side?

MR. PETERSON: I don't know if I could imagine a big group of business executives doing it. Maybe there would be a few. I can't imagine a commission of the quality that I mentioned saying it, and saying it not just to the President, but to the public.

MR. HASKINS: Charlie?

MR. KOLB: I'm not so sure, frankly, that you need a big group. I've been actually partly surprised by the effect that we had in campaign finance reform with a relatively small number of business leaders who were willing to stand up and say they didn't like the system. We had 300-plus endorsers as Pete knows, but when you got right down to it, there were 10 or 12 people that I could call on who would either write the op-eds or go on the news shows and be outspoken.

The thing that interests me, though, is I think we need to make the effort to find those people, and they are out there, and business leaders in many instances need cover and one way to give them that cover is to show them that they're not alone. But I do think we need to raise some important questions about the structure, and until we've changed the structure, I think it's going to be very difficult.

MR. HASKINS: The structure of?

MR. KOLB: Of Washington. Ask yourself how did we get to a situation where a self-described conservative Republican President who wanted to emulate Ronald Reagan, signed into law a Transportation Bill with over 6,000 earmarks? President Reagan vetoed a bill with what, 150? What's happened in Washington is redistricting is part of it. We've gotten to a situation in which you've got extremes in both parties and that's reinforced by things like Grover Norquist and his tax pledge. All of this feeds into a system in which there are no incentives to move to the center, no incentives for reasonable people who are concerned about practical solutions that benefit the country, to actually get some traction. So I think a commission is a great idea, but until you start to look at the structural reasons as to why Washington exists the way it does, I don't think you're going to make much headway. Part of that structure continues to be the way in which corporate money intersects with the political process.

MR. HASKINS: Go ahead.

MR. PETERSON: Chuck, I would argue just on that last point, excuse me, that if you look at the 9/11 Commission, it isn't just a question of a few people calling on the President. What happened to that commission? You had Tom Kean and Lee Hamilton on every TV show, who spent many, many hours on all the television networks, newspaper interviews and so forth, and all of a sudden the country got aware of some issues and problems it had never been aware of before. So I'm not thinking of a commission as largely walking into the Oval Office. I'm thinking of a commission as educating the public on the nature of the problems and why they're important and what needs to be done. And I think there are a few Americans out there who in many cases are not businessmen who do have great credibility.

MR. HASKINS: Tom?

MR. HEALEY: I would agree with what Pete said wearing my optimistic hat. My concerned hat, and I think this feeds into maybe the 2-year focus of Washington, D.C., is it's hard for commissions to deal with longer-term problems. You look at the Social Security Commission, and to come up with three possible solutions to Social Security is such an embarrassment for public policy that it's worse than pushing forward a solution to Social Security.

Pete said it and he's absolutely right, Social Security is a solvable problem. I remember hearing him once say that the good thing about Social Security is may prove to us that we can eventually do something about Medicare. Well, we haven't been able to do anything on Social Security, so heaven help us on Medicare.

Here's my concern with the commission. I think the commission is a great idea. I'm stunned the White House came up with it because they do like control, and they can lose control of it. If you think of commissions that worked, my favorite is actually the Greenspan Commission on Social Security in 1982, and that worked because there was a crisis. Social Security was running out of money and it needed to be fixed, and that was the catalyst and that caused action to happen.

The problem with these big issues that we're all talking about is, is there enough catalyst that business people and smart people of goodwill can actually make policy happen? And I worry that I don't see that, I don't see the catalyst.

MR. KOLB: Just two comments. First of all, in 1982, the system was less polarized than it is today. Second, I would agree with Pete, I think it's worth the effort. But the one difference about the 9/11

Commission is that 9/11 was emblazoned on everybody's consciousness. They got it. It was there. It was a national trauma. And for some of these extremely important demographic-driven issues, it's very hard to make them tangible because it's like the frog and the pot and the water gradually gets to boiling and by the time the frog realizes it's cooked, it's too late. That's the difference. So I think it's worth the effort, but you got to find a way to make these sometimes intangible issues very tangible so that the people get it. That's where the corporate scandal helped, and I'm optimistic that out of the current problem that Washington is wrestling, the Abramoff and other scandals, that there will be some good that comes out of it.

MR. HASKINS: I like the frog comparison, the heat goes up a little bit at a time and pretty soon it's cooked before it knows it. Unfortunately, the exact opposite is the situation here. It is the case that Republicans do not want tax increases, the President does not want tax increases, the entire Republican Leadership in the Congress, and they are not going to allow anything to be formed that would create the kind of situation you're describing here where any two former Republicans or honorary Republicans or whatever can go on television and say we need tax increases. They're just not going to let it happen. Is that right or not?

MR. KOLB: Under the current environment I would agree, yes.

MR. PETERSON: You see, the question that you're all raising is one of the profound questions of a modern democracy, particularly this one, can they deal with a silent, slow-motion, long-term situation where there is not a palpable crisis at the present time? Because with all of the focus on the next election and the next presidential election, these problems that we have been discussing are past the next election. So the question is, unless you want to rely on a crisis, and unfortunately, Chuck, the kind of crisis we could be talking about if we don't do anything about these problems could be a very severe economic crisis, it's easy to sit here and have glib discussions about hard landings, but you'd better think through what you're talking about with a hard landing. You're talking about sudden drops in the dollar, big increases in interest rates. Look at the amount of leverage that's already in this economy with consumer borrowing at record levels of disposable income, with 40 percent of the people with no down payments, and interest-only notes and interest rates going up, you could be talking here about a major, major economic event. The problem is we need some people out there to talk to the American people and explain what these events are that they ought to be worried about. The other approach is to say let the crisis happen.

MR. HASKINS: Questions from the audience, and a prize to anyone who shows even a slight ray of optimism. I've dashed all the questions. No one has any optimism.

QUESTION: [Off mike.]

MR. PETERSON: I'm not terribly sanguine about this, but I think it makes an enormous difference who the chairs of these commissions are and how widely known they are. I don't want to deprecate whoever the chairman of that commission and also the other, but they're not people at the level that I'm talking about. Getting these people to do it would be another very tough selling job, but I think the 9/11, certainly it was influenced by the nature of the problem, Chuck. But you also had some very, very vigorous co-chairmen there who were devoting their lives to this thing publicly.

MR. HASKINS: Tom?

MR. HEALEY: Some of it is, does the commission have an impact in terms of persuading the Oval Office, and it's the Oval Office that makes a difference. I think one of the sad anecdotes, there's a piece in the paper today that the commission chairmen on the Tax Commission received nice notes from the Secretary of the Treasury thanking them for their service and never got a note or an acknowledgement from the President. If you can't persuade the President, you're not going to have any impact.

MR. HASKINS: Another question? Alice Rivlin.

MS. RIVLIN: I want to go back to Tom Healey and his pension crisis. You left it unclear in my mind at least as to whether you saw a future without defined benefit pensions as a grim one. The things you're describing are transition problems from defined benefit to defined contribution. If we can get through the transition, is that all bad?

MR. HEALEY: It's not all bad, but it's going to exacerbate the fact that we can't get Social Security solved, and if there are 34 million covered under defined benefit plans today, highly likely some big percentage of them will not manage to save their DB money, will spend it as there's a lots of patterns of over 50 percent of the people going from one company to another never reinvest their DC plan money, they go spend it instead of saving it. We have a huge savings gap as Pete mentioned earlier in his litany of problems. It's just going to exacerbate that DB plans are a pretty efficient from of savings for 34 million people that we're not going to have.

MR. KOLB: Alice, I think the problem is actually deeper than that because I think what we're seeing in part forced by the trends of globalization is a real either unraveling of or change in the social contract in this country that characterized the relationship between government, organized labor, workers and business. Part of that social contract included if you work hard and play by the rules, you'll have lifetime employment, you'll get a pension with a specific payout, you'll get health care and you'll keep your job. A lot of those assumptions have now changed and there's a dynamic at work that we haven't sorted out, so I think it goes beyond defined benefit shifts to defined contribution. The whole concept of the social contract I think is in play and there's been no real national leadership to help us through it, and I think that's one of the big problems here. We're fighting a war, we're all supposed to be making sacrifices. When was the last time that you made a sacrifice? I can't think of when I did. It's a very different context. The rhetoric says one thing, but the reality is very different. And I think the issue about leadership is also true with regard to some of these demographic issues that we've been talking about today.

MR. HASKINS: The gentleman next to Alice?

MR. FRIEDMAN: Justin Friedman [ph], a recent college graduate. Mr. Kolb, I thought you might have some thoughts on this. Do you think that the lobbying reform movement in Congress is ambitious enough to fix the appropriations process and is this going to have a measurable impact on our fiscal situation?

MR. KOLB: The lobbying reform process by itself I don't think will do it. I think you need to look at other issues such as redistricting, revolving doors, a whole host of things. I'm encouraged that they're starting to do it, but then every time I see a step in one direction, you see the leadership kind of back-peddling on another.

Republicans have an opportunity here to go back to the principles that got them into the majority in 1994, and I'm referring to the Contract with America. I think a lot of them still don't realize how serious a mess they are in, so I remain optimistic, but it was the other Reagan, Ronald Reagan, who said trust, but verify.

MR. HASKINS: One more question here in the back.

QUESTION: I would just ask about one commission that a lot of people said did seem to work, and that was the BRAC process. What about the idea of an entitlement commission that came up with one plan and was able to present it to Congress with a yes or no, do you save Social Security or not kind of idea?

MR. HASKINS: He stumped the panel. I know the answer. It will never happen. He's comparing it to the—I didn't hear the whole thing, but the military base closing commission which makes a recommendation to the Congress and the Congress votes yea or nay, and if we had a commission like that that would recommend a solution to the deficit.

MR. KOLB: I agree with you, Ron, I don't think it will happen. I remember in the first Bush White House, working on the State of the Union one year, I came up with the idea of what would happen if we repealed the concept of entitlement in this country. No one that I know of has an entitlement. You don't have an endless limit to your credit card spending, or at least I don't, you don't have an endless limit to your checking account, but yet we've built most of the budget around the concept of entitlement, and it's not a sustainable concept. I remember talking with John Cogan who was at that point back at the Hoover Institution and he said, Charlie, you're kind of barking up the wrong tree. You're never going to change entitlements until you change the relationship in Washington between the committee structure on the Hill, the parallel relationship in the agencies and departments, and the lobbying role of business. So we need to address it.

MR. HASKINS: That gentleman right there did it on a limited basis in 1996, we ended at least one entitlement. Pete?

MR. PETERSON: I didn't want to leave this meeting because I flew up from New York for this, so I'm grabbing the microphone on a subject that I wish Brookings would get into, and the Institute for International Economics. It has to do with America's competitiveness in a very different world. When I was—the University of Chicago, I learned all about this wonderful model of the open world economy. You had developing nations and you had developed nations, and the developing nations were ill-educated and they could make the shoes and textiles, and the developed nations like ours could endlessly move up the productivity scale and come up with endless new value-added. It was a wonderful positive-sum game because the incomes of the developed countries went up wonderfully because they were getting higher-paid jobs and they were buying low-cost imports. The developing countries in turn had the jobs that came from labor intensive.

But look where we are today. China is producing 8 or 9 times more engineers than we are, and I'm sure you can have a debate about the quality. We have a situation today that the same is in India. Mass scores and science scores abroad are generally speaking better than ours. You have an entirely new communication apparatus operating at the present time. When I was a CEO in Chicago, making products overseas was a very difficult task. Transportation was slow and costly, you didn't have faxes, you didn't have video conferences, you didn't have Email, you didn't have people at the other end that spoke English and so forth, and it was a very complicated process. Today we have a situation where Jeff Immelt at GE, the CEO, tells me they can make their most sophisticated medical devices in China at a fraction of the cost that they can here.

So the question I would put to Brookings and the Institute for International Economics is we're going to have to develop the revenues somehow to pay off this debt we've got. As one of the earlier speakers indicated, that problem requires some manufacturing. How do we construct the system where there is an incentive to product things in America that is not protectionist? I don't know what the answer to that question is, but I think it's an important question, because I am not satisfied with these glib assertions that I hear that we're going to become a service economy and somehow that's going to solve all our problems. It's not clear to me what these services are we're precisely talking about. It's not clear to me where we get the manufacturing for exports.

So I really think there's an area here where some first-class brains need to do some very tough work because at the present time it is so easy to transmit innovation and knowledge abroad that I couldn't even imagine it was possible 20 years ago.

MR. HASKINS: I will now summarize the morning's proceedings. Point one, savor small victories. Point two, but we need victories. Thank you for coming. And join me in thanking the panelists.

[Applause.]

[END OF RECORDED SEGMENT.]