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P R O C E E D I N G S

MS. SAWHILL: Good morning everybody. Welcome to this event on The Budget, the Deficit, and the Future. I'm Isabel Sawhill; I'm Senior Fellow here at Brookings and I've been engaged in these budget battles for more years than I care to remember. I'm looking at Alice Rivlin right now who served as Director of OMB during the Clinton Administration and I had the pleasure of working for her and with her at that time.

I think that many of us who are going to be on this panel today are what one of our colleagues rather uncharitably calls fiscal scolds and what some people would a little more charitably call fiscal hawks. But in my humble view, a few more fiscal hawks, especially in high places, would be very helpful right now because the fact is that deficits and debt are an urgent problem and there's no one in a better position to explain why than my colleague Bill Gale, who you're going to hear from in just a few minutes.

And some of us who are members of what we call the fiscal seminar had the privilege of hearing Bill make a similar presentation about a month or two ago, and we were so impressed by his analysis that we wanted to make sure that it got a wider reception; ergo, today's meeting. And in addition to today's event, we are pleased to let you know that today's *New York Times* has a complete article that is very much about his work and his colleague Alan Auerbach and they also have an op-ed in today's *Los Angeles Times* for those of you who are interested.

Bill is the Vice President and Director of Economic Studies at Brookings. And he has always combined rigorous academic skills with a particularly skillful way of presenting his results to policy makers.

His presentation will be followed by comments from Alice Rivlin and Bill Hoagland. Both of them have very distinguished backgrounds. Alice is not only a former Director of OMB as I mentioned, but also is the Founder of the Congressional Budget Office and as a former Vice Chair of the Federal Reserve.

Bill Hoagland served as a top aid to the Senate Majority Leader Bill Frist and Staff Director of the Senate Budget Committee and he is now back in the private sector working hard on healthcare reform. And he says that's even more difficult than working on the deficit. And of course they are connected. He also suggested to me as we were chatting before the opening of this event that perhaps given the crowd that's here today we should charge admission and devote the proceeds to reducing the deficit. All of the bios are in your packets so I won't say more. And without further a due, turn this over to Bill Gale.

MR. GALE: All right. Thank you very much Isabel. One of the things I've learned as three years in heading Economic Studies is that you always get better introductions if someone who directly reports to you does the introduction for you. So thank you; I appreciate all of that.

The work this morning is co-authored with Alan Auerbach. For about ten years we've been doing what we think of as shadow budgets. Every time CBO puts out a long term estimate we put out a revised adjusted estimate and this work continues in that vein. A lot of other people around town, including everyone on this panel, are working on these issues.

So some of the numbers may not look so new to you as they might, but I hope that the analysis and the interpretation adds value. In terms of the general theme, if this were a Sesame Street episode it would be brought to you by the words "down," "big," and "bad." But I will try to interject at least one piece of good news into the talk.

All right; so let's start. Let's go all the way back to the year 2000. The budget was actually in good shape at that point. The current-year budget was in surplus; it was a record surplus, it was the third year in a row it was in the surplus. CBO had this famous projection of a 5.6 trillion dollar rising surplus over the next ten years.

And even over a seven year horizon, Alan and I estimated the fiscal gap, which I'll talk about later, was basically zero, even with Social Security and Medicare in short for all of the long term gap was -- the long term budget for seven years, at least was basically in balance.

In fact, you're not going to believe this if you are under 25, but the big concern in the year 2000 was that the U.S. was going to run out of public debt; that the CBO forecast that by the middle of the decade there will be no public -- no redeemable public debt left, that we will have paid off all of the public debt. And that was going to cause several concerns.

One, how would the Fed. conduct monetary policy. Two, what would investors do to buy safe assets if there were no treasury bonds available. And the possibility of running out of debt was one of the major factors that motivated Alan Greenspan in his testimony to Congress to encourage the 2001 tax cuts. I guess that would reduce revenues, that would force the government to issue more debt, and that would make sure the debt market was functioning.

All right. I'm not making this up; this is true. All right. So let's fast forward to now. Of course we have huge deficits right now, this year. That's fun to talk about but it's actually not the biggest concern. The bigger concern to the -- the medium-term deficit path, the ten year deficit path, is now clearly unsustainable. That's a policy that was inherited from the early administration, but is being continued under the Obama Administration. So it's a rare example of bipartisanship in Washington.

And the long term situation has become increasingly urgent. And as I was talking to people about this a couple of days ago; the question I got was how can a long term situation be urgent? And the answer is, you know, let me count the ways.

First, the Chinese Prime Minister has publicly questioned the security, the safety and security of Treasury debt. Right; that's an astonishing thing that never would have happened in 2007. It never would have happened in the past. Credit markets have shown an evidence of -- that people think there's a non-zero likelihood that the U.S. would actually default on it's debt in the next five years. That's never happened since probably the Civil War.

The Medicare Trust Fund is now projected to go bankrupt in 2017, which is basically the end of the next administration. That's -- eight years is not much time to deal with an issue like that. On top of that it's not just the Federal government.

State governments are in a horrible situation, California in particular. And European countries are also doing fairly badly -- a couple of months ago warned the United Kingdom that they might get downgraded on their debt status. That would be a remarkable event, but the U.K. debt-to-GDP ratio isn't appreciatively worse than the United States is; and then the United States debt-to-GDP ratio. So this is sort of a -- to the U.S.'s also.

So I mentioned that I'm going to give you some good news. I'm going to give you some good news now which is that we don't have to worry about paying off Treasury debt. We've solved that problem, all right; mission accomplished.

So what I want to talk about and there's basically three things. One is the current situation; where we are, how we got here. The second is what's going to happen next; either the ten year outlook or the long term outlook. And the third is what does it all mean, how do we synthesize all of this stuff.

So the 2009 budget deficit will sort of -- it'll be written up in every macroeconomic textbook. It'll go down in history. I'm not going to quote you all of the numbers. Basically everything that should be low is at a 50 year high; everything that should be high is at a 50 year low.

And it actually could be a lot worse because right now; interest rates are extremely low, which is shaving a couple of percentage points of GDP off of the deficit, and the massive federal -- massive intervention that the Federal Reserve has taken do not show up in the Federal Budget.

Now, the Federal Reserve argues that there is zero risk associated with that, but I would say that extending 1.2 trillion dollars in new lending facilities in the worst downturn in 70 years might well have some risk attached to it. But there's no numbers in the budget to reflect that.

So we're in a bad situation. How did we get here? Well, as I looked at the numbers I was reminded of a text I read as an undergraduate, the Ernest Hemingway's *The Sun Also Rises*, where one character says, "How did you go bankrupt?" -- that character is Bill, maybe that's why I remembered it -- "Two ways," Mike said, "gradually and then suddenly." And that's basically what's happened to us. From 2001 to

2008, policy changes dug about a seven percent of GDP hole in the budget deficit.

From 2008 to 2009, you know, the economy collapsed and the economic -- the economy and the response to the downturn is the suddenly part. I won't go through the details but if you think about policy gradually for seven years or eight years and then economy suddenly for one year, that's basically the answer.

All right; so let's look forward. I've got Hemingway and now I have Louis XIV -- a little bit. We want to look at the ten year outlook. There's three ways to do this. One is a CBO baseline. A second is what would've happened under Bush's policies and the third is what's going to happen under Obama's policies.

The CBO baseline is the starting point for all budget analysis. It is a mechanical projection of current law though, and therefore it's not the most realistic outcome. When I say that I want to emphasize this is not a criticism of CBO. I think CBO is probably the single best government agency in town. The reason CBO does this mechanical unrealistic thing is that that's what Congress tells them to do. So by law CBO has to do it in this manner.

But it assumes that all tax provisions that are temporary actually do expire. It assumes that discretionary spending stays constant in real terms. Both of those assumptions are not very realistic on either political or historical grounds.

So to create the Bush policy baseline we start with the CBO baseline, we extend all of the tax rules that are expected to expire, particularly the 2001 to 2003 tax cuts that expire at the end of 2010. We allow discretionary spending to grow with the inflation, as well as the population. That's a relatively conservative counter assumption. And we include the Stimulus Package. We do this so we can compare apples to apples later on but I'm fully aware that the Stimulus Package was not enacted by the Bush Administration. But that doesn't affect the results much. All of the interesting action is from 2012 on and the Stimulus Package expires in 2011.

All right; then the third policy, the third budget -- is Obama policy, that's just as proposed by the Administration and is estimated by the CBO. The basic picture for the next ten years looks like this. All right; the CBO baseline has deficits declining dramatically to 2% of GDP and then staying there. That's a nice outcome if we could get it but it's based on a series of unrealistic assumptions.

If you put in the assumptions for the Bush policy that I mentioned, you get deficits declining to about 5% of GDP by 2012 then rising to 6.4 at the end of the decade. Obama does worse than the CBO baseline but better than the Bush policy. Still, the deficit only -- it falls sharply but only to 4% of GDP by 2012 and then it rises to 5½% of GDP by the end of the decade.

Under both the Bush policy and the Obama policy deficits in the 11 years from 2009 to 2019, and yes that's 11, not ten, deficits in those 11 years would average over a trillion dollars and then after that they -- I'm sorry, they would average a trillion dollars and then after that they would average more than a trillion dollars a year. So we're talking major deficits under either scenario. And let's just focus on the Obama situation for -- the situation under Obama policy at the end of the decade to give you a sense of the issue.

If everything goes the way the Administration says it should, all of the political things get done, the economic recovers, we'll have a deficit of 5½% of output by the end of the decade. That doesn't sound so bad relative to some historical numbers, but that is a full employment number; that's after four years of the economy running along fully employed. So that would be the highest such deficit since the second World War. And that's the single number to keep in your head that demonstrates that we are on a path that's not sustainable.

There's some other numbers that show it. The public debt would be 82% of GDP and going up. The last time it was that high was

1948 when it was coming down sharply after the second World War. Spending would be over 24% of GDP. Again, the highest level since the second World War. And maybe my favorite statistic, net interest would be 3.8% of GDP, the highest level ever and bigger than defense spending in that year, bigger than non defense discretionary spending in that year.

So even in 2019, before Medicare, Social Security, Medicaid to really kick in, we'd be spending 4% of GDP a year just on net interest. Revenues, however, are below 19%. That's just basically the recent historical average. So that's a dire situation and that's if everything goes right; all right. Everything's not going to go right.

You can divide into economic assumptions and political assumptions. The economic assumptions, of course, the key issue is how does the economy do. A strong economy does wonders for the budget; a weak economy, of course, is horrible for the budget.

Right now the economy is doing less well than forecast and all of the people talking about how it's going to be -- we're going to bump along the bottom in the recovery for a while, all of those implications are that the budget situation is going to be worse than the official forecast right now.

The other thing to think about is we're in a global recession. It was induced by a collapse to the financial sector. The historical records suggest that those kinds of recessions take a long time to dig out of. This is not your father's recession. This is not the Fed. taking away the punch bowl, you know, interest rates go up. This is exactly the opposite. The Fed. practically threw the punch bowl at people and interest rates went way down and still the economy fell to the floor. Right; so this is -- it's likely that it's going to be a slow recovery and that's going to hurt the budget forecast.

The other thing to think about are the political assumptions that are baked into the forecast and these are truly heroic. It's hard to be in Washington for a long time and not get cynical about the way Congress operates. I'm hoping that Alice and Bill Hoagland, who are two of the most veteran Congress watchers, can convince me otherwise.

But when I look at the political assumptions that are built into the budget, I think they're -- it's going to be impossible to maintain. So first the stimulus package has to expire as scheduled; right. That may seem obvious to course; it goes for two years and then stops. But I'd be willing to make a side bet if anybody wants to.

Second, even with the high spending that was talked about in 2019, non-defense discretionary spending has to fall to its lowest share of the economy in 50 years; all right. That requires a lot of discipline; all right. And I'm doubtful about that. Third, we have to do these cuts in healthcare that Obama wants. Fourth, we've already messed this one up, a new cap and trade system is enacted with all of the permits auctioned, sold off. We've already given away about 80% of them I think.

And lastly, PayGo was installed and honored for a decade, which would be a remarkable achievement. Even if it were a remarkable achievement, I'd have to say a few more words about PayGo. PayGo strikes me as one of those "mission accomplished" things where everyone gets in a big lather and -- about how successful they are but it actually doesn't really solve any big concern. I think a PayGo is sort of someone standing on the deck of the Titanic saying you may not knock anymore holes into this ship. And standing there yelling that as the whole ship sinks; all right.

All of the projections in our paper assume that PayGo holds. The PayGo does nothing to stop long term budget catastrophe; all right. It does not apply to the built in growth of entitlements so all of the Medicare, Medicaid, and Social Security growth is, you know, completely under the radar screen as far as PayGo is concerned. Any wasteful initiative that got enacted in the past can continue unevaded, but any great idea, new idea, is subject to a very strict funding constraint. So it really doesn't get at the real issue. And amazingly, as proposed by the Obama Administration, it's even worse because what the Obama Administration would do -- would let three trillion dollars out the door on top of the 800 billion they just spent on the Stimulus Package, and then they would impose PayGo.

Well you have to kind of wonder at that point, you know, why bother. And so the way that I think about this is from 2001 to 2006 we had a Republican Congress, we had surpluses either in current years or likely in the future on the -- according to baseline and even then they wouldn't extend the Bush tax cuts and make it permanent.

So it's kind of odd that the Administration is choosing to let that three trillion dollars go out the door and yet when it comes to healthcare, they want to pay for every dime. That doesn't seem like a wise set of choices. But let me turn to the long term outlook real quick and then I will talk about the -- what it all means.

Alan defines something about 15 years ago called the fiscal gap, which is -- you can think of this as two ways. One is what immediate and permanent tax cut or spending -- tax increase, I'm sorry, or spending cut would we need right now to bring the long term fiscal situation balance.

Another way to think about it is what's the value, the discounted value or the difference, between expenditures, between non interest expenditures, and tax revenues forecast for the future. And we estimate this three different ways. We take the three scenarios for the first ten years and then we just build on Social Security, Medicare, Medicaid projections on top of that.

We assume a cost and share of GDP for other revenues and other spending and this is what this looks like. The lines down here are all revenue numbers. The red lines that are growing are all expenditure numbers. Basically Obama raises less taxes than CBO; Bush raises even less than Obama. Bush spends more than CBO; Obama spends even more than Bush does.

And you can see basically what's happening is Medicare and Medicaid spending, and to some extent Social Security, is just growing faster than the economy. And I guess the number to focus on here is the, you know, the last line. The Obama policy, the next 75 years, there's a 7%of GDP gap. On the permanent basis there's a 9%, 8.7% of GDP gap. If you like your numbers in trillions of dollars and you really want to freak yourself out, you can say 125 trillion dollars is the long term gap under the Obama policy. At some point it's just hard to figure out how to think about numbers like that.

So how do we close the gap? Well people usually say there's only two ways that you can do it. You can raise taxes or you can cut spending. There's actually two other ways; you can default on the debt, which is a form of a tax, or you can inflate. So people are talking about inflation concerns; that's what they have in mind as this fourth option.

We're going to focus on the first two options. If there's a 8.7% of GDP gap, you'd need about a 15 to 20% value added tax to eliminate that gap. You can see that in 2009 income tax revenues and corporate tax revenues combined are only 8.4% of GDP. That's -- we would have to double that immediately and permanently to close that 8.7% fiscal gap. So the main -- here; this is an enormous gap. We're not even close to talking about ways to close it.

Now, if healthcare is the cause of the rise in spending you might think that just cutting healthcare spending would solve the issue. Well, it turns out in order to get healthcare spending to solve the issue, you would need to have Medicare and Medicare spending start growing less fast than the economy immediately and permanently, whereas, it's been going faster than the economy for the last 50 years.

If you took seriously the health insurance agreement that Obama announced -- I mean the health agreement he announced a couple of weeks ago with many of the major actors in the health industry, that they were going to cut the spending growth rate of healthcare by 1.5 percentage points for 10 years, that would reduce the gap from 8.7 to 7.1% of GDP. So we still have a 7% of GDP gap.

And if you take seriously this notion that 30% of spending on medicine is wasteful and that you can wrench it all out of the system gradually over time so that you grow more slowly for 30 years, you'd still have a 5% of GDP gap. So even under heroic assumptions about health spending growth, you still have a 5% of GDP gap that you have to deal with.

So let's talk about what all of this means and this is -- I will now switch into the moralizing parent mode for one second. This is what mortgaging the future looks like. When people have talked about that for the last decade, this is what they mean.

We had a remarkable 25 year run in terms of the economy. We had this wonderful demographic holiday where the baby boomers where moving through their main earning years. Everything was looking right and we didn't do anything about this. And now, the economy's in tatters, the boomers are ready to retire, the world is sick of our debt, the problems are much bigger, and we have no choice; we have to do something now. And it's -- the reason we have such a big issue now is precisely because we've ignored these issues for 30 years.

Okay; back to analyst mode. Policy makers will face difficult choices. It's hard to impose physical discipline under normal circumstances. It's going to be even trickier now for several reasons.

One is if you impose discipline too soon, you risk the economy tanking again. That's what Christina Romer wrote about in the 1930's; that's what happened in the 1930's. If you hold off too long, markets may react very badly as investor fears grow. And the interestingly Greg Mancue, Bob Rubin, and Peter Orszag have all written about this at various times; Rubin and Orszag during Republican Administrations and Mancue during Democratic Administrations.

But it's still the case that there's this concern about the market tanking on the basis of investor fears. There's a couple of other reasons why fiscal discipline is going to be particularly hard right now. One is the states are going to come back in a year or two and ask for a lot more money.

They are in dire fiscal situation; it's going to be very difficult for the Feds to say no. Second, nobody wants to do tax increases. But at the same time, you can't really cut spending much in the short run. 75% of spending is on five things; Medicare, Medicaid, and Social Security, which when we talk about cuts we're talking about longer term cuts; net interest where when we're talking about cuts we're talking about defaulting. All right; and defense spending.

So either you have massive cuts in the rest of budget or you just can't cut spending very much over a five year horizon. Then there's one other issue here which I think is going to be important but hasn't really gotten a lot of talk, which is financial markets tend to recover first. They are leading indicators of the economy. The stock market predicts booms, recessions, et cetera. Labor markets take a long time to recover.

So imagine we're in a situation a year from now where Wall Street's doing fine, they're pulling in big money, the market's going up, but unemployment is still 9%, wage growth is still --, hours are still falling. That's going to create a very ugly, politically, populist situation where it's going to be very difficult to enact constructive long term policy.

So what does this mean? Well it means the future is now. We're basically running out of time. The problems could happen gradually in terms of the short term -- the gradual eating away of capital. They could happen suddenly if markets collapse or get scared. And what we really need is political leadership.

It's astonishing to me that the 2008 campaign was about who had the bigger tax cut rather than who was going to address this issue. And I understand why but you understand why it's hard to deal with this when the two candidates campaigned on who had the bigger tax cut.

So what would a measured solution look like? Alice is going to talk about solutions more. I just want to indicate that I have actually done more than just complain about the problem. We need to thread the needle between Romer's concerns about undoing the recovery and the other people's concerns about spooking markets.

So we don't want to cut of -- demand now. But if we could raise revenues gradually, via cap and trade system or value added tax, we can start cutting future spending now, as well, then we have the makings of a solution. I'll leave the details of that to Alice.

I just want to close on one point. I think, maybe the panelists will prove me wrong, I think there's pretty much no disagreement on the fact that we have a bad fiscal situation. You would think that would be a good news but Alan Blinder, who's one of the most serious students of economics and public policy, has something that he calls Blinder's Law, which is that economists have the least influence on policies when they are most in agreement.

And so by agreeing with each other, we may be dooming ourselves to a footnote, but given how often people complain about economists say on the one hand, on the other hand, this is a situation where no economist is saying on the other hand. And the sooner we can do something about it the sooner economists can all start arguing with each other again; thank you.

MS. RIVLIN: Thank you, Bill. I think this is a fabulously useful and illuminating paper. It's very careful, it's very meticulous, it's very balanced, it dissects the elements of the budget outlook to show us how we got here and how deadly serious that outlook is.

Nevertheless, folks, there's no new news here. Unless you've been hiding in a hole since the beginning of this decade, you already knew that the long run budget outlook for the United States was unsustainable. You knew this before the recession and the financial crisis that has sent the numbers into the stratosphere.

You knew that over the next several decades federal spending was going to grow faster than revenues largely because of Medicare, and Medicaid, and to a much lesser extent because of Social Security. You knew, if you were paying attention, that we would have to face that problem before our creditors stopped lending us money. And you also knew that there were only two things to do; raise taxes or reduce the rate of growth of spending and that realistically you were going to have to do both of those things.

That has been the set of facts for some time. If you were paying attention back in those wonderful years of 2000 when the near term surpluses looked so rosy that politicians were embolden to do dumb things like cutting tax rates for everyone, especially people who needed it least, and adding expensive benefits to Medicare, you knew that was a dumb thing to do and that Alan Greenspan not withstanding, there never was any real danger that we would pay off the debt.

So what this paper tells you is that the long term problem has gotten worse, that the debt is going up faster than the deficit, which makes the debt servicing problem a lot more critical as an element in this situation. That the actions that we should have known we were going to have to take are going to have to be bigger and sooner than you already knew.

Now, I submit that maybe that's good news. We can't ignore the looming problem anymore. It's going to get us into serious trouble. That elephant in the room that we were all not talking about is beginning to kick us in the shins. Rating agencies are grumbling. Chinese officials are rattling our cage; that's terrific. We needed that.

So what can we do? Well, I think the basic message is we can take action now, not that it would be easy, but we can take action now in the next year or two that will take effect after the economy is growing at a healthy pace, say 2012 and after that and that phases end gradually. Such as, I would offer five things we can do. I don't think it's a choice. I think we have to do them all.

One is fix Social Security. That involves several small fixes. Everybody who's looked at this problem knows what they are. But it must include changing the indexing so that future benefits rise less rapidly, particularly at the top of the income scale. Now, wasn't that a George Bush idea? Yeah, actually it was but divorced from private accounts, it is one that Democrats should embrace.

Second, we need to reform our income tax system to make it fairer and more progressive without raising marginal rates. We gradually need to turn major deductions into credits. Obama has put a toe in the water in the direction of having -- of phasing out credits -- fading out -- phasing out deductions at the top, but it's just a toe in the water. Especially the home mortgage deduction needs to be less generous and it should be a credit so it goes to everybody and we aren't differentially subsidizing mansions in the suburbs, which we have too many of anyway.

We gradually need to make health insurance provided by employers taxable to the employees. We need to get rid of some corporate loopholes into the bargain. But I wouldn't spend a lot of political capital there. Third, I agree with Bill that we ought to enact a VAT. We are the only major country that doesn't have a broad based consumer tax. If there's any lesson from this recent catastrophe it is that you get into trouble when you consume too much and borrow too much. And so we should revamp our tax system so that it discourages consumption a bit.

If we want to get it enacted we may have to dedicate it to something really important like healthcare. Economists never particularly like dedicated taxes but I think it would be worth doing that to get the value added tax on the books.

Fourth, as Bill also said, we need to revamp our system so that the prices of carbon based fuels rise gradually and predictably. Cap and trade can be used to do that but it's got to be serious. We've got to auction those permits so we get some revenue and we've got to make them gradual and make the cap gradually tighter so that it actually encourages -- to use less fossil fuels.

I would not raise the gas tax. I used to be for that, I'm not anymore. I would get rid of the gas tax, actually, and substitute a road use tax, a much better way to finance transportation so that people are charged per mile of the roads they use and with an add on for using congested roads at congested times. That would raise a considerable amount of revenue, which we could then use to compensate the losers and there would be losers and to improve public transportation.

And fifth, with respect to healthcare reform, I would do everything possible, everything we can think of to bend the curve, as they say, to reduce the rate of growth of healthcare spending. That's not going to be easy. We should start with Medicare. We should move aggressively on Medicare.

I like the President's proposal that Medpac, the group that has for years been putting out sensible suggestions about how to reduce the costs of Medicare; should have fast track authority. It's -- get enacted unless the Congress over takes them.

We need serious competition among plans on exchanges as proposed by the Obama Administration. I don't think it has to include a public plan but it has to include very serious competition. And we need a lot of cost effectiveness research fed into the system to begin bending the curve.

So I'd do all of those things. Won't this program harm recovery? I don't think so. I think it would help. It would give us more sustainable growth for the future and it would reassure that Chinese -- that we're actually going to be able to pay our debt.

Is this all impossible? Well, I don't think so. If you look at the charts in Bill -- in Alan's paper, they nicely take them back to before World War II. Well, you'll notice in World War II, because we were fighting a war, we could do anything we wanted. We could do quite drastic things in terms of raising revenues and devoting our national product to winning a war.

Now, this gap is 7 to 9% of the GDP. If somebody told you you're on an unsustainable track, you've got to cut your income -- you've got to raise your income or cut your spending by 7 to 9%, I think you'd probably do it. We can do this.

MR. HOAGLAND: Good morning, everyone. First of all, it's a real pleasure to be asked to comment on the Auerbach Gale Paper, along with my -- okay. It's a pleasure to be here to comment on the paper, along with my first real boss in this town. For those of you who may not know, I was fortunate to have been one of the original hires at the Congressional Budget Office in 1976 under Director Alice Rivlin.

Second, up front, let me admit to being an unrepentant budget scold, as defined by Steven Pearlstein. So it's difficult to find fault with a paper -- with a paper just on principle alone. Third, the paper I reviewed for this seminar was dated February 19th. And I realize it's been updated here today but I think it speaks well for the authors' analytical capabilities that the recently released biannual analytic CBO long term budget outlook roughly collaborates what you've found in terms of your -- this gap estimate back in the winter.

And also somewhat amazing to me was in the aggregate, what the Gale study produced unknowingly, probably, last February, was -- adjusted baseline that turned out to be essentially President Obama's budget. So how can I critique this paper? There's only four issues I want to comment on briefly here.

First, how we got here; second, the authors suggested back in February, again, today we're hearing it could be worse and playing the role of the budget scold, I think it is worse, confirmed in part by their statement, their updates today. Third, a brief comparison to the Congressional Budget Resolution, specifically on debt to GDP and finally a comment on solve and credit default swaps. Interesting, but I think it's not as relevant as the authors suggest.

Sources of changes; the paper has a brief discussion of the shift from projected budget surpluses to deficits over the last decade. The first chart in your packet appears -- uses what the former CBO Director Peter Orszag used to opine was his most hated CBO table.

Nonetheless, what the table tells me is we should all be humble in our ability to project the economy. Over one third of the difference between that 5.6 trillion surplus projected back in January 2001 and an actual deficit of 4.5 trillion over the same -- was due to economic projections alone. And I would also note, policy tax cuts explain 21% of the increase in the deficit while policy spending increases explain 46% primarily associated with discretionary spending increases primarily on the war -- global war on terrorism.

Number two, it could be worse. Not surprising, then I believe economic forecast particularly in uncertain times like now are inherently problematic. But separate and apart from the policy decisions made since the authors first released their paper last -- I know key economic variables assume for the study have deteriorated further, particularly in the nearer term.

Some examples if you believe in long term economic projections, nominal GDP over the next 10 year period used in this study is conservatively at least 6% lower, which would add another 1.4 trillion to the revenues needed to -- or increase -- or would have increased borrowing, all other things of course not changing.

In the near term, unemployment was assumed to average, I believe Bill in your study, for the entire year at 8.8%. Just last Thursday's 9.5% rate in June, we are already averaging for the first six months of this year 8.7, meaning that unemployment for the remainder of 2009 would have to decline and average slightly less than 8.9 for the next six months. I don't think that's going to happen.

Interest rates; the 10 year T-bill rate was assumed to average 2.9% this year in the underlying study. Ten year rates today are about 3.5, having reached 4% just a month ago with the highest yield markup in one day since May 2003. In response to a request from the ranking member of the House Budget Committee last week to an estimate -- to requesting CBO for the path where they looked at the interest rates.

If you take the 10 top projections of the most recent blue chips, or even if you assume interest rates rise at the rate between 1991 and 2000, a period under either scenario, you would still add another 1.2 to 1.3 to the estimates that have been prepared here, a trillion dollars on the debt burden over the country.

And I haven't even addressed the policy differences such as the assumptions embedded in the paper, as I understand, that assume that -- under what we call the sustained growth rate. There could be a 21% reduction in Medicare reimbursement rates. And that will take place next January; that's not going to happen. Or somehow that if we get to 10%, which I believe we will in unemployment rate later this fall, the Cobra provisions that were in the Stimulus Bill that provided us 65% subsidy to the uninsured, that somehow that's going to expire in November.

Or, given the recession's impact on the states with a lag, that a Democratically controlled Congress with 30 Democratic governors won't find a way to extend, if not increase the temporary 90 billion dollars in Medicaid matched to defray state costs, or that the Highway Reauthorization Bill will not be extended at the end of September at a higher spending rate morphing into a second stimulus bill.

And on healthcare reform, I am pleased that the President and the Congress are committed to not having healthcare reform add to the deficit. But stating very simplistic in my mind what should be obvious, if you add a trillion dollars of federal spending and offset it with a trillion dollars in taxes or spending cuts, then the aggregate, the baseline, has not changed.

Even OMB Director Orszag's recent blog confirms that within the next 10 year budget window the impact of healthcare reform on the deficit is negligible. What is worse, a very prime example, just yesterday in the Senate Help Committee they adopted a new long term disability program called the Class Act; great acronym. That because the premiums come before the benefits, which come later, it's back in -- allows them to save 58 billion dollars in the 10 year window but adds to the deficit in the long run. We still have a fiscal problem. It could be and probably is much worse.

On the budget resolution; focusing first on the debt to GDP. Not my calculations, but on the chart outlining the current congressional budget resolution in your packet, you will see that in just four years, not 10, the debt held by the public will reach 66%. Further, and I'm not editorializing because these are Congress' own numbers, debt held by the public will have grown at an astonishing 13.5% annual rate from 2008 to 13.

This at the same time that spending and revenue growth at only 4% yearly and economy growing at 3%. This is in itself an unsustainable forecast. Further, the debt held by the public as Bill has pointed out and others and you all know in this room, it excludes debt held by the Government and the largest of these of course being Medicare, HI Trust Fund, and Social Security.

And this may be editorializing, but if I use the statutory debt limit as a proxy for these liabilities on the chart gross debt, it grows nearly three times faster than the economy over the next five years, reaching nearly 100%. And worse, this just before the onslaught of retirements may be from the likes of me and 77 million others.

Finally, just one last point of comparison. Back in February, Bill and Alan estimated that the debt to GDP ratio in 2019 would be 59%. Today I think their estimate is closer to 88%. That's a 40% swing in just five months, highlighting just how -- all of this is.

Finally, on credit default swaps; on the risk -- rise in the risk premium, credit default swaps for the five year treasuries from last September to -- I would only point out that the widening spreads occurred following the bailout of Fannie and Freddie. With the tarp injections of funds into our banking system this spring and other actions taken at least in the broad measurement of sovereign health, shown in this particular chart, the markets do not appear, at least, to be as concerned as they were back in the winter -- defaults.

This index, and I will admit, and this market for these exotic instruments puzzles me. But I would counsel caution, Bill, against using index as a predictor of U.S. sovereign default. I am more concerned about the correlation between the rising U.S. debt to GDP and a declining value of the dollar, as shown in this last chart. The basic obligation of the issuer of global reserve currency is to maintain the dollar's value. And that risk today seems to me to be very much in question.

Never before has the world's biggest economy become the world's biggest debtor. And never before has the growth in foreign assets of other governments been so central in the financing of such a large deficit. And by the way, this is not just an academic exercise. The Federal Government is about 580 billion dollars shy of it's 12.1 trillion statutory debt limit.

If we are adding borrowing to the tune of about 40 billion a week, then shortly after returning from the August recess, right in the middle of a critical discussion about healthcare reform and funding, Congress will have to face this very difficult political vote to raise the limit as I say at the same time that they're considering very expensive overhaul of our nation's healthcare system.

The debt limit has always been raised. We have never allowed default and maybe traders in the credit default swaps will get a little bit more attention, Bill, however if something should happen there. So I conclude with these observations.

This is inherently risky business; making long term projections anytime. But it seems particularly so at this time. However, if the country was on an unsustainable fiscal path pre-crisis, I unfortunately have to conclude that we remain on an unsustainable fiscal path, even with the Administration's policy proposals. And I think Bill's study confirms that.

Sovereign credit default swap metrics are interesting, but the real variable we should focus on is that correlation between the U.S. debt to GDP and a declining value of the dollar. So the bottom line, from my perspective, it could be worse. We could be Britain. But I also do not see it getting much better under the expected current policies that have been outlined by this Administration.

MS. SAWHILL: We are now going to have a panel to further discuss this wonderfully optimist news we've just been told and figure out whether there's any way forward that makes sense. So I'd like all of the panelists to come up now. You should stay in your seats. If you need to leave the room you can do that on your own. We're not going to take any breaks. I do want to mention that our staff at the Center for Children and Families has done a lot of the organizing of this event.

I particularly want to thank my colleague Ron Haskins who did so much to make this event happen and he's going to be moderating this next session; right? So we can get mics up. Oh, we're going to do some -- I'm sorry. I forgot we're going to do some Q and A. I'm -- I was -- I'm jumping the gun; I apologize.

I was so interested in the last presentations that I forgot that we were going to have some discussion to give Bill a chance to respond to Alice and Bill and also to get questions for all of them in.

So we'll do that first, then we will turn it over to Ron Haskins to moderate the next panel; so sorry about that. Okay; I think that we should start with you, Bill, on any comments or reactions you want to make to anything that you've heard.

MR. GALE: Okay; well, thank to both of the -- definitely thank you to both of the discussions for excellent comments. I think if Alice were ever less optimistic than I was I would be worried and if Bill were ever more optimistic than I was I would be worried. So just real quickly, I agree with all of Alice's proposed ideas and I definitely applaud the constructive approach. I learned a significant number of things from Bill's comments. In particular, I agree completely with the could be worse part. It could be a lot worse and you've laid out a number of ways that we need to think about.

On the policy -- on how much of the gap is policy versus how much of it is economic forecasting, if you separate that out into 2001 to 2008 versus 2008 to 2009, you'll find that '01 to '08 it's almost all policy. There's -- the 2001 economic forecast for 2008 is almost exactly right. Now that's luck more than skill. But 2001 to 2008, of the 7.7% of GDP drop in the deficit, 7.1 is policy, 0.6 is the economy.

From '08 to '09, of course the bottom fell out of the economy and if you average the whole period, '01 to '09, you'd get the economic projections mattering the way Bill said they did but it was only in that last year that -- anyway, enough said.

On the congressional resolution, those are very sobering numbers. And on the CDS, the credit default swap markets, I don't believe the markets. I think -- I haven't found anyone on Wall Street who will say oh yeah, that market makes a lot of sense. You hear -- I've talked to dozens of people about how do I interpret this. It makes no sense that there were to be an 8% probability that the U.S. would legally default on senior debt in the next five years. If you're telling me that they might inflate away the debt over 50 years, I'd say yeah, there's a big risk of that but that's not what CDS markets cover. They cover legal defaults.

So I view that as a puzzle more than anything else and I wouldn't -- I like the emphasis on the debt to GDP ratio, the value of the dollar. One of the things none of us really talked about was one of the things that is at stake is the U.S.'s status as the issuer of the Reserve currency.

And that's really important because we were able to respond massively on a fiscal and monetary basis precisely because we're the Reserve currency and when things get risky the rest of the world comes here. But if we're not, if we're -- if we're a third world, you know, a Southeast Asian country that has a crisis in capital -- then they have to cut back and do austerity policies. We've had the luxury of not having to do that but we may well be wearing out our welcome in the world economy. Thank you both.

MS. SAWHILL: I want to now ask a question about healthcare reform. Obviously it's on all of our minds right now since we're reading about it just about everyday in the newspaper. And several of you have been very involved, both Bill and Alice, and the other Bill, in this debate. And it used to be thought or argued by many that we could bend the curve, as it's called, in other words slow the rate of growth of healthcare spending through a good healthcare reform bill.

I think that what we heard in this first session from almost everybody who addressed it was that there wasn't much optimism that that was going to happen. We would be lucky just to pay for the expansion of healthcare; that it wasn't going to do much to put a dent into the long term fiscal gap that Bill has identified. And in fact he gave some pretty scary numbers about what you would have to do to make that debt.

But, my question is, in general, what do you think about this argument about the prospects of bending the curve, not just paying for whatever we do over the next 10 years? And secondly, what are the most likely reforms that are needed if we want to bend the curve; any thoughts on that? So maybe starting with Alice.

MS. RIVLIN: I believe we can bend the curve if we aggressively move toward doing the research that allows us to say what's effective and what isn't and changing our reimbursement mechanisms to reflect that. Now, that's a lot of ifs. But if we are really determined to do that I think we could do it. CBO isn't going to score it.

So when we say we're just paying for healthcare reform over the next 10 years, we're just paying for it with -- savings and that's right. CBO shouldn't score these things because there isn't enough known for certain about how they will work. So I'm optimistic that we can do it if we want to. Now, it's not clear that we do. But it won't be --

MR. HOAGLAND: I have to take off my Cigna hat and lay it down here and put on my budget analyst hat. And my first response is I think we have to be very clear when we talk about bending the cost curve. We're talking about bending the national healthcare expenditures.

MS. RIVLIN: Right.

MR. HOAGLAND: Not just the Federal Governments Medicare and Medicaid.

MS. RIVLIN: Right.

MR. HOAGLAND: And that -- I agree with Alice in terms of modification to the reimbursement system in the Medicare. We should move away from the fee per service to a pay for performance. However -- I'll put back my Cigna hat on. However, you have to be -- you're not going to bend that curve if in simply reducing that you shift the cost right back out to the providers and the providers then pass it back to the Cignas, and the Aetnas, and the well points --

So, this is, to me, the most difficult part in bending the national curve. How do you reform Medicare, Medicaid, you can't do it just Medicare and Medicaid, you have to do it globally, you have to change those systems. So, some of things that Alice mentioned, totally support. Exchanges, major exchanges go with the exchanges. I call it Orbitz, eHealth, whatever you want to call it. Increased information, but change the way we reimburse.

And, also, despite the fact that it seemed to be going the other direction on Capitol Hill yesterday, I truly believe you need to cap the exclusion on health insurance to provide it to the employers, and I say that probably taking my Cigna hat off.

MS. SAWHILL: Okay, our next question, Alice laid out five options or solutions, and she said we needed to do them all, and on there was tax reform and Social Security reform in addition to doing something about healthcare. The two Bills, do you want to comment on Alice's agenda for reform?

MR. HOAGLAND: Go ahead. Do you want to go ahead first, Bill?

MR. GALE: Sure.

Again, I think the basic tendency are exactly right. We need to attack the major components of spending. We need to shore up the revenue system, make it not only work better, but make it larger. A number of the specific proposals Alice mentioned, I've advocated in the past. This may not be the most interesting discussion for the three of us to have here. I don’t think there’s any controversy here.

MR. HOAGLAND: The only thing I’d add is, Alice, in fixing Social Security, I think it’s time to come to a serious consideration of raising the age of retirement in this country.

MS. SAWHILL: Yes, oh, I agree.

MR. HOAGLAND: (Off mike).

MS. SAWHILL: Or should have mentioned that.

MR. HOAGLAND: The second thing is I had had a list before you even mentioned yours, and we had a lot of similarities. But just going a little bit outside the box here, I also think something you proposed many years ago, Alice, I still think has some merit in this world, though I realize discretionary spending is not -- I would think we ought to look at the way collapsing all of the federal, state grant programs that we have in this country into to some, maybe three or four majors, go in economic development, energy, infrastructure, collapse those into large, block grant-type proposals, back of the states and cap them for adjustment in the future. I think that’s another way of taking some of the responsibility out of Washington and put it back into the states. And then I’d eliminate the ag price support programs.

MS. SAWHILL: Okay, we're running out of time, but take a couple of questions from the audience.

Back here. And there's a mike coming right next to you.

MR. GUGGENHEIM: Yes.

MS. SAWHILL: Please introduce yourself.

Yes, I'm Joe Guggenheim with Simon Publications.

Just to throw a little wet ball on your discussion, I was curious; I've heard it since the 1950s, of the great problems that the country is going to be facing if we don't balance the budget.

If you go back and look at the history of the government deficit over that time, in times of war, in times of peace, times of inflation and recession, we've always had increases in the national debt and the budget deficit, and I want to really ask you: What has been the real problem for individual Americans? There is all of this talk about what's going to happen in the future, but if you could indicate to me the real problems that have occurred in the past 50, 60 years because we've been unable to balance the budget. In terms of comparing that to things like unemployment, poor healthcare, distressed cities, crime problems that affect individuals. Shouldn't that be our concerns rather than the budget? And I'm still waiting for all those dire consequences to come into play in the past 60 years.

MS. SAWHILL: Okay. Alice?

MS. RIVLIN: I think we were beginning to see dire consequences at the end of the 80s. Rising interest rates among others. Which do affect average Americans very seriously. And the deficit was headed up and we did something about it.

It's not true that we had never done anything. We shifted, we, the Clinton Administration and the Congress, which was mostly republican during that period, shifted, we slowed the rate of spending growth, we raised the revenues, we had a good economy partly as a result of that. We balanced the budget and we reduced the debt. I think that was a good thing to have done, and we'd be in worse trouble if we hadn't done it.

MR. GALE: I'd add two things, if I could, to that.

One is the deficits we're talking about now are different than the deficits we experienced in the first 170 years of republic, I guess 200 years. Until Ronald Reagan came into office, the basic rule was the debt to GDP ratio fell in peacetime and it rose dramatically in wartime.

So, Civil War and World War I, World War II, the debt ratio peaked, it got paid down very quickly, within 15 years after each of those wars, half of the debt was gone, within 25, two-thirds was gone.

What changed in the early 80s was we started running -- there was a little bump in the 30s really, the Depression, but that's probably understandable, too. What changed in the 1980s was during good times, non-war times, the debt to GDP ratio started rising. All right, and now, if you look at the projections we have, it's going to be rising even more. That's a very different world than temporary debt to finance war. So, that's point one.

Point two is it's sometimes hard to see the affects of deficits because the affects of deficits are things that don't happen, right? If an earthquake knocks down a building, you can say, oh, that earthquake knocked down a building. If there's a shortage of capital because interest rates are too high and the building does get built in the first place, no one walks by that vacant corner and says oh, the damn government, borrowing all the money that didn't let people finance that building.

So, there are all those buildings that are not being built. Whether it's education or infrastructure or other stuff, there are things like that just as a matter of arithmetic can't be happening, although, they can't be noticeably identified, nailed onto the government deficit simply because there's only so much investment, it's got to be financed. So, the affects are real, even if they aren't immediately tangible, and, so, a lot of the problems that people face, they think lack of education services, lack of infrastructure, stuff like that, those can be tracked directly to government finances.

MS. SAWHILL: Okay, I'm really worried about the time, and I apologize to those of you who wanted to get in, but there will be another chance. I do want to bring the other panel up here because they've been waiting very patiently. And we did go a little over on our presentation times here. So, let's bring the other panel up, and thank you, all. Alice, Bill Hoagland, Bill Gale for terrific presentations.

(Applause)

MR. HASKINS: All right, I've been looking forward to this panel for a long time, and, as you can see, we have a wonderful panel. Their biographical information in your folders.

So, let me just say my colleague, Bell Sawhill, whom you've already met. Ruth Marcus from the *Washington Post.* Stuart Butler from Heritage. Bill Galston from Brookings, and Bill Frenzel from Brookings.

All distinguished analysts of the budget, and at least in the case of Bill Frenzel and perhaps some of the others, have actually been involved in trying to solve some of these problems and voting in the Budget Committee and in the Congress.

So, we're going to follow our usual format. Each of them is going to make a brief opening statement. Then I'm going to ask some questions. Then the audience will ask questions. And, Bell, I'm sorry, but you will get more than one question, I promise.

So, let's begin with Bill Frenzel.

MR. FRENZEL: Thank you very much, Ron. And thanks to the people who have gone first. After hearing that overview by Bill Gale and the responses by Alice and Bill, if we're not all moved to tears, I suspect there is something that's wrong with us as is wrong with the policymakers whose goofy decisions brought us here.

Bill's paper is written with a handful of exciting words like "bleak, uncertain default," but, mostly, it's a rather calmly stated discussion of our long-term fiscal crisis and why it's substantially worsened in the last year. This is not his first venture into the dismal swamp of fiscal crisis, nor have others from Brookings been silent on the subject. A number of our people often joined by their counterparts and other think-tanks have been bewailing crisis, crises, fiscal gaps, and rising debt with increasing anxiety over the past several years.

Despite these dire warnings, the Craven Collective, that is 435 reps, 100 senators, and 1 president, remains unmoved, as do the various constituencies that put them in power. The last chapter suggests looking under the hood, garnered about 20 percent of the vote for president 17 years ago. For jurisdictional reasons, we'll leave to the political scientists the reason why the public continues to believe the free lunch is both still free and nutritious.

(Laughter)

As a person of limited academic background and dubious career experience, I'm doubly suspect to comment on Bill Gale's fine paper. The easy way out is to talk about the discussion part of his paper. That's the bleak and uncertain section, although, I would have designated it bleak and much too certain. Here, Bill, the optimist, has suggested that PAYGO rules would make the CBO baseline rather than the CBO's alternate scenario more plausible. I agree, but the policymakers find that that PAYGO cramps their style. Republicans like it, except that it inhibits tax-cutting. Democrats like it, except that it inhibits spending. The president likes it for all things small and insignificant, but insists on he's emptying any budget category large enough to make an impact. The unanimous rejection by the three policymaking centers in Washington makes a perfect political trifecta to doom PAYGO.

Bill also says that projections are uncertain. I wholeheartedly agree, but experience teaches that some projections like demographics are inexorable, and most others are simply too optimistic. In a quick phrase, the spenders are more ingenious than the projectors. And then he says that economic growth or lack thereof could make a big difference. Amen I say, but, again, I look to the record and find little solace.

My conclusion is that bleak and dire as the fiscal crisis has been described, it's undoubtedly going to be worse. Bill has not sugarcoated the situation, but a blunt, one-armed economist might phrase it differently, to which we're in the deepest doo-doo without a shovel in sight.

In addition to not being an economist, I'm also not a futurist. I can't pinpoint the event, process, or date for fiscal Armageddon. Following the Herb Stein rule that if something can't go on, it will stop, one might imagine that at some point, lenders, domestic and foreign, will stop lending to the Treasury of the United States. One might also imagine that the Craven Collective would get smart and heroic simultaneously, or that's the great American public would trade its free lunch into clear thinking and give a little less incentive to the collective, less incentive to stoke the boilers before the inevitable train wreck.

I can't imagine any of these things happening in my lifetime, but, perhaps, someone younger and smarter can. In the meantime, I merely continue to ponder by what license we claim the right to spend our grandchildren's money on ourselves and to condemn them to a quality of life inferior to our own.

I've cried wolf often enough to know that when I do it, no one moves from the fireside to defend the flock. Nevertheless, because I continue to do it, I deeply appreciate the good work of the individuals assembled here, and especially the great scholarship of Bill Gale, and thank them for their fine work. I only wish someone were listening.

(Laughter)

MR. HASKINS: Bill Galston.

MR. GALSTON: Well, I was asked to be two things, constructive and brief, and I will try to comply.

I actually have six points to make very quickly. Six points in search of a solution, perhaps.

Point number one, let's stop the pretense. The old fable was that tax-cutting through the magic of feedback mechanisms somehow equaled fiscal restraint and fiscal prudence. The new fable takes the form of the follow syllogism: Healthcare reform is entitlement reform, entitlement reform is fiscal constraint. Healthcare reform, therefore, is fiscal constraint, QED. But, as the president's own Counsel of Economic Advisors has pointed out in the relevant 10-year window, it makes almost no difference even if you make heroic assumptions about getting it down and sustaining it for that entire 10-year period. So, in this 10 years of potential crisis, we need to look elsewhere.

Point number two, what I'd call a fiscal Hippocratic oath. First do no harm. And let me give two examples of that. Whatever healthcare bill, if any, that we end up enacting, it should have strict, fiscal triggers to ensure deficit neutrality. That means look-backs on a regular basis and mandatory adjustments. Healthcare bills have a nasty habit of costing more than the projected cost, and we cannot afford to pile new deficits on top of the current deficits.

Another example, I agree with Bill Gale that we are likely to see considerable extensions of the "temporary stimulus bill." We must ensure that if we go down that road, we pay for every penny of those extensions. I could go on, but those are two examples of the fiscal Hippocratic oath.

Point number three, let us undertake to pay for the government we want. Let us stop pretending that federal government expenditures take only 20 percent of our gross domestic product. If we just adopt a steady-as-you-go policy and adopt none of the reforms and proposals in President Obama's budget, we will have a government that takes at least 22 percent of gross domestic product and probably more than that, making more realistic Bill Gale-ish assumptions. And the revenue streams he's pointed out is considerably lower for that. I submit that we cannot just keep patching the same leaky revenue boiler. We cannot get the job done through fiddling with the income tax system. We need, and I hope the president takes the lead in this, fundamental tax reform, which we have not seen from the earlier quarter of a century, that, among other things, shifts the base of federal government revenues away from the income tax and diversifies our revenue portfolio at the same time that it cleans up the mess.

Point number four, and here I join the emerging consensus, let's just fix Social Security. We know how to do it, it will not require major sacrifices from anyone, and getting it done will both cheer up with American people and their elected representatives, and it is possible to get something significant done, and will also clarify the dimensions of the remaining fiscal problem.

Point number five, and here I become a little bit more structural and build on some work that I've been doing recently, whenever possible, let us shift to a model of real insurance.

For example, there are ways of adopting a forward-funded insurance model for long-term term expenses that so many baby-boomers are going to be needing in the next quarter of a century. The alternative is to keep on piling pressure on the Medicaid Program, which will break the back of every state budget in the country sooner or later. We cannot go down that road.

Sixth and finally, I think we ought to take a deep breath and look hard at means testing the net benefits, that is the excess of benefits, over contributions for our major entitlement programs.

The political argument against that is that you will break the coalition supporting those programs if you go down that road. I've actually taken a cross-national look at increased means testing for entitlement programs throughout the OECD and there is exactly zero relationship between the level of means testing of those programs and the political coalition supporting those programs throughout the OECD.

Six points, five minutes. Thank you very much.

(Laughter)

MR. HASKINS: Stuart?

MR. BUTLER: Thank you, and I also want to compliment Bill Gale on his excellent and illuminating paper.

Isabel Sawhill and I actually co-chair a group of budget fanatics, I suppose, who meet here every month. Many of the speakers that you've heard are a part of that, and we contemplate the long-term budget situation. These are not cheerful meetings, and I'm going to propose actually next time instead of having coffee we have cheap gin at these to cheer us up.

(Laughter)

MR. BUTLER: And, also, some of us, including Isabel and Alice, have taken part in a tour of the country, the fiscal wakeup tour as we call it with others at Concord Coalition, and they all swear talking about these very issues around the country, the long-term situation, and I think one of the conclusions that we've all drawn from these conversations, I don't think I'm overstating this, but I think one of the conclusions is that it isn't just a question of looking at a laundry list of policy proposals, many of which we could agree on, we have to contemplate the fact that our political system itself seems to be incapable, is clearly incapable of dealing with these kinds of issues, and however we move forward, it has got to be in the context of thinking about the way our democracy functions and how we can look at the present situation and what we should do in the future in that context, and with that in mind, I just want to make three observations about Bill's paper and sort of the situation it lays out, and then a few recommendations, sort of based on the idea of looking at the political processes while it's actually looking at policy proposals.

First of all, just an arcane but critically important point, Bill focuses a lot on the baseline issues and to have a serious baseline in actually forecasting the future. This is very much inside the beltway sort of policy wonk stuff, but it's critically important to the politics of resolving these issues. For years, we have had an imbalance in the way in which baselines look at the future. People who support particular programs are given a free ride in assuming that those programs are automatically going to be renewed. Everybody who looks for what I'll call tax restraint that is not permanent has a baseline that says well, let's assume that your tax cuts expire, whatever you think of the policy matters, that's been an imbalance that's made it very difficult to get a serious conversation in the future, whether it be about PAYGO or any other issue.

And, so, I think Bill's adjustment and actually President Obama's adjustment now to make the baseline equal on both sides is a very important political development which I heartily endorse.

Second, it's not just the next 10 years; it's the next generation (inaudible) as it were.

The fact is that if you look at Bill's analysis beyond the next 10 years, that's when it really gets interesting, exciting, or depressing, depending on how you look at it. And the fact is that we are going into a trajectory now starting in the next few years of a level of government spending, of activity of the government far higher than we've ever experienced in this country. It is a major change in the scope and nature of government. We've never had a conversation about this in any serious way as a nation. We are either going to have to carry out that and have huge tax changes or huge debt changes, but it's a change in the nature of our country that has really gone by default.

And then the third observation I'll make is that here we are in the middle of our healthcare debate. When are we ever going to wake up to what's going on? We're talking yet again about a major, new entitlement. We're talking about phantom savings, wishful thinking that supposedly is going to "pay for this." Has anybody who's ever been here a few years, can they really believe any of this is actually going to be budget-neutral in the future? And, yet, we're going down this.

And those of us who've been looking at the long-term situation, I think just have to note that many of the really tough proposals, including dealing with Medicare and so on, that we've been talking about dealing with the long-term fiscal situation are now being used up as a partial down payment on a new entitlement. This is not good.

Let me just make a few points then about how we might think about moving forward in this situation.

I think first of all, as many of us have argued as we've met and agreed on, that we have to have a mechanism in the budget process to put the long-term fiscal situation -- and, again, I don't just mean 10 years, I mean the next generation situation, front and center in the political process during the budget debate so that we actually have a conversation about that and people have to vote on it, not just a debt limit or the next 5 or 10 years, but what is the next 30 years going to look like and do we agree on it and what do the American people think about it?

I think second, leading from that, we have to look at serious budgets for both the expenditure side and the tax side as we look ahead. I'm in favor of looking at budgeting revenue over the next 30 years and making adjustments if it isn't. I think we ought to have a debate on that, we ought to say do we want to have levels of taxation equivalent to what we have in Europe or not? Certainly, Blinder's Law will certainly not apply there. There will be big disagreements among economists and among Americans on that. But let's at least debate it instead of looking at this sort of phony argument of the 5 or 10 years, hence, is the only thing that matters.

Third, let's have a serious conversation about revenue and taxation in this country. Bill Gale has pointed out that if we were going to balance the books in the future on the revenue side, we'd need probably a 15 to 20 percent value-added tax. People who want healthcare are talking about an addition two to four value-added tax. Let's have a conversation about that, is that the kind of taxation we want in this country, and if we're going to agree to any level of increase in revenue, let us have some conversation about how do people like me who are very nervous that if you add new revenue and send it Washington, it will simply be spent and more. What are the guarantees that that will not happen? Because nobody like myself is going to agree to revenue increases if it's simply going to be spent and more.

So, there has to be a serious conversation of how we can actually guarantee that if there is to be more revenue, how it actually would go towards reducing the long-term deficit.

And then, finally, in the health area, and this has been said, and I just want to repeat it, that if we're going to talk about new commitments of spending in health area and not simply just have another quantum leap in the long-term problem that Bill has laid out, we have to have a mechanism that says if you're going to commit to new spending, let us have the savings that I think are phantom, but they say are real, let's have them realize and bank them, put them in the bank before we commit to the next phase of spending. Let's do it the old-fashioned way. Save first and then spend, not spend and say you really are going to save in the future.

Bye. Thank you.

MR. HASKINS: Ruth Marcus?

MS. MARCUS: As I look at this group and the previous panel, Bill Gale mentioned the Sesame Street, the word of the day brought to you by, I look and think of the other children saying one of these things is not like the other, and that one is me, I'm neither -- and thank you, Bill. It takes a parent. I'm not an economic expert and I'm not a public policy practitioner, but I can talk a little bit, and I hope intelligently, about the politics of the deficit, the public perception of the deficit, and particularly the capacity of those of us in the press, what remains of it, and for as long as we can cling on. To try to convey as best we can to the public the problems, the choices, the gap, not just the fiscal gap, but the rhetorical gap that so many people have already laid out so well between what we're talking about, what politicians are offering, and what it would really take.

I'm pretty new to the deficit, with the writing about the deficit game, so, I went for purposes of this panel back to the first editorial that I ever wrote about deficit. I was on deadline, and I don't entirely remember, but I suspect I called over to Brookings and had Bill Gale and some guy named Peter Orszag on the phone sort of talking me through what exactly I should be saying, and the jumping off point was a comment by the then-OMB director, Mitch Daniels, about how we shouldn't be hyperventilating about the deficit then. Well, he was talking about the terrible deteriorating fiscal situation, he was acknowledging how bad things had gotten, how bad things had gotten. We were going to see deficits in the range, he said, of 200 to $300 billion, and that was probably low-balling. Goldman Sachs was predicting a 2004 deficit that would come in at the startling number of $375 billion, and, of course, it came in higher than that at, I think it was 412. This now looks like a bargain, we'd be thrilled to have deficits in that range.

In fact, it's a rounding error in CBO calculations of healthcare costs and scores, and, so, this doesn't only put the current situation into perspective, and I suspect if we had Mitch Daniels here, he'd be in the back of the room hyperventilating into a paper bag at the thought of a $1.8 trillion deficit or wherever we'll end up. But to suggest some of the difficulties that lie ahead in trying to gain public attention on this issue, I think you have to give the public actually quite a bit of credit for intuitively understanding that we've got a problem on our hands here. That Ross Perot was able to get 20 percent of the vote and despite being rather demonstrably crazy.

(Laughter)

MS. MARCUS: Is a testament to the intuitive public understanding that a fiscal budget and national budget is something like a household and you cannot go on spending forever more than you take in.

If you look back at the public polling in Perot's times, in October of 1992, at the height of Chartism, 63 percent were worried a great deal that the deficit would grow out of control, 17 percent worried a good amount. That subsided greatly, and this is not an apples-to-apples comparison.

But my wonderful colleague, David Broder, who has written consistently over the years about the importance of dealing with this issue, and I'd just like to say if David Broder couldn't get everybody's attention, I'm not sure who can. He talked in June about how just 1 percent of the electorate put the deficit among their top concerns.

That may be, but the reality is that a $1 trillion deficit can concentrate the mind, even a public mind that would prefer to think about something else. And the most recent polling is back up to near Perot levels. A *Washington Post* poll from June showed 56 percent very concerned, and that's in the nature of 63 percent worried a great deal, and 31 percent somewhat concerned. So, the public basically gets it, but they get it, but they're getting mixed messages. We tell them it's a problem, but we also tell them yes, but we need to keep on piling it up for now. They may understand that, that is certainly correct, but it muddles the message. Furthermore, the message is muddled by the fact that they've been hearing this for awhile, and the sky has not fallen, everything has not collapsed, so, it's sort of like threatening your kids, right? This time, I'm really going to punish you. Well, if you haven't done it in the past, they sort of tend to stop listening. The public --

MR. HASKINS: You advocate punishing children, do you?

MS. MARCUS: Yes.

(Laughter)

MS. MARCUS: Yes, I advocate, I just don't manage to practice it very well.

So, how do you do this? And I'm getting the warning, so, I'm going to start talking a little bit faster here. And how do we in the press do it? Now we actually have metrics where we can measure what gets the public attention. I can tell you because I know if you write a column about Sarah Palin or if you write a column about Mark Sanford, you are going to get more readers. In fact, even more readers among economists.

(Laughter)

MS. MARCUS: Than if you write another column about the deficit. So, one of the things that we must, must do is figure out ways to both keep at this and translate it into understandable terms. When CBO-speak doesn't work, maybe CBO needs to go to red zone and yellow zone and orange zone. I think some of the specific numbers that Bill pointed out, the notion that the net interest is going to be the size of the Defense budget, you need to give people a grasp of real numbers to hold on to.

And, finally, and I'd love to get back to this more in the questions, the press can't do it alone. The public is smart, but what it's going to take is really sustained, political leadership. This is my new favorite phrase: the Craven Collective. The Craven Collective is not going to be able to do it, it needs presidential attention, and I extremely worry that it's not at the top of the presidential to-do list.

MR. HASKINS: Bell Sawhill?

MS. SAWHILL: Well, Ruth, I think you've given me an idea. I'm going to take a look at the budget of both Alaska and South Carolina and see if we can find a hook here to make the public more interested.

MS. MARCUS: Assume a lot of oil revenue.

MS. SAWHILL: I think that there's been a lot of consensus in everything we've heard about the problem and also, to some extent, although, perhaps, a little less, about what needs to be done, and, also, a consensus that it needs to be done soon and that the public and particularly our elected officials are not quite ready for taking the tough actions that we've all been saying are necessary.

I think when I reflect on the politics of this over the past decade or so, I think about the fact that politicians have been playing games with the public and the public has been influenced by that game playing. The republican game has been called starve the beast and the idea was you cut taxes and in depriving the government of revenue, it would eventually force spending cuts to match. And now we have a new democratic game, which if were cynical, you could call feeding the beast.

Fred Hyatt did a piece on this recently, but I'd been thinking about it even before that, where that game is that you increase spending and then you hope eventually that you can pivot to raising taxes once you've gotten the good stuff out there that people want.

Now, the current administration, in their defense, has not been quite that bad. They do agree that any new initiatives should be paid for. They agree that healthcare should be paid for, and there are some very big holes in their PAYGO proposal that have already been alluded to, and I think some of us are not happy with those exceptions, so, I want to just agree with Bill Galston on the need for a tougher Hippocratic growth year of do no further harm.

The problem is that none of that takes care of the deficits that already exist and that we all have been talking about for a long time, and the problem with the sort of liberal mantra now about get various new initiatives in place, expand healthcare, do something about infrastructure, do something about education, do something about energy is it's an eat dessert first strategy, and I, for one, don't believe that people are going to eat their spinach after they finish their chocolate mousse. Politics just doesn't work that way; we really need to combine the two.

Now, the public's response to this rather cynical "starve the beast/feed the beast" kind of political pendulum has been anger, cynicism, mistrust. Stuart mentioned that fact that many of us have been out there on the hustings as part of the Fiscal Wakeup Tour, interacting with the public, interacting with local officials, and the thing we hear more than anything else is thank you for being here to tell us the facts on these matters, but we are very, very cynical that anything is going to be done about it. We don't trust our elected officials, and that, in a way, is the worst consequence of what we've been dealing with.

In other words, we've all focused on the economic risks that the current fiscal situation poses, but we haven't thought enough, perhaps, about what it does to people's confidence in our democratic institutions, and that confidence is eroding very rapidly, and I think, in part, because of this problem.

So, I want to encourage you, Ruth, and other people in the media to continue to talk about these issues. All of us in the think-tank world and in the academic world have been writing about this for a long time. You could see out there on the table and in the front hall as you go out all of our many publications and op-eds and at some point we feel like we're talking to thin air. I do think and I don't say this just because you're here, Ruth, that the *Washington Post* has done a particularly good job on this front, but I don't see that many others in the media have. There has been some discussion of the fact that maybe if we can't get the Congress to do what they need to do along the lines that Alice recommended, perhaps, we could make some process changes that would help.

Many of us, for example, have called for some kind of an independent commission that would recommend changes in entitlements, changes in taxes, and that then there would be an expedited vote in the Congress, but, so far, even that idea has proved too controversial to be put forward, despite the fact that a group of think-tanks and others who participate in the fiscal seminar that Heritage and Brookings has convened over the last few years, everybody in that group recommended that this solution be tried.

Some of us have thought that a good solution might involve changing the default on fiscal policy so that we have some rules that Congress might be willing to enact because it would only bind their hands later and not immediately, but a default that would require that they actually vote to eliminate fiscal discipline instead of the other way around.

And some of the ideas floating around about healthcare reform that assume that there will be certain savings but back that up with an automatic trigger if those savings don't occur are in that category, although, I think many of us fear that when it comes time to pull whatever the automatic trigger is, Congress will simply get rid of the trigger.

Churchill once said that Americans usually do the right thing. I think that's what Alice was talking about, but he also added, but only after they've exhausted all of the alternatives. I think that the message of this forum has been that we don't have many alternatives left, and, for the sake of the country and especially for the next generation, I hope I'm wrong.

So, thank you.

MR. HASKINS: Ruth Marcus expresses some amazement that even economists would be interested in stories about Palin and Sanford, and I want to tell you that if I use the Brookings' economists as an example, the response to stories about Argentina are even greater.

Bell thinks that we have consensus. I want to make sure if there happens to be anybody writing for Des Moines of Schenectady that we really pin it down that we have an agreement. So, I'm just going to use the phrase that Bill used in his Los Angeles Times editorial this morning, you accuse the United States in financial matters of being a banana republic, so, with its great scholars, elected officials, former budget officials that we have on this panel, does everyone agree that this problem is huge and virtually bottomless? Anybody disagree with that?

Okay, hearing no --

MR. FRENZEL: I hear he's understating the problem.

MR. HASKINS: He's understating it, okay.

MR. FRENZEL: Yes. I think --

MR. HASKINS: So, we're a banana republic. That could be the headline?

SPEAKER: I think we should stop insulting bananas.

(Laughter)

MR. HASKINS: Okay, so, we do have agreement on that. Okay, so, now let's talk about solutions. The most fundamental, usually we think in a democracy, is the public. Ruth has been somewhat optimistic about the public. What is the evidence that the public is alarmed or is growing more alarmed? What do we think that the public might do? For example, are they going to vote differently in 2010?

Bill?

MR. GALSTON: I never make predictions, especially about the future, but --

MS. SAWHILL: But.

MR. GALSTON: And I'm not going to go there, but I do know the most striking piece of evidence that I've seen recently comes from the most recent NBC-Wall Street Journal poll which showed a meteoric rise in public concern about our fiscal situation. It surged from nowhere six months ago to second place. Thirty-five percent expressed, of course, the most worry about the economy, jobs, their personal economic futures. Twenty-four percent said the long-term fiscal situation, the deficit, and the debt. And you don't need an enormously-long memory to see that these latent concerns can be crystallized as Ross Perot did so effectively in 1992.

There is a correlation between the 1993 Clinton era policies of fiscal restraint that Alice was talking about and the fact that that issue was teed up by a crazy, but not entirely irrelevant, third-party candidate, and that suggests to me that there is a possible mobilization of public concern that could lead to a change dynamic on this issue.

Bill Frenzel?

MR. FRENZEL: I have kind of different look at it. I can remember when line item veto was polling 80 percent. I can remember when term limits were polling 90 percent throughout the country, but the collective knows how to deal with that sort of thing, and they were able to push both of those very popular items aside and all I can say is I'm glad that the idea is beginning to penetrate, but it's going to take some sustained public opinion before the policymakers are going to change their minds?

Bell?

MS. SAWHILL: I think that it's also encouraging, Bill, but I would point out that my interpretation of why this is happening is because republicans are one message right now in terms of a critique of the current Congress and administration which are, of course, overwhelmingly democratic by constantly harping on this theme, we're spending too much money and this is creating a fiscal unsustainable future, and it's good in a way that they're on that theme.

On the other hand, they basically have taken this hot potato and passed it to the other party and said after you (inaudible). We're not in power now, you own this government, it's up to you to raise revenues or cut spending.

So, the good news is yes, they're waking up the public, the bad news is that it's not clear to me that they're willing to sit down and put everything on the table so that we can do the things we need to do to get the problem under control.

MR. HASKINS: Amazing. You think republicans are cynical?

Ruth?

MS. MARCUS: Well, I'm as cynical as they come, but I think that the best evidence that there is a shift in the public mood, and I think it's partly for the reason that Bell said, is the increased responsiveness and vocalization of the administration on the subject of the deficit.

You sort of saw the promotion of PAYGO for all the flaws and the exceptions got a lot less attention as the administration knew they would than the basic concept, and they are responding to the concerns out there. On the other hand, if you look at the concerns about the deficit versus concerns about job creation and other things, people are always, and completely understandably, going to be more worried about what feels more immediate, and I think that's the complication.

So, good news that there is more attention, but it is competing with other very serious and more immediate economic concerns that the public is feeling, as well.

MR. HASKINS: So, after the public comes the Congress, where the votes will have to take place, we're really going to do something about this and the president?

I recently got a letter from Frank Wolf, who laid out this problem, just as we have here this morning. He said so, what's the Congress doing? Nothing. Absolutely nothing. Is that true, and what would it take to get the Congress to actually take strong action like had been suggested here by Bill?

MR. BUTLER: I think for the Congress to take action, it's got to be safe for them to do so. In other words, I think they've got to feel that if the public -- if they take tough action, they will not be sort of destroyed at the next poll.

I think one of the experiences that we've had in the fiscal wake up tour, as Isabel alluded to, that when you lay out the situation to the American people in a clear way, they get it and they want something done about it. We've occasionally had members of Congress come to witness their own constituents discussing this, and they have generally been surprised bordering on shocked at just how willing their own people are if the information is presented to actually support tough decisions, and I think that’s a critical part of what's got to happen here. Members of Congress have got to have essentially political permission to take the steps that they know privately have to be taken. I think the press has a very important role in this in helping to get the information out and reporting on how the public deals with that information, and encouraging politicians to take --

MR. HASKINS: And if this incurred and it became safer, can you imagine republicans supporting tax increases?

MR. BUTLER: Well, I think it’s quite possible for them to look at some form of change that will include taxes rising higher than they are today from GDP, so, we’re already on trajectory to do, and I think the issue there is going to be is there any guarantee that this not going to be a repeat of everything that’s ever happened from 1982 onwards of agreeing to a tax increase only to find that’s spent and more.

As I emphasized and I spoke, there has to be a guarantee that raising revenue is not just enabling, we don’t just become enablers for more spending. That’s precisely what's happening now in the healthcare debate, as I said. All proposals to raise revenue are not to cut the deficit, they are to partially pay for a new entitlement, that's why republicans will not accept revenue increases without any promise that somehow spending is going to come down.

MR. HASKINS: In general, you can't imagine republicans would accept revenue increased?

MR. BUTLER: Can, did you say, or cannot?

MR. HASKINS: No, that they would under the right circumstances --

MR. BUTLER: If the situation -- I --

MR. HASKINS: So, you can imagine --

MR. BUTLER: I think if there were the situation, which is hard to imagine right now, the situation where you could actually see an assurance that spending was going to be the size of government was going to be reduced, I think a lot of republicans would say given that, where there's a guarantee of that, trading taxes now for reduced taxes in the future, because we're going -- as Bill said, a 15 to 20 percent value-added tax is a massive tax increase. That's what's going to happen in the future. So, something that would guarantee that, but I see no prospect of such a guarantee.

MR. HASKINS: Bill Galston?

MR. GALSTON: Well, I would just add one element to Stuart's permission slip thesis, and that is that I find it difficult to imagine without presidential leadership that the Congress of the United States would feel at all secure or empowered to go down this road. I can imagine a State of the Union Address in which the president summoned his very considerable --

MR. HASKINS: When you say they (inaudible) how -- are you talking about President Obama?

MR. GALSTON: Yes.

MR. HASKINS: Okay.

MR. GALSTON: And I can imagine a State of the Union Address by this president who has very considerable powers of articulation, explanation, and persuasion that would create a very different political dynamic in the Congress. And I'll put it in the negative, absent that kind of presidential commitment, I find it inconceivable that members of the majority would change course to any significant degree.

MR. HASKINS: Bill Frenzel, do you agree with that, without presidential leadership, we're cooked?

MR. FRENZEL: I think it can't be done without presidential leadership, but I'm not sure it can be done even with presidential leadership.

Now, I'm a purple-hearted veteran of the most recent tax reform commission and the most recent Social Security reform commission. Two things that all of us agree need to be done, and the president was stiffed by his own congress and was unable to move forward on those. I'm told the same is true of Social Security with its president, although my contacts are noticeably weaker with the administration. But I believe the same to be true. The Congress is a formidable group to get around, and it's going to take a combination of a terrible situation which we have and really extraordinary presidential leadership and some real followership from the public, and I don't think we've seen either in the latter two yet.

MR. HASKINS: Audience? Short, succinct questions. Ooh, and no one raised their hand.

Up here in the front?

MR. GALSTON: Well, with that stipulation, who would?

SPEAKER: Thank you. I'm Mack (off mike) and hopefully --

MR. HASKINS: Can you speak more directly into the microphone? It's hard to hear you. It's on.

SPEAKER: Oh, okay. Medical care in the United States is not part of the market economy. The doctors charge whatever they want and nobody knows, there's no balance. Do you think that bringing medical care into the market economy could play a substantial role in reducing costs?

MR. HASKINS: So, the question is: If we actually reformed healthcare so that health were a part of the actual economy and operating on market principles, would that be a part of the solution?

Stuart, it sounds like it's tailor made for you.

MR. BUTLER: Part of the problem now is you've got a highly distorted health market economy. It's not that it isn't in the market, it's the market is basically designed or has been designed in such a way to almost guarantee that you will get inefficiency and far higher expenditure that anybody would rationally want. So, it's a question of restructuring and reforming the way the market actually operates. I think that should be done in several ways, and I'll do it very briefly.

I mean, one is to look at the open-ended tax treatment of healthcare today, which not only shields people from the actual marginal costs, but hides it in the language we say the only way you're going to get this tax break is to have your employer make all the decisions about what you get and not show you what he's spending. We need to move away from that with a cap, or, ideally, an elimination of the solution for healthcare through the place of work and putting in instead a more rational form of tax subsidy. That's one element.

I think opening up the market in a sense of I'm at the Heritage Foundation, I have a choice of two plans, both run by the same company. That's not a market. If you're in the federal employee system, you have 20 to 30 different choices from competing market. Let's open up the market that way. Yes, if we had a competing market with people really able to make real choices, to see the price, and to get a limited subsidy, we'd have a dramatic change in the way the market operates.

MR. HASKINS: Anybody else on the panel?

MS. SAWHILL: Yes, I would just like to point out quickly that the other side of this argument is that there are many other advanced countries where the government has a much bigger role in the healthcare system than we do in the U.S. They spend far less and they get just as good outcome.

MR. HASKINS: That's right.

MR. BUTLER: But they are a very different political and social culture than we are.

MR. HASKINS: Okay, let's have three, quick questions, and then the panel will answer them.

We'll start right over here.

SPEAKER: Mr. Taylor (sic), you talked of guarantees about taxes going toward the deficit. How can we practically put them into the law or the tax code, and how can we find a consensus on them to get them passed?

MR. BUTLER: Your question is to me?

SPEAKER: Yes.

MR. HASKINS: Well, wait, hold it. Another question? Right there on the edge, right by you? And right here.

SPEAKER: During the panel often, the question of military and Pentagon spending has seldom come up. Currently, we spend $460 billion a year on the Pentagon and the Defense budget. A lot of it to support unnecessary or outdated military installations, especially for the Air Force, and the amount that we spend per year is actually equal to the EU, Russia, and China combined.

So, should cutting the Pentagon's budget be on the table to reduce the deficit? If so, how much?

MR. HASKINS: Right here?

SPEAKER: My name is Dmitry Novik and my question --

MR. HASKINS: Hold the microphone right up to you.

SPEAKER: Oh, I am sorry. My question is very simple: Where is in your picture (inaudible) technological breakthrough and political breakthrough? All predictions is on old paradigm, is baseless. We see this in 2001. Prediction was (off mike) and terrible situation. Why? Because it was (off mike).

MR. HASKINS: Okay, panel. Any of the questions.

MR. GALSTON: Any another questions?

MR. HASKINS: Any of the three.

MR. GALSTON: Oh.

MR. FRENZEL: Remind us what the questions were.

MR. HASKINS: I couldn't possibly do that.

MS. SAWHILL: I mean, I'll just that, yes, obviously, defense should be on the table. I think Secretary Gates and the current administration has already addressing this in a pretty constructive way, and but that alone, it's a myth to think that defense savings alone are going to do more than contribute a modest amount to the problem we've identified.

MR. BUTLER: I mean, I agree that defense and defense spending and Defense Committee should be "on the table for discussion." What I actually think is that should be on the table, so should revenue be on the table, so should entitlements be on the table, and they should be considered equally in the conversation. We ought to make fundamental decisions about all of them. Or, as today, every year, we have to debate what the Defense budget is actually going to be, and we do make that discussion. We don't debate Medicare each year. It's on autopilot. And one of the things that's critically important is to get all these things on the table, to have a serious, adult conversation as a nation about how we want to deploy our results.

MR. HASKINS: Ruth Marcus?

MR. BUTLER: The second thing I would just say very quickly in terms of the issue of taxes and spending, I think the issue is the sequencing of this. What we get over and over again is to say let's change the tax code now, let's have a surcharge, let's change the rates, and we really promise that there will be savings in the future or it's going to be spent in a different way in the future.

MR. HASKINS: Ruth?

MR. BUTLER: Let's have it together so we make that decision.

MS. MARCUS: So, I want to link this to the previous conversation about presidential leadership and whether that's necessary, to which I think absolutely, yes, and whether it's sufficient to which I think almost certainly not, and I would say that the only path that I can see right now in my current gloomy state is to combine presidential leadership, I'd like to see the president give the State of the Union address that's written by Bill and Alice and Bill. Okay, he could stand up there and explain to people that you cannot run the kind of government you want on the kind of revenue we're bringing in. He's promised in his inauguration, inaugural address, and elsewhere to that kind of straight talk. Deficit reduction is something that he institutively, intellectually understands, it's not in his heart, it's not in his priority. He came to the *Washington Post* Editorial Board before he was sworn in, talked about how we have to stop kicking the can down the road. I'm still like following the can.

But I think that even if the president were able post-healthcare and everything else, prodded perhaps by the public and by republicans to step up to the plate on this, we need to have a mechanism, a commission, something that would give Congress the kind of permission slip that it needs that can -- I hate the notion actually of offloading these very important public policy decisions onto an external body for review and approval by Congress, but I've come reluctantly kicking and screaming to the conclusion that that's the only way we can make the, what is it, Craven Collective. And they're understandably Craven because they've been taught to be Craven and actually rewarded for being Craven to make them responds, and, so, I'd like to see both of those things.

MR. HASKINS: Bill Galston?

MR. GALSTON: Well, two points.

First of all, with regard to the Defense budget, it's obviously correct to say that it ought to be on the table, and Secretary Gates, I think, has very bravely proposed major cuts and eliminations in weapon systems. Whether the Congress will go along is a different question altogether, but at least he's started that discussion. Unfortunately, the events of recent years have demonstrated that our deficiencies in the area of military manpower, particularly ground troops, are at least as great as our excesses in the area of weapons procurement, so I think our expectations for net savings for the Defense budget have to be very modest at this point.

With regard to the sequencing and guarantee question, we are speaking as though within living memory, fiscal restraint has never occurred. As Alice and others have pointed out, that is simply not true.

I mean, there was a three-episode sequence that began in 1990 and ended in 1997 that really wrenched the Federal Government into a new and sustainable path, and I wish, along with everybody else in the room, I believe, that it had stayed there, and one of the things that's required to have a politically effective guarantee is both political parties ultimately signing on to whatever is agreed.

So, I have reluctantly reached the conclusion that Ruth reached about base realignment and closure style commissions to tee up hard choices and to define the options and to compel votes. I think that's necessary, but in addition to have it sustainable over time, great changes, and we're talking about a great change, cannot be built on slender, partisan majorities.

MR. HASKINS: Bill Frenzel?

MR. FRENZEL: With respect to the question about the DoD, I think it's an important one because everything should be on the table in every appropriation cycle. While Medicare and Social Security, they're the social contract, we dare not even talk about them. All of the discretionary expenditures are upgraded for demographic changes and cost of living, and it's just assumed that they're going along.

We need every item in the budget to compete with every other item. We need to decide how much we're going to spend, and then we figure out how much we'll give to each one, and we'll let the agriculture bleed for agriculture and activists bleed for children.

But, in the end, we got to have a budget that works. And, under our present system, we can't because most of the items in there are under perpetual protection and cannot be touched.

MR. HASKINS: Well, thank you. You've been a wonderful audience. Please join me in thanking the members of the panel.

(Applause)

MR. HASKINS: Bye-bye.

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CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, III

Notary Public in and for the Commonwealth of Virginia
Commission No. 351998
Expires: November 30, 2012