

THE BROOKINGS INSTITUTION
WHAT THE SUPER COMMITTEE SHOULD SAY

Washington, D.C.
Monday, November 21, 2011

PARTICIPANTS:

Panelists:

BRUCE KATZ
Vice President and Director, Metropolitan Policy
Program
The Brookings Institution

MICHAEL O'HANLON
Senior Fellow and Director of Research, Foreign
Policy
The Brookings Institution

ALICE RIVLIN
Senior Fellow
The Brookings Institution

* * * * *

P R O C E E D I N G S

MR. O'HANLON: Well good morning, everyone, and welcome to Brookings. I'm Mike O'Hanlon. Pleased to be joined by Alice Rivlin and Bruce Katz, talking today about the nation's fiscal future.

And when I last saw a lot of you in this room it was probably August, it was a happier day. We had dreams in Washington of the Redskins in the Super Bowl, and we had dreams in Washington and the country of a balanced federal budget and a Super Committee that might come to the rescue and give us great holiday cheer; first, before Thanksgiving with its report, and then before Christmas when the Congress would hopefully pass a fiscal renewal bill. Well, it doesn't appear that any of that's happening.

And so today we're here to talk a little bit about what happens next and I'm sure the prospects for any small sliver of hope that the Super Committee may still be grasping onto may come up in conversation, but I suspect we may also be talking more about what happens next, assuming the failure of this group to produce a bill that the Congress can pass. And therefore, the likelihood of a sequestration and all that follows thereafter as the automatic spending cuts kick in and we think of what to do next.

So that's the context. I think you all knew the context when you came. We're grateful to have you here. The way we'd like to proceed, to get right to it, is that I will first ask Alice Rivlin, who as we all know is one of the country's greatest economists and budget experts to talk about where we stand.

And it was about a year ago that Alice, as part of two deficit reduction commissions, laid out some proposals on where the country might go that have been central to the debate we've had ever since, but of course, have not yet produced the major changed in our deficit picture that we've hoped for.

And after Alice speaks for a bit, Bruce Katz, who runs our Metropolitan

Studies program will speak. And of course, one of the things we need to keep in mind in this whole conversation is where do we need to invest, even as in general, we're cutting. And that's front and center of what Bruce works on with his colleagues in the Metropolitan studies program thinking about those areas of infrastructure, science research, education, and so forth, that are crucial to economic recovery, where some more spending may actually be needed, or at least where we have to be very careful about how we cut if we're going to be watching out for our country's long term economic interests.

Then I will speak, taking off my moderator hat, speaking briefly as a panelist about the defense budget. And then after a little bit of exchange with each other we'll go to you. So without further ado, I'm going to thank both Alice and Bruce for being here, as well as all of you, of course. And, Alice, I'll just ask you to give us a sense of where things stand, so sort of how you feel on this Monday morning, but more generally, where we need to go next.

MS. RIVLIN: Well, I feel worse about the Super Committee than I do even about the Redskins. One can argue that they played well and almost won. One cannot argue that about the Super Committee. I feel very badly. I think this was a huge opportunity missed and I believe that it has been missed and that that will be announced later today.

So let me say a word about what they should have said, why they didn't say it, and maybe a bit about where we go from here. What they should have done, and had the power to do, was get the federal budget back on a sustainable track. That would have taken going well beyond the minimum requirement of 1.2 trillion, going big as many of us were saying, and actually solving the problem.

The 1.2 trillion does not stabilize the debt. The debt would still be

growing faster than the economy can grow and that is the definition of a bad problem. What we have to do is get the situation back on the track where the debt is not growing as fast as the economy. We did that for decades after World War II. We never paid off the debt; we just grew the economy faster than the debt. So that should be the objective.

It was basically the objective of the two commissions I served on, Simpson-Bowles and Domenici-Rivlin, and the arithmetic of this problem drives the answer. If you're going to get to a sustainable debt, you have to do two big things at the same time. The curbing of the growth of entitlement programs, especially Medicare and Medicaid, but it would be nice to get social security back on a firm foundation as well, and reform of the tax code so it's a better tax code and raises more revenues. Those two things have to be part of a solution and roughly the numbers were not 1.2 trillion, it was some combination of those two things to get to 4 or 5 trillion over the next 10 years.

A lot of us thought that that big scenario was easier than the small one and it certainly got a lot of attention. Simpson and Bowles and Domenici and I testified before the Super Committee about two and a half weeks ago, said that -- but there was an enormous group. Maybe enormous is too strong a word.

There was a big group in the Congress, around Senators Warner and Chambliss, but including Senators from both sides, quite a number of them that wasn't the gang of 6 anymore. It was more like the gang of 36 that wanted this kind of a solution. There was also a large group in the House. About 100 House members signed a letter saying, "Go big."

Why didn't it happen? I think there are a lot of culprits here. It was the basic problem of the polarization of the parties, and particularly the extremes of the parties, with much of the Republican contingent saying, "no revenues, no how, no way, even with reform of the tax code." A very small crack in that was the Toomey proposal a

week or so ago, but not a big crack.

And on the other side, a lot of Democrats saying, "No changes that would affect Medicare beneficiaries or social security recipients, ever." Those are very difficult positions since actually we have to do both of those things. But I think there was a failure of leadership. If the leadership, including the President, had really wanted this to happen, I think they could have made it happen. But they couldn't sell it to their caucuses.

They went back and tried to and the answer was no, we're not Republicans, we're not voting for a tax increase, not enough of us, and from the Democrats we're not voting for entitlement cuts.

So we are where we are. I think there's lots of blame to spread around. I think the business community could have done a better job. Maybe the (inaudible) community, well represented here, could have done a better job, but somehow we failed.

Now, the consequences are pretty serious, I think. We may not have a market meltdown because we're the only game in town. The Europeans are doing worse. I would expect an equity market reaction but not much bond market reaction in the near term. We may get a down grade.

But the really important thing is we've missed a big opportunity to fix not only the long run problem, but some short run problems. We need to extend the payroll tax, we need to extend the unemployment benefits, and those would have been easy to fold into a big deal, along with some other things like the so called doc fix. Now those have to be done separately and may not be done at all.

So those of you who know me know that I'm generally an optimist. I am not an optimist today. I think this is a very serious defeat.

MR. O'HANLON: Could I follow up with one question, Alice? Some

people are saying that sequestration, the automatic cuts that will now kick in, is really not the worse scenario and maybe we shouldn't sweat it so much because -- and obviously I don't agree with this because you're going to hear me say why I think the defense cuts have already gone far enough in a few minutes, but some people will say, "well, listen, this sets the stage for maybe the tax cuts of the Bush era to expire at the end of next year, which might be better for our deficit situation; it protects some of our entitlements, or most of them, and therefore things could be worse." Obviously you don't feel that way. How do you respond?

MS. RIVLIN: Things could be worse. They can always be worse. The scenario that you suggest, which is that the sequestration cuts go into effect as enacted, which means account by account, a mindless way to cut anything, whether defense or domestic, and heavy on discretionary spending, the annual appropriations, which have already been capped.

So no, I don't think that's a good idea and there will be other chances because the Bush tax cuts to expire at the end of 2012, not 2013, and that will be another moment in which maybe people get together and say, "Do we really want this to happen?" But there's no indication at the moment of a consensus on what to do in the face of any of those things.

MR. O'HANLON: And Bruce, that takes us to you.

MR. KATZ: Sure.

MR. O'HANLON: Perhaps for no happier news, but still, you've watched a number of programs that you're an expert in already take some hits.

MR. KATZ: Right.

MR. O'HANLON: And I wonder how you feel about what's likely to ensue hereafter.

MR. KATZ: Yes, I think my perspective is partly Washington based, but partly from someone who spends most of their time outside of Washington. And, you know, Mike sort of started off this morning saying how do you feel? I mostly feel physically exhausted. I was in the West Coast twice last week; back and forth to Reno, to D.C., back to San Francisco, and then somewhere in between ended up in Lansing. So I would say that as I talked with political, corporate, civic, university, labor, environmental leaders, as the normal course of my job, I would say they have sort of several views about the process underway here.

Obviously, they are deeply concerned and worried about the impasse. I would say, frankly, they're even more frustrated with Washington because they don't see the conversation about debt and deficits aligning with what they know needs to be achieved here. We just have to remember a few salient facts that should bound this conversation.

We lost 9 million jobs during the recession and we've barely regained, I think, about 24 or 25 percent of them. The Hamilton Project has put out a statistic that would say we need about 12.3 million jobs to regain the jobs we lost, and then to keep pace with population growth and labor market dynamics.

We do a monitor of the economic performance of each of the top hundred cities and metropolitan areas in the United States every quarter. Only 16 of these metropolitan areas -- and this is 2/3 of our population, 3/4 of our GDP -- only 16 of these metros have regained half of the jobs they lost during the downturn.

So when I'm out around the country, what people are focused on is growth, as well as deficit reduction. They fundamentally do believe that the federal government has to get its fiscal house in order. At the same time, they believe that we have to set a platform for the next generation of growth, which frankly is not like the

growth that we had pre-recession, which was highly characterized by consumption and over-leveraging and innovating in the wrong things.

So I would say their perspective is threefold. First, we've got to cut, but we've got to cut to invest. We've got to begin to invest in those things that are going to set our economy on a different path forward; substantial sustained investments in advanced research of development, basic science.

We do it, to some extent, in health obviously; we do it to defense. We have not invested in clean energy R&D to the extent that we need to do to crack the code on clean energy and low carbon. We need to invest in advanced manufacturing. Once we invest in basic science, we need to be much better about commercializing innovation and doing tech transfer so we don't just have the ideas in the United States, we begin to prototype products and begin, frankly, to produce and deploy and manufacture more of what we invent. And finally, we need to invest in next generation infrastructure, transportation and energy, and in the human capital that we need to set off this new generation of growth. So we need to cut to invest.

I was on this panel the other day with former Secretary of State, George Schultz. His recommendation, which sounded eminently feasible or intelligent, maybe not politically feasible, was end all of the tax subsidies for every kind of energy source that we have, whether it's oil, whether it's coal, whether it's nuclear, whether it's wind, whether it's solar, and shift a good portion of that funding into the kind of advanced R&D that we need.

Simpson-Bowles had an interesting recommendation, I thought, about a cut and invest committee, so that as we begin to scale back the federal government, we still retain these core investments.

So first thing that I think states and locals are focusing on is cut to invest,

second is cut and reform. So you mentioned the cuts that have already happened. I was chief of staff at the department of housing and urban development. I spent a period of time there at the beginning of the Obama Administration.

Last fiscal year, the Community Development Block Grant was cut \$900 million. This fiscal year, just the package that was just approved the other day, HUD, DOT, AGG, Commerce, CDBG was cut another \$200 million, the Home Program was cut \$600 million, the Public Housing Program was cut \$750 million. The cuts are already happening. What's not happening are the reforms that need to occur in these highly proscriptive, highly bureaucratic, highly top down programs, so that you can do more with less.

It's not enough to cut and just think it's all going to be fine, or presume that these programs are functioning so effectively and efficiently; they're not. These are legacy programs that haven't been reformed for quite some period. I think Simpson-Bowles talked about 44 job training programs across multiple agencies, 105 separate programs on STEM and science and engineering. The federal government needs to radically get its act together on the fiscal side and on the programmatic side.

Last point; about what I think the states and locals want to hear and I've got a recommendation of maybe how to do this: cut and devolve. Alice wrote a book 20 years ago called, *Reviving the American Dream*. If everyone does anything when they leave this place, go to the Brookings bookstore and buy this book.

It is as relevant today -- it is more relevant today, in some respects than it was 20 years ago. And what it basically says is we need a new division of responsibilities between the national government and the state and local governments for the 21st century. It states that the federal government needs to do less and needs to do it well. The states and their cities and metros really need to take on the productivity

agenda and the income enhancing agenda, and really have prime responsibility for some of the economic growth that needs to happen because it's so different across the country.

Again, I was in Reno on Monday and Lansing on Wednesday and -- on Friday. I mean these are three radically different economies. And it is hard to imagine a federal government being smart or strategic enough, in any century, to deal with those kind of differentiated economies. Let the states, let the cities, let the metropolitan areas have prime responsibility for that part of the domestic agenda; let the federal government begin to scale back, literally what it does, but just do it well.

So I think there's an enormous amount of concern out there, enormous amount of frustration out there. You know, mayors, governors, these folks are just uber-pragmatic about things, I mean, partly because they wake up every day in the supermarket by someone, then what have you done for me lately? I think as we go forward out of this wreckage, I really hope that we begin to set up some different vehicles, not just for deficit reduction, but for growth strategies, where the congressional class and the federal political class begins to go federalist. Bring in the governors, bring in the mayors, they're the get stuff done party. Let them sit on some of these committees and tell everyone up at this level what they've done in their states to balance budgets and get their economies moving together.

I think it would be a breath of realism and a breath of pragmatism to have Chris Christie and Andrew Cuomo sit in some of these sessions and begin to help what is a really hyper-divided governing class in this town begin to get its act together.

MR. O'HANLON: So, Bruce, that raises a question. One follow-up before I speak on defense. Since you're saying that localities and states could do more and the feds could do less in some areas, that raises the obvious question, how much can federal spending on domestic discretionary accounts be reduced? And I realize you

don't have necessarily a detailed final answer for us today across the entire government, but nonetheless, the question is germane with the sequestration kicking in. And I guess my question is do you feel that sequestration is going to go too far or do you feel it's compatible with what you just laid out? If, in fact, the Feds should do less, is it okay perhaps that a 10 or 20 percent real cut occur in the annual budget for domestic discretion?

MR. KATZ: Well, the kind of remaking federalism I'm describing also requires you to fundamentally remake the tax code, and how much gets raised at this level and how much can get raised at the state and local level, and I think that has to be sorted out. So it's not just about the cuts and revenue remain the same. I mean, we have to really begin to re-sort this out in some major structural ways.

You can cut dumb, you can cut smart. Sequestration sounds to me across the board as a cut dumb strategy.

MS. RIVIN: Absolutely.

MR. KATZ: I mean, it just says, hey, everything must be working the same, same effectiveness, same efficiency, just cut across the board. Again, when you think about what the federal government does with perspective of the growth need, both in the near term to create jobs and the long haul to restructure the economy, there are certain programs that are absolutely fundamental to that that really not only should be ring fenced and protected from cuts, but frankly, should be put on steroids.

I'll come back to one I did, clean energy R&D. I think NIH probably gets about \$30 billion now. The National Science Foundation probably gets 7 billion. I think DARPA probably gets on an annual basis 3 billion. ARPA-E, which is the Department of Energy's DARPA like R&D shop, gets \$180 million a year. It's not the only R&D investment in clean energy; we still have the National Labs. We should be at 15-, 20-,

\$25 billion a year in clean energy R&D if we are going to crack the code on low carbon and be the vanguard of a clean energy revolution.

If we don't do it, China will or Germany will, or they'll do it in some combination. So sequestration, to me, when you're really focusing on the growth trajectory this country needs to be put back on, makes absolutely no sense. It doesn't distinguish between apples, oranges and bananas in terms of what gets your economy functioning.

MR. O'HANLON: Alice.

MS. RIVLIN: I agree with that, and thanks for the plug, Bruce. But I think there's one thing that many people, including many of the ones, the mayors and governors you've been talking to, especially the Democratic ones, think there's some conflict between jobs and growth and deficit reduction. They're wrong about that.

MR. KATZ: Right.

MS. RIVLIN: And that has been one of the impediments to getting an agreement. And even the President has talked about pivoting from deficit reduction to jobs. And he's going to lose, unfortunately, the opportunity for some of the job growth that could have been folded into a larger deficit reduction deal, because we will not grow in the long run as long as our debt is rising too fast.

MR. KATZ: Absolutely.

MR. O'HANLON: And while you are buying books, I'm going to ask that, if you're getting two for the holidays, you get Alice's book, and you buy my new book, which is called *The Wounded Giant*. It's about America's armed forces in this age of austerity. And I want to talk about a couple of the ideas that are there.

But to relate it to today and to the likelihood of sequestration, let me

summarize and begin by saying I think sequestration would be a nightmare for our national security. And I hope very much that if, indeed, it kicks in, that it will be quickly superseded by subsequent action in 2012, so that we don't start to see the kinds of cuts that would otherwise be necessary.

There's some talk out there, including by one of the Republican presidential candidates, that the kinds of things that are now already happening are not real cuts, that's wrong. Real cuts are already happening to defense as a consequence of the August deal. And the first tranche of reductions that was mandated by the August provisions of this debt deal that was going to result in about 400 billion in 10-years savings or, according to the CBO baseline, which is sort of the steady state if you just stay with inflation, 350 billion in reductions over 10 years. In other words, we're 350 billion below what would be needed just to keep up with inflation already before sequestration.

Then you add on the cuts from sequestration, roughly another half-trillion dollars over 10 years for the military, and you wind up with an annualized budget that is about 20 percent less than what it is today, but it's actually even more reduction because I haven't included war costs in any of this discussion.

The war costs are assumed to come down anyway. They are there for not cost or not savings that the Pentagon can claim to justify or satisfy its requirements for deficit targets. And that's appropriate. We should be making our decisions on war and peace based on the merits of the case.

So the Pentagon should not be claiming credit. But that's another \$100 billion that's going to result each year by the time we are phasing our way out of Afghanistan by 2014.

So in other words, you're going to see total defense spending go from somewhere in the

range of 700 billion a year to somewhere in the range of 500 billion a year.

Now, I think most of that is okay. The war costs can and should come down, not right away. I was just in Afghanistan last week and I think we're going to need a couple more years of fairly sustained effort. The President has us headed down to 68,000 U.S. troops at the end of next summer from our current level closer to 100,000, I think that's okay. But I think we'll have to stay at 68,000 for the following year to do the job right, and then we can accelerate the cuts a little further, and so by 2014, we're down to a modest presence. I think that's doable.

And the good news is we are going to see, therefore, additional reductions in war spending each year. And by 2015, hopefully we're down to a very modest level. So we will have saved over 100 billion in the annual war budget by that point, maybe even 150 billion relative to what the peak had been last year. That's all as it should be.

On top of that, I think the base defense budget, the core, the peace time military establishment can get smaller and get smarter and more efficient. But let's bear in mind the constraints under which this has to happen.

President Obama, Secretary Clinton and Secretary Panetta have all been in East Asia recently, all have been underscoring at each and every turn that we are there to stay, in fact, that we're there to stay even more than people appreciate it before their trips; that we're not going to cut our military presence; that we're aware that North Korea is still a very severe threat, and that China, while a promising rising power, is nonetheless a rising power. Rising powers are dangerous, whether they want to be or not, it's almost in their DNA. I don't want to do a Bob Kagan imitation too much up here, but Bob would make this point very eloquently.

In history, any time a country rises the way China has, it is tempted to

use its new resources and capabilities and push others around and assert itself. I don't anticipate or favor a conflict with China, but it's very important that we stay robustly engaged in the region with our allies in order to sort of constrain China's growth in a constructive direction.

I think the strategy is working. We'd be foolish to pull back now just because our deficit problems have led us to feel that we can't sustain this. So we have to find a way to be still active in Asia, but do it more economically and in a more brutally efficient way.

And there are ideas out there to do this, and I'll just give you one very quickly which I wrote about last week in the newspaper, as well, which is the idea that I think today's Navy needs to do something that most sailors don't like and which would be challenging, and which some of my colleagues at Brookings have told me is harder than I want to believe, but nonetheless, I think it's doable, and it's the idea of having crews share ships. Let me explain. Today a ship is prepared in American waters for deployment. The crews train up, they sail across the ocean, it takes close to a month to do that. They go on station in the Persian Gulf or the Western Pacific, they spend about four months there, and then they turn around and come back and they lose another month in transit.

And meanwhile, because we always want to have one ship of a given type in either the Persian Gulf or the Western Pacific, we have to send another ship out, and there's an overlap in their deployments because the one sailing out before the other turns around and comes back to maintain continuous presence.

The bottom line is you need four or five ships in the fleet to sustain one on station the way we do things today. What I would submit is the Navy needs to do what it already has proven to be feasible in experiments, what it already does with

minesweepers: leave the ship forward deployed for one to two years, fly the crews to replace each other, and then they share a ship back home, as well, to train. If you do this, you get a lot of savings, and the number of ships needed to sustain that one on station.

I don't want to push the idea too far, because there are other reasons you need a certain size Navy. You might lose ships in a future war, for example, and an attrition reserve is necessary whether you do this rotation policy or not. But right now the Navy is out there saying we've got to add 30, 40 ships to the fleet relative to the current size of 284 major ships in order to sustain our global presence. That's not going to happen. Earth to Navy, it's not going to happen. And we need to find ways to be more innovative and creative. And with this kind of an approach, you can go below 284 ships and still sustain the kind of presence we have.

I don't say that in order to be harsh on the Navy. They're doing amazing things and I admire them, as we all do. The point is that even to get these \$400 billion or \$350 billion in 10-year cuts, you've got to do the kind of thing that I just mentioned, which is going to be uncomfortable, difficult and challenging for the services. And there are parallel ideas in other parts of the military. I won't go into detail. I'll just mention one more in passing.

For the last 20 years, we've had a basic strategy or a basic for sizing construct for the U.S. ground forces which has said we need to be ready for two major regional wars at once. We didn't always satisfy that requirement. And, in fact, in the last 10 years we did fight two major regional wars at once, and it turned out we had to make the Army and Marine Corps larger to do that. And even so, our troops really had to go the extra mile and then some.

So it's difficult to really scale back in a major way from that kind of

requirement. Nonetheless, in this new world, with Saddam Hussein gone and, therefore, Iraq no longer a looming threat the way it once was, I think it's time, as a matter of fiscal necessity, to go to a one-war requirement for the ground forces, and I call it actually a 1+2, one war plus two substantial stabilization missions, where the United States is one of several or many participating countries, but where the mission could last a long time.

And this could be Afghanistan post 2014; it could be Syria, or Libya, or Yemen, depending on how things go. If Kashmir becomes another flash point for a war between India and Pakistan, we could wind up with a stabilization and trustee mission there to prevent nuclear war in South Asia.

I won't go into all the kinds of details on these scenarios. But we've got to have the ability to respond, because these kinds of missions are potentially important and potentially beyond our ability to prevent whether we'd like to do them or not. And, therefore, my approach is a pretty brutal change in what has been seen as conservative force planning. Instead of two major regional wars at once, 1+2, one war plus two stabilization missions. And maybe the Army and Marine Corps shrink a little below where they were in the Clinton years as a result.

But even if you do that, you can't shrink them to small levels because the world is still dangerous. And some of these countries still have nuclear weapons or the potential for nuclear weapons, the potential to provide sanctuaries for transnational terrorism. We can't just wish these problems away because we're tired of being engaged overseas.

So what I'm trying to do is strike a balance here and I'll wrap up on this note. We've got to be brutally efficient and creative in how we challenge traditional ways of operating to be able to protect our core interests at less cost. But let's not pretend we can wish away those interests or wish away the missions. And the Western Pacific and

the Persian Gulf, which already receive most of our military attention, still require it.

One small note of disagreement with Secretary Schultz, if I could. Oil gets a huge subsidy because our military protects the Persian Gulf. And whether that's a formal subsidy in the tax code or not, it is a huge benefit that oil gets, which is one reason why I agree with Bruce that we should be increasing R&D in clean energy, because oil is getting a subsidy, in effect, of at least \$50 billion a year because of that military protection for the location where two-thirds of the world's oil reserves are still located.

But we can't wish away the fact that the Persian Gulf still has two-thirds of the world's oil reserves and that clean energy is not yet quite ready for prime time across the board. So we've got interests that are enduring. We can try to be more efficient in how we protect them. I think there are ways to do that and save 350, 400 billion over the next 10 years. I see no way to do that if you have to double the savings and double the cuts. And, therefore, I'm adamantly opposed to sequestration, and I hope this either doesn't happen somehow or that it's quickly softened and superseded by 2012 congressional action.

With that, I'm going to turn to my fellow panelists, see if they want to add anything at this juncture, and otherwise ask you to start preparing your questions for us. But any comments?

MS. RIVLIN: Let me just ask you a question, which is a factual question actually, about the effect of the end of the -- or the wind down of the war. Some military folks I've talked to say, you know, we lost all this equipment, we need to rebuild and modernize because of the war. Others say we've actually done a pretty good job of modernizing as we went and using the war funding to do that. What's right?

MR. O'HANLON: Well, I think that the equipment stocks have not been pummeled by the war, because where there had been specific needs identified, we tried

to address them, as you say, through the supplemental appropriations. Having said that, in broader terms, even beyond the war story, the Reagan buildup of the 1980s provided us a lot of new equipment, and, as you know, and I think you were very smart to do this as part of the Clinton Administration, you reduced defense spending and you disproportionately reduced procurement spending within that, because you realized we had stocks of new equipment that we could live off of for a while and spend less on acquisition for that 1990s period.

And the war supplementals have done nothing to change the fact that the Reagan era equipment is wearing out. And we can't, again, take the 1990s solution of simply deferring, because those same F-15s and F-16s, for example, are still in the fleet, except in the 1990s, they were 10 years old and now they're 20, 25 years old, and we've got to replace them, and the war supplementals did not replace that core stock of our military equipment.

MR. KATZ: Mike, just listen to -- I mean, I think it really gets to the point of what differentiates the defense establishment perhaps from the non-defense establishment and how it operates at the national scale. There's a level of planning, strategic planning, scenario planning that is going on, and there's the use of metrics that are continuously updated to inform that kind of strategic planning.

That does not happen with regard to what I would consider to be next generation economic growth models, right. I mean, we still don't quite measure things in the way we need to. And we clearly don't have, and this is something I think many of the President's private counsels have called for, we have really no long-term strategic plan. They've had to think about the growth policy, particularly given the fact that China, India, Brazil, et cetera, are totally online to many extents.

And someone said something to me the other day which was really quite

-- how many people in the audience have seen the movie *Moneyball* or read the book *Moneyball*? Right? So, this is a book that makes the point of -- well, it talks about the Oakland As and about how we used to measure things in baseball the wrong way and then we had this very interesting, intriguing character, Billy Beane, who found a new way to measure baseball performance and then applied it to the Oakland As and, *voila*, suddenly they were doing quite well.

I think we need to think post-recession the same way about the economy. And again, I focus on the city and metropolitan scale. Pre-recession we focused on consumption. How many different ways can we measure housing? We measured it. How many different ways can we measure retail? We measured it. When you try to measure exports at the local level, foreign direct investment, manufacturing and all of its complicated ways, trade and logistics, frankly we don't have the same kind of statistical base that we have with regard to the consumption economy.

So, I take from your military conversation this -- and it's not surprising, in some respects, but the way in which we've perfected a set of metrics, a set of performance measures, and a sort of an ethic of planning which we do not have on the domestic side and which we fundamentally need in a federalist way.

MR. O'HANLON: I'm going to ask you one question as we get ready to go to the audience. To give you credit and your program and some of your colleagues in the country, you have come up with certain specific recommendations and numbers.

MR. KATZ: Absolutely.

MR. O'HANLON: You already mentioned one today, which is where you think clean energy research could go.

MR. KATZ: Sure.

MR. O'HANLON: Could you give us another example, whether it's in

terms of infrastructural investment or some kind of encouragement or subsidy -- tax subsidy for economic renewal in cities or some area where you have actually done that analysis and you could, you know, highlight an example of what it could allow us to do?

MR. KATZ: Well, I think this is what makes this such an intriguing period, because if you think about the shift to a different kind of economy, it has enormous effects on infrastructure building and enormous effects on place-making. If you're going to shift to a more export-oriented economy, you have to have more advanced manufacturing, more advanced industry, and obviously more modern ports, whether they're sea, whether they're rail, whether they're air. If you're going to shift to a low-carbon economy you have to really think about the distribution and transmission of energy.

If you're going to think about an innovative economy, I think what Michael Bloomberg is doing in New York by trying to attract a Stanford or a Technion out of Israel, advanced engineering school, to the city sort of makes me -- shows that he's thinking very carefully about the interplay of density and innovation and so forth and so on.

So, we need a different scale of investment in infrastructure in the United States, but it can't be the old-style we're going to wait for the Feds to rain down name your favorite number, 50-, 75-, \$100 billion. It's got to be done in a public-private way.

And so what we've been working on increasingly, really, with the states and the metropolitan areas, because nobody's waiting for Godot and waiting for anything to happen at this level, is a new style infrastructure bank, green banks where there's a certain scale of public resources, but the goal is to leverage up private sector capital expertise to deliver this next generation infrastructure. So, it's both the size of the resources, but the manner in which the resources are deployed that has to change. And again, it has to be more distributed and diffuse, because I do think we may be entering a

century -- again, as Alice's book really telegraphed 20 years ago -- where the national scale has to scale back in its ambitions and the state and local scale have to scale up.

MR. O'HANLON: So again, I got to follow up because this, again, relates to the broader question about what's going on this week with the Super Committee.

MR. KATZ: Right.

MR. O'HANLON: To what extent is the failure of the Super Committee, as it seems likely, going to fundamentally get in the way of a lot of what you're talking about? Or to what extent is it just sort of one more confirmation for you and mayors and governors that you just shouldn't look to Washington and they'll get on with their private-public collaborations at a local level more or less unimpeded by this breakdown in Washington?

MR. KATZ: Well, the same way markets sort of already assume dysfunction, I think state and local leaders -- and I'm not just talking about governors and mayors because, you know, at the state and local level it's really governance as opposed to government. I mean, everything is sort of co-produced by corporate, civic, political, university, labor, and so forth. They've already presumed dysfunction in Washington and they already are changing how they function.

So I'll just give you one example which will sweep across many areas of domestic policy: transit. If you want to be a 21st century metropolis you need a 21st century transit system, interplay of commuter rail and light rail and rapid bus and so forth and so on to connect the hubs and the corridors and all the rest of it.

In Denver, they are building the largest light rail system in the United States, primarily funded with local money. In Los Angeles, the land of sprawl, they are dramatically extending out their transit system with smart land use and zoning, primarily financed by local revenue sources. They moved on. I mean, they're not expecting

Washington to get its act together. They know to compete globally they are going to have to make the kind of investments with their states and with their private sector to do so. They want a level of reform at this level, so that their presence and prominence in the global economy can be recognized and built on.

MS. RIVLIN: But none of this great stuff -- which I totally agree with and am enthusiastic about -- is going to happen if we have another recession.

MR. KATZ: Oh, absolutely.

MS. RIVLIN: And so they should be keeping in mind that if we don't get on top of the debt problem, we will be precipitated into a new recession. We don't know exactly when, but we could instead of gradually crawling out of this one be in a decade-long slump that would be much worse, and that would preclude just about everything.

MR. KATZ: No, Alice is absolutely right. I mean, I think this is why it's so critical to make the connection between the macro and the metro function because I do think that the metro areas and their states are where you have the pulse in the United States, both in the public and the private and the civic sectors. But if you lose sight of the macro needs that -- and then the platform doesn't exist to get this done.

MR. O'HANLON: Thank you. Well, let's go to you. Please wait for a microphone and then identify yourself. We'll start here in the fifth row. And then when you ask a question, please if you could direct it to one of us, if it's clearly for one of us, if you can.

MR. REUTER: Stewart Reuter, a retired submarine officer. I agree in principle with your comment of one forward deployed ship, however, having made 10 patrols with 2 complete crews per ship forward deployed; I see a problem in the surface Navy. A lot of ports don't let our nuclear ships in and in each of the areas you need to have a port for refueling, bringing aboard new chow, as well as shifting crews. And I see

some real problems with what you're saying.

I like it in principle, and we've done it with the minesweeps and the storm class PCs, but I don't think it will work at the aircraft carrier level.

MR. O'HANLON: Yeah, thank you, sir. And I agree that the aircraft carrier case is a different one and I should have clarified. My recommendations are to start with major surface combatants as the major next area of emphasis

Just so those of you who are not submariners or naval officers and don't follow this stuff as much know, there are about 300 people, typically, on a major surface combatant, a destroyer, or a cruiser. And so that's the class of ship where I think this idea is challenging and difficult and, again, my Navy and Coast Guard at Brookings have been reminding me of this in recent weeks and I accept very much their contention. And it's going to take a while to make it happen, even if we try to do it, because you're going to have to find the overseas ports where they can do more maintenance than they've been doing so far.

Now, as a matter -- and also, I concede that a smaller fraction of our maintenance will be done in American ports as a result of this. Maybe 5, 10, 15 percent less and, therefore, we're going to depend a little bit more on foreign partners. So, some people aren't going to like that in a time of economic downturn.

But the other point I'll add is it's going to take three, five, seven years to get to a situation where you can do this even for the surface combatants that I'm talking about, because of the kinds of issues you're getting at, and some people would probably challenge me and say even that is an optimistic timeline.

So, a moral of the story is, again, even if you're looking for big new ways to achieve cutbacks, it's going to take a while. And if you rush it too much, you also run the risk, in some programs at least, of contributing to the danger of recession because

you're pulling back on spending perhaps more quickly in some areas than we should. But from a military point of view, you also have to bear in mind the ground forces can't be cut back too fast because they're still heavily engaged in Afghanistan.

So anyway, I guess the moral of the story where I think we probably can agree is even if some of this happens, it's going to take a while and it's going to be hard and it's not going to be something you can just snap your fingers and make occur overnight.

Garrett.

MR. MITCHELL: Thanks. I'm Garrett Mitchell and I write *The Mitchell Report*. I want to make an observation which leads to a question. The observation is Bruce's comment about the light rail system in Denver.

MR. KATZ: Yes.

MR. MITCHELL: A situation with which I have some familiarity. The relevance here to the question is, Dick Lamb was elected governor in 1974 and was talking about these kinds of things and doing his level best to make them happen, and it's taken 30 to 35 years to get there.

So, here's the question.

MR. KATZ: Sure.

MR. MITCHELL: My takeaway from this conversation this morning is that if you could snap your fingers and have two things happen, you would have the capacity to cut smart and engage in devolution programs moving away from the Feds into the states. It strikes me that in order for each of those things to happen, you would have to have a radically different kind of political atmosphere and environment than we do today because what's engaged in cut smart and devolution, it seems to me frames the stark differences in perspectives about our politics.

So, I'm interested to know what steps -- what sequencing, if one can look at it that way -- do you see as possibilities? And is it correct to assume that that's apt to be like the light rail system in Denver? Something that's going to take us decades instead of years?

MR. KATZ: I think those are really very helpful and insightful comments.

Here's where I take to heart and why maybe we can accelerate some of this. And you're absolutely right; it took a long time for American cities and metros to understand the need to make these kinds of infrastructure investments. It's sort of a sign of, you know, how long these kind of paradigmatic shifts do take, whether it's regard to transit or advanced manufacturing or something else.

So a couple things that hearten me. I think the conversation coming out of the business community is quite different today than it was 5 or 10 years ago. Again, when you read the recent book by Andrew Liveris, the head of Dow Chemical, or you listen to what Jeff Immelt says, or if you listen to the tech community out of Silicon Valley, there seems to be a common prescription for growth coming from these tech and production-oriented leaders -- innovation-oriented leaders -- which gets to the kind of mix that I was describing before. Invest smart, invest in what matters, invest today to grow for the next 30 or 50 years, and that tends to be around innovation, R&D, infrastructure, and human capital. When all is said and done, it's those three things. So the fact that major business leaders seem to share the same perspective about what it will take to move forward is a platform for shift.

The second piece is the state and local level. There are obviously many partisan divides at the state and local level, and I don't want to be Pollyannaish about this, but I do believe that governors and mayors put place over party and collaboration over conflict. And when push comes to shove, what they do is strengthen the distinctive

strengths of their state, which come back to innovation, infrastructure, and human capital tailored to the economy of a Denver versus a Detroit or a Michigan versus a Colorado, right?

So, there is a pragmatic caucus out there. This country is rich in leadership in pragmatic, nonpartisan, bipartisan leadership. And what has to happen is this infecting of the federal class, which has become hyper-polarized and divided.

So, you know, I think structurally two things have to happen, and this gets to the history of how innovation happens in the United States in the public realm. The states are our laboratories; the metros are our centers of innovation. Whatever they do today, the federal government will be doing tomorrow. The more, even in a fiscally strapped time, we can get them to show the way forward across party lines, the more likely maybe we can repair the damage here.

The second piece is what I talked about before. Let's begin to have federalist super committees. I mean, this is a federal republic. We are like Germany; we are like a whole series of other countries around the world. We act as if these levels of government, even though they fundamentally interrelate, are completely separate and distinct. So, let's begin as we move forward around deficit reduction and growth to pull in the real pragmatic innovators from not just the political realm, but corporate, civic, and others. And that might begin to sort of heal, and not just heal but move us forward.

And again, you know, these cut smart, cut and devolve, these are simple phrases. They really do require the kind of profound shifts in this ossified, polarized realm.

MR. O'HANLON: Yes, ma'am. Here in the green shirt right there.

MS. BRANNAN: Kate Brannan, *Defense News*. While sequestration might be a dumb way to cut defense, is there a smart way to do it? I know in the Rivlin-

Domenici plan it calls for defense cuts that surpass what would be cut under sequestration. So, I'm curious if it's top-line number or the process itself that's so damaging for defense under sequestration.

Thanks.

MR. O'HANLON: Do you want to start with that?

MS. RIVLIN: Well, I rather think it is the mindlessness of the sequestration process which, even if the top-line number holds, I would hope that the details don't and that they begin thinking about some of the things that Mike has talked about as more sensible ways of cutting.

Well, leave it there.

MR. O'HANLON: Yeah, and I think to me it is the magnitude as well as the way in which it would happen. One of the problems -- and I should have linked this to the earlier discussion on swapping crews on the navy -- one of the problems with sequestration is, of course, cuts have to be so steep in 2013, and so you don't really have an opportunity to phase things in. You just have to do things abruptly, which probably means laying people off and other things that I think are risking the bond we've established with our men and women in uniform and also more broadly with smart defense planning, but the magnitude of a 20 percent reduction in the annual budget. So in other words, whatever it is today it would only be 80 percent as great by the end of the decade. That's too much as far as I can tell.

And I've got other ideas in the book, and they include, for example, reform to military pension and health care approaches, not in anything that would take money away from our wounded warriors. And I'm sure we all agree, if anything, we need to do even more for them. But for the middle-age retiree who, God Bless him or her, has served our nation very well, but they're off to a new career. Their earning potential is

great, and they're still getting a very generous military pension. Meanwhile the private 1st class who did one or two tours in Iraq and Afghanistan and then leaves the military gets no military pension whatsoever. I don't like that system. I think there are ways to reform that system, make it more fair and more economical and spend a little bit less. On the other hand, is it really right to be asking anybody in uniform to accept reductions in their benefits when we are so feverishly protecting every other entitlement that the rest of the country enjoys. And so part of the question here is one of fairness; you do better in budget reduction when you have a sense of shared sacrifice. And so it really troubles me that sequestration also targets defense and Bruce's budget disproportionately and leaves essentially untouched entitlements and tax policy. That's unfair, and it's not a smart way for us to shore up our longer term national security. So I have problems at every level with sequestration.

MS. RIVLIN: But in the end, after we've done the efficiencies and after we've reformed the personnel pension systems and health care, the real question is what role do we want to play in the world and are you correct that we should be prepared to have one major regional war and two other things that we're doing at the same time? The question of how much we want to spend on defense comes down to that in the end. There are a lot of efficiencies between here and there, but that's the big question we ought to be talking about.

MR. KATZ: I agree. In my book, I make a full-throated defense of protecting the interests that we currently protect. I don't see -- you know, a lot of people think we're wasting a lot of money, let's say, in Europe. We're not wasting money in Europe. We have only 75,000 troops and in most of the places we have people, the Europeans have built the infrastructure up over the years and the costs of being there are not notably greater than being here with the same forces. So you get savings by cutting

back on the size of your military. The military is sized primarily for these potential regional contingencies -- in the Western Pacific potentially against North Korea, potentially against Iran or in the broader Persian Gulf region. I don't see any way to responsibly reduce our commitment to those regions. And so while there may be more modest ways -- for example, in the Mediterranean we've cut back a lot in the Mediterranean. We might be able to cut back a little more, although, of course, we've all watched the Libya operation unfold this year where the U.S. role was nontrivial. It was a support role, but it was nontrivial. So I acknowledge there is some room for debate about -- there's plenty of room for debate, but I tend to think that the interests that we're defending justify continued defense, and they're important. They're inherent in many ways to our global economic system and to our security interests. So I would stand by then and look for ways to be more efficient and economical in how we protect them. But Alice is right. If you have to go deeper than that, then you've got to have a more fundamental revision about which interests you're willing to protect less and maybe gamble more with. Yes, sir?

SPEAKER: Greg Kiley with CSIS. I wanted to stick on that point for just another second, Michael. There's an argument that we are still business as usual even with the \$450 billion. You said that you've already seen the cuts. The cuts are already taking effect. The last Chairman of the Joint Chiefs on his last day said that the \$450 billion was across the board. He wouldn't have done it that way if he was in charge. But it was his last day so he was moving on.

We really haven't faced the tough choices; I'll give you two quick ones: Depots -- we have 17 public depots. It's a \$60 billion infrastructure. We're not really tackling that. We don't have the political will. Commissaries -- everyone that's ever done a study from CBO on from the beginning when I was there, too, said that's a wasteful

entitlement program that can be done so much cheaper. We don't have the political will to tackle these yet. I don't see the 2012 or the 2013 is really a serious budget yet to start tackling. So maybe sequestration is the forcing function, I mean sadly.

But I guess we'll want to take your thoughts on are we still currently in business as usual? I don't see the political will on the Hill to really tackle these tough issues.

MR. O'HANLON: I'll say a brief word. Alice may want to comment as well. You mention commissaries. My recommendations essentially eliminate them. Again, I'm not going to -- I'm surprised nobody's thrown anything at me -- but again, to get to \$400 billion in 10-year cuts -- and again, \$350, \$400, \$450, depending on which baseline you use -- what was mandated by the August part of the debt deal. To get to that level of savings, you've got to do the kind of things, Greg, that you were mentioning on top of all the other things I mentioned today. There is not \$400 billion in easy, identifiable waste to just scalpel off the defense budget, no matter what some people want to go around town claiming. There may be that much waste in the defense establishment, but it's marbled into the muscle in such a way that it's going to take a lot of effort to get it out. And so in the process, if you have to cut in the short term, you're going to actually have to make some really tough decisions about capabilities and about these sorts of benefits or programs or usual ways of doing business. I think they should happen. I'm in favor of the \$400 billion in 10-year cuts. I'm just not in favor of the sequestration. Alice, over to you.

MS. RIVLIN: Well, you're absolutely right. There are a lot of these things we've all talked about for a very long time. I left the Congressional Budget Office in 1983, and I have a sense of déjà vu. We did reports on a lot of these same things, and they have not happened. It's very frustrating.

MR. KATZ: My comment is there are these analogous -- you go into any state, particularly in the Northeast and the Midwest, and you have thousands of municipalities that all duplicate services. And I think what is happening in these states is the fiscal situation is so dire that the initial phase is let's consolidate services and back off all the rest of it. People like their municipalities. It's like they like their high schools. So let's not get rid of any of that. But there is a way to drive enormous efficiency through this consolidation approach, and I do believe that that's going to be one of the legacies of this prolonged recession. We may call it a recovery, but out there in the country it's a prolonged fiscal recession because it's just kicking in right now because of the property taxes and the sort of depressed amount of demand. So I think we're about to see a level of reform on the domestic side outside of this town, which is going to be quite remarkable. And it's finally allowing for the politics to catch up with the evidence.

MR. O'HANLON: And there are elements of hopefulness in this conversation even if we have a generally tough subject. Yes, sir, in the fourth row.

SPEAKER: Hi. I'm from Johns Hopkins University. I have one question for Director Michael and one question for Madam Alice. For Michael, I'm interested in this 1+2 formula. My question is how are you going to define a stabilization mission vis-à-vis war difference? Are there differences in terms of whether sending ground troops or not and also in terms of budget preparations?

My question for Madam Alice, I have seen some reports -- I'm new in town -- I've seen some reports about millionaires going to the Congress, asking to tax me more, and earlier before that billionaire Warren Buffett -- think it was him -- said that rich people had been coddled. Why do they do that and why do they say that? And is it going to produce any effect in terms of influence in the Congress' decisions on the budget cuts?

MS. RIVLIN: I think this is something -- you raise something of a quandary. It's absolutely true that the income distribution has gotten much more unequal over the last couple of decades -- actually longer -- but particularly recently when incomes have been growing slowly if at all and lower income people have been falling behind over quite a long period and the top 1 percent have been just making out like bandits. And so it's very tempting to say let's go after the top 1 percent. The question is how to do that. Whether you have surtax on millionaires or Warren Buffett's idea was actually quite limited. It was make sure that people at the highest incomes pay at least the average tax because much of his income is capital gains, dividends, and carried interest, all taxed at lower rates and that seems outrageous. All that's true, and I'd be happy to see both the Buffett rule and surtax at the very high end, but it doesn't solve the budget problem. The best way to solve the budget problem on the revenue side is thorough reform of the income tax, which would allow actual lowering of the rates -- you could still have surtax on millionaires -- and raise a good deal more revenue in a more progressive way. Because what the progressives generally fail to recognize is that the loopholes, the special provisions, the exclusions, et cetera, go very differentially to the upper income groups. So I would be -- I favor a drastic reform of both income taxes. We had one in Simpson-Bowles. We had a slightly different one in Domenici-Rivlin, but the idea is the same -- get rid of almost all of the exclusions and deductions, et cetera, broaden the base, lower the rates, and you'll have a more progressive income tax and more revenue.

MR. O'HANLON: On the 1+2 concept for sizing the ground forces -- and let me emphasize this is for primarily the ground forces because the Navy and the Air Force do need to think also about Western Pacific, Taiwan, Korea, and maritime contingencies as well as Persian Gulf contingencies where they could have operations

separate from the sort of things I'm talking about with the ground forces. The one war is sort of a big regional war, not unlike what we've been planning for the possibility of another North Korean aggression for many years, not unlike Operation Desert Storm or Operation Iraqi Freedom. But I guess because I have just listed several different conflicts of very different characteristics, one thing we have to bear in mind is we can't be too precise in our image of what future demands we're going to place upon the American military. And we need some cushions and some margins for error. And so when I talk about those two stabilization missions, I'm thinking notionally about a mission in which the international community, collectively under U.N. authorization, gets involved as part of a large multinational operation perhaps led by NATO, perhaps not, where the U.S. role is not unlike what we did in the Balkans where we provided typically a third of the ground forces. And I'm separating that from a place like the current operation in Afghanistan where even though there is a stabilization quality to it, it's also largely an offensive military campaign, and the U.S. role is predominant among the foreign powers. And so for the one war that I'm still focused on, the most likely candidate is Korea, North Korea. There are other possible cases as well, but that's the most likely. The stabilization missions I'm thinking of as just one example might be, let's say for example, that the Syrian looming civil war becomes just that and gets much worse. And finally let's just say hypothetically Assad flees, and he leaves the place in chaos. And that point, perhaps acting in collaboration with various actors from Syria itself, we authorize under U.N. auspices an international mission with the cooperation hopefully of some Syrians, but also with the lack of cooperation from others to go in and help stabilize the place. And that's going to be something that's not a full-bore war, but is going to be much more than a classic U.N. peacekeeping operation. That's the notionally sort of thing that I believe we need capacity for, not because I expect them to happen, not because I expect two to

happen at once, but because force planning has to allow for sort of the reasonable worst case.

Here in the second row, please.

SPEAKER: John Reveal from the Citigroup Research. I'm just kind of wondering what the next steps are. Where do we go from here? Is this something that is reflected -- the sequestration, that is -- in February's budget proposal? Is this an overhang throughout the election year where maybe some more panels are being created? Or is this something that's just kicked until late November 2012 after we have a new "governing mandate?" And this is all said with knowledge of the President and Senator Reid both saying that we're not legislating around sequestration; this is a commitment mechanism we put in place. So with all that in mind, I guess what's next?

MR. O'HANLON: Alice, do you want to start that and then maybe Bruce?

MS. RIVLIN: Remember the sequestration doesn't kick in until 2013. And I don't know what the answer to your question is. I think it's going to be very difficult for the administration to put forward a 2013 budget in the face of this. I would expect -- no inside knowledge on this -- that they would say here's a better thing to do in 2013 than sequestration. But the next moment I think -- there'll be two -- one is there's a lot of unfinished business that has to be taken care of that could have been folded into the super committee. That includes the alternative minimum tax and the so-called doc fix as well as extension of the payroll tax and other extensions. Something has got to be done about that stuff, and it's expensive. It's all expensive. It will add to the deficit, and that's why it's such a shame you can't fold it in. And I don't know what they'll do. I think some things will move forward and some won't. But the big moment is likely to be after the election but before the end of the year -- no matter who wins -- are the Bush tax cuts extended and if so, under what conditions and what do they get for it.

MR. O'HANLON: After the election and before the end of next year?

MS. RIVLIN: Right.

MR. KATZ: I think that lame duck period is going to be the crucial one for the tax calls.

MR. RIVLIN: Right, and you may or may not have a lame duck president, and you may or may not have change of control on the Hill. So it's all very uncertain.

MR. O'HANLON: Bruce?

MR. KATZ: I think from our perspective -- state, metro, local, across many sectors -- it's time to enter the conversation, and it's time to basically put forward what a cross-section of folks across both sides of the aisle would perceive as the next federalist compact. I mean, we see where Washington is going. The 2012 election will not resolve that. So what's the new compact, whether it's along the lines of what Alice suggested 20 years ago, which is still unbelievably relevant today whether it's at least if you're going to start cutting in this sort of across-the-board way, let's completely re-imagine the way a whole host of federal programs are designed and then executed by the folks who actually have to execute them.

You know, when I was chief of staff at HUD, my boss, Henry Cisneros, would say, every week, we don't build one home in this country, right. It's all delivered through this distributed network of public housing agencies and private sector developers and nonprofit community development, corporate -- they're the experts, they're the practitioners. We should be basically flipping the pyramid and having our programs or our policies be in the service of the folks who actually deliver all of this.

That's the kind of aggressive stance, I think, that an increasing number

of leaders in this country, sub-national, are going to have to take because they are the innovators and they are the pragmatists and, you know, I think that kind of stance actually could begin to inform the presidential debate and, frankly, could inform the governing that happens post 2012.

MS. RIVLIN: I don't want to discourage Bruce for a minute.

MR. KATZ: Right.

MS. RIVLIN: But this book that he is referring to, which I agree is more relevant now than it was 20 years ago, came out in 1992. Bill Clinton loved it, but he was governor of Arkansas.

MR. KATZ: Right.

MS. RIVLIN: And the first conversation we ever had in Little Rock was about how great he thought my book was. His interest faded as he became President of the United States. He had a different agenda because he was President and presidents, generally, are a little leery of turning things over to sub-national government.

MR. O'HANLON: Yes, ma'am, in the fifth row, I guess, or sixth. Please identify yourself if you don't mind.

MS. IRVING: I'm sorry, I'm Susan Irving. I do the doom-and-gloom show at GAO: long-term fiscal outlook and debt management.

MR. KATZ: Uh-oh.

MS. IRVING: I hate to pour a damper on all this glowing praise of the governors and the pragmatic caucus and maybe it's because the governors I watch most closely are in Virginia and Maryland, where I don't see all this in place of hard party stuff, but it seems to me that governors are always in favor of federalism until there's a hurricane, there's too much crime, there's a natural disaster, there's a court order to stop double bunking prisoners. You know, everyone in Louisiana is in favor of small

government, but last I checked, the federal government was keeping that state in business --

MR. KATZ: Right.

MS. IRVING: -- for the last five years. So, I'm a little suspicious of this sorting out, which is actually fundamentally non-American. I don't mean un-American, but if you look at American history it's not revolutionary, it's incremental.

So, I'd like to know -- not to mention I don't see any of this sorting out solving the drivers of the aggregate in the long-term. The thing we have to remember, as someone once said, that all of American political thought can be summed up in two sentences: Get the government off my back; there ought to be a law, preferably with a grant attached. So, how exactly do you envision seeing this conversation start at the same time we try to do something about taxes and health are?

MR. KATZ: Yeah. I probably disagree with your premise. I think there already is a sorting out happening in the United States.

MS. IRVING: (inaudible) liking that.

MR. KATZ: No, but it's a workaround. I mean, you know, what's going on at the metro scale, and frankly what's going on in a lot of states, and it's not across the board, there's not going to be one place that is doing all these things either at the state or metro, but they understand that they have to make some tough decisions to get back on a growth trajectory and they don't understand that their economies are particularly distinct. They can all desire to be Silicon Valley; they're not.

Some are advanced manufacturing platforms, some -- I mean, I was just in Nevada last week -- are essentially consumption economies, right, that need to diversify. But I think what you're going to see in the next three to five years, and you already have seen in state after state after state, is making the kind of targeted

investments in those infrastructure or cluster or higher ed areas that really relate to what they do best.

It's ugly ball because as they're doing those things, they're also cutting other things, right, so this is never perfect, but I do see a level of focus and discipline with regard to a certain segment of what can be considered transformative investments happening across the states and most of it is a workaround.

They haven't got to the point where they're just taking what has become a workaround and saying let this just be the norm now, okay, because that's a radical thought and it really says that the last 30 to 50 years of federal expansion needs to be radically rethought, not just with regard to entitlements, but with regard to a whole set of discretionary programs.

I think that will happen in the next -- I mean, I think that is going to happen and at a minimum what you'll see, probably, is a return back to what Nixon did in the early '70s and then Ford, you know, sort of completed and Reagan did more, which is the block granting and the consolidation and the stream -- I think that's coming, at a minimum, because you have so much accretion of special programs across so many areas of domestic policy, you need to be a rocket scientist to make any sense of this at the local or state level.

I mean, you know, the legacy government cleanout is coming, but it may also shift into this much more dramatic realignment with all the caveats that Alice said about President Clinton. It may move to that because people are frustrated out there.

MS. RIVLIN: I hope Bruce is right, but to come back to the deficit problem, remember, it's not discretionary spending that is driving the deficit.

MR. KATZ: Right.

MS. RIVLIN: It's not defense spending either. It is the entitlements. And

until we get on top of that, and I believe this tsunami of retirees is going to require both some reduction in the rate of growth of entitlements and new revenue -- until we get on top of that we have this thing hanging over our heads that we know is going to damage the economy sooner or later.

MR. O'HANLON: Thank you. Next question. Over here on the side.

You, sir.

MR. FARMER: Nick Farmer, retired citizen. This is for Bruce. It seems to me at the state and local level there are two big problems that you haven't mentioned equivalent to the entitlement and revenue or tax issue at the federal level, and that's public employee pensions --

MR. KATZ: Sure.

MR. FARMER: -- and public education.

MR. KATZ: Right.

MR. FARMER: Can you address those two?

MR. KATZ: Yeah, I think those are -- and, again, you have 50 states, which we might as well just presume are 50 different countries, and the question is just how bad were their bad habits, right? And that's really the only issue.

I was in California, real bad because California has become something like a plebiscite democracy as opposed to a representative democracy; no one's really in charge anymore in California. So, there's -- everyone should read this piece that Michael Lewis did in *Vanity Fair* recently about the overextension of California government and the crazy sort of liabilities that they face on the local on up.

I think, you know, my sense is in state after state, the rules of the game vary, but what you're seeing are governors beginning to try to get a hold of the major, you know, cost drivers.

Michigan, take an example, Governor Snyder was able to push through an emergency financial management law last year. He's now appointing emergency financial managers to Flint, to Pontiac, probably to Detroit. And they're going to have to first and foremost deal with these pension liabilities and begin to reorder and restructure.

The second issue that you mentioned is K-12. K-12 is sort of a mix of need for investment but need for radical reform, right. And what we've had, literally, in the last 20 years is the kind of distribution or expansion of responsibility for schooling, you know, through charters, through the public housing innovation zones. It's been a really interesting period, right. We haven't had it with a good portion or a whole number of other areas of domestic policy.

Schooling has really been opened up in the United States, but not uniform across the U.S. Right? And so, I do think what's happening at the state level is this war about how competitive we should make schooling. I mean, how much should we open up the system? Still have accountability standards, still have performance measures, but really allow for a much more dramatic distribution of, you know, the approaches.

I mean, the one thing about the states and the cities and the metropolitan areas, someone is doing something, right, to deal with the kind of systemic issues that we have. They may not be doing everything across the board, but if you want to find an example of state of the art innovation, you can find it.

And then the way we operate now, frankly, is less as a top-down society than as a bottom-up society, where innovation spreads virally through the private marketplace and through the political marketplace, primarily now as much by social media as by traditional media.

So, I actually do believe that we do have a group of leaders, not

uniformly, that understand what their systemic challenges are. There's a bunch of vanguard innovators out there, right, they are basically showing the way forward. And the viral kind of cycle we're in now where innovation is identified and then replicated and disseminated at almost warp speed is beginning to kick in.

That's probably a much more optimistic view than the Washington environment, which still has more top-down, more hierarchical, more emblematic of a 20th century than of a 21st century. So, I may be delusional, but I hope I'm not.

MR. O'HANLON: Okay, let's have two last questions together and then we're going to take our responses collectively and wrap up. So, the woman in, I guess, about the eight row, and then the gentleman right behind her diagonally. We'll take those together.

SPEAKER: This is for Ms. Rivlin. My name is Rachel Bane, I'm with B&A. Could you just talk about, assuming the failure of the super committee, the prospects for the unemployment insurance, tax extenders and payroll tax cuts?

MR. O'HANLON: Great. And then, sir?

SPEAKER: Thank you. Danny (inaudible) with Xinhua News Agency. My question is that how big you think would be the chance for the inaction and the political dysfunction lead to another credit downgrading from another major credit rating agency and how big would be the financial market reaction? Will that be strong enough for politicians in D.C. to carry out a great bargain? If not, what signal would be strong enough and would be the best timing? Thank you.

MR. KATZ: Would you like to start?

MS. RIVLIN: Sure. I don't know what will happen on the payroll tax extension and the unemployment. I think there may be a majority for extending those. It is very desirable in terms of not taking bigger risks with the economy right now and

whether there's a majority of the Congress that understands that or not, I am not sure, but it's certainly harder to do now that we've had the failure of the Joint Select Committee.

Downgrade, I think New York would take a downgrade very seriously, I don't think Washington would, and rightly so. Standard & Poor's and the rest of them, they don't know anything more about the federal budget than we do. The last downgrade didn't have much effect, main reason being the world still believes that we are the -- that U.S. Treasuries are the safest investment there is and I think we have to be even more dysfunctional than we are, and we're pretty dysfunctional at the moment, to dissuade investors from that view, and Europe looks worse. So, what else do you do with your money?

MR. KATZ: You know, there was an interesting post this morning by Ezra Klein about the failure to move forward, you know, with the payroll tax on unemployment because that obviously is going to have an effect on growth. It goes back to your point, the interplay of what is perceived as a deficit reduction kind of conversation and the growth conversation.

You know, I think we're in the middle of some kind of lost decade in the United States where the recovery is just going to be anemic, whatever happens on the private side will be sort of counterbalanced by what happens on the public side and that will be scaled back. And this kind of crisis is going to, in my view, actually generate more innovative kind of responses at the state and local level because the more growth is sluggish, the more the citizenry expresses their levels of concern and insecurity, the more the local and the state political class have to respond and they have to respond both to clean up the fiscal mess that you referred to before, with regard to pension liabilities and so forth and so on, but they also have to respond with a clear vision for growth going

forward: job creation in the near-term, broader, more productive innovative growth for the long haul.

And so in some respects, you know, this constant dysfunction of Washington is going to get the juices flowing elsewhere in the country. And I don't -- you know, but you can't dismiss the kind of cataclysmic kind of environmental effects of this, but it does send a signal to a lot of folks out there, political but also corporate, civic, and we're on our own, we better get control of our destinies to the greatest extent we can.

MS. RIVLIN: That's a silver lining, but it's a silver lining to a very dark cloud.

MR. KATZ: Oh, absolutely. Right.

MS. RIVLIN: And I don't think there's anything fundamentally good about 9 percent unemployment or the prospect of its getting worse.

MR. KATZ: Oh, absolutely.

MR. O'HANLON: And I'm going to pile on the sequestration scenario with one last closing comment of my own to link this to Afghanistan, and some of you may say, well, we all know even if sequestration kicks in it's not going to cut war spending, that's essentially treated separately, for better or for worse, but sequestration is going to have to look for deep defense cuts across the board and a lot of people are going to say that has to apply to the ground forces.

The ground forces are not yet ready to be substantially reduced because we've got a couple more years of sustained effort in Afghanistan that I think are necessary. It's a tough operation, it's a messy place, but I'm going to leave you with two words of hopefulness about Afghanistan if we stay patient: one is that in the last year, violence initiated by the enemy has declined 25 percent, if we're looking at the summer/early fall period of 2011 versus the summer/early fall period of 2010.

Now, the country as a whole hasn't yet really internalized or believed that life is getting more safe and stable and other kinds of violence, like from crime, may still be holding their own or going up a little bit. So, I'm not saying we've turned a corner fundamentally, but that is a hopeful sign.

Also, the Afghan army and police, as I repeatedly saw and heard and saw evidence about in my trip last week, the Afghan army and police are getting better, but they're not big enough yet, they're not experienced enough yet. They've got a lot of problems and if this were an event on Afghanistan I would talk about them in greater detail, but they do fight and they stand up for their country and they hold together as units, but they're not ready yet. We're going to need a couple more years of sustained effort. Once we're done with that, two to three more years, I think we'll wind up in an okay place in Afghanistan.

That's all I'll say for now. Probably not a great place, but not a terrible place and not another land that's prone to terrorist sanctuary, but again, sequestration gets in the way of that scenario because it cuts ground forces, probably, as well as everything else, by 2013 and that's too soon.

So, just one more way to take a shot at this scenario that, unfortunately, seems likely to unfold, at least in its initial steps, in the coming days.

Thank you all for being here and happy Thanksgiving. (Applause)

* * * * *

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.

Carleton J. Anderson, III

(Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2012