

THE BROOKINGS INSTITUTION

FALK AUDITORIUM

ARE THE SPENDING CAPS SUSTAINABLE?
DOMESTIC AND DEFENSE BUDGETS
THIS YEAR AND BEYOND

Washington, D.C.

Friday, January 16, 2015

PARTICIPANTS:

Moderator:

DAVID WESSEL
Director, The Hutchins Center on Fiscal and
Monetary Policy, and Senior Fellow, Economic
Studies
The Brookings Institution

Panelists:

RON HASKINS
Senior Fellow and Co-Director, Center on
Children and Families
The Brookings Institution

ROBERT F. HALE
Senior Fellow
Booz Allen Hamilton

MICHAEL O'HANLON
Senior Fellow and Co-Director, Center for 21st
Century Security and Intelligence
The Brookings Institution

ALICE RIVLIN
Senior Fellow and Director, Engelberg Center
for Health Care Reform
The Brookings Institution

* * * *

ANDERSON COURT REPORTING
706 Duke Street, Suite 100
Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

P R O C E E D I N G S

MR. WESSEL: Good morning. I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy here at Brookings, and I'm very pleased to be here today to discuss something which is in the category of really important and hard to understand, which is the caps that Congress and the president agreed to on domestic and defense spending.

Now, I'm going to give a little bit of an introduction, and I'll introduce the panel and we'll take it from there. You should know that C-SPAN is in the room, so if you fall asleep, your mother will see it (Laughter), so don't. And if your cell phone goes off, they'll like put one of those hearts around you, like they do at the ballgame.

SPEAKER: I used to get them.

MR. WESSEL: (Laughter) It's especially too, if you're on the panel. So, the history in the plumbing of all of this is complicated and packed with acronyms. The BCA, the BBA, the OCO, and jargon that only people in Washington could invent. Sequestration, CHIMPs, authorization appropriation. But it doesn't need to be that complicated.

When the next fiscal year begins on October 1st of this year, lawmakers have to pass a new set of appropriation bills or extend existing appropriations through a continuing resolution in order to avoid a government shutdown. And because of a budget control act passed in 2011 and the failure of a congressional super committee, there are now legal limits on spending; annually appropriated spending that were signed into the law by the president.

And although they were altered for 2013 and 2014 by the Ryan Murray Compromise, they are in place. If Congress tries to spend too much money, there's a system of across the board spending cuts that will ration spending down. Now, it's really

important to remember that we're talking about caps on annually appropriated spending. That's roughly a trillion dollars a year; roughly a third of the federal budget.

It's the stuff that funds the salaries of the park rangers, the gasoline and the bullets for the Army, the grants to state and local government. It does not include benefit programs like Social Security and Medicare and Medicaid and interest on the debt. They're not subject to the caps. And because nothing is ever simple in Washington, we'll talk about this when we get to defense, the caps don't apply to the money we spend in Afghanistan, and now that we're back in Iraq, in Iraq.

Our focus today is the ceilings that apply for the years going forward, from the fiscal year that starts October 1st, FY-2015, through 2021. For this coming fiscal year, the caps are only about \$2 billion higher than for the current fiscal year, without any allowance for inflation. That's about -- it would take about \$17 billion more to keep up with inflation; \$44 billion more to keep up with the growth of the economy.

And some people, most of them Republicans, think that's just fine that they want to shrink government. And other people, most, but not all of the Democrats, think this is nuts; that we're squeezing that part of the federal budget that includes almost everything you can consider an investment in the future. And some people, including some of the panel here, say it's a little hard to say whether we're spending too much or too little without asking, well, what is the money going for. And that's not something that the caps tell you. The caps are a level. Congress punted the decisions on what to spend more on and less.

I think it's important to remember that the caps have had an effect. People often think, oh, Congress does this, and then they evade it. But in this case, it's not true. The caps have constrained federal spending, perhaps not as much as they initially were intended to. They did play a role in the shrinking of the budget deficit, which

has come down quite a bit, and they, in my opinion, contributed to a premature tightening of fiscal policy when we were still suffering the after-effects of the Great Recession. But that's the past.

There is no question that the caps will be tougher and tougher for Congress to live with over time. Although they'll increase by about 2.4 percent a year over the next 5 years, that's roughly enough to compensate for inflation; not enough to compensate for population growth, or the growth of the economy, or what I sense is public demand for various programs to help the middle class, or whatever.

If the caps hold, and if current spending trends continue, CBO projects that 85 percent of the increase in annual spending over the next decade will go for Social Security, major health care programs and interest, which are not constrained by the cap, which are largely on auto pilot, and the pressure will come on that remaining slice of federal spending.

And as a result of that, measured against the size of the economy, that annually appropriated domestic spending will shrink, because the share of GDP, to levels we haven't seen in 40 years, and the level of public investment, domestic public investment will shrink accordingly. Now, with all that's going on in the world, the unrest overseas, the security threats at home, the struggles of the middle class, the difficulty of maintaining our infrastructure, Congress may decide that these caps sounded good, but they're just too hard to live with.

And without getting too mired, I hope, in the parliamentary detail, our goal here today is to take a close look at the economics and the politics of these caps; on why they matter, on what the money goes for, and what Congress is likely to do about them. And I'm fortunate to have really, a very experienced and excellent set of panelists here.

At the far end is Michael O'Hanlon, who is a senior fellow here at Brookings, co-director of the Center on 21st Century Security and Research. He's written several books, most recently one with Jim Steinberg on the U.S.-China relations. In his distant past, he actually worked at the congressional budget office. So did Bob Hale, who left the congressional budget office and went on to worry about even more, bigger numbers.

He was for five years, the undersecretary of defense and the comptroller at the Pentagon. That means he had a \$600 billion checking account to worry about. He's been the assistant secretary of the Air Force for financial management. He's spent time as executive director of an organization I never heard of before, the American Society of Military Comptrollers. And I bet that Christmas party was just wild and crazy (Laughter). After a distinguished career in government, he left the Pentagon in 2014, and is now at Booz Allen.

Next to him is my colleague, Ron Haskins, who is co-director of our Center on Children and Families, a senior consultant at the Annie E. Casey Foundation. He spent 14 years on the staff of the House Ways and Means Committee, where he played a key role in welfare reform, and spent some time, but less than a year for reasons I don't -- you can ask him about, in the George W. Bush's White House. His most recent book is a very interesting one. It's called show me the evidence. It's about President Obama's fight for rigor and results in social policy.

And last, but certainly not least, is Alice Rivlin, who if I read her resume, we'd be at 11:30, and I won't. She's now director of the Engelberg Center for Health Care Reform here at Brookings. She is, of course, the founding director of CBO, which is celebrating its 40th anniversary, a former director of OMB for Bill Clinton, a Vice Chair at the Federal Reserve. And relevant to these conversations, she is a fixture on every

single commission that we create to do something about the deficit. But fortunately, Alice, we don't judge you by the results you get (Laughter), just by the quality of the work.

MS. RIVLIN: Oh, you should judge by the results right now (Laughter).

MR. WESSEL: Right, okay. Yeah, cyclically adjusted.

What we're going to do here is, we're going to start -- I'm going to talk with each of the people up here for a while, and then, we'll obviously have time for questions. And because we want to do both defense and domestic, we're going to alternate a little bit.

But I'm going to start with Bob Hale. And Bob, I wonder if you could -- just for those of us who don't live and breathe the defense budget, which is now the people in the American Society of Military Comptrollers, but the other 99 percent of us, what's been happening to the defense budget over the last four or five years? What is the historical circumstance which we find ourselves now?

MR. HALE: So just for the record, that job was probably the most fun one I had ever had with training.

MR. WESSEL: That says something about your other one.

SPEAKER: Yeah.

MR. HALE: (Laughter) It probably does say a lot about me.

SPEAKER: It's an unfortunate thing to say (Laughter).

MR. HALE: So, the defense budget peaked in fiscal year '10. Since then, it has been coming down, the total budget down by about 25 percent after adjustment for inflation. The base part of the budget excluding wartime funds down about 15 percent.

In fairness, it went way up in the first decade of this century, after 9/11, and the cuts have not offset all of that gross. So, think of a sharp climb up a hill, and then

in the last five years, we've come down maybe half of that distance.

The numbers may be useful as context. I'd argue strongly that they don't say a lot about what you want to do in the future. That should be a risk cost trade-off that I hope we can talk about more later.

MR. WESSEL: And so, explain for a minute though, how it is that we have this big defense budget, but then when we fight a war, we have to load on more money to fight the way. That's part of the increase. Right?

MR. HALE: Well, the increase is partly to fight the war, but there was a fair increase in the base budget, as well. Many argued that we weren't at the end of the Clinton administration, spending enough to maintain the size of the military; to modernize it, to maintain infrastructure. So, war costs certainly played a big role in that sharp walk up the hill, but there were substantial increases in the base budget, as well.

MR. WESSEL: Okay, so look ahead. Where are we going?

MR. HALE: So in two weeks; a little bit more than two weeks, we'll get the president's budget for fiscal '16. I don't know. I'm out of government, for sure, what it will be, but I anticipate that the president will propose funding above those cap levels that David discussed for both defense and non-defense. Probably 30 to 40 billion in defense.

If they do that, I think there are broad ways Congress could respond. By far, in my mind, the least likely is that they could appropriate at the higher level, not change the caps. That would trigger a formal sequestration next January. And I might add, we use that word loosely, but that's the only thing that constitutes sequestration; the automatic cuts if they appropriate above the cap.

I think that's the least likely. Two other scenarios in my mind, are more likely. One, they could leave the caps, because that will be a tough political lift to change them, but bring the president's budget down to the cap levels. In that case, the agencies

will end up with sequester level budgets, but at least we would have made considered decisions about how to get down to that level.

And the last outcome, and the one I hope happens, is that we see another budget deal; probably a mini-deal along the lines of the two that we saw. There was one in 2013, and another -- 2012, I should say, another one in 2013. The last one was the Murray Ryan deal that David referred to, that raises the caps at least to some extent, and then appropriates at that level.

So that way again, they consider decisions, but as we get into this more later, I at least, believe that some modest increase in defense is appropriate, given the state of threats that we face today. So that's a brief outcome. Three scenarios; sequestration, the formal one least one likely in my mind.

MR. WESSEL: And is there an alternative to your third one, where since they have this account, which is called the Overseas Contingency --

MR. HALE: Contingency Operations.

MR. WESSEL: -- Operations -- that was intended for money for Afghanistan and Iraq.

MR. HALE: Right.

MR. WESSEL: It's not covered by the cap.

MR. HALE: Correct.

MR. WESSEL: Wouldn't it be possible for Congress to put more of the base budget in there and pretend?

MR. HALE: Well, to some extent, yes, but it is, by law, supposed to be for the added costs of wartime activities. Now, there's a gray area, and Congress has exploited it; so has the administration, I might add, me included, in the past, to put a little more money in there. But there's only so much you can do, I think, and still live within

that gray area.

So yes, OCO, as it's called, is a possibility way out, if we're going to stay with the current caps for defense. It won't do anything for non-defense, and that's an important point. There are problems there, too, at least, I think.

MR. WESSEL: Right. Michael, can we live within the caps on defense spending and be safe?

MR. O'HANLON: David, I think the short answer is, we can probably be safe here in the United States, but the world will begin to fray abroad, and it will be harder to manage China's rise, in a way that I think is most stabilizing to the region. And I'm not against China's rise, but I think if it happens too fast during a perception of American retrenchment, it could be quite destabilizing for the Western Pacific.

I think that the conflicts in the Middle East, while no one's talking about putting American brigade combat teams back in any of these conflict zones, and nor should they, nonetheless, the conflicts are far from over, and we're going to need to be able to do substantial things in those zones, whether we like it or not. Most of us don't like it for good reason, but it doesn't change the fact that what we just saw in France could happen here, and we're implicated in what's going on in this broader region.

I guess if I could just say one other thing by way of framing my way of looking at this, and just to give a couple more reference points, right now, we are planning to spend in 2015, in the course of this year, something just under \$600 billion on the military, and that includes somewhere in the range of 60 to 70 billion on the contingencies; not only Iraq and Afghanistan, but Ebola; adding some capability and some rotations to forces going to Estonia, Latvia and Lithuania to make sure Vladimir Putin takes seriously our NATO commitments to those countries, and a few other sundry things.

Anyway, we're at just under 600 billion. For reference, the Cold War average for the United States was about 500 billion. So, I'm adjusting for inflation. This is 2015 dollars. So, we're a little bit above the Cold War average. On the other hand, we're much below the Cold War average in the size of the military, so we're gotten a lot more expensive per person. And meanwhile, while we still represent 40 percent of global military spending, there's an interesting thing going on; China and Russia have very clearly moved into the number two and three positions behind us in a way that they were not in the 1990s.

In the 1990s, a lot of our big allies were in that sort of number two, number three role as Russia was essentially collapsing, and China was still beginning its rise. And now, we're at a point where our budget of just under 600 billion, and that includes the war costs, is still three to four times China's, but on the trajectories that both countries are on, in the next decade, you could start to see convergence.

And you know, that raises more questions than answers about whether that's okay, whether that's avoidable, at what pace we should allow that to happen. I'm just trying to give some reference points.

And then, just one last thing is that in the 1990s, when Alice was OMB director and Bob was at the Air Force, we were --

MR. WESSEL: The world was wonderful.

MR. O'HANLON: And the world was pretty good, but we were spending about 400 billion a year on the military, if you adjust for inflation, once we phased in the cuts from the Cold War force. But that was able to sustain a slightly larger force than we've got today. And so, one of the arguments people will make is well, today's world looks certainly at least as dangerous as the world in the 1990s, and yet, you're trying to cope with that world with a smaller military, and if you sequester or go to sequester level

cuts in any way, you're going to be forced to cut even further.

And so anyway, we can talk more about the specific service by service later on. But these are just some reference points. Four hundred billion is where we were in the '90s, 500 billion is the Cold War average, a little under 600 billion is where we are now. But as you know, we're headed downward more towards that \$500 billion mark.

MR. WESSEL: We have a smaller military because we pay each one of the troops more or because we're more capital intensive?

MR. O'HANLON: I'll say a quick word, and then I'll let Bob, who obviously managed this detail, add something. We certainly are paying more per troop. Military compensation is pretty good. There's a big commission now working on this with a lot of retired military as well as others. And I think they're going to say, you know, we may have to be a little more judicious about how we use military compensation, not because the typically private first class is overpaid.

But you have certain categories of people, for example, recent retirees from the military who might be 48 years old, have a new job, getting a new salary, but they still get 50 percent of their maximum paycheck annually forever. That's part of the military pension system that was designed for understandable reasons, and certainly, if those people are hurt or wounded and need care in the veteran's affairs budget, they should get it, and that's a totally separate part of the budget not covered by any of the numbers that we've been discussing today.

But you can ask questions about whether we're overcompensating in certain areas, and I think we probably are. So, that's part of it. But it's not really just the pay. It's the operating of the force. It's the cost per fighter, per ship.

And then, things like cleanup of military bases. There are all sorts of things. Everything is driving up that per person cost well above the rate of inflation.

MR. WESSEL: Alice, before -- I want to ask you about domestic, but I just want to ask you a political point with Bob and -- has raised. If Congress raises the caps on defense spending, is it plausible that they won't raise the caps on domestic spending?

MS. RIVLIN: Yes, I think so.

MR. WESSEL: Really?

MS. RIVLIN: You know, you're asking for speculation (Laughter).

MR. WESSEL: It's a think tank. We're supposed to speculate.

MS. RIVLIN: But remember, this is a Republican dominated Congress, and if they raise the caps on defense, it wouldn't surprise me that they kept the caps on domestic.

MR. WESSEL: Do you think the president would sign that kind of a bill?

MS. RIVLIN: Well, I don't know. It depends what else he was -- it would be part of a big negotiation and trading off this and that. But we're not in that world at the moment.

MR. WESSEL: Right.

SPEAKER: Wouldn't you say, Alice, though, that this would be a real indication of how Republicans are going to handle the current situation? Are they going to look for ways to cooperate with Democrats, look for ways not to provoke Democrats and so forth? I mean, they wouldn't mind provoking the president, but if they raise the fence and leave domestic discretionary where it is, that is really -- that's a war cry.

MS. RIVLIN: Well, maybe.

MR. WESSEL: A war crime?

MS. RIVLIN: Cry.

SPEAKER: Cry.

MR. WESSEL: Cry. Oh (Laughter). I was thinking.

MS. RIVLIN: You know more about Republican thinking than I do (Laughter), but I think there's another consideration here. When the sequestration was first being debated, and you remember, we thought it was something that would never happen because it would be so unacceptable to Republicans to cut defense --

SPEAKER: Right.

MS. RIVLIN: -- and so unacceptable to Democrats to cut domestic --

SPEAKER: Right.

MS. RIVLIN: -- that no way was it going to happen. We were wrong.

SPEAKER: Yeah, yeah.

MR. WESSEL: All right. So, let's turn to the domestic caps, Alice. Is it okay to live within these domestic caps, or do you think that would be a mistake?

MS. RIVLIN: I think it would be a mistake for the long run. I mean, we can live with them for another year, probably, without devastating effect. But I think there are several things to remember. One is that this crazy sounding category, non-defensive discretionary spending, is almost everything the government does, except those big entitlement programs and defense interest.

It covers the things we want our government to do and have wanted them to do for a long time, and it's not very large. It runs under 4 percent of our GDP, and has for decades; forever, actually, on the average, and --

MR. WESSEL: It's about something like 17 percent, I think, of all federal spending. Something on that order. Right?

MS. RIVLIN: Right. Something in that order. But if you think of it in relation to the size of the economy and think of all of these different programs; you mentioned some of them, that are in there, that it's been historically less than 4 percent of

GDP. It went above that in the '70s and then came down rapidly.

It went above it briefly with the stimulus, but has come down, and it's headed down, down, down (Laughter) in relation to anything; in relation to population, in relation to the size of the economy. So, I think one thing to say, even if you think what we spend for this set of programs is about right now, you should worry about the future, because the caps imply that this set of programs will not keep up with inflation or population or the growth of the economy.

I personally think that they're too low now; that we should be investing in the future -- that means, I think a big infrastructure program, and -- but I also think we should reform our tax system and pay for the investments in the future.

MR. WESSEL: Ron, what's your view on these domestic caps?

MR. HASKINS: I pretty much agree with Alice. I would emphasize, I think we're spending too little now, especially on infrastructure. That's several good examples. That's what it really comes down to, specifically, where should we be spending more money. And the infrastructure is, I think, the most likely candidate. A lot of people disagree.

I should have said first, I'm glad we did. I'm glad we have caps, because it shows at least, I'm going to call it one third seriousness of Congress to do something about the deficit. So, they focus all on one third of the budget, the discretionary spending, and ignore two thirds of the budget and the part that's growing like mad. We used to spend -- think of this -- we used to spend 70 percent -- almost 70 percent even as recently as the early '60s on discretionary spending, but because mandatory spending, namely Social Security and Medicare and so forth, has exploded so much, it's a declining part of the budget. And yet, that's where they focused their attention.

So, it's good that we're reducing the deficit. We have reduced the deficit.

But I don't see how those caps are sustainable. My only disagreement with Alice -- a very bad idea to do that, but I do it anyway, because I don't think the caps can be sustained. Now, that doesn't mean that everything is going to fall apart. It means that they're going to play games. That's what I think they'll do, just like you have overseas contingency -- you can have emergencies.

We do all kinds of things, and I'll bet you this year they'll have 20, 25, \$30 billion worth of you know, bill expanding. Under the budget act, they can do that, and I think they will. There's no way they can hold these caps, and it'll be even more difficult next year and more difficult the year after.

MS. RIVLIN: You could have said that three years ago, and probably did, and here we are with much lower spending --

MR. HASKINS: Yes, but we did -- we still took a damage of some of those provisions.

MS. RIVLIN: Sure.

MR. HASKINS: I think we'll do it even more now.

MS. RIVLIN: Maybe.

MR. WESSEL: Ron, you just wrote a book that says that a lot of what the government does may not do any good, and we should spend --

MR. HASKINS: Well, I didn't -- I omitted the word may. (Laughter)

MR. WESSEL: Okay. But isn't there some point to having a budget constraint here which says to the Congress, okay, look, live within these things, and let's spend more on the stuff that works and doesn't -- that's kind of the idea.

MR. HASKINS: Right.

MR. WESSEL: A: Isn't that a good idea? And B: Why doesn't that ever happen?

MR. HASKINS: Why it never happened?

MR. WESSEL: Yeah. Why don't they ever set priorities and spend more on what they should and less on what they shouldn't?

MR. HASKINS: I think it's just too hard. The government is gargantuan. I mean, you know, when you -- there's a book of government programs. If you dropped it on your toe, you'd have to immediately go to the hospital. I mean, it's over -- it's thousands of pages of little teeny eeny weeny -- the government is huge.

How could you -- we can't even control the Department of Defense. We were in a meeting a couple of months ago that an important senior official in the Department of Defense said, they don't even know what the budget is. Is that correct?

MR. O'HANLON: No, that's not right (Laughter).

SPEAKER: You can account for the whole -- I mean, I'm talking about a major general in the Marine Corps who said this, who's been working --

MR. WESSEL: Give Bob his number. Bob will set him straight (Laughter) --

MR. HASKINS: I think it's very, very difficult. But we could do a lot more of it. I told you before when we had started, that Peter Orszag said in this very room a couple of weeks ago, that we know less than 1 percent of federal spending, we really have any idea of what its impact is, and you kind of poo poed that number.

But I think it gives an idea of the scale of the thing. We have so many programs -- health programs, education program, all kinds of domestic programs that we just don't know --

(Simultaneous discussion)

MR. WESSEL: You still think the caps aren't a useful way of forcing priorities.

MR. HASKINS: I think they could be. I think they could be --

MR. WESSEL: But they're not.

MR. HASKINS: Here's why. Wait. One, just quickly.

MR. WESSEL: You won't let Alice get a word in here (Laughter).

MR. HASKINS: We're talking about culture here, and the culture of Congress is to cheat (Laughter). To figure out ways to round all kinds of provisions that they impose upon themselves, and they don't work because the Congress figures out ways around them.

MR. WESSEL: Alice?

MS. RIVLIN: I think that's rather unfair (Laughter). But the point is that even if you wanted to cut government spending, because you thought it was too high, and in the aggregate, I don't, on this set of domestic programs that we're talking about.

But even if you thought that, putting caps on is just squeezing down everything. Now, I'm not opposed to the caps, but the way Congress handles the caps is to say, well, we've only got this amount of money. We don't have time or we don't have the energy or we don't have the mandate (Laughter) to make decisions as to what we should fund and what we shouldn't.

So, what we'll do is just allocate these spending amounts among the subcommittees of the appropriations committee in what seems like a fair way, a little roughly, what they were doing last year, and let them figure it out. And they have the same problem.

They have a lot of constituencies leaning on them. They have a whole bunch of programs, as Ron has said, and everybody's screaming, don't cut us. So what do they do? What would you do? You cut everybody a little bit, and that's what we've been doing now for a very long time. Now, could we do better? I think so, but it would

take a really dramatic change in the way mostly administration and the Congress operate.

You'd have to have a president who said, let's change these priorities dramatically, and let's have a serious debate about how to do it, and/or you'd have to Congress that said, we really want to take a chunk of the budget, go over it and see whether we could do these things more effectively, whether we could do -- emphasize some priorities better. I don't think you could do the whole budget, and you certainly couldn't do it every other year, but you could set up a mechanism for reviewing a major piece of the budget, say, every three years or five years to see if the money could be spent better and the priorities were what Congress really wanted them to be.

MR. WESSEL: Bob?

MR. HALE: Could I add?

MR. WESSEL: Yeah.

MR. HALE: Yeah.

MR. WESSEL: Could I just ask you a quick question?

MR. HALE: Sure.

MR. WESSEL: So, is what Alice describes on the domestic side, is the military really any different? Isn't there a certain amount of the Air Force, the Navy, the Marines -- everybody has to get their share of the cuts?

MS. RIVLIN: Yes.

MR. HALE: I mean, broadly, the budget shares haven't changed a lot. That's a fair statement. Within those shares, they've changed a lot. Let me try to respond.

First off, I think it's way too harsh to suggest that overall, only one percent of government spending has any effect. I mean, I'll offer just a couple of

examples -- one obvious one. We haven't been attacked since 9/11, folks. Some other countries have, quite recently, unfortunately. That's a tribute, I think, to both our intelligence and to our military capability.

We got in and more or less out of two wars. You may not like the results of them, but they were accomplished in accordance with the will of the administration of the president and the Congress. So, we do do a number of things right, and I think it's unfortunate that we suggest otherwise.

In terms of accountability, we absolutely know where we're spending the money down to a great deal of detail. You may not like the results that you see. That's a fair point. And there are priorities set. I mean -- and I'll give you a current example.

We have cut back much more on ground forces over the last few years than we have in the others. That was a painful decision, I can assure you, within the Department of Defense, but it was one consciously made based on a strategy that we felt in the aftermath of Iraq and Afghanistan, we could afford smaller ground forces, and still cutting, but not as much, the naval and Air Forces.

So, I think Alice is right. We can do better, but it is not as if we're just taking this money and sort of randomly spending it wherever we want, and it's not the case that there's no effect.

MR. HASKINS: It's easy if you mischaracterize someone. That's not what I'm saying.

MR. HALE: Right.

MR. HASKINS: Let me give you some examples. If we resort to specifics -- I hate to do that, but if we did, we could find many things in a budget that I think even Alice would agree, are ridiculous, like farm subsidies.

SPEAKER: Right, and just to be fair to Peter Orszag -- Peter Orszag

wasn't saying that only 1 percent of the federal budget bought anything.

MR. HASKINS: All right.

SPEAKER: No, no.

SPEAKER: What he said was, talking about domestic programs, we don't -- it's only 1 percent that we know actually works. Right?

MR. HASKINS: That's correct.

MS. RIVLIN: Well, but you have to think about that.

SPEAKER: Yeah.

MS. RIVLIN: A little bit. I mean, for example, part -- one thing we do is air traffic control. I don't think we're investing enough in modernizing that system, but very few airplanes fall out of the sky. And another thing we do is interstate highways. We probably aren't maintaining those as well as we should, but you can drive from here to New York. We know what we're getting for that. So, it's not -- I think it's sort of silly to say we don't know what we're getting for government programs.

MR. HASKINS: There's a difference between knowing what you're getting and the effectiveness of it. You used the example of air traffic controllers. We have several air traffic controllers that are using cathode ray tubes, probably the only ones remaining in the whole world --

MS. RIVLIN: Well, that's why --

MR. HASKINS: -- in the airports, you make --

MS. RIVLIN: That's why I said they need to be modernized. Yeah.

MR. HASKINS: Well, so you need to spend more money on things like that.

MS. RIVLIN: Right.

MR. HASKINS: And less on things like agricultural subsidies.

MR. WESSEL: Michael, do you want to defend agricultural subsidies (Laughter)? Or Bob gave us three scenarios for what could happen to defense spending. I'm sort of interested in what odds you assign on those scenarios. What's going to happen this year?

MR. O'HANLON: Yeah, I think Bob's right, and I guess just to spell out one or two of the options before Congress -- and Ron and I have done a little writing, too. It seems to me this so-called Overseas Contingency Operations Fund that Bob talked about, and where there is some play in what you use it for, but not complete liberty to use and abuse that term for --

You could have Congress actually modify the law to allow a little -- even broader definitions. So for example, with Putin doing what he's doing in Ukraine. Should we be able to say that any activity in Europe by the U.S. military, even routine training, is essentially something we can fund through the OCO account? Because until we have a new president in two years, I doubt we're going to have a fundamental repeal of the Budget Control Act.

So, there's a very good chance we have to leave with the caps, and therefore, OCO, Overseas Contingency Operation, becomes your main safety valve. It's already helping. You could find a way to let it help more. You could define anything that's going on in terms of operations in Europe, essentially, as a deterrence related cost. And you could even do some of that with the Asia-Pacific, given that there's been a fair amount of turbulence.

Now, Bob, I'm sure can think of all of the complications in doing this more easily than I, and is probably thinking about how I've been at a think tank too long and not in the real world (Laughter), and I realize that it's not --

(Simultaneous discussion)

MR. HALE: I like the idea.

MR. O'HANLON: But there are ways to stretch the definition. Because for example, if the carrier goes from the United States to the Persian Gulf today, or the Arabian Sea, and it flies a few sorties or even just 10 percent of its total mission sorties over that whole six month deployment near Afghanistan, as I understand it, the entire deployment could be counted and funded out of the OCO.

Now, I think that's reasonable, because to get to the Arabian Sea, you had to actually do that long deployment, so it's not a complete abuse. It's not deceitful, but it is a broad and somewhat lenient definition of what a war cost is, and you could find ways to expand that. That may be the most realistic thing.

I think everyone has learned that sequestration per se is so painful and so ineffective that what Bob said is hopefully true; that the idea of Congress appropriating above the caps, and thereby necessitating this formal process of sequester, which is, as you know, this sort of across the board set of cuts, and then someone like Bob Hale and the service chiefs in the DoD world, they have to implement this. It's crazy. It's just nuts.

And I would hope that for all of our disagreements, we could recognize that there are legitimate disagreements over what defense spending should be. There is no legitimate role for a sequester as the mechanism to go to a lower funding.

MR. WESSEL: Bob, can you just talk a little bit about what it's like to be in the Pentagon and have to deal with these across the board spending cuts? How much of a waste of time was that?

MR. HALE: Well, that was -- I mean, in a perverse way, technically interesting, I have to say, to a comptroller. (Laughter) But the price was way too high and several things went wrong in 2013. The sequester, and as Alice said, all government leaders, including myself, thought we wouldn't do it. And so we didn't slow spending in

the early part of fiscal year '13.

We didn't want the phrase we used in the Pentagon, to sequester ourselves. Well, they did it. And so, suddenly, we found ourselves with six months to go, in the case of the Department of Defense, a \$38 billion cut exacerbated for DoD, because that was the year we underestimated some wartime requirements in OCO. And incidentally, the OCO is outside of the caps. It does get cut by the sequester. I've never understood the logic of that, but the lawyers insisted.

So, saw a cut in OCO. We had underestimated the amount. It all came together and had particularly devastating effects on the operating accounts. And we saw services do things I never thought they would. The Air Force stopped flying at 12 squadrons. They Army stopped sending units through its national training center, which is a culminating training event. The Navy is saying, well, we're not going to send a second strike group to the Persian Gulf, even though the combatant commander wanted it.

So, there were significant effects. So overall, it was exceedingly discouraging, and of course, followed hard on by the shutdowns. So, it was a lousy year.

MR. WESSEL: Ron, you suggested that even though there's no formal OCO escape patch, you know, there's always some way, emergencies or whatever. But let's say that the Republicans hold the line, that they want to stick with the caps. What are the consequences of that? What are the practical consequences of it?

MR. HASKINS: Well, I think the things that I mentioned, like we won't have -- our Air Force will continue to be among the worst in the world. I think we're rated something like 13th in terms of efficiency. Our infrastructure will continue to deteriorate. There's a recent report that shows that we're something like 17th in the world in the quality of our infrastructure.

And so, those are very concrete impacts. A lot of people were very concerned about NIH. Look at the budget of NIH. It's shocking. It goes up -- it's astounding, how much it went up. Somebody once told me that the president's budget has a certain level. Then the House gets it and adds to that. Then, the Senate gets it and adds to that, and then they vote on the -- they come out with the conference report, and it's still higher.

But now, for the last five years, at least according to the O&B baseline, it's actually been reduced, if you see it. It's just going like -- it looks like a mountain, and now we're coming back down. Not as much the mountain you talked about before on defense, but we're coming back down.

So, there will be many, many practical consequences. I don't think Republicans will do that. I talked two people that are involved -- staffers who are involved in the budget process, and they both said the same thing; that there will be ways that they'll be able to get a buck here and a buck there, and they won't have to strip -- they'll even say they'll live by the caps, but they really didn't live by the level of caps.

MS. RIVLIN: Well, I'm less prone to think that they'll find ways around it, but I think Ron's got some of the right things. What do you do when you have immediate needs that have to come out of your budget, whether you're a family or an institution? You generally let the maintenance go. You don't put on the new roof if it's not actually leaking.

We've been doing that for a long time in the federal government, and I'm not just talking about roads and bridges. I'm talking about national parks, and as we said, air traffic control, and a lot of prisons and a lot of things that we think need to be there and should be maintained in a modern way, but we haven't quite been able to do it.

Now, if you look at the projections for the next 10 years, it will get worse

and worse. We will put off more of the routine maintenance. We'll just not do those things, and at some point, it will catch up with us.

MR. WESSEL: Now, what about how this affects federal employees? I know there's a caricature of federal employees, that they don't work very hard and they're overpaid and they have too high pensions and stuff. But is that really true in the past -- given the caps and the shutdowns and the furloughs and all that?

MS. RIVLIN: Well, I think federal employees get a bad rap. Most of them work very hard; not everybody, but most of them work very hard and do a good job. And it has not been a growing part of our labor force. If you look over a long period, the federal civilian workforce is declining as a percent of anything; a percent of total labor force. And that's in part, because we have gotten more efficient. Computers do a lot of things that clerks used to do, and it's partly because they do work very hard.

MR. WESSEL: So, do any of the defense guys have a domestic question? And then I'll turn the tables.

MR. HALE: Well, I'd like to add on to what Alice said regarding federal employees. First, I'd distinguish between the military and the civilians. We give a great deal of credit, as we should, to the military. Public opinion polls show that it's the higher rated organization in terms of trust in the United States.

The civilians, on the other side, tend to be linked to government as a whole, and the public has a lot of distrust for government. So, I think they do get a bad rap. I think if you step back, I supervised many of them; watched many others during my tenure in the Pentagon. They do a lot of things right.

Some of the overall things -- we haven't been attacked, are partially of their doing. But more specifically, 80 percent of the workforce in the financial management community in the Department of Defense is civilians. They manage

through some of the toughest budget times in the sequester, and before and after, I might add, and it's still chaotic budgetarily.

A large percentage of the logistics folks are civilians in the Department of Defense. They conducted an exit from Afghanistan. Again, you may not like the results of the war, but they got us out of there in a land locked country where we had extreme problems logistically. And I could go on with other examples.

I think federal employees do a lot right, and as managers, as a former manager, one of my goals is to try to say that to them, because they are -- we do see a degradation of morale. And I think it is of concern in terms of recruiting new employees into the federal government.

MR. WESSEL: But I think that the perception among people who don't work for the government is that there are a lot of people who work hard, and the incompetent people never get fired. Is that true?

MR. HALE: That is a problem. I certainly don't want to sit here and say there's no improvements that should be made in the civil service, and two things need to happen. One: We need to be able to hire people more quickly. OPM has worked that issue hard; they've made some progress. It's still not where it needs to be.

And for a small number of poor performers, we do need to be able to fire them more quickly. It is just having managed a group of civil servants, there comes a point that you know -- there are always a few under performers. It is so difficult to actually make changes or to actually fire them, it's just not worth the effort and the time it takes with management.

So absolutely, we need to improve the civil service. But we also need to tell the majority who do work hard and are getting things done, that they are doing things right, so they'll stay with us and new people will come in.

MR. WESSEL: Michael, do you have any domestic questions you want to pose?

MR. O'HANLON: Yeah, let me just mention two categories of spending. I'd be curious if you folks have ways of thinking about whether the spending is high enough, too high, too low. Ron, you mentioned mental and NIH health issues --

MR. WESSEL: National Institute of Health.

MR. O'HANLON: But I'm curious about science at large; energy, research, other kinds of physical sciences' research, whether we spend enough. And how do we even set up a methodology to figure it out?

And then secondly, environmental protection. And that of course, partly overlaps with energy issues, with global warming kinds of considerations, and you know, trying to find alternative energy sources. But more generally speaking, how do you feel about the resources we have for environmental protection?

MS. RIVLIN: I think they could be spent better, but the effort to make sure that we don't have polluted air and polluted water and too many greenhouse gases going into the atmosphere, seems to be really important. Now, as people complain about the Environmental Protection Agency, I don't think they're complaining too much about the spending. They're complaining about regulations that could be simplified, or about doing something in a more market friendly way.

I mean, personally, I think we ought to have a carbon tax. It would be a lot more efficient and effective to control carbon emissions through raising the price by a tax than by putting the regulations on all of the coal fire plants. But we aren't doing that, and if we're not doing it, then we have to regulate it.

SPEAKER: I think the only thing to add to that, that I would think is important, is that you can count on that there will be constant criticism and attempts to

reign in the EPA. I wouldn't be surprised if they -- programs might even try to cut their budget.

But there will be a constant stream of criticism of the EPA and the oil ramps (sic) and so forth. The Republicans have been very bold about this in recent years, and I don't see any sign of it stopping.

SPEAKER: I would say one of the perverse effects of the caps that -- there's this ever present temptation to do tax credits, and then they're accused of having a complicated tax code, because doing the same thing through the tax code doesn't count against the spending caps.

MS. RIVLIN: Absolutely. If you think something is a federal responsibility, and we ought to be doing more of it, now, it's very hard to say, well, there ought to be a spending program that does that. But sometimes, you can accomplish the same thing by regulation, and sometimes, you can accomplish the same thing by adding one more provision to the tax code. And we've been doing that for decades, and the result is that we have a tax code riddled with special provisions which are essentially spending programs.

We decided we wanted to favor home ownership, so we made more generous deductions for your mortgage interest, which benefits you more if you have a larger mortgage and a higher income. So, we have a spending program which goes differentially to richer people with bigger houses. What sense does that make? I don't think very much. But it is part of the fallout of not having a spending program.

MR. HASKINS: And the given idea of the magnitude of this, the estimates run as high as a trillion dollars in losses in the tax code for exactly these kinds of provisions that Alice is talking about. If we really have tax reform, or I insist we're going to have tax reform, I think they will take a run on it. And if they do, they will pass it

in the House, I think. The Senate's another matter.

But one of the big things to do is they'll get rid of some of those loopholes, and it will be fun to watch. It was in '86. It will be very lively.

MR. WESSEL: But odds you're giving on tax reform in the next two years, Ron?

MR. HASKINS: One, 2 percent, at least (Laughter).

MR. WESSEL: So, ask the defense guys a question. There must be something you wonder about the defense budget.

MR. HALE: Wonder in the sense of whether --

MR. WESSEL: No, no. I want Ron to ask you a question.

MR. HALE: Oh, okay. Fine.

MR. HASKINS: Yes, I have a question.

MR. WESSEL: Oh, okay.

MR. HASKINS: Explain to me how -- I have seen numerous articles in fairly reliable places like the National Journal and Congressional Quarterly and so forth -- this is my source of information, because I've never been in the Department of Defense -- about the cost overruns on program after program after program after program.

I think it's pretty much accepted that you see the original estimate of what it costs to develop a new weapons system, for example, and before you know it, it costs twice as much or even more than that. How does that constantly happen?

MR. HALE: Well, I'm afraid it's human nature. And first off, you're roughly right. I mean, I used to say take the price early on in a weapons system and double it in real terms, and ask yourself whether you still want the weapons system, because there's at least a reasonable chance that will happen.

There tends to be underestimates early in the process in order to get the

program going. After all, budgets are always constrained. You want to get your program going, and then, unfortunately, what we tend to do with these programs when we finally get them near or into production is reduce the rates to accommodate budget changes, and that inevitably, induces inefficiency.

So, overruns are a problem. They're a little lower than they have been, and I think they've gotten a fair amount of attention in this administration. But I wouldn't want to sit here and say this problem is solved. I think part of it is human nature. I think you see it in most infrastructure projects outside the Department of Defense, as well.

I've seen articles, although I can't quote them, but I remember some, that looked at major infrastructure problems of similar complexity, and unfortunately, many of them have overruns, as well.

MR. WESSEL: Go ahead, Alice.

MS. RIVLIN: Isn't part of it the representative government?

(Simultaneous discussion)

SPEAKER: Oh, democracy, the root of all evil? Is that it?

MS. RIVLIN: (Laughter) Well --

SPEAKER: How did I miss a chance to beat up --

MS. RIVLIN: -- it is --

SPEAKER: -- on the Congress?

MS. RIVLIN: The importance of military spending, both procurement and military bases for jobs in so many congressional districts. And I have heard very conservative members of Congress say, government doesn't create jobs. It destroys them, and all that sort of thing. But it doesn't apply to the military base in my district. If we lost that, we would lose jobs.

Is there any way around this?

SPEAKER: I don't know how, other than a fundamental change. I remember seeing many years ago, a map of where all the subcontractors were. I think it was the B2 bomber. And there was a pin in virtually --

MS. RIVLIN: In every one, yes.

SPEAKER: -- every congressional district. (Laughter)

MS. RIVLIN: Yes, I remember that one.

SPEAKER: And I mean, the companies are smart enough to be sure that this happens, because they know the reality of it.

I think to some extent, representative democracy is inherently inefficient. That doesn't mean there aren't things you carve out and ask government to do because they can only do it, but you probably do want to minimize them, because it's not going to be as efficient as if you've got a truly competitive industry.

MR. HASKINS: And yet, we ought to at least acknowledge that the base closure commission turned out to be a very effective mechanism, and we've closed hundreds of bases around --

(Simultaneous discussion)

SPEAKER: We've done five rounds of base --

MS. RIVLIN: Yes, we got a few --

MR. HASKINS: Yeah.

MS. RIVLIN: We've got a few more that could be on the --

(Simultaneous discussion)

SPEAKER: We've got a few more to go. I mean, it's --

MR. HASKINS: I can understand that, but I mean, why --

MS. RIVLIN: Yeah.

MR. HASKINS: This is not a problem that you can't deal with.

MS. RIVLIN: Right.

MR. HASKINS: We have dealt with it.

MS. RIVLIN: Right.

MR. HASKINS: Under the terms of democracy, it's been very impressive.

SPEAKER: We've done five rounds of base closure, and the annual savings from those five rounds, which are now -- it completes \$12 billion a year. So, if we hadn't done them starting in the '80s, we'd be spending 12 billion more in perpetuity. So, absolutely, and we need another round of BRAC.

MS. RIVLIN: Is there a way to apply that to the procurement problem?

MR. O'HANLON: Yeah. You know, I don't see how easily to do that. I mean, Congress is part of the problem, but I think a lot of this is in the executive branch and the Department of Defense in the case of defense procurement.

I mean, several things happened. We don't tend to corral appetites as well as we should. There's a realization or -- by the creators of these systems that are going to be around for 20 or 30 years; they want them to function well, so they push the requirements to a level that is very expensive. And then, the problems I just cited of human nature keep the costs down low and get the programs started -- tend to lead to overrun.

So, I'd go back to what I said earlier. It's a little crass, and I certainly have never said it as a government official, but I think you should count on a certain -- you should look at a price of a weapon early in its life and say, do I still want this if it is somewhat more expensive.

MS. RIVLIN: Right.

SPEAKER: And if the answer is no, you'd better worry.

MR. O'HANLON: What I would add -- I certainly agree with the difficulty here. But I think there -- Alice, there is essentially a way in which there is a check on the system, which is if the question is, do I need to buy 22 B-2 bombers, and they're not each costing me a billion dollars, Congress might just say no.

And with the F-22 fighter, which was originally going to be a lot less expensive -- and I'm not blaming Lockheed Martin. It made a beautiful jet, and it's the best jet in the world, and I'm glad we have 189 of them. We were supposed to have 750. And two things happened. The Cold War ended, so we didn't need as many. But also, the price kept going up. And so, the Congress and the Pentagon decided we'd better curtail this program.

MS. RIVLIN: Yep.

MR. O'HANLON: And so what we do instead is, we keep the F-15s flying longer. So, there usually is an implicit backup plan, which is use the existing system longer, refurbish it, remanufacture it. And frankly, I think there's room within today's Pentagon budget to do a little bit more of that.

But I would say -- and this is the one point we haven't really touched on, just to sort of wrap up, as we move towards wrapping up this initial part of the event, even if you look for a lot of sort of reasonable reforms in how the Pentagon does business, you do that additional round of base closures. You get the healthcare premium changes that Bob and others were promoting. You make a few other efficiencies which they're trying to accomplish.

Even if you do all of this, you're probably going to essentially pay for the needed increase in your budget, because you were too optimistic about how much various things would cost. In other words, you need to do all of this just to tread water. You need to do the base closures and the military compensation reforms just to sort of

tread water and make the administration's plan self consistent.

Now, if we sequester in addition, where we cut further beyond where the administration is going, even if you do the base closures, which there's no sign Congress will do, and it takes five years to get the savings, anyway -- even if you do the compensation reforms, you are not going to begin to be able to pay for sequester with those kinds of efficiencies. So, you're going to have to cut the down Army down even further.

You're going to have to cut the Navy at a time when China's Navy is growing. And so, these are the kinds of specific issues that we should probably should get into with our friends here.

(Simultaneous discussion)

MR. HALE: Yeah, and I just want to make sure I understand the terms here.

You're not really talking about the process of across the board spending cuts. You're talking about living with the level of spending that would exist, if they either avoid the sequester by appropriating that much money, or being stuck with an across the boards.

MR. HALE: I think the caps are too low, regardless of how you get there.

MS. RIVLIN: Well, I think the same thing is really true in the domestic side. There are things that appear on people's lists of things that could be done better. For example, we have an awful lot of job training programs, and they don't work especially well.

I would be heartily in favor of a serious looking at those programs and consolidation of them and improvement of them, so that they are actually better at training people for real jobs. That said, it's not going to save much money. You ought to

be doing all of those kinds of things. But even if you do, the same thing is true. This amount for the whole set of discretionary, domestic programs is quite small and getting smaller in relation to the needs of a growing economy.

MR. WESSEL: Okay. We're going to turn to the audience here, unless somebody wants to make another point. All right.

So, raise your hand. Wait for a mike. Tell us who you are and try and keep your questions short. The gentleman behind you with the --

MR. MORGAN RUSSELL: Yes, thank you. Dan Morgan Russell at the University of Southern California.

Dr. O'Hanlon, you touched upon this a little bit in your first answer. But now that we've put these caps on defense spending and can't necessarily guarantee world stability, has this encouraged any of our NATO members to begin picking up the slack?

And if it has not, what level of defense spending or reduced defense spending will encourage them to spend a little bit more on world defense and stability?

MR. O'HANLON: Big question, but let me give short in the spirit of David's admonition. Short answer to your first question is no (Laughter).

Allies are spending less, as a rule, except in the Middle East. At least in East Asia, they're sort of holding the line, but most of them don't really spend enough, in my judgment. And certainly, NATO continues to go through the floor. NATO's spending among our allies in Europe, is very mediocre, even against the standards the alliance collectively established.

So, they're down to about 1.5 percent of GDP on average. We're still over 3 percent. We're headed towards 2.6, 2.8. The Cold War average for us was 6 to 10 percent, depending on the period. The Cold War average for them was 3 to 4

percent, but they're way below even their own current standards.

But secondly, your second question, a very good question. But I don't see evidence that there is a correlation, partly based on my first answer (Laughter). So, if we cut more, I don't think the answer is necessarily that at some point, the allies get serious about providing for their own defense.

I think the answer could be they become vulnerable to attack, or they wind up overcompensating and engaging in a regional arms race, because at least the nice thing about a strong American lynchpin to some of these alliances the allies can then plug into, is that it tends to keep sort of a lid on some of the regional tensions -- for example, Japan, Korea, China, which -- three countries that don't necessarily get along all that well, if you leave them (Laughter) to their own devices.

And so, I actually prefer a system in which there's a fairly strong American lynchpin, and I'm not sure I see evidence to think that if we simply cut, it will get a happier outcome from the allies doing more.

MR. WESSEL: Do you think Putin will lead to higher defense spending in Europe?

MR. O'HANLON: No.

MS. RIVLIN: And their economies are in much worse shape than ours.

MR. WESSEL: Right.

The gentleman here in the front? At the mike. Oh, here you are. Sorry.

MR. ULLMAN: I'm Harlin Ullman. Thank you. I wanted to ask -- actually, provoke you to think about disruptive events that might change the calculus for good or evil.

You can call them wildcards, ticking time bombs. For example, nobody I think, predicted oil at \$50 a barrel. I don't think anybody thought the Swiss were going to

take caps off the franc. In the case of the Defense Department, there may be hundreds of thousands of soldiers who come back with traumatic brain injuries which have not been detected, but will be, which will put huge pressure on the budget.

You've got a replacement program for the Ohio class for the (inaudible), and sometimes, for the whole nuclear industry. What sort of disruptive events do you think could really change the calculus that you worry about or could worry about, both domestically and internationally?

SPEAKER: Oh, in defense? Oh.

SPEAKER: No, answer it. No, go, please.

SPEAKER: Okay, interest rates. Interest rates are amazingly low, and yet, they're going to increase 262 percent in the next 10 years under the CBO baseline. If the interest rates went up, it would be -- that would really be a difficult event to contend with. And I don't see another way except cutting spending, and we'd have to raise revenues, I'm sure.

MR. HALE: Well, I'll take a couple. It's probably more Mike's line, but we've got an unstable ruler in North Korea. I don't think anybody can know what he is going to do. We have several tens of thousands of U.S. troops not very far away. I think that could definitely be a disruptive act.

Iran, I mean, it's just got to certainly continue to be worrisome. Events in Afghanistan could be disruptive, if things go poorly there. So, I can think of a number of foreign policy issues that would involve the Department of Defense heavily, and probably change the willingness to spend on the Department of Defense on the part of both the president and the Congress.

MR. O'HANLON: I'll just add one, which is -- and I know you thought about this, yourself, all out competition with China. So, it's something that I know Alice

fears. We had a panel here several years ago where she and Bob Kagan and I and Martin, I think, were talking about this, and what an arms race with China might look like.

But right now, it's not an arms race. It's an arms competition. We're spending 3 percent of GDP, 600 billion a year. They're spending 2 percent of their GDP, 150 billion a year. You know these numbers.

But they're on a strong, fast, upward trajectory, and it's not really clear how we're going to react as the curves start to converge. And are we going to try very hard to keep our defense budget level well above theirs? And if so, by how much? And how is this going to play in presidential politics?

And right now, I think there's no likelihood of a bid disruption just based on political debate and strategic debate and Brookings event and presidential campaigns. But if you actually had exchange of gunfire, perhaps provoked by -- or not provoked by, but catalyzed by some of our allies interacting with China in an unfortunate way, and we see an American ship sunk; maybe the Chinese weren't even shooting at us. Maybe they were shooting at the Taiwan Navy, but they missed. Who knows?

But something like that, even if it doesn't produce all out war, could produce an all out arms race, and that would be a disruptive event for the budget.

MR. WESSEL: It seems to me that another possibility -- so we have a very big debt to GDP ratio. We borrowed a lot of money during the recession, because we had a huge recession. It's not clear to me we could do that again, and I'm not so confident that we won't have that threat again, whether from outside of the United States or inside our own financial --

SPEAKER: Or you mentioned, some of the oil prices have got to help.

(Simultaneous discussion)

SPEAKER: Look, I think the most -- on the economic side, we could

have seen the worst of the last of the problems. We could be on the cusp of an increase in productivity and faster growth that would spin off more revenues and allow us to grow - that reduce the debt to GDP ratio much faster than we anticipated, if we got lucky and we had a good stream of growth. I don't put a high probability on that, but I wouldn't count it out.

MS. RIVLIN: Well, keeping the caps on will help that at a tremendous cost.

SPEAKER: Will help the numerator, not the denominator.

MS. RIVLIN: Exactly.

SPEAKER: I was looking for the -- he was looking for good news.

MS. RIVLIN: Well, I'm not sure what good news he's looking for.

SPEAKER: Faster GDP growth.

MS. RIVLIN: I think it would be good -- (Laughter) I think it would be good news if we had more domestic spending of the right kind. And what would trigger that? Possibly some kind of disaster that we don't want, like another bridge falling down or an air traffic disaster, or something competitive.

I mean, we did react to Sputnik, for those of you old enough to remember Sputnik. The Russians put the satellite up there, and then we decided we'd better spend more for science.

MR. WESSEL: There's a question over here? Gentleman in the front row?

SPEAKER: Hi. Scott Mossionni from Inside the Pentagon.

The Defense Department has been working on the long range research and development plan. Industry has kind of indicated that they've been a little bit reluctant, because the aperture is so large on it and the funding isn't that large. I was

wondering what you saw for the future of that program, the funding of the program and maybe its success.

SPEAKER: What is it anyways (sic)?

(Simultaneous discussion)

SPEAKER: (Inaudible) range bomber?

SPEAKER: No. You said -- you're talking about the defense innovative initiative and --

SPEAKER: Yes.

SPEAKER: So, it was a program announced several months ago by Secretary Hegel, looking for initiatives that could be game changers from an R&D standpoint. I mean, a new stealth, for example, I mean, it was certainly a game changer for precision guided munitions, or things that have changed warfare.

You know, I think it is still in gestation, and at least that's my sense, and I'm certainly not deeply involved in it. But the process of going through thinking about where we should invest R&D for the future is a healthy one, even if nothing dramatic comes out of it. I'm not sure you can legislate innovation or mandate innovation, but I think it is healthy to require the department to think, okay, am I spending in the right places? Are there areas where I should be more innovative?

And innovation, to some extent, is a state of mind, so maybe the Department of Defense needs to look for ways to be more agile. Maybe assigning some of its people to startups, for example, to interact with them in ways that may produce new ideas. I think it's a healthy process, and I don't know where it's headed, but I'm glad we're going down that road.

MR. WESSEL: The gentleman here in the middle? And then -- right where you are, and then the guy -- no, right in front of you. (Laughter) Then move on to

the gentleman --

MR. GORING: John Goring from City University.

GAO did two reports studying the effect of sequestration, and given Alice's concern about the slow eating away of the maintenance or seed corn of domestic agencies, what is the chance that Brookings would adopt the methodology that GAO used and create a Brookings -- a sequestration monitoring project, so that in addition to the many things you do, you provide every two or three years, regular reports on the state of the impacts of sequestration. So, rather than have ad hoc events like this one, there would be a permanent monitoring.

MS. RIVLIN: I think that's a good idea, but I would amend it. I've been bugging Dave, because he runs this new Hutchins --

SPEAKER: You put him up to this, didn't you? (Laughter)

MS. RIVLIN: -- to undertake some kind of a discretionary spending initiative. I would want it not just to monitor the effects of the caps, but also, to undertake the bigger question of where should we be spending more and where should we be spending less. And can we assemble some evidence about how programs are working or not working that will be guidance for the Congress on just that question.

MR. WESSEL: The gentleman in the blue? In the black in the back? Yeah?

SPEAKER: Bob (Inaudible) from out here at Brookings. You've all agreed that sequestration is bad. The budget caps probably aren't good either. A Republican Congress probably isn't going to be raising taxes anytime soon.

David, you kind of threw out there a minute ago, faster GDP growth. Well, where is the discussion though, regarding say the effect on the fiscal policy -- work on the fiscal policy from the Congress to perhaps, you know, free up the corporations to do more

of their capital spending, you know, that's -- you know, in that rising tide, all boats kind of a thing.

And wouldn't that really get rid of a lot of this entire discussion?

MS. RIVLIN: Corporations are sitting on a lot of money right now, (Laughter) and they could borrow more at very low interest rates, and they are not investing enough. It's not entirely clear what the government could do about that. Maybe you're suggesting corporate tax reform. I'd be for that, but I don't think there's much evidence that it would unleash a tidal wave of corporate investment.

MR. WESSEL: Phil? Over here?

MR. WALL: Hi, Phil Wall from Brookings. So, I'm wondering at what point these caps become painful enough and the decision is difficult enough that mandatory spending that's not the subject of this event, becomes more on the table, more a focus of debate, more maybe even a regular subject of budgeting for Congress.

SPEAKER: I think that it's going to happen regardless of the caps, because with Ryan being on Ways and Means Committee and talking about tax reform; also, he's been consistent supporter of premium support, which really could be a game changer, and he's not going to give up on that.

So, I wouldn't be surprised to see the House pass it again, what happened at the Senate -- pass it. I mean, there's some possibilities irrespective of the caps that Republicans will actually do the right thing and go after entitlement spending. As long as we have President Obama, I doubt that anything very big will pass, but it will be interesting to see.

MS. RIVLIN: But it's very hard politically, even if you're a Republican, to cut -- to either get tax reform that raises revenues or a significant entitlement reform. And it's much easier to cut this discretionary spending. I mean, I was, as David mentioned at

the beginning, a veteran of both the Simpson Bowls and the Domenici Rivlin commission, and we proposed tax reform, entitlement reform and caps on discretionary spending.

What have they done? They've tightened the caps way below what either commission recommended, and they didn't do anything about either tax reform or entitlement spending.

SPEAKER: But I think the one thing that might have changed enough that there could be some action on entitlements is that the Republican house has worked very hard to educate its members about how important Medicare is as a part of this problem, and how premium support is a reasonable solution, and they've supported premium support for three or four years, and they haven't suffered consequences in the electorate yet. So, I'm more optimistic than you are that they might do something.

MS. RIVLIN: But I think both entitlement reform and tax reform have to have bipartisan buy in. They have to have a lot of people around the country saying, we understand this and it's okay. And that's hard to achieve.

SPEAKER: I agree that it's hard, but the other factor that makes me a little bit hopeful is now the looming 2016 presidential race. And when I think about the individual players -- first of all, everyone is going to have to say how their plan will at least do as well for the deficit as the Budget Control Act, which is, as we know, not very good over the medium to longer term.

So, even though our deficits have been cut back to a manageable number at the moment, it's not going to stay that way based on baby boomers retiring and medical costs growing and all of the things people in this room know well about. And Alice can correct me, but it looks like the projections are for trillion dollar deficits again, not too long into the next decade.

SPEAKER: 2024, according to CBO.

SPEAKER: Yeah. And so, that becomes the would be second term of the next president, and therefore, a president who presumably is going to be asked on the campaign trail to explain his or her vision for the country, and presumably is going to want to explain the vision also, in terms of American power -- military, safety and long-term national growth, is going to have a hard time avoiding this question.

And just to give two names, if Hillary Clinton runs, as expected, she is a strong advocate of a strong national defense. She's also not going to want to leave any gray area about her bona fides on that subject, trying to become a woman from the Democratic party and Obama's former Secretary of State.

So, it's going to incumbent on her to explain how the U.S. military will do well under her watch, and also, how the country will grow in terms of its education, its infrastructure, its science and so forth. I mean, these are the things that amount to a presidential vision, and they require some degree of budget discipline. Now, anybody campaigning is going to have a temptation not to want to talk about cutting entitlements (Laughter), I agree.

But having said that, there are ways to limit the growth -- the cost of living formulas, and you can phase it in gradually. Anybody who is near retirement doesn't really have to meaningfully lose anything that they would have gotten otherwise. And for a Republican running, Republicans -- they may have the tea party within their broader GOP umbrella, but it's still the party of Ronald Reagan when it comes to presidential races, and I'm going to believe that until I'm proven wrong.

And any Republican -- you even see it in Rand Paul. Rand Paul is now becoming the guy who wants to build up American strength and then just not intervene, which is actually Reagan's legacy, as well. Reagan didn't use the military a lot. But Rand Paul, I think, has recognized that you don't become the Republican nominee by

being the Tea Party guy. And Paul senses he can win -- this is my interpretation, obviously, and you're probably a better expert on this than I. But any GOP frontrunner or likely nominee is going to have to explain how American power will improve on their watch, because that's the legacy of the party of Ronald Reagan.

So, I see presidential politics as a hopeful indicator not for what's going to happen this year, but for what could begin to happen, certainly, by 2017.

MR. WESSEL: That gentleman on the aisle there.

MR. BIGGS: Hi, Zach Biggs. I'm a reporter with Janes. I was hoping we could parse the difference between the 2016 caps and the rest of the years under the budget control act. Because with 2016, it's the last year that we have this flat spending for defense, in particular, before we start to see some of that increase that might be able to keep up with inflation.

You know, we heard the horror stories of what was going to happen as a result of the downturn. We're pretty much through the major part of that downturn. Now, you could say that it's going to be flat with inflation. But what's difference this year versus the subsequent years when there is an actual increase of the cap?

MR. HALE: Well, I find it hard to get too excited about those out years, because so much is likely to change. But you're right. I mean, even in 2016 under the caps for defense, there was about a 1 percent increase; probably not enough to keep pace with inflation, but there is an increase, and then it gets up in the two range, so it'll be roughly flat.

I'm not sure whether -- if the gist of your question is sort of nothing has gone wrong, so if we're flat, we're okay, I would take issue with that. I think military readiness has been significantly damaged, especially in 2013 with the sharp sequestration cuts and the other problems I described earlier.

And there's a gradual attempt to recover, but it's not there yet. We have underfunded in the out years of the defense budget's support activities; military construction is an obvious one. I mean, it was quite well funded around the 2010 period. It's now clearly underfunded. We're not spending enough to maintain. You can do that for a number of years, but you'll pay the price eventually.

So, there are problems that exist right now, and when you add to those the threats that at least I see as being pretty severe to U.S. national security, they lead me to believe that we do need to -- some modest increases in defense in order to fully meet our national security objectives.

SPEAKER: I'll give one example. Just look at the U.S. Navy. So, the U.S. Navy right now, which is probably the centerpiece service for dealing with China's rise has about 285 major ships, as they define them. And that's in contrast to twice that many in the 1980s. And about 350 even, in the 1990s. So in other words, it's substantially less.

Meanwhile, China has substantially increased its fleet. I'm not saying that we should be ready for an all out fight with China navally but I am suggesting that our ability to sustain presence and commitment and keep the region stable and help persuade China to rise in a generally reasonable and peaceful way, does depend on our being able to sustain capability in the Western Pacific region.

The Navy has tried, and President Obama, I think with a very smart rebalance policy has tried to say we're going to base a little higher fraction of the Navy in the Western Pacific region, so the historic average of 50 percent is now being increased to 60 percent by the end of this decade. That's the trajectory that we're on, and that makes good sense.

And that's just the way -- Hillary Clinton was part of that. I think it was a

very strong legacy of the first Obama term, and I think President Obama has tried to sustain it now into his second term. This trip to Beijing, I think, went well. He's trying to keep this concept going. The problem is, 60 percent of a smaller Navy could still be less than 50 percent of the old Navy, if you're not careful.

And right now, the Navy's ship building budget depends on increases in that budget top line, even if the ships come in on cost, which they won't, which means if you want to even grow the Navy modestly, you're going to have to see us get out of this, you know, downturn that we're in; certainly, avoid the sequestration mechanism, and I think, see modest real growth in the Navy budget in the years to come.

And I would say that's a reasonable standard by which to judge military efficacy. You can debate -- you know, the number of ships is not the be all and end all. It obviously depends which ships and what capability. And I'm not suggesting that numbers by themselves answer this question, but the logic of saying that we should at least be headed upwards towards a somewhat larger Navy at a time of such rapid Chinese growth, I think is a fairly compelling logic, but it's at risk under the caps that are now, you know, potentially going to arrive.

MR. WESSEL: Right? Mike's behind you to your left.

MR. TOM: Hi. Jason Tom from here at Brookings.

I wanted to ask -- there's a large department that gets grouped into domestic spending, but deals with security, as well, and that's DHS. And historically, DHS tends to be taken care of similar to Department of Defense, as well, and they get funded appropriations when others sometimes do not.

And going back to this system shock incident, we have what's playing out in France, and we have the ongoing discussion about what to do with DHS with the CR that comes up in February. So, I guess my question is, might this be instructive as to

how Congress approaches the issue of domestic spending and security, or is this just a one-off immigration issue? And I don't want to get involved in immigration policy. Thank you.

MS. RIVLIN: I think it's a one-off issue because of the president's executive order. I doubt there would have been any problem about moving ahead with the DHS budget but for that.

SPEAKER: But don't you think that it could be a symptom of one of the few things that Congress can really do, is hold up these spending bills in order to have leverage with the president. They can't override his veto in the Senate. The temptation to use the appropriation bills to get him to do stuff is enhanced.

MS. RIVLIN: Oh, it's certainly a temptation, and here's an example.

SPEAKER: Right.

MS. RIVLIN: It might happen again. But they did pass them all.

SPEAKER: Right.

MS. RIVLIN: And so they don't get another chance to do that with an appropriations bill for a while.

MR. WESSEL: Back there?

SPEAKER: Hi, my name is Diskey Yurashi from Japanese newspaper (Inaudible). I have a question about infrastructure investment.

So, I think the U.S. government, local and federal, were spending about 2, 3 percent of GDP back in the '60s or '70s, but now it's like less than 1 percent. So, my question is, why the U.S. government hasn't you know, reduced the investment infrastructure so much. Does that reflect you know, Republicans (Inaudible) seeking for a smaller government, or people's hostility toward public spending in general? Thank you.

SPEAKER: Well, I think there's several factors. One of course, is it's

been going a lot longer than Republicans have been in charge of Congress. I think both parties are -- bear some of the responsibility. And if you look at the individual systems, like spending on the highway trust fund, which people have known is a problem for a long time, and the Congress has not done anything -- virtually nothing about it, maybe they will this year.

So, I think it's not necessarily a partisan thing. It's just that with the -- it could be the Republicans' fault in this sense, that in order to do something serious about spending on infrastructure, I think there are going to have to be additional revenues of some kind. And that, Republicans clearly are completely against.

So, you need to think of creative ways, like investment bank of some kind, maybe a devoted change in the tax code that would produce revenues, that would produce a fund that could be used for investments in infrastructure or something like that. So, we are way lower. We're lower than the rest of the world. We've been declining for well over a decade, and we have a lot of problems.

There are estimates of the inefficiencies, and how long people wait in traffic and how much money we lose in airports because they're so inefficient. So, I think at some point, we are going to have to do something, but there will be some requirement on some kind of financing, other than an out and out tax increase, I think.

Republicans appear to be even reluctant to increase the gas tax, which has been declining for years and years and years and going to continue to decline. Cars are more efficient, oil is cheaper and so forth. So, I think that's the most important holdup, is some creative way to finance more investment in our infrastructure.

MS. RIVLIN: Well, I think you're right that the financing question has been the hold up. We decided to finance highways through a gas tax, and that was a great idea for a long time. But now, Americans are driving less and driving more fuel

efficient cars, and this is just a diminishing resource.

There are plenty of other ways to finance highways, including different kinds of taxes. A vehicle miles driven tax would make a lot more sense than a gas tax. But it's been hard to get people together, and I think it would have to be bipartisan, around a new look at how we finance highways and bridges and other infrastructure.

MR. WESSEL: So, it sounds like your answer is two-fold. One is, it is a symptom of how disappointing and dysfunctional our political system is, that something that's as popular as infrastructure can't get done. And secondly, how to finance it has become part of that ideological obstacle.

SPEAKER: I would say it's more that the Congress has not focused enough on ways to refinance it. I think that's the problem. They need to think of things, I agree, it probably has to be bipartisan. But it's got to be something that can at least be made to appear like it's not a tax increase.

So, I think there are problems here, but I think they're going to have to do something sooner or later, because we are really --

MS. RIVLIN: Well, I agree with that.

SPEAKER: -- having problems.

MS. RIVLIN: But I think that the idea that there's some magic out there that -- call it an investment bank or whatever, that's going to bring in a whole lot of private money to finance roads and bridges is something of a fantasy.

MR. WESSEL: Do you think it was a mistake that the stimulus didn't, with the benefit of hindsight, have more infrastructures?

MS. RIVLIN: I think it was a mistake that the stimulus bill wasn't larger, although they don't think they could have gotten a larger one through. And there was some infrastructure on some investment. Yes, there probably should have been more.

But it was a very hard case to make.

MR. WESSEL: Ron, don't you think there's just this general skepticism about government that has made it impossible for a lot of projects to get done? I mean, I don't know whether high speed rail is a good idea or not, but I never predicted it would become such a symbol of you know, everything that's wrong with the government or everything that's right with Jerry Brown. I mean, there's something more than just dollars and cents here.

MR. HASKINS: I think that's probably true, but still, at some point, reality is going to intrude.

MR. WESSEL: Right. At some point --

MR. HASKINS: And the Congress is going to have to do something, and it will.

MR. WESSEL: Well, Ron says at some point, Regality will interfere, and Michael actually thinks something good could come of the 2016 presidential campaign. In these conversations, that passes for wild-eyed optimism (Laughter).

So, join me in thanking our panel (Applause). Thank you for coming. And if there's a paper cup under seat or a sheet of paper, pick it up and put in the garbage can. We'd appreciate it. Thank you very much.

* * * * *

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, 2016