THE BROOKINGS INSTITUTION
FALK AUDITORIUM

FISCAL THERAPY:
CURING AMERICA'S DEBT ADDICTION AND INVESTING IN THE FUTURE

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PARTICIPANTS:

Welcome and Moderator:

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Keynote Speaker:

DOUGLAS ELMENDORF, Don K. Price Professor of Public Policy, Harvard Kennedy School; Former Director, Congressional Budget Office

Book Presentation:

WILLIAM GALE, Arjay and Frances Fearing Miller Chair in Federal Economic Policy Co-Director, Urban-Brookings Tax Policy Center

Panelists:

DOUGLAS ELMENDORF, Don K. Price Professor of Public Policy, Harvard Kennedy School; Former Director, Congressional Budget Office

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P R O C E E D I N G S

MR. WESSEL: Good morning. I'm David Wessel from the Hutchins Center on Fiscal and Monetary Policy here at Brookings. This is all the remaining people in Washington who care about the federal budget. This is it. I'm kind of worried that that's not a joke. I'm going to welcome everybody to the Tax Policy Center's fourth annual Donald Lubick Symposium. The symposium was launched in 2016 to honor Don's extraordinary record in promoting tax policy. Don has a distinguished career. He went to the University of Buffalo. He was a veteran of the U.S. Army Air Force. That's not a typo. I looked it up to make sure that's what it was called at the time. And Harvard Law School. He's taught in a number of law schools. Don has served every Democratic president from Kennedy through Obama and in between, he did some work in the private sector and he has returned to government repeatedly until he retired and we're very happy that Don is with us today, his wife Susan, his son Jonathan, and daughter-in-law Viola Lubick, who traveled from Israel to be with us today. I'll spare you the Netanyahu jokes because the real reason we're here today is to celebrate Bill Gale's new book, "Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future." It's a very ambitious book because I think it's two books in one. Half of it is an incredibly comprehensive survey of how the federal budget works, taxes and spending, but then, unlike a lot of other people, instead of just damning the problem, Bill puts his neck out and offers solutions, a detailed list of solutions, which actually add up, which is another thing that distinguishes from some of the other people who talk about it, budgets in Washington today.

So, we're very happy to have this opportunity. On behalf of the Hutchins Center, I need to plug our computer game on the budget so you can see if you have a better plan for bringing to fiscal stability than Bill Gale and there's an iPad out in the corner, outside the room, and this one and some of our RAs are there and we encourage you to try it and if you don't get a chance, you can play it online: fiscalship.org. We think it's a good way to help crystalize the choices that people have to make.

So, our plan for the day is we are very lucky to start off with the presentation by Doug Elmendorf who is now the dean and the Don K. Price professor of public policy at the Harvard Kennedy School. Doug has been in and out of Brookings over the years. He's been at the Treasury, the White House, the Federal Reserve, and of course, was director of the Congressional Budget Office from January, 2009 through March, 2015 and I've always admired his ability to crystalize the fundamental fiscal challenges we face in words that even members of Congress can understand.

After Doug speaks, Bill is going to make a presentation about his book. He has been allotted 20 minutes and at 20 minutes I want everybody to stand up and face the back of the room so he knows that his time is up. So, we'll have time for a panel with Doug, Bill, Maya MacGuineas, and Michael Strain. So with that, Doug Elmendorf.

MR. ELMENDORF: Good morning everyone and welcome. I am delighted to be back at Brookings today and honored to have been invited by Bill to offer my views on this important occasion. Bill Gale has been one of the most thoughtful and interesting voices on U.S. tax and budget policy for 30 years. If you have not spent enough time with Bill and his writings to know that, then this is your chance. This book offers you in one place a collection of great information and great wisdom. If you do know Bill and his works well enough to understand why he had been such a thoughtful and important to the budget policy discussions, this book is also your chance to have a lot of Bill's information and wisdom in one place.

So, all of you should have a copy of this book and if you don't already, then you should certainly get one on your way out. I have learned a tremendous amount from Bill over many years and I learned a lot more reading this book so I really commend it to you.

I also want to say here at the start how grateful I am to Bill for giving me the opportunity to join Brookings in 2006. At that point, I had been in Washington for more than a dozen years and I have been lucky enough to have interesting jobs where I can be engaged in policy discussion, but my role had mostly been in the shadows and Bill decided to take a chance on bringing me out into the public domain. And that opportunity to come to Brookings changed my life as chances to come to Brookings have changed many people's lives over many decades and I will always be grateful to you, Bill, for taking that chance on me and bringing me into this place and giving me the opportunities that have followed.

Bill's terrific book, "Fiscal Therapy," is about making choices. As he explains, federal debt is larger relative to the size of the economy today then at almost any point in our nation's history and the current policies will continue to rise indefinitely as far as the eye can see. That path is not sustainable and therefore, we will be forced at some point to make choices that increase federal taxes, reduce federal spending, or both. But Bill views the necessity of making choices as an opportunity as well and I think that is exactly right. As Bill explains, the federal government is not taxing or spending in ways that advance our national interest very effectively. Productivity growth is slow by historical standards yet we have reduced federal investment in infrastructure and research and development to nearly the smallest percentage of total output in my lifetime. And inequality has risen significantly and economic mobility has declined yet we have not responded with policies to expand access to high quality education and training for either young people or older people.

The share of the American population over age 65 is rising to unprecedented levels, which increases federal spending on our largest and most popular benefit programs and yet, we have reduced taxes to the smallest percentage of GDP than any sustained period for 80 years. And the tax system we do have, the way we raise revenue is neither efficient or equitable. We can do better. We need to do better and the way to do better is exactly as Bill says, which is to "focus on realistic solutions" based on "facts and evidence."

There is much that economists and policy analysts don't know about how the world works and our prescriptions for fiscal therapy should be offered with some humility just as prescriptions for fiscal therapy should be offered with some humility. Nonetheless, there is much that economists and other policy analysts do understand about the effects of thorough policies based on historical experience and careful research and that knowledge should be used in forming policy.

Bill's book presents the crucial facts and evidence about federal budget policy that elected officials should use in making budget decisions. I agree with many of Bill's specific recommendations on both the tax and spending side and I'm really delighted to see so much good sense in one place that I will carry around and refer to when I need it.

But I decided that rather than run through Bill's menu, I will focus on one issue and particular, an issue where my views may differ somewhat from Bill's views or the views of other members of the panel. That issue is whether we should be trying to reduce budget deficits in the near term. I think we should not. Specifically, I think the evidence shows that reducing projected budget deficits will be necessary ultimately, but would be a mistake to do now. Let me explain. My starting point is the low level of interest rates. The U.S. economy is now roughly at full employment, which is wonderful and the federal funds rate is only 2-1/2 percent. Most members of the Federal Open Market Committee expect a slight further increase at some point, while financial market participants are split about whether the next move will be up or down.

Thus, 2-1/2 percent seems pretty close to the equilibrium short-term interest rate in today's economy. The yield on 10-year treasury notes is also about 2-1/2 percent. That implies that financial market participants expect interest rates to stay close to 2-1/2 percent on average over the next decade and even longer-term treasury interest rates are also consistent with short-term rates staying close to the current level on average for a very long time.

Now, to be sure, predicting interest rates is very difficult. If I was really good at it, I would be speaking to you on a remote video link from an island in the South Pacific and I'm not so one should take interest rate predications with a grain of salt. Nonetheless, both logic and empirical evidence imply that a future of low interest rates is likely. As the financial crisis was beginning over a decade ago, the picture of interest rates that many of us had in our minds was low rates in the 60's, a peak of rates in the 70's and 80's, and then lower rates again in the 90's and (inaudible). Interest rates fell in the financial crisis and recession, which was not surprising, but it didn't rise much after that, which is surprising. If you draw a picture of interest rates today and drop off the period before 1990 so you can rescale, what you see from 1990 to today, now almost 30 years, is a consistent significant decline in interest rates.

A pattern of 30-year standing is not a flash in the pan. In addition, the similar declining rates can be seen in many countries around the world and Lukehouse Rachel and Larry Summers pointed out here at a meeting of the Brookings panel in economic activity last month, the global decline in interest rates has occurred even though public debt has surged in this country and many others.

As this pattern of globally low interest has become more apparent, a number of analysts have examined a large number of possible explanations. Some of the possibilities involve the declining demand for capital stemming from a diminished capital intensity of production, slower trend growth of the labor force caused by demographic changes, and slower growth in total factor productivity.

Other possibilities involve specific features of treasury securities that might push down their yield relative to the return on capital and other possibilities as well. I think a fair summary of this growing literature is that explaining interest rates even in retrospect is a complex and uncertain business, but that there are good reasons for rates to stay low for the foreseeable future. If interest rates really will stay low for a long time, what does that mean for our subject today?

Well, persistently low interest rates represent "a sea change for federal budget policy." That quotation is from a paper that I wrote with Louise Shaner in 2015 we published in the Journal of Economic Perspectives in 2017. We wrote in the paper that it is well understood that lower interest rates change the dynamics of the thorough budget. For any gap between non-interest spending and revenues, lower interest rates cause federal debt to compound more slowly. But it is less well understood that low interest rates change the desirable levels of deficits and debt.

Analyzing the implications of low rates for optimal
federal debt is complicated in part because the implications vary to some extent depending on the reasons that interest rates are low. My paper with Louise has a whole set of forks in the decision tree based on different explanations for what's been happening in financial markets. If you're interested, there is a summary version of our analysis in the Journal of Economic Perspectives and a longer more technical version that still lives on the Brookings website.

Our bottom line was "Many though not all of the factors that may be contributing to the historically low level of interest rates imply that federal debt should be substantially larger than it would be otherwise." Now, you should not just take our word for it. Other economists, including some more distinguished economists, have been toiling in this vineyard of late and have reached similar conclusions and I'm not aware of research that has examined the effects of interest rates on optimal debt that has reached contradictory conclusions. Therefore, I think it is appropriate at this point to conclude that the United States should have substantially more federal debt than most economists would have argued for several years ago and that conclusion further implied that there is less urgency to putting federal debt on a sustainable path than most economists would have argued several years ago.

This line of thought does not say that federal debt can rise indefinitely relative to total output, which is what would happen under current laws and policies regarding revenues and spending. Let me emphasize. Debt cannot rise indefinitely relative to total output and none of the recent research that I'm referring to suggests otherwise. Therefore, reducing federal budget deficits will be necessary at some point. The crucial question, though, is when should deficits be reduced and I think this literature and a set of points I will make now argue that the right answer to the question is that we should aim to reduce deficits now.

There are legitimate reasons that we should reduce budget deficits in the near term, but I think those arguments are less consequential then they first appear and are in my view significantly outweighed by the arguments for delaying action. Let me explain. One legitimate argument for acting soon is the interest rates might rise unexpectedly. As I noted, interest rate predictions should be taken with a grain of sale. Current predictions might be wrong. Rates might rise a lot quickly and I think we should hedge our bets and make budget decisions that would not be terrible if interest rates turned out to be higher than we expect. We should consider policy in the light of what we would think if interest rates turned out to be lower than we not expect, which is also a possibility.

Indeed, Larry Ball and Greg Manacue and I wrote a paper 25 years ago in which we analyzed the implications of recognizing the risk in the economy and in particular, the risk that interest rates might right a lot and economic growth might fall a lot and debt that had seemed sustainable at a point in time would turn out to be unsustainable. We concluded that treasury interest rates have often been low in American history precisely because they represent a hedge like in certain kinds of risk and therefore, sensible policy makers should take out insurance against negative developments by accumulating less debt than they would in a world of perfect certainty.

But they noted earlier current interest rates are quite consistent with the evolution of rates over 30 years now that is not just a flash in the pan and moreover, interest rates were generally quite low before the run up in the 1970’s. So, the anomalous period looks increasingly like the 70’s and 80’s not what has happened in the past 30 years. So, as a result, I think we should hedge our bets in formulating budget policy, but only to a limited extent.

I think a second legitimate argument for acting soon to reduce projected budget deficits is that significant changes in budget policy should be enacted well before those changes need to take effect so that the people whose benefits or taxes are being changed can plan ahead. For example, as many of you know, we are still phasing in an increase in the full retirement age for social security that was legislated almost 40 years ago and the gradual pace of that increase has helped some people plan ahead. However, most changes in tax rules and spending programs do not need to be announced far in advance. Moderate increases in income or payroll tax rates, for example, do not require significant advance notice and many people are not very far sided anyway about government policies even when they are already in law. After all, if everyone was saving an optimal amount based on a rational forecast of their future income, we would have much less need for social security then we actually have.

So, I do worry a little about announcing certain change in policy ahead of time, but I don't think that we need to announce all of our changes very far ahead and that reduces the urgency of acting well in advance of the problem.

I think a third legitimate argument for acting soon to reduce projected budget deficits is that elected officials tend to avoid hard budget choices and therefore, analysts should keep the pressure on and we see this sort of avoidance in a whole collection of federal budget decisions. Over the past decades, we see it in decisions by state and local government leaders to promise large pensions to current employees and not fund those pensions and we see this in other ways as well. But we should recognize that this inclination toward budget laxity is not an absolute. Our policymakers did not cut taxes or increase spending sufficiently in the great recession with significant negative consequences for Americans. German policymakers performed even worse with terrible consequences for a significant number of people across the eurozone. I did think in 2011 and '12 when I was watching very closely, that the Congress would have been more likely to enact short-term physical stimulus if our long-term physical outlook had been brighter. There is an argument for brightening that long-term outlook in order to encourage short-term action, but I now think that our long-term physical outlook will never become sufficiently bright. Everyone will feel (inaudible) about it to justify short-term physical stimulus on that basis. And we will just have to make the case for short-term physical stimulus on its own merits.

Moreover, I think we should be very careful as analysts to shade our analyses to offset what we perceive as biases in elected official's behavior. Our responsibility as analysts is to offer the best most objective analysis we can and leave it to our elected officials to make those decisions.

So, those arguments for near term action are not as strong as they first appear. What are the arguments again near-term action? I think there are two important ones. First, increases in federal taxes or reductions in federal spending would slow the economy in the short run and with the federal funds rate as low as it is, the contractionary effect of physical tightening would be dangerous for our economy. Physical tightening would reduce aggregate demand and all else equal would produce output in employment in the short run even though it would be good for output in the long run. Under the circumstance that we have viewed as normal for most of our professional lives, that contractionary short-term impulse would be offset be easing by the Federal Reserve, but current circumstances are not normal in the traditional sense. The fed does not have much room to cut the federal funds rate. Therefore, reducing budget deficits today would present a significant risk of reducing output and employment with all the attending economic and social costs.

The second reason I think we should not take action to reduce budget deficits in the near term is that most of the reduction should stem from an increase in revenue and Republican leaders are not ready to support revenue increases. We should focus on increasing revenue because decreasing spending in the ways that would be most likely, and I will explain in a moment, would be worse for our society at this point then letting budget deficits continue.

Let me explain. It is important to realize that there is no appetite in either of the major parties for significant cuts in our large federal benefit programs. The current Republican President has promised to maintain social security and Medicare and Medicaid although his actual proposals contradict that promise and a Republican controlled house over eight years voted on no legislation that would substantially reduce federal benefits except for repeal of the Affordable Care Act. The Republicans will not try to cut those large benefit programs. Surely, the Democrats will not either.

There is also little appetite in either party for significant cuts in annually appropriated non-defense spending. Such spending is already nearly the smallest percentage of GDP in more than half a century and no matter how much some elected officials like to complain about wasteful government spending, they also realize that their constituents want to have their food inspected, their borders patrolled, their highways built and prepared and those things are funded through non-defense discretionary appropriations.

Moreover, there is little appetite among a number of people in both parties for substantially cutting defense spending. So, on the spending side that leaves only the benefits focused on lower- and middle-income Americans. If federal spending was cut in the near term, this is the category of spending that would bear the brunt of those cuts. Contrary to some assertions that the current structure of benefits provides a comfortable hammock for people who do not work. That is not the case given the level of benefits and the conditions of the people who receive them. There is a growing body of evidence suggesting that at least some of the benefits enhance rather than diminish the life prospects of children who receive the benefits and we've experienced several decades of widening income and equality and declining upward mobility.

In these circumstances, cutting benefits for the people who have gained the least from overall economic growth during the past several decades would be a perverse policy action. And, yet, given the current resistance among Republican leaders to any tax increases, much less significant tax increases, I think that any efforts to reduce budget deficits in the near term would end up cutting benefits for lower- and middle-income Americans.

Therefore, for both economic and social reasons, I think we should not aim to reduce federal budget deficits in the near term, however, we will need to do so eventually and in the meantime, we can and should work hard to improve "the ways we tax and spend" as Bill opens his book. And in Bill's excellent book, he offers a tremendous number of important suggestions for how we can tax and spend in ways that are more effective in advancing our national goals and we should pursue that agenda with great vigor. Thank you very much.

MR. GALE: All right. Thank you very much. Thank you, David, for sharing today's event. Thank you, Doug, for being here for that great talk. I always felt like -- here at Brookings we talk about impact on public policy and it turns out one of the biggest ways I've ever had impact on public policy was by hiring you rather than writing stuff so I'll take it. I also want to thank all of you for being here today. It's a gorgeous day outside. You could have just said you were coming here and then headed off to the tidal basin so I appreciate your being here. I don't want to make this like an academy awards type of presentation, but I do want to thank a few people for their help on this project. Book writing it turns out is a team sport and not an individual sport.

So, first I want to thank Alan Auerbach for our 20 years of work on budget outlooks. I've learned an enormous amount from him on these issues. Second, I want to thank Larry Hoss who did a tremendous job editing the manuscript. If you like the way it's written, you can thank Larry. Just a remarkable job and a tremendous amount of advice, wisdom, and support to make the book possible. Third, Aaron Krupkin. He has worked for me for five years. His fingerprints are all over the book. Every imaginable way one could help, he has helped. I think every number in the book he has dealt with. I don't say that as a way to potentially blame him for any mistakes, but to just indicate the comprehensive nature of his work and his effort. It's greatly appreciated. And last, but not least, Diane Lin provided not only incredible support in so many ways, but actually came up with the title that everybody liked so much. So, thank you all and let's get on with it.

One piece of advice that book writers get is don't hide the ball, get to the point. So, I'm going to summarize the entire book in one slide here. Basically, argue that the economy is doing fairly well right now, but if you look forward, if look under the hood, you see two related issues that will come to the forefront. One is rising federal debt. The other is at the most conceptional level the way we tax and spend, but, in particular, lagging investments in crucial areas of the economy. I argue these problems sizable. They will have order effects on American families, but also that they are solvable and there is a three-part solution that I put forward.

The first is to control entitlements and I really mean social security and Medicare here. They are a huge part of the budget. There are ways to reform them that I'll talk about that are consistent with preserving their anti-poverty rolls and their social insurance features.

The second is to invest in the country in children, in infrastructure and research, and the book provides room in the budget for major investments in these categories.

And the third is to raise and reform taxes and we will talk about that a fair amount. But together these policies I argue will address both of the issues laid out in the front.

But before I turn to that, let's go back to the beginning. You've undoubtedly seen this graph before debt to GDP over time. In the U.S., you can divide the history into three periods. The first period, before 1980, it was only wars or recessions that caused debt to rise. As soon as the war ended and the recession ended, the economy recovered. The debt to GDP ratio came back down.

Starting in 1980, the second phase, Ronald Reagan's tax cuts, defense buildup, led to increase debt during peace time and a full employment economy. That led to a series of bipartisan budget agreements that ended up, combined with a strong economy, giving us surpluses as far as the eye could see at the turn of the century. Then Alan

Greenspan went to congress and told them they should cut taxes to avoid running out of public debt. As Doug was mentioning, then the issue of needing to keep the pressure on policymakers. Well, you didn't have to tell congress that twice. They cut taxes twice, we got into two wars, they created a new entitlement package and Medicare Part D, they raised discretionary spending, so we are a can do country and we solved the problem of not having enough public debt.

After that, of course, the great recession, the associated policies, and then the tax cut in 2017 and the budget deal in 2018 so you've deficits rising significantly since then.

The third period is the future and this is based on the forecast in the book. It is a relatively conservative forecast. I can go on the assumptions that people want, but you could easily get up to 200 percent of GDP by 2050 if you made more pessimistic assumptions. There are two differences in this period with earlier period. The one that's obvious is the debt is bigger then it will be in the past, but the one that is equally important is this is a permanent change. This is a permanent path. There is no war that's going to end and bring the debt back down. There is no recession that's going to end and bring revenues back up. Indeed, the economy is doing well.

So, we're in a new situation now and I was hoping that by researching fiscal history I would find the solution to our current fiscal issues. Instead, what I found out was our history tells us nothing about how to deal with the current solution.

So, this is actually my favorite chart in the whole book and not because it's particularly complicated or anything you haven't seen, but it's really a (inaudible) test. It's really a mirror. What you see in this chart will tell you what you think about the fiscal problem. One view is that this chart shows that spending is rising a lot, revenues are not rising much, therefore, it's a spending issue and, therefore, we should cut spending. You hear this from the conservative side all the time, it's a spending problem.

There's a second way to look at this, though, which is that it's a revenue issue and that is if you look at the increase in spending, it's due to two things. One is an increase in net interest, which is not really new government activity, it's simply government covering the costs of the deficits that ran in the past. And the other part of the increase in spending is merely the continuation of existing initiatives. There is no new government programs in this budget. So, this view would say that the real concern is the politicians haven't manned up and paid for what they've committed to spend and, therefore, it's a revenue issue.

I have a fair amount of sympathy for this view, but there's also a third view, which I also discuss in the book, which essentially it takes two sides of the scissors to do the cutting and so there is sort of more or less permanent imbalance here between what people want from government and what they're willing to pay for in government and that difference is going to get worse over time as the debt projections showed.

So, let me just show you one more graph before take a slight detour into economics. This just shows you the composition of spending. There's two interesting things here. One is that more than 100 percent of the increase is health, social security, and net interest. Social security, of course, levels off as the baby boomers get into retirement. Health keeps rising because of the assumption that health prices will outstrip inflation and because of the changing demographics. Net interest rises because interest rates are going up somewhat.

I should have mentioned earlier, interest rates stay below the growth rate during the whole 30 year period in the forecast that I showed you earlier. So, we can have a discussion later, but whether that means interest rates stay low or not, but they are less than the growth rate through the whole period. Even so, they rise by about 180 basis points over 30 years and, of course, that combined with the rising debt level causes net interest to rise.

The other thing to note is the decline in investment. Most of this is a non-defense discretionary spending that falls by about a quarter relative to GDP and the other mandatory also falls by about a quarter relative to GDP. This is where a lot of the social policy initiatives are.

All right. So, why do we care about debt? I feel like this discussion needs to be much more nuance than it often is in the public domain. First of all, let's stipulate that not all debt is bad. Using debt to fight recession as Doug mentioned a stimulus package is generally thought to be a good thing. Using debt to finance government investments, it's important to take into account the investment component as well as the debt component. And, of course, it provide a safe asset for investors, which in the crisis about a decade ago it was an important issue.

Second, it's not a crisis now. The debt problem is not a crisis and we can pay our debts for decades. We issue debt in our own currency. Treasuries are the safest asset in the world, etc. So, I think it's an economic mistake to argue that it's a crisis, but I think it's a strategic mistake also for two reasons. First, if you keep saying it's a crisis and it keeps not happening, there's a credibility gap. But, second, and a little more subtle, focusing on the crisis aspect of things implicitly makes the point that the reason we are concerned is that it might cause a crisis. All right. And I want to dispose you of that notion. The reason we are concerned is that even though it will not cause a crisis, it will cause gradual concerns. It will cause rising debt that's used to finance transfer payments. It will reduce future national income. This can either happen through a rise in interest rates, which would reduce the capital stock, or it could happen through an inflow of capital, which increases our foreign indebtedness and therefore, would require us to syphon off more future output to pay back our foreign lenders.

Note that that can happen even if interest rates don't rise. So, the national saving future national income impact does not require the interest rate channel to work. And estimates from CBO and others suggest that reducing the debt from 180 percent of GDP to 60 percent of GDP could raise output by between 8 and 20 percent depending on the model. And the reason I picked 60 percent is because once you've established that we're on this unsustainable path and you've established that there are problems with debt and growth, you have to figure out where we're headed. And so, I think the single hardest (inaudible) point in the book is trying to figure what the right debt target is and it's a mix of subjective and objective considerations. I won't bore you with the to and fro of how I came up with this number, but I do want to describe 60 percent in a couple of ways.

First, it's an average over a business cycle. It's not meant to be a per year basis. That would make recessions worse in the ways we all know about.

Second, obviously it's not zero debit. There are advantages to having some debt and zero is not an economically sound target and it's not even a balance budget rule. The proposals I'll show you actually get very close to a balanced budget, but that's by accident, by coincidence. A balanced budget is not what we should be aiming for. Sustainable debt to GDP ratio is the right target. So, this is higher than the historical average, which I took from '57 to 2007 that arguing -- we paid down most of the World War II debt by then or about half of it and 2000 is before the debt spiked again. So, this is sort of 50 years of kind of normal economic policy where the debt to GDP ratio was 36 percent. Sixty, the target is higher than that because interest rates are likely to be lower in the future as Doug mentioned. Because the more investment we get the more debt we can sustain. How we spend the money matters as much as how much we're taking on in debt.

And, third, the baseline level of debt is so high that getting it down from 180 to 60 is a big deal. You know, if we were starting at 100, I could say maybe well we could cut farther if we wanted to, but the initial conditions matter. So, then the question is well why not have an even higher debt level. After all, future generations are going to be better off compared to us and so they can incur more debt and there is sort of two arguments against that.

One is thank goodness earlier generations didn't do that to us and the other is the question of will future generations be better off then we are. This graph is taken from a paper by Ross Shedi and a few other people and I apologize that the horizontal access is 50. Keep that in mind. There should be a big area with the horizontal access being 0. But it basically shows that people born in 1940, by the time they became adults, 90 percent of them were better off in real terms then their parents were. But by 1980, only about half the people born in that year were better off than their parents were.

So, what's happening is the widening distribution of income is offsetting the fact that on average income goes up over years. So, a significant portion of people may not be better off than their parents in future years.

All right. So, if the target is 60 percent, then what does it take to get there and that's the fiscal gap, which Alan Auerbach came up with in the early 90's and that we have worked together on for 20 years since then.

The fiscal gap is about 4 percent of GDP. What that means is if we started in 2021 and we wanted to get to a debt to GDP ratio of 60 percent by 2050, we would need immediate and permanent cuts of 4 percent of GDP. Four percent of GDP is a hard number for people to get their hands around so what this graph does is show different ways of getting there. You need a 50 percent increase in income taxes, a 24 percent increase in all taxes, or a 21 percent cut in all non-interest spending, or 36 percent cut in all spending other than interest, Medicare, and social security.

So, these are big effects. Obviously, there is uncertainty just as obviously the longer we wait the bigger the changes have to be and to give you a sense of how sensitive these are, if you wanted the debt to GDP ratio to be 100 percent by 2050, rather than 2050 the gap would be 2.6 percent to GDP so about two-thirds as big if you were willing to settle with 100 percent.

These numbers tend to make people squirm and they come up with all sorts of clever ways to avoid what's staring them in the face. The first thing is why I put foreign aid in quotes. People tend to think that foreign aid something like 25, 28 percent of the budget. It's actually about 1 percent of the budget. Seventy percent of the budget is social security, healthcare, military, or net interest. All right. So, defense is already fairly low. Net interest we can't really cut. So, we're talking about social security and Medicare as areas --

social security and healthcare, sorry, as areas where significant spending cuts have to be explored. We're not going to be able to get there by cutting public television, Department of Education, Department of Commerce. Those are all small potatoes compared to where the money actually is.

The second idea people have is maybe we could create inflation and get out of the situation and we are uniquely situated not to be able to inflate away the debt. All right. Our financial debt is short-term so as soon as investors figure out the fed is inflating to reduce the debt, they are going to demand higher interest rates and our long-term debt is all indexed for inflation. Social security and effectively Medicare are indexed so you can't inflate away that debt.

So, inflation is not an option. Growth could help, but even significant increases in productivity growth rate do not generate that much in terms of reducing the debt to GDP ratio. So, you know, growth, if we can grow faster, yes, of course, we should do that, but realistic assessments suggest it's not going to get us out of the deep water and I feel a little stupid saying this, but I feel like I have to say this. We cannot tax cut our way to fiscal responsibility.

All right. So, what should we do. Very briefly, in the book on healthcare, I talked about expanding coverage and controlling cost. Premium support and Medicare, provider payment reform, letting Medicare negotiate pharmaceutical prices and formulary could all help. Medicare pays substantially more than Medicaid or VA pays, for example, for the exact same items. Social security, I was a member of a commission in the bipartisan policy center a couple of years. We came up with a social security reform plan. I borrowed it for the book. It basically raises retirement age, indexes, benefits with a change CPI. It raises the payroll tax cap. Basically, all social security proposals have those three features. We also make special efforts to protect low income retirees and there's an increase in payroll taxes there.

Investing in the future. We've got an extra 1 percent to GDP to strengthen social policy. I talked about several different areas where we could this. I think the most important is investing in children both for equity and efficiency reasons. The equity reasons should be clear. Children's status in life are not their own doing. It's based on their parent's circumstances, their neighborhoods, the schools they go to, etc. The efficiency reasons are also fairly compelling. We as a country are wasting resources by not getting education to the right people, by not utilizing the human capital that they could -- by not creating the human capital that they could have.

We need to patch holes in the safety net. It's amazing how low take up rates are in some of the major programs and so there are a variety of other things we can do in terms of social policy with that 1 percent of GDP.

Then on infrastructure, there's room in budget that I propose for a half of percent of GDP increase in infrastructure over the next 30 years and for doubling of federal research and development spending.

Now, our favorite topic, raising and reforming taxes. I go all in on this. A carbon tax based on a proposal that my colleagues Adele Morrison, Rork McKibben have put forward. Value added tax with a 10 percent rate. Both of those with offsets for low income households. On the business side, I think we need to repeal the passthrough provisions and move more toward a cash flow tax with, on the corporate side, a higher rate.

On the individual side, the imperative is to raise taxes on high income households. There are two reasons to do this. One is their income has tripled over the last 30 years, but their average tax rate has stayed the same. In a progressive tax system, that's not how it's supposed to work so there's room to raise their taxes. And the other reason is raising taxes on high income households is really the only way to get them to share in the fiscal burden. So, cutting social security is not going to do it. So, I have a number of proposals to raise taxes. These proposals are remarkably similar to the ones that Larry Summer has put in the Boston Globe about a month ago.

And the last thing on the tax side to emphasize is we need more funding for enforcement. The tax gap is something like 600 billion dollars a year. The IRS budget is something like 10 or 12 billion dollars a year. There is plenty of room to close the tax gap.

So, let me tell you how all this plays. This is a graph you've seen before with the deficit in there as well. The proposals I put forward in my estimate basically keep non-interest spending the same as they are in the baseline. That involves cuts in social security and health and increases in investments in kids and infrastructure and social policy. So, we're twisting the allocation of non-interest spending to focus more on investment purposes.

Total spending, though, comes way down and obviously, the difference there is net interest and the reason it comes down is because revenues go up by a lot and they go up relative quickly. The increase in revenues stems the debt problem keeps net interest payments low. So, the deficit goes almost to 0. Again, that's a coincidence. I was not aiming for a balanced budget. I don't care if we get to a balanced budget, but it turns out we're pretty close.

And then the debt projection looks like this. So, it gets down to 60 percent, but the important thing is not just that we get there, but how we get there.

On the impact, I will just mention my estimates in my head and based what I could read said this should raise growth, reduce inequality, raise mobility. The pen warden budget model people have just put out an estimate fiscal therapy plan that basically shows that it does boost GDP by about 7 percent I think and it significantly cuts the debt by significantly more than I have estimated. So, those seem consistent.

As Doug mentioned, these are realistic proposals. I view that as a feature not a bug. There are specified changes. There is not, you know, let's reach this goal and figure out some way to do it. Everything is specified and there are no growth effects included in the budget estimate so I'm not cheating in that way.

I want to mention three critiques and then I will stop. The first one is generally from the right and what they say is you got the problem right but you got the solution wrong. The second one is from the left and they say great solution but deficits are not a problem. And then the third critique is from all over, which is, like, politically how are we ever going to do this?

So, let me take those in order and the issue about taxes and growth, it's clearly possible to raise taxes in a way that destroy the economy. There's no question about that. But the way I propose is essentially a consumption tax, you know, which does not distort saving investment, a carbon tax, which fixes an externality in the economy, and moving the corporate tax to a cashflow tax, which improves investment incentives, and closing loopholes in the income tax system, which arguably is efficiency raising.

So, it's possible I think to raise taxes without hurting the economy and there's some evidence here the G7 countries have revenue from 1970 to 2015, they have revenue that's about a third higher than the U.S. This is all levels of government now. But the per capita income growth rate has been the same in the U.S. and the other G7 countries. Now, of course, their big difference with us is the value added tax, which I think supports my claim that it's possible to do this without hurting growth.

The issue from the left is the low interest rate argument that Doug mentioned. Let me just say a couple words about that. As I mentioned before, the interest rate is less than the growth rate in the entire forecast. That doesn't mean it's as low as it is today, but it's not skyrocketing. We're not getting into an interest rate debt spiral in the forecast. Even with low interest rates, even if interest rates never rise from the current level, so Doug said they've been low for 30 years, they stay that level for another 30 years, interest payments would go to 2.7 percent of GDP. That's almost as high as it was in the early 90's with 3.1, 3.2 percent which caused the concern for all the budget deals back then.

Another point is that interest rates have mixed effects on the long-term budget. If you're a borrower, you want lower interest rates. If you're saving for the future, you don't like lower interest rates. Lower interest rates make it harder to save for the future. So, a kid saving 50 bucks for a bicycle wants a really high interest rate because then he or she can save less. So, the government obviously has borrowed money, but the government is also facing these higher expenditures for social security and Medicare in the future and lower interest rates make it harder to prefund that effort essentially.

So, if you take the forecast out to 75 years, for example, you'll find that the impact on the long-term budget is less than it is under 30 years with lower interest rate.

The third point is that high debt may constrain fiscal policy even with low interest and we'll talk about this more I'm sure on the panel so I'll move on to the last point, which is the politics. There is probably no issue for which our current political system is more dysfunctional than long-term deficit reduction. It's got all the elements of a classic Mancur Olson problem. The benefits are diffuse and in the future and many of the people who would be getting them not only don't vote now. They may not even be alive now. Whereas the costs are concentrated and obvious. We raise someone's taxes they are going to object.

My late colleague, Charlie Schultz, had this thing that he called the hypocritic oath for politicians. The hypocritic oath, of course, for doctors is do no harm. In Charlie's words, the hypocritic oath for politicians was do no obvious harm and deficit reduction does obvious harm.

Public opinion doesn't help. The public dislikes red ink, but they dislike all the policies that reduce red ink. The no new taxes pledge, which most Republicans have signed, doesn't help. How can you negotiate on taxes and spending if one side has already taken taxes off the table? The founding fathers didn't help us with its complicated structure of government. You all know about the partisanship polarization and tribalism going on, but there is a particular issue that my colleague, Stewart Butler, highlighted to me several years ago, which is the two parties need to trust each other because deficit reduction involves a lot of changes over time and nobody wants to be the sucker holding the bag while the other party gets their changes and your own changes get taken away. So, there's got to be an element of trust that seems to missing right now.

And, finally, there is no crisis. As I mentioned, there's not back to the wall moment. Politicians don't act when they should, they act when they have to and the trust fund exhaustion might provide such an occasion for Medicare and social security and we can talk about that later.

I want to close on an optimistic note, not a pessimistic note, that maybe there is cause for hope and there's two elements here. One is fiscal sustaining ability is consistent with both conservative and liberal ideals. Liberals want an activist government. That requires resources. Conservatives want a sound government that also requires resources. And, second, let's remember there's a lot to be gained from fiscal reform. As Doug mentioned in the go through in the book, they were talking not just a stronger economy, but a more equal income distribution, more economic mobility, etc. So, there are potentials here, but we face sort of a classic Yogi Berra fork who said if you face a fork in the road, take it.

I could see two ways this is going. One is Max Bockus and Dave Camp several years ago did a listening tour on tax reform and one of the comments they got was, "What you should do is get rid of all the deductions that don't affect me." And if we go that route, it's not going to work. That's basically how we got to where we are right now. The other quote is often attributed to Winston Churchill, but it turns out he didn't say it. Aba Eban the Israeli politician did and that is, "You can always count on Americans do to the right thing after they have exhausted all of the other options." So, I don't know if that's true, but that's the thought I would like to leave you with and I thank you.

MR. WESSEL: Great. Thank you all for that. You've already met Doug and Bill and I'm joined by Maya MacGuineas who's president of the Committee for a Responsible Federal Budget and head of the committee to fix the debt, and my -- our colleague, our neighbor, Michael Strain, who's the John G. Searle Scholar and director of economic policy studies at the American Enterprise Institute, and I think I want to start -- I think I'd like to do this in a couple of chunks. One chunk is to ask Maya and Michael to respond to -- and Bill to

Doug's provocative opening statement. I told Doug that I prefer the post CBO Doug Elmendorf where they're (laughter) not quite so, you know, six of one, half a dozen of the others.

We can talk about the long-term where I think there's substantial agreement about the imperative, but in the near-term, Maya, won't you start? When Doug stands up there six feet from where you're sitting and saying we shouldn't reduce the near-term federal debt, what goes through your mind?

MS. MACGUINESS: Can you hear me with this mic; does that work?

MR. WESSEL: Yeah.

MS. MACGUINESS: Maybe that I like Doug the CBO Director slightly more, (laughter) but I still like Doug no matter which Doug (inaudible) and have a ton of respect for how he approaches it. I do come to a different conclusion and I guess there was one thing that felt like an inconsistency to me.

So the reasons that you said we don't -- so we all agree that the long-term debt is a problem, and the reasons that you said the short-term debt weren't that much of a problem, one of the major reasons was because you didn't think we should kind of worry about the political bias, right, that you don't think the goal should be to push back against politicians who have a propensity to borrow. But then what I heard you say one of the reasons we should put this off is, right now the political environment is such that the solutions would be policies that you don't really like. So that seemed a little inconsistent to me. Okay, so -- all right, so which is --

MR. ELMENDORF: Well, I -- I -- I don't -- I'm agreeing that it might seem that way. In a --

MS. MACGUINEAS: Okay.

MR. ELMENDORF: -- moment I will explain why.

MS. MACGUINEAS: Okay, so (laughter) -- and so I guess I think there are a couple of problems that we have gotten to this point, one, because we haven't been fiscally responsible for long enough now that we've actually just kind of changed the norms, and part of what we're going to have to do is bring the norms back to where if something is important enough to do, which a lot of things right now are, particularly public investments, they are important enough to pay for. Instead, our political environment acts like, "Oh, this is so important we shouldn't pay for it." That's going to have to switch at some time; from an economic perspective, now seems like a really good time to do that.

The economy is strong, unemployment is low. This is the highest a deficit has ever been when the economy was this strong. I do understand the -- the -- the good point that when interest rates are below growth rates you have an additional advantage that you wouldn't have otherwise, but we sort of squandered it. We already put in place so much borrowing and are on track for structural deficits to grow forever. We've already taken advantage of that. And one of the problems of when you -- when you overuse the interest rates are lower than growth rates is you actually put pressure to switch those. The more you take advantage of that opportunity, the more you push up the likelihood interest rates will -- will get faster than growth rates, and I just think we have two parties that is always using a fiscal environment as strategy instead of economics.

We -- I mean, I -- I frankly just agreed with every single thing Bill -- Bill Gale said in that book. The book is tremendous. I am now off the hook. I don't have to write a book (laughter) because you have written what I would write better.

MR. GALE: Okay.

MS. MACGUINEAS: But I think that -- that there are so many things we need to be focusing on right now, but we -- we need to neutralize the politization of the fiscal environment and that means people can't say, "I don't want to be fiscally responsible because it wouldn't lead to the policy outcomes I want." We've waited too long for that. So I think that was my main take. I do think it's interesting the Fed has less room to respond to changes in the fiscal situation right now. That's true, but it has always been the case that when we do, responsible consolidation growth was going to slow for a couple of years for the short-term and then it was going to be higher overall for that. We have to decide when that moment's finally going to be. It shouldn't be when it's forced upon us. It should have been before the baby boomers start retiring, and right now not doing it, I think is kicking the can.

MR. WESSEL: Michael, do you want to respond and then I'll get Doug?

MR. STRAIN: I do. I -- I'd like to start, of course, by saying that I -- I also like both Doug Elmendorfs, CBO (laughter) and -- and post CBO. And I'd like to thank Bill for writing this book. I reviewed it quickly. I got it -- I got it in the mail and then I -- I looked at -- I read the introduction right away and it was -- it was just a breath of fresh air to be -- to be reading someone making the argument that we need to take our long-term fiscal situation seriously, that we have a spending problem and a revenue problem and we need to address both and that we need to reorient -- Bill doesn't quite say it this way, but the way I am interpreting it, and Bill can correct me if I'm -- if I'm putting words in his mouth.

You know, we -- we need to worry about the American Dream and right now we act like the American Dream is a comfortable retirement with a reasonably sized state-provided pension and -- and health insurance. I would rather we think about the American Dream as -- as giving people the opportunity to work hard and strive and -- and -- and do well in life so that they don't need the government to be providing everything for them for the last 30 years that they're alive, and so reorienting federal spending away from a comfortable retirement and toward investing in -- in people and their youth and in their -- and in their early working years seems to me like exactly the right kind of thing we need to be doing.

None of that, of course, answers David's question which I will -- which I will now do. I think that -- I think that, you know, there's -- there's a way in which I think Doug's comments are right and a way in which I think Doug's comments are -- are -- are not quite how I -- how I view it. You know, it will always be a bad time to begin reducing the deficit. If we're going to have deficits for 30 years, any given year in that 30-year period will always be a bad time, it will always hurt the economy at that point in time, et cetera, et cetera, and it seems to me that the longer we wait to make needed changes the more pain we're going to inflict, so I think it's true that if we were to start sucking government money out of the economy that that would be a bad thing over -- over -- over the near term.

I also think it's' true that, you know, we should have done that 10 years ago and we should have done it 5 years before that, and if we're worried about the short-term economic effect, then we're -- we're just -- we're never going to do it. I think the smart way to do it is to, you know, pass policies today that kick-in several years down the road, one, because people can plan like -- like Doug mentioned, but -- but also that, you know, should kind of, you know, lessen the -- lessen the jolt from it, and those policies have to be sensible and reasonable kind of regardless of the fiscal situation because the point is to live with them for the next 20 or 30 years and not to address a specific moment in the business cycle. So, you know, politics are hard and -- and -- and, you know, I don't know what we'd get from this Congress and this President but holding politics costs that it seems to me like now is a good time to do that.

MR. WESSEL: Only an economist would say holding politics costs (laughter). So, Doug, why don't you respond to Maya's point, and then I -- I am confused about it sounds a little bit like that famous, "Grant me chastity, but not yet," line. Like, how do you know when we -- we need to switch from -- when will it be safe to deal with these long-run problems that you and Bill both agree on?

MR. ELMENDORF: Great. Thank you. First, Maya, I -- I was not as clear as I should have been; let me be clearer. I think it's totally reasonable for analysts, people in positions like mine now, to say based on my values and my assessment of politics, "I want to go this way; I don't think we'll go that way."

MS. MACGUINEAS: Mm-hmm.

MR. ELMENDORF: What I was trying to argue against was any of us slipping into thinking that we could overstate some problem, overstate some risk, you know, in a -- in a sort of subtle hidden attempt to steer the debate differently. So, you know, you might argue when I was in the Federal Reserve Board that we should be particularly worried at that time about higher inflation, that didn't mean the staff was allowed to sort of always nudge this inflation forecast on the high side.

We had to give the straight forecast and the policymakers could decide if they wanted to lean against something. That was their choice. So I just want us to be careful when all of us describe the urgency of addressing fiscal matters to describe that urgency in strictly -- in -- in terms of the analysis, and then if we have views we want to offer, to do so explicitly, and I tried to do that separately.

MS. MACGUINEAS: Yeah.

MR. ELMENDORF: On the matter of CBO Doug Elmendorf and the new Doug Elmendorf, (laughter), there are at least two reasons why I may sound different. One is that I was not allowed at that point to make policy recommendations. That's how the CBO should work and now I take the liberty to do that. But the second is that the world has actually changed. Like -- or at the very least, the economists' understanding of the world has changed in a way that is directly relevant to the optimal budget policy. So in 2013, CBO had projection of interest rates that was kind of up here and we started to get feedback of like, "What the heck are you folks doing?" And the up here was basically taking an average of the 1990 and 2007 period and people said, "Yeah, but that line is not bouncing around something -- that -- that path is not bouncing around a horizontal line. It's actually tilted like this." And so we started to take down the interest rate forecast considerably and then people started to do research about what the effects -- what the implications were of lower interest rates beyond the -- the mechanical ones that -- that CBO got right and what the implications were, and I think we've learned some things. Now, I think we should be careful. I think we should always be skeptical of arguments that this time is different, that we have a fundamentally new era and all of the old varieties should be discarded because I think there are a lot more new eras declared than actually occur.

(laughter) On the other hand, there are plenty of wars that have been lost because generals were fighting the last one and not the current one. Plenty of mistakes in economic policy had been made by people who, like me, grew up in some era when some set of concerns, some set of relationships were -- were -- were a certain way and when those things change, we didn't get off those. I think it's very important that we look squarely at 30 years of declining interest rates and take that seriously onboard, even if that requires people like me to give up sorts of things I've literally have been writing about for 30 years. And it is true that I am sounding like St. Augustine and -- but -- but the conditions matter.

I mean, the significant number of financial market participants think the Fed will cut rates next. They think there's a serious risk of a recession in the -- I don't think that is actually going to happen this year, but in the last three recessions, at least, the Federal Reserve has cut the federal funds rate by more than five percentage points. And even today, with big deficits, the funds rate is at 2 1/2 percent. So if you say, "Well, we can cut and we'll do it gradually so the opposite equal (inaudible) funds rate will -- will fall to one percent and we'll just kind of keep it at one," that gives you almost no room to maneuver against really negative shocks that can happen (inaudible) so this is not the right time.

MR. WESSEL: Hey, but -- so when do we -- when do you --

MR. ELMENDORF: Well, the signal is interest rates start to rise, and that matters in two ways. First of all, if we see interest rates start to rise, that is a signal, according to the analysis that Louise and I and others have done, that there is a greater economic cost to the crowding out from government debt so the costs of not addressing the deficit go up, but also interest rates rise, federal funds rate list further off the floor, and the Federal Reserve then has more room to offset the contractionary impulse.

MR. WESSEL: Okay. So, Bill, do you think Doug's crazy, or does it -- or do you think he understates the urgency of beginning to address the problem now?

MR. GALE: I -- I like all the Doug Elmendorfs that I have always known. Let me say a couple of things. One is, the issue is, is it important to reduce this year's deficit versus long-term deficit? I -- I'd happily sacrifice this year's deficit to get a long-term plan in place. The second point is the economists that Doug mentioned, Blanchard and Furman and Summers, who are talking about the fundamental changes of low interest rates which it's pretty reasonable are also not going whole-hog toward, you know, modern monetary theory or deficits don't matter, so Blanchard is saying current fiscal policy doesn't make sense, the Trump deficits are not justified although the Obama deficits were.

Furman and Summers talk about deficit delusion, but then they want to install a PayGo plan which the only reason you would do that is if you thought deficits matter, and then Summers came out with a -- a trillion dollars of increases in taxes on high-income households. Again, the only reason you'd do that is that deficits actually matter. If you really don't think there is a deficit concern, you would just cut taxes and raise spending, and I don't see anybody really arguing that, so, I mean, the -- the argument that Doug makes that the situation has changed because of low interest rates I think is correct.

MS. MACGUINEAS: Can I --

MR. WESSEL: So --

MR. GALE: The argument that there's no fiscal issue, what Doug is not saying is, I don't think is correct.

MR. WESSEL: Okay.

MS. MACGUINEAS: Can I build on that, because I want to reinforce a point and -- and make a slight tweak to one of them? But I think it's really important to notice that the very important work of Blanchard, he is also clear to state that the trajectory the U.S. is on is unjustified and troubling. So he is in no way saying that means our fiscal policy isn't a problem. He clarifies that it is in part because we've already built-in so many future deficits and also in part because we're not borrowing for very smart things which I think is one of the really important contributions that Bill makes.

The second thing about Furman and Summers, and I have a real problem with this in their paper, is they write an entire paper that basically says what we should -- there's deficit delusion, which I don't see any signs of it, because we've had a huge tax cut and a huge spending increase and two-thirds of this year's deficit is self-imposed from very recent policies, so that doesn't feel like deficit delusion from what I'm seeing.

But even beyond that, they write a paper that says what we really need is PayGo, except for recessions, agreed, and except maybe for infrastructure. We can discuss that, because I think that's a central piece of this. But at the very end they also say, "It's really hard to do nuance in papers," and remember, they're writing in *Foreign Affairs* which is a great place for nuance, (laughter) but they say if we were talking about the nuance thing, really what we should do is put in place a gradual plan that would bring the debt down as a share of GDP, which isn't PayGo with loopholes, it's actually more -- it's actually what Bill does. And so I think they wrote a whole -- a whole paper that's framed as PayGo with some loopholes as the answer, but really what they say is, "What we should be doing is putting the debt on the downward path," which is what most of us say.

MR. WESSEL: Well, you know, like you know how there are these analyses of the Torah that try and decide who wrote which chapter and who -- which -- which chapter. I suspect --

MS. MACGUINEAS: Yes. Larry and Jason, I think that's your --

MR. WESSEL: -- in the Furman-Summers thing we could -- we're going to (inaudible).

MR. ELMENDORF: I'll -- I mean, I'll be brief because I -- I agree with -- with -- what -- what Bill and Maya have said. I think -- I think -- I would just make two points, I think. One, you know, even -- even in a low interest rate environment, we have a -- we have a -- a serious problem with projected debt, and -- and Bill made that point in his presentation, that R is less than G in this whole period. I'm perfectly willing to --

MR. GALE: R less than G means interest rate is less than the growth --

MR. STRAIN: Interest rate is (inaudible) less than economic growth in that -- in that whole period, so, you know, it's not like low interest rates solve the problem. They -- they -- they clearly don't. They make it easier to live with, but -- but they don't solve -- they don't solve the problem, so the interest rate argument doesn't seem to me to be, you know, particularly compelling as a -- as an argument against putting the DGP on a declining ratio and doing that as quickly as possible. The -- the second point I would make is, you know, that -- that it's important I think to -- to distinguish between structural issues and cyclical issues, right, so the -- the problem we have with the -- with the national debt is structural. It will be true in periods of economic booms, it will be true in -- in periods of -- of recession, and it's because of this kind of structural mismatch, like the -- the scissors analogy Bill uses is -- is really apt.

The structural mismatch between spending -- the actual way these programs work and the spending that will -- that will result from the programs and revenues. And so, you know, we need to solve that problem regardless of what's happening with the macro-economic business cycle. During periods of recession, it's perfectly reasonable to have, you know, some sort of fiscal stimulus, and that's true whether or not we do smart things to tackle the long-term debt problem, so what we need is both. We need -- we need to change the structure of Medicare, to change the structure of Social Security, and to change the structure of -- of -- of federal revenues so the debt GDP is on a downward trajectory, and then if we encounter a recession in two years or three years, we can -- we can juice up the deficit in order to deal with that and we can do both at the same time.

MR. WESSEL: Michael, and when you -- when Bill chose that chart of his solution, it very nicely shows that he sees government spending as a share of GDP being relatively the same as projected. He would change the composition away from Social Security and Medicare and more to investments and he would close the fiscal gap by raising revenues a lot. Are you comfortable with that?

MR. STRAIN: I -- I'm comfortable with the kind of -- with the kind of broad stroke, you know, with -- with putting -- with reducing -- with reducing spending and -- and with increasing revenue. I think the conversation is to be about, you know, how do you -- how do you do that. I think the -- and that's where I think you --

MR. WESSEL: You're not worried about the size of government in the Gale plan?

MR. STRAIN: I think it's -- I think it will be very hard to lower the size of government by, you know, multiple percentage points as a share of GDP over the next 20 years. Just given the demographic realities facing the United States. I think that'll be very challenging. You know, I think Bill and I would probably disagree over, you know, the -- the magnitude of -- of that and -- and we'd be within a few percentage points of each other and -- and that's actually I think a good -- a good argument to have and a good conversation to have.

But in terms of the general thrust of it, I think -- I think we have a -- we had the demographic (inaudible) what the demographics are and we're not going to go back to tenement houses and we're not going to let old people who can't afford medical care die of cancer and -- and -- and so, you know, we have to -- you know, we -- we've made our bed and we have to -- to lie in it. But I think that -- that we need to -- we need to focus on -- less on the budget numbers and more on what are we -- what are we spending on; does the spending have high social value; are these programs that we -- that we think are worth taking money out of people's pockets and -- and having -- and having the government provide? In some cases that's going to be -- the answer is going to be, "Yes," and then in some cases the answer is going to be "No," but I think if we start from that premise and then figure out how to pay for it, we'll end up with a -- with a better outcome and I think we'll also end up with a -- with a smaller government.

MR. WESSEL: Bill, I think -- I think we've kind of missed a -- a question about why we have to worry about this. So the grass looks scary. You know, we go from the Rocky Mountains to Mount Everest, but I don't live in a world of percentage of GDP. I -- I'm thinking about a -- so there's some people who worry about the federal debt because they worry about debt. They're -- either they're -- have German heritage or they -- (laughter) or they misunderstand the difference between government and a household. But there are lots of people who say, "You know, we've been told for a long time that we need to worry about the federal debt. We were told that when it was at 35 percent of GDP; now we're told that it's 75 percent of GDP." As you point out there's no public pressure to do any of the tax in spending policies that would address the debt. There's none -- very few of the politicians seem worried about it.

The -- the forward-looking wisdom of financial markets doesn't suggest that even though the chart goes up that the financial markets are worried about it. I think that that's what's bred some of the modern monetary theory. It's kind of like we were told we had to worry about it, we don’t really have to, so let's find some justification not to worry about it. So if you're speaking to people who've heard all this stuff, who see the -- the fact that interest rates remain really low despite a high debt, what is it that we're worried about here? Why should we not be -- why not be complacent about the fact, you know, debt went up a lot and nothing went wrong, so let's keep going until something goes wrong?

MR. GALE: Okay, thank you. Let's see, where to start. The fact that people are not worried about it does not surprise me --

MR. WESSEL: No, I want to know -- tell me why people should worry about it.

MR. GALE: Okay. There -- there is three -- three levels, if you will. There is kind of the living standards of American households, there's the government ability to -- or government's willingness to address new issues whether it's, you know, big social initiatives or fight recessions or adequately finance what it does, and there is the international standing/security issues which are squishier, but people in the international community seem to feel very strongly that it undercuts the U.S. position in security and in international negotiations to be in -- in -- in a huge debt or position. But so those are the three levels. In terms of the living standard, the mechanism is the one we talk about. It's either crowding out or borrowing more from overseas --

MR. WESSEL: Crowding out means that because the government spends more, the private sector will have -- will -- will invest less and we'll be worse off in the long run.

MR. GALE: Right. Right. And then the borrowing from overseas means the private sector borrows the same amount as it would have anyway and we have the same output as we would have, but more of it will be siphoned off to foreigners in terms of capital income. And that then will playback through either the -- either the capital stock and therefore the productivity of American workers and their wages or it'll playout through -- we'll have the same output, but -- but we'll have less national income associated with it, and these effects are gradual and they're -- that doesn't mean that they're not sizable.

As I mentioned, CBO estimates between 8 and 21 percent if you extrapolate from 180 to 60. I think one of the big problems is the effects are kind of invisible, and in the sense that like if an earthquake knocks down a building and you walk by and you see this pile of rubble, it's very easy to think, "Oh, yeah, that earthquake knocked down the building." You can tell I've lived in California for nine -- nine years. But if you walk by an empty lot, it requires a lot of thinking to think, "Oh, gee, maybe the government borrowed so much money that no business could borrow money to build a building there." Right? And that's the kind of effect; it's a thing that didn't happen, so it's hard -- it's hard to see things that don't happen, but economic models, recent models tell us that those are the impacts.

On -- on just one comment on modern monetary theory, I think it's correct to say that a country that prints its own currency, borrows its own currency, can't -- literally can't default or literally wouldn't have to default, could always print more money, but in the same way that focusing on whether there's going to be a crisis misses the main things to worry about in the deficit, I think that observation, while accurate, totally misses what we need to worry about in terms of budget deficits.

MR. WESSEL: Mm-hmm. And let's talk -- the -- there's a lot of different solutions to different problems in the book. You -- it is comprehensive in the best sense of that word and I think it would be productive just focus on just a couple of them. And let me start with the climate change issue.

So you recognize as a lot of us do that we have to address climate change, and you suggest that taxing carbon is a way to do that and you have a proposal to do that, but I've noticed that a lot of the people who are in favor of applying the carbon tax -- proposing a carbon tax, to make it politically palatable, they want to give back all the money. They don't want to use any of it to reduce the -- the debt, or a future projected debt, and I wonder what does the panel think about that. Is that a -- is that just a politically necessary step to deal with climate change, or is it step in the wrong direction by denying us a source of revenue that can solve some of the problem? Yeah, Michael?

MR. STRAIN: I think it's a -- I think it's a -- a massive step in -- in the wrong direction. I think it's -- I think it's bad spending. You know, I think it's -- I think -- the -- the idea that we would be sending a -- a check for, you know, a few thousand dollars, or whatever, in the first year that would grow over time to households with $500,000-a-year-income, $200,000-a-year-income. I mean, that just seems like a -- like a ridiculous waste of money to me. I think, you know, the point -- I mean, Bill, I think said it well, that -- that by taxing carbon you can internalize it externality and that's a -- that's -- that's in an economic sense a good way to find revenue, but that means that -- that we should take that revenue and -- and use it so that we don't have to have as much debt and as large of deficits because of the harmful effects that debt and deficits have or we should use that revenue to reduce payroll taxes so that there are fewer disincentives to work or we should use that revenue to reduce income taxes so that there are fewer incentives to -- fewer disincentives to save and invest. You know, if you -- if you --

MR. WESSEL: Wait a minute. So are you saying, "It's okay to give the money back; just do it in a different way?"

MR. STRAIN: I'm saying -- well, yes, in that sense, sure. I mean, if you -- if you do it for payroll taxes, then you're concentrating the help in a relative sense on lower income people.

MR. WESSEL: You're not -- you're not -- you don't have a problem with a revenue neutral carbon tax. You're just saying you don't like the -- the -- the proposal out there incentive --

MR. STRAIN: Yeah, that's exactly right. I don't have a problem with revenue neutral carbon tax, but I do have a problem with taking the revenue and giving it to --

MR. WESSEL: So that's a revenue source. We're not going to have to deal with all these other things. Maya, you look like you want to say something.

MS. MACGUINEAS: I have a problem with the revenue neutral carbon tax. So -- so, to me, this is just another step in the ongoing growth of free-lunch economics. Right? It's like tax cuts pay for themselves, infrastructure is so important we shouldn't pay for it, we can just print out way out of it, and now anything that we ask you to do, we're going to raise a tax, but don't worry we'll give it back to you in another way. I do think there's a roll for a partial dividend in the carbon tax because I think the distributional effects would not be what we want, so either shifting some of them through a -- a dividend that's targeted and smaller or some other changes in the tax code, but we need more revenues.

Carbon tax is an eminently sensible form of revenues because it achieves multiple goals, and so we should use that revenue, I think, first to get our fiscal situation where we want it, and, second, for additional spending -- people should debate my preference would be there's a lot of investments we need to make. After we get the fiscal situation under control, peop0le should debate that.

But I also just want to reinforce. So Bill said there was three reasons we need to care about the fiscal situation already, and one of them is the sort of, "We don't see we're already worse off because of -- we have lower incomes today than we would have if we hadn't borrowed so much in the past." And the other -- but the next piece of it is, these future risks. We have so many things that we're looking at, whether it's the effects of global warming which we don't know what they're going to be, but we'd like to be prepared, for the future of work issues, the changing work environment, but they're just so many unmet needs and it's not just infrastructure anymore; it's much bigger. It's lifelong learning. It's huge insurances as the workforce changes that being in a tight fiscal situation now means we're not going to be able to respond to those.

MR. WESSEL: Right, so it's obvious -- there's an obvious argument that the reason to do something about this is to buy insurance, and people value insurance differently. I'm not sure, Maya, that you can make the case. It's not obvious to me that we're worse off now; living standards are lower now because of the fiscal situation. I don't think that's -- you -- that's a debating point. I don't think it's -- it's accepted. If we had -- if we had borrowed 10 percentage points less of GDP in the last 10 years, do you think we'd have higher living standards today?

MS. MACGUINEAS: I guess I didn't think it was that much up for debate given how little that we have borrowed for in the past has gone to investments and that we saw --

MR. WESSEL: Well, I agree -- oh, okay.

MS. MACGUINEAS: And that crowd out does exist, that there's -- we -- some effect of it.

MR. WESSEL: Right.

MS. MACGUINEAS: I think -- I mean, I'm not saying how large it is, but I think it is generally believed this is kind of the termites in the basement, but that wages -- that economic growth, wages, those things have been negatively effective.

MR. WESSEL: Yeah, I -- I think what people agree, if we'd invested in more of them we'd been better off. I'm not sure it follows that we borrow too much, but, Doug --

MS. MACGUINEAS: But we did have crowd out, and we did --

MR. ELMENDORF: So I was just weighing in on the carbon tax question. So I agree that the best economic policy is to impose a carbon tax or a price on carbon emissions in some way and to use the resulting revenue at some point down the road to narrow the budget gap, but I would none-the-less enthusiastically support a revenue neutral carbon tax, because addressing climate change is an urgent issue. Whether the water is lapping outside the windows here is not the point. The point is that there's a long, long time for a whole set of changes that have to be made. We're way behind already. We need to start now. The only way to really start with the -- with the force that we need and with the efficiency with which we need to do it, is to have an economy-wide --

MR. WESSEL: In other words, we wouldn't get the carbon tax unless it's revenue neutral, too.

MR. ELMENDORF: And we -- and we're not going to get it unless it's revenue neutral for a long time to come and I would take it over nothing.

MR. STRAIN: So holding politics constant, as you said, I would prefer to use carbon tax revenue for some combination of deficit reduction and structural form, but I signed the petition which gives the money back for precisely the reason Doug mentioned, it's more important to get a carbon tax in place and get to work on that. Not to be ridiculous about it, but if we don't address climate change we don't need to worry about Medicare or fiscal policy or anything else.

MS. MACGUINEAS: And so I think this is such -- this illustrates one of the big tensions that I see right now, which is there are so many things that we need to do that would be easier to do if we didn't have to pay for them, and there's always kind of this debate, and Republicans just happen to think it was the tax cut, something I disagreed with, but they thought it was so important that they shouldn't be constrained and now we'll see this with other investments, and there are legitimate arguments, and I think with global warming probably the most legitimate, but the point is that if we don't use one of those moments to push back and change the norm so that we actually are constrained by smart fiscal policy instead of expedient political choices, we will continue to make this situation worse.

MR. STRAIN: And in this particular -- and in this particular case, you know, I haven't -- giving the money back in the form of lower payroll taxes that would help low-income workers to give into the workforce, is something that -- I mean, I agree with my broader point, but I think that's something that -- I mean, that tradeoff I think is -- is much easier to debate than writing a check to every household in America regardless of how much income they are earning.

MR. WESSEL: Right. Bill, so I think there's widespread support on this panel, and elsewhere, for increasing public investment. I think there's -- there are differences of views about two things. One is, what is public investment; some people think it's only bridges and highways and maybe fiber optics, and other people say it's healthcare and education for low-income kids, point one. And point two, with interest rates so low, isn't -- isn't the economically wise thing not only the politically expedient thing to borrow to do it? So I'm interested in, how do you assure people that what we call public investment is in fact investment? Let's start with that one when we get to the --

MR. GALE: The history is checkered with examples of everybody calling whatever they happen to like, investment along the way that what Maya was just saying, that -- that everybody's pet proposals are so important that they don't need to be paid for. I mean, I -- I think there is -- I can't give you the canonical definition, but -- but I don't think it's that hard to say infrastructure is investment. I think it's appropriate to argue that investment in children is an investment in society and there is now growing evidence that these programs if they don't necessarily pay for themselves completely, they -- Medicaid and EITC and they pay for themselves a lot, and so I -- you know, the political system will always be subject to the political abuses, but -- but I don't think that should stop us from pushing the notion that the government should be investing in the future.

MS. MACGUINEAS: Two thoughts. One --

MR. WESSEL: Use the mic.

MS. MACGUINEAS: -- I'd love to have more of a -- of a CBO-like entity. If it weren't CBO doing more work on what the highest returns are, what the investments are, the -- and from a nonpolitical body to sort of get away from the, "Oh, my agriculture subsidies are great investments." But this country needs investment. We are fighting against massive demographic headwind. We know that economic growth is going to be slow. We need to be focused on investment with higher returns and having more impartial analysis of what that would be would help us greatly through this, I think.

But the second thing is from the literature that I've seen, take infrastructure investment, the returns are higher if it's paid for than if they're not. I've seen that from two studies. So there's still an argument that goes from the economics show that paid-for investment doesn't have to be immediate, doesn't have to be lined every year, but that it's -- there are higher returns if you offset the cost than if you don't, so then it still comes down to it's mainly political as an argument not to pay for it.

MR. GALE: Can I say a word about -- about priorities? I think, Maya, you're right when you say that part of the problem, an important part of why we've ended up where we have on federal budgeting, is that everybody says their thing is more important than whether the whole picture adds up. And I think that is a real danger, but -- but it is our responsibility to actually set priorities, and so balance -- achieving a sustainable fiscal path is not necessarily the most important thing that we should be accomplishing now, and I actually think it isn't, which is why I opened with an opening remarks, talked about the things we need to do.

I think you're right that we have to be careful about -- about always just saying everything is more important than this, and I think and this is just somebody else's problem. There's also no reason in economics or politics why -- why putting the federal -- federal budget on the more sustainable path is necessarily the highest objective that we should all be -- be paying allegiance to, and I think the view's we've offered about a -- a carbon tax, a revenue neutral carbon tax, because, in fact, it is more important now to address climate change, in at least my judgment, than it is to put a thorough budget on a sustainable path now, and I think one can make a -- a case, I -- I believe, that it is more --

given the economic divisions in the country, the growing economic divisions and the political and social consequences of that, I think it is more important that the future of our country now to make investments in a lot of people than we're making, and I think -- and one can disagree. I mean, that's -- that's not -- not saying I've proven that's right, but I think that is an explicit choice one can make, and if one does, then that guides you in certain directions.

MS. MACGUINEAS: Perhaps the other --

MR. WESSEL: But Maya's -- Maya's point is that we'll never decide. That's your point, right?

MS. MACGUINEAS: That's -- that's my point of where we ended up to, that we would never put it there, but my -- my other point related to what you said is that I don't look at debt reduction or fiscal policies actually one of the policy priorities in the same ways as the other things, because I think you could take that argument, you could also take keeping the nation safe if we're attacked. There's -- there's many examples that are much more important and certainly much more immediate than deficit reduction at that point.

I look at it more as a system. It's a system that helps create structural choices that you should borrow when you should borrow when there are downturns in the economy, when there are immediate emergencies when they're investments where it would make sense; that you shouldn't borrow because nobody wants to pay for things. So I then think we have to go back to, "This is our system," and then we budget the way you're supposed to, which is identify national priorities, evaluate the best ways to achieve them and then figure out how to finance them.

MR. WESSEL: Bill, could I just add one thing?

MR. GALE: Yeah, but I want to ask another question.

MR. WESSEL: I want to agree with what Doug said, and -- and what Maya said is that -- that there's no claim here that fiscal fallacy is the only problem facing the country and should take priority over (coughing) all issues. That would be -- that would be both counterproductive and silly, but it's a problem that's always there and, you know, we would benefit from addressing it, right, all these other problems --

MS. MACGUINEAS: And that fixing every other problem shouldn't worsen that problem. You should try to fix the other problems without deterioration of the fiscal situation. That would be the best.

MR. ELMENDORF: Bill, I -- given that this -- we're gathered here under the umbrella of the Tax Policy Center, I want to spend a couple of minutes talking about your proposals on taxes. In one summary of your proposal on taxes is that you pretty much want to raise every tax anybody ever thought of. You -- (laughter) you want to impose a VAT, you want to impose a carbon tax, you want to raise the tax on beer and wine, you want to raise the capital gains tax, you want to raise the estate tax, so what -- is there -- is there a theory to this madness or is it just we need the revenues, so a little bit here and a little bit there?

MR. GALE: I think there is a -- it's -- yes, there's a theory to the madness. If you --

MR. ELMENDORF: What a relief. I was worried you'd say no.

MR. GALE: -- if you look at the -- the carbon tax, it corrects the biggest externality in the economy. A consumption tax is a very efficient way to raise revenue that doesn't affect saving investment. Closing loopholes in the income tax is -- is efficiency improving, arguably. I mean, the -- the average rate is higher, but distortions across investments and choices are lower, and on the corporate tax I'd raise the rate but move to better investment incentives, so all of those are arguably efficiency improving and the -- one of the -- there's a tendency to focus on either revenues or efficiency which is unfortunate stove-piping because the more revenues the tax system raises, the more important it is that the tax system be efficient. Right?

If you have taxes at one percent of GDP, they can't really mess things up that much, but if you're writing to raise taxes from 18 to 23 percent, it's really important that you do it in an efficient manner. So that -- that was --

MR. WESSEL: Explain in layman's term what "efficient" means.

MR. GALE: Not -- not getting in the way of people's choices, not -- not subsidizing -- not picking winners the government -- the government's level or in the case of the carbon tax, correcting a missing cost that the market doesn't make people pay for. So making the economy work better.

MR. WESSEL: Michael, are you comfortable with all Bill's taxes?

MR. STRAIN: Well, I had the largest objection to the increased tax on alcohol (laughter). That -- that really jumped off the page. No, I'm not -- I'm not comfortable with -- with all of them. I think that full expensing on -- on the corporate side is great. I don't know why we would want to raise the corporate tax rate. If anything, I'd be pushing that even lower than -- than President Trump did. I think it's good to broaden the tax base. At the same time, I wouldn't further penalize capital investment -- you know, there's a -- there's a little bit of, you know, we need the consumption tax because that's efficient, but, you know, we should also -- it's efficient and -- and because it doesn't penalize savings and investment, but at the same time we need to penalize savings and investment further through -- through the income tax system, so I -- I wouldn't do that.

I mean, in general, I would -- I would push the tax code even further in a consumption tax direction then build it. I would have that consumption tax be progressive. I think that's -- I think that's -- that's very important. I would further reduce penalties to savings and investment in both the -- the income and -- and corporate sides, and I would be -- and hear my recollection of what -- of what Bill wrote is a little hazy, so correct me if I'm wrong. I would be more aggressive with the tax expenditures. You know, I think we should think of that as spending. That spending accrues to high-income households and -- and that's a -- that's a great source of -- source of revenue, so I'm -- I'm much more of the, keep the rent low, keep the savings and investment distortions as minimal as possible and move toward a consumption tax and -- and stop spending money for the tax code.

MS. MACGUINEAS: I'm comfortable with each one of those, of each one of the revenue ideas, and I think that there should have been more in tax expenditures.

Probably the only part I'm not comfortable is where my sense that a deal is, which is I don't think you can actually have an ultimate budget deal that is a hundred-percent fiscal gap reduced by increase in revenues, and then very good, I believe, but shifts in spending. So I think ultimately you'll have to have a deal that has some revenue increases and some net spending reductions. But it makes sense that where, from Bill says, that will be your opening offer and I think there'd have to be openness to more aggressive spending cuts.

MR. STRAIN: Two (inaudible). The -- the ultimate package, if you look at total spending, it's about 40-60 spending taxes. If you look at -- because I'm saving so much interest payment. And the reason to raise the corporate rate --

MS. MACGUINEAS: Yeah, but -- but the -- the Republicans would say that gets the stuff --

MR. WESSEL: Use the mic close to your mouth.

MS. MACGUINEAS: Oh. Well, the Republicans would say that part of that would be allocated to the revenue changes and park the spending.

MR. STRAIN: Yeah. And the reason to raise the corporate rate -- once you move to expensing is expensing sets the effective tax rate on equity finance (inaudible) investment equal to zero because you get the full deduction in first year, so what the corporate tax is doing is taxing rents and abnormally high returns and that's not distortionary, so you can lose the (inaudible).

MR. WESSEL: That one final -- I wonder if you would explain one final thing before we turn to the audience. It's often said that we can't solve our fiscal problem unless we find some way to slow the growth of healthcare spending. Is that true?

MR. STRAIN: Well, as a matter of arithmetic, you could raise taxes by a lot, but as a practical matter, I think we need to slow the growth of healthcare spending, but not just federal healthcare spending. We have a national problem. Federal government is -- pays for half or so of healthcare spending and it's a big problem of the federal budget; say local governments pay for some and a lot is paid by employers and individuals, and the growth rates of healthcare spending per person have been pretty similar over the last several decades in the public and private sectors. So there's not a federal government problem alone, but the federal government as the largest single payer for healthcare in the country has some particular leverage that I think it should use.

I think in healthcare the biggest mistake we've made in the last decade is to devote almost all of the bandwidth for thinking about healthcare policy to a confused effort to repeal the Affordable Care Act. And I say "confused" deliberately. In 2009 and '10, there was a serious debate in CBO. We tried to (inaudible) information to this debate about the right way for the country to move ahead with health insurance, but the effort to repeal has been confused because the Republicans have been asserting for almost a decade now that there is an alternative to the Affordable Care Act that would maintain the high levels of insurance coverage reached under the Act at much less federal spending and/or private spending and fewer rules. And neither logic nor evidence supports the proposition that that can be done, so it's been a decade of a lot of rhetoric, a lot of campaigning, but no progress toward that goal because that goal doesn't -- is impossible.

And what we've done, though, is to spend all of the time and energy of health policy analysts, of members of Congress on the relevant committees and so on in that elusory quest and have not devoted the time to thinking as much about real changes. Now, other things have been going on, thankfully, outside of the policy spotlight. The Affordable Care Act did put some things in place that -- the incentive for Medicare and Medicaid Innovations, part of a -- a centers for Medicaid and Medicare services are pursuing. Those are useful changes, but we need to spend much more time on that and give up this ongoing debate.

MR. WESSEL: So we could continue the healthcare conversation. Bill has a number of proposals, but --

MR. STRAIN: Because it can be done.

MR. WESSEL: What?

MR. STRAIN: It can be done.

MR. WESSEL: What can be done?

MR. STRAIN: We can repeal and replace the Affordable Care Act?

MR. WESSEL: You got a plan?

MR. STRAIN: I -- I see that we're in the red here.

MR. WESSEL: Be careful. You could become -- you could become HHS Secretary.

MR. STRAIN: (laughs)

MR. WESSEL: I haven't checked my phone, (laughter) and -- and we might have lost one.

MR. STRAIN: I mean -- I mean, there have been -- there have been plans. You know, there -- there have been plans that are (inaudible) by members of Congress and there have been plans from conservative thinktanks and, you know, take the tax expenditure and you turn that into a subsidy for catastrophic plans and you don't have the government mandating that everybody get insurance against ear infections and sinus infections. I mean, it's the -- you know, the -- the basic outlines are there. It's just getting the political will to -- to do it.

MR. WESSEL: So I -- with all respect, Michael, if -- if you -- there was a nice column in the *New York Times* last week by two of Michael's colleagues at AI, by Joann Totes and Jim Capretta --

MR. STRAIN: I read that after it was --

MR. WESSEL: -- well-known conservative analysts. The striking thing I thought in the piece was that about half of their ideas looked to me like putting things back into the Affordable Care Act the Republicans have fought to take out. They argue for expanding Medicaid in more places. They argue for worrying about reinsurance. Those are things that were built into the Affordable Care Act Republicans have fought against.

Another set of things they proposed were extensions of government's involvement in the health insurance market. It is automatic enrollment. It is worrying about drug prices. So I thought that column, from two conservative analysts, was well to the left of the Affordable Care Act as it now stands (laughter), so I'm not disputing there are things that one can do, but the core proposition, the animated Republican policymaking and campaigning for a decade, isn't true and that's a place they're not going to go, and if they got off that, then we could have a discussion about the things that Jo and Jim describe in their piece and instead of other (inaudible).

MR. STRAIN: It could be that we've reached the metaphysical point, right?

MR. WESSEL: Lesson learned. Don't bring up healthcare with 90 seconds left on the clock.

MR. STRAIN: Ha-ha-ha.

MR. WESSEL: So we -- we have time for some questions and I'm going to suggest that we'll take a couple of questions. I'm going to hope that each panelist doesn't respond to everyone. There's a -- in the back there's a -- is that you, Kim?

KIM: Yeah.

MR. WESSEL: So a couple of requests: Tell us who you are and try and keep the question to short and (inaudible).

MS. REVEN: Kim Rubens, Tech's Policy Center. I like a lot of what's being said. I think this is all really fun. My question, not surprisingly, is what role does state and local governments play in all this? If you change all the taxes, what does that mean for state and local taxes? If you're going to invest in kids, a lot of that is now done through state governments. In your book, and I haven't gotten far enough in to know this, do you talk about or think about what sort of doing some sort of overhaul like this would mean in a federalist system where you actually have to engage with other levels of government?

MR. WESSEL: Yeah, take another couple of questions then. Larry Checco out here in the front. And there's one over there in the aisle.

MR. CHECCO: Thank you. Larry Checco, Senior Advisor to Serve USA. I think there's been some low-hanging fruit that's been ignored in this conversation, and one is IRS tax enforcement. According to the Tax Policy Center, I think they're saying that there's about a hundred-billion dollars a year that goes uncollected and yet we continue to reduce the IRS budget which seems to me low-hanging fruit. It's crazy. Okay? The other thing I wish we would get away from and the question is: Can we finally stop reducing taxes on the wealthy? Can we do that, Mike? Because (laughter) -- you know -- you know, where I coming from with this.

MR. STRAIN: Wait, I'm not yet wealthy, so I know, and you're okay with it?

MR. CHECCO: No, but my -- my -- but you know --

MR. WESSEL: He's tied up -- he's tied up with the healthcare thing.

MR. CHECCO: All right, we'll -- we'll get back to healthcare. But, no, the trickle-down theory is a false -- is a false economic theory.

MR. WESSEL: All right, just to -- to --

MR. CHECCO: Thank you.

MR. WESSEL: -- I'll let Bill respond, but he mentioned, and does at length, in the book the IRS thing, but he -- over there? Yeah.

MR. WENTWORTH: David Wentworth; retired from the IMF. Bill, you said that politicians don't act until it's a crisis. Everybody agrees it's not a crisis, and yet none of the things that's being talked about can be done without the politician doing something, so when does it happen and how do we get there? That's a political question and not an economic question.

MR. WESSEL: Do you want to answer that one first, Bill?

MR. GALE: Yeah, sure. Sure. I learned from Maya that one of the favorite things that Leon Panetta says is that we make change through leadership or through crisis, and if we don't do it through leadership, then we'll do it through crisis. Is -- is that true?

MS. MACGUINEAS: That's right.

MR. GALE: And so you look at where are the back-to- the-wall moments, the Medicare Part A Trust Fund, the -- it's exhausted in 2026. The Social Security Trust Fund exhausted in 2034. That --

MS. MACGUINEAS: Maybe expiration of tax cuts --

MR. GALE: Maybe expiration of --

MS. MACGUINEAS: -- like, other action force moments.

MR. GALE: Right. Expiration of tax cuts, or a general rise in interest rates, but it's a good question, you know, how do they do it? On the other hand, you can look at someone like Ross Perot who ran a third-party campaign and got 19 percent of the vote by emphasizing this. So I think leadership is possible, but I agree that we're not seeing it right now.

MR. WESSEL: And what about the state and local questions?

MR. GALE: The state and local question, that's a great question. On the spending side, I presume that the money would be implemented in conjunction with current state initiatives that we would -- the mechanism would be to expand those initiatives. There's an interesting discussion on the value-added tax which where sales -- retail sales tax has traditionally been the -- the promise of the states, but they are horribly designed taxes. They -- they -- they exempt very large categories of consumption, businesses end up paying a big share of retail sales taxes, et cetera.

So a lot of state tax people object to the idea of a federal VAT on the grounds that it's impinging on the territory of the states, but being a federal guy, it feels to me just the opposite, that this -- there is nothing you could do that would help the states more than have a federal VAT. The states could then conform their taxes to the VAT and the federal government could actually collect the money and send it back to the states. So I think that that's an -- I think that that's an asset, not a -- not a liability of a value-added tax.

(inaudible).

MR. WESSEL: Do you give the states any of the money, she asks?

MR. GALE: From the federal VAT, no, but -- but the states can take their retail sales tax and convert them to VAT. So say -- say the federal VAT's 10 percent and the state has a 5 percent VAQT, then the government collects 15 percent, so 5 of it --

MR. WESSEL: But do you see -- do you see -- if you look at the big picture, we do a lot of our social policy through state governments.

MR. GALE: Right.

MR. WESSEL: We give -- Medicaid is partly federal, much of the highway transportation stuff. Do you see that as continuing, do you see that growing, do you see it shrinking? I think what she's asking, if you're a governor of a major state and do I read the Bill Gale plan, and say I'm going to have more responsibility and -- and the federal government's going to be taxing a lot more, so I'm going have a harder time taxing my people.

MR. GALE: I wouldn't read it that way. I would read it as we have -- on the tax side, we have a chance to -- to ease tax administration and make it more efficient and --

MR. WESSEL: What about the spending? Do you --

MR. GALE: -- tax mail order --

MR. WESSEL: -- think -- does that make -- that's going to be more money coming from Washington --

MR. GALE: -- and Internet sale --

MR. WESSEL: -- under the Gale plan to the states or less?

MR. GALE: I -- I presume that's how it would happen, yes.

MR. WESSEL: The investment would be?

MR. GALE: Yeah.

MR. WESSEL: Michael, do you want to respond to the comment about -- it's really about using the tax system to reduce inequality. Have we gone too far or not far enough in using the tax system to reduce inequality, or is it the wrong way to do it?

MR. STRAIN: So I think the -- the challenge of -- of kind of taxing the wealthy is that that wealth is not sitting under -- under mattresses. That wealth is being put to productive use in the economy and -- and that actually is one of Bill's arguments about why the debt matters, because if you believe in the interest rate channel then -- then you believe that you're slowing future investment and -- and that that lowers productivity and that has an impact on wages and then that has an impact on living standards.

So, you know, on the one hand I think it's, you know, easy to say there's this big pot of money there and we should go get it. On the other hand, you have to ask what's that -- what's that money actually doing. Having said that, you know, I think we need to be -- we need to be more aggressive in providing opportunity particularly for people who are lower income and, you know, that will involve spending money. That will involve doing things -- you know, some of these are -- are in the book, involved doing things like increasing earnings subsidies, like the earned income tax credit.

I would be in favor of a modest child tax credit expansion in order to help lower income people to -- to -- who have kids to -- to have some -- have some relief. You know, better investments in human capital through community colleges and all sorts of things like this, and those would have -- you know, would likely have a secondary benefit of reducing inequality because you're raising incomes at the bottom. But my focus would not be to say, "Okay, inequality is too high. How can we tinker with the tax code in order to -- in order to reduce it? I think -- I -- I just don't think inequality is -- is important enough for that to be the main goal, or one of the main goals in deciding what the structure of the tax system should be.

MR. WESSEL: This question over here and one down here. Anna, can you -- just raise your hand again but without the glasses so she can see you. Just -- right here on --

MR. MAZER: Cark Mazer.

MR. POSER: I'm sorry.

MR. WESSEL: Go ahead.

MR. POSER: Carl Poser. I do a lot of work on inequality, but more from the perspective of trying to include all people in the capitalist economy, particularly at the bottom. I'm very heartened to hear Michael talk about the regressivity of consumption taxes and carbon taxes and wanting to be progressive. My concern is -- is how do you do that in a way that matches -- you know, what you take away from the working class and the lower income to actually make sure that the -- the system gives it back to them?

For example, so how would just increase the -- the gas tax, but they also -- they offset it a little bit with an EIT expansion, but it leaves out most of the low class. So you have -- if -- if you a big increase in the gas tax, somebody with a lot of capital can buy a new car, and then -- and over a 10-year period they can be held harmless. Somebody driving a clunker to two jobs, they're not -- they're going to be harmed. So how do we do that, and I think the point that brings up, we have a shrinking middle class that -- that really is the support for all other revenue, and if we do things to harm their ability to even pay into the system, that's another consideration. So --

MR. WESSEL: Okay, thank you. And over here?

MR. WOGART: Peter Wogart from the country of the zero deficit (laughing) just wondering, thus, you know, the approach obviously for politicians may be difficult, but isn't is sound public finance as, you know, one looks at these three major tasks which Musgrave had proposed years ago that you have looked first at, you know, allocation distribution, sterilization. Then you add on if you want growth and environment and make these politicians look into those issues rather than the deficits which is an accounting issue.

MR. WESSEL: Okay. Bill, I think there's two elements to the first question. One is, how do you make a VAT and a carbon tax progressive, and the second is, aren't you proposing tax increases on the middle class?

MR. GALE: On the first one, there's a number of ways to -- countries and states have done different mechanisms. I think the easiest one would be essentially the equivalent -- the equivalent of a -- a card, that, you know, you'd say it's a 10-percent VAT. If you get a $2,000 subsidy essentially that's exempting the first $20,000 of your consumption, and that could be administered literally via a card; it could be administered via the tax system; it could be administered in other ways. There's a whole sub-literature on that. The other question was?

MR. WESSEL: And aren't you proposing a tax increase on the middle class?

MR. GALE: I think that taxes on the middle class would go up. I don't have the distribution analysis, but my sense is that they would from the -- the income tax and the payroll tax side, and what's -- the flip side of that is they would have a secure Social Security system; they would have a secure Medicare system; they would have a stronger economy with -- with more economic mobility, but I -- I think all -- I -- I have -- I do not have the formal distribution analysis, but everything I know tells me you cannot solve the fiscal problem on the backs of a small minority of households.

I mean, you can raise taxes on the wealthy and that can help, but the problem is big enough that the burdens need to be spread around and so while punting on the definition of the middle class because there are lots of definitions, my impression is that this would raise tax burdens on the middle income --

MR. STRAIN: Can I -- can I piggyback on that for just 30 seconds?

MR. WESSEL: Yeah, please.

MR. STRAIN: I -- I think I -- I completely agree with -- with what -- with what Bill said, and I think it's important that more people, particularly politicians, get comfortable with that notion and -- and talking about that. The broad middle class and -- and the definition changes and in a lot of years it seemed like it's everybody from the 20th percentile up to the 98th percentile counts as middle class, but, you know, regardless of how you define it, the broad middle class is going to have to accept some combination of -- of less generous Social Security and Medicare and higher taxes.

And there's a debate about how to balance those two, and I'm probably more on the side of less generous Social Security and Medicare than some people on the panel than I am on -- on higher taxes, but that's -- that's where the money is, and -- and if we're going to solve this problem, which -- which I think we should, and by solve it, I just mean, you know, have the GDP on a downward trajectory, then that's where -- that's -- that's where it's going to have to happen.

MR. WESSEL: Doug, you can comment on that, but I think I'm -- I'm going to reframe this question a little bit. So you spent a lot of years briefing members of Congress, and I think the sense is that telling them that they should have wise or sound fiscal policy doesn't seem to be a very convincing argument. (laughs) And I'm just wondering, what is it that -- that you think motivates them? I -- I prefer to believe that most of them want to do something other than get reelected, although some of them clearly don't, (laughs) but like so just, why isn't that a good enough argument to get them to do what needs to be done?

MR. ELMENDORF: So I respected and liked almost all of the members of Congress whom I had the chance to work with.

MR. WESSEL: Do we get a list of which is -- which the --

MR. ELMENDORF: No. No. And -- and I did -- and that was because I found them behind closed doors to be really quite interested, in almost every case, in making policy that would be good for the country and their constituents as they saw it. And member after member who really was committed, I thought, to -- to doing the thing that was best, but they came at these questions from a huge array of ideological perspectives, and often without a lot of background information.

We forget how busy an average member of Congress is in their day, how little they know about most issues they face before they come to the Congress, and so they don't -- they don't understand very much of the things that we're talking about here because (coughing) they have been busy doing other things. And so teaching them how we think about these problems, what Richard Musgrave and all the others have written is very hard, and one has to make it very tangible. So that your question to Bill, and why do we care?

Well, these numbers, we can draw pictures that really doesn't carry any weight. You have to make it feel real to people. And I think there's been a -- a -- and very central confusion which is people who think, "Well, why should," -- and Bill talked about some of this -- "Why should government spending be rising? We don't want a bigger government." And the answer to that is we have not legislated a bigger government for the -- for the most part. The answer is that our population is aging, and that healthcare spending per person is rising faster than GDP per person and this is the outcome of that.

So for any individual American who's 70 years old, they don't think they're getting something that they hadn't paid into, but there are a lot more of them what they're getting is way more expensive and that fundamental disconnect that view the government spending is rising not because we've done something deliberate to grow the government now, but because we're watching the playing out of programs we set in place years ago. That's that I think the fundamental misunderstanding, and people are not rushing to recognize that in a sense even when you tell it to them because it makes the choices harder. It means they can't get away with some easy out, one of the false solutions that Bill described.

I would just say one -- my -- my last two seconds is, I think it's very constructive we've had some real discussion about who will bear the burden of these changes. Distributional issues are important to any policy choice in any society, but they were especially important in our society following 30 years or more in which some members of our population at the -- mostly at the top of any distribution have done really well and lots of other people have not done very well, and that is not only an economic problem, it has been a crucial force behind some of the very significant political and social disarray that we see and taking seriously the -- the distributional consequences of policy as a particular imperative for us now.

MR. WESSEL: I think I have time for a couple --

MS. MACGUINEAS: Can I --

MR. ELMENDORF: Yeah. Sure, go ahead. Can you bring the mic to this gentleman for one after Maya speaks?

MS. MACGUINEAS: So two points on that. I think it is -- it's really appropriate that so much of this discussion is sort of moving not at just into distributional issues, but what I think is going to be huge discussion in this country which is the future of capitalism, and it's not going to be able to tweak the tax cuts that's going to make these changes. This is about how we're going to address wage differentials and the returns on capital and labor and that makes a ton of sense. That's going be even a more difficult discussion than fiscal sustainability has been in the past decades.

And to Doug's point, I agreed with everything he said about sort of these policymakers and behind closed doors except it's completely wrong for the moment, and by what I mean is like all of us are completely wrong for the moment because discussions in Brookings are so different than the kind of angst and outrage that is going on around the country where the only voices I'm noticing that have a platform are not talking about public policy.

And so what really is kind of confounding me is I look at this moment where it feels like the problems are growing faster than the solutions are; how do those of us who desperately care about good policy and structures and fairness in that discussion, how do we inject the ideas that I still believe are completely right into a political environment that has completely lost interest in that? I think that's a huge challenge right now.

MR. WESSEL: Okay. We're now -- gentleman here.

UNIDENTIFIED SPEAKER: One of the first lessons I learned in economics is what caused The Great Depression and the answer was too much money being concentrated into too few hands. Today we have a -- an income distribution that's worse today than it was in 1928. Now, last year the -- the net worth of the people at the top of our economic structure increased 25 percent. The carryover credit card debt for most of the people in this country increased from $6,000 to $7,000 in one year. All right? Now, we also spend --

MR. WESSEL: I -- I don't want a speech, so give us a question.

UNIDENTIFIED SPEAKER: My -- my question is, the distributional income -- the distributional effects of this income, this skewed income distribution, which is getting worse, and finally we have 10 aircraft carrier ballot groups steaming around out there doing God knows what and 20 percent of our children in poverty. Now, there is a question about, you know, what are we spending the money on?

MR. WESSEL: Right.

UNIDENTIFIED SPEAKER: The fact is that the -- the amount spent on interest in the next 5 to 7 years will be the equivalent of what we're spending on the defense budget now. There'll be nothing left for the discretionary -- in the discretionary budget except those two items.

MR. ELMENDORF: Right. Okay, so he had three questions, so I'm -- I'm going to pose them all. One is, is that Michael said that the distribution of income is not the primary problem we face, and he argued that it's the -- we are sowing the seeds of the next disaster. Second, he thinks we're spending too much on defense and, third, he makes a point that you do, Bill, that interest is going to be a bigger item in the budget than a lot of other things. You had a nice chart showing that. So those are three points; each of you gets to talk about one. You get to pick them.

MR. STRAIN: Well, I'll continue making you all hate me and -- and focus on inequality.

MR. WESSEL: We never have.

MR. STRAIN: The old -- the old Michael Strain and the new Michael Strain.

MR. WESSEL: It's not -- it's not that you've changed. It's that what's happened outside --

MR. STRAIN: The -- the world has changed.

MR. WESSEL: -- what's happened outside the world makes you look reasonable now.

MR. STRAIN: There's a lot to be said for that actually. So on inequality, you know, if you look at the last 10 years or so, it is very reasonable to argue that income inequality has been growing at a snail's pace. If you look at the last 10 years or so, you can even make a -- a pretty solid argument, and it -- it would be the argument that I would make, that income inequality is not growing for the last decade or so. You can -- yes, absolutely. You can -- you can look at a -- a couple of CBO charts and you can see that by some measures of income the Gini coefficient has actually declined over the last few years, which means that inequality has been -- has been shrinking. This has shocked all of you, (laughter) and you would have no idea that that was happening from the national conversation.

Now, perhaps what outrages people is not the rate of change of income inequality, but the level of income inequality. I'm -- I'm willing to believe that, but that's not what people are talking about. People are talking about how inequality is getting worse and worse and worse and worse and worse. If you look at the eighties and nineties when inequality actually was getting worse and worse and worse and worse, this was not the major topic of conversation because people were doing better, because lower income people and middle-income people were doing better at a faster rate. So I would argue that society as a whole actually cares a lot less about income inequality than the editorial page of the *New York Times* and -- and -- and, you know, many people here in Washington seem to think that it does, and what we should be focused on is not the width of the income distribution, but instead we should be focused on two things, how can we -- one, how can we make it easier for people at the bottom to do better, and, two, are we comfortable with wealthy people and the way in which they've earned their wealth, by which I mean, do we think that people are -- are earning their wealth through hard work and through talent, and, yes, through some luck, or do we think people are earning their wealth through corruption and -- and systematic horrible things, and if we think on the whole that -- that wealthy people got there because they're talented and they're hard working and -- and they had some good fortune, I think we should be comfortable with that.

If we have a society where people at the bottom are able to do better and policies exist and public money is spent to help make sure that happens, then I think that is also a good state of affairs, and -- and the width of the income distribution just I don't think matters that much to me and I actually don't think it matters that much to the rest of society either.

MR. WESSEL: Do you want -- do you want to expand on that, Doug?

MR. ELMENDORF: I can if you want. I think -- so -- so but I -- I disagree with -- I think with parts of your conclusion, Michael. I do think what matters very importantly to people lower middle parts of the income distribution is whether they see their lives improving and whether they see an opportunity for their children to have better lives than they've had, and we have not been serving them well with our economic system. The chart that for Raj Chetty that Bill showed in his presentation shows that most Americans or -- or many Americans are right to feel that their kids are not doing -- going to do better than they did in the way that those people did better than their parents in generations before them. So I think that a crucial focus we should have is on an improving this -- the wellbeing of people who are in the lower middle parts of the income distribution, and the set of policies that Bill proposes I think would -- would do that and their sense of having greater possibilities in their lives I think would go a long way toward leaving their concerns. That does not mean, though, in my mind that inequality is unimportant.

Even from leave this aside the economic aspects, there are political and social aspects of people who have over the last several decades -- leaving apart the debate about recent slices, have over the past several decades clearly grown away from the rest of the population, and those people have -- and maybe I'm in them, so "we" people have been able to move ourselves out of many of the concerns and some of the engagement with other people in society, and that I think that is damaging to our polity and our society even if the --

it has -- apart from any effects on the economic fortunes of people elsewhere in the distribution.

MR. WESSEL: Bill, I want to give you the last word. So if people leave this room and haven't yet read your book, what would you tell -- no, serious, what -- what is it that you want people to take away? You spend a lot of time; you said you and Aaron spent five years on this. If you have to boil it down, what is it that you want people to think about, to realize after this conversation in the book you did?

MR. GALE: I want to come back to that very first slide I showed which is that there are two sets of issues here, and this comes back to your question as well. It started out being a book about the federal budget and the problems and the long-term shortfall, and -- and it was way too being county-ish, if you will, counted, and -- and then I realized what the problem was. The second issue is there is a structural issue in the way we tax and the way we spend and you can't really separate them. You need to think of them together, is one point, and they are solvable problems is a second point.

MR. WESSEL: Thank you. So please join me in thanking the panel and thank (applause) all of you for coming.

MR. STRAIN: Great job.

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