Budget Outlook after the State of the Union: Part II

David J. Stockton says that if the budget sequester occurs on schedule, it could lower economic growth this year by three quarters of a percent and possibly increase unemployment.

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Steve Weisman: This is Steve Weisman with David Stockton of the Peterson Institute for International Economics, talking about what we learned from the President's State of the Union message this week. David said that if the sequester takes place, it could knock economic growth off by three-quarters of a percent and possibly even increase unemployment.

David you said that we need is a ten-year deficit reduction plan in the range of $2.5 to $3 trillion in addition to what's happened so far. Tell me if that's right. What would be your suggested composition of that in terms of revenues versus spending cuts?

David Stockton: That's roughly speaking right. I think we need to put the budget situation and our federal deficits on path so that we can reduce debt to GDP ratio. I think a safe territory would be to get that debt-to-GDP ratio down to about 60 percent. That would still be high by historical averages, but not to the historically unprecedented levels that we're currently at. Even most of those projections would show some stabilization of debt-to-GDP ratios.

If one looks a little further down the road, our aging population, the rising health care costs result in a debt to GDP ratio starting to rise towards the end of the next decade. It then goes on beyond that. So I think we need to be fairly aggressive about putting our fiscal house in better order. I think that's going to require some significant cuts in entitlement programs or slowing the growth of those programs significantly. That is going to be health care, which remains a very complicated and difficult issue.

I don't think that there are easy answers out there. At the same time I think we're going to need to see some substantial increase in revenues to bring things back closer to historical averages and probably a bit above that, given that we have to recognize that we're in a different demographic situation than we've been in most of the post-World War II period.

In terms of the rough split between those, it's going to need to be tilted more in the direction of slower growth of entitlements. But still I think revenues have a very important role to play there as well.

Steve Weisman: The President mentioned that the growth of health care costs has slowed down in the last three or four years. for reasons that are not clearly understood. Do you agree that that's a significant trend? Would you rather wait and see before you pop the champagne corks on that?

David Stockton: I think it's an encouraging trend, but we've seen a couple of other episodes in the last few decades where we had periods when the growth in health care costs slowed for a while and then sped up again. As you just noted, I think the reasons for those accelerations and decelerations aren't really very well understood. I wouldn't necessarily extrapolate the good news in the last few years on into the future. But I think it would be fair to recognize that there has been some good news there. I think trying to better understand what produced those outcomes would be useful in ensuring that we might be able to remain on that kind of trend.

I don't think we should take the experience of the last few years to indicate that we can be less vigilant about addressing health care costs going forward, because even with that slowdown, we still have a cost curve that's working against us.

Steve Weisman: Mr. Obama, has said that he was willing to put back on the table the cuts that he had proposed that were similar to those proposed by the Simpson Bowles Budget Commission. The Washington Post said the numbers weren't quite the same, but did you see any room there to be hopeful that the White House is willing to go toward entitlement cuts?

David Stockton: I think it was encouraging that the President mentioned entitlement reform and Medicare reform. Whether that will be either sufficient quantitatively to address the fiscal problems that we face or enough for Republicans to come back to the bargaining table, I don't really know for sure.

Steve Weisman: They're probably pondering that today.

David Stockton: I'm sure they probably are, but what the President didn't mention last evening, what he had previously put on the table, was changing the indexation formula for Social Security. I think if that remained on the table, that obviously would be sort of a favorable step in the right direction on the entitlement front.

Steve Weisman: You used the word 'aggressive' before in terms of achieving these savings, especially in entitlements. I don't think you mean doing it quickly in the next year, but rather spaced out.

David Stockton: That's a very good point Steve. Indeed I think a rational fiscal plan would be one that, in fact, tried not to impose very much fiscal restraint in the next year or so, allowing the recovery to gain a bit of momentum. The aggressiveness means moving with a sense of urgency to tackle our longer run fiscal problems. I think that can be done today without imposing restraint, your term, on the economy. Give agents, households, businesses, governments, time to adjust to the longer term adjustments that are going to be necessary in a least painful way as possible. But I do think we want to try to provide support to the economy in the near term, but reassurance that we are, in fact, addressing our longer term fiscal problems with a sense of urgency.

Steve Weisman: Always hard to do though, to enact tough steps that don't take place for years from now.

David Stockton: I think that's certainly true. We can hope that we will do. At some point, those longer term fiscal problems, even if they are not necessarily imminent today, can become so without a lot of forewarning. I think it would be prudent for the United States to be addressing those problems. There's certainly some risk that we will wait until the crisis is upon us. That will be the forcing mechanism for making the adjustments necessary. But if so, my guess is we'll get worse public policy, more painful adjustments and economic outcomes that are significantly inferior to those that we might be able to achieve if we took action today.

Steve Weisman: David, thanks very much.

David Stockton: Thank you Steve.