

# **Running on Empty: How the Democratic and Republican Parties Are Bankrupting Our Future and What Americans Can Do About It**

**by Peter G. Peterson**

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## **Introduction**

*C. Fred Bergsten, director, Institute for International Economics*

Let me welcome you today to the Institute for International Economics, to a very special luncheon meeting on a critical topic with some of the top experts and leaders in the world. I want to first thank our cohosts for this meeting, of which there are three: the Concord Coalition and Bob Bixby, the Committee for a Responsible Federal Budget and Maya MacGuineas, and the Center for Strategic and International Studies with President John Hamre and Richard Jackson, the director of the Center's Global Aging Initiative, which is directly related, as you will hear, to the topic that we are talking about today.

We'll start with the honorable Peter G. Peterson's presentation of his new book on the federal budget and the outlook for the nation's finances. It is fair to say that he has been one of the most persistent, persuasive, and courageous voices on US fiscal issues for the last couple of decades. This is his fifth book on numerous aspects of the topic, and I guess he is now getting things right, because this seems to be the most successful. It's been on the bestseller list for the last couple of weeks. There are indications that it may be going even higher, and so it seems to have caught a theme of interest throughout the country in addressing the fiscal problems that the United States now faces.

It is of course a special pleasure for me, here at the Institute, to introduce Pete Peterson. He was the founding chairman of the Institute for International Economics back in 1981. He remains chairman today and, I should add, for the indefinite future, as he sees no signs of slowing down in any of his activities. This, as you noted while coming in, is the Peter G. Peterson building, which he played a central role in both inspiring and constructing. And so it is a pleasure for me that this is in fact the biggest crowd we've ever had, rivaled only by that for President Vicente Fox of Mexico, at our opening day about three years ago.

In any event, it is only one of Pete Peterson's nongovernmental activities. He is of course chairman of the Council on Foreign Relations, founding president of the Concord Coalition, and is involved in a very wide range of activities of this type. In "real life," he is chairman of the Blackstone Group, one of the world's top private equity firms, which he cofounded in 1985, after having been CEO of both Bell & Howell Corporation and Lehman Brothers. On the government side, he was assistant to the president for international economic policy and then secretary of commerce in the early 1970s. In short, Peter Peterson is a very unique American: a corporate and financial leader, a distinguished public servant, and now a bestselling author.

It's a great pleasure to introduce my close friend and chairman Pete Peterson to talk about a topic of crucial importance to the country.

After Pete speaks, we will turn to Robert Rubin, secretary of the treasury from 1995 to 1998. We thought, as Pete said himself, that Bob was perhaps the best person to give us his perspective on the issues that Pete Peterson has raised, what the outlook might be going forward into the election campaign and beyond, and we'll turn to Bob to lead off the discussion. Then, Pete, Bob, and I will take the podium and start a panel discussion, bringing the audience in quickly, to be hosted by Alan Murray, DC bureau chief of CNBC and former DC bureau chief of the *Wall Street Journal*.

### **Presentation of the Book**

*Peter G. Peterson, The Blackstone Group*

I am often asked, "Why did you write this book now?" There are several answers to that. One is, I'm a terminal masochist, and I love being assaulted by my best friends. On my last book, Ted Sorensen issued the infamous and now famous comment about *Gray Dawn*. He said, "*Gray Dawn* is a book that once you put it down, you won't be able to pick it up." He called me the other day on getting my new book, called *Running on Empty*, and said, "When I saw the title of your new book, *Running on Empty*, I assumed it was an autobiography."

I thought John Whitehead was a great friend. He preceded me as chairman of the New York Fed, and I thought I was being gracious in cohosting a big 80<sup>th</sup> birthday celebration for him. He got up and said, "I just finished reading *Gray Dawn*. It's the only book I've ever read where you learn more from reading the blurbs than from reading the book." So that's one reason: my masochism is being more fully fed.

I have a second reason that sounds sanctimonious and self-righteous. But it has the virtue of being true. I am the happy father of five kids and nine grandkids. And, I am lucky enough to have carved out a life where I can spend some real quality time with them. And as I think about them, a comment by Dietrich Bonhoeffer, the German theologian, rings in my ears, "The ultimate test of a moral society is the kind of world it leaves to its children." And as we quietly pass on huge, and I think unthinkable, taxes and debts, as we quietly slip our kids and grandkids the check for our free lunch, I say we are failing that moral test.

I go further and suggest that in this political season it might not be a bad idea to reformulate the famous Ronald Reagan question, "Are we better off than we were four years ago?" by asking instead, "Is the future going to be better off? Are our kids and grandkids going to be better off than we are today?"

When I say that, some parents ask, "Are you suggesting that we don't care about our children?" And I say, "Absolutely not." But I am saying that parents and grandparents are being grossly misinformed and disinformed by an unhealthy combination of political and bureaucratic amnesia and anesthesia.

I once asked Margaret Thatcher, the only developed-country leader who has successfully attacked the long-term entitlement and fiscal problems, "Lady Thatcher, what do you people talk about at your G-7 meetings? Are the other leaders aware of this long-term problem?" She said, "Oh my yes, Mr. Peterson. They are very much aware of

it, but their theory is it's going to hit on somebody else's watch, and why should I take the pain for somebody else's gain?"

Now permit me to give you a few examples of what I consider to be the political high jinks, hypocrisies, and chutzpah, if you will. Let us start off with the unfunded, off the books, long-term liabilities--or if you prefer, hidden liabilities.

Official sources, and many unofficial, put the dollar level of unfunded liabilities at between \$45 trillion and \$74 trillion, depending on the timeframe. That is more than our collective net worth!

Now some hypocrisy and chutzpah. We passed unanimously in the Senate the Sarbanes-Oxley bill, in which we put public CEOs in jail if they don't accurately report their liabilities. Under ERISA [Employee Retirement Income Security Act of 1974], corporations are required to fund their long-term pensions over no more than 30 years. Were ERISA and the Sarbanes-Oxley bill to apply to the US government, it would add over one and a half trillion dollars to the annual budget.

While I suggest a number of reforms in the budget process--including first, reinstatement of the budget reinforcement act, including pay as you go; second, issuing a comprehensive long-term budget; and finally, developing accrual and generational accounting—I call my most fanciful the suggestion that Congress should now legislate that our government and public budgets be subjected to the same Sarbanes-Oxley/ERISA requirements as the rest of the public corporations.

And why is that fanciful? Because we can safely assume that the enthusiasm of Congress for that idea would be highly restrained. Why? For one thing, they would be jailed if they were to continue their current reporting, or I should say, nonreporting of these vast liabilities.

A second example of political high jinks is the trust fund. When I was secretary of commerce, for reasons that are not clear to me, *Time* magazine referred to me as the most powerful secretary of commerce since Herbert Hoover. I burst out laughing, because anybody who has ever had that job knows there has never been a powerful secretary of commerce. In any event, I started collecting oxymorons.

I believe the Social Security Trust Fund belongs in the first tier of classic oxymorons. In the first place, the Social Security Trust Fund should not be trusted, and it is not funded. We anesthetize the public with highly reassuring long-term statements that the trust funds are solvent for decades. Yet, we do not tell the public that the payroll taxes of our children and grandchildren would have to double to cover the costs of Social Security and Medicare. That is an unthinkable burden. We do not tell the public that whether you have a trust fund or not, you still face the same three hard choices: increased taxes, cut benefits, or try to borrow unprecedented amounts.

Now how much would we have to borrow? I think it's time we started thinking in cash flow terms, because these programs are obviously pay-as-you-go programs. The projected cash flow deficits for Social Security and Medicare go from a modest \$25 billion in 2003, to a projected \$783 billion in 2020, and trillions of dollars thereafter.

Then, of course, our political dialogue includes a lot of euphemisms and disphemisms. "We shall not pass our problems on to the next generation." Well who the hell do we think we're passing them onto? Or, "It's your money. You deserve to get it back." Who does the debt belong to? The ages, or what?

Milton Friedman tried to educate me, presumably, when I was at the University of Chicago. He used to teach us that a long-term tax cut is not a tax cut at all, if it is not accompanied by long-term spending cuts. It is just a deferred tax increase on your children.

Now another reassuring absurdity that we inflict on the American people is referring to these entitlements programs as a social contract. I had one course in commercial law in business school. And, I was taught a contract is not valid unless there is a meeting of the minds of the parties involved. Recently, some good friends gave a book party, and I thought I'd try to dramatize this point by inviting my wonderful seven-year-old granddaughter, Chloe up to the stage. And I said, "Chloe darling, have you signed on to trillions of dollars of unfunded liabilities? And this doubling of payroll taxes?" And this adorable girl says "Papa"—as she calls me—"I am going to have to sell a lot more lemonade, and you're going to have to increase my allowance." Indeed.

Now in my apparent need to offend everyone, I attack what I call the theologies of both parties. I use the word theologies deliberately, because a lot of these policies seem faith directed and relatively untouched by analysis, history, or evidence. And they are nearly always delivered with a kind of moral certitude.

My party, the Republican Party, seems to have adopted a tax cut theology, which has morphed into "any tax cut, any time." Now, to continue the theological metaphor: the tax cutters have formed an unholy alliance with the big-spending, big-government Republicans. Alas, a new oxymoron: the big-government Republicans.

Not just Pete Peterson, the curmudgeon, but highly conservative institutions and individuals agree. The CATO Institute refers to the "spending explosion." Dick Arme, the former very conservative majority leader, says, "We can't pin this one on the Democrats, we're in control of everything." Senator Chuck Hagel says, "Our party has lost its moorings."

In this vain, I was chagrined that my party, the so-called fiscally responsible party, voided the very budget enforcement mechanisms—pay-as-you-go, spending caps, and the like—that had made such a difference in the fiscally responsible 1990s.

Finally, these Republicans are joined by their fellow "starve-the-beasters." Paradoxically, their argument is in sharp contrast to that of the supply-side Republicans, who might argue that increased revenues would grow us out of any problem. The "starve-the-beasters" take the opposite view: cut taxes, they tell us, and revenues will fall. Then, we can get rid of or drastically cut these benefit programs.

I say to the "starve-the-beasters," you had better be careful what you wish for. Have you considered certain melancholy facts? One-third of the people at retirement age have no net financial savings. According to the Fed, half of all people aged 45 to 54 have total gross financial assets—not net, but gross—of less than \$46,000. According to the Social Security Administration, Social Security and other benefits account for 91 percent of the total cash income in the year 2000 for elderly households in the bottom fifth of the income distribution.

Now picture the scene, 77 million baby boomers, some significant portion of whom are in serious need of support. Am I to believe that if we suddenly say, "Sorry folks, there is a big cut in your benefits", there will be no political or social effects. And, the elderly will say, "Thanks...I needed that and I deserved that." By the way, when in a major crisis did governments get smaller?

So, to sum up what my party has done, they've done Lyndon B. Johnson one better. We have guns, butter, and tax cuts.

Now to my Democratic friends. In the interest of self-defense, I exclude Bob Rubin, at least for today. If my party cannot see a tax cut it does not like, it might be charged that many Democrats have hardly ever seen a universal entitlement program that they didn't like. Viewed historically, I think it is fair to say that they have been the prime movers, along with a few coconspirators, I have to admit, from my party, of the following rather startling trend. Over the last 40 years, federal benefits to individuals have gone up six times in inflation-adjusted terms.

Let's review the current Medicare prescription drug benefit. In spite of the fact that most serious analysts say that the projected costs of the current Medicare program are unsustainable, we heard not a single word from the Democrats about controlling the cost of the current program. Instead, Democrats complained that the new Medicare drug benefit plan does not go nearly far enough. In other words, let's make this unsustainable program even more unsustainable.

Now one might ask, Peterson, you have been boring us relentlessly since the early 80s about the entitlements. What is new; that is, beyond the obvious reality that the first baby boomers retire in only five years, and the next president is going to confront this reality directly on his watch?

I suggest there are three important new realities we must deal with. All three center around the basic theme of some profound disconnects between ends and means. All three are about our unwillingness to confront the long-term tradeoffs between national security, economic security, and retirement security.

First, we confront an unprecedented national security agenda to fight two wars: the war on terror abroad and the war on terror at home. While we say we'll pay any price, and we say that we know these wars will go on for years to come, we have in fact seriously underestimated the cost. And, we are fighting both wars without a war budget.

Some have forgotten that while our super power military is stunningly effective, it is also stunningly expensive. It is very different from the good old days—World War II, for example, which was a bit like organizing a federal jobs program, with quick training of inexpensive troops with inexpensive equipment. In today's hi-tech high-cost military, the brute fact is that these costs have ballooned—for example, a billion dollars a week for just two divisions in Iraq conducting "stability operations".

Some quick factoids. The CBO, which is after all under Republican control, has looked at our budget estimates for the next 10 years for defense and said they should be at least 18 percent higher or a trillion dollars more than the official estimates. And they remind us that the official budgets have no provisions for any wars. They also have no provision for additional troops, which 54 out of 61 members of the House Armed Services Committee have proposed. Were we to meet the criticism of having a ten-division army to meet our 12 decision priorities, the personnel-related expenses alone would come to about \$40 billion annually.

Then, of course, there is the war on terror at home. I am very proud of the work that the Council on Foreign Relations has done on homeland defense. Now in spite of all the rhetoric, there are obvious critical holes in our homeland defense. Cargo containers, first responders, health care systems, immigration control, protecting critical infrastructures such as energy sources, pipelines, refineries, and so on. Just to cover only

three of these vulnerabilities: Equipping our emergency responders, expanding our medical facilities, and protecting our ports would cost over \$120 billion over the next five years.

The second new reality that I think is receiving far too little attention are not simply the budget deficits, but the huge foreign or current account deficits—the so-called twin deficit. The previous record was in the 1980s, 3.7 percent of GDP. The dollar then fell by a third, and we experienced a stock market crash. Today, it is at 5.4 percent of the GDP, heading north by most accounts, into utterly uncharted territory.

Catherine Mann, a fellow at the Institute, is here, and she has some future estimates of current account deficits that might daunt even the most passionate optimist. Perhaps during the discussion, Fred can talk about that.

Currently, we import \$4 billion of foreign capital every day—half to finance war deficits, half for current foreign investments abroad. And even the IMF is giving us hell. They remind us that a current account deficit of 5 percent of GDP is typically a danger point. They remind us that external debt at 40 percent of the GDP—where we'll be in a few years—is “an unprecedented level for a large industrial country.”

So as part of this book, I interviewed a dozen leading experts about the twin deficits, experts who are much smarter than I am about such things. None of these people believe that our current account deficits are sustainable. In the administration I served, Herb Stein was our Nixon humorist, which I guess is another oxymoron. But you'll recall his famous words, “If something is unsustainable, it tends to stop.” And he said, if you don't like that, “If your horse dies, I suggest you dismount.” So the question we confront here is: do we get off gently, or do we get thrown off?

Now, roughly half of these experts say there is a substantial risk of some kind of hard landing. Paul Volcker, for example, says that there is a 75 percent chance of a crisis in five years. Rubin, who speaks with his usual understated and constructive ambiguity—by which I mean no one knows what he is saying—refers to “a day of serious reckoning.”

Remember that a hard landing envisions a sudden big drop in the dollar, a big spike in interest rates, nasty effects on financial markets in the economy, and so forth. The other experts predict a softer landing. But make no mistake; we're talking about a landing and not a takeoff. Now in truth, I don't think anyone knows how and when these deficits will be made lower and sustainable. But we know they must be.

The United States now directly or indirectly absorbs two-thirds of the total current surpluses run by every nation of the world. This cannot continue. But redressing this unsustainable global imbalance will require some profound and perhaps even traumatic structural and indeed cultural changes of our own and other countries' political economies. America must consume more, import relatively less, save relatively more, and export more, and the rest of the world will need to do the opposite.

Given the difficulties of these adjustments, our esteemed chairman of the Federal Reserve, Alan Greenspan, has said that nothing worries him more than the “clouds of emerging protectionism” as a possible “solution.” And speaking of our chairman, I am delighted he is here today. But I wonder, as tough as the agenda, Alan, has been on your watch, whether you might turn out to prefer it over that of your successor.

Whatever the outcome, I think these unprecedented twin deficits are great risks that a great country should not be taking. And I am not simply talking about the economic risk, I am talking about the national security risk and the foreign policy risk, of

betting how long the biggest debtor and the biggest borrower can also be a great leader and a great superpower.

The third new reality is a rapidly aging world and the gargantuan fiscal demands that come with it. We in the United States say that our 77 million baby boomer problem is huge. However the problem in other developed countries is far more severe and will hit sooner and harder. Why?

Their birth rates are far lower than ours. Thus, they confront a big drop in young tax-paying workers. The birth rate in Italy and Spain is 1.2, in Japan and France it's 1.4 or less; their benefits are much higher; they retire much earlier—in France only 34 percent of the people stay employed between the ages of 55 and 64; only 7 percent in continental Europe have a pension plan; the unions are much more powerful; the taxes are already much higher, averaging about 35 percent of payroll tax in Europe, 45 percent of the GDP overall tax burden.

Our friends at the Center for Strategic and International Studies have projected that the public benefits spending demand for the elderly in Japan, France, Germany, and Italy, will grow from 15 to 28 percent of the GDP in the next 40 years. That's unthinkable, it seems to me.

Speaking of Japan, let me tell you a little anecdote. I found myself at the Council on Foreign Relations, sitting next to Mr. Kuroda, who until recently had been the vice minister of finance and international affairs of Japan. The conversation goes roughly as follows: "Mr. Kuroda, is the aging society in Japan and the related demands going to present a significant problem to your country" ... "Oh yes, very serious problem" ... "Mr. Kuroda, how are you going to finance these burdens?" ... "Well Mr. Peterson, we have a high saving rate and a big current account surplus. And for a while we'll be able to sustain it that way" ... "Mr. Kuroda, aren't you financing 25 percent of our current account deficit? And have you figured out a way of spending the same money twice?" ... "A serious problem Mr. Peterson."

Finally, I lay out reforms in this book. They are built around the notion that we must substantially increase our rate of net national saving, which is now hovering near zero. And there are two ways to do this, obviously: One is to reduce the dissavings, or negative savings of the budget deficit, and without fundamental reform of the entitlements—this is a fool's mission, in my opinion. And the second is we have to increase personal savings directly per se.

As to reforming entitlements, may I say that both Social Security and Medicare require reform? However, I believe that not only is Medicare the biggest fiscal problem, accounting for three-fourths of the unfunded liabilities, but also a far more daunting problem in political and even moral or ethical terms.

Some say just drop Bush's tax cuts, at least on the wealthy. But the CBO [Congressional Budget Office] tells us that even if we repeal all of the Bush tax cuts, they are only about 10 percent of the problem. So we must confront the brute reality that reduction in benefits are absolutely essential in Social Security and Medicare.

Let's start with Social Security. After proposing in times past a variety of what we might call micro changes, gradually increasing the retirement age or an affluence test, or a Diet COLA, I've decided that this mille-step approach tends to aggregate a consensus of negatives. I've decided that a simpler macro approach has much to say for itself—not

just simpler to execute but simpler to explain to parents and their children, which I consider crucial to a long-term political solution.

It is quite widely known that Social Security benefits are indexed to inflation with cost-of-living adjustments (COLAs). It is not widely known that these benefits are also indexed to wages, and that makes it very difficult to grow out of the cost problem.

If we were to eliminate the wage indexing, we would essentially eliminate the unfunded liabilities of Social Security. If we have time to discuss it, I can explain why I believe that parents and their children being told that they are getting the same benefits in real terms can be presented as a fair and simple proposal.

My second proposal is for mandatory savings in personal retirement accounts of workers, of roughly 2 to 3 percent of the pay, with some subsidy for the poor. These funds would be managed by a public/private board.

Why mandatory you might ask? Fred Bergsten will recall that some years ago, when he chaired the Competitiveness Policy Council created by the Congress and the President, I was chairman of a subcommittee on capital formation—a subject about which I knew virtually nothing. So I invited the best savings economist from the left, right, and center. I asked that they educate me on the net effects on national savings—that is net, after considering all the costs of the tax incentives. The general conclusion was that the effect is both limited and ambiguous. But, I said, you keep saying that we have to increase our savings in this consumption-obsessed culture of ours. So, how do you propose that we do it? And virtually unanimously they said, in our consumption culture, it would have to be mandatory.

How to invest it? I propose these monies be put in global index funds, equity and fixed income. Why indexed funds? Because, in the first place, they reduce administrative costs substantially and thereby increase net returns. I want to remind you that many of these individual accounts we keep talking about will be very small for a while. And second, index funds avoid the political issues of which industries to invest in or not invest in. That becomes a political football.

Why a public/private board? I think it is essential that we get this money out of the hands of government, who have demonstrated that they will spend it. And, we must get the funds invested in the private sector.

Now what about Medicare? It is a much bigger and much more formidable problem. Why? Because it presents highly ethical life and death issues, and who decides, and how one decides who gets what treatments. Because it confronts what Dan Yankelovich calls a “maximum right” mentality—that Americans are “entitled”—not one of my favorite words—to all the latest high-tech, high-cost treatments. This is a mentality that has led our spending to be about two times that of the developed world, without any measurable difference in health outcomes. In this book, I present half a dozen proposals for controlling the cost of health care in ways that I hope are rational and humane.

Finally, what does one need to do politically? What are the possible scenarios? I give you two options or scenarios.

Option A, one I vastly prefer: A massive dose of truth telling. And, given the momentum and impact of the 9/11 Commission, I recommend that the next president immediately appoint such a bipartisan twin deficit commission of trusted Americans, of the quality of Tom Kean and Lee Hamilton. I’m talking about Paul Volcker, Bob Rubin,

Sam Nunn, Warren Rudman, and Bob Kerrey—Americans of that quality, and not the usual special interest devotees.

It will also require, in my opinion, bold leadership by a president, who not only educates but also leads Americans to take constructive action and ideally, creates a global consensus for other developed countries to also take action. This is indeed, in my view, a global problem if I ever saw one.

Next, entitlement reform has to be in a bipartisan setting. A partisan approach to reform energizes the “turkey shoot” phenomenon, which I used to experience in my home state of Nebraska. In other words, the “turkey” who lifts his or her head with a proposal gets shot.

Scenario B, much to be deplored, is a crisis scenario. And there are a lot of hard heads that I have talked to who believe this is what it will take to solve our long-term fiscal problem. Let us pray this is not the case, because it will engender all kinds of profound costs.

In closing, let me remind you that if you pick this book up, don’t put it down. You won’t be able to pick it up. Thank you very much.

## **Commentary**

*Robert Rubin, former secretary of the treasury*

Fred asked me if I would make some comments on the issues that Pete’s book raises. Pete had given me an inscribed copy of the book, which I was very appreciative of. He told me a moment ago, the reason he inscribed it was so I couldn’t resell it. I would have thought, given Pete’s humility, he might have thought that his signature added to the value, but who knows.

Let me start by saying that I thought Pete’s book was just terrific. It was a clear, objective, apolitical statement about realities that seem to me are stark and that in my judgment at least threaten to undermine our economic wellbeing, our national security, and our society, unless they are effectively addressed.

Pete mentioned his Margaret Thatcher anecdote, in which she said, in any given moment, it’s very easy for politicians to opt for current gratification, while letting somebody else pay the price for the future. But that doesn’t change the reality that there is a price, and at least in my view, in our country today, that price has the potential of being truly terrible.

I break the economic analysis into three periods. One of them is the eight years of our administration, the four years of the administration, and I think there are very important debates about which economic policies would have best promoted economic growth during those periods. And I think one can learn a fair bit from that with respect to the future, but that’s not the subject of today’s discussion.

As to looking forward, I break it down into two time periods. I tend to think of the next 10 years, which you know is the congressional budget window, as one period. And I at least think of that as the long term—maybe that’s because I live on Wall Street, where the short term is the next minute and the long term is a day. Anyway, that is a matter of nomenclature.

And then if you take the decades beyond that 10-year period, which is the period that Pete focuses the most on, I think of that as the long long term.

Most independent analysts are now projecting, as you know, a fiscal deficit of about \$5 trillion to \$5.5 trillion over the next 10 years. Goldman Sachs, for example, has put out a series of reports with estimates in that range. That is a \$9 trillion deterioration from the CBO's report in January 2001, once you make some methodological adjustments.

Moreover, that deficit will worsen every year, because as Pete said, in the middle of the next decade, baby boomer retirements start to accelerate at a rather rapid rate. Moreover, while 10-year numbers are obviously highly unreliable, it is equally true that there is no reason to think they'd be better rather than worse. In fact, Goldman Sachs thinks that the risk is more on the up side. And that, it seems to me, was a fundamental argument against the 2001 tax cuts, which were based on the notion of a very large projected surplus.

As Pete says in his book, and I think it's absolutely right, the 2001 and 2003 tax cuts, which are estimated to cost roughly \$4 trillion over the next 10 years, are at the heart of the 10-year budget deficit that Goldman Sachs and other independent forecasters now project. And I would add that the morass that we now have was totally unnecessary, because with respect to the tax piece of the stimulus—and of course the Fed was the most important part of the stimulus that we've had—the shorter-term stimulus could have been fully accomplished with temporary measures that would have been more efficient, more effective, and would have had no, or virtually no adverse, long-term effect.

I think these 10-year numbers are politically difficult to deal with, because, as Pete mentioned, we have serious geopolitical issues, national security issues, and difficult demographic issues. I would add one more, which is that we're going to compete with China and India, with large numbers of well-educated, low-wage workers, in a world where distance has been irradiated as a factor for many activities, because of real-time technology. I believe we are also going to have to invest very heavily in public education, basic research, certain kinds of infrastructure, and other matters.

Pete describes the very serious crowding-out effects that virtually all economists, or at least the mainstream economists, today agree on with respect to sustained long-term deficits. Pete also referred to an even more serious threat: a threat to interest rates, to business and consumer confidence, and more generally, to our markets and our economy. If the domestic and the international markets begin to believe that we are going into a period of fiscal disarray, then as a consequence they will lose confidence in our bond market and as a consequence of that plus our huge current account deficits, lose confidence in our currency—and as you all know, our current account deficit is in some fair measure spawned by our fiscal deficit.

These effects haven't been felt yet, although I do think that the prospects of these kinds of twin deficits have had some effect on confidence, on easiness, and on consumer and business behavior. But fundamentally, these effects have not yet been felt on interest rates. And the reason is that private demand for investment capital has been very weak. But I've been involved with markets my entire adult life, and I don't think there is any question that at some time, market psychology will change to reflect reality, as it always does. And when that happens the effects that Pete describes are highly likely to occur.

Pete referred to Paul Volcker saying that Paul thought there was a 75 percent chance of a crisis in the next five years.

To a limited extent, entitlement reform can be part of a solution to the next 10 or 15 years. Although I think that the practical reality is that entitlement reform will at best be a relatively small part of the solution to the 10-year problem—especially if you have the view of the current retirees, and soon retirees are, for practical purposes, off the table.

Thus, the solution will have to be primarily in revenues and spending from other parts of the budget. Having said that, as Pete so dramatically and effectively demonstrates, if you look out over the next several decades, entitlement growth presents a truly impossible problem that will almost surely lead to exceedingly unhappy results.

Again, it seems to me that the 2001 and 2003 tax cuts played a central role. Number one, if you adjust the AMT [alternative minimum tax]—given that the middle class is going to be swamped by the AMT, it seems to me that it is inevitably going to be adjusted—then those tax cuts over these many decades are, roughly speaking, equal to the increase in the cost of social security. In fact, if you present value it, the tax cuts are more expensive than Social Security.

The biggest problem, as Pete said, is Medicare.

Also, I think these tax cuts make reform far more difficult, because when the day we finally face reform comes, if we are in a situation where we have to say that we can afford tax cuts that are heavily weighted toward the most affluent but can't afford current Social Security and Medicare benefits, that situation, it seems to me, makes for exceedingly more difficult politics.

And that leaves me to politics and process. And on that matter I would make just a few very brief bullet-point type comments, and we can leave the rest for discussion.

First, most politicians like to talk about fiscal discipline. I lived through this in 1993 with President Clinton. Bill Hoagland can tell you the same thing from his experience. It's easy to talk about but excruciatingly difficult to do. And the best evidence is that our program in 1993 passed by two votes in the House and by a tie vote [in the Senate]—the vice president [Al Gore] supported us. And if you look at the political environment today, as Pete does so well in his book, one can get a sense of just how difficult this is going to be.

Second, in 1998—I don't think too many people remember this now—President Clinton considered the possibility, at least, of a few reforms of Social Security. We put out some feelers to see what the reactions might be. They were immediate and violent. And therefore were immediately taken off the table. I think that the “turkey shooting” example is right. In the environment we have today, if we try to put out a proposal to deal with these very difficult problems, in a campaign, they will be violently attacked and therefore, for practical purposes, either destroyed or severely damaged with respect to future use, which may say a lot about our political process.

Third, I think the only way to succeed—and I am not sure what the odds are that we can succeed, short of a serious disruption—is to have a president with a deeply internalized sense of the grave dangers we face, which Pete so aptly describes and a congruent sense of commitment to lead, working with the leadership of both houses and both parties, so there is joint ownership of these decisions.

Fourth, based on my own experience—and I guess I alluded to this a moment ago—I think even under those circumstances, even a committed president is very unclear what the odds are that we can succeed before disruption.

Finally, we need massively improved public understanding, which Pete also refers to, with respect to these issues—if we’re going to have the kind of political environment in which fiscal discipline and entitlement reform can be accomplished short of a crisis. Obviously the media could make a powerful contribution here. But it seems to me that such a broad-based and serious focus perhaps does not exist at the present time.

I think a great contribution could be made by somebody who cared enormously about these grave threats—individuals or foundations willing to fund a massive, multiyear public education campaign on these issues to try to create the framework within which politicians could then act.

With that, let me conclude by saying that I think all of us have to do whatever we can to try to increase public awareness. Thank you all very much.

### **Panel Discussion**

*Moderator: Alan Murray, CNBC/Wall Street Journal*

I’ll ask a few questions to get us started and then open the discussion to the audience because I am sure a lot of people out there have their own perspectives on this. But I will start with the news of the morning, which is that the Bush-Cheney campaign has put out a new advertisement this morning. It’s called the Era of Ownership, has lots of warm fuzzy photos of Bush on the ranch, and it talks about creating a society in which people own their own homes, own their own healthcare plans—I believe a reference to medical savings accounts—and own a piece of their own retirement, a reference to Social Security reform. Pete Peterson, does that amount to a first step in the direction of reforms that can seriously deal with this problem?

**Peterson:** Well, the difficulty with most such proposals, at least as I read them, is there is talk about taking some percentage of the payroll tax, for example, and putting it in individual accounts. Remember that these are pay-as-you-go systems, but there is very little talk about where you get the money to cover the so-called transition costs. Clearly, if you take this amount out, which will have to be funded by the government, and you don’t reduce the benefits for some period of time, what you are basically doing is adding to the problem. So I can’t be too impressed with these proposals until I understand where the money is going to come from.

**Murray:** Is it a movement in the right direction, the wrong direction, or no movement at all?

**Peterson:** I like the idea of people owning, or having personal accounts. I was CEO of a company in Chicago that had profit-sharing plans. I noted that the minute people had a sense of ownership in these plans it created a macro interest in how well the company was doing. So the proposal I had for mandatory saving would envision accounts owned by the individuals. They would understand what was in their accounts, and I think that is enormously important. But if you notice, I can be self-serving, and why not, under these

circumstances—Rubin had the insensitivity to suggest that I should have negotiated an honorarium from Bergsten for today and I just burst out laughing. Fred also believes in comparative advantage, and his entire life has been on reaching into other people's pockets. But there is a difference, if I can be self-serving about it, I at least have the honesty to say, here's where the money's going to come from to create this sense of ownership. And it comes from two sources. It comes from reducing the benefits and from having increased mandatory personal savings. So I want to know where the money is going to come from for these so-called ownership proposals.

**Murray:** So I think it is fair to say he's not overly impressed with what the Bush-Cheney campaign put out today, but I have spent a lot of time searching the Kerry campaign website, and I cannot find anything on entitlement reform—Medicare or Social Security. Why should we believe that a Kerry administration would deal with these problems?

**Rubin:** I am actually not bothered by the Kerry campaign. I am not sure what he said about entitlement reform. I don't think that he said much of anything. I know he's looked at it, I spent about 8 hours with him after the primaries and before the general campaign started and that transition period—I think there were five, yeah, four people who were formerly part of the campaign and I as sort of an outsider—talking about these next 10 years and if he is elected what he is going to face, because I think he's got an even worse problem than President Clinton faced coming in, in terms of these enormous deficits and the effect they can have on what will be his term if he is elected. And I don't think there is any question, at least in my mind, Alan, there is the turkey-shoot problem that Pete mentioned, but I don't think there is any question that he is focused on that as internalized and need to deal with, just as President Clinton had. I honestly don't think on entitlements that he has addressed them.

**Bergsten:** Could I just follow up on that? Because I think this immediate period, the next four years, and the next 8 to 10 years are really critical for the reasons that Pete has said, and how much is entitlement reform, how much is other things, we don't know, but I really want to ask a question to both Pete and Bob about that. Pete, you have posed a huge dilemma of political economy, you suggested that it is verging on the impossible to deal with the budget problem for all the reasons you said, but it is true that in the 1990s, there was a huge budget correction. Bob Rubin, as secretary of the treasury, his administration moved from a deficit of 6 percent when they came in to a surplus of 2 percent when they left. How do you explain that? How do you explain, given all those difficulties that you emphasized, that they were able to make that big an improvement, and does that suggest that it would not be so difficult to do it again? To Bob, my question is, since you as the architect of the improvement lived through it, you have written about it –

**Rubin:** President Clinton, I might add, would have a somewhat different view than what you just described.

**Bergsten:** Well, as you describe very persuasively in your book, President Clinton was absolutely crucial. But my question is, what would be needed from a President Kerry or a

second-term President Bush next year? What would be necessary by way of a new program to head off the kind of risk you, Volcker, and Pete have talked about? Would it be a precise program of five years of reduction like you did in 1993? Would it be more than that now? Would it have to bring the entitlements in? I think those are the immediate operational questions, and they are central to this election campaign, so I would like to hear both Pete and Bob on really a fundamental national issue.

**Peterson:** Well, let me take a shot at it. Other than Rubin's infinite charisma, which has to be a very important part of the explanation, it seems to me that there is a rather decisive difference between the Bush and Clinton administrations. We have gone through a decade or so of a very substantial reduction in the defense budget, and that reduction in the defense budget—from Bill Hoagland's here—from 5 to 6 percent of the GDP down to 3 percent, was an enormous aid in turning this deficit thing around. The reason I put emphasis on our national security needs, abroad and at home, is that it is my prediction—and I don't know whether Bill agrees—that if you want to talk about the national security interests, those expenditures are going to go up, not down, and that is a very decisive reason why, other than Rubin's charisma, I think it is considerably tougher in this situation than it was then.

**Rubin:** Fred, I would add that I totally agree with Peter. As Pete said, you've also got the entitlement problem—baby boomers start to retire in about four to five years. We are now a debtor nation instead of a creditor nation. I think we have a much more difficult environment, and the politics have gotten even worse than they were in 1993.

**Murray:** That's what I wanted to ask about, because it wasn't just 1993, of course it was 1983 as well, when significant changes were made. Has it become politically—you talk about this a little bit at the end of your book—more difficult to deal with these things than in 1983 or 1993?

**Peterson:** Of course in 1983, we had the power of that other supremely charismatic person, Alan Greenspan—that was supposed to be a joke, but I guess it wasn't—whom you may recall chaired a commission on this particular subject. Seriously, I think the problem is more difficult because I don't think that it is just a new cliché that we have become highly polarized. We have a Congress that is unbelievably, where 90-some percent get reelected. They are appealing both to the far right and the far left of their particular parties, and it seems to me that makes the kind of essential compromise that we are now going to have to deal with much more difficult.

**Rubin:** I would agree with Pete. Secondly I would add one more thing, the 1993 campaign was conducted, the economy started to decline, or growth slowed down enormously the second half of 1989, then you got into the early 1990s, you have a recession, and rightly or wrongly, people associated a lot of that with deficits—I remember the debate. And that created an environment in which Ross Perot and Paul Tsongas ran on deficit reduction, and that really had traction, and then that became part of President Clinton's campaign, but it was in the context of a situation where the American people felt—rightly or wrongly, I think rightly—that they had suffered

economically because of a sustained period of deficits. And you don't have that environment right now, Alan, so I think it is much more difficult.

**Murray:** But you were suggesting we may well have that at some point in the next four years.

**Rubin:** I'll tell you, I know an awful lot of people—because of what I do for a living and also because I am an investor—who are involved in thinking about money. I don't know if people would agree with this or not, but I don't, it is an interesting dichotomy, it is almost a schizophrenia, I think that almost all those who are thoughtful think that someplace out there, there could be just immense trouble. And yet, when you look at their forecast, and their investment, they very often don't take that into account. I asked one of them the other day, a person whose name everybody here would recognize, why that was, and he said, "Look, I think some places are in horrible trouble and I just hope to get off the merry-go-round before it stops. But the problem is there is no way of predicting when it is going to happen and we don't feel it yet and therefore it is very hard to stay out of markets." And I think that politics is sort of in an analogous situation.

**Murray:** Because I don't think that anybody thought when Bill Clinton was coming into office that his great moving passion in life was to put on the green eyeshades and balance budgets. What I remember happening in the early 1990s was that this was when James Carville, who might have had a very different agenda, started complaining about—he said, if I come back in another life, I want to be the bond market, because the bond market has the power. Well, that was his way of saying, I am sure, that in meetings, you would say, if we do that, the bond market will go crazy. There was an external force that forced you –

**Rubin:** Well, we still have an external force. At the present time, bond rates are relatively low because we have had this period of very low private demand for capital, but I think that at some point if private demand for capital picks up, or you just have a change in market psychology, for any one of many reasons, you could have a very different looking bond market.

**Murray:** And Fred, will it be the bond market or could it be a dollar crisis?

**Bergsten:** Well, Pete and Bob both mentioned the external side. Since this is the Institute for International Economics, maybe it is worth a word. It is important to remember that these deficits, though related, are not twin in any precise sense. For example, all the time that the budget deficit was coming down during the late 1990s, the current account deficit was going up. They were in fact moving in opposite directions, and there were similar periods historically, so they are not twin in any immediate or precise sense. Having said that, they are clearly related, as both of you said, and I would hypothesize that if the situation leads to a crisis, and action is forced by a crisis as opposed to rational preemptive action, it may very well be from the external side. We have put out on the table, and you can pick up when you leave, some new projections on the current account deficit by Catherine Mann, and she may elaborate if we get into this in the discussion, but

they are truly frightening. Pete referred to that. If you look at a reasonable projection for the current account deficit going forward, making reasonable assumptions about US growth, foreign growth, interest rates, and the like, you find the current account deficit starting to rise again by a full percentage point of GDP per year, and hitting something like 10 to 12 percent over the next five years. That is assuming no further change in the dollar exchange rate and making reasonable, rather conservative, growth assumptions—in other words, you really get to astronomical levels. If people came to believe that projection, I've got to believe there would be a sharp correction in the dollar exchange rate at some point along the way.

A question then—and it goes back to Pete and Bob—would that lead to a constructive policy response, namely something on the budget and the more underlying factors or, as Pete hinted and quoting the Chairman [Greenspan], trade protection or some irrational, ineffective, but politically understandable, response? That is one big question. The second thing is that this is really a global problem, not only for the aging reason Pete mentioned but also because when—I don't say if—the United States does have to bring its external deficit down, which means we have to consume less at home than we produce at home, you have to get the reverse outcome in the rest of the world. They have to be consuming more than they are producing. In other words, they have to increase domestic demand or else the world economy could go into the tank. The outlook on that is not promising. The euro has been the currency that has appreciated most against the dollar over the last couple of years with very little response by the Europeans to boost domestic demand. Yes, there was a little fiscal correction that actually broke the Maastricht requirements but nothing on monetary policy and very little on structural reform to pick up the slack from the inevitable decline in their external surpluses. That is a global adjustment problem, in addition to the enormous risks we face at home if the dollar went into a sharp fall after we are close to full employment in another year or so. That I think is one big conundrum. But the question to both of you: Is that likely to trigger constructive policy reaction, or might it make the thing worse?

**Peterson:** Dr. Rubin, I think you've served in the government more recently than I have, perhaps you want to make the hazardous bet on whether the response will be constructive or—

**Rubin:** We could ask Chairman Greenspan. He could give us clear and unambiguous guidance.

**Peterson:** He may be the only person in the world who makes you sound explicit. I'd like to make—I don't know why I want to do this, it is probably reckless—a kind of a softer point on our political situation. I am not a sociologist, I am not a political scientist, and I'm not even an economist. But I think one of the things that makes this a long-term problem, which is what I am focusing on, is the whole series of things that have happened to our culture over the last 40 to 50 years, which get partly expressed in the fact that we have gone from being the biggest saver in the world to the biggest consumer. They are reflected in the baby boomer generation, which kind of says, "I want it all, I want it now," and there is a lack of focus on the longer term for reasons that I am not smart enough or well educated enough to fully understand. But I am now old enough to have

remembered my parents' generation. And they spent a lot of time thinking about the long-term future and the idea that if we want to make an investment in whatever it is for the long-term future, we ought to pay for it. And I think something the next president has to focus on seriously as part of this politically very difficult educational job is to somehow get the country reoriented once again to our long-term future. How he does it I understand is just part of the problem, but it is an important part of the problem. I think the 1960s had a very divisive effect on this country. Vietnam, the assassination of African-American leaders, of presidents, of presidents' brothers created this feeling of "damn it, the world's unfair, and I need to be taken care of and to hell with other people, and let's take care of my particular needs." But I think there is something cultural going on in the United States that makes the handling of the long-term problems considerably more difficult than it might have been 10 to 20 years ago.

**William Coleman (former secretary of transportation):** I know there are people in Iraq now whom I admire very much, I just think you kind of over-jazz the situation when you say there aren't Americans who have the concern. Secondly, when you made your remarks, I thought about something that President Roosevelt once said that he had never seen a president who could be in office if he didn't get elected, and I think that if I took what you said in recommendation and gave it to President Bush to pitch for the next three months, or to Senator Kerry, I am pretty sure there would be an opening of the gap but the wrong way. Thirdly, I was very intrigued with something that Secretary Rubin said but didn't really express more. And that is that we have an asset in this country of about 25 percent of the people who are really not educated, and if you really could get them educated so they would be as smart as the three of you, that is a new asset, which may give us the next revival we need in terms of our economic activity. You are so successful because you have an opportunity, and if you could take the 25 percent that doesn't and really get them involved in the economic situation, that may be the answer to some of our problems.

**Murray:** Your political point, your second point, raises another interesting question. Somebody said to me the other day, this will never be dealt with in any president's first term.

**Peterson:** I believe I may be stupid, but I am not stupid enough to suggest my agenda in a presidential election campaign by either candidate. I said the next president should immediately convene a twin deficit commission, but not discuss the specific dimensions of the problem and specific reforms before the election.

**Murray:** But is it possible that if he wants a second term, he might decide that it is an agenda best left for four years?

**Peterson:** For another four years?

**Murray:** It could. I mean, 1983 and 1993 were both first terms.

**Rubin:** You know much more about politics than I do, but I think that if I were the next president or whoever it might be and, given—just like Clinton said in January 1993 in Little Rock, and we were talking about what to do, he said, I want to take on this deficit thing because we have to get the economy back on track and this is a threshold issue – he didn't say this, but I think he also sort of thought to himself that if the economy did not get back on track, he wasn't going to be a second-term president. I kind of think the next president could, well should, have that view; I'm not saying he will.

**Bergsten:** But just to elaborate that, if you take seriously the crisis risks that we were discussing and you felt that there was, to quote Volcker, a 75 percent chance in five years, which must mean a 60 percent chance or more than half in four years, then just from self preservation to get a second term you want to take preemptive action. That is of course a tricky calculation, depending on your sense of crisis risk, but also the fear of crowding out via higher interest rates, the things that motivated the Clinton administration to address the budget, but I would have thought that a replication of 1993 was a pretty sage choice for whoever is in the White House in January.

**Peterson:** I think the best time to do it, Alan, again none of us are politicians, is almost immediately upon taking office, because one of his political motivations is to try to take steps that make some kind of crisis less likely during the balance of his three or four years.

**Bergsten:** Therefore I am puzzled at your proposal for a commission, Mr. Chairman, would not that delay it a year?

**Peterson:** If we could get something done a year after October, I would say Hallelujah, but I think the extraordinary success of the 9/11 commission demonstrates that this country can be educated if the people on it are of true bipartisan, nonpartisan quality who are immensely respected.

**Murray:** Well the model in 1983 was to appoint the commission before the election but to tell them to keep their mouths shut until after the election, which I think they successfully did.

**Peterson:** Alan Greenspan is very good at keeping his mouth shut, certainly.

**Rob Dugger, Tudor Investment Corporation:** Alan, just a reminder, in 1987, there was no discussion of the S&L [savings and loan] crisis, and immediately upon completion of the election, the solution was implemented and very quickly enacted right afterwards. I would like to return to Fred's question, which had to do with what happened in the 1990s. Secretary Bob Rubin's successor in the position of secretary of the treasury, in a debate between Alan Krueger and Jim Heckman in a recent conference on human capital, offered a hypothesis that much of the strength of the economy in the 1990s was a result of human capital maturation, human capital that had been formed 40, 50, 60 years ago. And if I think about this, and the issue of how to make the transition to solve the political problem, I'm reminded of how often in polling education turns out to be the number one

voter concern. I'll just remark that Alan Greenspan has given five speeches in recent years on education, and those of us who read everything he says find those to be among his very best insights on the economy. Bob Rubin has talked about it and being bipartisan and moving quickly. I'm wondering if there's a way—when you talk over and over again Mr. Petersen in your book about kids and passing the buck to kids—if there's a political compromise to move this agenda forward that is inter-generational in nature. And can we work out something with respect to upper-income households and beneficiaries of the tax cut or seniors who are such large beneficiaries of Medicare and Social Security in a quid pro quo to take those benefits and allocate them to investing them in kids?

**Peterson:** Let me add a specific element to Chairman Greenspan and Bob's emphasis on education. It seems to me that some realities about our new competitors in China and India should be made clear to the American people. For those of you who have not looked at the numbers, these two countries produce several hundred thousand engineers and scientists a year. Last year, we produced, I believe, 65,000, and a substantial number didn't stay in this country. I think the next president could make a case that most people would understand that quite apart from the generic case for education, we are moving into a highly technological world, and if this idea that the higher-paying jobs are going to be in this country, it seems to me that they're going to be there because we got the people scientifically trained in order to do it. So among the national priorities that I'd put a lot of emphasis on is how do we regenerate once again a major thrust on science and technology and innovation, which I think is at the heart of our success in the long term.

**Bergsten:** Incidentally, that's the basis of many of the studies we've done here at the Institute. It is absolutely essential to have any hope of maintaining a political foundation for open trade policy, support for globalization and the like, because half the labor force still comprises high-school graduates or less, who are terrified of globalization, don't want to see any more of it, and indeed would prefer it rolled back. And only with a significant increase in the education level of the population as a whole do we really have any chance of getting out of the domestic political stalemate over the international trade and globalization issues that have plagued us for the last decade. Again, Chairman Greenspan's talked about that in a lot of speeches and is absolutely right—just one more reason to do what Bob was suggesting.

**Steve Charnowitz, George Washington University Law School:** I want to ask a question about the political process. Secretary Peterson offered the idea of a 9/11-type commission, and Secretary Rubin, I think, his model was Presidential leadership. I wonder if the panel could comment on this 9/11 commission model—because I think it offers a lot of positive elements such as a package, rather than piecemealing everything, tough choices being made, which is hard for any one politician or one president to do, the public profile of it, where everyone knows what the 9/11 commission is, and the willingness of the commission to push and fight for its proposals. Is that a good model? Dr. Bergsten I thought was beginning to express a little skepticism on it, but is that a good model for how we can tackle this intractable problem of the budget deficit and saving rate and, if so, shouldn't a president who intends to do that, shouldn't that

candidate tell us now that that's the way he's going to proceed to deal with these problems?

**Peterson:** I think one of the few things a candidate could do now, Bill, is not to talk about the reforms, because that would be the turkey shoot, but to talk about the process by which we are going to address the long-term problems. And, there aren't many but I mentioned some of them, there are a group of Americans who I think most Americans believe rise above partisanship, and that to me was the miracle of that commission: that you had people as different as the people on that commission who saw a larger national issue at stake, and were willing to throw away all the partisan flack, and talk about what was in the national interest. And I think if that commission were picked carefully, not the usual commission of, you know, this special interest constituency and that constituency and so forth, which is often a recipe for huge debates and no real resolutions, what Shepherd Mead once referred to as "the glob," I think you've got a shot now at doing the truth-telling that I think is utterly essential.

We suffer as a country from a kind of "shortermitis," as I've already indicated. When the people are told that the trust fund is going to keep things solvent for X decades in the future we can't blame the Americans for saying 'Well, that's a problem for somebody else. Somebody they believe in needs to tell them the truth. I think there are only two I can imagine: one is the President of the United States who obviously has to take the lead role, but I think there are a group of Americans, and I named some, from both parties, that Americans generally believe speak the truth. And I think that is a very important part of the educational process.

**Rubin:** I guess I would add that I guess the commission could serve a useful purpose, but I think there's a big distinction between this commission and the 9/11 commission dealt with very difficult issues and difficult choices, but those choices didn't affect people's everyday lives.

**Peterson:** Right, it's tougher.

**Rubin:** This one is going to involve choices that affect, very substantially in many cases, the everyday lives of people. And I think there's only one answer to this, I may be wrong, but I think there's only one answer, and that is having a president with an internalized sense of this, who's really willing to commit to doing what's needed. That doesn't mean a commission can't serve a useful purpose in the sense that Pete described, but I think it's a very different set of political problems than those involved with the 9/11 commission.

**Peter Orzag, Brookings Institution:** When Mr. Greenspan chaired the commission in 1983 it involved both benefit and revenue changes, so I just wanted to ask I guess Mr. Peterson, as part of your process for gathering information for this book, was there any budget analyst that you spoke with who believed that we address this problem without an increase in revenue, both because of the direct effects on the budget and also the political economy effects that Mr. Rubin spoke about. So if you could comment on just the accounting, and whether basically Rubin got the dynamics of the political economy right.

Is a grand political compromise here—scaling back or repealing the tax cuts and entitlement reform and is it impossible to do this without that?

**Peterson:** As I recall the numbers of the CBO—and Bill Hoagland would know better than I—the incremental cost of entitlements over the next 50 years, I believe, was about 10 percent of the GDP. The Bush tax cuts, I believe, are about 1 percent of the GDP, or something of that sort. It's not that I'm theologically biased against any tax increases but it seems to me that the major part of the reform has to be in terms of benefit reductions, because to try to pile this bigger tax load on the economy would have very serious effects on the economy, not to mention the individuals.

**Murray:** The immediate theological debate you'll get into is whether forcing people to contribute 2 percent of their payroll to a savings program is a tax.

**Peterson:** No, but if it's in their name and it's their account, and their money that's a very different thing than—if I may inject a little humor—a lockbox.

**Brent Scowcroft:** The notion of my saying something about economics is frightening even to me. But it seems to me we've been through this before. We had an administration in the 1980s, a supply-side administration that said you can spend your way out of deficits, and so on and so forth. Then we had an administration that inherited the results of that, that paid a price on 'read my lips' during the campaign, that cut back spending. If you proposed a new program, you had to pay for it by reduction somewhere else in your budget, which started the sense of discipline that then you all, Bob, inherited and continued, to your everlasting credit. But, it seems to me it is tough, and it putatively cost the president reelection, but it takes presidential leadership. I've been on lots of commissions, some of them work, some of them don't, but a commission whose time has come is more likely to work. Many of them go away not because they don't have bipartisan support, not because they don't have wonderful people on them, but because there's no imperative to pick it up. And this problem is on everybody's mind, and that's one of the reasons it'll work. But I think unless you have a president who's prepared to say you've got to do the things that you say, which are really very simple, and do them, it's not going to work.

**Murray:** Just to throw this on the table for the discussion as well. I talked to Governor Kean a lot about how he got this bipartisan consensus. He will tell you he thinks that the partisan atmosphere that exists today is worse than he has ever seen in his lifetime. In your book, you talk about redistricting the House of Representatives, what it means to have a House of Representatives, where the vast majority of Representatives never have to play to the middle, they only have to play to one side or the other, because that's the only thing that matters in their election. I've spent the last three years in the cable television news business, which I've come to conclude is sort of the front lines of what's going on in our society.

There's an interesting Pew poll that came out a few months ago. More and more people are customizing the news they receive. They're not getting their news and information from a common source. They are getting their news and information from

sources that reinforce the biases that they already bring to the table. They're doing that on television. They're doing that with newspapers too. I mean you can get the *Wall Street Journal* now and say, "Hey, I only want to read Paul Gigot's columns and baseball scores or whatever. That's all I want to know." Nicholas Negroponte has written interesting stuff about this, that the Internet and technology enable us to create kind of the "Daily Me"—just tell me the stuff I want to hear and don't tell me anything else. And that's, I think, another factor that's creating a kind of intense partisanship that didn't exist in 1983 or even 1993. There's a question right here.

**Ben Fairfax, State Department:** Pete Peterson talked about the need to cut entitlements. But isn't there in fact a growing pressure to increase entitlements, particularly in the healthcare area? Because so many Americans don't have health insurance, and also the cost of health insurance is rising. Even for people who have insurance, the costs go up every year. So you have tremendous pressure. But you also talked about the Medicare situation being very critical. But couldn't a possible solution for both of these problems, as well as the problem of competitiveness in our companies, be a consideration for a universal health care program? But, if you did this, wouldn't you have to consider severe cost containment, number one, including limiting malpractice suits, and number two, how to pay for this, which in most countries is paid for by VAT [value added tax], for example, in Canada and Europe?

**Peterson:** Let me take a shot at why I think the Medicare problem is so much more difficult, other than the fact that it's fiscally much bigger. Let me take one example, just to illustrate what Dan Yankelovich calls "the maximum right mentality." If you try to examine the reasons that we're spending twice as much, roughly, as other developed countries on healthcare, without any appreciable difference in outcome or longevity, in a previous book I decided to try to understand why that was. I'll just give you one example of many.

We spend a lot more money on the last few months of life than any other developed country, at least that I've been able to see. And I asked, for the last book, Neil Howe, will remember, Fred Plum, that brilliant head of neurology at New York Hospital, who is perhaps the country's leading expert on strokes, "What is it Fred, that other countries do with regard to the cases you deal with, where people have a very severe stroke and their quality of life is absolutely de minimus?" And if you don't believe me, I suggest you go into an intensive care unit some time, and just look at the scene you will see. If it's like the ones I've been to, an astonishing percentage of the people are in their 80s or early 90s, with tubes in them, the quality of life absolutely de minimus, but it's extraordinarily expensive. And I said, "Fred, what is it they do in other countries?" He said, "I want you to go into intensive care units in Europe and in Great Britain." I said, "Well, let's take Great Britain. What is it about how they handle people with a minimal quality of life who've suffered a totally debilitating shock?" He said, "They handle it very differently. The neurologist turns the patient over to the general practitioner, who sends the patient home, and they die the way people used to die, the so-called old man's death from pneumonia."

Now I've probably been responsible for more people losing elections than anybody in the world, and I had a long discussion with Richard Lamm, who some of you

will remember was the person who ran for governor of Colorado—and this is why I don't think you can approach this problem in a partisan way—and he became convinced that we ought to really focus on the enormous amounts of money we spend on the last few months of life, with a very minimal effect on quality of life. So, he ran for office, as you may recall, and he had the courage to suggest this was an issue that had to be discussed, and he got into living wills and a group of other proposals. He lost the election by a decisive margin. People said, "My god, this guy is talking about rationing." What in hell do we think we're talking about here? We're going to have to give up some marginal benefit that has some small effect but costs a lot? Look at the American health care system and at every high-tech high-cost development. People start talking to me about how wonderful the Canadian system is. Do you know that we have eight times the MRI units that Canada does per capita? You all know what happens with regard to long delays in Canada for certain kinds of surgery.

So one of the reasons that problem is so difficult, and Dan Yankelovich is right, this has become a notion, that Americans are entitled to any high-tech high-cost system, however small or marginal the benefit might be. And it's going to be a very tough proposition to sell the idea that we're going to have to give up some medical care in some cases. In my view it's one of the toughest political problems we have ever had in this country.

**Al Milliken, affiliated with Washington Independent Writers:** In your first chapter, "Bankrupt Parties, Bankrupt Nation," page 15, Mr. Peterson states, "For supply side Republicans, the pursuit of lower taxes has evolved into a religion, indeed a theology, that discards any objective evidence that violates the faith." To be fair to religion and theology and faith, isn't what you are talking about not true or pure, or undefiled religion, but rather a false, impure, cult-like faith that causes blindness and deafness in its followers?

**Peterson:** Can we have the next question? No, I don't think we should treat that quite so lightly.

Let me tell you about a discussion I had with a very famous editor of your editorial page, on *The Wall Street Journal*, because I considered Bob Bartley a very smart guy, but a theologian on this supply-side subject. And this is why it's very difficult to have a kind of rational debate if you're not really willing to talk about the evidence.

In 1981, five treasury secretaries and myself took a look at what was happening in the deficit situation. We organized a massive, bipartisan budget appeal. I was called to task by *The Wall Street Journal* editorial board, which is some experience I might add. I said: "I've looked carefully at your numbers, but the idea that in only three years we can go from where we are to a budget surplus and a trade surplus strikes me as very difficult to believe." And they said, "Pete, you just don't understand psychological economics, expectational economics..."

**Peterson:** I appeared on the Charlie Rose show with Bob Bartley, who has left us but, as I said, was an extremely bright fellow. I had finished reading his book called *Seven Fat*

*Years and How to Do It Again*, and he was waxing rhapsodic of all aspects of supply side as though there weren't any legitimate questions that could be raised. I said, "Mr. Bartley, I find it interesting that in this entire discussion of supply side you do not mention the huge increase in debt in this country." So he tried to dismiss me by saying, "Well, I would have thought someone with your background would have understood that debt as a percentage of the GDP is what is important." I said, "Mr. Bartley, tell me what your point is, because I do understand that." He said, "Do you realize public debt is half of what it was 50 years ago as a percent of GDP?" I said, "Let me see, 50 years ago, that would be 1948, 1947, right after the Second World War; I thought we were here to discuss Reaganomics, not the postwar period, when obviously debt was high." During Reagan's terms, federal debt rose from about 26 to 43 percent of GDP.

Now the point I am trying to make is that we must be willing as a country for both sides to look at evidence and history rather than recant our theologies—I give you another example during the break in the Charlie Rose Show. I liked Bob Bartley a lot, but he is a classic example of the theological approach to this. I said, "Bob, I think any of us can understand why a cut in marginal tax rates from a highly punitive level, as it used to be, you'll remember Bill 70 to 80 percent, can have a serious effect on incentives, on productivity, on working, and so forth. I find it hard to believe that a tax increase of 2 or 3 percent from 35 to 38 percent can create serious negative effects. And I said, "How do you explain Bob the fact that Bill Clinton raised marginal tax rates by a few percent and I don't recall all these catastrophic effects that you are talking about. So at the margin, explain those good years to me." And believe me, he said this: "Well, all that is, is a 15-year lag effect from Reaganomics." And I said, "But in 1981, you told me the effect would be in the next two years, not in the next 15 years." And that is part of what makes this so difficult: It is hard to look at evidence.

One of my dearest friends in the world is Peggy Noonan. She and I obviously do not share similar views on certain subjects, but she is a devout Catholic, and I love her dearly. It would not occur to me to get into a discussion with her about her Catholic religion because she is a person of deep faith, and I think that is one of the problems on this economic issues that we run into: It *is* theological, and it is very hard to have a rational discussion.

**Bernd Fischer, German Embassy:** Allow me a foreign perspective, if I may. Coming from a continent that has about double the amount of entitlements than the United States, especially if you add state and local levels, where, for example, for the streets of our capitals we may give a little more money than we see at least for northwest [Washington] DC where I live, I am a bit astonished that you are so withdrawn on the question of entitlements. For example, having heard that entitlements on education was an issue today and having crisscrossed your country and seen a lot of schools where one wonders if a little more entitlement may be an answer to the questions, the point that perhaps strikes me more than any others is that you may enjoy a growth of population, population that comes into the country from other countries, which may need more entitlements—unlike we Europeans who most probably will have a reduction in population over the next 10 to 15 years. So isn't it what you need perhaps, a very sound entitlement plan, entitlement program, more than anything else?

**Peterson:** Well, perhaps I didn't make clear, and I should have if I didn't. I hope I said that the problems in Europe are substantially more difficult, both in fiscal and political terms. Just look at what happens in France with the most modest proposal for an increase in retirement age from 55 to 57, and the whole country explodes. And that's why I said we need a global approach, which I know is a fantasy but is going to be important to do this, because I think you people are going to face a genuine crunch, because the number of taxpaying workers in your country over the next 20 to 30 years is going to decline dramatically, and you have an aversion to immigration, as I can understand, given the Muslim problem. So I think your problem with regard to this is far more serious than ours, but alas, we are depending on you to compensate for our low saving rate and our deficit.

**Bergsten:** We have now reached our modified witching hour. I want to thank very deeply our speakers, particularly my Chairman, Pete Peterson, Bob Rubin, Alan Murray for leading us through the discussion, and Chairman Greenspan for coming to be with us. I thank all of you for attending. This discussion is definitely going to continue. Meeting adjourned.