

**MAXWELL SCHOOL / PUBLIC AGENDA
POLICY BREAKFAST**

TRANSCRIPT

“Off Budget and on the Record”

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Transcript:

[The speakers were welcomed and introduced by Public Agenda's Vice President for Programs Jean Johnson and by Maxwell School Dean Mitchel Wallerstein.]

Robert Siegel: As somebody who was scoring budget deficits on Capitol Hill, and before that in the White House, how big is the federal budget deficit likely to get? How big a problem is it? How serious are people in Washington about reducing it?

Douglas Holtz-Eakin: I think the deficit for this year is going to be in the neighborhood of \$370 billion. That's a little bit south of the largest dollar deficit. My departure has improved things a little bit. It'll be a little under three cents out of the national dollar.

I think the right perspective on the federal budget outlook is roughly as follows: These are the good old days. We should savor them. These are the easy times. We can coast along for the next three or four years and have deficits that look like three cents on the national dollar, which are about half the peak in our post-war histories. They're not threatening. They are, in the end, probably not economically terribly damaging. Probably not enough to stir great change.

After that, all the bad news hits. The particularly bad news will be the retirement of the Baby Boom generation and the pressures that will place on Social Security and Medicare. Add in rising healthcare costs and the Medicaid program will ramp up as well. I think that for the next President there will be tremendous challenges. The person who runs for the presidency in 2008 will want to run again in 2012 and thus serve until 2016.

I don't see any easy way to get from here to there. There will be difficult choices made. They won't be in the next couple of years because there's no pressure to.

Siegel: There's nothing prohibiting us from starting to make those choices in the next couple of years.

Holtz-Eakin: I would agree. The most rational public policy move would be to in advance take on the challenges that we know are coming, where we have solutions and where moving sooner will be better than later.

Social security is the best example. There are a million ways to fix Social Security. I do it on the Metro every day, different combinations of a menu of solutions. Doing it now would resolve uncertainty about the future of the program. It'd be a great benefit to anyone who's affected by it, which is all Americans. It would resolve a big chunk of the federal budget puzzle. There's no reason, from a rational economist's perspective, why you wouldn't do it now.

One of the things I learned in Washington is the world is not run by rational economist motives. That's probably a good thing, but we missed a chance when we had a Social Security debate last year and in the end went nowhere. That's a moment that stands out as the most disappointing in my time in Washington.

Siegel: When you solve Social Security on the Metro, does the solution always include individual or private retirement accounts? Can you have a solution that simply is getting the input and the payouts back in some sync?

Holtz-Eakin: The decision for individual retirement accounts is a policy decision. Do you want to continue having a system that is a social insurance system where your retirement benefit is divorced in part, or in whole, from your experience in the labor market? You can get a retirement regardless of whether you had a disability, were a high earner or a low earner, or whatever it may be.

Do you want to move to more of a pension-style system in which your contribution then will depend on your success in the labor market? Your skill as an investor will determine what comes out and thus shift the nature of the system. The advantage to shifting it is you get more national savings probably.

That's a policy decision. We should decide what we want.

Siegel: Even if we decided on keeping a social insurance program, do you think we could afford it?

Holtz-Eakin: Social Security's the tiny problem. It's not hard to imagine fixing it. Right now we spend about four and a half cents of the national dollar on Social Security. If the [Baby Boom] retires as scheduled and we pay under current law, it'll rise to six and a half cents.

That's two percentage points of national income. It's not an overwhelming thing to face up to. You could contemplate just raising taxes to cover it, or you could shave the benefits. I think there's no reason we should honor the commitment to Doug Holtz-Eakin. My bumper sticker for Social Security reform is "Get Doug Holtz-Eakin."

Siegel: You are the problem in this?

Holtz-Eakin: I am the problem. I'm the trailing end of the Baby Boom generation. If you miss me, you've missed the Baby Boom generation. That means you've missed the money. You can't reform the system then. I'm a high-income American who can save for his own retirement, so I think they should get me.

Siegel: If the beginning of the whole discussion is people who are nearing retirement needn't worry, then we're missing the point of the discussion. They should be worrying if they're 15 years away from retirement?

Holtz-Eakin: The industry standard has been "Grandfather everybody 55 and older." That's one reason why I think moving now is important. I'm 48, that means you've got seven years until you've missed Doug Holtz-Eakin. Every year that we don't do something, we grandfather another cohort of the Baby Boom.

That's a lot of money being guaranteed for a long time in the future. I think people like myself should be worried properly. I think we're in a position to be worried. We should be part of the solution.

Siegel: Were the Congress and the public given a fair estimate of how much the war in Iraq would cost and what it would do to the budget?

Holtz-Eakin: Absolutely. We told them again and again and again. There are lots of estimates from the CBO about costs of the war. What was not done, something which I can't approve of, is the financing of the war was done outside the regular budget prospect. There was a pattern of it, which continues to this day, of applying to the Congress for funding in the supplemental appropriations bills.

Over the years, even that process has lost its integrity. The dividing line between the base appropriations and the supplementals has simply disappeared. There is now regular business in the supplementals and funding for Iraq and Afghanistan in the base. We've lost the integrity of the budget process with regard to defense spending.

I don't think that means we didn't know what this would cost. That doesn't mean that I think we've done a sensible job of budgeting for it. I don't think we were misled about the cost. That's a different issue.

Siegel: It turned out to be extremely low estimates (inaudible), \$50 billion.

Holtz-Eakin: I think there is a sincere debate about whether the underlying policy was fairly characterized. Whether the rapid victory in the war would translate into a rapid ascendancy of Iraqi peace. It's turned out that wasn't true. The budget estimates were built on that scenario, there's no doubt about it. In the end, budgets do reflect policy. The policy was, "Go in, win quickly." That was true—

Siegel: —Iraqi oil starts flowing rather quickly—

Holtz-Eakin: —establish peace quickly wasn't true. Everything comes out of that. Once it was clear that peace would not come quickly, all the budget numbers went up because the policy was very different.

Siegel: Is there ever a good time, in the view of conservative economists, to raise taxes? Is there ever a bad time to cut taxes?

Holtz-Eakin: There is, in my view, an unhealthy and analytically inappropriate focus on taxes. The threshold question is whether you're going to spend the money. Once you spend the money, you're going to pay for it one way or another.

The notion that somehow by controlling taxes you control what goes on in the government is backward. Taxes are the way you finance the decisions that you've made. There are better and worse ways to finance. You cannot systematically borrow for ongoing operations. That's a situation where you're going to have to raise taxes. If you decide to have a government that is going to be 25% of GDP and we have taxes that are 18%, you've got a problem. It would be appropriate to raise taxes.

The threshold question is, "Do you want to spend that much money?" My greatest frustration in five years in Washington has been the focus on tax policy. It's absolutely getting it backward. What we've seen over the past five years has been a great public debate over tax policy and only recently a recognition that we're spending a pile of money that ultimately, those bills are going to come due. That's important to recognize.

Siegel: When we talk about spending in Washington, the conventional wisdom is that when you set aside defense spending and various entitlement payouts, the area that people talk about is if (inaudible) doing away with waste, fraud, abuse, and wasteful spending on domestic programs, is timing. That seems to be the conventional wisdom about the budget discussion.

Holtz-Eakin: It has been a political decision to say that defense is off-limits in a time of war. It's also been the conventional wisdom that having expanded the Medicare program, you're not going to touch entitlements. The Social Security debate really reinforced that.

That leaves you with the one-sixth of the budget that is non-defense, non-entitlement annual discretionary spending. That's a very tiny lever to control the fiscal outlook. In the end, it won't work. The administration's approach has been to hold that flat, in nominal dollars, as far as they eye can see.

That has never happened. It's politically unrealistic. There's no policy underneath it. There's no specification of programs which will go away or maintain their current size to deliver that. It's a line, but it's not a policy. I don't think it makes a lot of sense.

Siegel: Let's talk about defense spending. Say you're a member of Congress and you have constituents' sons and husbands who are fighting in Iraq. On the evening news every night there are stories that their Humvees aren't adequately armor-plated, for example. Somebody comes, said, "Let's cut the defense budget." Can you do it? Can you realistically, when people are fighting the war, find big things to cut a defense bill?

Holtz-Eakin: Right now, we've gone from spending about \$300 billion a year in 2000 to over \$500 billion in 2006. Defense spending has risen dramatically in this period. That notwithstanding, if you take the full cost of the base defense policy that they've spelled out pretty clearly in a policy document called the [Future Years] Defense Program, ignoring Iraq and Afghanistan.

We're on track to spend 20% more in real terms than we are right now. We're going to go up by another fifth. We're going to be 15% above the height of the Cold War. That's outside of Iraq and Afghanistan. That's an enormous rise in defense spending.

Siegel: What are we spending it on?

Holtz-Eakin: We're going to spend it on buying old stuff that we didn't buy in the 1990s. When the Soviet Union fell apart, we didn't buy stuff, we felt safe. Now it's true that some of the equipment is getting old, that's a fact. If you don't buy things for a long time, everything gets old.

We're going to pay the troops a lot more. In addition to regular costs of sending them abroad, we're raising base pay as a matter of policy. There's the [vaunted transformation], the development of whole new weapon systems to deliver the same lethal force.

This is a very ambitious defense bill that tries to do all things simultaneously while fighting a war where the budgetary needs are clear and probably inviable. It seems to be sensible to ask the question, "Do you want to do it simultaneously?" Or do you want to focus attention on current operations, then come back to some of these other issues? If you take it off the table, you've taken a big chunk of the budget off the table.

Siegel: What was your sense after five years on both ends, combined of Pennsylvania Avenue, of the readiness to discuss the Pentagon budget?

Holtz-Eakin: There is no readiness to discuss the Pentagon budget in the administration. The Pentagon has received gloriously preferential treatment from the word go. Rumsfeld negotiated a big increase in the budget. They are exempt from the normal process within the administration.

The typical process is where agencies submit their potential budgetary requests to OMB. The analysts go through them, then there's the famed "passback." You passback and they say, "Don't even think about this. We're planning to eliminate that. You aren't on the preferred list."

The Pentagon's not going through the passback process. They got a number. They just keep spending within that number without a debting of the budget. I don't see anything in the administration that says they're going to change the way they're doing business.

Things are a little different on Capitol Hill. They're a little testy about the idea that all this money is showing up in supplementals. They're more than a little bit testy about the fact that they don't have what they view as appropriate oversight, both for the conduct of defense operations outside of the U.S. and within the base military budget.

I think that the temperature's very different in the Capitol right now. That's where I'd expect to see things change.

Siegel: From what you said earlier about when the good old days end, people running for office in 2008. If they're going to be effective and truthful, they're running on a lot of bad news. Politicians are going to be saying, "I'm going to start cutting things left and right. I'm going to be reducing benefits. I'm going to be raising taxes. I'm going to be cutting out defense."

Holtz-Eakin: It raises the question, why do you want to be President in 2008? I don't understand it.

Siegel: Seems to be several people who want to do it.

Holtz-Eakin: I agree.

Siegel: But it's going to be a rough ride over the next several years, you figure?

Holtz-Eakin: I think that there will be some tough moments. What you need politically has always been the major question. The question I get asked all the time is, "Do politicians understand this is going on?"

The answer is, of course they do. Yes, they do. You talk to members of Congress, they're smart, they're informed, they see this coming. So then you'll say, "Well, what's going to make it change?" I always change the subject.

I don't know what would be the divining political moment where you can change the terms of the debate and make fixing these problems politically advantageous. Whereas now, it's clearly the popular wisdom that fixing them is political death. People run away from it.

Siegel: Coincidentally, as you are speaking, the president of China, Hu Jintao, is visiting the United States. What should be the U.S. government's first concern in its relations with China?

Holtz-Eakin: It's a tie for first. There is no doubt that we have an array of deep concerns with our relationship with China. What will be the nature of the both competitive and cooperative strategic relationship? Help with negotiating North Korea? Are we going to get help negotiating with Iranian nuclear

weapons programs? What will be the way that they do business with Taiwan and the nature of that relationship?

There's the economic relationship, which I think is crucial to understand and to take care of. I'm in a minority camp where I don't view us as powerless in that relationship. I think we have a lot of genuine concerns about the way they conduct their international economic policies and some leverage as well.

The ongoing development of individual rights in China is a concern that we have to keep our eye on. It's a big country. Between China and India, we've got 40% of the world's population. Our policies toward China will affect a great many people. For that reason, all of those are important.

Siegel: Should we be afraid of Chinese economic growth—10% annual growth?

Holtz-Eakin: No. China's a poor country, very poor. Despite the fact they're growing fast, they're growing from a level of poverty. The best thing is you'd wish that they'd be richer because this is a large fraction of the globe that's living quite poorly.

I don't fear the growth, growth at this pace is not unusual at this stage of development. It's lasted a little bit longer than some others, but it's not that far off the scale, particularly in per capita terms. I don't fear that so much as I fear the fact that they're going to arrive at a level of world presence perhaps not equipped to handle it effectively.

They're going to get very old. The United States is aging, that's established. China is going to age much faster. The one-child policy really accelerates what's going on everywhere else in the world. They don't have social insurance programs of our type. They've enormous health problems. They've enormous environmental problems. The potential for internal unrest is enormous. I'd like to see them be fairly stable when they arrive at that point and growth would help in that regard.

Siegel: People have asked you about whether politicians, congressmen, understood what the economists are saying. The CBO is one of those offices in Washington that we count on to give us facts. But you are distant kin to government scientists, various people who come from academia into the government. I wonder if at this particular moment whether you think that the independent analyst, who's not spinning it, broadly enjoys respect and an interested ear in Washington. Whether these are bad days for people who aren't prepared to get an ideological bandwagon.

Holtz-Eakin: I don't have a great historical perspective on this. I do think that many analysts in Washington have gotten sucked into the perpetual campaign mentality. One of the things that people say about Congress particularly, but also the presidency, is that it's a perpetual campaign and we've lost governance. I think there's some truth to that.

One of the byproducts of that, which I think is particularly destructive, is that the staffs that are now present in the administration and in the Congress are campaign-oriented staffs. We are losing the deep infrastructure, which was the smart staff who've been there forever. Who know the programs, are interested in oversight, and do the governance. I think the staff level of deterioration's been a big one.

Campaign staffs get attention through slogans, marketing, all that stuff. Analysts who want to get their attention and work up through the bureaucracy lost sight of the fact that they want to stick to their portfolio. This is what I do, I'm an economist, I can explain to you the budget. I'm not a political campaigner. But if you slip into that in an attempt to get attention, you're now playing on their turf.

I think that's what's happened to a lot of the independent analysts. I don't think it's necessarily the result that they've been squashed. It's that the culture has shifted toward the way you say it as opposed to what you're saying.

Siegel: It's a great enticement to get involved in the action, and the action might not be exactly what you would write independently.

Holtz-Eakin: Right. There are so many economists who I've known as academics who come to Washington and the first thing they start talking about is political advice. They don't know anything about politics. It is a great enticement, it's a mistake.

Siegel: I once had an exit interview with Everett Koop, who was leaving as Surgeon General, who cut a very interesting figure in Washington. He explained his behavior to me more or less by saying, "I've always been a doctor. Whatever questions come my way, I answered the way I would if I were a doctor back in Philadelphia. That's what I am." I remember musing on what it would be like if everyone who came to Washington retained the ethics that they had brought them about what you say and what you do.

Holtz-Eakin: The mind boggles.

Siegel: Turning to our guests, starting with John Brademas, who does have a historical perspective of Washington.

Audience Member: I was rather surprised at what appeared to be your dismissive posture with respect to tax policy. I don't have the impression that in recent years (inaudible) tax policy. I heard (inaudible) say that it's always bad to raise taxes. You talked about appropriations and spending but you didn't say anything about what are known as tax expenditures and how they figure into the calculus.

We're fighting this enormously costly war. At the same time, the administration wants further to cut taxes. That boggles my mind as irrational and bad economics and bad politics. I think one of the problems is that as the war was gone into on false pretenses, the administration has lost public trust. There's no trust for domestic policy issues. All you have to do is look at the public opinion polls, how Congress stands, how the President stands.

I think we're in a real crisis of confidence the country. I've given two or three reasons that seem to justify that posture.

Siegel: First on tax expenditures, as Mr. Brademas said.

Holtz-Eakin: You made the mistake of asking someone who is a lifelong tax economist about tax policy. One of the reasons I try not to get off on this is I end up giving sermons. Let me give you a sermon in three short pieces.

Piece number one: The U.S. Tax Code is an unmitigated disaster. Let's just stipulate that. I have a long list of reasons why, and it needs a fundamental reworking. Tax expenditures will be on my list. The simultaneous presence of an individual income tax and an alternative minimum tax doesn't make a lot of sense. All the disincentives to invest in America presented by the [corporate] tax code. The whole variety of issues that I think you need to take care of. We need a better tax code.

Piece two: Should it be the case that every year, we ought to think about the level of taxation in the United States as a matter of broad economic policy toward sustaining growth? No. It took about fifty years, but we arrived in 1995 and late 1990s with a broad consensus that there was not any defensible reason why the Congress and the administration should, on an annual basis, try to fine-tune the U.S. economy through tax policy. It was too unwieldy. It was more likely to produce bad results than good results. That should be left to the Federal Reserve.

What happened in 2001 is that a campaign policy to reduce the overall taxes in the United States from 20% of GDP to 18% of GDP coincided with a recession. It was just fabulous good luck. It actually was a good thing to happen economically. Everyone somehow, having one bite of the apple, wanted a whole bunch of bites of the apple. Every year now, we're going through this business where we talk about, "What should we do in tax policy for stimulus?" Tax policy for this, that, or the third thing. That's crazy.

The third part of the sermon is, figure out how big the government's going to be. Put in place the tax code that people believe in, that raises the revenue in an equitable fashion, and move on. That's the background for my sentiment. I think we've gotten away from good tax policy in many dimensions. Our tax code's got problems, we're using it inappropriately. We're not paying attention to its core job, which is to finance the spending of the federal government.

Siegel: You speak of 2001 as having been a good time for a tax cut. Are we now at a good time for a tax increase?

Holtz-Eakin: I think at this point what we should do is just revamp the system, raise the revenue. We'll probably have to raise more revenue going forward and raise total taxes. I'd like to see that discussion be not just about the income tax, but about the payroll tax, which is not a particularly pretty tax from the economic point of view but is the tax that, for the majority of Americans, is the dominant tax in their lives.

The majority of Americans pay more in payroll than income tax. Part of my frustration is we're spending all our time fussing about the income tax. We need to talk about how we raise our revenue.

Audience Member: We seem to be entering a period of not only high-priced oil but, in all likelihood, a continuing long-term period of high-priced oil. Why don't you comment on the impact on the economy, also by extension, on the federal budget?

Holtz-Eakin: The impact on the federal budget's minimal. While the federal government buys some petroleum products directly, military uses among others, that's a tiny piece of the puzzle. Movement in oil prices doesn't affect the budget directly very much.

The impacts on the budget are indirect through economic performance on growth, incomes and inflation. One of the good pieces of news out of the most recent oil price rises is that they have not translated into broad-based inflation. That's a tribute to the conduct of monetary policy, both in the United States and around the world.

We are 30 years away from two things that happen simultaneously. We left the gold standard in the 1970s and we had the big oil price increases for the first time. I think the historical lesson is the central banks of the world flunked, [that some paint as cuts]. They couldn't handle monetary policy without the gold anchor. They didn't know what to do with these oil price increases. Central banks now do. We're not seeing this turn broad-based inflation. It won't be as damaging economically for that reason.

The second thing that has happened is broadly there is greater energy efficiency than at that time. We use about half the amount of petroleum per dollar of output that we used to. That's good.

I think we will survive these price increases if we're going to stay at \$70–80 a barrel for as far as they eye can see. The scenarios that are damaging are ones where you get spikes. You go to \$120. There's no good economic news that comes out of that. If the source of the \$120 is something to do with a terrorist event or some blowup in the Middle East, there's really nothing good that comes out of that.

It begs the question, do we want to place ourselves at risk for that kind of an event by doing so little to tame domestic consumption of oil and promote alternatives? That's the serious question.

Audience Member: You mentioned before that the Social Security problem is the tiny one, I guess meaning that the Medicare problem will be the big one going forward.

Holtz-Eakin: Yes, in an injudicious moment I said that Social Security is Grenada, Medicare is Vietnam. I didn't have a lot of those, but that was a bad one.

Audience Member: Do you see any way to fix the Medicare problem going forward?

Holtz-Eakin: Yes, we will, there's no question. For those who like apocalyptic numbers for breakfast, here are the apocalyptic numbers. If you look at the federal budget, we've got Social Security here at about four and a half cents of the national dollar. That's benefits paid each year. Here we've got Medicare and the federal portion of Medicaid, also a little above 4% of GDP, four cents of the national dollar. They're about the same size.

You go from now to five decades out, Social Security goes from four and a half to seven cents of the national dollar. It's more than 50% bigger. It's a big drain on the budget and on national resources. Medicare and Medicaid go from 4% to 20% of GDP, which is the current size of the entire federal government. Just enormous.

Will we deal with Medicare and Medicaid? We'll have to, because that's simply not going to happen. No one believes that. One of the reasons I want to fix Social Security is because it is the easy one. Ned Gramlich, who used to be at the Board of Governors at the Federal Reserve and is a brilliant

guy, said, "Social Security is spring training. Medicare is the regular season." Spring training comes first, you should do Social Security.

We know how, it's just money. You pick out the one part of the economy, you set it down somewhere else, fix it. Then turn to Medicare and Medicaid because they are bigger and they're harder. They are not about the structure of the programs, per se, although they contribute. They're about rising healthcare costs in the United States. That rising healthcare cost is not well-diagnosed.

In contrast to Social Security, where we know the problems come from—more old people, structure of the program—we don't understand why healthcare costs per person have risen 2.5% faster every year than income per capita for the past four decades. We think some of it has to do with better medical technologies. Some of it has to do with greater utilization. Some of it has to do with overuse. Some of it has to do with misuse. Somewhat has to do with inefficient record keeping.

Until we diagnose it, we can't fix it very well. While I believe we'll fix it, we'll do it differently. We can fix Social Security now because we know it. We have a diagnosis and a menu of solutions. We'll fix Medicare and Medicaid incrementally because we'll come to terms with our healthcare system incrementally. We'll make different changes. We'll do things like Massachusetts is doing, see how it works out. We'll try different experiments.

There's no question we have to do that. But it's a lot harder. I think it has a different solution, a far more incremental and experimental approach.

Audience Member: I remember hearing the Bush administration, or at least conservatives, say that what they wanted to do was starve the social programs of the 1960s in order to uproot them and get them out of the system so that tax moneys weren't spent in those ways. It seems to me that, much as Reagan spent the budget trying to get the Soviet Union to crumble and decay and fall from within, that's what's going on here with the social programs.

We're doing all this deficit financing so that when the game of chicken is finally joined, something's going to have to cave. Isn't that what the policy debate should be about, as opposed to whether to tax increase or decrease or not? Isn't it really social spending versus defense spending basically?

Holtz-Eakin: Number one, there are conservatives, Republicans who say things like that. I think that's out there in the debate. They're not fond of the social programs of the 1960s. They feel they've had detrimental social and economic consequences and they'd like to get rid of them.

Number two, we've run deficits. Fact. Number three, what is the linkage between those two, both in terms of a proactive decision to run deficits and implications for the ways policies play out? I think three is the interesting question.

I am not of the belief that there is this well-oiled vast conspiracy by this administration, Republicans in general, to run big deficits to crush Social Security and Medicare. I think we ran big deficits because of the administration's basic take on things, which was ad hoc and very short-term. They arrived with what they thought were surpluses. They committed themselves to the tax cut and went through with the campaign commitment. The recession hit. The equity market collapses, and 9/11 happens.

At that point, the basic mentality that I see in the administration is one that says, "We're going to do whatever it takes in the short-term and we'll fix the budget with the big fix in the long-term." You spend the money after 9/11, you fight the wars, and you fix the budget where you have to fix it. On Social Security, Medicare and Medicaid. Those are the big numbers, we all know that.

They arrive at the Medicare deal. The deal, if you think back, was, "We're going to do prescription drugs in exchange for reform." The only way to get the drugs in the original administration proposal was you had to go to a PPO or an HMO to get the drugs. They would not be available in fee-for-service Medicare.

It lasted a day. It was a Friday when that was the administration's position, it was gone on Saturday. They didn't get the deal, they got the drug bill.

Then Social Security. "We're going to do individual accounts. We'll fix the long-term budget. We'll get the deal." Didn't happen. This administration has never had a policy about the budget that was not too

fragile that they didn't get their preferred deal. It wouldn't blow up. That's in my readings of recent history. Could be wrong, but that's my reading.

Siegel: You're saying the administration brought policy concerns to each of these questions. If they didn't get the policy that they wanted—

Holtz-Eakin: They didn't get the budget. It's clear that if you go back to—I can remember looking at the budget in February 2002. I can remember Glenn Hubbard looking at me and saying, "Budget is policy. What does this budget say about our policy?" I said, "Win the war at all costs." There was no attempt to do anything else but spend the money. Policy trumped budget at every step, it continues to. Policy always trumps the budget.

Going forward, the serious question, "Can you do that (inaudible)"—I tried to give you the apocalyptic numbers. No, you can't. The defense ones, even if you do the big defense ramp-up, they pale in comparison. It will be the case that we'll deal with Social Security, Medicare, and Medicaid. It won't have anything to do with a vast right-wing conspiracy. It'll be arithmetic. We're going to have to do it.

Audience Member: I didn't say vast right-wing conspiracy.

Holtz-Eakin: I did. I'm their charter member. I just wanted to be honest about that.

Audience Member: Did you say before that we should not be using tax policy to stimulate the economy? If that's right, how would you overhaul the tax system? What would you ideally like to see? Would you like to see us remain basically on an income tax system? Do you think we should scrap that and go to the value-added tax or some national sales tax?

Holtz-Eakin: I don't like national sales taxes. I think that's a pipe dream. I want to take that off the table. I think that there's an enormous attraction to value-added taxes and their economic simplicity and their structure. But they're not progressive enough, at least for my taste.

I think you have to move something away from a value-added tax that has more progressivity built into it. Whether that's an income tax or David Bradford-style "X taxes," which are dressed up value-added taxes that have some progressivity, I don't have a strong religious taste for it at this point. Both have their flaws in practice. Both have great advantages over the current system.

The key thing will be to recognize what we have now. We have a payroll tax, which is the dominant tax burden for many people. Is that really what we want? A payroll tax is not a tax I think we would start out as one of the primary means of national finance, if we were to start over.

We have an income tax, which has morphed into a high-end surtax in the United States. One of the great myths is of the income tax as the broad-base revenue raiser and how you can do some sort of fair cut in income taxes or fair increases. No. Rich people pay the income tax. We should just be honest about that. 50% of Americans basically do not pay. They're at the bottom end, they don't pay the income tax. They get rebates and credits. The top 50% pay it all. The top 5% pay 50% of it.

It's high-end surtax in America. We either have to decide that's okay, it actually doesn't bother me. If it's going to be a high-end surtax, let's configure it for the tax lives of the rich. The rich have greater ability to legally avoid taxes. They have economic lives that don't look anything like the guy going to work with a lunch pail. Let's have a tax code that fits their circumstances, or let's scrap both income and the payroll tax and have a broad-based tax system that affects everyone. Make it progressive.

We don't talk about it like that. We pretend that the income tax is our grandfather's income tax. It's not. You can't give a tax cut to poor people. They don't pay the income tax. That's a payroll tax issue. You can't touch the payroll tax because it funds Social Security.

We're in this terrible box on the tax side. I don't think there's an honest public discussion about it at all.

Siegel: Should you abandon the earmarked payroll tax? Give up the fiction of Social Security being something that's separate from general revenue?

Holtz-Eakin: I think so. Among the things that leads you to do—imagine right now the discussion if we wanted to quote, “fix Social Security by raising the payroll tax.” How does that actually work? It says that you raise the payroll tax. In comes more payroll tax revenue than current benefits going out. You take that surplus and you invest it in one of the all-time [worst] investment vehicles ever invented: the U.S. unified budget. Where the rate of return has been negative forever.

There’s not a fiduciary person who could possibly sign that statement. That’s what we do. That is a fiction, the fiction that it’s separate. I’d get rid of the payroll tax. Social Security is a program, it’s an obligation. It’s what the government is there for. We should pay for it and pay for it efficiently. That’s an argument I can make. I promise you the politicians hate that.

Siegel: In 1992, a politician won the election over the deficit. It was Ross Perot. He won the election because Bill Clinton, regardless of what he had run on, had to effectively adopt Ross Perot’s priorities, understanding very intelligently that the man had expressed a deep anxiety in public. He didn’t express a macroeconomic anxiety. He said, “The deficit is the measure of how messed up things are in Washington. They can’t agree on in between taxes and revenue.” Do you think that there’s a possibility of that kind of discussion. It wasn’t that long ago that the deficit was seen as the worst thing ever, the devil in the devil [sic].

Holtz-Eakin: Two things on Ross. First, for the record, I drove him out of the presidential campaign. I was scheduled to brief him in Dallas on a Monday, on a Friday, he dropped out. I’ve always thought he looked at his schedule and said, “If I’m down to Holtz-Eakin, I’m out of here.”

What he brought to that era was a moral outrage at the way business was being done. We’re back there. You can take all the geeky economist arguments that I could bring to bear and put them aside and just be morally outraged at the way the Congress is doing business.

This is my party. There is no rational linkage between what coming in and what’s going out. There’s an adherence to cutting taxes and adherence to spending. Doesn’t add up at all. There’s a ferocious public attack on earmarks but there’s no movement to change the way we do business.

Audience Member: (inaudible) Democrat fix it?

Holtz-Eakin: I haven’t seen a Democrat that’s going to fix it either. I’m just frustrated, I’ll be honest about that. This is not a good way to conduct the people’s business. There’s a place for that.

Siegel: Speaking of, [Braginsky] made an interesting observation recently in the critique of the Iraq war policy. He faulted the President for speaking of “these times of war.” He claimed that Presidents Johnson, Kennedy, and Truman in Korea and Vietnam did not speak of the “times of war” and “this nation at war.”

The discussion of a nation at war is but insulating, Braginsky argued, but it also changes the nature of what we expect from the President, from the Congress, and what judgments should be made. The public is likely to accept that we should suspend various kinds of discipline because we are a nation at war. Do you think we’re a nation at war?

Holtz-Eakin: We are a nation at war. I think anyone who looks at the report of the 9/11 Commission recognizes that this is not an isolated event. This is a deep cultural divide that will de-adjudicate not just methods uniform of diplomacy but actually violence. We know that. We’re at war. I always thought of war as a disciplined exercise. Discipline is integral to military for a reason. I don’t see why we should suspend discipline at a time of war.

Audience Member: (inaudible) the gathering evidence of global warming, melting glaciers, melting icecaps. Dire predictions of what may transpire within the next couple decades. If Medicare and those issues you’ve been discussing so articulately this morning are the 600-pound gorilla, is global warming the 800-pound gorilla?

How do you rationally plan for a world where resources are going to have to be diverted to building dike systems and doing all sorts of things so New York City is not underwater?

Holtz-Eakin: There's a vast literature on thinking about global warming from an economics perspective. All of it argues that what you want to do now is buy insurance. That insurance can take many forms. You can go along on "beachfront in secure Syracuse," that's one approach. You could also try some other strategies.

The basic idea is to start pricing emissions, of carbon in particular, into the atmosphere. Also looking for the game-changing technological innovations that will allow you to do things without a reliance on carbon emissions.

The research part is out there. There's a lot of research. There's funding for research. The Climate Change Initiative in the United States is the single largest effort in that regard. We aren't pricing carbon emissions in any way at all. The obvious first step for the United States would be to institute some sort of carbon tax.

Siegel: On the assumption that it would greatly alter economic behavior when it came to energy consumption?

Holtz-Eakin: On the assumption that you want to start building into behavior the presumption that carbon is going to be more expensive. Where you put it initially is—you don't really want to put it in a way that it dramatically affects behavior. You want to put it in and start ramping it up as you learn more about the pace at which things are likely to hit.

One of the beauties of the way the atmosphere works is if you put a ton of carbon in now versus a ton of carbon next year, it doesn't really matter. The same amount gets retained in the long-run. You have great flexibility in the pace at which you address those emissions. Usually what you want to do is ramp up and take a lot more out at the end than up front because it's very disruptive to do it quickly.

We're not doing that first part, the initial pricing of the carbon, very effectively. There's a lot of dancing around the different approaches. Kyoto, which in the end was deeply flawed, and I don't think ever had a political future in the United States. Some sort of cap-and-trade program where you have pieces of paper that allow you to emit carbon into the atmosphere. You can trade them if you're short and sell them if you've got too many of them. Or just a tax.

My preference is for the tax. It's cleaner in terms of setting up the policy apparatus. The political dynamic will be that we won't overdo. Whereas with the cap-and-trade you run the danger of overdoing too quickly.

Audience Member: I'm very disappointed that you didn't explain better you mean by "We are at war." That is one of the fundamental questions. You just said, "Well yes, we are at war after 9/11." There are many kinds of wars. Are we talking about the world war? Are we talking about the clash of civilizations? Are we talking about terrorism? Say a little more about that.

Holtz-Eakin: Sorry if I was too curt on that. It's not my area of expertise. I'm repeating what I've read and learned. That is that there is a war against Islamic terrorism. That war, we characterize by terrorist events and the need to counter them. It will involve violence—dedication to violence on the part of terrorists and the need to deal with that violence on the part of the United States.

My point was simply that we need to both come to grips with that as the way we will conduct war as a long war against terrorism. Not as an invasion in the traditional sense or an [amphibious] event, something like that. The military's done that. If you look at the Quadrennial Defense Review this year, what the military is preparing to do is fight the long war and fight a traditional war against a near peer. Some large country with a large military.

The military's gotten there. They understand that this will be part of their mission in the years to come. The American public may or may not fully appreciate that. I don't think that should mean that we take a pass on thinking about the rest of our problems.

My point is simply that yes, this is part of life. Yes, we will have to conduct this war. Yes, it will be an ongoing war, will take a long time. Yes, the rest of life will go on. We'll not be able to pretend that we can't make other decisions just because we're doing this. That's my feeling.

END OF TRANSCRIPT