The Economy and Higher Education

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The Budget, the Deficit and Economic Policy

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Key Observations

The economic outlook is much more favorable than three years ago. The economy has proved itself resilient even though there's been quite extreme austerity.

U.S. debt is rising faster than the GDP, but not as fast as once feared. It's stabilized up around seventy percent.

The aging of the population is proceeding faster than thought, but the rate of health care spending has dropped dramatically enough that the Congressional Budget Office has built it into its projections.

In the long run entitlement reform and tax reform are necessary.

After a period of governing by crisis--debt limit crises, shutdown crises, fiscal cliff crises--policy making is a bit more functional. A budget was approved, appropriations bills enacted.

The cost of two wars has contributed to spending, but the level of debt is caused by demographics and healthcare, not by military spending, which is small compared to what it was in the cold war years.

The country has gone from a deficit cutting set of debates, to a period where people are debating about how to pay for things.

There's probably an opportunity to learn from the last few years of governing by crisis and rethink how to conduct the budgeting process.

Everyone hates the tax code; everyone believes that it ought to be reformed. The challenge has been how to make progress on moving towards a better tax code.

The chair of the Senate Finance Committee, Chairman Baucus, will be heading off to China as our Ambassador; as a political matter that will set back tax reform.

The President's budget will have attractive proposals for investment in early childhood education, for revamping training programs, for some infrastructure, but not much will happen.

Social Security needs to get back on a firm foundation, and it should be done outside the budget.

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MR BOSWORTH: I see that Alice Rivlin is here and Don Marron. Who's going first?

MS. RIVLIN: I'm glad to be here. Donald and I have the awesome assignment of talking about the Budget, the Deficit and Economic Policy. That's quite a lot. But let me start off by talking a little bit about what's happening in the economy, and turning a bit to the budget situation. We are in a lull in the budget wars. And I believe that's a good thing, that we may have a chance to actually think a bit about where the economy's going and what we want the government to be doing, and that's been very hard in the last several years.

To understand the budget outlook, I find it useful to go back about four years. In 2010 I was part of two bipartisan groups looking at the economy and the budget outlook. At that time the recovery had started, the stimulus was helping, the Federal Reserve was helping but nobody was really sure that we were on a solid track to recovery. Unemployment was still very high, and the budget deficit was extremely high, mostly because of what the recession had done to revenues, but also due to the stimulus. The automatic increases in spending for unemployment compensation were having an effect on the spending side. So we had a deficit of around ten percent of the GDP and over a trillion dollars, which sounds like a lot of money, and yet the economy was not recovering as fast as a lot of us hoped it would.

We knew those deficits would come down as the economy recovered and as the stimulus was spent. But when you looked beyond the deficit falling in the near term, you could see this looming demographic problem coming at us: the proportion of the population eligible for Social Security and Medicare and Medicaid was rising very rapidly and, on top of that, what seemed at the time to be an inexorable increase in health spending per person. Those made the longer term forecasts for the budget deficit look really scary.

We had a higher debt to GDP ratio than we'd had before the recession, and it was headed up very fast due to the demographics and the rapid increase in health spending. So the conclusions of commissions at the time were to do two things at once. Spend more in the near term to create more jobs and have comprehensive entitlement reform to slow the growth of health spending, and reform the tax system so we could raise more money in the future from a more pro-growth tax system.

There were differing emphases and apocalyptic predictions on both sides. Those most concerned with near term growth were saying that if we cut back on spending in the near term it's going to be a disaster for the recovery. And those on the other side were predicting that we could have a sovereign debt crisis if we didn't do something about the long run debt. Now some of us were saying, for heaven's sakes, let's do both. That was sensible but it didn't happen. We had an ugly three years of threatening to default on the debt, closing down the government once, fiscal cliffs; it was pretty awful. And it was a really unfortunate demonstration of how not to do economic policy.

So where are we now, after all of this? We have a much more favorable outlook in general than we had three years ago. The economy has proved itself quite resilient to all of those shocks even though we've had quite extreme austerity, lowering the amount of near term spending, first in the Budget

Control Act in 2011 and then with the sequester.

But despite all of the shenanigans in Washington, the economy does seem to be on a fairly steady, although far from adequate, growth track. We're a lot less worried about the sustainability of the recovery than we were three years ago. At the same time, we're a lot less worried about the long term budget deficit. We still are on a track, in the end of this decade and into the 2020s, to have the debt rising faster than the GDP, but not as fast as we thought. It's sort of stabilized at an admittedly high level, up around seventy percent, which is very high. But it's not going up as fast as we thought it was. Why is that?

Partly it's because the austerity that we have inflicted on ourselves has run its course, assuming that we will not reverse course and add greatly to appropriations and discretionary spending. The aging of the population is proceeding, if anything, faster than we thought, but the rate of health care spending has dropped dramatically enough that the Congressional Budget Office has built it into its projections.

So the apocalyptic thinking on both sides didn't turn out to be right. We now have a fairly slow growth economy and less scary, but still concerning, projections of a rising debt. In the longer run I think the worry is that two of the assumptions built into the budget projections may not hold. One is that discretionary spending cuts may just prove too severe, that we can't run the government without spending more; and, secondly, that the slowdown in health care spending may prove temporary.

So in the long run we still need entitlement reform and tax reform, which I hope Donald will talk more about. We need to do everything we can to slow the growth of health care spending through efficiency gains, not cutting care. We have an opportunity with the Affordable Care Act for a great experiment in federalism with different states doing different things and learning a lot about how to run a health care system better. Let me stop there.

MR. MARRON: It's a pleasure to be back and I think we tag teamed for you last year. A lot of what I say will echo some of the themes that Alice touched on. The first thing I want to do is frame where we were and where we are. If you think about fiscal policy-making over the last four or five years, we went through this unpleasant period of governing by crisis: debt limit crises, shutdown crises, fiscal cliff crises. More recently, we've gotten back to something that actually is close to regular normal order. I wouldn't say it's quite there, but it's pretty close: we had a budget, we enacted appropriations bills. You may have noticed we enacted an increase in the debt limit a couple weeks ago with a normal level of political grandstanding. Just for the record, the United States is not going to ever default on the debt in any of our lifetimes. But nonetheless, we used to have those concerns during these crises.

So we're in a much better place. It's a more functional way of trying to make policy and that's a step forward. Another change is that deficits and debt used to be among the top two economic policy issues we faced, along with the weakness in the economy. I would say that has receded significantly. We used to talk about striking grand bargains but grand bargain is a phrase that has lost its luster and is not one you hear in polite conversation so much anymore.

We haven't seen the President's budget yet but rumor has it that several of the ideas the President had included in his past budgets will no longer be in there because the prospects for grand bargaining have receded. For example, there was a proposal to change the way that social security and other benefits and portions of the tax code are indexed to inflation; that was quite controversial in some circles and according to this morning's news reports will not be in the budget.

When deficits and debt are high because the economy is in incredibly dire straits it's not a good time to be cutting deficits. The time to be cutting deficits and thinking about the long run is when the economy is recovering or, if you can walk and chew gum at the same time, you can pair stimulus with long term fiscal restraint.

But now, as deficits recede, concern about the long run budget outlook is receding and it's becoming much less of a tangible policy focuses here in Washington. The budget debates right now have become much more traditional. Policy makers want to do something and they have to figure out how to pay for it, that kind of thing.

We've gone from a deficit cutting set of debates at a time when running big deficits made sense, to a period now where it's a debate about how to pay for things that the policy makers want to do. I predict that if we get to narrower deficits we will go to the third type of policy making, which is enacting policies that increase the deficit. We're not quite there yet, although I would not be surprised if that comes.

Separate from the fiscal issues are issues in the inequality, mobility, and wages space that aren't necessarily predominately budget oriented. The current debate over the minimum wage is a key example of that.

On the tax front, everyone hates the tax code; everyone believes that it ought to be reformed. It's too complicated, it's bad for the economy, it's unfair; there's very broad agreement on that in principle. The challenge has been how to make progress on moving towards a better tax code. For several years the vision was that you could do tax reform as part of a grand bargain for two reasons. One is that a grand bargain would have to have an increase in revenue component, and the second is that you could make that increase in revenue less painful for people if you could improve the tax code at the same time. You could offer a much better, much less intrusive tax code and say, 'we're giving that to you in return for somewhat higher taxes.' We haven't gotten there yet. The folks in Congress who've been leading the tax reform effort have talked about this broad vision of lowering rates, broadening the base, getting rid of tax breaks, getting rid of loopholes. And there's a lot to be said for framing the issue that way. But policy makers very often talk more about the fun stuff, about the ice cream; they talk about cutting rates. When you have to talk about the spinach and the how you pay for it, it becomes much less politically tractable.

We've seen a little bit of change in the relevant committees. The chair of the Senate Finance Committee, Chairman Baucus, will soon be heading off to China as our Ambassador and so the momentum of the efforts he was investing in have changed. We'll have Senator Wyden taking the reins, who's a very creative and interesting legislator. But as a political matter I think that sets back whatever the timeline might have hypothetically been for tax reform. On the house side, Chairman Camp is allegedly going to release next week a framework or an outline or a proposal of tax reform ideas. I think what he has found is that what is remotely politically possible is somewhat less ambitious than people had originally hoped. For example, cutting the corporate tax rate to twenty-five percent from today's thirty-five percent, which many people have aspired to do, is just so difficult to pay for that you have to ratchet that back to be politically plausible.

My next observation may be more a statement about the think-tank, wonk community than the folks on the Hill, but I have observed an increase in interest about budget process. That if we're in a time period where the budget wars are calm and there's not a lot of change going on, there may be an opportunity to rethink how we do our budgeting here in the United States. This is the fortieth anniversary of the budget act that gave us the current system we have. The real policy issues are definitely the most important thing, but there's probably a good opportunity to learn from the last few years and rethink how we approach all these issues, as a process matter.

MR. BOSWORTH: Questions?

SPEAKER: Do you think the budget wars are over for many years? Or is it just a pause before the election?

MS. RIVLIN: I think it’s a truce, certainly until after the Congressional election. It depends a little bit on who wins. But what they did in the Murray-Ryan agreement was to set the spending levels for two years for fiscal 2014, which is the one we’re in, and fiscal 2015. Now that’s pretty nice. I think a good budget process reform would be to go to a biennial budget. Essentially they did this for this year. So I don’t expect there will be much action over the 2015 budget. The 2016 budget, which we would be talking about a year from now, will depend a little bit on what happens in the election.

MR. MARRON: I think Alice is right, and I think the folks who decided that threatening extreme budget wars was a good political strategy are probably now thinking that maybe that wasn’t the greatest idea in the world. So we’ll go through a period in which that’s not viewed as a plausible or attractive political option.

SPEAKER: I think both of you referenced possible interest in increasing discretionary spending going forward. I wonder if you have any sense of which programs might be favored and specifically if you think any additional money would be put into Pell grants.

MS. RIVLIN: I don’t expect much change in the near term. I think the President’s budget will have lots of very attractive proposals for investment in education, particularly early childhood education, for revamping training programs, for some infrastructure things, and ways of paying for them over a longer period. But not much will happen.

MR. MARRON: That sounds about right. I’m expecting discussion of, as Alice said, infrastructure, kids’ education, probably some training programs for older folks who are already in the work force, probably things around the manufacturing space. I think there’ll be some hearty discussion about these proposals but I’m not sure I expect to see that much change, particularly since elections are coming up later this year.

SPEAKER: I’d like to hear more from you on the federal and state balance sheets. Most states don’t publish, and in some cases don’t even understand, their post-retirement liabilities with respect to health care for state employees. Alice, you have talked a lot about reform and entitlement programs. What are the kinds of things you anticipate might be done and, second, will the states deal with these problems?

MS. RIVLIN: I tend to think less in terms of balance sheets and more in terms of demands for spending rising faster than the income growth. I think most states are in better shape than they were but they're still facing very severe pressures over time from their retiree health costs, their retiree pensions, and their Medicaid programs. And that's been helped a bit by the slowdown in health spending, which we hope will continue. What I would like to see first is the Social Security system back on a firm foundation, and that's not very difficult. It should be done outside the budget. We aren't talking about the long term future when we say that the old age and survivors' fund will be out of money in 2033 on the present course. 2033 used to seem like a long time from now, but it's not. People who are in their forties will be retiring in 2033, so we ought to do that, not to mention the disability fund. And we need a set of changes in health programs that will induce more efficient spending. That will help both at the state and the federal level.

MR. MARRON: A couple thoughts. First, at the federal level people almost never think in terms of balance sheets. They think about deficits and debt, so debt is a balance sheet concept, but they think in deficits and flow. If you ever actually look at the federal balance sheet, the federal government actually does have assets too, and one of the largest assets the federal government has is student loans. I don't know the exact numbers, but it's seven hundred billion dollars plus or minus two hundred billion dollars of assets that have been financed. It is an asset. It's something of value.

Just echoing Alice on Social Security -- you could get well-meaning wonks in a room like this and turn a few dials and put it on a sustainable course. It's largely not a technical problem. It's a political challenge. Now, the disability part of Social Security is going to run out of money somewhere in the 2016 range, which is within the forecast horizon and relevant political horizon. It is going to force some focus here in Washington on one of these long run challenges. I've already begun to hear many of my friends say they will address this by shifting money around, take some from the old age part, put it in disability and just have everything run out of money in 2030. I think it may actually be an opportunity for real reform.

As for the states, they are creative and variable in how they account for their long run obligations to their current workers and their retired workers. For example -- what discount rate do you use to estimate how valuable your pension obligations are? While there have been some accounting reforms to try to make that more normalized, many economists think their balance sheet position may understate the challenges they face.

At some point that may become a significant challenge.

SPEAKER: Military spending is really the source of the debt that we're talking about, isn't it?

MS. RIVLIN: Certainly the fact that we fought two wars has contributed to spending, but the level of debt is caused by the demographics and healthcare, not by military spending, which is actually quite small now compared to what it was in the cold war years.

SPEAKER: Is the unwillingness to use the money we collected for Social Security an issue?

MS. RIVLIN: It's true that we didn't build up enough of a surplus to pay for Social Security out of the accumulated surplus; we'd have been in real macro-economic trouble if we had.

MR. MARRON: The wars we had were extremely expensive, but if you look over the last thirteen or so years the single biggest contributor to the rise in debt over that time period was the financial crises and the policy response. Those things together are by far the biggest contributor. If you have an economy fall off the cliff, tax revenues plummet and spending goes up for good reasons. That's the primary thing that's driven the debt up so much.

SPEAKER: I want to ask you about student debt. Some democratic law makers want students to refinance their debt like you would your car or mortgage payment. If Congress were to pass such a plan, how would you propose the government pay for it?

MS. RIVLIN: There's a lot of concern about the level of student debt, and the amount of debt that professional students and graduate students come out with, not to mention undergraduates. But as you suggest, it's very hard to do anything about it without forking over a lot more money, and I'm not sure that's a serious discussion in the Congress.

SPEAKER: Could you say a word or two about research funding?

MS. RIVLIN: Research funding has suffered the fate of the sequester, the across the board cuts that have held down appropriations for everything. I think that's very short sighted but I don't think we're going to do anything much about it in the near term.

MR. MARRON: I think we've gone from the cutting phase, where discretionary took the brunt of many of the cuts, to now how do you pay for the things you want to change. Folks will put forward proposals to increase spending on research but they're going to feel constrained in the current environment by the need to find some way to pay for that. Requiring someone to give up something to pay for what you want is very hard to do. Not always impossible, but hard.

MR. BOSWORTH: Well, that might be a good note on which to change topics. Let's thank both Alice and Donald.