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War and famine. Peace and milk. — *Somali proverb*

The Fiscal Cliff Issue

"The grand bargain proponents would try to pit people who favor increasing or maintaining levels of spending on education, research and development, and infrastructure against people who want to defend the New Deal programs. In fact, this should lead us to understand where the fundamental flaw lies in the grand bargain position."

Sherle Schwenninger, page 14

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Who's Afraid of the Fiscal Cliff?

James Galbraith

Stripped to essentials, the fiscal cliff is a device constructed to force a rollback of Social Security, Medicare and Medicaid, as the price of avoiding tax increases and disruptive cuts in federal civilian programs and in the military. It was policy-making by hostage-taking, timed for the lame duck session, a contrived crisis; the plain idea now unfolding was to force a stampede.

In the nature of stampedes arguments become confused; panic flows from fear, when multiple forces — economic and political, in this instance — all appear to push the same way. It is therefore useful to sort through those forces, breaking them down into separate questions, and to ask whether any of them justify the voices of doom.

First, is there a looming crisis of debt or deficits, such that sacrifices in general are necessary? No, there is not. Not in the short run, as almost everyone agrees, but not in the long run, either. What we have are computer projections, based on arbitrary — and in fact capricious — assumptions. However, even the computer projections no longer show much of a crisis. The CBO has adjusted its interest rate forecast. Even under its "alternative fiscal scenario," the debt/GDP ratio now stabilizes after a few years.

Second, is there a looming crisis of Social Security, Medicare and Medicaid, such that these programs must be reformed? No, there is not. Social insurance programs are not businesses. They are not required to make a profit; they need not be funded from any particular stream of tax revenues over any particular time horizon. Reasonable control of health care costs — public and private — is necessary and sufficient to keep the costs of Medicare and Medicaid within bounds.

Third, would the military sequestration programmed to start in January be a disaster? No, it would not. Military spending is set to decline in any event, and it should decline as we adjust our military programs to our national security needs. The sequester is at worst harmless; at best it's an invitation to speed the process of moving away from a Cold War force structure to one suited to the modern world.

Fourth, would the upper-end tax increases programmed to take effect in January be a disaster? No, they would not. There is no evidence that the low tax rates on the wealthy encourage them to spend or invest, no evidence that higher tax rates would deter their potential spending and investment.

Fifth, would the middle-class tax increases, end of unemployment insurance, and the abrupt end of the payroll tax holiday programmed for the end of January risk cutting into the main lines of consumer spending, business profits,

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ABOUT THIS ISSUE

On November 13, 2012, EPS and New America Foundation co-hosted a conference entitled "Who's Afraid of the Fiscal Cliff?" in Washington DC, as part of a series of Bernard Schwartz symposia. This issue is comprised of edited transcripts from the sessions. To view the C-SPAN broadcast and other media coverage of the event, visit www.epsusa.org/events/1112conf/fiscalcliff.htm.

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Who's Afraid of the Fiscal Cliff? (continued)

and economic growth? Yes, but over time; in the first few weeks, the effects would be minimal. Congress could act on these matters separately, with a clean bill either before the end of the year or early in the new one.

Sixth, what about all the other cuts in discretionary federal spending? Yes, some of these would be very damaging if allowed. Simple solution: don't allow them.

In short, Members of Congress: pass the President's bill on middle-class taxes. Put in stop-gap funding as needed for early next year. Then, go home. Enjoy the holidays. Come back in January prepared to extend unemployment insurance, to phase out the payroll tax holiday gradually, to restore stable funding to necessary programs, and to start dealing with our real problems: jobs, foreclosures, infrastructure, and climate change.

The Fiscal Cliff Program

9:00am Welcoming Remarks
James Galbraith, Economists for Peace and Security

9:15—10:30am Session One: On the Cliff
Chaired by Stan Collender, Qorvis Communications, LLC
James Galbraith, Chad Stone, Bruce Bartlett, Stephanie Kelton,

10:30—11:45am Session Two: On the Military Sequester
Chaired by Richard Kaufman, Bethesda Research Institute
Carl Conetta, Heather Hurlburt, William Hartung, Winslow Wheeler

1:45—1:00pm Session Three: Essential Priorities—Social Security, Medicare, Medicaid, and Infrastructure
Chaired by Michael Ettlinger, Center for American Progress
Michael Lind, Mark Schmitt, Sherle Schwenninger, Monique Morrissey

Panelists

Bruce Bartlett is a columnist for *The Fiscal Times*, an online newspaper covering public and personal finance, and *Tax Notes*, a weekly magazine for tax practitioners and policymakers. He also contributes a weekly post to the “Economix” blog at the *New York Times*, and writes regularly for the *Financial Times*.

Stanley Collender serves as Managing Director and Partner of Qorvis Communications, LLC. Mr. Collender's financial and public affairs communications experience is extensive. He has received the Howard Award for lifetime achievement in federal budgeting from the American Society for Public Administration.

Carl Conetta has been Co-director of the Project on Defense Alternatives (PDA) since January 1991. Prior to joining PDA, Mr. Conetta was a Research Fellow of the Institute for Defense and Disarmament Studies (IDDS) and served for three years as editor of the IDDS journal *Defense and Disarmament Alternatives*, and the *Arms Control Reporter*.

Michael Ettlinger is Vice President for Economic Policy at the Center for American Progress. At CAP, Ettlinger heads up an economic policy team of over 25 people in addition to managing the economics team. Ettlinger has authored numerous reports and analyses on a range of economic issues. He spent six years at the Economic Policy Institute directing the Economic Analysis and Research Network.

Panelists

James K. Galbraith teaches economics and a variety of other subjects at the LBJ School. He holds degrees from Harvard (BA magna cum laude, 1974) and Yale (PhD in economics, 1981). He studied economics as a Marshall Scholar at King's College, Cambridge in 1974-1975, and served in several positions on the staff of the US Congress. He is Chair of the Board of Directors of Economists for Peace and Security.

William D. Hartung is a former senior research fellow in the New America Foundation's American Strategy Program. From 2007 through early 2011, Mr. Hartung ran the Arms and Security Initiative at New America, a project that is now part of the Center for International Policy, and that Mr. Hartung continues to lead. Before coming to New America, Mr. Hartung worked for 15 years as Director of the Arms Trade Resource Center at the World Policy Institute at the New School in New York City.

Heather F. Hurlburt is Executive Director of the National Security Network, a progressive nonprofit which develops and promotes for experts and non-experts alike national security policies that are both pragmatic and principled. From 2002-2008, Hurlburt ran her own communications and strategy practice, working on global and political issues with political, entertainment, and educational leaders.

Richard Kaufman is a member of the Board of Directors and a Vice Chair of Economists for Peace and Security. He was formerly a staff economist and general counsel of the Joint Economic Committee of the US Congress where he directed and authored numerous studies on national and international security issues including defense spending, procurement, research and development, and economic trends in Russia and China. He is Director of the Bethesda Research Institute.

Stephanie Kelton is Assistant Professor of Macroeconomics, Finance, and Money and Banking at the University of Missouri-Kansas City. She has a BS in Business Administration and a BA in Economics, both from California State University, Sacramento. After finishing her undergraduate degrees, she completed the MPhil in Economics on a Rotary Scholarship at Cambridge University.

Michael Lind is a co-founder of the New America Foundation, where he is Policy Director of its Economic Growth Program and Next Social Contract Initiative. A former editor and staff writer at *Harper's Magazine*, *The New Yorker*, *The New Republic* and *The National Interest*, he has taught at Harvard and Johns Hopkins. His most recent book is "Land of Promise: An Economic History of the United States." He is a member of the board of Economists for Peace and Security.

Monique Morrissey, economist, joined the Economic Policy Institute in 2006. She previously worked at the AFL-CIO Office of Investment and the Financial Markets Center. Her areas of interest include retirement security, executive compensation, the Federal Reserve, and financial markets.

Mark Schmitt is a Senior Fellow at the Roosevelt Institute. Most recently, Mark was executive editor of *The American Prospect*. He guided the *Prospect* during a period when it won several awards, including the Utne Reader award for best political magazine. Mark has worked in government and philanthropy, as well as journalism. He was policy director to former Senator Bill Bradley in the 1990s and a senior advisor on Bradley's 2000 presidential campaign, and directed a large program on political reform at the Open Society Institute. Before joining the Prospect, he was a senior fellow at the New America Foundation.

Sherle Schwenninger directs the New America Foundation's Economic Growth Program, and the Global Middle Class Initiative. He is also the former director of the Bernard L. Schwartz Fellows Program. Mr. Schwenninger was Founding Editor of *World Policy Journal* from 1983 to 1992, and was Director of the World Policy Institute at The New School from 1992 to 1996. More recently, Mr. Schwenninger served as Senior Program Coordinator for the Project on Development, Trade, and International Finance at the Council on Foreign Relations.

Chad Stone is Chief Economist at the Center on Budget and Policy Priorities, where he specializes in the economic analysis of budget and policy issues. He was the acting executive director of the Joint Economic Committee of the Congress in 2007 and before that staff director and chief economist for the Democratic staff of the committee from 2002 to 2006. He was chief economist for the Senate Budget Committee in 2001–02.

Winslow Wheeler is Director of the Straus Military Reform Project, Center for Defense Information at the Project On Government Oversight in Washington DC. Before joining the CDI in 2002, he worked on Capitol Hill for four US Senators from both political parties and for the Government Accountability Office. He is a contributor of periodic articles to *Foreign Policy* magazine and to *TIME* Magazine's "Battleland" blog.

Session One Summary: On The Cliff

Stan Collender: I often wonder what was going through Ben Bernanke's mind when he first used the phrase "fiscal cliff," or when it was decided that it couldn't really be said that, given the state of the economy, the combination of tax increases and spending cuts going into effect on January 1 and 2 will cut the deficit too far, too fast. Bernanke was really saying that he recommends the deficit be higher. No one recommending that the fiscal cliff be avoided, eliminated, prevented, or mitigated uses the phrase, "and we think the deficit should be higher," even though mathematically that's what must happen. It's an interesting communications challenge.

Stephanie, I'm going to start with you. Jamie says that we shouldn't panic; but you cannot turn on CNBC or Bloomberg without hearing talk from people who are in fact about to panic. Economically speaking, is there a reason we should be concerned about the fiscal cliff? Is the damage so great that this is something that has to be prevented absolutely, under any circumstances?

Stephanie Kelton: I think that the clear and present danger is not the deficit, the debt, or the so-called fiscal cliff; the danger is that we still have a very weak economy. People are in panic mode over the fiscal cliff because the population doesn't understand exactly what the fiscal cliff means.

It's actually generating quite a bit of support for both sides to come together. It seems like the right thing to do: put partisan differences aside, do what's best for the country, and figure out some way to avoid the cliff. In practice, that means striking some kind of deal, a grand bargain. It's important to keep in mind that the grand bargain itself is really a form of austerity. We have seen in Greece what adding austerity to a weak economy can do.

Stan Collender: The Congressional Budget Office says that GDP is going to fall by 2.9 percentage points if the fiscal cliff hits. I don't think that happens on January 1, is that correct?

Stephanie Kelton: The full effect certainly wouldn't happen immediately. The CBO is talking about what might happen between January and the end of the fiscal year, September 30. The estimate is that we would see a fairly sharp increase in unemployment, and GDP growth would actually turn negative, resulting in a return to recession.

Stan Collender: The Center on Budget and Policy Priorities has talked about this as a fiscal slope, not a fiscal cliff. Would you agree?

Stephanie Kelton: Although tax increases go into place all at once, there won't be billions of dollars on day one or day two. Spending cuts are phased in over a period of time, so, over the course of many months it could be fairly devastating for the economy. However, in a matter of days or weeks, no, there wouldn't be that kind of an outcome.

Stan Collender: Chad, could you speak about the Center's report, which came out in October, September?

Chad Stone: The first version actually came out almost six months ago, then was updated in November. We were concerned that people would be panicking and would strike a bad budget deal, and wanted to emphasize that it was not a "Wile E. Coyote" moment, where the economy goes out and then goes down. As we said, it's a slope, not a cliff.

Stan Collender: Please explain that a little bit further. What actually happens on January 1 and 2, in terms of the economic impact?

Chad Stone: The temporary payroll tax cut and long-term unemployed benefits expire. People see a reduction in their take-home pay; but it's a weekly, biweekly, or monthly amount. It's not that all of a sudden you get a bill for the whole thing at the beginning of the year. Over time it starts to build up. The alternative minimum tax kicks in for high-income people, but that doesn't hit until they actually file their returns in April. Things start slowly, and there is plenty of time to work a smart response.

Stan Collender: Bruce, on the tax side, can any of these issues be fixed retroactively?

Bruce Bartlett: It all can be fixed retroactively. There is no constraint whatsoever, and frankly that's one reason I'm very optimistic about this whole situation. One of the main barriers to any kind sensible economic policy, especially related to the debt or the deficit, has been that the Republican Party adamantly refuses to raise taxes by so much as a penny. Remember, the crisis began because of their refusal to allow the debt limit to increase. When finally they were brought to the bargaining table, they agreed to this sequester mechanism: $600 billion cuts in defense and $600 billion in domestic programs.

Everyone thought it would never happen, that the "super-committee" would come up with something better. The "super-committee," however, went completely down the drain because the Republicans wouldn't accept a single cent of tax increases. This might be a justifiable position if taxes were extraordinarily high. In fact, taxes have been extraordinarily low. The postwar average is 18.5 percent of GDP federal revenues. Right now they're 15.8 percent. If there were one iota of truth to the idea that low taxes stimulate growth, the economy would be booming.

Exit polls during the election showed quite clearly 60 percent of people support higher taxes to reduce the deficit. Once taxes have actually gone up, anything that fixes the problem is per se a tax cut. All of a sudden, the political dynamics change.

In my opinion, this will probably be all fixed within the first couple of weeks of January, made retroactive. It will have no impact on the economy whatsoever. The problem primarily concerns revenue. If we were raising the historical 18.5 percent of GDP in revenue, nobody would be saying we have to do anything.

Stan Collender: Bruce, given your remarks, I think it's important that we remind everybody that you used to be a Republican. You were a deputy assistant secretary for economic policy in the Reagan Treasury Department, and you were Jack Kemp and Ron Paul's chief economist.

Bruce Bartlett: Actually, I worked for Bush, HW; and drafted the Kemp-Roth Tax Bill.

Audience member: Since the scales are so different, isn't it unlikely that the US will follow Greece down the path to insolvency?

On The Cliff

Stephanie Kelton: When I mentioned Greece, I wasn't referring to the US becoming Greece, an analogy often used to create hysteria and to force people to think about ways to reduce deficits and bring down the debt. I was actually referring to what the impacts of austerity look like, and how it would be foolish to implement the same sorts of policies when the economic conditions call for something exactly the opposite. We're not going to cut our way to prosperity.

Second audience member: The argument behind all of this is that a social welfare state with decent benefits, like Social Security and Medicare, simply is not sustainable, that it is the generous social welfare system that has brought on the Euro crisis in France, Italy, England, and of course in Greece.

James Galbraith: The Euro crisis is a manifestation of the worldwide financial crisis. It's primarily a crisis of the banking system.

The principal victims of that crisis are the peripheral countries of Europe who are severely constrained by the fact that they are part of the Eurozone and cannot finance themselves, and are therefore basically subject to the dictate of the European Union, the European Central Bank, and the IMF.

The United States is not in that position. It's in exactly the opposite position. It is the country to which capital flows in a crisis, not the country from which capital retreats. The US Treasury has seen rising bond prices and falling interest rates on a long-term basis in the last five years, a sign of two things. Naturally it's a sign of the world situation, but it is also a sign that the United States government is a borrower in which one can have complete confidence because it pays its bills in a medium that it entirely controls. The risks of inflation and currency depreciation are extraordinarily remote.

Is our social welfare system such that it somehow poses a burden on the economy that cannot be sustained? No; the crisis, our system of Social Security and related programs, including the medical insurance programs, provided a massively stabilizing force that would otherwise have aggravated and accelerated the crisis.

The real crisis in Greece right now is the cutbacks in these programs, resulting in a reduction in pensions, increased poverty, a 25 percent unemployment rate, and the immigration of anybody who can emigrate, all of which undermine that country's social institutions. These are the consequences of the policies have been ordered.

The United States has the option of not following those policies. We are being stampeded into what would, in fact, make our situation dramatically worse, not better; and quite quickly.

Bruce Bartlett: The European welfare state is not too large to be managed. Virtually all of the differences are accounted for by one thing: instead of paying for health insurance privately, they pay through government. We're obsessed with not having government control of health expenditures because we're afraid it will lead to higher spending. The truth is that every single country with national health insurance pays about half as much for health as a share of GDP as we do. We pay 17 or 18 percent of GDP to health. We could have health outcomes no worse than in Britain, and we could have a huge tax cut of 8 percent of GDP. That's the promise of health reform.

Stan Collender: Stephanie, you've indicated that you have a presentation that you would like to make.

Stephanie Kelton: I see three possible options for dealing with the fiscal cliff. One is to do nothing, hit the cliff, and let the cuts and tax increases go into place. The second is to act with a sense of urgency to avoid the cliff, to strike some sort of a grand bargain, to jump before you hit the cliff. The last one is not to do anything rash, to stop, take some time, and think about what is needed to do to get the policy right.

What does it mean if we do nothing, reach the fiscal cliff, and get pushed over? The estimates are that this means something like reduction in the 2012 budget deficit somewhere on the order of not quite half, a cut in the deficit of a magnitude of around $487 million.

The business community is putting pressure on the president and others to come up with some way to avoid the cliff, get the deal done early. Will we jump at the chance to strike a grand bargain because it's perceived as the best way to avoid a recession and deal with our longer-term deficit problem?

The CBO has estimated what would happen if we hit the cliff, and created an alternative scenario keeping the Bush tax cuts to avoid the sequestration, but the extension of the payroll tax cut and unemployment compensation for long-term unemployed go away. Let's compare the two scenarios (below).

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FISCAL OR ECONOMIC MEASURE	CBO BASELINE	ALTERNATIVE SCENARIO
Federal Deficit in FY2013	$641 Billion	$1,037 Billion
Economic Growth in FY2013	-5% of GDP	1.7% of GDP
Unemployment rate for Oct – Dec 2013	9.1%	8.0%
Public Debt in 2022	58% of GDP	90% of GDP
Public Debt in 2035	84% of GDP	190% of GDP

On The Cliff (continued)

If we hit the cliff, we go into recession; GDP growth turns negative by next year, and unemployment rises to 9.1 percent. Under the alternative scenario, we avoid recession; the economy continues to grow, but at the expense of rising longer-term debt.

If we hit the cliff and nothing is done, the deficit falls from its current about 7 percent to between 4 and 5 percent of GDP. That's a sizable reduction. The Center on Budget and Policy Priorities advocates an alternative: $2 trillion reduction over ten years, which would stabilize the debt-to-GDP ratio and put the deficit at around 2.5 percent. Simpson-Bowles starts with a larger deficit, but aims to shrink the deficit to essentially zero at the end of ten years.

Budget surpluses are widely hailed as a very good thing, but if we're striving for balanced budgets or surpluses, we need to understand what that means. Any country's economy can be divided into three parts: the domestic government sector, the domestic private sector, and the rest of the world. These three pieces fit together perfectly because financial flows out of one sector end up in another sector. One sector can accumulate a surplus only if some other sector is running a deficit. It's a perfect mirror image. Everything has to net to zero.

Going back as far as the 1950s, the US government is almost always in deficit. The private sector, domestic households, and firms combined are almost always in surplus. There was a time when the United States ran trade surpluses against the rest of the world. We now run trade deficits, which means that the rest of the world is accumulating a surplus on us. The only way to keep the domestic private sector in surplus is for the public sector to be in deficit.

If the government collects more from us, running a surplus, and the rest of the world takes more from us, that drives the domestic private sector into deficit; it has to. It adds up exactly; so if you've got a 4.5 percent trade deficit and a 1 percent budget surplus, the private sector's going to be in deficit 5.5 percent. The only way to keep the private sector above zero is if the government's deficit is big enough to more than offset the trade deficit. The government's deficit has to be at least 4.5 percent of GDP or the private sector will fall below zero every single time.

If we hit the cliff, the CBO projection is that the government's deficit will shrink to around 2 percent of GDP. Deficits of 2 percent of GDP, together with trade deficits of 4.5 percent, mean the private sector by definition is going to be in the negative. If the government reduces its deficit, it is reducing the surplus of the non-government sector. The government's deficit is equal always and everywhere to the penny to the non-government's surplus.

> **"Being broke" drives lots of hysteria but has no economic meaning. Nothing prevents the US government from creating all the money it wants. The federal government is not like a household. The US dollar comes from the US government, not from China.**

"Being broke" drives lots of hysteria but has no economic meaning. Nothing prevents the US government from creating all the money it wants. The federal government is not like a household. The US dollar comes from the US government, not from China. We are very different from the countries that adopted the Euro, that can no longer issue currency in order to spend. The United States government is not revenue-constrained. and can't be forced into default. There's no economic reason for a grand bargain.

We're told we're living above and beyond our means; but, in fact, we're living far below our means. There is a large gap between our potential GDP and where we are. The difference is all of the output and income that are sacrificed, every day that we fail to bring this economy back to full employment. Factories aren't operating anywhere near historically high capacity utilization rates. We have millions of people who want to contribute, and we have useful things for them to do. What we don't have are enough jobs; yet here we sit, focused on a grand bargain, which is another way of saying austerity.

President Obama got it right when he said, "Companies are awash with cash, and what they've been missing are enough customers out there to prompt demand and justify them investing more in plants and equipment." Businesses need customers. Sales create jobs. Austerity reduces sales. Tax increases reduce income. Spending cuts reduce income. Both are the wrong medicine for the economy today. We've seen the effects of austerity. We don't want to follow Greece, Spain, and Italy over the cliff gratuitously.

Stan Collender: Chad, since CBPP was mentioned, do you want to respond?

Chad Stone: Our $2 trillion figure is actually a response to everyone's thinking that $4 trillion is needed to keep debt from rising faster than the economy, which ultimately is unsustainable. You can choose to take longer, and stabilize at a higher level of GDP, so less much deficit reduction is needed. It can be done faster in pursuing the dangerous austerity program, but you can get a trillion dollars over ten years just from allowing the Bush high income tax cuts to expire.

We argue very strongly that to stabilize the debt — not to balance the budget — requires a balanced deficit reduction program including revenues; but not on the backs of low-income households. In every past major budget deficit agreement, low-income programs have been exempted. Grand bargain doesn't mean austerity, but accepting larger budget deficits than we would otherwise have, and deferring debt stabilization.

James Galbraith: I would like to make three points about the long-term future.

On The Cliff

First, it is very difficult to forecast the fiscal position of the United States government 15 or 20 years out. Anybody who was here in the early 1990s would remember that no one then was expecting that there would be surpluses just a few years later, but the information technology boom was an aberration that came to an end. From 2000 onward, we were back into the much more normal position of the government running substantial budget deficits as the private sector rebuilt its financial position. The idea that one can control the future position of the debt and the deficit by actions taken today is extremely tenuous and debatable.

Second, two important assumptions are driving these projections. One is that the share of health care in GDP will rise to something like 40 percent or so. This is something that we know is not going to happen. We're not going to spend 40 percent of GDP on health care, so building that into a forecast is a mistake that should be corrected. The second assumption is that interest rates will rise to levels that are consistent with what they have been in the past. Yet, how likely is it that short-term interest rates are going to be driven up 400 basis points or so in three or four years? I think it's not likely at all; the economy would collapse. People's houses would lose value even more rapidly, they would default on their mortgages. It is a disaster that won't happen. Adjusting these assumptions to yield a less tendentious forecast would greatly ease the political climate surrounding this discussion.

Third, we need to consider (particularly in light of these uncertainties) our priorities. Unemployment, foreclosures, climate change, infrastructure — these are problems that have a very concrete form and place immediate and pressing demands on us. Why is this very uncertain, highly improbable deficit scenario driving our policy discussion? In three or four years, if it turns out that the people who have been wrong for decades on this question are right, the government can address that problem then. There's no reason to assume such an outcome, based on the record so far, nor on the positions being taken by capital markets. There are people and institutions, banks, foreign central banks, with a lot of money at play. Their attitude toward the United States government's fiscal position is very clear. Long-term interest rates, 10-year and 20-year rates on US Treasury bonds, are at historic lows. These facts reflect the true attitude of people with, as they say, "large amounts of money on the table."

Call for Papers: 17th Annual International Conference on Economics and Security, Stockholm
June 14 & 15, 2013

SIPRI (Stockholm International Peace Research Institute) is pleased to announce the 17th Annual International Conference on Economics and Security. The conference is co-organized by SIPRI and Economists for Peace and Security. The conference program will include research papers selected based on the call for proposals, with a mix of plenary sessions and parallel workshop streams on particular research areas. If you would like to present a paper, please send a title and an abstract of less than 300 words before April 1, 2013.

Call for papers information is at http://www.sipri.org/research/armaments/milex/ICES2013/call_for_papersold.
Papers should be sent to Sam Perlo-Freeman at perlo-freeman@sipri.org.

Session Two Summary: On the Military Sequester

Richard Kaufman: Pentagon leaders argue that the military sequester would be crippling and would endanger national security. Of course, the aerospace industries argue that there will be tens of thousands, or even hundreds of thousands, of jobs lost if the sequester were enforced. However, there's another way to look at the military sequester, especially if you conclude that the DoD is excessively large, riddled with inefficiency, and subject to the corrupting influence of the defense industry. The much-feared sequester could be a way of opening the door to rebuilding the nation by shifting resources from defense to domestic needs.

Our infrastructure needs alone are enormous: in addition to recovery costs from disasters such as Katrina and Sandy, the costs of repairing and replacing our water systems, dams, levies, bridges, roads, and highways are estimated at $100 billion. Our aging water systems, which annually discharge billions of gallons of untreated waste water into US surface waters, would cost $390 billion to replace. Construction of sea walls in the New York Harbor would cost about $20 billion.

Many more aspects of the military sequester will be discussed by our panel. We begin with Carl Conetta, co-director of the Project on Defense Alternatives.

Carl Conetta: I want to begin by setting a framework for thinking about a military policy in this period. What I think is most important for the country to recognize is that the principal strategic challenge that we face today is economic in nature, not military. That's what distinguishes this period from the years of the Second World War and the Cold War. Our principal task from a strategic perspective is to preserve and enhance the fundamental of national strength for the long term; principally, that means the economy. This must be done in the context of a world economy that is rapidly evolving, increasingly competitive, and distinctly unstable. That, I think, is the perspective on national strategy that we need to understand what to do with our military.

First, it's important to recognize that the Defense Department has been a debt-and-deficit leader. It grew in size faster than most other parts of the budget. It was ahead of the general rise in discretionary spending and it rose faster than the average rise in the overall federal budget. If we ask ourselves who the debt-and-deficit leaders were during this period, when we moved from a balanced budget to a terribly unbalanced one, DoD is among the culprits.

> **[T]he DoD is excessively large, riddled with inefficiency, and subject to the corrupting influence of the defense industry. The much-feared sequester could be a way of opening the door to rebuilding the nation by shifting resources from defense to domestic needs.**

It was during the period 1999-2010 that we accumulated a great deal of today's debt. The point I want to make is that, regardless of what you hear, since 2010 there's been very little reduction in defense spending, about 5 percent in real terms. It is true that there has been a significant reduction in war spending, and that will continue. Likewise, you might expect that Social Security spending and Medicare spending, Medicaid spending, that all of these things would go down dramatically if people stopped dying and getting sick and getting old. What has not gone down much at all is the base Pentagon budget. It rose about 42 percent since 1999; there's been a dramatic rise, but very little reduction.

A big question sequestration poses is, can we reduce defense spending by a trillion dollars over the next ten years? I think the answer is yes, certainly. It's a 13 percent reduction in real terms, a rollback to 2006. What's really required is to rethink how we produce military power and how we use it in the world, what roles we want military power to fulfill. If we are looking to make a deal, we can think about reducing defense spending 13 percent over three or four years, which will begin the process of releasing a trillion dollars. A 13 percent reduction over three or four years is well within the historical standard. Between 1989 and 1995, the defense budget reduced by 23 percent; we're talking about accomplishing significantly less than that.

The Project on Defense Alternatives recently released a report that takes us step by step toward that reduction. I think it's important to reduce the size of the military further than the president has suggested, down to about 1.15 million. We must rethink and reform how we buy equipment and what types of equipment we buy. Current standards and requirements are being established not by the challenges in the world in the military realm, but by defense industries. David M. Walker, former head of the Government Accountability Office, said defense requirements are being set not in terms of the collective national defense, but rather in terms of the individual service interest. An important part of this reform process is to rethink how we buy military power, as well as to reform exactly who leads that process.

Another good background piece of information is to compare our levels of military spending with military spending worldwide. The United States, our NATO allies, and other allies enjoy a 4-to-1 advantage over the aggregate of all of our potential challenger states, including China and Russia. During the Cold War period, the US and its allies and its adversaries were about equal. Over the past 20 years, we've established a 4-to-1 advantage in spending over our principal and potential military competitors.

When we are told that spending can't be reduced by 13 percent, what's actually being said is that a 4-to-1 advantage is not sufficient to allow a 13 percent rollback; that our defense expenditure can't tolerate the degree of change that will bring it back to approximately the 2006

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level. When our national leaders say a relatively modest reduction, about half of what we were able to accomplish at the end of the Cold War, will put the nation in risk, we should be hearing that we either have the wrong strategies, or the wrong leaders — or both.

William Hartung: One of the things that I learned from writing a history of the Lockheed Martin Corporation was that as much money, power, and influence it may have, the military-industrial complex doesn't always get what it wants. We saw that in the termination of the F-22 combat aircraft, at least a modest victory for sanity; and I think we'll see it going forward given the fiscal constraints on the budget.

There are two real issues. The military needs to be reshaped to meet current challenges, instead of chasing after Cold War threats or looking at refighting the Iraq or Afghan wars. In doing so, we can certainly spend less than is being spent now. We also need to rebuild our economy. There may be differences about the best way to do that.

My own opinion, however, is that shifting money toward public investment would be moving the economy forward much more quickly. The Aerospace Industries Association and its allies in Congress spent a good part of the last year telling us that, were we to make the modest cuts in Pentagon spending that Carl mentioned, the sky would fall. In part, this is based on studies that they funded, which claim that we could lose up to a million jobs if the sequester went through. That who benefit from the policy funded the study doesn't mean you shouldn't read the study, but the results should be considered with a grain of salt.

I see two major flaws in their approach. First, they assume that cutting the Pentagon budget is the only thing that is going to happen under sequester; nothing else is going to change. Therefore, if Pentagon spending is exempted from cuts, all will be well with the economy. In fact, the sequester also affects domestic programs. If the Pentagon were exempt from the sequester and cut domestic programs further, there would be an even deeper job crisis than under sequester proper. The reason is that military spending is a particularly poor job creator. A tax cut would create 25 percent more jobs; infrastructure investment, about 1.5 times as many jobs; education, perhaps two times as many jobs. In cutting the job creating programs to keep the Pentagon, you lose more jobs than you preserve. That's the main missing link in this sort of one-sided series of industry studies.

If the Pentagon were exempt from the sequester and cut domestic programs further, there would be an even deeper job crisis than under sequester proper. The reason is that military spending is a particularly poor job creator.

There were the same kind of exaggerations in the state and regional claims about the impacts. Pentagon spending is much more concentrated than the industry would have you believe. They're always saying things like, "If this plane isn't built, it's going to impact 44 states, and therefore we can't possibly get rid of it either politically or economically." In fact, a lot of those states that they're talking about do very little. If some guy is selling paper clips to the Pentagon, they count that state as one of the 44 states. There are some concentrated areas, like Fort Worth-Dallas, southern California, the Seattle area, and parts of Missouri, but it's a minority of the states. The notion that this spreads all over the place is not borne up by the few actual surveys that have been done.

A group of Republican senators took out a scare tour and talked about losing shipbuilding, military bases, and defense consulting firms in Virginia. Even though they tried to pin these potential effects on President Obama, he carried the state. I think the reason is that the potential effects were not as deep as advertised. People didn't go to the voting booths saying, "Oh my goodness, we're going to fall into the ocean if this change in our budget goes forward." The effect is a lot smaller than suggested, and contractors are still doing quite well.

For example, a company like Lockheed Martin has tens of billions of dollars in backlog and there are billions of dollars already in the pipeline from the government. Any cuts that occur will phase in over time; they're not going to happen on January 2. Companies may have to curb their profits a bit. They may have to rethink why they pay their executives $20 million a year, but they're not going to disappear as economic entities. The industry has survived past build-downs quite a bit more significant than current one.

The other issue that comes up is the broader economic impacts of Pentagon spending. Doesn't it give us great spinoffs, like nuclear power, the internet, and so forth? Well, yes; but spending $80 billion a year on R&D in the domestic sector might give you parallel spinoffs. Currently, the domestic economy and domestic industry are on the forefront of innovation; so in that case as well, I think we can afford to cut back. Remember, cutting back in this context means instead of the Pentagon getting $80 billion a year in R&D money, it gets maybe $75 billion.

The kinds of investments being made in the Pentagon sector are misplaced, not really meeting the threats that need to be addressed. Therefore, we can reshape and reduce the Pentagon budget without suffering, in fact, probably improving our security situation. It's kind of a perfect storm of the need for fiscal discipline and the need to take a look at how the Pentagon spends its money.

Winslow Wheeler: I'm going to talk about what I think are three fundamentals that we face in the future for the Pentagon budget.

The first fundamental is that the DoD is completely unprepared for its own future, which it thinks won't happen.

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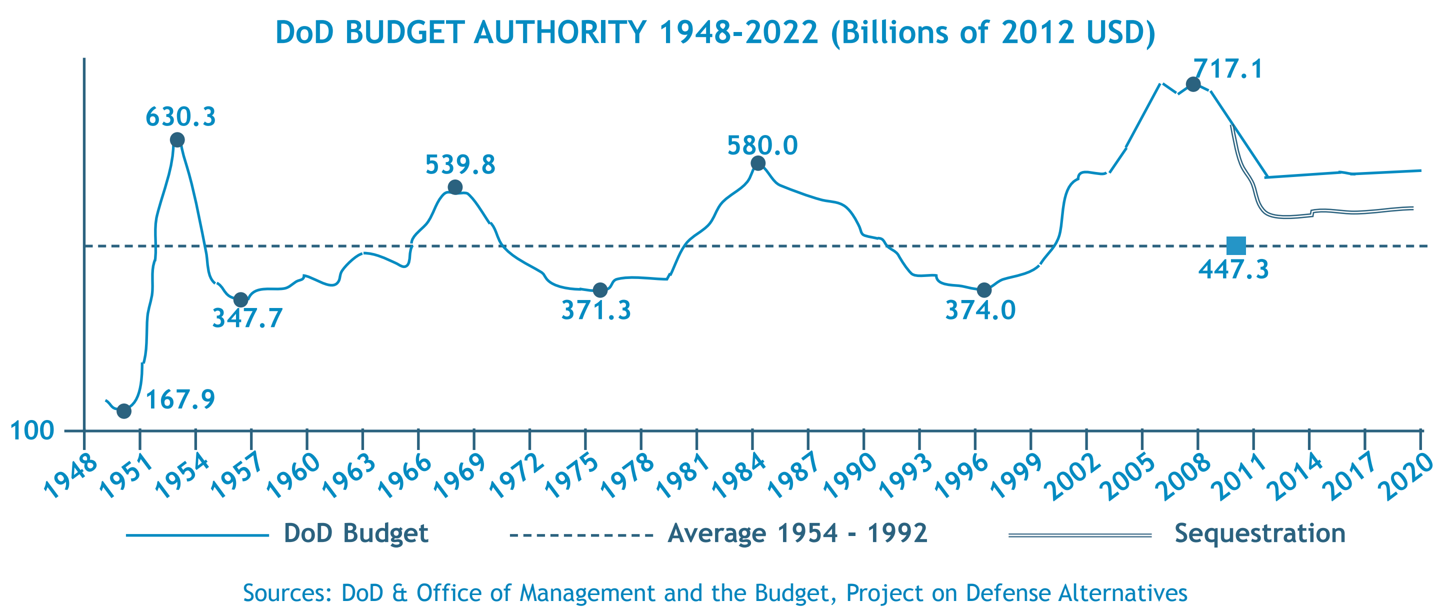
Compare the sequester level of spending, about $480 billion, to the historic norms after Korea — $347.7 billion in 2012 dollars; after Vietnam — $371.3 billion; and after the Reagan spend-up of $374 billion (below). The Defense Department's core belief is that the sequester level draw down isn't going to happen. It's going to be rescued from that. It's going to be something below the current Obama budget, but not as bad as the sequester; it couldn't possibly happen. Well, they need to check their own history, and, given popular attitudes about our international misadventures and our budget situation, there's no other direction for what's going to happen to Pentagon spending levels.

Point number two: even if I'm wrong about how deep the new build-down will go, not only will we not see budget increases above current levels, but there will be significant reductions. The Navy, for example, is planning on huge increases. The 2012 estimate for shipbuilding was $12 billion. The Navy's new 30-year plan calls for an annual average of $20-22 billion per year, depending on which CBO estimate you want to use. The Navy is going nowhere but south on shipbuilding budgets, and because of the Navy's proclivity for high-cost ships, the ship count is going to take a nosedive. During the presidential campaign, John Lehmann accused President Obama of having a plan to reduce the Navy to 250 ships. Well, Obama has no such plan. He's totally oblivious to these forces, but they'll be lucky to end this process at 250 ships. The CBO estimate of what's possibly going to happen is somewhere between 270 ships on the north end and 170 ships on the south end, assuming that the current cost estimates for these ships is about right. We know from past experience that CBO always has higher estimates for the Navy, but in reality even the CBO is a little bit low. The lower band of those ship count numbers is extremely possible. The Navy's shipbuilding budget also experiences stresses from other sources. For instance, if they're crazy enough to buy the F-35, which will be much more expensive to acquire and operate than existing aircraft, there's going to be a duel within the Navy budget between the F-35 and shipbuilding. They're both going to end up losing. As the Navy fleet shrinks, it will, of course, also be aging. New ships will be built at a slower rate than that at which the older ships are aging. The replacement rates can't match previous decades, so it's not a smaller, newer fleet; it's a smaller, older fleet.

Third point: DoD's leadership is mentally unprepared to face any of this stuff. I was astonished this morning when I read that somebody is floating Senator John Kerry's name as a candidate for secretary of defense. People like John Kerry are completely incapable of helping the Pentagon deal with the problems that I think are going to occur. There are other candidates for the leadership of the Pentagon to lead it through this era. Michele Flournoy is a very smart political wonk, but she has no background in any of these issues. Ashton Carter is perceived as a good manager; however, if you look at his job on the F-35, I simply cannot agree. He's not taken on any of the fundamental problems that the F-35 represents; he's let it float on into the future. It's going to face a phase in the sequester scenario that's going to do nothing but increase the cost for an airplane that is a gigantic disappointment in terms of performance. That was all the result of his management, so I don't see him as a competent candidate to lead the Pentagon through this future it's about to face.

Heather Hurlburt: To contrast the comments that my three predecessors have made, I want to make three comments about political realities and what that is going to mean for how the dynamics they have pointed to will play out.

First, the era of endless Pentagon spending is over. The Pentagon had a good eight- or nine-year run where nobody said "no" on anything. That very much changes an institutional culture in



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quite problematic ways. People who were out of the Pentagon for a few years and then had occasion to go back remarked upon how difficult it had become to say "no," and just how much this up-slope from 1999 to 2010 had really changed the culture internally. Much of what Winslow just said reflects that underlying reality.

Second, there has in fact been a significant shift in foreign policy and national security appetite, both within the two parties and on the part of the American public. There is no appetite for another land war in Asia. There is no appetite for continuing the war in Afghanistan,though there is a wing of the Republican party that takes the view that we should be in Afghanistan longer, do more in Syria, that we should do something militarily in Iran. The more politically-minded wing of the party was reading internal polling which said there's not much difference particularly on Afghanistan between Republicans and Democrats. There isn't the demand for the kind of military spending that we've seen over the last decade. There's no longer a public outcry for military spending on this scale as a response to terrorism either. Related to that, which is a bit of a two-edged sword, is the public's belief that there are cheaper technological solutions to our national security problems. For instance, the public, and many elites, perceive that instead of invading a country, you can just station drones along its border. Now, there's a whole fascinating strategic conversation about whether that's in fact correct and whether that policy is going to work over time. Also, technology is expensive, and, if your security is completely dependent on keeping hi-tech offense ahead of your adversaries' lower-tech, cheaper defense, that justifies the need for an endless R&D budget. Technology is often put forward and believed by the public to be a budget panacea. In fact, it's not.

The third point that should be made about appetite is that in the recent election at the presidential and congressional level, across party lines, we saw an effort to make candidates pay for expressing willingness to cut Pentagon spending, and really that had zero effect. On the political ground, the will to spend has shifted rather dramatically. The public is willing and interested to hear about waste and fraud-related Pentagon cuts. However, they also firmly believe that if you just go in and cut the Pentagon, you're going to hurt troops, their families, and veterans. It has to be said that the public's not entirely wrong: troops, benefits, retirement, and health care are the single biggest drivers. The public is on to something here; but it is also interesting how in the public mind the entire military establishment and the troops have become synonymous.

On the political ground, the will to spend has shifted rather dramatically. The public is willing and interested to hear about waste and fraud-related Pentagon cuts.

The army is the big loser when you're not having land wars, for obvious reasons. As the emphasis shifts to the Pacific theater, which is first and foremost about an ocean, and to a potential adversary, China, which nobody would ever invade and occupy with land forces, the question arises: what are we doing with this enormous army?

The second loser is those equipment manufacturers and specialists who produce things that are useful for land combat and high-intensity warfare. There are a number of systems designed for the Cold War, which the military has more of than they're going to need in the future, like the Abrams tank. Reducing their numbers makes complete sense from a strategic point of a view. From a military-industrial base point of view, it's more problematic.

Diversified contractors saw this coming. Some contractors have been busily expanding into the civilian side, into development assistance, and homeland security. Those contractors who haven't are the ones aggressively pushing the panic button over sequester. A politician from a state whose primary military contractors were not very smart has a problem. A politician from another state whose primary contractors are diversified, and are now doing disease surveillance, for example, can say, "I can't help you on Pentagon items, but I can help you with the CDC." That is complicating the political landscape.

Similarly, states with big army bases are going to have a problem, but those with naval bases are going to do great. Folks on the West Coast, where it makes much more sense to base your assets that are looking toward the Pacific, are going to do well; folks on the East Coast will find it a little more problematic.

Nukes play out similarly. On the one hand, nuclear weapons are of no use against terrorists. They're of no use against any stateless force, because it's very hard to deter someone who doesn't have a return address. We have so many more than China. In that sense, they're useless and expensive, and we could get rid of them. Relatively speaking, however, nuclear weapons are cheap. In the Pentagon world, this is actually true. So why don't we use nuclear weapons to assure deterrence, and then we don't have to station conventional forces in Korea, say. When we are discussing budgetary questions in the absence of strategy, we are going to get into the discussion of cheap in the short term versus cheap in the long term.

Having said all of this, what do we want for Pentagon leadership to make sure that we're actually managing the reality behind these numbers in a politically smart and a security smart way? It's not clear to me that is a bad idea to have someone who isn't deeply steeped in Pentagon management practices. I believe perhaps the single most important ability in whoever will be the next secretary of defense is the ability to say, "Why do we do it that way?" The person who's willing to challenge that way, repeatedly, would be my lead candidate for secretary of defense.

Session Three Summary: Essential Priorities — Social Security, Medicare, Medicaid, and Infrastructure

Michael Ettlinger: I think it's notable that the phrase "getting entitlements under control" doesn't have the words Social Security or Medicare in it, and it implies that something is out of control. This panel will be getting at what happens when you actually get beyond that phrase; it becomes a very different discussion. I think this discussion is going to be forced to examine what our society and economy really need: entitlement programs, but also bridges, roads, infrastructure, and all of the other things that the federal government does.

Monique Morrissey: My topic is, "Avoiding a Not So Grand Bargain." We've been getting the used car dealer hard sell. When you hear the hard sell, you know you're not being offered the best deal. Walk away, see what happens, and then come back.

One of my preoccupations is that even many progressives are convinced that Social Security really is in trouble, and that, in general, there's a big problem with aging and demographics. I want to convince you that there is no rush on Social Security. If the Democrats do one thing right, it should be to make sure that Social Security and the New Deal programs are left out of any bargain.

I also want to make the point that it's all politics, not economics. There are other ways of reducing the budget longterm. For instance, the Economic Policy Institute worked with the Congressional Progressive Caucus to develop the Budget for All, a ten-year budget that achieves the same level of public debt as the Republican budget and preserves the safety net, protects the middle class, and invests in job creation.

We've reached the high point of scare-mongering on Social Security. People are convinced that Social Security and Medicare together are going to bankrupt us in the future. Medicare is a health care system. If we don't solve the health care cost inflation, we have a problem, whether it's government spending or private spending. Aging is not a problem. We've saved

> **[T]he influx of women in the workplace and longer working hours have balanced demographic issues. The Social Security shortfall ...actually has more to do with slow wage growth and wage inequality, and more earnings above the wage cap.**

enough money in the Social Security trust fund to get us past most of the peak boomer retirement years. Life expectance growth is so moderate that, once the baby boomers retire, the costs as a share of GDP level off. If there's a demographic problem, it's the drop-off in births and in population growth. For the record, I'm in favor of gradually increasing the payroll tax to offset increases in life expectancy; it would be so slow and so modest that it wouldn't be much of a tax increase, and it would shut people up altogether. Usually, increased life expectancy is used as an excuse for raising the retirement age, which is an across-the-board cut, and well beyond what would be necessary to offset growth in life expectancy. It's true that life expectancy at birth has risen since the early days of Social Security. However, the influx of women in the workplace and longer working hours have balanced demographic issues. The Social Security shortfall that has emerged actually has more to do with slow wage growth and wage inequality, more earnings above the wage cap.

Social Security and Medicare, mandatory spending, is about 14 percent of GDP. Discretionary spending, including military spending, is 9 percent. Tax credits, which are about 8 percent of GDP, are left out; they are not considered spending, but a reduction in taxes. Why cut Social Security instead of cutting subsidies for 401Ks, two-thirds of which go to the top 20 percent of the population? In general, tax expenditures are very lopsided, very wasteful, and very inefficient.

Progressives disagree on three important areas. First is the importance of deficit reduction. I don't think it's a problem for a long time to come and I'm not worried about interest rates. Second, many progressives are willing to cut Social Security by reducing the cost of living adjustment because it would increase revenue. However, the cuts affect elderly beneficiaries disproportionately. Finally: whether to extend the payroll tax cut. It's one way to help the economy, but I believe it's a Republican trap that could be hard to get out of.

Michael Lind: The basic template of the Simpson-Bowles plan and similar grand bargain deals is that, in return for averting the fiscal cliff (or what some have called more accurately the austerity bomb), Congress will agree to longterm cuts in entitlements. In all the different versions of a grand bargain, longterm cuts to Social Security and Medicare and Medicaid are considered part of the deal, whatever the other details may be. We are told that we need this grand bargain to deal with the explosion of the public debt that has occurred over the last decade.

The public debt has come largely from the Bush tax cuts and the wars in Iraq and Afghanistan, which were funded exclusively by borrowing rather than by a mix of borrowing and taxes as in previous wars. The rest is revenue that was lost from the recession as individual payroll income tax receipts, and corporate income tax receipts, went down. A little sliver for federal spending on the TARP, the bailouts of Freddie Mac and Fanny Mae, federal unemployment insurance, and so on.

If you're looking for where the explosion in Social Security, Medicare, and Medicaid spending contributed to this,

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you won't see it. It's not there. Social insurance has not contributed at all to the present crisis. It's two wars, a recession, and tax cuts, which disproportionately benefited the rich. We are told repeatedly to deal with a demographic tsunami, a tidal wave of costs that will escalate in the near future and bankrupt America because we can't afford spending on the elderly, on Social Security, and Medicare. Public health care spending, Medicare, Medicaid, and Social Security are projected to go from a little less than 5 percent now to about 6 percent by 2040. That's not exactly a tsunami threatening to destroy our civilization and demanding immediate, urgent action. It means, essentially, that over the next half-century we need to either raise revenues by about 1.5 percent of GDP, or cut Social Security benefits by that amount; or you could think about reform of the retirement system as a whole. These are all debates worth having. We have decades to have them. Do we have to deal with the long-term financial outlook of Social Security in the lame duck session in the next couple of weeks? Evidently not.

There's more of a fiscal problem with the rise in Medicare and Medicaid costs. We expect it to go up to 10 percent of GDP by about the year 2040, from under 5 percent today. That's not insignificant; however, it does not serve the purposes of scaring people. Saying it goes from a little less than 5 to about 10 in 40 years is not terribly frightening and apocalyptic, and for that reason the scaremongers and the doomsayers typically use a chart that goes out to the 2080s; these costs have been extrapolated up to 40 percent, which is scarier than 10 percent in 40 years. Conceivably, you could project it out to the year 2200 AD and show that it would be 200 percent of GDP, right? We will have to act at some point, unless new technology, or delivery system reform, or something, solves the problem. Ultimately this is a political question, not an economic one.

One possibility under discussion for adjusting Social Security would be to index benefits to the chained CPI (consumer price index), which is an alternate measure of inflation (below). This appeals to individuals and organizations who want long-term Social Security cuts, because it gets the results they want. By calculating inflation differently, you allow inflation to erode the real value of Social Security benefits over time. The erosion of Social Security benefits by chained CPI is cumulative, and it gets worse as you get older. Therefore, when you're 65, it's less than one percent. If you live to be 95, assuming this system has been adopted, then it's a nearly 10 percent cut in your benefits compared to today.

I just want to make a political point. If you had a separate national conversation on what to do about Social Security over three or four years, and there was no rush, no deadline, no sense of urgency; if there were commissions that came up with proposals, and then there was legislation in Congress, it would be a lot more difficult to sell this to the public. Therefore, if you favor cutting entitlements, it makes perfect sense to try to bury this in the fine print of legislation on another subject like averting the fiscal cliff. It's just like putting a rider on a Defense Department bill for something that has nothing whatsoever to do with the Defense Department. I think the groups who want to cut social insurance know they can't win this argument if the grand bargain is unbundled. Their best chance, first of all, is to create a completely artificial sense of urgency; and second, to bury the cuts in some grand comprehensive package that will include tax increases, avert the alternate minimum tax, avert the sequestration, etc. It's probably the only political strategy that can achieve what they want, because if there's a mini-deal (instead of a grand bargain) setting aside the long-term entitlement reform and focuses only on the immediate obstacle course,

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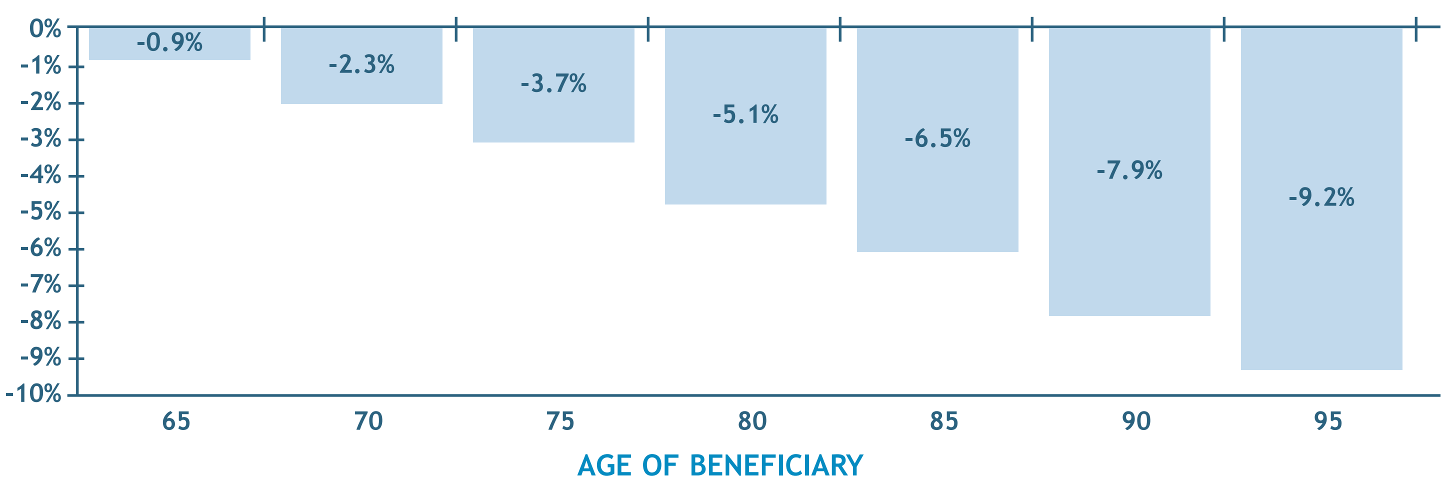
CUTTING SOCIAL SECURITY: CHAINED CPI

Percent cut in monthly benefits from chained CPI, compared to current-law benefits



Source: NWLC calculations based on Office of the Chief Actuary's memo, December 1, 2010

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we will revisit all of these things for generations to come. However, there won't be that sense of urgency or the ability to ram through a lot of ill-considered, ill-debated questions in the middle of the night, right before a deadline.

Sherle Schwenninger: I believe there is a fundamental flaw in the grand bargain. Is there a tradeoff between growth-enhancing public investment in infrastructure, education, research and development, and meeting our social security and Medicare obligations? I believe this is a false tradeoff, and that both are necessary in order to have a successful economy and sustain economic growth.

The grand bargain proponents would try to pit people who favor increasing or maintaining levels of spending on education, research and development, and infrastructure against people who want to defend the New Deal programs. In fact, this should lead us to understand where the fundamental flaw lies in the grand bargain position. That fundamental flaw is that the Simpson-Bowles framework attempts to impose a failed model of economic growth on us in perpetuity. The overall thrust of their message is to keep tax rates and public spending low, to prevent public spending from crowding out private investment, as if capital is scarce in the world.

I want to stress that this model of economic growth, a mild version of the supply-side economic philosophy that has guided economic policy for much of the last decade or two, is fundamentally ill-suited for the economic conditions that we will face over the next three to eight years. Indeed, these economic conditions call for increased spending on growth-enhancing public investment, as well as increased spending on Social Security and public-funded health care, in order to have robust economic growth. I believe a few trends will define our economic conditions over the next few years.

First, we're still in the early stages of a global de-leveraging process. The US faces another three to eight years of private sector household deleveraging, and a worldwide problem of weak external demand. In consequence, we will have a process of paying down debt that destroys demand in the private sector, and weakens private investment.

Second, there are two intersecting demographics that are going to exacerbate the supply-demand equation imbalance. Many emerging economies, already high-saving and production-oriented, will enter their peak savings and production period. At the same time, we're having a period of private savings catch-up in most of the advanced industrialized countries, as baby boomers save to prepare for retirement. That means there will be abundant capital, and a shortage of fixed income investments, leading to an enormous demand for US Treasury debt in the world.

> **Is there a tradeoff between growth-enhancing public investment in infrastructure, education, research and development, and meeting our social security and Medicare obligations? I believe this is a false tradeoff, and that both are necessary in order to have a successful economy and sustain economic growth.**

The third trend is the ongoing mechanization and automation of manufacturing and business services. This will reduce the demand for labor and available middle-income jobs. Therefore, labor will be abundant, employment will be very constrained, and we will continue to face distributive challenges, giving rise to further inequality.

Fourth, continued intense global competition in the trade sectors will place limits on companies' research and development, and infrastructure investment. That means more of the burden for R&D and infrastructure investment will fall to the public sector in the future. Simultaneously, we're going to have continued financial constraints at the state level in the US, which means that the federal government will have to compensate for cutbacks at the state level in education and other necessary investments, as well as support for social programs.

Finally, an energy surplus will develop because of technological advances in exploiting both oil and natural gas resources, combined with new energy efficiency measures that will greatly reduce US energy use. This will give us the wealth in income that we need to make up for the shortfall in Social Security and Medicare.

Economic conditions suggest that the challenges we face are the exact opposite of what the Bowles-Simpson grand bargain would impose on us as a growth strategy. Over the next five to eight, years we're going to face an ongoing shortfall of both domestic and global demand, excess capital in labor and excess capacity in many major industries, over-capacity in many sectors of the world economy, and distributive and inequality challenges caused by ongoing automation. In those circumstances, I would argue, we need more public investment; but we also need stronger Social Security and public health care programs to ease the distributive challenges. More public investment is needed to create jobs to fill the demand hole and to ensure adequate infrastructure and research, development, and training; but stronger social support programs are also necessary in a demand- and employment-constrained world in order to help further fill the demand hole, create jobs, and correct the inequality in the distributed justice challenge.

In other words, we need a growth strategy built on public investment-led growth that will in fact help crowd-in private investment and fill the demand gap that we face both domestically and globally.

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I have one final point. Having laid out the case for an economic growth strategy that is very different from that which would be imposed by Simpson and Bowles, I do understand the problem of political constraints on public spending. Private finance in many respects is still broken, and we have suffocated the public finance mechanisms, that is, the federal credit and guarantee programs. The establishment of a public bank for infrastructure and development would allow leverage of private capital and greatly increase public-private infrastructure investment at a time when private companies don't want to undertake spending; but it must be done so that it doesn't add immediately to public debt.

Mark Schmidt: One thing that does not come up enough is actually a reminder of why all these things are hitting at once, creating a "fiscal cliff." First, there is the Obama payroll tax holiday designed to give the economy a boost. By their nature, these were temporary and should be revisited; we may conclude that the economy still needs that boost, which would be totally appropriate. Then, the alternative minimum tax is basically always broken and always needs some changes to it. The sequesters on domestic and defense spending are products of the blackmail episode of 2011, when congressional leaders refused to extend the debt limit.

The biggest part of it, however, comes from the Bush tax cuts, and the reason the Bush tax cuts expire is an interesting story. In 2001, we had a budget surplus. Both Democrats and Republicans wanted to cut taxes. Democrats wanted to cut them by about half as much, and put more emphasis on the middle class, less on tax cuts for the rich. Republicans not only wanted what we have, they didn't want to be in a position where they had to compromise with Democrats at all, under any circumstances. To avoid possible compromise, they used the procedure known as budget reconciliation to pass those tax cuts with just 50 votes in the Senate. The problem is, budget reconciliation can't include anything that increases the deficit beyond a 10-year budget window; so they had to make the tax cuts expire after ten years in order to use that process.

Now, something that began as a deeply aggressive political maneuver has turned into a different kind of tool to force action on some budget decisions that we would not otherwise take. It's important to recognize that the fiscal cliff was created by a series of decisions, and many really never should have happened.

Real economic opportunity comes from...having the security that your health care isn't dependent on your job, that at least a portion of your retirement savings is secure. That base is important to being able to take other economic risks.

Also rarely discussed are some things on the other side of the fiscal cliff that are actually good. For example, the Bush tax cuts eliminated the Pease and PEP (Personal Exemption Phaseout) caps on personal deductions. They would come back into effect on the other side of the fiscal cliff — not a bad thing. The capital gains tax rate goes up from 15 percent up to 20 percent. It should be at the same level as other income, but that's some progress. The dividend rate goes up to the level of normal income.

Obviously there are things that need to be changed. You'd want to restore some of the refundable child tax credit, and the middle class tax cuts, and so forth; but there's a lot of good on the other side of the fiscal cliff. There's also the opportunity to think and talk about Medicare and Social Security with a little more rationality. I often worry that we treat these programs as secret and untouchable. Social Security has basically been changed every other year since it was created. It was changed about six times by Franklin Roosevelt. It was changed to eliminate the bias against African-American workers, changed to reflect the greater role of women in the workplace, and so forth. We should be unafraid to change and improve these programs; not just to cut their costs, but to ask, "What are they doing well, and how do we better achieve the goals of Social Security and Medicare?"

Real economic opportunity comes from having security. It comes from having the security that your health care isn't dependent on your job, that at least a portion of your retirement savings is secure. That base is important to being able to take other economic risks. We want to consider how we can make these programs work better to allow people to take full advantage of their own aspirations, and live better lives.

Two-thirds of people are already taking Social Security benefits at 62. I'm guessing a large portion of those people are not making a rational economic decision; it's just that they need that cash. We must find a way to ease that transition from the later years of working life towards retirement, perhaps by eliminating penalties for early retirement.

There's a reluctance to embrace increases in the payroll tax at the high end. We think that Social Security only works because basically it's a good deal for everybody. It has a certain amount of progressivity in it, but not so much that anybody is really worse off. The more the payroll tax is raised, of course, the more it does become a redistributive program, if you're not changing benefits in the same way. The public has more recognition that there are programs that redistribute and support people who have less, that others pay more. You see it in public support for programs like the State Children's Health Insurance Program. I think there's a willingness to accept that, so I don't think we have to cling to the funding model of Social Security exactly as it is. We should be willing to entertain some of those payroll tax increases, but all of that is on the other side of the fiscal cliff.

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UPCOMING EVENTS

•**March 20 — 22, 2013** The 1st West Africa Microfinance Conference will be held in Accra, Ghana.

The African Center for Peace Building (ACFOPB) will host the firstWAM Conference under the theme "empowering Africa for economic peace: the role of the microfinance sector." The WAM Conference seeks to address the challenges confronting the microfinance sector in the sub-region. The Conference aims to equipp the participants from the West Africa sub-region with the needed skills in managing microfinance business and to provide a common platform for sharing ideas, resources and network.

For more information, see
http://wamic.afcopb.org/invitation/?goback=.gde_2009987_member_193108690.

•**June 13 — 15, 2013** The 17th Annual International Conference on Economics and Security will be held at SIPRI, Stockholm, Sweden.

The conference programme will include research papers selected based on the call for proposals. It will combine plenary sessions and parallel workshop streams on particular research areas. Some of these sessions will seek to bring together SIPRI researchers and conference participants on issues related to SIPRI's areas of research.

Further details about the conference call for papers can be found at http://www.sipri.org/research/armaments/milex/ICES2013/call_for_papers.

•**June 24 — 26, 2013** The 13th Jan Tinbergen European Peace Science Conference will be held in Milan, Italy.

The Jan Tinbergen Conference is interdisciplinary. Presentations that address any issue relating to peace and security broadly defined are welcome. As in the past, the conference strives for a multi-disciplinary program comprising contributions with a wide range of theoretical and methodological approaches, including strictly theoretical work, game theory and formal modeling, statistical and econometric analysis, qualitative studies, and experiments.

Find out more about the conference when you visit
http://www.europeanpeacescientists.org/jan.html.