The Agenda for Shared Prosperity

Edited transcript for the "Beyond Balanced Budget Mania" forum

April 12, 2007 – 2:00 pm-4:30 pm
Economic Policy Institute, 1333 H St., NW,
Suite 300, East Tower, Washington, DC

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Robert Kuttner, The American Prospect
Dave Hakken, Resource Center for Independent Living
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LAWRENCE MISHEL: Welcome to this forum of the Agenda for Shared Prosperity. We at EPI, working with dozens of folks in academia and other policy groups, have undertaken this initiative for a number of reasons. First, the economy has been failing the American people in terms of providing growing living standards across the board. We note in particular the gap between productivity and wages, and productivity – the output of goods and services for hour worked which describes really the growth of the pie that we have to share – has grown around 15 percent since 2001. But the wages of both high-school-educated workers and college-educated workers has been flat in that time.

We believe that reconnecting the growth of the economy to the growth in pay is the great economic policy challenge of our day. And it should be the yardstick we use to measure any agenda for the economy: whether in fact it will reconnect pay and productivity. A second reason we started this policy initiative is that it's pretty clear that conservative policies have failed. Tax cuts have not provided shared prosperity. The American people now understand that individualized solutions like Social Security privatization or having your own health savings account or your own unemployment insurance account or your own this account, your own that account, is not going to address the needs that they have.

Third, a policy initiative is needed because the timid approaches that some are offering, even on the center left, are not up to the challenge. A few middle class tax credits for this or that are not going to address the need that the American people have for rising incomes in the face of all the pressure for downwards wages and the loss of quality jobs. Nor will an approach which is focused on accelerating globalization and balancing the budget be anyway sufficient to obtain shared prosperity. Instead, we believe we need solutions at the scale of the problem. Let me just describe a little bit about where we are headed in our policy initiative.

First, we believe that retirement income security is important. And the issue should not be reduced to how we fix Social Securities finances. The issue is how we provide the retirement income that the American people need which we believe to be 70 percent of their pre-retirement income is what they should get in retirement. How do we that? Second, how do we have a system that provides a health care that's affordable and accessible to everybody?

Third, we need a macroeconomic policy that gets us to low unemployment and keeps it there and keeps focused on that as the main priority. Fourth, we need a way to have workers, working people, share in this prosperity. And the one instrument for that which has not been available is people having the real right to organize and bargain collectively to be able to get their share of the pie.

Fifth, we need policies that address work family issues, that people can be both workers and raise families in a satisfying way. And last, I'll just mention education policies to close the great achievement gaps across income groups and by race and ethnicity. We will never be able to close these gaps unless we have a broad-based approach that includes really sizeable investments in early childhood development and early childhood education, unless we have social policies that provide for diminishing the poverty rates, the excessive housing mobility, health problems and so on that disadvantaged students face. So we need broad-based policies to make a reality of the promise of closing the achievement gaps.

That’s just a taste which leads us to budget policy, the topic of today’s forum. We’re going to examine issues of short-term budget policy as well as long-term budget policy. Now, it’s absolutely essential to start from the point that budgets reflect our priorities. They reflect our values. They reflect our values as much as anything else we do in this society.

And we need budget policies that allow us to address the nation’s needs. That’s clearly important. Unfortunately, the budget policy discussion too frequently focuses on two matters and leaves important matters undiscussed. One matter stressed by the conservatives is how do we cut revenue and keep it down? On the other hand, there are those who focus on how do we balance the budget as quickly as possible? Coupled with that is a focus on a so-called entitlements crisis.

By focusing either on tax cuts or deficit reduction and balancing the budget, we leave out a discussion of what we need for spending and what it takes to address the nation’s needs.

How do we address the nation's needs? How are we going to have a budget that addresses our social needs or addresses our need to invest in the future, whether for investing in children, energy renewables, health research, or transportation? We are providing this forum today to try to have a more balanced discussion of budget policy. And with good timing, we have Professor Stiglitz now with us.

What can you say about Professor Stiglitz other than this is a man who's really done it all. He's earned the highest honors any academic can hope to earn, starting with receiving the John Bates Clark Award which is given every other year to an economist under age forty who is judged the best economist of their generation. And just to top that, he became a Nobel Laureate in 2001.

But even before he became a Nobel Laureate, he had already achieved the highest positions in the policymaking world being the Chair of the Council of Economic Advisers under President Clinton and the Chief Economist at the World Bank. Over the last ten years, he's also emerged as a leading public intellectual, addressing popular audiences through books and other means like speaking to audiences like we have gathered today.

But Professor Stiglitz's contributions are critically important because they are a challenge to what I would call market fundamentalists. That has been true of his work at the theoretical level. And it's also been true in how he has approached policy, policy discussions about globalization, as well as domestic policy. I think you'll hear today that he's very willing to challenge the conventional wisdom if that's what the right economics dictates. So without further ado, Professor Stiglitz.

JOSEPH STIGLITZ: Well, it's a pleasure to be here and to talk on this very important subject. Budget debates are a useful way of trying to focus attention on fundamental issues on what the country's priorities are. But they also reflect views of the economy, of economic behavior. I think it's understandable that there should be a lot of focus on the deficit at the current time given the absolute mismanagement of the budget macroeconomic policies over the last six years. The magnitude of the increase in the deficit in the last six years has been very large.

But as one recognizes that we've had six years of badly managed budgets and badly managed macroeconomics, we have to look at what the realities of our economy are today. And that includes addressing some of the important social and economic priorities.

As we talk about deficits, we have to ask the following question about economic structure. If deficits lead to decreased growth, then a dollar spent on some activity has a cost that is in some sense greater than a dollar. Because we spend a dollar. We don't change taxes. The economy doesn't grow as well. On the other hand, if deficits lead to a stronger economy, then that means the net cost is less than a dollar. And to ascertain that, one has to make a judgment about where the economy is today.

There are four propositions I want to put forward this afternoon. The first is that we should never actually focus just on deficits, but on broader economic concepts. The deficit is only one of several accounting frameworks. And it's probably not the best way of assessing either the fiscal position of the economy or its economic position. I'll come back to each of these four propositions in a minute.

The second is deficits may or may not matter depending how the money is spent, how they arise and the state of the economy. The third is that the country has a large number of priorities, real priorities. I'll only talk about three of them, the challenge of globalization, the growing inequality, the health care crisis. But there are others such as our problems of energy and climate change. Meeting these, some of these, will require spending money that might create the larger deficit. And I'm going to try to argue that in fact if this money is spent well; it does make sense to do that, even if it led to a greater deficit.

And the fourth proposition is that the current state of the economy is such that deficit reduction, done the wrong way, could have a large macroeconomic cost. So that if you put it another way, if we spend money the right way, it could have two benefits, the direct benefit as well as the benefits that come from macroeconomic stimulation.

Maybe I should begin by giving what I think are two further points that are illustrative of these four points that I hope represent a consensus, not of everybody in Washington, but I think of all the right thinking people in Washington.

The first is that we as a nation and world would be better off if we ended the war in Iraq and reduced defense expenditure. That not only the expenditures in Iraq, but Star Wars weapons, represent weapons that don't work against enemies that don't exist. And if you waste money, that's a bad thing. Keynes talked about digging holes and pump priming and argued that even that could be a benefit. But I think given the list of priorities that the country has, we have a lot better ways of spending money than this particular form of pump priming. And in fact, this particular form of pump priming doesn't prime the pump very much. Because, as I argued in my paper on the Iraq war costs, the feedbacks of the re-expenditures don't come back to American as strongly as other forms of expenditure.

The second proposition, illustrative of this general view, is that there are ways of changing our tax structure, raising taxes on upper-income individuals, lowering taxes on lower-income individuals, packages that could reduce the deficit and strengthen the macro economy. So, a redesign of our tax structure could accomplish several of the objectives that I have talked about earlier.

Now, behind what I'm saying right now is a view that the economy is potentially going through a difficult time. I think most people see the economy right now as being weak.

The consensus forecasts are that growth in the United States will be slower this year than it was last year. And even conservative economists see a significant probability of a serious slowdown of the economy. Some people even see a recession. The mistakes in tax and monetary policy that we have made over the last six years are coming home to roost.

The mistaken tax policy, the tax cuts of 2001 and 2003, forced the burden of macroeconomic adjustment on monetary policy that led to low interest rates. Low interest rates did not lead to high levels of investments. The nation's balance sheet in a sense was such that people took on more debt. But they didn't spend that debt in productive real investments. In traditional monetary policy, lower interest rates lead to more investments.

So that while there's more public debt, there's also an increase on the asset side. In this particular case, what happened was that people refinanced their mortgages, took out larger mortgages. And it was the real estate sector, both directly and indirectly through refinancing of housing that provided a major stimulus to the economy that helped us to get out of the recession of 2001. But that has left a legacy of indebtedness. And it's important in this not to look at average numbers, but the whole distribution.

And that we are now seeing real problems in the subprime sector. And it's now reflecting in some other sectors that are also risky sectors of the mortgage market.

Forecasts continue to be that private housing prices will decline. It will be difficult to sustain the economy. In other words, in the last couple of years, consumption has been sustained by people taking money out of their houses. With house prices going down, that's going to be very difficult to continue, and let alone to increase in a way that would facilitate growth.

And that is one of the reasons that many people are pessimistic about the economy today. The problem is with that kind of weak economy, fiscal contraction – particularly poorly designed fiscal contraction – would exacerbate the problem and therefore risk the economy having a more significant slowdown than it otherwise would have had.

Now, that means we have to focus a great deal on managing aggregate demand and the difficult problem of rectifying the balances that we accumulated over the last six years. And there are ways of doing it. The example that I talked about before of redesigning our tax structure. We can redefine our tax structure in a way that would address the problem of the growing inequality in our society, stimulate the economy and reduce the deficit. But that will require careful modeling, careful analysis.

In 1993 at the beginning of the Clinton administration, we faced a problem of a very large deficit, much larger than today, and a weak economy. And we designed a package that had the effect of stimulating the economy. But we were very careful in designing the tax policies. We postponed the tax increases, most of the tax increases, until after the economy had recovered. And we focused what tax increases there were on upper income individuals so the impact would be minimal.

As another example, I think stronger expenditures on social programs – strengthened safety nets, more provisions for unemployment insurance – could again enhance growth and stability and help the economy face the challenges of globalization.

Before talking about these challenges of globalization, I wanted to go back to the first point. I wanted to emphasize a little bit more on what deficits mean and why we shouldn't focus on deficits themselves. What really matters is the country's balance sheet, its assets and its liabilities. Consider a company. You would never say, oh, this company is borrowing a lot and therefore, it is a bad company. You would always say what is it borrowing for? Is it for investment? You want to look at both its assets and its liabilities. You want to look at its balance sheet.

And you might also want to look at some of these cash accounts. But you would certainly want to look at its balance sheet. Well, when we talk about the deficit, we're talking about only one part of that balance sheet. We're talking about what's happening to the liabilities, what it owes, but not to what it's spending the money on.

And if you are borrowing money, which the United States has done, to finance a war in Iraq or to finance a tax cut for upper-income Americans, then the country is being left worse off. The balance sheet does look worse. You have a liability, but you don't have any asset on the other side. But if you are borrowing money to invest in education, technology, or, say, the safety net, then you may have a stronger economy. And this is particularly true when you're facing the kind of problem that our economy is facing today.

Yesterday, I was talking to the former Finance Minister of Sweden. And Sweden has been one of the countries that has been most successful in facing the challenges of globalization. It's a small economy, very open, with a significant manufacturing sector. In terms of some of the rhetoric that you hear in Washington and elsewhere, it should have been a disaster case. They have one of the highest tax rates. And it's not only true in Sweden: Finland and all the other Scandinavian also have very high tax rates. If you only looked at tax rates, you would say these countries would be a disaster. And we had a discussion in which the view was that their success was *in spite of*. No, it's not only in spite of, it was *because of* the high tax rates.

Why is that? It sounds counterintuitive. Well, the answer is it's how the money is spent. Again, looking at both sides of the balance sheet. It was spent in ways that led to a stronger economy, enabling the economy to face some of the challenges of globalization. The net result of this is that, for instance, Sweden and the other Scandinavian countries do much better than the United States on broader measures of success like human development indicators that look at not just GDP per capita, but also look at health and longevity in terms of labor force participation. They're doing very well. And they have a sense of social solidarity.

In a whole variety of indicators, they are doing not only well, but better than the United States. The United States has been, as I say, facing the big challenges of globalization and of inequality. Most of you know the data better than I do. That while US GDP has been growing, median income in the United States has been stagnating, actually going down in the most recent years. And people at the bottom, salaries have also been stagnating, not just recently but for a number of years.

Globalization necessitates people responding to change or moving from job-to-job. And in the Swedish model, they responded by providing for active labor policies and systems of social insurance that facilitate people moving from job-to-job and provide them with security. One of the aspects of success in a modern economy is willingness to undertake risk. And they would argue that because they have greater security, people are more willing to take risk. They've managed their macro economy to have full employment. But not only full employment at low, but full employment at high wages.

And so they have addressed a lot of the problems of insecurity, not perfectly but far better I think than the United States. And the result is, at least in many of the countries of Scandinavia, a much greater willingness to embrace change, the kinds of change that one needs in a dynamic economy.

All of this takes money. It doesn't come free. How you finance that, whether you do it out of taxes or deficits, may be of second order importance. In the long run, obviously, things have to be paid for. Resources have to be paid for. But as Keynes said, in the long run we're all dead. In the short run, we face a situation where we have the risk of a weak economy. And that short run context involves, a combination, I think, of a restructuring of our tax structure that would stimulate the economy more and provide greater equality to deal with the growing inequality that has faced the country over the last thirty years.

This would allow individuals to take more risk, invest more in education and technology, assisting active labor market policies that allow people to move from job-to-job. These kinds of comprehensive investment programs I think can provide the basis of a more dynamic economy that will in fact lead to, not only greater economic growth, but a more cohesive society.

Finally, let met just say a few words about a couple of the other issues that I think are areas that we need to spend more. And Henry's going to talk to you more about health care. And I agree with everything he says. So I don't want to repeat what he's going to say. But let me just for matters of emphasis bring out a couple of points.

The first is that there has been a lot of misrepresentation of the nature of the problems that we face with an aging population. There was an attempt by President Bush to scare us about the problems of Social Security. The numbers did not reflect, I think the real nature of the risk. Obviously, there's uncertainty. There's uncertainty about all the parameters, about growth rates of the economy, growth rates of productivity, migration, all the numbers that go into forecasting a program that's going to be going on for years in the future. And those inherently are difficult and uncertain numbers.

But two observations are worth making. The first is that the kinds of numbers that have been used to sell the tax cuts, optimistic rosy scenarios, are markedly different than some of the more pessimistic scenarios that are being used to say that we face a major problem of Social Security. For instance, some of my colleagues told me that if you just adjust the numbers on my migration and make the numbers of migration more realistic, the problems of the deficit and Social Security essentially go away.

The second thing is to put the numbers into perspective. Some of you may know the paper that I did on the cost of the Iraq war where we conservatively estimated the cost of the Iraq war between one and two trillion dollars. And that provides I think a new measure, a new metric, that I use for defining the magnitude of a problem. We could put Social Security on sound financial basis for the next 75 years for approximately somewhere between one-quarter to one-half of an Iraq war.

So if we can afford the Iraq war, what are we talking about a serious problem of financing, Social Security? It is a significantly smaller challenge. The health care most people think of is a more serious problem. But it's a problem with our health care system as a whole, both public and private. And there are a couple of things within our health care system that we can do that would potentially address again a very significant fraction of the problem.

For instance, we are facing skyrocketing drug costs. And a few reforms, like allowing the government to bargain for prices and creating a pharmacology list of drugs that are more effective like Australia does, would do wonders in using drugs more effectively. So what we need here is social science innovation – not even innovation, to compare with our innovation in our medical sciences – to figure out how to deliver the medicines in a way that is more efficient.

In general, the innovation system that we have for testing and making drugs is a very inefficient system based on monopoly and conflicts of interest, a variety of distortions, which lead to higher prices and I think less performance certainly per dollar spent.

A second observation is that practices, standard practices, on a large number of areas differ in various parts of the country. And in ways that are not really systematically related to outcome. And that at least suggests that if you switched from the most expensive to the least expensive practices that are consistent with equally good outcomes, there would be very large savings in costs that would help put the health care system on sound footing.

Now, the final challenge I wanted to just mention very briefly is climate change. I think the evidence that has come out this year has made it even more compelling than it was in the past. I was on the governmental panel of climate change in the 1995 review. And the evidence was overwhelming then. But we made a mistake. We did not expect, I think, it to play out as fast as it has. One of the aspects in which it’s come out much faster is, for instance, we didn’t anticipate the melting of the Arctic as rapidly.

I should tell a little story that I was in Davos where all the muckity mucks get together. And at a meeting session, oil executives were talking about climate change. And some of them were saying, you know, you guys are really looking at things in a very pessimistic way. You should look at the bright side of things. And what was that? And they said, well, because the Arctic ice cap is melting so fast, we will be able to get the oil underneath the Arctic sea at a much lower cost than previously we had calculated.

So there is a silver lining perhaps in every cloud. But the notion that it is clear that the accumulation of greenhouse gases in the atmosphere represent a significant risk. If we had many planets, we’d conduct an experiment on this planet and if it comes out the way that almost all the scientists are agreed will happen, we go onto the next one and say, well, we made a mistake. Too bad. That would be one thing. But the fact is we can’t go onto another planet. And if we make a mistake here, we have no alternative. And the consequences could be very severe.

It reminds me of a little joke that I heard about two planets actually going around and not bumping into each other, but coming close. And one of them was sighing, saying, you know, things are really terrible with all these humans, you know, the problems. And the other one that doesn't have any problems said, don't worry. It only lasts for a little while. And that sort of encapsulated the problem of global warming.

Some of the things we can do to deal with global warming will actually save us money. Getting rid of the energy subsidies that we have, including the depletion allowances that we have for oil, would save us money. The ethanol subsidies are outrageous. It almost costs as much in oil to get a gallon of ethanol, so the net output of that system is almost negative. We have a 50 cent tax on sugar-based ethanol, for instance, from Brazil. And we give a 50 cent subsidy to American corn-based ethanol. So we have an enormously distorted system. And getting rid of some of these distortions in energy would actually save us money.

But there are other things we will need to spend money on. We will need to spend money on a whole variety of technological innovations to address the challenges proposed by global warming. Research expenditures in this area have actually gone down in the last twenty years. So these are examples of things where we will need to spend money.

In short, what I wanted to say is just repeating what I said before: don't just ever focus on the deficit. Look at the broader set of issues. Among the broader set of issues are where the economy is today? And the economy today, I think, has a certain degree of precariousness where unthoughtful deficit reduction could have adverse effects. I think there are ways of restructuring our tax structures that could stimulate the economy, address some of the most problems of growing and equality and reduce the deficit.

But more generally, there is a wide agenda facing our society, important priorities that need to be addressed that will require expenditures. And the value of spending has to be weighed against the cost of any deficit. I think there are lots of ways that we can cut expenditures, most importantly in the defense area. But if we fail to do that, it is still almost surely worthwhile spending money in these other areas even if it has some effect on the deficit.

MISHEL: I want to take the privilege of asking the first question. There's much to be proud of in terms of the accomplishments of the economy in the Clinton era, especially the fast growth in incomes and wages starting around 1996 when I think you were actually the CEA Chair. Some people have attributed that to fiscal responsibility as the major cause. And I'm just wondering if you would comment on that.

STIGLITZ: Just like everybody would like to claim that it was because they were in office then that the economy did well. But one has to be very careful at attribution. I think the same thing is true about every policy that was in place. The idea that deficit reduction leads to a strong economy was an idea that Andrew Mellon tried in the midst of the Great Depression. And the effect, of course, was not positive. Then came Keynesian economics. Except when the economy is weak, increasing deficits and government spending can help stimulate the economy.

And that idea has remained at the center of economic analysis. It's been tested over and over again, and thought through in theoretical models. And I would argue it is as valid today as it was 75 years ago when Keynes put these ideas forth. Now, we've had some recent experiments at deficit reduction in the midst of an economic downturn. Nobody in their right mind might have done this. But IMF did this experiment.

And because of these experiments, we have lot more information. And we know that these kinds of policies of reducing the deficit, reducing the deficit in a recession or tightening monetary policy makes things worse. It happened in Argentina. It happened in Korea. It happened in country after country. Now, that poses the question, what about the United States in 1993? Is it an exception to this rule?

Well, that was actually one of the questions that I posed in my book "Roaring '90s". And there I point out two things. One, we were very careful in the timing of what we did. I mentioned that before. We didn't increase taxes and cut back expenditures until after the economy was already in its recovery pattern. And secondly, the way we increased taxes was mostly on upper-income individuals who we thought would have a lesser effect on the economy than increasing taxes on average Americans. And I think we were right.

Now, there is another thing that was peculiar about that particular period. And it’s important to realize the special circumstances that prevailed at that period. And that was the banking system had a large number of long term bonds. How it had come to all of this is a complicated story dealing with peculiar regulations that have no sound basis where the Fed decided that long-term government bonds were going to be treated as safe assets, even though long-term government bonds are still risky.

Because even though the government is not likely to bolt, our experience is that there is risk in the market price because of interest rate volatility. They were treated as a safe asset for purposes of capital adequacy, and risk-adjusted capital adequacy requirements. And that provided the incentive for banks to hold long-term government bonds rather than loans.

That contributed to the weakening of the U.S. economy. Banks held back their loans and the economy was weakened. But it was a very risky strategy. And the way the bookkeeping was done was also very bad. Long-term government bonds were yielding seven, eight percent. Short-term bonds, three or four percent. What’s the difference? Why were these two not the same number?

Well, there's a basic arbitrage formula that says the reason people were willing to hold the long-term is that long-term bonds are risky. And the expected value was that on average the long-term bonds were going to fall in price. And that was because it was expected that long-term interest rates were going to rise. It's a long answer. But the bottom line of all this is that they were gambling that they were allowed to book the income that they got on the long-term bonds even though they should have been putting this money on the reserve against the possibility, probability, that the bonds were going to go down in price.

So as a result of these complex income accounting mistakes and regulatory mistakes, they were induced to hold these loans. Well, not every mistake in policy turns out bad. On average it does. But in this particular case, what happened is Clinton got elected and actually even before that, there was an agreement in 1990 under Bush. And the process of deficit began. And as that happened, for a whole variety of reasons, the long-term interest rates came down. Whether it was due to the borrowing or to other global economic factors doesn't make any difference. Long-term interest rates came down.

And when the long-term interest rates came down, the price of these bonds went up. And it recapitalized our banking system. And the banking system once it was recapitalized was able to lend more. So it might have happened without deficit reduction. It might have been just luck. Or it might have been the deficit reduction contributed a little bit to the decline of interest rates and therefore stimulated the economy. But whatever the view is, one should not think of that as a normal situation. It was a peculiarity, a result of some bad regulatory mistakes, bad accounting. And good luck had it that Clinton was in office when these mistakes had their positive consequences.

QUESTION AND ANSWER SESSION

THOMAS PALLEY: I’d like to press you a little bit more on this question between budget deficits and interest rates. It’s really argued around town here that the case for reducing the deficit is that it will lower interest rates. What is your view on that?

STIGLITZ: There are two things. One is, what is the role of the Fed in controlling interest rates? The Fed has pretty good control of short-term interest rates. It is able, so far, to set the short-term interest rates at effectively any level that it wants to. It got them down to one percent. Now they’re at five percent. So I think that it is clear that there is no clear relationship between those short-term interest rates and budget deficits.

Now, of course, the Fed looks at inflation. And that has to do with aggregate demand and how aggregate demand is showing up as inflation. That’s why I say you have to pay very close attention to aggregate demand and the kind of shifts that I described before, for instance, in tax policy that were designed in ways to have offsetting effects on aggregate demand and leave that unchanged.

The second general point is we live in global financial markets. And so that even in terms of medium and long-term, our American financial markets are obviously affected by global liquidity. What Japan's central bank and financial markets do and, more broadly, their savings affect interest rates. We are not in a state where we are a fully integrated global economy. And so it is probably the case that budget deficits do have some effect on medium and long-term interest rates. So I don't want to ignore the possibility.

But finally, let me say all of this is very contingent on the state of the economy. It's more likely to have a significant effect when what you worry about is crowding out. And crowding out is more likely to be a significant problem when the economy is at full employment. If the economy is not at full employment, then it's less likely to be a problem. And what I articulated before is the view that there's a significant risk that the U.S. economy is going to be operating at less than its potential. And that's what I would be focusing on right now.

FRANK CLEMENTE: You several times talked about tax policies and the importance of them in terms of stimulating growth and dealing with income inequality and investment. Could you articulate your top three priorities in the tax area?

STIGLITZ: Well, the most important priority, I think, is on the degree of progressivity. I think we need to restore progressivity at least to where it was before. A second issue, and maybe that's part of this, is that we ought to be thinking about moving towards what one Senator has called a fair tax, where we tax capital gains, dividends, and wages all at the same rate. I think the argument for preferential treatment, capital gains, has always been very questionable. It leads to all kinds of distortions, tax evasion.

And the argument that was put forward for preferential treatment of dividends was to avoid double taxation, remember in 2003. Well, at the time, people said, well, what about firms that weren't paying taxes? They said, well, we'll take care of that. We'll only give relief for the firms that are already paying taxes. But, of course, in those midnight sessions when the bill finally goes through Congress, that particular provision was deleted. And so now we have many cases of zero taxation, not double taxation.

But a most important point is if the agenda had been to eliminate double taxation, there are many ways of eliminating double taxation and maintaining progressivity. What was done in the 2003 case was not focused on double taxation, but was focused on reducing progressivity. So I would have said, okay, I understand the issue of integrating our corporate individual income tax but there are ways of doing that that maintain progressivity.

ROBERT KUTTNER: As a secondary justification for getting that budget deficit reduced or getting the budget to surplus, you hear the trade imbalance blamed on macroeconomic factors. Some people argue that the trade imbalance is also partly the result of structural factors such as the fact that other countries practice a greater degree of economic nationalism than we do. And that the macro story is really more of an accounting identity that doesn't really tell you the direction of causality.

Where do you come down in that debate? How much of it is structural? How much of it is macro?

STIGLITZ: Well, actually, my view is a little bit more complex. And I have a chapter in my book "Making Globalization Work" where I try to deal with it. There is a basic identity, almost an identity that says that if you increase the fiscal deficit and you don't change anything else, the trade deficit goes up. And that's called the twin deficit problem. But if you look across countries and if you look over time, actually there's very little relationship between the fiscal deficit and the trade deficit.

And that raises the question, what is going on? First, the proposition that fiscal deficits cause trade deficits is almost a tautology if you understand the basic identities. The second is an observation, empirical observation, that there doesn't seem to be any clear relationship. But, of course, when the world changes, it doesn't hold everything else constant in the way that we did in the first experiment.

One way of thinking about what happened in the United States, our trade deficit has been constantly increasing. Underlying this was a period where we had a very large fiscal deficit. And then in the Clinton administration, we got the fiscal deficit down. And now we've got the fiscal deficit up again. But our trade deficit just moved very smoothly upward the whole time.

Now, what's going on? In the 1990s, we were lucky that we had an investment boom. Lots of people can talk different stories about technology, about irrational exuberance, about all kinds of stories. And we can talk about the story that I talked about before. The net effect of which was we didn't need a fiscal deficit to keep the U.S. economy at full employment because we had these irrationally exuberant people that were investing sometimes in a crazy way.

You know, at the end of the 1990s, 97 percent of the optic fibers had not seen the light. And, you know, that's great if it was a private sector pump priming, wasting money. But it helps the new information-age economy. And you didn't need deficit reduction. Now, if you have a large trade deficit, if you're going to get the economy to full employment, then you may need a fiscal deficit to stimulate the economy.

The magnitude of the fiscal deficit depends on how you structure your tax policy. So the Bush administration should be blamed for having a very badly designed tax policy that minimized the stimulus per dollar of deficit. It took a lot of work to get a policy that was so badly designed. But they did it. There are lots of other tax policies that could have had equal stimulus with a lot smaller deficit.

So we've actually done some testing of this in various countries. In particular, Canada comes out very clear that the trade deficit causes the fiscal deficit. In other words, when the trade deficit goes up, the fiscal deficit responds because the government wants to maintain full employment.

So the underlying problem then is to figure out what are the forces, the structural forces, giving rise to the trade deficit? And it's not, I would argue, so much of the imbalances in protection policies. As it is, there's a basic identity that the trade deficit is the difference between savings and investment. And Americans aren't saving very much. Last year, American saving was negative, household saving was negative. And that is a peculiarity of the United States. And we can have a big debate of what the reason for this is. But it is an abnormality.

And so long as we have that, it is likely to be the case that we will have problems of a trade deficit. But all this is part of a complex equilibrium system. And what we argue in the book "Making Globalization Work" is that one of the underlying structural reforms has to do with the global reserve system that helps account for why people are willing to continue to buy dollars, U.S. Treasury bills, even in a world in which confidence in the dollar is weakening.

PANEL DISCUSSION

ROBERT L. BOROSAGE: Thank you very much. There has been a great deal of focus lately on reducing the budget deficit. And there is simply too little argument, too little of a case made, for the kinds of public investments that we have slighted over the last decade and that we desperately need for our economy and for our society over the next years.

So I'm really pleased to introduce the panel that we have to shed a little light on this debate. We will challenge the conventional wisdom that holds much of the debate about public investment in terror, which is the notion that we have an entitlement crisis of rising and chronic deficits that make thinking about public investment very difficult.

We'll then look at, and make the positive case for, the economic and social returns on public investment and then look at a specific area – early childhood development – and the extraordinary returns that can come from investing on the front side of life rather than waiting and paying for the failures on the back side.

Let me introduce the panelists all at once. First up will be Henry Aaron to take on the conventional wisdom about the deficits in our future. And no one is better to take this question on than Henry Aaron who is in a sense a Washington institution in and of himself.

He is the Bruce and Virginia McGlory Senior Fellow at the Brookings Institute, a long time fixture in debates around the budget at Brookings. Among many offices and honors, he was an Assistant Secretary for Planning and Evaluation at the Department of HEW [Health, Education and Welfare] under the Carter administration; Chair of the Board of the National Academy of Social Insurance; Vice President and member of the Executive Committee of the American Economic Association; and President of the American Association of Public Policy and Management. The most recent book is *Can We Say No? The Challenge of Health Care Rationing*.

Following Dr. Aaron's presentation, we will enjoy a presentation from Max Sawicky who will be looking at the basic benefits of public investment and why public investment matters. Max is an economist here at EPI, where he studies and writes on public finance with a particular emphasis on the federal budget and tax policy. He's worked in the Office of State Local Finance of the U.S. Treasury Department. His reports for the Economic Policy Institute include the "Roots of the Public Sector Fiscal Crisis" and "Up From Deficit Reduction." And he is the editor of "The End of Welfare: Consequences of Federal Devolution for the Nation".

And finally, last but not least, we'll take a good look at child development policy and the incredible benefits of making investments on the front side of life. And we have Dr. Joan Lombardi here to do that. She is perhaps the pre-eminent person in the nation on this issue. She is currently the director of the Children's Project and certainly one of the leading experts in the country about childhood development and childhood family policy.

She chairs the Birth to Five Policy Alliance, a group of national organizations focused on getting resources to that crucial age for children at risk. She served as Deputy Assistant Secretary of HHS [Health and Human Services] in the Clinton administration and was the first director of the Child Care Bureau. She's the author of many different publications and will be able to give us real insight on childhood development policy. So, Dr. Aaron.

HENRY AARON: Being described as an institution makes my knees hurt even more than they normally do. The old saying is you can't tell the players without a program. I want to give you a bit of program on where I'll be coming from. I'm probably the right-winger on the panel today, and I want to own up to that fact. I say that as somebody who has been a lifelong Democrat and wears the designation liberal proudly. But I want to explain why I think deficits do matter and why I think a good deal of attention should be paid to them.

I do not disagree with anything that Joe said about our almost unlimited capacity to raise taxes stupidly or to cut spending foolishly. It is certainly the case that one can undertake budget measures that make less red ink flow, but make the nation less healthy by damaging the structure of the tax system or by withdrawing expenditures that do a great deal of good for the economy. But we live in an imperfect world where mistakes are going to be made. And we will raise taxes sometimes wisely, sometimes foolishly – ditto for expenditure policy.

The first question is if you were undertaking a new expenditure: Will it do you more good if you pay for it and reap the income from it or if you borrow and somebody else reaps the income from it? My answer to that is the former, not the latter. That’s one reason why deficit reduction is desirable. The second reason is, perhaps in the long run, more important. And it’s a political argument. I’m an economist so my credentials are lousy on that score. Well, come to think of it, a lot of politicians’ credentials are lousy on that score.

I believe that it is vitally important for the American future that what I’m going to call a liberal policy agenda remains or becomes once again acceptable to the American public. For the American public to be willing to support such an agenda, two conditions are vital. The first is a belief that the people running the country know how to manage it frugally and effectively. And the second is that incomes at least rise somewhat. And that takes me back to the first point. If we are reaping the additional income from wise public expenditures, incomes will rise.

So for both a reason of competence and for a reason of contribution to economic growth, I would argue that deficits do count and it is important for the nation to try in sensible ways to improve our long-term fiscal outlook. Now, the question is whether the debate on that outlook is now being presented in an honest and illuminating way to the American public and whether it is being presented in a way that is likely to produce a constructive political outcome. I think the answer to that question is that it is not being presented in that fashion.

Let me give you three examples of what I’m going to call the prevailing expert view. The first is a short squib from an editorial that economic columnist Robert Samuelson wrote last year in the *Washington Post* and updated just this week in an editorial. He has characterized the deficit problem as a monster at our door, traceable largely to the overpromising of entitlements. David Walker, who is the head of the Government Accountability Office, has described the deficit, in even somewhat more colorful terms, as a fiscal cancer, attributable to massive entitlements interacting with demographic trends.

And finally, in an academic or quasi-academic book co-authored by Boston College University Professor Lawrence Kotlikoff and journalist Scott Burns, the authors portray what the nation will look like down the road if current policies are allowed to continue in what they regard as the unsustainable way that they are currently moving.

The point that I want to try to argue today is that that method of presenting the issue to the American public is not constructive and is likely not to lead to a constructive political outcome. I'm going to use some numbers, officially produced by the Congressional Budget Office [CBO] in December of 2005 and updated in late January of this year, in a couple of publications released by the Center on Budget and Policy Priorities.

The first numbers that I want to show you are the projections of the long-term budget situation. The bars indicate the size of deficits measured as a share of GDP in which one subtracts all expenditures other than interest on the public debt from revenues. The excess of expenditures over revenues – excluding interest – is projected to be small currently, but then grow at an enormous rate as we move through the first half of the century. Now, why do those numbers go up?

The three quotations that I presented just a moment ago would have you believe that this growth is attributable to the general problems of entitlements, which means Social Security, health care, food stamps, the earned income tax credit, and a host of other programs that are not quite as large as the ones I've just mentioned but cumulatively very significant. And something has to be done to rein those in. There's an element of truth, but it is a distorting picture.

This picture repeats the deficit numbers – the bars that go below the line – but the black bars that are below the line present a different bit of information. Suppose one excludes from these long-term projections all revenues as a share of GDP that are currently allocated to health care. So you subtract that from the revenue budget. From the expenditure side of the budget, you subtract all growth in health care spending on Medicare and Medicaid under the CBO projection that I think most people regard as most plausible. The projection shows that health care spending continues to outpace income growth by 2.5 percentage points a year, which is actually a little less than how health care spending has outpaced income growth for about the last 45 years.

When you have all revenues other than those currently devoted to health care and all expenditures other than the increase that is projected to occur for Medicare and Medicaid, the difference shows a gradual and small surplus. Let's call it balance to give the benefit of the doubt to what's going on.

The point of this story is that, first of all, the fiscal problem that is projected to occur is entirely a health care financing problem. The second is that in this projection, taxes are projected to remain a constant share of GDP. And there isn't any other long-term budget problem, aside from that emanating from the growth of health care spending.

And finally, there's another point, which I think Joe emphasized, and it is vitally important not to forget. Health care spending is organic, private and public. As a practical matter it is exceedingly difficult and highly inequitable to try to cut health care spending, publicly financed on behalf of who: the elderly, the disabled, and the poor. At the same time, is it possible to think that we would maintain health care spending for the general population as a whole? Yes, it is, if we renege on the commitment forged at great pain and with great difficulty in the course of the 20th century to provide roughly comparable health care to those groups, similar to the health care that the rest of us enjoy.

Now, I think that it is very likely that we are going to have to confront the private side of this rising health care spending as well as the public. And I want to give you three other pictures, again based on CBO numbers as modified by the Center on Budget. This is a chart showing the index of the growth in per capita income – this is GDP per capita, not any narrower measure – that underlies the CBO's long-term projections.

Let's suppose that we don't cut any public spending, and that Medicare and Medicaid keep on growing as I indicated in those projections with those very large deficit numbers. Let's assume that the expenditure continues, and we raise taxes enough to pay it all. What happens to income left over after you've raised taxes to do that? What this picture shows is pretty handsome growth also in GDP net of taxes. It goes up too.

But now let's go one step further and subtract from that number private spending on health care that corresponds to the growth in health care spending in the public sector. What that shows is that the income that's leftover for everything else in the economy, other than taxes and private health care spending, stops growing and before the end of the period actually declines. It's very difficult for me to believe that this kind of a scenario would be sustainable or desirable over the long haul. Action would have to be taken to prevent the stagnation of private, non-health care consumption and investment outlays in the economy as a whole.

So what are the bottom line morals of the story that I’m trying to tell? The first one is there is a long-term fiscal problem, and every smidgeon of it is health care. Secondly, there is no budget-related entitlement crisis, other than health care. Third, we have to pay attention to private health care spending along with the problem of rising public outlays and that this attention is important for three distinct reasons.

First, there is fiscal policy and yes, it does count. Second, there is consumption growth, an essential foundation for maintaining a liberal society. Third, it is also important that we deal with rising health care costs to assure that access and affordability remain general.

And the final point is one which I think cannot be stressed too much. There is no practical way to deal with rising per capita public health care spending unless we reform the health care system as a whole. And that means the health care system that affects us all. Thank you, very much.

MAX SAWICKY: Welcome to EPI. Thanks for sticking around for my talk. It’s better to follow Henry Aaron than to precede Henry Aaron. When Joe Stiglitz was talking about the melting of the arctic, I was thinking I could also call this, “Always looking on the bright side of life from Monty Python.”

In 1986, not too far before I came to EPI, we had our fist big petition of economists. The thrust of that was to bemoan the stagnation of public investment, particularly financed by the federal government, to call for some rejuvenation, and, by extension, to try to rehabilitate the role of the public sector and motivate its importance for economic growth.

Now, we have learned people that appear on television in bow ties and Phi Beta Kappa pins who like to say that the government never creates any wealth. So let’s look at a nation’s wealth for a second. These figures are based on numbers from the administration’s Office of Management and Budget, so you know that you can take them to the bank. They check and recheck.

This [graph] gives you an overview of the nation’s capital, the nation’s wealth. The part that draws the most excitement in the public debate is private sector investment in plant and equipment – the black portion of that pie chart or 12% of what’s called national wealth in the analysis done by OMB. Of course, you can see by far the biggest piece is education. Estimating the value of this is far from an exact science. In this case, it’s based on historic cost. You have a smaller piece, R&D [research and development], some of which is publicly financed and some of which is privately financed, as in education. And the actual extent of public facilities is about two-thirds of the private sector plant and equipment.

So public capital is significant, if only in terms of the size of the economy. And, of course, it's the government that not only created wealth, but also financed a good bit of nearly every other piece of that pie chart in one way or another. So this gives you kind of a rough sense of the proportions of the assets, tangible and intangible, which are at least part of the basis for economic output.

Now, here is the rationale for public investment. If you suffered through an economics course, you were fed the rationale for public goods, which go to the unlikelihood they'll be provided adequately or at all by the private sector because it's either prohibitively costly to charge prices for them or because people cannot be excluded from the benefits of the good. If it's provided to one person, everybody, in effect, gets all of it. For example, if we defend half the nation from threat of some outside invader, in effect, we're defending everybody.

Now, where does investment come in? Well, public investment is providing for public goods in the future. If you think about that pie chart, the biggest pieces were education and the actual physical public facilities. The rationale for the public sector investing in those is tied in closely with the rationale for the public sector actually owning those facilities rather than, say, selling Yellowstone Park to Marriott and letting Marriott charge admission and otherwise run the thing.

In principle, almost anything can be privatized, but not everything should be privatized. Now, in terms of the potential benefits from public investment, I think the debate in the past has largely dwelled on economists’ view of what can measured in terms of the effects of gross domestic product on income. But I wanted to put first up on the list potential benefits that typically aren’t measured to households.

If the government builds a swimming pool and lets people swim in it, the benefits over time that it provides to people are not counted in gross domestic product. But they are certainly real and they could be important to somebody. So household benefits of any number of types potentially follow from public investment or public services in general, which often are not even considered in economic analyses that try to measure “in-go” and “out-go,” so to speak. On the more tangible side, there are benefits for public facilities, public investment, on the productivity in the private sector, and on output, which can be measured in terms of total output, the value of output, or value added.

One piece of that is actual profits to business firms. Along with that is how that extent of effect on profits leverages investment by business firms and improves businesses’ willingness to do their own investment, in effect spinning off from the public impact. Now, there are empirical studies on this, many of which come out looking very good for public investment. There's some dispute about the magnitude of the effects and even about whether there's any effect at all.

But on the whole, I would say the results of the research suggest that this is indeed worth considering. The specific investments, of course, have to be looked at in terms of their rationales. But, in general, the agenda here needs to be returned to. We were told about a bridge to the 21st century in 1996. In the '92 campaign, we heard about putting people first. And the consequence of that was not a great improvement in the commitment to public investment. Now we may have a chance to revisit this. So for these reasons, it's worth looking at.

The last thing is the regional effect. We actually published some research on that by Tim Bartek, who is very well regarded in this area. He found effects that were larger than he believed, but they were positive and significant. You have federal aid to state and local governments that leverages investment states wouldn't necessarily undertake to the same extent because the benefits spill over from one state to another. A state itself doesn't have the incentive to provide benefits to other states. So there's a case in that sense for federal leveraging of some state and local efforts. And, in fact, a lot of public capital, the physical part, resides in state and local government in the form of infrastructure.

Now, what's been happening with public investment? Well, there was a growth in public stocks in terms of the absolute amount in the post-war period through most of the 70s, which coincided with the growth of other social spending. I think we have Richard Nixon to thank for being one of the greatest social spenders in history. After 1980, that growth stopped. Public capital stocks were more or less flat relative to GDP, which means they grew, but not more quickly than GDP.

[This chart] shows investment flows year by year. The blue portion is federal structures and does not include the intangible stuff, like the education and R&D. This is more of the bricks and mortar, which is much more easily measured. We have federal structures, which you can see are not a big deal in the grand scheme of things, but that doesn't mean any particular one couldn't be very important. Just ask people in New Orleans. We've got state and local structures in which a great amount of that involved highways and related mass transit.

The equipment and software is relatively small compared to the rest of it. Let me go back to the trend. You can see that obviously it fell off a lot in the 70s. Here's the federal spending on physical capital, which sees a bit of a renaissance up to the 70s and then a flattening and some stagnation compared to GDP. There's investment in training. We have this anomalous increase under the Republican control of the White House and Congress, which is now threatened by extension of the tax cuts and things that Professor Stiglitz mentioned, including the diversion of resources to military.

What are our priorities? Whenever I give a list, people assume that I'm ranking them. I'm not. But we do put our favorite one first because that seems to be overwhelmingly validated in research in terms of the benefits of public investment. One of the important papers in this was by James Heckman at the University of Chicago who pointed out the important benefits of expanded investment in early childhood, not only for economic growth but for equity. Our next speaker will go into that in more detail.

Other things I'm very pleased to have anticipated include sustainable energy, which involves the mundane matter of human survival in terms of global warming, the national security implications of not having to rely so much on Middle East energy, and the benefits of environmental preservation and improvement. On health care, my former boss Lee Price liked to raise the importance of finding ways not to simply provide more health care innovations, but provide it more cheaply.

Can we afford this? Well, right now the present state of non-defense investment is very low. The federal budget is zooming in on $3 trillion a year. And the latest non-defense is a relatively small piece. Ramping that up significantly is relatively cheap at the moment in the context of the federal budget. If we transfer money from the military as was suggested, it's obviously not an issue at all in terms of deficit or taxes. So I think the affordability is not in question.

By contrast, I think the benefits of this are often compared to private investment. The importance of private capital tends to be inflated in the public debate. Sometimes it's compared to public [capital] as if some lord of the economy could switch a dollar from one to the other, which, of course, is not the way things work at all.

In terms of looking at the future, we need to, as Professor Stiglitz discussed, think of this investment as yet another form of saving. The only way to save is not just reducing debt, but it's also diverting resources to facilities and to capital that provides for the future. Thank you very much.

JOAN LOMBARDI: I'm delighted to be here to talk about an issue where we have surprisingly increasing bipartisan support growing. And I have as my title, "Science Benefits and Common Sense." I added common sense at my own peril. But I do think it's important for us to recognize the importance of early investing in very young children as also a common sense issue. It's unusual for me to be speaking about this. More and more what we're seeing across the country is economists and business people talking about this, but fewer and fewer child development people because other people are making our case.

I have four messages. If we're serious about shifting the odds for at-risk children as everyone is talking about education reform, we need to start early. Young children need good health, strong families, and positive early learning experiences. There is no magic bullet to assure that they'll succeed in school. To reach these goals, we have to increase investments with at-risk kids, beginning at the prenatal period and continuing through school entry. And these investments should be followed by improvements in the quality of K-3 education.

That’s in essence my message. I’m going to go through a series of slides fairly quickly, starting with what the science says. And here I’m talking about basic research on health, behavior, and learning, which have interestingly come together to tell us that it is the interaction of what we’re born with and the early experiences that shape brain architecture and responsibility. We’ve had a lot of publicity around brain research in the mid-90s. And it’s these domains of development – social, emotional, cognitive and physical – that really result in those later impacts on health behavior and learning.

It’s no secret that there are some key elements that influence those outcomes, including poverty, prenatal and early health care, nutrition, parent-child relationships, parent sensitivity, maternal education, and early learning experiences. Fortunately, along with that basic science, we’ve had a series of robust experimentally designed studies that have shown us long-term impacts. We have so many that it would be hard to go through them. I’m just going to put two of the most famous ones up there.

One is Abecedarian, a control group study done in North Carolina that showed impacts in special education, grade repetition, high school graduation, and four-year college. This pattern is being repeated over and over again, not only in this country, but around the world. The Perry Preschool Project is probably the most famous and similar to Abecedarian. Although Abecedarian was birth to five and Perry was preschool age children only, both studied low-income children. If we continue to look at the Perry findings at 27, they found earnings benefits, home ownership benefits, and fewer people on welfare at 40. The economics effects increased with earnings, employment, and more people saving.

So these are very robust findings that have contributed to several of the economists around the country talking about the cost-benefit ratio. This is from Art Rolnick and Rob Grunewald from the Minneapolis Federal Reserve, who talk about a 16% rate of return on investment, and a 12% public rate of return on investment. And they are famous for saying that this is better than what you get when you invest in a sports stadium. That is something we should talk about a lot here in D.C.

Peckman was referred to before and this is his chart on human capital with rate of return, again indicating the importance of investing early. So that's kind of the science and the benefits from the economic perspective. Let me turn to the common sense part a little bit. This is the status of children in the United States by income. Forty-four percent of children under the age of three are growing up in low-income families. Two-point-six million children, or one out of five, are growing up in poverty. Similar numbers at three and four get a little bit better as you get older. But it's still pretty troubling.

If we look at an Economic Policy Institute study on kindergarten entry on math and reading by SES, the picture is pretty clear with the lowest socioeconomic group doing the poorest upon kindergarten entry. It's very difficult to make up this gap if you don't address it early, no matter how much we try.

If we turn now from what children look like to what's happening in families, this is the number of young children spending time in some type of non-parental care on a regular basis. Look at that, 82% of four-year-olds spending time in care on a regular basis, and more than half of the children under three. I don't think the country's really caught up with what's going on out there.

If you look at percentage of income paid for care, higher-income families pay about 6%. These are Urban Institute numbers. Very low-income working families pay a quarter or more of their income. When you ask low-income families why they're not saving, it's because they're paying for their child care in a basically private market.

If we look at what's happening across the country, the good news is that we are seeing some state investments in early childhood. But they're still far from meeting the need. We are seeing states invest in zero to five, home visiting, Head Start, and pre-K, while public/private partnerships emerge. In 2005 to 2006, 38 states invested about $3.3 billion in pre-K, almost serving a million children while the numbers of four-year-olds have grown. In fact, the number of three-year-olds has been relatively stable, and this is some new data that was just released. And moreover, the quality across the country varies significantly. If we look at federal policies, I think we can really be clear that they are failing very significantly to keep up with what we know about the science and the benefits of early development.

We have too many families still not covered by family and medical leave. Of those families covered, if you ask the majority of them why they're not taking family and medical leave, you know the answer. It's because they can't afford to take it. Head Start, despite all the research that we have, only serves about half of eligible children. And eligibility is at the federal poverty level, which is very low given the fact that the poverty level hasn't been adjusted for years and doesn't take into consideration child care costs.

Early Head Start, which was started in the mid-90s, serves pregnant women and children under three – an important investment only serving about 3% of the eligible population. We can do better than this. The primary child-care funding stream in the country serves only one in seven eligible families served, and there are very limited investments in quality services. This is from the CLASP [Center for Law and Social Policy].

With federal funding in recent years, what we see is a decline in the number of children projected to be served. We basically had flat funding to low-income working families over the last six years. We have not been paying attention to this issue here in Washington. That's clear.

If we look at current federal and state funding, and Head Start and pre-K child care, we have different worlds. I'm sorry for this. We have an education history. And we've had a child care history. We know they should come together. They haven't yet in policy. We're spending about $10 billion on Head Start and state pre-K, and $6 billion of that is federal. We're spending about $11 billion total federal and state on child care subsidies that assist working families and, remember, I said only one out of seven eligible are served. We're spending about $3.5 billion through the tax system, through the child and dependent care tax and DCAP [Dependent Care Assistance Plans].

How much do we need? There have been three recent cost estimates done. One done by Julie Isaacs looks at if we invested primarily in early education for three-and four-year-olds and made some investments around very minimal home visiting. Her estimates are that we'll need about $18 billion in additional investments, $20 billion by the year 2012, and additional amounts for infancy.

Mark Greenberg has also done a paper looking at the next steps for federal child care policy, proposing a guarantee. Remember, we used to have a guarantee for child care assistance before welfare reform for those on welfare and for families transitioning off welfare for at least a year. We lost both guarantees, something that's very rarely talked about when people reflect back on what happened during the welfare years.

We all think we shouldn't go back to that policy, but we should guarantee some level of support for hard-working families below 200 % of poverty and some quality investments. The third cost estimate was done by Jens Ludwig and Isabel Sawhill. And I think this is probably the most comprehensive. It looks at what would it cost if we invested in eligible children using the Abecedarian model, the birth-to-five, high-quality model that was tested in North Carolina from the early 70s. They were calling for about a $40 billion investment phased in over 10 years and renewed direction for Title I to focus on the early grades.

It's clear to me that we should be at least tripling our investments. And again, I'm saying investments because I, and many economists, think they will result in benefits. We should be expanding FMLA [Family Medical Leave Act] and providing incentives to states to provide paid leave. California's one of the few states that have moved in this direction. Other states are using other mechanisms. But we should be doing more of that.

We should be assuring access to quality health care. We heard a lot about the cost that we're seeing in health care not on the young children side. We need to change that. We need to assure that every child gets a developmental screening. We need to be investing in Head Start, with a particular focus on early Head Start, especially as the states invest in pre-K. The federal investments in the early years should be the direction we're going.

We need to transform child care assistance, as I think Mark recommended, to a guarantee for families below 200% of poverty. That’s about $36,000 a year. And we need to provide a serious new infusion of investments in a variety of things, including parenting supports, quality improvements, birth-to-five, pre-school, and family literacy. I love that Joe Stiglitz talked about Sweden. We sometimes try to avoid pointing in that direction.

If I showed you a chart of how they invest and where their investments are, I would point to the tremendous amount of investment they do in the early years of life, both in health care and quality full-day care starting at infancy. So that’s my message. And I’m hoping that over the next few years, we’re going to begin to see this kind of investment and we’ll see this debate in the upcoming debate of domestic policy. Thank you.

Question and Answer Session

MISHEL: Now, we’ll take questions from the audience. I think the key point is to try to reduce this interim effect that has been developed around the notion of an entitlements crisis and focus it on the real problem, which is health care. And then we must raise once more the beginnings of the argument about the benefits for public investment.

DAVE HAKKEN: I'd like to address this issue of cuts in the entitlements. When you look at cutting Medicaid and not fully funding SCHIP, you've still got 9 million children that are uninsured. And basically, these are public health issue because there's a public health cost if you don't treat someone who is sick and they're young. Is there any way that you can actually change the debate so the debate is about the cost of not doing these things? And the reason I raise that question is because with a lack of the public health initiative, it just results in these chronic health conditions that consume enormous amounts of acute health care costs.

LOMBARDI: Well, I think that we're really interested in that kind of economic analysis, particularly on the health care side. Because we know that kids are not getting health screening, and we're not picking them up early. Our maternal and child health system is sorely inadequate, and so we're seeing those costs later on down the line. And I would encourage the economists in the audience to do a lot more looking at what that's costing later on.

MARK SCHMITT: Joe Stiglitz kind of alluded to the concept of a counter-cyclical fiscal policy in which you run deficits when times are bad and don't when times are good. And he seemed to be saying was that, given the precariousness of the economy for various reasons, now was not a time when one should be cutting the deficit. But by any standard measure of the economy, now would be the kind of time when you would not want to be running a deficit in order to be able to do so at some other time. I wonder if you can sort of bring that factor back into the discussion. I mean, if we're running deficits at this level with this kind of economy, what are we going to do when we are in a recession? And is there something about the way one would analyze the economy that would answer that question differently?

AARON: I understood Joe to be saying that he was concerned about the direction which the economy was going and that reckless turnaround in the budget could push the economy over into a recession. But let's stipulate that that's the case. And that argues for attending closely to current economic projections and measures of the tightness of the labor market as well as of inflation.

That said, I think that we would be better off over the long haul, assuming we remain close to full employment, if there is a gradual and measured shift in our budget in the direction of reduced deficits. I think that is a desirable objective on the grounds that it's better for us to own the stuff than for us to borrow overseas in order to pay for it. If we save now, our kids will own what we have bought rather than somebody else.

That's really where I end up. I think Joe is right that one does need to be cautious. We do have a pricked housing bubble. How much air is going to come out and how fast, nobody really knows. And it could have very adverse macroeconomic effects. So I think caution is in order. My feeling about the Bush tax cuts is somewhat like the bumper sticker that people in Oregon have, which is, "Thank you for visiting. Now go home."

The tax cuts that we had early in this decade were monumentally poorly designed, as Joe said.

But on the whole, even allowing for that, they did soften the impact of the recession because they did increase aggregate demand, inequitably to be sure. But whatever work they did is done. It's time for them to go. Thank you for visiting. Now go home.

SAWICKY: Well, I'm on the left. So I wanted to make the case for dissatisfaction. There's a few million people who have dropped out of the labor force since 2000. And that I think is an object of some concern. The lack of wage pressure is another indicator that the labor market is not all it could be. So in addition to the threats in terms of the future, I would make the case for stimulus at the present time.

Bill Dickens from Brookings wrote a paper sometime back that I like to remind people about, which is finding that there are relatively few points in our history when you could document wage pressure on the inflation. That says that the labor market was below its potential much more often than is ordinarily thought.

Now, the other issue here for me is the old principle about balancing the budget over the business cycle, which, of course, comes from Keynes and is a lot better than balancing the budget all the time or something worse than that. In principle, the deficit and debt can increase indefinitely. The analogy I use with people is rent. If rent is 20% of your income and your rent and your income both double, you can still afford your rent. If debt and interest grow at the same rate as the economy grows, that's sustainable indefinitely.

And you can find that that's not a fringe view. That's found in plenty of economists' writings. It's found in reports from the government accountability office and Congressional Budget Office. There's more flexibility on the spending side or the tax cut side for that matter than is allowed by balancing the budget over the business cycle, assuming you have the business cycle pegged correctly in the first place, which goes back to the reliability of narrowing your focus to the unemployment rate.

QUESTION: As I heard the elements in early childhood education, it related to the family members as a whole, and family support. And so I'm wondering if in fact as we discuss or look at social investments, we have to find some other new way of describing the issues. Because I keep thinking about how this is going to be conveyed to the general public. The success of any kind of change is the understanding of both the economic and the social investment and why. And so I'm offering it because I myself find it so complex to deal with. I mean, health issues can be delivered by the education system or in some other way. It's really more complex. And therefore, legislation gets to be put into stovepipes and that's some of the challenge. So I just raise it.

LOMBARDI: Well, just to comment on that. I used the term development because it's health and education together. And I think we have been simplistic in our approach to education to think that the family does not have an impact, and that what goes on in school doesn't have an impact. It's all interrelated because that's how development is.

AARON: Could I put in one point on the fiscal side again? It's come up a couple of times in the course of remarks that when – and we pray soon – the catastrophe in Iraq is brought to a conclusion, funds will be released because we won't be spending it fighting the war. I urge you not to count on it. And it doesn't matter who's elected president. We have burned up much of the physical capital that is essential for the United States to maintain military dominance in the world. And make no mistake, Republican or Democrat, that is going to be a goal of the next president as it has been of presidents from both parties until now.

Refurbishing that capital is going to be fabulously expensive. In budget projections that have been released by Brookings, the rule of thumb is that you knock out the war time supplement and you add back in virtually the same amount for refurbishing military forces. So at least for the next few years, regardless of what happens in the Middle East, we're going to have to find additional resources to pay for these good things we've heard about from Max and for early childhood interventions, as well.

BOB BAUGH: Max, I appreciate your comments on public investment and a number of categories. We've made massive investments in the military in this last number of years.

And the manufacturing sector of this country remains in absolute crisis as the monies have been depleted and as the work has been sent offshore.

And I think it's really important that we think in terms of public investment policy as you cited energy security. That is an investment that needs to be made. But it needs to be made in such a way that we encourage the innovation with these new alternative forms of energy to be done domestically so that we actually produce and build these things here and actually take advantage of the investment that's being made.

And as part of a broader strategic approach to industrial policy as we make public investments, we must think about how the money is actually spent and encourage it to be done so that it actually creates employment opportunities here. And it also creates new waves of innovation that become something we too can export to the rest of the world.

LOMBARDI: I second that. I think overall, it's really about wise investments. And I think early childhood is such a winner in this because we have such strong evidence. But a few of the slides that I took out of my presentation to keep it shorter were the economic analysis that we've been seeing emerge across the country about the contribution of sectors like child care and early education to the workforce, both with their contributing to the economy and the good jobs they're creating or potentially creating if we'd invest in them. Those won't be jobs that will be shipped overseas.

SAWICKY: Well, I agree with everything I heard. As was stated, the nature of these public facilities and services is obviously there's none here. You need people here to do the work of producing them or diverting resources to passenger rail and infrastructure of other types. So I think a push in this direction has that benefit. My only caution is that the first principle and rationale in terms of appealing to the broader public is that these things are worth doing for everybody, not just for the people doing the work.

RICHARD KOGAN: One of the underlying themes of this discussion was how seriously we should be concerned about deficit reduction – preserving surpluses should they occur versus the overwhelming need – and the obvious need for greater public investments. I think that if we in this room got to design the federal budget, we would do it right. The public investments that we need would take very high priority. But we don't.

There was a test case, a vote in the Senate on the budget resolution a little bit more than a week ago. An apparent surplus of $130 billion appeared in 2012 and a vote took place in the Senate on what to do with it. And the answer was that there would be $25 in tax cuts for every one dollar of increased investment.

So assuming that Joe Stiglitz is right and that every cost eventually has to be paid for, it strikes me that if we're going to do $25 in tax cuts for every one dollar in public investments, then we end up far behind in public investments and that we would have been better off if that vote had gone down and the Conrad principle of adhering strictly to a pay-as-you-go rule had been accepted. Comments?

AARON: Richard, I think you have done a genuine service in recalling us to the fact that we live in a town where bargaining and exchange of votes goes on as a matter of course. And that those of us who would like to see more of the kinds of things that have been discussed here frequently have to pay a very high price for that. A $125 billion surplus relative to some baseline in the public sector would mean somewhat lower interest rates, further growth of wealth here in the United States, and more capacity to do a whole range of things. One hopes that along with the bargaining we are able to avoid policies that concentrate that accumulation of wealth in just a very few hands. But there is the tradeoff that you described.

I was listening to "we need." "We need." "We need." I was thinking, yes, damnit, we should do. But saying we need doesn't make it so. We have to engage in the kind of bargaining that was described there. And for that reason, the flinty-eyed, green-bands-on-the-sleeve mode of counting pennies and being, if you will, more conservative in the management of the public purse has certain advantages.

LOMBARDI: Yes, and I think we need good investments. And that's what I think he's talking about, not just need that won't give return.

KOGAN: But doctor, let me challenge you a little on this. I think there's a set of ritual economic mantras that get repeated that in fact are not true. What was the number? $120 billion in 2012?

AARON: That was one example. It might not happen.

KOGAN: Which is an economy at that point of what? $12 trillion. It will make zero difference as an interest rate, whether you saved it or spent it or ...

AARON: Oh, absolutely. You won't notice it.

KOGAN: So making the point that if we had saved it, it would lower interest rates possibly is simply repeating a mantra that is not an economic reality.

AARON: That is not my motivation for favoring relatively balanced federal budget at high employment or better if possible. It is not for interest rate. It is for the two reasons that I stated during my comments. It means we own the stuff. And it means, therefore, that domestic incomes are growing a bit faster and the willingness of the American population to give a bit of that back to those who need it will be far greater than if their incomes are flat. And whenever they give something to somebody else, it comes out of their pockets.

SAWICKY: If we look at what is happening right now, I believe the House and Senate budget resolutions talked about raising domestic discretionary $14 billion over baseline in the face of this revenue surge that they also prescribe from expiration of the tax cuts and who knows what else. That tells me we may not be able to get the very good deal right now. But people making decisions right now are not really prepared to govern as the Democrats and we would like them to be. Alternatively, they might have come in there with an agenda that was well motivated for new spending initiatives that could capture the imagination and support of the public. And in that alternative reality, we would be thinking that we would have a different situation.

So, yeah. The way people think now and the way Congress behaves, which is, I think, largely influenced by what the public thinks about the budget and about taxes, is not satisfactory. And we're not going to expect a lot. Adopting a posture of budgetary austerity does not convince me that that is the road to motivating new initiatives that we would support. It's the motivation that has to be done sooner or later along with making the case for the revenue to finance that and I think all that requires a longer term process and people think differently than the way they do now.

MISHEL: Richard, that's a good point. I guess I would suggest that setting budget projections so you had a surplus was the error, and that there was a surplus of less than a percentage of GDP. What we've seen in the projections for both Bush and both Democrats in the House and the Senate is really a continued shrinkage of domestic spending relative to GDP – as you pointed out in your own work – to 40- or 50-year lows.

So it seemed to me that maybe the lesson is, why put a surplus out there for them to do tax cuts? Why not have it allocated to addressing the nation's needs for spending and aim for balance? Right now we have a deficit relative to GDP of less than 2%. Whether we get to balance or a half-percent of GDP deficit or a 1% of GDP deficit is not monumental in terms of the economy, you know.

And for the other priorities, I think Henry's right. It seems anyone who wants to be in government has to be able to show they can manage resources and that things aren't out of control. I'm not so sure that less is perfect balance as the aim. And so you can be fiscally responsible, manage the government, and allow more room for more domestic spending without running into the problem you've set.

SAWICKY: I'd just like to add quickly, percent of GDP compared to the public investment we're doing now is monumental in terms of the expansion.

BOROSAGE: Henry, you have last word if you'd like it.

AARON: I hope that the conditions change so that we get all of these programs. I'm a little skeptical. I worry about the impact of campaign contributions. I'll close with an anecdote. We have a Friday lunch at Brookings. E.J. Dionne is the emcee of the event, and various people come in. One of them was Tim Romer, a rather moderate-to-conservative Democrat. And I asked him the following question. He had talked about the fiscal problems and the lack of capacity to do much of anything. And I said, well, when do you think somebody will be prepared to stand up and say something slightly different from what President Clinton said when he said the era of big government is over? Instead, will somebody be prepared to stand up and say the era of tax cuts is over? And he was not prepared to say that. And as long as that environment continues, I think you've got the dynamic for what Richard Cogan described.

BOROSAGE: Thank you all. It's a pleasure. Thank our speakers.

(END OF TRANSCRIPT)