Second Meeting of the National Commission on Fiscal Responsibility and Reform
May 26, 2010
Dirksen Senate Office Building
9:30 am – 12:00 pm

Commission Members In Attendance:

Co-chairs Erskine Bowles and Sen. Alan Simpson (R-WY)
Executive Director Bruce Reed
Rep. Jeb Hensarling (R-TX-5)
Rep. Dave Camp (R-MI-4)
Rep. Jan Schakowsky (D-IL-9)
Rep. John Spratt (D-SC-5)
Rep. Xavier Becerra (D-CA-31)
Sen. Max Baucus (D-MT)
Sen. Richard Durbin (D-IL)
Sen. Kent Conrad (D-ND)
Sen. Judd Gregg (R-NH)
Sen. Mike Crapo (R-ID)
Sen. Tom Coburn (R-OK)
Ann Fudge
Andrew Stern
David Cote
Alice Rivlin

Also present:
Presenters Carmen Reinhart, Professor, University of Maryland, and Carlo Cottarelli, Director of Fiscal Affairs, International Monetary Fund

OPENING REMARKS

Mr. Bowles opens meeting
Sen. Simpson gives remarks
Mr. Bowles introduces speakers

- Professor Carmen Reinhart of the University of Maryland
- Carlo Cottarelli, Director of Fiscal Affairs at the International Monetary Fund

PRESENTATIONS

Carmen Reinhart Remarks

- Four parts to her presentation
    - The Global Setting – the stages of crises
    - Antecedents of crisis
    - The Aftermath of financial crises
    - Government debt
        - When does a severe financial crisis become a debt crisis?

        - What are the implications of high public debts for growth and inflation?
- Global setting
    - Crises:
        - Severe banking crises
        - Government internal debt crises
        - Government external debt crises
        - Inflation crises
        - Currency crashes
        - Stock market crashes
        - High crisis numbers at the end of WWII and into the 50s
    - Post WWII period – 50s, 60s, early 70s, up to oil crisis – was an unusual period of prolonged calm
- The antecedents
    - Leading indicators of crisis
        - Large capital inflows
        - Sharp housing and equity price run-ups
        - Inverted V-shaped growth trajectory
        - Marked rise in indebtedness
- Aftermath of financial crises
- Government debt
    - The true legacy of financial crises is government debt
    - Debt crises don't happen overnight – in Greece it was building overtime
- Links between debt and growth
    - Break down history into periods of where gross debt was either low, 30-60% of GDP, 60-90%, and 90%+
        - Can we see what growth was during those different stages?
        - What was average inflation performance?
        - At or above 90%, growth deteriorates markedly, with median growth rates falling by 1 percent, and average growth rates falling considerably more
        - Below 90%, there is little significant statistical difference
        - We are at 90% today.
    - For advanced economies, there is no statistical difference in inflation
    - In emerging markets, the difference is in both growth and inflation

Carlo Cottarelli Remarks
- Fiscal outlook in advanced economies
- Even before the recent European crisis, the debt level was rising It has been rising since 1975 (this is for G-7 economies)
    - Canada is the only country that hasn't had steadily increasing debt since the 70s. They brought it down by 40 percent in the 90s

- The possible recipe
    - The most important/critical thing is to eliminate the uncertainty about the future fiscal situation

    - The markets must be confident that a policy is not just for one year, but that it is a consistent policy
    - Stabilize age-related spending relative to GDP
    - Reduce non age-related spending
    - Raise additional revenues in an efficient and equitable manner

REPORTS FROM WORKING GROUPS

Mandatory Working Group – Discussion leaders: Sen. Gregg, Rep. Ryan, and Alice Rivlin

Sen. Gregg

- Experts in the areas of entitlements
- We intend to go forward
    - In the social security area, they are just trying to collect ideas, get as large a menu as you can possibly get, and then try to boil it until it appears
    - Actively seeking out all the different think tanks, a lot of groups have done wonderful studies on this, and they are going to make as comprehensible a list as possible
    - Erskine – there has been a lot of staff input and lots of cooperation – we have a good chance of extending the life of SS for 75 years, which would be a good goal
    - Simpson – no desire at all to punish people. But we need to stabilize social security.

Tax Reform Working Group – Discussion leaders: Sen. Conrad and Rep. Camp

Sen. Conrad

- Excellent first session, with presentations from Tom Barthold of SSA and Doug Elmendorf of CBO
- The most recent effort toward tax reform was 25 years ago come this Saturday, which lead to tax reform act of 1986
- We have a tax system that was structured at a time when America's competitive position wasn't something we needed to worry about
- Now, we need a system that raises revenue in a way that is fair and efficient, and we need to know our place in the world in terms of competitiveness
- We need to get as many options on the table as we can, from every philosophical stripe, evaluate them in terms of pros and cons, and see if we can't find some way to agree
- Clearly this is a difficult challenge

Rep. Camp

- We expect to get into greater detail on other issues, but we got a good overview of the tax system
- We spent quite a bit of time talking about revenue baselines, and that we are above the historical average of 18% from 2014 on

- We touched on corporate income tax
- We talked about the importance on non-corporate business income – the change in the structure of how businesses are formed has changed the levels of corporate versus personal income taxes

Discretionary Working Group – Discussion leaders: Sen. Coburn, Rep. Spratt

Rep. Spratt

- First meeting included a broad overview of discretionary spending, and how it fits into all spending
- CBO ad CRS both gave excellent presentations
- Non-defense discretionary spending is increasing in nominal terms
- Defense spending is increasing a lot
  - Nominal annual growth rate – 8.8%
- Cost of personnel has been going up considerably
- Defense spending has to be part of any realistic part of the deficit solution

MEMBER DISCUSSION

Rep. Schakowsky

- We focus on revenue and talk about spending cuts, but we don't talk about growth
- Our focus now needs to be creating jobs, not deficit reduction
  - In our zeal, we need to not move to a crisis mode in our focus on deficit reduction

Mr. Bowles

- The President gave us the goal of primary balance – 3% of GDP – by 2015, and that means we have to reduce the deficit by $240 billion dollars in the year 2015 – not BY 2015, but IN THE YEAR 2015.
- That would leave public debt at 75% of GDP
- What should the target be by 2020? Should it be 3%? Should it be 2%? 1%? Balance? What is the annual budget deficit gap?
  - 3% – we need primary savings of $470 billion in the year 2020, which will leave public debt to GDP ratio at 78%
  - 2% – $675 billion, 75%
  - 1% – $865 billion, 72%
  - Balance – over $1 trillion, 69%
  - Note: Cottarelli said gold standard is 60%
- Setting the right target will take some careful thought on our part
- It is essential that we as a group start thinking about where we want to be a decade from now

Sen. Conrad

- First goal is to stabilize debt at 3% in the near term
- But that isn't good enough, because, though stabilized, it is a debt that is too high
- Down the road, we need to be below 90% gross debt to GDP ratio

Ms. Rivlin

- Suggests we have both the gross debt and public debt numbers on each table
- We need to look further out, at least to 2030 in our trajectory
- We need a trajectory that has the debt coming down over time, both public and gross debts

Rep. Schakowsky

- As we make the suggestions for solutions, what may seem obvious – we need to look at the distributional effect – who is going to pay the costs? That will require some analysis, and we hope the Commission has all the info it needs to evaluate the proposals so we know what segment will bear the costs

Rep. Hensarling

- What we haven't explored is government expenditure to GDP ratios – historically, we have been at roughly 20% of GDP, we are at 25% today, and we are on a trajectory to be at 40%
- Looking at the alchemy of spending, revenues, and growth:
    - If we have double-digit economic growth, we could still not grow our way out of this
    - If we cut the entire discretionary budget, we only barely make balance
    - It is hard to escape the conclusion that everything will be necessary to solve the problem

Rep. Becerra

- It's important to make the distinction between correlation and causation when looking at debt levels versus growth
- The numbers are good for giving us guides, but we shouldn't pave this based on numbers but on what people need

Sen. Conrad

- We need to look out beyond 2015 and 2020, because what is critical is that overtime we get on a sustainable path
- We need to do far more than reaching 3% by 2015 – need to do more than stabilize the debt

Rep. Spratt

- It's important that we not get too prescriptive too soon – we should keep a comprehensive outlook for now

Sen. Crapo

- The reason the president created this Commission is because of his understanding that, intuitively, if we don't deal with our fiscal circumstances and mounting debt, we will pay a dear price – the ability to have the American dream

Mr. Cote

- Agree on a lot of the needs that have been expressed around the table, but without a robust economy, none of those needs can be satisfied
- How do we maintain a robust economy?
- 10 years out, we need to be running surpluses

Closing Remarks

Sen. Simpson
- We can't avoid the words of the executive order.
- Thanks for the patience, time, interest, good will, and good questions, and the hard work of the staffs
- Announcement of public hearing on June 30th, where Sen. Simpson and Mr. Bowles will hear from interested groups and individuals who want to give their input

Mr. Bowles
- June 9th, Discretionary Working Group meeting, 16th, the Mandatory Working Group, and then the 23 or 24th, the Tax Reform Working Group
- Next full Commission meeting is June 30, and afterwards, Sen. Simpson and Mr. Bowles, along with whatever Commissioners are available, will listen to the public at large and listen to what the public thinks the Commission should do

Chairman certification of the minutes:

Erskine Bowles