

## **Democratic Forum on the Economy**

### **“Addressing America’s Economic Challenges in the Wake of Hurricane Katrina”**

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Thank you for the opportunity to be with you today.

In my view, having been involved with markets my entire adult life, we are at a critical juncture with respect to the longer-term future of our economy, and the outcome at this juncture will be enormously affected – for good or for ill – by the policy actions we take in response to great issues we face. And in my judgment, we are on the wrong track on many fronts.

We have great strengths – such as our historical embrace of change, the dynamism of our society, our willingness to take risk, our relative openness to immigration, and our sheer size – and that creates the potential for a bright economic future. But, to realize that potential, we must meet many consequential and complex challenges, and failure to meet those challenges could well lead to serious or even severe difficulty at some point. The timing of that difficulty is impossible to predict – whether in the shorter-term or some years into the future, but the probability of difficulty and its likely magnitude increases with each year that we fail to address our problems, because those problems worsen, if unaddressed, with the passage of time.

With that, let me now focus more specifically on our challenges, which I tend to think of as falling within three baskets: our fiscal, current account and personal financial

imbalances; historic competitiveness challenges and our shortfalls in meeting those challenges; and a category I'll call other, including healthcare, energy, the excesses of our tort system and protection of the environment.

As to the imbalances, during the 1990's we recovered from 12 years of deficits and the quadrupling of the publicly held debt of the Federal Government to the point where by the year 2000 we had large current and projected surpluses. The 2001 and 2003 tax cuts, if made permanent and if the AMT is reformed, are projected by the CBO to cost \$4.0 trillion, including debt service, over the next 10 years and are at the heart of current mainstream forecasts of a 10-year deficit of about \$4½ to \$5 trillion, using those same assumptions. Ten-year numbers are highly unreliable, but the likelihood is as great that the deficits will be higher as they will be lower.

Moreover, by the end of the ten-year budget window, projected fiscal conditions become far more difficult, because the baby boomer retirements, and thus entitlements, begin to increase rapidly. The principal entitlement issue is the federal health care programs, which are projected to create longer-term fiscal problems of about five times those posed by Social Security. The Social Security reform program the administration seems to have been advocating would greatly increase deficits for the next 40 years, because the cost of private accounts is immediate and great while the savings begin later and grow slowly.

Also, as Hurricane Katrina has so tragically reminded us, the American people want government, in the context of our market based economy, to fulfill a wide range of purposes that markets by their nature can't and won't effectively serve, and a sound fiscal regime must include adequate resources to meet those needs, such as national security,

the requisite underpinnings for competitiveness in the global economy, law enforcement, and disaster relief.

As to the effects of fiscal ill discipline, virtually all mainstream economists agree that sustained long-term deficits will crowd out private investment, increase interest rates, reduce productivity, and reduce growth. Moreover, our fiscal deficits are particularly pernicious because they occur, uniquely to the U.S. amongst the industrial nations, in the context of large and increasing current account deficits, partly caused by our fiscal deficits, and a virtually zero personal savings rate combined with very high levels of household debt. And all of that greatly increases the far greater threat that both domestic and foreign markets begin to fear long-term fiscal disarray, and also become concerned about our currency because of that combination of fiscal deficits and current account deficits. Then, the markets may demand sharply higher interest rates for long-term debt and there could be a risk of a sharp downward move in our currency. Interest rates have not been materially affected so far, largely because of the large inflows of foreign capital, especially from central banks motivated by their own trade concerns, but that is not sustainable indefinitely. In addition, long-term deficits can have serious adverse effects on business and consumer confidence more generally.

In my view, the President and the leaders of both parties and both houses should come together and take joint accountability for making the extremely difficult decisions that must be made, with the focus on the most immediate problem, the projected deficits of the next ten years, and on laying the ground work for dealing with the largest problem, federal health care. (As an aside, the 2001 and 2003 tax cuts have a 75-year actuarial cost of 11 trillion dollars, while the Social Security 75-year deficit is estimated at 4

trillion dollars. Returning to Clinton era tax rates on incomes over \$200,000, plus retaining the estate tax, versus making the 2001 and 2003 tax cuts permanent plus AMT reform, would generate \$1.1 trillion over 10 years and \$4.0 trillion over 75 years.)

Let me now briefly turn to competitiveness. Large numbers of well-educated workers in low-wage environments, especially China and India, connected to the United States by real-time communication, pose an historic competitiveness challenge to us across a broad array of goods and services, with the latter newly including such activities as accounting, software development, legal research for law firms and reading x-rays for hospitals. There are no perfect answers, but protectionism would only make matters worse. The best path forward is to combine trade liberalization with a strong sense of urgency around a powerful domestic agenda to help those dislocated by trade and to promote American competitiveness, including public education, basic research, infrastructure and much else, with adequate government resources for funding and a sound fiscal regime.

As to my third basket of other challenges, let me just say that we need an energy policy that promotes alternative energy sources and conservation; healthcare policies that will constrain costs and broaden coverage; environmental policies that recognize our economic stake in a healthy environment; adequate measures to equip the poor to join the economic mainstream, and much else.

To conclude, we urgently need a renewed commitment to facing our problems and to providing the foundations for a healthy economy, and we must act now.