

**CENTER FOR AMERICAN PROGRESS**

**PROGRESSIVES AND THE NATIONAL DEBT:  
OPPORTUNITIES FOR SAVINGS: ENTITLEMENTS, DEFENSE AND  
NON-DEFENSE DISCRETIONARY SPENDING**

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MR. : If everyone could please take their seats we'll get going with this next panel, which is – you know, we've heard in general terms – well, we've heard in specific terms what the risks are and what the challenges are, and in general terms about some of the aspects that might contribute to a solution. Now we're going to roll up our sleeves a little bit in the next two panels and get more specific about some of the elements that might contribute to addressing our long-term deficit problems.

And at first – the first panel is going to concentrate on opportunities for savings in the federal budget and after lunch we'll be having a panel – or during lunch, really – a panel on raising revenues.

To moderate this panel, "Opportunities for Savings," will be Sam Fulwood, who's a senior fellow at the Center for American Progress. Prior to joining the center, Sam was a Metro columnist for the Cleveland Plain Dealer, capping a nearly three-decade journalism career that featured posts at several metropolitan newspapers including as a national correspondent for the Washington bureau of the Los Angeles Times.

He also worked as business editor and state political editor for the Atlanta Journal-Constitution and as an assistant city editor, business reporter, editorial writer and Johannesburg bureau correspondent for the Baltimore Sun. Sam is the author of two books: "Working from the Dream: My Life in the Black Middle Class" and "Full of It: Strong Words and Fresh Thinking for Cleveland."

Sam has been a Nieman Foundation fellow, an Institute of Politics fellow at Harvard University and a presidential fellow at Case Western University. So I'll turn it over to Sam. Thank you.

SAM FULWOOD: Thank you, Michael. It's been a long morning so far and I know people want to get to lunch, but I do think that just judging from the conversation prior to this panel there's a lot of interest in what we're going to talk about. So bear with us. I think it's going to be pretty exciting and we'll go through it rather quickly and entertainingly, I hope.

This panel will address three of the largest areas of government spending: entitlements, defense and non-defense discretionary spending. The massive size of this spending makes them the obvious targets for savings to address the deficits. These areas are also the places where the nation has important obligations that must be respected, especially as they affect the elderly and the disabled. And of course, national defense is critical to the safety of all of us. So you can see why this is a thorny problem.

To help us figure this all out and to address these issues we have on this panel: David Cutler, the Otto Eckstein professor of applied economics at Harvard University; my colleague,

Rudy deLeon, a senior vice president for national security and international policy at the – at CAP; and Peter Diamond, a professor at the Massachusetts Institute of Technology.

We'll begin with Rudy. And then after Rudy, Peter will speak and then David.

RUDY DELEON: Thanks, Sam. Well, defense. Looking at – wouldn't be a conference on the budget without looking at the largest piece of discretionary spending, which is the Department of Defense budget.

I've got some charts that we're going to put up here but I'd like to cover four things: one, the cost of the Iraq and Afghanistan military operations and the fact that that cost has been put on our children's credit card; two, I'd like to revisit the budget tools that in the 1980s and 1990s produced a capable, deployable military and also balanced the budget. And I see Frank Raines who, as director of OMB following Leon Panetta, was always good at giving us good direction from OMB to keep DOD on the line.

So one, Iraq and Afghanistan; two, budget tools that were critical in the '80s and '90s. Then three, look at a series of critical issues in today's defense budget that make the dollars more difficult to access. And then finally, talk about sustainable security, a different way for America to interact with the rest of the globe.

So first, that first issue, Iraq and Afghanistan. Next chart, please.

From fiscal 2001 to 2009, in the most conservative calculation possible, the country has appropriated 941 billion (dollars) for Iraq and Afghanistan. There's an additional 130 billion (dollars) in terms of transition funds and additional supplementals proposed for 2010, so if you take the 2001 to 2010 that will total 1.07 trillion (dollars) for Iraq and Afghanistan military operations, funded through supplementals, all charged on the national credit card.

Now, about two years ago some in the House side suggested that there be a surtax to cover Iraq and Afghanistan. Now I think I'd approach that more as the Bush tax cuts expire. A portion of that revenue needs to be directed towards this legacy bill that's there. And interestingly enough, the one group most supportive of having the fiscal policy match the operational policy are the men and women who are serving in the armed forces today because one of the things that they often ask is, where are the American people on this issue?

Four reasons – five reasons for why our funding Iraq and Afghanistan need to be tied to the American people. One, readiness; we're obviously going to take care of the troops. Two, sacrifice; 1.5 percent of the society is making a huge sacrifice in terms of operational deployment. It would be good if the rest of the society could back that. Three, fiscal responsibility. And I'm speaking faster than my charts. We've lost the – essentially the dynamic of the internal budget debate as we fund military operations through supplementals which are really not tied to the budget deficit.

Q: Excuse me. Is your figure for the war alone or does that include the regular defense budget each year?

MR. DELEON: That's just the war fighting bill. Okay? I'm happy to ask (sic) questions if you just let me finish.

Four, there's the legacy issue that will have some cost that will continue after Iraq and Afghanistan. And then finally, governance: the tools to maintain fiscal discipline. So as the Bush tax cuts come off we're going to want to look and see how we can deal with the legacy costs of the Iraq war, important for a variety of reasons.

Now, from fiscal '88 to 2000 there were a series of defense budget tools that contributed to a balanced federal budget. In response to deficits Congress approved the Gramm-Rudman budget sequestration rules. There was the breakup of the Soviet Union and the downsizing of the U.S. military under the base force that started by the Bush administration in '91. There was the Desert Storm and there was a unique fiscal arrangement among allies so that there was actually a financial operational fund that covered the global contribution to the cost of the 1991 Iraq war. And then finally, a series of extensive government fiscal policies that promoted deficit reduction.

Now, here, this is the next chart. Let's see if we can get that one up. There you go. So this is essentially 1998 to 2009. And we start on the furthest – the left-hand column – and that's the height of the Reagan buildup. In constant dollars that's 538 billion (dollars). You can see 1988 the Gramm-Rudman sequestration starting to take effect. The fall of the Soviet Union and that Bush-Cheney budget is driving things down. Then Aspin for President Clinton did the bottom-up review which actually accelerated the budget reductions that were already in the pipeline. Gramm-Rudman generated the Cheney base force.

And so what you see in the '93 to '98 is really the balance – defense's contribution to the balancing of the federal budget. It's not quite on – adjusted annual. You know, 538 billion (dollars) from a – 538 billion (dollars) down to 358 (billion dollars) is a sizeable reduction in annual defense spending.

With the budget balanced – there were some bills that were due, largely on the military personnel side, but what you see is that in 2001 the final Clinton-Cohen defense budget was roughly about 3 percent GDP, 391 billion (dollars). It funded some new initiatives. And then of course you see the George W. Bush budget increases up to the current level of 734 billion (dollars) projected for 2009, a 516 billion (dollar) base for DOD operations with supplementals slightly above 200 billion (dollars) added in for 2009. So this is the budget environment that the new administration has inherited.

Now, in terms of what drives this budget – next chart, please – slightly different than the Reagan budgets that the deficit reduction program encountered. That what drives the current defense program is Iraq and Afghanistan requiring a larger ground force. One of the things that produced the budget reductions in the '90s was downsizing the force from 2.4 million active duty – 2.2 million active duty down to 1.4 million. So what's driving the current budget is we are recruiting more ground forces because of the high operational tempo and the wear and tear on military personnel.

Second, there's the O&M that will support readiness of these troops and the fact that during the Cold War most of our troops were forward-deployed at garrisons and now our troops are operationally deployed on contingency missions and so the O&M rates turned out to be much higher for operational missions.

And then the procurement system from weapons, like the F-22 that was mentioned earlier, to the medical contracts. And as the civilian sector reduces spending on medical insurance and medical benefits, more and more persons are cascading into the DOD system who are eligible for it, increasing consumption and increasing cost.

So those three items are driving the defense budget. And as we look for savings, those have to be at the heart of the debate.

Now, there's a budget review going on in the Pentagon right now called the QDR. And so what are the key issues there? Military personnel and O&M are at the top. You've got to look at the cost growth in systems. Congress had the debate on the F-22 earlier this year but the fact is, is that current generation systems are so much more expensive they can't possibly replace on a 1 for 1 basis. If you look at the number of C-141s that the country had deployed for air lift versus the C-17, we're at the end of the C-17 program and we've only bought about a third of what the total force was. That's essentially just the intergenerational cost growth between systems. And then the historic underestimation of new technology as it's inserted. And then the fact that the default position for foreign policy has been to deploy U.S. forces.

And so all of these things have created a different global – set of global security challenges that the QDR has to focus on.

So as we look at that budget chart from the 1980s and 1990s, the first step is to re-establish those tools that really force tradeoffs, that require accountability and that move us away from this concept that we can take all of the costs and put them on a credit card for the next generation to focus on.

Now, I talked about the fact that we've gone from a Cold War where we were forward-deployed to a current environment where we are operationally and contingency deployed. And so this is one of the things that's driving the defense budget and so my last chart is thinking about a model that the Center for American Progress has developed – Gayle Smith, my former colleague now serving in the administration – but the model was sustainable security; to use all of the tools that are available to the United States in the national security area, not just simply the defense tools.

And so when we look and see proportionately what the State department is receiving in AID, which is about 40 percent of that – 52 billion (dollars) – there is a view that if we can expand some of the capabilities that State has and make them and the Agency for International Development more operational, we'll be able to start taking the burden off of DOD and that we'll be able to start focusing on problems before they're of the magnitude that they require U.S. troops.

One of the things you can do is begin by looking at the national security budget as an integrated piece instead of as stovepipes. And you can see clearly from this chart that a lot – that a bulk of the dollars, by far, go to DOD. And 50 percent of the DOD dollars go to military personnel or military operations.

So as we look at the deficit, I've not put a number on the table – right now spending is about 4.5 percent of GDP if we include the base bill plus supplementals. So I think challenge one will be to get it into the range of about 4 percent. And then challenge two will be to have budget tools that will help us make tradeoffs, make hard choices, and then also develop tools elsewhere in the federal government that can start to take some of the burden off our men and women in uniform who are serving.

MR. FULWOOD: Okay. Peter?

PETER DIAMOND: I'm going to attempt to control my own slides once we get started. I'm relieved that I'm still being allowed to speak with both Bob and Paul, suggesting that Social Security problem's too small to even worry about – (inaudible, laughter). Nevertheless, it seems it's worth doing and part of it is compared to Medicare and Medicaid and health spending generally. This falls in the category of low-hanging fruit.

Do I –

MR. : Yes. On the circle, the bottom-left button.

MR. DIAMOND: I don't know that we're there yet. I don't think I've been loaded yet. Well, enjoy – you could be looking – ah, there we go.

This is the starting place for talking about Social Security. It is the annual report of the trustees, the cash flow projection year by year. That roughly horizontal line – a little bit out of range, I guess – is the revenue coming in relative to taxable income. It's not perfectly horizontal because some of the revenue from taxing benefits goes back to Social Security, but it's pretty flat at the payroll tax rate.

The line that's first solid and then dotted is what it would cost to pay all the benefits in the benefit formula, ignoring the fact that the trust fund runs out of money at the place where the solid line drops down, because by law benefits can only be paid out of the money that's there.

The very sharp rise that comes first, no surprise that's the retirement of the baby boomers. And beyond that, after they've died out we have a little dip. The steady rise in the long-term is the expectation of improving mortality going on indefinitely in Social Security terms in 75 years. That's long enough. Things beyond that may not make a whole lot of sense. So that's there.

How big is it?

What am I not – what am I not pointing to? I'll just do it off there. That's quicker.

There, with the two horizons that get presented 75 years – which to my mind makes sense, long enough to show the patterns developing. Beyond that we're in science fiction land. I don't know that it makes a whole lot of sense to worry about. But infinite horizon is there. And I have the deficit there in three different terms.

The \$15.1 trillion figure is what you would use if you wanted to tell people this is an unbelievably big problem. It's so big we've got to do something radical. And the 0.7 percent of GDP is the way to say, this is such a small problem, let's not worry about it. My favorite number, and the one that makes sense, is that 1.9 percent. It makes sense first of all for being 75 years. It makes sense secondly because the program is keyed off payroll. Benefits are determined by earnings subject to tax. Revenues overwhelmingly are coming in out of payroll. Any fix we're going to do will still involve a system tightly tied to payroll. So that gives you this size of the problem.

Now, some people think, well, that's just one projection. And that's all it is, one projection. What happens if we make the argument that somehow this isn't going to happen; we really don't need to worry about it? Well, both the Office of the Actuary of Social Security and CBO do stochastic projections. They may not incorporate everything you think ought to be incorporated, but it's meant to give you a much broader picture of the different things that might happen.

And this is my favorite chart because it makes the point that you can't think in terms of a single projection; you've got to think of all the different things that might happen. And this is the probability of the trust fund hitting zero (dollars), and under current law – which obviously we get changed the night before, if not earlier – the checks don't go out at that point. And you can see the probability – they don't say 100 percent, but what in life is 100 percent? But the probability of Social Security running out of money is just way too large for anybody to feel it's okay to ignore it.

So then the question is, if we're not going to ignore it – because the problem is real – is it good to address it sooner rather than later? And I want to answer that just within the context of Social Security. From the previous panel, maybe if we get this passed that will satisfy the financial markets a little bit and this and that. Let me just focus on Social Security.

The longer we wait, the larger the annual changes need to be to fix that gap when we run out of money. So doing it sooner just makes it an easier problem and on the policy side means the sizes of the impacts on people are going to be smaller.

Secondly, proposals for reform, including the ones that came from the commission appointed by President Bush, normally include improvements in social insurance for the vulnerable as part of the package. Doing something significant for vulnerable groups without restoring actuarial balance seems to me to be a total political nonstarter. So if you'd like to do something for low-earners – long career low-earners – for widows, for orphans, for the disabled, you know your only chance of doing it is packaging it along with restoring actuarial balance.

And the third reason is it's going to be a much better policy if it's done by people who think social insurance is a good idea. And the people who think social insurance is a bad idea have as little say in the process as possible.

Let me remind you, President Clinton in the state of the nation address wanted to put all of the additional resources from the surplus into Social Security. Remember his slogan: "Save Social Security first." In contrast, when President Bush set up his commission one of the criteria that they were supposed to satisfy is no payroll tax increase. If you think Social Security matters, you've got to believe Social Security needs more resources. You cannot politically – and I would think it would also be wrong in terms of policy – do all of it on the tax side. So what's needed is to get a mix of revenue increases and spending cuts that is an attractive mix. And this is also the view in the eyes of the public.

Not working. What – try this one. Hit some other button first.

(Pause.)

MR. : Let's get the professional.

MR. DIAMOND: Okay. Well, let me go on. What should be up there is a survey by Alan Blinder and Alan Krueger asking people, very neutral terms: Here is the Social Security problem; how do you think we should fix it? Mainly by raising taxes? Mainly by reducing benefits? By relying on both? And overwhelmingly people wanted to not solve the problem just by cutting benefits. So President Bush was really out of step with the American public, but as you can see there the payroll tax is definitely part of the solution but doing something on the benefit side is also part of the solution.

The part that absolutely baffles me is that 22 percent. I think of those as the people who are waiting for the tooth fairy to come. (Laughter.)

So the point here is as a device for raising taxes, Social Security is a wonderful device. When you ask people, do you think we should raise taxes and send more people to Washington, the answer is an overwhelming no. If you ask people, would you like to raise taxes and earmark that money to finance something you really care about, the answer is an overwhelming yes. And Social Security is something we care about and Social Security has this beautiful structure that it's money in and money out. We don't really know how to fix all the problems in medical care. That's not putting down David; he has some good ideas. But everyone understands money in/money out. You want the money out, you've got to put the money in.

So in terms of what is happening with your tax dollars, particularly if you convince people or show them that the administrative costs are really tiny, this is a place where people are really willing to go along with it.

So what kind of plan makes sense? Well, you can roll your own. There's the Web site. A very large fraction of the ideas have been floated are reviewed on that Web site telling you how much of the deficit they take care of if you look at.

If you don't want to roll your own, there's an absolutely fabulous book – (laughter) – with a wonderful plan for doing something about it, and let me tell you a little bit about it. No numbers, but just the ideas because part of what we did in putting this together was begin by identifying why it is we have a problem with Social Security. And one of the pieces – and baby boomers are not the answer to that because obviously we've known they were coming for a long time. There is no surprise in the impact of the baby boomers on the Social Security projection.

The first is life expectancy growing, as I pointed out in the first slide. And a number of countries recognizing that this is an ongoing issue, one, have automatic adjustments for life expectancy. And that seemed to us to be a very good idea. But we wanted to do something rather different. It was a good idea for one of the plans from the Bush commission. It is the way the system works in Sweden and a number of other countries, but in all of those cases what they want to do is cut benefits – cut annual benefits so that lifetime benefits don't change so the system goes on costing the same. We thought that was a mistake.

We think as we go on and people live longer your ability to work, your ability to enjoy working and your ability to be better off are going to be out there. So it's not going to be a constant fraction of life expectancy we should expect people to work on. And if people are going to be retiring a bit earlier than that, then we need more money. So we proposed half of the increased costs coming from life expectancy on a year by year basis would be offset by reducing benefits and half would go by raising taxes.

Having future payroll tax rate increases as part of the package is with a longstanding Social Security tradition. From the beginning of Social Security right through to 1990 there was always a future payroll tax increase on the books. It's so much easier to legislate tomorrow's tax rate increase rather than today's. And of course, there was all sorts of posturing it's not going to happen while I'm in Congress, and occasionally the money wasn't needed and they would delay the start of it. But they never took them away. It would be great to have something like that back again.

Since the last reform there's been a dramatic increase in earnings in equality and we propose to do two things about that. One is to raise the maximal earnings that's subject to the payroll tax so we're back in roughly the same position relative to total earnings – we didn't even go all the way there – that we had back with the last reform. And secondly, a more progressive benefit formula as part of offsetting that.

The third element is the legacy cost. Now, Social Security was extremely generous to our parents and grandparents. If it hadn't been for that, certainly old age assistance would have been vastly larger; the living standards of the elderly would have been vastly lower. This was really something aimed at the whole country. And as a result the Social Security trust fund, as big as it is, is a lot smaller than it would have been if we hadn't been generous. So how do we want to share out that cost associated with history?

The first element is universal coverage. There are a huge number of state and local workers, including all of those in Massachusetts where I come from, who are outside Social

Security. They are not contributing the roughly 3, 3.5 percentage points of the payroll tax that are really just making up for the interest we're not earning on the assets that are not there. And so there's no reason that the state and local workers who had parents and grandparents – I think they all did – (laughter) – and a lot of them were covered by Social Security, should not bear a fair share of that.

And secondly, when spreading this burden around it seemed to us capping that 3 or 3.5 percent that people are paying at the limit that makes sense for paying people benefits – the taxable earnings base – is not the fairest way to spread the costs. So we proposed to tack on a tax like the Medicare tax with no limit on the earnings base but only at 3 percent. You don't get benefits for it; you're just picking up your share of having been good to your parents and grandparents.

Doing those two things and the other elements up above get us a long way towards solving the problem but they don't get us all the way there. And so our proposal for the rest – think of it as political compromise – is whatever is left you split 50/50 between tax increases and benefit cuts and you phase them in slowly over time as needed. Do all of that, with the kind of numbers we fed in, there's money available for the various groups for whom Social Security should be enlarged and not shrunken.

So what happens if we do that? Well, the trust fund – these are the numbers back in the book. It's a couple of years out of date. It wouldn't look all that different. Instead of the trust fund tanking it comes – builds up faster, comes down dramatically of course as the baby boomers retire; but by phasing in all of these changes slowly, it turns around.

Now, right now as a political matter, obviously individual accounts are dead. Nobody is going to stand up and say, this is a great time to drive the American workers into the stock market. But if we don't do anything about Social Security and the reports of its problems get steadily worse as that running out of money day comes closer, they will be back. It's like a bad movie. Individual accounts as an idea keep coming back. And I want to leave with you a couple of points about why that would be a disaster relative to the federal debt that this program is about.

A lot of economists like individual accounts but what they like is new taxes which we can feed into individual accounts as a way of raising national saving and also raising retirement benefits. But that isn't the way the political process – at least in the recent times – worked. The plan put forward by President Bush had people eligible to shift their payroll taxes, part of it, into their individual account rather than go into the trust fund. And then later on they would make it up by getting smaller benefits, so that on an individual basis the trust fund was more or less held safe relative to that diversion. But of course, the diverted revenue comes long before the benefit offsets and as a result the Social Security trust fund hits zero a lot sooner than without individual accounts.

Well, what do we do if that happens? Well, nobody's going to say, well, then we'll cut all of these benefits a lot earlier. That's what we've accomplished with the individual accounts. So the typical proposal with individual accounts: tap the Treasury to make up the gap. And

some people would say, and of course we'll take that out of that – everybody's favorite line in the budget, "waste, fraud and abuse."

If you think, on the other hand, more plausibly that it'll come out of additional borrowing, then of course we'll have more national debt outstanding to deal with. And these are numbers from the middle of the Bush administration – no stimulus in it, nothing like that – that – let's look at how much different plans that have been evaluated by the Office of the Actuary would add to the federal debt relative to GDP by carrying out the plan.

And at the very bottom you see two plans – the late Bob Ball is the other one there – that don't have individual accounts. And by addressing the shortcomings putting Social Security on a good trajectory by 2050, they've knocked about 25 percent of GDP off the debt-to-GDP ratio. Now, compared to Medicare that's peanuts, but I think 25 percent of GDP maybe counts as something worth paying attention to.

If you look at all of the plans with individual accounts, they all require additional federal borrowing in order to make them work. And some of them would blow you away in the sense that that's more than we think the federal government could borrow all by itself, even if there were no other deficits.

So let's get on Social Security. Let's remember that the public is going to be very happy if we really fix it and stop people from worrying about it. And a New Yorker cartoon is the way I like to end these talks. The guy on the desert island – a little hard to read – says, "Forget about me. Save Social Security." (Laughter.)

MR. FULWOOD: Way to end on that one. Peter said that David had some good ideas, so let's hear those good ideas.

DAVID CUTLER: Thanks. I will follow Peter and talk from up here initially.

With all the curve bending I do these days I feel like I should be taking more yoga classes, actually. (Laughter.) So I will try and give you a few contortions – thank you – about yoga.

I want to start off with a tale of two charts. So the first chart, this is I think CBO's favorite chart, at least if you judge by the number of times that CBO directors have shown the chart within, say, the past 24 hours. (Laughter.) So you can see federal spending under the alternative scenarios, the one that they think is more realistic, where basically the vast bulk of the growth of federal spending is associated with Medicare and Medicaid, at least for the next several decades.

The red line is superimposed by me, which is the share of GDP that's accounted for currently by tax revenues. So this just shows you the situation that you find yourself in if you keep tax revenue constant and you have increases in federal spending, particularly on health-care programs.

Peter, I – they make a little bit of allowance for you in Social Security, but I suppose you're supposed to feel inferior as a result of this chart. (Laughter.)

And there's Doug Elmendorf smiling at his chart. (Laughter.) In fact, this is my favorite chart, which is federal health spending with and without modernizing the health-care system. So you can see without reform the increase in federal spending as a share of GDP. And then I've shown you what I believe can be accomplished by modernizing health care. And I suppose I have two choices: You can either think I look better than Mr. Elmendorf or you think that my chart looks better than Mr. Elmendorf. Either one would be okay for these purposes. But I want to talk to you – I want to talk a bit about what that would mean.

So there's no path to budget balance that doesn't go through health care and I believe that we can do a good deal to promote that. And what I want to talk about is the difference between those two lines, which is what does involve – what does modernizing the health-care system involve?

And so the proposition that I want to put forward is that we can make health care be a normal industry – and John Podesta stressed this this morning – a normal industry in terms of the amount of productivity growth. That is, prices should not rise but actually fall with progress over time and they should fall at roughly the rate of the average industry. And I don't want to talk about the most productive industries in the economy; I want to talk about the average industry.

I first want to say what is – what are the hallmarks of industries that are more productive relative to industries that are less productive? That is, what characterizes a normal industry in comparison to health care? And there are really I think three attributes of a good, well-functioning industry. One is that it uses information technology a lot. So it knows what it's doing, who's doing it, why it's doing it, how much it's spending doing it. This is what the best firms do. The firms that are not very good don't do it very well. Of course, in health care the most noticeable thing is that there's very little knowledge about what we're doing and why we're doing it or how well we're doing for it and so we wind up doing a lot of things that we shouldn't do. That's the first component is the right information base.

The second component is to have compensation arrangements that are in line with what you want to do. And people have stressed this again this morning, the idea that people get rewarded for producing value. And by that I don't mean short-term AIG version of value but I mean the longer term version of value which is providing the service that people want and doing so effectively so that compensation arrangements support that.

And then the third is that once you have the information and once you have the appropriate compensation you have people be empowered to make those changes. That is, workers – frontline workers – can do that, backed up by management, by CEOs who are saying this is really the goal of the organization.

If you characterize all of the successful firms, well, they all do things differently. They all have these characteristics; that is, they are all information-based, they all have compensation

systems that work and they all have workers who are doing things right. In the famous example of Toyota, any worker can stop the production line. Why? Because they know what they're doing. They have the right information and they have the right incentives to do so.

Just to show you how out of place health care is, this chart shows you productivity growth by industry over the past decade or so. You'll understand in a minute why I chose the past decade or so. And you can see the most productive industries in the economy are things like information technology; that is, the production of software. Health care is way over on the right; it's the red one that's about four from the right. Productivity in health care is clearly mismeasured. It's probably a bit higher than that but nobody thinks that health care's a very productive industry.

Actually, you're tempted to think of the most productive industries as being manufacturing industries with very straightforward out-production processes and so on. That is actually not correct. Many of the most productive industries, many of the industries that have become most productive over time, are things that have all the hallmarks of health care in terms of service-oriented and individual processing and so on. Look at retail trade, which is up there, and think about what's happened with the rise of Wal-Mart and other kinds of technological changes in retail trade that have completely bypassed health care and you can understand the difference between them.

So how would you move health care to the left in this chart? That is, how would you make health care be more like an average industry? I've shown you the average that I was talking about. Well, they would – it would involve doing the kinds of things that I was just talking about: information, compensation and empowerment. And so let me just give you a few examples of that. I won't go through all the examples.

One is information. We took an enormous step along these lines in the spring with the passage of the American Recovery and Reinvestment Act. There was \$30 billion gross, \$19 billion net invested in health care IT. That will both provide the right information at the individual level – that is, when you go to see your doctor – but also the right information at the system level – that is, do we really know what works and what doesn't work?

Just an example along those lines, the way that we learned that Vioxx was killing people – you remember Vioxx, the painkiller which was killing people? The way we learned that Vioxx was killing people was because Kaiser did a study of their data and found that people were dying more after they were taking Vioxx. It was a wonderful public policy, great-spirited thing of Kaiser to do. It would be nice if we had some other ways of learning that beyond having Kaiser do that kind of study for us.

So that's the first part, is taking advantage of what we will have put in place already. We need to follow that up with changes in compensation arrangements, paying for value instead of paying for volume. It's got to start with Medicare. Medicare is the 800-pound gorilla here. About 40 percent of hospital payments come from Medicare, about 20 to 30 percent of doctor payments. You combine Medicare and Medicaid and the DOD and the VA, that's about half of medical care.

We have examples of this in various guises. The V.A. is a very good example of an information that – of an organization that has a lot of information and has very good compensation arrangements. It's what you call – what is it those things – public payer, public option kind of thing. (Laughter.) I can't remember exactly what it's called. But we have examples of those both in the public sector and the private sector when you get the information and the compensation arrangements right. If you look at all the top performers, they all have this (property ?) that the president and others emphasize. And so that's going to be the second pillar of it is starting with Medicare.

Third is insurance reform. Insurance has a part to play here which is going to be to focus again on value and not on – in this case not volume but discouraging sick people from being enrolled. That's a part of many of the reforms and is something that will go a long way towards getting the incentives of the insurance industry right.

And then last would be things about worker empowerment. It is the case that actually frontline workers in health care do an enormous amount, but within constraint. So for example, we waste an enormous amount of, let's say, primary care time by having doctors do things that nurse practitioners can do or physicians assistants or other folks can do. We do have a primary care crisis and at the same time the typical doctor will report that they spend 40 percent of their time filling out non-essential forms. So we're wasting 40 percent of primary care.

And by the way, if you put a – follow nurses around the hospital with a stop watch, the single most common thing that a nurse does – far and away more time than any other thing – is documenting things, typically taking readouts from computers in the patient's room, bringing them over to a desk and entering them into a computer. And that's about 35 percent of her time. And you ask, where is – where does all your money go? Into administrative expenses. They're more – but that much said, there are more clerical workers in health care than there are nurses.

So worker empowerment in the right sort of ways.

What can we expect? Well, let me tell you a little bit about productivity growth. It was very high in the U.S. in the post-war period into the early 1970s. It then declined to about 1 (percent) to 1.5 percent from the 1970s to the mid-1990s and then it sprouted up. Part of the sprouting up was the impact of information technology advances, particularly the Internet and what came along with it, following up on the personal computer. Part of it was changes in the nature of firms, going from big, hierarchical organizations to flatter decentralized organizations. And part of it was compensation arrangements that went along with that.

And so productivity growth rose by 1 (percent) to 1.5 percent in the typical business and that's really what we're talking about trying to reach in health care. There's no technological reason why it can't be reached. Health care is more complicated than most industries, all of which suggest that information and incentives can go further in health care, not that they can go less far. So I am actually quite optimistic about what one can do in terms of increasing productivity. Again, not by making health care be a standout but just by making it be a normal industry.

What could you do with that? Well, the first 10 years what I would like to do is to use the money to cover people, and then after that I would like to use the money to contribute to deficit reduction. This chart shows you how you can match up over time, spending on covering people with reducing health-care spending both through the methods that I was telling you about as well as through reducing just very obvious examples of overpayments. For example, we pay managed care private plans that serve Medicare beneficiaries 10 to 15 percent more than it costs to serve those folks. There's no reason why in this era or any era we should be overpaying.

So that's – so a combination of sort of getting rid of overpayments and doing what we know we need to do could actually have a fundamental impact on deficit – reducing the deficit by 2 (percent) to 3 percent within a few decades.

The big question is how well do the bills – how well does what's on the table actually stack up? And I think the answer is pretty well, actually, given all the bad press that they've been getting. There's a commitment to payment change with flexibility in various versions of the bills. I think they're actually fairly good on the payment change.

You know, everyone has their own list of gripes and I've got a few of them. I'm not going to highlight them because the overall message I want to give you is that actually a lot of them are on the right track and that they can really get us to the point where we can do this. As Peter said, it's not that we can write down exactly now how we're going to do it, but that we have a number of very promising ideas. And that's really where I want to leave things is with two points at the end.

One is to reinforce that this is not a leap; it is a path. Covering people is a leap. Either you put the money forward or you don't put the money forward. If you put the money forward, you can cover people. If you don't put the money forward, you can't cover people. Don't pretend you're doing it if you're not doing it. Do it or don't do it and just be done with it.

This is going to be a path; that is, you have to get the system to work right. You have to iterate as you go along and that's going to require probably 10 to 15 years. Not that there won't be any savings before that, but just that that's the timeframe over which we're going to have to be dealing with this. And along the way the provider support is going to be essential. We can spend the next decade fighting over doing things, in which case it would be a completely unproductive decade and we will be back in a decade from now having a very similar conversation; or we can try and work on this together. In fact, most of the providers, as well as most of the insurers, know what has to be done. That's why there's so much more support for reform this time around than there was 16 years ago.

We have a very good sense. The question is, can we lead people along the right path? I'm fairly optimistic, but then again I'm in the wrong line of business if you're not optimistic. But I think there's a lot of good stuff we can do.

MR. FULWOOD: I have a – (applause) – I have a whole stock of questions but I'm not going to ask because I know you want to eat lunch. But I do want to at least give an opportunity

from the floor to ask these gentlemen a couple of questions. So we'll take – I'm going to follow the same pattern that Sarah did. I'll take two questions, both at the same time, and then throw them to the panel to answer them all at the same time and – in the interest of saving time.

I think she had her hand up first and he has his hand up.

Q: Thank you. I have a question for Mr. Diamond and Mr. Cutler.

MR. FULWOOD: Also, tell us who you are.

Q: Oh. My name is Annabelle Fisher (sp). I'm a health care mental health provider. Started out my career at Mass General. Great hospital.

I'm kind of confused. If you could clarify with regard to Social Security and the payroll tax. My understanding is that the Social Security trust fund was where the Social Security monies went, but it seems that Congress keeps raiding the trust fund and you keep saying there won't be any money. So could you please clarify that?

Along with the payroll tax. If you earn over \$95,000 you don't have any payroll taxes taken out of your check. It may be higher or lower. I've never earned that much as a professional. So you talk about needing resources. Maybe we should increase the payroll tax for higher income folks.

And finally, do we need to look at means testing for very high income earners, such as the Warren Buffetts and the Bill Gates, who do create jobs? I know that's a sticky matter, but these are the folks who create the jobs and employment. Thank you.

Q: My name is Mark Paydom (ph). I'm attorney here for federal government. I have a question for David. I was wondering what portion of health-care spending goes not for actual health care but for the resources devoted to marketing and administering health insurance. And to follow that, if insurance companies cannot – no longer discriminate based on existing conditions, what actual social value are the insurance companies providing?

MR. FULWOOD: Quick responses.

MR. DIAMOND: The payroll tax revenue goes into the trust fund. And of course it gets spent. If you buy a savings bond the government gets the money. The government has debt outstanding because it borrows to spend the money. The fact that it's been spent has absolutely no relevance whatsoever for the effects that it's had on the economy.

To address that we have to ask the question, how much public debt would be in the hands of the public if it wasn't in the hands of the trust fund? And if all of that was out there in the hands of the public instead, we would have a much bigger problem to deal with because we'd have the same total debt problem to deal with but we wouldn't have any money for Social Security.

So raiding is a nonsensical sense. When I borrowed money to buy my house, I borrowed money to spend it. Is that meaning I was raiding your deposits in that bank? Obviously not. That's what it's about. That's what debt is about.

I think maybe – just very quickly – in the plan it did call for a tax on top of the maximum taxable earnings base and an increase in that base. It was aimed at preserving some of the political compromises that go back from the beginning. Obviously the goal here is to provide a decent replacement rate, a foundation for retirement. The people who are very earners, that's not a public concern, but how much do we want to hit them up for the progressive part of Social Security? What's a fair share? And we've had political compromises and in the plan the idea was to push the envelope a little bit but not take the kind of leap that would throw the basic wide acceptance of Social Security into possible dispute.

Keep in mind the aphorism which I think is right on target, that in our country a plan for poor people is a poor plan. And the idea that Medicare and Social Security are for everybody I think is a central part of the way they function in the political process.

MR. FULWOOD: David?

MR. CUTLER: The question was raised about administrative expenses. Within insurance about 12 percent of the revenue that insurance companies take in goes for administrative expenses. That's higher than it needs to be. With various kinds of reform we could reduce that by several percentage points, maybe 8 (percent) or 9 percent and nobody would be the worse off.

I think the broader point is that there is actually an enormous amount of administration in health care. And we toss around the phrase “administrative simplification” a lot but it's actually extremely relevant. The typical hospital spends about 3 percent of its revenue just processing bills. And a number of things are still done by paper and they could be done electronically. You say, why is it so complicated? In part that hospital will tell you that they are dealing with maybe four or five insurance plans but about 60 or 70 different plans. And it's just impossible for them to figure out how to automate things and so on.

One of the things that's interesting about the debate this year is the various provider groups and the insurance companies, when they went to President Obama in May they mentioned that one of the savings they all agreed they could realize was through administrative simplification. And that's exactly right. And there are two ways of looking at that. One is what the heck took you so long? And then the second is, okay, finally; how do we roll up our sleeves and get it done? And I think that's really going to be the challenge.

It's not so much going to be legislative, although clearly getting rid of the passing the hot potato will help. But it's going to be sitting down and figuring out, out of all the myriad things going on, how can we streamline to get them better? And I personally think you could have a goal of reducing those administrative expenses by, say, 50 percent within the next 5 to 10 years. And you could reach that just by thinking through what we do. That's separate from the care

that's provided and how it's provided and making that work better. I think they're both things that we need to work on.

MR. FULWOOD: We'll end with that. Thank the panel very much. Let's give them a hand. (Applause.)

(END)