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Statement of

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before the

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Chairman Spratt, Representative Ryan, and other members of the Committee, I am pleased to be here to offer my views on the federal budget and related issues. At the outset, I should underscore that I speak only for myself and not necessarily for my colleagues at the Federal Reserve.

My testimony will focus on the long-term budget outlook and will draw on the most recent set of long-term budget projections from the Congressional Budget Office (CBO), issued in December 2005. The CBO constructed its projections based on the assumptions that real gross domestic product (GDP) would rise about 3-1/2 percent per year in 2005 and 2006 and at a rate of 2.9 per cent per annum from 2007 through 2015. The growth projections through 2015 were in turn based on the assumptions that trend labor force growth will average 0.8 percent per year and that trend labor productivity growth in the nonfarm business sector will average 2.4 percent per year. The CBO has since updated those assumptions for the purposes of other analyses, but the revisions were not large enough to materially alter the broad contours of the fiscal outlook.¹ As for the longer-term outlook, the CBO assumed that the growth rate of real GDP will average about 2 percent per year starting around 2020. While such projections are subject to considerable uncertainty, the CBO's assumptions provide a sensible and useful starting point for assessing the budget situation over the longer run.

Before discussing that longer-run outlook, I will comment on recent budget developments. As you know, the deficit in the unified federal budget declined for a second year in fiscal year 2006, falling to \$248 billion from \$318 billion in fiscal 2005. So far in fiscal 2007, solid growth in receipts, especially in collections of personal and corporate income taxes, has

¹ According to the latest estimates of the Bureau of Economic Analysis (BEA), real GDP growth was 3.2 percent in 2005 and 3.4 percent in 2006, both figures stated on an annual-average basis. The figure for 2006 is the BEA's "advance" estimate; a revised estimate is scheduled for release today.

held the deficit somewhat below year-earlier levels. Of course, a good deal of uncertainty still surrounds the budget outcome for the year as a whole. Federal government outlays in fiscal 2006 were 20.3 percent of nominal gross domestic product (GDP), receipts were 18.4 percent of GDP, and the deficit (equal to the difference of the two) was 1.9 percent of GDP. These percentages are close to their averages since 1960. The on-budget deficit, which differs from the unified budget deficit primarily in excluding receipts and payments of the Social Security system, was \$434 billion, or 3.3 percent of GDP, in fiscal 2006.² As of the end of fiscal 2006, federal government debt held by the public, which includes holdings by the Federal Reserve but excludes those by the Social Security and other trust funds, amounted to 37 percent of one year's GDP.

Official projections suggest that the unified budget deficit may stabilize or moderate further over the next few years. Unfortunately, we are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade. In fiscal 2006, federal spending for Social Security, Medicare, and Medicaid together totaled about 40 percent of federal expenditures, or 8-1/2 percent of GDP.³ In the medium-term projections released by the CBO in January, these outlays increase to 10-3/4 percent of GDP by 2017, an increase of about 2 percentage points of GDP in little more than a decade, and they will likely continue to rise sharply relative to GDP in the years after that. As I will discuss, these rising entitlement obligations will put enormous pressure on the federal budget in coming years.

² Excluding the operations of both Social Security and Medicare Part A, the budget deficit in fiscal year 2006 was \$459 billion, or 3.5 percent of GDP. Like Social Security, Medicare Part A pays benefits out of, and receives a dedicated stream of revenues into, a trust fund.

³ Net of Medicare premiums paid by beneficiaries and amounts paid by states from savings on Medicaid prescription drug costs, these outlays were equal to 8 percent of GDP.

The large projected increases in future entitlement spending have two principal sources. First, like many other industrial countries, the United States has entered what is likely to be a long period of demographic transition, the result both of the reduction in fertility that followed the post-World War II baby boom and of ongoing increases in life expectancy. Longer life expectancies are certainly to be welcomed. But they are likely to lead to longer periods of retirement in the future, even as the growth rate of the workforce declines. As a consequence of the demographic trends, the number of people of retirement age will grow relative both to the population as a whole and to the number of potential workers. Currently, people 65 years and older make up about 12 percent of the U.S. population, and there are about five people between the ages of 20 and 64 for each person 65 and older. According to the intermediate projections of the Social Security Trustees, in 2030 Americans 65 and older will constitute about 19 percent of the U.S. population, and the ratio of those between the ages of 20 and 64 to those 65 and older will have fallen to about 3.

Although the retirement of the baby boomers will be an important milestone in the demographic transition--the oldest baby boomers will be eligible for Social Security benefits starting next year--the change in the nation's demographic structure is not just a temporary phenomenon related to the large relative size of the baby-boom generation. Rather, if the U.S. fertility rate remains close to current levels and life expectancies continue to rise, as demographers generally expect, the U.S. population will continue to grow older, even after the baby-boom generation has passed from the scene. If current law is maintained, that aging of the U.S. population will lead to sustained increases in federal entitlement spending on programs that benefit older Americans, such as Social Security and Medicare.

The second cause of rising entitlement spending is the expected continued increase in medical costs per beneficiary. Projections of future medical costs are fraught with uncertainty, but history suggests that--without significant changes in policy--these costs are likely to continue to rise more quickly than incomes, at least for the foreseeable future. Together with the aging of the population, ongoing increases in medical costs will lead to a rapid expansion of Medicare and Medicaid expenditures.

Long-range projections prepared by the CBO vividly portray the potential effects on the budget of an aging population and rapidly rising health care costs. The CBO has developed projections for a variety of alternative scenarios, based on different assumptions about the evolution of spending and taxes. The scenarios produce a wide range of possible budget outcomes, reflecting the substantial uncertainty that attends long-range budget projections.⁴ However, the outcomes that appear most likely, in the absence of policy changes, involve rising budget deficits and increases in the amount of federal debt outstanding to unprecedented levels. For example, one plausible scenario is based on the assumptions that (1) federal retirement and health spending will follow the CBO's intermediate projection; (2) defense spending will drift down over time as a percentage of GDP; (3) other non-interest spending will grow roughly in line with GDP; and (4) federal revenues will remain close to their historical share of GDP--that is, about where they are today.⁵ Under these assumptions, the CBO calculates that, by 2030, the

⁴ For example, in 2030, five of the six scenarios imply deficits ranging from 1-1/2 percent of GDP to nearly 14 percent of GDP; a sixth scenario is capable of producing a surplus, but it relies on the confluence of a very favorable set of assumptions.

⁵ For more information about this scenario, see the description of Scenario 2 in Congressional Budget Office (2005), *The Long-Term Budget Outlook*, December, pp. 5-13 and 48-49, www.cbo.gov/ftpdocs/69xx/doc6982/12-15-LongTermOutlook.pdf. Consistent with the assumptions used by the Medicare trustees, the CBO's intermediate projections for Medicare and Medicaid are based on the assumption that, over the long run, per beneficiary health expenditures will increase at a rate that is 1 percentage point per year greater than the growth rate of per capita GDP. Over the past twenty-five years, however, per beneficiary Medicare spending has actually exceeded per capita GDP growth by about 2-1/2 percentage points per year. Thus, a significant slowing in the growth of medical costs per beneficiary will be needed to keep expenditures close to those projected in this scenario.

federal budget deficit will approach 9 percent of GDP--more than four times greater as a share of GDP than the deficit in fiscal year 2006.

A particularly worrisome aspect of this projection and similar ones is the implied evolution of the national debt and the associated interest payments to government bondholders. Minor details aside, the federal debt held by the public increases each year by the amount of that year's unified deficit. Consequently, scenarios that project large deficits also project rapid growth in the outstanding government debt. The higher levels of debt in turn imply increased expenditures on interest payments to bondholders, which exacerbate the deficit problem still further. Thus, a vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments, which in turn adds to subsequent deficits. According to the CBO projection that I have been discussing, interest payments on the government's debt will reach 4-1/2 percent of GDP in 2030, nearly three times their current size relative to national output. Under this scenario, the ratio of federal debt held by the public to GDP would climb from 37 percent currently to roughly 100 percent in 2030 and would continue to grow exponentially after that. The only time in U.S. history that the debt-to-GDP ratio has been in the neighborhood of 100 percent was during World War II. People at that time understood the situation to be temporary and expected deficits and the debt-to-GDP ratio to fall rapidly after the war, as in fact they did. In contrast, under the scenario I have been discussing, the debt-to-GDP ratio would rise far into the future at an accelerating rate. Ultimately, this expansion of debt would spark a fiscal crisis, which could be addressed only by very sharp spending cuts or tax increases, or both.⁶

⁶ To give a sense of the magnitudes involved, suppose--for the sake of illustration only--that the deficit projected for 2030 in the CBO scenario were to be eliminated entirely in that year, half through reductions in discretionary spending and half through increases in non-payroll taxes. (Of course, in reality the fiscal adjustment would likely not occur in one year, but this hypothetical example is useful for showing the magnitude of the problem.) This fiscal

The CBO projections, by design, ignore the adverse effects that such high deficits would likely have on economic growth. But if government debt and deficits were actually to grow at the pace envisioned by the CBO's scenario, the effects on the U.S. economy would be severe. High rates of government borrowing would drain funds away from private capital formation and thus slow the growth of real incomes and living standards over time. Some fraction of the additional debt would likely be financed abroad, which would lessen the negative influence on domestic investment; however, the necessity of paying interest on the foreign-held debt would leave a smaller portion of our nation's future output available for domestic consumption. Moreover, uncertainty about the ultimate resolution of the fiscal imbalances would reduce the confidence of consumers, businesses, and investors in the U.S. economy, with adverse implications for investment and growth.

To some extent, strong economic growth can help to mitigate budgetary pressures, and all else being equal, fiscal policies that are supportive of growth would be beneficial. Unfortunately, economic growth alone is unlikely to solve the nation's impending fiscal problems. Economic growth leads to higher wages and profits and thus increases tax receipts, but higher wages also imply increased Social Security benefits, as those benefits are tied to wages. Higher incomes also tend to increase the demand for medical services so that, indirectly, higher incomes may also increase federal health expenditures. Increased rates of immigration could raise growth by raising the growth rate of the labor force. However, economists who have looked at the issue have found that even a doubling in the rate of immigration to the

adjustment would involve a cut in discretionary spending (including defense) of nearly 80 percent (relative to its baseline level) and a rise in non-payroll taxes of more than 35 percent. The need for such painful measures could be diminished by beginning the process of fiscal adjustment much earlier, thereby avoiding some of the buildup in outstanding debt and the associated interest burden.

United States, from about 1 million to 2 million immigrants per year, would not significantly reduce the federal government's fiscal imbalance.⁷

The prospect of growing fiscal imbalances and their economic consequences also raises essential questions of intergenerational fairness.⁸ As I have noted, because of increasing life expectancy and the decline in fertility, the number of retirees that each worker will have to support in the future--either directly or indirectly through taxes paid to support government programs--will rise significantly. To the extent that federal budgetary policies inhibit capital formation and increase our net liabilities to foreigners, future generations of Americans will bear a growing burden of the debt and experience slower growth in per-capita incomes than would otherwise have been the case.

An important element in ensuring that we leave behind a stronger economy than we inherited, as did virtually all previous generations in this country, will be to move over time toward fiscal policies that are sustainable, efficient, and equitable across generations. Policies that promote private as well as public saving would also help us leave a more productive economy to our children and grandchildren. In addition, we should explore ways to make the labor market as accommodating as possible to older people who wish to continue working, as many will as longevity increases and health improves.

Addressing the country's fiscal problems will take persistence and a willingness to make difficult choices. In the end, the fundamental decision that the Congress, the Administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including transfer programs such as Social Security,

⁷ CBO (2005), *The Long-Term Budget Outlook*, p. 3.

⁸ I discussed this issue in Ben S. Bernanke (2006), "The Coming Demographic Transition: Will We Treat Future Generations Fairly?", speech delivered before the Washington Economic Club, Washington, October 4, www.federalreserve.gov/boarddocs/speeches/2006/20061004/default.htm.

Medicare, and Medicaid. Crucially, whatever size of government is chosen, tax rates must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues in the long run. Thus, members of the Congress who put special emphasis on keeping tax rates low must accept that low tax rates can be sustained only if outlays, including those on entitlements, are kept low as well. Likewise, members who favor a more expansive role of the government, including relatively more-generous benefits payments, must recognize the burden imposed by the additional taxes needed to pay for the higher spending, a burden that includes not only the resources transferred from the private sector but also any adverse economic incentives associated with higher tax rates.

Achieving fiscal sustainability will require sustained efforts and attention over many years. As an aid in charting the way forward, the Congress may find it useful to set some benchmarks against which to gauge progress toward key budgetary objectives. Because no single statistic fully describes the fiscal situation, the most effective approach would likely involve monitoring a number of fiscal indicators, each of which captures a different aspect of the budget and its economic impact. The unified budget deficit, projected forward a certain number of years, is an important measure that is already included in the congressional budgeting process. However, the unified budget deficit does not fully capture the fiscal situation and its effect on the economy, for at least two reasons.

First, the budget deficit by itself does not measure the quantity of resources that the government is taking from the private sector. An economy in which the government budget is balanced but in which government spending equals 20 percent of GDP is very different from one in which the government's budget is balanced but its spending is 40 percent of GDP, as the latter economy has both higher tax rates and a greater role for the government. Monitoring current and

prospective levels of total government outlays relative to GDP or a similar indicator would help the Congress ensure that the overall size of the government relative to the economy is consistent with members' views and preferences.

Second, the annual budget deficit reflects only near-term financing needs and does not capture long-term fiscal imbalances. As the most difficult long-term budgetary issues are associated with the growth of entitlement spending, a comprehensive approach to budgeting would include close attention to measures of the long-term solvency of entitlement programs, such as long-horizon present values of unfunded liabilities for Social Security and Medicare.

To summarize, because of demographic changes and rising medical costs, federal expenditures for entitlement programs are projected to rise sharply over the next few decades. Dealing with the resulting fiscal strains will pose difficult choices for the Congress, the Administration, and the American people. However, if early and meaningful action is not taken, the U.S. economy could be seriously weakened, with future generations bearing much of the cost. The decisions the Congress will face will not be easy or simple, but the benefits of placing the budget on a path that is both sustainable and meets the nation's long-run needs would be substantial.

Thank you again for allowing me to comment on these important issues. I would be glad to take your questions.