Fiscal Issues: From Here to Eternity (with Apologies to Burt Lancaster, Deborah Kerr and Donna Reed)

Remarks before the Equipment Leasing and Finance Association Financial Institutions Conference

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, Ken [Bentsen]. You and your family have rendered great service to Texas in both chambers of the United States Congress. I held your uncle, Lloyd, in the highest regard, as I do you. And I especially appreciated the support you always gave to us on trade issues when I was deputy U.S. trade representative and you were serving the 25th District in the House of Representatives. You supported fast-track authority, Permanent Normal Trade Relations with China, and many other trade initiatives that were not necessarily the most popular within your party at the time. That took courage.

I am going to speak today—the day before you file your 2006 returns with the IRS—about fiscal policy, an area into which central bankers rarely wander. The idea for this speech came to me when I saw a recent rerun of *From Here to Eternity*, the film classic based on James Jones' great novel about Pearl Harbor. It won eight Academy Awards in 1953 and is perhaps best remembered for that steamy scene of Burt Lancaster and Deborah Kerr frolicking in the surf.

Ken, I want to say right up front that I was not thinking of your former employer here. I realize that in citing this great film, some film buff in the audience might remember that Donna Reed won an Oscar for *Eternity* by playing a "hostess" in an establishment cleverly named the New Congress Club—a reference to a different kind of congress. Instead, I was thinking of the longer-term picture of our nation's fiscal predicament, something that cannot fail to escape the attention of any Federal Reserve official looking down the field for issues that could prove especially vexing for central bankers charged with keeping inflation at bay.

Let me explain. But first, let me make clear, as I always do, that I speak only for myself today and not for others at the Fed or for my colleagues on the Federal Open Market Committee.

Just 15 years ago, our country confronted a record peacetime federal budget deficit of $290 billion. People of goodwill from both sides of our political spectrum got together and realized that deficits of this magnitude threatened the U.S. economy's long-term health. They made tough choices, and through a combination of fiscal prudence and strong economic growth, decades of deficits gave way to a remarkable $239 billion surplus in the year 2000.

In 2007, we again face a $200 billion deficit. Once again, people of goodwill are pledging to achieve a surplus by 2012. Indeed, the president's proposed 2008 federal budget envisions a gradual reduction in deficit spending from $244 billion this year to $187 billion in 2009 to $54 billion in 2011. In 2012, the federal budget would return to surplus, albeit a more modest one than was achieved seven years ago.

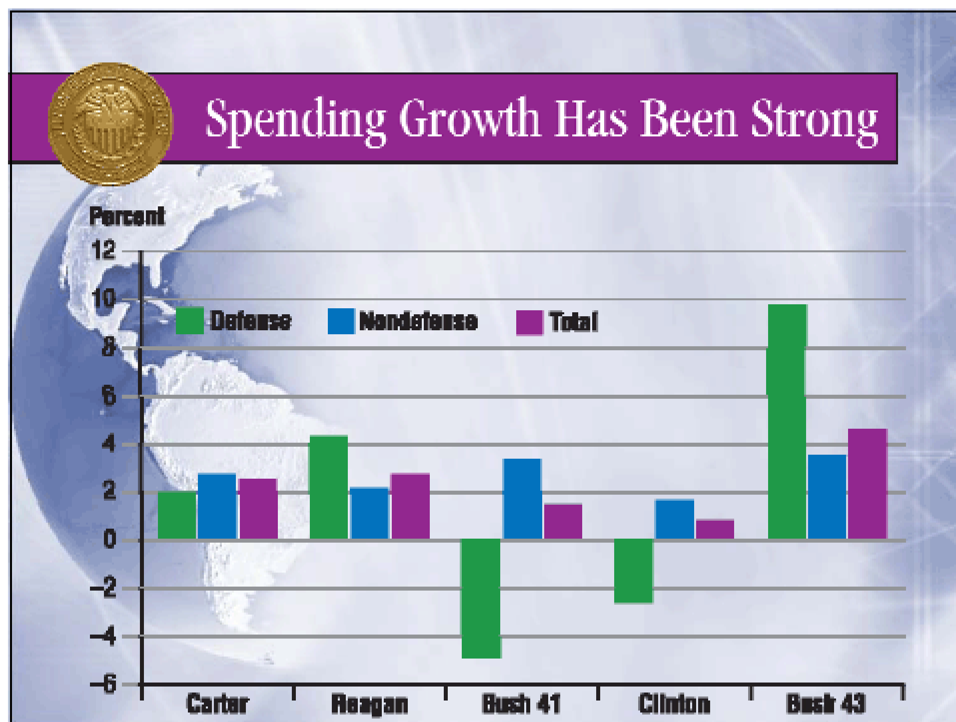
Of course, every economic forecast is based on assumptions. The good news is the macroeconomic forecasts behind that five-year march toward fiscal balance are actually quite reasonable—3 percent real annual GDP growth between now and 2012, coupled with a 4.8 percent unemployment rate. But the promise of a disappearing deficit rests on another important

assumption we should discuss in greater detail—that real spending growth will be held to a 0.4 percent annual rate, which is quite low by historical standards.

If you reckon that in fiscal matters, past is often prologue, then a good way to determine what will happen in the future is to look to the past.

Before doing so, let me remind you that the Federal Reserve is a strictly nonpartisan institution; when you enter the temple of the Federal Reserve, you check your partisan affiliation at the door. But you don't check your sense of humor, which is why a story told widely by George Shultz, the great Republican public servant, comes to mind. When he was director of President Nixon's Office of Management and Budget, he became worried about the amount of money Congress was proposing to spend. After some nights of tossing and turning, he called legendary staffer Sam Cohen into his office. Cohen had a long memory of budget matters and knew every zig and zag of budget history. "Sam," Shultz asked, "tell me something just between you and me. Is there any difference between Republicans and Democrats when it comes to spending money?" Cohen looked at him, furrowed his brow, and after thinking about it, replied, "Mr. Shultz, there is only one difference: Democrats enjoy it more."

I can't vouch for anyone's particular sense of enjoyment, nor should I as a Federal Reserve official. I think it best to stick to an analytical, "just the facts, ma'am" approach.



So what are the facts? What has the federal spending picture looked like in recent years? As you can see on the slide, real outlays from 2001 to the present have grown at an annual rate of 4.6 percent. By contrast, they grew at a 2 percent to 3 percent rate during the years Jimmy Carter and Ronald Reagan were in office, about 1.5 percent during Bush 41's tenure and 0.8 percent in the Clinton years. You notice that I refer to the presidents under whom this spending occurred. It is

important to remember that it takes two branches of government to tango on budget matters: the executive proposes, and the legislative disposes. Congress has the final say on all budget matters.

To some extent, these different growth rates reflect different circumstances. The Clinton years, for example, reaped the benefits of the post-Cold War peace dividend, whereas today's policymakers have been called upon to wage the war on terror. It is clear that defense spending has been responsible for much of the budget's deterioration. Real yearly defense outlays have grown by almost 10 percent in the wake of 9/11, reversing the steady decline since the end of the Cold War.

Nondefense outlays have also risen rapidly in the wake of 9/11, and for reasons not obviously related to national security. These expenditures have grown at a real annual rate of 3.5 percent over the past six years, the fastest sustained rate of the post-World War II era. I do not mean to suggest that any particular person or policymaker is responsible for this increase, but the fact is, the increase has occurred.

Using the past as our guide, let's consider just how bad the deficit picture could become. If we replace the 0.4 percent spending-growth assumption in the proposed budget with the 4.6 percent rate that has thus far prevailed in the 21st century, the $61 billion surplus projected for 2012 turns into a $701 billion deficit. That's a big number. To be fair, it is probably too big because it assumes that the rapid post-9/11 defense buildup will continue apace. It is perhaps more reasonable to assume that the central tendency of real annual spending growth between now and 2012 will more closely resemble the post-Vietnam War historical average of 2.3 percent. With this assumption, the 2012 deficit would be $231 billion—about as large as the one we face today.

Our national leaders are considering other fiscal reforms that could have a big impact on the deficit picture. Since tomorrow is Tax Day, let's start with the alternative minimum tax. The AMT is a "backup" income tax code put in place more than a generation ago to ensure every high-income household paid taxes. AMT rates are somewhat lower and flatter than ordinary income tax rates but without many common deductions, such as state and local taxes. We taxpayers must separately compute our liabilities under each tax scheme and pay the higher of the two obligations.

Only 20,000 people paid AMT in 1970. Less than 40 years later, 3.5 million households have been swept into the AMT net. If no action is taken, an estimated 20 million households will join them this year, and some 15 million more will be added to the ATM rolls by 2012.

Why the big jump this year? The answer—as is so often the case in the world of central banking—comes down to inflation. AMT brackets don't rise as price levels change or the economy grows, so over time, bracket creep pushes more and more people onto the AMT. A series of temporary patches has held the inflation component at bay. The relief has now expired, causing that 20 million-household jump.

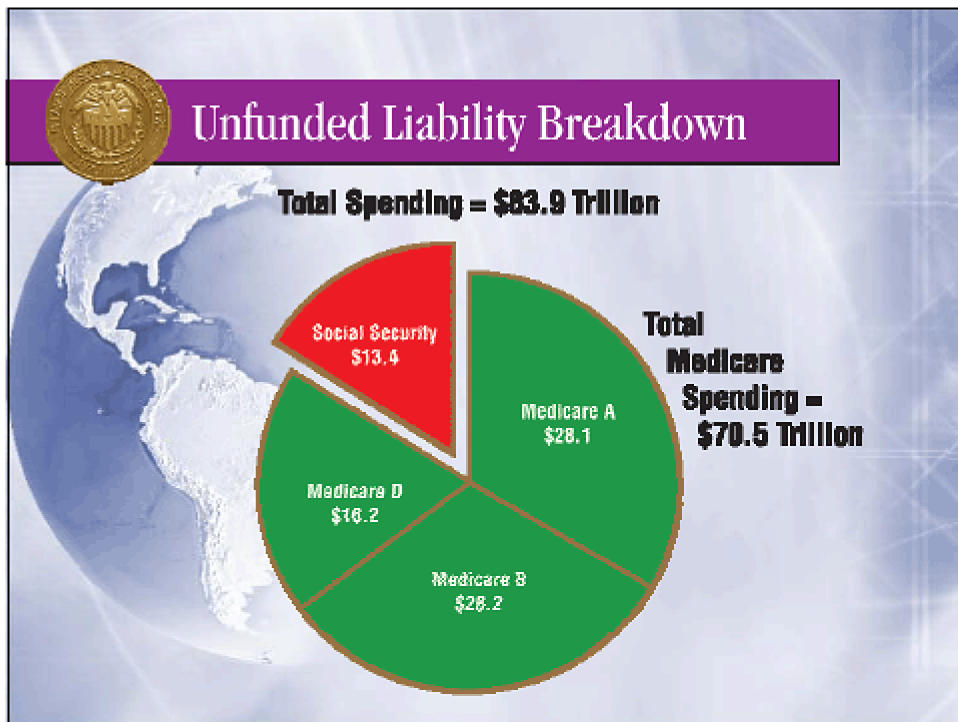
A consensus seems to have formed around the proposition that we should stop this from happening by extending the patches and permanently indexing the AMT for inflation. Such a change would substantially slow the march of households toward the AMT—but it would be a very expensive proposition. If tax cuts approved in 2001 and 2003 are made permanent, the AMT would cost the Treasury an estimated $945 billion over the next 10 years.

If the tax cuts aren't made permanent, AMT reform could be done more cheaply. That $945 billion tab could be reduced to $520 billion because fewer people would have to pay the AMT. Of course, the flip side of that picture is that households would pay more in taxes as other tax cuts on income also expire, using money that might otherwise have been spent on cars, furniture and travel. And, sure enough, a Treasury Department study finds that future economic activity might fall modestly if the tax cuts lapse. As is so often the case in the policy arena, every choice has its costs and its benefits. No easy solution is in sight.

In some respects, however, talking about near-term fiscal issues like the AMT and the tax cuts misses the bigger problem. These are issues we can likely—or at least conceivably—weather. The longer-term issue of entitlements is the more serious fiscal problem, with more significant potential consequences for the economy.

According to official government trustee reports, the infinite-horizon discounted present value of our unfunded liability from Social Security and Medicare—in common language, the gap between what we will take in and what we have promised to pay—now stands at $83.9 trillion. The potent combination of lower birthrates, higher medical costs and longer life expectancies provides little reason to hope that the figure will fall.

Just how big is an $83.9 trillion shortfall? Well, it is six times the U.S. gross domestic product. It is more than 100 times the country's annual defense budget. And it is about 10,000 times the annual budget of the Environmental Protection Agency. That is a lot of money, even for a central banker.



Let's explore this $83.9 trillion in a bit more detail (see slide). As you will see, the largest portion of the liability is the $28.1 trillion needed to fund Medicare Part A, which covers hospital

stays. Another $26.2 trillion comes from Medicare Part B, which covers doctors' services. And $16.2 trillion stems from Medicare Part D, the prescription drug benefit that took effect in January of last year. Finally, $13.4 trillion comes from Social Security, the topic of reform debate among Congress, the president and others in recent years. It is yet another example of the old rule that the amount of time spent debating a budget issue in Washington is always inversely proportionate to its cost.

When people think about these kinds of issues, they usually assume Social Security is the big problem. But, by golly, it isn't. As these figures show, the unfunded liability from Medicare Part D alone—the drug benefit—is greater than the entire Social Security shortfall. Taken together, Medicare's unfunded liabilities are more than five times that of Social Security. So while we can applaud policymakers who have tried to shore up Social Security, we must be ever mindful that the lion's share of the total $83.9 trillion unfunded liability problem will remain even if they succeed.

But we're a big country, so let's look at it on a per-person basis. If you divide the $83.9 trillion evenly among the 300 million U.S. residents, you get a per-person liability of $280,000—more than five times the average household's annual income. Each of us would have to pay that much today if we wanted to guarantee the solvency of our entitlement system for future generations.

Let me put it yet another way. The total unfunded liability from these programs encompasses about 7.5 percent of U.S. GDP from here to eternity, which works out to 68 percent of all federal income tax revenues from here to eternity. So instead of paying $280,000 per person now, we could permanently sequester 68 percent of all current and future income tax revenue for use only on Social Security and Medicare. Or we could permanently raise income tax rates by 68 percent to accomplish the same thing—although we'd actually need to jack it up even higher because a large tax hike would probably discourage some people from working.

Now that I have your attention, remember that to save promised benefits, we would have to dramatically cut spending starting right now or raise income taxes and never bring them back down. And by doing so, we would only be covering the *shortfall* from Social Security and Medicare payroll tax receipts. All other existing sources of entitlement funding, including payroll tax revenue, copays, deductibles and premiums, would have to remain in place.

This is not a pretty picture. And as bad as the situation currently is, the necessary response becomes ever more drastic the longer we wait. If past is prologue, the most likely response may be to adjust the parameters of the current system—for example, by raising the retirement age or making the payroll tax more progressive. Many options would improve the fiscal fitness of our entitlement system and reduce the need for drastic action elsewhere in the federal budget. But let's be honest: Any option would work only because some people would get less than they are currently slated to receive. Painful as that is, the question is whether other options on the table would be even more so.

Our short-term fiscal challenges are significant as we grope our way toward a future in which we begin to pay down the federal debt. The long-term challenge of entitlements is much more severe, with implications both for our own well-being and for the long-term strength of the global economy. Yes, we remain the biggest player on the global stage, but if we fail to get our

fiscal house in order, we could bequeath our descendants unconscionable debt and slow the global economy to boot. Is that to be our legacy?

At face value, fiscal policy may not seem a concern for the Federal Reserve. Taxing and spending, after all, are not the Fed's business. Congress holds the power of the purse. But the Fed cannot be an indifferent bystander to the overall thrust of fiscal policy. The reason is straightforward: Bad fiscal policy creates pressure for bad monetary policy. When fiscal policy gets out of whack, monetary authorities face pressure to monetize the debt, a cardinal sin in my mind.

I have spoken in previous speeches of our "faith-based currency," a term I use only slightly tongue in cheek. The dollar—like the euro, the yen, the British pound and other currencies—is what economists call a fiat currency. It is backed only by the federal government's power to raise the revenues needed to meet its obligations and by the rectitude of the U.S. central bank. If the market were to lose faith in either assumption, the dollar would be debased.

The Fed is not the answer to our fiscal woes. Remember, the executive proposes, and the legislative disposes. Congress, as keeper of the government's purse and the sole body with the power to tax and spend the people's money, is where the buck stops. Congress has the duty and the means to impose solutions to these imbalances, hopefully inspired by presidential leadership. And here is the rub: Voters like you elect the Congress. And you elect the president. You might chuckle at Sam Cohen's answer to George Shultz's question, but this is no laughing matter. Just as in the film *From Here to Eternity*, the lives of the cast of citizens of this great country are going to be dramatically altered by a calamitous development. The difference is that this one will come as no surprise; it is of our own making, and it is within our power to prevent. While we frolic in the surf of immediate economic prosperity and are consumed with all sorts of other political and economic melodramas and intrigues, we are being threatened not from some foreign enemy but from within.

History may place blame on this or that president or on Congress for failing to act. But, ultimately, the responsibility to solve these looming fiscal issues rests with voters. In the end, the person who is responsible for the $83.9 trillion meltdown that is happening before our very eyes—the person responsible for saddling each of your children and every other person you love with $280,000 in debt—is the one you look at in the mirror each morning.

Thank you and have a nice Tax Day.