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Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

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I appreciate the opportunity to appear before this Committee today, as you begin your deliberations on the budget for fiscal year 1989 The Summit Agreement reached with the Administration in November, if fully implemented, should maintain pressure on the deficit this year and next But it is crucial that further actions in support of a long-term policy of reducing budget deficits and the associated claims on the nation's supply of saving be implemented This morning, after a brief review of the current economic situation, I would like to address some of these longer-run fiscal concerns

As I reported to the Banking Committees last week, 1987 generally was a good year for the U S economy Real GNP rose nearly 4 percent, almost twice the pace of the previous year, and unemployment continued to decline In January of this year, the civilian jobless rate stood at 5 8 percent, nearly a percentage point below its year-ago level

Especially encouraging was the improvement in the balance between domestic spending and domestic production Although it is not yet evident in the nominal figures, there has been a marked turnaround in real net exports Our international competitiveness has been enhanced by the success of business and labor in increasing productivity and restraining cost pressures In addition, the lower level of the dollar on foreign exchange markets, because much of it was not passed through into wages and other costs domestically, also helped our firms price more competitively in foreign markets and compete with imports at home As a result, exports have been soaring in real terms and the growth of imports has slowed

This turnaround in the external sector also has contributed to better balance across domestic industries and regions of the country In particular, output in the manufacturing sector has picked up appreciably, in response to both stronger orders from abroad and higher levels of capital spending at home Improvement also was apparent among domestic energy producers and in agriculture, two sectors that had lagged considerably in recent years

On the negative side, virtually all broad measures of price inflation rebounded somewhat, after dropping sharply in 1986 And, although wage increases remained restrained, we clearly need sustained effort to bring about price stability.

As we move into 1988, members of the Federal Reserve Board and the Reserve Bank Presidents look for a moderate rise in real GNP over the course of this year, on the order of 2 to 2-1/2 percent The stock market plunge has added continued uncertainty to the outlook, and activity in the near term may be restrained somewhat by efforts to bring inventories into better balance with sales However, such an inventory-induced slowdown almost surely would be reflected first in shortfalls in manufacturers' orders, and for the moment at least, order books remain impressively solid In general, there are few signs of the imbalances that typify the late stages of a business cycle expansion Moreover, the external sector is expected to provide considerable support to domestic production throughout the year Inflation, meanwhile, is anticipated to fall within a range of 3-1/4 to 3-3/4 percent, similar to the 1987 pace The "central tendency" of our projections for real GNP growth this year encompasses the Administration forecast, but is somewhat stronger than that of the Congressional Budget Office, we also are a bit more optimistic on prospects for price inflation However, the differences are not large

In this context, the Federal Open Market Committee, at its meeting last month, set ranges of 4 to 8 percent for growth of M2 and M3 Expansion of money within these ranges, whose midpoints are one percentage point lower than those of last year, is expected to support continued economic growth at a pace that is consistent with sustained external adjustment and progress over time toward price stability Given the large movements of money relative to income in recent years and the unusual degree of uncertainty in the economic outlook, the FOMC widened the ranges for money growth to 4 percentage points and will continue to assess the behavior of the aggregates in light of information about the pace of business activity and the source and strength of price pressures, with particular attention to the performance of the dollar on foreign exchange markets and other indicators of the impact of monetary policy

Looking beyond 1988, prospects for maintaining balanced growth, as well as continued improvement in our external accounts, will depend importantly on developments in the federal budget It is encouraging that the latest figures from the Congressional Budget Office show the baseline deficit on a declining trend into the early 1990s, especially when you recall that, as recently as 1985, such projections approached $300 billion, or more than 5 percent of GNP Nonetheless, the deficits as currently estimated remain sizable, as a share of GNP as well as in absolute terms Moreover, relatively small changes in the assumptions underlying budget deficit projections can alter them quite radically, as recent history demonstrates

Throughout most of the postwar period, gross private domestic saving and investment were roughly in balance, at slightly more than 15 percent of GNP Budget deficits generally were small, at least by today's standards, and the U S showed a positive—and gradually increasing—net foreign investment position. In the 1980s, the pattern changed dramatically, as total domestic saving fell well below investment, reflecting not only the enormous federal deficits, but also a large drop in the private saving rate

That gap between domestic saving and investment has been filled by capital inflows from abroad This is neither a satisfactory nor a sustainable solution over the longer run Indeed, an examination of the historical record reveals that it has been the exceptional industrialized country that has been able to attract large capital inflows on an extended basis in the past quarter-century. In this regard, the lesson for the United

States is clear The widely anticipated improvement in the nation's current account balance will provide considerable benefits to the overall economy, but also will result in diminished capital inflows to the United States

The record also shows that the relatively healthy share of gross investment in GNP in the 1980s has masked a perceptible decline in the investment share measured net of depreciation—that is, the portion of investment spending that actually increases the nation's capital stock, rather than merely replacing worn–out equipment and structures This divergence reflects a continued shift in the composition of investment, away from long–lived assets such as structures toward high–technology and other shorter–lived equipment, which has raised the share of depreciation in gross investment

Achieving adequate investment rates—whether measured in gross or net terms—is critical if we are to equip the nation's productive facilities with the state–of–the–art technology and machinery necessary to enhance our international competitiveness This will require stepped–up domestic saving, in order to compensate for the anticipated slowing in capital inflows

It is difficult to explain why saving by households and businesses has fallen to such low levels, and there is considerable uncertainty about the outlook for saving in coming years Some arguments, such as the association between lower saving and the surging stock market of the mid–1980s, suggest that the low saving rate is a temporary aberration But other factors that are believed by some analysts to have depressed private saving, such as a diminished need to save for emergencies because of improvements in disability and life insurance coverage and the easier financing of "big–ticket" items, are likely to persist In any event, despite numerous initiatives, public policy has had little effect on private saving Indeed, over the years, we have enacted significant tax changes designed to provide incentives to saving, but the evidence of most economic studies suggests that the net effect has been to shift saving from one pile to another, without much impact on the total. Thus, the surest way to overcome our shortage of aggregate domestic saving is through sizable reductions in budget deficits Such steps are essential if we are to avoid greater pressures on financial and foreign exchange markets

The importance of taking actions to make a sizable dent in the budget deficit during periods of satisfactory economic performance becomes even more apparent when we recognize the likely effects on revenues and outlays of a future economic slowdown, if one were to occur While we all seek to avoid recessions, the Congress cannot count on indefinitely sustaining federal revenues by a growing economy.

The achievement of meaningful deficit reduction undoubtedly will require that some hard decisions are made. The adoption of the Gramm–Rudman–Hollings approach, and its reaffirmation last year, highlight all too vividly the extraordinary difficulty of making such choices There are no easy answers or magic formulas Nonetheless, economic logic and historical experience can provide a framework for analyzing the range of possible options.

I suspect that in the long run there are upside limits to the share of income that can be taxed For several decades, the overall federal tax bite has been fairly flat, at a bit less than 20 percent of GNP, and under current tax laws will remain in this range into the 1990s. This stability over time is not a coincidence, but is indicative of the public's aversion to rising tax burdens That sentiment was reflected in the many small tax changes in the 1970s, as inflation pushed many taxpayers into higher brackets, and in the large reductions that were enacted in the early 1980s Of course, no one likes higher taxes, but I also sense a more sophisticated awareness of the disincentives and economic inefficiencies that seem to grow disproportionately along with the size of the tax burden And people are skeptical that tax increases will translate fully into smaller deficits, given the reduced pressure to control spending that would result

This does not mean, however, that revenue changes should be dismissed out of hand Some specific taxes may serve other desirable objectives, while also bringing in needed receipts For example, I have long urged the consideration of a sizable increase in the federal gasoline tax A hike of 15 cents per gallon, for example, could raise close to $15 billion in revenues, while retail gasoline prices still would be well below the levels of the early 1980s And if energy use is restrained at all, there is a further benefit

But on the whole, deficit–reduction efforts must of necessity focus on the expenditure side of the budget Over the past three decades, we have seen marked shifts in the composition of federal spending, accompanied by a distinct uptrend in its ratio to nominal GNP That ratio, which reached 24 percent of GNP in the mid–1980s, has edged off in the past few years, in part because the Administration and the Congress have been relatively successful in holding the line on new programs.

I do not underestimate the difficulty of the task of further reducing the ratio of federal outlays to GNP Several rounds of deficit–reduction efforts already have taken care of the "easy" cuts Partly as a result, the composition of the budget has shifted toward those categories that are less amenable to control, at least in the short run In particular, interest payments were nearly $140 billion last year, and in light of prospective deficits, are likely to grow even larger in coming years The way to control these payments, and to get a handle on the scale of federal debt relative to GNP, is to concentrate on the remainder of federal spending and on the so–called "primary deficit"—that is, the deficit excluding interest payments (net of taxes on interest)

Looking at the programmatic part of spending, it is apparent that demographic trends, especially the shifting age profile of the population, will put substantial pressure on outlays in the years ahead At present, 38 million Americans, or about 15 percent of the population, are collecting social security retirement or disability benefits, most of them are insured under medicare as well. That figure will rise appreciably over the next decade.

Controlling the growth of outlays is crucial and will require close scrutiny of virtually all programs Such control, in the face of demographic pressures, will demand a willingness to take bold, controversial actions It is essential that this Committee focus on those changes that will result in significant saving, not just this year or next, but on a lasting basis.

It would be inappropriate for me to offer suggestions on specific program actions to reduce the deficit. You know all the alternatives. The choices are political, not economic. But simple arithmetic points clearly to those areas where the scope for action is greatest In this context, entitlement programs offer substantial opportunities for long–term budgetary savings, since they currently account for nearly half of total outlays. And with the base of expenditures certain to expand in conjunction with the increase in the beneficiary population during the next few decades, the deficit–reduction benefits of changes in the law today will accumulate over time, leading to much larger savings in the year 1995 and beyond than in, say, 1990 or 1991

Leaving aside the serious questions of evaluating military adequacy, the budgetary arithmetic of cutting defense spending is considerably less favorable In part, this is because the Summit Agreement already has solidified a recent trend toward reductions in appropriations from President Reagan's original overall defense plan But more fundamentally, defense programs are essentially lumpy A large share of spending in the early and mid–1980s went to build up our military asset base. But as we reach the requisite number of F–16 wings, air carrier groups, missile deployments, and the like, expenditures will fall back toward maintenance levels, which are significantly lower in real terms than the huge outlays of the past few years Accordingly, reductions in defense procurement programs are not translatable, as they are in entitlement programs, into very much larger cuts in the future

As for discretionary domestic spending, these programs are a small and shrinking share of the total, and many provide services that enjoy broad support Moreover, in a number of areas such as law enforcement, environmental protection, and air traffic safety, there are few feasible alternatives to the federal programs

There are, however, areas where the private sector probably can provide services more efficiently, and at lower cost, than the government The President's Budget placed a high priority on "privatization", and suggested several activities that could be transferred out of the federal sector I believe this emphasis is appropriate and deserves careful consideration on its own merits But I would stress that the resulting asset sales should not obscure the more fundamental budgetary issue Indeed, I would be troubled by the extensive use of asset sales as a long–run deficit–reduction strategy. Merely shifting the ownership of an asset from the government to the private sector has little effect on overall credit demands, moreover, it produces only a one–time budget saving

I also would be disturbed by the greater use of federal credit guarantees, as a substitute for on–budget outlays Such a substitution may lower the measured budget deficit, but it does not reduce the federal presence in credit markets Both the Administration and CBO have long argued that current budgetary procedures give a misleading impression of federal credit activity In this regard, the Administration's proposals for reform, which call for the explicit recognition and better measurement of the subsidy value of credit programs, point in the right direction

A smaller public sector would carry significant benefits in terms of improved efficiency of the overall economy. The relationship between the size of the government and economic performance is complex, and depends—among other things—on the mix of consumption and investment in government spending Moreover, budget figures do not capture the full scope of governmental activities on real resource allocation; the effects of government economic regulation on private activity may be sizable

International comparisons inevitably are difficult, and the empirical evidence is only roughly suggestive of broad trends But the disappointing macroeconomic performance of many industrialized countries over the past few decades, in the face of rapidly expanding public sectors, does raise questions about the true costs and benefits of large government expenditures Indeed, in several European countries with sizable public outlays on income maintenance, education, and health care, those programs are coming under increased scrutiny, in part because of a perception that some of them have had detrimental effects on individual incentives and resource allocation.

To sum up, the benefit from taking credible actions to curb federal outlays and related credit demands will be enormous Over the longer run, lower deficits will absorb less of our private saving and, all else equal, allow private investment to flourish Moreover, a clear demonstration to the financial markets that the current services budget has been set permanently on a more favorable track will have a handsome payoff currently in terms of lower real interest rates As I stated earlier, one way to achieve that outcome is to exploit the "wedge effect" arising from reductions in programs such as entitlements, where the savings tend to grow over time I should note too that, in my view, you run little risk of setting deficit–reduction objectives that would be excessive in macroeconomic terms, given the broad constraints of political feasibility And at some point in the future, it probably will be desirable to aim—not just for smaller deficits—but for outright budgetary surpluses

In closing, let me commend the Congress for initiating the National Economic Commission The Commissioners face an extremely difficult challenge, and I wish them well

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