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Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Finance

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As I have indicated to other committees of the Congress in recent days, our burgeoning structural budget deficit, unless addressed, will increasingly threaten the stability of our economic system. Time is no longer on our side. At 5 percent of GDP, the current deficit is very large by historical standards. After declining through 1996, the current services deficit starts on an inexorable upward path again. On a cyclically adjusted or structural basis, the deficit has hovered around 3 percent of potential GDP for the last ten years, a phenomenon without precedent in our peacetime history.

I am encouraged that the President and the Congress are making serious efforts to restore a measure of balance to our fiscal affairs.

It is beguiling to contemplate the downtrend in inflation in recent years in the context of very large budget deficits and to conclude that the concerns about their adverse effects on the economy have been misplaced. Regrettably, this notion is dubious. The deficit is a corrosive force that already has begun to eat away at the foundations of our economic strength. Financing of private capital investment has been crowded out and, not surprising, the United States has experienced a lower level of net investment relative to GDP than any other of the G-7 countries in the last decade.

To some degree, the impact of the federal budget deficits over the past decade has been muted as we imported resources to help finance them. This can be seen in our large trade and current account deficits. However, we should not--

indeed, we probably cannot--rely on foreign sources of funds indefinitely. If we do nothing, the markets will ultimately force an adjustment; by acting now to redress our internal imbalance, we can lower the risk of unpleasant stresses down the road.

I shall eschew, as I have in previous testimonies, comments on the specific elements of the deficit-reduction proposals currently under review by the Congress. I should like, nonetheless, to take the time you have made available, Mr. Chairman, to outline my views on the principles that should underlie current deliberations.

First, according to both the Office of Management and Budget and the Congressional Budget Office, deficits are likely to be held in check by relatively good economic performance over the next few years. But from 1997 on, budget outlays under existing law are projected to rise appreciably faster than the tax base. If such trends are not altered, stabilizing the deficit-to-GDP ratio solely from the receipts side, not to mention reducing it, will necessarily require ever increasing tax <u>rates</u>. This would surely undercut incentives for risk taking and inevitably damp the long-term growth and tax revenue potential of our economy. The gap between spending and revenues will not close under such conditions. Thus, there is no alternative to achieving much slower growth of outlays if deficit control is our objective. This implies not only the need to make cuts now, but to control the growth of future spending, so that it does not

exceed, and preferably is less than, the projected growth in the tax base.

The thought expressed by some that we can inflate our way out of the budget deficit is fanciful. Aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit. As I indicated in testimony to the Joint Economic Committee in January, there is a possibility that productivity has moved into a significantly faster long-term growth channel, which would boost real growth and tax revenues over time. But even if that turns out to be the case, short of an increase beyond anything that we can reasonably anticipate at this time, productivity, in itself, would not be enough to resolve the basic long-term imbalance in our budgetary accounts. Thus, while economic growth is necessary to contain budget deficits, it regrettably is not sufficient.

In deciding how to pare a structural budget deficit, it is important to be clear on the different roles of boosting taxes, on the one hand, and cutting spending programs on the other. All feasible taxes, by their very nature, restrain business activity. Hence, excluding so-called sin taxes and possibly environmental taxes, increases in taxes can only be justified to finance expenditures that are deemed essential. The level and composition of outlays to be financed by revenues is, in our society, a political matter, as is also the degree of progressivity and incidence of taxation. But over the long run,

it is important to recognize that trying to wholly, or substantially, address a structural budget deficit by increasing revenues is fraught with exceptional difficulties, and is more likely to fail than succeed.

All else equal, reducing the deficit would enlarge the pool of savings available for private capital investment. But investment will not automatically occur unless there are adequate incentives for risk taking.

A greater willingness of a society to consume less of its current income should lower real interest rates and spur such investment. But if risk taking is discouraged through excessive taxation of capital or repressive regulation, high levels of investment will not emerge and the level of saving will fall as real incomes stagnate.

The process by which government deficits divert resources from private investment is part of the broader process of redirecting the allocation of real resources that inevitably accompanies the activities of the federal government. The federal government can preempt resources from the private sector or direct their usage by a number of different means, the most important of which are: (1) spending, financed by taxation; (2) spending, financed by borrowing i.e., deficit spending; (3) regulation mandating private activities such as investment in pollution control or safety equipment, which are likely to be financed through the issuance of debt; and (4) government guarantees of private borrowing.

What deficit spending and regulatory measures have in common is that the preemption of resources, directly or indirectly, is not sensitive to the rate of interest. The federal government, for example, will finance its budget deficit in full, irrespective of the interest rate it must pay to raise the funds. Borrowing with government-guaranteed debt may be interest sensitive, but the guarantees have the effect of preempting resources from those without access to riskless credit. Government spending fully financed by taxation does, of course, preempt real resources from the private sector, but the process works through channels other than through real interest rates.

Purely private activities, on the other hand, are, to a greater or lesser extent, responsive to real interest rates. The demand for housing, for example, falls off dramatically as mortgage interest rates rise. Inventory demand is clearly a function of short-term interest rates, and the level of interest rates, as it is reflected in the cost of capital, is a key element in the decision on whether to expand or modernize productive capacity. Hence, to the extent that the demand for saving exceeds its supply, interest rates will rise until sufficient excess demand is finally crowded out.

The crowded-out demand cannot, of course, be that of the federal government, directly or indirectly, because federal government demand does not respond to rising interest rates. Rather, real interest rates will rise to the point that private

borrowing is reduced sufficiently to allow the entire requirements of the federal government, including its on- and off-budget deficits and all its collateral guarantees and mandated activities, to be met.

In these circumstances, there is no alternative to higher real interest rates diverting real resources from the private to the public sector. In the short run, nominal short-term interest rates may temporarily be held down if the Federal Reserve accommodates the excess demand for funds through a more expansionary monetary policy. But this will only produce greater inflation and, ultimately, have little, if any, effect on the allocation of real resources between the private and public sectors.

In such an environment, inflationary forces too often lead to increased risk premiums, higher real interest rates, and a higher cost of capital. This, in turn, engenders a foreshortening of the time horizon of investment decisions and a decreasing willingness to commit to the long term, a commitment that is so crucial to a modern technologically advanced economy. Structural budget deficits and excessive collateral credit preemptions are symptoms of a society overconsuming and undersaving and underinvesting.

While there is no substitute for political will in reining in outsized structural budget deficits, there are changes, I believe, that could make the budget process more effective. In particular, it is worth reconsidering sunset

legislation, which would impose explicit termination dates on spending programs. Expiring programs that still have merit should have no difficulty being reauthorized, but programs whose justification has become less compelling would not receive the necessary votes. Indeed, it is hard to imagine that sunset legislation would not lead to at least some improvement over the current situation, quite possibly fostering non-trivial budget savings.

It also would be useful to take a look at the current-services methodology for evaluating budget changes. A baseline estimate obviously is a necessary ingredient in the budget process that helps inform policymakers about the impact of policy proposals. However, the current services concept assumes that no further congressional, judicial, or bureaucratic actions will be taken to alter existing programs. This is quite unrealistic, but it would be of no particular significance were it not for the fact that the bias of such actions is patently toward more spending rather than less. Hence, merely owing to ongoing congressional deliberations, administrative rulings, and decisions, an add-on to the current services outlay estimates is required to get a better view of what might be termed the "expected" deficit of the future. It is not possible to know in advance which spending programs will be expanded, except that some will. In recent years, congressional current-services outlay estimates have consistently been adjusted upward in response to such technical reestimations of program costs.

Indeed, technical reestimates explain a significant part of the failure of the deficit to fall as contemplated at the time of enactment of the Omnibus Budget Reconciliation Act of 1990.

Finally, while I do not favor a balanced budget amendment on the grounds that it might be impossible to enforce, I would support a constitutional amendment, or even a legislative provision, that stipulates that all revenue and expenditure initiatives require supermajorities (for example, 60 percent) to pass both houses of the Congress. Combined with sunset legislation, such a procedure could probably go far to neutralize the obvious propensity of our political system toward structural deficits.

Let me conclude by reiterating my central message. The deficit is a malignant force in our economy. How the deficit is reduced is very important; that it be done is crucial. Allowing it to fester would court a dangerous erosion of our economic strength and a potentially significant deterioration in our real standard of living. Fortunately, we have it in our power to reverse this process. This Committee has an important role in this process. Speaking as a citizen, I wish you well.