Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

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Mr. Chairman and members of the committee, I am pleased to be here today and to offer my views on the outlook for the economy and current fiscal issues. I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

As you know, the U.S. economy appears to have made the transition from a period of subpar growth to one of more vigorous expansion. Real gross domestic product (GDP) rose briskly in the second half of last year, fueled by a sizable increase in household spending, a notable strengthening in business investment, and a sharp rebound in exports. Moreover, productivity surged, prices remained stable, and financial conditions improved further. Overall, the economy has lately made impressive gains in output and real incomes, although progress in creating jobs has been limited.

The most recent indicators suggest that the economy is off to a strong start in 2004, and prospects for sustaining the expansion in the period ahead are good. The marked improvement in the financial situations of many households and businesses in recent years should bolster aggregate demand. And with short-term real interest rates close to zero, monetary policy remains highly accommodative. Also, the impetus from fiscal policy appears likely to stay expansionary through this year. At the same time, increases in efficiency and a significant level of underutilized resources should help keep a lid on inflation.

This favorable short-term outlook for the U.S. economy, however, is playing out against a backdrop of growing concern about the prospects for the federal budget. As you are well aware, after having run surpluses for a brief period around the turn of the decade, the federal budget has reverted to deficit. The unified deficit swelled to $375 billion in fiscal 2003 and appears to be continuing to widen in the current fiscal year. According to the latest projections from the
Administration and the Congressional Budget Office (CBO), if current policies remain in place, the budget will stay in deficit for some time.

In part, the recent deficits have resulted from the economic downturn in 2001 and the period of slow growth that followed, as well as the sharp declines in equity prices. The deficits also reflect a significant step-up in spending on defense and higher outlays for homeland security and many other nondefense discretionary programs. Tax reductions--some of which were intended specifically to provide stimulus to the economy--also contributed to the deterioration of the fiscal balance.

For a time, the fiscal stimulus associated with the larger deficits was helpful in shoring up a weak economy. During the next few years, these deficits will tend to narrow somewhat as the economic expansion proceeds and rising incomes generate increases in revenues. Moreover, the current ramp-up in defense spending will not continue indefinitely. Merely maintaining a given military commitment, rather than adding to it, will remove an important factor driving the deficit higher. But the ratio of federal debt held by the public to GDP has already stopped falling and has even edged up in the past couple of years--implying a worsening of the starting point from which policymakers will have to address the adverse budgetary implications of an aging population and rising health care costs.

For about a decade, the rules laid out in the Budget Enforcement Act of 1990, and the later modifications and extensions of the act, provided a procedural framework that helped the Congress make the difficult decisions that were required to forge a better fiscal balance. However, the brief emergence of surpluses eroded the will to adhere to those rules, and many of the provisions that helped to restrain budgetary decisionmaking in the 1990s--in particular, the limits on discretionary
spending and the PAYGO requirements--were violated more and more frequently and eventually allowed to expire. In recent years, budget debates have turned to choices offered by those advocating tax cuts and those advocating increased spending. To date, actions that would lower forthcoming deficits have received only narrow support, and many analysts are becoming increasingly concerned that, without a restoration of the budget enforcement mechanisms and the fundamental political will they signal, the inbuilt political bias in favor of red ink will once again become entrenched.

In 2008—just four years from now—the first cohort of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits may be claimed and the age at which about half of prospective beneficiaries choose to retire; in 2011, these individuals will reach 65 and will thus be eligible for Medicare. At that time, under the intermediate assumptions of the OASDI trustees, there will still be more than three covered workers for each OASDI beneficiary; by 2025, this ratio is projected to be down to 2-1/4. This dramatic demographic change is certain to place enormous demands on our nation’s resources—demands we almost surely will be unable to meet unless action is taken. For a variety of reasons, that action is better taken as soon as possible.

The budget scenarios considered by the CBO in its December assessment of the long-term budget outlook offer a vivid—and sobering—illustration of the challenges we face as we prepare for the retirement of the baby-boom generation. These scenarios suggest that, under a range of reasonably plausible assumptions about spending and taxes, we could be in a situation in the decades ahead in which rapid increases in the unified budget deficit set in motion a dynamic in which large deficits result in ever-growing interest payments that augment deficits in future years. The
resulting rise in the federal debt could drain funds away from private capital formation and thus over time slow the growth of living standards.

Favorable productivity developments, of course, can help to alleviate the impending budgetary strains, but no one should expect productivity growth to be sufficient to bail us out. Indeed, productivity would have to grow at a rate far above its historical average to fully resolve the long-term financing problems of Social Security and Medicare. Higher productivity, of course, buoys expected revenues to the system, but it also raises Social Security obligations. Moreover, although productivity has no direct link to Medicare spending, historical experience suggests that the demand for medical services increases with real income, which over time rises in line with productivity.

Today, federal outlays under Social Security and Medicare amount to less than 7 percent of GDP. In December, the CBO projected that these outlays would increase to 12 percent of GDP by 2030 under current law, using assumptions about the growth of health-care costs similar to the intermediate assumptions of the Medicare trustees; when spending on Medicaid is added in, the rise in the ratio is even steeper. To be sure, the rise in these outlays relative to GDP could be financed by tax increases, but the CBO results suggest that, even if other non-interest spending is constrained

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1 Under current law, faster productivity growth would not affect individuals who are already retired because their benefits are indexed by the consumer price index (CPI). However, it would raise initial benefits for future retirees through its effect on real wages over time. In the end, productivity would have to rise about 3-1/2 percent per year, about 2 percentage points per year faster than the trustees' current intermediate assumption, to eliminate the Social Security imbalance over seventy-five years; productivity growth would have to be even more rapid to achieve balance in perpetuity.
fairly tightly, ensuring fiscal stability would require an overall federal tax burden well above its
long-term average.

Most experts believe that the best baseline for planning purposes is to assume that the
demographic shift associated with the retirement of the baby-boom generation will be
permanent—that is, it will not reverse when that cohort passes away. Indeed, so long as longevity
continues to increase—and assuming no significant changes in immigration or fertility rates—the
proportion of elderly in the population will only rise. If this fundamental change in the age
distribution materializes, we will eventually have no choice but to make significant structural
adjustments in the major retirement programs.

One change the Congress could consider as it moves forward on this critical issue is to
replace the current measure of the “cost of living” that is used for many purposes with respect to
both revenues and outlays with a more appropriate price index. As you may be aware, in 2002, the
Bureau of Labor Statistics introduced a new price index—the chained consumer price index (CPI).
The new index is based on the same underlying individual prices as is the official CPI. But it
combines those prices so as to remove some of the inadvertent bias in the official price index, and
thus it better measures changes in the cost of living, the statutory intent of the indexing. All else
being equal, had a chained CPI been used for indexing over the past decade, the cumulative unified
budget deficit and thus the level of the federal debt would have been reduced about $200 billion;
higher receipts and the reduction in debt service associated with those higher receipts account for

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\[2\text{In particular, the chained CPI captures more fully than does the official CPI the way that consumers alter the mix of their expenditures in response to changes in relative prices.}\]
roughly 60 percent of the saving, with the remainder attributable to lower outlays. Shifting to the
chain-weighted measure would not address perhaps more fundamental shortcomings in the
CPI—most notably the question of whether quality improvement is adequately captured—but it
would be an important step toward better implementation of the intention of the Congress.

Another possible adjustment relates to the age at which Social Security and Medicare
benefits will be provided. Under current law, and even with the so-called normal retirement age for
Social Security slated to move up to 67 over the next two decades, the ratio of the number of years
that the typical worker will spend in retirement to the number of years he or she works will rise in the
long term. A critical step forward would be to adjust the system so that this ratio stabilizes. A
number of specific approaches have been proposed for implementing this indexation, but the
principle behind all of them is to insulate the finances of the system, at least to a degree, from further
changes in life expectancy. Sound private and public decisionmaking will be aided by determining
ahead of the fact how one source of risk, namely demographic developments, will be dealt with.

The degree of uncertainty about whether future resources will be adequate to meet our
current statutory obligations to the coming generations of retirees is daunting. The concern is not so
much about Social Security, where benefits are tied in a mechanical fashion to retirees’ wage
histories and we have some useful tools for forecasting future outlays. The outlook for Medicare,
however, is much more difficult to assess. Although forecasting the number of program beneficiaries
is reasonably straightforward, we know very little about how rapidly medical technology will
continue to advance and how those innovations will translate into future spending. To be sure,
technological innovations can greatly improve the quality of medical care and can, in theory, reduce
the costs of existing treatments. But because medical technology expands the range of treatment options, it also has the potential of adding to overall spending—in some cases, significantly. As a result, the range of possible outlays per recipient is extremely wide. This uncertainty is an important reason to be cautious—especially given that government programs, whether for spending or for tax preferences, are easy to initiate but can be extraordinarily difficult to shut down once constituencies for them develop.

In view of this upward ratchet in government programs and the enormous uncertainty about the upper bounds of future demands for medical care, I believe that a thorough review of our spending commitments—and at least some adjustment in those commitments—is necessary for prudent policy. I also believe that we have an obligation to those in and near retirement to honor what has been promised to them. If changes need to be made, they should be made soon enough so that future retirees have time to adjust their plans for retirement spending and to make sure that their personal resources, along with what they expect to receive from the government, will be sufficient to meet their retirement needs.

I certainly agree that the same scrutiny needs to be applied to taxes. However, tax rate increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base. The exact magnitude of such risks is very difficult to estimate, but they are of enough concern, in my judgment, to warrant aiming to close the fiscal gap primarily, if not wholly, from the outlay side.

The dimension of the challenge is enormous. The one certainty is that the resolution of this situation will require difficult choices and that the future performance of the economy will depend on
those choices. No changes will be easy, as they all will involve lowering claims on resources or raising financial obligations. It falls on the Congress to determine how best to address the competing claims. In doing so, you will need to consider not only the distributional effects of policy change but also the broader economic effects on labor supply, retirement behavior, and private saving.

History has shown that, when faced with major challenges, elected officials have risen to the occasion. In particular, over the past twenty years or so, the prospect of large deficits has generally led to actions to narrow them. I trust that the recent deterioration in the budget outlook and the fast-approaching retirement of the baby-boom generation will be met with similar determination and effectiveness.