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Statement of

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

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Mr. Chairman, Ranking Member Spratt, and members of the Committee, I am pleased to be here today to offer my views on the federal budget and related issues. I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

The U.S. economy delivered a solid performance in 2004, and thus far this year, activity appears to be expanding at a reasonably good pace. However, the positive short-term economic outlook is playing out against a backdrop of concern about the prospects for the federal budget, especially over the longer run. Indeed, the unified budget is running deficits equal to about 3-1/2 percent of gross domestic product, and federal debt held by the public as a percent of GDP has risen noticeably since it bottomed out in 2001. To be sure, the cyclical component of the deficit should narrow as the economic expansion proceeds and incomes rise. And the current pace of the ramp-up in spending on defense and homeland security is not expected to continue indefinitely. But, as the latest projections from the Administration and the Congressional Budget Office suggest, our budget position is unlikely to improve substantially in the coming years unless major deficit-reducing actions are taken.

In my judgment, the necessary choices will be especially difficult to implement without the restoration of a set of procedural restraints on the budget-making process. For about a decade, the rules laid out in the Budget Enforcement Act of 1990 and in the later modifications and extensions of the act provided a framework that helped the Congress establish a better fiscal balance. However, the brief emergence of surpluses in the late 1990s eroded the will to adhere to these rules, which were aimed specifically at promoting deficit reduction rather than at the broader goal of setting out a commonly agreed-upon standard for determining whether the nation was living within its fiscal means. Many of the provisions that helped restrain budgetary decisionmaking in the 1990s--in particular, the limits on discretionary spending and the PAYGO requirements--were violated ever more frequently; finally, in 2002, they were allowed to expire.

Reinstating a structure like the one provided by the Budget Enforcement Act would signal a renewed commitment to fiscal restraint and help restore discipline to the annual budgeting process. Such a step would be even more meaningful if it were coupled with the adoption of a set of provisions for dealing with unanticipated budgetary outcomes over time. As you are well aware, budget outcomes in the past have deviated from projections--in some cases, significantly--and they will continue to do so. Accordingly, a well-designed set of mechanisms that facilitate midcourse corrections would ease the task of bringing the budget back into line when it goes off track. In particular, you might want to require that existing programs be assessed regularly to verify that they continue to meet their stated purposes and cost projections. Measures that automatically take effect when costs for a particular spending program or tax provision exceed a specified threshold may prove useful as well. The original design of the Budget Enforcement Act could also be enhanced by addressing how the strictures might evolve if and when reasonable fiscal balance came into view.

I do not mean to suggest that the nation's budget problems will be solved simply by adopting a new set of rules. The fundamental fiscal issue is the need to make difficult choices among budget priorities, and this need is becoming ever more pressing in light of the unprecedented number of individuals approaching retirement age. For example, future Congresses and Presidents will, over time, have to weigh the benefits of continued access, on current terms, to advances in medical technology against other spending priorities as well as against tax initiatives that foster increases in economic growth and the revenue base.

Because the baby boomers have not yet started to retire in force, we have been in a demographic lull. But this state of relative stability will soon end. In 2008--just three years from now--the leading edge of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits can be drawn and the age at which about half of those eligible to claim benefits have been doing so in recent years. Just three years after that, in 2011, the oldest baby boomers will reach 65 and will thus be eligible for Medicare. Currently, 3-1/4 workers contribute to the Social Security system for each beneficiary. Under the intermediate assumptions of the program's trustees, the number of beneficiaries will have roughly doubled by 2030, and the ratio of covered workers to beneficiaries will be down to about 2. The pressures on the budget from this dramatic demographic change will be exacerbated by those stemming from the anticipated steep upward trend in spending per Medicare beneficiary.

The combination of an aging population and the soaring costs of its medical care is certain to place enormous demands on our nation's resources and to exert pressure on the budget that economic growth alone is unlikely to eliminate. To be sure, favorable productivity developments would help to alleviate the impending budgetary strains. But unless productivity growth far outstrips that embodied in current budget forecasts, it is unlikely to represent more than part of the answer. Higher productivity does, of course, buoy revenues. But because initial Social Security benefits are influenced heavily by economywide wages, faster productivity growth, with a lag, also raises benefits under current law. Moreover, because the long-range budget assumptions already make reasonable allowance for future productivity growth, one cannot rule out the possibility that productivity growth will fall *short* of projected future averages.

In fiscal year 2004, federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of GDP. The long-run projections from the Office of Management and Budget suggest that the share will rise to 9-1/2 percent by 2015 and will be in the neighborhood of 13 percent by 2030. So long as health-care costs continue to grow faster than the economy as a whole, the additional resources needed for such programs will exert pressure on the federal budget that seems increasingly likely to make current fiscal policy unsustainable. The likelihood of escalating unified budget deficits is of especially great concern because they would drain an inexorably growing volume of real resources away from private capital formation over time and cast an ever-larger shadow over the growth of living standards.

The broad contours of the challenges ahead are clear. But considerable uncertainty remains about the precise dimensions of the problem and about the extent to which future resources will fall short of our current statutory obligations to the coming generations of retirees. We already know a good deal about the size of the adult population in, say, 2030. Almost all have already been born. Thus, forecasting the number of Social Security and Medicare beneficiaries is fairly straightforward. So too is projecting future Social Security benefits, which are tied to the wage histories of retirees. However, the uncertainty about future medical spending is daunting. We know very little about how rapidly medical technology will continue to advance and how those innovations will translate into future spending. Consequently, the range of possible outcomes for spending per Medicare beneficiary expands dramatically as we move into the next decade and beyond. Technological innovations can greatly improve the quality of medical care and can, in some instances, reduce the costs of existing treatments. But because technology expands the set of treatment possibilities, it also has the potential to add to overall spending--in some cases, by a great deal. Other sources of uncertainty--for example, the extent to which longer life expectancies among the elderly will affect medical spending--may also turn out to be important. As a result, the range of future possible outlays per recipient is extremely wide. The actuaries' projections of Medicare costs are, perforce, highly provisional.

These uncertainties--especially our inability to identify the upper bound of future demands for medical care--counsel significant prudence in policymaking. The critical reason to proceed cautiously is that new programs quickly develop constituencies willing to fiercely resist any curtailment of spending or tax benefits. As a consequence, our ability to rein in deficit-expanding initiatives, should they later prove to have been excessive or misguided, is quite limited. Thus, policymakers need to err on the side of prudence when considering new budget initiatives. Programs can always be expanded in the future should the resources for them become available, but they cannot be easily curtailed if resources later fall short of commitments.

I fear that we may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver. If existing promises need to be changed, those changes should be made sooner rather than later. We owe future retirees as much time as possible to adjust their plans for work, saving, and retirement spending. They need to ensure that their personal resources, along with what they expect to receive from the government, will be sufficient to meet their retirement goals.

Addressing the government's own imbalances will require scrutiny of both spending and taxes. However, tax 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, in my judgment, they are sufficiently worrisome to warrant aiming, if at all possible, to close the fiscal gap primarily, if not wholly, from the outlay side. In the end, I suspect that, unless we attain unprecedented increases in productivity, we will have to make significant structural adjustments in the nation's major retirement and health programs.

Our current, largely pay-as-you go social insurance system worked well given the demographics of the second half of the twentieth century. But as I have argued previously, the system is ill-suited to address the unprecedented shift of population from the workforce to retirement that will start in 2008. Much attention has been focused on the forecasted exhaustion of the Social Security trust fund in 2042. But solving that problem will do little in itself to meet the imperative to boost our national saving. Raising national saving is an essential step if we are to build a capital stock that by, say, 2030 will be sufficiently large to produce goods and services adequate to meet the needs of retirees without unduly curbing the standard of living of our working-age population.

Unfortunately, the current Social Security system has not proven a reliable vehicle for such saving. Indeed, although the trust funds have been running annual surpluses since the mid-1980s, one can credibly argue that they have served primarily to facilitate larger deficits in the rest of the budget and therefore have added little or nothing to national saving.

In my view, a retirement system with a significant personal accounts component would provide a more credible means of ensuring that the program actually adds to overall saving and, in turn, boosts the nation's capital stock. The reason is that money allocated to the personal accounts would no longer be available to fund other government activities and--barring an offsetting reduction in private saving outside the new accounts--would, in effect, be reserved for future consumption needs.

The challenge of Medicare is far more problematic than that associated with Social Security. A major reason is the large variance of possible outcomes mentioned earlier coupled with the inadequacy of the current medical information base. Some important efforts are under way to use the capabilities of information technology to improve the health-care system. If supported and promoted, these efforts could provide key insights into clinical best practices and substantially reduce administrative costs. And, with time, we should also gain valuable knowledge about the best approaches to restraining the growth of overall health-care spending.

Crafting a budget strategy that meets the nation's longer-run needs will become ever more difficult the more we delay. The one certainty is that the resolution of the nation's unprecedented demographic challenge will require hard choices and that the future performance of the economy will depend on those choices. No changes will be easy, as they all will involve setting priorities and, in the main, lowering claims on resources. It falls to the Congress to determine how best to address the competing claims on our limited resources. In doing so, you will need to consider not only the distributional effects of policy changes but also the broader economic effects on labor supply, retirement behavior, and private saving. In the end, the consequences for the U.S. economy of doing nothing could be severe. But the benefits of taking sound, timely action could extend many decades into the future.