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EVOLVING FISCAL CHALLENGES

Alan Greenspan,
Chairman, Federal Reserve Board;
testimony before the Senate Budget Committee,
January 25, 2001.

I am pleased to appear here today to discuss some of the important issues surrounding the outlook for the federal budget and the attendant implications for the formulation of fiscal policy. In doing so, I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

The challenges you face both in shaping a budget for the coming year and in designing a longer-run strategy for fiscal policy were brought into sharp focus by the release last week of the Clinton Administration's final budget projections, which showed further upward revisions of on-budget surpluses for the next decade. The Congressional Budget Office also is expected to again raise its projections when it issues its report next week.

The key factor driving the cumulative upward revisions in the budget picture in recent years has been the extraordinary pickup in the growth of labor productivity experienced in this country since the mid-1990s. Between the early 1970s and 1995, output per hour in the nonfarm business sector rose about 1-1/2 percent per year, on average. Since 1995, however, productivity growth has accelerated markedly, about doubling the earlier pace, even after taking account of the impetus from cyclical forces. Though hardly definitive, the apparent sustained strength in measured productivity in the face of a pronounced slowing in the growth of aggregate demand during the second half of last year was an important test of the extent of the improvement in structural productivity. These most recent indications have added to the accumulating evidence that the apparent increases in the growth of output per hour are more than transitory.

It is these observations that appear to be causing economists, including those who contributed to the OMB and the CBO budget projections, to raise their forecasts of the economy's long-term growth rates and budget surpluses. This increased optimism receives support from the forward-looking indicators of technical innovation and structural productivity growth, which have shown few signs of weakening despite the marked curtailment in recent months of capital investment plans for equipment and software.

To be sure, these impressive upward revisions to the growth of structural productivity and economic potential are based on inferences drawn from economic relationships that are different

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from anything we have considered in recent decades. The resulting budget projections, therefore, are necessarily subject to a relatively wide range of error. Reflecting the uncertainties of forecasting well into the future, neither the OMB nor the CBO projects productivity to continue to improve at the stepped-up pace of the past few years. Both expect productivity growth rates through the next decade to average roughly 2-1/4 to 2-1/2 percent per year -- far above the average pace from the early 1970s to the mid-1990s, but still below that of the past five years.

Had the innovations of recent decades, especially in information technologies, not come to fruition, productivity growth during the past five to seven years, arguably, would have continued to languish at the rate of the preceding twenty years. The sharp increase in prospective long-term rates of return on high-tech investments would not have emerged as it did in the early 1990s, and the associated surge in stock prices would surely have been largely absent. The accompanying wealth effect, so evidently critical to the growth of economic activity since the mid 1990s, would never have materialized.

In contrast, the experience of the past five to seven years has been truly without recent precedent. The doubling of the growth rate of output per hour has caused individuals' real taxable income to grow nearly 2-1/2 times as fast as it did over the preceding ten years and resulted in the substantial surplus of receipts over outlays that we are now experiencing. Not only did taxable income rise with the faster growth of GDP, but the associated large increase in asset prices and capital gains created additional tax liabilities not directly related to income from current production.

The most recent projections from the OMB indicate that, if current policies remain in place, the total unified surplus will reach $800 billion in fiscal year 2011, including an on-budget surplus of $500 billion. The CBO reportedly will be showing even larger surpluses. Moreover, the admittedly quite uncertain long-term budget exercises released by the CBO last October maintain an implicit on-budget surplus under baseline assumptions well past 2030 despite the budgetary pressures from the aging of the baby-boom generation, especially on the major health programs.

The most recent projections, granted their tentativeness, nonetheless make clear that the highly desirable goal of paying off the federal debt is in reach before the end of the decade. This is in marked contrast to the perspective of a year ago when the elimination of the debt did not appear likely until the next decade.

But continuing to run surpluses beyond the point at which we reach zero or near-zero federal debt brings to center stage the critical longer-term fiscal policy issue of whether the federal government should accumulate large quantities of private (more technically nonfederal) assets. At zero debt, the continuing unified budget surpluses currently projected imply a major accumulation of private assets by the federal government. This development should factor materially into the policies you and the Administration choose to pursue.

I believe, as I have noted in the past, that the federal government should eschew private asset accumulation because it would be exceptionally difficult to insulate the government's investment decisions from political pressures. Thus, over time, having the federal government hold significant amounts of private assets would risk sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise.

Short of an extraordinarily rapid and highly undesirable short-term dissipation of unified surpluses or a transferring of assets to individual privatized accounts, it appears difficult to avoid at least some accumulation of private assets by the government.

Private asset accumulation may be forced upon us well short of reaching zero debt. Obviously, savings bonds and state and local government series bonds are not readily redeemable before maturity. But the more important issue is the potentially rising cost of retiring marketable Treasury debt. While shorter-term marketable securities could be allowed to run off as they mature, longer-term issues would have to be retired before maturity through debt buybacks. The magnitudes are large: As of January 1, for example, there was in excess of three quarters of a trillion dollars in outstanding non-marketable securities, such as savings bonds and state and local series issues, and marketable securities (excluding those held by the Federal Reserve) that do not mature and could not be called before 2011. Some holders of long-term Treasury securities may be reluctant to give them up, especially those who highly value the risk-free status of those issues. Inducing such holders, including foreign holders, to willingly offer to sell their securities prior to maturity could require paying premiums that far exceed any realistic value of retiring the debt before maturity.

Decisions about what type of private assets to acquire and to which federal accounts they should be directed must be made well before the policy is actually implemented, which could occur in as little as five to seven years from now. These choices have important implications for the balance of saving and, hence, investment in our economy. For example, transferring government saving to individual private accounts as a means of avoiding the accumulation of private assets in the government accounts could significantly affect how social security will be funded in the future.

Short of some privatization, it would be preferable in my judgment to allocate the required private assets to the social security trust funds, rather than to on-budget accounts. To be sure, such trust fund investments are subject to the same concerns about political pressures as on-budget investments would be. The expectation that the retirement of the baby-boom generation will eventually require a drawdown of these fund balances does, however, provide some mitigation of these concerns.

Returning to the broader picture, I continue to believe, as I have testified previously, that all else being equal, a declining level of federal debt is desirable because it holds down long-term real interest rates, thereby lowering the cost of capital and elevating private investment. The rapid capital deepening that has occurred in the U.S. economy in recent years is a testament to these benefits. But the sequence of upward revisions to the budget surplus projections for several years now has reshaped the choices and opportunities before us. Indeed, in almost any creditable baseline scenario, short of a major and prolonged economic contraction, the full benefits of debt reduction are now achieved before the end of this decade -- a prospect that did not seem likely only a year or even six months ago.

The most recent data significantly raise the probability that sufficient resources will be available to undertake both debt reduction and surplus-lowering policy initiatives. Accordingly, the tradeoff faced earlier appears no longer an issue. The emerging key fiscal policy need is to address the implications of maintaining surpluses beyond the point at which publicly held debt is effectively eliminated.

The time has come, in my judgement, to consider a budgetary strategy that is consistent with a preemptive smoothing of the glide path to zero federal debt or, more realistically, to the level of federal debt that is an effective irreducible minimum. Certainly, we should make sure that social security surpluses are large enough to meet our long-term needs and seriously consider explicit mechanisms that will help ensure that outcome. Special care must be taken not to conclude that wraps on fiscal discipline are no longer necessary. At the same time, we must avoid a situation in which we come upon the level of irreducible debt so abruptly that the only alternative to the accumulation of private assets would be a sharp reduction in taxes and/or an increase in expenditures, because these actions might occur at a time when sizable economic stimulus would be inappropriate. In other words, budget policy should strive to limit potential disruptions by making the on-budget surplus economically inconsequential when the debt is effectively paid off.

In general, as I have testified previously, if long-term fiscal stability is the criterion, it is far better, in my judgment, that the surpluses be lowered by tax reductions than by spending increases. The flurry of increases in outlays that occurred near the conclusion of last fall's budget deliberations is troubling because it makes the previous year's lack of discipline less likely to have been an aberration.

To be sure, with the burgeoning federal surpluses, fiscal policy has not yet been unduly compromised by such actions. But history illustrates the difficulty of keeping spending in check, especially in programs that are open-ended commitments, which too often have led to much larger outlays than initially envisioned. It is important to recognize that government expenditures are claims against real resources and that, while those claims may be unlimited, our capacity to meet them is ultimately constrained by the growth in productivity. Moreover, the greater the drain of resources from the private sector, arguably, the lower the growth potential of the economy. In contrast to most spending programs, tax reductions have downside limits. They cannot be open-ended.

Lately there has been much discussion of cutting taxes to confront the evident pronounced weakening in recent economic performance. Such tax initiatives, however, historically have proved difficult to implement in the time frame in which recessions have developed and ended. For example, although President Ford proposed in January of 1975 that withholding rates be reduced, this easiest of tax changes was not implemented until May, when the recession was officially over and the recovery was gathering force. Of course, had that recession lingered through the rest of 1975 and beyond, the tax cuts would certainly have been helpful. In today's context, where tax reduction appears required in any event over the next several years to assist in forestalling the accumulation of private assets, starting that process sooner rather than later likely would help smooth the transition to longer-term fiscal balance. And should current economic weakness spread beyond what now appears likely, having a tax cut in place may, in fact, do noticeable good.

As for tax policy over the longer run, most economists believe that it should be directed at setting rates at the levels required to meet spending commitments, while doing so in a manner that minimizes distortions, increases efficiency, and enhances incentives for saving, investment, and work.

In recognition of the uncertainties in the economic and budget outlook, it is important that any long-term tax plan, or spending initiative for that matter, be phased in. Conceivably, it could include provisions that, in some way, would limit surplus-reducing actions if specified targets for the budget surplus and federal debt were not satisfied. Only if the probability was very low that prospective tax cuts or new outlay initiatives would send the on-budget accounts into deficit, would unconditional initiatives appear prudent.

The reason for caution, of course, rests on the tentativeness of our projections. What if, for example, the forces driving the surge in tax revenues in recent years begin to dissipate or reverse in ways that we do not now foresee? Indeed, we still do not have a full understanding of the exceptional strength in individual income tax receipts during the latter 1990s. To the extent that some of the surprise has been indirectly associated with the surge in asset values in the 1990s, the softness in equity prices over the past year has highlighted some of the risks going forward.

Indeed, the current economic weakness may reveal a less favorable relationship between tax receipts, income, and asset prices than has been assumed in recent projections. Until we receive full detail on the distribution by income of individual tax liabilities for 1999, 2000, and perhaps 2001, we are making little more than informed guesses of certain key relationships between income and tax receipts.

To be sure, unless later sources do reveal major changes in tax liability determination, receipts should be reasonably well-maintained in the near term, as the effects of earlier gains in asset values continue to feed through with a lag into tax liabilities. But the longer-run effects of movements in asset values are much more difficult to assess, and those uncertainties would intensify should equity prices remain significantly off their peaks. Of course, the uncertainties in the receipts outlook do seem less troubling in view of the cushion provided by the recent sizable upward revisions to the ten-year surplus projections. But the risk of adverse movements in receipts is still real, and the probability of dropping back into deficit as a consequence of imprudent fiscal policies is not negligible.

In the end, the outlook for federal budget surpluses rests fundamentally on expectations of longer-term trends in productivity, fashioned by judgments about the technologies that underlie these trends. Economists have long noted that the diffusion of technology starts slowly, accelerates, and then slows with maturity. But knowing where we now stand in that sequence is difficult -- if not impossible -- in real time. As the CBO and the OMB acknowledge, they have been cautious in their interpretation of recent productivity developments and in their assumptions going forward. That seems appropriate given the uncertainties that surround even these relatively moderate estimates for productivity growth. Faced with these uncertainties, it is crucial that we develop budgetary strategies that deal with any disappointments that could occur.

That said, as I have argued for some time, there is a distinct possibility that much of the development and diffusion of new technologies in the current wave of innovation still lies ahead, and we cannot rule out productivity growth rates greater than is assumed in the official budget projections. Obviously, if that turns out to be the case, the existing level of tax rates would have to be reduced to remain consistent with currently projected budget outlays.

The changes in the budget outlook over the past several years are truly remarkable. Little more than a decade ago, the Congress established budget controls that were considered successful because they were instrumental in squeezing the burgeoning budget deficit to tolerable dimensions. Nevertheless, despite the sharp curtailment of defense expenditures under way during those years, few believed that a surplus was anywhere on the horizon. And the notion that the rapidly mounting federal debt could be paid off would not have been taken seriously.

But let me end on a cautionary note. With today's euphoria surrounding the surpluses, it is not difficult to imagine the hard-earned fiscal restraint developed in recent years rapidly dissipating. We need to resist those policies that could readily resurrect the deficits of the past and the fiscal imbalances that followed in their wake.

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