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Testimony before the Senate Subcommittee on Fiscal Responsibility and Economic Growth
September 13, 2011

A decade ago, the Federal Reserve embarked upon a serious effort to identify how the Fed's Open Market Operations, the core of monetary policy, could be implemented in an economy with projected surpluses that would eventually eliminate the availability of outstanding federal debt for Federal Reserve operations.

Those surpluses, regrettably, thoroughly undermined the fiscal prudence that had emerged in the 1990s. Chronic deficits back then fostered a fiscal regime of paygo and increasingly prudential fiscal policies. We viewed paygo as essential to stem budgets that were inherently prone to excess.

We have now come full circle to a point where, as much as I wish it were otherwise, there is no credible scenario of addressing our fiscal problems without inflicting economic pain. We have been procrastinating far too long in coming to grips with the retirement of the baby-boomer generation, a fiscal problem that has been visible for decades. By 2006, with chronic surpluses already a distant memory, the Trustees of Medicare Part A indicated, according to calculations by the Council of Economic Advisors, that:

> The Medicare program does not have enough projected revenue to cover projected future spending . . . A reduction in Medicare Part A expenditures by 51 percent would be necessary to make the Medicare Trust Fund solvent.[1]

But rather than repairing that huge shortfall, and a lesser one in Social Security, we expanded entitlements still further, without a matching source of revenue.

Our major problem is not only that spending has been rising rapidly, but that it has been in the form of entitlements, rather than of discretionary outlays such as war spending or bridge

[1] *Economic Report of the President*; February 2007; pg. 93.

building that cease when the activity comes to an end. Entitlements, however, once bestowed, are very difficult to rescind.

The growth of our economy in the years ahead is bound to slow. The retiring baby-boom generation is the most skilled and productive of the current cohorts of our labor force. They are being replaced by the younger people who, as students, did so poorly in 1995 and since, in international test score comparisons in math and science.[2] As a consequence, their incomes, a proxy for their relative productivity, have trailed the relative incomes of previous new labor market entrants, enough to subtract as much as a tenth of a percentage point in annual productivity growth – a number which cumulates to significance over time.

Moreover, the growth of our civilian labor force, short of a major change in immigration, should parallel a slowing in the growth of the working age population, most of whom are already born. Professor Robert J. Gordon of Northwestern University has concluded that his most recent twenty year forecast of the growth rate of per capita real GDP "represents the slowest growth of the measured American standard of living over any two-decade interval recorded since the inauguration of George Washington."[3]

In the years ahead, increasing entitlements will be pressing against shrinking economic growth. The Congressional Budget Office's August forecast was based on data published prior to the Bureau of Economic Analysis' major downward revision of GDP for recent years.

My preference going forward, as I have noted on previous occasions, is something akin to the budget recommendations of Paul Ryan, the Chairman of the House Budget Committee. I regret, however, for now at least, that Ryan's budget lacks the votes for passage. And, as

[2] TIMSS.
[3] Gordon, Robert J. *Revisiting U.S. Productivity Growth over the Past Century with a View of the Future,* NBER Working paper No. 15834, March 2010.

European current experience underscores, delays in implementing policy reform can be destabilizing.

Of the politically feasible budget proposals on the table, that proffered by the Bowles-Simpson National Commission on Fiscal Responsibility and Reform, appears most substantive.

What impressed me most of Bowles-Simpson is that it addresses tax expenditures. Cuts in tax expenditures can be alternatively structured, and viewed, as cuts in outlays rather than a reduction in revenues. The deduction for interest on home mortgages, for example, could just as easily have been reconstituted as a subsidy payment to homeowners. Similarly, oil and gas depletion allowances could be restructured as subsidies to producers. Subsidies, I might add, of whatever stripe, distort the optimum functioning of markets, and ultimately, the standard of living of society as whole.

I do not know whether a budget crisis is immediately on the horizon or is years off. What I do know is that if we presume that we have a year or two before starting long-term restraint, and we turn out to be wrong, the consequences could be devastating. If currently we are wrong in being overly fiscally cautious, that is a problem that is readily solvable.