ECONOMIC OUTLOOK AND CURRENT FISCAL ISSUES

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ECONOMIC OUTLOOK AND CURRENT FISCAL ISSUES

WEDNESDAY, FEBRUARY 25, 2004

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Gutknecht, Toomey, Hastings, Portman, Brown, Crenshaw, Putnam, Tancredo, Franks, Garrett, Hensarling, Brown-Waite, Spratt, Moran, Moore, Neal, Edwards, Scott, Ford, Capps, Thompson, Baird, Cooper, Emanuel, Davis, Majette, and Kind.

Chairman NUSSLE. Good morning and welcome to this hearing of the House Budget Committee. Today, we have with us the very distinguished Chairman of the Federal Reserve, Alan Greenspan, to discuss with our committee the economic outlook and the Federal budget.

Chairman Greenspan, welcome again to the Budget Committee. We appreciate the time that you are always willing to spend with this committee, discussing the economy and discussing the budget over the years. We appreciate the opportunity for that discourse and discussion again today.

It has been about a year since you last testified before the committee—actually, almost a year and a half now—and at that time, our Nation was really still in the early stages of recovering from the terrorist attack of September 11, 2001, and its aftermath. We were facing uncertainties at that time about the war in Iraq, and we still had an economy that at least appeared to me and to many of my constituents in Iowa was having a difficult time getting back on track. I think it is true for many within the country.

No one should underestimate that the challenges that we have had to overcome these last 3 years have been difficult, and in fact, we have been, I think, as successful as we have is really something that we need to discuss today with you: Why is it that we have seen some of the successes that we are on the threshold of being able to really take advantage of at this point in time?

Today, we are really in a much different position—and certainly a much better—position than last time you came before the committee. I have got a couple of charts just to illustrate this point, the economy, in showing robust growth; and strong growth is expected really to continue. In the third quarter of 2003, we saw an amazing GDP growth of 8.2 percent, the highest surge in 20 years.

And that was the followed by a strong growth rate of 4 percent in the fourth quarter—still strong, certainly, by historic standards.

Housing—starts in chart 2—were running at their highest level in 20 years, as you can see there.

In chart 3, mortgage interest rates continue to run at their lowest levels in three decades, and the bank prime rate is at its lowest level in 45 years. Certainly you have quite a bit to do with that, Mr. Chairman. We appreciate that.

Inflation, in chart 4, has been running at its lowest rate in four decades, and I know this is a chart that you are intimately familiar with. This is probably one of the first charts, as I understand it, that you pay attention to, as inflation is one of your concerns.

The U.S. real exports of goods and services rose in the fourth quarter at a rate of 19 percent, which was the fastest pace in 7 years, which is a good indicator, particularly for those of us who have States where we are concerned about exports, where we are so export dependent.

We have seen a significant increase in the stock market, and the Dow Jones industrial average up 40 percent since March of last year.

Chart 5, in addition—and the most important, I think, which is labor—the markets, the labor markets appear to be improving. For the past 20-straight weeks, unemployment insurance claims have remained low and below the benchmark regarded by economists as a sign of an improving labor market.

In chart 6, we have got an unemployment rate down to 5.6 percent from the 6.3 percent last June. I am not sure anyone predicted that we would be that low, particularly this early in 2004.

And the last chart, chart 7, really at this point in time, as you can see, the payroll—employment is growing again. We need an economy that steadily expands job opportunities for our citizens, so that everyone who wants to work can work and so that every working person knows that they can actually get ahead and balance their own family budget, which really is the most important budget that I think we should be concerning ourselves with here, because if their budget is not working, really none of the budgets of our country are working.

We have asked Chairman Greenspan here today not only to review the current and clearly improved economic picture, but also how we got to this point, and what he believes is the best course of keeping the momentum going. Certainly a large part of that discussion will focus on the impact of tax relief packages passed in 2001, 2002, and 2003. I am eager to hear the chairman's thoughts on what roles those policies continue to play and how we must now build a foundation of sustained economic growth.

As I know you have said before, Chairman Greenspan, and I have certainly said time and time again, in addition to getting and keeping our economy going, we have got to get our hands around the other piece of the puzzle, that is controlling Federal spending. It really does matter. It matters to this committee, maybe more so than it matters to any other committee.

We are going to continue to believe in this committee that the deficits do matter. They are not the be-all and end-all, certainly, but they are indicative of some of the challenges that we have to deal with.

All spending must be paid for, either through taxes, borrowing, or growth in the economy, and those are burdens—certainly, taxes and borrowing are burdens on the economy. And for that simple reason alone, controlling spending itself is a policy, I believe, for continuing economic growth.

You have testified before, and you strongly urged this committee and the Congress to renew expiring discretionary caps, PAYGO spending controls; and as you know, those laws have been allowed to lapse. I strongly support reviving those statutory controls. I would like to discuss that with you today and would be interested in your thoughts on that.

I am sure that it wouldn't hurt at all if you would encourage us in your way to continue to fight for budget enforcement tools. It is one thing to have a budget plan; it is yet another to enforce it and give predictability not only to the Federal Government, but also to the markets, that we are going to plan our work, own our plan and stick to it and enforce it over time. I think that gives predictability that is important stability for the economic markets.

So we welcome you back.

Chairman Greenspan will be with us for 2 hours today, until noon. He has agreed to testify until that point. So what we would like to do today is, as much as possible, ask questions. If you have a speech you would like to put into the record, we would ask unanimous consent that it be allowed to put in at the opening, at this point in time. And with that, I would turn to Mr. Spratt for any comments he would like to make.

Mr. SPRATT. Mr. Chairman, welcome back. We appreciate your coming here to testify. We know that you are called upon many times to do it, and we appreciate the fact that you would come and appear before our committee.

Mr. Chairman, you may recall it, but 4 or 5 years ago as we were basking in the glory of budget surpluses, you were good enough to come over to the Library of Congress, to the Member's Room, and meet with the Democratic members of this committee and talk about the budget and the economy and the best thing that we could do with the impending surpluses, which were substantial.

At that time there was a proposal developing that instead of borrowing and spending Social Security surplus, as we had for years in the past, we would instead take the surplus building and accumulating in the Social Security trust fund and use it to buy back or buy up outstanding Treasury bonds, thereby reducing the debt held by the public and increasing net national saving.

As I recall, you told us then you approved of the idea, and you told us this was the probably the single most efficient way we could restore some of the deficiency, the woeful deficiency in saving in our domestic economy.

A year or so later, President Bush came to office. I think it is partly because he was not here during the 15 years we struggled to subdue and get our hands around the deficit, he bought into a "blue sky" forecast that indicated that we had surpluses of $5.6 trillion between 2002–11. And in effect he bet the budget on this forecast, even though we warned at the time that there were storm clouds gathering over the economy, and that those numbers weren't so rosy. They might not be obtained. There ought to be a margin for error and a margin for unexpected contingencies.

Well, we have had three things happen now, Mr. Chairman. First of all, the OMB now comes to us and tells us we were wrong, that surplus was overstated by at least 55 percent. That is their acknowledgement today. That means there wasn't a $5.6 trillion surplus at all; it was an economist's construct. And the economists now tell us that they have got to reconstruct it, and it looks like more in the range of $2.6 trillion.

If that is a correct estimation of the cumulative surplus between 2002–11, that means all of it comes from Social Security. And if we therefore have tax cuts, knowing that we only have a surplus of $2.6 trillion and all of it comes from Social Security, then our plan for using the Social Security surplus to buy back debt, increase net national savings, and drive down the cost of capital is out the window. It is not doable anymore.

Secondly, we have had contingencies come up, national defense, terrorism. We are spending, by our calculation, a trillion dollars in the Bush years under the Bush defense plan, more than was anticipated to be spent alone in 2001–02.

Then, of course, we have had a recession intervene, and it required some stimulative steps on the part of the government, which also have taken a toll on the budget.

But the question we want to put to you today is, where do we go from here? How do we get back on that track?

I think you would still agree that we have a deficiency of net national saving in the country, when the government "dis-saves"—that is what a deficit is—we are only contributing to the problem; and we are skating on pretty thin ice, given the fact that most of our debt issued today is being bought by foreigners. We are cutting taxes, largely for upper-bracket taxpayers, then going out into the world capital markets and borrowing the money to make up for the lost revenues. A lot of it is coming from China. Certainly debt means dependency, for governments and for individuals; surely this practice cannot go on forever.

And secondly, we have got a reconstruction of the deficits, as we see when we make realistic adjustments to the spending line and to the revenue line when we factor in, for example, the expiring tax cuts and when we consider what the likely cost of our deployment in Iraq and Afghanistan are going to be; and instead of taking the middle course between those two lines, it takes the lower course. And 10 years from now we are about where we are now. We tread water. There is a little bump for a good economy right now.

We want to ask you when you testify, do you think this is a course that is sustainable? Do you think these numbers are consequential? If so, what are the consequences for our Nation and for our economy?

Thank you for coming. We look forward to your testimony today.

Chairman NUSSLE. Mr. Chairman, your entire statement will be made part of the record, and you may proceed as you wish. Again, welcome to the Budget Committee.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much. Mr. Chairman and members of the committee, as always, 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, and prospects for sustaining the expansion in the period ahead are good. This favorable short-term outlook of 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 deficits welled to $375 billion in fiscal year 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, if current policies remain in place, the budget will stay in deficit for some time.

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 the 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 that they signal, the in-built political bias in favor of red ink will once again become entrenched.

In 2008, just 4 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 two and a quarter. 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 the GDP. In December, 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 noninterest spending is constrained 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 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 age distribution materializes, we will eventually have no choice but to make significant structural adjustments in the major retirement programs.

One change that the Congress can 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 that chained the Consumer Price Index. The new index is based on the same underlying individual prices as in 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.

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 a 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 decision-making 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 truly daunting. The uncertainty is especially great for Medicare, because we know very little about how rapidly medical technology will continue to advance and how those innovations will translate into future spending. 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 these considerations, I believe that a thorough review of our spending commitments and at least some adjustments in those commitments is necessary for prudent policy.

I also believe that we have an obligation to those in or 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, but history has shown that when faced with major challenges, elected officials have risen to the occasion. In particular, over the past 20 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.

Thank you very much, Mr. Chairman. I look forward to your questions.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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 year 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 4 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 2¼. 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 healthcare 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 noninterest spending is constrained 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 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.

Chairman NUSSLE. Thank you, Mr. Chairman. And again, for Member's purposes, Chairman Greenspan has to leave at noon. So I would ask Members not only to stay within their 5 minutes, but to use that time as efficiently as possible.

Please turn on the clock for me, too.

Mr. Chairman, as you say in your statement, during the next few years, these deficits will tend to narrow somewhat as the economic expansion proceeds and rise in income generates increases in revenue. Moreover, the current ramp-up in defense spending will not continue indefinitely, and that obviously will remove, as you say, an important factor for driving deficits higher.

I want to make sure, in saying that, are you suggesting that we have time to begin the process to control spending and to get the deficits under control? Or are you suggesting that we should take the time now, combined with what you say, naturally, will be occurring in the economy and with personal incomes and with some of the needs for that spending to be naturally decreased, that we should take that time now?

So how much time, in your judgment, do we have to demonstrate not only to you, but also to the American people and the marketplace that we are serious about controlling the deficits and the budget?

Mr. GREENSPAN. Mr. Chairman, I think the time is reasonably short largely because it is going to take a long time in and of itself to institute and create a different line of projection and trajectory for both revenues and spending to work their way into the process. The particular point where I think we have to be very careful is that point at which the expectation of looming deficits in the next decade begins to impact on long-term interest rates.

Currently, I don't know where that is. I don't believe it is in the immediate future. It is out there somewhere. It is out there in this decade by all of the analysis that we can make. And I would suggest that it is essential, if our purpose is to find a way of gliding into what is probably one of the most difficult fiscal situations we have ever faced, because of the sharp rise in the baby boom generation retirement coupled with fairly extensive entitlement programs for all of those people as they move from working, productive people into a long-sought retirement.

My judgment is that it is going to take several years at a minimum to construct programs which are credible to the markets. And I think it is very important that what we do, as far as fiscal policy is concerned, is to fend off what will invariably be the case if no action is taken at all.

In other words, if we are looking strictly at a current services budget, we are going to be confronted within a few years with a marked upward ratcheting of long-term interest rates, which is very debilitating to long-term economic growth.

Chairman NUSSLE. Well, then let's take the short term for a moment.

Is a tax increase at this moment in time for our economy the right recipe if, in fact, we can begin to demonstrate within a fiscal blueprint the ability to control spending, both on the discretionary and at least begin to control spending on the mandatory side of the ledger?

Mr. GREENSPAN. Mr. Chairman, I think that the outlook on the whole fiscal issue is so daunting that it is important that we maintain the revenue base, meaning that we maintain economic growth, such that we are able to get the types of revenues that we need and will need in the future to meet our obligations.

The crucial issue out here is the rate of growth of productivity and the rate of growth of the economy. What history does tell us is that keeping tax rates down will tend to maximize that. And while I fully recognize that it is an easy solution to a problem, when you have a deficit, to increase taxes, it is not evident to me that over the long run that actually works.

So it is crucially important as step No. 1 to make sure that we have the same sort of viable, expanding economy which we have been observing for a number of years; and that requires, in my judgment, significant restrain the tax side.

As I say in my prepared remarks, I am fully aware of the fact that it may not be possible to keep the tax rate down and still maintain some semblance of deficit control. Because of this concern that I would have, I would strongly recommend that the priority of evaluation start with the expenditure side—focussing on what can be constrained, what can be reduced—and only after you have run out of all of those options, would I advert to the revenue side, recognizing that you have long-term potential stability if the adjustments are made primarily on spending, and if there are significant increases in taxation, risks are there to the long-term economic outlook and, therefore, the revenue base itself.

Chairman NUSSLE. Let me suggest to you in my final—and I apologize for going over. Let me just suggest to you, as a final question, a scenario and ask for your comment on whether or not you believe this would be at least a serious, short-term beginning toward solving this problem:

No. 1, we have a transportation bill that fits within the tax revenue base that has been segregated for its use, the Road Use Trust Fund. The President has suggested a 21-percent increase in transportation spending remaining within the trust fund balances. Congress passing the bill that actually accomplishes that, and not deficit spending for transportation, but allowing that 21-percent increase for job creation, that is No. 1.

No. 2, a budget plan that does limit spending growth below what the President has suggested, bringing the deficit down below $500 billion for this first year, as an example, as opposed to the $521 billion deficit that the President proposed, and that we at least begin the process of looking at some of the mandatory side. Certainly all of it would be difficult, as you suggested, but beginning that look.

No. 3, that we do pass a cap extension and a PAYGO extension. If you saw those three items work their way through this committee and through the Congress, would that give you a positive reflection on what we are doing and a serious attention toward deficit reduction, or are there other steps that you would suggest in order to demonstrate seriousness?

Mr. GREENSPAN. I would first, Mr. Chairman, restore PAYGO and discretionary caps. Without a process for evaluating various tradeoffs, I see no way that any group such as a Congress can come to a set of priorities which will effectively reflect the will of the American people.

So doing things without the PAYGO and discretionary caps is a good start, but urge you to make certain that you are getting the process in place, because a lot of very seriously difficult decisions are going to have to be made by this committee and your counterparts in the Senate; and unless you have a mechanism for arraying priorities, I think it is going to be an almost impossible job. And I would say, the first priority is process, and then anything you can do subsequent to that I think is very helpful.

Chairman NUSSLE. Thank you.

Mr. Spratt.

Mr. SPRATT. Mr. Chairman, to follow up on your last comment, in saying that you would favor an extension of the PAYGO rule, do you mean the PAYGO rule in its original form that would apply both to entitlement increases and to tax cuts so that both would have to be offset and be deficit neutral?

Mr. GREENSPAN. Yes. I am talking about the particular rule that was in place before its expiration on the September 30, 2002.

Mr. SPRATT. Let me show you again the chart that I had in my opening statement, because what we have tried to do in this particular chart is assume realistically what happens if all of the tax cuts that are slated to expire are, in fact, renewed.

Across the bottom line there, we have tried to make what we regard as politically realistic corrections, including the major assumption that all of the expiring tax cuts will be renewed. As a consequence, there is a bit of an uptick in the bottom line of the budget, and then for the next 10 years, it ranges from nearly $400 billion to $500 billion.

No. 1, do you think this is a sustainable course, and if not, what are the consequences likely to be if we take this course? No. 2, will it affect long-term interest rates, as you warned?

Mr. GREENSPAN. Well, actually that particular pattern probably is already embodied in the marketplace.

Mr. SPRATT. You think the markets are assuming that we will be $500 billion in deficit still 10 years from now?

Mr. GREENSPAN. But remember, $500 billion in 2014 as a percent of a GDP will be significantly less than today. It is still a problem.

I am worried about larger budget deficits than that.

Mr. SPRATT. As a result of Social Security and Medicare?

Mr. GREENSPAN. I think, Congressman, that there is a wide range of error. Not on Social Security—Social Security we know within certain limits what can happen; it is a defined benefit program.

We really do not have a clue about the outlook for Medicare and never have. It has been a remarkably difficult forecasting process, largely because the technology has been awesome and unforecastable, as indeed all innovation is. And with the advances currently in place and the type of things that are developing, I am not saying the most probable outcome is something significantly different from the intermediate report of the Medicare trustees, but the range for error is quite large. I think this committee has to take into consideration the possibility that there may be a problem there. And if there is, then we have a more unstable set of numbers than that.

That looks like a very smooth curve to me. And the one thing we know about the real world is it never looks like the smooth projections we put down on paper.

Mr. SPRATT. Let me ask you this. You said that you were for an extension of the original PAYGO rule, which would apply to tax cuts as well as to entitlement increases.

Does that mean you would advise us that as we approach these sunsets and expirations and existing tax cuts, that they be offset before the renewal be passed?

Mr. GREENSPAN. Yes, sir.

Mr. SPRATT. Thank you very much, sir.

Let me ask you also about the jobless recovery we find ourselves in. It is unlike most of the 10 recessions that we have experienced since the end of the Second World War. Here we are years after the official recovery and we still have a loss of 2.2 million jobs in the private sector—2.9 million in the private sector, 2.2 million overall.

There is some controversy about which is the best source for estimating the job losses in the economy. The so-called Business Establishment Survey, which goes to business establishments and looks at their payrolls, a large sample of, I think, 400,000 firms; or the Household Survey, which has a large sample, but still a much smaller sample and interviews and extrapolates from individual households.

Has the Fed done work in this area to see which is a better index indicator of unemployment?

Mr. GREENSPAN. Not of unemployment, but of job growth, yes, Congressman. It turns out that, as best we can judge without getting into the details, the Household Survey, which is constructed by getting the average relationship in a 60,000 sample between the proportion of people working and the proportion of people in those households and then applying that ratio to an estimate of population is less reliable. As best we can judge, looking at it from a variety of different sources, the immigration numbers that are implicit in the population projections extended from the year 2000 when the Census was taken, are much too high, and indeed, they seem to have flattened out significantly from September 2001, thereafter.

I say this, as what would be implied in population numbers if we took not the 400,000 sample that you referred to in the so-called "payroll sample," but the full, insured unemployment count, so it is almost a Census count, and convert that into the implied level of population. What we find is, the Census Bureau's projection of the population just goes straight up, and this revised, synthetic population goes up through September 2001, then flattens out quite significantly.

The implication here is that immigration is probably grossly overestimated, and if that is the case and the population is actually going on a slower path than the official data, if you take the household ratios—that is, of employment to population ratios—and multiply them by the lower population trajectory, you will get a lower growth rate in household employment.

So we have concluded that the data on the so-called "payroll survey" is assuredly the more accurate of the two and that our suspicion is that at the end of the day there will be revisions in the household data.

Now, with one caveat, let me just make a point here which is that it is true that self-employed people are not in the payroll series. And those numbers have behaved far more strongly than the underlying payroll data, so if you add both of them together, you probably have got the best estimate of what true employment is. That shows less of a decline than you were quoting, Congressman, but still shows something far more closely related to the payroll, rather than the household series.

Mr. SPRATT. Well, one final question. You lean strongly in favor of spending cuts as opposed to tax increases in order to resolve this problem. But, let me read you what a fine young economist named Peter Orzag has developed as to what we would have to do on the spending side to erase this deficit.

It would take a 48-percent cut in Social Security benefits, a 57-percent cut in Medicare, elimination of the Federal contribution to Medicaid, or a 53-percent cut in all spending other than defense, homeland security, Social Security, Medicaid and Medicare, or an 80-percent cut in all domestic discretionary spending.

Don't those indicate to you that—that slight suggestion in your testimony today, that tax increases might have to be part of the solution?

Mr. GREENSPAN. You are merely describing the size of the problem that you are confronted with.

Mr. SPRATT. I am, indeed. But you have been around the town much longer than most of the people in this room. Do you think that cuts of that magnitude are politically realistic?

Mr. GREENSPAN. I don't think that they are. But I still think you have to start with the presumption that you are going to get as much as you can on that side, because what I think has happened in this country is, we have constructed by statute a series of entitlements which, when multiplied per capita, per person, per retiree, by the number of retirees, that we know with an almost marginal error, we have a level of commitment of real resources to fund those requirements which is very large relative to the potential GDP.

We are dealing with real resources. Finance is merely an intermediate way of trying to measure what we are doing. And I am basically saying that we are overcommitted at this stage.

To the extent that we try to resolve the overcommitment on the government side by raising taxes, we are risking lowering the rate of economic growth and the revenue base. And I am merely suggesting, how I would go about it.

Let me be very specific.

If you are able, which I don't believe you will be, to resolve this issue wholly on the spending side, that will create a fiscal trajectory which is sustainable over the longer term with fairly strong economic growth associated with it.

If you try to do it all on the tax side, my suspicion is you will find that you don't succeed because the tax base will begin to erode.

Somewhere in the middle—probably, in my judgment, far closer to the spending side than the tax side—is the necessary outcome.

But our problem essentially is, we have been making commitments without focusing on our capability of meeting them, and I think it is terribly important to make certain that we communicate to the people who are about to retire, what it is that they are going to have to live with. And if we promise more than we can actually physically deliver, I think it will be a major blot on our whole fiscal process.

So I am saying that this is a much larger problem than we can handle, and the only thing that will bail us out, as far as I can see, is if Medicare for reasons I don't understand, comes in at the lower end of all of the projections that are currently being made.

Mr. SPRATT. Sounds like divine intervention to me. Thank you, Mr. Chairman, very much for your testimony.

Chairman NUSSLE. Mr. Gutknecht.

Mr. GUTKNECHT. Thank you.

Dr. Greenspan, it is always great to have you up here. Just for the record, I agree with virtually everything that you have said. And to put it in short what you said about the retirement entitlements, we are writing checks that our children may not be able to cash. Isn't that true?

Mr. GREENSPAN. Yes, sir.

Mr. GUTKNECHT. I want to come back to one of the things that is most disturbing to us here, something that was alluded to by Mr. Spratt, and that is what OMB told us just 3 years ago, that we could be looking forward to surpluses of $5.5 trillion. They have now revised that and said at that point in time they should have only said it was $2.2 trillion.

How do we square those rather enormous differences between economic projections?

Mr. GREENSPAN. It is inherent in what we are trying to do. Remember, we have got two very large numbers. And over these years, it has been $1 [trillion] to $2 trillion on receipts and $1 [trillion] to $2 trillion on expenditure. What we are trying to do is to measure the difference between those two; and very small differences, even in the current period, create very large differences. Any small differences in either of the totals create very large differences in the difference. And when you start to project that problem out into the future, the range of error is awesomely large.

In fact, I remember CBO used to have a spread of probabilities, and it ranged, at first glance, extraordinarily wide. And it turned out, 2 years later they were outside of even that huge spread.

The reason I raise this question in my prepared remarks about the error issue here is that you can't create budget policy strictly on the basis of trying to focus on a specific forecast. You have got to take into consideration what will happen if you are wrong. What are the consequences of being wrong?

And what I am saying is that the consequences of being wrong on the tax side, that is, raising too much in tax revenues for the purpose of solving this particular problem, create potential downsides which are far greater, in my judgment, than mistakes on the other side.

Mr. GUTKNECHT. Can I come back to a question that we have here—that I have, because I do think the economy is improving, and I appreciate the fact that you believe the economy is improving and will continue to improve.

But that leaves us with a question that I can't explain, that is, if the economy—when we are seeing the kind of growth that we are seeing is as strong as it is, why do receipts to the Federal Government continue to lag so badly?

Mr. GREENSPAN. Well, I think that is an issue which always confounds OMB and CBO.

It is these so-called "technical adjustments," which they try to figure out currently, when all they can see are tax receipts and their estimates of income from the gross domestic product. Until they get statistics on income a couple of years later, they really have no way of knowing exactly why these relationships changed.

I don't know the answer to that. I do know that, of course, they have been adjusted down. There is a general expectation that in the short run they will be revised back up.

We had an unexpected dip the last couple of years. Most budget projectors are presuming that it is going to come back. I frankly don't have a clue.

Mr. GUTKNECHT. Well, I appreciate your candor.

One last point: I do hope you will continue to speak out on the issue of returning to PAYGO and spending caps or some version thereof, because it is clear if you look at the charts where this Congress began to lose its way, is when those were allowed to expire; and I think the time has come for us to have something with teeth in it relative to the way we budget and the way we spend the people's money.

Thank you very much.

Mr. SHAYS [presiding]. I thank the gentleman.

We have on our list Mr. Neal and Mr. Edwards and Ms. Capps on this side, and Mr. Franks and Mr. Garrett on our side. We now go first to Mr. Neal.

Mr. NEAL. Thank you.

Mr. Chairman, let me raise a question with you about amnesia. The Republican majority leader here suggested in the late 1990s— and I say this as one who has been around for this debate for 16 years——

Mr. GREENSPAN. I have been engaged with you for 16 years.

Mr. NEAL. You have, Mr. Chairman, first on the Banking Committee, then on the Ways and Means Committee and on the Budget Committee. We have engaged well.

But I want to ask you a couple of questions here.

The Republican majority leader in the late 1990s said that those votes that we were to take were taking us down the road to a depression. And the chairman of this committee at the time, my friend, Mr. Kasich, and a good guy, he said we were headed toward fiscal Armageddon with the budget votes that we took with Bush I and twice with Clinton.

Is it your position that there was a pretty strong economic performance in the mid-to-late 1990s?

Mr. GREENSPAN. There was, indeed.

Mr. NEAL. Would you suggest that that investment boom, the maturation of productivity as we witnessed it, now is continuing?

Mr. GREENSPAN. The productivity boom is certainly continuing.

Mr. NEAL. The productivity boom. So if the economic performance, Mr. Chairman, of the 1990s was so outstanding, what was so bad about the tax system that we had in the mid-to-late 1990s?

Mr. GREENSPAN. I never said there was something wrong about the tax system in the 1990s.

Mr. NEAL. We appreciate that. That helps my point.

Mr. Chairman, let me ask you this: My friends on the other side repeatedly say that we received and achieved a great victory in the tax cut on capital gains, for example, in 1997.

They claim that this was a very important source of economic growth. Well, what was so bad about that system in 1997 that we had to change it with these tax cuts that we have today?

Mr. GREENSPAN. Well, first of all, remember that the revenues that were coming in during that period and subsequent to that period were very heavily influenced by the stock market, first, in realized capital gains; secondly, in surprisingly large amount, the taxes on the exercise of stock options.

That disappeared virtually overnight, as the people in California have been observing with some chagrin, so that the illusion of a high revenue input of the system was an illusion which carried on for quite a period thereafter.

If you are asking my judgment, over the longer run, if you do not continuously cut tax rates, you will end up with ever higher taxation, because there is so-called, as you know, drift in tax brackets, called "bracket creep." So, in my view, we should be continuously cutting taxes to keep the burden contained. That is my general position. That has always been my position.

Mr. NEAL. You were party to those conversations, apparently, with Secretary O'Neill in terms of discussions as to this PAYGO issue. We have been through this, again over this decade and a half.

Did you support the O'Neill position in those discussions with the President as to how we should proceed with tax cuts?

Mr. GREENSPAN. I was not in the meeting with the President. Is that what you mean?

Mr. NEAL. Well, I think Mr. O'Neill suggests that there were meetings that took place, I think—I believe he suggested in the Price of Loyalty, his book, that the tax cuts should be reduced if the deficits become problematic.

Was that a position that you shared? Did you have any discussions?

I assume that——

Mr. GREENSPAN. In fact, I think I may have testified before this committee on that issue.

Mr. NEAL. So you would agree with that position?

Mr. GREENSPAN. I suggested that triggers ought to be part of the package.

Mr. NEAL. OK.

Mr. GREENSPAN. That is what we had been discussing. I presume that is what you are referring to, the O'Neill situation.

Mr. NEAL. Yes, it is.

Mr. GREENSPAN. I recommended it publicly before this committee.

Mr. NEAL. We appreciate your comments.

I would once again, Mr. Chairman—just as I close, I am still troubled by the argument that when we all herald the mid-to-late 1990s in terms of great economic achievement, why we had to radically alter the tax structure as we proceeded to this period of time.

Thanks for your testimony.

Mr. SHAYS. Thank the gentleman.

We are going to go to Mr. Franks, then Mr. Edwards, then to Mr. Garrett.

Mr. Franks.

Mr. FRANKS. Thank you, Mr. Chairman.

Mr. Greenspan, we appreciate so much your testimony here today, your candor and just your erudite understanding of some of the things that really make it difficult for a lot of us to clearly grasp. Economics is something that the nomenclature, the complexity of it is something that I think overcomes most of the general public, including the one that is talking to you.

Having said that, you have put forth some general ideas that I think reflect those of us of a conservative Republican persuasion very clearly.

Might I ask you a fairly direct question? Do you believe, as was articulated as far back as in the Kennedy administration, that carefully crafted tax cuts ultimately increase the revenue to government?

Mr. GREENSPAN. I believe that economic growth obviously is the key to revenue for government, and carefully crafted tax cuts are one factor involved in encouraging such growth.

Mr. FRANKS. Well, that essentially brings me to the next question. In terms of the greatest factors in your mind to incent productivity and economic growth, what would those factors be in the public policy area that we can control in this body?

Mr. GREENSPAN. It depends on how broad you wish to get. That part of our economy which has been most important in expanding economic growth is the ever increasing flexibility that has occurred in this economy over the last 25 years. I have discussed this at length in many different venues. The result is the flexibility is reflected in the fact that we have indeed come through a period since mid-2000 characterized by a very sharp decline of the stock market, by a collapse in investment, by 9/11, by corporate scandals and then of course the wars in Afghanistan and Iraq, and the economy barely moved. It absorbed all of these shocks which in my judgment would have created a severe economic contraction 30 or 40 years earlier. That is basically coming about because of the flexibility that is implicit in those events. Our ability to get through those events is the result of a bipartisan 25-year move toward deregulation in a lot of different areas, of the remarkable increase in technological advance which has made the economy far more efficient and far more capable of responding to adversity.

Information technology, as we are all aware, has made everybody capable of making decisions in real time instead of waiting for your accountant to give you what is happening to your inventories 3 weeks later when you have already produced more than you need. You have obviously very considerable improved flexibility from that, coupled with a very major set of deregulations in the financial markets which has created a degree of capability of this system functioning, which is where I believe our economic growth is largely coming from. And my judgment is that the most important thing that can happen is to maintain that degree of flexibility. And it is the reason why I find protectionism as a possibility very disturbing, because I do not think we are aware of how much of our prosperity reflects the extra ordinary expansion of the global economy in the last 30 or 40 years.

Mr. FRANKS. Sir, I am pretty much out of time but I appreciate you articulating what some of us have talked about for a long time, that perfect storm on the horizon relating to the aging baby boomer population.

Mr. SHAYS. Thank you. We will go to Mr. Edwards, Mr. Brown, and then Mrs. Capps.

Mr. EDWARDS. Chairman Greenspan, thank you for being here today. You have been consistent in saying that tax cuts, whether in 2001 or today, being made permanent should be matched with significant spending restraints and cuts as well. You have been consistent, but my concern is that many of my colleagues in Congress and leaders in the administration conveniently hear the first part of your speech and ignore the second part. They accept "let us vote for tax cuts." It is great, Chairman Greenspan now says they should be made permanent, but they fail to heed your other advice that you have to match that with spending cuts.

I will make a prediction today. Not one member of this Budget Committee—and there are a lot of good responsible members on both sides of the aisle—will officially embrace major cuts in present services for Medicare or Social Security, some of the issues that you raised in your testimony. So once again, as we did in 2001, we are starting down the path where people are using your comments about make these tax cut permanent and digging a massive hole for our children and grandchildren, and I have two small children and care deeply about the deficit burden we are putting on their backs, as do you.

My question is this, unless I find an outpouring of support from our Republican colleagues today to say that they will vote for reductions in Medicare present services, having just voted to increase Medicare expenditures by $534 billion, unless they come out for that or Social Security services cuts I want to ask you how much spending do you think should be reduced in the President's 5-year budget projections to do two things: One, reduce the already massive deficit and; two, to help pay for the cost of making President Bush's temporary cuts permanent?

My second question is if Congress does what I believe you and I think we will do, as we will be deficit hawks, spending hawks in our speeches and spending doves in passing budgets, and all of recent history proves that is what is going to happen, how serious a problem do you think it is if the end result is in the next 5 to 10 years we have an average of $300 billion a year or more in deficits?

Mr. GREENSPAN. I think the crucial issue here is first to get the budget process up and back to where it was before it was allowed to expire, because I must say I was quite surprised at how effective the Budget Act of 1990 was. I figured that the Congress with 51 percent, just a majority, could overrule everything and would, and you did not. And I think there are reasons why you do not. I think there is a deep seated understanding that there is something terribly wrong in creating deficits of this size. It is very tough for anybody in the Congress, as we have all known over the years, to do other than create a benefit for somebody. That is easy and it is done all the time but we have also learned it is a ratchet. Once you grant it you cannot take it back or it is very difficult to do so.

I can personally go through the budget and say I would do this, this and this if I were Budget Director, but I do not think that is the point. I think the point is if you put a process in place and this committee and your counterpart over in the Senate fixes in aggregate where you are going, you are actually going to be forced to make choices.

Mr. EDWARDS. I agree with you and can I ask this though. Given that I believe the administration and the Republican leaders, the majority party in the House and Senate, have opposed those PAYGO rules vis-a-vis tax cuts, given that process is not going to most likely be put in place that you are proposing, I am not asking you to give me specific programs you would cut by specific amounts, but overall how much do we have to cut spending to pay for making those tax cuts permanent and how much additional spending cuts must there be to pay for the already structural deficits we had before you make the tax cuts? Give us a ball park figure if you could.

Mr. GREENSPAN. I cannot because I have not looked at the figures. I am acutely aware of the numbers that Mr. Spratt was quoting, and obviously you cannot get from here to there wholly on those numbers. I fully recognize that. That is the point. The question is that you have got to essentially look to see what can be done and you cannot just give a number, you have got to look within the programs. I used to be heavily involved in budget processing and knew item by item and in very great detail and I know that to make a generalized judgment without knowing what is in those programs is foolish.

Mr. SHAYS. Mr. Greenspan, if you could in order to get all the Democratic members, and there are more of them, we are doing pretty well but we need to stay with that 5-minute rule if I could. We will go to Mr. Brown, Mrs. Capps and then I am next in line.

Mr. BROWN. Chairman Greenspan, I would like to continue along with the same line of questioning. It has been estimated there would have been 2-million fewer jobs in America today if we had not adopted a Tax Relief Act during the last 3 years. What is your opinion of that?

Mr. GREENSPAN. I do not know where that number comes from and I could not comment on it because it requires a whole series of assumptions, but clearly I think that the tax cut has had an effect on the economy, a positive effect, and I have commented accordingly. But translating that effect into jobs, given how variable the productivity numbers are, is in my judgment very tough to do.

Mr. BROWN. If you could give me an estimate of how you feel the economy might sustain if we allowed the tax cuts to expire.

Mr. GREENSPAN. Well, I have said on many occasions in my judgment that they should be continued because I think over the long run they will benefit this economy. I am not thinking in terms of the short run. I do not think that is an issue. I am thinking strictly in terms of the long-term viability of this economy.

Mr. BROWN. I know we have been trying to track numbers, the $5.6 trillion surplus, and trying to track it over a 10-year period, and it seems to me that it is difficult to try to project what is going to happen next year much less trying to project what is going on 10 years down the road. In light of that, in light of the way our budget is structured, do you feel that we would be better served if we had a different level of accounting, say asset accounting rather than expense accounting, on a year-to-year basis?

Mr. GREENSPAN. It is possible that we could improve a good deal of what we are doing and that our accounting is not covering all of the areas of contingent liability which we have. I am not sure, however, that that creates the political will that is involved in the process unless you have a budget process structure which automatically requires trade-offs, not only on outlays and taxes but guarantee programs and other ways by which the Federal Government preempts real resources. I was involved with the Social Security Commission in 1983, and we were going nowhere until all of the sudden we locked ourselves into a specific ultimate goal which meant we either have to change the receipt side or the benefit side. Everybody agreed to what that difference had to be. And once you got to that point the trade-offs gradually ground to a point where there was virtual unanimity, not quite unanimity, but a very large majority for a single set of proposals. That is why I emphasize process because if you take any single program and put it on the table and try to argue whether or not it is desirable or not, it will always end up being desirable. It is only when it is matched against another one you have a choice, either this one or this one. You cannot have both; that is, actually make the true choices.

Mr. BROWN. Let me shift gears a bit. We keep hearing all the time about spending Social Security proceeds. If we did not spend the Social Security proceeds then what could we do with the proceeds?

Mr. GREENSPAN. Are you referring to the trust funds proceeds?

Mr. BROWN. Yes, sir.

Mr. GREENSPAN. I must say that from a point of view of budget control I think the unified budget is the appropriate balance against which this committee ought to be functioning. I think the various trust funds we set up are intra-governmental, and they do not really create anything with respect to decision making. And if frankly they were all eliminated, I would find that nothing would be lost. So I am not a fan of trust funds except when they are used to constrain expenditures, which they do on occasion but that is only because people take them more seriously than I think they really should.

Mr. BROWN. I thank you very much.

Mr. SHAYS. I thank the gentleman. Mrs. Capps, then Mr. Toomey and then Mr. Thompson.

Mrs. CAPPS. Mr. Greenspan, welcome to our hearing today. Thank you for being here. In a recent speech you gave to the Greater Omaha Chamber of Commerce, you highlighted the importance of good education to the long-term health of the economy. I read this speech with great interest and I agree with your assessment that general access to our quality education has been critical to our economic growth to date and is perhaps even more critical to the future of our Nation's success. And it is one of the reasons I am very disappointed with this administration's failure to meet its commitments on education funding. I also believe that similar arguments, and this is the reason for bringing up education, can be made about the importance of health care to our economy. And I would like to ask you about this subject in the time allotted to me.

As a school nurse I can tell you that healthy students are better students. Illness and injury are a distraction from studies. I believe they are also a distraction from our economy. When large portions of the work force lack health care their ability to be productive is reduced and our economy suffers. The Kaiser Commission on Medicaid and the Uninsured reports that 40 percent of nonelderly uninsured adults have no regular source of health care and forego needed care; that over a third of the uninsured had trouble paying medical bills in 2003, a quarter were contacted by collection agencies; and that the uninsured are more likely to be hospitalized for avoidable reasons.

For these reasons it is my belief that making sure our population has good access to quality health care is also a critical element in sustained economic growth. And in the context of this hearing today and of what you have told us about the baby boom generation, I would like to focus on the younger subset and ask you your assessment about the importance of access to health care for our economy today.

Mr. GREENSPAN. If I were to list all of the various things, programs, commitments, ideas that would be helpful for this economy and this society, I think I would prove that we find that the indispensable number of programs which have to be funded represent a percent of the GDP which is not capable of being reached. So I emphasize again the question of process, that we have got to line up what our various priorities are, and the only vehicle this country has got to do this is the Congress of the United States. And you are the representatives of the people and we all cannot, near 300 million of us, cannot get in the middle of the street and make these decisions. They have to be made and in the process of being made a number of highly desirable programs do not get funded, and there is no choice about that. In other words, it would be very nice if the GDP were twice what it is and we can do all of this. But it is not and it will not be, and so we are confronted with the issue of choice and choice presupposes process. And I do not know any other way to do it.

I cannot disagree with anything you just said. I am sure that if I were to look at the evidence I would find what you are saying is correct. And yet if you line up all of the potential programs, all of which are highly desirable, indeed in one sense almost obligatory, we do not have the resources to do them all.

Mrs. CAPPS. If you say that health care is one of a number of many programs, we are not getting to the fact of how basic it is to survival and to productivity. There are a number of ways we can deal with health care. That is what we are faced with here. Professor Gruber of MIT says this administration's tax credit proposal will only help 1.9 million of the 40 million uninsured despite its $70 billion price tag. So I am asking if there is a way that we can structure the programs, any programs to more adequately address this need.

Mr. GREENSPAN. Mrs. Capps, I am not sufficiently familiar with the programs to give you any sensible judgment on that. I do know, however, that every program that you get involved in is extraordinarily complex and initial views are often wrong, especially when you begin to look at the details, and I would hesitate to try to get involved in something which I know would take me 5 hours to answer.

Mr. SHAYS. I thank the gentlewoman. We will go to Mr. Toomey, then Mr. Thompson and then Mr. Crenshaw.

Mr. TOOMEY. Thank you, Mr. Chairman. Thank you, Mr. Greenspan, for your testimony here today.

My question is on a topic we really have not dealt with too much thus far today. I want to preface it by observing that we certainly seem to have a remarkable period of achieving virtual price stability and the inflation in recent years has been remarkably innocuous and at this point seems to continue to be so. But I cannot help but observe that we have had in recent years an extremely accommodative monetary policy. We have commodity prices very broadly, if not across the board, significantly higher in recent months and quarters. Gold is over $400 an ounce. The dollar has had a very significant decline in recent months. When I look at that combination of events it strikes me that historically this kind of combination of events would suggest that inflation if it is not with us now is not terribly far away. The question is, one, how have we managed to have these kind of events occur without yet seeing an inflationary problem? Is it productivity? Is it more the huge increase in global productive capacity, the increase in the global labor force as a practical matter integrated into the economy? Is there something systemic that means that these kinds of historical indicators are no longer useful or in fact is it just that we have got a little bit more time before this does in fact catch up with us?

Mr. GREENSPAN. I think it is basically what you suggest. It is productivity. It is the extraordinary rise in competition coming from globalization. And there are structural changes, but that does not mean that inflation is permanently subdued. It merely means that the trade-off pattern is different from what it was. But remember that most of the items which you have discussed, mainly the commodity prices, are far smaller in today's economy than they were 20, 30 years ago. In fact, an ever increasing part of our economy is becoming conceptual rather than physical. And all of the items which are in the standard commodity index, including gold, are essentially physical rather than intellectual. That is not to say they are not important. They tell you various important things about how this economy is behaving, but what we observe is this extraordinary degree of globalization and increased competition and a monetary policy which has generally been constraining in the early period of inflation. So what we were doing was continuously leaning against the inflation to assist it coming down. But with productivity where it is, it overwhelms any inclusionary forces that are coming from a number of the issues that you raised.

Having said that, we watch this whole process exceptionally closely, and as I have said in recent speeches, central banks' formal fundamental mandate is price stability because it is that which we believe will induce maximum sustainable economic growth. So it has been a remarkably important decline in the rate of inflation. We expect it to continue this way for a while, but we are not by any means convinced that inflation has somehow disappeared from the scene. We are certain it has not.

Mr. TOOMEY. Right. And if productivity increase has been one of the main contributing factors to holding down inflation, I think you have testified in the past that you do not believe that productivity can continue to increase at the pace it has in recent quarters, which makes sense given historical levels of productivity growth. Does a decline in productivity growth become, therefore, an indirect sort of indication of future inflation?

Mr. GREENSPAN. What it tends to do obviously is move unit labor costs from what has been a deep negative, meaning that they have been going down for quite a considerable period of time, first to stability and then, depending on what productivity is, they would start to rise. Under those conditions, obviously, the pressures will switch. We have not seen that yet. We have not seen any real evidence of pressure but we are watching very closely.

Mr. SHAYS. I thank the gentleman. We go to Mr. Thompson then Mr. Crenshaw and then to Mr. Baird.

Mr. THOMPSON. Chairman Greenspan, thank you for being here. Thank you also for your very honest explanation of the PAYGO system. The idea that we can bifurcate that somehow I do not think helps us fix the problems that we are in and I think it really lacks the credibility. I believe we need to address what I believe are very, very serious fiscal problems. As far as putting a process together, as you so eloquently explained, I think the one thing we have to be mindful of here is that there is a strong element of honesty in that discussion as well. The idea that we can continue to see increases in services, decreases in tax cuts, it is just not real, or tax revenues, it is just not real. We need to be honest, as you point out, when we manage our expectations. I believe that will be a very important part of us on both sides of this dais to fix the problems that we face.

I am particularly concerned about foreign debt and the amount that foreign individuals and foreign countries hold of our debt. I have some numbers that I find to be frightening. The idea that 70 percent of the last year's record $373 billion deficit were financed by foreign investors concerns me, a 33-percent increase in the past 2 years. Japan holds almost $600 billion of our debt, China holds almost $150 billion of our debt, and I am concerned that this leaves us a possible victim to economic problems that are outside of our control. And add to that the fact that the billions of dollars that we are paying in interest on this debt is not even being paid or part of it is not even being paid to folks right here, but instead this becomes the biggest foreign aid program that we have in this country. I am worried about what may transpire because of this. I would like to hear your thoughts on it.

Mr. GREENSPAN. I presume, Congressman, you are concerned about the issue of what would happen if they started to sell these securities.

Mr. THOMPSON. To sell them, to threaten to sell them or to somehow decide that we are not such a good investment and do something else with the money. I think it has got some interest rate ramifications.

Mr. GREENSPAN. We have looked at that in some detail. First of all, let us take the issue, assuming the selling of the securities, and see what happens. We are dealing not only with the size of the Treasury debt owed to the public but we are dealing with a whole big block of securities in the United States and all securities compete with each other. So there is no question that if there is a sale of foreign assets which are largely held by the central banks or the ministries of finance, that it has an effect but it is very small. Not only are the amounts of money, as large as they are, as you are noting, relatively modest against the aggregate markets in this country, but they also tend to be disproportionately short-term instruments. And short-term instruments are huge in the United States. The liquidity is such that their effects are relatively modest. And remember that short-term rates are to a large extent controlled by the Federal Reserve's basic policies. Now, obviously, we cannot suppress rates without expanding our balance sheet, creating huge increases in the money supply and creating the problem that our colleague had mentioned. But within a fairly broad area we can and do. Granted, the numbers look very large.

Mr. THOMPSON. It is fast approaching $2 trillion on our $7 trillion debt.

Mr. GREENSPAN. I will venture that they will become a number that at some point will disturb me, but at the moment and in the foreseeable future it is still a problem for the future, not for the current period.

Mr. SHAYS. I thank the gentleman very much. We will go to Mr. Crenshaw, then Mr. Baird, then to Mr. Putnam. Then we will go down the Democratic list and if there is time I would like to finish up with questions.

Mr. Crenshaw.

Mr. CRENSHAW. Thank you, Mr. Chairman, for being here today. I have a couple of questions, one related to this change in projections from surpluses to deficits. And everything that I read, to a certain extent they are changed because of the tax cuts, but only maybe some in Congress have said that might be responsible for 25 percent of the change in direction. Part of that is due to the war, the increase in spending, but a great deal, probably the majority of the change in those projections is due to this historical phenomenon which we have talked about, that revenues have declined for the last 3 years, that I think you said you are not really sure why. But does it not make sense that, and maybe comment on the fact that we have kind of made the point, other people have made the point that it is hard to kind of cut enough spending to ultimately solve the problem. If the President's budget increases nondefense discretionary spending to one-half of 1 percent and we froze it, that one-half of 1 percent I think lowers the deficit by $3 billion, the point being that we certainly have to control spending but that may not be enough. Other people would say we just need to raise taxes and solve it.

I guess the question becomes, in this phenomenon of declining revenues, does it not make sense somewhere, somehow that they will turn around? Maybe you can comment on that because to a certain extent I do not know that we just grow our way out of the deficit, but to a certain extent as the economy grows and as projections change I have to believe that makes a huge impact on the projection of deficits. Could you kind of comment on that?

Mr. GREENSPAN. Most of those longer term projections of revenue growth are already built into the current services budget. It is possible that productivity will grow faster, for example, than CBO is estimating. The problem is that we are at the cutting edge of technology in this country. We cannot borrow technology to increase our productivity growth. We have to invent it, largely. That means that we are limited to how fast productivity can grow, and historically, even in our best periods for protracted growth, we very rarely get above a 3-percent annual rate. The reason for that is it takes time to invent things, to reorganize, to improve the way we produce things. And as a consequence we do not know how to move fast enough. If we were borrowing technology from somebody else, we could do that pretty quickly. And indeed a number of the developing countries borrowed our technology and increased their GDP growth rate very rapidly. We do not have that capability. So I doubt very much if we can find a scenario which would say we cannot grow our way out of the deficit. More exactly, we can grow our way out of the commitments which look to be out there, essentially for Medicare. Medicare is really the significant fiscal problem because we do not have a grip on how big a number that could be. And as a consequence, I would say to plan to grow our way out of this problem is probably unwise. I do not think we can do it.

Mr. CRENSHAW. Thank you. The last question has to do, we have touched on this, in terms of short-term interest rates. A lot of people feel like we are not saving enough and we are kind of stoking consumer demand by these low rates. We are exporting our net worth to other countries. In a broader sense, could you comment on your view of the dollar? We have certainly seen a dramatic increase in exports based on that. Are you concerned at all? Is that an urgent issue with you in terms of the dollar, in terms of that?

Mr. GREENSPAN. I am not allowed to talk about exchange rate fluctuations in the sense that we have an agreement with the Treasury Department that I can talk about the exchange rate but not in a policy sense. And your question unfortunately is right at the edge and I would just as soon let the Secretary of the Treasury answer your question at some point.

Mr. SHAYS. I thank the gentleman. We are going to Mr. Baird, then to Mr. Putnam and then Mr. Emanuel, go down the Democratic list. I would like to fit myself in too as well. Mr. Baird.

Mr. BAIRD. Mr. Chairman, I am glad you are here today. We periodically in the Congress get letters calling for the abolition of the Federal Reserve. Sometimes as of late I have wondered if it has actually happened and I am glad you are here to show it has not. The reason I have wondered that is because both in this committee and in some cases in public statements by the administration and others, we hear the administration taking a great deal of credit for the low interest rates, and it seems to me that the Federal Reserve deserves most of the credit for that. I have a two-part question. The first is to what extent would you say that the currently low interest rates are the result of the Federal Reserve policy versus actions of the Congress or the executive branch? That is the first part. The second question, to what extent do you belive the low interest rates deserve the credit for much of the economic recovery that we are seeing today?

Mr. GREENSPAN. Congressman, let me say first that I think a substantial factor in the low interest rates is the low inflation rate. And the low inflation rate, as I indicated before, is the consequence of a number of things, largely globalization and the competition that has come from globalization and a whole series of structural changes, including, as I mentioned before, the bipartisan deregulation that has been going on for a quarter of a century.

Part of the interest rates being where they are, is the consequence of the Federal Reserve; to an extent that we maintained a policy of constraint at times when inflation was moving, we have assisted in bringing the rate structure down. But I do think there are far broader forces which impact on inflation and therefore on interest rates. And to answer your last question, have interest rates being this low been a positive factor, certainly.

Mr. BAIRD. Do you have an estimate to what extent that applies? I will give you an example. When I am at town hall meetings and I ask people how many have refinanced their homes it is a tremendous number. And that must be putting a lot of disposable income back into our economy, relative, for example, to say the so-called middle class tax cut. Do you have a sense of how much business investment or additional spending by average American citizens has happened because of refinancing or low interest rates for business investment?

Mr. GREENSPAN. Yes, we do. We estimate what the actual has happened to debt service costs of the home owning households, as a result of the very substantial refinancing which occurred last year. It is, not a large number but it is enough in the way to have really made a difference for those who have refinanced. That is they brought their rates down and it has impacted on their monthly commitments. I do not know how to match it at this particular point against the tax cuts. The data are available, but I do not have it at hand at the moment.

Mr. BAIRD. I thank the chairman.

Mr. SHAYS. Mr. Putnam, then Mr. Emanuel and Ms. Majette.

Mr. PUTNAM. Good morning, Mr. Chairman. A year ago in testimony both before this committee and to the Joint Economic Committee, there was a great deal of talk about deflation and we have touched on inflation this morning. Is deflation no longer a problem despite the falling dollar and continued low interest rates? I would be interested in hearing about that as well as some talk perhaps behind the scenes at the Federal Reserve on setting inflationary targets.

Mr. GREENSPAN. The issue of deflation has never been a high probability. But our concern is that were it to happen, the consequences would be extraordinarily negative. And therefore we have been keeping a very close eye on the possibilities of deflation emerging. As I have commented previously in various statements, speeches and testimonies, the probability of deflation which a year ago was very low is now much lower. It is not zero but we are fortunate in the sense that looking at the way prices of goods specifically are behaving and looking at the structure of demand and supply in various different markets, the probability of deflation has gotten to a point where it is not the size of the threat that it was a year ago.

Mr. PUTNAM. And are there discussions about setting inflationary targets?

Mr. GREENSPAN. Well, there is a very significant discussion going on in the economics profession of inflation targeting as such. Obviously, we talk about it and implicit in most of our actions are targets in the sense that my formal target is price stability. I think it is very difficult to get a specific price index in which you say this is exactly where price stability is. But as I have said many times, I think we are there. CPI, core CPI, for example, is 1 percent. We know there are significant biases remaining in the price indexes we use so that true price stability would be reflected in price indexes which were increasing slowly, probably somewhere between a half a percent and something a little under a full percentage point. So in that regard I think we are at price stability.

I cannot speak for the rest of my colleagues, but we all have a general view of where we would like to be and we vote accordingly. Do we have an explicit number, an explicit price index? We do not, and I am not sure that that would actually enhance the capability of our doing a better job. There are those I must tell you who do believe that and we are in continual discussion. I do not think it is a big issue because the practical implications are not very large. We all agree where we want to be, and we largely interpret the numbers the same way. So I am not sure if we actually had a published explicit target whether it would make all that much difference.

Mr. PUTNAM. Thank you. With regard to mandatory spending, both sides of the aisle speak of this a great deal, the explosion of health care costs combined with the demographics of this country is of great concern. If Congress were to act to shift the ratio of mandatory versus discretionary spending, if we were able to move that mark away from the two-thirds mandatory, one-third discretionary figure where it roughly is now, and move the transportation projects, the farm programs, the student loan programs, let us say all programs in mandatory other than Social Security and Medicare and perhaps some veterans programs, would there be some credit given by the markets? Would that have an appreciable beneficial effect or would it create uncertainty over the level of funding and particularly destabilize economy prices?

Mr. SHAYS. If we could have a short answer.

Mr. GREENSPAN. I think it will depend, if you were to do that, what impact it had on the decision making process with respect to outlays. It is what you do, not what you say or how you categorize it, which matters in my judgment.

Mr. PUTNAM. Thank you.

Mr. SHAYS. Let me say, Mr. Chairman, we have basically six members, including myself. We could get you out at 10 after. Would that meet your need?

Mr. GREENSPAN. Certainly, I appreciate that.

Mr. SHAYS. Mr. Emanuel, Ms. Majette, then Mr. Scott.

Mr. EMANUEL. Mr. Chairman, I will try to be quick. Mr. Chairman, as I read your testimony and listen to you today, my sense is that your analysis is that we are getting very close to having a structural deficit which the markets will perceive as dangerous versus a cyclical deficit and that your recommendation is that we need to deal with that problem, and between the IMF's view and Goldman Sach's view of deficits being dangerous and CBO and OMB's which are manageable, you have tipped the scale that we are getting very close, not there yet, to a structural deficit which will be dangerous for the market's inception.

My own view is I do not believe we should be cutting entitlements to pay for these tax cuts if we make them permanent, which is also one of the things that has been said here. My own view is we have tried to finance, which is proving history wrong, three wars with three tax cuts, and you cannot do it. That is what has resulted in deficits, not the entitlement spending.

In that sense and I raise with Mr. Thompson my own concern about foreign countries owning our securities, and I think we are getting close to a Suez moment with China owning so much of our securities. I know you have said you analyzed it over at the Fed, but have you analyzed China owning so many of these securities and then have a situation like we did 2 years ago where a plane went down in China with a political context associated with it if they decide to dump our securities? Was that part of the analysis of the Fed, not just the financial short term of dumping securities but the political context that would ignite such a move?

Mr. GREENSPAN. I do not want to say what we have or have not analyzed, but I can assure you that we have looked at all potential contingencies.

Mr. EMANUEL. Thank you, Mr. Chairman. I will leave that there.

The second point is we look at the issue of employment and the lag I think in where the economy is going at this point in the employment sector. Has the Fed looked at the benefit structure, that is health care, retirement, as one who is a hindrance toward hiring, that in fact at this point in the economy there should be more employment and in fact health care costs, retirement costs, legacy costs, you are going to decide to keep somebody and have them work longer hours rather than hire a new employee? Have you guys looked at that at the Fed?

Mr. GREENSPAN. What we have looked at is the evidence of what is causing the slowdown in employment growth. We have broken it down into a problem whereby we look at new hires and separations whether voluntary or involuntary. The separations are reasonably close to what you would expect to be happening given the growth that this economy has exhibited in recent quarters. It is pretty much on schedule. What is missing is the new hires are far below where they ordinarily would have been historically given this rate of growth. We attribute that wholly to the issue of productivity growth. That is, business people confronted with an increase in orders are finding that they are able to meet those orders, expand production for customers, without increasing hiring. They can do that largely because there are unexploited inefficiencies in their particular establishments which are a carryover from the very large expansions that occurred in the latter part of the 1990s. And it is that which is creating the difficulty.

Mr. EMANUEL. Lastly, this may be more of a statement than a question. As you said, between the two entitlements you see Medicare as a bigger kind of dagger given the unexplained improvements in technology, longevity. There has been a bipartisan effort to deal with the recent prescription drug benefit on how to control costs. One of the ways was using market mechanisms. Obviously you will not endorse any principle, but whether you are using re-importation or allowing the Secretary of HHS to negotiate, if you are going to have the benefit of that, there is a place here where Congress is trying to get the government to act like a business and we have been prevented from doing that. I am glad to hear that you see that costs like this are dangerous to the long term health. Some of us believe we have to control it or pay for it or be more efficient in the way we do that. I am not going to ask you or put you in a position to answer that.

Mr. SHAYS. I thank the gentleman. We will take the Democratic side of the aisle and then go to Mr. Portman. Ms. Majette and then Mr. Scott and then Mr. Portman.

Ms. MAJETTE. Thank you, Mr. Chairman. Thank you, Dr. Greenspan, for being here today. If I understood your testimony earlier, you said that carefully crafted tax cuts would help in terms of our strengthening our economic situation. I was wondering if you could elaborate on what particular types of tax cuts would stimulate the economy perhaps more so than the ones that were passed in 2001 and 2003, and are there particular types of tax cuts that have a more stimulative effect on the economy or less so and particularly with respect to small businesses and the benefits of reducing the burdens, the tax burdens, on small businesses.

Mr. GREENSPAN. Well, I have testified before this committee and others that I thought that eliminating or, as is in fact was done, reducing the double taxation on dividends has been an important factor in creating incentives for capital investment. And I would certainly put the continued low tax rate, hopefully zero tax rate, on dividends as a high priority. The major problem, however, is the fact that we have what we call bracket creep, in the sense that we do index tax brackets for consumer price changes, but because productivity is not captured in that calculation the actual effect is that you do not fully index the brackets in that respect and more and more incomes move into ever higher brackets and so the overall tax load continues to grow. I think that is detrimental to growth and my general focus on long-term tax cuts is largely focused on eliminating bracket creep.

Ms. MAJETTE. Thank you. With respect to the debt to GDP ratio, and you mentioned that a little bit earlier, is there a point at which that ratio gets to be too large and what do you think about how we should address that issue?

Mr. GREENSPAN. That is one of the toughest questions we have. We know that as it gets up to numbers well above where we are today that other countries have run into trouble. But it is a very good question in that we do not know exactly where higher is not good.

Can we take some debt increase? Yes, we can. Would it be destabilizing? I can conceive of a scenario in which it would not be. But that is where the dangers begin to arise. When the ratio of debt to GDP begins to rise, the debt servicing burden obviously increases because the interest payments have got to be paid out of the GDP or out of the income which is generated by the GDP. So there is a whole series of economic evaluations as to exactly what determines that degree of stability, but we do not know a specific number in a practical sense until we actually begin to construct various scenarios.

And all I could say about the current outlook is the implicit growth rate, when we consider the lower probability, but still reasonable probability, trajectories of receipts and outlays, creates debt to GDP levels which I would find of great concern.

Ms. MAJETTE. Thank you.

Mr. SHAYS. Mr. Scott. We are getting more members coming. I am getting concerned that I will be able to have everybody speak.

Mr. SCOTT. Thank you, Mr. Chairman, for your testimony. This chart shows what happens when you are willing to make the tough choices. As you will remember, the tough choices in 1993 resulted in some politically unpopular results. Although we eliminated the deficit and went into surplus, it had political consequences on those of us who voted in favor of the green.

You have indicated that you need to make the tough choices and I appreciate that and also that you need to make the choices on both sides, both on taxes and on spending, you just cannot make tough choices on one. You have talked about the debt and deficit in terms of the GDP. It seems to me that the GDP would be a measure of capacity to deal with the deficit and the debt, but a more accurate figure for fiscal responsibility ought to be how much of our budget is paid for with borrowed money. We are right now spending a higher portion of our budget with borrowed money than any time since World War II. Does that speak to fiscal responsibility?

Mr. GREENSPAN. Well, it is a measure of lack of fiscal responsibility.

Mr. SCOTT. Thank you. Your testimony outlines things we can do to reduce Social Security. We have a Social Security surplus for a purpose. Several years ago somebody noticed that we will be running into the red and we are overtaxing Social Security so that we can deal with the upcoming deficit. This is not like a road tax trust fund where you decide not to build roads this year. You deal with it. You continue taking the money. These are liabilities that are real.

Now, we have been told that what the top 1 percent got as a 2001 tax cut would have been sufficient if put into the Social Security Trust Fund to build up the trust funds enough so that we could have paid Social Security benefits for 75 percent without reducing benefits. Your testimony suggests that if we give them a tax cut, as we did, we have to deal with it by increasing the age, adjusting COLAs, possibly privatizing for those younger retirees as if our choice was we got to cut taxes and then we will scramble the best we can to try to deal with Social Security in the future. Could we have made a different choice?

Mr. GREENSPAN. Well, my recommendations are recommendations I have been making for 20 years that are technical in the following sense: The intent of the Congress is to hold Social Security benefits to the cost of living. The problem is that the indexes we have been using to adjust for the cost of living are technically deficient. They are being improved upon by the Bureau of Labor Statistics to try to eliminate these biases and I was merely suggesting that if the intent of the Congress is to be met that a far better index is available to do that.

With respect to the issue of indexing longevity, that is merely the question of addressing the fact that the average age that, let us see, the proportion of the population over 65 is going to continue to increase indefinitely.

Mr. SCOTT. But that is the choice we make. What you are suggesting is rather than maintaining Social Security, the President means we are actually improving it and we have a choice. We could improve Social Security essentially through the back door, increasing benefits, or we could give a tax cut to the top 1 percent. We have a choice. I do not know what choice you would have made but Congress made the choice that we are going to have to deal with the COLAs, increase age and everything else.

Let me see if I can get in another quick question.

Mr. SHAYS. It needs to be quick.

Mr. SCOTT. Tax cuts with borrowed money. What effect does the fact that we are borrowing money to fund the tax cuts have on their ability to create jobs?

Mr. GREENSPAN. I do not think there is a relationship there. The deficit does what it does and the tax cuts do what they do. And I think that to relate them in my judgment is not necessarily appropriate. I do think that, deficits are something we should endeavor to avoid.

But if we allow the tax burden to rise, we are going to have problems with our revenue base. So the choices are, basically, how do you run fiscal affairs? And I think that requires that you look at both receipts and expenditures in the context of deficits. And I don't know, other than just to look at the budget process, how one makes those judgments.

Mr. SHAYS. Thank the gentleman.

If we can go to Mr. Portman.

Mr. PORTMAN. Thank you for your thoughtful testimony today—I was here earlier—and your thoughtful analysis of what our choices are.

I would disagree with my friend from Virginia that our choices were the top 1 percent tax breaks versus Social Security. Our choices were, are we going to have economic growth that enables us to then have the revenue to be able to get out of our deficit situation and to see jobs come back to this country? And it is starting to happen, so I agree with your structuring our choices.

And, Mr. Spratt, I appreciate your opening statement, which I thought was very constructive. I think you analyze some of our challenges very accurately. At the end you said, how do we get back on track?

As you know, Mr. Chairman, one way people talk about being back on track is to allow the tax relief that Mr. Scott talked about to expire—the 2001 tax relief, 2002, and 2003. You have talked a little bit about the overall tax burden growing because of the way in which productivity has grown, and, therefore, the indexing is imperfect.

Do you agree that we ought to allow the tax relief to expire?

Mr. GREENSPAN. I have testified previously that my preference is that it does not.

Mr. PORTMAN. The second question I have relates to your testimony.

You talked about the aging population. You talked about investment and savings. And I don't want to put you on the spot this morning—although you have probably been put on the spot for the last couple of hours and you have handled it so well—but it seems to me there are two big issues out there. One is savings overall. And now, as you know, we have a 2.3 national savings rate, we are told, which is anemic and far lower than it has been even in the recent past, and much lower than our trading partners or other developed economies.

Second, we have this crunch you talked about of the demographics and the retirement crunch. You talked about health care costs, but—obviously, an overall problem with an aging population living longer. And my question to you is, would you support this Congress encouraging savings on a long-term basis that would affect retirement?

Right now we have a 401(k) program, we also have the IRA programs, the Roth IRA. We also have a defined benefit program. The question is, somewhat along the lines of what the President talked about, would you be supportive of Congress encouraging the incentives for long-term savings and perhaps also encouraging those folks of modest income, who are not saving, to be able to save by providing some kind of a match, much as you would have in a 401(k) program, but now have the Federal Government play some role there?

Do you think that would be constructive with regard to our economy and with regard to the second issue, which is the retirement crunch?

Mr. GREENSPAN. Well, Congressman, I think that anything that would enhance national savings in and of itself is good. The crucial question that we always confront in this regard is whether particular programs actually do that. And I think it is important in proposing any particular program to make sure that it, indeed, does increase savings. And I think over the past we have had some mixed results on that.

We are fortunate, I might say, in the one respect, that despite the fact that we have a very low savings rate, we are forced, in order to maintain our level of investment, to essentially borrow foreigners' savings, which is our current account balance. We seem to use those savings in a very effective way, in that our rates of return on investment, as reflected in the dramatic increases in productivity, say that we are very efficiently using what we have.

But what we have is not large enough, because in a sense we are required to borrow too much from our trading partners abroad.

Mr. PORTMAN. Thank you, Mr. Chairman.

Mr. SHAYS. Mr. Moore, you are next.

Mr. MOORE. Thank you.

Thank you, Mr. Chairman. Ms. Majette, in her question, asked you if—she didn't say it in these words—but if all tax cuts are created equal; that is, do they have the same stimulus and effect on our economy in terms of productivity.

I guess my question to you is, to try to follow up on that for just a minute, you indicated, Mr. Chairman, that lower tax rates on dividends is a very positive thing in your estimation. Isn't that correct?

Mr. GREENSPAN. That is correct, yes.

Mr. MOORE. If we are looking at different kinds of tax cuts, such as AMT, marriage penalty, things of that nature, my question, I guess, is about the estate tax and permanent repeal of the estate tax.

There is—sometimes everything is not black and white, and you don't need to go to one extreme or the other. And some people right now are proposing permanent repeal of the estate tax.Others are proposing increasing the credit to $3 million per person, so for a husband and wife it would be about a $6-million increase.

Do you have any thoughts about what might be—what might be worthwhile there in terms of—and I guess my question, too, is, what kind of effect would that have on the economy, a repeal of the estate tax?

Mr. GREENSPAN. I have struggled with that issue. I don't know where I come out. I think there are obvious questions of its impact in certain areas of the economy, but it is hard to pin down exactly what the impact is. And not having hard evidence, I really can't have an opinion on that.

Mr. MOORE. OK.

Mr. Edwards asked you earlier, I think, and Mr. Emanuel, I think—anyway, somebody asked you about foreign holdings of our securities and our debt in this country. And I think Japan has over $500 billion, and China, over $150 billion. And you said at one point—this is not an exact quote, but close, I think—there would come a number which would disturb me.

I am not going to ask you for a precise number, but can you give us a range of when we ought to start being disturbed about how much foreign governments own of our debt?

Mr. GREENSPAN. Let me first make a general statement.

What history has shown is that because we have ever more open markets and greater globalization and larger trade throughout the world, the ratio of assets and liabilities of each country—external assets, external liabilities—has been rising much faster than trade. And so aggregate holding of claims of foreigners against United States residents has been rising at a very significant pace and will continue to do so, so long as international intermediation continues to expand. That is good, not bad.

It is only when the liabilities, net of assets, become a huge burden to finance, then we begin to have a problem. But I don't think that you can look at this issue in terms of U.S. Treasury securities or corporate debt or something of that nature. The total is what is relevant here.

The only way in which you can come up with a number which says that we are in trouble in financing is when the aggregate of liabilities, less the assets as a ratio to the GDP, become sufficiently large as to make financing that net difference between liabilities and assets exceptionally difficult.

We are nowhere near that point at this stage. But obviously, the current account deficit is 5 percent of the GDP, which effectively means that that ratio is increasing by 5 percentage points of the GDP each year, so long as we stay at this level.

Mr. MOORE. So in and of itself——

Mr. SHAYS. We have two more. And I need to get them out. Is that alright, sir?

Mr. MOORE. Yes, sir.

Mr. SHAYS. Mr. Hensarling is going to question for 2 to 3 minutes. Then we will go to you, Mr. Ford.

Mr. HENSARLING. Thank you, Mr. Chairman.

Chairman Greenspan, due to the fact that I was at a markup earlier, I missed some of the questioning. My assumption, though, is that you heard a lot of the debate between whether or not tax increases or spending restraint would be the best method by which to address our Federal budget deficit.

I, for one, have concluded that given that we passed $350 billion of tax relief versus $28.3 trillion in spending in the last budget, that roughly 99 percent of the challenge lies on the spending side, especially since we are now spending over $21,000 per household for only the fourth time in the history of the Republic.

In previous testimony, I believe that you have spoken about the need for budget process reforms, specifically about reauthorizing PAYGO and discretionary spending. Is that correct on my part?

Mr. GREENSPAN. That is correct.

Mr. HENSARLING. My question, Mr. Chairman, is, there are many other positive ideas in the budget process reform category that have been discussed in Congress, such as the sunsetting process, setting up a BRAC-like commission for different government programs, setting up a rainy day fund so that we can start planning for emergencies.

My question is, have you specifically looked at other budget process reform ideas, and if so, what conclusions have you come to?

Mr. GREENSPAN. Well, Congressman, I, for a number of years, have argued that we ought to sunset virtually everything. And indeed, at one point, I said "everything," and a Senator said to me, "Including the Federal Reserve Act," and I said, "Yes."

Any institution which is essentially functioning appropriately, should be able to pass very readily in a sunset process. I am aware that there are technical problems involved in sunsetting certain types of ongoing legislation, especially relating to expenditure and taxation, but I think the principle of sunsetting is a very useful concept.

Mr. SHAYS. Thank you.

Mr. Ford, you have the floor.

Mr. FORD. Thank you. I will be real quick.

Thank you, Mr. Chairman for being here. Good to see you again. Tell your wife I said, "hello."

You talked about the choices, and Rob Portman asked some good questions. But I just want to be straight and make sure that we are consistent here.

If I am not mistaken, when Mr. Portman asked about continuing these tax cuts you said, "yes." When it comes to defense spending you say, "yes," but you are against the rising deficits.

My friend, Mr. Hensarling, meant—not $28.2 trillion in spending; I think you might have gotten your decimal points mixed up, because we didn't have $350 billion in tax cuts and $28.2 trillion in spending. If we did, we all be very happy around here if we spent that kind of money on all the programs we want it spent on. So I think you might have had your decimal points mixed up.

Where do you say, "no?" Because I like tax cuts like everybody else. And I ask that in the context of the AMT. More than half of the families in America earning $100,000 or less are to be hit by this thing in the few years. Where do we say, "no?" Because we are all trying to set priorities, but we disagree over things here, obviously.

But, I mean, it is easy—if Rob Portman asked me if I want tax cuts, I am going to say, "yes." If he asks me if I want more spending in schools, if I ask him if he wants more spending in Cincinnati schools, he is going to say, "yes," I hope. If he asks me if I want more spending on defense, I am going to say, "yes."

Where do we—I mean, expiring taxes, where do you cut them off.

Mr. GREENSPAN. I would give you a long, long list. I don't have a vote.

What I am trying to say is—individually, specific programs are useful. But overall, we are still caught with the budget process. And not all of the particular items that I, you, or anybody else would like can be fundamentally fit into any budget process. I recognize that.

I can give you my individual views as to where the budget of the United States ought to be, and it will balance.

Mr. FORD. I would agree with anybody. If you put $350 billion back into the economy, that is going to stimulate something. I think the question that Dennis Moore and others have had about "all tax cuts are not created equal" is a fair one to ask; and perhaps it calls for longer than 2 minutes and 45 seconds.

I know we want to close out.

Do you see any harm in the administration's not including in its budget costs for the war this go-around, and should they include that? Should they make some ball park guesstimate, Mr. Chairman, based on our experience, with the war in Iraq and the war in Afghanistan?

Mr. GREENSPAN. I remember the 1967 budget in which it was not included, as you may recall.

Mr. FORD. I was not born yet, but I will take your word.

Mr. GREENSPAN. I think that the President has said that those numbers are not included. We all know roughly what they are. I would like to see some rough estimates in, and endeavoring to understand where the budgets are, I do make that adjustment.

Mr. FORD. So you think they should.

Mr. GREENSPAN. I would like to see it in.

Mr. FORD. Last question, Mr. Chairman.

I know we are all hesitant to say which programs we would cut and what initiatives would be cut. Everybody—we talk about the spending; we are only talking about—not only, but when you look at the tax cuts versus the spending, we are talking about $400 or $500 billion in terms of nondefense discretionary spending.

How much would you cut from spending? I mean, we—if the debate here is spending restraints versus tax cuts, I will accept that.

Perhaps this is a conversation that we need to have on the committee here as well, Mr. Chairman. But how much would you cut in terms of discretionary spending to help us lower this deficit?

Mr. GREENSPAN. I would cut as much as feasible, largely because the longer-term fiscal outlook is assured if we resolve most, if not all, of the problem from the outlay side. But to the extent we try to adjust it from the tax side, we are increasingly creating difficulties with respect to economic growth and the tax base. The more taxes, the more tax rates are raised; that is the principle I would go by.

Mr. FORD. If we cut the entire discretionary spending, I don't know if we would cover the projected deficit for next year. So, I mean, we can zero the whole doggone thing out and still not, according to what the projections are for the deficit for this year, be able to cover.

And I yield back.

Mr. SHAYS. Mr. Greenspan, I would like to finish up. I won't take my full 5 minutes. But what I think that Mr. Hensarling was referring to $28 trillion of future spending over 10 years and a $300 billion tax cut over that frame.

But let me ask you this. Should we have in this committee a 10-year budget or a 5-year budget?

Mr. GREENSPAN. Implicitly, you have got 10- and 20-year budgets, but you can't really detail them in a useful way because you have no way of making estimates.

Mr. SHAYS. This committee is trying to decide whether we go out with a 5-year budget or 10-year budget.

Mr. GREENSPAN. I understand that. All I am saying to you is, I can't answer that question.

But I would say, irrespective of the particular length, you should have a judgment as to where that is taking you beyond the end of the particular period which you have chosen.

Mr. SHAYS. OK. Let me also say that I sometimes say you speak in tongues. I don't think that anyone could claim that today. Usually we both leave feeling you agreed with us—not that that is always intended. But I would say that I think your message was stronger to my side of the aisle than it was down the middle.

I think that we really should ponder what you say about PAYGO, both as it relates to spending and taxes, and that it be incorporated now rather than later. And having been on the Budget Committee for 10 years in the 1990s, I know the impact it had. And I think your message is loud and clear.

I also would love to know your answer to Mr. Emanuel's question about structural debt versus cyclical, whether—do you think that we are playing close to having this become a structural debt?

Mr. GREENSPAN. I do, Mr. Chairman.

Mr. SHAYS. And finally, sometimes when you say something that may not seem controversial in the committee, it has been reported in the wire services that, quote, unquote, you want to cut Social Security. And I just want to give you the opportunity to make sure we are—the article in AP was very clear. The headline was, "Greenspan urges Social Security cuts," and I just want to give you an opportunity to be pretty precise as to what you are suggesting.

Mr. GREENSPAN. I am not urging Social Security cuts. Over the last 20 years, I have argued for an improvement in the cost-of-living adjustment, which is statutorily what is required.

I am saying we have better technical means of doing what the intent of the Congress is. And I am merely repeating the same proposals I have been making ever since I was chairman of the Social Security Commission. I have not changed in the slightest.

Mr. SHAYS. I just wanted to make sure that we dealt with that.

So, anything you would like to put on the record before we adjourn?

Mr. GREENSPAN. Thank you. I appreciate it.

Mr. SHAYS. Thank you very much. I ask unanimous consent that members be allowed 7 days to submit statements for the record and that the record remain open for that period.

Thank you. We are adjourned.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

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