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THE ECONOMIC OUTLOOK AND CURRENT FISCAL ISSUES

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

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THE ECONOMIC OUTLOOK AND CURRENT FISCAL ISSUES

WEDNESDAY, MARCH 2, 2005

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

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

Members present: Representatives Nussle, Ryun of Kansas, Crenshaw, Putnam, Wicker, Barrett of South Carolina, Lungren, Bradley, Ryan of Wisconsin, Hensarling, Bonner, Portman, Spratt, Moore, Edwards, Capps, Cooper, Davis, Case, Jefferson, Kind, Allen, Cuellar, McKinney, and DeLauro.

Chairman NUSSLE. Good morning, and welcome to today's Budget Committee hearing. Today we welcome back to the committee and we are pleased to have with us the Chairman of the Federal Reserve Alan Greenspan to discuss the economic outlook and the Federal budget. I will note to members that Chairman Greenspan will be available here in the committee until 1 p.m., so I will stick to the 5-minute rule, and I ask all members to do so so we can give an opportunity to all members to ask questions today to as many as possible.

Chairman Greenspan, welcome back to the Budget Committee. We are ever so pleased that you take time to come and visit with our committee on a regular basis. It is something that we look forward to, and we really do appreciate the advice and counsel that you provide us.

Each time that you appear before the committee, the economy continues to look better and better. Particularly in the last few years, we have seen steady improvement, and it is not only a testament to the resilience and flexibility of our great American economy, but also to what I would suggest are policy successes of the past several years, everything from tax relief to your guidance on monetary policy.

Last year you appeared before this committee on two occasions, in February and then again in September. When you were with us in February, we were just beginning to see stronger real growth as our economy was rebounding from the recession and other adverse factors that we had faced, including the bursting of the stock market bubble, corporate scandals, the terrorist attacks of September 11, the ensuing global war on terrorism. Yet at that time, just last year, we were still waiting to see solid evidence of stronger job growth and success.

When you appeared before us 6 months later, last September, we had seen continued strong real growth in the economy; in fact, the best in 20 years. We were finally seeing solid evidence of improvements in the labor markets with falling unemployment and increases in payroll jobs. But still there were many critics who were claiming that it was a jobless recovery, and it was the worst economy since the Great Depression. I would certainly hope that we are all thankful that those critics were wrong.

Today the general consensus of both the public and private forecasters is that the U.S. economy is now in sustained expansion with solid growth, real gross domestic product (GDP) and payroll jobs, and with low unemployment and low inflation. Today real GDP has increased for 13 consecutive quarters, and real growth rates in 2004 was 4.4 percent, the strongest growth in 5 years, and one of the strongest rates of growth in the past 20 years.

Private forecasters expect solid growth to continue, and even the Federal Reserve published forecasts expects real GDP to grow at 3½ to 4 percent this year and 3¼ to 3¾ next year. Real business equipment investment has increased at a 15 percent annual rate over the past year and a half, the best performance in 7 years. The investment tax relief we passed, I believe, helped to make that happen. We see the best performance of the housing markets in decades with housing construction its best in 20 years; and home ownership, record high for our country.

Perhaps the most important, our labor markets are in much better shape. Unemployment rate is down to 5.2 percent and is now lower than the decade averages for the 1970s, 1980s, and 1990s. Payroll employment has increased by 2.7 million jobs over the past 20 months, and forecasters are expecting ongoing significant gains of about 190,000 jobs per month, or 2¼ million more jobs by the end of the year. Significant improvement in jobs and labor markets has occurred and is expected to continue as new claims for unemployment insurance are at their lowest levels in over 4 years.

How did we get to this point? Well, certainly, again, we remember back to what many would suggest was a much better time. On September 10 of 2001, we were running a surplus. We all remember those days, and everyone is well aware this Nation has been through an incredibly difficult number of years personally, for individuals, for families, for men and women serving in our military, for our men and women on the front lines protecting our country, people in our economy who are job creators, and people who have lost jobs and have gotten retraining and have gained jobs back, as well as the uncertainties of our global war on terrorism.

In response, Congress and the President acted together. We took quick, deliberate action to correct not only the economic growth deficits that we faced, but also the challenges and deficits that we faced in our homeland security and military defense. As a result of this response to those challenges and the necessary spending associated with that response, we have seen a return to budget deficits.

Chairman Greenspan, when you were with us last year at this time, the administration had projected a deficit of $512 billion for fiscal year 2004, and you told us that if we wanted to reduce that deficit, not only had we better keep the economy growing in cre-

ating jobs, but we had to do a better job of getting control of Federal spending.

Last year we worked to ensure continuation of critical tax relief that we had passed, which I believe played a significant role in boosting the economy out of the recession through recovery and into a sustained expansion. We also, for the first time in really a long time, started to get our hands around the out-of-control discretionary spending that we provide here in Congress, and lo and behold, the deficit actually started to go down. We ended last year with a deficit of $412 billion, still way too high by anyone's count, but $109 billion less than what we anticipated at the start of the year, 20 percent off the top of the deficit in 1 year.

That is a good start and one that we have to continue, but I know, and I think we all know, that strong, sustained economic growth and tight funding on our discretionary programs, even level funding for that matter, will not get us back to balance. Don't get me wrong, we need to do both, and we have done both, but they are just not enough.

This year President Bush has taken what I believe are some tough but necessary next steps in his budget for slowing our currently unsustained rate of spending growth. They are the same kinds of ideas that we have floated in this committee many times, but we have the President's commitment and leadership, and not only does his proposal hold all nonsecurity spending below inflation, but it begins a process of looking for savings in the largest part of the Federal budget. Fifty-five percent, colleagues; 55 percent of our budget is on automatic pilot. It simply operates as a mandatory expenditure without any controls. That is that mandatory side of the budget we talked about, the automatic pilot, the entitlements.

I commend the President for these new efforts, and it is pretty clear that Congress may not—maybe not in the exact way that the President has proposed, but in whatever way we decide, must begin to propose slowing the rate of growth in the largest, most rapidly growing part of our budget if we even want to think about reducing the deficit, let alone getting us back to balance.

I understand the criticism and the complaints and a little bit of whining has already occurred, because you go into these mandatory accounts, and all sorts of people come out of the woodwork to begin their criticism. We have heard from Governors who say, not yet, not this year, let us do it next year. Trust us; we will come forward with a reform proposal. And I believe what we have been able to accomplish in the last week to 10 days a recognition that we can't wait until next year to begin the discussion of reform proposals.

Take Medicaid as an example. The Governors have told us seemingly in unison that they don't want an arbitrary number to drive the policy, but a number will drive the schedule. We have their attention, and we have them at the table. We have begun the discussion of reform, and it is an important discussion that has to be sustained.

So while I understand people will say, well, not in my backyard, not in this particular area, please don't do it this year, please don't pick an arbitrary number, the good news is we are beginning a discussion on the mandatory entitlement side of the budget, particu-

larly in the health care accounts which are unsustainable, have been growing out of control, and without significant reforms through a reconciliation process that we will go through this year—without that kind of discipline, they will grow out of control and envelope the entire budget.

It doesn't mean reconciliation has to begin in May, as is typically the challenge. We can work with the Governors to bring forward a reform proposal on Medicaid, invite them to the table, invite Secretary Leavitt to the table, former Governor, who is an honest broker who can talk through Medicaid, and we can have their ideas, their proposals, their reforms considered the exact same way we did welfare reform back in 1996.

Is this hard work? Yes. Don't let anybody think it isn't going to be hard work. But we have the right people talking about it. We have the right people invited to the table. They are beginning serious discussions about reform proposals, and it is all because the President brought up his budget, and we have been discussing reconciliation.

So I understand there will continue to be complaints and criticism that somehow this is going to be difficult, and somehow it shouldn't happen this year, and wait until next year to do reform, which, as my father always said, tomorrow never comes. Well, tomorrow never comes in the budget process either. We have to begin that work today, but we can put us on a schedule on something that is predictable and invite the right people in for reforms.

So we have asked Chairman Greenspan back with us today to first review the current economic picture and also to hear what he believes is the best course for keeping our momentum going with regard to spending restraint and budget deficit reduction. I anticipate we will hear more of your views on a very challenging issue of Social Security reform. I am looking forward to receiving your testimony on a number of topics that I know members are interested in inquiring about. We appreciate your willingness to come before our committee today.

And with that, I will turn it over to my friend and colleague to Mr. Spratt for any comments he wishes to make.

Mr. SPRATT. Thank you very much, Mr. Chairman. And thank you, Chairman Greenspan, and welcome back to the Budget Committee. We appreciate you coming.

Picking up on where the chairman left off, we are all pleased to see the economy back on its feet, but I have to note that Chairman Greenspan is only one sentence into his statement before he warns, in Fedspeak, the positive short-term economic outlook is playing out against a background of concern about the prospects for the Federal budget, especially over the longer run.

It is daunting, Mr. Chairman, to compare where we were 5 years ago, sitting on a surplus of $236 billion, to where the Government is today, $2.2 trillion deeper in debt and only going deeper. It is demoralizing to see President Bush's budget with big national security increases, and yet no sense of shared sacrifice, no effort to pay for the national security, which we don't dispute the need for; indeed, even more tax cuts to come, more tax cuts proposed. And so there is no wonder that we see no end to the deficits in this budget.

The President's budget claims a budget of $390 billion for the year 2006. Mr. Chairman, you know and I know this is a piece of budget artifice because it omits the cost of deploying troops in Iraq and Afghanistan, running at least $5 billion a month. The President's budget also calls for more tax cuts, but omits any mention of the alternative minimum tax, which will cost, by the estimate of the Congressional Budget Office (CBO), $640 million to correct so we don't see it applied to middle-income taxpayers for whom it was never intended.

And most incredibly of all, the President calls for Social Security reform that allows 4 percentage points to be peeled off FICA taxes and diverted into private accounts beginning in 2009, but his budget breathes barely a word about fiscal consequences. There is hardly more than a footnote and nothing in the tables dealing with the $754 billion that the administration acknowledges that it has to borrow between 2009 and 2015 to pay for the transition. There is nothing close to full disclosure, by which I mean an honest acknowledgment that $1.4 trillion must be borrowed the first 10 years this plan is in effect, and $3.5 trillion must be borrowed during the next 10 years.

If we can put up chart No. 2, this is the consequence of that kind of borrowing, $4.9 trillion over the next 20 years. And yet you are only halfway up the mountain when you get to that level. We have only parts and pieces of the plan the President is proposing, but using data that the actuaries at Social Security have supplied, this graph shows how we plot the rising mountain of debt. Indeed, it is Himalayan, a Mount Everest of debt under the President's plan, debt increasing, by our calculation, every year for the next 50 years as a percentage of GDP. No household and no individual and no government can run on the basis where every year it accumulates more debt, its debt grows faster than its income does. When the President's budget is adjusted just for these several big realities, the unified deficit goes up, not down, and never goes away as this graph, graph No. 3, shows. Indeed, it is hard to figure how we will ever again in our lifetimes see the budget balanced.

Here are the questions we hope you will address today, Mr. Greenspan. Is this budget on a sustainable path? Basically is this budget something that you can put on paper, you can project these numbers, but can we take this path without expecting to see some severe consequences down the road? Can the Government run such deficits and hold harmless our economy and the value of the dollar? Are deficits of this magnitude consequential? What risks do we run in the world of financial markets if financial markets see the deficits as endless and enormous?

Chart No. 4, for example, shows what we plot to be the President's budget over the next 10 years. It gets worse, not better. Deficits cannot go down. They don't go away. And at that point on the horizon, there is no near-term prospect for the resolution of the deficits.

There is an old adage attributed to Hippocrates that we should first do know harm when you find yourself faced with problems like this. I want to ask you about two particular applications of that time-honored rule.

First of all, the tax cut passed in 2001 and 2003 were predicated on surpluses that were acknowledged to be substantially overestimated. They have gone. They have been replaced by unending deficits. Recognizing that the projected surpluses were paper projections and might not obtain, these tax cuts were written to expire on December 31, 2010, for the most part.

You have called for the renewal of the Budget Enforcement Act of 1991 and its strictures, particularly the PAYGO rule and discretionary spending caps. Do you still hold to the view that the PAYGO rule should be reinstated, and they should apply to these expiring tax cuts so they have to be fully offset if they are renewed?

Secondly, you decry in your testimony the looming deficits. You have been an advocate of this position for a long time, but you also support the concept at least of private accounts for Social Security, partial privatization, which you acknowledge will add to the deficit in the near term and for a long time to come.

I know the argument, we have heard it made here before. What you will be doing in that case is detracting or subtracting from public saving and adding to private saving. And maybe it is more than a wash if you put the money in private accounts beyond the reach of the Government, but nevertheless, this requires the Government to borrow substantial sums to bridge transition and borrow these sums at a time when we were already scheduled to go into the open markets and convert trust fund debt into publicly funded debt, because I suppose if we are going to meet our obligations in the 2020s, 2030s, and onto the 2040s, we are going have to liquidate our debt from trust fund debt to publicly held debt.

When you put these two together, aren't we tempting fate? Aren't we straining the economy and taking risks that we should be wary of taking? What are the consequences of the policy, what are the risks, the pitfalls, the downside of the proposals we have before us.

We have a plateful of problems, Mr. Chairman. And we appreciate your thoughtful testimony and the time you have taken to come here. We look forward to hearing your testimony and to ask you questions about it. Thank you for coming.

Chairman NUSSLE. Thank you Mr. Spratt.

With that, Chairman Greenspan, welcome back to the House Budget Committee. We are pleased to receive your testimony. I will ask, before you begin, unanimous consent that all members have the opportunity to place a statement, an opening statement, in the record at this point. Without objection, so ordered.

[The prepared statement of Mr. Putnam follows:]

PREPARED STATEMENT OF HON. ADAM H. PUTNAM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, I am pleased to join with you today to continue our review and discussion concerning the Fiscal Year 2006 budget, and I would once again like to welcome Chairman Greenspan.

While our Nation is clearly facing and unsustainable budget deficit, it is important to acknowledge the remarkable economic recovery that we are experiencing, the increase in paid jobs that are being produced, as well as the startling growth in the rate of homeownership. The final quarter of 2004 was the 13th consecutive quarter of economic growth for our Nation, with GDP increasing at 3.8 percent, an incredible recovery following the 2000–2001 recession. Overall, in 2004 the GDP grew 4.4 percent, the strongest annual performance in the last 5 years. Also in 2004, payroll

employment positions increased by 2.2 million. Unemployment is at 5.2 percent, lower than the decade average for the three previous decades. Homeownership is at a record high. Our goal must be to continue on this path of strong recovery while simultaneously curtailing the rate of spending that we have seen over the last decade. The economy is strong, and reigning in spending is a reasonable policy to keep it so.

An issue that we have the responsibility to address sooner, rather than later, is Social Security. Social Security is safe for today's seniors—but it is in serious danger for future retirees. Each year, there are more retirees taking money out of the system, with not enough additional workers to support them. Currently, Social Security has a total unfunded obligation under current law of more than $10 trillion. Personal accounts provide Americans who choose to participate with an opportunity to share in the benefits of economic growth by participating in markets through sound investments. Any delay by Congress in addressing the issue limits options for reform and increases costs of all options. Addressing Social Security now is fiscally responsible, and we owe that to our younger workers.

In addition to Social Security, we much address other mandatory spending programs that have been running on "automatic pilot" for decades. Our current budget is comprised of too high a percentage of mandatory spending programs. Our role here must be to reevaluate the justification for their place in the entitlement side of the ledger.

Congress has worked in recent years to ensure that America has the resources it needs for its security. We are the taxpayer's last line of defense against excessive or wasteful Federal spending. I believe that Congress must establish priorities in these difficult times, recognizing, not ignoring the fact that we are at war, and that defense needs cannot grow at current rates without concurrent trade-offs in other parts of the budget.

This year's budget must offer long-term solutions to generational issues facing us. Social Security, Medicare and Medicaid all find themselves on unsustainable glide paths into deficit oblivion. War and the threats to our homeland continue to draw resources our of the treasury without compounding economic benefit and trade deficits reflect an unhealthy imbalance. The historic early decisions are behind us, Mr. Chairman. It is time to earn our keep.

Thank you, Mr. Chairman.

Chairman NUSSLE. Chairman Greenspan, welcome back to the committee, and we are pleased to receive your testimony.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman, Ranking Member Spratt, and members of the committee. Let me just first say that I will be excerpting from my full text and request that it be included in the record.

Chairman NUSSLE. It will be.

Mr. GREENSPAN. I want to emphasize that I will be speaking on the Federal budget and related issues, but I am speaking for myself and not necessarily for other members of the Federal Reserve Board.

The U.S. economy delivered a solid performance in 2004, and thus far this year activity appears to be expanding at a reasonably good pace. However, the positive short-term economic outlook is playing out against the backdrop of concern about the prospects for the Federal budget, especially over the longer run. As the latest projections from the administration and the Congressional Budget Office suggest, our budget position is unlikely to improve substantially in the coming years unless major deficit-reducing actions are taken.

In my judgment, the necessary choices will be especially difficult to implement without the restoration of a set of procedural restraints on the budget-making process. Reinstating a structure like the one provided by the Budget Enforcement Act would signal a re-

newed commitment to fiscal restraint and help restore discipline to the annual budgeting process. Such a step would be even more meaningful if it were coupled with the adoption of a set of provisions for dealing with unanticipated budgetary outcomes over time.

The original design of the Budget Enforcement Act could also be enhanced by addressing how the strictures might evolve if and when reasonable fiscal balance came into view. I do not mean to suggest that the Nation's budget problems will be solved simply by adopting a new set of rules. The fundamental fiscal issue is the need to make difficult choices among budget priorities, and this need is becoming ever more pressing in light of the unprecedented number of individuals approaching retirement age.

Because the baby boomers have not yet started to retire in force, we have been in a demographic lull, but this state of relative stability will end soon. In 2008, just 3 years from now, the leading edge of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits can be drawn, and the age at which about half of those eligible to claim benefits have been doing so in recent years. Just 3 years after that, in 2011, the oldest baby boomers will reach 65 and thus be eligible for Medicare.

Currently 3¼ workers contribute to the Social Security System for each beneficiary. Under the intermediate assumptions of the program's trustees, the number of beneficiaries will have roughly doubled by 2030, and the ratio of covered workers to beneficiaries will be down to about two. The pressures on the budget from this dramatic demographic change will be exacerbated by those stemming from the anticipated steep upward trend in spending per Medicare beneficiary.

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

In fiscal year 2004, Federal outlays for Social Security, Medicare and Medicaid totaled about 8 percent of gross domestic product. The long-run projections from the Office of Management and Budget (OMB) suggest that the share will rise to 9½ percent by 2015 and will be in the neighborhood of 13 percent by 2030. So long as health-care costs continue to grow faster than the economy as a whole, the additional resources needed for such programs will exert pressure on the Federal budget that seems increasingly likely to make current fiscal policy unsustainable. The likelihood of escalating unified budget deficits is of great concern because they would drain an inexorably growing volume of real resources away

from private capital formation over time and cast an ever larger shadow over the growth of living standards.

The broad contours of the challenges ahead are clear, but considerable uncertainty remains about the precise dimensions of the problem and about the extent to which future resources will fall short of our current statutory obligations to the coming generations of retirees.

The uncertainty about future medical spending is daunting. We know very little about how rapidly medical technology will continue to advance and how those innovations will translate into future spending. Technological innovations can greatly improve the quality of medical care and can in some instances reduce the costs of existing treatments. But because technology expands the set of treatment possibilities, it also has the potential to add to overall spending, in some cases by a great deal. As a result, the actuaries' projections of Medicare costs are highly provisional.

These uncertainties, especially our inability to identify the upper bound of future demands for medical care, counsel significant prudence in policymaking. The critical reason to proceed cautiously is that new programs quickly develop constituencies willing to fiercely resist any curtailment of spending or tax benefits. As a consequence, our ability to rein in deficit-expanding initiatives, should they later prove to have been excessive or misguided, is quite limited.

I fear we may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver. If existing promises need to be changed, those changes should be made sooner rather than later. We owe future retirees as much time as possible to adjust their plans for work, saving and retirement spending.

Addressing the Government's own imbalances will require scrutiny of both spending and taxes. However, tax increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base. The exact magnitude of such risks is difficult to estimate, but in my judgment they are sufficiently worrisome to warrant aiming if at all possible to close the fiscal gap primarily, if not wholly, from the outlay side. In the end, I suspect that unless we attain unprecedented increases in productivity, we will have to make significant structural adjustments in the Nation's major retirement and health programs.

Our current largely pay-as-you-go social insurance system worked well given the demographics of the second half of the 20th century, but as I have argued previously, the system is ill-suited to address the unprecedented shift of population from the workforce to retirement that will start in 2008. Much attention has been focused on the forecasted exhaustion of the Social Security Trust Fund in 2042, but solving that problem will do little in itself to meet the imperative to boost our national saving. Raising national saving is an essential step if we are to build a capital stock that, by, say, 2030 will be sufficiently large to produce goods and services adequate to meet the needs of retirees without unduly curbing the standards of living of our working-age population.

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

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

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

Crafting a budget strategy that meets the Nation's longer-run needs will become ever more difficult the more we delay. The one certainty is that the resolution of the Nation's unprecedented demographic challenge will require hard choices, and that the future performance of the economy will depend on those choices.

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

Chairman NUSSLE. I thank you, Mr. Chairman, for your testimony.

[The prepared statement of Alan Greenspan follows:]

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

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

The U.S. economy delivered a solid performance in 2004, and thus far this year, activity appears to be expanding at a reasonably good pace. However, the positive short-term economic outlook is playing out against a backdrop of concern about the prospects for the Federal budget, especially over the longer run. Indeed, the unified budget is running deficits equal to about 3½ percent of gross domestic product, and Federal debt held by the public as a percent of GDP has risen noticeably since it bottomed out in 2001. To be sure, the cyclical component of the deficit should narrow as the economic expansion proceeds and incomes rise. And the current pace of the ramp-up in spending on defense and homeland security is not expected to continue indefinitely. But, as the latest projections from the Administration and the Congressional Budget Office suggest, our budget position is unlikely to improve substantially in the coming years unless major deficit-reducing actions are taken.

In my judgment, the necessary choices will be especially difficult to implement without the restoration of a set of procedural restraints on the budget-making process. For about a decade, the rules laid out in the Budget Enforcement Act of 1990 and in the later modifications and extensions of the act provided a framework that helped the Congress establish a better fiscal balance. However, the brief emergence of surpluses in the late 1990s eroded the will to adhere to these rules, which were

aimed specifically at promoting deficit reduction rather than at the broader goal of setting out a commonly agreed-upon standard for determining whether the Nation was living within its fiscal means. Many of the provisions that helped restrain budgetary decisionmaking in the 1990s—in particular, the limits on discretionary spending and the PAYGO requirements—were violated ever more frequently; finally, in 2002, they were allowed to expire.

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

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

Because the baby boomers have not yet started to retire in force, we have been in a demographic lull. But this state of relative stability will soon end. In 2008—just 3 years from now—the leading edge of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits can be drawn and the age at which about half of those eligible to claim benefits have been doing so in recent years. Just 3 years after that, in 2011, the oldest baby boomers will reach 65 and will thus be eligible for Medicare. Currently, 3¼ workers contribute to the Social Security system for each beneficiary. Under the intermediate assumptions of the program's trustees, the number of beneficiaries will have roughly doubled by 2030, and the ratio of covered workers to beneficiaries will be down to about 2. The pressures on the budget from this dramatic demographic change will be exacerbated by those stemming from the anticipated steep upward trend in spending per Medicare beneficiary.

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

In fiscal year 2004, Federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of GDP. The long-run projections from the Office of Management and Budget suggest that the share will rise to 9½ percent by 2015 and will be in the neighborhood of 13 percent by 2030. So long as health-care costs continue to grow faster than the economy as a whole, the additional resources needed for such programs will exert pressure on the Federal budget that seems increasingly likely to make current fiscal policy unsustainable. The likelihood of escalating unified budget deficits is of especially great concern because they would drain an inexorably growing volume of real resources away from private capital formation over time and cast an ever-larger shadow over the growth of living standards.

The broad contours of the challenges ahead are clear. But considerable uncertainty remains about the precise dimensions of the problem and about the extent to which future resources will fall short of our current statutory obligations to the coming generations of retirees. We already know a good deal about the size of the

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

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

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

Addressing the government's own imbalances will require scrutiny of both spending and taxes. However, tax increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base. The exact magnitude of such risks is very difficult to estimate, but, in my judgment, they are sufficiently worrisome to warrant aiming, if at all possible, to close the fiscal gap primarily, if not wholly, from the outlay side. In the end, I suspect that, unless we attain unprecedented increases in productivity, we will have to make significant structural adjustments in the Nation's major retirement and health programs.

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

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

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

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

costs. And, with time, we should also gain valuable knowledge about the best approaches to restraining the growth of overall health-care spending.

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

Chairman NUSSLE. Let me barely scratch the surface on a number of items in my 5 minutes. First, it appears that you agree that the economy appears to be in some definition of sustained expansion, that we have had solid GDP growth, jobs, and low inflation. Even though this should be good news for the budget outlook in the short run, your testimony indicates that you don't think we can grow our way out of our budget problems. Would you expand on your feeling in that regard?

Mr. GREENSPAN. Yes, Mr. Chairman. The reason basically is the huge potential expenditure in Medicare concerning which we have very little understanding and essentially, at this stage, very little control. Implicit in both the Social Security System and in Medicare are mechanisms, direct and indirect, that indicate that in the event of either a rise in inflation or a rise in real growth in the economy, the benefits in both of those programs go up over the long run reasonably proportionately. So in a sense the more we grow, the more the benefits rise, and as a consequence, we can't work our way out directly.

Now it is the case that especially in Social Security there is a substantial lag between the acceleration of productivity and when it ultimately feeds into benefits through the link which occurs as a consequence of the fact that initial benefits are linked to wages, which pick up the productivity changes. So over the long run, you are effectively, under current law, guaranteeing real benefits. And while that is not actually the case on the Medicare system, as a practical matter it is turning out to be that way. So it does not appear as though we can look to the mere acceleration in productivity—which, of course, is the only way we can grow increasingly—as a resolution to our fiscal problem in this respect.

Chairman NUSSLE. And yet our economy is growing. We have seen some great news in the last number of quarters in particular, so there is growth. And what would you suggest—let us focus on taxes. There are a number of reasons why we have seen growth, but if you could focus on tax policy for a moment and suggest to us which tax policy changes you felt during the last 3 or 4 years were the most significant in getting us back on track and accelerating that growth.

Mr. GREENSPAN. There was a particular part in the recent changes in tax policy which I thought and continue to believe was highly desirable, and that is the partial elimination of the double taxation of dividends. There is a major efficiency question here with respect to how the economy functions, and it has always been my view, and it is the view of a number of economists, that inte-

grating the individual and corporate tax would improve the efficiency of the economy, increase its growth rate and in the end increase revenues. And the action taken with respect to reducing specifically taxation on dividends received I thought was a very useful and major structural change in the budget. It is the case that other elements of the tax cut were effective and instrumental in reducing the weakness that occurred in the economy in 2001, but they are no longer playing a role of any significance today.

Chairman NUSSLE. Taking that tax policy for a moment and remembering back, as I am sure you can as well as I can, to the debate at that time, it was one of the more controversial and partisan tax policy changes that were made. There was not a lot of broad support for that tax policy change. And as a result, it was controversial, and as a result of not having arbitrary rules, such as paying for tax cuts, quote/unquote, as many people like to use in the parlance of budgetspeak around Washington—as a result of not having that arbitrary rule, we were able to pass an elimination, partial elimination, of the double taxation for dividends.

I would hate to see an arbitrary rule because of—for partisan purposes only, which appears to be one of the reasons why they are often put in to prevent us from making a very important emergency change to our economy and to our Tax Code in order to elicit a very positive change in our economy, which you are suggesting occurred and many others are suggesting occurred. To me, it is important for us to have pay-as-you-go for spending. But do you really see tax relief as Government spending—other than obviously earned income tax credits where we are handing out money—but actual changes in tax policy as really spending on the part of Government? That to me is not spending. Why do you stick to this position as you have very forcefully over the years, when, in fact, something as important as the double taxation of dividends most likely would not have been done as a result of an arbitrary budget rule?

Mr. GREENSPAN. I do so, Mr. Chairman, because I grant you that if everyone believed as I do, and I realize you do, that the solution to the budget problem is far more sensibly addressed on the outlay side, then it wouldn't make very much difference. But it is an arguable issue, and this is a democracy, and we do have differing views and people holding differing views, and compromise is essential in getting a functional legislature to work its will. And in full recognition of that, and in recognition of the fact that there are people who don't agree with either you or me on this issue, I think we require that to be symmetrical, because it is the principle that I think is involved here; namely, that you cannot continuously introduce legislation which tends to expand the budget deficit, because down the road, the impact of an ever-rising deficit, especially as a percent of the GDP, creates some significant weakness in the structure of the economy. So it is not an issue of economics. It is an issue, if you want to put it that way, of political economy.

Chairman NUSSLE. And I won't put words in your mouth. You are able to do that very well yourself. But let me tell you what I believe I heard and what that means to me, and that is there was a time where pay-as-you-go applied to both sides of the ledger for political compromise. One of the challenges that we have is that be-

cause you stick to that position, there are those who say that we are not doing proper budgeting out here because we don't pay for taxes, quote/unquote.

I agree with you. It was part of the political compromise that was reached a numbers of years ago. It had its impact. It worked for a time, but it has been used as a political hammer, an anvil, against good tax policy at a time when our economy needed that kind of a shot in the arm. I agree with you on the issue that it needs to be there to pay for spending. That is what Government pays for is its spending. But taxes are paid by people, not by Government, and while I understand your point of view that there may be a political necessity or compromise in order to reach new budget rules, I happen to also agree with you that the more important way to address budget discipline is on the spending side.

With that, I will yield to Mr. Spratt.

Mr. SPRATT. Mr. Chairman, let me pick up where you left off and say that there are few big variables out in the future that will determine the course of the deficit, and one is what happens to the tax cuts that were enacted in 2001 and 2003 when they expire in 2010, at the end of 2010? The chairman has said, sitting right there in that chair twice before, we should reenact, renew the Budget Enforcement Act of 1991. You declared yourself a skeptic, if not a cynic, at one time as to whether or not those rules would work and came here, and Mr. Copeland said, I was only too pleased to say that I was wrong. They have had a more salutary effect than I ever suspected they might have. And you called twice that I recall, Mr. Chairman, for a double-edged PAYGO rule. Political compromise or not, it would apply both to entitlement increases and to tax cuts.

Is it still your position that if we renew the PAYGO rule, it should apply to both; if we have tax cuts, including the renewal of the expiring tax cuts in 2010, that these should be fully offset?

Mr. GREENSPAN. It is still my position. The principle of containing budget expansion is the overriding principle here. And while, as I just indicated before, I could prefer to structure PAYGO in a different way, that we have some form of PAYGO system which is agreed upon by the Congress, in my judgment, is the overriding consideration here, because as you point out, it was quite effective in actually stemming budget inefficiencies and expansion during the period when it was in law.

I argued strenuously before this committee, I think, days before its expiration in September 2002, that the act should be renewed. I still do that. And even though I still believe that partial elimination of the double taxation of dividends deserves to be extended, because I think it is a fundamentally important issue, nonetheless, the principle which is important comes first. If I were voting, which, of course, I don't, I would vote for continuing the partial elimination of the double taxation of dividends, but I would also offer PAYGO offsets in order to implement that.

Mr. SPRATT. Let me ask you something about a different line. You have also been an outspoken opponent for some time that the Social Security trustees would use the common public trust fund and invest some portion of it in—invest some portion of it in equities and the stock market, which is what private pension plans and

public pension plans. The Federal Reserve pension plan, I believe, is two-thirds invested in equities. But you have been an opponent of Social Security doing the same thing.

The administration is now proposing that the set-aside of these private accounts would be invested in a limited range of accounts, modeled after the Thrift Savings Plan (TSP); therefore, it would be created by the Government. The investment manager would likely be chosen by the Government. They would operate under statutory provisions that would structure the program, and from time to time the managers will be chosen, the thing would be bid and rebid.

Isn't this getting very close to having the trust fund, the Social Security Trust Fund, invested? The Government is really the player here calling the shots, which would be the same case if you had a trustee appointed for the investment of the common trust fund.

Mr. GREENSPAN. It is, Congressman. It is the one part that is as yet an unannounced program, about which I have a certain pause for exactly the reasons you indicate.

Mr. SPRATT. Let me ask you one final question. That is today's debt is different from a debt when we were taking economics's 101. And reading Samuelson as college students, we were all told that the debts—its importance is not that great, but today's debt is different because increasingly it is held by foreigners. I have a chart here, I think No. 3, which shows you the percentage of debt that is increasingly held by foreign entities, central banks, Government treasuries and foreign individuals. Is this a qualitatively different kind of debt from a debt we have incurred and held in past years?

Mr. GREENSPAN. No, it is not. It is caused, as you know, by the fact that, one, we have fallen far short in domestic savings, so-called national savings, and as a consequence, to maintain our domestic investment, we have had to increase our borrowing of savings from abroad to a very significant extent. And to the extent that the evidence of that debt is U.S. Treasury instruments, it is reflected in the chart that you have there.

The second issue, remember, is the fact that they choose to invest here and——

Mr. SPRATT. They could choose not to invest here, probably more readily than domestic citizens.

Mr. GREENSPAN. They could, but the fact they choose to invest here suggests they believe that the rates of return in this country and the nature of the assets which they can hold under U.S. law are exceptionally attractive. The question basically is should we not be concerned in the sense that this is a reflection of the fact that we save too little, and that if we are concerned about these figures, the answer is not to prohibit foreigners from purchasing our securities, but rather to create a situation in which we have enough domestic savings that the need to borrow foreign savings is reduced dramatically.

Mr. SPRATT. I wasn't going to suggest that we prohibit it. Far from it. We would be in a terrible crisis if we restricted foreign acquisition of our debt. But it would seem to me there comes a time, particularly when we have woefully deficient domestic savings—there could be a time when foreigners become satisfied that they have enough and, for portfolio diversification purposes, they decide to move into other debt.

Mr. GREENSPAN. Indeed. It is exactly the point I have been making over the last year or two. It is not an issue only of the rates of return or the quality of the assets which we offer, which are world class, but there does come a time when it is conceivable you are holding too much of your existing assets in one set of countries. And merely for diversification purposes, one would evidently start to move.

There is, I must tell you, however, very little evidence that that is even going on, even though there have been some rumors in the press and the like that there has been a significant move out of U.S. dollars. That may occur somewhere down the line years ahead. Nobody really knows for sure, but there is very little evidence that what is occurring recently is more than technical moves backwards and forwards.

Mr. SPRATT. Thank you, sir.

Chairman NUSSLE. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman.

And, Chairman Greenspan, thank you for being with us today and for your optimistic assessment of our economy, your good news about 2004, and also looking forward to 2005, which you see as sustained growth.

My first question to you would be on the tax side, and if you could give us an assessment of what you think the role was of the tax relief in 2001, 2002, and indeed 2003. You talked about the dividend tax relief. Capital gains relief was also enacted that year. What role do you think it played in having us have the relatively strong economic growth we have seen and the job growth we have seen, over 2 million new jobs in the last year, 2004? What role will it be going forward in 2005?

Mr. GREENSPAN. The main effect of tax cuts is on the GDP. Its effect on employment is indirect in the sense that sometimes the GDP is created by accelerated output per hour, which increases standard of living, but doesn't increase employment, so that an analysis of tax cuts should always focus on the issue of what they do to economic growth.

It is fairly apparent that tax cuts were a significant factor in stemming the weakness that was occurring in the American economy subsequent to the bursting of the bubble in 2000. And while you don't know exactly how and by what amounts, it is evident from the very shallow recession that occurred as a consequence of the number of imbalances that were occurring in the latter 1990s, that a goodly part of the support did come from tax cuts.

It is less important now in the sense that the economy is now developing its own momentum. Capital investment is picking up. The orders are coming in reasonably well. An increasing number of business executives are indicating that their business is good and getting better.

Mr. PORTMAN. We have had a discussion of PAYGO, but as a general rule do you believe as these tax relief provisions that were put in place in 2001, 2002, and 2003 begin to expire, that they should be extended, or should we have tax increases, and what effect would that have on the economy?

Mr. GREENSPAN. I have only commented on the one which has always been important to me, which is reducing part of the double

taxation of dividends. All I am saying is that my general view is I would like to see the tax burden as low as possible. And in that context, I would like to see tax cuts continued. But as I indicated earlier, that has got to be, in my judgment, in the context of a PAYGO resolution.

Mr. PORTMAN. Talking about national savings, my second question is about that, and I think you rightly pointed out the challenge is the retirement of the baby boomers, and the fact between Medicare and Social Security we have an unfunded challenge.

With regard to national savings, you supported national personal savings accounts and Social Security. I do believe there is a big distinction, as Mr. Spratt mentioned, between the Government investing directly and individuals directing that investment, even if it is within Social Security, which is very much what the President's personal account proposal includes. But with regard to adding to savings, do you also believe that we should in addition to having personal accounts, which I support, also encourage savings among employers, among individuals through 401(k)s? 401(k)s is now almost $2 trillion in savings, and IRAs over $3 trillion now, and we could do a lot more. Do you think we should also be as a Congress focusing on the private savings side and providing more inducements for that?

Mr. GREENSPAN. I do, Congressman. There is a dispute amongst economists about how much, say, the 401(k)s and IRAs have contributed net to domestic savings. There is an argument that part, and some argue all, is merely a reshuffling of existing savings and doesn't add anything net. I suspect that there is a net increase. It is hard to prove, and I haven't found any of the analyses both pro and con fully conclusive, but the issue is of such an overriding consideration that anything we can do to enhance incentives to save I think we are obligated to do.

Mr. PORTMAN. I would make one obvious point that this is about long-term retirement savings. Even if there is some displacement of other savings, looking at the savings habits of American households and even businesses, certainly by encouraging long-term savings, you have net long-term savings, I believe.

And second, just to warn us all on PAYGO, the PAYGO rules as applied to that kind of savings doesn't work well when we are talking about a 10-year budget projection. So much of that comes back in terms of taxation at the end that cannot be accounted for in the 10 years.

Chairman NUSSLE. Mr. Moore.

Mr. MOORE. Mr. Chairman, thank you for your service to our country over the years. I want to follow up on a couple of questions that Mr. Spratt asked you about, investment by foreign nations in our debt. You said they made a choice to do that. What if they decided to disinvest and not hold that debt anymore? What practical effects would that have on our markets here for our economy?

Mr. GREENSPAN. We have examined that in some detail because the size of both our current account deficit and the extent to which that impacts on our domestic economy are relevant issues for policy.

What we have judged is that the fairly significant purchases of U.S. securities or claims in general on American citizens have low-

ered long-term interest rates modestly, but not to a really considerable extent. And one would presume that the response is symmetrical. In other words, if it does not have a more than a moderate effect moving rates down, slowing the accumulation to zero or even doing some divestiture is likely to have an impact of equal size in the other case. In neither event in our judgment does it appear to be a dominant force.

Now, I have to point out that these are judgments which always have to be reevaluated at all times, and we continue to do so. Obviously, we rethink our positions to make sure they are still sound. And these numbers vary from time to time, but our general conclusion at this stage is we do not perceive that as a really significant problem for our domestic economy.

Mr. MOORE. Thank you. Chairman Greenspan, as you know, the payroll and income tax revenue that is credited to the Social Security Trust Funds is actually deposited into the general Treasury and effectively becomes part of the Government's operating account. Many Americans I think are not really aware of how this takes place, and I think they really believe that Social Security money that is paid in by American taxpayers is actually in a Social Security "trust fund" instead of used for current operating expenses of the Government.

As you know, the Social Security trustees have named 2042 as a date that people should be concerned about us when this account becomes "insolvent." the Congressional Budget Office says 2052, and the date that you say we should have a great concern about is 2008, which is a lot closer. Whatever the date, whatever the date, whether it is 2042, 2052, or 2008, I think all of us would agree that the threat to the Social Security Trust Fund is real and needs to be dealt with in a bipartisan manner.

On February 8, I introduced legislation that would take the Social Security Trust Fund off budget and say to Congress and say to the President that money paid for Social Security taxes cannot be used for any purpose but for Social Security purposes, and I am talking about partial retirement benefits, disability, and survivors benefits.

I guess my question to you is, and I want to add also, the administration's fiscal year 2006 budget, which was released last month, would spend $2.6 trillion of the projected Social Security surplus over the next 10 years. If Congress protected the Social Security surpluses and really credited them to a Social Security Trust Fund, would that go any step in the right direction toward trying to preserve and protect Social Security and extending the solvency and the life of Social Security in the future?

Mr. GREENSPAN. I believe it would, Congressman. First of all, of course, as you know, the previous statutes have required the bookkeeping to change and, indeed, you will find on the monthly Treasury statements that the deficit is split between on budget and off budget, and the off budget is essentially the Social Security Trust Funds.

The difficulty that we have is that, one, as you pointed out, that even though there is a trust fund, the question is not what it is invested in, it is what the funds are used to finance. And there was back in 2001 sort of a mythical lockbox, but the trouble with the

mythical lockbox is that it should have been real, because it did convey the notion that these are funds that should be accumulated to invest directly or indirectly into the capital assets which are built up so that when the retirees who are putting the funds into the trust fund retire, the physical goods that they need for retirement are being produced, and that the claims which are the benefits that the Social Security trustee pays out to the beneficiaries can be used to purchase those real assets.

On a strictly pay-as-you-go system, which worked very well for a long period of time because the demographics were working very well, you didn't need a trust fund, it didn't matter, and indeed the trust fund was there mainly for some semblance that monies were being accumulated. But the truth of the matter is, as you point out, that they weren't.

So the issue is if you can separate, you will create additional savings that are required. But remember what is implied here. If we are talking, say, roughly a unified budget deficit of $400 billion and, as I recall, the Social Security Trust Fund grows in recent years, including interest at $150 billion a year, if you move the Social Security Trust Fund or just, say, move the whole office to San Francisco into a special system which is unrelated to Washington, and require that all budgetary activities of this committee and your counterparts in the Senate and the rest of the budgetary processes are required to deal with what would we now call on budget——

Mr. MOORE. Yes, sir.

Mr. GREENSPAN. We would be dealing with not $400 billion, but $550 billion.

Mr. MOORE. But that is a radical notion, to tell the truth to the American people, isn't it?

Mr. GREENSPAN. The presumption is that in doing that, you will get the Congress to scale that back and every dollar they scale back from the $550 billion is true net savings to the economy, which is essentially what a retirement program needs. The reason I am in favor of private accounts, or one of the major reasons is, I believe it is easier to move the private system to California than it is to move the Social Security Administration.

Mr. MOORE. Thank you, Mr. Chairman.

Chairman NUSSLE. I have a feeling it will move back from San Francisco in about 2016 when we have to start putting general funds into Social Security.

Mr. Ryun.

Mr. RYUN OF KANSAS. Mr. Chairman, thank you. Chairman Greenspan, I want to thank you for your time today and for testifying, but also being willing to answer our questions.

Social Security is on the minds of I think all of us, as well as many back home in our districts, and it has become a major forefront here in Washington. Some have characterized it as being a financial crisis; others have said it is doing just fine, there aren't any real problems with it.

With your insights, how would you characterize and assess the financial well-being, if you will, of the Social Security system?

Mr. GREENSPAN. Well, as I tried to outline in my prepared remarks, a retirement plan is essentially a plan which enables you to forego consumption now. As I once put it to a committee, it is

as though you went to the supermarket every week and when you came home, you put 10 percent of what you bought in your basement and you then used it when you retired. Effectively, that is really what a retirement system is.

In a more sophisticated sense, instead of putting the groceries in the basement, you invest in real productive capital assets which produce even more physical goods and services that you need.

The sole purpose of a financial system—which is associated with the physical volume process—is to facilitate the physical movement of goods and services, and what the pay-as-you-go system does not do is have a mechanism which creates a buildup of savings to create the real resources. And, I must say, your colleague on the other side of the aisle's notion would help in that regard, but it is still not fully funded, and one thing about private accounts is they have at least the capability of doing that.

Mr. RYUN OF KANSAS. So if you wouldn't characterize it as being fine or in crisis, how would you characterize it? If it is not in crisis, how long do you think it will be before we actually head toward that?

Mr. GREENSPAN. This is one's definition of a crisis. If you are in the financial business, as I am and have been all my life, a crisis is something that is about to happen, and in this case, nothing is about to fall off the cliff in the next 2 or 3 years. Indeed, the first sign of a really serious issue is when the leading edge of the older part of the baby boom starts to retire 3 years from now. Is it a serious problem? It is an exceptionally serious problem. How one likes to use terminology is less relevant than describing what reality is, and reality is daunting.

Mr. RYUN OF KANSAS. Thank you very much, Mr. Chairman.

Mr. PORTMAN [presiding]. Mr. Edwards for 5 minutes.

Mr. EDWARDS. Thank you, Mr. Chairman.

Chairman Greenspan, thank you for what I interpret as your serious and sober warning to Members of Congress that we better get our fiscal house in order or the future economy, economic growth, our children's future will pay a very heavy price, along with promised benefits to seniors in that generation.

If I could make an observation after 3 years of watching you testify before this committee, it would be this: that you honestly come before this committee and say in effect that trillion-dollar tax cuts, if matched with equal spending cuts, can increase our savings rate, increase economic growth, and help the future of our economy. The practical result is, my Republican colleagues hear your comments about the tax cuts, implement those, but do not support equal trillion-dollar spending cuts. It might cut a billion here or a billion there, although the truth is, even the Bush administration that wants to sound like a hawk on spending cuts, is increasing three of the five largest Federal programs of the thousands of programs we fund, and those five programs represent two-thirds of every dollar we spend.

So as a consequence, what I have seen after the 3 years of your testimony here, which has been honest, straightforward, good advice, is that deficits continue to get larger and we are at an impasse. I see no way out of this impasse right now, quite frankly. My Republican colleagues will continue to listen to your comments

about the tax cuts, but be unwilling to even support some of the cuts proposed in spending in this year's budget proposed by President Bush.

We Democrats, some of us who would be willing to make some tough spending cuts to get back to balanced budgets, will not do so if, in our value system, we think we are going to ask veterans to make sacrifices on health care, seniors to lose access to nursing homes, and students to lose access to college student loans simply to fund tax cuts for Americans making over $300,000 or $400,000 a year.

So year after year, we are at this impasse. You have observed this impasse. My question is, first, if we do not change this impasse, if we do not break this impasse, what will be the consequences on interest rates and the economy over the next 10 years, in your judgment?

Secondly, would you care to comment about whether it might be appropriate to do what former President Bush did in 1990 when he said that a campaign promise of "Read my lips, no new taxes," isn't as important as the future fiscal soundness of our economy and brought Democrats and Republicans together, asking both sides to make compromises; the Republicans to compromise on tax cuts and Democrats to agree to compromise on spending increases, once assured those compromises on spending were not going to just fund tax cuts for the wealthiest.

So, in summary, again, how serious will be the consequences of this impasse that you have witnessed over the last 3 or 4 years, and is it time for us to do something dramatically different, perhaps with a bipartisan budget summit led by President Bush?

Mr. GREENSPAN. Well, Congressman, if you merely project how the actuaries interpret current law into future spending and tax obligations, you have an extraordinary rise in the unified budget deficit. If that is literally the path on which we find ourselves, we will find sooner rather than later that long-term interest rates begin to rise, and that when you begin to do the arithmetic of what the rising debt level implied by the deficits tells you and add interest costs to that ever-rising debt at ever-higher interest rates, the system becomes fiscally destabilizing, and what you end up with is probably a stagnant economic system quite conceivably, not only a slowdown in the rate of growth, which is what I have indicated is the normal expected outcome of events such as this, but unless we do something to ameliorate it in a very significant manner, we will be in a state of stagnation.

And the reason why I seriously raise the question about trying to solve the problem on the tax side is that what history does tell us is that when taxes get increased above certain levels, you begin to get significant slowdown in economic growth and, therefore, in the revenue base. So you don't get all of the taxes or, I should say, tax receipts that you expect to get in raising rates, and I think you have to be very careful in doing that.

And how one comes together to resolve this overall issue and what compromises both sides make is obviously up to the committee to do. But if you ask me what the consequences of doing nothing are from this stage forward, I would just as soon not have to contemplate that.

Mr. EDWARDS. Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Putnam.

Mr. PUTNAM. Thank you, Mr. Chairman, and welcome to you, Dr. Greenspan.

A number of the reform proposals for Social Security, both those that involve allowing persons to divert a portion of their Social Security taxes and those that create personal accounts above that involve significant transition costs. Could you please comment on the microeconomic effects of how we reform the system that, as you very eloquently put in your written statement, desperately needs it, and possibly personal accounts provide, in your words, a more credible means of insuring the program, adds to overall savings and boosts the Nation's capital stock?

How will the markets react to those intermediate transitions?

Mr. GREENSPAN. Congressman, this is the one very difficult problem of evaluation that we have. In the program, as I read it in the newspapers, the program would essentially take U.S. Treasury bonds and sell them, take the proceeds and put them into a forced savings account. And in terms of the impact on the supply and demand for securities, because the recipients of the account can't sell the securities that they get, it should be a wash, because the amount of money that is moved from Government savings to household savings is the same. You increase the unified budget deficit, you increase household savings, and it is a wash with respect to total domestic or national savings.

In principle, one would assume that the impact would have zero effect on interest rates. But we don't know that, and it is an interesting question that is involved here, and that is the reason why I have argued in earlier testimony that moving in this direction should be cautious and gradual, because you don't want to find that you have a fairly extensive program and learn that the theoretical change in interest rates, which seems to make a great deal of sense to economists, is not the way the markets look at it.

So in this respect, I think it is important to move gradually and see what the response is. And remember, in the spirit of taking Social Security off the unified budget, remember the unified budget was originally constructed for the purpose of evaluating how Government financial activity impacts the economy, meaning impacts interest rates. And for the vast proportion of transactions, the actual unified budget deficit, plus whether it is increasing or decreasing, is a fairly good measure of what the impact on the economy is.

In this particular case, where you are setting up forced savings for a very protracted period of time, the principal purpose of the unified budget accounting system is being violated and, in that regard, using the unified budget to evaluate this process requires an asterisk; but how important that asterisk is, is something we really don't know and will not be able to tell until we move forward with this program and see the extent to which modest changes in private accounts affect interest rates.

Mr. PUTNAM. Thank you, sir. Let me also ask, in your testimony you refer to provisions for mid-course corrections to deal with unanticipated budgetary outcomes. It appears to describe triggers, which I believe in the past you, in previous discussions about tax

policy, frowned upon. Could you please elaborate on that and if you do, in fact, call for some type of trigger?

Mr. GREENSPAN. No. In fact, I have testified before this committee in the past indicating that various initiatives, both on the tax and on the expenditure side, which have long-term consequences, require some mechanism for the committee to reevaluate them after a specific period of time to be assured that the actual purpose of the program and its financings are what you voted for. And if it turns out that that is not the case, then there should be a mechanism, either automatically in which it happens by some formula, or requiring a reevaluation and maybe even a revote by the Congress on a particular piece of legislation, because too often what we find is that we put in front of the Congress a particular program and with it is an associated long-term forecast. And the extent to which those forecasts have not been realized, as you know far better than I, are too numerous to mention.

We are no longer in the period 50 years ago when the vast proportion of the budget was what we now call "discretionary" and subject to annual evaluation by the Congress. We now have a very significant part of both the expenditure side and the tax side, which is an automatic system. And sometimes these things veer off track and there is no mechanism to address them. And if we actually had such a mechanism, I think the budget policy process would be far improved, significantly improved.

Mr. PUTNAM. Thank you very much.

Chairman NUSSLE. Mrs. Capps.

Mrs. CAPPS. Thank you, Chairman Nussle. Chairman Greenspan, thank you for meeting with us today.

In your opening statement, you made the following comment: Unless we obtain unprecedented increases in productivity, we will have to make significant structural adjustments to the Nation's major retirement and health programs.

I would like to focus on the first half of that statement and relate it to something you said at the Banking Committee hearing recently. This is a quote: "The failure of our society to enhance the skills of a significant segment of our workforce has left a disproportionate share with lesser skills. The effect, of course, is to widen the wage gap between the skilled and lesser skilled."

Now, given your concern about the lesser skilled, I would like to have your comment on the deep cuts in the Department of Education included in the President's current budget. In particular, aren't cuts in programs like vocational and technical education and student loans likely to work against the creation of a higher-skilled work force; and if we shift the burden more completely to the States, many of which are in deficit as well, can we expect them to take over these responsibilities? More broadly, shouldn't we as a society and as a Federal Government be investing more in developing our workforce if we want to see higher rates of productivity and economic growth?

I have asked this chart be put up, because I know you have expressed concern in the past about income inequity, and I would hope that you would tie your comments, if you can, to our investment in education.

Mr. GREENSPAN. Well, Congresswoman, I think you are exposing what the real dilemma of this committee is.

Mrs. CAPPS. Yes.

Mr. GREENSPAN. On the one hand, you have issues of trying to make the economy and the revenue base expand, and on the other hand you want to increase expenditure, both of which are valuable choices and valuable programs. But if you put them together, you get an increasing deficit which causes the economy to short circuit.

So the question that you have to resolve is how does one balance these particular choices. And the problem that is invariably the case under such circumstances is that you are choosing between things of value. In other words, no program appears before this committee which is of no value. And if you have things which increase expenditures and you have things which reduce revenues, unless you can find a way to repeal the laws of arithmetic, you are in very serious trouble. And I think that this is something which is merely a restatement of what the nature of the problem is.

And I could answer your question, but my answer is irrelevant because it essentially merely just gets to the issue which must be resolved by the representatives of the American people, and it is a very tough choice. If I were a Member of the Congress, I would have to struggle with it and I would come up with my own particular choices, but I would recognize that I would be one of 435 people in this House. And you are far more adept at political issues than I, judging that I am sitting here and you are sitting there.

Mrs. CAPPS. I guess I just have in front of me the vision of the superintendents of a particular county in California that I met with on Monday, the day before yesterday, looking at this proposed budget and what it will do to the very real young people and retrained workforce people in my communities. And I am sure this is reflected across the country. We are talking about an investment in our economy when we invest in education; is that not true?

Mr. GREENSPAN. Well, I am not going to repeat what I have said, but I think it is an issue which you have to debate with your colleagues, and I trust that in a reasonable period of time, you will come up with some resolution of what is a very serious set of choices. And what is causing the set of choices, to a very large extent, is an unprecedented demographic shift which we are not going to be able to alter. It is going to be with us because with the inexorable turn of the calendar, we are going to get a very large acceleration in the number of people moving from the labor force into retirement, and that has very significant fiscal implications, and there is no way to get around it. You either choose to do something in advance which will ameliorate the problem but not completely eliminate it, or wait until the problem is right on you, in which the solutions are going to be very painful.

Mrs. CAPPS. Well, I guess I am not getting any comfort from your response. Thank you very much.

Chairman NUSSLE. Mr. Wicker.

Mr. WICKER. Thank you, Mr. Chairman, and thank you, Chairman Greenspan, for your testimony.

You know, for the benefit of people watching on C-SPAN, I just want to remind our audience what a lengthy and distinguished record our witness has today: appointed, designated as Chairman

of the Federal Reserve by President Reagan, by the first President Bush, by President Clinton, and by our current President. So I think it is fair to say that everyone realizes, Mr. Chairman, that you do not come here with a political agenda, and I appreciate that.

Your testimony is not surprising, but in my view, it is nonetheless profound. You say that there are imbalances, significant problematic imbalances between our resources as a Government and the commitments that we have taken on; that these imbalances very much need to be addressed. Yet you say that to address these with tax increases would be very worrisome, and I agree with that.

You also mention the fact that because of the demographics, this turning of the calendar that you mentioned to Mrs. Capps, Social Security needs to be fixed, and the sooner the better. But you also point out that it needs to be repaired in two respects. One, that we need to solve the problem of having enough money in the system to make the payments, but also it should be changed in a way that encourages national savings.

I appreciate you clearing up this sort of alarmist talk that has been going on around the city about the amount of American debt that is held by foreigners. Clearly, it is a concern, but as you pointed out, it is an indication that people all over the world view investing in the United States as a very sound investment. And to suggest rather simplistically that if the Chinese or Koreans decide that they no longer want our bonds, that somehow they could call them in and that would create a crisis, I think it is good that that has been debunked today. If they want to sell our debt, they could sell it to a willing buyer on the open market, or if they do not want our debt, they can refuse to purchase any more of our bonds. But I appreciate your testimony on the record in that regard.

And then I understand that you said, with regard to the national debt owned by foreigners, the greatest problem is that we are not buying it ourselves, that it is not Americans who are saving money and buying U.S. Treasury instruments, because we need to increase our national savings. So you say that must be part of our Social Security fix, and I appreciate that.

There are folks that say going to these individual investment accounts, even though it would increase investment, that it dismantles this great program of Social Security, this social contract that we have had for half a century or more, that we take care of the needy elderly, that it is too risky. I find it hard to believe that you would recommend a scheme that would be too risky for Americans, that you would recommend a scheme that would somehow violate the Social Security safety net.

So I would ask you to comment on that. Do you have a comfort level that we can move to individual accounts, gradually and cautiously, as you say, without harming this compact that we have had between the workers and the elderly and that we will not return to the elderly poor?

Mr. GREENSPAN. There are numbers of different ways of essentially guaranteeing a level of benefits in any of these programs, whether it is under Social Security, whether it is partial privatization, whether it is any particular form of retirement structure. As best I can judge, in every case where people have come up with very different alternatives to some mix of private and public ac-

counts, there is always some component in there which is a guarantee against any extreme problem. And I think there should be.

So that is not where the issue lies. The issue has got to lie in two areas. One is a critical issue. We cannot have a pay-as-you-go system when the demographics that confront us lead us eventually to a position where there will be fewer than two workers per retiree. It just will not work. In 1935 and for the next 50 years, it worked exceptionally well because you had population growing at a sufficiently rapid pace so that there was always a large number of younger people coming up, as you increased the population, relative to the number of people who were retired. But when you get the population growth slowing down, and especially the extraordinary improvement in life expectancy after age 65, the arithmetic no longer works for pay-as-you-go, and what you need is a system which creates the savings that are invested in real assets to produce the real consumption in retirement. That is the first issue.

The second issue is that private accounts have one important element in them, in that instead of a guaranteed annuity for retirement, which is what Social Security is, you actually have a claim to wealth; even though that wealth is immobile until you retire, it is, nonetheless, yours. And the question of being able, after retirement, to have various alternatives, including bequeathing it to your children, is a value which I think is worthwhile developing in this country, because there is just too little wealth below the median-income level. And what private accounts will do is to create the building up of actual individual wealth, which I think is a value in and of itself.

Mr. WICKER. Thank you, Mr. Chairman. Let me just observe that I believe in our witness today we have truly a national treasure, and sometimes I have had to listen to him when I didn't particularly like the answer. I hope that the American people and American policymakers are listening to his testimony today. Thank you for your indulgence.

Chairman NUSSLE. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

Thank you, Chairman Greenspan. I would like to add your distinguished predecessor to the list of great chairmen, because Paul Volcker did an outstanding job as well. I know it is premature, but I already feel sorry for your successors, because they have tough acts to follow.

Last week, the Blue Dog Coalition, a group of Democrats who are fiscal and defense hawks, introduced a reform package and we borrowed proudly from some of our friends across the aisle, the Republican Study Committee, to come up with bipartisan reforms that will help us address the deficits we face; such reforms as discretionary spending caps—and our caps are actually tougher than the President's in this budget—reforms such as a cost estimate on every bill so that we know what we are spending around here; a roll call vote on every bill that costs $50 million or more, instead of just voicing it through this Congress; things like identifying earmarks and explaining them, so that we cannot have willy-nilly pork-barrel spending around here; commonsense measures including the Balanced Budget Amendment of the Constitution, which was part of the Republican Contract With America. But we also in-

cluded real PAYGO, pay-as-you-go, and I remember in prior testimony, you could even recall the day in 2002 when Congress let that provision expire, that provision that was so helpful to us in curbing our borrowing and spending appetite. So the Blue Dog program was introduced last week, we call it a 12-step program, 12 steps to get our Nation off its borrowing and spending drunken binge that we are on right now. I would like to invite our colleagues across the aisle to cosponsor that measure as well as our Democratic friends, because it includes what you highlight in your testimony: real PAYGO.

If the gentleman—I am sorry he has left now, our friend from Mississippi—if he truly values your leadership as he describes, he will also endorse your call for genuine PAYGO to curb our spending habits here. So that is a step.

Another step is we started a bipartisan savings caucus last week, Senator Rick Santorum, Senator Kent Conrad on the Senate side, joining together in a bipartisan fashion on the House side to promote voluntary savings and to again implement parts of your testimony, which we read and admired, to try to boost our national savings rate.

Let me ask you this, Mr. Chairman. In your testimony you mentioned the need for mid-course correction, getting us back on track when we discover we have made a mistake in a spending or a tax program. Well, in 2003, this Congress voted for a giant new entitlement program in the Medicare drug benefit. We know now—and we were only allowed 26 hours to read that bill, not the usual 3-day period, so very few Members knew what was in it. We know now that that one piece of legislation will add $8.1 trillion to the unfunded obligation of our Nation over the next 75 years. That one bill alone is twice as large as the total Social Security problem we face. That one bill alone was passed by this Congress in the dark of night, a vote starting at 3 o'clock in the morning, that became the longest vote in American history.

So if we were going to have a mid-course correction, wouldn't it make sense to trim or perhaps even repeal that legislation that sunk our Nation deeper into debt than any of us could possibly have imagined, and a bill that had a cost estimate that was deliberately hidden from this Congress under threat of firing of a Federal employee, so we were deprived even of that knowledge of the true cost of that bill at the time?

So if we are going to implement your good advice, whether it be with PAYGO, real PAYGO, as is in the Blue Dog proposal, or to have a real mid-course correction, wouldn't it make sense to adopt some of these measures?

Mr. GREENSPAN. Well, Congressman, all I will say is that all of the items I indicated in my prepared remarks refer to the total budget of the United States.

Mr. COOPER. Well, there are very few single votes that we could cast that would do more to reduce unfunded liabilities of this Nation, of $8.1 trillion, than what we passed just a year or two ago.

Mr. GREENSPAN. I cannot dispute your arithmetic.

Mr. COOPER. Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Crenshaw.

Mr. CRENSHAW. Thank you, Mr. Chairman.

I would like to ask just a question or two about the economy and where you think it is headed. You mentioned that you feel good about the direction of the economy, that it is fairly healthy, but this issue about the yield curve as it flattens, it seems to me as you raise short-term rates, you would expect long-term rates to go up, and that is not happening. I read somewhere that you describe that as a conundrum.

The conventional wisdom would say that if long rates don't go up when short rates go up, that there is some sort of indication of a slowing of the economy. On the other hand, people could argue that inflation is under control and the economy is healthy. I would like you to comment on that. I mean, what is your view as the yield curve narrows—I guess it was back at the end of 2001 when it actually inverted and that kind of foretold some problems in the economy. But if you could maybe expand on what you mean when you say it is a conundrum; is it a short-term aberration, or are you concerned at all? Could you talk a little bit about that?

Mr. GREENSPAN. Yes, Congressman. The history of most of the programs of raising short-term rates by the Federal Reserve is that they have, in the early stages, been matched by rising long-term rates; and I must add in part that is merely almost an arithmetically required relationship, because you can view, say, a 10-year U.S. Treasury note as an average of all interest rates from 1 or 2 days, 5 years, 7 years, out to 10 years. And to the extent that the overnight rate or the very short-term rates have risen, it affects the average and is actually embodied in the yield of the 10-year note. So the normal expectation is that when you move, you will move the long-term rate if for no other reason than you are moving the average in the very beginning.

Historically, toward the end of a tightening period when it becomes clear that the impact is to restrain inflation—you will find that increasing short-term rates does move long-term rates down, and that is largely because reducing the inflation premium embodied in long-term rates will bring the yield down.

What we have had in the most recent episode, as you point out, is we moved up and long-term rates went down far sooner than is typically the case. And we examined the possibility that you suggested, namely, this may be an indication that the economy is about to soften. But if that were the case, we wouldn't be finding a number of other indicators such as stock prices going up. And we essentially put that aside as an explanation, because it was very evident, as I indicated earlier in my testimony, that this economy is not in the process of moving into a significant slowdown.

The result of that is we began to look in different areas as the potential cause, and none of them was without a qualification, which is the reason I said it is indeed a conundrum. Now, I must say since then, long-term rates have moved up, and it is less of a conundrum in that respect. But it is an unusual change in the way markets behave.

Mr. CRENSHAW. Would you distinguish it from 2001 when it was really more—it was short-term rates were pretty stable and the long-term rates were coming down, and that created—is that more of a scary scenario when you are not really moving short rates up and find that long rates don't follow; but you had fairly short rates

which, for some reason, foretold a softening of the economy, the long rates actually went below.

Mr. GREENSPAN. You remember at that time the Federal funds rate was actually quite high, and we at that particular point, observing the bubble beginning to unwind, wanted to make certain that we did not lower the Federal funds rate too much, too soon, and allow a partially deflated bubble to reinflate with greater potential problems down the road. So that we held the short-term rate longer than would ordinarily be the case until we were reasonably confident that the deflating of the bubble was well underway. So we had the very unusual pattern that you alluded to.

The reason that long-term rates went down, obviously, is that the economy was clearly moving down, or the rate of increase was slowing fairly dramatically. So that was a very special case which very rarely happens. And indeed, it wouldn't be comparable at all to the type of market performance that we have been observing in the last year or so.

Mr. CRENSHAW. Thank you very much.

Chairman NUSSLE. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Chairman Greenspan, good morning, good afternoon to you. If I understand your testimony from listening to it in my office most of the morning, I certainly understand that you are concerned about Congress' ability to address the Social Security shortfall. But I want to draw in my questions a distinction between addressing the Social Security shortfall, if you will, and the specific government program the President wants to institute, and that is adding retirement accounts.

Let me begin by asking about something that Josh Bolten, the OMB director, said when he came here a few weeks ago. With respect to the transition costs that we would expect if we move toward private accounts and the impact it would have on the current financing of the system, he said, "The transition financing does not represent new debt. These are obligations that the Government already owes in the form of future benefits."

Do you agree that the transition costs and the borrowing that would occur does not represent new debt, Mr. Chairman?

Mr. GREENSPAN. Well, what he is referring to is how we would be regarding the Social Security system, were we like the private sector on accrual accounting, instead of measuring the impact on Social Security of taxes when they are paid in and benefits when they are paid out, but not addressing the issue that the working-age population is accruing under law ever-increasing benefits, which are obligations of the U.S. Government. If we had accrual accounting, we would be required to be including them as expenditures at the time earned and not at the time paid. If we were under that system, I might point out parenthetically, our current debt to the public, which is now roughly $4 trillion, would probably be $10 trillion more than that, because that is the present value of the obligations that we owe to people currently in the workforce who will retire. So that the issue that I believe Josh Bolten was raising was in the context of a gap accounting system with accruals, that if you then moved accounts from the public sector to the private sector, it literally has no effect.

Mr. DAVIS. Let me ask you a series of follow-ups on that, Mr. Greenspan. From the standpoint of foreign investors and domestic investors in the stock market, which would pose the greater threat to investor confidence, in your opinion, large-scale borrowing costs to pay for the retirement plan, or a failure of this Congress to enact the President's plan in the 109th Congress? Which would pose the greater threat to investor confidence?

Mr. GREENSPAN. Well, first of all, there is no distinction between what impacts on foreign versus domestic.

Mr. DAVIS. I understand that. I understand that.

Mr. GREENSPAN. I know how I think the markets ought to behave under various different sets of circumstances. But I must tell you that I have found, much to my chagrin, that they do not always work that way, and I only find out why 6 months or 6 years after the fact.

Mr. DAVIS. Would you agree that, really, it is only a guess and there is no particular reason to think that the markets would be somehow disturbed or investors would be disturbed if in the 109th Congress we failed to pass retirement accounts?

Mr. GREENSPAN. Well, the issue is that the market may be unaffected whether you pass it or you don't pass it.

Mr. DAVIS. Then let me ask another follow-up question along those lines. What do you think would produce the more enthusiastic response from the market if we could somehow snap our finger and we could choose between reinstituting PAYGO rules today or passing private retirement accounts? Which of those two do you think would invoke a greater enthusiasm from the market?

Mr. GREENSPAN. I really can't answer that question. It is a very interesting question, but I really don't know the answer.

Mr. DAVIS. What about from Alan Greenspan; which would produce a more enthusiastic response, PAYGO rules or retirement accounts?

Mr. GREENSPAN. I would like both, and you put me in the same situation as I just put your colleague in over there.

Mr. DAVIS. Before my time runs out, let me put one last question to you.

Mr. WICKER [presiding]. It seems to have run out.

Mr. DAVIS. If you will give me 30 seconds, Mr. Chairman. Let me give you four issues, well, four issues, one question. I will be extremely brief.

Enacting private accounts for Social Security, that is one possibility; dealing with what Mrs. Capps asked you about, that is the gap between skilled and unskilled workers; regulatory reform for the GSEs, and dealing with the gap; and in the math and science performance between American high school students and students in other industrialized nations. If you had to take those four issues, would you put—again, looking at the 109th Congress, what we will be doing over the next 2 years, would you put the enactment of private accounts at the top of that list of four issues for us?

Mr. GREENSPAN. You were actually listing what I consider to be probably the four most important issues that will confront the long term of this economy. I would just hopefully not have to choose amongst them. I would like to see you move on all of them.

Mr. DAVIS. But you wouldn't put private accounts at the top of that list of four priorities, would you?

Mr. GREENSPAN. No. They are all very important.

Mr. WICKER. Thank you. Mr. Barrett.

Mr. BARRETT OF SOUTH CAROLINA. Thank you, Mr. Chairman.

Mr. Chairman, I was looking at the President's 2006 budget. One of the things that a group of us have been talking about—us being some fiscal conservatives—what we are talking about is a projected savings in the President's budget of about $38.7 billion over the next 5 years, and I think over 10 years that is a little over $70 billion. When we are talking about a $2 trillion-plus budget, a $10 trillion-plus economy, some of the things that I think that I have seen come from the White House in the big scheme of things don't seem to add up to a whole lot of money. And there is a group of us, again, that seem to think maybe we need to go a little further. Maybe we need to show not only our constituents, the taxpayers, but the world, that we are serious about this looming problem.

Is this figure, this $40 billion figure, Mr. Chairman, over 5 years, is that a drop in the bucket; or, in your opinion, do we need to get some serious numbers, some serious money on the table?

Mr. GREENSPAN. Well, Congressman, I have observed this process for a very long period of time, and I think that what Presidents tend to do is to try to avoid budgets which—as you elect to call it—are dead on arrival; and they tend to craft budgets which they perceive will not be dead on arrival. And it may very well be that the ones we need to actually consider are ones which most people think would be dead on arrival but, in the end, turn out not to be.

The size of our problem is very large. I regret to say that the word "billion" does not encompass the nature of the problem.

Mr. BONNER [presiding]. The gentleman from Hawaii, Mr. Case.

Mr. CASE. Thank you. Mr. Greenspan, I share with my colleague, Mr. Cooper, membership on the House Blue Dog Caucus, and I think you can put my question and comments in that perspective.

Budgets, of course, are ultimately statements of policy expressing priorities, and that is what our job is, as you have definitely and accurately reflected.

I don't believe, as we look at the big picture of our Federal budget, that the basic facts are at serious issue. We have increasing expenses. Clearly you have talked to that. We have leveling revenues, attributable primarily to temporary tax cuts. The gap has led to chronic deficits and exploding debt.

The policy choices and priorities that are our job to make are for the most part, unfortunately, portrayed in Congress from a polar extreme perspective. And I think you can say there have been two directly different contrasting views expressed in this debate.

One would be basically that all of the temporary tax reductions are sacrosanct. We are not going to touch them. We want to go on with further tax reductions. And we will balance the budget, if at all, by—in the medium and short term—accumulating deficits and debt. And in the long term, whether we balance the budget or not, we will have radical reductions in Federal spending.

The other view is that we have needs that are growing and we have got to meet these needs. That is the number one priority with continued increases in funding, and we can't really afford to con-

tinue all of the tax cuts that we want. And if we are going to balance the budget, there are consequences there.

I think I have to say honestly, that personally and frankly I find both of these formulations not the right formulations. I cannot accept either one of those formulations as either wise or palatable or good overall public policy. I think they both, if carried to their extreme, have serious consequences on the economic and social fabric of our country.

I am always trying to look for a better formulation. And I have to confess that my biggest frustration in my service in Congress is the lack of commitment on a bipartisan basis—Mr. Edwards spoke to this—to find a better overall formulation, one which takes the best elements of both of those formulations but avoids the negatives of both of those formulations. Finding something that will actually work.

I have been listening to your testimony, and I want to ask you this straight out. You must have, in your thinking, some personal PAYGO calculation, some overall balancing of the best of these formulations and the worst of these formulations, that works from your perspective, that you believe over the long run will deal with what you have said and what you must believe is a chronic problem for our country, which is high deficits and exploding debt. You have testified to elements of support. For example, twice this morning you talked about your support of the continued elimination for the double taxation on dividends. You have testified on the expense side—and I think it is on the expense side, at least in the short term, to your support for some elements of private accounts.

Do you have some overall formulation or set of priorities, some overall calculus, that is somewhere in the middle of these two extremes?

Mr. GREENSPAN. Congressman, yes, I do.

Mr. CASE. What is it?

Mr. GREENSPAN. I am not about to say for just a moment. The reason why I hope that is true is that there is no way for me to actually think through what I think is necessary in how the economy will evolve, given what is currently on the books with respect to both taxes and outlays. The arithmetic is fairly obvious when you begin to project it out. And with the inevitable issue of we are all going to get a year older every year and, therefore, a very large number of us who are not retired will, creates a very sharp issue of alternatives. And I have been thinking of all the various things of what I would do if I were a Congressman, because unless I did that, I couldn't be sure that I had all the pieces put together and I would be making generalizations.

Mr. CASE. On the spending side, would you say given your calculus, the calculus you are talking about, that on the expense side of things, you are certainly concerned about the entitlement growth? Would that be correct?

Mr. GREENSPAN. I think what we have done is we have promised more to people who are not quite retired, but who will be retired over the next 20 years, than I actually think we have the material capability of supplying. I think this is utterly inappropriate. I think this is unfair. I think we owe it to those people to only promise to them what we have a reasonable chance of delivering. Public policy

should not be structured in a manner in which when we promise something to somebody who really has to depend on it, that we come up late in the game and say, sorry, we made an arithmetical mistake.

Mr. CASE. I am going to conclude with a rhetorical question because I'm out of time, on the calculus on the revenue side. At some point, there must be a sense of priorities that you have in terms of what tax reductions we can afford to extend in this calculus that will have a benefit to the economy on an ongoing sustainable basis and what we can't. And I will leave it at that.

Mr. GREENSPAN. I obviously do.

Mr. BONNER [presiding]. The gentleman from California, Mr. Lungren.

Mr. LUNGREN. Thank you very much, Mr. Chairman.

And thank you, Mr. Chairman, for being here. I observed you at a distance since I left this place 16 years ago, and it is fun to be here and hear you directly. I would ask you to revise your remarks, however. You said that you would like to move that trust fund from Washington to San Francisco. I wish you would be 100 miles short of that and just deposit it in Sacramento.

Mr. GREENSPAN. So moved.

Mr. LUNGREN. You talk about the mythical lockbox versus the real lockbox and you wish we kept the concept of a real lockbox. Is there any merit to the suggestion that personal accounts actually amount to a real lockbox? That is, the way I explained it to my constituents last week when I was home at a town hall meeting, the only way you can keep my grubby hands off of it is to make sure it is a personal lockbox. No matter how we construct it, there is always a temptation of a future Congress to use that money to fund something else, as we have been doing for years.

Mr. GREENSPAN. I agree with that.

Mr. LUNGREN. There is something I would like to mention to you. When I had a town hall meeting last week, two-thirds of the questions at least were on Social Security. And 175 people were there as a result of MoveOn.org. Some of them were there as a result of AARP. Some of them were there as a result of unions getting them there, and some of them that were there were because they were my constituents who had no other prompting.

One of the problems we had in discussing it was reference to testimony you had given either last week or the week before in which you started to talk about a crisis, and you backed away from crisis and used other language. I know today you said it is an extremely serious problem and the reality is daunting.

I would ask you to address the folks that were at my town hall who used your words to say it was not a crisis as a reason to say we ought not to do anything about Social Security any time in the near future. And that is the reaction I got. I know that was a misunderstanding of what you said. If someone said that to you in response to you saying it is not a crisis because you have chosen your words very carefully, how would you respond to that?

Mr. GREENSPAN. The term "crisis" is in the dictionary without specification of what the time frame is. I choose to use it for relatively short-term issues. In that regard, it is not a crisis, but that doesn't mean that even though the problem is longer term, that we

shouldn't be addressing it starting now; indeed, we are probably overdue with respect to when this issue should have been addressed. Indeed, I am arguing that we historically have made commitments which in retrospect we probably should not have made. And the reason is we did not have the ability to actually provide the resources that those promises required. So in that respect, we are overdue.

Mr. LUNGREN. I sit here before you as an example of the problem you have indicated in demographics. I am 58 and I will turn 59 later this year. So in 3 years, I will turn 62, part of that baby boom generation you are talking about. Baby boom generation, a lot of people forget, it is defined as those people who came back from World War II and started conceiving the rest of us, and a tremendous explosion of population. We have seen a tremendous decrease in population rates since that time.

I want to throw one question at you, at least to get a little bit of reaction from you. We are dealing also with another important public policy question on immigration and that is unrestrained illegal immigration. I have been dealing with that for 25 years. One of the concerns I have is an overreaction to that. People would believe we need to clamp down on all immigration. If we clamp down on all immigration, literally closing the doors to immigration, wouldn't that have a further negative impact on our ability to continue paying for those promises we have talked about in the future?

Mr. GREENSPAN. Unquestionably, that is true. However, I wouldn't argue that our immigration policy should be determined by the ability to fund the Social Security Trust Funds. I happen to believe that this country has benefited greatly from immigration, and indeed it is critical that we keep our doors open for talented people or anybody who wants to effectively pick themselves up from where they are and is going to the trouble of finding something in the United States, which historically has been what has made this country great.

But, nonetheless, the arithmetic you apply is relevant. And indeed a considerable amount of Social Security taxes occurs as a consequence of the fact that a fairly significant part of our population increase are indeed immigrants.

Mr. LUNGREN. Thank you very much.

Mr. BONNER. Chairman Greenspan, with your indulgence, let me inform the committee that the next two members on the majority side to be recognized in order are Mr. Bradley of New Hampshire and Mr. Hensarling, and on the minority side, Mr. Jefferson and Mr. Allen. The gentleman from Louisiana.

Mr. JEFFERSON. Thank you, Mr. Chairman. I appreciate the opportunity to ask a question or two.

Mr. Chairman, you have testified in response to a question I think Chairman Nussle asked this morning about the effects of the tax cuts on the rebound in the economy, if you will, and the growth in economic growth. And you are careful not to pinpoint all of those tax cuts as having an effect on that, but accepting the one on the elimination or the reduction of taxes on dividends as having a salutary effect, in your opinion, on growth. I think you also expressed that whatever effect those other taxes or any of them might have

had, except for that one, have probably run their course or at least jump-started the economy.

With that in mind, does it make sense to talk about further tax reductions in the context of this overall desire on the part of all of us to reduce the deficit?

Mr. GREENSPAN. This is the reason why I would like to see PAYGO and discretionary caps so that the process that is involved, when bills are brought up either on the tax side as tax cuts or as new programs of expenditure, it is perfectly conceivable that in the period where deficit reduction is the major priority that you would still want to have certain new spending programs and certain new tax cut programs because you don't want to freeze the system. It requires adjustment as years go on, even if you are on a long-term policy of reducing the deficit. But if you are going to be able to do that, you need a mechanism which prevents either tax cuts or spending increases veering you off the long-term track of deficit reduction.

Unless the Congress reinstitutes a process to handle these very difficult problems, it is an extraordinarily difficult thing to do. And were I, as I said before, a Member of the House, I would have certain views on both taxes and spending, but I would wish to be constrained in my recommendations in a manner which requires me to offset as the law requires.

Mr. JEFFERSON. I think most of us agree that as you set the paradigm, further tax increases—I don't think there is an argument here for tax increases nor for thinning reductions. We recognize there is something to be done there. The dilemma we find ourselves in is talk about the effectiveness of further tax reductions in the sense of those that, as you have pointed out, may have already made that contribution, such as it might have been, say the dividend aspect of it, without having this thought of analysis you are talking about when we simply say, we have them now and let us extend them further.

The trouble—the conversation goes every time you talk about, well, we might not want to extend that, the other side says that is a tax increase. That doesn't seem to make any more sense than saying that when they first enacted it with a sunset, that it amounted to them voting for a tax increase in 2011. So this is simply a play on words to box in discussion about that.

And I am wondering if you can help us to get out of this business by not extending these tax cuts that were designed to jump-start the economy and argue that these now amount to tax increases on the part of those who would say, well, they served their purpose at best and let them fall at the sunset.

Mr. GREENSPAN. I agree that terminology should not be policy issue. I mean, the argument that you can make is that if the markets believe that the tax cuts will be extended and are taking actions such that capital investment is going forward, or something like that, then you can argue on the policy grounds that they should be extended. But I would certainly agree with you that the mere choice of words as a response to the question is not an adequate response.

Mr. JEFFERSON. Thank you, Mr. Chairman.

Mr. BONNER. The gentleman from New Hampshire, Mr. Bradley.

Mr. BRADLEY. Thank you very much, Mr. Chairman.

And, Mr. Chairman, thank you for your long and distinguished service to our Nation. I would like to follow up on my colleague's question from California, Mr. Lungren. When asked the questions about the looming funding problems, your answer is that we need to have reform of entitlement spending, Social Security and Medicare, starting now.

Would you care to discuss with us what happens if that reform is not in place, what kind of problems will our Nation face, the impact on short-term and long-term interest rates and the impact on our economy if we delay?

Mr. GREENSPAN. Congressman, let me start off by saying that there are certain things that we know with a reasonable degree of accuracy and others which we know only very generally. We do know the number of Social Security and Medicare retirees over the next 20 years with a reasonably tight degree of numerical tolerance, and we do know with some degree of accuracy what under existing law the stream of benefits out of the Social Security Trust Funds will be. What we know only very imprecisely is what Medicare per beneficiary is going to be over the next 20 years, and that is largely because the number of issues which will determine that are very large and the variance of each one of those determinants is itself large. And so it is remarkable how variant it could be, basically because of the fact that, once committed and once enacted, we have exhibited considerable difficulty in reversing policies. I think it is essential that we be quite prudent before extending policies, because we don't have very much leeway of unwinding them once they are enacted.

Since I believe that the range of probabilities are such that we can have exceptionally large Medicare bills, we must assure ourselves that we are sufficiently prudent to enact laws which essentially do not get us into a position that does grave damage to the economy. If we do and we effectively create very large unified budget deficits, and we are unable to bring them in in a reasonable period of time, we will find that we will very significantly destabilize the system, because, as I mentioned earlier, interest rates would rise as a consequence and we would have very grave difficulties in restoring balance to the American economy. And this is an issue which focuses on, say, 2015 to 2025, or something of that nature, but something which needs to be addressed sooner rather than later to avoid that happening.

Mr. BRADLEY. Thank you for that answer. I believe that when you testified in front of the Senate a couple of weeks ago, you indicated that moving to personal retirement accounts alone was not sufficient to help restore the solvency of Social Security. Would you care to expand upon that?

Mr. GREENSPAN. I think there are two ways of coming at this; namely, what is happening to the full funding and saving of accounts that are required to create the real resources, and what happens in strictly the financial system itself.

On the financial system itself, what, as I understand it, the President's accounts will do is to trade off claims to benefits in the far distant future for essentially funds now, the interest on which will create those benefits later on, and that in essence is a wash.

It does not effectively close the $3.7 trillion, 75-year gap or the $10 trillion gap in perpetuity. In that regard, I was merely stipulating that from an accounting point of view, it does not address the particular gap. But what it does do, in my judgment, is create the possibility of building real savings in a manner better than the pay-as-you-go system does. But that is the real resource side, not the financing side. I was addressing the financing side.

Mr. BRADLEY. Thank you.

Mr. BONNER. Time of the gentleman has expired. In an attempt to inform the members of their next order, the Chair inadvertently overlooked Mr. Kind. Mr. Kind.

Mr. KIND. Thank you Mr. Chairman.

Chairman Greenspan, you have always been very gracious to this committee for your time and indulgence and you have shown that today.

One of the frustrating aspects, getting back to the whole Social Security issue, is the inability of the Congress and perhaps mostly the American people to at least agree on the facts, and that has been frustrating especially in light of some of the rhetoric that is being used now in terms of bankruptcy, bust, no money, driving off the cliff. I mean, if we can't at least agree on the facts in regards to the long-term challenges we are facing, it is going to be hard to find the common ground that is going to be needed to lock arms to address this very important issue. And I think a person in your position, it would be extremely helpful as far as laying out the facts, and I think you tried doing that in your most recent testimony before the Congress and I commend you.

But another challenge that we are facing that is even more daunting—and you have been very eloquent on this—is the annual growing structural budget deficits that is going to make it harder to make these types of decisions. There was a period of time in the 1990s—and either people are overlooking or forgetting it—when the Clinton administration was putting forth some pretty bold proposals on how to save Social Security first that didn't advance very far, and perhaps it didn't fit into a certain philosophy of certain people, like calling for the privatization of the program, and therefore they weren't interested in working to solve the problem right now.

We are back into an era of annual structural budget deficits. And I appreciate your honesty and consistency in your testimony in regards to the need to reinstate the budgetary tools that worked so well in the 1990s, the pay-as-you-go, having it apply to both the revenue and spending scheme of the budget, which you have been very consistent on. And most of us on this side of the aisle at least did not want to see those tools expire in 2002 when they did. And we have been calling for reinstituting them, just to instill a little bit of fiscal discipline in this equation.

But what is scary to me—and perhaps you can shed some light given your expertise—what is different with these deficits today that we didn't experience during the eighties when they were being accumulated until we were able reverse things in the 1990s is really two things: One is the increased foreign ownership of our debt. In fact, 44 percent of the debt today is being bought up by foreign entities, Japan being the number one purchaser, soon to be sur-

passed by China as the number one purchaser of our Government debt. And I don't believe it is going to be in our best long-term economic interest to be so dependent on a country like China to be floating this money to finance our deficits. And it is troubling, and I think it is troubling to people back home when they start hearing this more and more, that there is a new dynamic in regards to these deficit spendings.

And the second feature is the fact that not since the pound sterling has the U.S. dollar really faced a rival currency in the international market. And perhaps we are getting close to seeing that more and more with the advancement of the euro and the European Union and the increased value of the euro and the decline of the dollar we have seen over the last couple of years.

What type of risk are we facing or what would start raising your alarm bells in regards to the financial markets and the financing of these deficits and perhaps the flight of foreign capital into other areas rather than seeing that invested here and keeping us afloat at least in the short term?

Mr. GREENSPAN. Congressman, I think we have to recognize we have very limited choices. We are now borrowing the equivalent of almost 6 percent of our GDP annually. And we use that essentially to finance domestic investment. In order to curtail that, meaning in order to curtail at least in part the amount of investment that is being made in the United States, we would have to either curtail domestic investment in this country—which I obviously hope we will not be trying to do—or increase domestic savings. There are no other possibilities. And granted, we don't want to alter the amount of housing we construct in this country or the amount of plant and equipment that enhances our productivity; but the question is how do we finance it? And there is only one alternative, and the alternative is basically to increase domestic savings. And that means either savings as evidenced by the unified budget balance, or household savings, or savings by corporation and depreciation reserves or in undistributed profits. That is it. And so that there are just a limited number of things that we can do.

And it reminds me of the time in 1983 when I was chairman of the Social Security Commission. Our first meeting we sat down and said well, the trust fund is about to run out. We can either raise taxes, lower benefits, or rely on general revenues. And there was a remarkable judgment made by Claude Pepper, who was a member of the committee, that we would not rely on general revenues. So you had to do one thing or the other. And I will tell you, for the several meetings thereafter, the resistance to acknowledging that 2 plus 2 equals 4 was the most dominant aspect of the conversation of the commission until we finally exhausted ourselves and said, there is no alternative, we have to act. I trust that that is eventually what is going to happen in this case.

Mr. KIND. Thank you.

Mr. BONNER. The gentleman from Texas, Mr. Hensarling

Mr. HENSARLING. Chairman Greenspan, let me add my voice to those appreciating your patience and your service to your country.

CBO says over the next decade, Medicaid is going to grow, on average, 9 percent a year—Medicaid, almost 8, Social Security about 5½, I suppose, in the outlying decades. It gets only worse.

If I could have slide No. 5, please.

Mandatory spending today is almost 55 percent of our budget. We have had a lot of discussion on the benefits of a PAYGO system applied to mandatory. But isn't it true that as presently conceived this applies to new programs? In other words, if these present, the big three, Medicare, Medicaid and Social Security, are growing at these rates and in roughly 20 years we are going from a little less than 50 percent of our budget to approaching two-thirds of our budget, PAYGO would have no impact on the growth rate of those; is that correct?

Mr. GREENSPAN. That is correct.

Mr. HENSARLING. In your testimony you say that, in my judgment, the necessary choices will be especially difficult to implement without the restoration of the set of procedural restraints on the budget-making process. Believing that the world tends to work off of incentives, if we wanted to further incent Members of Congress to go in and reform some of these entitlement programs, wouldn't a superior mechanism or process mechanism be to negotiate some type of cap on the growth of mandatory programs, thus hopefully giving further impetus to Congress to make reforms?

Mr. GREENSPAN. Indeed. And that is what I was hoping I was expounding on in my prepared remarks when I refer to glide paths of various programs, because unless you do that, there is no way to confront any of these issues.

As I indicated before, 50 years ago we had programs which were mandatory in very narrow areas—we had agriculture, we had Social Security, but they were very small. And the vast proportion of the budget was what we now call discretionary, and none of these things were required back then.

But the world has changed dramatically. Unless you have a new type of process to regularize your system, it is extraordinarily difficult to do. So if the type of program you had in mind is what was implemented, I think that would be a very major benefit to this country.

Mr. HENSARLING. I have seen—if these growth rate trends are indeed accurate, and have you looked at models, say, over the next two to three decades of what it would take if we went the tax increase route in order to keep pace with these unreformed programs and to balance to our budget, what the tax rates would have to be on the American people?

Mr. GREENSPAN. We have run models of that nature.

Mr. HENSARLING. What magnitude would the tax increases be?

Mr. GREENSPAN. They vary significantly, but it is very difficult to judge because you have to compare experiences at various different levels of tax regime in various countries around the world and see how they behave and see if you can draw general principles from them. It is a very large part of the economic analysis, and a very good part of what we call development economics is in this area. And at least as I read the data, there is no question that the more stable the economy the slower the growth—in other words, there is a fundamental tradeoff here between sense of security and a standard of living. And this country, of course, has gone to both extremes. In the 1830s, we had rampant laissez faire, ca-

veat emptor, and an economy which was beginning to develop surprisingly in a very vigorous way.

We had, during World War II, a centrally planned economy, which was a wholly different sort of structure. So we have been in various different areas. And this is one of the very crucial basic decisions which the Congress has got to make. You know, what type of society do we want? What part of it should be guaranteed by Government, what part should be allowed to be free, competitive, and what are the effects thereof? And this is where the Congress' choice comes in, because the Congress essentially is the only vehicle we have which reflects the value tradeoffs of the American people.

Mr. BRADLEY [presiding]. The Chair would recognize the gentleman from Maine, Mr. Allen.

Mr. ALLEN. Thank you, Mr. Chairman, for being here. I also like others appreciate the time that you devote to this committee. I was particularly grateful for the caution and balance. And in some of your testimony, it was a striking contrast to the head of OMB and the Treasury Secretary of the United States who sat in that chair a few weeks ago. And what I am talking about is that you made it clear that though you believe in principle, there should be no effect on interest rates with borrowing for private accounts, you are not willing to make a $5 trillion bet in 20 years to that effect.

Both Mr. Bolten and Mr. Snow said they talked to Wall Street analysts and Treasury analysts and that we shouldn't worry; that there would be no impact on interest rates.

I appreciate the more cautious approach. I also appreciated the point you made about the tax cuts of 2001 and 2003, that they did help, you know, bring us out of a down period in the American economy, but they have no significant impact at the moment in stimulating the economy.

My question really has to do with your preference—and I know these preferences, we all have these preferences—just what balance of expenditure and taxation that we prefer. Back home in Maine, people tend to think there ought to be a balance between money coming in and money going out in their personal lives, in their businesses, and in their government. And I agree with that. But I am struck by one thing that today, my understanding is that tax revenues to the Federal Government are at the lowest level since 1959 as a percentage of our gross domestic product. That is before Medicaid was created, before Medicare was created, and clearly the 01 and 03 tax cuts have had a significant effect, according to CBO, in dropping revenues to the level they are today. I don't believe, as I am sure you don't, that the problems with Medicare and the problems with Social Security can be solved by tax increases. That is not what we want.

But is there room—you have made it clear that any tax reduction should be dealt with through a PAYGO process—is there room for some enhanced revenue to deal with the challenges we face, knowing that it won't deal with the entire problem over the next few years by not extending, by not making permanent the President's upper-income tax cuts to help deal with the general fund deficit that we have today?

Mr. GREENSPAN. Well, Congressman, these are the decisions, as I just indicated to your colleague, that the Congress has to make, because these are where the critical tradeoffs are. If you ask me, if we were to move taxes up by X, whatever X is, does it mean the economy will collapse? If X is very large, yes. But if it is very small, unlikely. It is an incremental issue and it is something we have to be careful of because the real strength of the American economy at this stage is its exceptional flexibility. We have got the ability to absorb shocks of all sorts and seemingly rebound.

As recent as 30, 40 years ago, 9/11 would have had major negative consequences to this economy. The GDP went down significantly for 6 weeks after 9/11 and then it stabilized. And that flexibility in part reflects the fact that the size of government is not all that large in this economy, and that as you increase the size of government, the flexibility goes down. You improve the guarantees, but at a cost. And it is that fundamental view of what type of society you want, which is what I think is of the most important role of the American Congress.

Mr. ALLEN. I take your point about the importance of balance.

Just one question on trends. It would be normal, would it not, for a society that is aging as ours is, and as Japan's is, as the Europeans are, to spend a somewhat larger percentage of our gross domestic product on retirement and health care as that population ages, so that that trend line, you would expect some additional expenditure from the Federal Government?

Mr. GREENSPAN. Of course.

Mr. BRADLEY. The Chair now recognizes Mr. Ryan.

Mr. RYAN OF WISCONSIN. I thank the Chairman.

Mr. Greenspan, thank you for spending time with us today and I appreciate your indulgence. I wanted to go on to Social Security and ask you a few questions. We have a few options ahead of us restoring solvency to Social Security. We can raise payroll tax rates, we can reduce the benefit formula for future retirees, or do personal retirement accounts, or a combination of all of those. I wanted to get your read and your opinion on the economic benefit in general and the particular benefit to future retirees on a plan to restore solvency to Social Security by having a combination of personal retirement accounts with their typical benefit offset that accompanies that idea, and possibly a benefit formula change for future retirees, those under 55, compared to a traditional fix to the system of a combination of benefit changes and tax increases.

What do you think would be the impact to the economy by having personal retirement accounts as a component of the plan that restores solvency in general for the economy and for our future retirees in particular?

Mr. GREENSPAN. Congressman, I testified that I think the existing essentially pay-as-you-go system has become ill-suited to the demographics of the future. Keeping aside the issue of private accounts for the moment, a system which is constructed to work under certain demographic conditions, and indeed did so for 50 years, is not going to work in my judgment anywhere the way it is supposed to, or had in the past, with the demographics that we perceive going forward. So something has got to give. We can patch the pay-as-you-go system as much as we want. We could do so if

we had to by extending the age of initial benefits. We could do so by altering the bend points. We could do so by changing the inflation formula. We could do a lot of things.

But I think we are touching a system which is fundamentally inappropriate for the future of this country because of the nature of the demographics, and the demographics have very profoundly changed since Social Security was initiated in 1935.

The question therefore arises: What are the alternatives? I happen to think that going to private accounts is a way in which we can create the full funding that is essential, and it is a system by which we can ensure the retirement benefits of those who will retire in very large numbers in the years ahead.

In the interim, trying to do combinations of both is a perfectly sensible approach. But as I view it, we have to find a better model than exists today.

Mr. RYAN OF WISCONSIN. Having personal retirement accounts is another way of making a future retiree's benefits more secure for their retirement.

And also, do you believe personal retirement accounts as a component to a system of solvency does help improve solvency, because when you have a personal retirement account policy, if it is a company with a benefit offset, with that feature in place do you believe that personal retirement accounts can help us achieve solvency for the system and make those future retiree benefits more secure?

Mr. GREENSPAN. I wouldn't say the pay-as-you-go benefits are insecure in the sense that there is nothing to prevent the Federal Government from creating as much money as it wants and paying it to somebody. The question is, how do you set up a system which assures that the real assets are created which those benefits are employed to purchase? So it is not a question of security. It is a question of the structure of a financial system which assures that the real resources are created for retirement as distinct from the cash. The cash itself is nice to have, but it has got to be in the context of the real resources being created at the time those benefits are paid and so that you can purchase real resources with the benefits, which of course are cash.

Mr. BRADLEY. The Chair would now recognize the gentleman from Alabama, Mr. Bonner.

Mr. BONNER. Chairman Greenspan, in Washington, DC, we use words like "rescind" and "allow tax cuts to expire" and things like that, but most communities and most towns in America really don't use those words. And yet that will be a discussion that we will have in the coming months in terms of what we do with the tax cuts that have already been enacted that do have an expiration date on them if no further action occurs.

In your view, if Congress—if this Congress or future Congresses do not find it prudent to make those tax cuts permanent, and those tax cuts therefore do go away, would you consider that a tax increase on the American taxpayer given that we are about 6 weeks away from April 15?

Mr. GREENSPAN. I would assume that the issue is not relevant to where we are with reference to April 16. As I was saying, I would much prefer to raise the question with respect to policy and not get involved with definitions in the dictionary. And the reason

is, the key question here is to what extent would extending the tax cuts, which may or may not have already been discounted in the financial markets, help the economy or not help the economy, and not get involved in debates on language because that doesn't produce policy.

And I would just as soon argue the merits of the particular program. Since I am on the side of extending them, I am perfectly willing to argue the merits. And I think we ought to do that. And I hope we could sort of talk policy rather than language, which is a tendency which we seem to get involved in, and I can't complain too much because I get involved in it, too. And I must admit that I am often accused, probably justifiably, of terminologies that don't exactly enhance understanding.

Mr. BONNER. I will accept that. But let me ask you to shift gears for a moment. I would like to follow up to a question that Mr. Crenshaw started with regard to interest rates, because taxes and interest rates are two issues that the American people have to deal with on a daily basis. Interest rates, back in our communities and around family tables, are an important factor with regard to whether or not Americans can buy a new home or buy a new car or make some other purchase that they would have to borrow the money in hopes of refinancing or hopes of paying back. And here in Congress, interest rates are important, obviously, because they are partially used to determine the budget that we set aside for debt service. And in a few days, we will be called upon to produce that budget.

That being the case, I certainly would be interested in knowing where you could foresee interest rates heading in the next 5 years. That could be useful information as we go about our work in the next few days.

Mr. GREENSPAN. Congressman, if you could tell me where the inflation rate is going to be in 5 years, I can tell you what the interest rate will be in a fairly narrow range. So I think it is appropriate to rethink the question of where interest rates will be largely in consequence of the inflation implications of budget deficits and the extent to which that, because they are perceived that way, impacts interest rates in advance. Because what we have found is that the history of interest rates has largely been the history of inflation. When it is high, interest rates are high. When it is low, interest rates are low. And yes, they are movements in what we call real interest rates which is sort of the interest rate excluding the inflation premium, but those fluctuations are really quite minor.

So I would just say that I would just track whatever you perceive the budget deficit projection is likely to be over the years and translate that into inflation and add it to a fairly small number, which is the real interest rate. I don't know any other way to get a forecast to that.

Mr. BONNER. Thank you.

Mr. BRADLEY. Thank you. The Chair recognizes Mr. Cuellar.

Mr. CUELLAR. Thank you, Mr. Chairman. Chairman Greenspan, I appreciate the work you have done as Chairman of the Board of Governors for the Federal Reserve Board and, of course, your staff for so many years. We really appreciate your work.

Let me direct your attention to the trade deficit. The United States back in 2004 ran a trade deficit on goods and services in an amount of about $618 million. That was up $121 billion—sorry, billion dollars from the 2003 trade deficit, which was at $497 billion.

What does that mean when you talk about this large trade deficit that we have? That is, the net importation of goods and services, instead of having more exportation—as you know, more exportation means more jobs for the American people—but when you look at this large trade deficit that we have, what does that mean in simple terms to the American economy and what does that mean in simple terms to the ordinary American?

Mr. GREENSPAN. Well, first let me just say that all of the analysis that economists have been involved with over the years has found little relationship between the trade deficit and jobs. We have had low unemployment rates with large deficits. We have had low unemployment rates with large surpluses. The issue is largely the extent to which we interrelate with the rest of the world. And it turns out that the net imports of goods and services moves very closely, with the so-called current account deficit, which is a measure of how much money we have to borrow to effectively finance the net trade deficit. And what we do in that process is open up our economy to a significant amount of foreign investment, and, at the same time, open up our economy to very considerable access to goods from abroad, which we obviously purchased because they are either cheaper or better than what we produce at home.

And the way things stand at this stage is that the combination of the desire on the part of the American people to purchase foreign goods as distinct from American goods and the willingness of foreigners to finance imports by the amount of money they are willing to invest here, that combination is what is creating these numbers.

We would not have a trade deficit, if there was not an interest on the part of Americans to buy foreign goods. Remember, there wasn't 50 years ago—I mean we basically had a large trade surplus and imports were not all that large. But that has changed, and it has changed because Americans have perceived that the quality and the price of foreign-made goods is to our satisfaction. If our views change, that figure is going to go down. Or if foreigners are increasingly less willing to invest at the rate, the $600 billion rate they are investing, we won't be able to finance that. It is basically an issue of choice on the part of the American people of what we want to do with our purchasing power.

Mr. CUELLAR. You are saying that the trade deficit, when you look at this chart up there, has no effect on the employment level in the United States? Is there any concern to have a trade deficit besides saying Americans want to buy more foreign goods? Are there any concerns we ought to look at?

Mr. GREENSPAN. Yes. The concerns really in large part reflect the fact that the current account deficit, meaning the borrowing that is done to finance those, accumulates over the years and that debt to foreigners requires us to pay interest on the debt, and that hence gets to an even larger amount.

What we have to be sure of is that everything is in balance. To the extent that we don't want to create too large a net debt to for-

eigners who may not wish to finance it at some point, we obviously should constrain our appetite for imported goods.

But the one thing that works very well for us is that we have prices and exchange rates and differential wage rates in various countries. And markets create a balance of these things. And it is one of the reasons why globalization has effectively improved the standard of living in the United States, very materially in my judgment, and as best I can judge has improved the standards of living of all of those who have chosen to engage in open free trade.

It is a very complex set of institutions that are involved in this and there are a lot of people who are disadvantaged by severe competition, whether it is domestic competition or foreign competition. And what we have learned is that as difficult as competition is for a lot of us, and very few of us like our competitors, it is tough, we have to acknowledge the fact that competition has actually enhanced standards of living and has made us all work harder, better, and created I think a better society.

Mr. CUELLAR. Thank you, Mr. Chairman.

Mr. BRADLEY. The Chair would recognize Ms. McKinney.

Ms. MCKINNEY. Thank you, Mr. Chairman. And thank you, Chairman Greenspan, for your indulgence.

Earlier, Chairman Nussle noted that the economy is growing. And, Chairman Greenspan, you say in your written testimony that the economy delivered, quote, "solid performance in 2004." but I would suggest that the solid performance, sadly, has been solid for just a few. I and my constituents would like to take America's growth personally, but only a few Americans can. For far too many, especially African Americans and Latinos, health care, housing, college education are hard to afford. And, sadly, too many Americans have been left behind.

Of white families, three quarters own their own homes, while the majority of Asian Americans, Native Americans, Latinos, and African Americans are renters. In just 6 years, from 1995 to 2001, wealth for families of color grew for families—for white families grew by 37 percent, but for families of color, wealth fell by 7 percent.

Chairman Greenspan, we can grow together or we can grow apart. And it is clear from these statistics compiled by United for a Fair Economy, that too many of us are growing apart. When our country invested in its citizens with the GI bill, Social Security, civil-rights laws, and affirmative action, we grew together. But somehow the policies beginning in the 1980s have resulted in today, that the wealthiest 10 percent own 70 percent of our country's wealth. It is clear that we are growing apart. And I don't think that is sustainable.

Chairman Greenspan, what policies do you suggest to halt the trends that are now being created that are creating two Americas?

Mr. GREENSPAN. Well, Congresswoman, I agree with almost everything you said, and I have addressed that in testimony before various committees of this Congress. As has been indicated, actually quoting my own testimony, I have been very much concerned about the fact that we are finding the distribution of income in this country for the last 20 years, 25 years, has been growing apart. This is essentially, as best I can judge, tracing back the causes, due

to the fact that we are not educating our children to significantly move through the 4th to the 12th grade and a goodly number of them into college and beyond to have the skills that we need to staff an increasing capital stock, which is getting ever more sophisticated.

It strikes me the issue really is fundamentally at an education level. And we have got to find the means by which we educate our students so that we don't find, as we now find, that our fourth-grade students are somewhat above average in world standards, but by the time they reach the 12th grade, they are in the bottom quarter. The rest of the world somehow seems to educate their children better than we do ours.

We have got to find out why that is true and remedy it, because, as I said in testimony on innumerable occasions, a democratic society does not function in an effective manner unless everybody in that society has a commitment to the society's health and advance. And the only way you do that is to create a level of commitment to the society which ends up with incomes which may be scattered but don't get continuously and increasingly concentrated the way they have in the last 20 years.

Ms. MCKINNEY. Thank you, Mr. Chairman, and thank you, Chairman Greenspan.

Mr. BRADLEY. The Chair would now recognize Ms. DeLauro.

Ms. DELAURO. Thank you, Mr. Chairman, and thank you, Chairman Greenspan. I am the last person, so I am between you and lunch and anything else. So I promise to be brief and I will ask both of my questions at the same time and they both have to do with jobs and the economy.

First, even though we have seen GDP growth relatively strong in the past several quarters, we haven't seen the type of job growth that was typical in last economic recoveries. I want to know why you think that is the case. Do you think we will need higher levels of GDP growth in the future in order to be able to reach full employment?

Secondly, we have now seen the number of people with incomes below the poverty line increase by more than 4 million since 2000. In fact, this administration has seen the highest average annual increases in poverty levels of any administration, except the first Bush administration, since the official poverty statistics were calculated in the 1960s. The increases occurred in spite of the relatively low unemployment rates. It appears that low-wage workers are either already working or have become discouraged and dropped out of the labor force. But either way, they can't achieve more than a poverty-level standard of living. Should this be a concern for the future?

Mr. GREENSPAN. This is an extension directly of my answer to Congresswoman McKinney. The basic problem that we have in this country is that the children from the fourth grade are not moving forward in their educational progress sufficiently quickly, and the consequence of that is that you end up with too few highly skilled people coming out of schools relative to the demand that the increase in technology is requiring, which has induced a very rapid increase in the wage rates for the highly skilled people.

Concurrently, because people have not moved up enough in the higher skills, and they are left back in the lesser skills areas where the demand is actually falling—you find that their wages become stagnant, and you get the inevitable consequence of an increasing concentration of income. And what this says to me is that we have got to address this issue, find ways of improving the skills and moving children up through our educational system, so that when they come out into the labor market, we find that there are more than adequate numbers of skilled workers and that therefore their wages don't go up all that much and that the balance in the lesser skilled is such that their wages go up the same as the skilled.

And indeed, as Congresswoman McKinney mentioned, after World War II the GI bill and all the education that a lot of men got during the Armed Forces, created degrees of skills for decades, which essentially kept the spread between skilled and nonskilled workers relatively constant, and therefore the concentration of income didn't change. If anything, it actually went down.

Ms. DELAURO. Let me pursue that for a second. And I suspect you don't agree with me on this issue, but we are also watching a very large number, though we don't have a mechanism for tracking, where there is a range of jobs which require some skill, or maybe some of the information technology jobs which awhile ago we thought that that was a real future—and it can be a real future—but we are watching those jobs at $40, $50, $60, $75,000-a-year jobs that are going overseas. They were once blue-collar jobs and we thought, my God, there is no way they are going to make up that difference.

But we are watching white-collar jobs move overseas, leaving less of an opportunity and a lower standard of living for people in this country with nowhere to go, and watching the Federal Government cut back on education and training programs and once again, curtailing opportunity.

The question is, where do these people go when—jobs that require skill and training are now also a portion of what is happening; those jobs are leaving the country.

Mr. GREENSPAN. Congresswoman, the most rapidly increasing aspect of our educational system are the community colleges.

Ms. DELAURO. And vocational education, except we are cutting vocational education.

Mr. GREENSPAN. The big issue is the community college. When I was in high school, we used to call it vocational education, and I did electrical wiring, and there were significant jobs, once you got out of high school, high-paying manufacturing jobs.

The economies change because value preferences of people change. And what is critical here is that the demand for a community college is such because they are essentially trying to address precisely the type of skill gap that you are mentioning. Will they succeed in doing it fully? I don't know. I am chagrined by the fact that we have, as I said before, a significant shortfall in the educational advances of our children by the time they get to the 12th grade. And I find that unacceptable, and we have to find out what is it that they do abroad that we don't.

Ms. DELAURO. Thank you, Mr. Chairman.

Mr. BRADLEY. Mr. Chairman, thank you for your patience today. And on behalf of the entire committee, we thank you for your testimony. And I now declare the hearing adjourned.

Mr. GREENSPAN. Thank you, Mr. Chairman.

[Whereupon, at 1:07 p.m., the committee was adjourned.]

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