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Achieving Fiscal Sustainability

Remarks by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

to the

National Commission on Fiscal Responsibility and Reform

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I am pleased to be here today at the first meeting of the National Commission on Fiscal Responsibility and Reform. The President has assigned Chairman Bowles, Chairman Simpson, and their colleagues the very substantial task of charting a path to fiscal sustainability for the United States. The deliberations of this commission are especially timely because some of the fundamental sources of long-term fiscal imbalances are no longer distant forecasts, but instead are unfolding in the here and now.

The task of developing and implementing sustainable fiscal policies is daunting, but meeting this challenge is absolutely essential. History makes clear that failure to achieve fiscal sustainability will, over time, sap the nation's economic vitality, reduce our living standards, and greatly increase the risk of economic and financial instability.

### **Long-Term Fiscal Challenges**

Our nation's fiscal position has deteriorated appreciably since the onset of the recession and the financial crisis. The exceptional increase in the deficit has in large part reflected the effects of the weak economy on tax revenues and spending, along with the costs of policy actions taken to ease the recession and steady financial markets. As the economy and financial markets continue to recover, and as the actions taken to provide economic stimulus and promote financial stability are phased out, the budget deficit should narrow over the next few years.

However, even after economic and financial conditions have returned to normal, in the absence of further policy actions, the federal budget appears set to remain on an unsustainable path. A variety of projections that extrapolate current policies and make plausible assumptions about the future evolution of the economy show a structural budget gap that is both large relative to the size of the economy and increasing over time.

Moreover, as debt and deficits grow, so will the associated interest payments, an obligation that in turn further increases projected deficits. Unfortunately, we cannot grow our way out of this problem. No credible forecast suggests that future rates of growth of the U.S. economy will be sufficient to close these deficits without significant changes to our fiscal policies.

Among the primary forces putting upward pressure on the deficit are rapidly rising health-care costs and the aging of the U.S. population. Federal spending for Medicare and Medicaid has increased substantially as a share of our national income over the past several decades, spurred both by the rising number of beneficiaries in these programs and by ongoing increases in spending per beneficiary. Under policies in place prior to the recent enactment of the health-care bill, budget projections showed that spending for Medicare and Medicaid would roughly double as a share of national income over the next two decades and would continue to rise significantly further in subsequent years. At this point, the effects of the recent legislation on federal health-care spending over the long term are uncertain, in part because they depend importantly on implementation. But we do know that continued increases in health-care costs at the rate seen in recent decades, together with the aging of the population, would put enormous pressures on the federal budget in coming years. Controlling health-care costs while still providing high-quality care to those who need it will be critical not only for budgetary reasons, but for maintaining the dynamism of the broader economy as well.

The aging of the U.S. population will also strain the Social Security program, as the number of individuals expected to be working and paying taxes into the system is rising more slowly than the number of people projected to be receiving benefits. This

year, there are about 5 individuals between the ages of 20 and 64 for each person aged 65 and older. By the time most of the baby boomers have retired in 2030, this ratio is projected to have declined to around 3. The projected fiscal imbalances associated with the Social Security system are notably smaller than those for federal health programs, but they still are significant and thus present an important challenge for policy.

Elsewhere in the budget, noninterest spending for programs outside of Medicare, Medicaid, and Social Security has comprised roughly half of total outlays over the past couple of decades. These expenditures support national defense and homeland security, education, transportation, and income-security programs, along with many other activities. The commission will have the difficult job of weighing the economic, social, and other benefits of these programs and comparing the implications of cuts in these areas against other means of closing the fiscal gap.

Choices regarding Medicare, Social Security, and other spending programs cannot be made in a vacuum but must be combined with decisions about how much revenue the government will raise and how it will raise it. No laws are more basic than the laws of arithmetic: For fiscal sustainability, whatever level of spending is chosen, revenues must be sufficient to sustain that spending in the long run. At the same time, economic vitality is enhanced when taxes are not excessive and are collected through a system that is economically efficient, equitable, and transparent. At present, a broad consensus exists that the U.S. tax code does not satisfy these criteria and is in need of reform. I suspect that it is too much to ask the commission to review the tax code in detail, but a full picture of our budgetary dilemma will require attention to the strengths and weaknesses of our current system of raising revenue.

## **The Path to Fiscal Sustainability**

The ultimate goal of the commission's efforts should be to put us on a path to fiscal sustainability. One widely accepted criterion for sustainability is that the ratio of federal debt held by the public to national income remain at least stable (or perhaps even decline) in the longer term. This goal can be achieved by bringing spending, excluding interest payments, roughly into line with revenues. Unfortunately, most projections suggest that we are far from this goal, and that without significant changes to current policy, the ratio of federal debt to national income will continue to rise sharply. Thus, the reality is that the Congress, the Administration, and the American people will have to choose among making modifications to entitlement programs such as Medicare and Social Security, restraining federal spending on everything else, accepting higher taxes, or some combination thereof.

Achieving long-term fiscal sustainability will be difficult, but the costs of failing to do so could be very high. Increasing levels of government debt relative to the size of the economy can lead to higher interest rates, which inhibit capital formation and productivity growth--and might even put the current economic recovery at risk. To the extent that higher debt increases our reliance on foreign borrowing, an ever-larger share of our future income would be devoted to interest payments on federal debt held abroad. Moreover, other things being equal, increased federal debt implies higher taxes in the future to cover the associated interest costs--higher taxes that may create disincentives to work, save, hire, and invest. High levels of debt also decrease the ability of policymakers to respond to future economic and financial shocks; indeed, a loss of investor confidence in the ability of a government to achieve fiscal sustainability can itself be a source of

significant economic and financial instability, as we have seen in a number of countries in recent decades.

Neither experience nor economic theory clearly indicates the threshold at which government debt begins to endanger prosperity and economic stability. But given the significant costs and risks associated with a rapidly rising federal debt, our nation should soon put in place a credible plan for reducing deficits to sustainable levels over time. Doing so earlier rather than later will not only help maintain the U.S. government's credibility in financial markets, thereby holding down interest costs, but it will also ultimately prove less disruptive by avoiding abrupt shifts in policy and by giving those affected by budget changes more time to adapt.

### **Conclusion**

The path forward contains many difficult tradeoffs and choices, but postponing those choices and failing to put the nation's finances on a sustainable long-run trajectory would ultimately do great damage to our economy. I thank the members of the commission for their willingness to serve and urge them to demonstrate to the American people that serious, well-intentioned citizens can come together to craft credible and sustainable solutions to our budgetary challenges.