

## Ben S Bernanke: Fiscal sustainability and fiscal rules

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the Annual Meeting of the Rhode Island Public Expenditure Council, Providence, Rhode Island, 4 October 2010.

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The recent deep recession and the subsequent slow recovery have created severe budgetary pressures not only for many households and businesses, but for governments as well. Indeed, in the United States, governments at all levels are grappling not only with the near-term effects of economic weakness, but also with the longer-run pressures that will be generated by the need to provide health care and retirement security to an aging population. There is no way around it – meeting these challenges will require policymakers and the public to make some very difficult decisions and to accept some sacrifices. But history makes clear that countries that continually spend beyond their means suffer slower growth in incomes and living standards and are prone to greater economic and financial instability. Conversely, good fiscal management is a cornerstone of sustainable growth and prosperity.

Although state and local governments face significant fiscal challenges, my primary focus today will be the federal budget situation and its economic implications.<sup>1</sup> I will describe the factors underlying current and projected budget deficits and explain why it is crucially important that we put U.S. fiscal policy on a sustainable path. I will also offer some thoughts on whether new fiscal rules or institutions might help promote a successful transition to fiscal sustainability in the United States.

### Fiscal challenges

The budgetary position of the federal government has deteriorated substantially during the past two fiscal years, with the budget deficit averaging 9–1/2 percent of national income during that time. For comparison, the deficit averaged 2 percent of national income for the fiscal years 2005 to 2007, prior to the onset of the recession and financial crisis. The recent deterioration was largely the result of a sharp decline in tax revenues brought about by the recession and the subsequent slow recovery, as well as by increases in federal spending needed to alleviate the recession and stabilize the financial system. As a result of these deficits, the accumulated federal debt measured relative to national income has increased to a level not seen since the aftermath of World War II.

For now, the budget deficit has stabilized and, so long as the economy and financial markets continue to recover, it should narrow relative to national income over the next few years. Economic conditions provide little scope for reducing deficits significantly further over the next year or two; indeed, premature fiscal tightening could put the recovery at risk. Over the medium- and long-term, however, the story is quite different. If current policy settings are maintained, and under reasonable assumptions about economic growth, the federal budget will be on an unsustainable path in coming years, with the ratio of federal debt held by the public to national income rising at an increasing pace.<sup>2</sup> Moreover, as the national debt grows,

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<sup>1</sup> For a discussion of fiscal pressures at the state and local levels, see Ben S. Bernanke (2010), “Challenges for the Economy and State Governments,” speech delivered at the Annual Meeting of the Southern Legislative Conference of the Council of State Governments, held in Charleston, S.C., August 2.

<sup>2</sup> For example, see the alternative fiscal scenario in the Congressional Budget Office (2010), *The Long-Term Budget Outlook* (Washington: CBO, June (revised August)). Stabilizing the ratio of federal debt to national income requires that spending on everything other than interest payments on the debt be brought into rough

so will the associated interest payments, which in turn will lead to further increases in projected deficits. Expectations of large and increasing deficits in the future could inhibit current household and business spending – for example, by reducing confidence in the longer-term prospects for the economy or by increasing uncertainty about future tax burdens and government spending – and thus restrain the recovery. Concerns about the government’s long-run fiscal position may also constrain the flexibility of fiscal policy to respond to current economic conditions. Accordingly, steps taken today to improve the country’s longer-term fiscal position would not only help secure longer-term economic and financial stability, they could also improve the near-term economic outlook.

Our fiscal challenges are especially daunting because they are mostly the product of powerful underlying trends, not short-term or temporary factors. Two of the most important driving forces are the aging of the U.S. population, the pace of which will intensify over the next couple of decades as the baby-boom generation retires, and rapidly rising health-care costs. As the health-care needs of the aging population increase, federal health-care programs are on track to be by far the biggest single source of fiscal imbalances over the longer term. Indeed, the Congressional Budget Office (CBO) projects that the ratio of federal spending for health-care programs (principally Medicare and Medicaid) to national income will double over the next 25 years, and continue to rise significantly further after that.<sup>3</sup> The ability to control health-care costs as our population gets older, 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 Social Security, as the number of workers paying taxes into the system rises more slowly than the number of people receiving benefits. This year, there are about five individuals between the ages of 20 and 64 for each person aged 65 and older. By 2030, when most of the baby boomers will have retired, this ratio is projected to decline to around 3, and it may subsequently fall yet further as life expectancies continue to increase. Overall, the projected fiscal pressures associated with Social Security are considerably smaller than the pressures associated with federal health programs, but they still present a significant challenge to policymakers.

The same underlying trends affecting federal finances will also put substantial pressures on state and local budgets, as organizations like yours have helped to highlight.<sup>4</sup> In Rhode Island, as in other states, the retirement of state employees, together with continuing increases in health-care costs, will cause public pension and retiree health-care obligations to become increasingly difficult to meet. Estimates of unfunded pension liabilities for the states as whole span a wide range, but some researchers put the figure as high as \$2 trillion at the end of 2009.<sup>5</sup> Estimates of states’ liabilities for retiree health benefits are even more uncertain because of the difficulty of projecting medical costs decades into the future. However, one recent estimate suggests that state governments have a collective liability of almost \$600 billion for retiree health benefits.<sup>6</sup> These health benefits have usually been

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alignment with tax revenues over time. Equivalently, the so-called primary budget deficit (the budget deficit exclusive of interest payments) must be reduced to zero.

<sup>3</sup> See the two long-term scenarios for mandatory federal spending on health care shown in figure 2–3, p. 41, in CBO, *The Long-Term Budget Outlook*, in note 2.

<sup>4</sup> See Rhode Island Public Expenditure Council (2010), *Analysis of Rhode Island’s Debt Including Pension and OPEB Obligations* (Providence, R.I.: RIPEC).

<sup>5</sup> See Alicia H. Munnell, Richard W. Kopcke, Jean-Pierre Aubry, and Laura Quinby (2010), *Valuing Liabilities in State and Local Plans* (Chestnut Hill, Mass.: Center for Retirement Research at Boston College, June).

<sup>6</sup> See Pew Center on the States (2010), *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform* (Washington: PCS, February).

handled on a pay-as-you-go basis and therefore could impose a substantial fiscal burden in coming years as large numbers of state workers retire.

It may be scant comfort, but the United States is not alone in facing fiscal challenges. The global recession has dealt a blow to the fiscal positions of most other advanced economies, and, as in the United States, their expenditures for public health care and pensions are expected to rise substantially in the coming decades as their populations age.<sup>7</sup> Indeed, the population of the United States overall is younger than those of a number of European countries as well as Japan.<sup>8</sup>

### **The need for fiscal sustainability**

Let me return to the issue of longer-term fiscal sustainability. As I have discussed, projections by the CBO and others show future budget deficits and debts rising indefinitely, and at increasing rates. To be sure, projections are to some degree only hypothetical exercises. Almost by definition, unsustainable trajectories of deficits and debts will never actually transpire, because creditors would never be willing to lend to a country in which the fiscal debt relative to the national income is rising without limit. Herbert Stein, a wise economist, once said, "If something cannot go on forever, it will stop."<sup>9</sup> One way or the other, fiscal adjustments sufficient to stabilize the federal budget will certainly occur at some point. The only real question is whether these adjustments will take place through a careful and deliberative process that weighs priorities and gives people plenty of time to adjust to changes in government programs or tax policies, or whether the needed fiscal adjustments will be a rapid and painful response to a looming or actual fiscal crisis. Although the choices and tradeoffs necessary to achieve fiscal sustainability are difficult indeed, surely it is better to make these choices deliberately and thoughtfully.

Arguably, the imperative to achieve long-term fiscal sustainability is an opportunity as well as a challenge. Opportunities for both taxing and spending reforms are ample. For example, most people agree that the U.S. tax code is less efficient and less equitable than it might be; moreover, the code is excessively complex and imposes heavy administrative and compliance costs. Collecting revenues through a more efficient, better-designed tax system could improve economic growth and make achieving sustainable fiscal policies at least somewhat easier. Likewise, many federal spending programs doubtless could be reformed to achieve their stated objectives more effectively and at lower cost. Certainly, continued efforts to reduce health-care costs and government health spending, while continuing to ensure appropriate care for those who need it, should be a top priority.

Failing to address our unsustainable fiscal situation exposes our country to serious economic costs and risks. In the short run, as I have noted, concerns and uncertainty about exploding future deficits could make households, businesses, and investors more cautious about spending, capital investment, and hiring. In the longer term, a rising level of government debt relative to national income is likely to put upward pressure on interest rates and thus inhibit capital formation, productivity, and economic growth. Larger government deficits increase our reliance on foreign lenders, all else being equal, implying that the share of U.S. national income devoted to paying interest to foreign investors will increase over time. Income paid to foreign investors is not available for domestic consumption or investment. And an increasingly large cost of servicing a growing national debt means that the adjustments,

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<sup>7</sup> See International Monetary Fund (2010), *Navigating the Fiscal Challenges Ahead*, IMF Fiscal Monitor Series (Washington: IMF, May).

<sup>8</sup> For example, see Neil Howe and Richard Jackson (2003), *The 2003 Aging Vulnerability Index* (Washington: Center for Strategic and International Studies and Watson Wyatt Worldwide, March).

<sup>9</sup> See Herbert Stein (1997), "Herb Stein's Unfamiliar Quotations," *Slate*, May 16, [www.slate.com/id/2561](http://www.slate.com/id/2561).

when they come, could be sharp and disruptive. For example, large tax increases that might be imposed to cover the rising interest on the debt would slow potential growth by reducing incentives to work, save, hire, and invest. Finally, a large federal debt decreases the flexibility of policymakers to temporarily increase spending as needed to address future emergencies, such as recessions, wars, or natural disasters.

It would be difficult to identify a specific threshold at which federal debt begins to pose more substantial costs and risks to the nation's economy. Perhaps no bright line exists; the costs and risks may grow more or less continuously as the federal debt rises. What we do know, however, is that the threat to our economy is real and growing, which should be sufficient reason for fiscal policymakers to put in place a credible plan for bringing deficits down to sustainable levels over the medium term. The sooner a plan is established, the longer affected individuals will have to prepare for the necessary changes. Indeed, in the past, long lead times have helped make necessary adjustments less painful and thus politically feasible. For example, the gradual step-up in the full retirement age for Social Security was enacted in 1983, but it did not begin to take effect until 2003 and will not be completed until 2027, thus giving future retirees ample time to adjust their plans for work, saving, and retirement.

### **Fiscal rules**

Amid all of the uncertainty surrounding the long-term economic and budgetary outlook, one certainty is that both current and future Congresses and Presidents will have to make some very tough decisions to put the budget back on a sustainable trajectory.

Can these tough decisions be made easier for our elected leaders? At various times, some U.S. Congresses and foreign governments have adopted fiscal rules to help structure the budget process. Fiscal rules are legislative agreements intended to promote fiscal responsibility by constraining decisions about spending and taxes. For example, fiscal rules may impose constraints on key budget aggregates, such as total government expenditures, deficits, or debt. In the remainder of my remarks I will discuss the use of fiscal rules to address longer-term budget problems, beginning with a review of the U.S. and foreign experience.

The United States has seen several attempts to apply fiscal rules, with mixed results. In 1985, the Congress enacted the Gramm-Rudman-Hollings law which, among other things, specified a target path for the federal deficit, including the elimination of the deficit by 1991. However, the target path proved to be unattainable, and eventually the entire structure was abandoned. One problem with this approach was that its primary focus and measure of success was the current budget deficit. Although the emphasis on the current deficit was understandable, the approach ran aground of the fact that the budget deficit is driven not only by the choices of the Congress, but also by the performance of the economy. If the economy is strong, for example, the deficit is almost bound to improve, as tax revenues increase and spending on the social safety net decreases; conversely, if the economy weakens, the deficit is likely to rise, notwithstanding prior efforts by the Congress to better manage government spending and taxes.

With fiscal concerns still prominent, in 1990 the Congress and the President adopted a new approach, with two key elements. First, this alternative approach capped the level of discretionary federal spending – that is, the spending subject to annual appropriations, including defense and nondefense purchases of goods and services. Second, it imposed a pay-as-you-go (PAYGO) rule on tax revenues and mandatory spending, which is spending that continues automatically without an annual reauthorization; entitlement spending such as Medicare, Medicaid, and Social Security makes up most of this category. The PAYGO rule required that any tax reduction or mandatory spending increase be “paid for” with offsetting tax hikes or spending cuts, so that projected deficits over the 5- and 10-year horizons would not be worsened. Supported importantly by the strong economic growth of the 1990s, these

rules are seen by many observers as having helped put the deficit on a declining path; indeed, the federal government generated a few annual surpluses. The discretionary spending caps and the PAYGO rule were allowed to expire after the 2001 fiscal year, in part because concerns about deficits were waning at the time.

Currently, the Congress operates under more-limited PAYGO rules. The rules require that offsets for spending increases or tax cuts must be found within a 10-year budget horizon, but they also exempt a number of significant tax and spending programs. Putting aside these details of implementation, given current budgetary challenges, the key question is whether the traditional PAYGO approach is sufficiently ambitious. At its best, PAYGO prevents new tax cuts and mandatory spending increases from making projected budget deficits worse; by construction, PAYGO does not require the Congress to reduce the ever-increasing deficits that are already built into current law.

Many other countries have experience with fiscal rules. The European Union, by treaty, established fiscal rules in the early 1990s, with the goal of ensuring that all members would maintain sustainable fiscal policies. The rules specified that countries should keep their government deficits at or below 3 percent of their gross domestic products (GDP), and that government debt should not exceed 60 percent of GDP. Even before the recent financial crisis and recession, however, the enforcement mechanisms for these rules did not prevent these targets from being breached, and fiscal problems in several euro-area countries have recently been a source of financial and economic stress. European leaders are working to strengthen their tools for enforcing fiscal discipline.

Although fiscal rules have not been panaceas in the United States or the euro area as a whole, a number of other economies, in Europe and elsewhere, seemed to have found fiscal rules to be helpful in achieving greater budget discipline. For example, Switzerland, Sweden, Finland, and the Netherlands all realized improvements in their fiscal situations after adopting rules that limit spending. Canada saw improvement in its deficit after it implemented spending limits in the early 1990s, and its ratio of public debt to national income fell substantially after 1998 when it put in place a “balanced budget or better” rule. A number of emerging market nations, such as Chile, have also applied fiscal rules with some success. According to the International Monetary Fund, about 80 countries currently are subject to national or supranational fiscal rules.<sup>10</sup>

Clearly, a fiscal rule does not guarantee improved budget outcomes; after all, any rule imposed by a legislature can be revoked or circumvented by the same legislature. However, although not all countries with fiscal rules have achieved lower deficits and debt, the weight of the evidence suggests that well-designed rules can help promote improved fiscal performance.<sup>11</sup> I will discuss four factors that seem likely to increase their effectiveness.

First, effective rules must be transparent. By shining a light on the problem and the range of feasible solutions, transparent policy rules clarify the budget choices that must be made, help the public understand those choices, and encourage policymakers to recognize the broader fiscal consequences of their decisions on individual programs. In particular, transparent fiscal rules may help solve what economists refer to as a collective action problem. When faced with spending decisions, most elected representatives want to be seen as garnering the greatest possible benefit for their constituents. But if a prior agreement limits the size of the available pie, it may be easier to negotiate outcomes in which everyone accepts a little bit less. Of course, transparency is enhanced by good watchdogs. In the United States, the nonpartisan CBO has ably served that role since 1974. Nongovernmental organizations that focus on budget issues, such as nonprofit think tanks, can also promote transparency.

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<sup>10</sup> See the International Monetary Fund (2009), *Fiscal Rules – Anchoring Expectations for Sustainable Public Finances* (779 KB PDF) (Washington: IMF, December).

<sup>11</sup> See IMF, *Fiscal Rules*, in note 10.

Second, an effective rule must be sufficiently ambitious to address the underlying problem. As I mentioned, PAYGO rules, even when effective, were designed only to avoid making the fiscal situation worse; they did not attack large and growing structural deficits. In the current U.S. context, we should consider adopting a rule, or at least a clearly articulated plan, consistent with achieving long-term fiscal sustainability. Admittedly, an important difficulty with developing rules for long-term fiscal sustainability in the United States is that, given the importance of health-care spending in the federal budget, the CBO would need to forecast health-care costs and the potential effects of alternative policy measures on those costs well into the future. Such forecasting is very difficult. However, any plan to address long-term U.S. fiscal issues, whether or not in the context of a fiscal rule, would have to contend with forecast uncertainties.

Third, rules seem to be more effective when they focus on variables that the legislature can control directly, as opposed to factors that are largely beyond its control. For example, as I noted, actual budget deficits depend on spending and taxation decisions but also on the state of the economy. As a result, when a target for the deficit or the debt is missed, ascribing responsibility may be difficult. Current congressional procedures generally require the CBO to “score” proposed spending and tax programs for their budget effects over a specified, longer-term horizon; this approach, although not without its problems, has the advantage of linking budget targets directly to legislative decisions.

Fourth, and perhaps most fundamentally, fiscal rules cannot substitute for political will, which means that public understanding of and support for the rules are critical. For example, the fiscal rules that Switzerland adopted in 2001 had overwhelming popular support; the widespread support no doubt contributed to their success in helping to reduce that country’s ratio of public debt to national income. Conversely, in the absence of public support and commitment from elected leaders, fiscal rules may ultimately have little effect on budget outcomes. Educating the public about the consequences of unsustainable fiscal policies may be one way to help build that support.

## **Conclusion**

Today I have highlighted our nation’s fiscal challenges. In the past few years, the recession and the financial crisis, along with the policy actions taken to buffer their effects, have eroded our fiscal situation. An improving economy should reduce near-term deficits, but our public finances are nevertheless on an unsustainable path in the longer term, reflecting in large part our aging population and the continual rise in health-care costs. We should not underestimate these fiscal challenges; failing to respond to them would endanger our economic future.

Well-designed fiscal rules cannot substitute for the political will to take difficult decisions, but U.S. and international experience suggests that they can be helpful to legislators in certain circumstances. Indeed, installing a fiscal rule could provide an important signal to the public that the Congress is serious about achieving long-term fiscal sustainability, which itself would be good for confidence. A fiscal rule could also focus and institutionalize political support for fiscal responsibility. Given the importance of achieving long-term fiscal stability, further discussion of fiscal rules and frameworks seems well warranted.