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Fed Chief Warns That Entitlement Growth Could Harm Economy

By STEVEN R. WEISMAN

WASHINGTON, Jan. 18 — Warning against complacency over the federal deficit, Ben S. Bernanke, the Federal Reserve chairman, said Thursday that recent positive trends on the budget were a “calm before the storm,” masking a long-term danger posed by looming deficits in Social Security and Medicare.

“The longer we wait, the more severe, the more draconian, the more difficult the adjustment is going to be,” Mr. Bernanke said in response to a question at a Senate hearing about when lawmakers should tackle the growth of spending in the twin entitlement programs. “I think the right time to start is about 10 years ago.”

Mr. Bernanke’s comments were consistent with his past warnings, and those of his predecessor, Alan Greenspan, about the unfinanced cost of the postwar generation’s retirement. But his tone was more urgent, and it seemed aimed at the arrival of a new Democratic-led Congress that is just now setting its priorities.

His comments also dovetailed with statements by the Treasury secretary, Henry M. Paulson Jr., favoring efforts to curb the cost of entitlements this year, despite skepticism among some lawmakers that painful steps to deal with the problem cannot be taken two years before a presidential election.

Mr. Paulson has begun discussions with leading Democrats in Congress on Social Security and budget matters, but the administration has not shown its hand with specific proposals. President Bush’s earlier proposal to convert a portion of Social Security benefits for some future retirees into individual investment accounts failed to even reach a vote in Congress.

Mr. Bernanke’s tone of urgency echoed the comments of Senator Kent Conrad, a North Dakota Democrat who has long criticized the Bush administration’s tax cuts and warned of the risk of long-term federal deficits. Only now, Mr. Conrad was leading the hearing and welcoming Mr. Bernanke’s warnings. Before Mr. Bernanke took office, he initially told lawmakers that he would avoid commenting on fiscal policy once he became Fed chairman. But like his predecessors, he has found it hard to stay out of the debate, especially when Congressional leaders demand to hear his views.

Still, Mr. Bernanke was careful not to enter the partisan fray over taxes and spending on Capitol Hill. He said repeatedly it was not his role to dictate how Congress should deal with the problem, despite efforts by Mr. Conrad and other Democrats to get him to oppose extending the Bush administration’s tax cuts, which expire in 2010.

Neither did Republican senators succeed in prodding him to praise the Bush tax cuts specifically or tax cuts generally, as they used to be able to do with Mr. Greenspan. The previous Fed chairman said frequently that it would be better to reduce spending than increase taxes, and his support of the Bush tax cuts in 2001 angered Democrats and helped ease their passage.

Instead, Mr. Bernanke, in his first testimony since the election remade the political landscape in Congress, said it was up to lawmakers to decide what levels of spending on social programs are appropriate, and then set taxes at a level necessary to pay for them.

Asked by Republicans to echo their view that tax cuts lead to increased revenues, Mr. Bernanke said that tax cuts spur economic growth but that they “usually do not pay for themselves” by generating more tax revenue than they drain from the Treasury.

“I’m going to try to avoid making specific recommendations on tax policy,” he said in response to a question from Senator Judd Gregg of New Hampshire, the ranking Republican on the Senate Budget Committee. “I don’t think there’s a magic number. I only say that there is a difficult balance there.”

To another Republican senator, Wayne Allard of Colorado, Mr. Bernanke referred to the cost of government programs and said: “Whatever it is, you have to pay for it. That’s what I’m saying.”

Mr. Gregg also sought to make the point that, under Mr. Bush, the federal deficit had declined in the last two years because of rising tax revenues resulting from economic growth. Mr. Bernanke’s entire testimony was intended to say that, while true, this trend was virtually irrelevant to the problem at hand.

The Fed chairman came to a hearing of the Senate Budget Committee citing recent long term projections by the Congressional Budget Office that Social Security and Medicare outlays will rise from 8.5 percent of annual economic output to 10.5 percent in 2015 and 15 percent in 2030.

These costs, in turn, would force the United States to keep borrowing, pushing the ratio of publicly held federal debt from its current level of 37 percent of the economy to about 100 percent in 2030, a level reached in the past only during World War II.

“If government debt and deficits were actually to grow at the pace envisioned by the C.B.O.’s scenario, the effects on the U.S. economy would be severe,” Mr. Bernanke told the committee. He said the trends would slow economic growth, drain away funds for private investment and sap confidence of consumers, businesses and investors.

Mr. Paulson’s negotiations with Congress have been very preliminary, his aides say. The talks will probably not begin in earnest until after President Bush’s State of the Union speech on Jan. 23, when he is expected to outline not only his approach on entitlements but on the overall budget.

Mr. Bush has said that the tax cuts are all but sacrosanct in his view, and Democratic leaders say they do not expect to try this year to rescind even the parts of them that most benefit the rich. Administration officials say they are waiting for the Democrats to lay out their own approach to the budget, taxes and entitlements.

Mr. Bernanke seemed to go out of his way to agree with every questioner, but he flatly disputed the trade views of Senator Bernard Sanders of Vermont, newly elected as an independent but who describes himself as a socialist and votes as a Democrat.

When Mr. Sanders said that recent trade deals with China and with Mexico and Canada had eroded jobs, the

Fed chairman said: “I don’t agree with that.” He said that the nation’s $800 billion trade deficit resulted from a low savings and high consumption rate in the United States, not those or other trade deals.