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Senate Finance Committee – Our Fiscal State of Affairs

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Chairman Baucus, Senator Hatch and other members of the Senate Finance Committee. Thank you for the opportunity to appear today and discuss the critically important question of our nation's serious fiscal challenges.

Before I address some of the relevant key statistics, the related risks, and discuss a possible path forward, I want to briefly address the issue of our broader cultural challenge. It is very relevant to where we are and what we need to do to restore fiscal sanity and sustainability.

While the United States is an exceptional and great nation, we have strayed from many of the founding principles that made us great. These include such principles as limited government, individual liberty and fiscal responsibility. From a fiscal perspective, it includes such values as thrift, savings, investment, limited debt, and stewardship. We believed in and, for the most part, were true to these principles and values for almost 200 years. However, within the past 30 years, we have lost our way both as a country and a society. We must now restore our belief in and commitment to these principles in order to ensure that America remains great and our future will be better than our past.

I do not want to provide a lot of statistics, but a few statistics and charts will be instructive. The high point of federal public debt/GDP was at the end of World War II when it was about 112 percent of GDP. (See Exhibit I). At the end of World War II, the U.S. was over 50 percent of global GDP and demographic trends were working in our favor. In addition, after World War II America took a number of steps to promote economic growth (See Exhibit II) and restore fiscal responsibility. As a result, debt/GDP levels plummeted from an all time high at the end of World War II to less than 40 percent of GDP by 1980.

Today's public debt is about 65 percent of GDP and growing rapidly. In addition, if you add the debt owed to Social Security and Medicare, which I believe you should, federal debt is close to 95 percent of GDP and growing rapidly.

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Real debt per capita is another informative way to look at our debt. On a per capita basis, our current federal debt level is over double what it was at the end of World War II and growing rapidly. (See Exhibit III).

How did we get to this level of debt? You will see that federal government spending per capita adjusted for inflation has grown dramatically since the end of World War II, especially in the past 10 years. Real per capita spending is now about 50 percent greater than at the peak of World War II. In addition, our current deficits per capita are larger than during World War II. (See Exhibit IV). While it is clear that we achieved a lot for the deficits that we ran and debt that we accumulated during World War II, there are serious questions regarding what we are getting for today's deficits and mounting debt burdens.

Today's deficits and debt levels are a matter of growing public concern; however they are largely driven by a range of temporary factors. Therefore, the real risk that we face is not today's deficits and our current debt but the ones that lie ahead. These are driven largely be known demographic trends, rising health care costs and an outdated tax system. Based on our current path, we are headed for deficits and debt levels that are clearly irresponsible and unsustainable. (See Exhibits V and VI).

Believe it or not, the projections that are provided by federal government agencies are in actuality optimistic absent fundamental reforms. They do not adequately consider the rise in interest rates that most assuredly will occur with any attempt to fund the projected debt levels, especially considering total expected global sovereign debt financing needs and the likely available capital. Importantly, as was the case in Greece, such a rise in interest rates can come very quickly if we lose the confidence of investors.

There is already evidence that market forces are beginning to show a concern regarding future interest rates. For example, the Federal Reserve has been buying a majority of our new debt in recent months and is now the largest holder of federal debt. China and other foreign investors are buying short-term U.S. debt in order to hedge against future increases in interest rates and declines in the value of the dollar. In addition, PIMCO, the largest domestic holder of U.S. public debt for its investors, recently divested its holdings in Treasury securities. They did so based on their belief that current interest rates do not adequately compensate investors for future interest rate risks.

The truth is that the Federal Reserve's purchases of federal debt amounts to self dealing. It may serve to hold down interest rates in the short-term but it distorts the market and increase our longer-term risk. Eventually, the Fed's positions must be unwound. When this occurs, we will see what real interest rates will be.

Importantly, the U.S. has the lowest average debt maturity of any major sovereign nation. In addition, we have very low interest rates by historical standards. Therefore, when interest rates rise, our interest costs will increase rapidly.

To help put things in perspective, for every 1 percent increase in interest rates the U.S. incurs about $150 billion in additional interest costs based on today's debt levels. That is over 10 times what the U.S. currently spends on international affairs which, rightly or wrongly, many Americans question. And what do we get for interest? Absolutely nothing!!!

While the figures that I have reviewed should be enough to make a clear and compelling case for a change in our current fiscal path, there is one more dimension that I need to address. Namely, how does our debt/GDP level compare to other major nations and how does the U.S. stack up in the area of fiscal responsibility and sustainability?

Based on an IMF study issued in 2010, when you consider total federal, state and local public debt as a percentage of GDP, the U.S. had higher debt/GDP levels than the UK, Spain, Ireland and Portugal. In addition, the U.S. was less than 10-years from Greece's levels. However, when you consider the debt owed to Social Security and Medicare, we were less than three years from the debt/GDP levels that Greece had when it experienced its debt crisis and riots in the streets.

Just last month, the Comeback America Initiative (CAI) and Stanford University's Masters in Public Policy program issued the first Sovereign Fiscal Responsibility Index (SFRI). This fiscal fitness index ranked 34 nations on their fiscal responsibility and sustainability. It considered a range of quantitative and qualitative measures and relied on data from respected international organizations like the IMF and OECD.

Australia ranked 1st and Greece ranked 34th. Where does the U.S. rank? Shockingly we ranked number 28. (See Exhibit VII). We are not in a good neighborhood on this list. Therefore, we must take steps to move up the list soon and before we have our own debt crisis. After all, a U.S. debt crisis would result in a much more severe recession than the last one and it would be felt around the world.

Fortunately, there were two pieces of good news that resulted from the SFRI project. First, several of the highly rated countries, for example New Zealand and Sweden, faced their own crises in the 1990s. They made tough choices and now rank high on the index, 2nd and 4th, respectively. In addition, a second raking list was created based on an assumption that the Congress and the President were able to enact a comprehensive reform package that would achieve the same "bottom line" fiscal impact as the package of recommendations made by the National Fiscal Responsibility and Reform Commission. The result was moving the U.S. up from the 28th position to the 8th position. The U.S. would also achieve fiscal sustainability for over 40 years and move up to 3rd in fiscal governance. Therefore, why haven't the Congress and the President done more with the Commission's recommendations? Are they waiting for a crisis?

Now that I have provided a foundation of where we are, where we are headed and how we compare to others, it's important to discuss a possible way forward. First, the Congress and the President should be commended for reaching an agreement on spending levels for 2011. At the same time, Washington policymakers took way too long to do so given the fact that the result only involved about a 1 percent reduction in total federal spending. In essence, they were arguing over the bar tab on the Titanic.

There is a fiscal iceberg floating ahead that threatens to sink our Ship of State, which is why our policy makers must turn their attention to the much bigger fiscal problems. Specifically, the fiscal 2012 budget and, much more importantly, the debt ceiling debate will represent both key challenges and opportunities.

Why do I say that? The recent budget discussions left about eighty-two percent of federal spending and the need for comprehensive tax reform off the table. This is totally inappropriate since the structural deficits that serve to threaten our collective future, are driven primarily by entitlement programs and outdated tax systems. As the National Commission on Fiscal Responsibility and Reform recognized, these areas must be on the table in order to restore fiscal sanity and ensure fiscal sustainability.

Effectively addressing our structural deficits will require major transformational reforms in all major areas of the federal government. This includes reforming Medicare, Medicaid, Social Security, other health care programs, defense, other spending cuts and constraint, and comprehensive tax reform that achieves numerous objectives, including increased revenues as a percentage of the economy over our historical average.

Given the comprehensive nature of the needed reforms, their complexity, and the political difficulties associated therewith, it will take a range of actions over a number of years in order to put the federal government on a more prudent and sustainable path.

Therefore, it is important to have a game plan for attacking this challenge in a manner that meets three key tests for desirability and feasibility of any major reform proposals. They are:

- Does the proposal make economic sense, is it socially equitable, and is it culturally acceptable?

- Does it pass a math test? Namely, if you are attempting to balanced the budget or stabilize debt/GDP at some reasonable and sustainable level, do the numbers associated with the proposed reforms add up and achieve the desired goal.

- Is it politically feasible? Namely, can it achieve majority support in the House, obtain 60 votes in the Senate, and gain the signature of the President?

If proposals do not pass the above three tests, they are likely to fail. And failure is simply not an option in connection with putting the federal government's finances in order. Failure to do so will ultimately result in a crisis that would reduce the U.S. Government's position in the world, our national security, our standard of living at home, and potentially domestic tranquility in our streets.

Given the above, what is a possible path forward? First, the Congress and the President need to agree on spending levels for fiscal 2012. This will take some time and, hopefully, will be achieved on a much timelier basis and constructive manner than for fiscal 2011. Much more importantly, over the next couple of months the Congress and the President need to agree on how much to increase the debt ceiling limit and under what conditions.

In my view, the decisions associated with the debt ceiling limit may represent the most important fiscal decisions that will occur before the 2012 elections. It seems that the Democrat's and the Administration's Plan A seems to be to raise the debt ceiling in an unrestricted manner. This is totally unrealistic given today's political environment. On the other hand, the Republican's Plan A seems to be to raise the debt ceiling limit conditioned on the passage of a constitutional balanced budget amendment. Irrespective of the merits of such an amendment, the votes are not likely there based on

its current form. Therefore, the country needs a Plan B because doing nothing is simply not a viable option.

A Plan B should be able to achieve bipartisan support in Congress and from the President. One possible approach would be to raise the debt ceiling limit by a considerable amount conditioned on three key provisions. They are:

- Agreement on a top line level of spending for fiscal 2012. This agreed level may not occur for some time and; therefore, there may have to be two authorized levels of increase. One if agreement on fiscal 2012 spending occurs by a date certain and a lower level if it does not.

- Much more importantly, it's time to re-impose statutory budget controls with automatic enforcement mechanisms starting no earlier than 2013. Among other things, these controls would include a new element. Namely, specific annual debt/GDP targets with default mechanisms if such targets are not met. Such targets could be set based on the work of the National Fiscal Responsibility and Reform Commission and/or the Peterson/Pew Commission. The default mechanisms would include automatic discretionary spending cuts, including in the security area, an automatic freeze of indexing and waiver of premium increase limits for mandatory spending programs, and automatic temporary tax surcharges for deficit reduction. The ratio for these could be based on the good work of the National Fiscal Responsibility and Reform Commission. In addition, any temporary tax surcharge should be shown as a separate line item beginning with the 2014 individual tax returns.

- Authorize and fund a meaningful citizen education and engagement effort that draws lessons from the Social Security effort during the Clinton Administration in 1998 and the Peterson/MacArthur/Kellogg effort in the summer of 2010. I took part in both efforts, which involved America Speaks.

The above approach would demonstrate to our foreign lenders and the American people that Washington is serious about addressing the structural deficits that lie ahead and putting our nation's finances in order. They would also provide time and a means for the public to be informed and engaged regarding the magnitude of the fiscal challenges that we face and the types of reforms that will be necessary to effectively address them. This will be necessary in order for elected officials to be able to make the necessary decisions without losing their jobs.

Importantly, the default mechanisms are just that. They would not come into effect unless the Congress and the President failed to act in a timely or effective manner. In addition, the Congress and the President could agree on reforms that result in a different ratio and mix of spending cuts and revenues than the default mechanism. There are clearly significant philosophical differences in how best to address our fiscal gap. At the same time, there is a growing consensus that we must act to close it.

Finally, and very importantly, the above approach will ensure that something happens if the Congress and the President fail to act. This is critical since a debt crisis could incur in the U.S. within 2-3 years absent substantive action.

Thank you again for the invitation to testify. In summary, it's time to focus on the future, put the public interest over special interests and progress over partisanship. We must take steps to address our

structural deficits and put our finances in orders before it’s too late. It's time for leadership rather than more laggardship and crisis management from Washington. Our nation's founders and our families deserve it, and our collective future depends on it.