

Chapter One

We the People: Keeping the Economy and the Nation Strong

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When I became the seventh Comptroller General of the United States, I was shocked to find out when I assumed office in 1998 that the agency that I headed, the Government Accountability Office (GAO), had been in business since 1921 and had no integrated, forward-looking, and outcome-based strategic plan. Now, there are some Federal agencies that are in the same category today that have been in business a lot longer. But what I was even more shocked to find out is that the United States, which has been in business since 1789 as a constitutional republic, still has no strategic, integrated, forward-looking, and outcome-based strategic plan. It is an outrage and an issue we must address.

As a result, we spend a lot of time dealing with immediate needs. We also spend a lot of time focusing on how much money we are going to spend and how much in tax preferences we are going to give. We do not focus enough on what goals and objectives we are trying to achieve, what works, what does not work, what is affordable, and what is sustainable. This exercise has to consider not just today but macro trends and challenges that are affecting us and everyone else in the world and their implications for tomorrow.

We put such a plan in place at GAO, and it is the closest thing that exists to a strategic plan for the Federal Government, but the GAO is in the legislative branch. So we need one for the executive branch. It needs to be led by the OMB (Office of Management and Budget), and hopefully, eventually it will be.

But I can tell you that when you look at performance, you have to look at three dimensions. First, how are we doing based upon our desired outcomes and our key objectives? Second, are we getting better, or are we getting worse? And third and very importantly, ask a question that the United States rarely asks: "How do we compare to our competitor groups or comparator groups?"

If we answered these questions, we would find that while we are above average in many things, we are below average in too many things,

and the things that we are below average in are, in many cases, leading indicators with regard to what our future economy is going to be like, what our future position in the world is going to be, and what our future standard of living at home will be. Things like savings, critical infrastructure, investments in basic research, educational outcomes, and healthcare outcomes are key leading indicators, and in all of these areas, we are *below average for an industrialized nation*.

We have rested on our past success too long. We have rampant myopia, tunnel vision, and self-interest. It has reached epidemic proportions in the halls of Congress and in Washington, DC. We need policy, operational, and political reforms, and we need them soon because we have a dysfunctional constitutional republic. If we do not take steps to keep our economy strong for both today and tomorrow, our national security, international standing, standard of living, and even our domestic tranquility will suffer over time. That is the bottom line.

Let me provide you with some context. Today, we have very large short-term deficits—\$1.4 trillion plus. Debt is mounting at a rapid rate, and we now have about \$13.4 trillion in total debt subject to the debt-ceiling limit. That is a matter of concern, and it is the number-two issue among the American people, only behind the economy and jobs.

While the American people are rightfully concerned about our current debt, it is only the tip of the iceberg, but what threatens the ship of state and our collective future is the part of the iceberg below the water that is represented by off-balance-sheet obligations—tens of trillions in unfunded promises that do not represent deficits today but will represent deficits and debt tomorrow. They represent the true threat to the ship of state.

Even after the economy recovers, even after unemployment is down, even after the “wars” are over—and I put that in quotes because Congress has not declared war since World War II—even after the temporary tax cuts have expired, and even after the financial services and housing crises have long passed, this country faces large, known, and growing structural deficits due to known demographic trends and rising healthcare costs. This enormous problem requires solutions now because our foreign lenders are starting to get nervous and the situation will only get worse absent meaningful reform actions.

The Federal Government has grown dramatically since its founding. In 1800, 11 years after the founding of the Republic, it represented

2 percent of the U.S. economy. This year, it represents 25 percent, which is above the recent average of 21 percent. But if we do not reform our existing entitlement programs and other aspects of government, it will represent about 40 percent of the economy by 2040, and that does not count state and local governments.

The composition of the budget has changed dramatically in the last four decades. Forty years ago, it was dominated by defense at 42 percent. Today, it is dominated by social insurance programs, which grow faster than inflation and grow faster than the economy even when the economy is growing. Forty years ago, when Congress came to town, they got to decide how 62 percent of the budget would be spent, of which today defense is about half of the discretionary budget. Now they decide how about 38 percent gets spent, and if we continue on our status quo, do nothing, let-it-ride policy, it will go down to 18 percent by 2040. This obviously is an imprudent and unsustainable course.

Interestingly, those of you who are scholars of history and the Constitution will find that every enumerated responsibility envisioned by the Founding Fathers for the Federal Government under the Constitution is in discretionary spending, every single one, and discretionary spending is what is getting squeezed. If you look at what has happened in the last 9½ years, our debt has more than doubled, and worse, we do not like to count all of our debt. There is a little creative accounting going on.

There are two kinds of debt: the debt held by the public, and that debt that we owe to Social Security, Medicare, and other trust funds. That debt is also backed by the full faith and credit of the United States Government. It is guaranteed as to principal and interest. It will be honored, but the Federal Government does not want to call it a liability. It wants to tell people who are covered under Social Security and Medicare that they can count on it, and I think you can, but our current accounting treatment is wrong and it should change.

This situation has resulted in understating our true deficits and our true debt to GDP (gross domestic product) for many years, and as far as I know, we are the only country that has so-called trust funds because ours are ones that you can't trust, and they are not funded.

If you look at the last consolidated financial statements of the United States, which were issued earlier this year, as of the end of September 30, 2009, the last fiscal year end, you will find that the total liabilities and unfunded promises primarily for Medicare and Social

Security, the total of the liabilities and unfunded promises, have more than tripled since the year 2000—\$62 trillion—and most of this is off the balance sheet.

How much is \$62 trillion? It is over \$200,000 per person. It is over \$500,000 per household. Believe it or not, median household income in the United States is \$50,000 a year. So that means that under our status quo, do nothing, let-it-ride path, the typical American household has a second or third mortgage equal to ten times their annual household income, but there is no house backing this mortgage, and the American people do not even know about it.

If you look at deficits and surpluses since 1800, you will find that we have had a long-standing tradition in this country of not running large deficits unless we were at war, a declared war, or we faced great economic challenges, such as the Great Depression or a recession.

But within the last several decades, this country became addicted to deficits and debt and conspicuous consumption. Economists changed from trying to have a balanced budget over the economic cycle, to a point where they said, “Well, let us try to achieve no more than the growth of the economy over a cycle,” such that it became acceptable to run deficits of 2 to 3 percent of GDP, even in good times, and times of peace.

The result of that is, you changed the standard. Then what happens when you are in a recession? What happens when you are at war, whether it is declared or undeclared? What happens when you have a national emergency or non-business cycle challenge, a crisis like the housing and financial services meltdown? Deficits of 10 percent of GDP plus. We have lost our metrics. We have lost our way. We have strayed from the principles and values that this country was founded on, including thrift, savings, limited debt, and stewardship, and that needs to change.

Now, what about Social Security? Well, it was running surpluses for a lot of years, and every dime of that surplus was spent for other government operating expenses and replaced with a nonmarketable bond, but those days are over. Social Security is running a deficit now, primarily because of the recession and more people retiring early, and it is going to be in a permanent deficit position within about 5 years, adding to our fiscal challenges rather than reducing them.

What about the future? If we tax at historical levels, 18.3 percent of GDP, which is the green line, and if we do not reform government, this is what the future will look like: the fastest growing expense will be interest on the Federal debt; the second fastest growing Federal expense

will be out-of-control healthcare costs, which are still out of control despite the latest healthcare bill. And they are eating everybody's lunch, including the Defense Department's.

And what about debt to GDP? The only time in the history of the United States that we had public debt over 60 percent of GDP was at the end of World War II. But guess what? We got something for that. We defeated the Axis powers, we saved the free world, we avoided attack on the continental United States, and after World War II, we were over 50 percent of the global economy, demographics were working in our favor, and the dollar was as good as gold.

So what did we do? We did a number of things to try to help rebuild the Axis powers and other nations that had experienced mass destruction, in order to stimulate global demand. We did a number of things to invest in our people through the GI Bill and our infrastructure through the highway system. We did a number of things to try to help maintain sound fiscal policy, and we obviously grew the economy very fast, because we dominated the global economy.

Those days are over. We are still a superpower, but we will not be the only superpower forever. That status is temporary. We are still the leading nation on Earth, but we are one of a number of important nations on Earth. And we have to recognize reality, not continue to live on our past successes. We have to start focusing on the future and on results. Guess what? Today, our debt to GDP is above 60 percent for only the second time in the history of the United States, and it's rising rapidly. If you counted the debt that we owe to Social Security and Medicare, it is over 90 percent of GDP.

And what about Greece, Italy, Portugal, Spain, Ireland, the United Kingdom? If you look at appropriate metrics, which are total Federal, state, and local debt held by the public—again, ignoring the trust fund debt—if you just look at that, according to a 2010 International Monetary Fund report, we are already worse than Spain, we are already worse than Ireland, we are already worse than the United Kingdom, and we are within 10 years of being where Greece is today.

What about that debt that we owe to Social Security and Medicare? If you count that, we are within 3 years of being where Greece is today. We are not Greece, but Greece used to be the greatest civilization in the history of mankind. Greece is the cradle of democracy, and ruled most of the world during Alexander's time. Unfortunately, we have more rope because we have over 60 percent of the global reserve currency, but

we do not have unlimited rope, and we are not exempt from the laws of prudent finance.

We are a safe haven in times of uncertainty, but that is temporary. We need to wake up; we need to recognize reality. We need to start making tough choices before people lose confidence in our ability to put our own financial house in order, because if we don't get our act together, we will have our own debt crisis. The result would be something much worse than what we saw a couple of years ago during the financial services meltdown.

Believe it or not, the four factors that caused the financial services meltdown exist for the Federal Government's own finances, but nobody is going to bail out America! We have to solve our own problems.

This is where we are headed regarding debt to GDP, and this is optimistic, because this is the latest projection from the CBO (Congressional Budget Office) that assumes we are going to get a lot of savings with regard to the latest healthcare bill. Those savings are unlikely since the Medicare Chief Actuary gave an adverse opinion on the latest trustees' report for Medicare. That is unprecedented.

And what about self-reliance? At the end of World War II, we had the highest debt to GDP in our history, but we had no foreign debt. Americans saved, Americans invested in their future, Americans invested in their country's future, but unfortunately, such is not the case today.

We have, therefore, had to become reliant on foreigners for two things: oil and capital. We are reliant upon oil, and we are reliant upon foreign lenders to finance our escalating deficits and debt. That is not in our long-term economic, foreign policy, national security, or domestic tranquility interest. It is also imprudent. Don't forget: You must pay attention to your foreign lenders. They have more leverage on you; you have less leverage on them. They have already flexed their muscles.

One of the reasons that all of us now guarantee over \$5 trillion in Fannie Mae and Freddie Mac debt is because Japan and China demanded it. They had significant holdings in those securities. They were not previously backed by the full faith and credit of the United States Government. They got their way, and the taxpayers will pay the price.

Now, what are our foreign lenders doing? They are going short on their investments in U.S. Treasury securities. There is very little purchasing going on of 30-year treasuries. People have also cut back on 10-year treasuries. Why? Because in times of uncertainty, the United States is a safe haven, and therefore, people are willing to buy Treasury

securities because of our rule of law, political stability, the fact that we have over 60 percent of the world's global reserve currency, and uncertainties regarding the stock market. As a result, investors are willing to compromise returns in order to preserve their principal. How do you do that? In the short term, it is Treasury securities.

But the real question is what are interest rates going to be over time, under our present path, and the other thing that the credit rating agencies do not even consider is what is the dollar going to be worth over time. That is why it is very understandable that foreign players are going short on the duration of their Treasury portfolios. As a result, we have the shortest average maturity of our debt of any industrialized nation. That means when interest rates go up, after the economy turns around and unemployment goes down, when there is more competition for capital, we will feel it much faster than others will because we have not locked in these low interest rates for the long term.

When I was Comptroller General, we recommended the Treasury Department go to 50-year bonds, and not only did they not go to 50-year bonds, they eliminated the 30-year bond. Now they have brought it back, but it is not a real attractive investment. More and more, people are going into the TIPS (Treasury inflation-protected securities), which in the short term you do not make much on but which is a good hedge against what the future may hold.

And if interest rates end up going up a mere 200 basis points, 2 percent, it will have a dramatic effect on the Federal budget. Health-care costs are eating our lunch. And if you look at the Federal budget, Medicare and Medicaid represent our primary healthcare challenges, but escalating healthcare costs exist throughout government. Social Security is not the big challenge, and it does not face an immediate crisis. It is not the biggest challenge; however, it is the biggest opportunity in the entitlement reform area.

Healthcare grows much faster than inflation, in part due to demographics, and because we have an equivalent of an arms race for medical technology. Our fee-for-service system also results in perverse incentives. As a result of these and other factors, we spend double per capita on healthcare and we get below-average societal results. We spend double per capita on kindergarten through 12 education, and we get below-average results. It is not a lack of money. We are spending too much money. The system is broken. We have to look at incentives, transparency, and accountability changes to make these systems more

successful and sustainable. They need to be dramatically reformed in order to get different results.

You cannot get different results by throwing more money at a system that is dysfunctional, inadequate, and unsustainable. Even in the United States, there is tremendous variation between how much procedures cost, even in the Medicare program, because of differences in practice, and that is why we have to go to evidence-based approaches. Almost 30 percent of Medicare's cost is in the last year of life—and a lot of that makes no sense and is not in the patient's interest.

And what about defense? We spend more than the next 14 countries combined on national defense. Now, in fairness, the dollar goes further in some places than others. Some people do not pay what we do for labor. Secondly, some places are more transparent about their costs than others. But the simple truth is, we take on a disproportionate share of the global security burden. We are doing too much, others are not doing enough, and we cannot sustain what we have right now.

And who pays for all of this? Well, most of the revenue comes from payroll taxes and individual income taxes, only 7 percent from corporate taxes. Who pays taxes? At least 42 percent of Americans pay no income tax. Let me restate that: At least 42 percent of Americans pay zero income tax, and a significant percentage of those get rebates through the Earned Income Tax Credit. Why is that a problem? Because every express and enumerated responsibility under the Constitution of the United States is funded either solely or primarily by income taxes. So that means that these individuals get a free ride on the constitutional role of the Federal Government. That is a dangerous disconnect in a democracy.

These individuals pay payroll taxes, and, in fact, most people pay more in payroll taxes than income taxes, but those payroll taxes are not adequate to fund the programs that they are supporting. There are tens of trillions in unfunded obligations for Medicare and Social Security. And yes, corporations get special tax preferences, and they need to be on the table for reconsideration as well.

We have a progressive tax system. When you consider payroll taxes and income taxes, both, all Federal taxes, the top one-half of one percent of Americans earn 15 percent of total income, and they pay 23 percent of total taxes. But depending upon what their source of income is and how creative they are with the tax system, they can have a low effective tax rate.

Now what about state and local governments? We have discussed the numbers for the Federal Government. Our national challenge is

worse than our Federal challenge. Under current policies, state and local deficits are projected to more than double as a percentage of GDP, even after the economy recovers. We are all in the same boat, and bad news flows downhill. We have greater interconnectivity and interdependency along with a number of common challenges that we have to face together.

And what about savings? Our personal savings rate has declined considerably since World War II, and our net national savings rate was negative in 2009 for the first time since the Great Depression.

What are the drivers of government deficits at all levels? They include the factors we have described: expansion of government, health-care costs, retirement income costs, disability and welfare systems, critical infrastructure, education costs, outdated and inadequate revenue systems, and myopia, tunnel vision, special interests, and self interest. And what are some of the things we need to do at a high level? First, when you are in a hole, what is the first rule? Stop digging. One of the first things that we have to do is reimpose tough statutory budget controls that address discretionary and mandatory spending as well as tax preferences in order to stabilize our debt/GDP at a reasonable level.

Secondly, we need to reimpose tough but reliable discretionary spending caps. We need to impose mandatory reconsideration triggers for spending and tax preferences that would take effect when unemployment hits 8 percent. We should not undercut the recovery, but we have to recognize the reality. When you look at leading indicators, structural unemployment is probably going to be about 2 percent higher than it has been historically. We have been eating our seed corn for too long, and we are going to pay a price for it. Long-term economic growth is probably going to be about 1 percent less than it has been because we have been living on the past rather than investing to create a better future.

We should reform Social Security to make it solvent, sustainable, secure, and more savings oriented. Why? It represents our biggest opportunity to exceed the expectations of all generations of Americans. We can show our foreign lenders we can do something and be able to gain some credibility with the American people by demonstrating that Congress can actually get something done.

We need to look at our healthcare costs. As a result of the latest legislation, healthcare is going to increase as a percentage of GDP: You cannot reduce costs by expanding coverage. It is an oxymoron. You have to make tough choices.

Believe it or not, we are the only major industrialized nation that does not have a budget for healthcare. We have a fee-for-service system,

which is part of the problem. We have a proliferation of technology. We do not have evidence-based standards. We have not reformed our malpractice system. We have subsidized very lucrative healthcare plans for the well off, and we provide taxpayer subsidies for billionaires who voluntarily sign up for Medicare Part B and Part D. Those are just a few of the things that we are going to have to take a look at, among many others.

We should have universal coverage, but we have to have an honest discussion and debate with the American people about what level of universal coverage is appropriate, affordable, and sustainable. I would respectfully suggest that that is coverage that supports preventative medicine and wellness programs and provides protection against catastrophic accidents and illness for the entire population while providing more protection for the poor and disabled. We can afford and sustain that. The government has promised way too much more in healthcare than they can deliver, including for defense and veterans. There is no way that the current system is sustainable.

We need to do comprehensive tax reform to make our system more competitive, streamlined, simplified, and equitable while generating enough money to pay our bills and deliver on the promises we intend to keep.

We need to reprioritize and reengineer the base of government to make it future focused and results oriented, including the Defense Department.

There is unbelievable waste in many parts of government including defense. The problem is there is no line item that says *waste*, and when I was at GAO, nobody had even defined waste. Waste is taxpayers as a whole not receiving reasonable value for money, both today and over time.

Waste is different than fraud. Waste is different than abuse and mismanagement. Fraud exists, especially in healthcare because that is where the money is, but waste is the biggest problem. Unfortunately, you cannot get to it because it is not as transparent. There are a lot of vested interests. Frankly, Congress pushes a lot of the waste by forcing the Defense Department to buy things that it does not want and we do not need.

And so we have to have some special processes to be able to re-baseline government to make it more future focused and more results oriented. We have a National Commission on Fiscal Responsibility

and Reform that is going to report by December 1. We need a new Hoover II Commission that will start focusing on the government to re-baseline and re-engineer it. We need to focus on the future and to generate more results in an affordable and sustainable manner.

A lot of people are talking about doing a lot of things with regard to the defense budget and a lot of cuts will happen because we are in a \$62 trillion hole, and that hole grows by several trillion dollars a year by doing nothing, and defense is about 20 percent of the Federal budget and about 50 percent of discretionary spending.

The government has grown too large, promised too much, not delivered enough, and has waited too long to deal with these problems. As a result, we are going to have to renegotiate the social insurance contract, while providing a sound, secure, and sustainable social safety net. We are going to have to re-engineer and reprioritize and re-baseline government, including cutting discretionary spending and constraining it over time. We are also going to have to re-engineer our tax system and raise more revenue.

Our fiscal challenge is primarily a spending problem, but taxes will have to go up. And they will go up on a lot more people than those making \$200,000 or more. Why? There is a new four-letter word in Washington, and it is not “debt.” No, it is “math.” The numbers just do not work. You have people on the far right who say, “We will grow our way out.” It would take double-digit, real GDP growth for decades to grow your way out. It has not happened; it will not happen.

You have people who say, “We can inflate our way out.” You cannot inflate your way out because while inflation will reduce the burden of the current debt, the problem is not the current debt; it is the tens of trillions in unfunded obligations that will be future debt that grows faster than inflation and faster than the economy grows.

You have the liberals who say, “Well, we can tax our way out.” You would have to double Federal taxes by 2035. The American people will never allow themselves to be taxed at that level. We are going to have to do a number of tough things, and we need to do them sooner rather than later, because the miracle of compounding is working against us. When you are a debtor and you delay tough decisions, the miracle of compounding works against you. When you are an investor and you make tough decisions sooner rather than later, the miracle of compounding works for you.

We must make sure that we have adequate resources to protect this nation and to ensure our national security broadly defined, but it needs to be based upon credible threats for both today and tomorrow. We need to do it with the resource constraints that we think we have and are going to have over time.

It is time that we wake up, recognize reality, start making some tough choices in order to make sure that we stay a superpower and that we make sure that our future is better than our past, and that we discharge our stewardship responsibilities to our children and grandchildren.

The Roman Empire fell after a thousand years for a lot of reasons. I will mention four. See if they sound familiar: a decline in moral values and political civility at home, overconfidence and overextension around the world, fiscal irresponsibility by the central government, and inability to control its borders. We need to wake up, recognize reality, learn from history, and start looking at future indicators and comparing ourselves to our competitors and comparators. And yes, we can make these tough choices and make sure that America stays great and the American Dream stays alive. We cannot do it until we recognize that we are addicted to debt, we are addicted to conspicuous consumption. We need to change our ways before it's too late.

We need the 12-step plan for re-engineering the Federal Government, because we have dependencies, and until you recognize that you have a problem, you are not going to solve the problem. And what is going to have to happen to solve the problem is, the first three words of the Constitution have to come alive: *We the People*.

I will do my part. All that I ask is that you do yours.