United States Senate

Committee on Homeland Security and Governmental Affairs

Federal Spending Oversight and Emergency Management Sub-Committee

Hearing on "The Effect of Borrowing on Federal Spending"

March 29, 2017

Washington, DC

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Chairman Paul, Ranking Member Peters, and other members of the Sub-Committee, thank you for the opportunity to testify today on this important topic. I am currently a Senior Strategic Advisor with PwC Public Sector. I am also a member of a number of Governing Boards and Advisory Committees. However, today I am testifying as a private citizen and the immediate former Comptroller General of the United States.

The title of this hearing is: The effect of Borrowing on Federal Spending. The short answer is there are several implications of our current federal spending and borrowing practices. They include:

o. Additional debt results in higher interest costs that can serve to crowd out other federal spending, especially discretionary spending, and/or increase pressure for tax increases.

o. The Congressional Budget Office (CBO) has projected that interest costs will be the fastest growing expense in the federal budget on a percentage basis over the next 10-years. And what do we get for interest? Nothing!

o. Excessive levels of debt as a percentage of the economy (GDP) can serve to reduce economic growth and job opportunities. It can also cause a "crisis of confidence' in the U.S. dollar and much higher interest rates if the market ever decides that the federal government has lost control of its finances and is not willing or able to regain control over them.

0. Additional debt serves to mortgage the future of our children, grandchildren and future generations at a time when they will face increasing competition in a much more interconnected and competitive global marketplace.

From a broader perspective, the United States has strayed from many of the key principles and values that it was founded on and which made us great. The federal government has also grown too big, promised too much, and needs to enact a variety of reforms in order to help create a better future for our country and its citizens. The balance of my statement will provide some background and ideas regarding these matters.

The United States was founded based on certain basic principles and values. These include, but are not limited to: individual liberty and opportunity, personal responsibility and accountability, limited but effective government, rule of law and equal justice under the law, fiscal responsibility, intergenerational equity and stewardship. Stewardship requires that leaders not just deliver positive results today, not just leave things better off when they leave than when they came, but also leave things better positioned for the future. This is consistent with the long-standing American value of doing everything possible to provide each generation with more opportunity and a better standing of living than the past. This important tradition is now at significant risk.

For many generations the United States was disciplined about federal spending and focused on the express roles allocated to the federal government under the U.S. Constitution. However, in 1913 three things happened that served to significantly increase the size and scope of the federal government and undercut state's rights. Specifically: adoption of a federal income tax; creation of the Federal Reserve, and; direct election of the U.S. Senators rather than have them appointed by State legislatures.

Since 1913 the federal government has grown from 2% of the nation's economy to about 21% today and increasing. Stated differently, the federal government is over 10 times larger today on a relative basis than in 1913 and it's still growing. In addition, in 1913 the Congress controlled 97% of all federal spending annually. The only thing that Congress did not control was interest expense. Today, in Fiscal 2016, 69% of federal spending was deemed to be "mandatory spending" (See Exhibit A). Shockingly, the 31%

of federal spending that was controlled included all of the express and enumerated responsibilities outlined for the federal government under the Constitution, and all investments in our future.

Discretionary spending is coming under increasing pressure since mandatory spending is increasing at rates faster than the economy due to known demographic trends and rising health care costs. The bottom line is, Congress has lost control of the budget, our debt burdens are escalating to imprudent levels, and our collective future is now “at risk”.

The federal government is still adding debt faster than the growth rate of the economy and interest rates have started to rise. The Congressional Budget Office (CBO) now estimates that interest expense will be the fastest growing category of spending growth as a percentage of the budget over the next 10-years. A recent independent analysis by Brian Riedl of the Manhattan Institute showed that if interest rates were to return the average rates in the 1990s that, the 2027 projected budget deficit would increase from $1.4 trillion to $2.2 trillion.

Speaking of interest rates, the Federal Reserve has only recently begun to increase its discount rate. The Fed still has trillions of U.S. Government debt that it needs to dispose of. Social Security is now in a negative versus positive cash flow position since interest credits are a non cash item. In addition, the appetite for foreign government investment in U.S. Government debt is declining for a variety of reasons. All of these factors will serve to put upward pressure on interest rates over time, especially if the economy starts to grow at a more brisk rate.

Since the beginning of our republic, there have only been two times in our nation’s history that federal public debt as a percentage of the economy (GDP) exceeded 40%. Those two times during the later part and in the immediate aftermath of World War II and in the 21st Century, including today. After World War II, the U.S. was over 50% of global GDP, there were 0ver 16 persons working for every person drawing Social Security benefits and the dollar was a good as gold. U.S. brought back fiscal responsibility and took a range of steps to grow the economy much faster than the nation’s public debt. The result was a dramatic reduction in federal public debt/GDP from over 100% of GDP to less than 40% by 1980. Today, federal debt held by the public is approaching 80% of GDP and, based on estimates by the Government Accountability Office (GAO), the percentage of debt held by the public/GDP is on a path to rise to levels far in excess of the nation's historical high absent a major course correction (See Exhibit B).

Today the U.S. represents about 24% of global GDP, there are about 3.1 persons working for every person on Social Security and the dollar is not backed by gold. Current trends are not positive in any of these areas.

Defusing our nation's ticking debt bomb will require an unprecedented public education and engagement effort as a prelude to major budget, tax, Social Security, Medicare/Medicare, health care, defense, government organization/operations, and political reforms. I led a 27 state effort in the fall of 2012 to test how such an effort could be conducted and whether it would serve as an effective means to bring Americans together to achieve a common goal (i.e., reducing public debt/GDP to a stated level by a specified date) and in a manner that was consistent with stated principles and values that could achieve a super-majority support and served to bring people together than rather than divide people apart.

The result of the above effort proved that achieving the needed comprehensive reforms is possible. For example, 77% to over 90% of representative groups of voters in Ohio and Virginia, both so-called "swing states, agreed on a range of reforms in all of the above referenced areas that would result in public debt/GDP being reduced to 60% by 2030 in installments and in a manner that would be sustainable over time. I would be happy to answer any questions about this effort should you so desire.

The primary mechanism that Congress has used to control the level of federal debt in the past is the debt ceiling limit. While this mechanism in only direct debt speed brake the Congress has, it has not proven to be effective in limiting the growth of federal debt, forcing a reconsideration of proper role of the federal government, including the need to reform mandatory spending programs and tax expenditures. In fact, total federal debt subject to the debt ceiling limit will soon pass $20,000,000,000,000. This is about 105% of GDP and about 3.5 times what the same number was in 2000! Clearly, the federal government has lost control of its finances.

Arguably, 2003 was the year that the federal government lost its way. In that year alone, the federal government passed a second round of debt financed tax cuts, invaded a sovereign nation without declaring war and charging the cost to the nation's credit card, and expanded Medicare to add prescription drugs. The latter action added over $9 trillion in new unfunded obligations when Medicare was already underfunded by over $19 trillion! And this occurred just three short years after the then Chairman of the Federal Reserve testified that he was concerned that the federal government might pay off all the federal debt. A concern that I did not share and testified accordingly at the time. One thing is clear, we don't have to worry about that anymore.

In my view, given recent history, the debt ceiling limit needs to be replaced with stronger statutory budget controls and a Constitutional amendment that would limit public debt/GDP with specific targets and automatic enforcement mechanisms if the targets are not met. In my view, a debt/GDP fiscal responsibility approach is vastly superior to a "balanced budget" approach. I am happy to discuss why and a related illustrative amendment, should you so desire.

As you may be aware, there is currently an effort underway to achieve a state led Convention under Article V of the Constitution to restore fiscal responsibility at the federal level. Twenty eight of the required 34 states have already passed related resolutions and several groups are working to make this concept a reality. One of these groups is called the Balanced Budget Amendment Task Force. Michigan is one of the 28 states that has passed a related fiscal responsibility resolution but Kentucky has yet to do so. Hopefully the Kentucky legislature will do so either this year or next.

Speaking of states, I lead an annual effort to rank the 50 states based on their relative financial position, competitive posture and migration patterns. This report reveals a wide disparity among the states. It also serves to demonstrate that cash-based "balanced budget" amendments have not proven to be effective mechanisms to ensure fiscal prudence and sustainability at the state level. As an example, both Kentucky and Michigan are required to have "balanced budgets". However, both states face fiscal sustainability challenges of differing degrees of magnitude due, in large part, to underfunded retirement plans. Kentucky is ranked number 49 and Michigan number 41 out of the 50 states in relative financial position, with number 50 (i.e., New Jersey) being the worst state (See Exhibit C).

States need to take steps to improve their competitive posture and put their finances in order. After all, eventually the federal government will take steps to restructure its finances, and when it does, the downdraft will have an adverse impact on troubled states. In addition, while the federal government can create money and manipulate interest rates, state governments can't. And while municipalities can file for bankruptcy, states can't. Furthermore, most Americans do not want to leave the United States; however, most do not have a problem leaving a state, especially when they retire.

In summary, we live in a great nation but we have strayed from the principles and values that made us great. We are currently on an imprudent and unsustainable fiscal path. We need to be honest with ourselves and the American people. Tough choices are required on the spending and revenue side of the budget in order to restore fiscal responsibility, enhance economic growth, and create a better future. The sooner we start making those choices the better so the miracle of compounding can start working for us rather than against us as it is now.

Thank you again for the opportunity to testify. I would be happy to answer any questions that members of the sub-committee may have.