September 6, 2011

Ken Spencer Memorial Lecture

By: Hon. David M. Walker, Founder and CEO of the Comeback America Initiative

and Former Comptroller General of the United States (1998-2008)

Thank you for that kind introduction. It is a pleasure to be back in Australia. It is also an honor to be able to deliver the Ken Spencer lecture.

This is the fourth time I have been in Australia. The first time my wife Mary and I came as tourists. The second time I came as a partner and Global Managing Director of Arthur Andersen's Human Capital Services Practice. The third time as Comptroller General of the United States. This time I am coming as Founder and CEO of the Comeback America Initiative (CAI), a member of the Accounting Hall of Fame and the Trilateral Commission, and Chairman of the United Nations Independent Audit Advisory Committee (IAAC). The Australian Government supported my election to the IAAC in 2008 and I want to again thank your government for its support.

Before I begin my formal remarks, I'd like to say a few words about Ken Spencer. Ken was a true leader in the accounting profession. He was a principled person of high integrity who believed in global accounting standards. He was a founding trustee of the IASB and a great ambassador for accounting professionals and Australia. He made a difference during his lifetime, and he is well deserving of having this lecture named in his honor.

Now that I am on Australian soil, it's appropriate to speak about some of our commonalities and differences. For example, our countries have a common mother country - England. We both are

democracies that share a common language - English. Our countries are of similar size, and both countries have been blessed with considerable natural resources and oceans that provide some additional level of national security. Finally, both our currencies are named the dollar - although yours is now worth more than ours despite the size of our economy and the fact that the U.S. Dollar is the world's largest reserve currency.

There are also a number of differences between our two nations. For example, we are in different hemispheres, the U.S. has a more diverse population that Australia, and Australia is much more fiscally responsible than the U.S. More on this in a few minutes.

There are many topics that I could address today, but I have decided to address the increasing global concerns regarding sovereign debt challenges, in general, and the United States, in particular. This is a very serious issue that will have significant implications for the world, America and Australia.

At the outset, let me note that several of the same driving forces that caused the financial crisis in 2008 are also contributing to the sovereign debt challenges being experienced today, especially in the U.S. First, there is a disconnect between those who benefit from prevailing practices and those who bear the risk and will pay the price when the bubble bursts. For example, the U.S. is currently mortgaging the future of its children and grandchildren at record rates, while also reducing investments in their future, even though they will face much tougher competition in a more competitive, interconnected and interdependent world. Second, there is not enough transparency regarding the huge off-balance sheet obligations, commitments and contingencies that are the true threat for many sovereign nations. These obligations are typically multiple times the liabilities that are on the balance sheet. In the U.S., the major drivers are the Medicare and Social Security programs for the elderly. These obligations are growing faster than inflation and faster than the economy when the economy is growing. And the U.S. is not the only country facing this future threat which is driven largely by known demographic trends and rising health care costs. Third, too much debt, not enough focus on cash flow, and over-reliance on myopic and narrowly based credit ratings. Finally, a failure of governance, oversight, and risk management functions to act in both the public and private sectors until a crisis was at the doorstep. And when that crisis came in 2008, government reacted without adequate thought and due diligence. It also acted in a manner that treated the symptoms rather than the disease, and that over-promised and under-delivered in connection with economic growth and unemployment.

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Today, the world is experiencing a range of economic challenges. There are growing concerns regarding whether we may experience another global recession. There are also significant concerns regarding the sovereign debt challenges facing a number of nations, especially in Europe. These two factors, along with others, have recently resulted in significant declines in global stock markets, dramatic increases in market volatility, and a rise in selected commodity prices, especially gold.

Given current global conditions, the U.S., and certain other major nations, must take steps to address their current weak economies, unemployment, and under-employment challenges while, at the same time, addressing the forces that are driving the large, known and growing structural deficits in future years. These structural deficits, and the mounting debt burdens they will bring, serve to threaten our collective future. The U.S. and other debt challenged countries must take steps that produce results on both of these fronts in a timely and coordinated manner. Doing otherwise will not be effective or credible.

Turning to the issue of performance and relative position, I am a firm believer that it is critical to have three key pieces of information in order to perform a credible analysis. First, what are the raw data on current performance. Second, what are the trends and projections on performance. Finally, how does one's performance compare to relevant comparator groups. These three factors are relevant for individuals, companies and countries.

Unfortunately, American elected officials do not typically benchmark the U.S. against other countries. All too many of our elected officials assume that the U.S. must rank in the top three countries in just about every key area. The truth is, we lead in many areas, but we lag in a number of important ones as well, including K-12 education performance, health care outcomes, and fiscal responsibility.

In order to measure how different nations rank relative to one another in terms of fiscal sustainability, CAI and Stanford University developed the Sovereign Fiscal Responsibility Index (SFRI). The SFRI was designed to be a “fiscal fitness” index of sorts. The related report, which was issued in late March of this year, noted that of 34 major nations, Australia was ranked number one, Greece was number 34, and the U.S. ranked an embarrassing number 28. These rankings were based largely on IMF data and analyses, and they considered such factors as a country's fiscal space, fiscal path, and fiscal governance structure.

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Fiscal Fitness Index: Overall Results (Best to Worst)

1. Australia
2. New Zealand
3. Estonia
4. Sweden
5. China
6. Luxembourg
7. Chile
8. Denmark
9. United Kingdom
10. Brazil
11. Canada
12. India
13. Poland
14. Netherlands
15. Norway
16. Slovakia
17. Korea
18. Mexico
19. Israel
20. Slovenia
21. Austria
22. Finland
23. France
24. Spain
25. Germany
26. Belgium
27. Italy
28. **United States**
29. Hungary
30. Ireland
31. Japan
32. Iceland
33. Portugal
34. Greece

Source: Sovereign Fiscal Responsibility Index.

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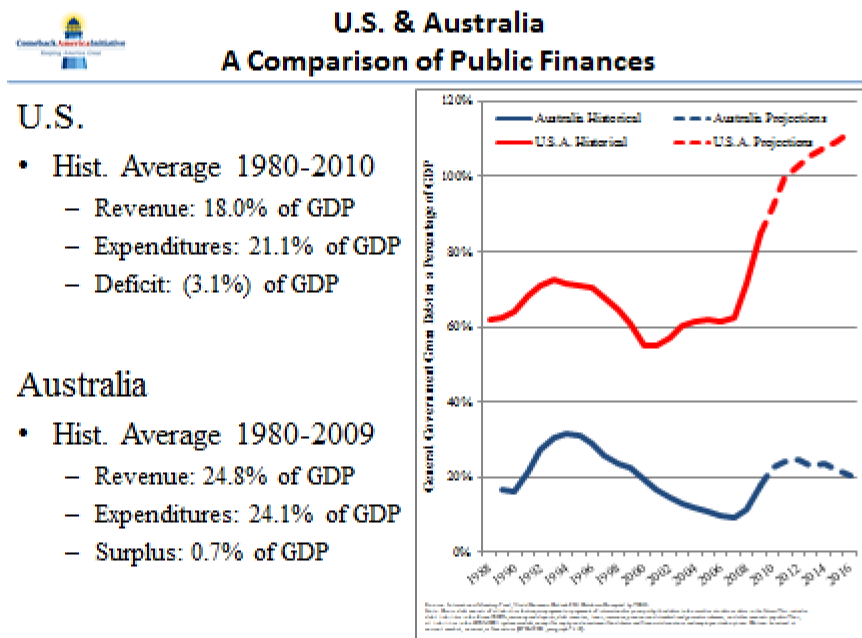
Congratulations go to Australia and condolences to Greece. Knowledgeable people are well aware of Greece's financial challenges, but it's important for more people to understand why Australia was ranked number one. More on that shortly.

As we look to create a better future, it is important to learn from the past and from others. The United States is not used to doing this, but it is critical that we do so given the serious fiscal challenges that we face. From a historical perspective, it's instructive to remember some things from Greek, Australian and even U.S. history.

Greece is the cradle of democracy. It used to be the greatest civilization on earth. It once controlled most of the known world during Alexander's time. And yet today Greece is a shadow of its past, in part because the Greek people strayed from the principles and values that made them great in the past. It's also important to note that the Greek government grew too big, promised too much, and waited to restructure until the markets forced it to. When the Greek government did act, since it had waited too long, it was forced to take dramatic actions quickly. In addition, since the government had not been open with its people, it faced civil unrest in the streets. If we don't learn the lessons of Greece, the same can happen in other countries, including the U.S. Importantly, we at CAI and others are trying to do what we can to make sure that the U.S. avoids a Greek tragedy.

Now let's explore the Australian experience. As all of you probably know, Australia faced escalating deficits and mounting debt burdens in the early 1990s. At that time Australian debt/GDP levels were relatively low but were headed up at a disturbing rate. As a result, the Australian dollar was coming under increasing pressure and the major credit ratings agencies were taking a much harder look at Australia's finances. This situation existed despite the fact that Australia's federal debt/GDP levels were considerably lower than the U.S.



Fortunately, political leaders in Australia came together and took a number of steps to address the then current challenges while also helping to put Australia on a more prudent and sustainable long-term fiscal path. This was aided, in part, by your parliamentary system and a commitment by your Prime Minister and leaders of the major political parties to act preemptively in order to avoid a debt crisis. Looking ahead and acting preemptively in appropriate circumstances is, in part, what leadership is all about.

Some of the preemptive steps by the Australian Government include passage of the Charter of Budget Honesty Act of 1998. That Act included a number of important and timeless principles designed to maintain on-going economic prosperity and welfare of the people of Australia both for the present and the future.

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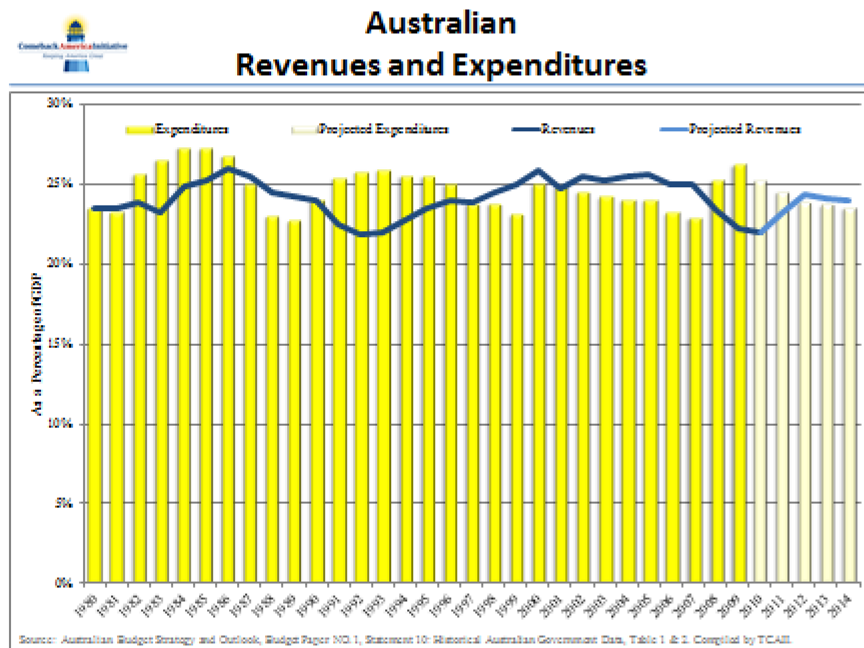
In short, the principles in the Act address the management of financial risks; promoting national saving; appropriate counter-cyclical demand management; tax burden stability and predictability, and tax system integrity, and; having regard to inter-generational equity. In order to operationalize these principles, the Australian government adopted and has maintained the medium-term fiscal target of "budget balance", on average, over the course of the economic cycle. This makes good sense and stands in stark contrast to the absence of a defined fiscal policy in the U.S. and to recent and current federal fiscal practices.



As a result of the above, Australia has put its finances in order, and your economic, employment, currency and competitiveness position and prospects have improved dramatically as a result. Australian fiscal policy has also added more incentives, transparency and accountability mechanisms to ensure fiscal responsibility and sustainability over the long term. And your culture seems to be committed to maintaining fiscal prudence over time. Clearly, the U.S. and others have something to learn from Australia. At the same time, your current and projected levels of federal spending and taxation are higher than are likely to be culturally acceptable or politically feasible in the U.S. absent a huge crisis.

Furthermore, Australian monetary policy has served to strengthen the independence of your Central Bank, while focusing its mission on an effective monetary policy that will keep consumer price inflation

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between 2-3 percent, on average, over an economic cycle. This too stands in stark contrast to the expansion and more aggressive intervention by the U.S. Federal Reserve to stimulate the economy and address unemployment, even though such actions may serve to further reduce the value of the dollar and stoke the flames of inflation over time. Just another example of short term gain while increasing the risk of long-term pain.

What about lessons from U.S. history?

In order to win America's independence and gain ratification of what arguably is the greatest political document in the history of mankind - the U.S. Constitution - the U.S. took on federal and state debt equal to 40 percent of the then total economy. Today, the comparable number is over triple that level and growing at record rates.

How did this happen? It's because our country strayed from the principles and values that made us great. Ones like limited government, individual liberty and opportunity, fiscal responsibility, and inter-generational equity. The sad but simple truth is that starting in the 20th Century the U.S. Government began to grow dramatically as a percent of the economy. Believe it or not, in 1800 the U.S. federal government was only 2 percent of the economy. It's about 25 percent today, and is headed to about 40 percent by 2040 given our present course. If you add state and local, government in the U.S. would become over 50 percent in the U.S. economy. That is both culturally unacceptable and economically undesirable.

The numbers don't lie; starting in the early 1980s the U.S. became addicted to consumption and debt. The inflation adjusted increases to the U.S. debt ceiling limit makes this clear.

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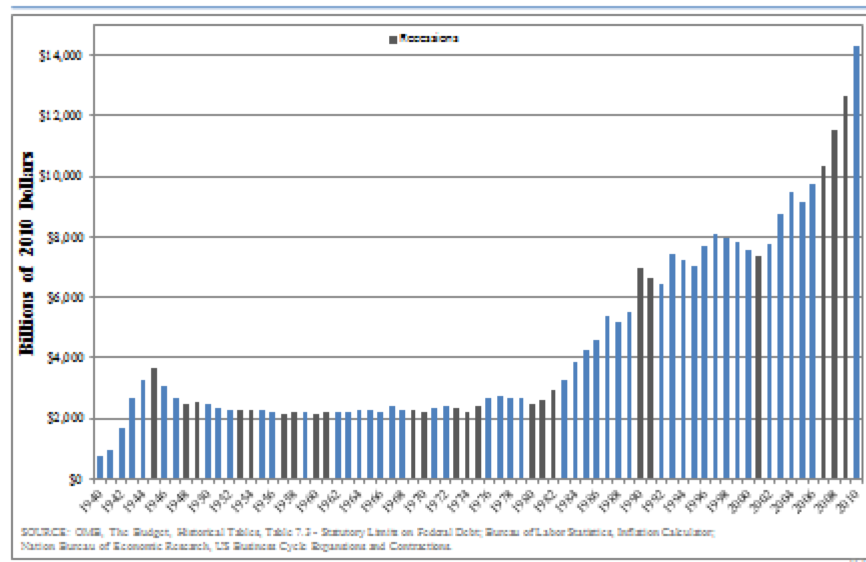
Statutory Debt Ceiling



Many economists also began to argue that deficits equal to the size in the growth of the economy were alright. This may be fine when debt levels are low, but it is not acceptable at today's levels much less tomorrow's. More importantly, if your objective is to allow for recurring deficits equal to the expected growth in the economy, rather than a balanced budget over an economic cycle, then what happens when a nation is engaged in war, faces a recession, and/or various national emergencies? Deficits escalate dramatically and debt burdens mount rapidly. That is where we are today in the U.S. And yet, our "baby boom" demographic spending tsunami lies ahead and is just beginning to hit our shores. As a result, projected U.S. fiscal imbalances are expected to escalate dramatically if social insurance programs aren't reformed, defense and other spending programs aren't constrained, and revenue levels return to and remain at the recent historical average.

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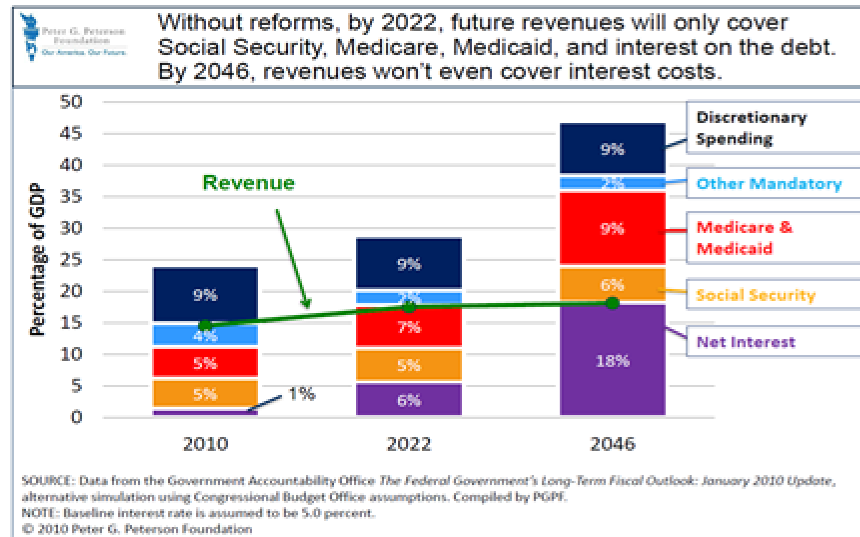

America temporarily came to its senses in the 1990s due, in part, to the political courage and individual commitment of two presidents - one Republican and one Democrat. Both George Herbert Walker Bush (R-41) and William Jefferson Clinton (D-42) did three things in common. First, they supported tough statutory budget controls that constrained spending and severely limited the federal government ability to expand programs or engage in tax cuts that would exacerbate the nation's future fiscal challenges. Second, they did not expand entitlement programs, which arguably is the most imprudent action since these programs are the hardest to reform politically. Finally, they both broke campaign promises relating to taxes when they were faced with the facts and realized that such promises were irresponsible. They went 3 for 3 and, in American baseball terms, had a perfect batting average on these issues.

Fast forward to George Walker Bush (R-43) and Barack Obama (D-44). They did exactly the opposite and went 0 for 3 in connection with these three key fiscal tests. That means, in American baseball terms, they struck out! And while George Bush's (43) record is closed, Barack Obama can change course. The real questions are- will he and if so when? I am hopeful that he will begin to do so in his widely anticipated speech in September; however, in the current environment in Washington, even speech dates result in political battles between the President and the Republicans.

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I have encouraged the White House to have the President provide specific suggestions to the Congress on steps that should be taken to help improve economic growth and reduce unemployment. He also needs to provide specific recommendations for consideration by the Joint Select Committee for Deficit Reduction that must report later this year. We MUST make progress on both our short-term economic/unemployment and structural deficit and debt challenges.

Returning to the diagnosis, the cold but hard truth is that America has strayed from certain fiscal principles and values that made it great. Namely, controlled spending, limited debt and fiscal stewardship. We must return to these if we want America to stay great and for America's future to be better than its past.

All of us at CAI are doing everything we can to help ensure that we do so sooner rather than later, and before we face a U.S. debt crisis that would be felt not just in the U.S., but around the world, including here in Australia. It is with this in mind that CAI has engaged in two important projects in recent months. The first relates to the new Sovereign Fiscal Responsibility Index (SFRI) that I mentioned earlier, and the second is our "Restoring Fiscal Sanity" report that was issued in late July. I will discuss this report a little later.

All of you are aware of our recent debate regarding the U.S. debt ceiling limit. I must say that, from my perspective, the debate was both disturbing and embarrassing. It showed how dysfunctional our political system has become, and how Washington has become a place dominated by laggardship rather than leadership. As a result, it is clear that the U.S. needs to engage in a range of political as well as policy reforms in order to create better future. These political reforms are beyond the scope of my talk but I would be happy to answer any related questions.

While we clearly needed to raise the debt ceiling limit, we also needed to do something concrete to demonstrate that we were going to begin to address the structural deficits that lie ahead. These are driven by social insurance programs, defense and other spending, and our outdated tax system. However, we should not have waited until less than 12 hours before hitting the wall, and our political leaders should have achieved a much more substantive deal than the one they struck.

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The debt ceiling debate and resulting agreement caused S&P to downgrade U.S. Debt from AAA to AA+ for the first time in history. They did so due to serious concerns regarding the ability of Washington to make the tough choices necessary to restore fiscal sanity, and due to the failure to achieve at least $4 trillion in deficit reduction over the next 10-years. S&P was severely criticized for their action and both Moody's and Fitch did not follow their lead; however, they may in the future if the U.S. does not start putting its fiscal house in order soon.

The special Joint Select Committee for Deficit Reduction that was created by the debt ceiling legislation is set to report by November 23. That bipartisan and bicameral Committee of 12 is supposed to come up with at least $1.5 trillion in additional deficit reduction over 10-years. If they don't, $1.2 trillion in automatic spending cuts will take place.

In my view, given recent events, the new Joint Select Committee should seek to achieve at least $3 trillion in additional deficit reduction over the next 10-years rather than their $1.5 trillion target in the legislation. I hope the new Joint Select Committee is up to the task but the composition of the Committee is not a cause for great optimism.

Irrespective of what the Joint Select Committee does, most major social insurance and tax reforms will not occur until after the 2012 election. In my view, it is critically important that the U.S. engage in a fact-based, non-partisan and solutions oriented citizen education and engagement effort in order to pave the way for needed transformational reforms. It is wholly unrealistic to expect for major social insurance and tax reforms to occur without actively engaging the American people beyond Washington, DC, including in new and unprecedented manners.

On a somewhat different historical note, even our own accounting profession's history can provide some valuable lessons for the current U.S. fiscal situation. As we all know, Arthur Andersen went from the global gold standard for a professional services firm to G-O-N-E in less than two years for several reasons. First, based on my experience as a partner from 1989- 1998, the firm strayed from the principles and values that made it great. Second, several years after I left the firm to become Comptroller General, a few people did not do their job and leadership did not take it seriously enough. Third, the government over-reacted and indicted the firm rather than the responsible individuals. As a

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result, even though the Supreme Court ruled that the government over-reached, the market took over and put Andersen out of business.

Washington elected officials need to learn the lessons from history and the experiences of other countries, including Australia. American policymakers also should recognize that steps need to be taken to ensure that we do not experience a double dip recession, and work to bring down unemployment in the near-term, while also beginning to take concrete and credible steps to defuse our ticking debt bomb. As I said previously, we must do both and soon.

It is with this in mind that CAI developed and published the "Restoring Fiscal Sanity" report. That report provides a clear, concise and compelling summary of the current U.S. financial position and long-range fiscal outlook. It also includes two fiscal frameworks with specific illustrative reforms designed to avoid a U.S. debt crisis and restore fiscal sanity. The report addresses the budget process and needed controls, as well as illustrative reforms in all major budget categories, including our major social insurance programs, defense and other spending, and comprehensive tax reform. The “bottom line” is that both frameworks put everything on the table and result in much lower debt/GDP levels over time.

Time does not allow, nor would you probably like me to cover the proposed reforms in detail. However, I will be happy to answer any questions that you may have after I complete my remarks. The below summarizes the key fiscal implications of the two illustrative frameworks and compares them to several other recent U.S. fiscal reform proposals. You can also find a copy of this report, the SFRI report, and other valuable information on CAI's web site at www.tcaii.org.

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Comparison

	Baseline		EPI		CAI Preemptive Framework	
	2021	2035	2021	2035	2021	2035
Receipts	20.8%	23.3%	21.6%	24.1%	20.8%	21.5%
Outlays	24.0%	28.3%	24.5%	27.8%	21.8%	23.1%
Deficit*	3.2%	5.0%	2.9%	3.7%	1.0%	1.5%
Debt	76.7%	91.5%	76.5%	81.7%	62.9%	51.4%

	CAI Reactive Framework		Heritage		Fiscal Commission	
	2021	2035	2021	2035	2021	2035
Receipts	20.8%	21.5%	18.3%	18.5%	20.3%	21.0%
Outlays	20.1%	21.8%	18.1%	17.7%	21.8%	21.0%
Deficit*	-0.7%	0.3%	-0.2%	-0.8%	1.6%	0.0%
Debt	50.9%	28.2%	58.2%	30.0%	68.5%	40.0%

Note: Fiscal Commission data for 2021 is from the Commission for a Responsible Federal Budget re-estimate of the Fiscal Plan and data for 2035 is taken from the assumptions found within the Fiscal Commission report "The Moment of Truth". Deficit*: Negative numbers represent surpluses.

Now that I have discussed selected sovereign fiscal challenges, it's appropriate to discuss certain issues relating to the credit ratings agencies and our own profession. With regard to the ratings agencies, there has been significant controversy in the aftermath of S+Ps down grading of U.S. debt. While some of the criticism is valid, some of it is not. In any event, in my view, the recent criticisms miss the "big picture" point.

The objectives and approaches of major ratings agencies are outdated in the case of sovereign debt, especially in connection with the U.S. Specifically, they are very myopic and narrowly focused. Ratings agencies typically look out 12-24 months. In addition, they are focused solely on default risk and do not give adequate consideration to off-balance sheet obligations, interest rate risk, and currency risk in the case of foreign investors. In the case of the U.S., these are all very serious and relevant factors for an investor in U.S. Treasury securities to consider. It's time for these agencies to modernize their approaches.

In the case of the U.S., America will never default on its debt. Why? Because the Fourteenth Amendment to the U.S. Constitution guarantees payment to U.S. debt holders and veterans pensions. It does not; however, guarantee payment of anything else. In addition, the U.S. has the ability to print

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money to pay its debts since it issues debt in its own currency. At the same time, doing so would be both inflationary and negative for the value of the U.S. dollar over time. I note that the U.S. Dollar has already declined in value in recent times to the point where both the Australian and Canadian dollars are now worth more than the U.S. dollar.

Beyond needed reforms by the ratings agencies, our own accounting profession is in need of additional reforms in connection with accounting/reporting and auditing practices. First and foremost, we need to continue to move to principle-based and global standards. These can be supplemented but not supplanted by national regulatory agencies from a disclosure standpoint if they find it necessary to protect the public interest. I and many others are looking forward to the Securities and Exchange Commission's ruling concerning the use of IFRS for public companies traded on U.S. Exchanges.

Government accounting and reporting standards also need to be enhanced in connection with social insurance obligations and intra-governmental debt. More emphasis of fiscal sustainability and inter-generational equity is also in order. I am pleased to say that considerable progress was made in the U.S. during my tenure as Comptroller General in these areas, but more progress is needed.

I also believe that additional emphasis needs to be placed on performance reporting. After all, the public needs to understand what results are being achieved with the resources and authorities that governments have been granted.

From an auditing perspective, our profession also needs to recognize that issuing "going concern" opinions when an entity is within one year of failing is a little late and wholly inadequate when dealing with sovereign nations. Therefore, auditors need to use emphasis paragraphs in their audit opinions to point out clear and compelling dangers that lie on the horizon. I did so as Comptroller General of the United States in connection with the U.S. Government's financial statements, and I encourage other external auditors of government entities to do the same in appropriate circumstances.

As I bring my remarks to a close, all of us should remember that the law and professional standards represent the floor of acceptable behavior. Ultimately, true leaders will do what is right even if it may not be popular. Let us hope that our government, our profession, and other leaders will have the

patience, persistence and perseverance, and be willing to undergo the pain that comes with transformational change efforts before one prevails. But prevail we must.

Let us work together to help improve our countries and profession for both today and tomorrow. Thank you again for the opportunity to deliver the Ken Spencer Memorial lecture.

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