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National Commission on Fiscal Responsibility and Reform

Statement of

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Thank you for the opportunity to testify today on America's fiscal outlook. I speak to you today as an investor in U.S. companies and a forty-year financial professional. I am the managing partner of Hanover Investment Group, a market advisory firm that specializes in helping asset managers navigate significant changes in fiscal conditions. I am also vice chairman of the Governing Board of INETeconomics.org and co-founder of the Partnership for America's Economic Success.

Prior to Hanover I was a partner in Tudor Investment Corporation for fifteen years and responsible for its global policy analysis. As you may know, Tudor is an asset management company active in commodity, currency, bond and equity markets worldwide. Before Tudor, I served as Policy Director for the American Bankers Association, where my work focused on facilitating development of the Resolution Trust Corporation and solving the U.S. Savings & Loan problem. I began my career at the Federal Reserve Board of Governors in the early 1970s and served as a senior staff member of both the House Financial Services Committee and the Senate Banking Committee in the 1980s.

Please note that my testimony is solely my own and should not be regarded in any way as representing the views of any member of the advisory boards of Hanover Investment Group, INET, the Partnership for America's Economic Success, or any of their affiliate institutions or organizations.

The essence of what I have to say today is this. Global wealth is rising. Human capabilities, technical knowledge and cross-border collaboration -- the sources of true wealth -- continue to expand worldwide. Ten or fifteen years from now, advances in almost every area of human endeavor will mean few of us would want to go back to the current period. However, between then and now a lot can happen. There is much to be optimistic about, but this was also true in the years before some of the most disruptive turns in U.S. history. Fiscal conditions put us again at such a point. What this commission does in the next six months will shape America's future in profoundly important ways.

Investors need three things from this commission --

1. Spending, tax and regulatory principles that make moral and economic sense to families and business people and assure that scarce resources will be allocated to high-return economic activities.

2. Actions that unify citizens and stop the worsening trend toward government service cutoffs and civil disruption, and that respect the fact that American's aren't going to tolerate a fiscal adjustment that is shaped by power-politics or unfairness.

3. Recommendations for year-by-year revenue and spending targets that over the next 10 to 15 years will bring the U.S. budget into sustainable balance, and a framework which guarantees that this time, the revenue and spending targets will be met.

If this commission does not give investors reasons to believe the U.S. is going to solve its budget problem, it will give them a reason to sell stocks heavily. The combination of commission and government inaction will cause investors to begin to subtract the present-value of spending cuts and tax increases from company bond and stock prices. Investors will sell bonds and stocks until their prices are in line with fiscal-cost adjusted valuations. To prevent such a U.S. stock market sell-off, this commission needs to anchor investor expectations in a bedrock view that the U.S. government is going to solve its fiscal problem.

If this commission's actions do not serve to unify citizens, it will deepen divisions that are splitting our nation into warring factions and diminish investor hopes that the U.S. has the political will to get its budget back on track. This commission must be a model of bipartisanship. If you are not, you will confirm the market's worst fears that Congress is crippled by partisanship, is unable to act in advance to prevent a crisis and a crisis is therefore inevitable.

If this commission cannot identify an economic priority that makes the economy stronger, it will contribute to making it weaker. The true key to innovation, competitiveness and fiscal sustainability is American human capital. We can achieve none of our economic goals if we cannot strengthen our families and improve child nutrition and healthcare, early child care and education, and elementary and secondary education. This commission should state categorically that while there are many things on which it cannot agree, all its members do agree that the U.S. government should place its greatest emphasis on strengthening American human capital.

This commission should consider adopting the State and Federal Resource Allocation Principles proposed by the Partnership for America's Economic Success. If this commission cannot establish a set of principles on which to make tough budget choices, those choices will be made by raw political power. Resources allocated this way rarely unify voters or strengthen the economy. Amend the PAES guidelines as needed, but do not fail to come forward with an agreed-upon set of tax and spending principles that make economic and moral sense to families and business people and assure that scarce resources will be allocated to high-return economic activities.

Budgets and civil commitments

Budgets are not about money alone. Government budgets express the fabric of civil commitments that citizens have made to each other over many decades. Those commitments – public safety, education, good roads, freedom from government over-regulation, and reasonable taxes -- are built into local, state and federal budgets. People organized their families and businesses around these commitments. The very slowness with which they accumulated and were reaffirmed year after year in budget legislation, attested to their firmness and reassured people they could safely organize our lives around them.

When we talk about a budget crisis, it is a crisis not because there is not enough money. It is a crisis because the fabric of our society is being ripped apart, threatening families and businesses. The main responsibility of this commission is to assure voters and investors that the fabric of our society will be preserved. To do this it must to identify a priority or commitment so compelling, that if we can be assured that this commitment will be met, we will be agreeable to adjusting the others and constructing a new framework of civil commitments peacefully and cooperatively.

Bringing U.S. fiscal conditions back into sustainable balance will require adopting a set of Fiscal Rules.[1] Agreement on fiscal rules requires a political consensus, and a consensus requires broad voter belief that their most important civil priorities will be met. Voters understand that major changes are needed. They know the old civil commitment framework is unsustainable. To support and participate quickly and smoothly in building a new one, voters need to know that the principles that will guide how fiscal rules are implemented are ones that put their highest life interests first.

Commission values and principles

Ten years ago, Bill Seidman was running from meeting to meeting in Tokyo trying to persuade Japanese leaders to restructure their banks and agencies. Because I had a small role in the political side of the U.S.

S&L restructuring, he asked me to attend some meetings with him. In the meetings, Seidman repeatedly stressed key restructuring steps beginning with establishing a sense of urgency, building a re-engineering coalition and communicating a vision. I later learned these steps were the first three of eight components that Harvard Business School researchers found characterized all successful business and institutional restructurings. The eight tests had been described six years earlier in John Kotter's book *Leading Change*, and to an important degree the validity of the tests was based on Seidman's S&L restructuring success.

The tests are universal in the sense that they're not about business, they're about human behavior. Accordingly, they apply to corporate, institutional, and even national restructuring efforts. They can be used by asset managers to judge institutional and political risks. If the tests aren't being met, risks are probably still rising.

In the Harvard framework there are eight tests or steps in every successful restructuring. The first three are: (1) Is there a visceral sense of <u>urgency</u> sufficient to motivate action? (2) Is there a guiding <u>coalition</u> strong and broad enough to accomplish the restructuring? (3) Has a compelling <u>vision</u> of what the restructuring will accomplish been developed? These are the eggs, flour and milk of a cake recipe. There are more steps to making the cake, but if you don't have the first three, there's little need to talk about the others.

In the U.S., so far, a sense of urgency about fiscal conditions strong enough to drive real action doesn't exist. There is wide awareness of the arithmetic of U.S. budget conditions and deepening fear, and steps are being taken – such as this Commission – to deepen public understanding, but there is little sense yet of a need to actually take action.

Coalition? Despite near universal awareness, there is no coalition with sufficient power to guide and keep fiscal restructuring on course, and political polarization makes building such a coalition more difficult.

Vision? This is the most critical deficiency. So far, there is no unified, clear, values-based yet pragmatic vision of fiscal reform. Economists and pundits, with the casualness that comes only from experts whose ox's are not being gored, urge the U.S. to impose VAT-type sales taxes, eliminate subsidies to housing, healthcare, and agriculture, and make "sensible adjustments" to entitlements like Social Security. When asked how to enact these in a democracy, they become as mute as a child asked to solve a nuclear physics problem. Serious institutions like the Peterson-Pew Commission on Budget Reform and the Center for Budget and Policy Priorities are digging deeper, weighing and offering concrete ideas on technical process changes and detailed spending cuts and tax increases. These helpfully inform members of Congress, but as yet, they have not coalesced into a vision that can persuade voters.

In slowly evolving crises, such as this one, a vision usually needs an event that eliminates debate and squeezes out extraneous considerations. The event – a tipping point – boils matters down to their essential elements and crystallizes action. Pearl Harbor did this in 1941. The South's capture of Fort Sumter did it in 1861. For a vision we need, then, two things – a values-based, economically sensible set of principles that voters can support, and an event to unleash it. So far, we have neither.

Values and principles in budget decision-making

This commission needs to establish a set of principles on which to base tough budget choices and reshape our civil commitments. Boiling choices down to their basic, underlying values can help clarify difficult problems and inform decision-making. Expressed as principles, these values are essential for building public support for the choices our country needs to make. Absent chosen principles, decisions will be made on the basis of raw political power. Resources allocated this way rarely unify voters or strengthen the economy.

The principles this committee adopts need to make practical sense to families, businesses and government leaders and be applicable in pragmatic ways across all tax, spending and regulatory policies. With these criteria in mind, the Partnership for America's Economic Success offered the following public-investment principles:

1. **Human Capital –** To achieve economic growth and fiscal sustainability, government should emphasize strengthening the skills and capacities of America's workforce.
2. **Young Children –** In developing human capital, our nation should focus especially on children, from before birth to five years of age, and their families.
3. **Evaluation –** Return on investment should be a key consideration in public resource allocation decisions.
4. **Transparency –** Government should enable citizens to understand and participate in the assessment of revenue and spending decisions.
5. **Sustainability –** State and federal budgets should be viable over the long term.

This commission should consider the proposed Partnership guidelines and amend them as needed, but in no circumstance come forward without a set of budget principles on which it can agree. If the commission fails to issue a unified report, it will signal to investors worldwide that the U.S. government will not likely be able to avert a fiscal crisis.

The Partnership principles are forward looking. They put the life success of the next generation first in budget decision-making. They reflect the strongest values of family strength, quality child care, nutrition, health and education, and the strong involvement of seniors. If this Commission were to adopt these principles, it would provide the U.S. government with a values-based, economically sensible vision for how resources should be allocated.

This set of principles in combination with a disciplined set of revenue and spending targets for the next 10 to 15 years, would provide what investors need. The combination of economically smart principles and disciplined fiscal targets would unify voters, make moral and economic sense, and signal to Congress and the White House that their political decisions need to comply with the fiscal targets and put kids-first.

Putting families and kids first as the Partnership principles do, is not a new idea. It is and has always been a very simple and very clear idea. When the ship is sinking, children and families get on the lifeboats first and the rest of us go to the highest part of the ship and sing "Nearer My God to Thee".

Economic growth and human capital

The Partnership principles focus on human capital because our most important economic resource is our people. The strength of families and the quality of child care and education directly determine the quality of our workforce, global competitiveness, productivity, growth and job creation. All of our innovation, energy independence, and especially budget sustainability depend on our workforce. As House Budget Committee Chairman said a few months ago, "If we don't get human capital right, little else matters."[2]

Over 40 million foreign workers enter the world's labor force every 12 months. In just 48 months the new entrants exceed the number of people in the entire U.S. labor force. They may not be as educated in general as Americans yet, but they are as fit and as disciplined and willing to work. The emerging economies where these people live are no longer just places where our cell phones and computers are made. They are becoming centers of innovation and breakthrough technology in everything from information science to health care. They work and save. We consume and borrow. The results are debts we owe to them of almost incalculable size and evidence everywhere of our failure to invest adequately in our people.

Importantly, raising and educating our future workforce accounts for over 10% of U.S. GDP. About 195 million Americans are involved in raising children – roughly 80 million mothers, 60 million fathers, and 50 million grandparents[3], and at least 5 million others involved in providing the goods and services children need[4]. This is over half the U.S. population.

Americans routinely think of agriculture, manufacturing and finance as essential, identifiable economic sectors. But oddly we do not think of raising children this way. If asked, we have no problem saying what the farming, manufacturing and banking sectors do. But when it comes to raising children, we tend to think of teaching, education, toys and the other aspects of children's lives as separate activities.

Business people, however, know nothing gets made or sold without people and that their employees are the most important input in producing and delivering everything. In all, there are about 155 million U.S. workers[5], and 139 million are employed by businesses[6]. Most executives see their main responsibility to be human-resource management.

Clearly people are a critically important input to our economy. Without team-ready, educated, healthy young adults prepared to enter the workplace or college, there would soon be no economy. The priority this commission places on youth human capital development will determine in important ways whether we have a strong competitive future workforce, which in turn will determine whether we have any hope of achieving budget sustainability.

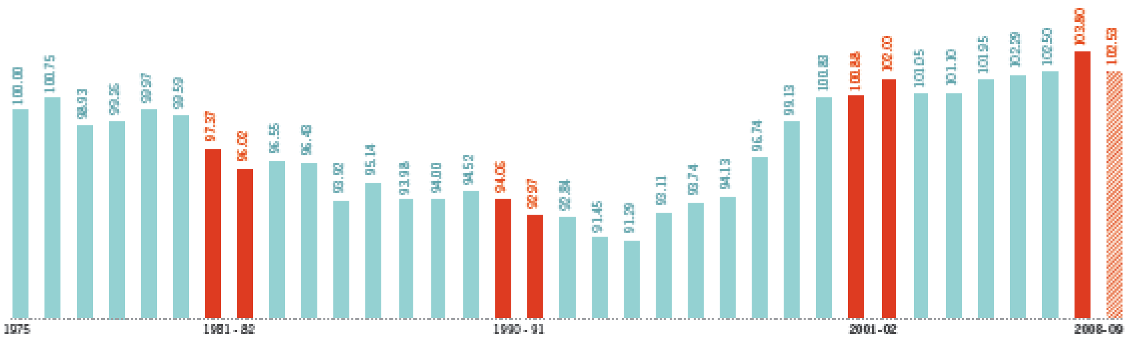
The evidence we have in hand is not encouraging on this point and underscores the need for this commission to make human capital and the life success of every child in America the U.S.' top budget priority. The most recent broad assessment of the performance of the entire youth human capital sector was done in 2007 by the Defense Department. Though designed to focus narrowly on preparedness for entry into the armed services, it provided an important insight. The Defense Department study found that more than 75% of U.S. young adults 17 to 24 years-old cannot qualify to serve in the military. They cannot qualify because they lack high school degrees, clean criminal records, or adequate fitness.[7] Business executives in complex technologically advanced companies have told me that their health and fitness standards are more relaxed than the military's, but they estimate that more than 60% of young adults can't qualify to work for them for the same reasons.[8] For the military, the portion of the economy that raises, educates and provides all the goods and services children need to grow up right, is performing at about a 25% success rate. For the modern business sector, the success rate is perhaps as low as 40%.

Other often cited evidence indicates the U.S. has fallen behind most developed nations in the past thirty years. Programme for International Student Assessment (PISA) and National Assessment of Education Progress (NAEP) scores, and No Child Left Behind Act (NCLB) and high school graduation data, indicate that United States has fallen to 25th among developed countries, high school graduation rates have deteriorated relative to the needs of our economy, and racial and ethnic achievement gaps have widened. We are not building the stock of human capital we need to replace the human capital created by the investments in family, health and education in the 1940s, 50s, and 60s.

Improved U.S. performance in youth human capital development will almost certainly improve long-term economic performance directly. Near-term, because the sector is so large, expenditures in it will affect the economy directly. Moreover, improvements in the youth human capital sector will affect how well other sectors perform. A hospital will be more productive if a call-center employee is herself more productive because she is confident she is being a good parent and her daughter is being well cared for in a near-by quality early education center.

The young adults covered by the Defense Department study were young children in the early 1990s. They likely were affected by the economic downturn that occurred when they were very young. Researchers at the Foundation for Child Development at Duke University developed an index of child wellbeing that may have a bearing on the Defense Department findings. Notice in the chart below how deeply the wellbeing data deteriorated in the early 1990s.[9] If the Defense Department findings do reflect early 1990s economic conditions, we can expect to see an improvement in the job-readiness of young adults in seven or eight years when children who were very young in the late 1990s reach young adulthood.

Child Wellbeing Index



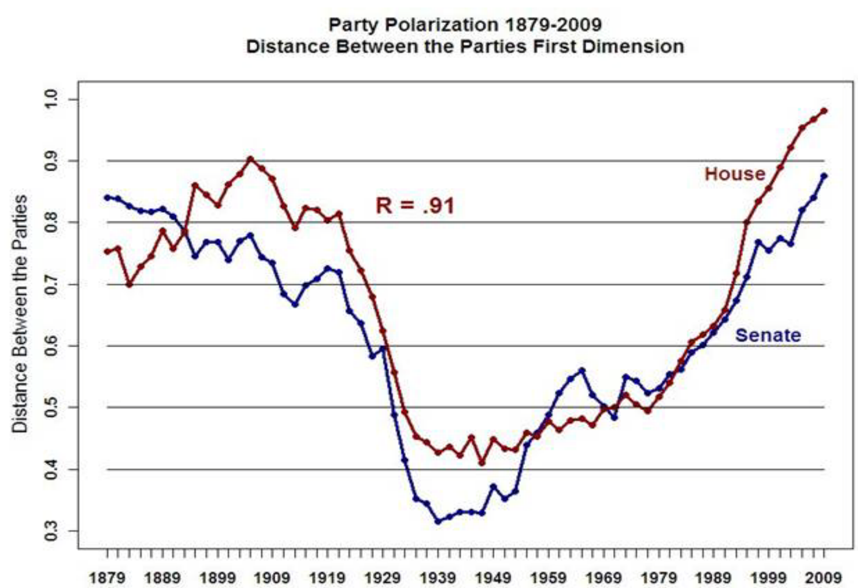
Foundation for Child Development, Duke University

The data in the chart run only through 2009. If we extrapolate the depth and likely duration of the current downturn, we can begin to get a sense of what the future holds for young adult job-readiness.

Solving our human resource problem is going to require the best efforts of every one of us, even our seniors. Family strengthening, nutrition, healthcare, quality child care and education, and the reinvestment of the life experience and wisdom of older American's in the lives of younger ones are urgently needed. The priorities and principles this commission establishes will determine whether we have the workforce we need in future years.

Budgets and political polarization

Economists talk about the current downturn in terms of the 1930s. Politically the two periods are very different, and the difference will likely make the economics very different too. Inter-party struggle has risen above the highs of the last 150 years. The chart below provides a historical overview.[10] Polarization began to rise quickly in the early 1980s when worries about the Social Security System surfaced and the U.S. began to rely heavily on inflows of foreign savings.



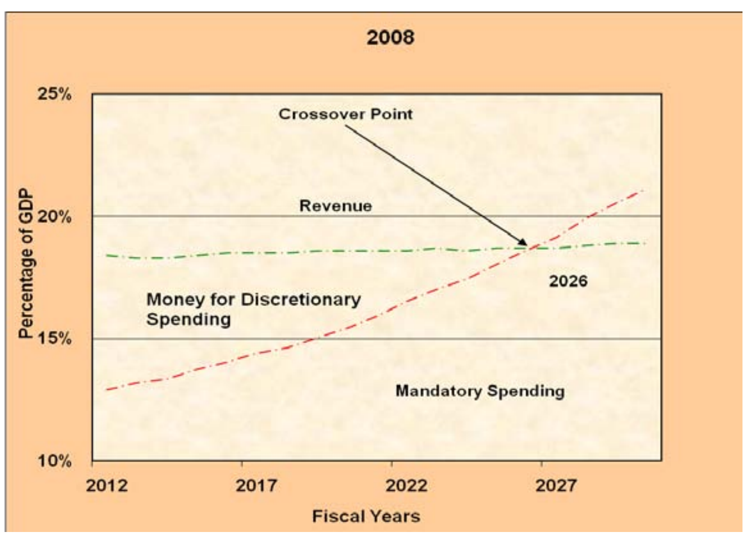
In our analysis the shrinking gap between revenues and expenses is the main driver of polarization. Political polarization began its upward march in the early 1980s when Congress first became alarmed about Social Security's sustainability and the U.S. began to rely heavily on inflows of foreign savings. As the U.S. current account deficit deepened and fiscal deficits became more persistent, polarization intensified.

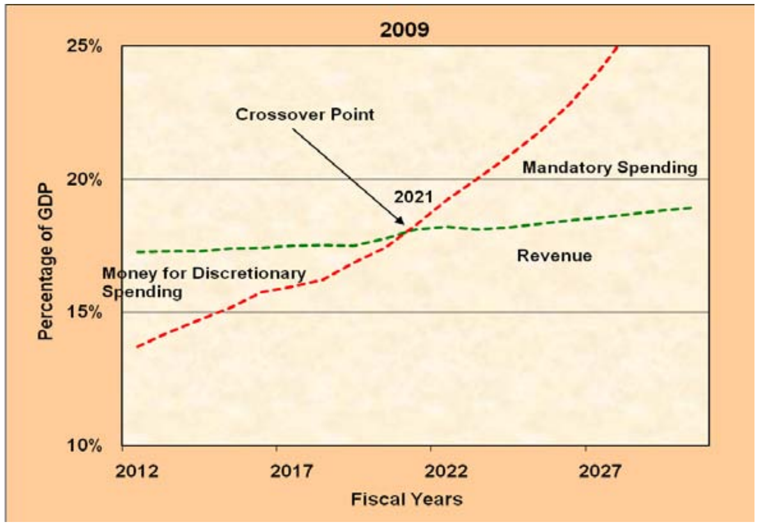
In 2008 budget agencies projected that mandatory spending would use all revenues by 2026, just 18 years in the future. That is, they showed that in 18 years the revenue and mandatory spending lines would cross, leaving no revenue for discretionary spending without huge tax increases, spending cuts or rising deficits, even under favorable economic conditions. Then things got much worse. As the charts below show, the crossover year moved nearer, from 2026, to 2021, and then to 2019, where it is today. As the crossover year drew closer, partisanship deepened further. As budgetary oxygen materially declined over the past two decades, politicians started fighting for air.

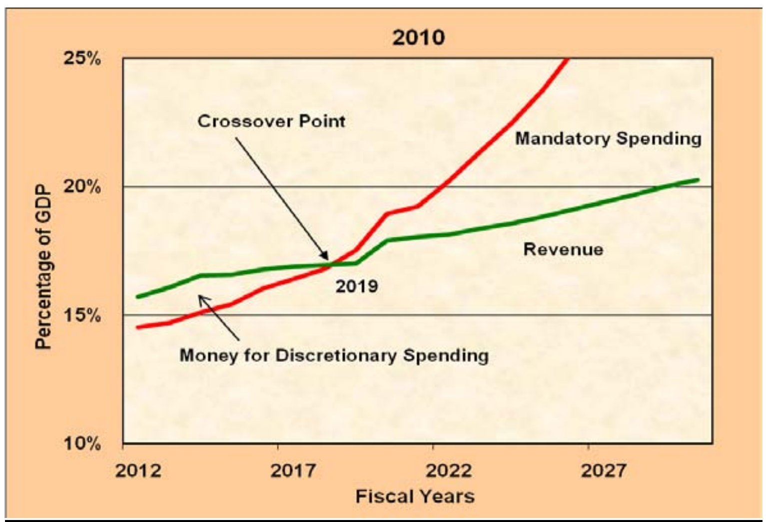
In the charts below, note how quickly the revenue and mandatory spending lines converge and squeeze "Discretionary Spending". Discretionary spending is annual appropriations for government activities such as air traffic control, federal courts and prisons, the CIA and FBI, homeland security, national defense, foreign aid, parks, highways, etc. – and earmarks, the increasingly vital lubricant of political deal-making. "Mandatory Spending" includes Social Security, Medicare, and other statutory entitlements, and interest on federal debt, which also must be paid to avoid default. "Revenue" is total federal revenues. All are expressed as a percent of GDP. The triangle formed by "Revenue" and "Mandatory Spending" is what's left for "Discretionary Spending" – before having to resort to unsustainable borrowing.

In 2008, revenue available for "discretionary spending" was declining almost half a percent a month -- 5.5% per year, 33% every six years, zeroing out in 18 years. To get a sense of what this means, imagine Americans locked in a room with the air turned off and told in 18 hours there will be no oxygen left. As people sense the problem, they begin to jostle for air. As hours go by, things get grim. That is where we are now and unless this commission can provide a compelling framework for making tough choices.

Fiscal Outlook in 2008, 2009 and 2010
Mandatory Spending Exceeds All Federal Revenue at Steadily Earlier Points
Absent Very Large Spending Cuts or Increases in Taxes or Deficits Mandatory Spending







U.S. fiscal condition in comparison to others

Before turning to a discussion of the possible market effects of commission inaction, it is useful to have a sense of how the U.S. compares to other developed economies. The table below from the IMF report, *Fiscal Monitor: Navigating the Fiscal Challenges Ahead, May 2010*, shows in detail the amounts of fiscal adjustment needed to achieve primary balance in 2030 for 22 advanced economies.[11]

The table obscures important differences among countries. While the 2008 crisis has been a factor, some countries are experiencing a sizable, simultaneous deterioration of structural balances unrelated to the crisis (e.g., Japan and the United States). For others structural imbalances have been deepened by the crisis (e.g., Ireland, Spain, the United Kingdom). Still other countries entered the crisis with relatively high initial structural deficit levels that would have required adjustment even in the absence of the crisis (e.g., Greece, Portugal). Finally, for a few countries the adjustment need is almost entirely the result of high pre-crisis debt levels (e.g., Belgium and Italy).[12]

The average adjustment needed for the G-20 advanced economies to regain debt to GDP stability is 9.3 percent of GDP between 2010 and 2020. Summarizing the IMF's Debt and Primary Balances table, we can see that the amount of fiscal adjustment needed to bring U.S. debt ratio back down to 60 percent of GDP in 2030, is one of the higher amounts among developed economies.

Economy	Required Adjustment Between 2010 and 2020
Germany	4.0
Canada	4.4
Australia	5.2
United Kingdom	9.0
Greece	9.2
Spain	9.4
Ireland	9.8
United States	12.0
Japan	13.1

Table 1. Advanced Economies: Needed Fiscal Adjustment— An Illustrative Scenario (Gross Debt Target)
(In percent of GDP)

	Current WEO Projections, 2010			Illustrative Fiscal Adjustment Strategy to Achieve Debt Target in 2030	
	Gross Debt	Primary Balance	Cyclically Adjusted Primary Balance	Cyclically Adjusted Primary Balance in 2020-30	Required Adjustment betw een 2010 and 2020
Australia*	**19.8**	**-4.7**	**-4.6**	**0.6**	**5.2**
Austria	**70.7**	**-3.0**	**-2.4**	**2.2**	4.7
Belgium	**100.1**	**-1.4**	**-1.1**	**3.6**	4.7
Canada	**83.3**	**-4.3**	**-2.2**	**2.2**	4.4
Czech Republic	**37.6**	**-3.7**	**-2.4**	**1.2**	**3.7**
Denmark	**51.2**	**-5.1**	**-3.1**	**1.2**	**4.3**
Finland	**49.9**	**-5.1**	**-3.0**	**1.4**	**4.4**
France	**84.2**	**-6.0**	**-4.6**	**3.7**	8.3
Germany	**76.7**	**-3.4**	**-1.6**	**2.4**	4.0
Greece*	**133.2**	**-2.4**	**-2.4**	**6.8**	9.2
Hong Kong SAR	**0.6**	**-1.4**	**-3.5**	**0.3**	**3.8**
Iceland	**119.9**	**-2.7**	**1.7**	**2.6**	0.9
Ireland	**78.8**	**-10.0**	**-6.0**	**3.8**	9.8
Israel	**77.5**	**-1.3**	**-1.0**	**1.8**	2.8
Italy	**118.6**	**-0.8**	**0.9**	**5.0**	4.1
Japan*	**227.1**	**-8.3**	**-6.5**	**6.7**	13.1
Korea	**33.3**	**2.5**	**2.8**	**-0.5**	**-3.3**
Netherlands	**64.2**	**-4.1**	**-3.4**	**2.1**	5.5
New Zealand	**30.3**	**-2.8**	**-0.4**	**0.5**	**0.9**
Norw ay*	**53.6**	**8.3**	**8.5**	**8.6**	**0.1**
Portugal	**86.6**	**-5.6**	**-4.1**	**3.7**	7.8
Singapore	**88.0**	**-3.0**	**-2.7**	**2.1**	4.7
Slovak Republic	**37.3**	**-4.2**	**-3.2**	**0.8**	**4.1**
Slovenia	**35.2**	**-4.9**	**-3.3**	**0.7**	**4.0**
Spain	**66.9**	**-8.7**	**-5.8**	**3.6**	9.4
Sw eden	**42.9**	**-4.0**	**-1.6**	**0.7**	**2.3**
Sw itzerland	**39.8**	**0.1**	**0.8**	**0.0**	**-0.8**
United Kingdom	**78.2**	**-8.8**	**-5.4**	**3.6**	9.0
United States*	**92.6**	**-9.2**	**-7.6**	**4.4**	12.0
Average (PPP-weighted)	**97.8**	**-6.5**	**-4.9**	**3.8**	**8.7**
Advanced G-20	**104.4**	**-7.0**	**-5.3**	**4.0**	**9.3**
Higher debt	**106.4**	**-7.2**	**-5.5**	**4.2**	**9.7**
Lower debt	**32.7**	**-0.9**	**-0.4**	**0.8**	**1.1**

Sources: April 2010 *WEO* and IMF staff estimates.
Notes: The table reports gross debt; for some countries with sizable assets, net debt is considerably smaller. CA balances are reported in percent of nominal GDP (in contrast to the conventional definition in percent of potential GDP). General government data are used where available. In the illustrative fiscal adjustment strategy, the CAPB is assumed to improve gradually from 2011 until 2020; thereafter, it is maintained constant until 2030. The last column shows the CAPB adjustment needed to stabilize debt at the end-2012 level by 2030 if the respective debt-to-GDP ratio is less than 60 percent (no shading, "lower debt"); or to bring the debt ratio to 60 percent in 2030 (shaded entries, "higher debt"). The analysis is illustrative and makes some simplifying assumptions: in particular, up to 2015, an interest rate–growth rate differential of 0 percentage point is assumed, broadly in line with *WEO* assumptions, and 1 percentage point afterward regardless of country-specific circumstances.
* For Australia, the figures do not take account of the latest federal government budget, released on May 11, which envisages a return to federal government surpluses by 2012/13. Data for Greece are based on the assumption that adjustment amounting to 7.6 percent of GDP (as in the authorities' program) is implemented in 2010. Illustrative scenarios for Japan are based on its net debt, and assume a target of 80 percent of GDP, which corresponds to a target of 200 percent of GDP for gross debt. For Norway, maintenance of primary surpluses at their projected 2012 level is assumed (primary balance includes oil revenue whereas elsewhere in this document the non-oil balance is shown). For Portugal and Spain, the figures do not reflect additional deficit reduction plans announced May 10. For the United States, the CAPB excludes losses from financial sector support.

Market effects of commission inaction

Fortunately few people now believe that a high price means an asset is inherently valuable. The last few years have put to rest the flawed idea that markets are "rational" and reflect all information about underlying assets. We all now know, or should know, that markets can hold on to mistaken beliefs and ignore important information for a long time. At some point, however, an event or a particularly incongruent piece of information, or the movement of more far-sighted investors, cracks the beliefs, and a cascade of selling occurs.

The most recent example is Greece. It taught investors that what they thought were fiscal imbalances that would not be a problem for many years in the future, can actually wreak havoc on asset prices now. As the projected fiscal shortfalls increase, the ultimate amount of tax hikes and spending cuts also increases. This burden is like an off-balance sheet liability. As more and more asset managers incorporate this liability into their analysis of the value of corporate bonds and stocks, they want higher rates of return to cover fiscal risk.

Until Greece, no one thought much about fiscal adjustment costs, or if they did, they thought about them in the way many politicians still do – something that does not need to be dealt with until far in the future. The Greek experience showed us that fiscal adjustment costs can be calculated and these costs have a present-value, which can affect markets now.

Commission and government inaction will cause investors to begin to subtract the present-value of spending cuts and tax increases from company bond and stock prices. If you do not do your part to firmly anchor market expectations that the U.S. is going to solve its fiscal problems, investors will sell U.S. corporate bonds and stocks until their prices are in line with fiscal-cost adjusted valuations. In my judgment, this process may explain why Treasury bond prices now are rising somewhat while U.S. corporate debt and stock prices are falling. It may be that some private sector participants are becoming a bit worried about U.S. government spending cuts and tax increases, and want higher rates of return to cover fiscal adjustment liability risk.

Let me give you a few specific examples. Several months ago I received a telephone call from an executive of a well-known company. His comments crystallized in my mind the threat to the U.S. stock market if this commission and our government fails to firmly anchor investor expectations that this nation can and will get our budget back on track.

The caller asked if I could help his company think through how to shrink their U.S. corporate footprint and avoid the costs of U.S. government spending cutbacks and tax increases. He talked at length about Moody's mid-April report. Moody's said U.S. ratings are "stable," but that "distance-to-downgrade" has substantially diminished and warned that:

> Growth alone will not resolve an increasingly complicated debt equation. Preserving debt affordability at levels consistent with Aaa ratings will invariably require fiscal adjustments of a magnitude that, in some cases, will test social cohesion.[13]

The question on the caller's mind was how can his company avoid or minimize the impact of "fiscal adjustments", which in plainer language means large government spending cuts and tax increases. He was particularly worried about the possibility that the fiscal adjustments needed to balance the U.S. budget are so large they will "test social cohesion". What he was looking for was a way to change his company, as he said, from a U.S. company to a "U.S.-based" company.

I declined the consulting engagement. My goal is to make the U.S. a place companies want to locate to, not want to leave. I am certain there are changes in how public resources are spent and how revenues are gathered that would make the U.S. significantly more productive. I believe that only a few years after those changes are implemented, very few Americans will want to go back to the old ways of spending and taxing. Yes, in the near-term, GDP will be affected. Households and companies that benefit from the current mix of spending and taxing will feel adjustment pains. Longer-term, however, all households and businesses will be stronger, and our economy will move to a higher, sustainable growth path.

Clearly the spending cuts and tax increases needed to balance the federal budget are absolutely unavoidable. To think otherwise is to believe there is a kind of fiscal tooth-fairy who will magically come and leave the money we need under OMB's pillow. Equally clearly, the fiscal adjustments will echo through our economy in powerful, complex ways and impact every household and business in our society. Can we put numbers on these impacts? There is no way I know of to put a dollar value on social cohesion but we can get an insight into the possible asset price effects of fiscal adjustment costs.

Fiscal adjustment and company net worth

Every member of this commission when you were talking about our budget deficits has no doubt at one time or another said: "America is mortgaging its future". This metaphor is accurate. Our longer term fiscal shortfalls are like a mortgage that we all have to pay off one way or another. But on whose balance sheet should this mortgage appear and how big is it?

Congressional Budget Office long-term fiscal and economic projections provide answers. CBO projects moderate economic growth and assumes that deficits above 3% of GDP are unsustainable. Using CBO numbers, the 10-year unsustainable shortfall expressed in present value terms is $8.8 trillion, the 20-year shortfall is $20.5 trillion, and 30-year is $43.9 trillion. Let's use the middle number, $20.5 trillion. This is the current value of the 20-year gap that spending cuts and tax increases must close to get the U.S. budget back on track.

Closing this gap will be a burden for households and businesses. If a company or its customers use government services such as the federal court or air traffic control systems, or benefit from any direct or indirect government subsidies or guarantees, company profits will be affected by the unavoidable spending cuts and tax increases.

What is the split between households and businesses? What each pays in federal taxes may be as good a guide as any. Over the past several decades, companies paid about 10.5% of all federal taxes. Accordingly, under this reasoning, U.S. companies together have an off-balance sheet liability of at least 10.5% of the fiscal adjustment. The corporate share of the 20-year fiscal adjustment cost would be $2 trillion.

What does this mean for an individual company? Exxon, for example, is the largest U.S. business taxpayer and pays on average about 11.6% of all corporate federal taxes. The present value of its share of the 20-year fiscal adjustment cost would be 11.6% of $2 trillion, or about $237 billion. Exxon's 2009 book net worth was $111 billion. If this 20-year liability were put on Exxon's balance sheet, it would go book-equity negative by about $127 billion. Exxon is not alone. The same is true for Microsoft, Wal-Mart, and most other U.S. companies. See the table below.

Corporate Book Net Worth Relative to Fiscal Adjustment Cost
($ billions)

Company	A: Book Value Net Worth	B: Present Value Fiscal Adjustment Cost			C: Adjusted Book Net Worth A-B=C		
	Dec 2009	10-year	20-year	30-year	10-year	20-year	30-year
Exxon	$110.57	-$94.87	-$237.43	-$520.61	$15.70	-$126.86	-$410.04
Microsoft	$39.56	-$32.96	-$82.48	-$180.85	$6.60	-$42.92	-$141.29
Wal-Mart	$65.29	-$44.80	-$112.11	-$245.82	$20.49	-$46.83	-$180.53

Fiscal adjustment and company market value

When investors buy corporate debt and equities, balance-sheet net worth is important, but future earnings is more important. Future earnings determine how much income there is to service debt and what the value of the income stream a stockholder is buying. From this perspective, the central value determinants are the relationships between the present value of expected earnings and the present value of expected fiscal adjustment costs. If I saw analyses and discussions of these factors in academic and business journals, I would personally be willing to believe that investors are taking fiscal adjustment costs into consideration when they value corporate debt and equities. But I don't believe they are because to my knowledge there is essentially no research on this subject. Even absent research, I would believe it, if U.S. equity investors told me that they think fiscal adjustment costs are reflected already in stock prices. I have asked many investors, the answer so far is unanimously no.

Market Value Relative to Fiscal Adjustment Cost
($ billions)

Company	A: Market Value Dec 2009	B: Present Value Fiscal Adjustment Cost 20-year	C: Adjusted Market Value A-B=C 20-year
Exxon	$396.97	-$237.43	$159.54
Microsoft	$223.86	-$82.48	$141.38
Wal-Mart	$447.71	-$112.11	$335.60

*Bloomberg market data. Discounted cash flow analysis. All figures in billions of USD.

But if current prices are actually reasonable, what might be missing from an analysis of the present value of fiscal adjustment costs? Three answers come to mind.

First, an allocation of the costs to U.S. households and businesses based on federal taxes paid is simply wrong. Instead we should be allocating the costs far more broadly, say, to households and businesses of our trading partners. Our fiscal deficits historically financed their economic development. Accordingly, it can be argued that they will bear a portion of our fiscal adjustment burdens.

Second, companies like Exxon, Microsoft and Wal-Mart are global and have such large off-shore earnings that the discounted value of these earnings would swamp U.S. fiscal adjustment costs. This would especially be true if there were a large fall in the exchange rate value of the dollar.

Or third, debt and equity markets are seeing through the fiscal adjustment chaos and are pricing enormous profit growth on the other side when public finances are restructured and efficient. Because of my own optimism about post-adjustment growth, competitiveness and innovation, I am attracted to this idea, but not enough yet to be an investor in U.S. publically traded stocks.

Commission actions and stock price movements

Commission members, please look at the 15-year chart below of Microsoft's stock price. Microsoft has over 140,000 individual and institutional investors. Its year-end 2009 book net worth was $39.5 billion. Its market value is about $226 billion. And the present value of share of the 20-year federal budget short-fall, based on its federal tax payments, is about $82.5 billion.

Microsoft

Do you want to do anything -- make blatantly partisan statements, fail to issue a unified report, or fail to make clear long-term recommendations -- that would cause domestic and foreign investors in Microsoft begin to seriously doubt the U.S. is able to solve its fiscal problems?

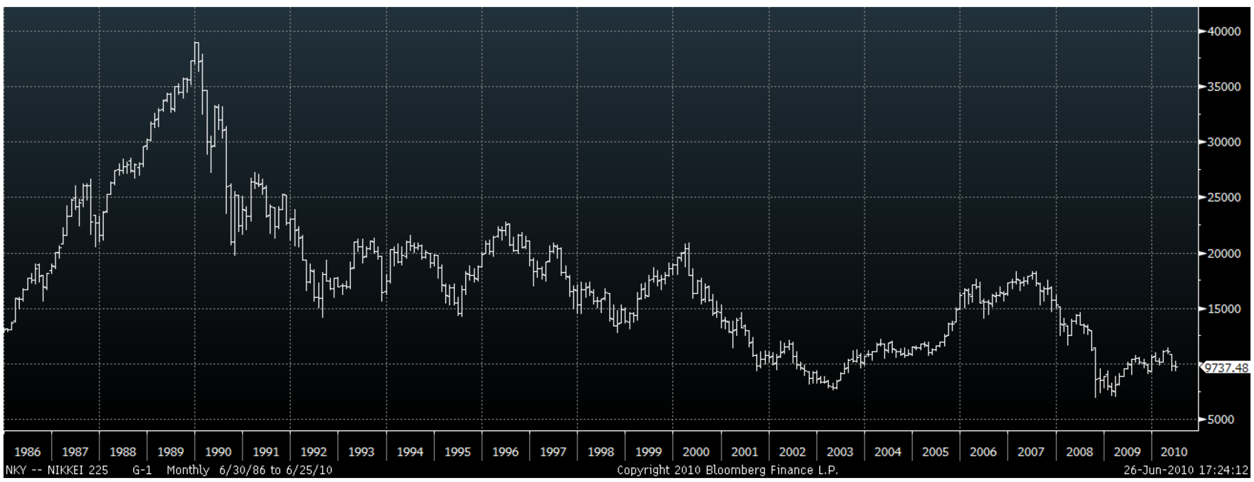
More and more business leaders are speaking out about budget deficits and the unavoidable fiscal adjustments needed to deal with them. Last week Ivan Seidenberg, Verizon's CEO, addressed the Economic Club of Washington. Among other things he expressed deep concern about tax increases. As head of one of America's most technologically advanced companies, clearly he is thinking about how government spending cuts and tax increases will affect Verizon customers and how much they can spend on telephone services. No doubt he is also worried about how inevitable fiscal adjustments threaten a wide range of direct and indirect government benefits his company and many others receive. Some people criticized Seidenberg for not offering any specific suggestions on how to deal with the budget. This criticism is misplaced. Seidenberg is responsible mainly for maximizing the value of his company's stock. How to deal with the budget is this Commission's responsibility.

Below is a 15-year chart of Verizon's stock price. There are over 770,000 individual and institutional investors in Verizon's stock.

Verizon

Those investors need this commission to adopt spending, tax and regulatory principles that make economic and moral sense to families and business people and assure that scarce resources will be allocated to high-return economic activities. They need this commission to come forward with a plan that unifies citizens and stops the current trends toward government service cutoffs and civil disruption, and respects the fact that American's are not going to tolerate a fiscal adjustment that is shaped by power-politics or unfairness. Investors in Verizon and all other U.S. companies need this commission to provide year-by-year revenue and spending recommendations that over the next 10 to 15 years bring the U.S. budget into sustainable balance.

Below is a 25-year chart of the Tokyo stock market. Japan never fixed its fiscal deficit problems. If this commission fails to do its job, it will contribute to making the U.S. stock market look the same.



Thank you.

Endnotes

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[5] Bureau of Labor Statistics, Employment Situation Summary Table A. http://www.bls.gov/news.release/empsit.a.htm

[6] Ibid, Table A-13. http://www.bls.gov/news.release/empsit.t13.htm

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[9] 2010 Child Wellbeing Index, Foundation for Child Development, p 7 http://www.fcd-us.org/usr_doc/FINAL_2010_CWI_Annual_Release.pdf

[10] *Polarized America* by McCarty, Poole and Rosenthal

[11] *IMF Fiscal Monitor: Navigating the Fiscal Challenges Ahead*, p 60

[12] *IMF Fiscal Monitor: Navigating the Fiscal Challenges Ahead*, p 60

[13] "Moody's Says U.S. Debt Could Test Triple-A Rating", *New York Times*, March 15, 2010 http://www.nytimes.com/2010/03/16/business/global/16rating.html