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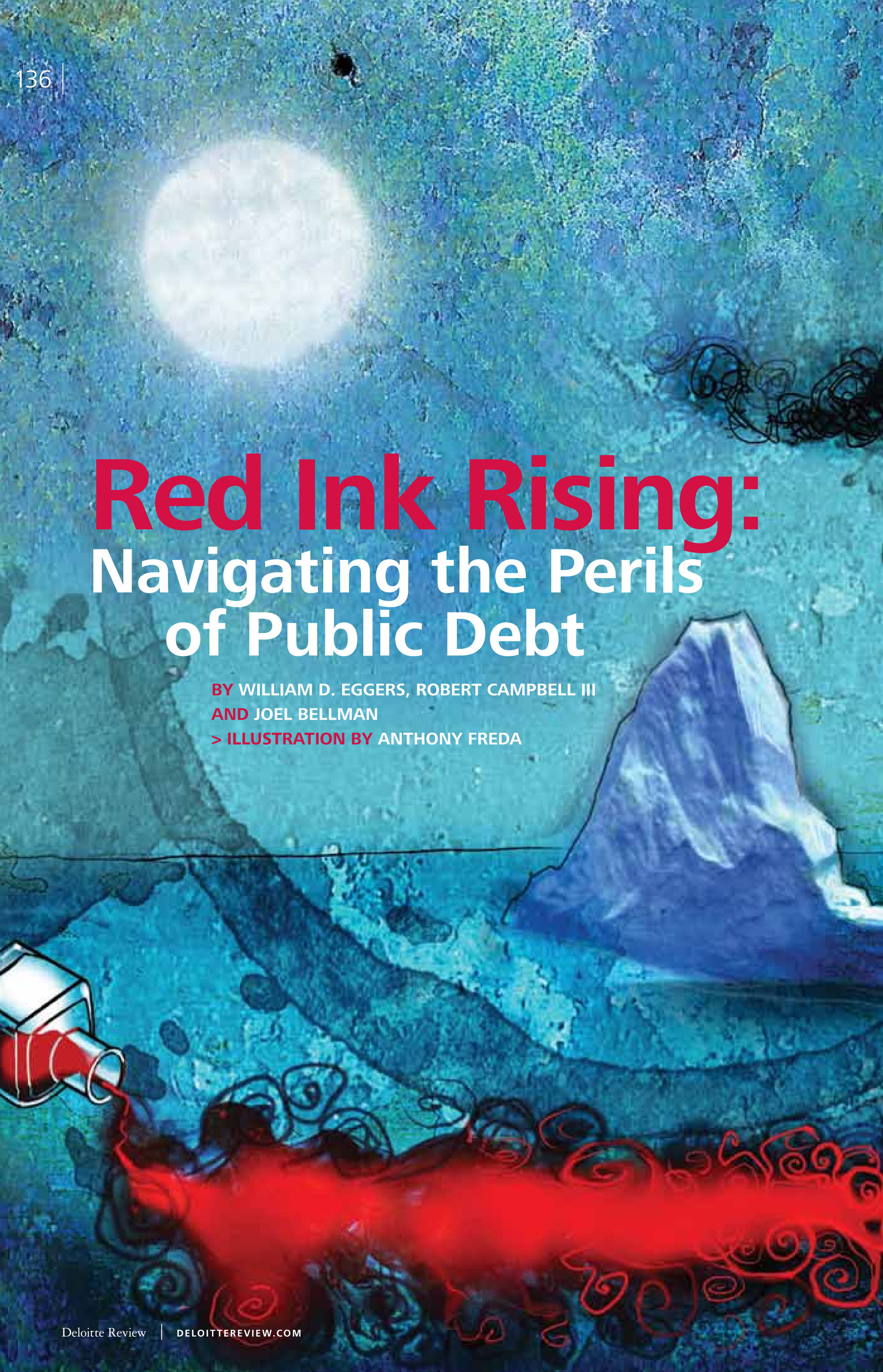
BY WILLIAM D. EGGERS, ROBERT CAMPBELL III AND JOEL BELLMAN
> ILLUSTRATION BY ANTHONY FREDA



Red Ink Rising:
Navigating the Perils of Public Debt

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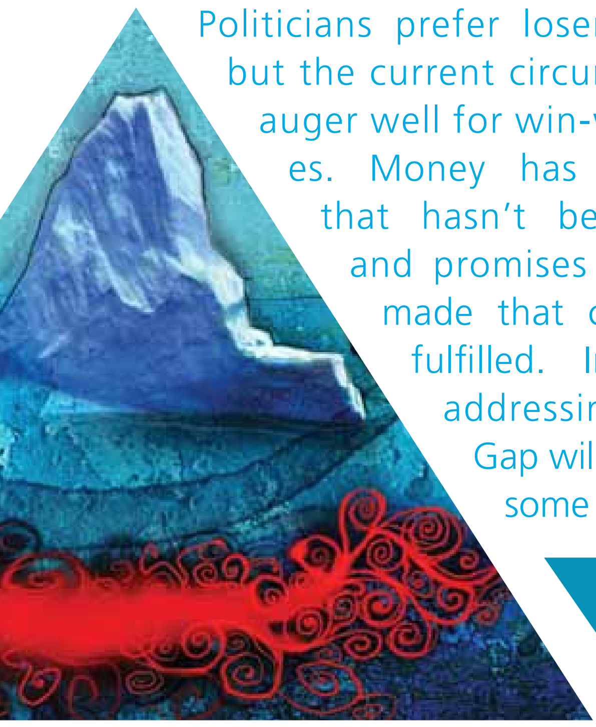
On February 27, 2007, the U.S. Federal Home Loan Mortgage Corporation—popularly known as "Freddie Mac"—announced that it would no longer be buying the most risky subprime mortgages or mortgage-related securities.

At the time, "subprime" was a word that hadn't permeated the public lexicon; only a handful of the most savvy financiers understood what Freddie Mac's move meant. Everyone knows now: a lit fuse under a mountain of fiscal dynamite, causing devastation to world economies. And it would be particularly devastating to one sector: government.

States, provinces, cities and nations worldwide now face an existential threat in the form of a massive fiscal imbalance between expected revenues and promised expenditures, and some of them are already feeling the effects. Greece made headlines, but Spain, Italy, Portugal and a host of others are all dealing with serious fiscal distress. Ireland, for example, faces a budget deficit this year of a staggering 32 percent of its GDP, while countries such as the United Kingdom and the United States are staring down sobering deficit forecasts.

Currently, federal debt in the United States is north of $13 trillion, or about 95 percent of GDP. To put this in perspective, 13 trillion $1 bills, laid end to end, side to side, would pave every interstate, highway, and country road in America – twice.

State budgets are similarly bleak. For example, California, New Jersey and New York have largely staved off insolvency thanks to federal largesse in the form of the stimulus package – and even with $33 billion in "bailout" funds from Washington D.C., California issued IOUs in lieu of payment during the summer of 2009 and faced a $20 billion gap in 2010. Local governments from Vallejo, California (which declared bankruptcy in 2008) to Detroit are looking at a potential death spiral of tax hikes and population flight. How to deal with that crisis will be the most essential and pressing issue facing every one of the 26 new governors taking office in 2011. Veterans and rookies alike face a sea of red ink splashed across their budgets. The underlying threat is something we call "the Gap." The Gap is a twofold problem, consisting of a fiscal gap between revenue and expenditures and a performance gap between the way government currently operates and the realities of the new economy.



Politicians prefer loser-free solutions, but the current circumstances don't auger well for win-win approaches. Money has been spent that hasn't been earned, and promises have been made that cannot be fulfilled. Inevitably, addressing the Gap will create some pain.

The fiscal gap has both cyclical and structural components. Its cyclical guise emerges when the economic cycle dips, causing public spending to outstrip revenues in the short to medium term. This is now happening all over the world.

It happened in previous recessions and it will happen in future ones.

The structural nature of the current Gap, while exacerbated by the cyclical downturn, is more fundamental. That is, even if there is an economic upturn, sizable structural shortcomings will persist. Countries have overcommitted their current and future resources. Steadily rising costs for pensions and health care benefits, together with significant demographic shifts, mean that incremental changes or across-the-board cuts in the costs of administration are vastly insufficient to address the Gap.

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It will be a challenge to the entire democratic governance model, requiring systemic, structural changes to bend the government's cost curve down as well as courage and persistence on the part of political leaders and citizens. Getting from here to there requires concurrent navigation of three distinct phases that comprise one long, grinding journey to fiscal sustainability: the Conceptual, Blueprint and Transformation phases.

THE CONCEPTUAL PHASE

Achieving agreement on the magnitude of the problem

In *The March of Folly*, Barbara Tuchman examines a series of historical examples in which powerful institutions behave with self-destructive folly: Great Britain's alienation and eventual loss of the American colonies, for example, or the United States' tragic policies during the Vietnam War.

To qualify as true folly for Tuchman, these fiascos must share several key characteristics. The poor policy choices must occur over an extended period of time, rather than comprising a single irrational action. Furthermore, the destructive policies must be pursued by a number of institutional leaders, not just a lone, deranged leader. And, finally, there must be significant voices loudly proclaiming the folly of these policies even as they are being pursued. Folly isn't just foreseeable in hindsight: It's foreseen in real time, with plenty of time to alter course.

By this definition, the looming fiscal crisis facing democratic governments around the globe has all the trappings of a modern sequel for Ms. Tuchman. Over several decades, political leaders have pursued fiscal policies that have brought us to the precipice. Meanwhile, a host of voices—including nonpartisan government entities such as the Congressional Budget Office, the International Monetary Fund, and the Organization for Economic Cooperation and Development (OECD)—

offered ample warning. Meticulous charts and graphs grimly depict the mathematical certitude that our current policy of spending (and promised future spending) is unsustainable.

Tuchman describes folly as a "process of self-hypnosis" in which political leaders cling to an established course despite mounting evidence of its risk. In essence, altering or abandoning destructive policies begins as a psychological journey, one in

The Six Fiscal Truths that cannot be wished away

Strategy 3:
Design a constructive idea generation environment

Strategy 5:
Tell the story publicly

which the dire reality of one's circumstances aren't merely noted – they're embraced.

These policies are the product of failed imagination, an inability to fathom the fact that poor policy choices jeopardize the prosperity that has been the hallmark of democracy since the end of World War II (at least). King George III couldn't imagine a group of ragtag colonists defying the mighty British Empire, and a series of presidents couldn't imagine how tiny North Vietnam could withstand America's military prowess. However, these limits of the imagination don't alter the reality. The unthinkable happens anyway.

But reality, it has been said, is the thing that keeps on happening even if you don't believe in it. Political leaders of all stripes have chosen not to believe in the deleterious impact of rising debt. The interest alone on the U.S. federal debt in 2020, for example, will be $1 trillion – 1.5 times the total amount currently spent on defense and intelligence. If matters continue on their present course, the entirety of U.S. federal revenue in 2020 will only cover interest, Social Security and Medicare.

Here in the real world, accumulating debt—whether for an individual, company or nation—matters. The first stage on the road to fiscal health is to move past historical misconceptions about why many Western democracies face such a daunting fiscal picture. Misattributed causes, after all, tend to produce inefficacious cures.

The root of the problem is neither local nor the result of individual actors. Instead, the cause is rooted in the systems of governance. The freedom and prosperity that generally accompany democracy create rising standards of living. These, in turn, have led to longer life expectancy, earlier retirement and declining birth rates. At the same time, this wealth and the politics of electoral democracy have prompted the expansion of a host of social entitlement benefits, including old-age pensions, health care, and expanded benefits for various interest groups. Many well-intended policies haven't been revisited, and they don't take into consideration significant demographic shifts over time. This combination of shifting demographics and growing obligations fuels the growing mismatch between revenues and expenses. We have been living in collective denial. Acceptance is an important step in coming to terms with the difficult choices we now face.

How can leaders break through the conceptual barriers and close the Gap? Or as the finance committee chairman of a major American city asked us, "How can we get people to see just how bad it is?"

There is evidence that working across party lines can help to paint a vivid picture of the coming disaster. A strong example of such a bipartisan solution is the Conservative-Liberal coalition government in the United Kingdom. By and large, the campaigning parties avoided talking about the bad news in the months before the U.K. election in May 2010. The post-election period, however, was markedly different. In part, this was driven by the fact that no party won an overall majority in Parliament, a rare situation that forced cross-party discussion and eventually set the scene for the coalition itself to be formed. Since then, the behavior of the parties in the coalition has taken this further. A formal coalition agreement was signed that acknowledges the urgency of reviewing public spending. Responsibility for the spending cuts now sits jointly with both parties.

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"This is the great national challenge of our generation," said George Osborne, the U.K.'s chancellor of the exchequer, "after years of waste, debt and irresponsibility, to get Britain to live within its means. It is a time to rethink how government spends our money."

Even Ed Miliband, the new leader of the opposition Labour party, has pledged not to oppose every cut – a reflection that the necessity of spending cuts is accepted by the majority of the British population.

"I believe strongly that we need to reduce the deficit," said Miliband. "There will be cuts, and there would have been if we had been in government. Some of them will be painful ... I won't oppose every cut the coalition proposes."[1]

The United Kingdom has moved quickly from a situation in spring 2010 when deficit reduction was a taboo topic to the current situation where the International Monetary Fund (IMF) stated: "The U.K. economy is on the mend. Economic recovery is under way, unemployment has stabilized, and financial sector health has improved."[2] The implementation challenges are still to come, but for the United Kingdom at least, the Conceptual Phase is over.

The United States is a different story. American politicians have yet to achieve consensus about how and when to tackle the problem. To be sure, the 2010 election was a referendum on the size and scope of government. Moreover, two high-profile fiscal commissions, the Bipartisan Debt Reduction Task Force and President Obama's Deficit Commission, have been raising alarm bells about the need for tough choices to be made soon. The Bipartisan Debt Reduction Task Force has called for stabilizing debt at the current percentage of GDP by the end of the decade. Even this seemingly modest objective has a $7 trillion price tag. Despite all this, the two major political parties have yet to find areas of comprimise around the tough choices needed to address the problem.

THE BLUEPRINT PHASE

Designing a workable political roadmap for taking the hard steps

Even if you assume a universal acceptance of the Conceptual Phase's conclusions—that our fiscal trajectory is unsustainable, and that the public sector is ill-equipped for its looming challenges—it still wouldn't ensure moving forward in any particular manner. Agreeing that you have a problem is not the same as deciding what to do about it.

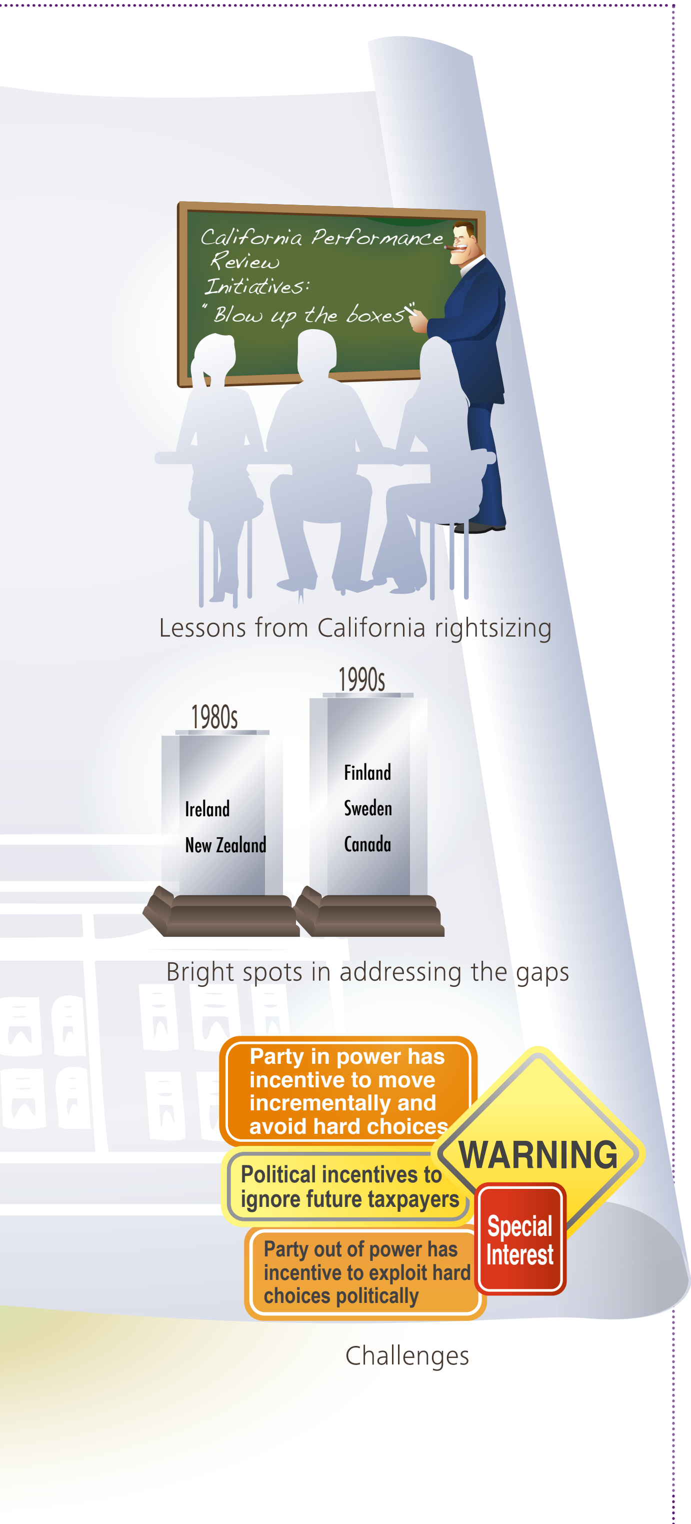
The Blueprint Phase tends to be much harder to navigate, given the unpredictable machinations of electoral and partisan politics. This phase features several realities that make progress daunting. While at times, political leaders will place the public interest above any electoral considerations, the politics of this don't make such choices easy for several reasons:

- Special interest politics work against dealing with the Gap.
- Current elected officials at every level tend to have a political incentive to serve their current constituents over future taxpayers. As a consequence, the

POLITICAL PHASE

best time, politically, to deal with the Gap will always be "soon."

- In general, any party out of power has an incentive to exploit for political gain the hard choices the ruling party might make toward closing the Gap.
- In general, any party in power has an incentive to move incrementally



rather than get blamed for the pain associated with moving boldly to close the Gap.

No one knows better just how treacherous the politics of downsizing can be than California Governor Arnold Schwarzenegger, who took office in California in 2003 dedicated to reining in out-of-control state spending. In his first state of the state address, he called the state government "a mastodon frozen in time" with "multiple departments with overlapping responsibilities" and pledged to "blow up the boxes" of state government. He launched a major reform initiative that proposed some of the most sweeping and radical reorganization changes ever proposed in the state. He even sponsored four major ballot initiatives, including one to limit expenditures. All the while, Schwarzenegger never stopped warning Californians of the consequences of sticking with the status quo – a future of mounting budget deficits and a state government that was becoming virtually ungovernable.[3]

The result? The legislative initiatives backed by the governor lost at the polls, the reform initiative generated little change, and the status quo in the legislature prevailed. More importantly, the grim future predicted for California has come to pass. Despite massive federal money, the state has been reduced to issuing IOUs, and despite large tax hikes and deep service reductions, the state still faces massive budget deficits and a staggering debt.

Avoiding such a fate is fraught with political perils. Success in this phase requires political mechanisms that allow the hard choices to be made jointly, with shared blame and credit. One such approach that has seemed to work is the Base Realignment and Closure Model (BRAC), which helped depoliticize a necessary

CANADA'S PROGRAM REVIEW: LESSONS IN BALANCING THE BUDGET

By Jonathan Hopkins, Howard Yeung and Jane Locke; Deloitte Canada

In the early 1990s, Canada faced a stark decision — take action to reduce its deficit and debt or face the consequences on the world financial markets. By 1993, the country had one of the highest debt-to-GDP ratios among the G8 nations, leading Canadians to rank debt reduction as a higher priority than even job creation. Maintaining fiscal sovereignty became the primary talking point of all political parties in parliament, and a broad national consensus emerged to help the government introduce a process called Program Review in the 1994 budget.

The main objective of Program Review was to ensure that government resources were dedicated to the highest priority requirements for which the federal government was best placed to deliver services. Instead of across-the-board budget cuts, the government applied six tests to make tough decisions on which programs to preserve, which to transfer to other orders of government, which to outsource or privatize, and which to eliminate altogether: (1) Do the programs serve the public interest? (2) Is government involvement necessary? (3) Is the federal role appropriate? (4) Is there scope for private sector involvement? (5) Are there opportunities for increased efficiency? (6) Are the programs affordable?

Program Review led to some very significant changes in the role and footprint of the state. For example, the federal government privatized the nationalized railway system, transferred airport ownership to local operating authorities, commercialized a major maritime shipping channel, and transferred air navigation service delivery to a new nonprofit company. Instead of owning, operating and subsidizing transportation channels, the government decided to focus on its core responsibility to develop policies and regulations to ensure an efficient, safe and secure transportation system. By the time each of these changes was implemented, Transport Canada had reduced its budget by almost 50 percent, and it was not the only department to see significant change. Many other departments also realized significant reductions of between 20 and 60 percent through similar decisions and actions.

The Program Review initiative was incredibly successful and a major factor in allowing the Canadian federal government to reduce program spending by over $15 billion, reduce the size of the public service by 45,000 employees, run eleven consecutive annual budget surpluses between 1997 and 2008, and withstand the disruption of the recent economic crisis as well or better than any of its G8 counterparts. With changes in government in 2003 and 2006, the initiative has since been replaced by a new Canadian process called Strategic Review that preserves the intent of the original six tests, focuses on individual departments, and runs on a four-year cycle to continuously align government spending to its highest priorities.

defense retrenchment in the 1990s. Congress had to vote up or down on a package of proposals within 45 days. This process helped to overcome parochial political interests in Congress. Similar thinking could be applied elsewhere and to other areas of government.

Another approach is to create a sunset process: an action-forcing mechanism to encourage elimination, reform and merger. Under sunset, after an independent agency reviews an entity, the legislature has to pass a new law to save it. In the language of choice architecture, it shifts the default status to "terminate."

The Texas Sunset Commission, arguably the most successful sunset process in the United States, has resulted in 54 agencies being abolished and 12 agencies being consolidated over the years. For every dollar invested in the sunset program, the state has earned a return of $31, resulting in $784.5 million in estimated savings between 1982 and 2007.

The legislators who sit on the sunset commission are proud of their independent viewpoint.

"We're not constrained by convention," explained Representative Carl Isett, the 2008 chairman of the Texas Sunset Commission. "We don't come in with any preconceived ideas. We don't care how they've done things in the past. We come in with ideas as reformers."[4]

Other pain-sharing strategies include semi-independent performance review boards, program reviews and targeted "blue ribbon commissions." The track record of all of these is decidedly mixed, but under the right circumstances they can be helpful. For example, Canada's program reviews, described in the "Canada's Program Review" sidebar, helped slash the size of the Canadian public service by 19 percent.

In the United States, the magnitude of the federal debt precludes a single, catch-all solution. Cost management—even aggressive cost management—can't cut $7 trillion over nine years from a $2.4 trillion annual budget. This is what would be required to stabilize U.S. debt at the current percent of GDP to 2020. Increasing taxes to raise enough revenue to pay down the debt would be politically unacceptable and compromise economic growth. Relying on the economy to outgrow the debt is not plausible. Instead, the Bipartisan Policy Commission task force on the federal debt in the United States has concluded that stabilizing the U.S. debt will take a combination of tough policy decisions, cost reductions and, at least temporarily, some revenue enhancements.

There is no silver bullet to navigating the Blueprint Phase. Carrying out that plan and actually closing the Gap will be the work of the Transformation Phase.

TRANSFORMATION PHASE

THE TRANSFORMATION PHASE

Delivering the cost reduction program

Even if the Blueprint Phase produces a sophisticated roadmap for what ought to be done, successfully altering a government's structures to deliver on that plan represents a daunting execution challenge. On top of the typical execution challenges are all the political and cultural obstacles.

Focused leadership

Communicate early and often

Avoid the overconfidence trap

Closing the performance gap in government will likely require a public culture that embraces a relentless pursuit of innovation – a commitment to adopting new, more efficient ways of creating public value. Re-examining both mission and methods will be essential for governments seeking to become sustainable in an era of retrenchment.

Such a shift will not come easily. Public bodies throughout the world are rarely designed to be flexible. Typically they have evolved over a number of years around functional areas (e.g. defense, education) with structures adept at delivering a fixed service within a fixed budget but poor at responding to change. The bureaucratic barriers to change in the public sector greatly exceed those in the private sector due to a culture of risk aversion and program protection and as a systemic consequence of the way government is organized. No corporate entity has a board of 535 as represented by the U.S. Congress. Navigating the Transformation Phase is about overcoming these barriers.

When Georgia Governor Sonny Perdue took office in 2003, he was naturally curious about the state of the state he was just elected to govern. How well was it functioning? Was it optimizing spending? Did it actually need to be doing all the jobs that it had taken on? Was it running efficiently? These are questions familiar to every newly elected executive.

To answer them, Perdue created the Commission for a New Georgia, made up of an enlivening mix of Republicans and Democrats, business people, public servants, nonprofits, think tankers, other experts and administrative staff to help conduct research and propose action. In addition to its eclectic makeup and the staff assistance, one other thing made the commission different from most others: It didn't produce fat reports. Instead, it made recommendations for fixing things as it found things to fix.

The commission is credited for finding savings and new revenues totaling upwards of $200 million. Based on the commission's findings, the state's fleet of vehicles was downsized by almost 10 percent; surplus real estate was sold for over $22 million; leases were renegotiated to save almost $9 million; and state energy rates were adjusted, saving the state another $6 million. The state now auctions retired cars and equipment on the Internet, increasing sales revenue

BRIDGING THE GAPS UK STYLE

By Tom Harris, Deloitte Research, Deloitte UK

In October 2010 the U.K.'s new coalition government published the "Spending Review" – a plan to reduce public spending significantly over a concentrated 4-year period beginning in 2010-11. This plan will extract around $128 billion from U.K. government spending through a combination of budgetary retrenchment (that involves some public sector redundancies), reducing the U.K.'s overall welfare bill, and a large program of public asset disposals and property rationalization. The overarching target is to eliminate the U.K.'s structural deficit by 2014-15 (i.e., to ensure government has the same amount of money coming in as it has going out each year). Making inroads into national debt is a separate question, but the British government hopes that improved GDP growth will enable it to bring down national debt more quickly and cut debt interest payments that currently run to around $68 billion each year.

But many analysts regard the U.K.'s Spending Review as more than just a cost-cutting exercise. Meeting the performance gap is also central to strategic planning. The new government wants to reconfigure its role in society by opening up the supply of public services in areas such as schools, prisons or welfare provision to third-party providers from the private and voluntary sectors. It is hoped this work will drive up standards through improved choice and competition, whilst at the same time divert some liabilities for service provision away from the state. Policymakers envisage the U.K.'s future public services to be smaller, more targeted, more efficient, more localized and quicker to adopt new innovations.

Importantly, the government is also attempting to develop what it calls the "Big Society" where citizens exercise greater choice and control around how services are delivered and managed. For areas that remain part of government's responsibility, there will be renewed emphasis on efficiency and value for money thorough outsourcing – not only of traditional back office areas, but also in middle office (e.g., customer contact centers) and even front-line services such as welfare or environmental services. Transformation of this kind is difficult and takes time, but the U.K. government hopes it can confront both the fiscal and performance gaps through its Spending Review, which marks the beginning of fiscal austerity in the U.K.

by 30 percent.[5] (One of the more celebrated eBay auctions was for a Learjet that the state hadn't even realized it owned – courtesy of a major drug bust.)

There is likely to be some internal friction between the cost reduction team and the various department leaders. That is by design. The cost reduction team is supposed to be disruptive.

To be successful, leaders should build achievable, robust programs that contain a portfolio of initiatives to reduce costs. The biggest traps include taking on too many initiatives at once or constructing a cost reduction portfolio that lacks balance and coherence. This can lead to one initiative diluting the benefits of another and possibly a wider failure of confidence in the whole program.

It is essential that initial cost reduction initiatives succeed – in a visible manner so as to build positive momentum. The new chief executive needs to deliver some early, visible wins in order to make sustainable inroads into the underlying cost base and begin to change the culture to one of spending restraint.

"If you're trying to come out of a fiscal hole as deep as most governments are looking at now, you have to attack spending on every front," explains Indiana Governor Mitch Daniels. "We did a number of things that were very large, that brought very large savings immediately, but you also have to do literally hundreds of lesser things that add up. You need to build a culture that challenges every expenditure."

A "funnel" approach may be the best way to identify worthwhile initiatives as well as weigh political considerations. Not all cost-cutting ideas will, or should, make the cut. Develop a score sheet that places political and other risks, complexity, and time to implement on a scale. Look at the level of cost savings in comparison to where an opportunity falls on those other scales, and weigh options against each other.

The approach should use rigorous financial metrics. This requires having a credible system for tracking a key set of performance metrics for all major governmental programs. Such a system needs to have the full blessing and constant involvement of the executive, and it needs to include baseline data, performance targets and timely reporting on actual performance.

In Maryland, Governor Martin O'Malley has aggressively pursued his new results-informed approach to state government. Early on, this meant closing down the state's expensive and ineffective maximum security prison, signaling right away that the new governor would be bringing the same data-driven approach to Maryland that he had honed as mayor of Baltimore. One key to a data-driven approach to governance, says O'Malley, is that numbers should never be used as a bludgeon.

"You have to go about this with real openness and transparency," O'Malley said.

"We might lean hard on a department, but it's never a matter of giving a department head a blindfold and a cigarette and putting them up against the wall."[6]

In the U.K., the Transformation Phase began in earnest with the much-anticipated October 2010 release of the Comprehensive Spending Review, which sets the budgets across government for four years. (See "Bridging the Gaps" sidebar.) One difficulty in the U.K. is that public spending has risen in real terms continually for two decades. Therefore, very few of today's generation have any experience with cost reduction. As a result, both commitment and capability are patchy.

Serious cost cutters should be prepared for a rocky implementation road. Real cost cutting will be difficult, and it won't come without some pain. The alternative approach, however, of continued unsustainable spending will create even greater pain in the near future.

MINDING THE GAP

Dealing with the Gap will be the central challenge of governments around the world for the foreseeable future. The goal: to achieve a sustainable government that is fiscally balanced and structured for the realities of the 21st century. The future of countries, cities and states across the globe hangs in the balance. This will be a long journey, one that will require successfully navigating conceptual, political and execution issues.

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Endnotes

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