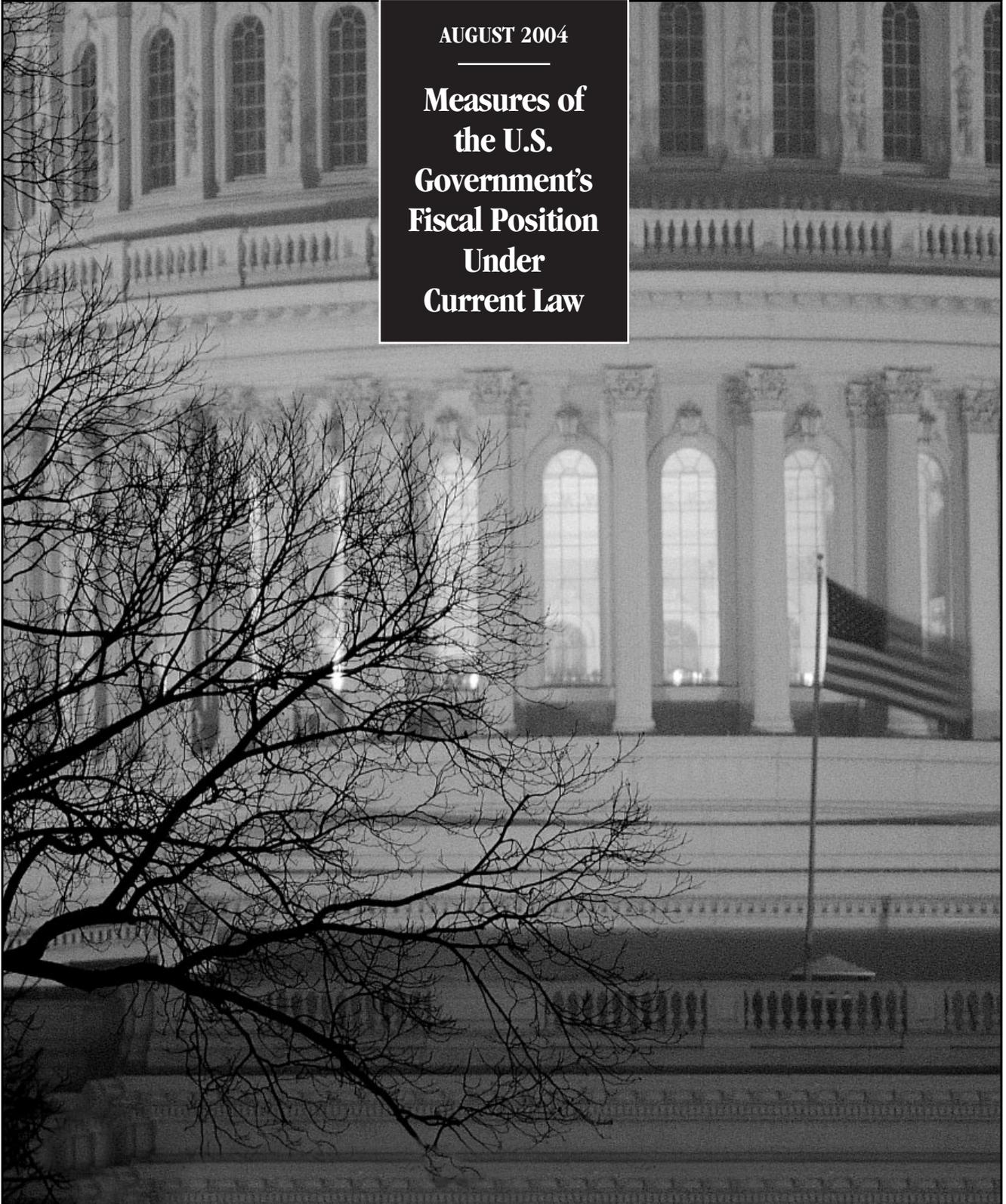


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CONGRESSIONAL BUDGET OFFICE

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**CBO**  
PAPER

AUGUST 2004

**Measures of  
the U.S.  
Government's  
Fiscal Position  
Under  
Current Law**







# **Measures of the U.S. Government's Fiscal Position Under Current Law**

August 2004





## Preface

**P**olicymakers and other observers have expressed concern about the federal government's current and future liabilities and commitments as the aging of the U.S. population brings demographic pressures to bear on the major federal retirement programs. Reflecting those concerns, the Concurrent Resolution on the Budget for Fiscal Year 2004 included a provision directing the Congressional Budget Office (CBO), in consultation with the Senate Budget Committee, to prepare a report presenting estimates of the current and future costs of federal programs, as well as estimates of the contingent liabilities of some of those programs and of the government's unfunded liabilities. This paper responds to that provision, explaining financial accounting and other approaches to measuring the federal government's fiscal position and describing the strengths and weaknesses of those alternatives. In keeping with CBO's mandate to provide objective, impartial analysis, the paper makes no recommendations.

Many analysts contributed to the report. David Torregrosa and Marvin Phaup of CBO's Microeconomic and Financial Studies Division coordinated its preparation, with contributions from Deborah Lucas of Northwestern University and CBO's Elizabeth Robinson and Robert Sunshine. Roger Hitchner provided direction, and Douglas Hamilton offered helpful comments. In addition, Paul Burnham, Kim Cawley, Paul Cullinan, Sandy Davis, Heywood Fleisig, Peter Fontaine, Geoffrey Gerhardt, Kathleen Gramp, Arlene Holen, Noah Meyerson, Sam Papenfuss, John Sabelhaus, Eric Schatten, Michael Simpson, and Thomas Woodward, all of CBO, made useful suggestions, as did Dave Koitz, John Sturrock, and Eric Wang, who have since left CBO. Jim Patton of the University of Pittsburgh and a member of the Federal Accounting Standards Advisory Board (FASAB); Robert Bramlett and Wendolyn Comes, also of FASAB; Glenn Follette of the Federal Reserve Board; Robert Kilpatrick of the Office of Management and Budget; Ron Feldman of the Minneapolis Federal Reserve; and Allan Lund of the Department of the Treasury's Financial Management Service (FMS) reviewed several drafts. Colleen Graham of the FMS and Jagadeesh Gokhale of the CATO Institute supplied some of the data.

Leah Mazade edited the report, and Christine Bogusz and John Skeen proofread it. Rae Roy typed early drafts of the text. Maureen Costantino prepared the report for publication and designed the cover. Lenny Skutnik produced the printed copies, and Annette Kalicki prepared the electronic versions for CBO's Web site.

Douglas Holtz-Eakin  
Director





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## Summary

**A** provision included in the Concurrent Resolution on the Budget for Fiscal Year 2004 requested information about three areas of the government's finances: the costs of current federal activities and programs over the long term, contingent liabilities (in general, money that the government could owe for potential losses through its insurance or other programs), and so-called unfunded liabilities for programs such as Social Security and Medicare. The provision directed the Congressional Budget Office (CBO), in consultation with the Senate Budget Committee, to report on those costs and liabilities—which could grow with the expected aging of the U.S. population over the next several decades and with the benefits and services that the government would provide under current law.

CBO finds that the government already provides much information about those budgetary demands and their likely size through federal financial reporting in the budget, the financial statements of the U.S. government, and various supplements to each. However, the government's current financial reporting—especially for the three potential claims on fiscal resources on which the Sense of the Senate provision focuses—presents long-term fiscal pressures and financial risks in an uneven manner. In particular:

- The future costs of current programs are a quantitatively significant source of growth in the long-term demand for government resources. Those costs are regularly reported as supplementary budget information (such as CBO's analyses of the long-term budget outlook) and notes to the financial statements. Those sources provide depictions of future budgetary demands and related uncertainty.
- Contingent liabilities arising from government operations and programs raise concerns because their magnitude and timing are difficult to predict. The

presentation of contingent liabilities in both the government's budgetary and financial documents could be improved.

- The term "unfunded liabilities" has been the source of considerable confusion, leading some people to misconstrue the economic significance of trust funds and trust fund balances. The term may also suggest that certain liabilities are funded when, in fact, the real source of all funding is the government's ability to levy taxes.

### **Federal Financial Reporting**

The financial condition of any public or private entity is the result of the flow of cash and other resources into and out of the entity over time. Those flows may be represented in a number of ways, each of which provides a different perspective on the same information. The federal budget, for example, includes the government's recent past, current, and near-term future revenues and expenditures generally on a cash-flow basis. By contrast, the government's financial statements report cumulative (past) net flows as well as some of the assets that the government owns or controls and the liabilities that it owes. Both presentations, however, are based on the underlying flows of financial resources that are at the center of the government's financial position.

Through the budget and the financial statements—and supplemental presentations built on the data they contain—federal financial reporting provides extensive information on the projected future costs of current programs, investments, and other governmental activities. However, at present, those sources do not systematically present the financial risks and uncertainty surrounding contingent liabilities, a category of claims that could change the demands on the federal budget.

## Current Financial Measures of Programs' Future Costs, Contingent Liabilities, and Unfunded Liabilities

The three specific areas of concern about current financial measures noted in the budget resolution's provision differ significantly both in concept and in their potential magnitude. The future costs of current programs, while not known with certainty, can be estimated by projecting cash flows on the basis of expected demographic and economic conditions over an extended time span. In contrast, contingent liabilities are cash flows of unknown size and timing that result from the federal government's assumption of financial risk. Unfunded liabilities are computations of imbalances between particular cash flows (for example, payroll taxes and Social Security benefits).

### Future Costs of Current Programs

The government's near-term expected cash flows are shown in five- and 10-year budgets. But the legislation governing certain major federal programs commits the government to payments much farther into the future. Scheduled federal outlays—especially for social insurance programs such as Medicare and Social Security—are expected to grow significantly over the next several decades. To depict the financial consequences of that growth, *long-term budget projections* extend the budget's horizon for 50 to 100 years. Those projections show that future federal spending as a percentage of gross domestic product (GDP)—excluding interest payments on government debt held by the public—could range from 17 percent to 33 percent in 2050, versus the 18.5 percent share for such spending in 2003.<sup>1</sup> As a result, unless taxation reaches levels that would be unprecedented for the United States, current spending policies are unlikely to be financially sustainable over the next 50 years.

Supplements to the government's financial report also display some financial flows expected over the long run. Those flows are usually expressed as discounted present values.<sup>2</sup> *Summary present-value measures* augment the information found in the financial report by tallying in a single number those expected long-term obligations.<sup>3</sup> As of 2003, for example, the government's outstanding responsibilities for social insurance benefits were reported to be \$26.9 trillion, most of which was attributable to Social Security and Medicare.

1. Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003), Table 1-1, p. 7.

Long-term budget projections present useful information about future expenditures under current law. While informative about the direction and magnitude of spending pressures, the particular numerical estimates are characterized by considerable uncertainty. Some analyses attempt to quantify the estimates' inherent broad range of uncertainty.

Summary present-value measures are subject to the same uncertainty; in addition, they obscure information about the projected timing and trends of spending commitments and require analysts to choose discount rates. Those summary measures of costs are also difficult to interpret. For most major federal programs, those measures reach trillions of dollars but provide little information about the resources that will be available to pay costs as they occur. One useful approach is to compare those costs with GDP, which represents the economic resources available for public as well as private activities.

### Contingent Liabilities

The federal government provides explicit or implicit insurance coverage against a number of contingencies: the failure of banks and pension plans, property and casualty losses from terrorism and natural disasters, and crop failures—to name some of the largest. Under each of those programs, the federal government assumes the risk of future losses. Although the range of possible claims is potentially extensive, contingent liabilities are not likely to be large relative to the total federal budget. However, it is rare to be able to anticipate the timing or amount of what must be paid.

The budget recognizes the losses from those contingencies when the government makes cash payments to beneficiaries. Multiyear budget projections attempt to anticipate a "normal" amount of such spending. However, in any budget period, it is possible that no outlays will be made or that income from premiums will exceed outlays.

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2. The present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. A discount rate is applied to future cash flows to account for the fact that people place less value on a dollar in the future than they do on one in the present, and so a dollar today is worth more to them than a dollar tomorrow.
  3. Such summary measures use an accrual approach rather than a cash basis, accounting for transactions when they occur rather than when the resulting cash comes in or goes out.

The resulting net cash inflow could cause observers to underestimate the government's exposure to loss—especially when the commitments involve costs associated with infrequent events. By comparison, the government's financial report includes estimates of some contingencies, in accompanying notes—but only for losses considered reasonably possible. For example, the most recent such estimate of net contingent liabilities for federal insurance programs (that is, amounts not offset by future premiums) totaled \$93 billion in 2003. Almost all of that amount consisted of potential liabilities of the Pension Benefit Guaranty Corporation.

Although federal financial reporting contains a significant amount of information about some contingencies, all reports of contingent liabilities are incomplete. No report includes all contingencies, such as the federal government's expected responses to natural disasters (for example, earthquakes or floods) or the financial risks associated with government-sponsored enterprises (such as Fannie Mae and Freddie Mac). Yet federal supplemental emergency appropriations in response to natural disasters averaged more than \$5 billion annually in the 1990s. Nor do those measures include contingencies associated with government support of multilateral financial institutions.<sup>4</sup> And if the government-sponsored enterprises were to receive a federal bailout (which is not currently required by law), the costs would probably be tens of billions of dollars.<sup>5</sup>

A second cause of incomplete reporting on contingent liabilities involves the manner in which the federal government estimates the magnitude of those potential claims. Those uncertain future costs may be underestimated because no cost is currently recognized for bearing the risk associated with uncertainty.<sup>6</sup>

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4. See the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, *The Costs and Budgetary Treatment of Multilateral Financial Institutions' Activities*, before the Senate Committee on Banking, Housing, and Urban Affairs, May 19, 2004.

5. See the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, *Regulation of the Housing Government-Sponsored Enterprises*, before the Senate Committee on Banking, Housing, and Urban Affairs, October 23, 2003.

6. See Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees* (August 2004).

### Unfunded Liabilities

The term “unfunded liability” has been used to refer to a gap between the government's projected financial commitment under a particular program and the revenues that are expected to be available to fund that commitment. But no government obligation can be truly considered “unfunded” because of the U.S. government's sovereign power to tax—which is the ultimate resource to meet its obligations.

The term “unfunded liability” is most often used in relation to trust funds and trust fund balances. That linkage may create the impression that, because those funds report positive balances, future federal commitments are already “paid for,” or funded. And certain taxes—especially payroll taxes for Social Security and Medicare, which are credited to those trust funds—may lead taxpayers to believe that they have paid for future benefits. Trust funds can be useful mechanisms for monitoring the balance between earmarked receipts and a program's spending, but they are basically an accounting device, and their balances, even if “invested” in Treasury securities, provide no resources to the government for meeting future funding commitments.<sup>7</sup> When those payments come due, the government must finance them in the same way that it finances other commitments—through taxes or borrowing from the public. Thus, assessing the state of the federal government's future finances requires measuring such commitments independently of their trust fund status or the balance recorded in the funds.

More particularly, such an assessment requires determining whether a gap exists between revenues and expenditures over time, information provided by the budget and by long-term budget projections. For example, revenues dedicated to the Social Security program will remain at approximately 5 percent of GDP for the foreseeable future, whereas program outlays will rise to above 6 percent of GDP by 2050—an annual gap of more than 1 percent of GDP at that time.<sup>8</sup>

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7. See Congressional Budget Office, *Federal Debt and the Commitments of Federal Trust Funds*, Long-Range Fiscal Policy Brief No. 4 (revised May 6, 2003), and *Acquiring Financial Assets to Fund Future Entitlements*, Long-Range Fiscal Policy Brief No. 8 (June 16, 2003).

8. For more detail, see Congressional Budget Office, *The Outlook for Social Security* (June 2004).

A related approach is to express program flows as assets and liabilities and focus on the difference, yielding a measure of the aggregate fiscal imbalance, or fiscal gap, for the government as a whole. Such measures incorporate the assumption that taxes will remain at specified levels, a premise required for calculating the difference between what costs are likely to be and the resources that will be available to fund them. Some analysts estimate that the fiscal gap for the entire federal government today is between 6.5 percent and 7.5 percent of the present value of GDP.<sup>9</sup>

As with long-term projections, measures of fiscal imbalance are necessarily uncertain and require a number of

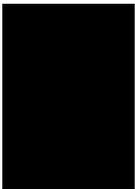
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9. The first estimate is from Jagadeesh Gokhale and Kent Smetters, *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities* (Washington, D.C.: AEI Press, 2003). The second estimate is from Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "Reassessing the Fiscal Gap: The Role of Tax-Deferred Saving," *Tax Notes*, vol. 100, no. 4 (July 28, 2003), pp. 567-584.

somewhat arbitrary assumptions about future spending and tax policy. Also, present-value measures are difficult to translate into policy prescriptions because they obscure the pattern of expenditures over time. Programs such as Social Security and Medicare, for which costs are expected to increase in the future, offer a useful example. The actuarial measure of the programs' solvency is strongly linked to the period selected for analysis.<sup>10</sup> Many policies could be adopted that would set the actuarial balance to zero over the next 30 to 50 years but leave an imbalance in subsequent years. Moreover, policies based on actuarial or present-value measures might assume that future federal commitments could be paid for in advance by accumulating governmental receipts in advance of expenditures. However, as explained above, earmarked receipts are an accounting device, and such receipts cannot be separated from other government finances and set aside for future expenditures.

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10. Actuarial estimates are the summary measures used primarily by federal social insurance programs.



# Measures of the U.S. Government's Fiscal Position Under Current Law

In the coming decades, the federal government will face a number of fiscal demands under current law. In particular, as the U.S. population ages—in large part the result of the demographics of the baby-boom generation and the continued lengthening of life spans in the United States—increased demands will be placed on the budget to fund retirement- and medical-related benefits. Adding to the substantial array of future fiscal commitments is the responsibility for potential liabilities in the form of government-insured losses stemming from unforeseeable events.

Some concerns exist that policymakers and citizens may not be adequately informed about the expected demands on the federal budget in coming decades. Despite the large amounts of information included in the budget and federal financial reports, many observers believe that current federal financial reporting may not adequately reflect the long-term fiscal position of the United States.<sup>1</sup> The Concurrent Resolution on the Budget for Fiscal Year 2004 included a provision that directed the Congressional Budget Office (CBO), in consultation with the Senate Budget Committee, to report on three areas in which current financial reporting on long-term fiscal demands may be particularly problematic: the long-term costs of federal programs, contingent liabilities, and so-called unfunded liabilities.<sup>2</sup>

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1. Concerns about that issue are widely shared. See, for example, General Accounting Office (now the Government Accountability Office), *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (January 2003); Peter S. Heller, *Who Will Pay? Coping with Aging Societies, Climate Change, and Other Long-Term Fiscal Challenges* (Washington, D.C.: International Monetary Fund, 2003); and the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, *The Economic Costs of Long-Term Federal Obligations*, before the House Committee on the Budget (July 24, 2003).

This analysis describes the various measures that are used to track the government's financial transactions and fiscal position. It concludes with a discussion of the current reporting on the three key areas of interest to the Senate.

## Budgets, Financial Statements, and Other Fiscal Measures

The financial condition of any public or private entity is the result of the cash and resource flows into and out of that entity over time. Those flows can be described in various ways, but financial reporting generally takes one of two approaches: a presentation of past, current, and near-term future revenues and expenditures on a cash-flow basis.<sup>3</sup> For the government, that information is provided in the *budget* and in the government's *financial report*, a statement of the entity's assets and liabilities and changes in those values. Both of those documents are updated and issued annually.

To provide a longer-term perspective, *long-term budget projections* typically extend the annual budget's forecast of the near term (five to 10 years) to between 50 and 100 years; those projections are made on a cash-flow basis under current law. *Summary present-value measures* convert long-term budget projections into net liabilities by discounting expected flows to their present values.

All financial reporting is based on the same transactions but presented in a variety of formats. Each measure has strengths and limitations; no single approach can provide

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2. Section 608 of H. Con. Res. 95, Concurrent Resolution on the Budget for Fiscal Year 2004, 108th Cong., 1st sess. (2003).

3. Cash accounting recognizes, or takes account of, transactions when cash inflows or outflows occur. Accrual measures recognize transactions in the period in which they occur even though the cash flows do not occur until some time in the future.

an all-purpose picture of the government's finances. Taken together, however, the measures may be designed to complement one another and offer a gauge of the current and future financial implications of present policies.

### The Budget of the U.S. Government

The federal budget, which is submitted by the President to the Congress each year in February, consists of multiple volumes and databases that report on various aspects of the government's financial condition and performance to date.<sup>4</sup> Included in that analysis are detailed tables for each spending account (which describe past-, current-, and budget-year expenditures) and several volumes that provide additional analysis. Each year, the Office of Management and Budget (OMB) issues budgetary reporting requirements to agencies, and those guidelines change frequently so as to gather new data that are thought to be of interest to policymakers and the public.

The budget has two primary reporting functions. The first is to report on the past and expected flows of cash into and out of the U.S. Treasury, and for the most part, the budget assigns those cash flows to the year in which they occur. Specifically, the budget reports revenues and expenditures for the past year; estimates revenues, obligations, and expenditures for the current year; and projects future revenues and spending for five- or 10-year periods on the basis of current law. (Those current-law projections make up what is called the budget baseline.) In some instances, the budget counts as outlays some amounts that are obligated now but will be paid in the future. Examples include the expected costs of federal loan guarantees.<sup>5</sup>

The budget's second informational function is to provide reliable information on which the Congress can base de-

terminations about funding for the government's programs and activities and to present a comprehensive proposal from the President for spending during the budget year and subsequent periods. The President and the Congress generally use "budget authority"—which is provided in appropriations or through other laws—to direct and limit the amount of the government's "obligations" (binding legal agreements to purchase items or services). Those obligations eventually result in cash outlays (funds paid out of the Treasury). The President's budget records and projects each step in the process—from the provision of budget authority through an agency's obligation of funds to the resulting outlays from the Treasury.

A key measure of fiscal balance for the federal budget is the surplus or deficit in a given year—the difference between revenues received by and outlays from the Treasury. In 2003, for example, the deficit was \$375 billion (see Table 1 for CBO's estimate of the March 2004 baseline, including surplus/deficit projections). Another key budgetary measure of the government's financial position is the amount of its debt that is held by the public (generally in the form of Treasury securities). If the government spends more than it collects, it borrows the balance from the public. If it collects more than it spends, it reduces the debt.<sup>6</sup> In general, the cumulative measure of imbalances (across all periods) is the sum of all surpluses and deficits—or government debt held by the public. At the end of fiscal year 2003, that debt totaled \$3.9 trillion, or 36 percent of gross domestic product (GDP). Comparisons of government debt held by the public and GDP are an important measure because GDP represents the economic resources available to finance public as well as private activities.

### The Federal Government's Financial Statements

Issued annually by the Treasury, the financial report of the U.S. government includes assets, liabilities, and net

4. The term "budget" can apply to a variety of plans. For example, "the budget" may also refer to the budget resolution (the fiscal plan adopted by the Congress) as well as to the appropriation and authorizing legislation enacted to carry out that plan. In this report, the term "budget" refers to the President's budget request. The "budget year" refers to the first year for which discretionary appropriations have not yet been enacted and for which the budget proposes a spending plan.

5. That treatment is required by the Federal Credit Reform Act of 1990, under which the budget accounts for credit programs so that their costs can be more easily compared with the costs of other kinds of federal spending.

6. The change in debt held by the public does not exactly equal the surplus or deficit. For example, the budget deficit for 2003 was \$375 billion, but the increase in debt held by the public for that year was \$373 billion. Most of the difference between the two measures is attributable to the funding of financing accounts for federal direct loan programs—which increased the government's borrowing requirements but not outlays or the deficit. The government also reduced the Treasury's cash balances in 2003, which lessened borrowing (by freeing up that cash for other purposes).

**Table 1.****CBO's March 2004 Baseline Projections**

(Billions of dollars)

	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005- 2009	Total, 2005- 2014
<b>Revenues</b>														
Individual income taxes	794	762	885	997	1,074	1,146	1,237	1,335	1,528	1,684	1,786	1,896	5,339	13,569
Corporate income taxes	132	161	223	264	272	274	275	277	285	295	306	318	1,308	2,789
Social insurance taxes	713	747	789	830	868	906	946	988	1,031	1,076	1,123	1,173	4,340	9,732
Other	144	148	152	164	170	178	185	184	190	215	224	234	849	1,896
<b>Total</b>	<b>1,782</b>	<b>1,817</b>	<b>2,050</b>	<b>2,255</b>	<b>2,384</b>	<b>2,505</b>	<b>2,643</b>	<b>2,785</b>	<b>3,035</b>	<b>3,271</b>	<b>3,439</b>	<b>3,620</b>	<b>11,837</b>	<b>27,986</b>
On-budget	1,258	1,273	1,477	1,654	1,755	1,846	1,953	2,064	2,282	2,484	2,618	2,762	8,685	20,895
Off-budget	524	545	572	601	629	659	690	721	753	786	821	858	3,152	7,091
<b>Outlays</b>														
Discretionary spending	825	895	936	956	973	998	1,021	1,045	1,074	1,091	1,122	1,150	4,882	10,364
Mandatory spending	1,179	1,245	1,297	1,352	1,429	1,511	1,601	1,694	1,806	1,880	2,011	2,142	7,190	16,724
Net interest	153	155	180	220	257	282	302	318	330	338	340	343	1,241	2,911
<b>Total</b>	<b>2,158</b>	<b>2,295</b>	<b>2,413</b>	<b>2,528</b>	<b>2,659</b>	<b>2,791</b>	<b>2,924</b>	<b>3,057</b>	<b>3,211</b>	<b>3,309</b>	<b>3,473</b>	<b>3,635</b>	<b>13,314</b>	<b>29,998</b>
On-budget	1,795	1,911	2,014	2,120	2,237	2,355	2,472	2,586	2,721	2,795	2,932	3,064	11,199	25,297
Off-budget	363	384	398	408	421	435	452	471	490	514	541	571	2,115	4,702
<b>Surplus or Deficit (-)</b>	<b>-375</b>	<b>-477</b>	<b>-363</b>	<b>-273</b>	<b>-274</b>	<b>-286</b>	<b>-281</b>	<b>-272</b>	<b>-176</b>	<b>-38</b>	<b>-34</b>	<b>-15</b>	<b>-1,477</b>	<b>-2,012</b>
On-budget	-536	-638	-537	-466	-482	-509	-519	-523	-439	-310	-314	-302	-2,513	-4,402
Off-budget	161	161	174	193	208	224	238	250	263	273	280	287	1,036	2,390
Debt Held by the Public	3,914	4,385	4,762	5,048	5,335	5,633	5,927	6,212	6,400	6,450	6,496	6,525	n.a.	n.a.
<b>Memorandum:</b>														
Gross Domestic Product	10,829	11,469	12,091	12,682	13,236	13,862	14,519	15,187	15,862	16,562	17,301	18,070	66,389	149,371

Source: Congressional Budget Office.

Notes: Off-budget entries in the table are spending or revenues excluded from the budget by law, such as the revenues and outlays of the Social Security trust funds and the transactions of the Postal Service.

n.a. = not applicable.

cost. The report primarily uses an accrual rather than a cash basis of accounting.<sup>7</sup> An accrual system recognizes transactions when they occur rather than when the resulting cash comes in or goes out. For example, the financial accounts recognize the costs of federal employees' pensions and other retirement benefits as they are earned. Similarly, changes in environmental and disposal liabilities are estimated and reported as expenses when agencies become liable for cleaning up hazardous waste at federal sites rather than when the government actually pays for

that remediation. Thus, under an accrual approach, sums that are committed in the current period but that will be paid out later are included in the current period's expenses.

The primary goal of the financial report is to provide a statement of the government's net financial position and how that position changed—in terms of the income the government received and the expenses it incurred—during the fiscal year (October 1 through September 30). The government uses a format much like that used by publicly traded corporations. The report is prepared according to generally accepted accounting principles pro-

7. See Department of the Treasury, *Financial Report of the United States Government* (February 27, 2004), for the 2003 report.

mulgated by the Federal Accounting Standards Advisory Board (FASAB) and consolidates the reports of individual federal agencies.<sup>8</sup> It consists of multiple statements, including a balance sheet and statements of the government's operations and net cost; extensive disclosures, in the "Stewardship Information" section, about social insurance programs (especially Social Security and Medicare) and so-called stewardship land (such as wilderness areas and national forests); notes to the statements, which summarize significant accounting policies and provide more details on particular categories of assets and liabilities; and a discussion and analysis of the financial results for the reporting period.

**The Balance Sheet: Assets and Liabilities.** The balance sheet, one of the major statements in the financial report, indicates the government's financial condition through the assets it owned or controlled as well as through the liabilities it owed at the end of the reporting period (see Table 2). Because the balance sheet summarizes the results of all resource flows to date (in the form of assets and liabilities), it is often considered the best source of information on the government's holdings of monetary assets and noncash items (such as accounts receivable), inventories, property, structures, and equipment. The statement also reports liabilities (for example, debt held by the public, pension liabilities, and environmental and disposal liabilities) in accordance with FASAB-promulgated standards.

The balance sheet does not include all federal assets and foreseeable outflows of resources. Specifically, some government assets are not considered spendable resources, and many of the government's potential commitments do not meet the high threshold requirements for a recorded asset or liability. As an example, the asset side of the balance sheet currently omits vast holdings of public land.<sup>9</sup>

However, the financial report provides information on a broader range of claims in other parts of the document. For example, the balance sheet does not include payments for Social Security and Medicare until they are due and payable because these do not represent a current liability—current law may be changed to alter future payments. However, projected payments are reported in the

special section on the government's so-called stewardship responsibilities. Nor does the balance sheet encompass contingent liabilities for losses that may occur in federal insurance programs. Information on those potential costs is provided either through notes to the statements or as required supplemental data.

In keeping with its focus on the financial effects of events that have already occurred, the balance sheet also omits what many regard as the government's most valuable "asset": its power to levy taxes. Future tax receipts (excepting those that currently constitute a "receivable," in accounting terms) are omitted because they do not meet FASAB's definition of an asset—which requires not only the likelihood of future economic benefit but a past event that conveyed ownership or control to the reporting entity. Thus, future income tax revenues are not counted as an asset to the government until taxable income is earned and taxes on it are collectible.<sup>10</sup>

The government's net position can be positive (more assets than liabilities) or negative (more liabilities than assets). At the end of 2003, the government's reported net position was an excess of liabilities over assets of \$7.1 trillion, largely reflecting the government's borrowing to finance accumulated deficits and its accrued liabilities for federal employees' and veterans' benefits (see Table 2). As a percentage of GDP, the government's net position represented about 66 percent. By contrast, the budget's main measure of indebtedness—government debt held by the

8. The Department of the Treasury, OMB, and the Government Accountability Office established FASAB in 1990 to develop accounting standards and principles for the federal government.

9. The Office of Management and Budget also produces a federal balance sheet; for 2003, it valued federal land at \$553 billion and mineral rights at \$649 billion. See *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives*, Table 12-1, p. 188. In addition, although the land's value is not "booked" (recorded on the asset side of the balance sheet), federal accounting standards require information on the number of acres of land held and descriptions of so-called heritage assets (such as monuments, museums, and historical sites). See *Financial Report of the United States Government* (February 27, 2004), pp. 94-97.

10. Revenues are recognized once a legally enforceable claim exists and the collection is probable and measurable. The accounting method used for taxes is a modified cash-basis method rather than one with an accrual basis. See Federal Accounting Standards Advisory Board, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, Statement of Federal Financial Accounting Standards No. 7 (May 10, 1996), paragraphs 5, 6, and 46-49.

**Table 2.****The Federal Government's Balance Sheet, 2002 and 2003**

(Billions of dollars)

	2002	2003
<b>Assets</b>		
Cash and Monetary Assets	141.6	119.6
Receivables		
Accounts <sup>a</sup>	32.0	33.8
Loans <sup>a</sup>	219.2	221.1
Taxes	21.4	22.9
Inventories and Related Property <sup>a,b</sup>	192.2	241.2
Property, Structures, and Equipment <sup>a,b</sup>	324.7	658.2
Other Assets	<u>65.4</u>	<u>97.1</u>
<b>Total Assets</b>	<b>996.5</b>	<b>1,393.9</b>
<b>Liabilities</b>		
Accounts Payable	55.8	62.2
Debt Held by the Public and Accrued Interest	3,573.2	3,944.9
Federal Employee and Veterans' Benefits	3,589.4	3,880.0
Environmental and Disposal Liabilities	273.0	249.9
Social Insurance and Other		
Benefits Due and Payable	95.3	100.0
Insurance Programs <sup>c</sup>	53.9	69.9
Loan Guarantees	28.1	34.6
Other Liabilities	<u>148.0</u>	<u>157.1</u>
<b>Total Liabilities</b>	<b>7,816.7</b>	<b>8,498.6</b>
<b>Net Position (Assets minus liabilities)</b>	<b>-6,820.2</b>	<b>-7,104.7</b>
<b>Total Liabilities and Net Position</b>	<b>996.5</b>	<b>1,393.9</b>

Source: Congressional Budget Office based on Department of the Treasury, *Financial Report of the United States Government* (updated March 30, 2003), p. 58; *Financial Report of the United States Government* (February 27, 2004), pp. 62 and 123; and unpublished data from the Treasury's Financial Management Service.

Note: The balance sheets are figured as of September 30, the end of the government's fiscal year.

a. Reported on a net basis.

b. The amount for 2002 excludes the Department of Defense's holdings.

c. The category's title is somewhat misleading because the total for 2003 includes amounts for items such as retirement benefits owed to contractors working for the Department of Energy (\$9.8 billion) and to the District of Columbia's teachers, police, and firemen (\$8.3 billion).

public and reported on a cash-flow basis—totaled \$3.9 trillion, or 36 percent of GDP.

Even though the federal balance sheet bears a strong resemblance to that of a private company, the interpretation of the government's net position differs significantly from that of net equity, the corresponding measure for a private firm. A private firm with negative equity is insolvent. Because a sovereign government that retains its

power to tax can continue to operate indefinitely, the government's net position indicates the extent to which the cost of past government activities will have to be paid in the future.

**Net Operating Cost.** The financial report uses the "Statements of Net Cost" and the "Statements of Operations and Changes in Net Position" to report how the government's financial position has been affected by the income

it received and the expenses it incurred during the reporting period. Just as the budget deficit is linked numerically and conceptually to changes in debt held by the public, the government's net operating cost for a particular year—after some minor adjustments—is the change in the government's net position. Because losses on the statements of net cost will result in either a reduction in assets or an increase in liabilities, the amount of the loss equals the decrease in assets plus the increase in liabilities. (The reverse is true for operating gains.)

Like the balance sheet, the government's net operating cost (which can also be expressed as revenues minus the net cost of operations) reflects a broad range of resources. For example, the net operating cost includes as expenses pensions and other postretirement benefits that were earned by federal military and civilian employees during the reporting period, increases in federal liabilities for environmental cleanup operations, and the depreciation of assets. Nevertheless, because the purpose of the net operating cost measure is to represent only recognizable, or "bookable," income and costs, the measure falls short of being comprehensive.<sup>11</sup> For example, it recognizes no costs for contingent liabilities related to disasters or acts of terrorism beyond the amounts actually incurred during the reporting period and no revenues from taxes on income earned in the period that are not yet owed by taxpayers.

Because the government's financial statements take in some accrued as well as current expenses, a significant share of the costs being reported in the net operating measure is related to activities conducted in earlier periods. Specifically, current expenses in this context reflect benefits earned in the current period, interest on benefits earned in previous periods, and reestimates of the cost of benefits earned in past periods. For example, in 2003, the total expense reported for federal pensions was \$152 billion, and the amount reported for federal retiree health insurance was \$135 billion. The cost of federal employees' deferred compensation earned during the year was \$39 billion for pensions and \$21 billion for retiree health insurance.<sup>12</sup> Interest on retirement-related liabilities was \$115 billion for pensions and \$52 billion for retiree health benefits, and actuarial adjustments (to correct for

discrepancies between estimated and actual results) increased federal liabilities for pensions by \$2 billion and retiree health benefits by \$62 billion. Thus, the current-services component of those costs (the amount representing costs for 2003—\$60 billion) was only about 20 percent of the total costs (\$287 billion).

The net operating cost reported in the financial statements for fiscal year 2003 was \$665 billion. That measure can be reconciled with the budget's summary measure—the surplus (or deficit), which was \$375 billion in 2003—by taking into account increases in liabilities for future payments of military pensions and retiree health benefits, veterans' compensation, and the pensions and retiree health benefits of federal civilian employees, which the budget does not currently include. That reconciliation is carried out in the financial report (see Table 3).<sup>13</sup> As a general rule, the additional accruals that are not part of the budget make it likely that any shortfall indicated in the financial report's statements of operations will be larger than the budget deficit.

### Long-Term Budget Projections

The use of an extended budgetary planning horizon (for example, five- and 10-year periods rather than one year) allows policymakers to see more of the consequences of current policy decisions, which may better align those decisions with longer-term budgetary goals. For the same reason, some policymakers prefer even longer-term projections, including those with 50- to 100-year spans.<sup>14</sup> CBO and OMB both produce long-term estimates, which are based on assumptions about the continuation of current laws, long-run rates of productivity and growth of the labor force, and alternative paths for several variables: medical costs (in the Medicare and Medicaid programs), other mandatory spending (including Social Security and unemployment insurance), and defense and nondefense discretionary spending. Such projections are

11. If an asset (or liability) is "bookable," it can be recorded on the asset (or liability) side of the balance sheet according to guidance provided by the Federal Accounting Standards Advisory Board.

12. Deferred compensation is the portion of employees' compensation for services (hours of labor)—in the form of pensions and retiree health benefits—that employees receive at a later date in addition to their current salary and health benefits.

13. See Department of the Treasury, *Financial Report of the United States Government* (February 27, 2004), p. 60.

14. For the latest such projections, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003); and *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives*, pp. 190-200.

**Table 3.****Reconciling Net Operating Cost and the Budget Surplus or Deficit, 2001 Through 2003**

(Billions of dollars)

	2001	2002	2003
<b>Total Budget Surplus or Deficit (-)</b>	<b>127.0</b>	<b>-157.7</b>	<b>-374.8</b>
Increase in Liabilities			
Military pensions and health benefits	-406.8	-32.4	-101.1
Veterans' compensation	-139.3	-157.3	-105.6
Federal civilian pensions and health benefits	-50.1	-38.9	-79.9
Other <sup>a</sup>	<u>-13.1</u>	<u>-13.8</u>	<u>-25.1</u>
Subtotal	-609.3	-242.4	-311.7
Change in Environmental and Disposal Liabilities <sup>b</sup>	-5.7	33.8	23.1
Depreciation Expense	-21.4	-20.5	-71.2
Budget Deficit Components Not in Net Operating Cost			
Fixed asset purchases	34.4	40.9	102.0
Repayments on the principal of loans made before credit reform	-19.9	-8.2	-9.1
Other <sup>c</sup>	<u>-19.9</u>	<u>-10.8</u>	<u>-23.3</u>
Subtotal	-5.4	21.9	69.6
<b>Net Operating Cost</b>	<b>-514.8</b>	<b>-364.9</b>	<b>-665.0</b>

Source: Congressional Budget Office based on data from Department of the Treasury, *Financial Report of the United States Government* (updated March 30, 2003), p. 56; and *Financial Report of the United States Government* (February 27, 2004), p. 60.

Note: Net operating cost is the annual change in the government's net financial position (the difference between its assets and liabilities).

- Includes insurance programs, the Exchange Stabilization Fund, and contractual services as well as other miscellaneous programs.
- Costs from federal operations that are known to result in hazardous waste and that the federal government is required, by statute or regulation, to clean up.
- Covers a variety of components, including tax receivables, increases in benefits due and payable, accounts payable, prior-period adjustments, and increases in other assets and inventory. Some of those components are included in the budget deficit but not in net operating cost in the government's financial statements.

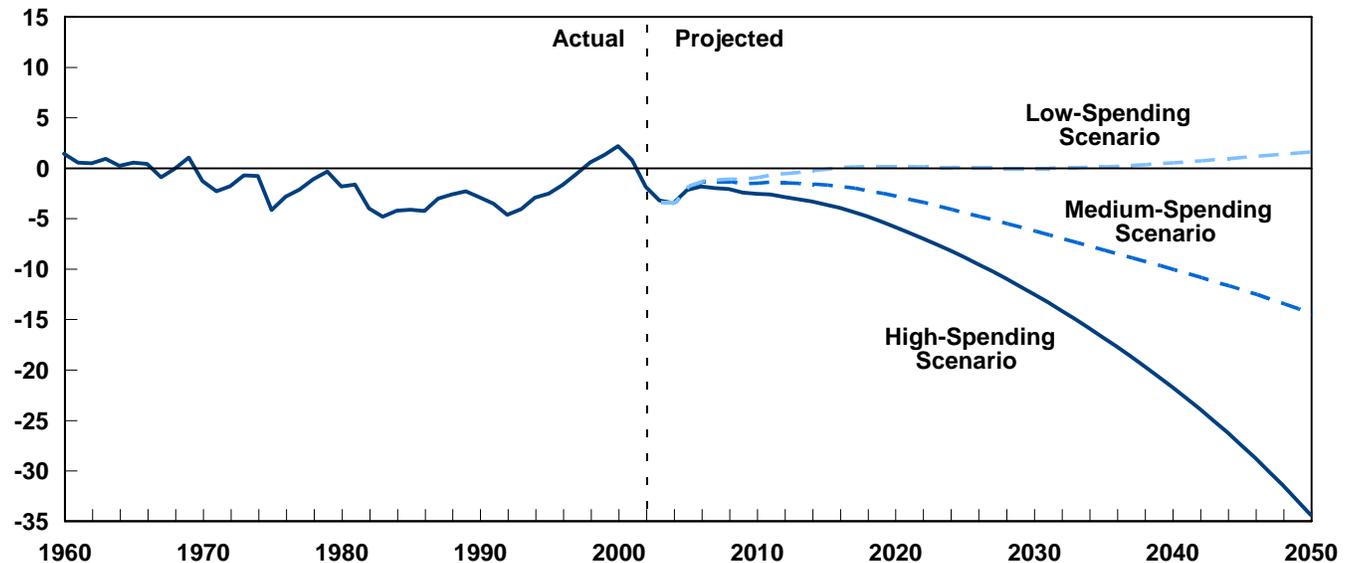
now included in both the Administration's annual budget documents and in the information provided in the government's financial report.

Long-term budget projections provide a different outlook on the government's fiscal position from the one offered in the balance sheet primarily because they project future tax collections and expenditures. Such projections forecast cash inflows and outflows for all current programs and policies under current law as far into the future as is thought useful. Another strength of long-term budget projections is that they show the path of future fiscal imbalances over time, which is useful in designing remedial policies.

Many analysts who prepare long-term budget projections indicate the uncertainty attached to those future-year numbers. Because that uncertainty has many sources, such analyses typically show projected spending and revenues under current law using a variety of assumptions. Perhaps most obviously, uncertainty arises in projecting future economic conditions, which profoundly affect both receipts and outlays; thus, the analyses usually attempt to reveal the effect of changing assumptions about the economy. In addition, because the Congress determines discretionary spending in its annual appropriation bills and its decisions are difficult to foresee, long-term projections must incorporate an assumed path for that type of spending. OMB in its long-term projections, for instance, assumes that discretionary spending will grow with inflation and, alternatively, with nominal GDP.

**Figure 1.****Total Surplus or Deficit Under CBO's Long-Term Budget Scenarios**

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure was adapted from CBO's *The Long-Term Budget Outlook* (December 2003). For more information about the scenarios, see Table A-1 and Chapter 1 in that report. All scenarios, which were computed without taking economic feedbacks into account, assume that after 2012, taxation levels remain at 18.4 percent of GDP.

The growth of costs for the government's major health care programs is also a substantial source of budgetary uncertainty. CBO includes alternative paths in its long-term projections that show, for example, total federal spending for Medicare and Medicaid in 2050 ranging from 6.4 percent of GDP to more than 21 percent, up from 3.9 percent in 2003.<sup>15</sup>

As with traditional budgetary analyses, a key indicator of the federal government's overall fiscal position is the gap between revenues and outlays over time—that is, the surplus or deficit. CBO's recent long-term budget analysis indicated that if overall taxation levels remained at 18.4 percent of GDP after 2012, the gap might grow from 3.5 percent of GDP in 2003 to as much as 35 percent in 2050. Alternatively, the budget could produce a surplus, depending on the assumed course of federal spending (see Figure 1).

Another important indicator of the government's financial condition is federal debt held by the public. Under the surplus/deficit paths illustrated in Figure 1, federal debt could grow from 36 percent of GDP in 2003 to a multiple of GDP in 2050 (see Figure 2). Or, depending on the projections' underlying assumptions about the future course of federal spending, federal debt could trend down to zero.

**Summary Present-Value Measures**

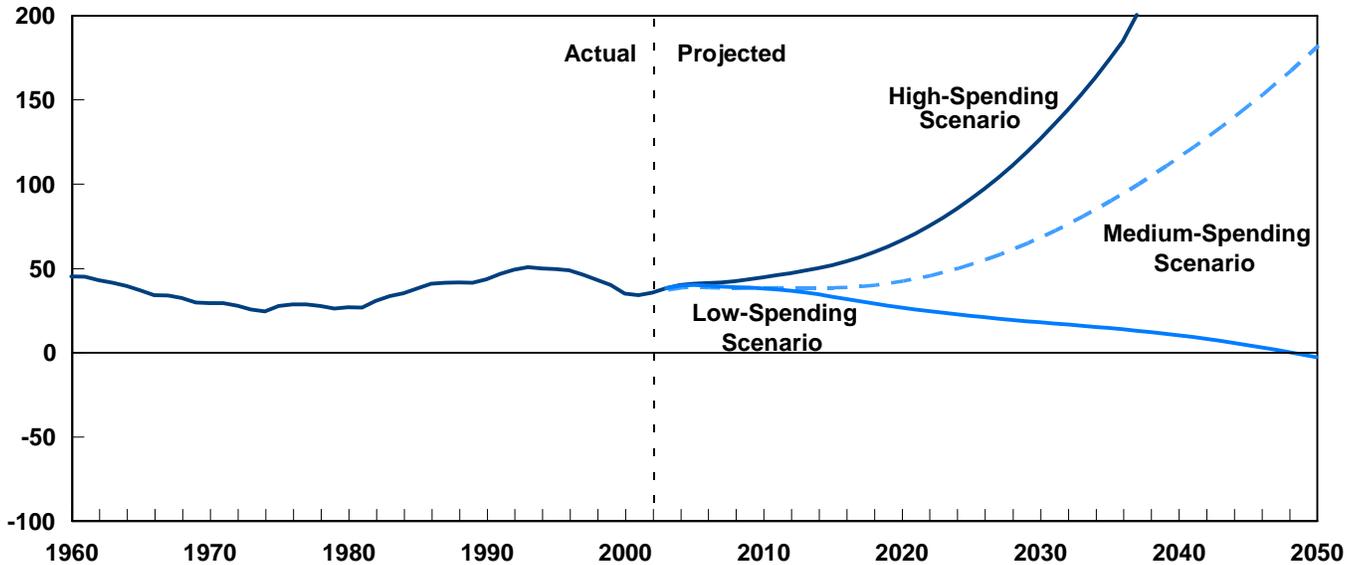
In general, present-value measures translate a projection of long-term cash flows into one number that reflects the time value of money—but they may differ in their specifics. Some may deal with cash flows over different periods, such as 50 years or even an “infinite horizon,” incorporating the assumption that current law continues indefinitely. Other measures may focus only on liabilities; still others, on both assets and liabilities (in so-called “fiscal imbalance” measures).

Notwithstanding such differences, the creation of all present-value measures follows essentially the same two-step process. First, analysts calculate future cash flows for a specific program or set of programs (such as the cash

15. For additional detail, see Congressional Budget Office, *The Long-Term Budget Outlook*.

**Figure 2.****Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios**

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure was adapted from CBO's *The Long-Term Budget Outlook* (December 2003). For more information about the scenarios, see Table A-1 and Chapter 1 in that report. All scenarios, which were computed without taking economic feedbacks into account, assume that after 2012, taxation levels remain at 18.4 percent of GDP.

flows provided in long-term budget analyses). Second, they discount the value of that spending (or revenues, or both) over a specific period to produce one number. A discount rate is applied to the annual cash flows to determine their present value because people place less value on a dollar in the future than they do on one in the present. Consequently, a dollar today is worth more to them than a dollar tomorrow.

One commonly used summary measure is the fiscal imbalance of the federal government over an infinite horizon. That measure, which is the present value of all federal fiscal shortfalls for all programs relative to the present value of GDP, indicates the general extent of the gap. One recent study, for example, calculated a fiscal imbalance of \$45.5 trillion, or 6.5 percent of the present value of GDP (see Table 4 on page 10).<sup>16</sup>

Most (5.4 percent of the present value of GDP) of the fiscal imbalance estimated in that study was attributable to Medicare and reflects how much the program's spending

is expected to exceed the receipts earmarked for it. One reason that the imbalance for Medicare was so large is that the premiums paid by recipients cover only 25 percent of benefits for Part B, Medicare's Supplementary Medical Insurance. Another contributing factor was the cost of the President's proposal for prescription drug coverage as it was presented in the 2004 budget (\$6.1 trillion, using the study's infinite-horizon approach). That cost raised the estimated imbalance by about 1 percent of

16. Jagadeesh Gokhale and Kent Smetters, *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities* (Washington, D.C.: AEI Press, 2003). The calculation used OMB's economic assumptions and the Social Security Administration's demographic assumptions and interpreted current policies as including the President's proposals in his budget request for 2004. Gokhale and Smetters' results indicated that under their assumptions, restoring fiscal balance would require an immediate and permanent payroll tax hike of 16.6 percentage points, a two-thirds increase in income taxes, or a cut of 45 percent in Social Security and Medicare benefits. Delaying implementation of those measures would increase the size of the necessary adjustments.

**Table 4.**

## Sensitivity of Fiscal Imbalance Measures to Different Discount Rates and Growth Assumptions

(Percentage of the present value of GDP)

	Fiscal Imbalance Under							
	Midrange Assumptions		Alternative Discount Rates <sup>a</sup>		Alternative GDP Growth Rates per Capita <sup>b</sup>		Alternative Growth Rates of Health Care Outlays per Capita <sup>c</sup>	
	Billions of 2002 Dollars	Percentage of GDP	High	Low	High	Low	High	Low
Social Security	7,204	1.0	0.9	1.2	1.2	0.9	1.0	1.0
Medicare <sup>d</sup>	37,590	5.4	4.9	6.0	6.7	4.5	7.3	3.9
All Other Federal Programs	676	0.1	0.1	0.1	-2.3	1.7	1.0	-0.6
<b>Total Fiscal Imbalance</b>	<b>45,470</b>	<b>6.5</b>	<b>5.9</b>	<b>7.3</b>	<b>5.7</b>	<b>7.1</b>	<b>9.4</b>	<b>4.3</b>

Source: Congressional Budget Office based on Jagadeesh Gokhale and Kent Smetters, *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities* (Washington, D.C.: AEI Press, 2003), Table 5, p. 39; and unpublished data supplied by Jagadeesh Gokhale.

Note: The present value of GDP over an infinite horizon was \$699.07 trillion in 2003, according to Gokhale and Smetters.

- The midrange assumption for the discount rate was 3.6 percent, the high assumption was 3.9 percent, and the low assumption was 3.3 percent.
- The midrange assumption for GDP growth per capita was 1.7 percent, the high assumption was 2.2 percent, and the low assumption was 1.2 percent.
- The midrange assumption for the "excess" growth of health care outlays per capita (the difference between the annual growth of outlays for Medicare and Medicaid per capita and the annual growth of GDP per capita) was 1.0 percent, the high assumption was 1.5 percent, and the low assumption was 0.5 percent.
- Based on current policy in 2003 and the policies proposed in the President's 2004 budget request, including the Administration's plan for a Medicare prescription drug benefit.

the present value of GDP.<sup>17</sup> (The proposal was enacted, with some modifications, as the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Public Law 108-173.)<sup>18</sup>

Such measures, however, are particularly sensitive to assumptions about the growth of productivity, the growth of Medicare costs, and the discount rate used to convert those future cash flows to present values. The assumption about cost increases for Medicare is the most critical influence. Consider an assumption that health care outlays

per beneficiary will grow 1.0 percent faster than real (inflation-adjusted) GDP per capita through 2080. Adjusting that rate down or up by 0.5 percent would result in a total fiscal imbalance, under the assumptions of the Gokhale-Smetters study, that ranged from 4.3 percent of the present value of GDP to 9.4 percent (see Table 4).

17. See the statement of Joseph Antos and Jagadeesh Gokhale, American Enterprise Institute, "The Cost of Adding a Prescription Drug Benefit to Medicare," before the Subcommittee on Human Rights and Wellness of the House Committee on Government Reform, July 17, 2003; and Joseph Antos and Jagadeesh Gokhale, "A Benefit That Is Bad for America's Health," *Financial Times*, June 20, 2003.

18. Actuaries for the Medicare program estimate that the prescription drug benefits established by the Medicare Modernization Act will raise expenditures by 2.4 percent of GDP over an infinite horizon and that premiums will cover an amount equal to 0.4 percent of GDP. The remainder will be covered by general revenues (1.8 percent of GDP) and state transfers (0.2 percent). The actuaries also project a fiscal gap of 2.4 percent of GDP for Medicare's hospital insurance program (Part A) and 2.5 percent for its Supplementary Medical Insurance (Part B). See Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2004 Annual Report*, pp. 60-61, 99-100, and 108-109.

Small changes in the discount rate will also generate large swings in the overall fiscal imbalance measure. Lowering the discount rate from 3.6 percent to 3.3 percent, for example, would increase the total imbalance from 6.5 percent of the present value of GDP to 7.3 percent.

## Future Program Costs, Contingent Liabilities, and Unfunded Liabilities

The provision in the budget resolution identified three specific aspects of the government's financial position—the future costs of current programs, contingent liabilities, and so-called unfunded liabilities—that have generated concerns about the adequacy and transparency of the information provided in current budgetary and accounting reports.

The three specific concerns noted in the provision differ significantly in concept and potential magnitude. The future costs of some programs are a significant source of growth in the demand for government resources. Contingent liabilities (which also arise from current programs or activities) are likely to contribute much less to that growth, but they are particularly difficult to predict in both their magnitude and timing. Unfunded liabilities attempt to quantify the gap between the future costs of current programs and the resources that are expected to be available to fund those costs. Their magnitude reflects the scope of programs and resources included in the calculation.

### Future Costs of Current Programs

Some large federal programs entail cash flows for as long as current law is unchanged. Near-term flows are captured in the government's five- and 10-year budgets, and long-term flows are shown in projections that can look 100 years or more into the future. CBO, in its December 2003 report *The Long-Term Budget Outlook*, analyzed six different budgetary scenarios and projected that future federal spending as a percentage of GDP (excluding interest payments on debt held by the public) could range from 17 percent to 33 percent in 2050, versus 18.5 percent in 2003. That report concluded that “unless taxation reaches levels that are unprecedented in the United States, current spending policies will probably be financially unsustainable over the next 50 years.”

Medicare is the source of the largest potential growth and the most uncertainty among current programs because much of its spending is driven by the costs of medical

care. Those costs have been rising for the past 40 years at a pace significantly faster than that of inflation. Depending on the assumptions made about the future path of health care spending, projected costs can vary greatly. CBO estimates that Medicare expenditures could rise from approximately 2 percent of GDP in 2003 to between 5 percent and 17 percent in 2050 (see Figure 3).

Social Security is also a significant source of future spending growth, but the future increase is likely to be smaller and more predictable than that for Medicare. CBO projects that expenditures for Social Security will grow from 4.4 percent of GDP in 2003 to more than 6 percent in 2030 (see Figure 4) and to nearly 7 percent by 2100.

The government's financial report also contains selected summary measures of those costs. The social insurance statement included in the financial report for 2003 describes \$26.9 trillion in social insurance responsibilities—\$11.7 trillion attributable to Social Security and \$15.0 trillion to Medicare (see Table 5).<sup>19</sup> Those commitments are reported on a 75-year closed-group basis—that is, they represent present-value estimates of benefits in excess of contributions and earmarked taxes for participants who were at least 15 years of age at the start of the period. (Specifying the age in that way makes it a “closed” group; an “open” group would include everyone alive during the 75-year span.)

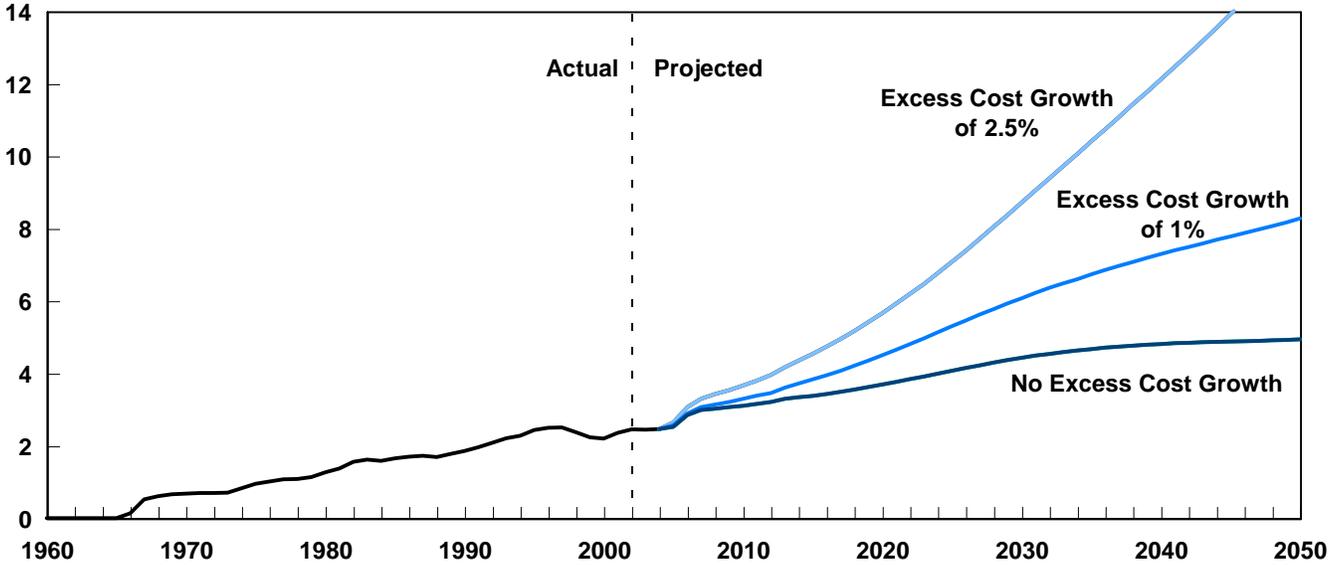
Two concerns are sometimes voiced about the usefulness of those data on future costs: their uncertainty and the difficulty in interpreting them. The uncertainty arises from the problems involved in developing such projections—specifically, in accurately forecasting over many decades such things as underlying economic conditions, relevant global events, and demographic and other factors. Some analyses of long-term program costs attempt to properly quantify the level of uncertainty associated with the estimates. The broad range of the uncertainty confirms the lack of precision of the particular estimates but does not negate the information regarding the scale of long-term spending pressures. Summary present-value measures may obscure that uncertainty by discounting

19. That estimate for Medicare preceded the most recent report of the Medicare trustees, which contains their first estimate of the 75-year cost of the new prescription drug benefit (Part D of Medicare). See Board of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2004 Annual Report*.

**Figure 3.**

**Medicare Spending Under Current Law**

(Percentage of GDP)



Source: Congressional Budget Office.

Note: This figure was adapted from CBO's *The Long-Term Budget Outlook* (December 2003). For more information about the scenarios, see Table A-1 and Chapter 1 in that report. Excess cost growth, figured on an average annual basis, is growth in Medicare's costs per enrollee above the rise in GDP per capita.

those flows—using arbitrary discount rates—to a single number.

Interpreting summary measures of costs—which for the largest government programs often reach trillions of dollars—can also be quite challenging because many of the measures do not include information about the resources that will be available to pay those costs. One solution is to compare the costs with GDP, which represents the economic resources available for public as well as private activities.

**Contingent Liabilities**

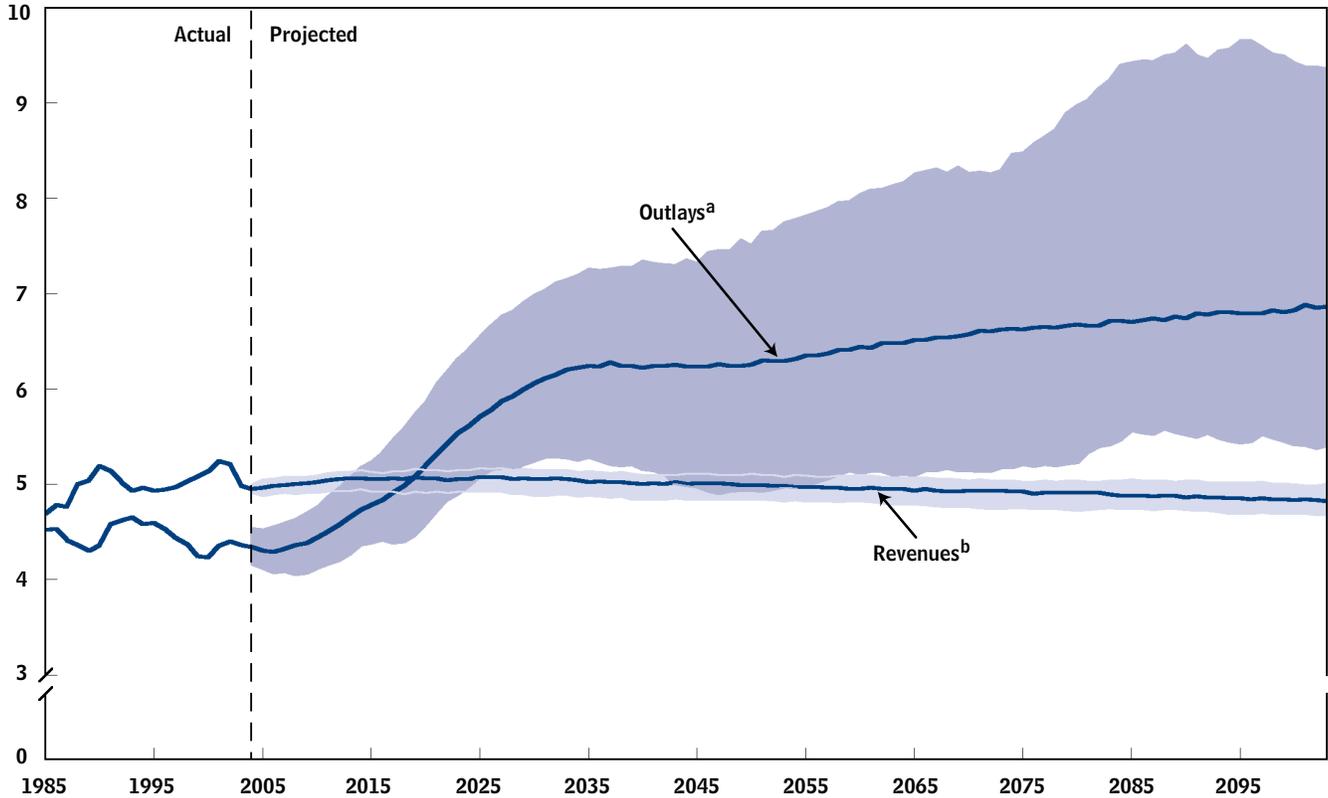
The federal government provides explicit and implicit insurance coverage against the failure of banks and pension plans, against property and casualty losses from terrorism and natural disasters, and against crop failures—to name some of the largest programs. The budget recognizes the losses from those events, or “contingencies,” when cash outlays—in the form of insurance or other kinds of payments—are made. Foreseeable losses are recognized in the

government’s financial statements as liabilities if the losses have already been triggered by past events. However, contingent liabilities, which lack such a trigger, appear in the financial report not as line items but as notes.

Although a large body of information exists for some contingencies, the various measures of the government’s total potential liabilities are incomplete in two primary areas. First, the measures do not include certain categories of contingent liabilities, such as the government’s expected responses to large natural disasters (for example, earthquakes and floods) or the risks associated with government-sponsored enterprises (such as Fannie Mae and Freddie Mac). Second, the manner in which the federal government calculates contingent liabilities may be too limited—especially in its neglect of the cost of risks related to changing economic conditions. (Private estimates routinely factor such risks into their measures of contingencies.) Efforts, including some by CBO, are currently under way to develop means of systematically valuing the potential losses from some of those contingencies.

**Figure 4.****Social Security Spending and Revenues Under Current Law**

(Percentage of GDP)



Source: Congressional Budget Office.

Note: The dark lines indicate CBO's projections of expected outcomes, and the shaded areas show ranges of uncertainty around each projection. For more discussion, see Congressional Budget Office *The Outlook for Social Security* (June 2004).

- a. Scheduled benefits and administrative costs.
- b. Payroll taxes and revenues from the taxation of benefits.

**Reported Contingent Liabilities.** As the budget shows, federal insurance programs report net inflows of cash (mainly from premiums) in most years; however, the programs also represent a large contingent liability. Some of the expected losses from insurance programs are recorded in the budget but only those for which cash payouts are expected during the period that the budget covers.<sup>20</sup> More generally, under the budget's cash flow accounting, insurance programs appear to be costly only in past "bad"

years (years with a high level of claims) and profitable in past good years. The budget also reports contingent liabilities for loan and other credit programs. However, with the exception of credit programs, unless a specific cash flow or subsidy can be identified or reliably predicted for a specific contingent liability, the total liability or risk will generally not be recognized in the budget.

The federal financial statements and their accompanying notes disclose information about the government's outstanding commitments and contingent liabilities. Commitments include legal obligations for the cost of operations and capital leases, undelivered orders, and callable

20. The expected future cost of federal insurance programs is reported in *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives*, pp. 92-97.

**Table 5.****Social Insurance and Other Federal Commitments, 2001 Through 2003**

(Billions of dollars)

	2001	2002	2003
Social Insurance <sup>a</sup>			
Social Security	10,542	11,215	11,742
Medicare <sup>b</sup>			
Part A	6,012	6,409	7,287
Part B	6,471	6,487	7,719
Other <sup>c</sup>	<u>35</u>	<u>38</u>	<u>110</u>
Subtotal	23,060	24,149	26,858
Additional Commitments			
Undelivered orders	498	539	596
Multilateral development banks	69	70	62
Long-term leases	49	50	47
Other <sup>d</sup>	<u>45</u>	<u>49</u>	<u>45</u>
Subtotal	661	708	750
<b>Total Social Insurance and Other Commitments</b>	<b>23,721</b>	<b>24,857</b>	<b>27,608</b>

Source: Congressional Budget Office based on Department of the Treasury, *Financial Report of the United States Government* (updated March 30, 2003), pp. 6 and 120; and *Financial Report of the United States Government* (February 27, 2004), pp. 12, 64, and 130.

Note: Responsibilities and commitments are figured as of September 30, the end of the government's fiscal year.

- Numbers are the present value of 75-year projections of benefit payments in excess of contributions and earmarked taxes for participants who were at least 15 years of age at the start of the period.
- These estimates preceded the most recent report of the Medicare trustees and so exclude 75-year costs for the new prescription drug benefit (Part D).
- Includes Railroad Retirement, Black Lung, and unemployment insurance payments.
- Includes commitments for certain activities of the Department of Agriculture, the National Oceanic and Atmospheric Administration's satellites and weather systems, the Tennessee Valley Authority, and the Department of Transportation.

capital for multilateral development banks such as the World Bank.<sup>21</sup> Contingent liabilities include projected costs for pension and deposit insurance. To be recorded in the notes to the financial statements, contingent losses need to be "reasonably possible" (the likelihood of loss is less than 50 percent but more than "remote").<sup>22</sup> The federal government reported \$112 billion of contingent liabilities for 2003. Of that total, \$93 billion was attributable to federal insurance programs and \$9 billion to

unadjudicated claims against the government (see Table 6).

Consistent with their long-term commitments, the government's two largest insurance programs, the Pension Benefit Guaranty Corporation (PBGC) and the Federal Deposit Insurance Corporation (FDIC), have financial statements that generally provide a longer-term perspective.

*Pension Benefit Guaranty Corporation.* PBGC insures most defined-benefit pension plans sponsored by private

21. Callable capital in this case takes the form of a commitment to supply capital to honor the debts of a multilateral development bank if the bank cannot otherwise meet its obligations. Thus far, no such capital has been supplied. See the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, *The Cost and Budgetary Treatment of Multilateral Financial Institutions' Activities*, before the Senate Committee on Banking, Housing, and Urban Affairs, May 19, 2004.

22. Office of Management and Budget, *Accounting for Liabilities of the Federal Government*, Statement of Federal Financial Accounting Standards No. 5 (December 1995), p. 11, paragraph 35, and p. 13, paragraph 40.

**Table 6.****Contingent Liabilities of the Federal Government, 2001 Through 2003**

(Billions of dollars)

	2001	2002	2003
Insurance Programs			
Pension Benefit Guaranty Corporation	11.0	35.5	85.6
Federal Deposit Insurance Corporation	7.0	7.3	5.9
Other insurance programs	<u>0.1</u>	<u>0.5</u>	<u>1.0</u>
Subtotal	18.1	43.3	92.5
Unadjudicated Claims <sup>a</sup>	8.9	9.4	8.8
Other <sup>b</sup>	<u>21.4</u>	<u>17.3</u>	<u>11.1</u>
<b>Total Contingent Liabilities</b>	<b>48.4</b>	<b>70.0</b>	<b>112.4</b>

Source: Congressional Budget Office based on Department of the Treasury, *Financial Report of the United States Government* (updated March 30, 2003), p. 121; and *Financial Report of the United States Government* (February 27, 2004), p. 129.

- a. In 2003, the largest contributor to this category was \$10.3 billion for the Department of Defense's (primarily, the Army's) environmental and disposal contingencies.
- b. Includes losses that are "reasonably possible, more than remote but less than probable." (The federal government's balance sheet and statement of net cost report losses that are probable.) The amounts shown are not offset by future premiums.

employers. Its financial report discloses contingent liabilities for large pension plans sponsored by financially weak firms—firms whose credit rating is below the minimum necessary to consider their debt "investment grade." At the end of 2003, those contingent liabilities totaled \$86 billion, a sharp rise from the \$35 billion reported for 2002.<sup>23</sup> And unless the business prospects of the troubled firms improve, PBGC's liabilities at the end of 2004 could be significantly greater than those recorded for 2003 (see Box 1). CBO estimates in its 10-year budget projections that PBGC's benefit payments will total close to \$50 billion over the 2005–2014 period and that the agency's receipts from premiums, interest, and assets of terminated plans will total \$36 billion.

*Federal Deposit Insurance Corporation.* The FDIC insures deposits in commercial banks and savings associations. Contingent liabilities for the FDIC are reported for cases in which it has identified a troubled institution with an elevated risk of losses. As of December 31, 2003, the agency was reporting contingent liabilities of \$2.3 billion for banks and \$0.2 billion for thrift institutions (for example, savings and loans and mutual savings banks).<sup>24</sup> Thus, the FDIC does not foresee a significant risk of multiple large-bank failures.

23. Pension Benefit Guaranty Corporation, *2003 Annual Report* (2004), pp. 33–34.

**Omitted Contingencies.** A number of potentially large contingent liabilities are not included in the measures of the government's financial position. Although no statutory requirement exists for most federal relief following natural disasters (such as large earthquakes and hurricanes), homeowners, small businesses, and state and local governments frequently anticipate and receive substantial federal assistance for uninsured losses following those events. After Hurricanes Andrew and Iniki in 1992, for example, the federal government provided more than \$4.4 billion of assistance to the affected areas. Similarly, the region struck by the Northridge earthquake in 1994 received \$9.5 billion in aid.<sup>25</sup> Yet federal financial reports record no contingent liabilities for large-scale federal disaster assistance. Nor do they include an amount representing the government's exposure to possible losses through its provision of federal flood insurance, even though the government has contracted to provide reimbursements on insured properties in the event of

24. See Federal Deposit Insurance Corporation, *2003 Annual Report* (2004), pp. 53–54, 75–76, 85, and 93–94. Note that these estimates of contingent liabilities are lower than those reported by the Treasury in the 2003 *Financial Report*. Part of the difference derives from different reporting dates, but most of it is attributable to the FDIC's new method for estimating possible losses, which was adopted in December 2003.

25. Congressional Budget Office, *Federal Reinsurance for Disasters* (September 2002), Table 5, p. 16.

**Box 1.****The Balance Sheet for the Pension Benefit Guaranty Corporation**

The financial statements of the Pension Benefit Guaranty Corporation (PBGC) and, in particular, its negative net position have alerted policymakers to a possible future burden on taxpayers from losses that have already been incurred. PBGC insures about \$1.5 trillion in projected pension benefits in more than 30,000 defined-benefit plans.<sup>1</sup> As of September 30, 2003, PBGC reported liabilities of \$45.3 billion—the present value of the benefits it guarantees for single-employer plans that have terminated or that are likely to be terminated (see the table to the right). Of that amount, \$38.9 billion is attributable to pension plans that are controlled by trustees or already terminated and \$5.2 billion is attributable to probable future terminations. In the past, about 80 percent of the plans classified as “likely to be terminated” have been. Those liabilities are reported on both PBGC’s and the federal government’s balance sheets.

PBGC’s liabilities are partly offset by \$34 billion in assets and receivables of the terminated plans that it is handling. (The agency’s balance sheet does not reflect future premium income.) PBGC’s net position is thus -\$11.2 billion—a change of -\$7.6 billion from 2002, when it reported a net position of -\$3.6 billion. That change is the accrual measure of PBGC’s costs (the measure recognizes transactions when they occur, whether or not cash changes hands) and is reported as a current expense in the federal financial statements. As recently as 2001, PBGC was reporting a positive net position of \$7.7 billion.<sup>2</sup> Meeting PBGC’s commitment to insure pension benefits may lead to additional support by taxpayers if future premiums are insufficient to offset new liabilities.

1. Employment-based retirement plans that promise retirees a certain benefit upon retirement, regardless of the plan’s investment performance.

**PBGC’s Balance Sheet for Single-Employer Plans as of September 30, 2003**

Item	Billions of Dollars
<b>Assets</b>	
Cash and Cash Equivalents	3.2
Investments	
Bonds	17.3
Equities	12.6
Other	<u>0.1</u>
Subtotal	30.0
Receivables	<u>0.8</u>
<b>Total Assets</b>	<b>34.0</b>
<b>Liabilities</b>	
Present Value of Future Payments for:	
Benefits	
Trusteed plans	38.9
Terminated plans <sup>a</sup>	0.5
Settlements and judgments	0.1
Claims for likely terminations	<u>5.2</u>
Subtotal	44.6
Other	<u>0.6</u>
<b>Total Liabilities</b>	<b>45.3</b>
<b>Net Position</b>	<b>-11.2</b>
<b>Total Liabilities and Net Position</b>	<b>34.0</b>

Source: Congressional Budget Office based on Pension Benefit Guaranty Corporation, *2003 Annual Report* (2004), pp. 22-23.

a. Pending trusteeship.

2. For an explanation of the factors contributing to PBGC’s worsening condition, see the statement of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the Senate Special Committee on Aging, October 14, 2003.

flooding.<sup>26</sup> Over the past 10 years, receipts of the flood insurance fund have exceeded disbursements; the largest net outlay in any one year was \$459 million, in 1995.

Another set of contingent liabilities that goes unreported is that for the financial risks posed by government-sponsored enterprises—despite the federal government's implicit guarantee of their obligations.<sup>27</sup> The International Monetary Fund as well as other analysts contends that the enterprises' capital may be insufficient to cover the risks that they are currently taking.<sup>28</sup>

Under some circumstances, the federal programs that are not disclosed as contingent liabilities in the financial statement notes could pose greater risks for taxpayers than those that are reported. On November 26, 2002, the federal government assumed much of the cost of terrorism-related property and casualty losses, but again, the financial statements reported no contingent liabilities related to that insurance. Specifically, the Terrorism Risk Insurance Act of 2002 requires the government to co-insure, or bear, 90 percent of all losses up to an annual cap of \$100 billion after the insurance industry sustains specified losses—\$12.5 billion in total losses in 2004, rising to \$15 billion in 2005.<sup>29</sup> (The program is set to expire at the end of 2005.) In 2002, CBO estimated that the law would increase direct spending by \$6.3 billion and in-

crease governmental receipts by \$3.5 billion over the 2003-2013 period.<sup>30</sup> To date, no claims have been made under that program. The government currently charges no premiums for that coverage, but the Treasury is required to assess surcharges on policyholders after the losses to recover at least some of what it has paid out.

Another criticism of federal reporting is that the valuation of contingencies omits the cost of "market risk." Market risk arises from future changes in overall economic conditions; it is not included in the budget, in the financial statements, or in other means of federal financial reporting because expected cash flows are converted to liabilities by applying a discount rate equal to the rate on Treasury debt. Market risk can affect many programs, including loan programs, the Pension Benefit Guaranty Corporation, and the multilateral financial institutions. Private valuations of equities and other financial instruments routinely include an estimate of market risk.<sup>31</sup>

### Unfunded Liabilities

No federal obligation can be truly considered "unfunded" because of the government's sovereign power to tax to meet its obligations. However, the term "unfunded liability" has been used to refer to gaps between the projected financial commitment to a program or expenditure and the earmarked revenues that are expected to be available to fund that commitment. In particular, certain budgetary terms—notably "trust funds" and "trust fund balances"—may create the impression that because those funds report positive holdings, future federal commitments are paid for. Moreover, the payment of certain taxes, especially payroll taxes for Social Security and Medicare that are credited to trust funds, may lead taxpayers to believe that they have "paid for" certain benefits.

Trust funds can be useful mechanisms for monitoring the balance between earmarked receipts and a program's spending, but they are basically an accounting device,

26. For estimates of risk that taxpayers bear for losses insured by the federal government's flood insurance program, see the statement of Jayetta Z. Hecker, Director, Physical Infrastructure, General Accounting Office, before the Subcommittee on Housing and Community Opportunity of the House Committee on Financial Services, published as General Accounting Office, *Flood Insurance: Challenges Facing the National Flood Insurance Program*, GAO-03-606T (April 1, 2003).

27. See the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, *Regulation of the Housing Government-Sponsored Enterprises*, before the Senate Committee on Banking, Housing, and Urban Affairs (October 23, 2003); and Wayne Passmore, *The GSE Implicit Subsidy and Value of Government Ambiguity*, Finance and Economic Discussion Series Paper No. 2003-64 (Board of Governors of the Federal Reserve System, December 2003).

28. International Monetary Fund, *Global Financial Stability Report: Market Development and Issues* (Washington, D.C.: International Monetary Fund, September 2003), pp. 16-22.

29. For an analysis, see Jeffrey R. Brown and others, *An Empirical Analysis of the Economic Impact of Federal Terrorism Reinsurance*, Working Paper No. 10388 (Cambridge, Mass.: National Bureau of Economic Research, March 2004).

30. For its cost estimate, CBO did not predict how much insured damage would be caused by terrorist attacks in any specific year. The agency's estimate of the cost of financial assistance instead reflects how much the government might be expected to pay insurers on average. That average weighs the probabilities of various outcomes of possible future attacks, ranging from damages of zero up to very large amounts.

31. See Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees* (August 2004).

and their balances, even if “invested” in Treasury securities, provide the government with no resources for meeting future funding commitments.<sup>32</sup> When those payments come due, the government must finance them in the same way that it finances other commitments—through taxes or borrowing from the public. Thus, assessing the state of the federal government’s future finances requires measuring such commitments independently of their funding status.

The budget and the financial statements both provide information on the government’s total unfunded liabilities through their displays of the surplus (or deficit) and of the government’s net financial position, respectively. The budget and long-term budget projections also report the gap between revenues and expenditures for specific trust-fund-related programs over time. For example, CBO projects that although the total revenue dedicated to the Social Security program will remain at approximately 5 percent of GDP for the foreseeable future, program outlays will rise to over 6 percent of GDP by 2050, creating an annual gap of more than 1 percent of GDP at that time.<sup>33</sup>

Unlike long-term projections, measures of fiscal imbalance produce a single measure of the fiscal gap. (In order to calculate the difference between what costs are likely to

be and the resources that will be available to meet them, such measures generally assume that taxation will remain at specified levels.) Some analysts estimate that the fiscal gap for the entire federal government today is between 6.5 percent and 7.5 percent of the present value of GDP.<sup>34</sup> Measures of fiscal imbalance can also be applied to a specific program (if one assumes that the program has a dedicated stream of revenues). For example, CBO estimates that a 100-year measure of the fiscal imbalance in the Social Security program is 0.5 percent of GDP.<sup>35</sup>

Such numbers are difficult to translate into policy prescriptions, however, because they do not reveal the pattern of expenditures over time. In cases in which costs are expected to increase over time, the fiscal imbalance measure of solvency relies heavily on the period selected for assessment. Various policies could be devised that would set the actuarial balance to zero over the next 30 to 50 years, but they would leave a fiscal imbalance in subsequent years. Moreover, policies based on present-value measures may assume that future federal commitments can be paid for in advance by accumulating governmental receipts in advance of expenditures. However, earmarked receipts are an accounting device, and such receipts cannot truly be separated from other government finances and set aside for future expenditures.

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32. See Congressional Budget Office, *Federal Debt and the Commitments of Federal Trust Funds*, Long-Range Fiscal Policy Brief No. 4 (revised May 6, 2003), and *Acquiring Financial Assets to Fund Future Entitlements*, Long-Range Fiscal Policy Brief No. 8 (June 16, 2003).

33. For more details, see CBO’s June 2004 report, *The Outlook for Social Security*.

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34. The first estimate is from Gokhale and Smetters, *Fiscal and Generational Imbalances*. The second is from Alan J. Auerbach, William G. Gale, and Peter R. Orszag, “Reassessing the Fiscal Gap: The Role of Tax-Deferred Saving,” *Tax Notes*, vol. 100, no. 4 (July 28, 2003), pp. 567-584.

35. Congressional Budget Office, *The Outlook for Social Security*.



