

Tax Expenditures Task Force Meeting Minutes

September 11, 2015

9 AM to 11 AM

441 G Street NW, Washington, D.C.

Room 5N30

- **Attendance**

The following task force members and officials were present at the meeting: Messrs. Bell, Edwards, McClelland, McTigue, Morgan, and Murrin; Mses. Sergent, Taber, Thornton, and Valentine; and Mr. Weiner. The executive director, Ms. Payne, and support staff, Mr. Perry, were present throughout the meeting.

- **Approval of August Meeting Minutes**

Minutes for the August task force meeting were approved at the beginning of the meeting.

- **Summary of August Board Meeting**

Mr. Perry updated the FASAB board members (the Board) on the task force's progress at the August Board meeting, held on August 26th and 27th. He noted that many questions raised during the Board meeting would be addressed by the task force's "Tax Expenditures Explained" document once it is presented to the Board at the October FASAB meeting. The draft version of this document was not shared with the Board at the August meeting due to the pending changes in several sections. Mr. Perry provided the task force's plan and timeline for sharing its recommendations to the Board. He noted that the goal was to share the task force's recommendation during the December FASAB meeting.

Staff note: The purpose of the "Tax Expenditures Explained" document is to provide background and context for respondents to any future Board proposal. Respondents who are less familiar with tax expenditures may find it challenging to respond to a proposal absent such background and context. Revision of this document is an ongoing project of the task force. See the June, July, and August minutes, subsequent meeting minutes and Board briefing materials (as they become available) for additional information with respect to revisions made to this document.

Ms. Payne noted that the task force will be invited to attend both the October and December Board meetings to address the Board's questions and to share the task force's products and recommendations directly with the Board.

Given the complexities and additional time needed for addressing component entity reporting issues, task force recommendations provided at the December meeting will likely focus on government-wide reporting recommendations.

- **Discussion with GAO Audit Partners**

Mr. Perry introduced Messrs. Gary Engel and Robert Dacey, both representing the U.S. Government Accountability Office (GAO) as experienced audit partners on the government-wide consolidated financial statement audit. Mr. Perry thanked them for

their attendance and asked that they provide an overview of what types of audit procedures GAO would be required to perform over tax expenditures estimates and disclosures, if such information were included in the Management Discussion and Analysis (MD&A), Required Supplementary Information (RSI), and/or Other Information (OI) sections of Treasury's Financial Report of the U.S. Government (Financial Report).

Disclaimer: The views expressed and insights provided represent those of Mr. Dacey (GAO's Chief Accountant and a FASAB Board Member) and Mr. Engel (Managing Director of GAO's Financial Management and Assurance mission team) are their own and do not represent the views of the Board or GAO. The Board operates through due process and expresses its views in its official publications.

Mr. Dacey noted that the placement—or classification—of tax expenditures information within Basic Information, RSI, or OI; does impact the nature and extent of GAO's audit procedures.

- For RSI (*Staff Note: MD&A is considered to be RSI in the auditing standards*):

Mr. Dacey noted that GAO would perform several procedures over RSI, including: reading the material, determining whether there are any material inconsistencies with information and underlying data reported in the financial statements and footnotes and information obtained during the audit, assessing whether the information is consistent with the reporting requirements established by FASAB, gaining an overall understanding of the underlying processes and controls over tax expenditure estimates, obtaining and reviewing support for the tax expenditure estimates and considering the quality of the support, and considering whether the overall form and presentation are not misleading and are placed in an appropriate context, including consideration of the adequacy of information presented about the basis for reported amounts. He said they would also consider any known issues related to the reliability of the reported tax expenditures. For example, GAO previously reported that almost half of the dollar amount of tax expenditures did not have their own line item on tax forms and that for such tax expenditures the reported amounts may be based on information inferred from economic aggregates.¹ One task force member noted that for the largest tax expenditure, the exclusion for employer-provided health insurance, more information is to be reported on tax forms.

Mr. Dacey noted that, although GAO may report on deficiencies, omissions, and other issues with RSI; these issues would not impact GAO's audit opinion of the financial statements. This is because RSI is not deemed to be essential in order for the financial statements to be fairly presented in accordance with GAAP.

Staff note: See Attachment 2 for additional context surrounding audit requirements over RSI.

- For OI (*Staff Note: OI is unaudited*):

Mr. Engel noted that, although GAO would not perform detailed substantive testing over tax expenditure estimates reported in OI, it would gain an understanding of and report on any unusual or misleading factors, data, and assumptions used in any tax expenditure estimation methodology.

¹GAO, *Tax Expenditures: IRS Data Available for Evaluations Are Limited*, [GAO-13-479](#) (Washington, D.C.: Apr. 30, 2013).

Mr. Dacey pointed out that the Board has encouraged the inclusion of certain information in the OI section of Treasury's Financial Report in the past, and that Treasury has reported such information.

(Staff note: OI is defined as information that accompanies basic information and RSI, but is not required by a body that establishes GAAP. FASAB may encourage OI but this would not be a requirement within FASAB standards.)

Task force members expressed their concerns about the level of rigor associated with RSI, as well as the implications of audit procedures given the subjectivity and the extent of management judgment involved with the identification and measurement of tax expenditures. For example, Treasury's Office of Tax Policy identifies the non-taxation of Medicare benefits as a tax expenditure, whereas the Joint Committee on Taxation does not consider Medicare benefits to be a tax expenditure. Mr. Dacey responded that significant caveats along with information concerning key drivers, assumptions, and sensitivity analyses may be necessary to couple with tax expenditure estimates (for both totals and individual estimates), which could present a challenge associated with estimating tax expenditures and including such estimates in RSI or Basic Information.

One task force member noted that the information available to support the estimates has improved for employer-sponsored insurance estimates and that, for select items, the data is improving. Mr. Dacey and Mr. Engel acknowledged that there may be fewer concerns over the reliability of the underlying data used to estimate tax expenditures coming directly from tax returns, but that significant tax expenditures are not derived from data directly coming from returns. One consideration regarding placement of the information should be the cost of audit coverage relative to the potential quality improvements given the inherent limitations.

One task force member noted that the sustainability projections—which include 75-year revenue projections—are becoming basic financial information in Treasury's Financial Report, and experts may disagree on some of the embedded assumptions within those projections. Mr. Dacey responded that one key difference with the revenue projections and tax expenditures is that for the revenue projections, one can look back and compare revenue projections to historically reported actual revenue received each year and consider adjustments needed to the projections going forward, whereas the reliability of Treasury's estimation models for most tax expenditures can never be measured and validated against actual transactions. There is also a reasonableness concern given that publicly reported conflicts among experts may be confusing to the reader. The auditor would take such conflicting information among tax expenditure experts into account.

A few task force members expressed that reporting 1) the existence of tax expenditures, 2) the uncertainty and subjectivity surrounding their amounts, and 3) conveying the magnitude of tax expenditures are all important points for readers to understand; as the existence and magnitude of tax expenditures materially impacts the financial condition and full cost of the U.S. Government. One task force member cautioned that, while the magnitude of tax expenditures is important for readers to understand, too much information and voluminous, detailed caveats would be inappropriate and may not be necessary in order to sufficiently inform readers. One task force member noted that it may be important to inform readers about the changes in tax expenditures over time.

For example, a growing number or magnitude of tax expenditures may be important information to disclose.

Mr. Dacey also expressed his personal view that it may be useful and logical to comprehensively explain tax expenditures in a broader context, coupling tax expenditures with other areas impacting the government's revenues such as the current tax gap and other revenue and benefits received by taxpayers that are not taxed.

Mr. Engel suggested that hyperlinking to other outside sources to help readers understand the magnitude of tax expenditures would not have audit implications, provided that the language referring readers to such outside resources was appropriate.

A few task force members noted that there may be ancillary benefits to shining a light on tax expenditure estimates and subjecting the numbers to some audit procedures to assess their reasonableness, such as improving the support for the estimates.

One task force member noted that there are three perspectives that currently exist within Treasury's Financial Report for the task force to consider: 1) the annual amount of tax expenditures—which aligns with the income statement, 2) deferred tax expenditures—which aligns with the balance sheet, and 3) projections of tax expenditures which would align with sustainability information. The member noted that, given that all three perspectives are relevant and align with information contained within the financial statements, all three perspectives warrant consideration by the task force and the Board during the development of proposed tax expenditure requirements.

Mr. Dacey agreed that the importance of tax expenditures, their magnitude, and their impact on the government's financial position are unquestioned and pointed out that the key determination for the task force—and ultimately the Board—to make is the appropriate nexus of tax expenditures in relation to the financial statements. Relevant considerations might include: (1) the timeliness of the information and consistency with the financial statements—tax expenditures that would be available for the 2015 consolidated financial statements would be based on tax law and assumptions from July 1 of the reporting year, (2) the basis of accounting—the reported tax revenue is on modified cash basis, based principally on cash received, rather than accrual which would be based on when the revenue was earned, and the revenue, being on a principally cash basis, includes collections from various tax years which may be inconsistent with the basis for the tax expenditure estimates, (3) potential users of the information and availability of the information elsewhere, which would include OMB and JCT estimates of tax expenditures and related supporting materials, and (4) the nature of the information—tax expenditures include tax deferrals which are timing differences. Further, existing concept statements acknowledge that some information is better provided by, or can only be provided by, financial reporting outside of general purpose financial reports.

One task force member inquired as to whether disclosure of the existence of tax expenditures (for example, the MD&A text from illustration A) should be included in the footnotes to the financial statements. Mr. Dacey reiterated that it may be helpful to make the reader aware of tax expenditures within the footnotes, as well as other items that impact revenue such as the tax gap. Such disclosures would not significantly change the audit effort.

A task force member asked if inclusion of estimated tax expenditures in RSI might lead to a significant first year audit cost but reduced audit cost in later years. Mr. Dacey thought reductions in audit cost over time would depend on the actual ability to improve the estimates and he speculated that near term improvement was not likely given the soft nature of the estimates. Mr. Engel suggested that if the goal is to alert the reader to the existence and magnitude of tax expenditures – as it is for tax gap – then providing OI may be a better option. Other members noted that not all tax expenditures are equal in terms of the cost-benefit from improved quality in estimates; for example, improving the quality of the estimates of imputed rental income is not likely to improve future decisions.

The group thanked Messrs. Dacey and Engel for sharing their insights and answering questions.

- **Member Feedback and Discussion Regarding Drafts of Tax Expenditure Illustrations and Placement of Tax Expenditure Information within the Financial Report of the U.S. Government**

In light of the discussions with GAO, Ms. Payne asked the task force to share their feedback and ideas on how the illustrations should be revised or changed (see Attachment 3).

Staff note: The purpose of the Illustrations will be to for the task force to convey to the Board how the task force recommends that tax expenditure information be reported in Treasury's Financial Report. Such illustrations will facilitate Board deliberations and enable the Board and its staff to draft proposals based on aspects of the Illustrations that may be supported by the Board. See subsequent meeting minutes and Board briefing materials, as they become available, for information regarding the revisions made to this document.

The task force was generally supportive of Illustration A with respect to how tax expenditures are introduced, defined, and contextualized for readers; however, task force members did have technical comments to provide after the meeting.

One task force member noted that some tax expenditures, such as refundable credits, are accounted for and embedded within the statement of net cost and, therefore, the MD&A illustrations would need to be revised in some way in order to reflect this.

The task force was generally supportive of including a disclosure in basic information (the footnotes to the financial statements) that introduces the concept of tax expenditures and how they generally impact revenues.

The task force expressed a variety of views with respect to the placement of information regarding the magnitude and/or estimates of tax expenditures within Treasury's Financial Report. The task force was generally not supportive of including the top individual tax expenditure estimates within RSI (see Attachment 3 – RSI Illustration B) or Basic Information; however, some of the task force members remained supportive of disclosing the magnitude—either a point estimate or range—of the estimated total tax expenditures within RSI, while also disclosing the limitations and major assumptions underlying such a total. These task force members were primarily concerned with the primary purpose of the financial report—which is to inform users of the government's finances. These members noted that the exclusion of information about the magnitude

of tax expenditures—which may be in excess of one trillion dollars—may be inconsistent with the overall purpose of the financial report.

Several task force members were more supportive of including estimates in OI as a starting point. These task force members were primarily concerned about the nature and extent of the judgment involved and the subjectivity inherent in identifying and measuring tax expenditures, and the quality, timeliness, and availability of reliable data. These conditions pose unique challenges impeding Treasury's ability to 1) develop estimates generally accepted as reliable and fair and 2) include estimates within RSI or Basic Information without negative and/or potentially inherently unresolvable audit challenges.

One task force member noted that there are a host of implications for tallying up all tax expenditures, including fundamental disagreements between Treasury and the Joint Committee on Taxation about estimation methodologies and whether or not certain things in the Internal Revenue Code constitute a tax expenditure or not. Moreover, this task force member noted that including such a tally in itself may not ultimately be the primary information that should be conveyed to the reader in the financial report.

- **Member Comments and Updates to “Tax Expenditures Explained” Document (see Attachment 4 of meeting agenda)**

Ms. Payne and Mr. Perry asked task force members to electronically provide their technical comments and feedback on the latest draft of this paper. Detailed discussion on the latest revisions was forgone due to time constraints.

- **Next Steps**

Ms. Payne thanked the task force for their hard work and noted that she and Mr. Perry would work to 1) incorporate technical comments, update, and revise the “Tax Expenditures Explained” document; 2) write up and distribute meeting minutes for task force review; 3) revise illustrations—based on discussions and feedback including new options received to-date—and distribute them for comment; and 4) begin the first draft of the task force's recommendations to the Board.

One task force member noted that it will be important for the task force to include the pros and cons of the various options and recommendations for the Board to consider in its deliberations—particularly with respect to areas likely to generate extensive deliberations and disagreements among respondents to Board proposals.

Mr. Perry noted that, in order to meet the October FASAB meeting deadline, technical comments and updates to the “Tax Expenditures Explained” document would need to be incorporated relatively quickly. In addition, the Appendix table included in the paper would likely need to be traced and verified before presenting it to the Board.

Tax Expenditures Task Force Meeting – Agenda
September 11, 2015 – 9:00 AM to 11:00 AM
441 G Street NW, Washington, DC Room 5N30

9:00 – 9:15 **1. Summary of August Board meeting**
Approval of August meeting minutes

9:15 – 9:45 **2. Discussion with GAO Audit Partners:**

- *Mr. Gary Engel – Managing Director, Financial Management and Assurance (former first partner of the CFS audit)*
- *Mr. Robert (Bob) Dacey – Chief Accountant (second partner of the CFS audit), FASAB Board Member*
- ❖ Audit requirements/procedures in MD&A, RSI, OI (See **Attachments 1 and 2**)
- Cost-benefit considerations; implications for the audit / report; other questions?

9:45 – 11:10 **3. Task force discussion on the placement and/or inclusion of various information and disclosures within MD&A, RSI, and OI**

- ❖ Comments on draft illustrations (**Attachment 3**)
- ❖ Phases – follow up on member suggestions at last meeting

11:10 – 11:22 **4. Tax Expenditures Explained Paper Revisions (See **Attachment 4**)**

- ❖ GPRA MA updates: coming soon
- ❖ Share draft with the Board at October meeting

11:25 – 11:30 **5. Next Steps**

- ❖ What will our recommendations include? How will they be presented?
 - Final versions of **Attachments 3 and 4** will accompany our recommendations
 - Areas of consensus: The goal is to provide a compelling document to the Board that: 1) describes how the TF reached its conclusions and 2) demonstrates that the TF carefully considered financial statement users' information needs, as well as the inherent challenges and limitations associated with implementing the recommendations.
 - Areas of disagreement: For any areas of disagreement, we will provide an opportunity for TF members to share any reservations and alternative recommendations/approaches with the Board as well.

Attachment 1 – Sample requirement wording

Attachment 2 – RSI audit requirements

Attachment 3 – Illustrations A and B – first draft of MD&A & RSI

Attachment 4 – Tax Expenditures Explained – latest version

Attachment 1: How Wording of FASAB Requirements Impacts Audit Procedures

Purpose: *This attachment will facilitate discussion at the August FASAB tax expenditure task force meeting regarding how the nature and wording of potential FASAB RSI requirements may significantly impact audit procedures over such information.*

Wording Scenario 1: General Requirement for Preparing Estimates

Provide as required supplementary information estimates of the five largest individual and corporate income tax expenditures for the current and previous fiscal years.

Under this scenario, the estimates would likely be prepared by Treasury based on factors such as:

1. Current law
2. Available tax, economic, demographic, and other data
3. Reasonable economic assumptions consistent with the most recent President's Budget submission

Wording Scenario 2: Requirement to Report on Estimates Published Elsewhere

Include as required supplementary information the following information as reported in the most recent report of the U.S. Department of the Treasury's Office of Tax Policy on tax expenditures:

1. The five largest individual and corporate income tax expenditures
 2. The total number of tax expenditures
-

Discussion Topic:

How would the wording of hypothetical FASAB requirements in the scenarios above impact the expected procedures of both the preparer and the auditor?

Attachment 2: Audit Considerations regarding Basic Information and RSI

This summary table serves as an aid to the reader in understanding the audit implications of the required supplementary information.

RSI	
Is the information required to be in the federal financial report? Source: FASAB, Statement of Federal Financial Accounting Concepts (SFFAC) 2, Entity and Display, par. 73C and AICPA Auditing Standards as Clarified (AU-C) 730.04	Yes
Is the information deemed essential if the financial statements are to “present fairly” in conformity with GAAP? Source: FASAB SFFAC 2, par. 73B and 73C, and AICPA AU-C 730.04	No
What are the objectives of the auditor regarding basic information and RSI?	The objectives of the auditor when a designated accounting standard setter requires information to accompany an entity's basic financial statements are to perform specified procedures in order to a. describe, in the auditor's report, whether required supplementary information is presented and b. communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter. (AICPA, AU-C 730.03)
What audit fieldwork is required?	Limited procedures pursuant to AU-C 730.05-.06.
What is to be provided in the auditor's report?	Statement that the auditor has applied certain limited procedures and a statement that the auditor does not express an opinion or provide assurance on the information. (AICPA, AU-C 730-.08-.09)
What audit report mention is required if the information is missing or not prepared in conformity with guidelines?	Include a statement that management has omitted the information and the information is required and is an essential part of financial reporting. Also, the auditor would state that the opinion on the basic financial statements is not affected by the missing information. (AICPA AU-C 730.08e) In addition, if the measurement or presentation of the information departs materially from the prescribed guidelines, the auditor would

RSI

state that although the opinion on the basic financial statements is not affected, material departures from the prescribed guidelines exist and the auditor would describe the departures.
(AICPA AU-C 730.08f)

Source: The Federal Accounting Standards Advisory Board developed this summary but does not establish audit standards. For guidance regarding auditing standards, please refer to the source documents identified in the summary.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

The Fiscal Year (FY) 2014 *Financial Report of the United States Government (Financial Report)* provides the President, Congress, and the American people with a comprehensive view of the federal government's finances, i.e., its financial position and condition, its revenues and costs, assets and liabilities, and other obligations and commitments. The *Financial Report* also discusses important financial issues and significant conditions that may affect future operations, including the need to achieve fiscal sustainability over the medium and long term.

Pursuant to 31 U.S.C. § 331(e)(1), the Department of the Treasury (Treasury), in cooperation with the Office of Management and Budget (OMB), must submit an audited (by the Government Accountability Office or GAO) financial statement for the preceding fiscal year, covering all accounts and associated activities of the executive branch of the United States Government¹ – the central component of the *Financial Report* – to the President and Congress no later than six months after the September 30 fiscal year end. To encourage timely and relevant reporting, OMB accelerated both individual agency and governmentwide reporting deadlines.

The *Financial Report* is prepared from the audited financial statements of specifically designated federal agencies, including the Cabinet departments and many smaller, independent agencies (see organizational chart on the next page). As it has for the past seventeen years, GAO issued a “disclaimer” of opinion on the accrual-based, consolidated financial statements for the fiscal years ended September 30, 2014 and 2013. GAO also issued disclaimers of opinion on the 2014, 2013, 2012, 2011 and 2010 Statements of Social Insurance (SOSI), and disclaimers of opinion on the 2014 and 2013 Statements of Changes in Social Insurance Amounts (SCSIA). A disclaimer of opinion indicates that sufficient information was not available for the auditors to determine whether the reported financial statements were fairly presented in accordance with Generally Accepted Accounting Principles (GAAP). In FY 2014, 33² of the 37 most significant agencies earned unmodified opinions on their financial statement audits.³

The FY 2014 *Financial Report* consists of:

- Management's Discussion and Analysis (MD&A), which provides management's perspectives on and analysis of information presented in the *Financial Report*, such as financial and performance trends;
- Principal financial statements and the related notes to the financial statements;
- Required Supplementary Information (RSI), Required Supplementary Stewardship Information (RSSI), and Other Information; and
- GAO's audit report.

In addition, a Citizen's Guide is included to provide the American taxpayer with a quick reference to the key issues in the *Financial Report* and an overview of the Government's financial position and condition.

Mission & Organization

The Government's fundamental mission is derived from the Constitution: “...to form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare and secure the blessings of liberty to ourselves and our posterity.” The Congress authorizes and agencies implement programs as missions and initiatives evolve over time in pursuit of key public services and objectives, such as providing for national defense, promoting affordable health care, fostering income security, boosting agricultural

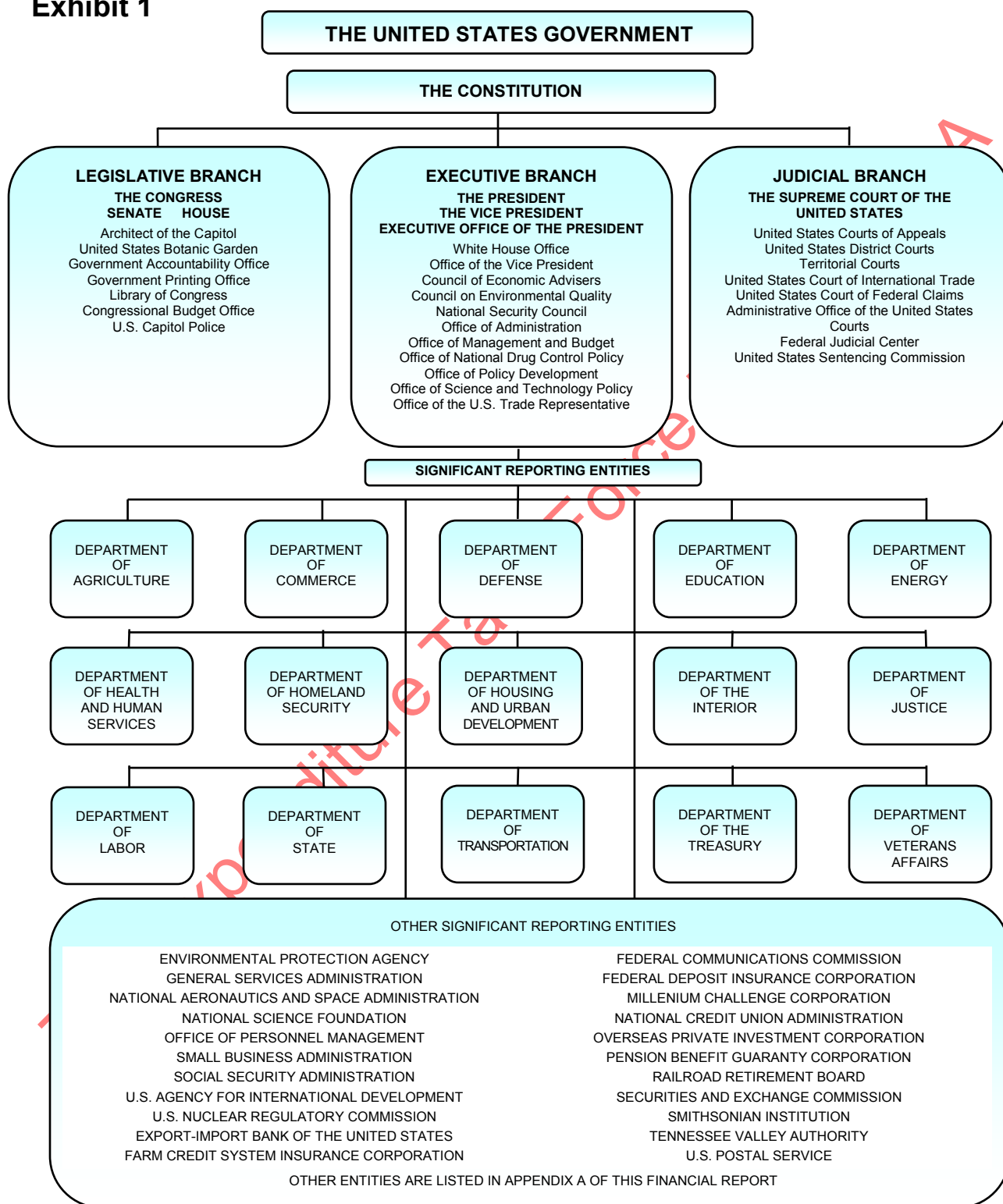
¹ The Government Management Reform Act of 1994 has required such reporting, covering the executive branch of the Government, beginning with financial statements prepared for FY 1997. Treasury and OMB have elected to include certain financial information on the legislative and judicial branches in consolidated financial statements as well.

² The 33 agencies include the Department of Health and Human Services, which received disclaimers of opinion on its 2014, 2013, 2012, 2011, and 2010 SOSI and on its 2014 and 2013 SCSIA. The audit opinion for the Department of Housing and Urban Development (HUD) was not available as of the issuance of this *Financial Report*.

³ The Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Farm Credit System Insurance Corporation (FCSIC) are among the 37 significant entities. However, because these entities operate on a calendar year basis (December 31 year end), their 2014 audits are not yet complete. Statistic reflects 2013 audit results for these organizations.

productivity, providing veterans benefits and services, facilitating commerce, supporting housing and the transportation systems, protecting the environment, contributing to the security of energy resources, and helping States provide education. Exhibit 1 provides an overview of how the U.S. Government (Government) is organized.

Exhibit 1



The Government's Financial Position and Condition

A complete assessment of the Government's financial or fiscal condition requires analysis of historical results, projections of future revenues and expenditures, and an assessment of the Government's long-term fiscal sustainability. This *Financial Report* discusses the Government's financial position at the end of the fiscal year, explains how and why the financial position changed during the year, and provides insight into how the Government's financial condition may change in the future.

Table 1 The Federal Government's Financial Position and Condition				
Dollars in Billions	2014	2013	Increase / (Decrease)	
			\$	%
FINANCIAL MEASURES				
Gross Cost	\$ (4,251.4)	\$ (3,940.9)	\$ 310.5	7.9%
Less: Earned Revenue	\$ 417.9	\$ 415.5	\$ 2.4	0.6%
Gain/(Loss) from Changes in Assumptions	\$ (3.5)	\$ (131.2)	\$ 127.7	97.3%
Net Cost¹	\$ (3,837.0)	\$ (3,656.6)	\$ 180.4	4.9%
Less: Taxes and Other Revenue:	\$ 3,066.1	\$ 2,842.5	\$ 223.6	7.9%
Unmatched Transactions & Balances	\$ (20.4)	\$ 9.0	\$ 29.4	326.7%
Net Operating Cost²	\$ (791.3)	\$ (805.1)	\$ (13.8)	(1.7%)
Assets³:				
Cash & Other Monetary Assets	\$ 264.9	\$ 206.3	\$ 58.6	28.4%
Loans Receivable, Net	\$ 1,123.5	\$ 1,022.3	\$ 101.2	9.9%
Inventories & Related Property, Net	\$ 318.4	\$ 311.1	\$ 7.3	2.3%
Property, Plant & Equipment, Net	\$ 878.3	\$ 896.7	\$ (18.4)	(2.1%)
Other	\$ 480.2	\$ 531.9	\$ (51.7)	(9.7%)
Total Assets	\$ 3,065.3	\$ 2,968.3	\$ 97.0	3.3%
Liabilities³:				
Federal Debt Held by the Public & Accrued Interest	\$ (12,833.6)	\$ (12,028.4)	\$ 805.2	6.7%
Federal Employee & Veterans Benefits	\$ (6,672.6)	\$ (6,538.3)	\$ 134.3	2.1%
Other	\$ (1,259.8)	\$ (1,310.9)	\$ (51.1)	(3.9%)
Total Liabilities	\$ (20,766.0)	\$ (19,877.6)	\$ 888.4	4.5%
Net Position (Assets minus Liabilities)	\$ (17,700.7)	\$ (16,909.3)	\$ (791.4)	(4.7%)
SUSTAINABILITY MEASURES				
Social Insurance Net Expenditures⁴:				
Social Security (OASDI)	\$ (13,330)	\$ (12,294)	\$ 1,036	8.4%
Medicare (Parts A, B, & D)	\$ (28,483)	\$ (27,302)	\$ 1,181	4.3%
Other	\$ (103)	\$ (102)	\$ 1	0.6%
Total Social Insurance Net Expenditures	\$ (41,916)	\$ (39,698)	\$ 2,218	5.6%
Total Federal Government Noninterest Net Expenditures⁵	\$ (4,700)	\$ (4,000)	\$ 700	17.5%
BUDGET DEFICIT				
Unified Budget Deficit⁶	\$ (483.4)	\$ (680.3)	\$ (196.9)	(28.9%)

1 Source: Statements of Net Cost.

2 Source: Statements of Operations and Changes in Net Position.

3 Source: Balance Sheet.

4 Source: Statements of Social Insurance (SOSI). Amounts equal estimated present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain 'Social Insurance' programs (Social Security, Medicare Parts A, B, & D, Railroad Retirement - Black Lung is projected through 2040). Amounts reflect 'Open Group' totals (all current and projected program participants during the 75-year projection period).

5 Represents the 75-year projection of the Federal Government's receipts less non-interest spending as reported in the Statement of Long-Term Fiscal Projections in the Required Supplementary Information section of the *Financial Report*.

6 Source: Final Monthly Treasury Statement (as of 9/30/2014 and 9/30/2013).

Note: Totals may not equal sum of components due to rounding.

Table 1 on the previous page and the following summarize the federal government's financial position:

- The Government's gross costs increased by \$310.5 billion (7.9 percent) to \$4.3 trillion. Deducting \$417.9 billion in revenues earned for goods and services provided to the public (e.g., Medicare premiums, national park entry fees, and postal service fees) and adding \$3.5 billion in net losses from changes in assumptions (e.g., interest rates, inflation, disability claims rates) results in the Government's net cost of \$3.8 trillion in FY 2014, an increase of \$180.4 billion (4.9 percent) as compared to FY 2013.
- Taxes and other revenues increased \$223.6 billion (7.9 percent) to \$3.1 trillion, which, when offset against the Government's net cost, with some adjustment for unmatched transactions and balances, results in a "bottom line" net operating cost of \$791.3 billion for FY 2014, as compared to \$805.1 billion for FY 2013.
- Comparing total 2014 Government assets of \$3.1 trillion to total liabilities of \$20.8 trillion (comprised mostly of \$12.8 trillion in federal debt held by the public and accrued interest payable⁴, and \$6.7 trillion of federal employee and veterans benefits payable) yields a negative net position of \$17.7 trillion.
- The sum of debt held by the public (\$12.8 trillion) and intragovernmental debt (\$5.1 trillion) equals gross federal debt, which, with some adjustments is subject to the statutory debt limit. As of September 30, 2014, the Government's total debt subject to the debt limit was \$17.8 trillion. Congress suspended the debt limit twice during FY 2014: first, from October 17, 2013 through February 7, 2014; and again from February 15, 2014 through March 15, 2015.

This *Financial Report* also contains information about potential impacts on the Government's future financial condition. Under federal accounting rules, social insurance expenditures, as reported in the Statement of Social Insurance (SOSI) and the Statement of Long-Term Fiscal Projections (included in the RSI section of the *Financial Report*) are not considered liabilities of the Government. They can, however, provide a valuable perspective on the sustainability of the Government's fiscal path:

- The SOSI compares the actuarial present value⁵ of the Government's projected expenditures for scheduled benefits for Social Security, Medicare Parts A, B and D, and other social insurance programs over 75 years⁶ to a subset of the revenues⁷ supporting these programs. For 2014, these projected expenditures exceeded projected revenues by about \$41.9 trillion, a \$2.2 trillion increase over 2013 social insurance projections.
- Total projected expenditures, including other major programs (e.g., defense, Medicaid, and education) and tax revenues provide another perspective of the Government's projected fiscal condition. Over the next 75 years, under current policy, the present value (PV) of the Government's total non-interest expenditures (including its social insurance programs) is projected to exceed the PV of total receipts by \$4.7 trillion.

The Government's current financial position and long-term financial condition can be evaluated both in dollar terms and in relation to the economy as a whole. Gross Domestic Product (GDP) measures the size of the nation's economy in terms of the total value of all final goods and services that are produced in a year. Considering financial results relative to GDP is a useful indicator of the economy's capacity to sustain the Government's many programs. For example:

- The unified budget deficit (i.e., including the consolidated receipts and outlays from federal funds and the Social Security Trust Fund) decreased from \$680.3 billion or 4.1 percent of GDP in FY 2013 to \$483.4 billion or 2.8 percent of GDP in FY 2014, the lowest deficit-to-GDP level since 2007 and less than the average of the last 40 years.⁸
- The budget deficit is primarily financed through borrowing from the public. As of September 30, 2014, debt held by the public, excluding interest payable, was \$12.8 trillion (74 percent of GDP).

⁴ On the Government's balance sheet, debt held by the public and accrued interest payable consists of Treasury securities, net of unamortized discounts and premiums, and accrued interest payable. The "public" consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the federal government.

⁵ Present values recognize that a dollar paid or collected in the future is worth less than a dollar today because a dollar today could be invested and earn interest. To calculate a present value, future amounts are thus reduced using an assumed interest rate, and those reduced amounts are summed.

⁶ The Black Lung Program is projected through September 30, 2040.

⁷ Social Security is funded by the payroll taxes and revenue from taxation of benefits. Medicare Part A is funded by the payroll taxes, revenue from taxation of benefits, and premiums that support those programs. Medicare Parts B and D are primarily financed by general revenues and premiums. By accounting convention, general revenues transferred to Medicare Parts B and D are eliminated in consolidation at the governmentwide level and, as such, are not included in the SOSI.

⁸ [Final Monthly Treasury Statement \(as of September 30, 2014 and 2013\)](#), [10/15/14 press release – Joint Statement of Treasury Secretary Jacob J. Lew and OMB Director Shaun Donovan on Budget Results for Fiscal Year 2014](#).

- The projected \$41.9 trillion net present value excess of expenditures over receipts over 75 years for the programs reported in the 2014 SOSI represents about 4.0 percent of the present value of GDP over 75 years. The excess of total projected non-interest spending over receipts of \$4.7 trillion discussed in the 'Statement of Long Term Fiscal Projections' in the RSI section of the *Financial Report* represents 0.4 percent of GDP. As discussed in this *Financial Report*, these projections can, in turn, have a significant impact on projected debt as a percent of GDP.

Fiscal Year 2014 Financial Statement Audit Results

For FY 2014, GAO issued an eighteenth consecutive disclaimer of audit opinion on the accrual-based, governmentwide financial statements. In addition, GAO issued disclaimers of opinion on the 2014, 2013, 2012, 2011 and 2010 SOSI, and disclaimers of opinion on the 2014 and 2013 Statement of Changes in Social Insurance Amounts (SCSIA). The SOSI and SCSIA disclaimers stem from significant uncertainties (discussed in Note 24, Social Insurance), primarily related to the achievement of projected reductions in Medicare cost growth as reflected in the SOSI.

Twenty-one of the 24 agencies required to issue audited financial statements under the Chief Financial Officers (CFO) Act received unmodified audit opinions (the audit opinion for the Department of Housing and Urban Development (HUD) was not available as of the release of this *Financial Report*), as did 12 of 13 additional significant reporting agencies (see Table 2 and Appendix A).⁹

The Governmentwide Reporting Entity

These financial statements cover the three branches of the Government (legislative, executive, and judicial). Legislative and judicial branch reporting focuses primarily on budgetary activity. Most executive branch entities, as well as certain legislative branch agencies are required, by law, to prepare audited financial statements. Some other legislative branch entities voluntarily produce audited financial reports.

A number of entities and organizations are excluded due to the nature of their operations, including the Federal Reserve System (considered to be an independent central bank under the general oversight of Congress), all fiduciary funds, and Government-Sponsored Enterprises (GSEs), including the Federal Home Loan Banks, the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Emergency Economic Stabilization Act (EESA) of 2008 gave the Secretary of the Treasury temporary authority to purchase and

Table 2: FY 2014 Agency Financial Statement Audit Results

Chief Financial Officers (CFO) Act Agency	Audit Opinion
Department of Agriculture (USDA)	Unmodified
Department of Commerce (DOC)	Unmodified
Department of Defense (DOD)	Disclaimer
Department of Education (Education)	Unmodified
Department of Energy (DOE)	Unmodified
Department of Health and Human Services (HHS)	Unmodified ¹
Department of Homeland Security (DHS)	Unmodified
Department of Housing and Urban Development (HUD)	Pending
Department of the Interior (DOI)	Unmodified
Department of Labor (DOL)	Unmodified
Department of Justice (DOJ)	Unmodified
Department of State (State)	Unmodified
Department of Transportation (DOT)	Unmodified
Department of the Treasury (Treasury)	Unmodified
Department of Veterans Affairs (VA)	Unmodified
Agency for International Development (USAID)	Disclaimer
Environmental Protection Agency (EPA)	Unmodified
General Services Administration (GSA)	Unmodified
National Aeronautics and Space Administration (NASA)	Unmodified
National Science Foundation (NSF)	Unmodified
Nuclear Regulatory Commission (NRC)	Unmodified
Office of Personnel Management (OPM)	Unmodified
Small Business Administration (SBA)	Unmodified
Social Security Administration (SSA)	Unmodified
Other Significant Reporting Entities	
Export-Import Bank of the United States	Unmodified
Farm Credit System Insurance Corporation (FCSIC)	Unmodified ²
Federal Communications Commission (FCC)	Unmodified
Federal Deposit Insurance Corporation (FDIC)	Unmodified ²
Millennium Challenge Corporation (MCC)	Unmodified
National Credit Union Administration (NCUA)	Unmodified ²
Overseas Private Investment Corporation (OPIC)	Unmodified
Pension Benefit Guaranty Corporation (PBGC)	Unmodified
Railroad Retirement Board (RRB)	Disclaimer
Securities and Exchange Commission (SEC)	Unmodified
Smithsonian Institution	Unmodified ³
Tennessee Valley Authority (TVA)	Unmodified
U.S. Postal Service (USPS)	Unmodified

¹ Received disclaimer of opinion on Statement of Social Insurance and Statement of Changes in Social Insurance Amounts.

² Entities operate under calendar year (CY)-end. Opinions reflect CY 2013 audit results.

³ Opinion on the most recent annual report, covering FY 2013.

⁹ The 21 agencies include the Department of Health and Human Services, which received disclaimers of opinions on its 2014, 2013, 2012 2011, and 2010 SOSI and its 2014 and 2013 SCSIA.

guarantee assets from a wide range of financial institutions through the Troubled Asset Relief Program (TARP). Following U.S. GAAP for federal entities, the Government has not consolidated into its financial statements the assets, liabilities, or results of operations of any financial organization or commercial entity in which Treasury holds either a direct, indirect, or beneficial majority equity investment. Under Statement of Federal Financial Accounting Concepts (SFFAC) No. 2, these entities meet the criteria of paragraph 50 and do not appear in the Federal Budget section "Federal Programs by Agency and Account." As such, these entities are not consolidated into the financial reports of the Government. However, the values of the investments in and any related liabilities to such entities are presented on the balance sheet. Appendix A includes a list of the agencies and entities contributing to this *Financial Report*.¹⁰

The following pages contain a more detailed discussion of the Government's financial results for FY 2014, the budget, the economy, the debt, and a long-term perspective about fiscal sustainability, including the Government's ability to meet its social insurance benefits obligations. The information in this *Financial Report*, when combined with the Budget of the U.S. Government, collectively presents information on the Government's financial position and condition.

Accounting Differences Between The Budget and the Financial Report

Each year, the Administration issues two reports that detail the Government's financial results: the *Budget of the U.S. Government (Budget)*, prepared primarily on a "cash basis", and which provides a plan for future initiatives and the resources needed to support them, as well as prior year fiscal and performance results; and this *Financial Report*, which provides the President, Congress, and the American people a broad, comprehensive overview of the cost on an "accrual basis" of the Government's operations, the sources used to finance them, its balance sheet, and the overall financial outlook.

Treasury generally prepares the financial statements in this *Financial Report* on an accrual basis of accounting as prescribed by U.S. GAAP for federal entities.¹¹ These principles are tailored to the Government's unique characteristics and circumstances. For example, agencies prepare a uniquely structured "Statement of Net Cost," which is intended to present net Government resources used in its operations. Also, unique to Government is the preparation of separate statements to reconcile differences and articulate the relationship between the budget and financial accounting results.

Budget of the U.S. Government	Financial Report of the U.S. Government
<p><u>Prepared primarily on a "cash basis"</u></p> <ul style="list-style-type: none"> Initiative-based and prospective: focus on current and future initiatives planned and how resources will be used to fund them. Receipts ("cash in"), taxes and other collections recorded when received. Outlays ("cash out"), largely recorded when payment is made. 	<p><u>Prepared on an "accrual and modified cash basis"</u></p> <ul style="list-style-type: none"> Agency-based and retrospective – prior and present resources used to implement initiatives. Revenue: Tax revenue (more than 90 percent of total revenue) recognized on modified cash basis (see Financial Statement Note 1.B). Remainder recognized when earned, but not necessarily received. Costs: recognized when incurred, but not necessarily paid.

¹⁰ Since programs are not administered at the governmentwide level, performance goals and measures for the federal government, as a whole, are not reported here. The outcomes and results of those programs are addressed at the individual agency level and can be found in each agency's financial report. Go to www.performance.gov for more information about Government performance.

¹¹ Under U.S. GAAP, most U.S. Government revenues are recognized on a 'modified cash' basis, or when they become measurable. The Statement of Social Insurance presents the present value of the estimated future revenues and expenditures for scheduled benefits over the next 75 years for the Social Security, Medicare, Railroad Retirement programs; and through September 30, 2040 for the Black Lung program.

Budget Deficit vs. Net Operating Cost

The Government's primarily cash-based¹² budget deficit decreased nearly 29 percent (\$197 billion) from approximately \$680.3 billion in FY 2013 to about \$483.4 billion in FY 2014 (the lowest since 2008) due to a combination of higher receipts and stable outlays in FY 2014. The \$246.9 billion (8.9 percent) increase in receipts can be attributed to a stronger economy and the expiration of certain tax provisions. Growth in wages and salaries made collections of individual and payroll taxes strong throughout the year. Another contributor to the increase was the expiration of the temporary cut in payroll taxes and the increase in tax rates on income above certain thresholds, which went into effect in January 2013. Outlays increased 1 percent (\$50 billion). The comparatively small increase was due to the net effect of: (1) spending decreases across many agencies and programs, including the Department of Defense, the unemployment insurance program, and the Federal Deposit Insurance Corporation; and (2) spending increases for Social Security, Medicare, Medicaid, and student loans, along with lower dividend receipts from the GSEs, Fannie Mae and Freddie Mac which are recorded as offsets to spending.¹³ The Government's largely accrual-based net operating cost also decreased, but only slightly by \$13.8 billion (1.7 percent) from \$805.1 billion to \$791.3 billion during FY 2014. As explained below, net operating costs are affected by both changes in revenues and costs.

The budget deficit is measured as the excess of outlays, or payments made by the Government, over receipts, or cash received by the Government. Net operating cost, on an accrual basis, is the excess of costs (what the Government has incurred, but has not necessarily paid) over revenues (what the Government has collected and expects to collect, but has not necessarily received). Net operating cost typically exceeds the budget deficit due largely to the inclusion of cost accruals associated with increases in estimated liabilities for the Government's postemployment benefit programs for its military and civilian employees and veterans. Similarly, the difference between the budget deficit and net operating cost can also be affected by changes in certain asset valuations, such as investments, and in other liabilities, such as estimated insurance and guarantee program liabilities. The longer-term estimated costs of these programs are included in the Government's net operating cost, calculated on an accrual basis as described above, but are not included in the largely cash-based budget deficit. In addition, the costs of certain assets, such as property plant and equipment, are recorded in the budget as outlays when purchased but are capitalized as assets and included in net operating cost as depreciation expense (an accrual cost) as they are used over the useful life of the asset. Significant changes in the Government's net operating cost, including those related to the aforementioned longer-term estimated costs, are discussed in the next section.

The Reconciliation of Net Operating Cost and Unified Budget Deficit

Statement, as summarized in Table 3, shows how the Government's net operating cost from the primarily accrual-based financial statements relates to the more widely-known and primarily cash-based budget deficit. Table 3 shows how many of the elements described above contribute to the \$307.9 billion net difference between the Government's budget deficit and net

operating cost for FY 2014, more than half of which is attributable to: (1) a \$134.3 billion increase in liabilities for Federal employee and veteran benefits payable, and (2) a \$44.4 billion decrease in the value of Treasury's

Table 3: Net Operating Cost vs. Budget Deficit

Dollars in Billions	2014	2013
Net Operating Cost	\$ (791.3)	\$ (805.1)
Change in:		
Federal Employee and Veteran Benefits Payable	\$ 134.3	\$ 264.3
Environmental and Disposal Liabilities	\$ 20.0	\$ 10.1
Property, Plant, and Equipment, Net ¹	\$ 18.4	\$ (41.7)
Investments in Government-Sponsored Enterprises (GSEs)	\$ 44.4	\$ (30.9)
Insurance and Guarantee Program Liabilities	\$ 28.3	\$ (26.4)
Yearend Upward/(Downward) Credit Reform Subsidy Reestimates, Net ²	\$ 22.9	\$ (23.1)
Other, Net	\$ 39.6	\$ (27.5)
Subtotal - Net Difference:	\$ 307.9	\$ 124.8
Budget Deficit	\$ (483.4)	\$ (680.3)

1 Net effect of: capitalized fixed assets, depreciation expense, and asset disposals and revaluations

2 Net effect of: yearend upward/(downward) credit reform subsidy reestimates and effect of prior year (upward)/downward credit reform subsidy reestimates.

¹² Interest outlays on Treasury debt held by the public are recorded in the budget when interest accrues, not when the interest payment is made. For federal credit programs, outlays are recorded when loans are disbursed, in an amount representing the present value cost to the Government (excluding administrative costs), or the credit subsidy cost. Credit programs record cash payments to and from the public in nonbudgetary financing accounts.

¹³ 10/15/14 press release -- [Joint Statement of Treasury Secretary Jacob J. Lew and OMB Director Shaun Donovan on Budget Results for Fiscal Year 2014](#).

investments in two GSEs – Fannie Mae and Freddie Mac.¹⁴ These and most of the other “Change in” amounts summarized in Table 3 affect net operating cost, but not the budget deficit.

The Government's Net Position: “Where We Are”

The Government's financial position and condition have traditionally been expressed through the *Budget*, focusing on surpluses, deficits, and debt. However, this primarily cash-based discussion of the Government's net outlays (deficit) or net receipts (surplus) tells only part of the story. The Government's accrual-based net position, (the difference between its assets and liabilities), ~~and~~ its “bottom line” net operating cost (the difference between its revenues and costs), and tax expenditures (revenue losses attributable to special tax code provisions) are also key financial indicators.

Costs and Revenues: “What Went Out & What Came In”

The Government's *Statement of Operations and Changes in Net Position*, much like a corporation's income statement, shows the Government's “bottom line” and its impact on net position (i.e., assets net of liabilities). To derive the Government's “bottom line” net operating cost, the *Statement of Net Cost* first shows how much it costs to operate the federal government, recognizing expenses when incurred, regardless of when payment is made (accrual basis). It shows the derivation of the Government's *net cost* or the net of: (1) gross costs, or the costs of goods produced and services rendered by the Government, (2) the earned revenues generated by those goods and services during the fiscal year, and (3) gains or losses from changes in actuarial assumptions used to estimate certain liabilities. This amount, in turn, is offset against the Government's taxes and other revenue reported in the *Statement of Operations and Changes in Net Position* to calculate the “bottom line” or *net operating cost*.¹⁵

Table 4: Gross Cost, Revenues, Net Cost, and Net Operating Cost					
Dollars in Billions	2014	2013	Increase / (Decrease)		
			\$		%
Gross Cost	\$ (4,251.4)	\$ (3,940.9)	\$ 310.5		7.9%
Less: Earned Revenue	\$ 417.9	\$ 415.5	\$ 2.4		0.6%
Gain/(Loss) from Changes in Assumptions	\$ (3.5)	\$ (131.2)	\$ 127.7		97.3%
Net Cost	\$ (3,837.0)	\$ (3,656.6)	\$ 180.4		4.9%
Less: Taxes and Other Revenue	\$ 3,066.1	\$ 2,842.5	\$ 223.6		7.9%
Unmatched Transactions and Balances	\$ (20.4)	\$ 9.0	\$ 29.4		326.7%
Net Operating Cost	\$ (791.3)	\$ (805.1)	\$ (13.8)		(1.7%)

Table 4 shows that the Government's “bottom line” net operating cost decreased slightly from \$805.1 billion in FY 2013 to \$791.3 billion in FY 2014. This \$13.8 billion (1.7 percent) decrease is attributable to a number of offsetting revenue and cost changes over the past fiscal year as summarized in the following.

Gross Cost and Net Cost

The *Statement of Net Cost*, starts with the Government's total gross costs of \$4.3 trillion dollars, subtracts revenues earned for goods and services provided (e.g., Medicare premiums, national park entry fees, and postal service fees), and adjusts the balance for gains or losses from changes in actuarial assumptions used to estimate certain liabilities, including federal employee and veterans benefits to derive its net cost of \$3.8 trillion, a \$180.4 billion increase (4.9 percent) over FY 2013.

Typically, the Government's net cost is impacted by a variety of offsetting increases and decreases. The more significant drivers affecting the change in net cost during FY 2014 were:

- The loss on changes in assumptions associated with the Government's civilian and military benefits programs amounted to \$3.5 billion in FY 2014 as compared to \$131.2 billion in FY 2013, representing a \$127.7 billion decrease in net cost. Agencies administering these types of programs employ a complex series of assumptions, including but not limited to interest rates, beneficiary eligibility, life expectancy,

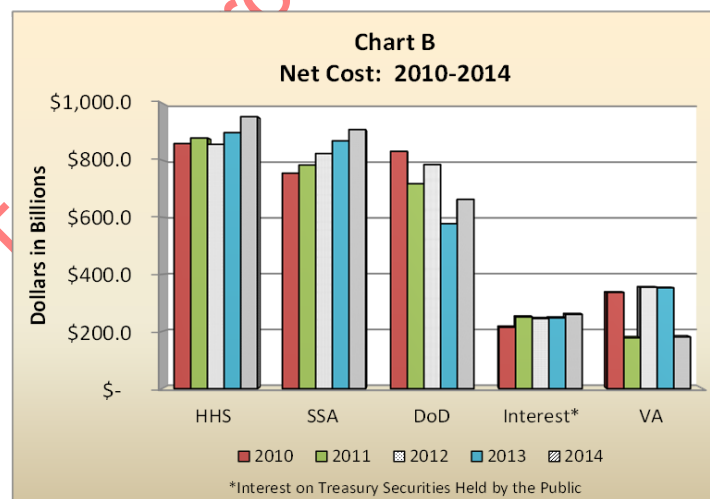
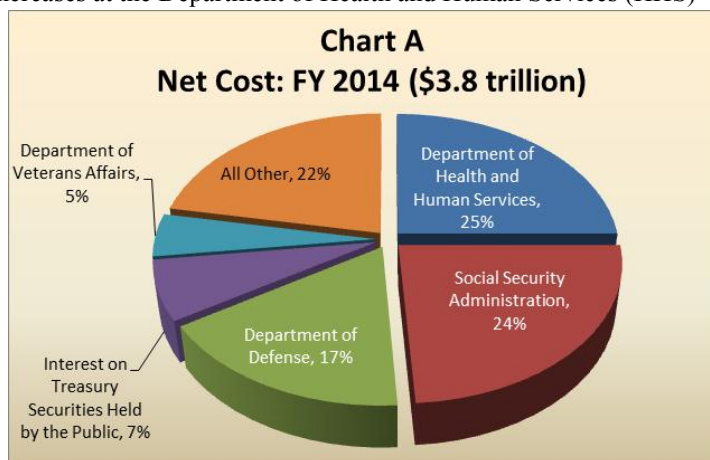
¹⁴ Department of the Treasury FY 2014 Agency Financial Report, p. 27

¹⁵ As shown in Table 4, net operating cost includes an adjustment for unmatched transactions and balances, which represent unreconciled differences in intragovernmental activity and balances between Federal agencies. These amounts are described in greater detail in the Other Information section of this *Financial Report*.

medical cost levels, compensation levels, disability claims rates, and cost of living to make annual actuarial projections of their long-term benefits liabilities. The Department of Veterans Affairs (VA) and the Office of Personnel Management (OPM) reported significant decreases in losses from changes in these assumptions for FY 2014;

- Most of the Department of the Treasury's (Treasury's) \$131.2 billion net cost increase is attributable to the effect of changes in the fair value of Treasury's investments in two GSEs – Fannie Mae and Freddie Mac – and to the decrease in dividend receipts from the GSEs¹⁶;
- \$55.8 billion and \$39.4 billion net cost increases at the Department of Health and Human Services (HHS) and the Social Security Administration (SSA), respectively, primarily due to cost increases of the benefits programs that these agencies administer (HHS – Medicare and Medicaid programs, SSA – Old Age Survivors and Disability Insurance (OASDI) programs);
- a \$46.4 billion cost increase at the Department of Education, largely associated with increases in the projected long-term costs of its direct student loan programs due to changes in the types and availability of repayment plans and increases in default rates¹⁷; and
- a \$26.5 billion decrease at the Department of Labor, primarily due to decreases in unemployment benefits provided under existing legislation and lower levels of unemployment as compared to FY 2013.¹⁸

Chart A shows the composition of the Government's net cost. In FY 2014, two-thirds of total net cost came from DOD, the Social Security Administration (SSA), and the Department of Health and Human Services (HHS). These three agencies have consistently incurred the largest agency shares of the Government's total net cost in recent years (Chart B). As indicated above, HHS and SSA net costs for FY 2014 (\$951.5 billion and \$906.4 billion, respectively) are attributable to major social insurance programs administered by these agencies. The *Statement of Social Insurance (SOSI)* and the related information in this *Financial Report*, including the broader discussion of the Government's long-term fiscal projections, discuss the projected future revenues, expenditures, and sustainability of these programs in greater detail. DOD's net costs of \$662.3 billion relate primarily to operations, readiness, and support; personnel; research; procurement; and retirement and health benefits. Chart A shows that the Department of Veterans Affairs (VA) as well as interest on debt held by the public contributed an additional combined 12 percent, and the other agencies included in the Government's FY 2014 Statement of Net Cost accounted for a combined 22 percent of the Government's total net cost for FY 2014.



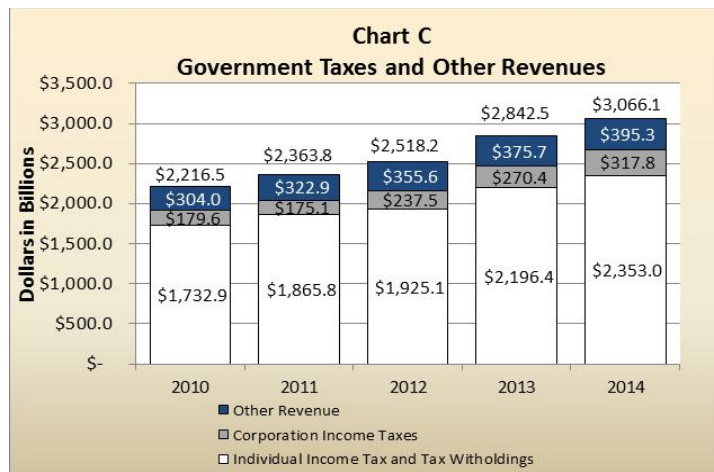
¹⁶ [Department of the Treasury FY 2014 Agency Financial Report](#), p. 22-23. See also Note 9 – Investments in GSEs – of this *Financial Report*.

¹⁷ [Department of Education FY 2014 Agency Financial Report](#), p. 30

¹⁸ [Department of Labor FY 2014 Agency Financial Report](#), p. 27

Taxes and Other Revenues - Getting to the "Bottom Line"

As noted earlier, taxes and other revenues from the *Statement of Operations and Changes in Net Position* are deducted from total net cost to derive the Government's "bottom line" net operating cost. Chart C shows that increases in each of the three taxes and other revenue categories shown - individual income tax and withholdings, corporation income taxes, and other revenue - combined to increase total Government taxes and other revenues by \$223.6 billion (7.9 percent) to nearly \$3.1 trillion for FY 2014. This change is primarily attributed to an overall increase in individual and corporation income tax collections.¹⁹ As noted in the earlier discussion of budget receipts, these increases largely stem from a stronger economy and growth in wages and salaries, as well as and the expiration of certain tax provisions. Earned revenues from Table 4 are not considered "taxes and other revenue" and, thus, are not shown in Chart C. Individual income tax and tax withholdings and corporation income taxes accounted for about 77 percent and 10 percent of total revenue, respectively in FY 2014; other revenues from Chart C include excise taxes, unemployment taxes, and customs duties.



As previously shown in Table 4, the increase in taxes and other revenues more than offset the increase in net costs, resulting in a slight total net decrease of \$13.8 billion (1.7 percent) in the Government's net operating cost from \$805.1 billion for FY 2013 to \$791.3 billion for FY 2014.

Tax Expenditures – Impact on "What Came In" and "The Bottom Line"

"Tax expenditures" refers to preferences in tax law ensuring more money is available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production.

Tax expenditures can reduce taxes owed or provide cash in the form of a refundable tax credit. They resemble federal spending in that such provisions, by helping to determine total federal revenues, have an impact on the federal deficit/surplus; however, they are not treated the same as federal spending for budgetary or financial reporting purposes. Tax expenditures are not subject to the annual budget process and can only be removed through tax legislation. Tax expenditure estimates do not appear in the net operating cost calculation in Table 4 above.

These and other issues concerning tax expenditures are discussed in further detail in the Required Supplementary Information section of this Financial Report.

Assets and Liabilities: "What We Own and What We Owe"

The Government's net position at the end of the year is derived by netting the Government's assets against its liabilities, as presented in the *Balance Sheet* (summarized in Table 5). It is important to note that the balance sheet does not include the financial value of the Government's sovereign powers to tax, regulate commerce, and set monetary policy. It also excludes its control over nonoperational resources, including national and natural resources, for which the Government is a steward. In addition, as is the case with the *Statement of Operations and Changes in Net Position*, the *Balance Sheet* includes a separate presentation of the portion of net position related to funds from dedicated collections. Moreover, the Government's exposures are broader than the liabilities presented on the balance sheet, when such items as the Government's future social insurance exposures (namely, Medicare and Social Security), as well as other fiscal projections, commitments and contingencies, are taken into account. These exposures are discussed later in this Management Discussion and Analysis (MD&A) section as well as in the required supplementary disclosures of this *Financial Report*.

¹⁹ Department of the Treasury FY 2014 Agency Financial Report, p. 28

Assets – “What We Own”

As of September 30, 2014, the Government held about \$3.1 trillion in assets, an increase of \$97.0 billion (3.3 percent). The Government's assets are comprised mostly of net loans receivable (\$1,123.5 billion) and net property, plant, and equipment (\$878.3 billion).²⁰ From Note 4, the Department of Education's (Education's) Federal Direct Student Loan Program accounted for \$778.6 billion (69.3 percent) of total net loans receivable. Education's credit program receivables balances increased by more than a third over the past two fiscal years largely due to increased direct loan disbursements, attributable to the continued effect of 2011 legislation requiring a transition for new loans from guaranteed student loans to full direct lending by Education.²¹

Beyond the assets reported on the Government's balance sheet, other significant resources are available to the Government, including stewardship assets, natural resources, and the Government's power to tax and set monetary policy.

Liabilities – “What We Owe”

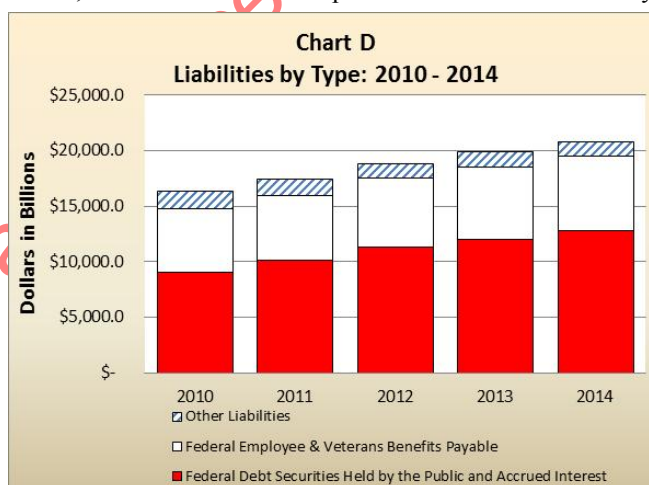
As indicated in Table 5 and Chart D, of the Government's \$20.8 trillion in total liabilities, the largest liability is federal debt securities held by the public and accrued interest, the balance of which increased \$805.2 billion (6.7 percent) to \$12.8 trillion as of September 30, 2014.

The other major component of the Government's liabilities is federal employee and veteran benefits payable (i.e., the Government's pension and other benefit plans for its military and civilian employees), which increased \$134.3 billion (2.1 percent) during FY 2014, to \$6,672.6 billion. OPM administers the largest civilian pension plan, covering nearly 2.7 million current employees and 2.5 million annuitants and survivors. The military pension plan covers about 2.1 million current military personnel (including active service, reserve, and National Guard) and approximately 2.7 million retirees and annuitants.

Federal Debt

The unified budget surplus or deficit is the difference between total federal spending and receipts (e.g., taxes) in a given year. The Government borrows from the public (increases federal debt levels) to finance deficits. During a budget surplus (i.e., when receipts exceed spending), the Government typically uses those excess funds to reduce the debt held by the public. *The Statement of Changes in Cash Balance from Unified Budget and Other Activities* reports how the annual unified budget surplus or deficit relates to the federal government's borrowing and changes

Table 5: Assets and Liabilities					
Net Position	2014	2013	Increase (Decrease)		
Dollars in Billions			\$	%	
Assets					
Cash & Other Monetary Assets	\$ 264.9	\$ 206.3	\$ 58.6	28.4%	
Loans Receivable, Net	\$ 1,123.5	\$ 1,022.3	\$ 101.2	9.9%	
Inventories & Related Property, Net	\$ 318.4	\$ 311.1	\$ 7.3	2.3%	
Property, Plant & Equipment, Net	\$ 878.3	\$ 896.7	\$ (18.4)	(2.1%)	
Other	\$ 480.2	\$ 531.9	\$ (51.7)	(9.7%)	
Total Assets	\$ 3,065.3	\$ 2,968.3	\$ 97.0	3.3%	
Less: Liabilities, comprised of:					
Federal Debt Held by the Public & Accrued Interest	\$ (12,833.6)	\$ (12,028.4)	\$ 805.2	6.7%	
Federal Employee & Veteran Benefits	\$ (6,672.6)	\$ (6,538.3)	\$ 134.3	2.1%	
Other	\$ (1,259.8)	\$ (1,310.9)	\$ (51.1)	(3.9%)	
Total Liabilities	\$ (20,766.0)	\$ (19,877.6)	\$ 888.4	4.5%	
Net Position (Assets Minus Liabilities)	\$ (17,700.7)	\$ (16,909.3)	\$ (791.4)	(4.7%)	



²⁰ For financial reporting purposes, other than multi-use heritage assets, stewardship assets are not recorded as part of Property, Plant, and Equipment. Stewardship assets are comprised of stewardship land and heritage assets. Stewardship land consists of public domain land (e.g., national parks, wildlife refuges). Heritage assets include national monuments and historical sites that among other characteristics are of historical, natural, cultural, educational, or artistic significance. See Note 25 – Stewardship Land and Heritage Assets.

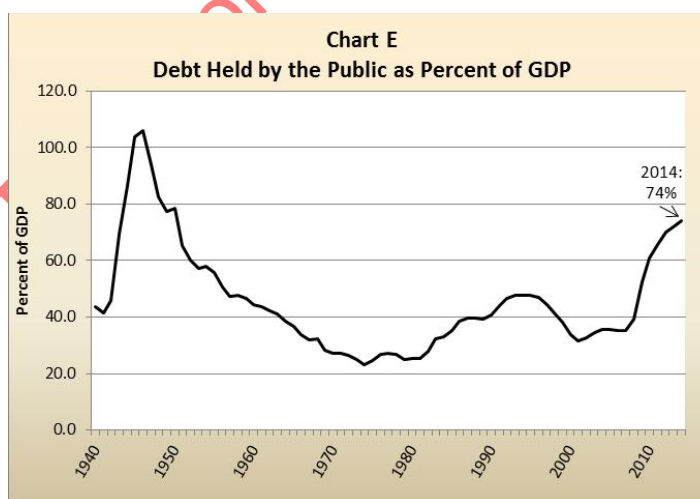
²¹ With the enactment of the SAFRA Act, formerly known as the Student Aid and Fiscal Responsibility Act, which was included as part of the Health Care and Education Reconciliation Act of 2010 (HCERA) (Pub. L. 111-152), beginning in July 2010, no new loans were originated under the Federal Family Education Loan (FFEL) Program ([FY 2014 Federal Student Aid Financial Report](#)). See also: [U.S. Department of Education FY 2014 Agency Financial Report](#) p. 25.

in cash and other monetary assets. It also explains how a budget surplus or deficit normally affects changes in debt balances.

The Government's publicly-held debt, or federal debt held by the public, and accrued interest, which is reported on the Government's balance sheet as a liability, is comprised of Treasury securities, such as bills, notes, and bonds, net of unamortized discounts and premiums; and accrued interest payable. The "public" consists of individuals, corporations, state and local governments, Federal Reserve Banks, foreign governments, and other entities outside the federal government. Federal debt held by the public and accrued interest totaled \$12.8 trillion as of September 30, 2014. As indicated above, budget surpluses have typically resulted in borrowing reductions, and budget deficits have conversely yielded borrowing increases. However, the Government's debt operations are generally much more complex than this would imply. Each year, trillions of dollars of debt mature and new debt is issued to take its place. In FY 2014, new borrowings were \$7.5 trillion and repayments of maturing debt held by the public were \$6.7 trillion. Both represented decreases over new borrowings and debt repayments as compared to FY 2013.

In addition to debt held by the public, the Government has about \$5.1 trillion in intragovernmental debt outstanding, which arises when one part of the Government borrows from another. It represents debt issued by the Treasury and held by Government accounts, including the Social Security (\$2.8 trillion) and Medicare (\$270.6 billion) trust funds. Intragovernmental debt is primarily held in Government trust funds in the form of special nonmarketable securities by various parts of the Government. Laws establishing Government trust funds generally require excess trust fund receipts (including interest earnings) over disbursements to be invested in these special securities. Because these amounts are both liabilities of the Treasury and assets of the Government trust funds, they are eliminated as part of the consolidation process for the governmentwide financial statements (see Note 12). When those securities are redeemed, e.g., to pay future Social Security benefits, the Government will need to obtain the resources necessary to reimburse the trust funds. The sum of debt held by the public and intragovernmental debt equals gross federal debt, which (with some adjustments), is subject to a statutory ceiling (i.e., the debt limit). At the end of FY 2014, debt subject to the statutory limit (DSL) was \$17.8 trillion.

Prior to 1917, the Congress approved each debt issuance. In 1917, to facilitate planning in World War I, Congress established a dollar ceiling for federal borrowing. With the Public Debt Act of 1941 (Public Law 77-7), Congress and the President set an overall limit of \$65 billion on Treasury debt obligations that could be outstanding at any one time. Since then, Congress and the President have enacted a number of measures affecting the debt limit. In February 2013, with the enactment of the No Budget, No Pay Act of 2013 (Public Law 113-3), Congress suspended the debt limit, enabling the debt to increase as needed through May 18, 2013. In accordance with provisions of the Act, the debt limit was reinstated on May 19, 2013 at a level of \$16.699 trillion. Because the new debt limit was set at the level of then outstanding debt, Treasury began implementing "extraordinary measures", on a temporary basis, which were still in effect on September 30, 2013, to keep the DSL under the statutory limit.²² On October 17, 2013, P.L. 113-46 again suspended the debt limit, this time through February 7, 2014, after which the limit was re-instated at a level of \$17.212 trillion. P.L. 113-83 again suspended the debt limit, this time from February 15, 2014 through March 15, 2015. It is important to note that increasing or suspending the debt limit does not increase spending or authorize new spending; rather, it permits the



²²A delay in raising the statutory debt limit existed as of September 30, 2013. When delays in raising the statutory debt limit occur, Treasury often must deviate from its normal debt management operations and take a number of extraordinary measures to meet the Government's obligations as they come due without exceeding the debt limit. Extraordinary measures taken by Treasury during the period of May 20, 2013, through October 16, 2013 resulted in federal debt securities not being issued to certain federal government accounts. As a result of Treasury securities not being issued to the Government Securities Investment Fund (G Fund) of the Thrift Savings Plan (TSP) of the Federal Retirement Thrift Investment Board (FRTIB), Treasury reported miscellaneous liabilities in the amount of \$120.4 billion that represent uninvested principal of and related interest for the G Fund that would have been reported as Federal Debt Securities Held by the Public and Accrued Interest had there not been a delay in raising the statutory debt limit as of September 30, 2013, and had the securities been issued. Treasury fully repaid its obligation to the G Fund by restoring them with accumulated uninvested principal and related interest through October 16, 2013. See Note 17, Other Liabilities for more information.

United States to continue to honor pre-existing commitments to its citizens, businesses, and investors domestically and around the world.

The federal debt held by the public measured as a percent of GDP (debt-to-GDP ratio) (Chart E) compares the country's debt to the size of its economy, making this measure sensitive to changes in both. Over time, the debt-to-GDP ratio has varied widely. For most of the nation's history, the debt-to-GDP ratio has tended to increase during wartime and decline during peacetime. That pattern continued to hold following World War II until the 1970s. As shown in Chart E, wartime spending and borrowing had pushed the debt-to-GDP ratio to an all-time high of 106 percent in 1946, but it decreased rapidly in the post-war years, falling to 79 percent by 1950, 44 percent in 1960, and the postwar low point of 23 percent in 1974. Since then, the ratio has increased, growing rapidly from the mid-1970s until the early 1990s. In the 1990s, strong economic growth and fundamental fiscal decisions, including measures to reduce the federal deficit and implementation of binding "Pay As You Go" (PAYGO) rules, generated a significant decline in the debt-to-GDP ratio over the course of the 1990s, from a peak of 48 percent in 1993-1995, to 31 percent in 2001. During the last decade, much of this progress was undone as PAYGO rules were allowed to lapse, significant tax cuts were implemented, entitlements were expanded, and spending related to defense and homeland security increased. By September 2008, the debt-to-GDP ratio was 39 percent of GDP. The extraordinary demands of the last economic and fiscal crisis and the consequent actions taken by the federal government, combined with slower economic growth in the wake of the crisis, pushed the debt-to-GDP ratio up to about 74 percent as of September 30, 2014.

The Economy in Fiscal Year 2014

A review of the nation's key macroeconomic indicators can help place the discussion of the Government's financial results in a broader context. As summarized in Table 6, the economy continued to expand at a moderate pace during FY 2014. Job growth picked up. The unemployment rate declined during FY 2014 to its lowest level in six years, but remained a bit above the 5.5 percent average that prevailed in the 1990s and 2000s.

	FY 2014	FY 2013
Real GDP Growth	2.7%	2.3%
Residential Investment Growth	-0.7%	14.4%
Average monthly payroll job change (thousands)	233	201
Unemployment rate (percent, end of period)	5.9%	7.2%
Consumer Price Index (CPI)	1.7%	1.2%
CPI, excluding food and energy	1.7%	1.7%
Treasury constant maturity 10-year rate (end of period)	2.52%	2.64%
Moody's Baa bond rate (end of period)	4.81%	5.39%

* Some FY2013 data may differ from the FY2013 *Financial Report* due to updates and revisions.

Real (i.e., inflation-adjusted) GDP expanded 2.7 percent during FY 2014, accelerating from the increase recorded over the four quarters of FY 2013. Consumer spending also rose 2.7 percent during FY 2014, faster than the increase during the previous fiscal year. The recovery in the housing sector slowed in FY 2014 and residential fixed investment declined by 0.7 percent, compared with a surge of 14.4 percent during FY 2013. Growth of nonresidential fixed investment strengthened, accelerating to 7.6 percent during FY 2014 from 3.0 percent during the previous fiscal year.

Labor market conditions improved further during FY 2014, with the pace of job growth picking up and the unemployment rate declining as the fiscal year progressed. The economy added 2.8 million nonfarm payroll jobs during FY 2014, exceeding the 2.4 million jobs created during the previous fiscal year. On a monthly basis, nonfarm payroll employment advanced at an average rate of 233,000 jobs, faster than the average monthly increase of 201,000 in FY 2013. The number of unemployed persons fell from 11.3 million in September 2013 to 9.2 million in September 2014. The unemployment rate declined 1.3 percentage points, from 7.2 percent in September 2013 to 5.9 percent in September 2014. At the end of FY 2014, the unemployment rate was 4.1 percentage points lower than the peak of 10.0 percent, reached in October 2009.

Inflation trended higher in the latest fiscal year, largely reflecting higher food price inflation, but remained at a moderate level. The headline consumer price index (CPI) rose 1.7 percent during FY 2014, up from 1.2 percent in FY 2013. Underlying core inflation (the CPI excluding food and energy) was stable at 1.7 percent during FY 2014, the same as during the previous fiscal year. Both headline and core inflation in FY 2014 remained low by historical standards.

Growth of real disposable personal income accelerated during FY 2014, to more than double the rate seen in the previous fiscal year as stronger growth in nominal disposable personal income slightly offset a pickup in

inflation. The level of corporate profits rose 1.4 percent during FY 2014, compared with a gain of 4.9 percent during the previous fiscal year.

The solid performance of the U.S. economy in FY 2014 occurred against a backdrop of generally stable conditions in financial markets. Yields on corporate bonds of moderate risk were about 275 basis points above the rate on 10-year Treasury securities at the end of FY 2013. This spread decreased early in the fiscal year and remained below that level throughout the year, ending FY 2014 at 229 basis points. The difference between the 3-month London Interbank Offered Rate (LIBOR) and the 3-month Treasury rate stood at 23 basis points at the end of FY 2013. This spread generally narrowed over the course of the latest fiscal year, before edging back up more recently, ending FY 2014 at 22 basis points.

The Long-Term Fiscal Outlook: “Where We Are Headed”

While the Government’s immediate priority is to continue to foster economic recovery, there are longer-term fiscal challenges that must ultimately be addressed. Persistent growth of health care costs and the aging of the population due to the retirement of the “baby boom” generation²³, increasing longevity, and lower birth rates will make it increasingly difficult to fund critical social programs, including Medicare, Medicaid, and Social Security.

Fiscal Sustainability

An important purpose of the *Financial Report* is to help citizens understand current fiscal policy and the importance and magnitude of policy reforms necessary to make it sustainable. A sustainable policy is one where the debt-to-GDP ratio is stable or declining over the long term.

To determine if current fiscal policies are sustainable, the projections discussed here assume current policy will continue indefinitely and draw out the implications for the growth of debt held by the public as a share of GDP.²⁴ The projections are therefore neither forecasts nor predictions. As policy changes are enacted, actual financial outcomes will be different than those projected.

The projections in this *Financial Report* indicate that current policy is not sustainable. The debt-to-GDP ratio is projected to reach 321 percent in 2089 and to rise continuously thereafter. Preventing the debt-to-GDP ratio from rising over the next 75 years is estimated to require some combination of spending reductions and revenue increases that amount to 2.1 percent of GDP over the period. While this estimate of the “75-year fiscal gap” is highly uncertain, it is nevertheless nearly certain that current fiscal policies cannot be sustained indefinitely.

It is important to address the Government’s fiscal imbalances soon. Delaying action increases the magnitude of spending reductions and/or revenue increases necessary to stabilize the debt-to-GDP ratio. For example, it is estimated that the magnitude of reforms necessary to close the 75-year fiscal gap is more than 20 percent larger if reforms are delayed by just ten years, and more than 50 percent larger if reform is delayed 20 years.

The estimates of the cost of policy delay in this *Financial Report* assume policy does not affect GDP or other economic variables. Reducing deficits too abruptly would be counterproductive if it slows the economy’s recovery. Conversely, delaying fiscal adjustments for too long raises the risk that growing federal debt would increase interest rates and slow economic growth. In the near term, it is crucial to strike the proper balance between deficit reduction and economic growth.

The Primary Deficit, Interest, and Debt

The primary deficit – the difference between non-interest spending and receipts – is the only determinant of the debt-to-GDP ratio that the Government controls directly. (The other determinants are interest rates and growth in GDP). Chart F shows receipts, non-interest spending, and the difference – the primary deficit – expressed as a share of GDP (primary deficit-to-GDP ratio). The primary deficit-to-GDP ratio grew rapidly in 2009 due to the financial crisis and the recession and the policies pursued to combat both. The ratio remained high from 2010 to 2012 despite shrinking in each successive year, and fell significantly in 2013 and 2014. The primary deficit is

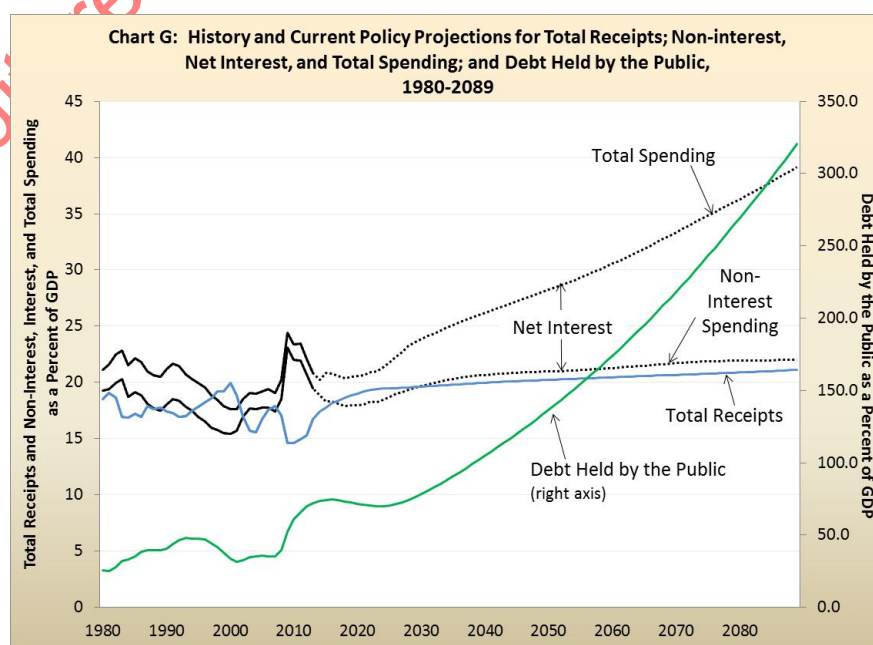
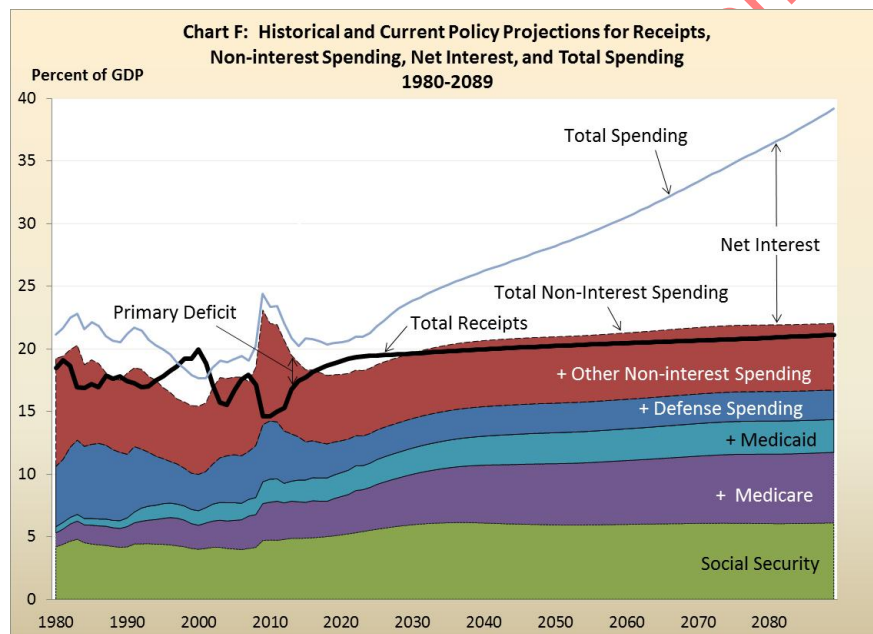
²³ Refers to the segment of the population born during the post-World War II era during which time birth rates in the U.S. were higher than normal.

²⁴ Current policy in the projections is based on current law, but includes extension of certain policies that expire under current law but are routinely extended or otherwise expected to continue, such as reauthorization of the Supplemental Nutrition Assistance Program.

projected to shrink in the next few years as spending reductions called for in the Budget Control Act (BCA) continue and the economy continues to recover, becoming a primary surplus in 2017 that peaks at 1.2 percent of GDP in 2021. Between 2022 and 2037, however, increased spending for Social Security and health programs due to the continued retirement of the baby boom generation and increases in the price of health care services is expected to cause the primary surplus to steadily deteriorate and become a primary deficit starting in 2030 that reaches 0.7 percent of GDP by 2039. After 2039, increasing longevity and slowing in the pace of health care price increases cause the primary deficit to GDP ratio to rise slowly to 1.1 percent in 2071, before falling back to 0.9 percent by 2089.

The receipt share of GDP fell substantially in 2009 and 2010 and remained low in 2011 and 2012 because of the recession and tax reductions enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The share rose to 17.4 percent in 2014 and is projected to return to near its long-run average as the economy fully recovers and as a result of the higher tax rates enacted under the American Taxpayer Relief Act (ATRA). After 2020, receipts are projected to grow slightly more rapidly than GDP as increases in real incomes cause more taxpayers and a larger share of income to fall into the higher individual income tax brackets.

The non-interest spending share of GDP is projected to stay at or below its current level of about 19 percent until 2028, and to then rise gradually to 20.8 percent of GDP in 2042 and 22.0 percent of GDP in 2089. The reductions in the non-interest spending share of GDP over the next few years are mostly due to the expected reductions in spending for overseas contingency operations, caps on discretionary spending, and the automatic spending cuts mandated by the BCA; the subsequent increases are principally due to growth in Medicare, Medicaid, and Social Security spending (see Chart F). The aging of the baby boom generation over the next 25 years is projected to increase the Social Security, Medicare, and Medicaid spending shares of GDP by about 1.2 percentage points, 1.7 percentage points, and 0.6 percentage points, respectively. After 2039, the Social Security spending share of GDP gradually declines and then returns to 2039 levels, while the Medicare and Medicaid



spending share of GDP continues to increase, albeit at a slower rate, due to projected increases in health care costs. The Affordable Care Act (ACA)²⁵ provision of health insurance subsidies and expanded Medicaid coverage boost federal spending and other ACA provisions significantly reduce per-beneficiary Medicare cost growth. On net, the ACA is projected to substantially reduce the cost growth rate of federal expenditures for Medicare over the next 75 years. However, as discussed in Note 24, there is uncertainty about whether the projected cost savings, productivity improvements, and reductions in physician payment rates will be sustained in a manner consistent with the projected cost growth over time.

The primary deficit-to-GDP projections in Chart F, along with projections for interest rates, determine the debt-to-GDP ratio projections shown in Chart G (right axis) on the previous page. That ratio was 74 percent at the end of FY 2014 and under current policy is projected to be 70 percent in 2024, 117 percent in 2044, and 321 percent in 2089. The debt-to-GDP ratio rises at an accelerating rate despite primary deficits that flatten out because higher levels of debt lead to higher net interest expenditures, and higher net interest expenditures lead to higher debt. The continuous rise of the debt-to-GDP ratio after 2024 indicates that current policy is unsustainable.

These debt projections are generally higher than the corresponding projections in the FY 2013 *Financial Report*, but still lower than those made in the FY 2012 *Financial Report*. For example, the debt-to-GDP projection for 2087 (the final projection year for the 2012 report) is 309 percent in this year's *Financial Report*, 272 percent in the FY 2013 *Financial Report*, and 395 percent in the FY 2012 *Financial Report*.²⁶

The Fiscal Gap and the Cost of Delaying Policy Reform

The 75-year fiscal gap is one measure of the degree to which current fiscal policy is unsustainable. It is the amount by which primary surpluses over the next 75 years must rise above current-policy levels in order to prevent the debt-to-GDP ratio from rising. It is estimated that running primary surpluses that average 1.6 percent of GDP over the next 75 years would result in the 2089 debt-to-GDP ratio equaling its level in fiscal year 2014, which compares with primary deficits that average 0.4 percent of GDP under current policies. The 75-year fiscal gap is therefore 2.1 percent of GDP, which is 10.3 percent of the 75-year present value of projected receipts and 10.0 percent of the 75-year present value of non-interest spending.

It is noteworthy that preventing the debt-to-GDP ratio from rising over the next 75 years requires that primary surpluses be substantially positive on average. This is true because projected GDP growth rates are, on average, smaller than the projected government borrowing rate over the next 75 years. The implication is that debt would grow faster than GDP if primary surpluses were zero on average. For example, if the primary surplus was precisely zero in every year, then debt would grow at the rate of interest in every year, which would be faster than GDP growth.

Table 7 illustrates the cost of delaying policy to close the fiscal gap by comparing three policies that begin on different dates. The first policy begins immediately and calls for increasing primary surpluses by 2.1 percent of GDP in every year between 2015 and 2089. This is accomplished

by invoking some combination of spending reductions and revenue increases that amount to 2.1 percent of GDP in every year over the 75-year projection period. The second policy in Table 7 begins in 2025. Because the same fiscal consolidation must be compressed into ten fewer years, this policy change is more abrupt, calling for primary surplus increases amounting to 2.5 percent of GDP in every year between 2025 and 2089. Similarly, if debt is allowed to accumulate unabated for 20 years, then closing the 75-year fiscal gap would require even more abrupt primary surplus increases amounting to 3.1 percent of GDP in every year between 2035 and 2089. The differences between the primary surplus boost starting in 2025 and 2035 (2.5 and 3.1 percent of GDP, respectively) and the primary surplus boost starting in 2015 (2.1 percent of GDP) is a measure of the additional burden policy delay would impose on future generations. Future generations are harmed by a policy delay of this sort because the higher the primary surplus is during their lifetimes the greater the difference is between the taxes they pay and the programmatic spending from which they benefit.

Table 7	
Costs of Delaying Fiscal Reform	
Period of Delay	Change in Average Primary Surplus
No Delay: Reform in 2015.....	2.1 percent of GDP between 2015 and 2089
Ten Years: Reform in 2025.....	2.5 percent of GDP between 2025 and 2089
Twenty Years: Reform in 2035..	3.1 percent of GDP between 2035 and 2089

Note: Reforms taking place in 2014, 2024, and 2034 from the 2013 Financial Report were 1.7, 2.1, and 2.6 percent of GDP.

²⁵ P.L. 111-148, as amended by P.L. 111-152. The ACA expands health insurance coverage, provides health insurance subsidies for low-income individuals and families, includes many measures designed to reduce health care cost growth, and reduces the annual increases in Medicare payment rates.

²⁶ See the Required Supplementary Information section of the [FY 2013 Financial Report of the U.S. Government](#) for more information about changes from the long term fiscal projections for FY 2012.

Conclusion

The Government took significant steps towards a sustainable fiscal policy by enacting the ACA in 2010, the BCA in 2011, and ATRA in 2013. The ACA holds the prospect of lowering long-term per-beneficiary spending growth for Medicare and Medicaid, the BCA significantly curtails discretionary spending, and ATRA increases revenues. Together, these three laws substantially reduce the estimated long-term fiscal gap. But even with these laws, the debt-to-GDP ratio is projected to remain relatively flat over the next ten years and then commence a continuous rise over the remaining projection period and beyond if current policies are kept in place. This trend implies that current policies are not sustainable. Subject to the important caveat that changes in policy are not so abrupt that they slow the economy's recovery, the sooner policies are put in place to avert these trends, the smaller the revenue increases and/or spending decreases will need to be to return the Government to a sustainable fiscal path over the long term.

While this *Financial Report's* projections of expenditures and receipts under current policy are highly uncertain, it is nevertheless nearly certain that current policy cannot be sustained indefinitely.

These and other issues concerning fiscal sustainability are discussed in further detail in the Required Supplementary Information section of this *Financial Report*.

Social Insurance

The preceding analysis of the Government's long-term fiscal projections considered Government receipts and spending as a whole. The Statement of Social Insurance (SOSI) provides a more focused perspective of the Government's "social insurance" programs: Social Security, Medicare, Railroad Retirement, and Black Lung.²⁷ For these programs, the SOSI reports: (1) the actuarial present value of all future program revenue (mainly taxes and premiums) - excluding interest - to be received from or on behalf of current and future participants; (2) the estimated future scheduled expenditures to be paid to or on behalf of current and future participants; and (3) the difference between (1) and (2). Amounts reported in the SOSI and in the RSI section in this *Financial Report* are based on each program's official actuarial calculations. By accounting convention, the transfers of general revenues are eliminated in the consolidation of the SOSI at the governmentwide level and as such, the general revenues that are used to finance Medicare Parts B and D are not included in these calculations even though the expenditures on these programs are included. For the FY 2014 and 2013 SOSI, the amounts eliminated totaled \$24.7 trillion and \$22.5 trillion, respectively. SOSI programs and amounts

Table 8: Social Insurance Future Expenditures in Excess of Future Revenues

Dollars in Billions	2014	2013	Increase / (Decrease)	
			\$	%
Open Group (Net):				
Social Security (OASDI)	\$ (13,330)	\$ (12,294)	\$ 1,036	8.4%
Medicare (Parts A, B, & D)	\$ (28,483)	\$ (27,302)	\$ 1,181	4.3%
Other	\$ (103)	\$ (102)	\$ 1	0.6%
Total Social Insurance Expenditures, Net (Open Group)	\$ (41,916)	\$ (39,698)	\$ 2,218	5.6%
Total Social Insurance Expenditures, Net (Closed Group)	\$ (56,680)	\$ (53,974)	\$ 2,706	5.0%
Social Insurance Net Expenditures as a % of Gross Domestic Product (GDP)*				
Open Group				
Social Security (OASDI)	(1.2%)	(1.2%)		
Medicare (Parts A, B, & D)	(2.9%)	(3.0%)		
Other	0.0%	0.0%		
Total (Open Group)	(4.0%)	(4.0%)		
Total (Closed Group)	(5.4%)	(5.5%)		

Source: Statement of Social Insurance (SOSI). Amounts equal estimated present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain 'Social Insurance' programs (e.g., Social Security, Medicare). 'Open Group' totals reflect all current and projected program participants during the 75-year projection period. 'Closed Group' totals reflect only current participants.

* GDP values used are from the 2014 & 2013 Social Security and Medicare Trustees Reports and represent the present value of GDP over the 75-year projection period. As the GDP used for Social Security and Medicare differ slightly in the Trust Fund Reports, the two values are averaged to estimate the 'Other' and Total Net Social Insurance Expenditures as % of GDP.

Note - some totals may not equal sum of components due to rounding.

²⁷ The Black Lung Benefits Act (BLBA) provides for monthly payments and medical benefits to coal miners totally disabled from pneumoconiosis (black lung disease) arising from their employment in or around the nation's coal mines. See <http://www.dol.gov/compliance/topics/benefits-comp-blacklung.htm>

are included in the broader fiscal sustainability analysis in the previous section, although on a slightly different basis (as described in the RSI section of this *Financial Report*).

The SOSI provides perspective on the Government's long-term estimated exposures and costs for social insurance programs. While these expenditures are not considered Government liabilities, they do have the potential to become expenses and liabilities in the future, based on the continuation of the social insurance programs' provisions contained in current law. The social insurance trust funds account for all related program income and expenses. Medicare and Social Security taxes, premiums, and other income are credited to the funds; fund disbursements may only be made for benefit payments and program administrative costs. Any excess revenues are invested in special non-marketable U.S. Government securities at a market rate of interest. The trust funds represent the accumulated value, including interest, of all prior program surpluses, and provide automatic funding authority to pay for future benefits.

Table 8 on the previous page summarizes amounts reported in the SOSI, showing that net social insurance expenditures are projected to be \$41.9 trillion as of January 1, 2014 for the "Open Group," an increase of \$2.2 trillion over net expenditures of \$39.7 trillion projected in the 2013 *Financial Report*.²⁸ The 2014 amounts reported for Medicare reflect the "projected baseline scenario" for Part B.²⁹

Table 9 summarizes the principal reasons for the changes in projected social insurance amounts during 2014 and 2013. The following briefly summarizes the significant changes for the current valuation (as of January 1, 2014) as disclosed in Note 24, Social Insurance. See Note 24 for additional information.

- Change in valuation period: This change replaces a small negative net cash flow for 2013 and replaces it with a much larger negative net cash flow for 2088. As a result, the present value of the estimated future net cash flows decreased (became more negative) by \$1.8 trillion.
 - Changes in economic data and assumptions: for both Social Security and Medicare, the ultimate annual rate of change in the CPI for Urban Wage Earners and Clerical Workers (CPI-W) is assumed to be 2.7 percent per year, compared to 2.8 percent per year in the prior period, making the ultimate average increase in the CPI-W more comparable to recent historical annual increases. Otherwise, the ultimate economic assumptions for the current valuation are the same as those for the prior valuation. However, starting economic values and the way these values transition to the ultimate assumptions were changed.
 - The ratio of average taxable earnings to the average wage index is lower by 1.9 percent in 2012 and 1.5 percent in 2013, compared to the previous valuation period.
- In addition, there were two main changes in economic methodology:
- Projected labor force participation rates for the older population are slightly lower for the current valuation in order to better reflect the participation rates between never-married and married populations and the improvement in life expectancy.
 - Different earnings levels are assigned to three distinct groups of the other immigrant population supplied by demography.

Table 9: Changes in Social Insurance Projections		
Dollars in Billions	2014	2013
Net Present Value (NPV) - Open Group (Beginning of the Year)	\$ (39,698)	(38,554)
Changes In:		
Valuation Period	\$ (1,769)	\$ (1,813)
Demographic data and assumptions	\$ (54)	\$ (285)
Economic data and assumptions ¹	\$ (605)	\$ (273)
Law or policy	\$ 29	\$ (520)
Methodology and programmatic data ¹	\$ (90)	\$ 1,034
Economic and other healthcare assumptions ²	\$ (318)	\$ (94)
Change in projection base ²	\$ 589	\$ 807
Net Change in Open Group measure	\$ (2,218)	\$ (1,144)
NPV - Open Group (End of the Year)	\$ (41,916)	\$ (39,698)

¹ Relates to SSA.

² Relates to HHS.

Note - totals may not equal sum of components due to rounding.

²⁸ 'Closed' Group and 'Open' Group differ by the population included in each calculation. From the SOSI, the 'Closed' Group includes: (1) participants who have attained eligibility and (2) participants who have not attained eligibility. The 'Open' Group adds future participants to the 'Closed' Group. See 'Social Insurance' in the Required Supplementary Information section in this *Financial Report* for more information.

²⁹ The projected baseline scenario includes the assumption that the current-law physician updates will be legislatively overridden and that physician updates will be 0.6 percent each year starting with 2016. (2014 Medicare Trustees Report, p. 8/footnote 5)

These changes decreased (made more negative) the present value of the estimated future cash flows by \$605 billion.

- Changes in economic and other healthcare assumptions: The assumption changes, specific to the Medicare projections, included, but were not limited to:
 - The projections emphasized in the 2014 Medicare Trustees Report were changed to reflect the projected baseline scenario. This scenario assumes that the physician payment updates required under the current-law sustainable growth rate formula will be permanently overridden by lawmakers. The use of these projections increases the present value of estimated future expenditures, compared to the current law projections, for Part B by roughly 11 percent and for Total Medicare by about 5 percent.
 - Utilization rate assumptions for inpatient hospital services were decreased and case mix increase assumptions for skilled nursing facilities and home health agencies were decreased.

These and other related changes decreased (made more negative) the present value of the estimated future cash flows by \$318 billion.

Projected net expenditures for Medicare Parts A and B declined significantly between FY 2009 and FY 2010 reflecting provisions of the ACA. As reported in Note 24, there continues to be uncertainty about whether the projected cost savings and productivity improvements will be sustained in a manner consistent with the projected cost growth over time. Note 24 includes an alternative projection to illustrate the uncertainty of projected Medicare costs. As indicated earlier, GAO disclaimed opinions on the 2014, 2013, 2012, 2011 and 2010 SOSI because of these significant uncertainties.

Costs as a percent of GDP of both Medicare and Social Security, which are analyzed annually in the Medicare and Social Security Trustees' Reports, are projected to increase substantially through 2035 because: (1) the number of beneficiaries rises rapidly as the baby-boom generation retires and (2) the lower birth rates that have persisted since the baby boom cause slower growth in the labor force and GDP.³⁰ According to the Medicare Trustees' Report, spending on Medicare is projected to rise from approximately 3.5 percent of GDP in 2013 to 6.9 percent in 2088 (based on the projected baseline under the Trustees intermediate set of assumptions, as noted earlier). The Hospital Insurance (HI) Trust Fund is now expected to remain solvent until 2030, (four years later than projected in last year's report). Under the projected baseline, scheduled HI tax revenue would be sufficient to pay 85 percent of HI costs in 2030 and 77 percent by 2088.

As for Social Security, combined spending is projected to increase gradually from its current level of 4.9 percent of GDP to about 6.2 percent by 2035, declining to 6.0 percent by 2050 and remaining between 6.0 and 6.1 percent through 2088. The Social Security Trustees' Report indicates that annual OASDI income, considered on a theoretical basis, including interest on trust fund assets, will exceed annual cost and trust fund assets will increase every year until 2020, at which time it will be necessary to begin drawing down on trust fund assets to cover part of expenditures until asset reserves become depleted in 2033 (unchanged from last year's Report). Continuing tax income would be sufficient to pay 77 percent of scheduled benefits in 2033 and 72 percent of scheduled benefits in 2088. However, the DI Trust Fund alone is expected to deplete much sooner, by the end of 2016, at which time 81 percent of scheduled benefits would be payable.³¹ The projections assume that full Social Security and Medicare benefits are paid after the corresponding trust fund assets are depleted.

As noted earlier, it is apparent that these programs are on a fiscally unsustainable path (as was previously discussed and as noted in the Trustees' Reports). Additional information from the Trustees Reports may be found in the RSI section of this *Financial Report*.

Systems, Controls, and Legal Compliance

Systems

As federal agencies demonstrate success in obtaining opinions on their audited financial statements, the federal government continues to face challenges in implementing financial systems that meet federal requirements. The number of CFO Act agencies reporting lack of substantial compliance with one or more of the three Section 803(a) requirements of the Federal Financial Management Improvement Act (FFMIA) was 10 in FY 2014 and 9 in FY 2013, and the number of auditors reporting lack of substantial compliance with one or more of the three Section

³⁰ [2014 Annual Trustees Reports on Social Security and Medicare \(Summary\)](#), pp. 3, 11.

³¹ [2014 Annual Trustees Reports on Social Security and Medicare \(Summary\)](#), pp. 3, 10.

803(a) FFMIA requirements was 11 in both FY 2014 and FY 2013. These results underscore the importance of current initiatives to standardize the financial management practices across the federal government.

Controls

Federal managers have a fundamental responsibility to develop and maintain effective internal controls. Effective internal controls help to ensure that programs are managed with integrity and resources are used efficiently and effectively through three objectives: effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The safeguarding of assets is a subcomponent of each objective.

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, is the policy document that implements the requirements of 31 U.S.C. 3512 (c), (d) (commonly known as the Federal Managers' Financial Integrity Act or FMFIA). Circular No. A-123 primarily focuses on providing agencies with a framework for assessing and managing risks more strategically and effectively. The Circular is currently being revised to reflect changes incorporated in GAO's recently updated Standards for Internal Control in the federal government. The revised Circular will be available to the Agencies in the near future. The Circular contains multiple appendices that address, at a more detailed level, one or more of the objectives of effective internal control. Appendix A provides a methodology for agency management to assess, document, test, and report on internal controls over financial reporting. Appendix B requires agencies to maintain internal controls that reduce the risk of fraud, waste, and error in Government charge card programs. Appendix C implements the Requirements for Effective Estimation and Remediation of Improper Payments. Appendix D defines new requirements for determining compliance with the FFMIA and will contribute to efforts to reduce the cost, risk, and complexity of financial system modernizations.

The total number of reported material weaknesses for the CFO Act agencies was 27 and 29 for FYs 2014 and 2013, respectively.³² Effective internal controls are a challenge not only at the agency level, but also at the governmentwide level. GAO reported that at the governmentwide level, material weaknesses resulted in ineffective internal control over financial reporting. While progress is being made at many agencies and across the Government in identifying and resolving internal control deficiencies, continued diligence and commitment are needed.

In FY 2015, HHS and Treasury will begin to perform comprehensive risk assessments to determine areas that might affect payment accuracy in the Marketplaces and related programs created under the Affordable Care Act. The status of these risk assessments will be reported in the agencies' FY 2015 Agency Financial Reports (AFR). In the interim, both agencies have established internal controls to provide for effective program operations, reliable financial reporting, and compliance with laws and regulations.

Legal Compliance

Federal agencies are required to comply with a wide range of laws and regulations, including appropriations, employment, health and safety, and others. Responsibility for compliance primarily rests with agency management. Compliance is addressed as part of agency financial statement audits. Agency auditors test for compliance with selected laws and regulations related to financial reporting. Certain individual agency audit reports contain instances of noncompliance. None of these instances were material to the governmentwide financial statements. However, GAO reported that its work on compliance with laws and regulations was limited by the material weaknesses and scope limitations discussed in its report.

Financial Management Progress and Priorities

Since the passage of the CFO Act of 1990, the federal financial community has made important strides in instilling strong accounting and financial reporting practices. This year, 21 of the 24 CFO Act agencies obtained an opinion from the independent auditors on their financial statements as of the issuance of this *Financial Report*. Out of the 24 major CFO Act agencies, there were 21 clean opinions and two disclaimers in FY 2014³³. In addition, 25 auditor-identified material weaknesses were reported in FY 2014, an approximately 59 percent decline from the 61 material weaknesses that were identified at the start of this past decade. An increasing number of federal agencies have initiated and sustained disciplined and consistent financial reporting operations, implemented effective internal

³² FY 2014 material weaknesses do not include audit results for HUD. HUD's audit results were not available as of the date of this report. The audit results are expected to be reported in March 2015. HUD's FY 2013 four material weaknesses are included in the governmentwide FY 2013 audit results.

³³ The 21 agencies include HHS, which received a clean opinion on all statements except the Statement of Social Insurance and the Statement of Changes in Social Insurance, both of which received a disclaimer of opinion. The audit opinion for the Department of Housing and Urban Development (HUD) was not available as of the release of this *Financial Report*.

controls around financial reporting, and have successfully integrated transaction processing and accounting records. These efforts have resulted in improved results on financial statement audits. However, weaknesses in basic financial management practices and other limitations continue to prevent two of the CFO Act agencies, and the Government as a whole, from achieving an audit opinion.

Today, accountability means providing transparent information to the public about where and how federal dollars are being spent. It means protecting against fraud. It means avoiding wasteful or excessive use of taxpayer funds. It means ensuring that the federal government is not only responsible stewards of taxpayer dollars, but frugal stewards as well, looking for every opportunity to save money and create greater efficiencies.

The federal government has come a long way since the passage of the CFO Act in 1990. Today, the federal financial management community is focused on three important improvement initiatives:

- Improving the quality, utility, and transparency of financial information;
- Protecting against waste, fraud, and abuse; and
- Helping agencies maximize the impact of their limited financial resources.

Improve the Quality, Utility, and Transparency of Federal Financial Information

DATA Act

The Digital Accountability and Transparency Act (DATA Act), signed on May 9, 2014, sets forth a clear vision for the future of Federal spending transparency. The Act primarily amends the Federal Funding Accountability and Transparency Act (FFATA) by requiring that all federal spending be displayed on a website in a searchable, downloadable, and machine-readable format. This includes information on obligations, outlays, budgetary authority, unobligated balances, and other budgetary resources for each appropriations account. It also expands award reporting to include all award spending and requires that OMB and Treasury issue data definition and exchange standards by May 2015. By 2017, all agencies must report this data to a centralized website and adhere to the data standards and guidance issued by OMB and Treasury. This will expand Federal spending transparency and unlock spending data for use by the public and agencies. Posting this financial information will allow spending comparisons across and within agencies that have never been possible before.

Since the DATA Act was signed into law, OMB and Treasury have been partnering to lead governmentwide implementation. They have established a robust governance structure with representatives from agencies and functional communities fostering collaboration on data standards, policy changes, USAspending.gov improvements, and agency implementation. The implementation project plan was developed to be collaborative, iterative, incremental, and agile, with a data centric focus. This approach sets the foundation for future success with shorter term and intermediate deliverables.

USAspending.gov

USAspending.gov was established to provide clear information on federal award spending. Continuing to improve the quality, utility and transparency of this federal spending information is a foundational Administration commitment to open government, as identified in the U.S. Government's National Action Plan for Open Government. To continue its efforts to improve the quality of spending data, OMB will issue additional policy guidance to adjust USAspending.gov reporting requirements and procedures pursuant to the DATA Act. To align our federal spending and financial management transparency efforts, the Administration has transferred responsibility for USAspending.gov from GSA to Treasury. Treasury's leadership in executing a governmentwide federal spending transparency vision enables the federal government to move forward in achieving the objective of making spending data more useful, accurate, and timely – consistent with the agency's other work through financial reporting, work on improper payments, among other priority areas. Over the next year, USAspending.gov will reflect improvements in both website usability and functionality, leveraging the lessons and successes learned from Recovery Act reporting and data display.

Moving forward, in concert with Treasury, OMB will continue to collaborate with the Government Accountability & Transparency Board and both federal and non-federal stakeholders to evolve the Administration's governmentwide spending transparency framework to effectively provide the public with transparent information about how federal dollars are being spent.

Protect Against Waste, Fraud, and Abuse

Improper Payments

Addressing improper payments is a central component of the Administration's overall efforts to eliminate waste, fraud, and abuse. When the President took office in 2009, the improper payment error rate was 5.42%, an all-time high. Since then, the Administration, working together with Congress, has made progress by strengthening accountability and transparency through annual reviews by agency inspectors general, and expanded requirements for high-priority programs. As a result of this concerted effort, in FY 2013 the Administration reported an improper payment rate of 3.53%. Over FY 2014, the federal government experienced improper payment rate increases in major programs including Medicare Fee for Service, Earned Income Tax Credit, Medicaid, Unemployment Insurance, and Supplemental Security Income. Other major programs experienced a decrease in improper payment rates, including Medicare Part C, Supplemental Nutrition and Assistance, and Public Housing/Rental Assistance. On net, these changes resulted in a governmentwide improper payment rate of 4.02%³⁴. Additionally, DOD has taken steps to improve its improper payment sampling and estimation plan for the Defense Finance and Accounting Service's (DFAS) Commercial Payments to implement recommendations made by the Government Accountability Office (GAO)³⁵. Furthermore, agencies recovered roughly \$20 billion in overpayments through the payment recapture audits and other methods in FY 2014.

The Administration continues to use the Budget to build on congressional and Administration action to reduce improper payments. For example, the President's FY 2016 Budget includes a number of program integrity proposals aimed at reducing improper payments and improving government efficiency. In addition, the Administration recently provided agencies with new tools in a revised OMB Circular No. A-123, Appendix C to tackle improper payments. OMB A-123, Appendix C provides guidance to agencies and Inspectors General on key improper payment activities, including risk assessments, estimating and reporting, recoveries, and compliance reviews. The enactment of the Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012 provided an opportunity for OMB to re-examine Appendix C to ensure agencies are able to more efficiently reduce their improper payment rates, while also complying with multiple legislative and administrative requirements. The goal of this overhauled version of Appendix C is to transform the improper payment compliance framework to create a more unified, comprehensive, and less burdensome set of requirements. Appendix C accomplishes the following, among other things:

- Consolidates and streamlines reporting requirements so agencies can spend less time producing compliance reports and more time focusing on game-changing solutions for achieving payment accuracy;
- Establishes new reporting categories to provide more granularity on improper payment estimates to inform more effective corrective actions and more focused strategies for reducing improper payments;
- Introduces a new internal control framework to ensure that payments are made in the right amount, to the right entity, and for the right purpose; and
- Provides guidance to help strengthen the statistical validity of agency improper payment estimates and includes payments to Federal employees in the definition of improper payments.

The Government is also advancing data analytics and improved technologies to prevent improper payments before they happen. In doing so, as part of the President's Do Not Pay Initiative, the Administration established a Do Not Pay System of Records at the Department of the Treasury and the Administration looks forward to continuing the Administration's work with the new Congress on the Improper Payments Agency Cooperation Enhancement Act (IPACE Act), which includes many of the Administration priorities on sharing death data to prevent improper payments. Another significant improper payment data analytics effort includes the Centers for Medicare & Medicaid Services' (CMS) Fraud Prevention System (FPS), a state-of-the-art predictive analytics technology to identify and prevent fraud in the program. Finally, the Department of Labor continued a Federal-State partnership with state governments through the Unemployment Insurance (UI) Integrity Center for Excellence to facilitate the development and implementation of UI integrity tools by the States and to share best practices in the detection and reduction of improper payments.

Combating improper payments within the federal government is a top priority for the Administration and it will continue to explore new and innovative ways to address the problem. Every dollar paid in error represents an

³⁴ The Department of Housing and Urban Development (HUD) received an Annual Financial Reporting extension to March 1, 2015. When HUD payments are excluded from the governmentwide figures, the improper payment rate is 4.03 percent. DOD's Commercial Payments were first included in the governmentwide rate in FY 2013. When the DOD commercial payments are excluded from the governmentwide figures, the FY 2013 rate is 4.00 percent and the FY 2014 rate is 4.46 percent.

³⁵ [Significant Improvements Needed in Efforts to Address Improper Payment Requirements, GAO-13-227.](#)

unacceptable waste of public resources, and this Administration is committed to keeping up the fight to reduce waste, fraud, and abuse and continuing to attack this challenge with every tool at its disposal.

Improving Grants Management

On December 26, 2013, OMB published final guidance to better target risk and reduce waste, fraud, and abuse (2 CFR Part 200—Uniform Administrative Requirements, Cost Principles, And Audit Requirements for Federal Awards). This final guidance was developed by the interagency Council on Financial Assistance Reform (COFAR) to improve effectiveness for the approximately \$600 billion awarded annually in federal financial assistance. Representing a two-year collaborative effort across the federal government and its partners -- State and local governments, Indian tribes, research and higher education institutions, nonprofit organizations, and the audit community -- the guidance rethinks and reforms the rules that govern our stewardship of federal dollars. It streamlines eight existing OMB Circulars on financial management into one consolidated set of guidance in the CFR. Specifically, the revised policies emphasize risk-based decision making to reduce administrative burden and waste, fraud, and abuse by:

- Eliminating duplicative and conflicting guidance;
- Focusing on performance over compliance for accountability;
- Encouraging efficient use of information technology and shared services;
- Providing for consistent and transparent treatment of costs;
- Limiting allowable costs to make the best use of federal resources;
- Setting standard business processes using data definitions;
- Encouraging non-federal entities to have family-friendly policies;
- Strengthening oversight; and
- Targeting audit requirements on risk of waste, fraud, and abuse.

The COFAR worked closely with federal agencies to develop, issue, and implement regulations for the new guidance in the Code of Federal Regulations by the effective date of December 26, 2014. The COFAR has established metrics that will measure the effectiveness of the new policies and is working with federal and non-federal stakeholders to develop additional training and outreach resources. In addition, OMB and its partners are continuing complementary work to strengthen program outcomes through innovative and effective use of grant-making models, performance metrics, and evaluation, as described in OMB Memorandum M-13-17 on *Next Steps in the Evidence and Innovation Agenda*. In September 2014, OMB issued Memorandum M-14-17, *Metrics for Uniform Guidance (2 C.F.R. 200)*, which required agencies to report required baseline data for administrative metrics to OMB.

Help Agencies Maximize the Impact of their Limited Financial Resources

Benchmarking

Federal agencies lack a complete set of tools and reliable data to measure their performance in key administrative areas. This discourages agency executives from taking necessary steps to reduce costs, efficiently deploy resources, and improve quality of service. In addition, agencies are often hesitant to adopt shared services for mission-support functions without “apples-to-apples” data that allows them to compare options, quantify potential savings, and ensure equal (or better) service quality. Finally, the absence of governmentwide benchmarks can hamper the identification and sharing of effective management practices, because OMB and agencies lack full visibility into which agencies or shared service providers are the top performers in a given function.

The federal government’s efforts to improve the efficiency of the Government aim to increase the quality and value of core administrative operations and enhance productivity to achieve cost savings. Establishing cost and quality benchmarks for these operations will create the tools the federal government needs to measure its performance in key mission-support areas, including human resources, finance, acquisition, IT and real property. OMB met with agencies and then issued customized memos to each of the 24 CFO Act Agencies, summarizing takeaways from the meetings and agreed-upon follow-up actions based on noteworthy benchmark results. The federal government is currently working with agencies on preparing for the next round of collection by (1) Improving the data quality, consistency and relevance of the Efficiency metrics collected earlier in 2014; and (2) Developing a set of Effectiveness metrics to capture operational quality and customer satisfaction with mission-support services.

Improving Effectiveness and Efficiency in Financial Operations and Systems

The Administration continues to make significant progress in the effort to minimize the costs and risks associated with agency financial systems modernization. In 2013, OMB issued M-13-08: *Improving Financial Systems Through Shared Services*. This new guidance directs all executive agencies to use, with limited exceptions, a shared service solution for future modernizations of core accounting or mixed systems and names the Office of Financial Innovation and Transformation (FIT) at the Department of the Treasury as OMB’s partner in evaluating shared service providers and agency modernization plans. In 2014, two cabinet level Departments began working with Federal Shared Service Providers (FSSPs) to plan migration to shared services.

In addition, OMB and FIT built on these efforts by:

- Identifying and formally designating four FSSPs at the Treasury Department, USDA, DOI, and DOT;
- Developing performance and cost information for all FSSPs through a product services catalog;
- Developing meaningful benchmarks and metrics in support of the President’s Management Agenda to measure the cost, quality, and performance of financial operations throughout the Government; and
- Developing a sound governance model to support greater use of shared services by agencies while ensuring adequate input on major decisions by customer agencies.

Driving Real Property Efficiencies through Better Data and Data Analytics

The federal domestic building inventory is diverse and contains 300,000 buildings requiring approximately \$21 billion of annual operation and maintenance expenditures, including approximately \$6.8 billion of annual lease costs. Within the inventory, there are opportunities to realize cost savings by utilizing space more efficiently and reducing the portfolio. In 2013, the “Freeze the Footprint” Policy (OMB Management Procedures Memorandum 2013-02) was issued, requiring agencies to freeze their real property footprint. As a result, agencies reduced their federal domestic office and warehouse space by 10.2 million square feet in FY 2013. To improve the quality of federal real property data in FY 2014 Performance and Accountability Reports (PARs)/AFRs, agencies were required to validate and report “Freeze the Footprint” square footage and associated operations and maintenance costs in their 2014 financial statements.

In FY 2015, the Government will issue a real property framework that provides operational guidelines for agencies to manage its real property to improve efficiency. Over time, the framework will improve utilization of government-owned buildings to reduce reliance on leasing, lower the number of excess and underutilized properties, and improve the cost effectiveness and efficiency of the federal real property portfolio.

Conclusion

The federal government has seen significant progress in financial management since the passage of the CFO Act more than 20 years ago. Yet significant challenges remain. The issues that the federal government faces in the

Government today require our financial managers to move beyond the status quo and to generate a higher return on investment for our financial management activities. The steps outlined above leverage the tools and capacities in place today, and refocus energies on critical and emerging priorities – cutting wasteful spending, improving the efficiency of our operations and information technology, and laying a foundation for data quality and collaboration as the federal government enters a new era of transparency and open Government.

Additional Information

This *Financial Report's* Appendix contains the names and websites of the significant Government entities included in the *Financial Report's* financial statements. Details about the information in this *Financial Report* can be found in these entities' financial statements included in their Performance and Accountability and Agency Financial Reports. This *Financial Report*, as well as those from previous years, is also available at the Treasury, OMB, and GAO websites at: http://www.fiscal.treasury.gov/fsreports/fs_reports_publications.html; <http://www.whitehouse.gov/omb/financial/index.html>; and <http://www.gao.gov/financial.html>, respectively. Other related Government publications include, but are not limited to the:

- *Budget of the United States Government*,
- *Treasury Bulletin*,
- *Monthly Treasury Statement of Receipts and Outlays of the United States Government*,
- *Monthly Statement of the Public Debt of the United States*,
- *Economic Report of the President*, and
- *Trustees' Reports* for the Social Security and Medicare Programs.

Limitations of the Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the federal government, and the financial condition and changes in financial condition of its social insurance programs, pursuant to the requirements of 31 U.S.C. § 331(e)(1). These statements are in addition to the financial reports used to monitor and control budgetary resources that are prepared from the same books and records.

United States Government Required Supplementary Information (Unaudited) For the Years Ended September 30, 2014, and 2013

Fiscal Projections for the U.S. Government – Fiscal Year 2014

[Abridged]

Social Insurance

[Abridged]

Tax Expenditure Task Force Illustration A

Tax Expenditures

Definition

“Tax expenditures” refers to preferences in tax law ensuring more money is available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures can reduce taxes owed or provide cash in the form of a refundable tax credit.¹ Tax expenditures arise from special provisions allowing an exclusion, exemption, or deduction from gross income, a credit, a preferential rate of tax, or a deferral of liability. They resemble federal spending in that such provisions impact the federal deficit/surplus by affecting income tax revenues; however, they are not treated the same as federal spending in budgetary or financial reporting.

Estimates

Tax expenditure estimates are now available annually from Treasury’s Office of Tax Policy.² The estimates are for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in assessing the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures. Treasury provides the tax expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President’s Budget is issued.

Tax expenditure estimates are developed to aid policymakers. It is important to understand that these are not transaction-based amounts. The estimates are updated annually using the best available data and models. However, data limitations and resource constraints are inherent in the process. For example, some data collected on tax returns are not available in time for the annual estimates; other data are not collected on tax returns at all and must always be estimated.

Major considerations regarding the estimates include the following:

- Significant judgment is required to identify and measure special provisions of the income tax code. For example, preferential rates for capital gains are considered a tax expenditure; however the progressive income tax system is not considered to be a preferential rate or a tax expenditure.
- As with expenses incurred with spending programs, an individual tax expenditure estimate does not necessarily equal the increase in federal revenues (or the change in the deficit) that would result from repealing the special provision. It is assumed that there is no behavioral response to the repeal of the related provision; however, the estimate does account for switching from itemized deductions to standard deductions when repealing a provision would impact the type of deduction claimed by taxpayers.
- Estimates are based on tax law enacted as of July 1 of the reporting year and assume that any provisions scheduled to expire will expire. Provisions likely to be extended are ignored for estimation purposes until such legislation is actually enacted. Extensive knowledge of tax policy may be required in order to understand multi-year tax expenditure projections.
- Treasury relies on economic data and projections to estimate the current utilization of the tax preferences not reflected on tax returns. The use of the preference is then projected into the future using assumptions that are consistent with the Administration’s economic forecast.

¹ A refundable tax credit is provided even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer’s tax liability as outlays. So, this type of tax expenditure is included in the budget to the extent payments exceed the taxpayer’s tax liability.

² These estimates are prepared annually by Treasury for inclusion in the President’s Budget and are made available at <http://www.treasury.gov/resource-center/tax-policy/Pages/default.aspx>.

Deferred Maintenance and Repairs

[Abridged]

Other Claims for Refunds

[Abridged]

Tax Assessments

[Abridged]

Risk Assumed

[Abridged]

Federal Oil and Gas Resources

[Abridged]

Tax Expenditure Task Force Illustration A

United States Government Required Supplementary Information (Unaudited) For the Years Ended September 30, 2014, and 2013

Fiscal Projections for the U.S.
Government – Fiscal Year 2014

Social Insurance

[Abridged]

Tax Expenditure Task Force Illustration B

Tax Expenditures

Definition

“Tax expenditures” refers to preferences in tax law ensuring more money is available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures can reduce taxes owed or provide cash in the form of a refundable tax credit.¹ Tax expenditures arise from special provisions allowing an exclusion, exemption, or deduction from gross income, a credit, a preferential rate of tax, or a deferral of liability. They resemble federal spending in that such provisions impact the federal deficit/surplus by affecting income tax revenues; however, they are not treated the same as federal spending in budgetary or financial reporting.

Estimates

Tax expenditure estimates are now available annually from Treasury’s Office of Tax Policy². The estimates are for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in assessing the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures. Treasury provides the tax expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President’s Budget is issued.

Tax expenditure estimates are developed to aid policymakers. It is important to understand that these are not transaction-based amounts. The estimates are updated annually using the best available data and models. However, data limitations and resource constraints are inherent in the process. For example, some data collected on tax returns are not available in time for the annual estimates; other data are not collected on tax returns at all and must always be estimated.

Major considerations regarding the estimates include the following:

- Significant judgment is required to identify and measure special provisions of the income tax code. For example, preferential rates for capital gains are considered a tax expenditure; however the progressive income tax system is not considered to be a preferential rate or a tax expenditure.
- As with expenses incurred with spending programs, an individual tax expenditure estimate does not necessarily equal the increase in federal revenues (or the change in the deficit) that would result from repealing the special provision. It is assumed that there is no behavioral response to the repeal of the related provision; however, the estimate does account for switching from itemized deductions to standard deductions when repealing a provision would impact the type of deduction claimed by taxpayers.
- Estimates are based on tax law enacted as of July 1 of the reporting year and assume that any provisions scheduled to expire will expire. Provisions likely to be extended are ignored for estimation purposes until such legislation is actually enacted. Extensive knowledge of tax policy may be required in order to understand multi-year tax expenditure projections.
- Treasury relies on economic data and projections to estimate the current utilization of the tax preferences not reflected on tax returns. The use of the preference is then projected into the future using assumptions that are consistent with the Administration’s economic forecast.

Selected major tax expenditures are presented in the table below.

¹ A refundable tax credit is provided even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer’s tax liability as outlays. So, this type of tax expenditure is included in the budget to the extent payments exceed the taxpayer’s tax liability.

² These estimates are prepared annually by Treasury for inclusion in the President’s Budget and are made available at <http://www.treasury.gov/resource-center/tax-policy/Pages/default.aspx>.

Selected Major Tax Expenditures, Fiscal Years 2015 and 2014					
		2015		2014	
		Dollars (in billions)	% of GDP	Dollars (in billions)	% of GDP
I	Exclusion of employer contributions for medical insurance premiums and medical care	\$ 206.4	1.14	\$ 195.1	1.12
I	Capital gains (except agriculture, timber, iron ore, and coal)	85.4	0.47	76.1	0.44
I	Exclusion of net imputed rental income	78.8	0.43	75.2	0.43
I	Mortgage interest expense on owner-occupied residences	69.5	0.38	66.9	0.38
I	Defined contribution employer plans	68.0	0.37	62.5	0.36
C	Deferral of income from controlled foreign corporations (normal tax method)	64.6	0.35	61.7	0.35
I	Step-up basis of capital gains at death	63.4	0.35	60.4	0.35
I	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	47.5	0.26	45.7	0.26
B	Deductibility of charitable contributions, other than education and health	44.3	0.24	41.9	0.24
I	Capital gains exclusion on home sales	36.9	0.20	35.5	0.20
B	Exclusion of interest on public purpose State and local bonds	42.1	0.23	39.7	0.23
I	Exclusion of interest on life insurance savings	27.1	0.15	26.2	0.15
I	Deduction for property taxes on real property	26.3	0.14	26.9	0.15
I	Self-Employed plans	23.9	0.13	23.8	0.14
I	Social Security benefits for retired workers	25.5	0.14	23.2	0.13
I	Treatment of qualified dividends	22.1	0.12	21.0	0.12
C	Accelerated depreciation of machinery and equipment (normal tax method)	17.2	0.09	16.6	0.10
I	Child credit	15.7	0.09	15.7	0.09
I	Individual Retirement Accounts	13.6	0.07	13.0	0.07
C	Deduction for US production activities	8.9	0.05	10.4	0.06
I	Exclusion of benefits and allowances to armed forces personnel	10.0	0.05	9.9	0.06
B	All other tax expenditures	219.3	1.2	221.4	1.3
Total		1,216.5	6.69	1,168.9	6.72

Key: I = Individual; C = Corporate; B = Both Corporate and Individual

Sources: FASAB based on Analytical Perspectives, Tax Expenditures, Table 3. FY2016.

Deferred Maintenance and Repairs

Other Claims for Refunds

Tax Assessments

Risk Assumed

Federal Oil and Gas Resources

[Abridged]

Tax Expenditure Task Force Illustration B

Tax Expenditures Explained

Purpose

The Board is concerned with ensuring that federal financial reporting assists report users in evaluating the service efforts, costs, accomplishments, and fiscal sustainability of the federal government and understanding how these efforts and accomplishments have been financed.

~~Tax expenditures have historically received little focus in federal financial reporting. Despite similarities to federal spending in their impact on service efforts, costs, accomplishments and fiscal sustainability, tax expenditures have historically received little focus in federal financial reporting.~~ Establishing reporting requirements that assist report users requires an understanding of ~~this complex topic~~, the methods used to estimate tax expenditures, and considerations in using those estimates. This paper provides an overview of the topic to aid respondents in considering the Board's proposal. Specifically, this paper:

1. provides the definition ~~of~~ tax expenditures and describes the six types of tax expenditures,
2. provides context with respect to the purpose of tax expenditures, why tax expenditures are important, and the relationship of tax expenditures to government performance, taxpayer behaviors, and the economy; and
3. summarizes how tax expenditure estimates are prepared by Treasury. This ultimately impacts how tax expenditure estimates can be used and interpreted.

Background

"Tax expenditures" refers to preferences in tax law ensuring more money is available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures can reduce taxes owed or provide cash in the form of a refundable tax credit.¹

They resemble federal spending in that such provisions, ~~by helping to determine impact total federal revenues, have an impact on~~ and the federal deficit/surplus by impacting income tax revenue; however, they are not treated the same as federal spending ~~in for~~ budgetary or financial reporting purposes. Tax expenditures are not subject to the annual budget process and can only be removed through tax legislation. Tax expenditures estimates do not appear in the Statement of Net Cost and they are not used in calculating the Government's net revenue.

Definition

The Congressional Budget and Impoundment Act of 1974 (the Budget Act) defines tax expenditures as

¹ A refundable tax credit is provided even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer's tax liability as outlays. So, this type of tax expenditure is included in the budget to the extent payments exceed the taxpayer's tax liability.

“revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.” (Section 3(3) of Public Law 93-344)

How Tax Expenditures Are Identified

Step 1: The first step in identifying tax expenditures is determining what the tax baseline is so that the provisions considered “special” (see definition above) can be distinguished from those provisions consistent with a baseline tax system. For the federal income tax, the baseline tax system is a comprehensive income tax with certain practical provisions that are generally accepted as being part of a baseline tax system. Accordingly, provisions such as the personal exemption, standard deductions, deductions of expenses incurred in earning income, and a progressive rate structure are considered to be part of the baseline tax system for measurement purposes.

Step 2: After determining the baseline tax system, the credits, deductions, special exceptions and allowances that reduce tax liability below the level implied by the baseline tax system are then considered to be tax expenditures.

See Appendix A for a list of the **five**-largest **individual and corporate** income tax expenditures.

Types of Tax Expenditures

There are six types of tax expenditures—exclusions, exemptions, deductions, credits, preferential rates, and deferrals. Table 1 describes each and provides an example.

Table 1: Examples of Provisions That Are Tax Expenditures When They Are Exceptions to the Normal **[Baseline] Tax Structure**

Tax expenditure	Description	Examples
Exclusion	Excludes income that would otherwise constitute part of a taxpayer's gross income.	Employees generally pay no income taxes on contributions their employers make on their behalf for medical insurance premiums.
Exemption	Reduces gross income for taxpayers because of their status or circumstances.	Taxpayers may be able to reduce their tax liability if they have a dependent who is a child aged 19 through 23 and is a full-time student.
Deduction	Reduces gross income due to expenses taxpayers incur.	Taxpayers may be able to deduct state and local income taxes and property taxes.
Credit	Reduces tax liability dollar-for-dollar. Additionally, some credits are refundable meaning that a credit in excess of tax liability results in a cash refund.	Taxpayers with children under age 17 potentially can qualify for up to a \$1,000 partially refundable, per child credit, provided their income does not exceed a certain level.
Preferential tax rate	Reduces tax rates on some forms of income.	Capital gains on certain income are subject to lower tax rates under the individual income tax.

Table 1: Examples of Provisions That Are Tax Expenditures When They Are Exceptions to the Normal [Baseline] Tax Structure

Deferral	Delays recognition of income or accelerates some deductions otherwise attributable to future years.	Taxpayers may defer paying tax on interest earned on certain U.S. savings bonds until the bonds are redeemed.
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Source: GAO-13-167SP: Guide for Evaluating Tax Expenditures.

In considering these six types, note that it may be possible to achieve the same outcome in a variety of ways. For example, it may be possible for some public policy purposes to be achieved through a preferential rate, a deduction, or a credit. Because a variety of approaches can produce the same cash effect, the types are different in form rather than substance.

Budget Act Requirements and History

The term “tax expenditures” was introduced in 1967 by Assistant Secretary for Tax Policy, Stanley Surrey, in a speech calling for a “full accounting” of them. Following his speech, estimates were prepared by the U.S. Department of the Treasury (Treasury) and later by the Joint Committee on Taxation (JCT).

In 1974, the Budget Act charged the House and Senate Budget Committees with the duty “to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies” to Congress on a recurring basis. The Budget Act further required that the annual President’s Budget include tax expenditure estimates.²

Estimates are now available annually from both the JCT³ and the President’s Budget.⁴ Each JCT report contains a discussion of the concept of tax expenditures, identification of new tax expenditures enacted into law, a general explanation on how the committee staff measures tax expenditures, estimates of tax expenditures, and distributions of selected individual tax expenditures by income class.

~~The Treasury prepares estimates provided in~~ The President’s Budget ~~provides estimates.~~ ~~These estimates are~~ for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in determining the relative merits of achieving specific public goals through the use of tax expenditures. ~~Treasury provides the tax~~

² Kleinbard, Edward. Tax Expenditure Framework Legislation, *Research Paper Series and Legal Studies Research Paper Series*, Paper No. C10-1. USC Center in Law, Economics and Organization. 2010.

³ See <https://www.jct.gov/publications.html?func=select&id=5> for JCT Publications on Tax Expenditures. As of July 17, 2015 estimates for fiscal years 2014-2018 were available in JCX-97-14.

⁴ See https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/ap_14_expenditures.pdf for the Fiscal Year 2016 President’s Budget. The Analytical Perspectives, Chapter 14 provides estimates for fiscal years 2014 through 2024. (Last accessed July 17, 2015.)

expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President's Budget is issued.⁵

Comment [WP1]: Edits intended to tie the President's Budget to the Treasury Estimates.

Government Performance and Results Act – Modernization Act

The Government Performance and Results Act Modernization Act of 2010 (GPRA MA) (Public Law 111-352) requires OMB to 1) coordinate with agencies to develop a Federal Government performance plan to be updated no less than annually, 2) identify relevant tax expenditures contributing to priority goals within the plan, and 3) periodically assess whether tax expenditures are contributing as planned. Each agency's annual performance plans are also required to identify regulations, such as relevant tax expenditures, that contribute to performance goals.

[Update for any information about implementation immediately prior to issuance.]

How the Department of the Treasury Prepares the Administration's Estimates

As noted in the definition above, tax expenditures arise from special provisions allowing an exclusion, exemption, or deduction from gross income, a credit, a preferential rate of tax, or a deferral of liability. Deciding whether a provision of tax law is a special exception to the baseline income tax system is a matter of judgment. The baseline used by the Treasury is adapted from a comprehensive income tax in which income is the sum of consumption and the change in net wealth in a given period of time. This baseline assumes an individual income tax and a separate corporate income tax.⁶

Preparing tax expenditure estimates requires consideration of certain information about the economy; presently and in the future. The Treasury estimates for economic activity are consistent with the economic assumptions in the President's Mid-Session Review of the prior year's budget and reflect current law as of July 1.⁷

Each tax expenditure is measured by the difference between tax liability under current law and the tax liability that would result if the tax expenditure provision were repealed. It is assumed that there is no behavioral response to the repeal of the provision and taxpayers simply recalculate their tax in the absence of the provision in question. Thus, tax expenditures calculate revenues forgone by the existence of the rule but not necessarily the amount of revenue that would be raised if it were repealed. For example, the ability to deduct mortgage interest expense on owner-occupied housing is considered to be a tax expenditure. The tax expenditure estimate reports the revenue change that would occur if this deduction were repealed but it does not take into account any revenue effect that might occur as a result of most changes in the taxpayers' behavior, such as taxpayers' decisions to own homes. However, in recalculating

⁵ Most recent estimates have been published by Treasury in August of each year. See <http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx> for the latest estimates of tax expenditures. (Last accessed September 2, 2015.)

⁶ Treasury and the Joint Committee on Taxation differ in the assumed baseline from which tax expenditures are measured. For a summary of the differences see Altshuler, Rosanne and Robert Dietz. "Reconsidering Tax Expenditure Estimation." *The National Tax Journal*, June 2011, 64 (2, Part 2), 459-490.

⁷ "Current law baseline" refers to the budget estimates prepared by the Administration based on laws enacted at the time they are prepared. If a provision will expire under currently enacted law then the baseline projections reflects the effects of that expiration.

the tax due in the absence of this deduction, the tax expenditure estimate does assume the taxpayer would switch from itemizing deductions to claiming the standard deduction if that were tax minimizing in the absence of the ability to deduct mortgage interest on an itemized return.

When possible, the Treasury uses samples of tax returns provided by the Internal Revenue Service to develop estimates of recent and future utilization of the tax credits, exemptions and deductions that make up each tax expenditure. For tax expenditures not reflected on tax returns—income exclusions, for example—Treasury economists rely on other economic data to estimate the current utilization of the tax preference. The use of the preference is then projected into the future using assumptions that are consistent with the Administration's economic forecast.

Year-to-year differences in the calculations for each tax expenditure reflect changes in tax law, including phaseouts of tax expenditure provisions and changes that alter the baseline income tax structure, such as the tax rate schedule, the personal exemption amount, the standard deduction, ~~as well as~~ other factors. For example, the dollar value of tax expenditures tends to increase and decrease as tax rates increase and decrease, respectively, without any other changes in law.

Understanding Estimates

Tax expenditure estimates are developed to aid policymakers. It is important to understand that these are estimates rather than transaction-based amounts. The estimates are updated annually using the best available data and models. However, data limitations and resource constraints are inherent in the process. For example, some data collected on tax returns ~~is~~ are not available in time for the annual estimates; other data ~~is~~ are not collected on tax returns at all and must always be estimated.

The major considerations regarding the estimates are identified below.

Not Necessarily Equivalent to Forgone Revenue. Estimates should be regarded as approximations. As with expenses incurred with spending programs, individual tax expenditure estimates do not necessarily equal the increase in federal revenues (or the change in the deficit⁸) that would result from repealing these special provisions because:

- a. eliminating a tax expenditure may have incentive effects that alter economic behavior, and
- b. tax expenditures are interdependent even without incentive effects.⁹

Difficulty in Calculating Totals. A ~~grand~~ total for the estimated tax expenditures is not provided in Analytical Perspectives ~~the President's Budget~~ because each tax expenditure is estimated independently assuming other parts of the Tax Code remain unchanged.

⁸ Note that repealing certain spending programs would also not reduce the deficit by the amount of spending because of interaction with other programs and the tax system. For example, Social Security benefits may be taxed so that eliminating the benefits would also reduce tax revenue and possibly increase spending in other benefit programs. Thus, the change in the deficit would be smaller than the direct spending eliminated through the adjustment to the Social Security program.

The estimates might be different if two or more tax expenditures were changed simultaneously because of potential interactions among provisions. Nonetheless, other experts do present a total summing the separate estimates. The Congressional Budget Office (CBO) has modeled the interaction of the largest provisions under current tax law and found that interactions that overstate the effect are similar in size to interactions that understate the effect.¹⁰ As a result, they conclude that the total is a meaningful estimate for the general magnitude of tax expenditures under current tax law. If the law changes in significant ways the interactions may not result in offsetting over- and understatements of the effect to the same extent. -

Completeness. As noted earlier, significant judgment is required to identify special provisions of the income tax code. Given the complexity of the tax code, differences in judgment lead some to include provisions in tax expenditure lists that others would exclude and vice versa. In addition, special provisions can be included in taxes other than income taxes (for example, payroll or excise taxes) but these generally are not included in reports on tax expenditures.

Expiring Provisions. Estimates are based on tax law enacted as of July 1 of the reporting year and assume that any provisions scheduled to expire will expire. As noted above, provisions likely to be extended are ignored for estimation purposes until such legislation is actually enacted. In other words, estimates are based on current law rather than analyzing policy outcomes likely to occur. As a result, an extensive knowledge of tax policy may be required in order to understand multi-year tax expenditure projections when provisions are scheduled to expire or when provisions of previous legislation are phased in.

Alternatives. Estimates involve significant judgment and, as a result, there are alternative approaches to estimation. For example, alternatives regarding the application of marginal tax rates, treatment of related tax provisions, or selection of a different baseline (such as a consumption tax rather than an income tax) would impact tax expenditure estimates. In addition, **Cash Effects vs. Net Present Value.** While estimates are provided for the cash (current revenue) effect for each of the ten fiscal years in the period covered by the projections, a present value alternative that considers the full life cycle of the taxable activity may be more useful. For tax expenditures that involve deferrals or other long-term revenue effects, the present value effects are important because deferrals will reverse in later years, and a present value estimate for the activity in the current calendar year would include this activity, is provided as well. The present value effects are important because deferrals will reverse in later years. (Note that deferral provisions may result in tax expenditures for which the cash effect of the later reversals are wholly outside the ten year window used for the annual cash effect estimates. The present value estimates capture all of the future revenue impacts.)

Comment [WP2]: In response to suggestions that the PV be cast as an alternative measure, this section was revised to discuss alternative approaches broadly.

¹⁰ Congressional Budget Office. *The Budget and Economic Outlook: 2015 to 2025*. January 26, 2015.

Appendix A: Top Five Largest Tax Expenditures

Tax Expenditures – Ranked by Fiscal Year 2015 Revenue Effect

(In Billions of dollars, based on assumptions from the Mid-Session Review of the 2015 Budget.)

Comment [WP3]: Table was updated to indicate "both" and to show single year revenue effects and percent of GDP.

Selected Major Tax Expenditures, Fiscal Years 2014 and 2015					
Individual (I) Corporate (C) or Both(B)		2014		2015	
		Billions of Dollars	Percentage of GDP	Billions of Dollars	Percentage of GDP
I	Exclusion of employer contributions for medical insurance premiums and medical care	\$ 195.1	1.12	\$ 206.4	1.14
I	Capital gains (except agriculture, timber, iron ore, and coal)	76.1	0.44	85.4	0.47
I	Exclusion of net imputed rental income	75.2	0.43	78.8	0.43
I	Mortgage interest expense on owner-occupied residences	66.9	0.38	69.5	0.38
I	Defined contribution employer plans	62.5	0.36	68.0	0.37
C	Deferral of income from controlled foreign corporations (normal tax method)	61.7	0.35	64.6	0.35
I	Step-up basis of capital gains at death	60.4	0.35	63.4	0.35
I	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	45.7	0.26	47.5	0.26
B	Deductibility of charitable contributions, other than education and health	41.9	0.24	44.3	0.24
I	Capital gains exclusion on home sales	35.5	0.20	36.9	0.20
B	Exclusion of interest on public purpose State and local bonds	39.7	0.23	42.1	0.23
I	Exclusion of interest on life insurance savings	26.2	0.15	27.1	0.15
I	Deduction for property taxes on real property	26.9	0.15	26.3	0.14
I	Self-Employed plans	23.8	0.14	23.9	0.13
I	Social Security benefits for retired workers	23.2	0.13	25.5	0.14
I	Treatment of qualified dividends	21.0	0.12	22.1	0.12
C	Accelerated depreciation of machinery and equipment (normal tax method)	16.6	0.10	17.2	0.09
I	Child credit	15.7	0.09	15.7	0.09
I	Individual Retirement Accounts	13.0	0.07	13.6	0.07
C	Deduction for US production activities	10.4	0.06	8.9	0.05
I	Exclusion of benefits and allowances to armed forces personnel	9.9	0.06	10.0	0.05
Sources: FASAB based on Analytical Perspectives, Tax Expenditures, Table 3. FY2016.					