



October 7, 2016

Memorandum

To: Members of the Board

Robin M. Gilliam

From: Robin M. Gilliam, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subject: **Determine Next Phase of Risk Assumed¹ – Tab 2**

MEMBER ACTION REQUESTED

**Provide comments on next steps by
Friday, October 14, 2016.**

MEETING OBJECTIVE:

- Discuss next steps for risk assumed project

BRIEFING MATERIAL:

This memorandum provides staff's analysis and recommendations regarding proposals for the next risk assumed phase.

Attachment 1: United States Government Required Supplemental Information (Unaudited) For the Years Ended September 30, 2015, and 2014: The Sustainability of Fiscal Policy pages 169 - 177

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of FASAB or its staff. Official positions of FASAB are determined only after extensive due process and deliberations.

BACKGROUND:

The Federal Accounting Standards Advisory Board (FASAB or “the Board”) undertook a project in August 2011 to improve the accounting and reporting of all significant risks assumed by the Federal Government.

The Background section (page 1) in the original project plan Appendix² noted the following:

The types of risks assumed may be explicit, such as in the case of providing insurance and guarantees, while others may be implicit. Risks may be implied in contractual agreements and in relationships with other entities like states who administer federal programs. Both explicit and implicit risks may need to be identified and reported as part of efforts to demonstrate stewardship over resources, help determine the cost of programs, and plan risk mitigation strategies.

However, reporting on explicit and implicit risks presents financial reporting issues, including how to measure items and whether the items should be recognized in financial statements, disclosed, or reported as RSI.³ Additional FASAB guidance could help address these issues and better achieve the operating performance, stewardship, and systems and control objectives of financial reporting.

Due to the breadth of the *Risk Assumed* project, the Board decided In February 2013 to break it into multiple phases.

February 2013 Newsletter - *Risk Assumed*:

During the February meeting’s technical agenda session the Board agreed to address the risk assumed project using a phased approach given the challenges inherent in addressing such a broad topic (i.e., exposures that could result in future outflows of the federal government). Insurance and non-loan guarantees will be addressed in the first phase of the project. **This approach will allow development of principles for measuring and reporting risk where risk is most clearly identifiable** – insurance and guarantees providing explicit indemnification to identified parties.

² *Risk Assumed Project Plan* –August 11, 2011, Board Memorandum, http://files.fasab.gov/pdffiles/Tab_D_RISK_ASSUMED1.pdf

³ Required Supplementary Information (RSI)

The Board completed the first phase in September 2016 and will issue Statement of Federal Financial Accounting Standards (SFFAS 51), *Insurance Programs*, in mid-January 2017 after the 90-day sponsor review.

The Board achieved a monumental success in completing phase I by defining insurance programs and how to address uncertainty for explicit risks beyond the reporting period.

As noted in the February 2013 newsletter, the Board's intentions are to use the recognition and measurement standards promulgated in SFFAS 51 as a foundation and basis for the remaining phases of the Risk Assumed project.

In addition to insurance programs, the original project plan (pages 6-7) identified the following list of significant risks:

2. **implicit guarantees** resulting from:
 - a. disaster/relief programs
 - b. certain assistance programs (particularly where a qualifying event may lead to long-term assistance)
 - c. regulatory actions
 - d. related party involvements
 - e. other existing policies or programs
3. **commitments** such as:
 - a. contractual commitments requiring future resources or that may require future resources
 - b. treaties and other international agreements
4. **inter-governmental financial and programmatic dependency**
5. **other potential risks assumed**

Staff Analysis and Recommendations:

Based on the original project plan and other information that has become available during phase I, there are a number of directions the Board can take with the next phase of the risk assumed project.

The following discussion looks at areas that the Board should consider in determining how to proceed with risk assumed.

A. Fiscal Risk Analysis and Management

The International Monetary Fund (IMF) *Update on the Fiscal Transparency Initiative*⁴ includes *Fiscal Risk Analysis and Management* as Pillar III of a four-pillar structure. The following are taken directly from Pillar III, *Update on the Fiscal Transparency Initiative*.

Figure 1, page 4



⁴ <https://www.imf.org/external/np/pp/eng/2014/061614.pdf> June 15, 2014

III. Fiscal Risk Analysis and Management

Governments should disclose, analyze, and manage risks to the public finances and ensure effective coordination of fiscal decision-making across the public sector.

3.1. Risk Disclosure and Analysis: *Governments should publish regular summary reports on risks to their fiscal prospects.*

3.1.1. Macroeconomic Risks: The government reports on how fiscal outcomes might differ from baseline forecasts as a result of different macroeconomic assumptions.

3.1.2. Specific Fiscal Risks: The government provides a regular summary report on the main specific risks to its fiscal forecasts.

3.1.3. Long-Term Fiscal Sustainability Analysis: The government regularly publishes projections of the evolution of the public finances over the long term.

3.2. Risk Management: *Specific risks to the public finances should be regularly monitored, disclosed, and managed.*

3.2.1. Budgetary Contingencies: The budget has adequate and transparent allocations for contingencies that arise during budget execution.

3.2.2. Asset and Liability Management: Risks relating to major assets and liabilities are disclosed and managed.

3.2.3. Guarantees: The government's guarantee exposure is regularly disclosed and authorized by law.

3.2.4. Public Private Partnerships: Obligations under public-private partnerships are regularly disclosed and actively managed.

3.2.5. Financial Sector Exposure: The government's potential fiscal exposure to the financial sector is analyzed, disclosed, and managed.

3.2.6. Natural Resources: The government's interest in exhaustible natural resource assets and their exploitation is valued, disclosed, and managed.

3.2.7. Environmental Risks: The potential fiscal exposure to natural disasters and other major environmental risks are analyzed, disclosed, and managed.

3.3. Fiscal Coordination: *Fiscal relations and performance across the public sector should be analyzed, disclosed, and coordinated.*

3.3.1. Sub-National Governments: Comprehensive information on the financial condition and performance of sub-national governments, individually and as a consolidated sector, are collected and published.

3.3.2. Public Corporations: The government regularly publishes comprehensive information on the financial performance of public corporations, including any quasi-fiscal activity undertaken by them.

TABLE 1: Analysis of Federal Accounting Standards in Relation to the IMF Recommendations for Disclosing Fiscal Risks:

IMF		FASAB	
#	Fiscal Risks (Sources of risk "shocks")	Standards or Active Projects	Discussion
Fiscal Disclosure and Analysis:			
3.1.1	Macroeconomic Risks	SFFAS 36 - <i>Comprehensive Long-Term Projections for the U.S. Government</i>	RSI identifies the major factors expected to have a significant impact and how the factors are expected to change over time. RSI provides the results of alternative scenarios based on variations in one or more significant assumptions.
3.1.2	Specific Fiscal Risks	No current requirements	Elements related to risk are reported but not summarized.
3.1.3	Long-Term Fiscal Sustainability Analysis	SFFAS 36 - <i>Comprehensive Long-Term Projections for the U.S. Government</i> SFFAS 17- <i>Accounting for Social Insurance</i>	Requires projections in basic information along with extensive disclosures and RSI.
Risk Management:			
3.2.1	Budgetary Contingencies	NA	

IMF		FASAB	
#	Fiscal Risks (Sources of risk "shocks")	Standards or Active Projects	Discussion
3.2.2	Asset & Liability Management	Various standards including SFFAS 1, 2, 3, 5, 6, 7, 10, 38, 44 (all as amended)	<p>Assets and liabilities are presented on an accrual basis (with some exceptions such as stewardship land and natural resources) with disclosures that may address:</p> <ul style="list-style-type: none"> • sensitivity analysis • range of reasonably possible losses for contingent liabilities <p>A review for consistency regarding such disclosures may be warranted.</p>
3.2.3	Guarantees	<p>SFFAS 2, <i>Accounting for Direct Loans and Loan Guarantees</i></p> <p>SFFAS 51, <i>Insurance Programs</i></p>	<p>SFFAS 2 as amended provides for disclosures but does not require discussion of risks.</p> <p>SFFAS 51 in final stages of ballot, sponsorship review and publication around mid-January 2017. SFFAS 51 will require discussion of risk exposure.</p>
3.2.4	Public Private Partnerships	SFFAS 49, <i>Public-Private Partnerships: Disclosure Requirements</i>	Disclosure requirements completed with a focus on risk – recognition/measurement possible future project
3.2.5	Financial Sector Exposure		Financial Regulations (Banking Sector Risk) – see discussion below
3.2.6	Natural Resources	SFFAS 38 (Oil and Gas) and Technical Bulletin 20011-1 (Other than Oil and	RSI provides the value and changes in value of such

IMF		FASAB	
#	Fiscal Risks (Sources of risk “shocks”)	Standards or Active Projects	Discussion
		Gas)	assets. No sensitivity analysis or other risk discussion required.
3.2.7	Environmental Risks		Disaster Relief – see discussion below
Fiscal Coordination:			
3.3.1	Sub-National Governments		Inter-governmental & Programmatic Dependency – see discussion below
3.3.2	Public Corporations (for example, state owned enterprises)	SFFAS 47, <i>Reporting Entity</i>	Addressed reporting on risk associated with disclosure entities.
		SFFAS 47, <i>Reporting Entity</i>	Defined related parties and noted that Government Sponsored Enterprises (GSE) would generally be related parties. Requires disclosures of the nature of the relationship and an understanding of financial risk exposure. – see discussion below.
			Commitments, including contractual, treaties, other international agreements – see discussion below

In June 2016, IMF published *Analyzing and Managing Fiscal Risks—Best Practices*⁵. This document expands upon the framework outlined in *Update on the Fiscal Transparency*, Pillar III, with a discussion in the Executive Summary of how:

- Comprehensive analysis and management of fiscal risks can help ensure fiscal and macroeconomic stability.
- Countries need a more complete understanding of these potential threats to their fiscal position.

⁵ *Analyzing and Managing Fiscal Risks: Best Practices* <http://www.imf.org/external/np/pp/eng/2016/050416.pdf>

- Countries should also enhance their capacity to mitigate and manage fiscal risks.
- Countries should make greater use of probabilistic forecasting methods when setting long-run objectives and medium-term targets for fiscal policy.⁶

Page 26 provides the following information:

Box 5. Examples of Institutional Arrangements for Fiscal Risk Analysis and Management

The **New Zealand** Treasury has ultimate authority and control over borrowing, contracting obligations and assessing fiscal risk. However, individual agencies are primarily responsible for monitoring and provisioning for contingent liabilities and various risks within their functions. The Treasury publishes a regular statement on managing fiscal risks. All explicit fiscal risks are subject to parliamentary approval.

Australia operates a decentralized model, with agencies responsible for managing and reporting on risks through their annual report and contribution to a Fiscal Risk Statement that is published as part of the budget.

The **United Kingdom** has established a fiscal risk group within HM Treasury to identify and monitor fiscal risks. The group is chaired by the Treasury Chief Economist and comprised of senior treasury officials (including the tax department, spending areas, international, and financial stability department). It produces a dashboard of fiscal risks, with estimates of total exposure and rankings using the traffic light system. The U.K. Office of Budget Responsibility is also preparing to publish an in-depth fiscal risk report every two years, in addition to its regular semi-annual reporting on risks around the medium-term forecast.

South Africa has also established a fiscal risk committee with a mandate to identify the major sources of fiscal risk and quantify them as far as is possible, monitor risks and propose mitigating measures, and report on risks both for internal purposes and to the public. The committee meets quarterly and incorporates a wide range of actors from within the National Treasury that are required to report on their area of expertise. It is supported by a secretariat in the Fiscal Policy Department of the Treasury.

The **United States** has recently created an enterprise risk management office, headed by a chief risk officer within the Treasury Department, and is considering establishing similar risk management efforts in other agencies.

⁶ *Analyzing and Managing Fiscal Risks: Best Practices Executive Summary*,

The following is a snapshot of Australia’s Statement of Risks and Table of Contents:



STATEMENT 8: STATEMENT OF RISKS

A range of factors may influence the actual budget outcome in future years. The *Charter of Budget Honesty Act 1998* requires these factors to be disclosed in a Statement of Risks in each Budget and Mid-Year Economic and Fiscal Outlook. This Statement outlines general fiscal risks, specific contingent liabilities and specific contingent assets that may affect the budget balances.

CONTENTS

Risks to the budget — overview	8-3
Economic and other parameters	8-5
Fiscal risks	8-5
Contingent liabilities and assets	8-7
Significant but remote contingencies	8-11
Communications and the Arts	8-11
Defence	8-12
Industry, Innovation and Science	8-13
Infrastructure and Regional Development	8-13
Treasury	8-14

Contingent assets — unquantifiable	8-28
Defence	8-28
Health	8-28
Industry, Innovation and Science	8-29
Contingent liabilities — quantifiable	8-29
Defence	8-29
Employment	8-29
Environment	8-29
Foreign Affairs and Trade	8-30
Health	8-30
Infrastructure and Regional Development	8-30
Treasury	8-31
Contingent assets — quantifiable	8-32
Defence	8-32
Government loans	8-33
Higher Education Loan Programme	8-37
Commonwealth-State financing arrangements — Housing and Specific Purpose Capital	8-37
Concessional Loan for Asbestos removal in the ACT — Mr Fluffy loose fill asbestos remediation	8-37
Clean Energy Finance Corporation	8-37
International Monetary Fund New Arrangements to Borrow	8-38
Indigenous Home Ownership, Business Development and Assistance	8-38
Student Financial Supplement Scheme	8-38
Trade Support Loans Programme	8-38
Papua New Guinea Liquefied Natural Gas	8-39
Drought Concessional Loans	8-39
Zero Real Interest Loans	8-39
Indigenous Land Corporation	8-40
Development Import Finance Facility	8-40

Statement 8: Statement of Risks

Table 1: Disclosure of fiscal risks, contingent assets and contingent liabilities, and assets and liabilities in the Budget Papers

Category	Type ^(a)	Disclosure
Fiscal Risks	Fiscal Risks	Statement of Risks
Contingent assets and contingent liabilities	Significant contingent assets and liabilities considered remote ^(b)	Statement of Risks
	Unquantifiable contingent assets and liabilities that are improbable but not remote	Statement of Risks
	Quantifiable contingent assets and liabilities that are improbable but not remote	Statement of Risks
	Contingent assets and liabilities excluded on the basis of immateriality ^(c)	None
Assets and liabilities	Assets and liabilities that are probable and can be reliably measured	Balance sheet ^(d)
	(Additional disclosure to increase transparency on loans over \$200 million has been included in the Statement of Risks for the first time in the 2014-15 Budget)	
	Assets and liabilities that are probable but have an uncertain timing or amount (provisions)	Balance sheet

(a) Items that are described as probable have a 50 per cent or higher chance of occurrence.

(b) Significant contingent assets and liabilities considered remote, whilst previously reported in the Statement of Risks, are separately identified under a new heading for the first time. This is consistent with reporting in the financial statements of departments and the consolidated financial statements.

(c) Only risks with a possible impact on the forward estimates greater than \$20 million in any one-year, or \$50 million over the forward estimates period, are considered material and disclosed in this Statement.

(d) Unearned income from charging guarantee fees is shown as a liability in the balance sheet.

In addition to the summary above, the statement of risks provides a narrative discussion of each category including the nature of the relationships and risks. For the quantifiable risks, dollar amounts are provided to reveal the maximum exposure.

Staff would like the Board to consider two things in relation to “Box 5” on page 9:

1. Enterprise Risk Management (ERM)⁷ policies were recently issued by the Office of Management and Budget (OMB). Staff requests the Board consider aligning our efforts with ERM to understand how managing risks at the enterprise level may reveal fiscal risks for program expenses and liabilities.
2. Australia's Fiscal Risk Statement. By implementing a governmentwide financial risk statement, FASAB would provide a consolidated presentation of information

⁷ OMB A-123 OMB Circular No. A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*

currently available in multiple reports and potentially fill gaps in risk information (e.g., sensitivity analysis for certain assets and liabilities not now provided).

The following items were considered during the initial work on of the risk assumed project and relate to fiscal risks as identified in the IMF Fiscal Risk Analysis and Management discussion. Many of these are not exclusive and, hence, may overlap with another area. Potential overlaps are footnoted.

B. Implicit Guarantees

The first area is implicit guarantees. Unlike explicit guarantees that are identified in an arrangement prior to an adverse event (and were addressed in phase I), implicit guarantees are a reaction to an adverse event that may have a serious to devastating impact on society and our economy, such as climate change or a recession. Therefore, policies and programs either exist or are created to address relief and stabilization efforts once an adverse event has occurred.

There are however certain qualifications that must be met, usually through an application process either at the federal level for direct funding or through a State agency that will distribute the benefits from grants received.

Implicit guarantees may be received through the following: disaster relief programs, means-tested entitlement programs, financial regulation, including policies or programs implemented to stabilize the economy, i.e. TARP, and/or government sponsored enterprises (GSEs).

1. Disaster Relief

The federal government assumes risks for major disasters declared or emergencies requested [see Table 1 -IMF 3.2.7 - Environmental Risks] by a Governor and approved by the President. According to the GAO-16-37 study on climate change, “over the last decade, the federal government incurred over \$300 billion in costs due to extreme weather and fire, according to the President’s 2016 budget request.”

The Stafford Act⁸ governs the authorization of federal programs to provide disaster relief; there are currently 14 departments with 78 agencies or programs responsible for disbursing funds. Funds are primarily disbursed to states through grants to address public assistance.⁹ A Preliminary Damage Assessment (PDA) is usually completed to determine the impact and magnitude of damage to warrant federal support.

⁸The Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§ 5121-5207 (the Stafford Act) §401.

⁹Disaster relief could be considered under the inter-governmental and programmatic dependency area.

The following is a summary of 2015 disaster relief funding.¹⁰

Disaster Relief Obligated during 2015 for 79 Declared Disasters			
Total Estimated	584,249,811.00	87%	PA
Total Obligated	1,114,756,556.09	13%	IA
	(530,506,745.09)	100%	

As of Sept 29, 2016						
Public Assistance (PA)			Individual Assistance (IA)			
Estimated PA	Public Assistance (approved) Grants Obligated	Difference	Estimated IA	Households Program - Dollars Approved	Difference	Ind Aps Approved
482,576,025.00	969,897,407.58	(487,321,382.58)	101,673,786.00	144,859,148.51	(43,185,362.51)	33,090.00

When considering whether to pursue disaster relief, individually or as part of implicit guarantees in the next risk assumed phase, consider the complex, crosscutting issue that climate change is posing in relation to how many agencies provide services (14 Departments/78 agencies/programs).

At an individual program level, costs are insignificant and may not readily appear on an agency’s financial statement. However, consider how aggregating and presenting all related program expenses and liabilities in the governmentwide consolidated financial report (CFR) would provide the total financial impact of these fiscal risks.

2. Means-Tested Entitlements

The federal government assumes risks for social welfare through means-tested entitlement programs [see Table 1 - IMF 3.2.3 - Guarantees]. Benefits or financial assistance are based on an individual’s or household’s income and/or assets and must be verified through an application process usually at the state level.

The federal government provides assistance aimed at helping people with low-incomes who may earn too little to meet their basic needs, cannot support themselves through

¹⁰ Staff gathered information for all 79 2015 declarations on September 29, 2016 from https://www.fema.gov/disasters/grid/year/2015?field_disaster_type_term_tid_1=All,

work, or who are disadvantageded in other ways.¹¹ Federal grants are provided to the states to implement these programs.¹²

Table 2 provides a list of means-tested entitlements for 2015 from the detail behind Table 8.2—Outlays by Budget Enforcement Act Category Constant (FY2009) Dollars 1962–2021¹³ as provided at the August 2016 meeting.

TABLE 2:

MEANS-TESTED ENTITLEMENTS		(in billions of dollars)
Account Name	Total	
	2015	
Funds for Strengthening Markets, Income, and Supply (section 32)	740,000	
Child Nutrition Programs	20,948,000	
Supplemental Nutrition Assistance Program (SNAP)	76,070,000	
Child Care Entitlement to States	2,821,000	
Children’s Research and Technical Assistance	46,000	
Payments to States for Child Support Enforcement and Family Support Programs	4,040,000	
Temporary Assistance for Needy Families (TANF)	15,942,000	
Child Enrollment Contingency Fund	9,000	
Children’s Health Insurance Fund	9,233,000	
Payment Where Adoption Credit Exceeds Liability for Tax	16,000	
Payment Where American Opportunity Credit Exceeds Liability for Tax	4,153,000	
Payment Where Child Tax Credit Exceeds Liability for Tax	20,592,000	
Tax	60084000	
Pensions benefits (Veterans)	5,299,000	
Medicaid and CHIP Payment and Access Commission	1,000	
	219.994.000	

¹¹ GAO-15-516 *Federal Low-Income Programs – Highlights Report*

¹² Means-tested entitlement programs could also be considered under the inter-governmental and programmatic dependency area.

¹³ <https://www.whitehouse.gov/omb/budget/Historicals>

3. Financial Regulations (Banking Sector Risk)

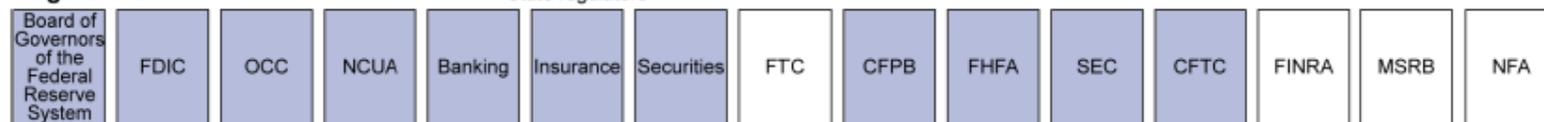
The federal government assumes risks for the safety and soundness of the financial system including depository institutions, securities and derivative markets and insurance [see Table 1 - IFM 3.2.5 - Financial Sector Exposure].

According to GAO-16-175: “The 2007-2009 financial crisis highlighted the lack of an agency or mechanism responsible for monitoring and addressing risks across the financial system. The Dodd-Frank Act tried to address this gap in systemic risk oversight by placing this responsibility on a collective group of financial regulators and other entities through the creation of the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR). However, collaborative efforts have not been sufficient, and FSOC’s authorities are limited and unclear.”¹⁴ The following is a chart from GAO-16-175.

¹⁴ GAO-16-175 *Financial Regulation: Complex and Fragmented Structure Could be Streamlined to Improve Effectiveness*.

U.S. Financial Regulatory Structure, 2016

Regulators



- CFPB Bureau of Consumer Financial Protection
- CFTC Commodity Futures Trading Commission
- FDIC Federal Deposit Insurance Corporation
- FHFA Federal Housing Finance Agency
- FINRA Financial Industry Regulatory Authority
- FTC Federal Trade Commission
- MSRB Municipal Securities Rulemaking Board
- NCUA National Credit Union Administration
- NFA National Futures Association
- OCC Office of the Comptroller of the Currency
- SEC Securities and Exchange Commission

Regulated entities

- Safety and soundness oversight
- Consumer financial protection oversight
- Securities and derivatives markets oversight
- Insurance oversight
- Housing finance oversight
- Consolidated supervision or systemic risk-related oversight

■ Financial Stability Oversight Council member agency

Source: GAO. | GAO-16-175

Note: This figure depicts the primary regulators in the U.S. financial regulatory structure, as well as their primary oversight responsibilities. "Regulators" generally refers to entities that have rulemaking, supervisory, and enforcement authorities over financial institutions or entities. There are additional agencies involved in regulating the financial markets and there may be other possible regulatory connections than those depicted in this figure.

Due to the 2007-2009 financial crisis the government implemented the Troubled Asset Relief Program¹⁵ (TARP).

Home » Initiatives » Financial Stability » TARP Programs

TARP Programs



Treasury established several programs under TARP to help stabilize the U.S. financial system, restart economic growth, and prevent avoidable foreclosures.

Although Congress initially authorized \$700 billion for TARP in October 2008, that authority was reduced to \$475 billion by the Dodd-Frank Wall Street Reform and Consumer

Protection Act (Dodd-Frank Act). Of that, the following amounts were committed through TARP's five program areas:

- Approximately \$250 billion was committed in programs to stabilize banking institutions (\$5 billion of which was ultimately cancelled).
- Approximately \$27 billion was committed through programs to restart credit markets.
- Approximately \$82 billion was committed to stabilize the U.S. auto industry (\$2 billion of which was ultimately cancelled).
- Approximately \$70 billion was committed to stabilize American International Group (AIG) (\$2 billion of which was ultimately cancelled).
- Approximately \$46 billion was committed for programs to help struggling families avoid foreclosure, with these expenditures being made over time.

The authority to make new financial commitments under TARP ended on

October 3, 2010. As of December 31, 2015, cumulative collections under TARP, together with Treasury's additional proceeds from the sale of non-TARP shares of AIG, exceed total disbursements by more than \$12 billion. Treasury is now winding down its remaining TARP investments and is also continuing to implement TARP initiatives to help struggling homeowners avoid foreclosure.

¹⁵ <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx#>

In determining whether the Board should include financial regulations individually, as part of implicit guarantees, or as a fiscal risk, please consider the following:

- While TARP did exceed total disbursements by more than \$12 billion in collections, what did it really cost the government to implement TARP to reestablish safety and stability in affected institutions?
 - How many resources got moved from existing programs to address this financial crisis?
 - How many other implicit guarantee programs were implemented or over-utilized, like the means-tested entitlement programs, because citizens were now low income, without jobs and without homes?
- What is the total financial impact resulting from the financial regulatory system that is responsible for managing the safety and stability risk of financial institutions?
 - Could aligning the FASAB Risk Assumed project with ERM address how risk management practices impact the financial management and reporting of the risks assumed by policy or program missions?
- What would the governmentwide CFR really disclose if ALL expenses and liabilities for all programs resulting from the risk assumed from these fiscal shocks were aggregated and presented in the CFR?

4. Government Sponsored Enterprises (GSEs)

Government Sponsored Enterprises (GSEs)¹⁶ [see Table 1 - IMF 3.3,2 – Public Corporations] are private enterprises established and sponsored by the federal government for public policy purposes. As private companies they are not included in the budget totals but the budget does present the statements of financial condition for GSEs.

The following is a brief description of GSEs from the 2013 OMB Analytical Perspectives, page 1431:

—The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) provide assistance to the secondary market for residential mortgages.

—The Federal Home Loan Banks assist thrift institutions, banks, insurance companies, and credit unions in providing financing for housing and community development.

¹⁶ GSEs could also be considered under the financial regulations (banking sector risk) area.

—Institutions of the Farm Credit System, which include the Agricultural Credit Bank and Farm Credit Banks, provide financial assistance to agriculture. They are **regulated by the Farm Credit Administration**.

—The Federal Agricultural Mortgage Corporation, also a Farm Credit System institution under the regulation of the Farm Credit Administration, provides a secondary market for agricultural real estate, rural housing loans, and certain rural utility loans, as well as for farm and business loans guaranteed by the U.S. Department of Agriculture.

Before the financial crisis for 2007-2009, the risk assumed for GSEs seemed minimal because their “securities are not backed by the full faith and credit of the federal government.” However, the government did do exactly that through financial stabilizations programs - per the 2010 Analytical Perspectives, page 209:

TREATMENT OF FINANCIAL STABILIZATION PROGRAMS

U.S. financial stabilization efforts include programs administered by Executive Branch agencies (principally Treasury, the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA)) and by the Federal Reserve. The Troubled Assets Relief Program (TARP), administered by Treasury, has injected capital into banks and other financial institutions by purchasing preferred stock, guaranteed assets of financial institutions, and provided loans and other support to the auto industry. Treasury has also provided support for the major Government Sponsored Enterprises (GSEs) in the housing area, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), which have been placed under conservatorship by the Federal Housing Finance Administration, including purchasing GSE preferred stock and purchasing mortgage-backed securities issued by GSEs. The FDIC and NCUA have taken steps to provide liquidity to the banking industry.

Therefore, the risk assumed for GSEs is much higher than originally expected due to future federal interventions. A rationale for Federal intervention is to prevent instability in the financial and housing market.¹⁷

Staff is seeing an emerging theme as to the total governmentwide expenses and liabilities resulting from a multitude of agencies and programs charged with delivering

¹⁷ 2017 Analytical Perspectives, page 308
<https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/spec.pdf>

goods/services to manage these implicit risks/fiscal shocks. Again, the Board should carefully consider how users would benefit from a financial risk statement.

C. Commitments

The federal government may assume significant risks when entering into contractual commitments that require future resources or treaties and other international agreements.

Per the *Treaties in Force* State Department Document¹⁸

... the term “treaty” in the generic sense as defined in the Vienna Convention on the Law of Treaties, that is, an international agreement “governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.” The term “treaty” as a matter of U.S. constitutional law denotes international agreements made by the President with the advice and consent of the Senate in accordance with Article II, section 2 of the Constitution of the United States.

Treaties in Force include bilateral and multilateral treaties and other international agreements to which the United States is a party.

As of January 1, 2013, the federal government has committed to risks assumed for over 500 treaties.

D. Inter-Governmental Financial and Programmatic Dependency

The federal government may assume significant risks through inter-governmental financial and programmatic dependency. This may be related to the means-tested entitlement programs, education, highway, and/or housing where the States receive federal grant money to carry out a federal mission, such as providing nutrition and other services for low income individuals or households. States are dependent on federal funding, while being charged with fulfilling their duties in an efficient and effective manner.

¹⁸ January 1, 2013, *Treaties in Force* <http://www.state.gov/s/l/treaty/tif/>

GAO emphasized the need for awareness of fiscal pressures across all levels of government in report GAO-10-899, *Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs*:

All levels of government face long-term fiscal challenges which could affect future federal funding of intergovernmental programs, as well as the potential capacity of state and local governments to help fund and implement these programs. The interconnectedness which defines intergovernmental programs requires that officials at all levels of government remain aware of and ready to respond to fiscal pressures. These pressures have implications for a wide range of federal, state, and local programs, policies, and activities, and include costs associated with health care, physical infrastructure, state and local employee pensions and retiree health benefits, and education, among other areas. **Actions to address the nation's long-term fiscal outlook will be needed at all government levels in coming years and the challenges cannot be adequately met by shifting burdens from one level of government to another.**

E. Contingent Liabilities – prior to the risk assumed project, the Board undertook a liability definition project. This project was closed in August 2011 with research used for the risk assumed project. In light of all the new risk management policies¹⁹ the Board may want to review the definition of contingent liabilities and/or the recognition and disclosure requirements as part of the next phase.

According to SFFAS 5, *Accounting for Liabilities of the Federal Government*:

35. A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm a gain (i.e., acquisition of an asset or reduction of a liability) or a loss (i.e., loss or impairment of an asset or the incurrence of a liability).

36. ... When a loss contingency (i.e., contingent liability) exists, the likelihood that the future event or events will confirm the loss or the incurrence of a liability can range from probable to remote. The probability classifications are as follows:

- Probable: The future confirming event or events are more likely than not to occur, with the exception of pending or threatened litigation and unasserted claims. For pending or threatened litigation and unasserted claims, the future confirming event or events are likely to occur.
- Reasonably possible: The chance of the future confirming event or events occurring is more than remote but less than probable.

¹⁹ OMB Circular No. A-123, Management's Responsibility for Enterprise Risk Management and Internal Control

- Remote: The chance of the future event or events occurring is slight.

Criteria For Recognition Of A Contingent Liability

38. A contingent liability should be recognized when all of these three conditions are met:

- A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).¹⁹
- A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity's management believes the claim is likely to be settled in favor of the claimant).
- The future outflow or sacrifice of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount). [See SFFAS 12.]

While deliberating the issuance of SFFAS 49, *Public-Private Partnerships: Disclosure Requirements*, the Board reviewed and discussed the relationship and association of the guidance in SFFAS 5 related to remote risks of loss. In clarifying the relationship between SFFAS 49 and SFFAS 5, the Board was clear that preparers should not dismiss disclosing risks that are deemed to be remote.

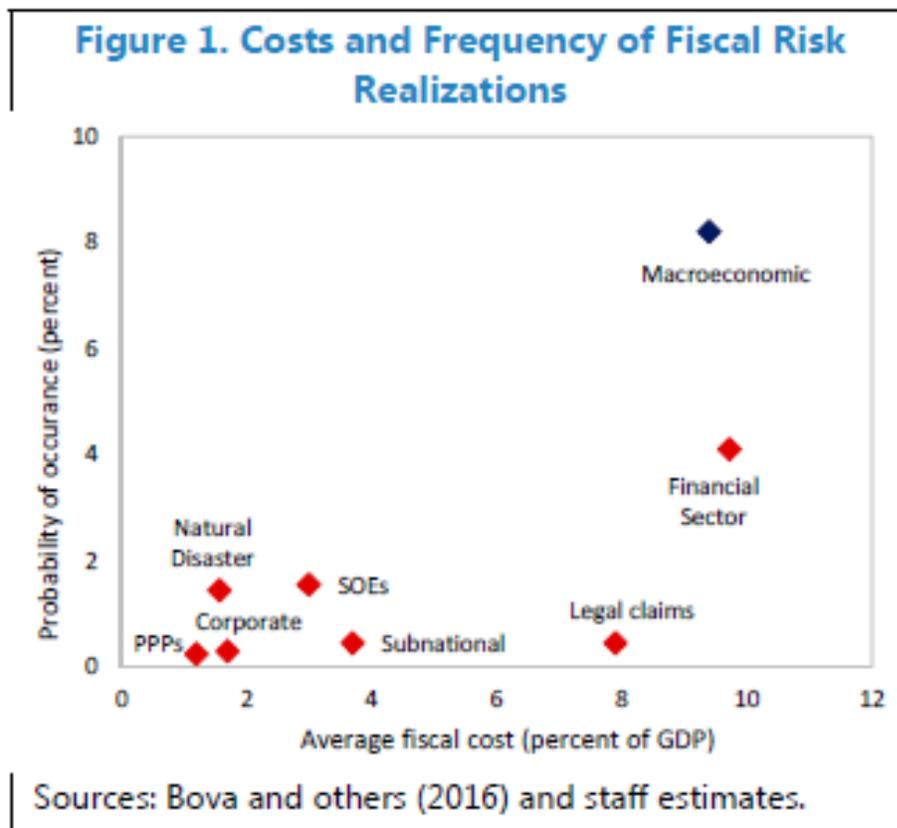
When addressing risk assumed, including remote risks of loss may lead to more accurate financial statement reporting as related to an entity's or governmentwide' s risk profile.

F. Macroeconomic Shocks

Macroeconomic shocks are another source of fiscal risk. According to the IMF's 2016—*Analyzing and Managing Fiscal Risks: Best Practices* page 8 macroeconomic shocks have the highest probability of occurrence and fiscal cost as a percent of Gross Domestic Product (GDP).

Per page 5, A.8: In preparing this paper, staff [IMF] conducted the most comprehensive survey of fiscal risks to date, looking at sources of shocks to government debt in 80 countries between the period 1990 and 2014.

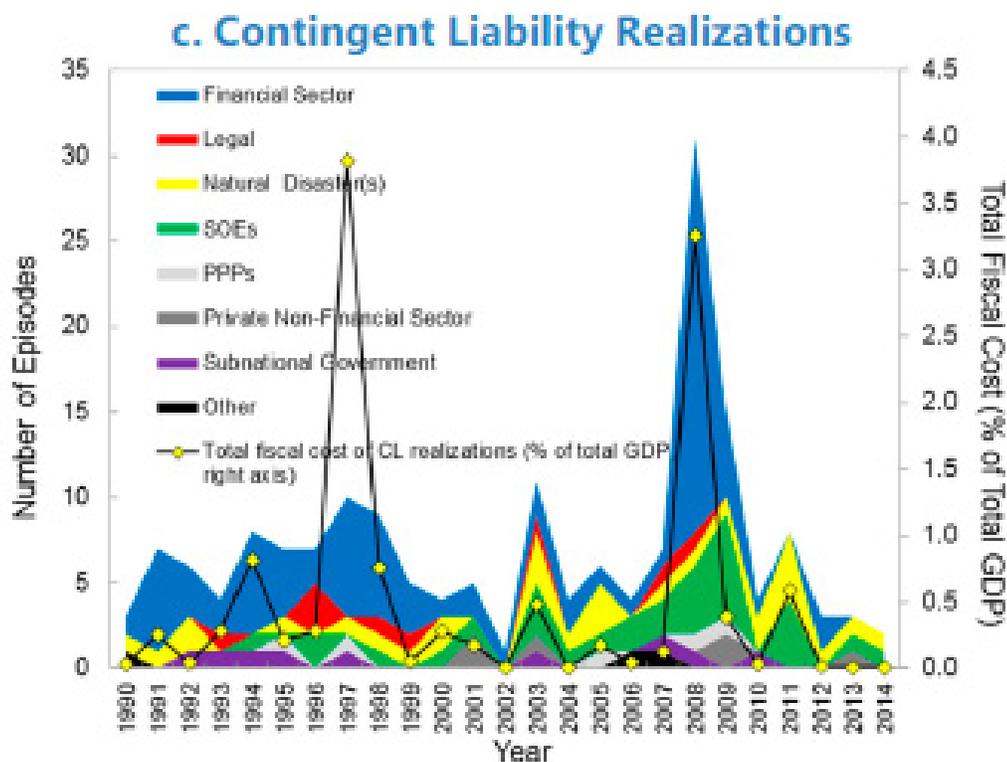
See Figure 1 below for the various fiscal risks that materialized over this period, whose fiscal impact on the average cost of GDP and likelihood are summarized:



Macroeconomic shocks in the form of sharp declines in nominal GDP growth are relatively frequent and have large **implications for public debt**. Public finances are typically hit by a macroeconomic shock once every 12 years, with an average fiscal cost equivalent to around 9 percent of GDP.

[Footnote 3: Macroeconomic shocks were calculated separately from the survey. Episodes were identified as those where nominal GDP growth falls by one standard deviation relative to its average. The fiscal cost is the loss in revenue resulting from lost output (compared to the case in which nominal GDP had continued to grow at the five year average rate preceding the crisis).]

Page 8: ...fiscal shocks are highly correlated. Macroeconomic downturns tend to trigger the realization of other shocks, such as financial sector crisis, the collapse of SOEs and subnational governments, and other contingent liabilities. These shocks are also highly correlated with each other, with a distinct bunching of contingent liability realization during crisis periods as shown below in figure 2. *Nature of Fiscal Risks c-Contingent Liability Realizations:*



Source: Bova and others (2016).

SUMMARY & RECOMMENDATION:

In summary, while the Board may choose to piecemeal risk assumed by focusing on one of the fiscal shocks or sources of risks identified above, staff believes that a governmentwide approach—including an alignment with ERM and providing a Fiscal Risk Statement or summary —would best serve our users in understanding the full financial impact of significant risks assumed in relation to the fiscal sustainability of the federal government.

In relation to fiscal sustainability, the United States Financial Report of the United States Government FY 2015, Required Supplemental Information Report²⁰ notes the following:

²⁰ See Attachment 1 for the full discussion of sustainability of fiscal policy and the effect of different assumptions (pages 169-178)

Required Supplementary Information (Unaudited) For the Years Ended September 30, 2015, and 2014

The Sustainability of Fiscal Policy

One of the important purposes of the *Financial Report* is to help citizens and policymakers assess whether current fiscal policy is sustainable and, if it is not, the urgency and magnitude of policy reforms necessary to make fiscal policy sustainable. A sustainable policy is one where the ratio of debt held by the public to GDP (the debt-to-GDP ratio) is ultimately stable or declining.

According to staff analysis in Table 1, FASAB is disclosing risks assumed, but in separate and distinct buckets. This project gives the Board an opportunity to review the risk related disclosures, identify gaps, and review options to summarize disclosures about risks. Therefore, staff recommends a governmentwide perspective to address risks that may impact fiscal sustainability.

Question 1: Does the Board want to approach the next phase of the risk assumed project from a governmentwide perspective to address risks that may impact fiscal sustainability?

QUESTION FOR THE BOARD:

Question 1: Does the Board want to approach the next phase of the risk assumed project from a governmentwide perspective to address risks that may impact fiscal sustainability?

NEXT STEPS:

- Review current risk related disclosures
- Identify gaps
- Review options to summarize disclosures about risk

MEMBER FEEDBACK

Please provide editorial input and responses to the above questions to Ms. Gilliam by Friday, August 19, 2016, at gilliamr@fasab.gov with a cc to Ms. Payne at paynew@fasab.gov

If you have any questions, please contact Ms. Gilliam at 202-512-7356 or gilliamr@fasab.gov

PAGE INTENTIONALLY LEFT BLANK

TAB 2

RISK ASSUMED

Attachment 1

United States Government
Required Supplemental Information (Unaudited)
For the Years Ended September 30, 2015, and 2014:

The Sustainability of Fiscal Policy

Pages 169 – 177

October 2016

PAGE INTENTIONALLY LEFT BLANK

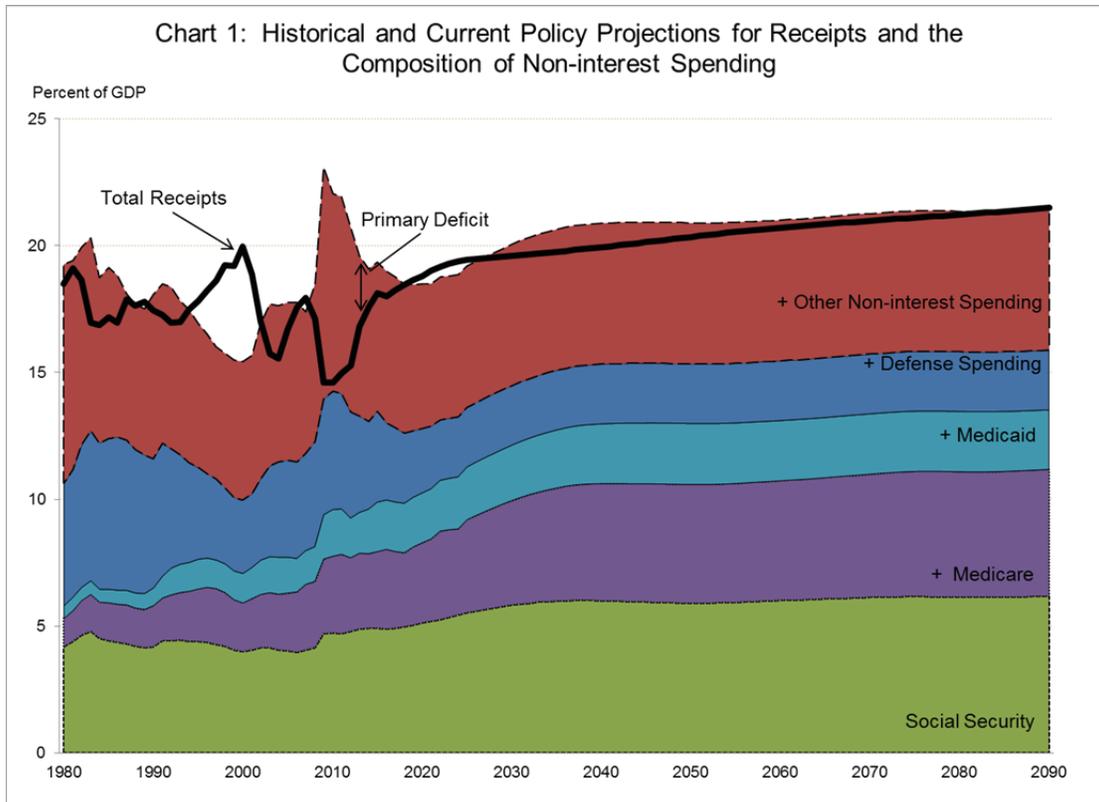
United States Government Required Supplementary Information (Unaudited) For the Years Ended September 30, 2015, and 2014

The Sustainability of Fiscal Policy

One of the important purposes of the *Financial Report* is to help citizens and policymakers assess whether current fiscal policy is sustainable and, if it is not, the urgency and magnitude of policy reforms necessary to make fiscal policy sustainable. A sustainable policy is one where the ratio of debt held by the public to GDP (the debt-to-GDP ratio) is ultimately stable or declining.

As discussed below, the projections in this report indicate that current policy is not sustainable. If current policy is left unchanged, the projections show the debt-to-GDP ratio will fall about 6 percentage points between 2015 and 2025 before commencing a steady rise, exceeding its 2015 level (74 percent) by 2031, exceeding 100 percent by 2043, and reaching 223 percent in 2090.

These conclusions are rooted in the projected trends in receipts, spending, and surpluses/deficits in the context of current law and policy, although, as described in the following pages, there is considerable uncertainty surrounding these projections. The projections are on the basis of policies currently in place and are neither forecasts nor predictions. For comparison, under the 2014 projections, the debt-to-GDP ratio fell about 4 percentage points between 2014 and 2024 before commencing a steady rise, exceeding the 2014 level (74 percent) by 2028, exceeding 100 percent by 2039, and reaching 321 percent in 2089.



Current Policy Projections for Primary Deficits

A key determinant of growth in the debt-to-GDP ratio and hence fiscal sustainability is the primary deficit-to-GDP ratio. The primary deficit is the difference between non-interest spending and receipts, and the primary deficit-to-GDP ratio is the primary deficit expressed as a percent of GDP. As shown in Chart 1, 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 projected to shrink in the next few years as the discretionary spending limits called for in the *Budget Control Act of 2011 (BCA)* remain in effect and the economy continues to recover. Starting in 2019, receipts are projected to exceed non-interest spending, and this primary surplus is projected to peak at 0.5 percent of GDP in 2024. After 2025, however, increased spending for Social Security and health programs due to the continued retirement of the baby boom generation is expected to cause the primary surplus to steadily deteriorate and become a primary deficit in 2028 that reaches 1.0 percent of GDP in 2038. The primary deficit gradually decreases beyond that point as the aging of the population continues at a slower pace, and becomes a primary surplus in 2085 that reaches 0.1 percent of GDP in 2090.

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 *2009 American Recovery and Reinvestment Act (ARRA)* and the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*. The share rose to 18.1 percent in 2015, exceeding its 30-year average of 17.2 percent due to continued economic growth and the higher tax rates enacted under the *American Tax Relief Act (ATRA) of 2012*. Receipts are projected to grow slightly more rapidly than GDP as increases in real (i.e., inflation-adjusted) incomes cause more taxpayers and a larger share of income to fall into the higher individual income tax brackets. Other possible paths for the receipts-to-GDP ratio and the implications for projected debt are analyzed in the “Alternative Scenarios” section.

On the spending side, the non-interest spending share of GDP is projected to stay at or below its current level of about 19 percent until shortly before 2030, and to then rise gradually to 20.9 percent of GDP by 2040 and 21.4 percent of GDP by 2090. 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 (OCO), caps on discretionary spending and the automatic spending cuts mandated by the BCA, and the subsequent increases are principally due to faster growth in Medicare, Medicaid, and Social Security spending (see Chart 1). 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 1.1 percentage points, 1.6 percentage points, and 0.4 percentage points, respectively. After 2040, the Social Security spending share of GDP gradually declines, returns to 2040 levels in 2060 and then increases slightly, while the combined Medicare and Medicaid spending share of GDP continues to increase, albeit at a slower rate, due to projected increases in health care costs.

The *Patient Protection and Affordable Care Act*, as amended by the *Health Care and Education Reconciliation Act of 2010 (ACA)* significantly affects projected spending for both Medicare and Medicaid. That legislation expands health insurance coverage, including Medicaid, includes many measures designed to reduce health care cost growth, and significantly reduces Medicare payment rates. On net, the ACA is projected to substantially reduce the annual increases in Medicare payment rates over the next 75 years. The Medicare spending projections in the long-term fiscal projections are based on the projections in the 2015 Medicare trustees’ report, and those projections show a substantial slowdown in Medicare cost growth. The projections assume that Medicaid enrollment increases and that Medicaid cost per beneficiary grows at the same reduced rate as Medicare cost growth per beneficiary. As discussed in Note 23 to the U.S. Government’s Financial Statements, these projections are subject to much uncertainty about the ultimate effects of the ACA’s provisions to reduce health care cost growth. Even if those provisions work as intended and as assumed in this projection, Chart 1 shows that there is still a long-term gap between projected receipts and projected total non-interest spending.

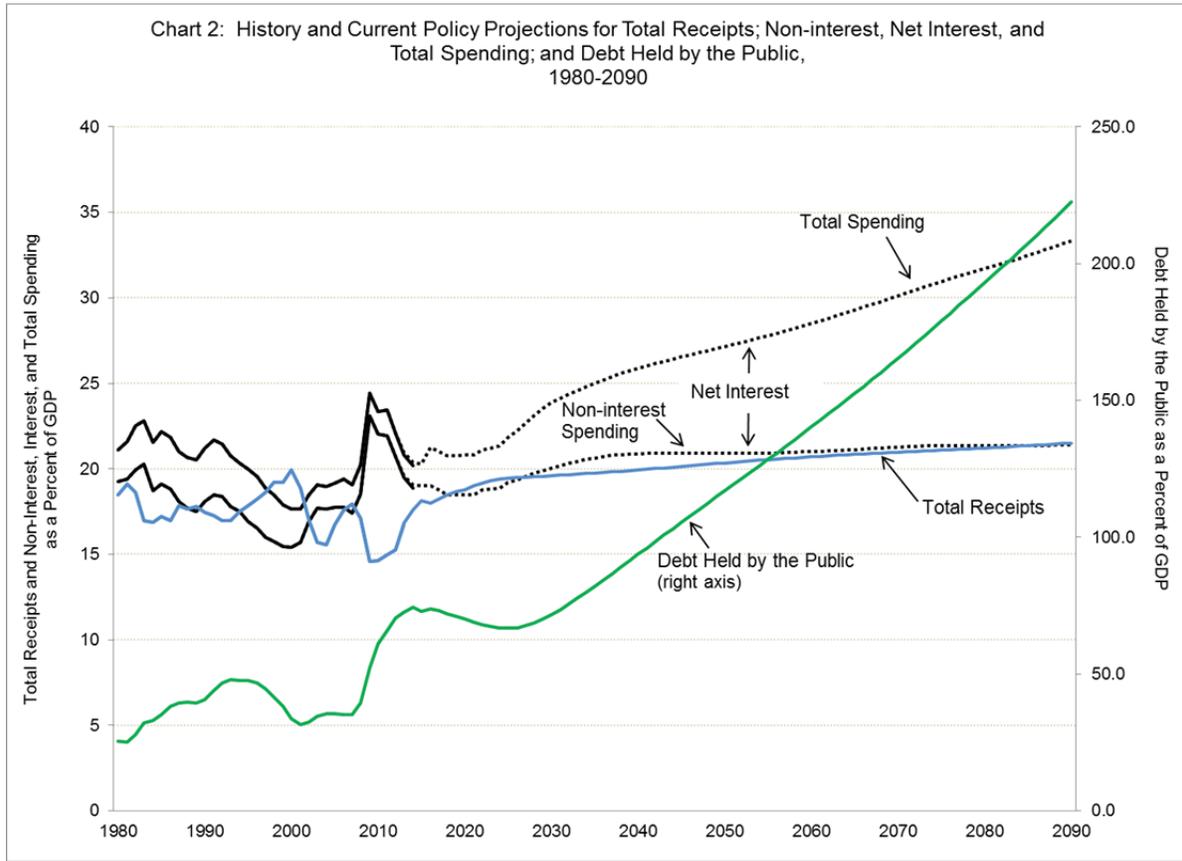
Current Policy Projections for Debt and Interest Payments

The primary deficit projections in Chart 1, along with projections for interest rates and GDP, determine the projections for the debt-to-GDP ratio that are shown in Chart 2 (right axis). That ratio was 74 percent at the end of fiscal year 2015, and under current policy is projected to be 67 percent in 2025, 106 percent in 2045, and 223 percent in 2090. The continuous rise of the debt-to-GDP ratio after 2025 indicates that current policy is unsustainable.

The change in debt held by the public from one year to the next is approximately equal to the unified budget deficit, the difference between total spending and total receipts.¹ Total spending is non-interest spending plus interest spending. Chart 2 (left axis) shows that the rapid rise in total spending and the unified deficit is almost entirely due to projected interest

¹ The change in debt each year is also affected by certain transactions not included in the unified budget deficit, such as changes in Treasury’s cash balances and the non-budgetary activity of Federal credit financing accounts. These transactions are assumed to hold constant at about 0.4 percent of GDP each year, with the same effect on debt as if the primary deficit was higher by that amount.

payments on the debt. As a percent of GDP, interest spending was 1.2 percent in 2015, and under current policy is projected to reach 4.4 percent in 2035 and 12.0 percent in 2090.



Another way of viewing the change in the financial outlook in this year’s report relative to previous years’ reports is in terms of the projected debt-to-GDP ratio in 2088, the last year of the projection period in the FY 2013 report. This ratio is projected to reach 217 percent in the fiscal year 2015 projections, which compares with 315 percent projected in the fiscal year 2014 projections and 277 percent projected in the fiscal year 2013 projections.²

The Cost of Delay in Closing the 75-Year Fiscal Gap

The longer policy action to close the fiscal gap is delayed, the larger the post reform primary surpluses must be to achieve the target debt-to-GDP ratio at the end of the 75-year period. This can be illustrated by varying the years in which reforms closing the fiscal gap are initiated while holding the target ratio of debt to GDP in 2090 equal to the 2015 ratio (74 percent). Three reforms are considered, each one beginning in a different year, and each one increasing the primary surplus relative to current policy by a fixed percent of GDP starting in the reform year. The analysis shows that the longer policy action is delayed, the larger the post-reform primary surplus must be to bring the debt-to-GDP ratio to 74 percent of GDP in 2090. Future generations are harmed by delays in policy changes because delay necessitates higher primary surpluses during their lifetimes, and those higher primary surpluses must be achieved through some combination of lower spending and higher taxes and other receipts.

As previously shown in Chart 1, under current policy, primary deficits occur in much of the projection period. Table 1 shows primary surplus changes necessary to make the debt-to-GDP ratio in 2090 equal to its level in 2015 under each of the three policies. If reform begins in 2016, then it is sufficient to raise the primary surplus share of GDP by 1.2 percentage points in every year between 2016 and 2090 in order for the debt-to-GDP ratio in 2090 to equal its level in 2015 (74 percent). This policy raises the average 2016-2090 primary surplus-to-GDP ratio from -0.3 percent to +0.9 percent.

² For further information on changes from the 2013 projections, see the Required Supplementary Information in the 2014 *Financial Report*.

Table 1
Costs of Delaying Fiscal Reform

Timing of Reforms	Required Change in Average Primary Surplus
Reform in 2016 (No Delay)	1.2 percent of GDP between 2016 and 2090
Reform in 2026 (Ten-Year Delay)	1.5 percent of GDP between 2026 and 2090
Reform in 2036 (Twenty-Year Delay) ...	1.9 percent of GDP between 2036 and 2090

Note: Reforms taking place in 2015, 2025, and 2035 from the 2014 Financial Report were 2.1, 2.5, and 3.1 percent of GDP, respectively.

In contrast to a reform that begins immediately, if reform begins in 2026 or 2036, then the primary surpluses must be raised by 1.5 percent and 1.9 percent of GDP, respectively, in order for the debt-to-GDP ratio in 2090 to equal 74 percent. The difference between the primary surplus increase necessary if reform begins in 2026 and 2036 (1.5 and 1.9 percent of GDP, respectively) and the increase necessary if reform begins in 2016 (1.2 percent of GDP) is a measure of the additional burden policy delay would impose on future generations. The costs of delay are due to the additional debt that accumulates between 2015 and the year reform is initiated, in comparison to the scenario in which reform begins immediately.

These projections likely understate the cost of lengthy policy delays because they assume interest rates will not rise as the debt-to-GDP ratio grows. Under the current projections, the debt-to-GDP ratio is stable through 2030 and then grows rapidly. If a higher debt-to-GDP ratio causes the interest rate on government borrowing to rise, thus making it more costly for the government to service its debt and simultaneously slowing private investment, then the primary surplus required to return the debt-to-GDP ratio to its 2015 level would also increase. This dynamic may accelerate with higher ratios of debt to GDP, potentially resulting in there being no feasible level of taxes and spending that would reduce the debt-to-GDP ratio to its 2015 level. The potential impact on the projections of interest rates rising as the debt-to-GDP ratio rises is explored in the “Alternative Scenarios” section.

Alternative Scenarios

The long-run outlook for the budget is extremely uncertain. This section illustrates this inherent uncertainty by presenting alternative scenarios for the growth rate of health care costs, interest rates, discretionary spending, and receipts. (Not considered here are the effects of alternative assumptions for long-run trends in birth rates, mortality, and immigration.)

The population is aging rapidly and will continue to do so over the next several decades, which puts pressure on programs such as Social Security, Medicare, and Medicaid. A shift in projected fertility, mortality, or immigration rates could have important effects on the long-run projections. Higher-than-projected immigration, fertility, or mortality rates would improve the long-term fiscal outlook. Conversely, lower-than-projected immigration, fertility, or mortality rates would result in deterioration in the long-term fiscal outlook.

Effect of Changes in Health Care Cost Growth

One of the most important assumptions underlying the projections is the projected growth of health care costs. Enactment of the ACA in 2010 reduced the projected long-run growth rates of health care costs, but these growth rates are still highly uncertain. As an illustration of the dramatic effect of variations in health care cost growth rates, Table 2 shows the effect on the size of reforms necessary to close the fiscal gap of per capita health care cost growth rates that are one percentage point higher or two percentage points higher than the growth rates in the base projection, as well as the effect of delaying closure of the fiscal gap.³ As indicated earlier, if reform is initiated in 2016, eliminating the fiscal gap requires that the 2016-2090 primary surplus increase by an average of 1.2 percent of GDP in the base case. However, that figure increases to 4.0 percent of GDP if per capita health cost growth is assumed to be 1 percentage point higher, and 8.5 percent of GDP if per capita health cost growth is 2 percentage points higher. The cost of delaying reform is also increased if health care cost growth is higher, due to the fact that debt accumulates more rapidly during the period of inaction. For example, the lower part of Table 2 shows that delaying reform initiation from 2016 to 2026 requires that 2026-2090 primary surpluses be higher by an average of 0.3 percent of GDP in the base case, 0.8 percent of GDP if per capita health cost growth is 1 percentage point

³ The base case health cost growth rates are derived from the projections in the 2015 Medicare trustees’ report. These projections are summarized and discussed in Note 23 (see Table 1B in particular) and the “Medicare Projections” section of the RSI for the SOSI.

higher, and 1.7 percent of GDP if per capita health cost growth is 2 percentage points higher. The dramatic deterioration of the long-run fiscal outlook caused by higher health care cost growth shows the critical importance of managing health care cost growth, including through effective implementation of the ACA.

Table 2			
Impact of Alternative Health Cost Scenarios on Cost of Delaying Fiscal Reform			
Scenario	Primary Surplus Increase (% of GDP)		
	Starting in:		
	2016	2026	2036
Base Case.....	1.2	1.5	1.9
1% pt. higher per person health cost growth.....	4.0	4.8	6.1
2% pt. higher per person health cost growth.....	8.5	10.2	12.8
	Change in Primary Surplus Increase if Reform is Delayed From 2016 to:		
	2026		2036
Base Case.....		0.3	0.6
1% pt. higher per person health cost growth.....		0.8	2.1
2% pt. higher per person health cost growth.....		1.7	4.4

NOTE: Increments may not equal the subtracted difference of the components due to rounding.

Effects of Changes in Interest Rates

A higher debt-to-GDP ratio is likely to increase the interest rate on Government debt, making it more costly for the Government to service its debt. Table 3 displays the effect of several alternative scenarios using different nominal (and real) interest rates than assumed in the base case on the size of reforms to close the fiscal gap as well as the effect of delaying closure of the fiscal gap. If reform is initiated in 2016, eliminating the fiscal gap requires that the 2016-2090 primary surplus increase by an average of 1.2 percent of GDP in the base case, 1.5 percent of GDP if the interest rate is 0.5 percentage point higher in every year, and 0.9 percent of GDP if the interest rate is 0.5 percentage point lower in every year. The cost of delaying reform is also increased if interest rates are higher, due to the fact that interest paid on debt accumulates more rapidly during the period of inaction. For example, the lower part of Table 3 shows that delaying reform initiation from 2016 to 2026 requires that 2026-2090 primary surpluses be higher by an average of 0.3 percent of GDP in the base case, 0.4 percent of GDP if the interest rate is 0.5 percentage point higher in every year, and 0.2 percent of GDP if the interest rate is 0.5 percentage point lower in every year.

Scenario	Primary Surplus Increase (% of GDP) Starting in:		
	2016	2026	2036
Base Case: Average of 5.4 percent over 75 years.....	1.2	1.5	1.9
0.5 percent higher interest rate in each year.....	1.5	1.9	2.5
0.5 percent lower interest rate in each year.....	0.9	1.1	1.4
	Change in Primary Surplus Increase if Reform is Delayed From 2016 to:		
		2026	2036
Base Case: Average of 5.4 percent over 75 years.....		0.3	0.6
0.5 percent higher interest rate in each year.....		0.4	0.9
0.5 percent lower interest rate in each year.....		0.2	0.4

NOTE: Increments may not equal the subtracted difference of the components due to rounding.

Effects of Changes in Discretionary Spending Growth

The growth of discretionary spending has a large impact on long-term fiscal sustainability. The current base projection for discretionary spending assumes that after 2021, discretionary spending keeps pace with the economy and grows with GDP. The implications of two alternative scenarios are shown in Table 4. The first alternative scenario allows discretionary spending to grow with inflation and population after 2021 so as to hold discretionary spending constant on a real per capita basis. (This growth rate assumption is still larger than the standard 10-year budget baseline assumption, which assumes that discretionary spending grows with inflation but not with population.) The second alternative scenario sets discretionary spending in 2022 to levels consistent with the path established prior to the sequestration required by the failure of the Joint Select Committee on Deficit Reduction, and then grows discretionary spending with GDP from that point forward. As shown in Table 4, the fiscal gap decreases significantly if discretionary spending grows with inflation and population, from 1.2 percent of GDP to -0.3 percent of GDP. Conversely, if discretionary spending rises to the levels prior to Joint Committee sequestration in 2022 and then grows with GDP, the fiscal gap increases from 1.2 percent of GDP to 1.6 percent of GDP. The cost of delaying reform is greater when discretionary spending levels are higher. Initiating reforms in 2026 requires that the primary surplus increase by an average of 0.3 percent of GDP per year in the base case, and also increase by 0.3 percent of GDP if discretionary levels return to pre-Joint Committee sequestration levels. If delayed until 2036, the primary surplus must increase by an average of 0.6 percent of GDP in the base case, and increase by 0.8 percent of GDP at pre-sequestration levels.

Table 4

Impact of Alternative Discretionary Spending Growth Scenarios on Cost of Delaying Fiscal Reform

Scenario	Primary Surplus Increase (% of GDP) Starting in:		
	2016	2026	2036
Base Case: Discretionary spending growth with GDP after 2021.....	1.2	1.5	1.9
Growth with inflation and population after 2021.....	(0.3)	(0.3)	(0.4)
Reversion in 2022 to pre-Joint Committee sequester levels and growth with GDP.....	1.6	1.9	2.4
	Change in Primary Surplus Increase if Reform is Delayed From 2016 to:		
	2026	2036	
Base Case: Discretionary spending growth with GDP after 2021.....		0.3	0.6
Growth with inflation and population after 2021.....		(0.1)	(0.1)
Reversion in 2022 to pre-Joint Committee sequester levels and growth with GDP.....		0.3	0.8

NOTE: Increments may not equal the subtracted difference of the components due to rounding.

Effects of Changes in Individual Income Receipt Growth

The growth rate of receipts, specifically individual income taxes, is another key determinant of long-term sustainability. The base projections assume growth in individual income taxes over time to account primarily for the slow shift of individuals into higher tax brackets due to real wage growth (“real bracket creep”). This assumption approximates the long-term historical growth in individual income taxes relative to wages and salaries and is consistent with current tax code policy without change, as future legislation would be required to prevent real bracket creep. As an illustration of the effect of variations in individual income tax growth, Table 5 shows the effect on the size of reforms necessary to close the fiscal gap and the effect of delaying closure of the fiscal gap if long-term receipt growth as a share of wages and salaries is 0.1 percentage point higher, than the base case, as well as 0.1 percentage point lower than the base case. If reform is initiated in 2016, eliminating the fiscal gap requires that the 2016-2090 primary surplus increase by an average of 1.2 percent of GDP in the base case, only 0.2 percent of GDP if receipt growth is higher, but 2.3 percent of GDP if receipt growth is lower. The cost of delaying reform is also affected if receipt growth assumptions change, much as was the case in the previous alternative scenarios.

Table 5
Impact of Alternative Revenue Growth Scenarios on Cost of Delaying Fiscal Reform

Scenario	Primary Surplus Increase (% of GDP)		
	Starting in:		
	2016	2026	2036
Base Case: Individual income tax bracket creep of 0.1% of wages and salaries per year....	1.2	1.5	1.9
0.2% of wages and salaries per year after 2025.....	0.2	0.2	0.3
0.0% of wages and salaries per year after 2025 (no bracket creep).....	2.3	2.7	3.5
	Change in Primary Surplus Increase if Reform is Delayed From 2016 to:		
	2026	2036	
Base Case: Individual income tax bracket creep of 0.1% of wages and salaries per year....		0.3	0.6
0.2% of wages and salaries per year after 2025.....		0.0	0.1
0.0% of wages and salaries per year after 2025 (no bracket creep).....		0.5	1.2

NOTE: Increments may not equal the subtracted difference of the components due to rounding.

Fiscal Projections in Context

In this report, a sustainable policy has been defined as one where the Federal debt-to-GDP ratio is stable or declining. However, this definition does not indicate what a sustainable debt-to-GDP ratio might be. Any particular debt ratio is not the ultimate goal of fiscal policy. Rather, the goals of fiscal policy are many, including: financing public goods, such as infrastructure and government services; a strong and growing economy; and managing the national debt so that it is not a burden to future generations. These goals are interrelated, and readers should consider how policies intended to affect one might depend on or affect another.

This report shows that current policy is not sustainable. In evaluating policies that could alter that trajectory, note that national debt may play roles in both facilitating and hindering a healthy economy. For example, Government deficit spending may support demand and allow economies to emerge from recessions more quickly. Debt may also be a cost-effective means of financing capital investment, promoting economic growth, which may in turn make debt levels more manageable in the future. However, economic theory also suggests that high levels of national debt may contribute to higher interest rates, leading to lower investment and a smaller capital stock which the economy can use to grow. Unfortunately, it is unclear what debt ratio would be sufficiently high to produce these negative outcomes, or whether the key concern is the level of debt per se, or a trend that shows debt increasing over time.

Whether the actual experience of countries supports a relationship between national debt and economic growth remains an open research question. It is not possible to perform randomized experiments on economies, and historical experience, while valuable, is filled with confounding events and circumstances. Some countries with high debt-to-GDP ratios have been observed to experience lower-than-average growth, while other countries with similarly high debt ratios continue to enjoy robust growth. Analogously, low debt-to-GDP ratios are no guarantee of strong economic growth. Moreover, the direction of causality is unclear. High debt may undermine growth; low growth may contribute to high debt.

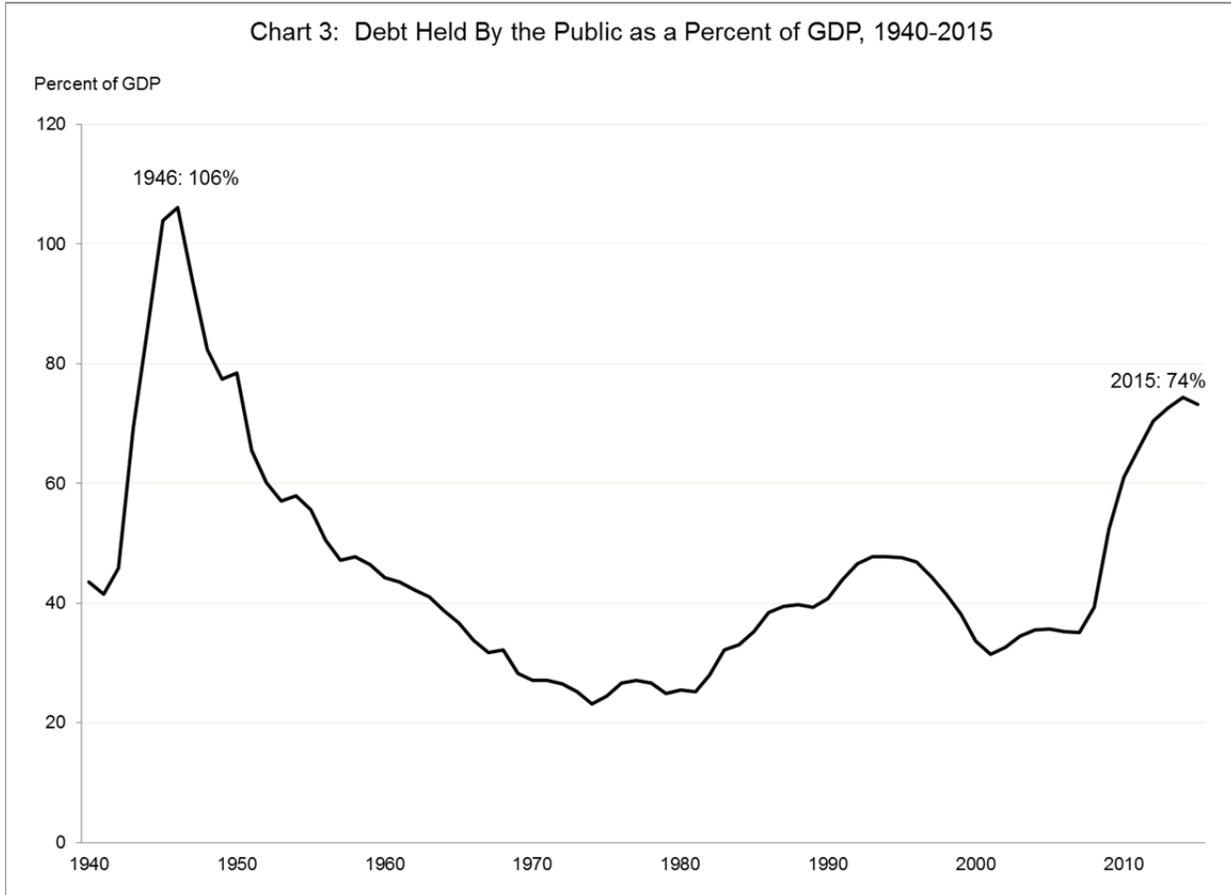
Nevertheless, to put the current and projected debt-to-GDP ratios in context, it is instructive to examine the experiences of other countries as well as that of the United States. The United States Government's debt as a percentage of GDP is relatively large compared with central government debt of other countries, but far from the largest among developed countries. Based on historical data as reported by the International Monetary Fund (IMF) for 24 select countries, the debt-to-GDP ratio in 2013 ranged from 7 percent of GDP to 174 percent of GDP.⁴ The United States is not included in this set of statistics, which underscores the difficulty in calculating debt ratios under consistent definitions, but the IMF does report a

⁴ Government Finance Statistics Yearbook, Main Aggregates and Balances, available at <http://data.imf.org>. Data is for D1 debt liabilities for the central government, excluding social security funds.

similar debt statistic for the United States as 82 percent of GDP.⁵ Despite using consistent definitions where available, these debt measures are not strictly comparable due to differences in the share of government debt that is debt of the central government, how government responsibilities are shared between central and local governments, how current policies compare with the past policies that determine the current level of debt, and how robustly each economy grows.

The historical experience of the U.S. may also provide some perspective. As Chart 3 shows, the debt-to-GDP ratio was highest in the 1940s, following the debt buildup during World War II. In the projections in this report, the U.S. would reach the previous peak debt ratio in 2045. However, the origins of current and future Federal debt are quite different from the wartime debt of the 1940s, which limits the pertinence of past experience.

As the cross-country and historical comparisons suggest, there is a very imperfect relationship between the current level of central government debt and the sustainability of overall government policy. Past accrual of debt is certainly important, but current policies and their implications for future debt accumulation are as well.



Conclusion

The United States took a potentially significant step towards fiscal sustainability in 2010 by reforming its system of health insurance through enactment of the ACA. The legislated changes for Medicare, Medicaid, and other health coverage hold the prospect of lowering the long-term growth trend for health care costs and significantly reducing the long-term fiscal gap. Furthermore, enactment of the BCA in August 2011 placed limits on future discretionary spending, while enactment of ATRA in January 2013 increased receipts under current policy. But even with these laws, the projections in this *Financial*

⁵ Data is for D1 debt liabilities for the central government, including social security funds. For the few countries where both central government debt ratios (excluding and including social security funds) are reported, the values are similar.