Federal Accounting Standards Advisory Board

February 3, 2012

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Fiscal Sustainability Reporting - Tab F[1]

MEETING OBJECTIVES

To provide feedback to the preparers regarding fiscal sustainability information presented in the fiscal year (FY) 2011 consolidated Financial Report of the U.S. Government (CFR). The session was requested by the Office of Management and Budget to ensure that any input the members may have is available to assist in meeting the reporting objectives articulated in Statement of Federal Financial Reporting Standards (SFFAS) 36, *Comprehensive Long-Term Projections for the U.S. Government*.

SFFAS 36 provides that the financial statement and some of the other components of fiscal sustainability reporting that are currently required supplementary information (RSI) will transition to basic information in the CFR in FY 2013.

Example aspects of this reporting that the Board may wish to consider include but are not limited to:

- Does the reporting meet the Board's expectations for the reporting requirements?
- Are the graphic illustrations effective and informative?
- Does the narrative use "plain English" effectively for readers who are not subject matter experts?
- Is the length of the reporting (about 11 pages) appropriate?

[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 the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

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BRIEFING MATERIAL

This memorandum summarizes the objectives and major requirements of SFFAS 36 and how they relate to the major sections of fiscal sustainability reporting in the CFR. It also includes suggested questions for Board discussion. In addition, the following items are attached:

- Attachment 1 is the U.S. government's fiscal sustainability reporting in the FY 2011 CFR
- Appendix 1 is a copy of SFFAS 36, *Comprehensive Long-Term Projections for the U.S. Government*

BACKGROUND

The requirements of SFFAS 36 are being implemented following a three-year transition period beginning in FY 2010, during which all information is presented as RSI. Beginning in FY 2013, the required information will be presented as a basic financial statement, disclosures, or RSI, as designated within the standards.

This section of the memorandum summarizes the objectives of the reporting requirements and how SFFAS 36 requirements addressed them. However, members not on the Board during the development of SFFAS 36 are encouraged to review SFFAS 36 in its entirety, including the Basis for Conclusions (Appendix A) and the illustrative examples of financial statements, narrative, and graphics (Appendix B).

The suggested questions are not intended to be all-inclusive, and members are encouraged to introduce additional observations and recommendations.

Recap of Project History

This project was initiated to address FASAB's Reporting Objective 3, in particular sub-objective 3b, below:

> ***Objective 3: Stewardship***
>
> Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future. Federal financial reporting should provide information that helps the reader to determine whether:
>
> a) the government's financial position improved or deteriorated over the period
> b) future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
> c) government operations have contributed to the nation's current and future well-being.[2]

The Board's working definition of "fiscal sustainability" was the federal government's ability to continue, both now and in the future, current policy without change regarding public services and taxation without causing debt to rise continuously as a share of GDP.[3]

The Board worked with a task force of subject matter experts to consider what

[2] *Statement of Federal Financial Accounting Concepts* (SFFAC) 1, pars. 134-145, available at http://www.fasab.gov/codifica.html (accessed May 7, 2009).

[3] Determining how much a government can depart–in magnitude and/or duration–from this general notion of fiscal sustainability is beyond the scope of the Board's efforts.

information would most likely help readers of the consolidated financial report of the U.S. Government (CFR) assess whether future budgetary resources will likely be sufficient to sustain public services and meet obligations as they come due

The fiscal sustainability task force participants included representatives from the American Enterprise Institute, the Cato Institute, the Brookings Institution, and the Urban Institute; the Chief Actuaries for Social Security and Medicare; technical experts from the Treasury Department, the Office of Management and Budget (OMB), the Government Accountability Office (GAO), and the Congressional Budget Office (CBO); members of Congress; and academics in the areas of public policy and communication.

All of the communication experts and many of the technical experts on the task force strongly emphasized the importance of simplicity of presentation. The Board noted that one of the greatest challenges inherent in Fiscal Sustainability Reporting is the tension between technical rigor and simplicity of presentation.

STAFF DISCUSSION GUIDE

The purpose of this agenda session is to provide an opportunity for members to provide feedback to the preparers regarding the FY 2011CFR. Such feedback may assist them in meeting the reporting objectives of SFFAS 36 over time. This session was requested by the OMB member.

Because staff believes that some of the most critical information on fiscal sustainability is presented in the supplementary information that will continue to be reported as RSI, the following discussion guide presents materials in suggested order of importance.

1. Cost of delay in addressing projected shortfalls 5
2. Additional Graphics and Narrative in RSI 8
   a) Projections and Trends 8
   b) Alternative Scenarios 15
   c) International Context 20
   d) Trends Beyond the Projection Period 22
3. Basic Financial Statement and Accompanying Narrative 23

1. Cost of delay in addressing projected shortfalls

At the December 2011 Board meeting, Mr. Steinberg noted that the FY 2011 reporting in the CFR on the "cost of delay" appeared to differ from his expectations. Staff has developed the following analysis to facilitate Board discussion of this section of the reporting.

Paragraph 41 c of SFFAS 36 requires that RSI should explain and illustrate:

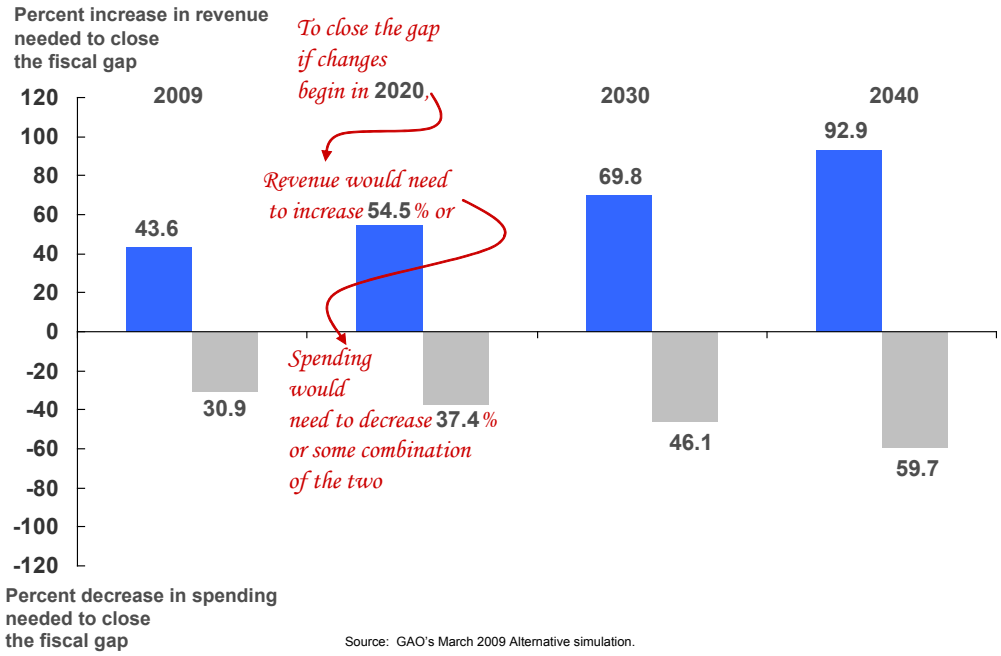
[c] if an excess of projected non-interest spending over projected receipts is indicated by the projections, the likely impact of delaying action. For example, graphics could illustrate the progressive increase in the change that would be needed to close the fiscal gap by (1) reducing non-interest spending, or (2) increasing receipts.

Appendix B of SFFAS 36 shows how this requirement could be met with sample narrative and a simple graphic that would attract and hold the attention of a reader. It would also enable members of the public to relate the information to their immediate concerns, such as tax rates and the level of government services.

> *From Appendix B, Section 6, of SFFAS 36:*
>
> **What are the Costs of Delaying Action?**
>
> How soon action is taken will affect how much the government would have available to spend on various priorities. The measures below show, for each of the years presented, how much the government would have to immediately and permanently either raise receipts or cut non-interest spending – or some combination of the two –

to close the fiscal gap* if action begins in that year. For example, if action does not begin until 2040, non-interest spending would have to be permanently reduced by 59.7% or receipts increased by 92.9% (or some combination of the two) relative to 2009 levels of spending and receipts.

*In this projection, "closing the fiscal gap" means to maintain the government's debt at the same size (in relation to the economy) as it was at the beginning of the projection period.



SFFAS 36 provided these illustrations to highlight the importance of presenting information on cost of delay in a manner that would be easily understandable to readers of the CFR who are not subject-matter experts.

Paragraph 9 of SFFAS 36 says that:

Fiscal Sustainability Reporting should be understandable to the intended users of the CFR. The primary intended users of this report are citizens and citizen intermediaries (for example, the media, public interest and advocacy groups, and others). The CFR should be easily understandable to the "average citizen" who has a reasonable understanding of federal government activities and is willing to study the information with reasonable diligence.

In addition, several of the task force members stressed the importance of effective communication, including simplicity of presentation when possible.

The CFR presented this information as follows:

From the FY 2011 CFR, page 155:

The Cost of Closing the 75 - Year Fiscal Gap

The longer policy action to close the fiscal gap is delayed, the larger the post-reform primary surplus must be to stabilize the debt-to-GDP ratio by the end of the 75 year period. Varying the years in which reforms are introduced while holding constant the ultimate target ratio of debt to GDP helps to illustrate the cost of delaying policy changes that close the fiscal gap. The reforms considered here increase the primary surplus relative to current policy by a fixed percent of GDP starting in the reform year. Three such policies are considered, each beginning in a different year. The analysis shows that the longer policy action is delayed, the larger the post-reform primary surplus must be to stabilize the debt-to-GDP ratio in 2086. Future generations are harmed by policy delay because higher primary surpluses imply lower spending and/or higher taxes than would be needed with earlier deficit reduction.

As previously shown in Chart 1, under current policy, primary deficits occur in virtually every year of the projection period. Table 3 shows primary surplus changes necessary to make the debt-to-GDP ratio in 2086 equal to its level in 2011 under each of the three policies. If reform begins in 2012, then it is sufficient to raise the primary surplus share of GDP by 1.8 percentage points in every year between 2012 and 2086 in order to have a debt-to-GDP ratio in 2086 equal to the level in 2011. This raises the average 2011-2086 primary surplus-to-GDP ratio from -0.7 percent to 1.1 percent. In contrast to a reform that begins immediately, if reform is begun in 2022 or 2032, the primary surplus must be raised by 2.2 percent and 2.8 percent of GDP, respectively, in order to reach a debt-to-GDP ratio in 2086 equal to the level in 2011. The difference between the primary surplus increasing in 2022 and 2032 (2.2 and 2.8 percent of GDP, respectively) rather than in 2012 (1.8 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 debt-to-GDP ratio rising during the interim period, which increases the future amount of interest that must be covered with the primary surplus. Delaying reform increases the cost of reaching the target debt-to-GDP ratio even if the target year is extended beyond 2086, since the starting debt-to-GDP ratio will be higher.

These estimates likely understate the cost of delay because they do not assume interest rates will rise as the debt-to- GDP ratio grows. If a higher debt-to-GDP ratio increases the interest rate, making it more costly for the government to service its debt and simultaneously slowing private investment, the primary surplus required to return the debt-to- GDP ratio to its 2011 level will also increase. This dynamic may accelerate with higher ratios of debt to GDP, potentially leading to the point where there may be no feasible level of taxes and spending that would reduce the debt-to-GDP ratio to its 2011 level. The potential impact of changes in interest rates is among the variables explored in the following section.

Table 3

Costs of Delaying Fiscal Consolidation

Period of Delay	**Change in Average Primary Surplus**
No delay: Reform in 2012	1.8 percent of GDP between 2012 and 2086
Ten years: Reform in 2022	2.2 percent of GDP between 2012 and 2086
Thirty years: Reform in 2032	2.8 percent of GDP between 2012 and 2086

Note: Reforms taking place in 2011, 2021, and 2031 from the 2010 Report were 2.4, 2.9, and 3.7 percent of GDP.

Question 1

1. Does the Board wish to provide feedback to the preparers on this section of the reporting?

2. Additional Graphics and Narrative in RSI

a) Projections and Trends

Sub-paragraphs 41 a and b of SFFAS 36 require the following:

[41] RSI should explain and illustrate:

a. trends in:

(1) historical and projected Treasury debt held by the public as a share of GDP,

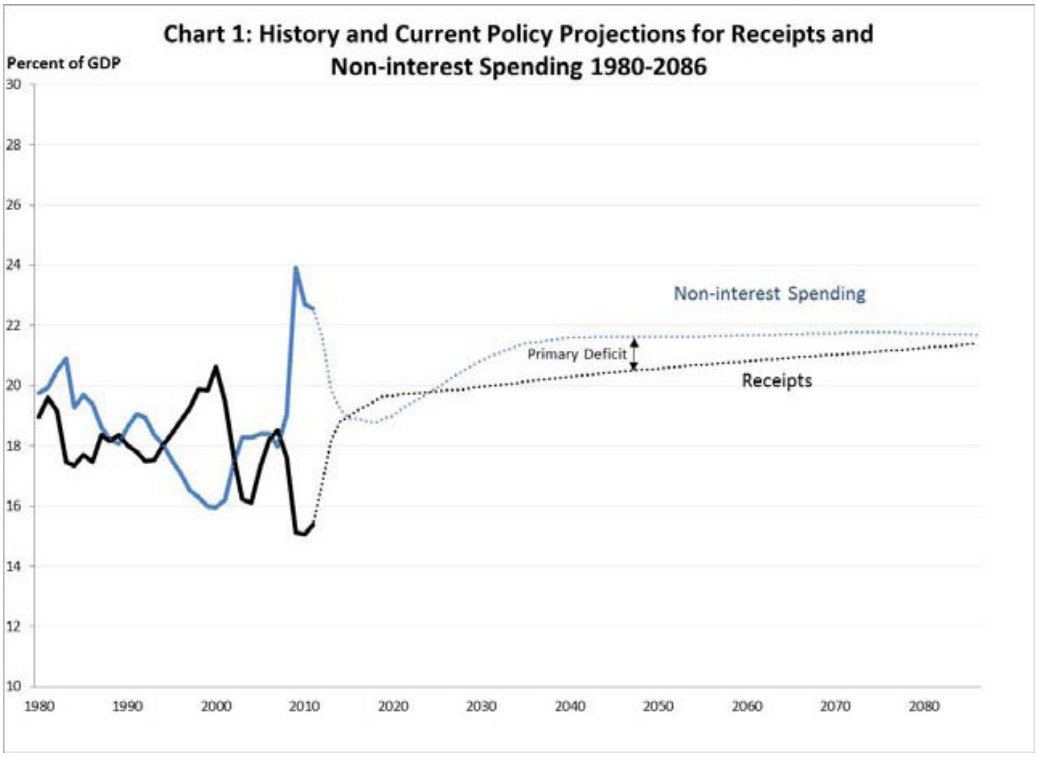
(2) historical and projected receipts and spending, and

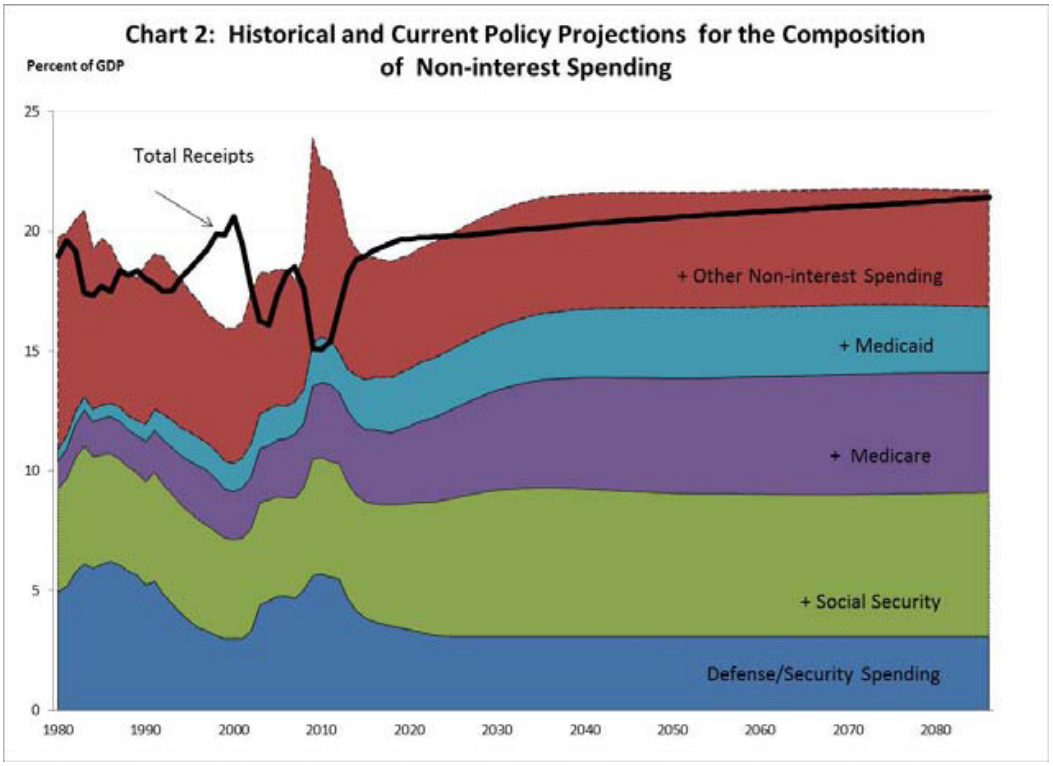
(3) historical and projected deficits and surpluses for a progression of years beginning at least 20 years before the current year and, at a minimum, extending to the end of the projection period used in the basic financial statement. These amounts should be presented at regular time intervals (for example, every five years or ten years).

b. the major factors that are expected to have a significant impact upon projected receipts and spending, and how such factors are expected to change over time. For example, two such factors may be (1) the rising cost of health care and (2) demographic trends. Information about how such factors have changed and are expected to change over time is necessary to assist the reader in understanding the factors that influence fiscal projections.

The requirements in sub-paragraphs 41a and b were addressed as follows:

From the FY 2011 CFR, pages 151-154:





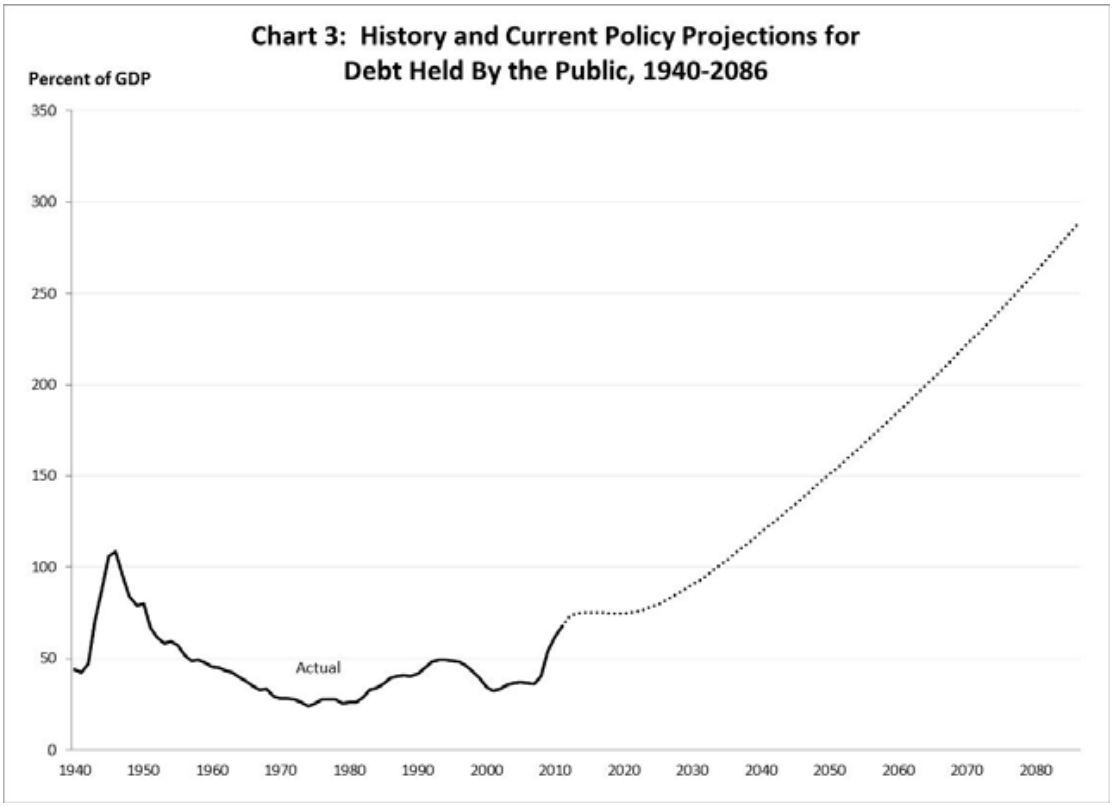


Chart 3: History and Current Policy Projections for Debt Held By the Public, 1940-2086
Percent of GDP
350
300
250
200
150
100
50
0
Actual
1940
1950
1960
1970
1980
1990
2000
2010
2020
2030
2040
2050
2060
2070
2080

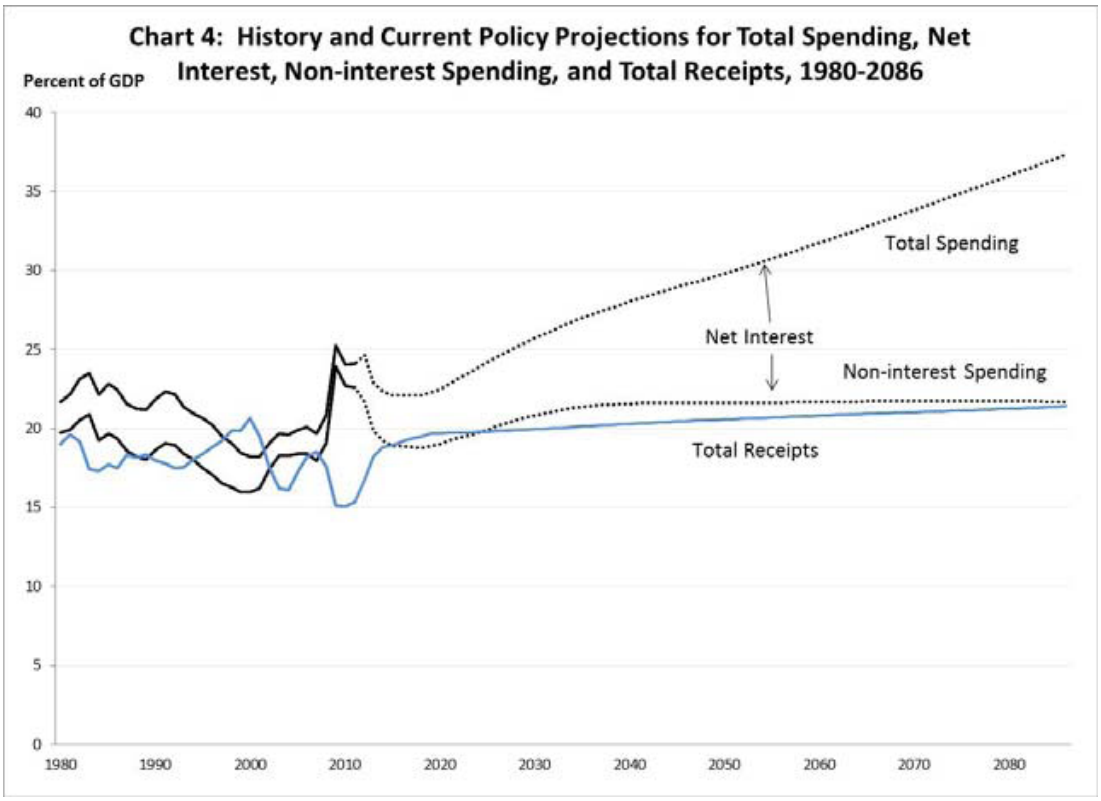


Chart 4: History and Current Policy Projections for Total Spending, Net Interest, Non-interest Spending, and Total Receipts, 1980-2086
Percent of GDP
40
35
30
25
20
15
10
5
0
Total Spending
Net Interest
Non-interest Spending
Total Receipts
1980
1990
2000
2010
2020
2030
2040
2050
2060
2070
2080

The Sustainability of Fiscal Policy

An important purpose 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 it sustainable. A sustainable policy is one where the ratio of debt held by the public to GDP (debt to GDP) is stable over time. The discussion below focuses on balancing revenues and expenditures over time, and does not consider fairness or efficiency implications of the reforms necessary to achieve sustainability.

It is shown below that, under current policy, the ratio of debt to GDP is projected to rise only 1.2 percent from 2013 to 2022, before resuming faster growth over the remainder of the 75- year window, eventually exceeding 280 percent by 2086. The continuing rise in this ratio by the end of the 75-year horizon means that current policy is unsustainable. If these projections were extended beyond 2086, deficits excluding interest would persist as the population continues to age and if the other assumptions made for the 75-year horizon continue to hold. Persistence of the primary deficit beyond the 75-year horizon implies that the ratio of debt to GDP would continue to grow beyond the 75-year horizon.

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 and stayed large in 2010 and 2011 due to the financial crisis and the recession and the policies pursued to combat both. The primary deficit ratio is projected to fall rapidly between 2012 and 2019 (turning to surplus in 2015) as spending reductions called for in the BCA take effect and the economy recovers. Between 2019 and 2035, however, increased spending for Social Security and health programs due to continued aging of the population is expected to cause the primary balance to steadily deteriorate. A primary deficit is expected to reappear in 2025 that reaches 1.3 percent of GDP in 2035. After 2035, the projected primary deficit-to- GDP ratio slowly declines as the impact of the baby boom generation retiring dissipates. Between 2035 and 2086, the projected primary deficit averages 0.9 percent of GDP.

The revenue share of GDP fell substantially in 2009 and 2010 and increased only modestly in 2011 because of the recession and tax reductions enacted as part of the 2009 ARRA and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The share is projected to return to near its long-run average as the economy recovers and the temporary tax cuts expire. After the economy is fully recovered, 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.[9] This projection assumes that Congress and the President will continue to enact legislation that prevents the share of income subject to

the Alternative Minimum Tax from rising.

On the spending side, the non-interest spending share of GDP is projected to fall from its current level of 22.6 percent to about 20 percent in 2013, and stay at or below that level until 2026, and to then rise gradually and plateau at about 22 percent beginning in about 2040. The reduction in the non-interest spending share of GDP over the next two years is mostly due to the caps on discretionary spending and the automatic spending cuts mandated by the BCA, and the subsequent increase is principally due to growth in Medicare, Medicaid, and Social Security spending (see Chart 2). The retirement 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 1.4 percentage points, 1.3 percentage points, and 1.0 percentage points, respectively. After 2035, the Social Security spending share of GDP is relatively steady, 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.

Both Medicare and Medicaid projections continue to be significantly affected by the enactment of the ACA in 2010. The reform expands health insurance coverage, but the long-term budgetary effect will depend on the effectiveness of provisions designed to reduce health care cost growth. The 2011 Medicare trustees' report reflects the ACA and thus projects reductions in future Medicare cost growth as called for by the new law. If the trustees' report projections hold true, there will be a substantial slowdown in future Medicare spending and following the projections methodology outlined above there will also be a slowdown in future Medicaid spending growth. However, even with this reduced growth in Medicare and Medicaid spending, there is still a persistent gap between projected receipts and projected total Federal non-interest spending.

The overall 75-year present value net excess of non-interest spending over receipts expressed in Table 1 of $6.4 trillion (0.7 percent of the 75-year present value of GDP) for the 2011 projections can be expressed in terms of funding sources. In these projections there is an excess of receipts over spending of $6.0 trillion or 0.7 percent of GDP among programs funded by the government's general revenues but an imbalance of $12.4 trillion or 1.4 percent of GDP among Social Security (OASDI) and Medicare Part A, which are funded by payroll taxes and which are not funded in any material respects by the government's general revenues. By comparison, the 2010 projections showed that programs funded by the government's general revenues had an imbalance of $5.3 trillion or 0.6 percent of GDP while the payroll tax funded programs had an imbalance of $11.0 trillion or 1.3 percent of GDP.[10] While the imbalance for payroll tax funded programs has actually risen modestly since 2010, programs funded by general revenues are no longer in imbalance in 2011 and show a large present value surplus more than offsetting the increase in the dedicated imbalance. This speaks further to the gains brought about through the BCA in 2011.

As shown in Table 1 and discussed above, the 2011 projection of the 75-year present value imbalance of spending over receipts of $6.4 trillion is a sizable drop from the 2010 projection, which measured the 75-year imbalance as $16.3 trillion. Table 2

breaks down the sources of the change in this key projection from 2010 to 2011 and clearly illustrates the projected effects of newly enacted legislation as the main driver of the change since last year. The changes due to enacted legislation shown on Table 2 reflect the effect on the long-term fiscal imbalance of the incorporation of the passage of key pieces of legislation since 2010 including the 2011 full year continuing resolution, as well as the BCA. The enactment of discretionary caps in the BCA improved the long run fiscal imbalance in the 2011 projections by $7.0 trillion and the additional deficit reduction from the automatic spending reductions improved the fiscal imbalance by $4.1 trillion. Technical adjustments and changes to modeling assumptions improved the fiscal picture by $2.3 trillion since 2010. The main source of these changes are actual budget numbers being lower than projected in 2010, as well as refinements to the fiscal projections model. Also reflected are revised economic assumptions, as well as the effect of changing the projection period from 2011-2085 to 2012-2086, which collectively somewhat reduce the overall decreases brought about since 2010 from legislation.

Another way of viewing the improvement in the financial outlook in this year's Report relative to last year's Report is in terms of the projected level of publicly-held debt in 2085. The ratio of publicly-held debt to GDP in 2085 is projected to reach 283 percent in this year's Report, which compares with 352 percent projected in last year's Report.

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 ratio of debt held by the public to GDP that are shown in Chart 3. That ratio was 68 percent at the end of fiscal year 2011, and under current policy, it is projected to exceed 76 percent in 2022, 125 percent in 2042, and 287 percent in 2086. The continuous rise of the debt-to-GDP ratio illustrates 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.[11] Total spending consists of non-interest spending plus interest spending. Chart 4 shows that the rapid rise in total spending and the unified deficit is almost entirely due to projected interest payments on the debt. As a percent of GDP, interest spending was 1.5 percent in 2011, and under current policies it is projected to reach 5 percent by 2031 and nearly 16 percent by 2086.

9 Projected revenues also account for increases (as a share of GDP) in employer-sponsored health insurance costs, which are tax exempt.
10 If payroll and self-employment taxes and related assets in the OASDI Trust Funds or Medicare Part A become insufficient to cover related benefits, as indicated by projections, additional funding for each of these two programs would be necessary or scheduled benefits would need to be reduced. If the government's general revenues are insufficient to cover both mandated transfers to Medicare Parts B and D and spending for other general government programs funded by the government's general revenues, either Medicare Parts B and D revenues (premiums and state transfers), or the government's general revenues would need to

be increased, spending for Medicare Parts B and D and/or other general government spending would need to be reduced, and/or additional amounts would need to be borrowed from the public.

11 Debt held by the public is also affected by certain transactions not included in the unified budget deficit, such as changes in Treasury's cash balances and the nonbudgetary activity of Federal credit financing accounts. These transactions are assumed to hold constant at about 0.6 percent of present value GDP.

b) Alternative Scenarios

Paragraph 41 d of SFFAS 36 requires the following:

[41] RSI should explain and illustrate:

d. [4]the results of alternative scenarios that are consistent with current policy without change. Alternative scenarios are projections in which one or more significant assumptions is varied from the assumptions used in the projections presented in the basic financial statement. The choice of alternative scenarios presented should consider both those that result in larger as well as those that result in smaller net differences between the present value of projected receipts and non-interest spending. Projections for alternative scenarios may be displayed in a table format. The major causes of the differences between the results of the alternative scenarios and the basic financial statement should be explained.

The CFR presented alternative scenarios for changes in health care costs and changes in interest rates:

> *From the FY 2011 CFR, pages 155-157*:
>
> **Alternative Scenarios**
>
> The long-run outlook for the budget is extremely uncertain and therefore it makes sense to consider possible alternative projections to indicate the range of uncertainty. There are many dimensions to the projections for which reasonable variations could be considered. Some of the key issues concern long-run economic and demographic assumptions. The long-run fiscal gap is partly the result of demographic patterns that have emerged over the last 50 years with lower birth rates and reduced mortality. 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 nursing care. A shift in expected fertility, mortality, or immigration rates could have important long-run effects on the projections. Increases in immigration or fertility rates, or reduction in the mortality rate would improve the longterm fiscal projections. Conversely, decreases in immigration or fertility rates, or improvements in the mortality rate would result in deterioration in the long-term fiscal projections. The remainder of this section will focus on two important variables that can also impact fiscal projections: the growth rate of heath care costs and interest rates.

[4] The requirements in sub-paragraph 41 c on the cost of delay were addressed in the section of cost of delay, beginning on page 5 of this memorandum.

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 growth rates, Chart 5 and Table 4 show the effect on future primary deficits as well as the present value imbalance of growth rates that are one percent higher or two percent higher than the growth rates in the base projection. Relative to the base assumption of 0 percent average excess health cost growth, the one percent higher health care cost growth scenario raises the 75-year present value of non-interest spending less receipts to 4.8 percent of GDP, compared to 0.7 percent of GDP assumed in the base projection. The two percent higher health cost growth scenario raises the 75-year present value of non-interest spending less receipts even further, to 7.5 percent of GDP. The dramatic deterioration on 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.

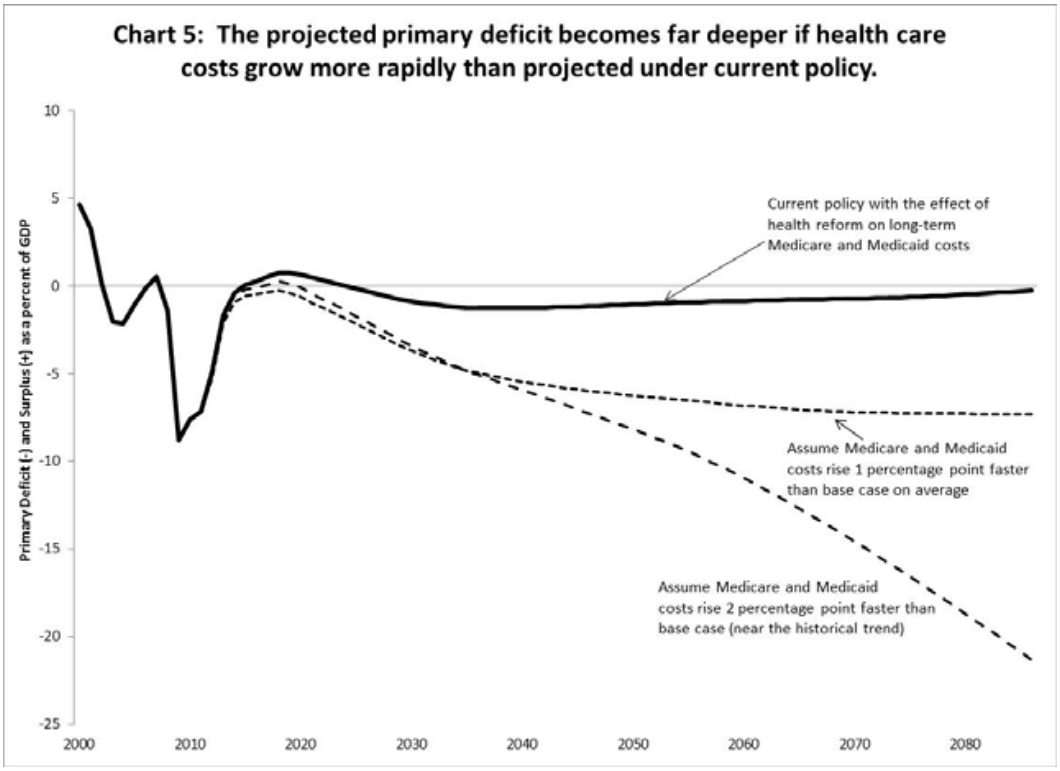


Table 4		
Impact of Alternative Health Cost Scenarios on 75-year PV Imbalance		
Scenario	**75-Year Present Value Fiscal Imbalance**	
	Dollars in Trillions	% GDP
Base Case: 0% Average Excess Health Care Cost Growth	6.4	.7
1% Average Excess Health Care Cost Growth	42.7	4.8
2% Average Excess Health Care Cost Growth	66.5	7.5

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. If a constant ratio of debt to- GDP is not achieved and the ratio continues to rise continuously, long-term interest rates would be expected to rise further, worsening the debt ratio in the process. Chart 6 and Table 5 display several alternative scenarios where differing interest rate assumptions are used from the base case found in the Social Security trustees' report. In the scenario where the interest rate rises a constant one-half percentage point above the base projection starting in 2012, the debt-to-GDP ratio in 2086 rises from 287 percent to 378 percent. As shown in Table 5, the present value imbalance falls from $6.4 trillion to $5.5 trillion. Adding a full percentage point to the base projection starting in 2012 raises the 2086 debt-to-GDP ratio to 502 percent, but drops the 75-year fiscal imbalance to $4.7 trillion. To show the effects of achieving balance and lowering long-term debt-to-GDP and interest rates, lowering interest rates by one-half percentage point from the base projection starting in 2012 in turn lowers the 2086 debt ratio to 220 percent; however lowering the interest rate raises the 75-year present value imbalance to $7.6 trillion. It is clear that there is risk to continuing down a path of rising debt-to-GDP ratios, with a compounding impact that could lead to even worse consequences if no policy actions are taken.

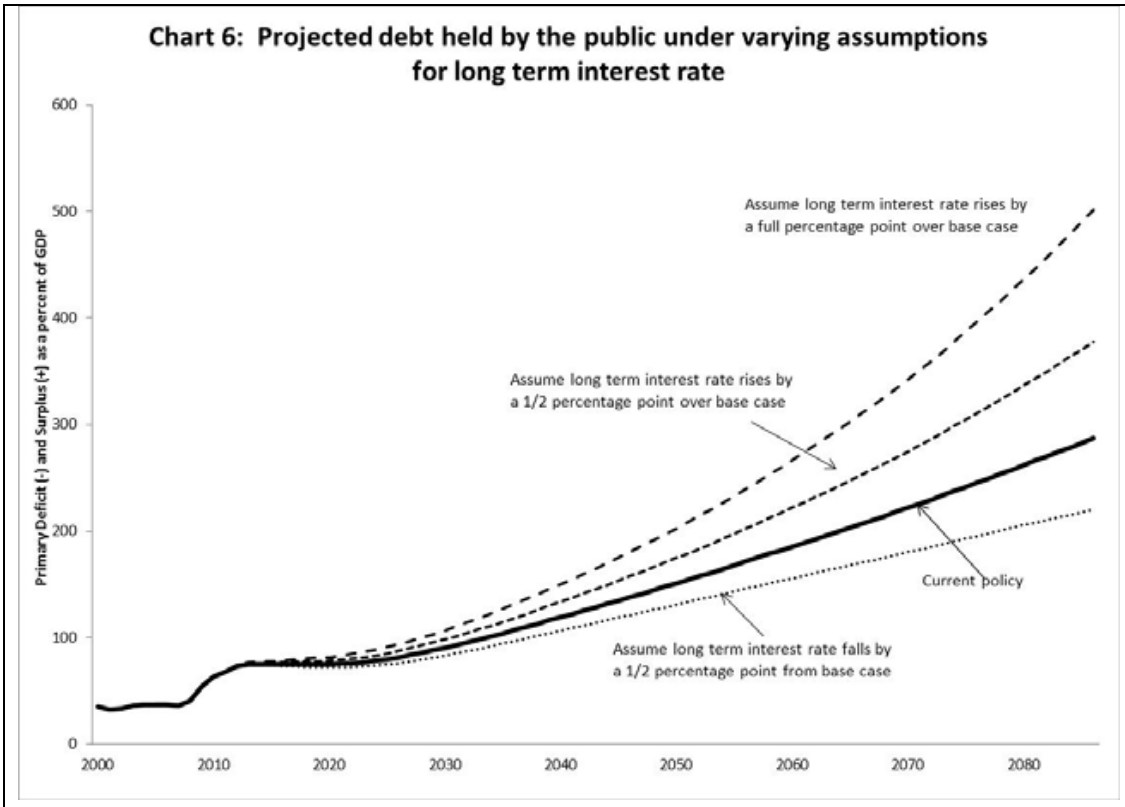


Chart 6: Projected debt held by the public under varying assumptions for long term interest rate
Primary Deficit (-) and Surplus (+) as a percent of GDP
600
500
400
300
200
100
0
2000
2010
2020
2030
2040
2050
2060
2070
2080
Assume long term interest rate rises by a full percentage point over base case
Assume long term interest rate rises by a 1/2 percentage point over base case
Current policy
Assume long term interest rate falls by a 1/2 percentage point from base case

Table 5

Impact of Alternative Interest Rate Scenarios on 75-year PV Imbalance

Scenario	75-Year Present Value Fiscal Imbalance	
	Dollars in Trillions	% GDP
Base Case: 0% Average Excess Health Care Cost Growth	6.4	.7
1% Average Excess Health Care Cost Growth	42.7	4.8
2% Average Excess Health Care Cost Growth	66.5	7.5

Other key economic assumptions in this report include the future growth rate of real GDP, which itself depends on assumptions such as future growth in the labor force and labor productivity. Historically, U.S. labor productivity has increased at a rate of about 2 percent or more per year, but there have been periods when productivity grew less rapidly and other periods in which it grew faster. Productivity growth has averaged 2.5 percent per year over the last 15 years, which is above its long-run trend. In these projections, the rate of productivity growth is assumed to be somewhat below its long-run trend, which is a conservative assumption. It is unlikely that higher productivity growth will be sufficient to resolve the long-run budget problem. Faster growth will lead to higher wages, which will lead to more tax revenue in the near term, but these gains will be partly offset by higher payments for Social Security and other benefit programs in the long term, because benefits are tied to wages. Inflation is not a major factor in these calculations. Changes in the trend rate of inflation have offsetting effects on future revenues and future spending, so the budget effect is more nearly neutral in the long run.

c) International Context

Paragraph 42 of SFFAS 36 provides that:

[42] RSI should also include an explanation of the significance of the data presented or other information that puts the data into context. Options for context may include but are not limited to:

a. comparison of the data/trend with past U.S. trends and trends in other developed nations,
b. where to find information about outside organizations that use similar data to assess the long-term implications for an entity or sovereign government, for example, the role of rating organizations and/or European Union rules for member nations, and/or
c. information that may be helpful to readers in assessing whether financial burdens without related benefits were passed on by current-year taxpayers to future-year taxpayers.

This requirement is addressed on page 157 of the CFR:

> *From the FY 2011 CFR:*
>
> **Fiscal Projections in Context**
> All of the major countries of the world have outstanding government debt. The United States Government's debt as a percentage of GDP is relatively large compared with other countries, but far from the largest among the countries in the Organization for Economic Co-operation and Development (OECD). Based on historical data as reported by the OECD, the 31 OECD countries ranged in debt ratios in 2009 from 6 percent of GDP to 126 percent of GDP, with the United States in the higher echelon.[12] However, each country is different in how it finances its sovereign debt, how robustly its economies grow, and how fair and stable taxation and benefits are across generations and income levels, so the comparison of current debt levels across nations and what they mean for fiscal projections across nations is not well defined. Past accrual of debt is certainly important, but future action encompassed in fiscal projections is a more prudent gauge for comparison.
>
> Several countries have begun to produce long-range fiscal projections in the last two decades. However, comparisons are difficult because the coverage of the reports and the time horizon projected vary across countries. The horizon for most of these reports is less than 75 years, and the projections are not always updated annually. Some of the countries that have produced long-range projections have shown sustainable policies in the long run, although the recent

financial crisis will have worsened the near-term budget outlook in almost every country. Early developers of such fiscal projections include Australia, New Zealand, Canada, the United Kingdom, Denmark, Sweden, Norway, and the Netherlands. [13]

12 Central Government Debt, OECD National Accounts Statistics (database) available at http://www.oecd-ilibrary.org/finance-andinvestment/total-central-government-debt-2010_20758294-2010-table1
13 The Organization for Economic Cooperation and Development (OECD) released a policy brief in October 2009 (available at http://www.oecd.org/dataoecd/40/26/43836144.pdf) describing the efforts of different member countries to produce long-term fiscal projections.

d) Trends Beyond the Projection Period

Paragraph 43 of SFFAS 36 requires discussion of trends beyond the projection period:

[43] RSI should discuss the implications of the trends in receipts and spending for periods following the end of the projection period. This requirement may be met by providing projections for an infinite horizon or a narrative discussion.

This requirement is addressed by narrative on page 151 of the CFR:

> *From the FY 2011 CFR:*
>
> If these projections were extended beyond 2086, deficits excluding interest would persist as the population continues to age and if the other assumptions made for the 75-year horizon continue to hold. Persistence of the primary deficit beyond the 75-year horizon implies that the ratio of debt to GDP would continue to grow beyond the 75-year horizon

Question 2

Does the Board wish to provide feedback to the preparers on the required additional narrative and graphics?

3. Basic Financial Statement and Accompanying Narrative

The requirements for the basic financial statement, "Long-Term Fiscal Projections of Federal Receipts and Spending," are in paragraphs 36 - 40 of SFFAS 36:

[36] The basic financial statement, Long-Term Fiscal Projections for the U.S. Government, should state the projection period and display the following projected amounts as both present value dollars and as a percentage of the present value of GDP for the projection period indicated:

a. receipts, disaggregated by major programs such as Medicare, Social Security, and all other receipts, and total receipts;[19]

b. non-interest spending, disaggregated by major programs such as Medicare, Medicaid, Social Security, and all other non-interest spending, total non-interest spending; and

c. the difference between projected receipts and projected non-interest spending.

[19] Full payment of amounts due to Social Security and Medicare HI Trust Funds must be included as receipts for Medicare and Social Security, and outlays for "rest of government."

[37] After the initial year of implementation, the basic financial statement should also present comparative amounts for the current year and prior year, and the net change for each line item from the prior year as both present value dollars and as a percentage of the present value of GDP for the projection period indicated.

[38] Fiscal gap information should be provided, either on the face of the financial statement or in the disclosures.

[39] Disclosures should include an explanation of the following limitations:

a. Forward-looking projections require assumptions and estimates relating to future events, conditions, and trends; actual results may differ materially from those that are projected.

b. Forward-looking projections focus on future cash flows, and do not reflect either the accrual or modified-cash basis of accounting.

c. Projections are <u>not</u> forecasts or predictions; they are designed to answer the question "what if?" – for example, what would be the impact on federal borrowing if current policies without change were continued for a long period of time?

d. Forward-looking projections may also encompass hypothetical future trends or events that are not necessarily deemed probable (for example, the assumed ability to continue issuing new public debt indefinitely).

e. Fiscal Sustainability Reporting is limited to the activity of the federal government, and does not include activities of state and local governments or the activities of the private sector.

f. The summary measures cover a finite period and consideration should be given to trends following the end of the projection period. Disclosures should refer the readers to the RSI for a further discussion of this limitation.[20]

[[20]] See paragraph 42.

[40] Disclosures should also include:

a. a "plain English" explanation of present value and interest rates used to calculate present value.

b. significant policy assumptions used in making the projections.

c. any significant differences in economic and demographic assumptions from those used for Social Security and/or Medicare in the preparation of the SOSI and a reference to the note presenting assumptions used in the SOSI.

d. an explanation of the most significant departures from current law–for example, allowing for exceeding the statutory limit on federal debt.

e. the significant reasons for the changes when year-by-year comparisons are displayed. For example, significant changes may be attributable to the following broad causes:

   (1) valuation period (for example, the beginning of the projection period is one year later);

   (2) changes in policies (legislation); and

   (3) changes in assumptions or estimates.

f. The net excess of non-interest spending over receipts disaggregated between (1) programs funded by the government's general revenues (which would currently[21] include Federal Supplementary Medical Insurance (Medicare Parts B and D), as well as other programs), and (2) major programs that are funded by payroll and self-employment taxes and that are not financed in any material respect by the government's general revenues (which would currently consist of Social Security (Old Age, Survivors and Disability Insurance (OASDI)) and Medicare Part A), accompanied by a discussion of the different funding mechanisms for the two types of programs.

[[21]] Currently" means as of the date of Board approval of this SFFAS in June 2009.

The FY 2011 CFR addressed these requirements as follows.

From the FY 2011 CFR, page 148:

Table 1: Long-Term Fiscal Projections of Federal Receipts and Spending						
	75-Year Present Values[1]					
	Dollars in Trillions			% GDP[2]		
Receipts:	2011	2010	Change	2011	2010	Change
Social Security Payroll Taxes	39.1	37.8	1.3	4.4	4.4	0.0
Medicare Payroll Taxes	13.0	12.4	0.6	1.5	1.4	0.0
Individual Income Taxes	93.5	90.6	2.9	10.5	10.5	0.0
Other Receipts	34.7	34.4	0.3	3.9	4.0	-0.1
Total Receipts	**180.2**	**175.2**	**5.0**	**20.3**	**20.2**	**0.0**
Non-interest Spending:						
Defense Discretionary	28.7	31.0	-2.3	3.2	3.6	-0.4
Nondefense Discretionary	15.4	30.7	-15.4	1.7	3.6	-1.8
Social Security	51.8	49.1	2.6	5.8	5.7	0.1
Medicare Part A[3]	17.6	17.3	0.4	2.0	2.0	0.0
Medicare Parts B&D[4]	21.1	20.4	0.7	2.4	2.4	0.0
Medicaid	24.0	24.2	-0.3	2.7	2.8	-0.1
Other Mandatory	28.1	18.8	9.3	3.2	2.2	1.0
Total Non-interest Spending	**186.7**	**191.6**	**-4.9**	**21.0**	**22.1**	**-1.2**
Non-interest Spending less Receipts	6.4	16.3	-9.9	0.7	1.9	-1.2

1/ 75-year present value projections for 2011 are as of 9/30/2011 for the period FY 2012-2086; projections for 2010 are as of 9/30/2010 for the period FY 2011-2085.

2/ The 75-year present value of nominal GDP, which drives the calculations above is $889.8 trillion starting in FY 2012, and was $865.6 trillion starting in FY 2011.

3/ Represents portions of Medicare supported by payroll taxes.

4/ Represents portions of Medicare supported by general revenues. Consistent with the President's Budget, Parts B & D are presented net of premiums.

From the FY 2011 CFR, pages 147-151:

Fiscal Projections for the U.S. Government – FY 2011

This section is prepared pursuant to Statement of Federal Financial Accounting Standard (SFFAS) 36, Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government. It is intended to help readers of the Financial Report of the U.S. Government (FR) assess whether future budgetary resources will be sufficient to sustain public services and to meet future obligations as they come due, assuming that the Federal Government's current policies for spending and taxation are continued. Such an assessment requires prospective information about receipts and spending, the resulting debt, and how these amounts relate to the economy. The assessment is also referred to as reporting on "fiscal sustainability."

The information in this section is important not only for its financial, but also its social and political, implications. Financial reports should provide information that can help readers assess the likelihood that the Government will be able to continue providing the equivalent level of public services and to assess whether financial burdens without

related benefits will be shifted to future taxpayers. Fiscal sustainability reporting should assist the reader in understanding these financial, social, and political implications.

The projections and analysis presented here are mathematical extensions and extrapolations based on an array of assumptions as described below, including the assumption that current Federal policy does not change. These projections cannot be interpreted as forecasts or predictions of the future, in part because they encompass hypothetical future trends or events that are improbable. This is the second year in which this information is included with the other Supplemental Information, and the methods and assumptions used in producing this section are still under development.

Statement of Long Term Fiscal Projections

Table 1, on the following page, presents projections of the Federal Government's receipts and non-interest spending.[1] Receipt categories include individual income taxes, Social Security and Medicare payroll taxes, and all other receipts. On the spending side, the projections include both discretionary programs, such as defense spending, which are funded through annual appropriations, and mandatory (entitlement) programs, such as Social Security and Medicare, which generally provide benefits under permanent or multi-year appropriations. The Federal budget provides the framework used for the projections in Table 1, which differs in some respects from the presentation of the projections in the trustees' reports for Social Security and Medicare (as explained below). The key assumptions used in the long-term fiscal projections are summarized in the next section. This year's projections for Social Security and Medicare are based on the same economic and demographic assumptions as are used for the 2011trustees' reports and the Statement of Social Insurance, while comparative information presented from last year's report is based on the 2010 trustees' reports. Projections for the other categories are consistent with the assumptions used for the trustees' reports. In order to produce a more realistic projection of the fiscal outlook under current policy, the projections assume several likely departures from current law, noted below.

The projections in Table 1 are expressed in present value dollars as of October 1, 2011, and as a percentage of the present value of Gross Domestic Product (GDP).[2] The present value of a future amount, for example, $1 billion in March 2021, is the amount of money that if invested on October 1, 2011 in an account earning the government borrowing rate would have a value of $1 billion in March 2021.[3] The present value of a receipt or expenditure category over 75 years is the sum of the annual present value amounts. GDP measures the total value of all final goods and services produced in the U.S. in a year and is a standard measure of the overall size of the economy. When expressing a receipt or expenditure category over 75 years as a percent of GDP, the present value dollar amount is divided by the present value of GDP over 75 years. Measuring receipts and expenditures as a percentage of GDP is a useful indicator of the economy's capacity to sustain Government programs. The interest rates used to compute present values are the rates that underlie the projections in the 2011 Social

Security and Medicare trustees' reports, with comparative present values presented from last year's report consistent with the 2010 trustees' report. The use of discount factors consistent with the Social Security actuaries rate allows for consistent present value budget calculations over 75 years between this report and the trustees' reports. Present value calculations under higher and lower interest rate scenarios are presented in the "Alternative Scenarios" section.

The projections shown in Table 1 are made over a 75-year time frame, consistent with the time frame featured in the Social Security and Medicare trustees' reports. As discussed later, one notable difference between the analysis in the Long-Term Fiscal Projections and the trustees' reports is that these projections are based on fiscal years starting on October 1, 2011, whereas the trustees' reports feature projections made on a calendar-year basis. This difference allows the projections to start from the actual results from fiscal year 2011. This Report also considers the period of time beyond the 75-year window, noting most importantly that the assumptions become more uncertain the further in time the projections are extended. This report compares projections of fiscal sustainability between 2011 and 2010, with significant changes between the two years evident in Table 1 and characterized and explained in Table 2 in the "Current Policy Projections for Primary Deficits" section.

Just as the financial statements give information about the financial position of the Federal government, but not State or local governments, the analysis and discussion of long-term fiscal projections for the U.S. Government does not address the fiscal sustainability of State and local governments.

1 For the purposes of this analysis, spending is defined in terms of outlays. In the context of Federal budgeting, spending can either refer to budget authority – the authority to commit the government to spend an amount – or to outlays, which reflect actual payments made.

2 GDP is the total market value of all final goods and services produced domestically during a given period of time. The components of GDP are: private sector consumption and investment, government consumption and investment, and net exports (exports less imports). Equivalently, GDP is a measure of the gross income generated from domestic production over the same time period.

3 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.

Assumptions Used and Relationship to Other Financial Statements

A fundamental assumption underlying the projections in Table 1 is that current Federal policy – as defined below –does not change. The projections are therefore neither forecasts nor predictions. If policy changes are enacted, perhaps in response to projections like those presented here, then actual fiscal outcomes will of course be different than those projected.

Even if policy does not change, actual expenditures and receipts could differ materially from those projected here. This is because the long-range projections are inherently uncertain and because simplifying assumptions are made. One key simplifying assumption, for example, is that interest rates paid on public debt remain unchanged, regardless of the amount of debt outstanding. It is likely that if the debt rises as shown in these projections, future interest rates will increase. To help illustrate this uncertainty, present value calculations under higher and lower interest rate scenarios are presented in the "Alternative Scenarios" section.

The projections in Table 1 focus on future cash flows, and do not reflect either the accrual basis or the modified-cash basis of accounting. These cash-based projections reflect receipts or spending at the time cash is received or when a payment is made by the Government. In contrast, accrual-based projections would reflect amounts in the time period in which income is earned or when an expense or obligation is incurred. The cash basis is consistent with methods used to prepare the Statement of Social Insurance (SOSI) and the generally cash-based Federal budget.

The following summarizes the assumptions used for the key categories of receipts and spending presented in Table 1 and in the related analysis:

• **Social Security**: Social Security (OASDI) spending in the fiscal projections is based on the projected expenditures in the Social Security trustees' report for benefits,[4] plus the Railroad Retirement interchange, but excluding administrative expenses. The projections of Social Security payroll taxes and future Social Security spending begin with actual budget data for FY 2011. The projected growth rates for future spending and payroll taxes are derived from the spending and tax growth rate projections underlying the latest trustees' report.

• **Medicare**: Current law Medicare spending is based on incurred expenditures from the 2011 Medicare trustees' report, which reflects the changes in Medicare that are projected to result from passage of the Affordable Care Act (ACA) in 2010. However, some adjustments are required to convert these amounts to Medicare spending as measured in these projections and in the budget. Medicare Part B and D premiums,[4] as well as State contributions to Part D, are subtracted from gross spending in measuring Part B and Part D outlays in the projections and the budget just as they are subtracted

from gross cost to yield net cost in the financial statements.[5] The budget treats the premiums as "negative spending" rather than receipts, since they represent payment for a service. This is similar to the financial statement treatment of premiums as "earned" revenue as distinct from all other sources of revenue, which are unearned. In the budget, Government receipts are defined as payments obtained through the Government's sovereign power to tax, similar to (unearned) revenue in the financial statements. With these adjustments, Medicare spending net of administrative costs corresponds to Medicare spending in the budget. The 2011 long-term fiscal projection uses historical budget data from FY 2011 for Medicare spending and Part A payroll tax revenues, with both growing at growth rates presented in the trustees' report. Also, as discussed in Note 26, there is uncertainty about whether the projected reductions in health care cost growth will be fully achieved. Note 26 includes an alternative projection to illustrate the uncertainty of projected Medicare costs.

• **Medicaid**: The model for the Medicaid program starts with the projections from the 2010 Actuarial Report on the Financial Outlook for Medicaid prepared by the Office of the Actuary, Centers for Medicare and Medicaid Services (CMS).[6] As projections in that report only extend until 2019, the model assumes that Medicaid benefits in 2020 and later years grow at the same rate per beneficiary as Medicare benefits grow. Supporting this assumption is a historical trend where the average annual growth in Medicaid outlays per beneficiary from 1987 to 2011 has been within 0.2 percent growth per year of the average annual growth in Medicare outlays per beneficiary over the same period. The model accounts for the effects of the ACA to reflect higher future enrollment, as calculated by CMS, and reflects other adjustments to align the base projections with the latest budget data. The Medicaid projections reflect the temporary increase in Medicaid spending due to the American Recovery and Reinvestment Act of 2009 (ARRA) and the phaseout of that spending.

• **Other Mandatory Spending**: Other mandatory spending components are assumed to increase by the rate of growth in nominal GDP, implying that such spending will remain constant as a percentage of GDP in the long run. Adjustments are made for temporary spending that is not expected to persist in the long run: the mandatory spending authorized by ARRA and other stabilization measures including temporary expansions in unemployment insurance benefits, the implementation of the Troubled Asset Relief Program (TARP), the purchase of government sponsored enterprise (GSE) preferred stock, and higher net spending for the Federal Deposit Insurance Corporation (FDIC). The 75-year present value of these temporary measures totals $0.1 trillion.

• **Discretionary Spending:** In these projections, aside from the expected reductions in Overseas Contingency Operations (OCO) spending, discretionary spending is capped at the levels enacted in the Budget Control Act of 2011 (BCA) through FY 2021, after which it resumes growth at the same rate as nominal GDP, and thus plateaus at a long-term level of 3.1 percent of GDP by 2023 once the OCO adjustment has been fully phased out. Adjustments are made for the discretionary components of temporary spending authorized by ARRA. The 75-year present value of OCO and the discretionary measures

in ARRA total $0.6 trillion, or 0.1 percent of present value GDP.

• **Receipts (Other than Social Security and Medicare)**: Instead of attempting a projection of the entire income distribution, the fiscal projections link individual income taxes to wages and salaries, and all other receipts to GDP. Individual income taxes are projected to return to their historical ratio to wages and salaries of about 17 percent over the next several years, and from that point on to increase gradually to almost 28% in 2086 to reflect the progressive nature of the Federal income tax, which implies that as real wages rise over time, the average taxpayer will move into higher tax brackets. The levels of individual income taxes are also adjusted over the next several years for the phase-out of the temporary tax cuts enacted by ARRA. Computing individual income taxes as a ratio of wages and salaries allows the projections to reflect changes in the ratio of taxable income to total GDP. All other receipts also rise over the next several years back to their historical ratio to GDP of around 4 percent from 1979 through 2010.

• **Further Budget Control Act (BCA) Deficit Reduction:** The BCA created the Joint Select Committee on Deficit Reduction with a goal to reduce the deficit by at least $1.5 trillion. Because the Joint Committee failed to reach agreement on a deficit reduction proposal, under current law automatic procedures specified in the BCA will result in $1.2 trillion in reductions in discretionary and mandatory spending through 2021. The projections assume that such automatic reductions occur or that the reductions are replaced with an equivalent set of cuts, with the effects estimated through 2021 using the procedures set forth in the BCA and the resulting lower levels of spending grown with nominal GDP thereafter.

• **Interest Spending**: Interest spending is determined by projected interest rates and the level of outstanding debt held by the public. The long-run interest rate assumptions convert those in the 2011 Social Security Trustees Report[7] to a fiscal year basis. The average interest rate over the projection period is 5.6 percent. These rates are then used to convert future cash flows to present values as of the start of fiscal year 2012.

Departures from Current Law and Policy

As noted earlier, the long-term fiscal projections are made on the basis of current Federal policy, even where current Federal policy would not be continued under provisions of current law. For example, the projections presented in Table 1 and throughout this analysis are made without regard to the statutory limit on outstanding Federal debt. The projection also assumes several other departures from current law: continued discretionary appropriations throughout the projection period, the continued payment of Social Security and Medicare benefits beyond the projected point of trust fund exhaustion, extension of some of the 2001/2003 tax cuts, indexing of the alternative minimum tax (AMT), and the reauthorization of many mandatory programs with expiration dates prior to the end of the 75-year projection period. The projections assume reductions in Medicare physician fees will occur as scheduled under current law, just as they are reflected in the Medicare trustees' report and in the Statement of

Social Insurance.[8]

4 As indicated in the more detailed discussion of Social Insurance in Note 26 to the financial statements.

5 Medicare Part B and D premiums and State contributions to Part D are subtracted from the Part B and D spending displayed in Table 1. The total 75-year present value of these subtractions is $8.1 trillion, or 0.9 percent of GDP.

6 Christopher J. Truffer, John D. Klemm, Christian J. Wolfe, and Kathryn E. Rennie *2010 Actuarial Report on the Financial Condition for Medicaid*, Office of the Actuary, Centers for Medicare and Medicaid Services, United States Department of Health and Human Services.

7 As indicated in the more detailed discussion of Social Insurance in Note 26 to the financial statements. Congress has acted repeatedly to prevent the reductions in Medicare physician fees from taking place, but recent actions have also included spending reductions to offset the cost of physician fee relief. The assumption here that future reductions will occur as scheduled under current law is comparable to an assumption that the reductions will be overridden but the resulting costs will be paid for with reductions in other areas.

8 Congress has acted repeatedly to prevent the reductions in Medicare physician fees from taking place, but recent actions have also included spending reductions to offset the cost of physician fee relief. The assumption here that future reductions will occur as scheduled under current law is comparable to an assumption that the reductions will be overridden but the resulting costs will be paid for with reductions in other areas.

Question 3

Does the Board wish to provide feedback to the preparers on the basic financial statement and accompanying narrative?

QUESTIONS

1. Does the Board wish to provide feedback to the preparers on the reporting of the cost of delay?

2. Does the Board wish to provide feedback to the preparers on the required additional narrative and graphics?

3. Does the Board wish to provide feedback to the preparers on the basic financial statement and accompanying narrative?