



September 7, 2007

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: Fiscal Sustainability Reporting- **Tab B**

NOTE: 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.

Goals for this agenda session:

- 1) To obtain Board consensus on objectives of fiscal sustainability reporting, and
- 2) Educational session: to discuss issues relating to assumptions, particularly budget policy assumptions for revenue and spending projections

1) Objectives: Fiscal sustainability reporting

The attached draft objectives (Section 1) reflect comments received from members through August 27, 2007. This document includes a discussion of existing requirements on forward-looking reporting in the Management's Discussion and Analysis (SFFAC 3 and SFFAS 15), including the broad concept of "financial condition."

The draft objectives are intended to clarify that the scope of the proposed reporting requirements would be limited to the Financial Report of the U.S. Government, and would not impact agency-level financial statements or any potential "stand-alone" report that might be required by law in the future.

Questions for the Board:

- a. Is the scope of the objectives sufficiently clear?
- b. Are there any objections to the attached draft objectives?

2) Assumptions

Attached at Section 2 is a discussion of assumptions. The objective of the Financial Report of the U.S. Government is to provide useful information to readers in support of the Fiscal Sustainability reporting objectives, and not to provide policy recommendations. Ideally, projections of future inflows and outflows should be reasonable, policy-neutral and consistent with current law. However, a major difficulty arises when current law is:

- (1) inconsistent with reasonable expectations,
- (2) does not extend far enough in the future, or
- (3) does not address events that may be reasonably expected to occur.

The attached discussion includes a summary of current practices and Task Force recommendations, as well as a staff analysis and tentative staff recommendations.

Questions for the Board begin on page 14.

3) “Plain English” FAQs

Attached at Section 3 are “plain English” FAQs for use as a reference. The FAQs may also be included in a future exposure draft.

4) General Comments

Also attached are some general comments from Dr. C. Eugene Steuerle. Staff believes that Dr. Steuerle’s comments might relate more directly to the issue of reporting social insurance obligations/promises/liabilities than to the focus of this paper (objectives of fiscal sustainability reporting and assumptions for Federal government-wide revenues and spending), but they are included in this package because Dr. Steuerle directed his comments to the full Board.

Attachments:

Section 1: Objectives

Section 2: Assumptions

Section 3: “Plain English” FAQs

Section 4: General comments from Dr. C. Eugene Steuerle

Section 1: Objectives

Objectives of Fiscal Sustainability Reporting

Background: Federal Financial Reporting Objectives

1. In SFFAC 1, the Board established four objectives of federal financial reporting. These objectives provide a framework for assessing the existing accountability and financial reporting systems of the Federal Government and for considering new accounting standards.¹ The four objectives address:
 1. Budgetary Integrity,
 2. Operating Performance,
 3. Stewardship, and
 4. Systems and Controls.
2. Objective 3, Stewardship, is the primary focus for this [proposed] statement. Objective 3 says that:

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.²
3. Sub-objective 3B states that:

Federal financial reporting should provide information that helps the reader to determine whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.³
4. While federal financial reporting is not expected by itself to accomplish the stewardship reporting objective, it can contribute to meeting the objective.⁴ Sub-objective 3B is concerned with the future and with the resources expected to be consumed through programs of the federal government in the future. Other nations have addressed such concerns through reports addressing “fiscal sustainability.” While a precise definition has not been developed, countries generally describe fiscal sustainability in a manner consistent with the following statement:

Fiscal sustainability is the government’s ability to manage its finances so it can meet its spending commitments, both now and in the future. It ensures future generations of taxpayers do not face an unmanageable bill for government services provided to the current generation.⁵
5. Adding information about fiscal sustainability to the consolidated financial report of the

¹ SFFAC 1, par. 109.

² SFFAC 1, par. 134.

³ SFFAC 1, par. 139.

⁴ SFFAC 1, par. 235.

⁵ Australia, Intergenerational Report 2002-3, page 2. Available at: http://www.budget.gov.au/2002-03/bp5/html/02_BP5Overview.html#P23_3643

US Government would contribute to meeting subobjective 3B of the overall stewardship objective. The more detailed objectives of fiscal sustainability reporting presented below were developed as one means of guiding the Board in selecting from a variety of possible graphic, tabular and/or statement formats as well as in identifying the most important areas to be addressed in narrative.

Objectives of Fiscal Sustainability Reporting

6. Fiscal sustainability reporting should provide information to assist readers of the Financial Report of the U.S. Government in answering the following questions:
 - Will future budgetary resources of the U.S. Government likely be sufficient to sustain future public services and to meet obligations as they come due?
 - Does the balance of future budgetary resources and future claims potentially lead to unsustainable increases on Federal borrowing?
 - Are future generations of taxpayers likely to face higher taxes and/or more limited government services?
 - Do current government operations and current trends shift costs of services for past and current generations to future generations?
7. In order to answer these questions, fiscal sustainability reporting should include forward-looking information about the future effects of current and anticipated⁶ demands, risks, uncertainties, events, conditions and trends.
8. Assessing whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due is important not only because it has financial implications but also because it has social and political implications. For example, users of financial reports want information that is helpful in assessing the likelihood that the government will continue to provide the current level of benefits and services to constituent groups and to assess whether financial burdens were passed on by current-year taxpayers to future-year taxpayers without related benefits. The latter notion is sometimes referred to as “interperiod equity.”
9. Fiscal sustainability reporting should be understandable to the intended audience of the Financial Report of the U.S. Government. The primary intended users of this report are citizens and citizen intermediaries (such as the media, public interest and advocacy groups, and others). The Financial Report of the U.S. Government should be easily understandable to the “average citizen” who has a reasonable understanding of Federal

⁶ SFFAS 15, par. 3, footnote 3 - "Anticipated" may include the effects of future events that are deemed probable, for which a financial forecast would be appropriate. The term may also encompass hypothetical future trends or events that are not necessarily deemed probable, for which financial projections may be appropriate.

government activities and is willing to study the information with reasonable diligence. Moreover, the Financial Report of the U.S. Government is a general purpose report; it tells users where to find additional information in other reports and publications, such as reports issued by the Department of the Treasury, the Government Accountability Office, the Office of Management and Budget, and the Congressional Budget Office.⁷

Scope of [proposed] Fiscal Sustainability Reporting Requirements

10. The [proposed] reporting requirements for fiscal sustainability reporting apply to the consolidated financial report of the U.S. Government. They do not apply to financial statements prepared at the agency level. They also do not affect the reporting in the *Budget of the U.S. Government* or any other special purpose type of report.

Limitations of Fiscal Sustainability Reporting

11. The [proposed] fiscal sustainability reporting should include an explanation of the following limitations:
 - (a) Forward-looking statements are projections that require assumptions and estimates relating to future events, conditions, and trends, and actual results may differ materially from those that are projected in the forward-looking statements;
 - (b) Where indicated, forward-looking statements may also encompass hypothetical future trends or events that are not necessarily deemed probable (such as the assumed ability to continue issuing new public debt indefinitely), for which financial projections may be appropriate.
 - (c) Fiscal sustainability reporting is limited to the activity of the Federal government, and does not include activities of state and local governments.

⁷ See SFFAC 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*, par. 6-7 and 15-20.

Draft Basis for Conclusions

[Staff note: The following background information could be included in the Basis for Conclusions section.]

Financial Position versus Financial Condition

- A 1. Fiscal sustainability reporting is focused on the financial condition of the Federal government as a whole. Financial condition is forward-looking and multi-dimensional. Assessing financial condition would require financial and non-financial information related to the long-term fiscal outlook for the Federal government. Therefore, fiscal sustainability reporting should provide information about the future to help readers assess the magnitude of future spending and revenues and the burden that any resulting deficits might place on future taxpayers.⁸
- A 2. Indicators of financial position, such as the balance sheet, are the starting point for reporting on financial condition but must be supplemented in a variety of ways. For example, trends in financial position may assist readers in assessing the overall direction of the Federal government's finances. However, readers may find, among other things, a current law budget projection under a range of alternative assumptions⁹ to be helpful in assessing the financial condition of the U.S. Government. Presenting information about the overall size of the economy relative to the budget projections may assist readers in assessing whether the projected budget amounts are reasonable in comparison to past experience or the experience of other countries. Thus, reporting on financial condition requires financial and nonfinancial information about the national economy and society, as well as about the government itself.¹⁰ Table 1, "Comparison of Financial Position and Financial Condition," summarizes the distinguishing characteristics of Financial Position and Financial Condition.

⁸ SFFAC 1, par. 262.

⁹ SFFAC 1, par. 145.

¹⁰ SFFAC 1, par. 144.

Table 1: Comparison of Financial Position and Financial Condition

Financial Position	Financial Condition
Entity perspective	Broad perspective including national trends
Accrual based data	Additional, forward-based information
Financial data	Financial and nonfinancial data
Assets, liabilities and net position	Future effects of: <ul style="list-style-type: none">• current demands, risks and uncertainties, and• anticipated future events, conditions and trends
Example: Balance Sheet	Examples: <ul style="list-style-type: none">• Projections of revenue and spending• Nonfinancial data, such as demographic trends• Past and projected future Federal activity relative to GDP

A 3. SFFAC 3, *Management's Discussion and Analysis* (MD&A), addressed many of the elements of financial condition. SFFAC 3 says that the MD&A should answer questions such as the following, to the extent that they are relevant and important for the entity:

What is the potential effect of changed circumstances, and of expected future trends? In other words, to the extent that it is feasible to project the effects of these factors, will future financial position, condition, and results, as reflected in future financial statements, probably be different from this year's and, if yes, why? (Any such discussion should acknowledge that the future is unpredictable and will be influenced by factors outside the reporting entity's control, including actions by Congress.)¹¹

A 4. SFFAC 3 describes three different categories of information:

- Current demands, risks, uncertainties, events, conditions, and trends;
- Future effects of current demands, risks, uncertainties, events, conditions and trends; and
- Future effects of anticipated future events, conditions, and trends.¹²

¹¹ SFFAC 3, par. 14.

¹² SFFAC 3, par. 31-33.

Section 2: Assumptions

Assumptions (Policy and Economic)

Introduction

The objective of the Financial Report of the U.S. Government is to provide useful information to readers in support of the Fiscal Sustainability reporting objectives, and not to provide policy recommendations. Ideally, projections of future inflows and outflows should be reasonable and consistent with current law.

Note: Due to the inherent uncertainty of long-range policy and economic assumptions, any “base” scenario selected would be incomplete without an accompanying discussion that includes alternative assumptions.

Primary Challenge: Limitations of “Current Law” Assumptions

A major difficulty arises when current law is (1) inconsistent with reasonable expectations, (2) does not extend far enough in the future, or (3) does not address events that may be reasonably expected to occur.

An example of the first situation, “inconsistent with reasonable expectations,” is when:

- current law includes tax provisions such as tax cuts that expire within several years, and
- there has been a historical trend of extending those tax provisions before they expire — but only for a short period, generally one year.

“Current law” would indicate that the tax provisions will expire on schedule, while “reasonable expectations” based on recent historical trends would indicate that the tax provisions will be extended.

An example of the second situation, “does not extend far enough into the future,” is discretionary spending for which funding is only legislated on a year-by-year basis.¹³ In such cases, “current law” does not extend beyond the next few years; in many cases it extends for only one year. Another example is authorizing legislation that expires in a few years (such as student assistance for higher education or agricultural price supports).

An example of the third situation, “does not address events that may be reasonably expected to occur,” is when current law may contain a provision that restricts spending on certain social insurance programs, such as Social Security and Part A of Medicare, to the amounts in the Social Security or Medicare Trust Funds, respectively, plus current

¹³ In the Federal budget process, “discretionary spending” refers to outlays from budget authority that is controlled by annual appropriation acts. Annual appropriation acts are required for the continuing operation of all Federal programs that are not “mandatory.” “Mandatory spending” includes entitlement authority such as Social Security and Medicare and payment of interest on the national debt. Congress controls mandatory spending by controlling eligibility and setting benefit and payment rules, rather than by annual appropriation legislation. For additional information, see *A Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP. Available at: <http://gaoweb.gao.gov/gaoproducts.php>.

revenue. However, current law does not provide for any reductions in Social Security scheduled benefits or Medicare reimbursement rates due to lack of funding. Thus, current legislation does not address what will happen when the trust fund balances are exhausted, although this event may reasonably be expected to occur.¹⁴

Recommendations of the Technical Group, Fiscal Sustainability Task Force¹⁵

The consensus of the technical group was that policy assumptions inherent in the OMB Table¹⁶ - the 5-year President's Budget- should NOT be used for fiscal sustainability reporting. The technical task force members believe that fiscal sustainability reporting should not include proposed changes in policy.

A majority of the task force members believe that for mandatory spending, a modified version of "current law" (ignoring the trust-fund exhaustion cap), which might also be termed "current services" represents the most reasonable assumption for social insurance programs. However, several of the task force members believe that any deviation from current law requires a subjective judgment that can be biased; those members noted that the most common deviations from current law often appear to have the same direction of bias (increased deficits) for both revenue and outlay projections.

Projections for discretionary spending are more uncertain than projections for mandatory spending, since "current law" often only addresses the current year, although there was some agreement that projecting discretionary spending growth at the same rate as assumed Gross Domestic Product (GDP) per capita would be reasonable. However, it was noted that projecting defense discretionary spending is particularly difficult.

Reports issued by the Government Accountability Office (GAO) reflect the difficulty of choosing between current law and "reasonable expectations." The GAO's forward-looking reports often display two different projections: the 10-year CBO baseline, which is then projected into the future (called "baseline extended") and a different projection that includes expected modifications to the 10-year CBO baseline amounts (called an "alternative simulation").

¹⁴ According to the 2007 Trustees Reports, the Social Security Trust Fund is expected to be exhausted in 2041, and Medicare's Hospital Insurance Trust Fund is expected to be exhausted in 2019. For the first time, a "Medicare funding warning" was triggered in 2007, signaling that non-dedicated sources of revenues- primarily general revenues- will soon account for more than 45 percent of Medicare's outlays. By law, this warning requires that the President propose, and the Congress consider, remedial action. However, until remedial action is taken, it is difficult to determine how to project future spending for Medicare. A similar situation exists for Social Security, although the amounts are smaller and the expected date for trust fund exhaustion is much further in the future.

¹⁵ Handout: May 2007 Board meeting, page 2.

¹⁶ Table 13-2 in Chapter 13, "Stewardship" of *Analytical Perspectives*, U.S. Budget, FY 2008, page 184.

Staff believes that the GAO's approach to show two different sets of numbers provides a more complete picture than selecting one or the other. However, this approach does not achieve one of the most important characteristics of effective communication, one that was strongly emphasized by all of the Communications members, and many of the Technical members, of the task force: simplicity of presentation.

Table 2 below summarizes the policy assumptions that are used in reporting by the Treasury Department (reporting on social insurance in the Financial Report of the U.S. Government), the Government Accountability Office (GAO), the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), and the recommendations of the Fiscal Sustainability Task Force Technical Experts.

The current practices historically have varied at times: for example, a member of the Fiscal Sustainability Task Force noted that the OMB's projections historically have sometimes included "bracket creep"¹⁷ for revenues, and sometimes not.

¹⁷ "Bracket creep occurs because individual income tax brackets are indexed for inflation rather than wage growth. When wages grow faster than inflation, the effective tax rate increases, which can increase revenues as a share of GDP.

1 Table 2. Comparison of assumptions used by the Congressional Budget Office, the Office of Management and
2 Budget, the Treasury Department for the Statement of Social Insurance (SOSI), the Government Accountability
3 Office, and the Fiscal Sustainability Task Force Technical Experts recommendations
4

	CBO Baseline	OMB Stewardship Reporting	Treasury: SOSI in Financial Report of the U.S Government	GAO Baseline Extended	GAO Alternative Simulation	Task Force Technical Experts Recommendation
Policy Assumptions:						
Revenue: Earmarked (Social Security & Medicare)	Current Law	President's Budget	Current Law	Current Law	Current Law	Current Law
Revenue: Non- earmarked	CBO's last comprehensive long-range outlook had a baseline (Current Law) ¹⁸ and a variant that extended the 2001 and 2003 tax cuts for 10 years and then held revenues constant at 18.3% of GDP.	President's Budget for 2007- 2012, then gradually returning to 18.3% of GDP	N/A	CBO's baseline through 2017, then constant at 20.1% of GDP (CBO's projection at 2017	All expiring tax provisions extended through 2017, thereafter equal to 40- year historical average of 18.3% of GDP plus CBO's estimate of revenue from tax-deferred retirement plans	NOT President's budget 2007- 2012.

¹⁸ "Current Law" for non-earmarked revenue would imply that the 2001 and 2003 tax cuts expire and that the AMT expands vastly its reach (although eventually the AMT would diminish because bracket creep from real wage growth would push most people into a regular income tax rate that exceed the AMT rate).

	CBO Baseline	OMB Stewardship Reporting	Treasury: SOSI in Financial Report of the U.S Government	GAO Baseline Extended	GAO Alternative Simulation	Task Force Technical Experts Recommendation
Revenue: Additional assumptions	Variations with and without bracket creep			See GAO report cited below for additional detail.	See GAO report cited below for additional detail.	The primary question is whether or not to provide for “bracket creep” or to assume the historical constant of 18.3% of GDP.
Outlays: Mandatory	Deficit Control Act of 1985 ¹⁹ : (Current law, excluding trust fund “cap”)	President’s Budget excluding Social Security reform policy proposals	Current law, excluding trust fund “cap”	CBO baseline through 2017, then based on Trustees intermediate projections, and constant with GDP for other mandatory	Same as “Baseline Extended”	Current law, excluding trust fund “cap”
Outlays: Discretionary	Deficit Control Act of 1985 (grows with composite pay/nonpay inflation)	President’s Budget, then growth equal to nominal GDP growth	N/A	CBO baseline for first 10-years, then growth equal to nominal GDP growth	Growth equal to nominal GDP growth	No consensus; Possibilities include growth equal to assumed nominal GDP growth per capita,, or straight-lined as a constant share of GDP

¹⁹ Although the provisions of the Deficit Control Act that pertain to the baseline expired at the end of September of 2006, the CBO continues to follow the specifications of the Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974 in preparing its projections. See *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*, page 5. Available at: <http://www.cbo.gov/ftpdoc.cfm?index=7731>.

- 1 Sources:
- 2 **CBO Baseline:** *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*. Available at:
- 3 <http://www.cbo.gov/ftpdoc.cfm?index=7731>.
- 4 **OMB Stewardship Reporting:** Chapter 13, “Stewardship” of *Analytical Perspectives*, U.S. Budget, FY 2008
- 5 **SOSI/FR:** FY 2006 Financial Report of the U.S. Government
- 6 **GAO:** *The Nation’s Long-Term Fiscal Outlook*, April 2007 Update (GAO-07-983R)

Staff Analysis and Recommendations: Policy Assumptions

Introduction

As noted previously, although it might seem intuitive to base assumptions upon “current law,” major difficulties arise when current law:

- (1) appears to be inconsistent with reasonable expectations,
- (2) does not extend far enough into the future, or
- (3) does not address events that may be reasonably expected to occur.

The only consensus of the technical experts was that the above difficulties are extremely difficult- perhaps impossible- to address in a manner that is completely consistent, reasonable, and politically neutral. The staff recommendations below represent what staff believes to be potentially acceptable, rather than “ideal,” treatment of policy assumptions.

Staff analysis: Situation 1

In the first situation (current law appears to be inconsistent with reasonable expectations) the advantage of using assumptions based upon “reasonable expectations” is that they would represent a more realistic prediction.

The disadvantages of using assumptions based upon “reasonable expectations” are:

- it may be difficult to develop a definition of “reasonable expectations” that would be sufficiently objective to be used as an alternative to current law, and
- using “reasonable expectations” that conflict with current law may be viewed by some readers as a policy recommendation.

Staff recommendation: Situation 1

One possible definition of “reasonable expectations” might be when expiring provisions in current law have been changed in a consistent direction for a given number of years- perhaps, at a minimum, the past five years. An example of this would be the limitation on total Federal borrowing: every time the limit has been approached (or reached), Congress has passed legislation increasing the debt ceiling.

Accordingly, staff recommends that in situations where current law appears to be inconsistent with “reasonable expectations” **as defined above**, policy assumptions could be based upon “reasonable expectations.” Regardless of which assumptions are used, the narrative should include an explanation and alternative scenario presenting projections that would appear to be more likely to occur.

Question for the Board:**Does the Board agree with staff recommendation for Situation 1?****Staff analysis: Situation 2**

In Situation 2, current law does not extend far enough into the future. For example, discretionary spending is generally controlled by annual appropriation acts (see note 13 of this document for an explanation of discretionary and mandatory spending).

The primary options for discretionary spending are to use the President's Budget or the Budget Enforcement Act baseline, followed by some trend growth rate, or to assume that the level of spending in the current year and recent past will continue.

The technical experts were unanimous in recommending against the President's Budget for policy assumptions.

The advantage of using current trends is that they would have a more accurate predictive value. The disadvantage to using current trends is that there are numerous ways to define current trends and a definition would need to be developed that is both reasonable and technically feasible for use in preparing fiscal sustainability reporting for the Financial Report of the U.S. Government.

Staff recommendation: Situation 2

Staff believes that it is reasonable to assume that current trends will continue. For example, it could be assumed that discretionary spending will continue as a constant share of GDP. Another alternative would be to assume constant real spending per capita (which could give a different result from assuming growth at a constant share of GDP); yet another alternative would be to assume constant growth at the rate of inflation, which may be different than the growth of GDP.²⁰ (Historically, nondefense discretionary spending has grown roughly with GDP while defense discretionary spending has grown slightly faster than inflation but less than GDP, often in a non-linear pattern.

Staff believes that if the Board agrees in principle, the details of the "current trends" baseline (for example whether the baseline should be based on a five-year average, ten-year average etc.) could be determined at a later date, after discussion with representatives from the Office of Management and Budget, the Government Accountability Office, the Congressional Budget Office and the Treasury Department. Regardless of which baseline is used, the narrative should include an explanation of the assumptions used and alternative scenarios.

²⁰ For example, the CBO projects that the rate of inflation will be lower than the rate of GDP growth for 2007-2017. See page xi, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*. Available at: <http://www.cbo.gov/ftpdoc.cfm?index=7731>.

Question for the Board:**Does the Board agree in principle with staff recommendation for Situation 2?****Staff analysis: Situation 3**

In the third situation, current law does not address events that may reasonably be expected to occur (for example the exhaustion of the Medicare Hospital Insurance Trust Fund). As noted previously, although current law limits outlays to the amounts available in the trust funds and current earmarked revenue, current law does not provide for any reductions in benefit payments or reimbursement rates due to lack of funds. Thus, current law is inconsistent and does not provide an answer.

Staff recommendation: Situation 3

Staff agrees with the consensus of the technical experts in that it is extremely difficult- perhaps impossible- to address budget policy assumptions in a manner that is completely consistent, reasonable, and politically neutral. Accordingly, staff believes that there are no “ideal” solutions, and that staff recommendations for Situations 1, 2 and 3 represent what staff believes to be potentially acceptable, rather than “ideal,” policy assumptions.

For situation 3, when current law is inconsistent, staff believes that in selecting an assumption, the priorities should be:

- maintaining consistency with other existing forward-looking financial statements, currently the Statement of Social Insurance (SOSI) (highest priority, when applicable), and
- where “likelihood” cannot be determined, selecting the assumption that results in a larger outflow or a smaller inflow.

Staff believes that when current law is inconsistent, the assumption of a legal provision that results in a larger outlay (in this example, the continued payment of current reimbursement levels) or smaller revenue will occur should be selected, based on the notion of conservatism. The projection should be **accompanied by a narrative** that explains what would happen if the alternative event occurs (in this example, the narrative would explain what percentage of Medicare reimbursements could not be paid).

Question for the Board:**Does the Board agree with staff recommendation for Situation 3?**

Economic Assumptions

Economic assumptions are somewhat broader in scope than policy assumptions, since they include such factors as population demographics and economic growth. However, the elements of economic assumptions are generally influenced more by a variety of external factors than by direct legislative impact.

There was no consensus from the task force technical experts for economic projections, such as growth in GDP, although none objected strongly to either CBO, OMB or the economic assumptions currently used for the Social Security and Medicare portions of the Statement of Social Insurance (SOSI).

Table 3 displays representative elements of CBO and OMB assumptions, with a comparison with the economic assumptions currently used for Social Security and Medicare in the Statement of Social Insurance.

Table 3: Major Elements of CBO and OMB Economic Assumptions, Compared with Assumptions used in the Statement of Social Insurance (SOSI)

	CBO Baseline (2007-2017)	OMB Stewardship Reporting	SOSI assumptions for Social Security and Medicare
Economic/Demographic Assumptions:			
Consumer Price Index inflation	Average 2.2% per year	2007-2017: Administration projections used for the budget, constant thereafter ²¹	Intermediate Trustees Reports assumption: 2.8%
Population demographics (birth/death/immigration)	Intermediate Trustees reports assumptions	2007-2017: Administration projections used for the budget, Intermediate Trustees Reports assumptions thereafter	Intermediate Trustees Reports assumptions
Real GDP growth ²²	Average 2009-2012: 2.9% 2013-2017: 2.5%	2007-2017: Administration productivity projections used for the budget period, constant thereafter at 2.3%, combined with Trustees Intermediate assumptions for labor force growth	Intermediate Trustees Reports assumption: 1.7%

Sources:

CBO Baseline: *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*. Available at:

<http://www.cbo.gov/ftpdocs/cfm?index=7731>.

OMB Stewardship Reporting: Chapter 13, “Stewardship” of *Analytical Perspectives*, U.S. Budget, FY 2008

SOSI/FR: FY 2006 Financial Report of the U.S. Government

One of the technical experts noted that there are several advantages to using the economic assumptions used in the preparation of the SOSI:

- Since the SOSI is now a basic financial statement, auditors are bound by generally accepted auditing standards to examine and assess the

²¹ After that, projected holding constant inflation, interest rates and unemployment at the levels assessed for 2017. Details of OMB projections:

Real GDP growth: average 3% for 2008-2012 (3.1% in 2008, declining to 2.9% in 2012)

CPI inflation: average 2.42% for 2008-2012 (2.6% in 2008, declining to 2.3% in 2012)

²² There are two major components of projections for real GDP growth: productivity (real GDP per capita) and labor supply. While productivity growth is typically assumed to be constant, labor force growth varies over time with the demographic assumptions.

reasonableness of the assumptions. For the Medicare and Social Security Trustees Reports, the assumptions are all subject to audit.

- In contrast, the CBO and OMB economic assumptions are not subject to generally accepted auditing standards.
- If the SOSI economic assumptions are used, there would be consistency between the economic assumptions used for the SOSI and for the fiscal sustainability reporting.

Staff recommendation for economic assumptions

Staff believes that the advantages of using the SOSI assumptions for Social Security and Medicare listed above are compelling, and recommends the use of economic assumptions for fiscal sustainability reporting that are consistent with the assumptions for Social Security and Medicare in the SOSI.

Statement of Federal Financial Accounting Standards (SFFAS) 17 does not prescribe specific economic assumptions for Social Security and Medicare in the SOSI.

Accordingly, staff recommends that the requirements for fiscal sustainability reporting should not dictate specific economic assumptions, but rather require that the primary displays should use economic assumptions that are consistent with the economic assumptions for Social Security and Medicare in the SOSI. In addition, the narrative should include information about how different economic assumptions would impact the projections.

Question for the Board

Does the Board agree with staff recommendation for economic assumptions?
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Section 3:

“Plain English” FAQs

“Plain English” FAQs for Fiscal Sustainability Reporting

1 - What is **GDP**?

A nation's **gross domestic product**, or **GDP**, is one of the ways for measuring the size of its economy. The GDP of a nation is defined as the market value of all final goods and services produced within a country in a given period of time. The most common approach to measuring and understanding GDP is the expenditure method:

$$GDP = \text{consumption} + \text{investment} + \text{government spending} + (\text{exports} - \text{imports})$$

2 - Why does the **debt to GDP ratio** matter?

The debt to GDP ratio, for the purposes of Federal fiscal sustainability reporting, is the amount of Federal (Treasury) debt held by the public divided by GDP. [An alternative ratio would be the amount of total public debt (Federal, state and local) divided by GDP.]

The debt to GDP provides an indication of a nation's ability to repay its public debt by comparing the size of its debt to the size of its economy. For example, during the formation of the European Union (EU), one of the conditions for membership in the EU, which included eligibility to convert its currency to the Euro, was that each nation had to meet certain conditions, including debt-to-GDP ratio. This protected the stability of the Euro.

3 - What is **present value**?

Present value is an adjusted amount that takes the “time value of money” into consideration. The “time value of money” is illustrated by a question such as: “At ten percent annual interest, how much do I need to put into the bank to have \$100 one year from today?” Clearly, the amount you would need today would be less than \$100.

In present value calculations, the further out in the future the needed amount, the smaller is the amount that you would need today. In the first year, you earn interest on the amount that you deposit (the “principal” amount). But in the second year, you earn interest on both the original principal amount and the amount of interest that was earned in year one. In year three, you would earn interest on:

- the original principal amount, plus
- the interest earned in year one on the principal amount,
- the interest earned in year two on the principal amount, and
- the interest earned in year two in year one's interest earnings.

This is colloquially called “the magic of compounding.” If inflation is less than the rate of interest earned (in this example, ten percent per year), the “magic of compounding” is an advantage to the party that is earning the interest.

4 - What is the **fiscal imbalance** measure?

The fiscal imbalance is the total of existing debt plus future projected deficits, expressed in present value dollars.

5- What is the **fiscal gap** measure?

The fiscal gap is the change in spending or revenue that would be necessary to maintain public debt as a constant percentage of GDP.

6 - What factors affect projections?

Projections are affected by two kinds of assumptions:

economic assumptions and **budget/policy assumptions**.

Economic assumptions include projected changes in GDP, inflation (price indexes), the unemployment rate and interest rates. They also some demographic changes, such as birth rates and longevity (other demographic factors such as net immigration and retirement age may have a policy component).

Budget/policy assumptions include projected changes in the amount and sources of taxes that will be collected, and projected spending on both mandatory and discretionary programs.

Projections or simulations are also affected by **uncertainty**. Economic assumptions are generally expressed in a range of possible results. Budget/policy assumptions are generally expressed by providing alternative scenarios that show more than one possible broad direction in which policy might proceed.

7- What are “projections or simulations”?

Projections or simulations are not forecasts or predictions; they are designed to ask the question “what if?” For example, possible “what ifs” may include that tax cuts are (a) allowed to expire or (b) be extended. Projections or simulations are useful in order to present alternative future scenarios, but it is important to clearly explain the nature of the information being presented.

8 - What is the difference between **earmarked revenue** and other revenue, and what is the nature of **Federal trust funds**?

“Earmarked revenue” is revenue that comes from a source that is distinct from general tax revenues and may be used only for the purpose for which it is collected. Examples of earmarked revenue are: Social Security taxes, Medicare taxes, Federal Unemployment taxes, and federal excise taxes on gasoline.

Earmarked revenue is generally accounted for in the budget separately, in accounts categorized as “special funds” or “trust funds.” Examples include the Social Security Trust Fund, the Medicare Trust Funds, the Unemployment Trust Fund and the Highway Trust Fund. The distinction of whether an earmarked fund

is categorized in the budget as a “special fund” or a “trust fund” is the applicable legislation. In order to reduce confusion between accounts designated as “trust funds” in the budget and private-sector trust funds, FASAB’s Statement of Federal Financial Accounting Standards (SFFAS) 27, *Identifying and Reporting Earmarked Funds*, prohibits the use of the term “trust fund” for earmarked funds except when referring to the legal title of the fund, and requires the following note disclosure to explain the nature of Federal trust funds:

Investments in Treasury securities for earmarked funds should be accompanied by a note that explains the following issues:

- The U.S. Treasury does not set aside assets to pay future expenditures associated with earmarked funds. Instead, the cash generated from earmarked funds is used by the U.S. Treasury for general Government purposes.
- Treasury securities are issued to the earmarked fund as evidence of earmarked receipts and provide the fund with the authority to draw upon the U.S. Treasury for future authorized expenditures (although for some funds, this is subject to future appropriation).
- Treasury securities held by an earmarked fund are an asset of the fund and a liability of the U.S. Treasury, so they are eliminated in consolidation for the U.S. Government-wide financial statements.
- When the earmarked fund redeems its Treasury securities to make expenditures, the U.S. Treasury will finance those expenditures in the same manner that it finances all other expenditures.²³

²³ SFFAS 27, paragraph 27.

Section 4: General Comments from Dr. C. Eugene Steuerle

Date: 9/5/2007

From:

Eugene Steuerle
Senior Fellow
The Urban Institute

I think it is a mistake to think that there is one way to account for a set of "liabilities" in the federal budget for which there are no underlying assets. The complication is how to account for a set of "promises" made by legislators that may or may not be fulfilled--in part because other societal priorities may take precedence. These promises do have some greater force of law today than the likely appropriations that will be made tomorrow in the non-mandated programs, but they do not have the same force as federal debt. At the same time, I see merit in the budget accounts trying to account for them.

In any case, I do think that the FASAB can make a decision until it has followed through on an experiment I have suggested. It should experiment with several methods of accounting for these "promises." Then it should see how the accounting under each method would be affected in the following circumstances:

The enactment of the 1983 Social Security legislation.
The enactment of the recent Medicare drug bill.
The contraction and then expansion of retiree health benefits for the armed forces.
A change in the underlying interest rate (actual or estimated).
An expansion of some employee benefit (which also reduces Social Security taxes).
A change in the Social Security tax rate (which also reduces income tax collections).
A change in the BLS measure of the CPI.
A formal legal change in the price index applied to Social Security benefits.
A decision by Congress to increase some rate of payment for a particular medical procedure.
A decision by HHS to increase some rate of payment for a particular medical procedure.
A decision by some states to change their methods of paying for Medicaid.
The enactment of some guarantee by Congress, with expected costs into the future.

What would be measured as an increase in liabilities under each suggested procedure?
What would not?

How would headlines on these issues play out under each procedure? For instance, what would the headline be for the 1983 Social Security legislation? How do they contrast under alternative methods?

How would each change be described, not just measured, in the accounts?
How would those descriptions match up with the reports of the Social Security and Medicare Boards of Trustees?

Also repeat the experiment assuming that two or more of these changes takes place simultaneously.

Until this basic background work is done, I do not think the FASAB has any basis for choosing any one method over another. In the end, as I note, I believe that its conclusion will be that alternative methods must be offered, with the liability associated with unfunded promises (of the type that can and have been rescinded) given ranges from 0 to 100 percent of the liability associated with government debt.

Thank you.
