



March 9, 2007

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Comes, Executive Director

Subj: **Fiscal Sustainability Reporting- Tab C¹**

Objective: To (a) update the Board on meetings held (b) show edits to the final draft briefing package that will be sent to the “technical experts” group on March 15, 2007, and (c) provide a copy of the cover letter that was sent to the “technical experts” group on March 5, 2007, along with a copy of “Preliminary Views- Accounting for Social Insurance, Revised,” as requested by the Board at the January 2007 meeting.

Meeting with Allen Schick

On February 22, 2007, Wendy Comes and Eileen Parlow met with Allen Schick to receive his input on the technical issues, since he will not be able to attend the April 5, 2007 meeting. Dr. Schick has been asked to review staff’s documentation of his thoughts and comments, which will be combined with those of the larger group that will meet on April 5, 2007.

Attached is a recent article, “Sustainable Budget Policy- Concepts and Approaches” prepared by Dr. Schick for the Organization for Economic Co-operation and Development (Attachment 1).

Staff Meeting with CBO, GAO, OMB and Treasury Department Representatives

On February 26, 2007, Wendy Comes and Eileen Parlow met with Benjamin Page of CBO, Thomas McCool of GAO, Robert Anderson and Patrick Locke of OMB (Mr. Locke will not be able to attend the April 5 meeting), and James Duggan of Treasury. At this helpful and informative staff-level meeting, some edits were recommended for the briefing letter, which will be sent to the “technical expert” task force members on March 15, 2007 (Attachment 2).

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.

Additional Letter regarding Alternative View

The additional letter recommended by the Board at the January 2007 meeting was sent on March 5, 2007 (Attachment 3).



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***PUBLIC GOVERNANCE AND TERRITORIAL DEVELOPMENT
PUBLIC MANAGEMENT COMMITTEE***

OECD-Asian Senior Budget Officials

SUSTAINABLE BUDGET POLICY – CONCEPTS & APPROACHES

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SUSTAINABLE BUDGET POLICY: CONCEPTS AND APPROACHES

1. It wasn't long ago that fiscal sustainability was an issue only for underdeveloped and emerging market economies that have fragile capital markets, rising debt and an expanding public sector, and are vulnerable to cyclical disturbances or financial contagion. Recently, however, concern about fiscal sustainability has spread to advanced countries, some of which have established ongoing processes for assessing their capacity to maintain their fiscal position for an extended period. Australia, New Zealand and the United Kingdom review fiscal sustainability as part of their new fiscal responsibility regimes introduced during the past decade. Member countries of the European Community comment on sustainability in their medium-term budget frameworks submitted to EC pursuant to the Stability and Growth Pact, and EC reviews the long-term outlook in its annual report on fiscal policy. The United States annually reviews the long-term sustainability of social security and medicare, the two largest claimants on future budgets.

2. Concern about sustainability has been fueled by the projected ageing of populations in OECD countries and the likely surge in government spending on pensions and health care. For the most part, it has not been driven by concern about the current fiscal position of countries. In fact, countries with sound positions (such as Australia and New Zealand) have been in the forefront of this movement. Interest in sustainability has been stirred by innovations in accounting and economic analysis, such as accrual accounting and budgeting, the application of present value analysis to government budgets, intergenerational accounting, and fiscal gap analysis. None of these is standard budget practice, but some are likely to be built into the routines of budgeting in the future. It is also likely that countries will experiment with different techniques, and that some will build sustainability analysis into the annual budget process, while others will conduct such studies as a free-standing exercise.

3. In migrating from underdeveloped to highly developed countries, fiscal sustainability has shifted in focus from the near term to the distant future. In less developed countries, the immediate concern is whether the government will be able to service its debt if capital flees, the currency depreciates, and interest rates surge. This is the principal focus of sustainability work carried out by the International Monetary Fund. Its "assessments have two main dimensions: indicators of public debt and deficits, and medium-term fiscal projections."¹ In OECD countries, the focus is on the long-term, typically 30-50 years ahead. Even countries that have had persistent budget deficits and elevated debt loads do not sense impending fiscal crisis; in fact, they have little difficulty financing current budget shortfalls. But many OECD countries are concerned that although their current fiscal posture is sound or manageable, it might not be a generation or two from now as future governments are encumbered with the costs of past policies and commitments. Inherently, fiscal sustainability in the OECD community has a long-term perspective that aims to prepare for the future by sensitizing governments to the need for prudent action to sustain economic wellbeing for future generations.

4. Fiscal sustainability is more than projecting the future; it is about the urgency of policy changes, as well as the need for new budget tools to assess the governments' fiscal position because conventional instruments are not up to the task. A medium-term expenditure framework (MTEF) and fiscal rules, two of the most prominent contemporary innovations, extend the time frame of budgeting 3-5 years ahead, but they are not attuned to long-term issues. An MTEF does not look far enough ahead, and coupled with hard constraints, it may spur some stressed governments to engage in budgetary legerdemain which improves

the medium-term outlook at the expense of the country's long-term fiscal health. This is not mere speculation, for a number of EU countries have used one-off savings to meet SGP requirements.²

5. Although their time horizon is too short for sustainability work, MTEF and fiscal rules introduce techniques, such as baseline projections, which can be extended to analyze a country's future fiscal position. Fiscal rules also have relevance because they sensitize governments to the downstream implications of budget policy. But the fact that governments and academics are working to devise new accounting and reporting tools to gauge sustainability indicates that existing techniques do not suffice.

6. This paper is based on the expectation that sustainability will be an essential element of future budget work. Section 1 makes the case that sustainability has multiple dimensions arising out of the diverse perspectives of those urging attention to the issue. Some of the main approaches to analyzing sustainability are described in Section 2, which discusses their application to the budget process. The concluding section focuses on means of feeding sustainability results into the formulation of budget policy.

1. The Multiple Dimensions of Sustainability

7. The shift to a long-term horizon has expanded the ways governments and international organizations think about sustainability. The term has retained its original meaning as a measure of the solvency of government, but it has acquired several dimensions that pertain to governments that have no difficulty meeting current obligations. Contemporary sustainability analysis focuses on fiscal conditions that may retard economic growth, cause tax burdens to rise, or transfer significant costs to future taxpayers. The added dimensions reflect concern that governments have accumulated long-term liabilities that do not appear in current budgets or balance sheets but may disadvantage future generations when they come due. The expanded concept of sustainability is grounded on the norm that responsible governments should not do harm that will appear decades after the relevant policies were adopted.

8. We may delineate four dimensions of sustainability. Although they are separated here for analysis, in practice, they tend to appear in tandem.

Solvency The ability of government to pay its financial obligations

Growth Fiscal policy that sustains economic growth

Stability The capacity of government to meet future obligations with existing tax burdens

Fairness The capacity of government to pay current obligations without shifting the cost to future generations

The four dimensions overlap, but it is useful to draw their implications by examining each separately.

9. **Solvency** is usually thought to be a problem in some underdeveloped or emerging market countries, particularly those that have boosted public spending, taken on additional debt, and have an inadequate tax base. When misfortune arrives, often brought by a cyclical downturn or financial contagion, capital flees, currency plummets in value, and the government must rollover debt at very high interest rates, while borrowing more to stay afloat. These are countries that IMF rushes in with emergency assistance, in exchange for which it demands that they restore solvency by correcting unsustainable fiscal imbalances. A typical IMF demand is that the government run a primary surplus in order to finance its debt.

10. Solvency can be an issue in any country that takes on excessive debt. Although they may not face capital flight in the foreseeable future, affluent countries are sometimes tempted to debt finance current obligations, whether in response to political pressure or out of confidence that they can afford to do so. Some observers believe that this is the current fiscal predicament of the United States, and that its current

course is unsustainable. In budget projections that run out to 2050, the Congressional Budget Office concluded that under certain plausible budget scenarios

the growth of debt would accelerate as the government attempted to finance its interest payments by issuing more debt – leading to a vicious circle in which ever-larger amounts of debt were issued to pay ever-higher interest charges. Eventually, the costs of servicing the debt would outstrip the government's ability to pay for them, thus becoming unsustainable.³

11. CBO's warning relates to the long-term outlook. The 50 years covered by its projections are a long way off, but CBO argues that it is appropriate to take action now to abate long-term imbalances. It provides specific examples of how timely action can avert projected insolvency.

12. Solvency is typically measured in business in reference to the firm's net worth. Applying this method to government is difficult because few have comprehensive balance sheets that cover all liabilities and assets. Moreover, net worth is a misleading measure in government because it does not include the power to generate additional revenue by raising taxes. Nor does it include the value of future pension liabilities. At best, the balance sheets now produced in national governments provide an incomplete but nevertheless useful statement of financial condition.

13. Sustained Growth is one of the twin objectives of the European Community's Stability and Growth Pact (SGP) which commits Euro zone countries to budget imbalances below 3 percent of GDP and gross debt below 60 percent. The case for these limits rests on the argument that growth will not be sustainable if deficits and debt breach these parameters. Thus, the broadened concept of fiscal sustainability encompasses the notion that government should manage their finances prudently so as to assure future growth. In line with this reasoning, Britain's long-term fiscal objective is to ensure "that the public finances are sustainable, contributing to a stable environment that promotes economic growth."⁴ In this light, fiscal policy is adjudged to be unsustainable if it would cause potential output to be lower at some future time than it would otherwise be. The logic of this argument runs as follows: The best way for government to meet future obligations, which certainly will be greater than today's, is by having a robust economy which supplies government additional revenue from the dividends of economic growth. If, however, fiscal imbalances diminish future growth, the dividends will be smaller or vanish altogether and government will be hard pressed to cover its obligations.

14. This reasoning led the European Commission in its 2004 review of public finance in EMU countries to argue that "the risk of unsustainable public finances increases considerably if the Member States do not achieve the SGP goal of budget position of 'close to balance or in surplus'". The report concluded that this position "is in the economic self-interest of Member States both individually and collectively ... it creates room for budgetary manoeuvre to either cut taxes or to increase growth-enhancing expenditures on items such as investment and R&D."⁵

15. Sustaining growth by running balanced budgets represents a sharp break with postwar economic doctrine which typically regarded deficits as appropriate in bad times and manageable in good times. This reversal in economic reasoning has been due to several transformations: from viewing the budget as an instrument of short-term cyclical adjustment to a means of undergirding structural soundness over an extended period; from looking at the budget as a policy statement for a year (or few years) immediately ahead to treating it as a strategic plan of future government financial capacity; and from formulating the budget as an instrument of government expansion to constraining it to be a stabilizer of government size. These shifts correspond to changes in contemporary political sentiment. Confidence in the capacity of government to sustain growth by taxing and spending more has waned. Moreover, recognition that the bulge in government spending will be in the form of transfer payments that subsidize consumption has weakened analytical support for the expansionary policies that once were popular.

16. **Stable taxes.** Maintaining the tax burden at or near current levels has become a dominant objective of fiscal policy in many OECD countries. This objective is highlighted in Australia's *Intergenerational Report* which views "A balanced budget over the medium-term, given a reasonable degree of stability in the overall tax burden" as "one of the key requirements for sustainable financial arrangements."⁶ In running 40-year projections, the report assumes that Commonwealth revenues will remain a constant proportion of GDP. A key aim of the report is to assess the risk that tax burdens will rise in the future to accommodate spending pressures. It concludes that the Commonwealth's fiscal position may be unsustainable because the projected trajectory of spending would compel higher taxes (or a larger debt) in the future.

17. The underlying premise of this sustainability argument is that tax burdens already are very high and that governments should adopt prudent fiscal positions that obviate pressure for future increases. In this version, the objective is to sustain tax burdens at their current level or lower. This dimension of sustainability is congruent with contemporary sentiment in most OECD countries, and is reflected in the leveling off of tax burdens after decades of steep increases. Of course, sustainability recognizes that taxes cannot be constrained if downstream spending demands are not. The notion that spending pressures must be abated to lower the probability of higher taxes in the future is as prevalent in countries with relatively low tax burdens as in high-tax countries. Even countries that have current budget deficits have joined the tax-cutting parade. At times, such behavior would have been viewed as undermining sustainability; nowadays, it is often seen as diminishing the risk that taxes will be higher in the future.

18. During much of the 20th century, the tax burden and economic output expanded throughout the OECD community. In many (certainly not all) countries, it came to be accepted that by producing an educated workforce, efficient transport, income security, and other social goods, expansionary government establishes favorable conditions for economic growth. Taxes were the price households and firms paid for purchasing government-supplied goods that elevated living standards. Governments (and most voters) were not troubled by the rise in taxes because disposable incomes also were rising and government was supplying more benefits. Sustainability strongly indicates that times have changed, partly because tax burdens are hovering around 50 percent in some countries, partly because of diminished trust and confidence in government performance. It matters little that popular images of government may be wrong; it does matter that voters look to government for lower taxes.

19. Here is where sustainability enters the picture, for spending trends embedded in government commitments and political expectations point to sizeable tax hikes in the future. Arguably, the surest way to maintain solvent government in the decades ahead is to generate sufficient additional tax revenue to cover the looming rise in public spending. The sustainability norm seeks to deter this option by defining tax stability as a core fiscal objective.

20. **Fairness.** The final version views fiscal policy as sustainable when tax burdens and expenditure benefits are equitable across generations. In this perspective, it is not fair to provide benefits to one age cohort that will have to be paid for by taxes levied on younger cohorts. This concept of sustainability is embedded in Australia's *Intergenerational Report* which asserts: "Fiscal sustainability ... ensures future generations of taxpayers do not face an unmanageable bill for government services provided to the current generation."⁷ Further, a sustainable fiscal stance "promotes fairness in distributing resources between generations of Australians."⁸ Britain's Long-Term Public Finance Report declares a primary objective of fiscal policy to ensure "that spending and taxation impact fairly both within and between generations."⁹

21. Operationalizing fairness may be more difficult than measuring budget balances, for as Peter Heller has observed in his insightful book *Who Will Pay?*, "there is no single definition or universally accepted measure of fairness ... Should future generations be expected to bear a higher tax burden than current generations would be willing to accept for themselves, because they will be richer? What obligations

should future generations have toward current working generations?”¹⁰. Budget makers have enormous difficulty assessing fairness among current beneficiaries and taxpayers; it is even more difficult to reason through equity issues across generations, from those who are newly born to those who are nearing the end of long lives. Not only do layers of assumptions have to be made about distant tax burdens and expenditures, but normative questions demand attention. Would a fairness norm rule out any difference across generations or only those (in the words of Australia’s report) that are truly “unmanageable”? Perhaps it is the sharp divide across generations that gives rise to fairness concerns: today’s citizens are (by a wide margin) net gainers; tomorrow’s generations are projected (also by a wide margin) to be net losers. However, there is another way of defining this issue. Government policies that distribute costs and benefits may be regarded as a social contract across generations. In the same way that today’s citizens pay higher taxes and enjoy elevated material wellbeing compared to their forbears, future taxpayers should be expected to pay for and enjoy the greater affluence and enriched public services bequeathed to them. The counterargument is that the social contract has been broken by the prospective huge shift of costs and benefits across generations. Today’s older citizens have negative effective tax rates (taxes minus benefits) in excess of 25 percent; tomorrow’s will have effective positive net tax rates in excess of 50 percent. This breaches any social contract that may have been accepted in the past.

22. Here is where sustainability joins up with fairness. Grossly unfair distributions are not sustainable in either political or economic terms. Politically, because future payers are likely to rebel against confiscatory tax rates; economically, because the wellbeing of the country will be retarded by the overriding need for tax rates that are strong disincentives for work, saving, and investment.

23. The four definitions of sustainability focus as much on the tax burden as on the public debt, though (of course) elevated debt can be expected to exert upward pressure on tax rates. In contrast to developing and emerging market countries where sustainability is a concern that arises out of inadequate tax mobilization, in industrial countries the problem is that tax rates already are very high. But in all types of countries, sustainability analyses project that the tax revenue to GDP ratio will have to rise to finance commitments that will come due in the future.

2. Modes of Sustainability Analysis

24. Because it is a new area of analysis and because making assumptions about the future can be done with a variety of techniques, there is no standard way of projecting taxes and burdens 30-50 years ahead. One approach is to examine the future from the vantage point of the country as a whole; another is to look at it from the position of an individual taxpayer who will receive a flow of costs and benefits from government; still another is to consider a similarly situated age cohort. Some techniques build on standard budget methods to project the future; others are grounded in accounting rules and analyze the future by means of a balance sheet. Some take a whole of government perspective; others focus on major programs (such as social security) that have long-term implications. All require heroic assumptions about economic and social trends, such as rates of growth, price changes, and life expectancy. Rather than discuss methodological differences, this section relates various techniques to existing budget practices. If sustainability becomes an ongoing issue, it is highly likely that budget practices will evolve to incorporate an elongated time frame into analyses of revenue and spending proposals.

25. **Baseline projections.** Governments that have moved to an MTEF (or have otherwise lengthened their time horizon) typically use baseline projections to connect current budget policy to medium-term fiscal outcomes. Sustainability analysis often uses similar techniques, but extends the time frame 30 or more years ahead. Baseline projections begin with the government’s current budget position (including policy changes that have already been approved but will not take effect until some future date). In constructing baseline projections, the overriding assumption is that existing revenue and spending will be continued as far ahead into the future as projections extend, without any substantive change. Of course,

these projections are based on critical assumptions about GDP, wage and productivity trends, interest rates, and much more. In constructing a baseline, government has to reckon with revenue or spending provisions that are time-limited, that is, under current law, they will not remain in effect for the entire period covered by the baseline. In many such cases, there is strong probability that expiring provisions will be extended. Therefore, dropping time-limited items from the baseline may provide a misleading picture of future budget conditions. New Zealand's practice is to systematically report on such provisions, thereby allowing citizens and others to exercise judgment on whether it is realistic to assume they will not be continued. This provides a fuller view of fiscal trends, but it is not the practice in other countries that rely on baselines.

26. Baseline projections are inherently unrealistic because it is highly unlikely that budget policy will be frozen as the number of pensioners receiving public money escalates. It is also unrealistic because (in most governments) the baseline projection does not assume significant changes in economic performance as a consequence of tax and spending policies.¹¹ Despite these limitations, baselines serve two valuable purposes in budgeting that can be applied to sustainability projections. First, they provide insights into future budget conditions if government stays on its fiscal course. This is especially useful in contemplating a distant future in which demographic and other conditions may be quite different from what they are today. Second, they provide a basis for estimating the impact of proposed or adopted policy changes on future budgets. In these projections, any variance between the baseline projection and revised estimates is defined as the future budget impact of policy change. In this way, baseline projections enable policy makers to assess the impact of changes in revenue or spending policies on the government's fiscal position.

27. Although baseline projections usually provide point estimates, in anticipating the future it would be preferable to present a range of plausible fiscal outcomes. Within the range, estimates would be differentiated by the assumptions on which they are grounded. It also would be feasible to base projections on alternative scenarios of key variables such as life expectancy, health costs, economic growth and interest rates. A surfeit of scenarios might drown the projections in confusion, but it would be sensible to construct 3-5 scenarios. Finally, it would be prudent to "stress test" long-term baseline projections to assess how they might be affected by significant changes in underlying assumptions.

28. In sum, while long-term forecasting is not yet common in budgeting, it almost certainly will become standard practice in many countries in the years ahead. Because baseline projections can be lengthened from the medium-term to the distant future, they are likely to become the most frequently applied technique of government in assessing long-term sustainability. However, budgets will automatically have as dominant a position in exploring sustainability as they have had in estimating annual or medium-budget conditions. Economists and other policy analysts will vie to construct novel means of relating current budget postures to long-term sustainability.

29. **Balance sheet analysis.** During the past decade, some analysts have viewed the balance sheet as a fuller and more reliable statement of financial condition than the budget. In contrast to budgets which include only those flows that are within its ambit, the balance sheet includes all (explicit) assets and liabilities, regardless of their budget status. Moreover, it includes all liabilities, not only those that are sovereign debt. The structure and content of the balance sheet are regulated by national or international accounting norms and are independently audited. Although national budgets usually are on the cash basis, the balance sheet accrues income and expense, thereby enabling government to recognize certain downstream liabilities long before they become due. Properly constructed, a balance sheet would provide a comprehensive account of the government's net worth and of future payments likely to arise out of existing liabilities. For these reasons, various scholars have urged that the government's fiscal position be assessed in reference to the balance sheet rather than the budget.¹²

30. But the balance sheet has inherent limitations that greatly diminish its utility as a measure of long-term sustainability. One problem is that the balance sheet recognizes only explicit liabilities, but many obligations of government are embedded in expectations about how it will behave in the future; another is that the balance sheet recognizes liabilities arising out of past actions, not future obligations arising out of current policy. In assessing long-term sustainability, however, implicit commitments and future obligations weigh far more heavily than those that are explicit or have already been incurred. In fact, no government records future pension obligations on its balance sheet, though some append notes in which various matters that do not meet recognition standards are discussed. This is an area where accounting norms are likely to evolve in the future, but it would be imprudent for the balance sheet to show implicit liabilities or prospective payments for liabilities that have not yet been incurred. Doing so would make implicit obligations explicit, worsening the government's financial predicament and loading it with future payments that it might otherwise avoid.

31. The balance sheet is a snapshot of financial condition at a point in time; it is not a projection of what might occur in the future. It does not include revenue or obligations that have not yet accrued, nor does it differentiate between liabilities that may come due within the next year and those payable in the distant future. It does not assign a present value to the taxing capacity of government or to future revenue flows from the existing tax structure. In fact, pursuant to established accounting rules, the balance sheet completely ignores the capacity to generate revenue in the future. It does, however, account for certain unfunded liabilities, that is, for incurred liabilities that are not financed by accrued revenue. Some finance experts have argued that the balance sheet presents a misleading picture of future financial condition and that net worth is not a useful measure of a government's solvency; others have noted that the balance sheet applies identical recognition rules to liabilities and assets, that net worth is a relevant measure of government's capacity to finance incurred liabilities, and that the balance sheet is not designed to be a prognosis of future financial condition. What the balance sheet can do is to provide a starting point (other than the baseline) for projecting future sustainability, but doing so requires consideration of matters that are not recorded on the balance sheet.

32. The balance sheet and related financial statements are likely to have greater prominence in assessing current and prospective fiscal conditions. One reason is the expansion of accounting and reporting standards to cover matters that were not previously recorded; another is the prospect of linking (or integrating) financial statements and the budget. At present, few national governments pay attention to the financial statements they are required to prepare; they see these statements as a technical chore that has little to do with the decisions they make or the financial issues they confront. This is likely to change as accounting standards are elaborated and monitored by national and international organizations. Recent developments in the U.K. may be a harbinger of a broader scope for these statements. The British Government has announced that beginning with the 2006-07 financial year, it will publish whole of government accounts (covering national and local governments and public corporations) based on generally accepted accounting practice. In addition to accounting for incurred obligations, these new accounts will provision for certain future liabilities and will contain notes on contingent liabilities. This approach expands the balance sheet to include or provide information on various liabilities that have not yet accrued. Britain's approach is not likely to be an isolated move, for the International Public Sector Accounting Standards Board and other authorities are devising new rules that will expand the information that must be reported. As accounting practices are expanded, leading-edge governments will apply the same standards to budgets, and will conform or reconcile them to financial statements. The integration of budgets and financial statements will unfold in stages, probably over an extended period, but it will provide a fuller basis for assessing fiscal sustainability.

33. **Fiscal gap analysis.** Fiscal sustainability is a problem when there is a gap between a targeted debt level and the debt that would ensue if tax and spending policies were continued without change. In measuring this gap, the government (or analysts) select a target year as well as a target for the debt/GDP

ratio. In other words, gap analysis focuses on a fixed point in time, not on a stream of years. This method enables government to calculate the primary balances it will have to run to assure that the projected deficit does not exceed the targeted level. A fiscal gap of zero would indicate that current fiscal policy is sustainable; that is, the debt target can be met without increasing the tax burden or cutting future expenditures. A fiscal gap above zero would indicate that the projected debt exceeds the target and government will have to boost revenue or curtail spending to sustain its fiscal objective.

34. Fiscal gap measures can be developed for a number of target years (for example, 2030, 2040, and 2050) as well as for a range of debt burdens (40% of GDP, 50%, 60%). By adjusting the debt target and year, government can construct alternative scenarios and policy paths for the future. Thus, in contrast to baseline projections which often highlight the unsustainability of fiscal trends, gap analysis emphasizes the policy response required to maintain (or restore) sustainability. Projections focus on the fiscal problems that lie ahead, fiscal gap studies indicate the scale of change in revenue and spending policy needed to stabilize public finance. Of course, gap analysis itself is grounded on long-term projections, and is therefore sensitive to the time frame and underlying assumptions.

35. One variant of fiscal gap analysis, generally referred to as the intertemporal budget constraint (IBC), calculates the primary balance (the surplus or deficit exclusive of interest payment) required to stabilize (eliminate, in some versions) the debt burden. This is done by discounting to present value all projected future revenue and spending flows plus the current debt burden. An intertemporal budget gap exists when the present discounted value of projected primary balances does not cover the current debt burden. This method extends gap analysis in several ways: it calculates the prospective gap for an indefinite period rather than for a target year; it recognizes that the present value of fiscal gaps depend on the timing of future financial flows; and it establishes a fiscal constraint – the debt burden – to guide policy. But like all long-term projections, the IBC is sensitive to the starting year of the projection and the discount rate.

36. **Generational accounting.** The approaches discussed thus far define sustainability in terms of the aggregate fiscal position of government. They do not focus on the fairness of fiscal policy across generations, that is, on the benefits that each age cohort will receive (mostly in transfer payments) and the taxes it will pay. Age cohorts may be defined by year of birth or may be grouped into broader categories such as 5-year intervals or decades. Net transfers (taxes paid minus transfers received) are calculated for each cohort. Generational balance (or fairness) exists when future generations have the same net transfers as do current generations. Country studies typically show that while current generations have negative tax rates (they receive more from government than they pay) future generations face extremely high (in some cases, confiscatory) tax rates.

37. Generational accounting is a controversial instrument.¹³ Its advocates propose to replace the traditional method of accounting for the government's revenues and expenditures, and to thereby shift the accounting basis from the present stock of assets and liabilities to long-term flows to and from citizens. Generational accounting is a relatively new technique and is still undergoing development. Its key value may well lie in bringing together disparate information on the future implications of public finances in a single number that is comprehensible by the public at large. It can also be a useful tool in assessing changes in tax or expenditure policy which affect the distribution of costs and benefits across generations. But the apparent simplicity of generational accounts masks the many assumptions underlying it, including the assignment of revenues and expenditures to specific generations. It can be reasonably concluded that rather than replacing traditional measures of government revenues and expenditures, generational accounting will provide useful supplementary information along with a variety of other methods that shed light on long-term financial trends.

3. Budgeting for Sustainable Public Finance

38. Fiscal sustainability is (or should be) a vital issue for all national governments in the OECD community because spending pressures will escalate as populations age and prior commitments or expectations for income transfers and health services come due. In some OECD countries, demands on the budget will not peak for another 30-50 years; in others, they will mature much earlier. Almost all face a fiscal future in which a larger share of the budget is allocated to age-sensitive programs. Many, possibly most, will trim commitments/expectations to order to avoid significantly higher debt or tax burdens. It may be politically expedient to defer action until problems are imminent, but it would not be fiscally prudent to do so.

39. Some countries (such as Australia, Sweden and the United Kingdom) have acted decisively to ameliorate future budget pressures by restructuring their pension systems or pre-funding future payments; most have made no adjustments or only marginal ones that will not significantly ease demands on future budgets. A few (such as New Zealand) have moved to accommodate future fiscal pressures by reducing the current debt burden. Norway has locked away much of the revenue from oil and gas exploration to assure that these monies are available to future generations. Setting up reserves is not a viable option, however, for countries struggling with current budget imbalances. Nor is it feasible for countries that have annual budgets or medium-term frameworks to extend the time boundaries of the budget process to the next 30-50 years. Many countries are still developing techniques to assess the impact of current revenue and spending decisions on the next 3-5 years; they do not yet have the capability to budget for a much longer horizon.

40. Yet the distant future cannot be ignored, for it will creep up on fiscally-stressed governments one year at a time. As far off as it may be, the future can be foreseen, not with perfect certainty but with a sense of the magnitude of the trends that await coming generations. By modeling future trends and calculating the present value of future revenue flows and spending demands, governments can sensitize themselves and voters to the fiscal path that lies ahead. Some may be spurred to revise tax or spending policies on the basis of the new information, while others may lack sufficient political strength or will to change course. All would have a fuller picture of how future fiscal prospects might be affected by current budget actions. Many will become more vigilant in considering options that would worsen future budget conditions.

41. Significantly, countries that have systematically examined the long-term fiscal outlook tend to be ones that have taken the strongest measures to assure sustainability by restructuring pension systems or setting aside funds for future needs. In fact, efforts to ease long-term budget pressures have preceded the publication of long-term sustainability reports. Perhaps governments that have already acted to reduce long-term fiscal pressures are more inclined to be transparent about their future so as to deflect political pressure to reverse their reforms. But all countries can benefit from boldly facing up to their future budget predicament.

42. **Building sustainability analysis into the budget process.** One option for facing the future would be to formally include long-term projections in the annual budget or medium-term framework. These projections would be updated each year the same way that medium-term estimates are rolled forward. The projections would be baselines; they would assume that current (or approved) revenue and spending policies will be continued and that no significant changes will be made. The budget would set out the key social and economic assumptions that underlie the long-term projections, including the estimated impact of fiscal trends on national output, prices, and interest rates.

43. Although it may be feasible to attach long-term baselines to the budget, in my view, it would not be prudent to do so. One should distinguish between a budget, which is inherently a plan for one or more

financial years, and a projection, which is an assumption about how the future might unfold. The budget presents the government's revenue and spending proposals, including policy changes; baseline projections assume that existing policies will not be changed. The budget recommends a specific amount for each revenue or spending item voted by the legislature; the projections often provide a range of estimates or alternative scenarios. The projections will be revised frequently before the target year arrives as policies change, new methodologies are used and fresh information or insights impel changes in basic assumptions. Some revisions will be exceedingly large, opening the projections to misinterpretation when the distant outlook improves or deteriorates. If sustainability projections were published in the core budget, they might be mistaken as government recommendations, rather than as forecasts.

44. Although these projections should be integrated into the budget, neither should they be entirely separate from it. The risk that long-term projections will be ignored is no less a problem than the risk that they will be misused. In my view, the best course would be to report on the long-term prospect in a separate document, but to summarize key findings in a supporting schedule that is included in the budget. This is the tact taken by the United Kingdom. Australia publishes an intergenerational report every five years as one of a series of papers that accompanies the annual budget. To my knowledge, no country has established a long-term budget framework comparable to the medium-term frameworks that are now in vogue. While a medium-term framework constrains the budget actions that government takes in the light of their impacts on revenue and spending levels for each of the next 3-5 years, the long-term projections have not yet been hardened into budget constraints.

45. It is highly probable that some governments will move to regulate the long-term budget impacts of current decisions. The budget resolution adopted by the U.S. Congress in 2005 contains a new provision (effective only in the Senate) that bars consideration of any measure that would cause mandatory spending to increase by more than \$5 billion in any of the four ten-year periods between 2016 and 2055. This provision may be waived by supermajority vote, and does not pertain to the House of Representatives. Nevertheless, it indicates the direction that budget rules might take as governments strive to constrain politicians from shifting costs to future generations.

46. Expansion of the time horizon will take different paths, but governments moving in this direction are likely to take (or consider) the following steps. First, they will develop baseline projections of future revenues and expenditures under current law. Without these baselines, it will be difficult to gauge the impact of current decisions on future budgets. Second, governments will develop capacities to estimate the changes that will occur in future revenues or spending as a consequence of policy change. These estimates will be made at the time the policy change is considered or adopted. They often will be wide of the mark, but they will sensitize governments to the reality that today's actions alter future budget conditions. Third, the methods for estimating these impacts will vary among governments. Some will estimate the present value of changes in future revenues or expenditures; others will estimate these impacts in current or constant dollars, and some will calculate the changes as a proportion of GDP. Fourth, some governments will establish rules that restrict the government's authority to take actions that would increase future deficits (or debt) or reduce projected surpluses.

47. The procedures outlined here would regulate policy changes that affect future budgets. They are generally similar to those used by governments that have medium-term expenditure frameworks, but rather than working with a 3-5 year horizon, they have a 30-50-year prospective. There is no significant methodological difference between a medium-term framework and a distant one, but it must be recognized that the further ahead one looks into the future, the shakier the assumptions are. The problem is not only that long-term estimates are unreliable and will likely prove to be wrong; there is a risk that opportunistic politicians will manipulate the process in ways that would adversely affect future budget conditions. For example, suppose a government were to adopt a "deficit neutral" rule that bars any revenue or spending change that would increase future deficits. It would be possible for a government to "pay for" spending

increases in one program by proposing offsetting cuts in other programs. The tradeoff will not be an equal exchange, however, if the savings were canceled (or trimmed) before they took effect.

48. Regulating policy changes in reference to baseline projections would not deal with imbalances that already are embedded in the budget. This approach might deter governments from making matters worse; it will not; however, restore sustainability in countries where governments are on a fiscal course that would compel significant future increases in the tax or debt burden. It would be appropriate, therefore, for such governments to introduce policy changes that ease future budget pressures. It is not within the scope of this paper to recommend substantive changes in tax or spending policy, but we may offer a generalization that pertains to a broad swath of national policy. During the past half century, national governments in industrial countries have become the holders of risk for society. They have taken on a broad array of direct and contingent liabilities that typically come due decades after critical policy decisions were made. Most of these pertain to income support in the form of pensions, health care, disability insurance, unemployment benefits, and other transfers. The countries which have a more favorable long-term outlook tend to be those that have shifted some of the risks back to households. Doing so is, of course, highly controversial and may have some adverse political or social side-effects. But no matter what means they employ to measure sustainability, governments will not be able to sustain their fiscal course if they continue to be the holders for all major financial risks in society.

49. It behooves national governments to take an inventory of the risks they are holding and to report on them on supplemental notes appended to annual financial statements. Some direct, certain liabilities should be recognized on the balance sheet, but those that are contingent, implicit, or remote should not. Governments should also explore arrangements for contingent liabilities that reduce moral hazard and their exposure to future adverse events.

50. **Managing the sustainability process.** As envisioned in this paper, governments should consider four complementary approaches for bolstering sustainability. One would be to construct long-term fiscal scenarios using cutting-edge socio/econometric techniques such as generational accounting and present-value accounting. Second, governments should extend baseline projections beyond the medium-term using methods that have been applied in medium-term frameworks. Third, governments should estimate the impact of current policy changes on its long-term fiscal outlook. Finally, they should reconfigure fiscal risks, so that a greater portion is shared by households and current generations.

51. Some have suggested that sustainability work requires a greater degree of independence than conventional budget tasks and should therefore be conducted outside government. While government should not have an exclusive claim in assessing future fiscal conditions, it should have a prominent role. In my view, all four responsibilities outlined in the preceding paragraph should be assigned to government. In countries that assign the ministry of finance a broad swath of fiscal and economic responsibilities, it would be the appropriate institution to lead sustainability work. In those that have separate budget and economic management institutions, it would be appropriate for both to cooperate in carrying out these responsibilities. Because of the specialized skills and experience requisite for constructing baselines, it would be unwise to exclude the budget office from this work. When government reports on sustainability, its findings are likely to be regarded as more authoritative than those produced by outside analysts. The attention that sustainability reports have earned in Australia, New Zealand, the United Kingdom and a few other countries is a strong indicator of the advantage of conducting this work in-house. Moreover, then government takes responsibility for the findings, there is a greater probability that it will act to ameliorate downstream problems.

52. Although long-term sustainability does not normally vary significantly from one year to the next, there is considerable gain in routinizing the process by reporting each year. The annuality of these reports fosters an expectation that government will take the problem seriously and that its findings will be fed into

the budget and other decisions. OECD's statement on Best Practices for Fiscal Transparency call for a report assessing the long-term sustainability of current budget policies to be issued every five years, or when major changes are made in revenue or spending programs. It stresses that all key assumptions underlying the projections contained in the report should be made explicit and a range of plausible scenarios presented. Reporting at 5-year intervals would be a considerable gain for governments that do not presently produce any long-term forecast, but as sustainability becomes more embedded in budget work, best practice may be to shorten the interval and to report annually or every other year.

53. The manner in which key findings are presented will strongly influence the consideration they receive. Sustainability analysis is complex, open to a variety of methodological approaches, often produces a range of estimates and an array of scenarios. For the results to filter to the media and the public, it is important that they be presented in ways that non experts can comprehend, even if doing so requires that some of the findings be simplified. One example of effective communication is the annual report of the trustees of the social security system in the United States. Each year the report captures front-page attention because it specifies the year in which the social security fund will be depleted if current policy continues without change. The trustees are appointed by the government but exercise independent judgment in their report which is regarded as an objective and authoritative forecast. The most recent report, issued in March 2005, projected that the main medical insurance fund will be exhausted in 2020 and that the social security fund will be exhausted in 2041. The report also contains 75-year actual forecasts that show social security expenditures rising from 4 to 6 percent of GDP and medicare expenses soaring from 3 percent to almost 14 percent. Layers of assumptions undergird this single statistic, and these are appropriately discussed in the body of the report. It should be feasible to devise simple measures for the various types of sustainability analyses that national governments and outside experts have used to portray the fiscal future.

54. This paper began by noting that sustainability concerns have migrated from underdeveloped to developed countries and have shifted from medium- to long-term concerns. The long-term may appear distant, but in reengineering fiscal policy, it is already here. Most persons who will receive public pensions and health benefits 40 or 50 years from now are already in the country's work force, contributing social insurance taxes and building expectations of what they will receive from government. Sooner or later all countries will have to confront the reality of expectations outracing means. Those that take on the task earlier will find it somewhat less onerous than those that tarry.

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- 1 International Monetary Fund, Assessing Sustainability, May 28, 2002, p. 12.
2 European Commission, Public Finances in EMU 2004,
3 Congressional Budget Office, The Long-Term Budget Outlook, December 2003, p. 14.
4 United Kingdom, HM Treasury, Long-Term Public Finance Report: An Analysis of Fiscal Sustainability,
December 2004, p. 4.
5 European Commission, p. 59.
6 Commonwealth of Australia, , the Treasury, Intergenerational Report 2002-03, Budget Paper No. 5, 14
May 2002, p. 2.
7 Ibid.
8 Ibid.
9 United Kingdom, HM Treasury, p. 4.
10 Peter S. Heller, Who Will Pay?, International Monetary Fund, 2003, p. 130.
11 See, Dan Crippen, "Countering Uncertainty in Budget Forecasts", IECD Journal on Budgeting, vol 3, No 2,
useful advice on dealing with the inherent uncertainty of long-term budget scenarios.
12 See Mario Blejer and Adrienne Cheasty, eds. How to Measure the Fiscal Deficit: Analytical and
Methodological Issues, International Monetary Fund, 1993.
13 OECD, Public Management Service, "Budgeting for the Future," 1996 Meeting of Senior Budget Officials.



Federal Accounting Standards Advisory Board

March 15, 2007

[Name, title]

Dear _____,

Thank you for accepting the Board's invitation to participate in a Task Force on Fiscal Sustainability Reporting. Your participation will assist the Board in improving reporting to the public about the long-term fiscal outlook of the U.S. Government.

This briefing package contains the following:

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|---|----|
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| 2. Plan to Address the Issue | 4 |
| 3. Existing Reporting in the Financial Report of the U.S. Government (FR) | 5 |
| 4. Existing Reporting in (a) the Budget of the U.S. Government (b) the Trustees Reports for Social Security and Medicare and (c) Other Sources | 8 |
| 5. Suggested Topics for Consideration by the Task Force | 10 |

The meeting for the technical experts will be held on April 5, 2007 from 9:00 A.M. to 3:30 P.M. in room 7B16 at 441 G Street, N.W., Washington, DC. (A second meeting may be convened, if necessary.)

If you have any questions, concerns or comments, please contact Ms. Eileen Parlow, Assistant Director and project manager, at 202-512-7356, e-mail ParlowE@fasab.gov or me at 202-512-7357, e-mail ComesW@fasab.gov

I look forward to working with you on this important issue.

Sincerely,

Wendy M. Comes
Executive Director

1. The Issue

The mission of the Federal Accounting Standards Advisory Board (FASAB) is to develop accounting standards for the Federal government after considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and the needs of other users of Federal financial information.

Accounting and financial reporting standards are essential for public accountability and for an efficient and effective functioning of our democratic system of government. Thus, Federal accounting standards and financial reporting play a major role in fulfilling the government's duty to be publicly accountable and can be used to (1) assess the government's accountability and its efficiency and effectiveness, and (2) contribute to the understanding of the economic, political, and social consequences of the allocation and various uses of Federal resources. (For more information on the FASAB's organization and mission, see <http://www.fasab.gov/aboutfasab.html>)

The FASAB is considering what information would be most likely to enable readers of Federal financial reports to determine whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due. Ultimately, this may enhance the public's understanding of long-term fiscal issues.

Many believe that Federal financial reports currently do not adequately address the Federal financial reporting objective, titled "stewardship," presented below.

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. [Source: Statement of Federal Financial Accounting Concepts (SFFAC) 1, pars. 134-145, available at <http://www.fasab.gov/codifica.html>]

SFFAC 1 indicates that "financial condition" is a broader and more forward-looking concept than that of "financial position" as reported via the balance sheet. Reporting on financial condition requires information about the national economy and society, as well as about the government itself. Indicators of financial position, measured on an accrual basis, are the starting point for reporting on financial condition but must be supplemented in a variety of ways. Many of the examples provided in SFFAC 1 suggest a projection of the economy as a whole to provide a context against which to assess budget projections. (SFFAC 1, par. 144-145)

Attachment 2

Although the annual Financial Report of the U.S. Government includes a Statement of Social Insurance and extensive accompanying information, it may not adequately address the financial condition of the government as a whole, particularly regarding projected long-term fiscal imbalances. In its audit report on the Fiscal Year (FY) 2006 Financial Report of the U.S. Government, the Government Accountability Office (GAO) noted the following:

The Nation's Fiscal Imbalance

While we are unable to express an opinion on the U.S. government's consolidated financial statements, the following key items deserve emphasis in order to put the information contained in the financial statements and the Management's Discussion and Analysis section of the *2006 Financial Report of the United States Government* into context. Despite improvement in both the fiscal year 2006 reported net operating cost and the cash-based budget deficit, the U.S. government's total reported liabilities, net social insurance commitments, and other fiscal exposures continue to grow and now total approximately \$50 trillion, representing approximately four times the Nation's total output (GDP) in fiscal year 2006, up from about \$20 trillion, or two times GDP in fiscal year 2000. As this long-term fiscal imbalance continues to grow, the retirement of the "baby boom" generation is closer to becoming a reality with the first wave of boomers eligible for early retirement under Social Security in 2008. Given these and other factors, it seems clear that the nation's current fiscal path is unsustainable and that tough choices by the President and the Congress are necessary in order to address the nation's large and growing long-term fiscal imbalance. [Source: Financial Report of the U.S. Government, 2006, Government Accountability Office Report, page 152. This document is available at <http://www.fms.treas.gov/fr/index.html>]

The bipartisan Concord Coalition, in partnership with the Heritage Foundation, the Brookings Institution, the American Institute of Certified Public Accountants, the AARP and other organizations, has been conducting a "Fiscal Wake-Up Call Tour" in an attempt to inform the American public of the nation's long-term fiscal imbalances. (For further information, see <http://www.concordcoalition.org/about.html> and "Tour Q&A" at <http://www.gao.gov/special.pubs/longterm/tourqa.html>)

Attachment 1 is a copy of a presentation given at a Fiscal Wake-Up Tour event by the Comptroller General entitled *Saving Our Future Requires Tough Choices Today*, (Manchester, New Hampshire, February 13, 2007, GAO-07-495CG).

Attached for additional detail and background are:

- Opening Remarks at the [Congressional Budget Office] Director's Conference on Long-Term Budget Challenges, December 8, 2006 (Attachment 2)
- "Stewardship" from the FY 2008 Budget of the U.S. Government, "Analytical Perspectives" volume (Attachment 3) The complete volume is available at <http://www.whitehouse.gov/omb/budget/fy2008/>

Attachment 2

In addition, enclosed is a bound copy of the 2006 Financial Report of the U.S. Government.

2. Plan to Address the Issue

The Board is requesting the recommendations of a task force whose members have technical knowledge relevant to the issues and/or communications expertise relevant to the challenge of how to effectively communicate information on fiscal sustainability. A list of the “technical experts” task force members is presented as Attachment 10.

A subsequent “financial statement users/communications experts” group will review the recommendations of the technical experts and discuss reporting options that would maximize the understandability of the information presented. This group will include members of Congress, the media, and academia.

Note: Suggested topics for consideration by the Task Force members are in section 5 on page 10 of this document.

Next Steps

a) A roundtable meeting for the “Technical Experts” is scheduled for April 5, 2007 to discuss the views of task force members on the technical issues and recommendations that individual members wish to make. A second meeting may be convened, if necessary.

b) After this meeting, FASAB staff will draft a paper to convey the group’s views and recommendations to the “Financial Statement Users/Communications Experts” group. The technical experts will be asked to review the draft paper to ensure that their views and recommendations are adequately presented.

c) The Financial Statement Users/Communications Experts group will meet (tentatively in June 2007) to discuss communications options. The technical experts may also opt to attend this meeting, if desired.

c) FASAB staff will draft the tentative recommendations and alternative proposals resulting from the above. Members of both the technical and communications groups will be asked to review and comment on this document (tentatively in late July 2007).

d) After review by task force members, FASAB staff will present recommendations to the FASAB for consideration at the September 2007 Board meeting. The FASAB will review the recommendations of the task force and will deliberate on whether new reporting standards should be proposed. A resulting proposal would be documented in an Exposure Draft and released for public comment.

3. Existing Reporting in the Financial Report of the U.S. Government (FR)

Existing Reporting Requirements for the Financial Report of the U.S. Government: Overall Long-Term Fiscal Outlook

Current reporting requirements for the U.S. Government's long-term fiscal outlook are contained in paragraphs 3 and 6 of Statement of Federal Financial Accounting Standards (SFFAS) 15, *Management's Discussion and Analysis*, (MD&A) as follows:

[3] MD&A should include forward-looking information regarding the possible future effects of the most important existing, currently-known demands, risks, uncertainties, events, conditions and trends. MD&A may also include forward-looking information about the possible effects of anticipated future demands, events, conditions, and trends.³ Forward-looking information may comprise a separate section of MD&A or may be incorporated with the sections listed above.

[6] MD&A should deal with the "vital few" matters; i.e., the most important matters that will probably affect the judgments and decisions of people who rely on the general purpose Federal financial report (GPFFR) as a source of information. (The specific topics mentioned in *Concepts for Management's Discussion and Analysis* are examples of items that might be relevant for MD&A of a given entity.) Matters to be discussed and analyzed are those that management of the reporting entity believes it is reasonable to assume could:

- lead to significant actions or proposals by top management of the reporting unit;
- be significant to the managing, budgeting, and oversight functions of Congress and the Administration; or
- significantly affect the judgment of citizens about the efficiency and effectiveness of their Federal Government.

³The word "anticipated" is used in a broad, generic sense in this document. In this context the term may encompass both "probable" losses arising from events that have occurred, which should be recognized on the face of the basic or "principal" financial statements, as well as "reasonably possible" losses arising from events that have occurred, which should be disclosed in notes to those statements. "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. Such information about the possible effects of anticipated future demands, events, conditions and trends, if presented, should include the term or label "projected" or "projection," and the key hypothetical underlying assumptions should be explained. As with other information presented in MD&A, no examination of this information by the auditor is now routinely included within the scope of an audit of a federal entity's financial statements; however, preparers and auditors may find useful background information in the AICPA's Statements on Standards for Attestation Engagements Nos. 1 and 4, codified as section 200, "Financial Forecasts and Projections," of the AICPA's *Codification of Statements on Standards for Attestation Engagements*.

Attachment 2

The FASAB elaborated on the above requirements in its companion concept statement, SFFAC 3, Management's Discussion and Analysis, which explains the Board's expectations regarding the description of future effects of both existing and anticipated events, conditions and trends.

Attachment:

Statement of Federal Financial Accounting Concepts 3, pars. 32-36 (Attachment 4)

In addition to reporting on the long-term fiscal outlook, there are also reporting requirements for social insurance programs in SFFAS 17, *Accounting for Social Insurance*. The SFFAS 17, as amended by SFFAS 26, requires that for both Federal agencies and the government-wide Financial Report:

- a liability be recognized when payments are due and payable to beneficiaries or service providers and
- a basic financial statement, the Statement of Social Insurance, be presented that displays the actuarial present values of future benefits for, and contributions and tax income from or on behalf of (a) current participants who have not yet attained retirement age, (b) current participants who have attained retirement age, and (c) future program participants.

Supplemental information is also required to be reported to facilitate the assessment of:

- the long-term sustainability of the program from both an entity and a governmentwide perspective and
- the ability of the program and the nation to raise resources from future program participants to pay for benefits proposed to present participants.

The required supplemental information includes long-range cashflow projections, and long-range projections of the ratio between the number of those paying taxes earmarked for the program and the number of program beneficiaries, and projections of income and expenditures as a percentage of taxable payroll and as a percentage of Gross Domestic Product (GDP).

The required supplemental information also includes a sensitivity analysis that shows the effect of varying several significant assumptions to show the effect on the projections. Significant assumptions include birth and death rates, net immigration, the real wage differential, and the real interest rate. The "real wage differential" is the difference between the annual percentage increase in wages in covered employment and the inflation rate, as measured by the Consumer Price Index.

(See SFFAS 17, pars. 9, 10, 27 and 31 as amended by SFFAS 26, par. 5.)

Existing Reporting in the Financial Report of the U.S. Government

In FY 2006, the Management's Discussion and Analysis section of the Financial Report of the U.S. Government included a discussion of long-term spending trends for Social Security and Medicare:

Trustees Long-Range Outlook (2005-2080)

Social Security and Medicare costs increase steeply between 2010 and 2030 because the number of people receiving benefits will increase rapidly as the large baby-boom generation retires. Thereafter, Social Security costs grow slowly primarily due to projected increasing life expectancy. Medicare costs continue to grow rapidly due to expected increases in the use and cost of health care. The continued development of new technology is expected to cause per capita health care expenditures to continue to grow faster in the long term, than the economy as a whole.

Comparison of projected Social Security and Medicare costs to gross domestic product (GDP) is a commonly-used metric for fund analysis. Medicare costs are projected to exceed Social Security's in 2024. Social Security expenditures amounted to 4.3 percent of GDP in 2006 and is projected to increase to 6.3 percent of GDP in 2080. Medicare's cost amounted to 3.2 percent of GDP in 2006 and is projected to grow more than threefold to 11.0 percent of GDP in 2080. Absent reform, Social Security and Medicare together will more than double as a percentage of the U.S. economy, from nearly 6 percent in 2006 to over 17 percent by 2080. [Source: Financial Report of the U.S. Government, 2006, page 18.]

Following the two paragraphs quoted above, an additional section of the Management's Discussion and Analysis, "The Government's Net Liabilities and Its Responsibilities" (pages 19-20), provides additional information.

In addition, Note 23, "Social Insurance," and the Stewardship Information section (pages 107-136) provide over 30 pages of detailed information on long-term projected status of Social Security, Medicare, and other social insurance programs.

The GAO has recommended a separate financial statement on sustainability, described in the "Government Accountability Office Comptroller General's Statement" on the FY 2006 Financial Report of the U.S. Government:

Although improvements have been made, additional financial reporting enhancements are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. Specifically, the federal government's financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include a Statement of Fiscal Sustainability—providing a long-term look at the sustainability of social insurance in the context of all federal programs.^[9] The reporting on fiscal sustainability should include additional information that will assist in

Attachment 2

understanding the sustainability of current social insurance and other federal programs, including key measures of fiscal sustainability and intergenerational equity,^[10] projected annual cash flows, and changes in fiscal sustainability during the reporting period. Further, earmarked Social Security and Medicare taxes that have not yet been used to pay benefits should be recorded as deferred earmarked revenue, resulting in an additional liability for such social-insurance-related obligations.^[11] As of September 30, 2006, such “unused” earmarked taxes related to social insurance totaled over \$2 trillion.

[Source: Government Accountability Office Comptroller General’s Statement, page 29 of the Financial Report of the U.S. Government, FY 2006.]

[9] The Statement of Fiscal Sustainability would show the relationship between the present value of projected revenues and outlays for social insurance and for all other federal programs.

[10] Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

[11] The FASAB recently issued the preliminary views document, *Accounting for Social Insurance, Revised* (Washington, D.C.: Oct. 23, 2006), which discusses differing views on accounting for social insurance.

Attachments:

- Statement of Social Insurance, FY 2006 (Attachment 5. Full report is available at: <http://www.fms.treas.gov/fr/index.html>)
- Required Supplemental Information, FY 2006 Financial Report of the U.S. Government (Attachment 6. Full report is available at: <http://www.fms.treas.gov/fr/index.html>)

4. Existing Reporting in (a) the Budget of the U.S. Government (b) the Trustees Reports for Social Security and Medicare and (c) Other Sources

(a) Existing Reporting in the Budget of the U.S. Government

Chapter 13, “Stewardship,” of the U.S. Budget’s *Analytical Perspectives*, in particular, (see especially Part III, “The Long-Term Budget Outlook”) provides detailed estimates of budget projections for the U.S. Government as a whole.

Part I of this chapter, in a section titled “Relationship with FASAB Objectives,” notes that:

The [U.S. Government] *Financial Report* also includes a statement of social insurance that reviews a substantial body of information on the condition and sustainability of the Government’s social insurance programs. The Report, however, does not extend that review to the condition or sustainability of the Government as a whole, which is a main focus of this chapter, and it does not try to relate the Government’s assets and liabilities to private wealth or broader economic and social conditions. [Source: *Analytical Perspectives*, Budget of the U.S. Government, Fiscal Year 2008, page 176.]

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The Budget of the U.S. Government is published on a different timetable from the annual financial statements. The financial statements of the U.S. Government are published in mid-December for the fiscal year ended September 30th. The relevant chapter in the U.S. Budget's *Analytical Perspectives* is somewhat outdated as it is issued the previous February. However, updated data is available as part of the U.S. Budget's Mid-Session Review, issued in July of each year.

(b) Existing Reporting in the Trustees Reports for Social Security and Medicare

The annual Trustees Reports for Social Security and Medicare provide hundreds of pages of detailed reporting and estimates. Since 1983 the Trustees have published, in addition to the regular full report, a summary document which contains a brief and easier-to-understand summary of the highlights of the full report. During the 1980s and in 1990, the summary was included as part of the larger report. Since 1991 the summaries have been published as separate documents. Each year, the Office of the Actuary publishes the current summary document on its website along with the longer full report.

The timing of the Trustees Reports varies; they are generally issued in March of each year, although they were issued in May of 2006. The summary reports may be a valuable resource for citation in potential reporting on fiscal sustainability. A copy of the 2006 Summary Report is attached (Attachment 7).

(c) Existing Reporting: Other Sources

Since 1992, the GAO has published long-term fiscal simulations of what might happen to Federal deficits and debt levels under varying policy assumptions. The most recent is "The Nation's Long-Term Fiscal Outlook: January 2007 Update" (Attachment 8).

The Congressional Budget Office (CBO) issues an annual report, "The Budget and Economic Outlook" with periodic updates. The most recent is "The Budget and Economic Outlook: Fiscal Years 2008-2017." The summary section of this report is attached (Attachment 9). The CBO also issued "The Long-Term Budget Outlook" in December 2005. Both reports are available on the CBO website at www.cbo.gov.

Attachments:

- Status of the Social Security and Medicare Programs: A Summary of the 2006 Annual Reports- Social Security and Medicare Boards of Trustees (Attachment 7. Full report available at: <http://www.ssa.gov/OACT/TR/>)
- The Nation's Long-Term Fiscal Outlook: January 2007 Update (Attachment 8: GAO-07-510R, dated February 23, 2007)
- The Budget and Economic Outlook: Fiscal Years 2008-2017, Summary section (Attachment 9. Full report available at www.cbo.gov)

5. Suggested Topics for Consideration by the Task Force

Technical Issues (to be discussed at the April 5, 2007 meeting):

Information relating to fiscal sustainability is currently available from numerous sources, including those described above and attached. The complexity and sheer volume of the available information may be an impediment in promoting understanding of the issue by the general public.

Potential areas for discussion include but are not limited to:

- (a) Within Federal financial reporting objectives, reporting on fiscal sustainability requires information to determine “whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.” Should this objective be supplemented through more detailed goals? For example, fiscal sustainability is assessed by considering the stability of debt as a percent of gross domestic product (GDP) over time.
- (b) What specific measures would be the most useful and meaningful to financial statements users? Examples include:
 - i. Projected cash inflows and outflows (with or without historical deficit/surplus trends)
 - ii. Relationships between projected cash flows and projected GDP (with or without historical trends)
 - iii. Per capita amounts and/or ratios for selected items
 - iv. Key dates for the Medicare and Social Security trust funds
 - v. Potential measures of intergenerational imbalance and/or fiscal gap
 - vi. Other measures providing context for government spending (examples: ratio of national debt to GDP; percentage of foreign holdings of Treasury bonds)
- (c) For each specific measure selected, should current, future and/or historical trends be presented? If so:
 - i. which future time periods should be presented (example: short term (10-year), and/or long term (75-year), and/or infinite horizon)?
 - ii. which past time periods should be presented?
- (d) Should existing reports (such as the Trustees Reports) be utilized when the financial reports are being prepared (November)?
- (e) What policy assumptions should be used (e.g., current law, current law adjusted based on reasonable expectations, or the Administration’s Budget Proposal)?
- (f) Which economic assumptions should be used?

Attachment 2

- (g) How should uncertainties (such as higher or lower projected ranges) be presented, referenced or explained?
- (h) Should interdependencies be addressed through modeling or should the models assume behavior remains constant over time?
- (i) How can the sensitivity of the projections to changes in assumptions be succinctly explained to readers?

Communications Issues (to be discussed at the future Financial Statement Users/Communications Experts meeting(s))

The specific issues to be discussed will align with the recommendations of the technical experts. General issues may include:

- (j) Should a list of selected “dashboard indicators” be recommended?
- (k) Should sustainability reporting be an element within the financial statements that could also stand alone as a popular report?

Attachments and Links:

- (1) Comptroller General's presentation, *Saving Our Future Requires Tough Choices Today*, Fiscal Wake-Up Tour at Saint Anselm College, Manchester, New Hampshire, February 13, 2007 GAO-07-495CG. (Available at <http://www.gao.gov/cghome.htm>)
- (2) Opening Remarks at the [Congressional Budget Office] Director's Conference on Long-Term Budget Challenges, December 8, 2006 (Available at <http://www.cbo.gov/publications/past90days.cfm>)
- (3) “Stewardship” from the FY 2008 Budget of the U.S. Government, “Analytical Perspectives” section (Available at <http://www.whitehouse.gov/omb/budget/fy2008/>)
- (4) Statement of Federal Financial Accounting Concepts 3, paragraphs 32-36 (Available at: <http://www.fasab.gov/codifica.html>)
- (5) Statement of Social Insurance, FY 2006 (Available at <http://www.fms.treas.gov/fr/index.html>)
- (6) Required Supplemental Information, FY 2006 Financial Report of the U.S. Government (Available at: <http://www.fms.treas.gov/fr/index.html>)
- (7) Status of the Social Security and Medicare Programs: A Summary of the 2006 Annual Reports- Social Security and Medicare Boards of Trustees (at <http://www.ssa.gov/OACT/TRSUM/trsummary.html>)
- (8) The Nation's Long-Term Fiscal Outlook: January 2007 Update (GAO-07-510R, dated February 23, 2007; also available at www.gao.gov)
- (9) The Budget and Economic Outlook: Fiscal Years 2008-2017, “Summary” section. Full report available at www.cbo.gov)
- (10) List of Task Force members (technical experts group)

Enclosure:

Financial Report of the U.S. Government (bound copy)



March 5, 2007

Dr. Joseph Antos
The American Enterprise Institute
1150 Seventeenth St., N.W.
Washington, DC 20036

Dear Dr. Antos:

Enclosed for your information is a copy of *Preliminary Views- Accounting for Social Insurance, Revised*. This document can also be accessed via the FASAB website at <http://www.fasab.gov/exposure.html>.

The document is focused primarily on the question of reporting expenses and liabilities for social insurance programs on the operating statement and balance sheet. It presents two "Views," a Primary View and an Alternative View.

The Alternative View is presented in paragraphs 42-87. It recommends sustainability reporting in paragraphs 75-84 and provides an illustrative example in Appendix C. The proposed statement and the Preliminary Views document are referenced in the briefing package for the fiscal sustainability task force on page 7.

Although the Board as a whole has not deliberated upon the Alternative View, the Board asked staff to send a copy to the "technical experts" members of the task force.

The Alternative View proposal and illustration will not be a part of the April 5, 2007 meeting agenda, unless the task force participants wish to address it.

Looking forward to meeting with you in April.

Sincerely,

Wendy M. Comes
Executive Director

Cc: Members of the FASAB



Federal Accounting Standards Advisory Board

March 5, 2007

Dr Jagadeesh Gokhale
Cato Institute
1000 Massachusetts Avenue, N.W.
Washington, DC 20001-5403

Dear Dr. Gokhale:

Enclosed for your information is a copy of *Preliminary Views- Accounting for Social Insurance, Revised*. This document can also be accessed via the FASAB website at <http://www.fasab.gov/exposure.html>.

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Sincerely,

Wendy M. Comes
Executive Director

Cc: Members of the FASAB



Federal Accounting Standards Advisory Board

March 5, 2007

Dr. Allen Schick
Brookings Institution, Governance Studies Program
1775 Massachusetts Avenue, N.W.
Washington, DC 20036-2188

Dear Dr. Schick:

Thank you for meeting with us on February 22, 2007 to share your thoughts on fiscal sustainability reporting for the U.S. Government. Enclosed for your information is a copy of *Preliminary Views- Accounting for Social Insurance, Revised*. This document can also be accessed via the FASAB website at <http://www.fasab.gov/exposure.html>.

The document is focused primarily on the question of reporting expenses and liabilities for social insurance programs on the operating statement and balance sheet. It presents two "Views," a Primary View and an Alternative View.

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We would appreciate any comments that you might wish to share- either on the Questions for Respondents, or specifically on the straw-man Statement of Fiscal Sustainability. Many thanks.

Sincerely,

Wendy M. Comes
Executive Director

Cc: Members of the FASAB



Federal Accounting Standards Advisory Board

March 5, 2007

Dr. C. Eugene Steuerle
Urban Institute
2100 M Street, N.W.
Washington, DC 20037

Dear Dr. Steuerle:

Enclosed for your information is a copy of *Preliminary Views- Accounting for Social Insurance, Revised*. This document can also be accessed via the FASAB website at <http://www.fasab.gov/exposure.html>.

The document is focused primarily on the question of reporting expenses and liabilities for social insurance programs on the operating statement and balance sheet. It presents two "Views," a Primary View and an Alternative View.

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Looking forward to meeting with you in April.

Sincerely,

Wendy M. Comes
Executive Director

Cc: Members of the FASAB