



November 16, 2007

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Payne, Executive Director

Subj: **Fiscal Sustainability Reporting – Tab F**

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.

Objective: To review a draft exposure draft (ED) for a proposed standard: “Comprehensive Long-Term Fiscal Projections for the U.S. Government,” gain tentative approval of (1) the revised objectives section and (2) guidance on selection of assumptions, and obtain initial feedback on draft display options.

The attached partial draft ED includes coverage of objective and assumptions. These sections have been revised based upon member comments at the September 2007 Board meeting and staff consultation with task force members representing the Department of the Treasury (Treasury), the Office of Management and Budget (OMB), the Government Accountability Office (GAO) and the Congressional Budget Office (CBO). I hope to gain tentative approval of these portions of the ED at the December meeting.

The attached draft ED also includes initial draft requirements for a proposed reporting package within the context of the consolidated financial report of the U.S. Government (CFR). The proposed reporting package includes

- (a) a “primary summary display” and
- (b) required additional reporting in the form of narrative and graphic displays.

Future Board discussions will address the potential placement of the proposed reporting package within the CFR. These discussions will be in coordinated with the conceptual framework project on communications methods, which addresses the presentation and

audit status of information within a general purpose federal financial report. For this reason, items have been given titles such as “Primary Summary Display” that are neutral in terms of where they might be placed within the CFR.

With respect to the draft displays and other components of the reporting package, I hope to obtain feedback from you regarding the merits of three possible summary displays including the pros and cons of displaying “per capita” measures. Selecting one or more sample display(s) to be included in the ED involves many discrete decisions. At this time, my goal is to identify any initial preferences you have between the displays. I will provide a complete analysis of issues and options raised by task force members at later meetings. As such issues are addressed; I will incorporate the necessary changes in the summary display(s).

Issues for such future discussions include:

- Appropriate horizon for summary amounts: 75 years, 100 years, or “infinite” horizon,
- Whether it is appropriate to display range or point estimates on the face of the primary display,
- Initial discussion of proposed requirements for additional information to be provided via narrative and graphics,
- Placement and audit status of the proposed reporting package within the CFR in coordination with separate concepts project,
- Title for the “primary summary display” that is appropriate to its proposed placement within the CFR,
- Whether the scope of this project should be expanded to include generational accounting beyond the cohort information already in the SOSI, and
- Changes in assumptions (whether prior periods displayed should be restated for significant changes in economic or policy assumptions).

Note also that aspects preferred in one display may be added to another display to arrive at an overall preferred display.

Questions for the Board:

Specific questions for the Board appear on pages 3, 4, 6, 12, and 13 of this document, and on pages 44, 46, and 52 of the draft ED.

Board members are also encouraged to send questions and comments on any aspect of the draft ED directly to staff at any time. Staff is best able to research questions that are received prior to Board meetings.

Following is a more detailed discussion of the draft that may serve as a guide to Board discussion in December.

1) Objectives

Staff revised the “Objectives” sections (paragraphs 1-10 and Basis for Conclusions paragraphs A2-A3 and A7-A9) based upon the Board’s discussion and recommendations at the September 2007 Board meeting. Changes include:

- Integrating the notion of “current policy” into the objectives section,
- Streamlining the example list of four questions that the report should assist the reader in answering to two, and
- Removing the Australian description of fiscal sustainability and including the general expectation that current policy may be fiscally sustainable in the absence of permanent deficits and rising debts.

Question for the Board:

Are there additional comments on the objectives portion of the ED?

2) Assumptions

Staff revised the “Assumptions” sections (paragraphs 19-31 and Basis for Conclusions paragraphs A 10- A 29) based upon the Board’s discussion and recommendations at the September 2007 Board meeting. The Board recommended general guidance and asked that staff confer with the federal members of the task force. On October 15, 2007, we met with the technical experts representing OMB, CBO, GAO and Treasury on the Fiscal Sustainability Task Force, revised the draft based on their input and provided another opportunity for them to comment. In addition, staff sought comments from the entire task force on the draft material and incorporated comments as appropriate.

The revised ED explains that the overall objective is a projection consistent with current policy and provides general guidance regarding situations when current law is not consistent with current policy. Definitions of current policy, policy assumptions and economic assumptions are included.

With respect to conservatism, staff previously recommended requiring the selection of the least optimistic assumption if no single assumption within a range of assumptions was most likely. The draft now provides that conservatism be considered in the context of the overall set of assumptions so that the projection is not systematically biased toward higher deficits.

Questions for the Board:

- a) Are there areas where the intent of the text is unclear?
- b) Does the Board agree with the definition of “current policy” and the explanatory text?
- c) Does the Board agree with the guidance regarding situations when current law would not result in projections consistent with current policy?
- d) Does the Board agree with the revised guidance regarding conservatism?
- e) Does the Board agree with the guidance on economic assumptions?
- f) Are there other comments on the draft regarding assumptions?

3) Milestone Dates

The dates for issuance of the ED, the comment period, and the public hearing are the dates in the Project Plan and reflect the Board’s interest in issuing an ED as promptly as feasible due to the importance of the subject matter and the concept that this reporting is likely to evolve over time in response to user feedback. The dates will be changed if necessary.

4) “Per Capita” measures

“Per capita” measures allocate a total amount- which can be either a historical amount or the present value of a projected amount- among members of designated populations (e.g., total population, workers, or households). Population segments other than individuals (such as households) need to be defined and explained.

The Task Force technical group did not come to a consensus regarding whether per capita amounts should be displayed. Significant technical issues were raised regarding the appropriate denominator when the numerator is the present value of flows over a specified time horizon. Staff has attempted to provide options that are technically appropriate because the communications group believes that some per capita information is helpful.

Per capita amounts are presented with certain of the display options. Draft display option A was based on the statement of fiscal sustainability presented in the Social Insurance PV and includes per capita amounts. Draft display option B was offered by one of the task force members – Jagadeesh Gokhale – and does not include per capita amounts. Draft display option C was developed by staff and includes selected per capita amounts. However, the inclusion of per capita amounts is an option that can be considered separate from any preferences among display formats. (In fact, per capita amounts may be included in the narrative or as an added graphic rather than on the face of the display.)

Below are the advantages and disadvantages of “per capita” measures:

Pro:

- Per capita measures may be useful in conveying to the reader the magnitude of the projected fiscal imbalance. Many of the amounts inherent in the projections are very large- often multiple trillions of dollars. Such amounts are difficult for a reader to assess unless some context is provided. Per capita measures provide context to help the reader assess the information provided.
- Per capita measures are generally calculated only for selected high-level totals rather than for each detail or line item displayed. This summarization provides a focal point, a “bottom line.” A “bottom line” was strongly recommended by the communications group.
- The communications group- and several of the technical members- emphasized that the information should answer questions such as “Why should I care? What does this mean to me (or to people important to me)?” Per capita measures have the potential to provide information meaningful to individuals.

Con:

- Several technical members strongly objected to the use of per capita summary numbers using current-year population for the denominator. Such values would imply that the current-year population is solely responsible for funding program shortfalls into the distant future. Those members believe that any changes needed to address the shortfalls projected through, for example, the next 75 years, must be spread across the population throughout that 75-year period, and cannot be handled solely by today's workers. (Staff note: This objection could be resolved by the careful selection of denominators for per capita measures.)
- “Per capita” measures for infinite-horizon projection periods present special problems. It is uncertain how a reasonable “per capita” denominator for the “infinite horizon” ratio would be selected and explained, especially if the denominator includes an estimate of all individuals that enter the population during the projection period.
- Two Task Force members believe that even present value per capita amounts can be misinterpreted, because the reader will compare the amount with current salary levels and not understand the role of potential future productivity increases. One Task Force member objects to “per capita” amounts because they represent amounts distributed equally among individuals with widely different abilities to pay.

Staff recommendation:

Based upon the above pros and cons, staff believes that some per capita measures are both meaningful to readers and technically reasonable. These measures are:

- a) Per capita measures of historical information based upon population as of the historical date. For example, a per capita display of Treasury debt held by the public as of the financial statement date is important information for readers.
- b) Per capita measures of projected information for a finite-horizon projection period, when the denominator is the projected population for the entire projection period.

Staff believes that some per capita measures can be misleading or confusing to readers. These measures are:

- c) Per capita measures of projected information based upon only the current population. Staff agrees with the technical experts who object to this measure.
- d) Per capita measures of projected information for infinite-horizon projection periods. Since the denominator should represent the total future population forever, staff believes that such a display would be less meaningful to readers and would capture less interest than a finite-horizon projection and per capita ratio.

Accordingly, staff recommends that per capita measures (a) and (b) above should be included in proposed reporting and that per capita measures (c) and (d) above should be excluded.

Question for the Board:

Does the Board agree with staff recommendation on per capita measures?

5) Primary Summary Display

The ED presents three initial options for a primary summary display. The third option, Option C, is a combination of some of the elements of Options A and B; the Board may wish to combine any features into a new primary display.

The information common among the displays is:

- a) Each presents summary – or present value - amounts for specified time periods.¹
- b) Present value of receipts and outlays with Social Security and Medicare amounts separately displayed (but with varying detail between the displays). “Rest of government” is presented with no further disaggregation.

¹ Some of the technical experts on the task force object to summary measures because they do not portray the timing of or trend in receipts and outlays. Summarized values also can not convey information beyond the period summarized. The communications experts on the task force supported summary measures and staff believes summary measures supplemented by narrative and graphics that convey the timing and trend information is the optimal approach.

- c) The calculated net present value over the selected time period is the “bottom line.” (One proposal includes net financial assets in the calculation while the others do not.)
- d) Significant required narrative and graphics would accompany each display. The quality and clarity of the narrative is critical to communication. Absent high quality narrative, any display or graphic selected is not expected to meet the reporting objective.
- e) Each display includes some information as a percent of GDP.
- f) Each display would be accompanied by:
 - An explanation of key terms
 - An explanation of assumptions
 - Narrative and graphics to show trends of annual deficit or surplus as a % of GDP
 - Narrative and sensitivity analysis for alternative scenarios for major assumptions
 - Narrative explaining how options for addressing any issues will become more limited and/or the impact of the options more severe if action is delayed

The unique features of each display will be discussed and the pros and cons of each will be presented below. Our objective for the meeting is to (1) determine the level of support for a summary display and (2) identify any preferences or concerns members have with each option. We will further develop the options

Option A: Summary of Long-Term Fiscal Position

Option A is based upon the proposed “Statement of Fiscal Sustainability” that was included in the Alternative View of *Preliminary Views – Accounting for Social Insurance, Revised*.² Revisions were made based upon recommendations of the communications members of the Task Force. In addition, staff has added potential sub-lines to “Receipts and Outlays” to clarify that the payment of principal and interest on borrowings from the Social Security and Medicare HI Trust funds represent receipts for Social Security and Medicare and outlays for “rest of government.”

Option A is described in paragraphs 35- 36 of the ED and illustrated in Appendix B on pages 33-35. In addition to the information common in all displays, Option A provides:

- Two time horizons, 75 year and the infinite horizon (referred to as All Future Years in the illustration).
- It presents total receipts and total outlays as subtotals before arriving at the bottom line of “fiscal imbalance.”

² See *Preliminary Views – Accounting for Social Insurance, Revised. Paragraphs 75-76 and Appendix C, pages 118-119.*

- Present value dollars and percent of GDP are presented for all receipt and outlay components as well as the bottom line.
- Per capita information is provided based on current population for each citizen, full-time worker and household.
- Per capita information is provided based on current and future population for each citizen, full-time worker and household.
- The “fiscal gap” is presented as an alternative sustainability measure.

With the exception of the headings and the added current and future population per capita amounts, this display was included in the preliminary views (PV) document regarding social insurance. Respondents to the PV were asked to comment on the proposed statement of fiscal sustainability. Of the 41 respondents answering that question (question 4), 29 supported the statement. (The briefing material at Tab A of the binder for the July 2007 Board meeting provides a summary and staff analysis of the responses.) A few respondents expressed reservations regarding the infinite horizon, the cost of the proposal, and the use of summary (PV) measures. Some respondents indicated that a separate project was needed. Overall, it is difficult to reach conclusions based on the PV results but staff believes the initial reactions received through the PV process should be considered in developing the proposal.

Note: Option A displays both 75-year and infinite horizon amounts. The issue of selecting horizons for projection periods will be developed for discussion at the February 2008 Board meeting.

Pro:

1. Option A avoids any potential “moving window” problem³ by displaying both 75-year and infinite horizon projections. (The issue of selecting specific horizons for projection periods will be developed for discussion at the February 2008 Board meeting.)
2. Option A may make the information more meaningful-- and large amounts easier to grasp-- by presenting per capita amounts by citizen, full-time worker, and household.
3. Several of the technical Task Force members believe that the “fiscal gap” measure is important and meaningful for readers.

Con:

1. Option A is too information-rich to accommodate a comparative side-by-side with the corresponding amounts at the end of the previous fiscal year. Accordingly, it

³ The “moving window” problem occurs when there are significant changes to an estimate from one year to the next that are caused by the passage of time. For example, if a projection period is 75 years, the activity in “year 76” is outside the projection period for that year, but will be included in the projection period for the following year.

would fail a critical test mentioned by more than one of the outside technical experts: that it should clearly show whether the situation improved or worsened during the fiscal year. FASAB's Stewardship objective focuses on "the impact on the country of the government's operations and investment **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."⁴

2. Option A presents two new concepts—fiscal imbalance and fiscal gap—which are defined in term of mathematical formulas. Since Option A includes other complex concepts such as "infinite horizon" and "present value," it is displaying too much information at once, in contrast to the goal of "simplicity" that was emphasized as being a critical element of effective communication by a majority of the Task Force communications experts.
3. One of the technical task force members objects to the inclusion of the "fiscal gap" measure. He believes that because it is associated with keeping debt-to-GDP constant, specifying the definition of a fiscal gap measure is not sufficient by itself. It also requires specification of the level of the debt-GDP ratio that would be considered consistent with sustainability. Simply specifying the ratio at its current level would generally be inappropriate because a small increase in the ratio may be consistent with fiscal sustainability. Explaining why any particular level of a "sustainable" debt-GDP ratio makes sense would require additional complicated explanations and could be subject to continuing challenge. He believes that in terms of both technical accuracy and ease of presentation, the fiscal imbalance measure appears to be superior, and he recommends dropping the fiscal gap measure from the ED.

Option B: Future Implications of Current Policies

Option B was developed in consultation with Jagadeesh Gokhale. Dr. Gokhale, a senior fellow at the CATO Institute, is a task force member and responded to the PV on social insurance. Staff worked with him to refine his initial proposal. The title for his display is *Future Implications of Current Policies*.

Option B is described in paragraphs 37-40 of the ED and illustrated in Appendix B on pages 37-40. In addition to the information common in all displays, Option B provides:

- Subtotal net present values for Social Security and Medicare (labeled unfunded costs) as well as disaggregation within each program of amounts related to "past and living generations" and amounts related to "future generations" (those not yet born and under age 15 at the projection date)
- Present value amounts for seven reporting periods – the prior and current years and each of the next five years (these amounts include cash flows occurring from the beginning of the projection year through the end of the time horizon)

⁴ SFFAC 1, par. 134 (**bold added**)

- “Unfunded costs” as a percent of GDP are presented for the net present value of Medicare, Social Security, the rest of government, and all of government for each of the two historical and five projection years.
- To provide information regarding the timing of flows, a second table is included that presents the cumulative total for years 1-5, 1-10, etc. (The final column labeled “all” is the infinite horizon – which is the horizon preferred by Dr. Gokhale – amount.)
- To show trends in operating cost and net financial assets, a third table presents the total operating cost, revenue, net operating cost, financial assets, liabilities and net financial assets for the current and four past years as well as five projected years.

Pro:

1. The title is helpful in communicating what the amounts shown represent. (Note: this title could also be used for Option A or Option C.)
2. The format includes side-by-side comparison of current year and prior year, so that the reader can assess changes from year to year. Accordingly, Option B would pass a critical test mentioned by more than one of the outside technical experts: that it should clearly show whether the situation improved or worsened during the fiscal year. FASAB’s Stewardship objective also focuses on “the impact on the country of the government’s operations and investment **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.”⁵
3. The breakout of Medicare and Social Security include the effect of any existing balances in the Social Security and Medicare HI Trust Funds.
4. Part 1 shows a year-by-year projection for the five years following the current year.
5. Part 2 shows cumulative total unfunded costs into the infinite horizon in a concise manner that allows the reader to observe trends.

Con:

1. Part 1 disaggregates only two basic cohorts: “living generations” and “future generations,” with “past generations” being grouped with “living generations” and “future generations” defined as individuals under 14 years of age at the reporting date, including unborn. Although this breakout implies generational accounting, staff believes that the two cohorts are too large to be useful in assessing generational fairness. The scope of this project does not currently include an assessment of generational accounting, which would require, for example, an assessment of how to aggregate “generations,” and/or whether 10-year age groups would be more objective. In addition, the generational breakout is only applied to social insurance, and not to other government

⁵ *Ibid.* (bold added)

activities. Staff believes that the display of generational accounting that is limited to social insurance programs is more appropriately addressed by the SOSI and not by the summary display for fiscal sustainability reporting.

2. “Additional Information” calls for the projection of “Net Financial Assets” for five years into the future, which may be difficult or impractical for the preparer. For example, the projections in the primary summary display may already take into account some or all of the financial assets and liabilities that are reported on the balance sheet. If so, the preparer could not simply add “net financial assets” (which would likely be a negative amount) to the projections if the projections may include dispositions of the net financial assets, because this would result in double counting.
3. The table does not explain the changes from the prior year to current year or between the projection periods. The explanation of changes is important to an understanding of the underlying causes for these changes.

Option C: Long-Term Implications of Current Policies

Option C is described in paragraph 41 of the ED and illustrated in Appendix B on pages 39-41.

Option C includes the following modifications to Options A and B, based upon the Pros and Cons discussed above for Options A and B:

1. A temporary title for Option B (Long-Term Implications of Current Policies) has been used for Option C. Staff recommends that Board’s selection of a title for this display should be postponed until after the Board has concurred on its placement within the CFR.
2. The display has been limited to a single projection period (100 years) rather than Option A’s two projection periods (75 years and infinite horizon) to allow side-by-side presentation of the current year and prior year. Selection of a specific single projection period (for example, 75 years, 100 years, or infinite horizon) will be discussed at a future Board meeting. The staff recommendation is that a single projection period, and not two projection periods, should be used for the primary display.
3. The Option B display showing “Unfunded costs as a percent of present value of GDP” for the prior year, the current year, and projections for five years into the future has been included in Option C.
4. Per capita measures based upon current population are not included, because this ratio would imply to some that the current-year population is solely responsible for funding program shortfalls into the distant future. Per capita measures based upon current plus future population are retained.
5. Staff has added a per-capita display of the national debt as of the end of the current and prior fiscal years. This display is important information for readers. It requires no assumptions about future events because it presents historical information.

Staff recommendation:

Staff believes that all three options have merit. The Board also may wish to combine some of the elements of Options A, B, or C into a new option. Staff recommends that Option C should be tentatively selected, subject to modification based upon the Board's discussion of the "horizon" issue at the February 2008 Board meeting.

Question for the Board:

Does the Board agree with staff recommendation for a summary display (Option C, with future discussion of the projection period)?

6. Terminology: "Fiscal Sustainability Reporting"

"Comprehensive Long-Term Fiscal Projections and Accompanying Narrative and Graphics in the Financial Report of the U.S. Government" is a very long title and would be cumbersome to insert into every sentence in the ED that refers to the proposed reporting as a whole. In order to refer to this reporting more concisely, staff is proposing two options for an abbreviated "short term," which would be defined in the ED as a short term for "Comprehensive Long-Term Fiscal Projections and Accompanying Narrative and Graphics in the Financial Report of the U.S. Government." The two options are (a) "fiscal sustainability reporting" and (b) "long-term outlook reporting."

Question 3 on page 7 of the draft ED discusses the term "fiscal sustainability" in the context of a title for the primary summary display as follows:

Q3. The Board's mission is to issue reporting requirements for the Federal government's general purpose financial statements, and not to recommend budget policy. This exposure draft proposes a title for the summary display: "Summary of Long-Term Financial Position," "Future Implications of Current Policies" Long-Term Implications of Current Policies," or "Summary of Financial Condition." An alternative title, "Statement of Fiscal Sustainability," might imply to some that the Board has established or plans to establish specific rules that define "fiscal sustainability," and/or budget rules that would result in fiscal sustainability. However, others have indicated that the "plain English" meaning of the words "fiscal" and "sustainability" should be adequate, and that the title "Statement of Fiscal Sustainability" might be more appropriate. Do you believe that the summary display should be titled:

- a. "Statement of Fiscal Sustainability"
 - b. One of the other titles above and described in paragraphs 29 through 37 ("Summary of Long-Term Financial Position," "Future Implications of Current Policies," "Long-Term Implications of Current Policies," or "Summary of Financial Condition.")
 - c. A title not listed above (please specify).
- Please explain your choice.

In addition, paragraph 6 of the draft ED currently states:

[6] In this Statement, “**Fiscal Sustainability Reporting**” is the short term for “Comprehensive Long-Term Fiscal Projections and Accompanying Graphics and Narrative in the Financial Report of the U.S. Government.”

A similar explanation is made in FAQ 1 on page 51.

Depending upon the outcome of the Board’s discussion at the December Board meeting, staff will substitute either “Comprehensive Long-Term Fiscal Projections and Accompanying Narrative and Graphics in the Financial Report of the U.S. Government” or a different short term throughout the ED.

Question for the Board:

Do you agree that “Comprehensive Long-Term Fiscal Projections and Accompanying Narrative and Graphics in the Financial Report of the U.S. Government” would be a cumbersome term to use throughout the ED every time that the proposed reporting is being referred to as a whole? If so, should the “short term” be:

- (a) “fiscal sustainability reporting”
- (b) “long-term outlook reporting” or
- (c) some other term?

7) Background: Illustrations of situations requiring assumptions

To accommodate a request from one of the Board members, attached are illustrations of several situations where “current law” would not be adequate as a basis for projections.

8) Background: Canada’s Public Sector Accounting Board Statement of Principles

Canada’s Public Sector Accounting Board (PSAB) has issued a Statement of Principles, “Indicators of Government Financial Condition” that proposes a Statement of Recommended Practice (SORP) that would encourage reporting by Canada’s national and provincial governments. [Staff note: A PSAB “Statement of Principles” is comparable to a FASAB Preliminary Views document in that it is intended to precede a subsequent potential exposure draft.]

The proposed SORP would encourage voluntary reporting of long-term fiscal issues, “in order to improve and harmonize Canada’s public sector reporting.” The proposed SORP would not constitute GAAP for Canada’s governmental entities, but would rather provide general guidance and encouragement.

Paragraph 15 of the PSAB Statement of Principles mentions FASAB's current project on this topic. In contrast to Canada's Statement of Principles, the proposed FASAB ED is a proposed Statement of Federal Financial Accounting Standards and would require specific reporting in the CFR.

This document is presented to ensure that members are aware of developments in other nations.

9) Background: IPSASB Proposed Project: Fiscal Sustainability

The International Public Sector Accounting Standards Board (IPSASB) will consider initiating a project on long-term fiscal sustainability at its November 29-30, 2007 meeting in Beijing, China. Attachment 7 is a copy of the Project Brief for this discussion.

- The November 13, 2007 memorandum to the IPSASB Members includes a description of the FASAB project, and notes that:

There has been tentative staff-level discussion of a joint project between the FASAB and the IPSASB on fiscal sustainability. IPSASB Staff's view is that, given the fact that FASAB has already initiated their project, the timescales for the FASAB and the fact that FASAB meets much more regularly than IPSASB, a fully-fledged joint project will be difficult. However, Staff has had considerable informal discussion and has agreed to share agenda materials and other papers. IPSASB Staff members attended the July meeting of the FASAB, at which fiscal sustainability was a major agenda item.⁶
- IPSASB staff recommends a Task Force for this project, and recommends that a FASAB staff member participate in the Task Force. The proposed Task Force would develop a Consultation Paper with a target date of September 2008.⁷

Attachments:

1. Draft ED, "Comprehensive Long-Term Fiscal Projections and Accompanying Narrative and Graphics in the Financial Report of the U.S. Government"
2. Summary of Board Decisions at Past Board Meetings
3. Milestones: Target Dates for Fiscal Sustainability Reporting Project
4. Illustrations: Challenges in Projecting Spending and Revenues
5. PSAB (Canada) Statement of Principles, "Indicators of Government Financial Condition"
6. CBO, *The Long-Term Outlook for Health Care Spending*
7. IPSASB November 13, 2007 Briefing Memorandum: *Fiscal Sustainability and Draft Project Brief and Outline*

⁶ IFAC IPSASB Agenda Item 5, Fiscal Sustainability, November 13, 2007 memorandum, pages 1-2. Available at: <http://www.ifac.org/PublicSector/Meeting-BGPapers.php?MID=0120>.

⁷ *Ibid*, November 13 memorandum page 8 and Draft Project Brief and Outline, page 8.



Federal Accounting Standards Advisory Board

**Reporting Comprehensive Long-Term Fiscal Projections for the
U.S. Government**

Statement of Federal Financial Accounting Standards XX

Exposure Draft

Written comments are requested by **August 15, 2008**

May 15, 2008

Staff draft- Do Not Circulate

THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General, established the Federal Accounting Standards Advisory Board (FASAB or “the Board”) in October 1990. FASAB is responsible for promulgating accounting standards for the United States Government. These standards are recognized as generally accepted accounting principles (GAAP) for the federal government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, federal executives, federal program managers, and other users of federal financial information. The proposed standards are published in an Exposure Draft for public comment. In some cases, a discussion memorandum, invitation for comment, or preliminary views document may be published before an exposure draft is published on a specific topic. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. After review by the three officials who sponsor FASAB, the Board publishes adopted standards in a Statement of Federal Financial Accounting Standards. The Board follows a similar process for Statements of Federal Financial Accounting Concepts, which guide the Board in developing accounting standards and formulating the framework for federal accounting and reporting.

Additional background information is available from the FASAB or its website:

- “Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board.”
- “Mission Statement: Federal Accounting Standards Advisory Board”, Exposure drafts, Statements of Federal Financial Accounting Standards and Concepts, FASAB newsletters, and other items of interest are posted on FASAB’s website at: www.fasab.gov.

Federal Accounting Standards Advisory Board
441 G Street, NW, Suite 6814
Mail stop 6K17V
Washington, DC 20548
Telephone 202-512-7350
FAX – 202-512-7366
www.fasab.gov

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Federal Accounting Standards Advisory Board

May 15, 2007

TO: ALL WHO USE, PREPARE, AND AUDIT FEDERAL FINANCIAL INFORMATION

The Federal Accounting Standards Advisory Board (FASAB or the Board) is requesting comments on the exposure draft of a proposed Statement of Federal Financial Accounting Standards entitled, *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government*. Specific questions for your consideration appear on page 6 but you are welcome to comment on any aspect of this proposal. If you do not agree with the proposed approach, your response would be more helpful to the Board if you explain the reasons for your position and any alternative you propose. Responses are requested by August 15, 2008.

All comments received by the FASAB are considered public information. Those comments may be posted to the FASAB's website and will be included in the project's public record.

We have experienced delays in mail delivery due to increased screening procedures. Therefore, please provide your comments in electronic form. Responses in electronic form should be sent by e-mail to fasab@fasab.gov. If you are unable to provide electronic delivery, we urge you to fax the comments to (202) 512-7366. Please follow up by mailing your comments to:

Wendy M. Payne, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW, Suite 6814
Washington, DC 20548

The Board's rules of procedure provide that it may hold one or more public hearings on any exposure draft. A public hearing for this exposure draft has been scheduled at 9:00 AM on August 20, 2007 in Room 7C13 at the GAO Building, 441 G Street, NW, Washington, DC.

Notice of the date and location of this public hearing also will be published in the Federal Register and in the FASAB's newsletter.

Tom L. Allen
Chairman

Executive Summary**What is the Board Proposing?**

The Board is proposing a comprehensive summary display as well as specific narrative and graphic displays for the annual consolidated financial report of the U.S. Government (CFR).

How would this proposal contribute to meeting the federal financial reporting objectives?

This proposal supports the Stewardship Objective (Objective 3):

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.¹

In particular, this proposal directly addresses sub-objective 3B:

Federal financial reporting should provide information that helps the reader to assess whether future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due.²

This proposal would provide specific reporting requirements that the Board believes will be useful to readers in assessing the potential future impact of current levels of spending and taxation.

¹ Statement of Federal Financial Accounting Concepts (SFFAC) 1, paragraph 134.

² SFFAC 1, paragraphs 135 and 139.

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Questions for Respondents

The FASAB encourages you to become familiar with all proposals in the Statement before responding to the questions in this section. In addition to the questions below, the Board also would welcome your comments on other aspects of the proposed Statement.

The Board believes that this proposal would improve federal financial reporting and contribute to meeting the federal financial reporting objectives. The Board has considered the perceived costs associated with this proposal. In responding, please consider the expected benefits and perceived costs and communicate any concerns that you may have in regard to implementing this proposal.

Because the proposals may be modified before a final Statement is issued, it is important that you comment on proposals that you favor as well as any that you do not favor. Comments that include the reasons for your views will be especially appreciated.

The questions in this section are available in a Word file for your use at www.fasab.gov/exposure.html. Your responses to the Questions for Respondents should be sent by e-mail to fasab@fasab.gov. If you are unable to respond electronically, please fax your responses to (202) 512-7366 and follow up by mailing your responses to:

Wendy M. Payne, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW, Suite 6814
Washington, DC 20548

All responses are requested by **August 15, 2008**.

- Q1. This exposure draft proposes reporting that would support FASAB Objective 3, Stewardship, and in particular, Sub-Objective 3B:

Objective 3: 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.³

³ SFFAC 1, par. 134.

Sub-Objective 3B: 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.⁴

Do you agree that the proposed reporting supports the above objectives? If not, please explain why you disagree.

- Q2. This exposure draft provides a potential format for a summary display, in addition to narrative and graphics. (Descriptions begin at paragraph 19 and illustrations of pro forma summary displays begin on page 33.) Do you believe that this format would be understandable and meaningful for readers of the consolidated financial report of the U.S. Government (CFR)? Please note any changes that you believe should be made to the requirements for a summary display.
- Q3. The Board's mission is to issue reporting requirements for the federal government's general purpose financial statements, and not to recommend budget policy. This exposure draft proposes a title, for the summary display: "XXXXX." An alternative title, "Statement of Fiscal Sustainability," might imply to some that the Board has established or plans to establish specific rules that define "fiscal sustainability," and/or budget rules that would result in fiscal sustainability. However, others have indicated that the "plain English" meaning of the words "fiscal" and "sustainability" should be adequate, and that the title "Statement of Fiscal Sustainability" might be more appropriate. Do you believe that the summary display should be titled
- "Statement of Fiscal Sustainability"
 - Another title, such as "Summary of Long-Term Financial Position," "Future Implications of Current Policies," "Long-Term Implications of Current Policies," or "Summary of Financial Condition,"
 - A title not listed above (please specify).
- Please explain the reasons for your choice.
- Q4. This exposure draft proposes narrative and graphic displays to effectively communicate to the reader to observe historical and projected trends and to help the reader understand the "why" (the driving factors) of the projections. The requirements begin at paragraph 42 and illustrations begin on page 42.

⁴ SFFAC 1, par. 139.

Questions for Respondents

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- a. Do you believe that the required narrative and graphics would be useful in helping the reader to understand the information that is reported in the summary display?
 - b. Are there any items that you believe should be added to, or deleted from, the requirements for narrative and graphics? If so, please explain.
- Q5. In this proposed Statement, projections or simulations are prepared not to predict the future, but rather to answer the question “what if.” Accordingly, projections or simulations require assumptions to be made about the future. The Board believes that the most useful projections for assessing the future implications of current policy (government benefits, services and taxation) are those that are based on current policy, but that alternative projections also would be useful to the reader in assessing options other than current policy. This exposure draft proposes broad and general guidance for policy and economic assumptions for long-term projections with a primary focus on the continuation of current policy. The guidance begins at paragraph 19. Do you believe that the guidance for assumptions is appropriate? If not, please explain.
- Q6. Currently, the CFR does not request comments from readers or provide contact information for readers’ comments. The Board expressed an interest in receiving feedback from financial statement users because such comments may be helpful in assessing whether the comprehensive long-term fiscal projections and the accompanying narrative and graphics in the CFR are understandable and meaningful for financial statement users. Do you agree that the CFR should include contact information for readers’ comments, in particular regarding the comprehensive long-term fiscal projections and accompanying narrative and graphics?
- Q7. The Frequently Asked Questions (FAQs) at Appendix C provide a “plain English” explanation of terms and concepts used in long-term projections.
- a. Do you find the FAQs helpful?
 - b. Should the CFR include any of the FAQs to promote understandability of the terms and concepts? If so, please specify the FAQs that should be included.
- Q8. [Future question about the placement of reporting: principal statement(s), notes, RSI, MD&A, etc.]
- Q9. [Future question about effective date.]
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Introduction

Purpose

1. In Statement of Federal Financial Accounting Concepts (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.⁵ The 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 Statement. Objective 3 states 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.⁶
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.⁷
4. While federal financial reporting is not expected by itself to accomplish the stewardship reporting objective, it can contribute to meeting the objective.⁸ 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.
5. The Board believes that adding comprehensive long-term fiscal **projections**⁹ and accompanying narrative and graphics to the consolidated financial report of the U.S. Government (CFR) will contribute to meeting sub-objective 3B of the stewardship objective. The more detailed objectives presented below were developed as one means of guiding the Board in selecting from a variety of possible summary display formats as well as in identifying the most important areas to be addressed in narrative and/or graphic format.

⁵ SFFAC 1, par. 109.

⁶ SFFAC 1, par. 134.

⁷ SFFAC 1, par. 139.

⁸ SFFAC 1, par. 235.

⁹ Terms defined in the Glossary are shown in **bold-face** the first time they appear.

Objectives of Comprehensive Long-Term Fiscal Projections and Accompanying Graphics and Narrative (“Fiscal Sustainability Reporting”)

6. In this Statement, “**Fiscal Sustainability Reporting**” is the short term for the comprehensive long-term fiscal projections and accompanying narrative and graphics to be provided in the CFR. Fiscal sustainability reporting should provide information to assist readers of the CFR in assessing whether future budgetary resources of the U.S. Government will likely be sufficient to sustain public services and to meet obligations as they come due,¹⁰ assuming that **current policies**¹¹ are continued.¹²
7. 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 such an assessment has financial implications but also because it has social and political implications. For example, users of financial reports should be provided with 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.¹³ Fiscal sustainability reporting should assist the reader in understanding these financial, social and political implications.
8. Generally, fiscal sustainability can be assumed if continuation of current policy is unlikely to lead to permanent deficits and rising public debt as a share of **Gross Domestic Product (GDP)**.¹⁴ Therefore, projections or **simulations** of deficits, or surpluses, and debt are central to any assessment of fiscal sustainability. Such projections would assist the reader in answering questions such as:
 - Does the projected balance of future cash inflows and outflows under current policies potentially lead to unsustainable increases in federal borrowing?

¹⁰ SFFAC 1, par. 139.

¹¹ In this standard, “current policy” refers to current levels of Federal government services and benefits (for example, current reimbursement rates for Medicare and scheduled benefits for Social Security) combined with current levels of taxation.

¹² Note that fiscal sustainability reporting does not extend to supporting a detailed assessment of whether current policies are optimal; rather, it addresses the fiscal outlook if current policies are continued.

¹³ The latter notion is sometimes referred to as “interperiod equity.”

¹⁴ Determining precisely how much a government can depart – in magnitude and/or duration- from this general notion of fiscal sustainability is beyond the scope of the Board’s efforts.

- Are the costs of services for past and current generations being shifted to the future, so that current or future generations of taxpayers are likely to face higher taxes and/or more limited government services?
9. Projections and simulations are not forecasts or predictions; they are designed to ask the question “what if?” Projections and simulations are useful in order to display alternative future scenarios, but it is important to clearly explain the nature of the information being presented.
10. Fiscal sustainability reporting should be understandable to the intended audience of the CFR. The primary intended users of this report are citizens and citizen intermediaries (such as the media, public interest and advocacy groups, and others). The CFR should be easily understandable to the “average citizen” who has a reasonable understanding of federal government activities and is willing to study the information with reasonable diligence. Moreover, the CFR is a high-level summary 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 (GAO), the Office of Management and Budget (OMB), and the Congressional Budget Office (CBO).¹⁵
11. The Frequently Asked Questions (FAQs) at Appendix C provide a “Plain English” explanation of terms and concepts used in this Statement.

Materiality

12. The provisions of this Statement need not be applied to immaterial items. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

Effective Date

13. The final provisions of this Statement are expected to be effective for fiscal year 2010. Earlier implementation is encouraged.

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

Accounting Standard

Definitions

14. Fiscal Imbalance

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

15. Fiscal Gap

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

16. Policy Assumptions

Policy assumptions address the level of services provided by the federal government as well as the framework for assessing taxes and fees. 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.

17. Economic Assumptions

Economic assumptions address the economic factors that are not under the direct legislative control of the federal government (for example, population demographics, inflation and growth in Gross Domestic Product).

Scope

18. The reporting requirements in this Statement 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.

Recognition and Measurement

Policy and Economic Assumptions

19. Fiscal sustainability reporting for the U.S. Government should provide information that helps the reader to determine whether current policy¹⁶ is

¹⁶ In this standard, “current policy” refers to current levels of Federal government services and benefits (for example, current reimbursement rates for Medicare and scheduled benefits for Social Security) combined with current levels of taxation. “Current levels” is not equivalent to

likely to produce future budgetary resources sufficient to sustain public services and to meet obligations as they come due. Long-term projections of current levels of federal benefits and services and current levels of taxes and other revenues should help the reader to understand the implications of current policies and other factors such as demographic trends.

20. Long-term projections [or simulations] are derived from models that rely heavily on assumptions. There is an expectation that such models will evolve over time. Therefore, this Statement provides guiding principles for making choices among alternative assumptions. The guiding principles address two types of assumptions: policy and economic assumptions.
21. Policy assumptions address the level of services provided by the federal government as well as the framework for assessing taxes and fees.
22. Economic assumptions address the economic factors that are not under the direct legislative control of the federal government (for example, population demographics, inflation and growth in Gross Domestic Product (GDP)). When combined with policy assumptions, economic assumptions determine the level of future inflows and outflows that are consistent with the policy assumptions.
23. To illustrate the distinction between policy and economic assumptions: the Social Security program provides benefits. Assumptions relating to future Social Security eligibility and benefit formulas represent policy assumptions, while the assumptions about population demographics, labor participation rates, productivity growth and other factors represent economic assumptions.

Policy Assumptions

24. With some exceptions, projections of future inflows and outflows should be based upon current law. However, in many instances a simple assumption of "current law" will not provide an adequate basis for long-term projections under current policies. For example, in some cases current law expires almost immediately, or does not fully support current levels of benefits or services, or would produce levels of taxation that are significantly different from current levels. In these cases, the preparer should use judgment in applying the general guidelines presented below.

levels measured in dollars. In the broader context of current policy, current levels are to be considered with respect to the service or benefit being provided and the general relationship of taxation to the economy (e.g., taxable income, GDP or some other base).

25. When a simple assumption of current law does not provide a basis for projections of future inflows and outflows that is consistent with current policies, assumptions should reflect “current policies” as defined in this standard. Following are examples:

- (a) Legislation providing for **discretionary spending**¹⁷ provides funding that extends at most a few years into the future. Therefore, assumptions will be required in order to prepare a long-range projection.
- (b) Some provisions of tax law, such as the Alternative Minimum Tax (AMT) that is not indexed, do not provide for future taxation at current levels. Current law would result in the AMT negatively impacting many more taxpayers in the future and, depending on the circumstances, it might be reasonable to assume that action will be taken to preserve the current impact of the AMT.
- (c) Current law also may include provisions that have been changed in a consistent direction over a period of time. For example, the statutory limit on federal debt has been consistently raised.

26. In those cases where current law may not be consistent with current policies, as defined in this standard, the preparer is not required to assume a uniform growth rate for all types of revenues and spending; however, if different growth rates are projected for different types of revenues and spending, the assumptions used should be internally consistent. Assumptions may be based on, but are not limited to, the notion that spending or revenues are likely to:

- (a) Maintain a constant share of Gross Domestic Product (GDP)¹⁸
- (b) Grow with inflation¹⁹

¹⁷ 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>.

¹⁸ Gross Domestic Product (GDP) is the total market value of goods and services produced domestically during a given period. The components of GDP are consumption (both household and government), gross investment (both private and government), and net exports.

¹⁹ Inflation is growth in a general measure of prices, usually expressed as an annual rate of change.

- (c) Maintain a constant real²⁰ per capita level
27. The preparer should use judgment in selecting assumptions and make adjustments when appropriate.
28. When a range of possible assumptions seems consistent with current policy, the preparer should consider the concept of **conservatism**.²¹ The concept of conservatism implies that the preparer should select the less optimistic assumptions. In light of the large number of assumptions required, this concept should be applied with care to avoid systematically biasing the projection. When the preparer is unable to determine the assumption most consistent with current policy, the preparer is not always required to select the assumption representing the worst case scenario. Rather, the preparer should view the constellation of such assumptions as a whole and make individual selections which result in a reasonable overall projection.
29. In addition, the narrative should disclose that the projections displayed are not forecasts or predictions; they are designed to ask the question “what if?” and the narrative should disclose the major “what ifs” that are being projected.

Economic Assumptions

30. The economic assumptions used in the primary displays for fiscal sustainability reporting should be consistent with the economic assumptions used for Social Security and Medicare in the preparation of the Statement of Social Insurance.
31. The narrative should include information about the economic assumptions used and how different economic assumptions would impact the projections. If an administration’s economic assumptions differ significantly from that of the Social Security and Medicare Boards of Trustees, the narrative should explain the difference in economic assumptions, explain the reason(s) why the different economic assumptions were selected, and report the impact of the alternative assumption(s) upon the projection(s).

²⁰ In economic terms, “real” means adjusted to remove the effects of inflation.

²¹ Conservatism has been defined in the context of private sector reporting as follows: “Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate; however, if two amounts are not equally likely, conservatism does not necessarily dictate using the more pessimistic amount rather than the more likely one.” Financial Accounting Standards Board (FASB) Statement of Concepts No. 2, paragraph 95.

Note to the Board:

Selection of discount rates to be applied in arriving at any required net present value amounts will be addressed at a later date.

Uncertainty

32. Long-range projections should be accompanied by a narrative that includes
- (a) a listing of significant assumptions,
 - (b) explanation of why the significant assumptions used were selected,
 - (c) discussion of the effects of uncertainty,
 - (d) how different assumptions would affect the projection (including alternative scenarios where appropriate), and
 - (e) specific citations of sources (such as the Annual Trustees Reports for Social Security and Medicare, specific CBO and GAO reports, and the Budget of the U.S. Government) where the reader will find more detailed information about significant assumptions, alternative scenarios.

Changes in Assumptions

Note to the Board: The following paragraph is a place-holder for treatment of changes in assumptions. Staff will develop this issue for discussion at a future Board meeting.

33. Changes in assumptions should be disclosed and the reason for the changes should be explained in the narrative and the impact of the changes in assumptions upon the projection(s) should be disclosed. If changes in economic assumptions or policy assumptions result in significant changes to projections, any prior year(s) displayed should be restated. The restated amounts and the original amounts reported should be displayed comparatively, either on the face of the summary display or as a table in the narrative section. The narrative should explain the change(s) in assumptions and discuss the impact of the change(s).

Summary Display

34. This exposure draft presents a format for a summary display. A description of the potential format appears below, and a pro forma illustration appears in Appendix B.

Note to the Board:

Three potential summary formats, Options A, B and C are described below. Pro forma illustrations appear in Appendix B, page 33 (See pros and cons in December 2007 briefing memo).

Option A

35. The summary display, *Summary of Long-Term Fiscal Position*, should display the following projected amounts, as both PV dollars and as a percentage of the present value of GDP as of the period indicated:

- Receipts, disaggregated by Medicare, Social Security, and all other revenues, and total receipts
- Outlays, disaggregated by Medicare, Medicaid, Social Security, and all other outlays, and total outlays
- Fiscal Imbalance (Net of receipts and outlays)
- Fiscal Imbalance per citizen, full-time worker, and household: current population
- Fiscal Imbalance per citizen, full-time worker, and household: projected population
- Fiscal Gap as of the current year-end and prior year-end.

36. The narrative should explain the concepts of present value dollars, GDP, time horizons and other terms used in the summary display, such as fiscal imbalance and fiscal gap. Additional requirements for narrative and graphics are provided in the “Requirements for Narrative and Graphics” section of this document, beginning at paragraph 43.

Option B

37. A summary display, *Future Implications of Current Policies*, should present the present value of all projected unfunded costs for Medicare, Social Security, and the rest of the federal government as both present value dollar amounts and a percent of the present value of GDP as of the period indicated: prior year, current year, and each of the five years following the current year. The projected unfunded costs include all costs beginning in the year indicated through the projection period.

38. In addition, a second display should project total cumulative unfunded costs at 5, 10, 25, 50, 75 and 100 years, with a final column for “all” indicating the infinite horizon.
39. A third display should report net financial assets²² for each of the past 4 years, the current year, and projected for each of the following five years.
40. Requirements for narrative and graphics appear in the section “Requirements for Narrative and Graphics” beginning at paragraph 42.

Option C

41. Option C is a modified version of Option A, developed by staff based upon the “pros-and-cons” for Options A and B discussed in the December briefing memo. It displays a single projection period, rather than two projection periods, to allow side-by-side display of amounts. It includes only one display of the “per capita” fiscal imbalance, with “current and future population” as the denominator. It adds a “per capita” display of Treasury debt as of the end of the current and prior fiscal years.

Required Narrative and Graphics

42. Narrative and graphics serve a critical role in making economic concepts and projections accessible to a variety of audience segments, and in helping readers to understand long-term projections by explaining the significant factors that are driving projected trends, by illustrating trends graphically, and by providing context for the information provided.
43. The narrative should explain and illustrate the major factors that are expected to have a significant impact upon future inflows or outflows of the U.S. Government. Graphic illustrations of these factors should be included and referenced in the narrative. Examples of major factors that are currently expected to have a significant impact upon the future inflows and outflows of the U.S. Government include but are not limited to:
- (a) Rising costs of health care
 - (b) Demographic trends
 - (c) Trends in deficit spending
44. The narrative should also describe the trend in Treasury debt held by foreigners, along with a simple line graph or a graphic showing two or more

²² “Financial assets” are defined as cash and cash equivalents.

pie charts to show the change through the current year. The narrative should explain the potential risks or benefits and likely consequences of such a trend.

45. For international perspective, the narrative should include target debt levels established by selected other nations, such as the U.K., Canada, New Zealand, and the European Commission, and explain how the projected U.S. debt levels compare. Selected nations should include both the lowest and highest debt level targets.
46. The narrative should explain the nature of federal “trust funds” if their balances are material during the projection period. The explanation should refer the reader to the financial statement note disclosure required by paragraph 27 of Statement of Federal Financial Accounting Standards (SFFAS) 27, *Identifying and Reporting Earmarked Funds*, which explains that:
 - (a) 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.
 - (b) 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).
 - (c) 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.
 - (d) 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
47. The narrative should refer the reader to more information on the nature and composition of Treasury securities by cross-referencing, including URL as needed, and hyperlink to existing publications by the Treasury Department.
48. The preparer should present separate graphic displays for the most significant factors. The quantitative data supporting such graphics may be provided in an appendix or other secondary display, or cross-referenced (and/or hyperlinked) to a more detailed report, such as the President’s Budget, a Congressional Budget Office report, or the Trustees Report (*Status of the Social Security and Medicare Program*).²⁴

²³ SFFAS 27, paragraph 27.

²⁴ Available at: <http://www.ssa.gov/OACT/TR/>.

49. The narrative should explain the significance of the graphic(s) and put the information into context. Examples of context include but are not limited to:

- (a) comparison of the data/trend with that of other developed nations,
- (b) comparison of the data/trend with everyday life, such as spending in excess of income over a long period of time, and/or
- (c) where to find information about outside organizations that use similar data to assess the long-term implications for an entity or sovereign government, such as the role of rating organizations and/or European Union rules for member nations.

The Disadvantages of Delaying Action

50. If projections indicate a fiscal gap, the narrative should discuss the disadvantages of delaying action, including:

- (a) There are risks involved in ever-increasing Treasury borrowing.
- (b) Changes in tax rates and/or benefits would need to be larger if action is delayed.

Examples should be provided.

Limitations of Fiscal Sustainability Reporting

51. The narrative should include an explanation of the following limitations:

- (a) Forward-looking projections and simulations require assumptions and estimates relating to future events, conditions, and trends; actual results may differ materially from those that are projected;
- (b) Where indicated, forward-looking projections and simulations 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. However, the narrative should direct the reader to any recent reports that address the long-term fiscal outlook for state and local governments.²⁵

²⁵ For example, the GAO reports *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge with the Next Decade*, July 18, 2007 (GAO-07-1080SP) and *The Nation's Long-Term Fiscal Outlook* August 2007 Update (GAO-07-1261R) address the long-term fiscal outlook for state and local governments.

Request for Feedback from Readers of the CFR

52. The CFR should request feedback from readers of the CFR, in particular regarding the comprehensive long-term fiscal projections and accompanying narrative and graphics. Readers should be provided with a mailing address and an e-mail address for comments. A copy of comments received should be forwarded to the Board.

Effect on Current Standards

53. [To be developed, based on future Board decisions about placement of information (principal statements/notes, MD&A, etc.)]

Effective Date

54. These standards are effective for periods beginning after September 30, 2009. Earlier implementation is encouraged

The provisions of this Statement need not be applied to immaterial items.

Appendix A: Basis for Conclusions

This appendix discusses some factors considered significant by members in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Some factors were given greater weight than other factors. The guidance enunciated in the standards – not the material in this appendix – should govern the accounting for specific transactions, events or conditions.

Project History

The Issue

- A 1. The FASAB considered what information would be most likely to help readers of the CFR to assess 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.
- A 2. Many believe that federal financial reports currently do not adequately address the federal financial reporting objective, titled "stewardship," presented below.
- Objective 3: Stewardship**
Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial condition has changed and may change in the future. Federal financial reporting should provide information that helps the reader to determine whether
- a) the government's financial position improved or deteriorated over the period,
 - b) future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due, and
 - c) government operations have contributed to the nation's current and future well-being. [Source: Statement of Federal Financial Accounting Concepts (SFFAC) 1, pars. 134-145, available at <http://www.fasab.gov/codifica.html>.]
- A 3. In particular, existing reporting may not adequately address sub-objective 3b above.

Plan to Address the Issue

- A 4. The Board requested the recommendations of a Fiscal Sustainability Task Force whose members have technical knowledge relevant to the issues and/or communications expertise relevant to the challenge of how to effectively communicate complex information on long-term fiscal issues.
- A 5. The task force members included representatives from the American Enterprise Institute, the Cato Institute, the Brookings Institution, and the Urban Institute; the Chief Actuaries for Social Security and Medicare; technical experts from the OMB, the CBO, the Treasury Department, and the GAO; members of Congress; and academics in the areas of public policy and communications.
- A 6. FASAB staff also researched existing reporting on government-wide fiscal sustainability by other developed, English-speaking countries such as the U.K., Australia, New Zealand and Canada, and conferred with staff of the International Public Sector Accounting Standards Board.

Financial Position versus Financial Condition

- A 7. 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.²⁶
- A 8. 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 assumptions²⁷ 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

²⁶ SFFAC 1, par. 262.

²⁷ SFFAC 1, par. 145.

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.²⁸ Table 1, “Comparison of Financial Position and Financial Condition,” summarizes the distinguishing characteristics of Financial Position and Financial Condition.

Table 1: Comparison of Financial Position and Financial Condition

Financial Position	Financial Condition
Entity perspective	Broad perspective including reporting on the nation’s economy and other external 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 9. 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.)²⁹

²⁸ SFFAC 1, par. 144.

²⁹ SFFAC 3, par. 14.

Assumptions

Limitations of “Current Law” Assumptions

- A 10. Although current law is a reasonable starting point, a simple projection of “current law” would not always reflect current policies regarding benefits, services or tax rates. For example, current law often does not extend far enough into the future to be used as a basis for long-range projections. In other instances, current law may not provide for future levels of benefits, services or tax rates that are consistent with current levels.
- A 11. Major provisions of current law often do not extend far into the future to be used as a basis for a long-range projection. Discretionary spending is primarily based upon annual appropriation acts, and even some mandatory spending (see note 17) programs are subject to authorizing legislation that expires in the near future. For example, the legislation authorizing several mandatory programs (such as Food Stamps, student assistance for higher education and agricultural price supports) expires and would require legislative action for the programs to continue past the expiration date.
- A 12. 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 available in the Social Security or Medicare Trust Funds, respectively, plus inflows of **earmarked revenues**. However, current law does not provide for any specific reductions in Social Security scheduled benefits or Medicare reimbursement rates that would occur 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.³⁰
- A 13. Current law also may include tax provisions such as tax cuts that expire within several years, along with a historical trend of extending those tax provisions before they expire — but only for a short period, generally one year.

³⁰ 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.

In such situations, “current law” would indicate that the tax provisions will expire on schedule, while a projection based upon current levels of taxation, and reasonable expectations based on recent historical trends may indicate that the tax provisions will be extended.

Comments Provided by the Technical Group, Fiscal Sustainability Task Force

- A 14. A majority of the task force technical experts believe that for mandatory spending on social insurance programs, a modified version of “current law” (ignoring the exhaustion of the Social Security and Medicare Hospital Insurance Trust Funds- see paragraph A 12), which might also be termed “current services” represents the most useful assumption for social insurance programs. However, a minority believe that any deviation from current law requires a subjective judgment that can be biased.
- A 15. Projections for discretionary spending are more uncertain than projections for mandatory spending, since “current law” often only addresses the next one or two years. However, there was some agreement that projecting discretionary spending growth at the same rate as assumed Gross Domestic Product (GDP) per capita would be an example of a reasonable option.
- A 16. A recent report issued by the GAO³¹ illustrates the tension between choosing current law versus current level of services and taxes. The report primary displays contains two different projections in a single graphic presentation: the 10-year CBO baseline, which is then projected into the future (called “baseline extended”) and a different projection (called an “alternative simulation”), which includes modifications that are described in the narrative.
- A 17. 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. All of the Communications members and many of the Technical members of the task force strongly emphasized the importance of simplicity of presentation. The Board noted that one of the greatest challenges inherent in fiscal sustainability reporting is the tension between technical rigor and simplicity of presentation.
- A 18. Historically, practices have varied. For example, a member of the Fiscal Sustainability Task Force noted that past OMB projections have sometimes included “bracket creep”³² for revenues and sometimes not.

³¹ *The Nation’s Long-Term Fiscal Outlook* August 2007 Update (GAO-07-1261R).

³² “Bracket creep” occurs because individual income tax brackets are indexed for inflation rather

- A 19. Among the options for discretionary spending are to use the Budget or the Budget Enforcement Act baseline, followed by some trend growth rate, or to assume that the level of benefits or services in the current year and recent past will continue.
- A 20. The technical experts were unanimous in agreeing that the administration's proposals are not the most appropriate basis for projections of revenues and outlays.
- A 21. The Board believes that the most useful reporting on fiscal sustainability would illustrate the long-term effects of current levels of benefits or services and tax revenues. However, there are numerous ways of projecting current levels into the future. 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.³³ (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.)
- A 22. The Board believes that the details of the baseline for projecting "current level of service" or "current level of taxes" should be left to the judgment of the preparer and auditor. Regardless of which baselines are used for a primary presentation, the narrative should include an explanation of the assumptions used and alternative scenarios.
- A 23. Current law may 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 specific reductions in benefit payments or reimbursement rates due to lack of funds. Thus, current law is inconsistent and does not provide an answer.

than wage growth. When wages grow faster than inflation, the effective tax rate increases, which can increase revenues as a share of GDP.

³³ 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*, January 2007. Available at: <http://www.cbo.gov>.

- A 24. When current law is inconsistent, the Board believes that in selecting assumptions, the projections should indicate current levels of government benefits, services and taxation, and should answer the question “what if current levels were continued over time?” The resulting projection should be accompanied by a narrative that explains what would happen if an alternative event occurs (in the example in paragraph A 23, the narrative would explain what percentage of Medicare reimbursements could not be paid if legislation does not provide for maintaining current levels).

Economic Assumptions

- A 25. Economic assumptions are somewhat broader in scope than policy assumptions, since they include such factors as population demographics and economic growth. The elements of economic assumptions are generally influenced more by a variety of external factors than by direct legislative impact.
- A 26. 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).
- A 27. Table 1 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.

Appendix A: Basis for Conclusions

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Table 1: 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	2.5% in 2007; average 2.2% per year for 2008-2017	2007-2017: Administration projections used for the budget, constant thereafter ³⁴	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 ³⁵	Average 2009-2012: 2.9% 2013-2017: 2.5%	2007-2017: Administration productivity projections used for the budget period, constant thereafter at 2.3%, 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*, January 2007.

Available at:

<http://www.cbo.gov>.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

³⁴ 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)

³⁵ 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.

A 28. One of the technical experts noted that there are several advantages to using the economic assumptions used for Social Security and Medicare in the preparation of the SOSI:

- Since the SOSI is now a basic financial statement, auditors are bound by generally accepted government auditing standards to examine and assess the 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 auditing.
- If the economic assumptions used for Social Security and Medicare in the preparation of the SOSI are used, there would be consistency between the economic assumptions used for the SOSI and for the fiscal sustainability reporting.

A 29. Statement of Federal Financial Accounting Standards (SFFAS) 17, *Accounting for Social Insurance*, does not prescribe specific economic assumptions for Social Security and Medicare in the SOSI. Accordingly, the Board concurred that the reporting requirements for fiscal sustainability reporting should not dictate specific economic assumptions, but should require that the primary displays for fiscal sustainability reporting 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.

International Perspective

A 30. Other nations have issued reports addressing “fiscal sustainability.” While a precise definition has not been developed, countries generally describe fiscal sustainability in a manner consistent with the following:

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.³⁶

³⁶ Australia, Intergenerational Report 2002-3, page 2. Available at: http://www.budget.gov.au/2002-03/bp5/html/02_BP5Overview.html#P23_3643

The magnitude of the fiscal imbalance

- A 31. The technical group of the Fiscal Sustainability Task Force did not come to agreement regarding the display of summary numbers on a per capita, per worker and/or per household basis. Although per capita amounts may be useful in conveying the magnitude of the fiscal imbalance, several task force members objected to the use of per capita summary numbers that use current-year population or workers, because this may imply that the current-year population is (or should be) solely responsible for funding program shortfalls into the distant future. Those task force members believe that any changes needed to address the shortfalls projected through, for example, the next 75 years, must be spread across the population throughout that period, and cannot be handled solely by today's workers.
- A 32. Other technical members noted that per capita amounts may be useful in conveying the magnitude of projected fiscal imbalances and could be displayed if summary amounts are divided by the population that parallels the horizon indicated and that a narrative explains present value and the nature of the numerator and denominator.

Recognition and Measurement

Summary Display (Options A, B and C)

- A 33. Option A, *Summary of Long-Term Fiscal Position*, is a simplified version of the "Statement of Sustainability" that was proposed in the Alternative View of *Preliminary Views: Accounting for Social Insurance, Revised* (PV). Adaptations were made to the version proposed in the PV based upon comments from the Communications members of the Fiscal Sustainability Task Force.
- A 34. Option B, *Future Implications of Current Policies*, is based upon a recommendation from one of the technical group members of the Fiscal Sustainability Task Force.
- A 35. Option C, *Long-Term Implications of Current Policies*, Option C is a modified version of Option A, developed by staff based upon the "pros-and-cons" for Options A and B discussed in the December briefing memo.

Request for Feedback from Readers of the CFR

- A 36. Currently, the CFR does not request comments from readers or provide contact information for readers' comments. The Board expressed an interest in

receiving feedback from financial statement users because such comments may be helpful in assessing whether the comprehensive long-term fiscal projections and accompanying narrative and graphics in the CFR are understandable and meaningful for readers.

Appendix B: Example Formats and Illustrations

Option A: Summary of Long-Term Fiscal Position

Summary of Long-Term Fiscal Position

As of September 30, 20XX

	75 Years		All Future Years	
	PV Dollars	%GDP*	PV Dollars	%GDP*
Receipts				
Medicare	\$ XX.X	X.X%	\$ XX.X	X.X%
Social Security	XX.X	X.X%	XX.X	X.X%
All other receipts	XX.X	X.X%	XX.X	X.X%
Total Receipts	\$ XX.X	X.X%	\$ XX.X	X.X%
Outlays				
Medicare	\$ XX.X	X.X%	\$ XX.X	X.X%
Medicaid	XX.X	X.X%	XX.X	X.X%
Social Security	XX.X	X.X%	XX.X	X.X%
Rest of Federal Government**	XX.X	X.X%	XX.X	X.X%
Total Outlays	\$ XX.X	X.X%	\$ XX.X	X.X%
Fiscal Imbalance***	\$ XX.X	X.X%	\$ XX.X	X.X%

Per Capita, based on current population:

Fiscal Imbalance per:	(in dollars)	(in dollars)
Citizen	\$ XX	\$ XX
Full-time Worker	\$ XX	\$ XX
Household	\$ XX	\$ XX

Per Capita, based on current and future population:

Fiscal Imbalance per:	(in dollars)	(in dollars)
Citizen	\$ XX	\$ XX
Full-time Worker	\$ XX	\$ XX
Household	\$ XX	\$ XX

Other Sustainability Measures

	(in trillions)	(in trillions)
Total Fiscal Gap****	\$ XX.X	\$ XX.X

Descriptions of the following columns/line items should appear directly below the summary display:

* GDP (Gross Domestic Product) can be roughly defined as all of our nation's income or everything the country produces.

** Rest of government: The repayment of principal and interest on borrowings from the Social Security and Medicare HI Trust Funds should be included in receipts for Social Security and Medicare, and Outlays for Rest of government. If material, these amounts should be displayed on separate sub-lines.

*** The fiscal imbalance is the present value of net receipts/outlays plus public debt. The fiscal imbalance illustrates the amount of present value dollars that would be necessary to balance future outlays and receipts and repay existing debt. The fiscal imbalance measure places no constraints on the level of debt. However, excessively high levels of debt can have serious negative consequences on the Government through substantial interest cost in relation to receipts and be unsustainable in attracting investors.

**** The fiscal gap assumes the public debt is maintained at a constant percentage of GDP. Fiscal gap measures assist in understanding the effect of allowing public debt to increase as a constant percentage of GDP. This amount illustrates the amount of present value dollars that would be necessary to maintain public debt as a constant percentage of GDP.

The "current population" amounts show what amounts would be needed from each person, worker, etc. in the current year to eliminate the fiscal imbalance. (Present value numerator, current population denominator)

The "current and future population" amounts show what amounts would be needed from the total number of persons, workers, or households projected to comprise that population group at any time during the entire 75-year projection period.

Accompanying Narrative and Graphics

A) Explanation of assumptions:

- Demographic trends, including assumptions about longevity, birth rates and immigration.
- Policy assumptions for revenues and outlays for: Medicare, Social Security, and rest of federal government. Full payment of principal and interest due to Social Security and Medicare HI Trust Funds must be shown as revenue for Medicare and Social Security, and outlays for "rest of government."
- Explanation in "plain English" of present value.
- Explanation of interest rates used to calculate present value.

B) Additional narrative and graphics: see page 42.

C) Additional information:

Appendix B: Example Formats and Illustrations

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-
- Narrative and graphics to show trends of annual deficit or surplus as a % of GDP, at intervals beginning at least 20 years before the current year and future years projected to at least 75 years after the current year. [Example: 1980, 1990, 2000, 2010, 2020, 2040, 2060, 2080 and 2100 or “All”]
 - Narrative and sensitivity analysis for alternative scenarios for major assumptions (spending and tax rates, discount rates).
 - Narrative that explains how options for addressing the issue will become more limited and/or the impact of the options more severe if action is delayed.

Appendix B: Example Formats and Illustrations

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Option B: Future Implications of Current Policies

Option B is a two-part summary display, with additional supplementary information.

Part 1- Future Implications of Current Policies¹

Present value dollars, in billions:

	Prior Year	Current Year	Projections				
	2006	2007	2008	2009	2010	2011	2012
Medicare							
Future Net Benefits of Living Generations	XX	XX	XX	XX	XX	XX	XX
Less: Trust Funds	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Net Benefits of Past and Living Generations (subtotal)	XX	XX	XX	XX	XX	XX	XX
Net Benefits of Future Generations	XX	XX	XX	XX	XX	XX	XX
Unfunded Costs: Medicare	XX	XX	XX	XX	XX	XX	XX
Social Security							
Future Net Benefits of Living Generations	XX	XX	XX	XX	XX	XX	XX
Less: Trust Funds	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Net Benefits of Past and Living Generations (subtotal)	XX	XX	XX	XX	XX	XX	XX
Net Benefits of Future Generations	XX	XX	XX	XX	XX	XX	XX
Unfunded Costs: Social Security	XX	XX	XX	XX	XX	XX	XX
Rest of Federal Government							
Present Value of Future Expenditures	XX	XX	XX	XX	XX	XX	XX
Plus: Debt held by Medicare and Social Security Trust Funds	XX	XX	XX	XX	XX	XX	XX
Less: Present Value of Receipts	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Less: Net Financial Assets	(X)	(X)	(X)	(X)	(X)	(X)	(X)
Unfunded Costs: Rest of Federal Government	XX	XX	XX	XX	XX	XX	XX
Total Unfunded Costs (Fiscal Imbalance)	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>

¹ Explanation of revenue and expense assumptions for “current policies.” (See guidance for assumptions in paragraphs 19 - 33 of this document.)

Appendix B: Example Formats and Illustrations

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Unfunded Costs as a percent of present value of GDP

	2006	2007	2008	2009	2010	2011	2012
Unfunded Costs: Medicare	XX	XX	XX	XX	XX	XX	XX
Unfunded Costs: Social Security	XX	XX	XX	XX	XX	XX	XX
Unfunded Costs: Rest of Federal Government	XX	XX	XX	XX	XX	XX	XX
Total Unfunded Costs (Fiscal Imbalance)	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>

Part 2: Projected accumulation of total unfunded costs from the beginning of the current year (2007)

	Cumulative Total in Years Including the Current Year						
	1-5	1-10	1-25	1-50	1-75	1-100	All
Total Federal Obligations Under Current Policies							
Medicare	XX	XX	XX	XX	XX	XX	XX
Social Security	X	XX	XX	XX	XX	XX	XX
Rest of Federal Government	X	XX	XX	XX	XX	XX	XX
Total- present value dollars	XXX	XXX	XXX	XXX	XXX	XXX	XXX

The following are details for line items in Parts 1 and 2 that should be explained in the narrative.

Living generations include those aged 15 and older in the indicated year ("closed group"). "Net benefits of living generations" is the present value of the one-hundred year closed group liability.

Future generations include those aged 14 and younger and unborn generations as of the indicated year ("open group"). Net benefit of future generations is the open group liability.

Present value of "Future Expenditures for the Rest of Federal Government" excludes net interest.

"Net Financial Assets" are cash and cash equivalents less liabilities (see additional information below).

"All" column (Part 2) is calculated in perpetuity.

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The following additional information would be placed in the “narrative” section.

Additional information: Projection of Net Financial Assets

	<i>Past Years</i>				<i>Current Year</i>	<i>Projections</i>				
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
OPERATING COSTS										
Total Operating Costs	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX
Less: Taxes and All Other Revenues	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX
Net Operating Costs	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX
BALANCE SHEET										
Financial Assets*	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX
Less: Liabilities	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX
Net Financial Assets*	X	X	X	X	X	X	X	X	X	X

* Financial assets are cash and cash equivalents.

Accompanying Narrative and Graphics (Same as for Option A)

A) Explanation of assumptions:

- Demographic trends, including assumptions about longevity, birth rates and immigration.
- Policy assumptions for revenues and outlays for: Medicare, Social Security, and rest of federal government. Full payment of principal and interest due to Social Security and Medicare HI Trust Funds must be shown as revenue for Medicare and Social Security, and outlays for “rest of government.”
- Explanation in “plain English” of present value.
- Explanation of interest rates used to calculate present value.

B) Additional narrative and graphics: see page 42.

C) Additional information:

- Narrative and graphics to show trends of annual deficit or surplus as a % of GDP, at intervals, beginning at least 20 years before the current year and future years projected to at least 75 years after the current year. [Example: 1980, 1990, 2000, current year, 2010, 2020, 2040, 2060, 2080, 2100 or “All”]
- Narrative and sensitivity analysis for alternative scenarios for major assumptions (spending and tax rates, discount rates).
- Narrative that explains how options for addressing the issue will become more limited and/or the impact of the options more severe if action is delayed.

Option C: Long-Term Implications of Current Policies

Long-Term Implications of Current Policies

Amounts projected to 100 years

	As of September 30, 20XX (Current Year)		As of September 30, 20XX (Prior Year)	
	PV Dollars	%GDP*	PV Dollars	%GDP*
Receipts				
Medicare	\$ XX.X	X.X%	\$ XX.X	X.X%
Social Security	XX.X	X.X%	XX.X	X.X%
All other revenues	XX.X	X.X%	XX.X	X.X%
Total Receipts	\$ XX.X	X.X%	\$ XX.X	X.X%
Outlays				
Medicare	\$ XX.X	X.X%	\$ XX.X	X.X%
Medicaid	XX.X	X.X%	XX.X	X.X%
Social Security	XX.X	X.X%	XX.X	X.X%
Rest of Federal government**	XX.X	X.X%	XX.X	X.X%
Total Projected Outlays	\$ XX.X	X.X%	\$ XX.X	X.X%
Fiscal Imbalance***	\$ XX.X	X.X%	\$ XX.X	X.X%

Per capita, based on current and future population:

Fiscal Imbalance per:	(in dollars)	(in dollars)
Citizen	\$ XX	\$ XX
Worker	\$ XX	\$ XX
Household	\$ XX	\$ XX

Per capita, based on current population

National debt per:	(in dollars)	
Citizen	\$ XX	\$ XX
Worker	\$ XX	\$ XX
Household	\$ XX	\$ XX

Other Sustainability Measures

	(in trillions)	(in trillions)
Total Fiscal Gap****	\$ XX.X	\$ XX.X

Appendix B: Example Formats and Illustrations

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Descriptions of the following columns/line items should appear directly below the summary display:

* GDP (Gross Domestic Product) can be roughly defined as all of the nation's income or everything the country produces.

** Rest of government: The repayment of principal and interest on borrowings from the Social Security and Medicare HI Trust Funds should be included in receipts for Social Security and Medicare, and Outlays for Rest of government. If material, these amounts should be displayed on separate sub-lines.

*** The fiscal imbalance is the present value of net receipts/outlays plus public debt. The fiscal imbalance illustrates the amount of present value dollars that would be necessary to balance future outlays and receipts and repay existing debt. The fiscal imbalance measure places no constraints on the level of debt. However, excessively high levels of debt can have serious negative consequences on the Government through substantial interest cost in relation to receipts and be unsustainable in attracting investors.

**** The fiscal gap assumes the public debt is maintained at a constant percentage of GDP. Fiscal gap measures assist in understanding the effect of allowing public debt to increase as a constant percentage of GDP. This amount illustrates the amount of present value dollars that would be necessary to maintain public debt as a constant percentage of GDP.

The "current population" per capita amounts show what amounts would be needed from each person, worker, etc. in the current year to eliminate the fiscal imbalance. (Present value numerator, current population denominator)

The "current and future population" per capita amounts show what amounts would be needed from each person, worker, or household projected to be included in that population group for any portion of the projection period. In this example, the "current and future population" of full-time workers would be the sum of: (a) the number workers that are in the workforce at the beginning of the period and (b) the projected number of full-time workers that will enter the workforce during the 75-year projection period. Alternatively, workforce participation could be disregarded and simple age demographic could be used (for example, citizens 15-65).

Unfunded Costs as a percent of present value of GDP

	Prior Year	Current Year	<i>Projected</i>				
	2006	2007	2008	2009	2010	2011	2012
Unfunded Costs: Medicare	XX	XX	XX	XX	XX	XX	XX
Unfunded Costs: Social Security	XX	XX	XX	XX	XX	XX	XX
Unfunded Costs: Rest of Federal Government	XX	XX	XX	XX	XX	XX	XX
Total Unfunded Costs (Fiscal Imbalance)	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>

Accompanying Narrative and Graphics (Same as for Options A and B)

A) Explanation of assumptions:

- Demographic trends, including assumptions about longevity, birth rates and immigration.
- Policy assumptions for revenues and outlays for Medicare, Social Security, and rest of federal government. Full payment of principal and interest due to Social Security and Medicare HI Trust Funds must be shown as revenue for Medicare and Social Security, and outlays for “rest of government.”
- Explanation in “plain English” of present value.
- Explanation of interest rates used to calculate present value.

B) Additional narrative and graphics: see page 42.

C). Additional information:

- Narrative and graphics to show trends of annual deficit or surplus as a % of GDP, at intervals beginning at least 20 years before the current year and future years projected to at least 75 years after the current year. [Example: 1980, 1990, 2000, 2010, 2020, 2040, 2060, 2080, and 2100 or “All”]
- Narrative and sensitivity analysis for alternative scenarios for major assumptions (spending and tax rates, discount rates).
- Narrative that explains how options for addressing the issue will become more limited and/or the impact of the options more severe if action is delayed.

Additional Information

The following additional information should supplement the summary display.³⁷

1. Rising cost of health care

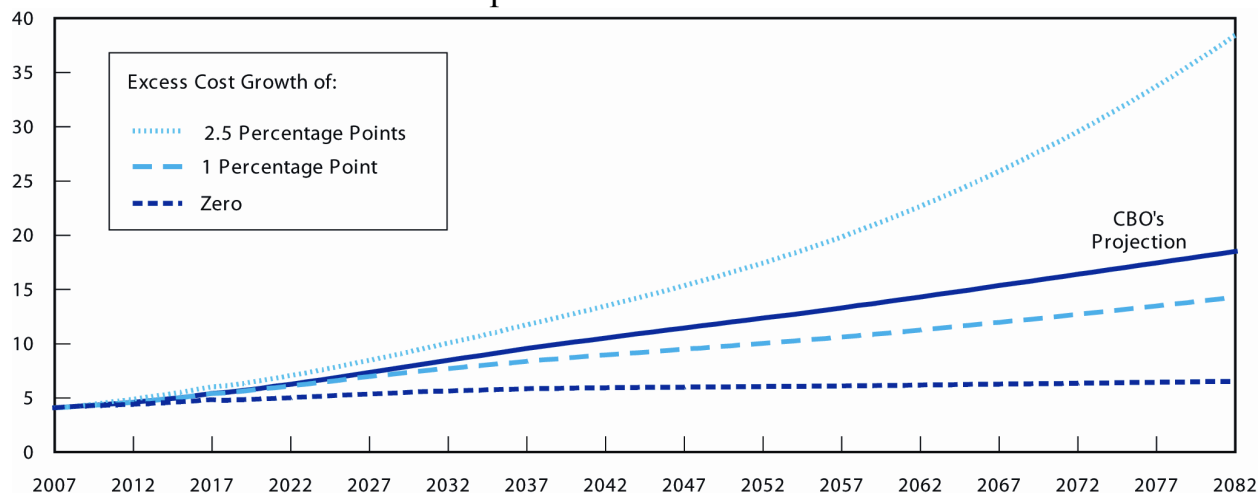
If the rising cost of federal spending on health care is a major factor in the long-term spending projections, it should be reported as follows:

- (a) If the growth in health care costs exceeds the growth in GDP, the narrative should explain that the growth in any spending program cannot continue indefinitely to exceed the growth in the economy, because at some point, the costs would exceed the resources that can be extracted from the economy.
- (b) A range encompassing three alternative scenarios (baseline, high and low estimates), along with a potential “most likely” trajectory if different from “intermediate,” should be presented in a graphic as a percentage of GDP. The graphic could use the example format in Illustration 1a on the following page.

³⁷ See paragraph 43 of this standard.

Illustration 1a: Range of Alternative Assumptions Graphic

Federal Spending for Medicare and Medicaid as a Percentage of Gross Domestic Product Under Different Assumptions About Excess Cost Growth



Source: Congressional Budget Office, *The Long-Term Outlook for Health Care Spending*, November 2007, Figure 5, page 15. Available at: <http://www.cbo.gov/>.

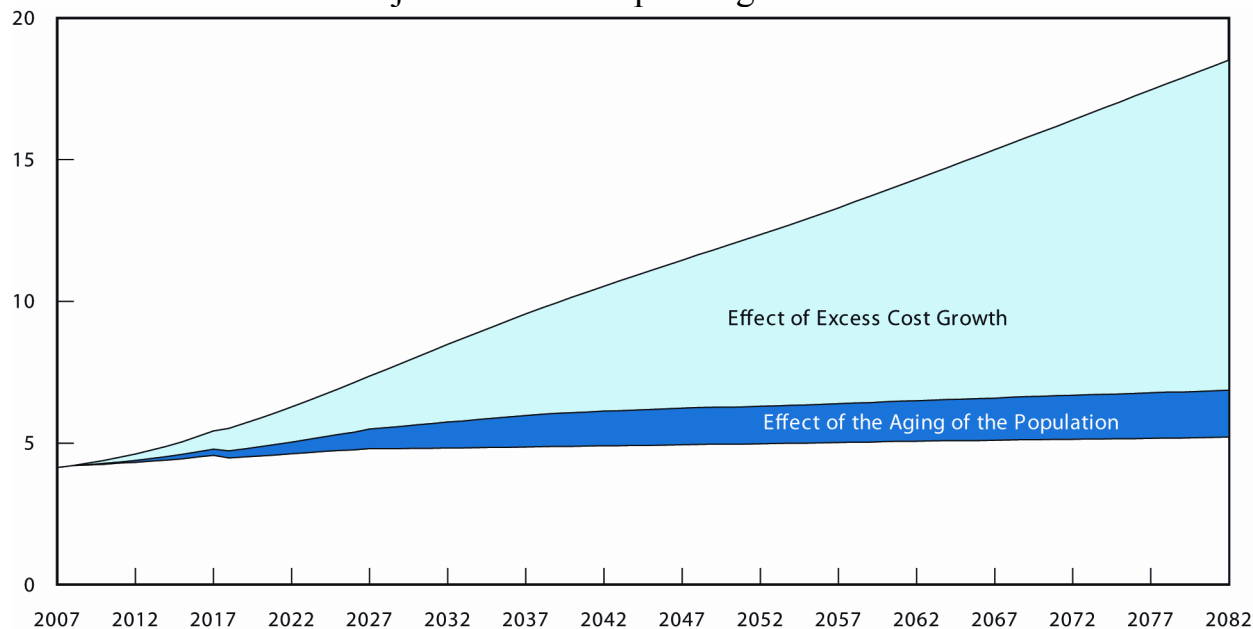
A narrative should describe the assumptions involved in the low, intermediate and high projections, and if applicable a fourth, “most likely” projection.

In addition, a graphic should display the relative contribution of two or more major cost drivers. For example, Illustration 1b on the following page displays the effect of the aging of the population on Federal spending on Medicare and Medicaid versus excess cost growth.³⁸

³⁸ Excess cost growth refers to the number of percentage points by which the growth of annual health care spending per beneficiary is assumed to exceed the growth of nominal gross domestic product per capita.

Illustration 1b: Relative Contribution of Two Major Cost Drivers

Sources of Growth in Projected Federal Spending on Medicare and Medicaid



Source: Congressional Budget Office, *Op. Cit.*, page 14.

Note to the Board:

For major cost drivers that have a significant element of uncertainty, staff believes that it may be best to show projections of spending as a range, as in the above graph, than a point estimate.

Questions for the Board:

1. Do you agree that a graphic showing projected ranges is a helpful illustration of the uncertainty inherent in the projection?
2. Do you agree that the graphic showing the relative contribution of two cost drivers (aging versus excess cost growth) is informative for readers?

2. Demographic trends

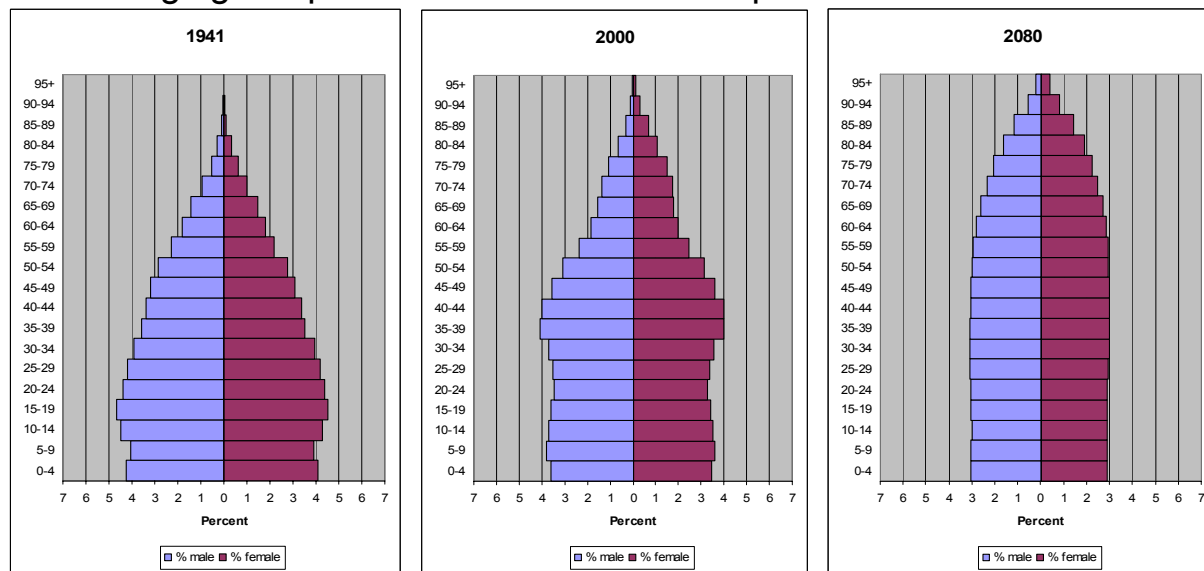
The narrative should describe demographic trends and briefly explain the major drivers of change in demographic trends, such as trends in longevity and birth rates, and refer the reader to more extensive coverage of the topic in other existing reports, such as the Social Security and Medicare Trustees Reports. The narrative could describe the change in the ratio of workers to retirees and how this change relates to long-term fiscal outlook for social insurance programs.

A simple graphic to accompany and illustrate the narrative should follow the format of the example shown below. The illustrative sample format below is called an “age/gender pyramid.” The graphic could display two or three age/gender pyramids side-by-side, for example:

- (1) the current (or other baseline) year minus at least 50 years,
- (2) the current year (or other baseline year, such as 2000), and
- (3) a projection of the current (or other baseline) year plus at least 50 years.

Illustration 2: Age-Gender Pyramid

The Changing Shape of the United States' Population



Source: Social Security Administration, Area Population Statistics.

Note to Board: Social Security staff prepared the above graphs using population statistics for years that were readily available. If the Board concurs in principle with this requirement, staff will ask Social Security for a similar graph for 1950 and 2050 instead of 1941 and 2080.

Question for the Board:

Do you agree that the above graph is a useful format for communicating demographic trends to the reader?

Alternatively, simple age demographics rather than workforce participation could be used, (i.e., “over 64 instead of “retired,”) provided that they are used consistently.³⁹

The narrative could also discuss the “total dependency” ratio (dependent children plus retirees per worker) for each “worker-to-retiree” ratio that is provided in the narrative.

The narrative also could provide perspective by explaining that similar demographic trends are occurring in other developed countries, and provide examples of developed nation(s) projected to have a greater number of retirees per worker than the U.S., and developed nation(s) projected to have fewer retirees per worker.

3. Trends in deficit spending

The trends in deficit spending could be graphically displayed as a percentage of GDP. For example, projections for future trends could be based upon the application of the current year’s tax rates, benefit formulas and Medicare reimbursement rates on mid-range demographic trends and GDP growth, with a constant interest rate. Underlying data tables could be shown in accompanying information rather than part of the primary display.

Alternative scenarios may present changes in taxes or spending that are embodied in current law, such as the expiration of tax provisions and/or reductions in Social Security or certain Medicare benefits to the level that could be financed with trust fund resources plus dedicated inflows.

3(a) Deficit spending trends

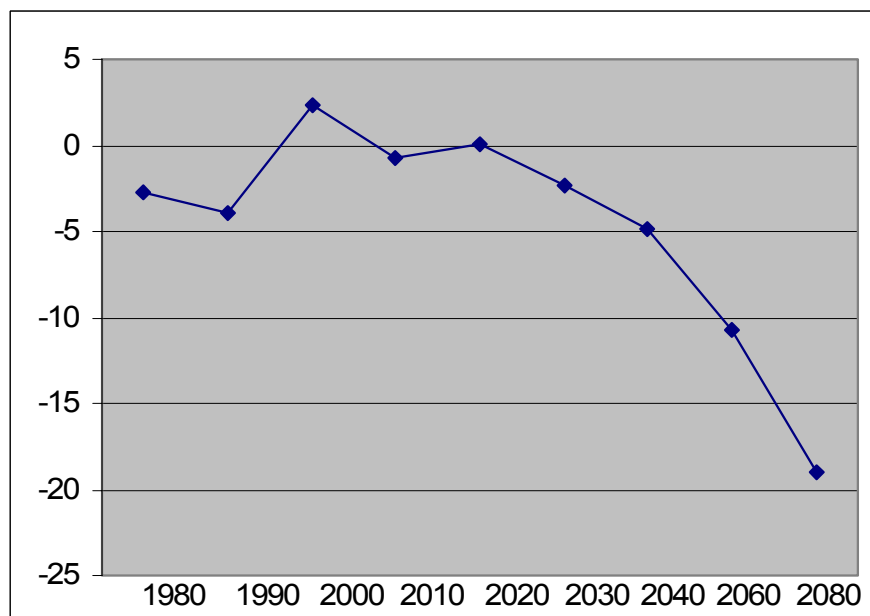
One graphic could display the deficit as a percentage of GDP, showing at a minimum the current year minus 20 years, the current year and the current year plus 75. The narrative should discuss the advantages and disadvantages of displaying projections far into the future, such as increasing uncertainty versus the “moving window” issue.⁴⁰

³⁹ The European Commission defines the total dependency ratio as the “Population under 15 and over 64 as a percentage of the population aged 15-64.” *European Economy: Special Report 1/2006*, page 313.

⁴⁰ The “moving window” problem occurs when there are significant changes to an estimate from one year to the next that are caused by the passage of time. For example, if a projection period is 75 years, the

Illustration 3a: Projected Deficit/Surplus as a Percentage of GDP

Projected Deficit/Surplus as a Percentage of GDP

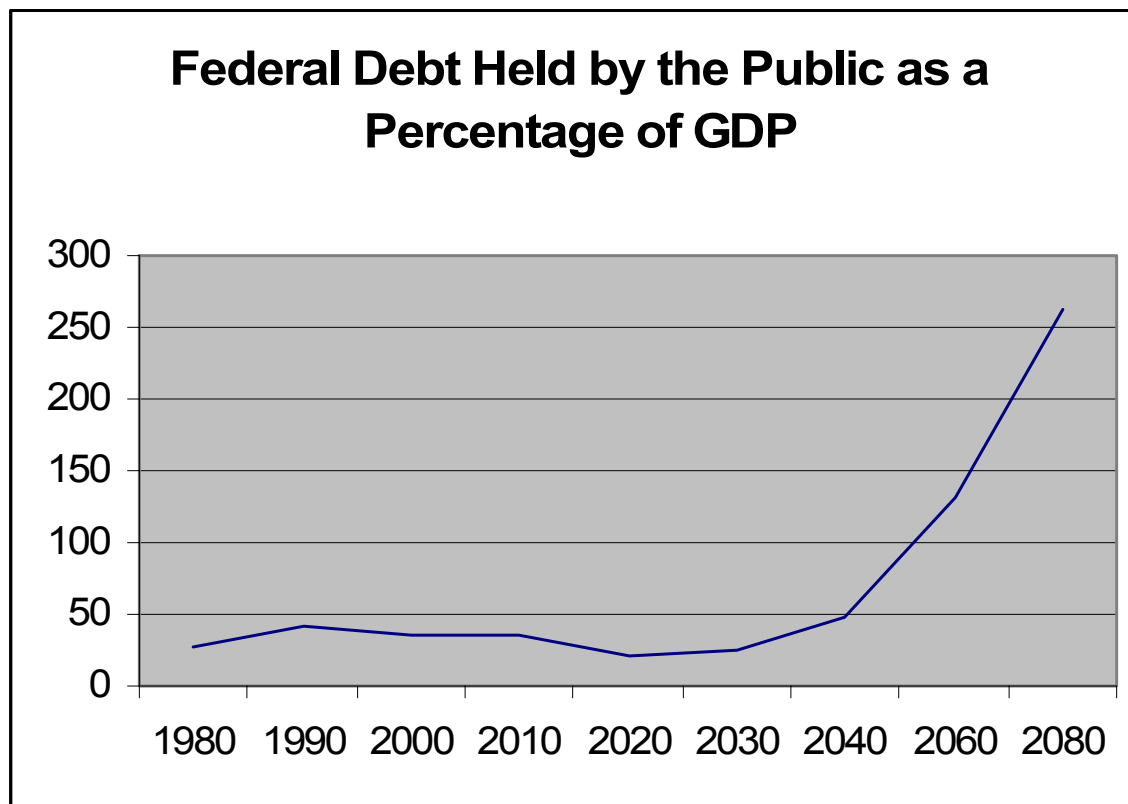


Data source: Office of Management and Budget, Table 13-2, Chapter 13, "Stewardship," *Analytical Perspectives*, FY 2008 Budget.

3(b) Increase in Treasury debt

A second graphic for this section could display the projected increase in Treasury debt as a percentage of GDP, showing at a minimum the current year minus 25 years, the current year, the current year plus 25 years, and a final column labeled "all" to show the infinite horizon. This graphic should illustrate the assumption that increased borrowing would be substituted for increased taxes and/or reduced spending.

activity in "year 76" is outside the projection period for that year, but will be included in the projection period for the following year.

Illustration 3b- Increase in Federal Debt Held by the Public

Data source: Office of Management and Budget, Table 13-2, Chapter 13, "Stewardship," *Analytical Perspectives*, FY 2008 Budget.

3 (c) Foreign Holdings of U.S. Government Debt

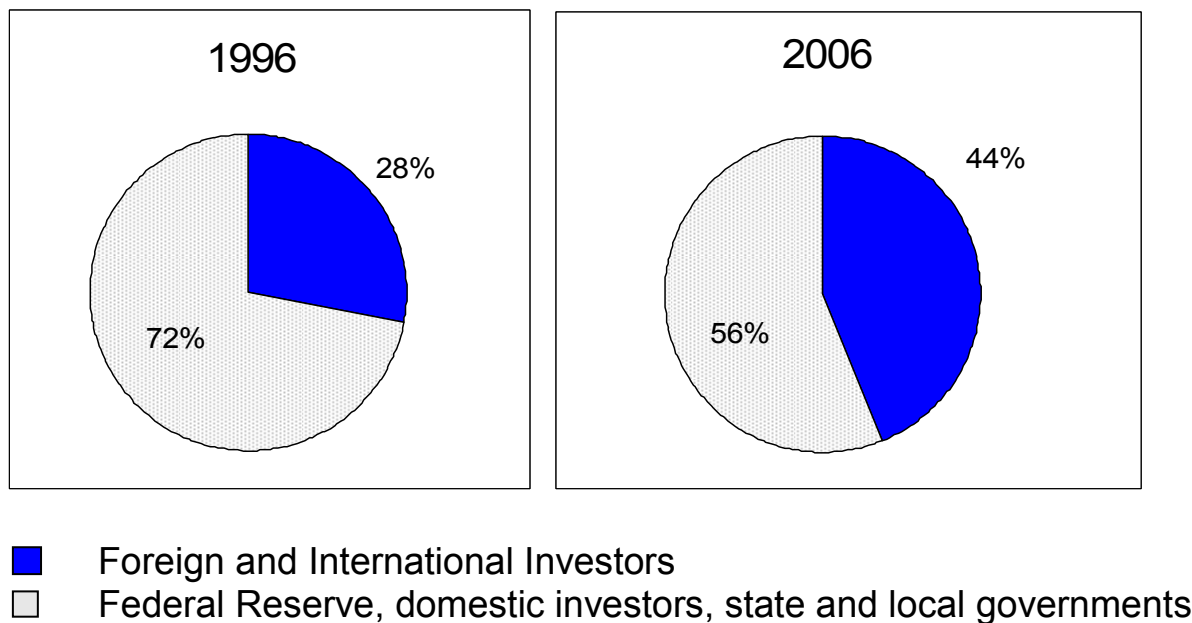
A graphic and a table should display information about foreign holdings of U.S. Treasury debt. The graphic should display the historical amount of foreign holdings of Treasury and federal agency debt for a minimum of **10 years** through the most recent date for which data is available. This graphic could be presented as either a line graph (Illustration 3c-1) or by two or more side-by-side pie charts (Illustration 3 c-2).

A table accompanying the graphic (3c-1 or 3c-2) should list the amounts held by the top ten nations holding Treasury debt at the most recent date for which data is available (see Illustration 3c-3 below). The nations of Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates should be aggregated and displayed as “Middle East Oil-Exporters.” A note or a cross-reference to the source report should provide information on the amount of U.S. Treasury debt held by the individual Middle East Oil-Exporting nations.

Illustration 3c-1: Line Graph Option



Data source: *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2006*, issued May 2007 by the Department of the Treasury, Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Table 1, page 3. Available at: <http://www.treas.gov/tic/fpis.html>.

*Illustration 3c-2: Pie Chart Option***Foreign Ownership of U.S. Treasury Debt Has Increased**

Adapted from: GAO-08-217CG, October 30, 2007, chart 18

Illustration 3c-3: Table of top ten foreign investors in U.S. Government Debt

A table that displays the ten largest major foreign investing countries should accompany the graphic showing the trend in foreign holdings.

Foreign Holdings of U.S. Government Debt*

by Major Investing Country

As of June 30, 2006

Billions of Dollars

Japan	719
China, mainland	619
Luxembourg	90
Middle East Oil-Exporters**	78
United Kingdom	75
Cayman Islands	57
Belgium	56
Switzerland	43
Netherlands	35
Canada	<u>22</u>
Total	1,794

* U.S. Treasury Long-Term Debt and U.S. Agency Long-Term Debt

** Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates

Data source: *Ibid.*, Table 4, "Value of foreign holdings of U.S. Securities, by major investing country and type of security, as of June 30, 2006" page 8. Available at: <http://www.treas.gov/tic/fpis.html>.

A narrative accompanying the graph and table should explain the potential risks or benefits and likely consequences of trends in foreign holdings of U.S. Treasury debt.

Staff recommendation:

Staff recommends that the ED include both a line graph and a pie chart format, to allow the preparer flexibility in illustrating the trend in foreign holdings of U.S. Treasury debt. If the Board prefers to select a single option, staff recommends a pie chart format to avoid visual monotony because the previous three graphics are also line graphs.

Questions for the Board:

1. Do you believe that the above graphics and table provide information about U.S. Treasury debt in an understandable way?
2. Do you believe that there should be two options provided in the ED for the percentage of foreign holdings, U.S. Treasury Debt, or should a single option be presented?

Appendix C: FAQs

FAQ 1. What is “Fiscal Sustainability Reporting”?

“Fiscal Sustainability Reporting” is the short term for “Comprehensive Long-Term Fiscal Projections and Accompanying Narrative and Graphics in the Financial Report of the U.S. Government.”

FAQ 2. 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: $GDP = \text{consumption} + \text{investment} + \text{government spending} + (\text{exports} - \text{imports})$

FAQ 3. Why does the **debt-to-GDP ratio** matter?

The debt to GDP ratio, for the purposes of federal financial 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 ratio 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 initial 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.

FAQ 4. 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 today in order 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.

FAQ 5. What is the fiscal imbalance measure?

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

FAQ 6. 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.

FAQ 7. What are projections and simulations?

Projections and 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 and simulations are useful in order to display alternative future scenarios, but it is important to clearly explain the nature of the information being presented.

FAQ 8. What factors affect projections?

Projections are affected by two kinds of assumptions: policy assumptions and economic assumptions.

Policy assumptions address the level of services provided by the federal government as well as the framework for assessing taxes and fees. 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.

Economic assumptions address the economic factors that are not under the direct legislative control of the federal government (for example, population demographics, inflation and growth in Gross Domestic Product).

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

FAQ 9. 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.⁴¹

⁴¹ SFFAS 27, paragraph 27.

Appendix D: Abbreviations

CBO	Congressional Budget Office
CFR	Consolidated Financial Report of the U.S. Government
FAQ	Frequently Asked Question
FASAB	Federal Accounting Standards Advisory Board
GAO	Government Accountability Office (formerly, General Accounting Office)
GDP	Gross Domestic Product
OMB	Office of Management and Budget
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards
SOSI	Statement of Social Insurance
U.S.	United States

Appendix E: Glossary

Conservatism - Conservatism has been defined in the context of private sector reporting as follows:

“Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate; however, if two amounts are not equally likely, conservatism does not necessarily dictate using the more pessimistic amount rather than the more likely one.” Financial Accounting Standards Board (FASB) Statement of Concepts No. 2, paragraph 95.

The concept of conservatism implies that the preparer should select the less optimistic assumptions. In light of the large number of assumptions required, this concept should be applied with care to avoid systematically biasing the projection. When the preparer is unable to determine the assumption most consistent with current policy, the preparer is not always required to select the assumption representing the worst case scenario. Rather, the preparer should view the constellation of such assumptions as a whole and make individual selections which result in a reasonable overall projection.

Current Policy - In this standard, “current policy” refers to current levels of federal government services and benefits (for example, current reimbursement rates for Medicare and scheduled benefits for Social Security) combined with current levels of taxation. “Current levels” is not equivalent to levels measured in dollars. In the broader context of current policy, current levels are to be considered with respect to the service or benefit being provided and the general relationship of taxation to the economy (e.g., taxable income, GDP or some other base).

Debt to GDP Ratio - The debt to GDP ratio, for the purposes of federal financial reporting, is the amount of federal (Treasury) debt held by the public divided by Gross Domestic Product.

Discretionary Spending - 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.

Earmarked Revenue – 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.” 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 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.⁴²

Economic Assumptions - Economic assumptions address the economic factors that are not under the direct legislative control of the federal government (for example, population demographics, inflation and growth in Gross Domestic Product).

Federal “trust funds” - 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*

⁴² SFFAS 27, paragraph 27.

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.⁴³

Fiscal Sustainability Reporting – In federal financial reporting, “Fiscal Sustainability Reporting” is the short term for “Comprehensive Long-Term Fiscal Projections and Accompanying Graphics and Narrative in the Financial Report of the U.S. Government.”

Gross Domestic Produce (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 = consumption + investment + government spending + (exports – imports)

Mandatory Spending - “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

Policy Assumptions - Policy assumptions address the level of services provided by the federal government as well as the framework for assessing taxes and fees.

⁴³ SFFAS 27, paragraph 27.

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.

Projections - Projections and 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 and simulations are useful in order to display alternative future scenarios, but it is important to clearly explain the nature of the information being presented.

Simulations - Projections and 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 and simulations are useful in order to display alternative future scenarios, but it is important to clearly explain the nature of the information being presented.

FASAB Board Members

Tom L. Allen, Chair

Robert F. Dacey

John A. Farrell

Norwood J. Jackson, Jr.

Robert P. Murphy

James M. Patton

Robert N. Reid

Alan H. Schumacher

Harold I. Steinberg

Danny Werfel

FASAB Staff

Wendy M. Payne, Executive Director

Project Staff

Eileen W. Parlow

Federal Accounting Standards Advisory Board
441 G Street NW, Suite 6814
Mail Stop 6K17V
Washington, DC 20548
Telephone 202-512-7350
FAX 202-512-7366
www.fasab.gov

Attachment 2: History of Board Decisions on Fiscal Sustainability Reporting

Board Meeting Date	Question/Item for Discussion	Board View
May 2006	Staff presented a proposal to form a task force to address fiscal sustainability reporting, with technical experts from think tanks, social insurance actuaries, and members of the user community. The Board discussed providing task force representation and/or staff support from the FASAB's sponsoring agencies (OMB, GAO, CBO and Treasury).	Board concurred that staff should begin to form a task force and draft a project plan.
July 2006	Board reviewed: <ol style="list-style-type: none"> 1. Outline of draft briefing package for the "technical experts" task force members, and 2. List and bios for proposed task force members (technical experts and financial statement users/communication experts) 	Board approved, with minor changes: <ol style="list-style-type: none"> 1. Outline for the briefing package for the "technical expert" task force members and 2. List of proposed task force members.
January 2007	Board reviewed: <ol style="list-style-type: none"> 1. Draft briefing package for Task Force technical members, and 2. Updated list of outside technical members who accepted invitations and Federal members who would serve as technical experts for the April 4, 2007 Task Force meeting 	Board approved the briefing package for the task force technical members and asked that a copy of the PV Alternative View document also be sent to them.
March 2007	Board was briefed on: <ol style="list-style-type: none"> 1. Results of the April 5, 2007 meeting with technical members of the task force. 2. Results of February 22, 2007 meeting with Allen Schick, who could not attend April meeting. 3. Staff meeting with OMB, CBO, GAO and Treasury technical representatives. 	N/A
May 2007	Handout for the Board: update on April 2007 Task Force meeting	N/A

Board Meeting Date	Question/Item for Discussion	Board View
July 2007	<ol style="list-style-type: none"> 1. Board was briefed on results of the June 19, 2007 “Communications Group” Task Force meeting. 2. Topics addressed at the July Board meeting: <ol style="list-style-type: none"> (a) Whether to develop reporting objectives versus a definition of “fiscal sustainability”, and (b) Need for user feedback. 3. The Board was also provided with an international survey of fiscal sustainability reporting and a draft project plan for this project, including milestone target dates. 	<p>Board concurred that:</p> <ol style="list-style-type: none"> (a) Staff should draft objectives that would be based upon Stewardship objective, and (b) Staff should continue to explore potential avenues for user feedback.
September 2007	<p>Board discussed</p> <ol style="list-style-type: none"> 1. objectives and 2. assumptions <p>for fiscal sustainability reporting</p>	<ol style="list-style-type: none"> 1. Board expressed general agreement on the draft objectives, with some revisions. 2. Board concurred that: <ol style="list-style-type: none"> (a) Staff should develop broad guidelines for assumptions rather than detailed rules, and (b) Assumptions should be based upon current law, except when current law does not provide for continuance of current levels of spending and taxation.
December 2007	<p>Board reviewed draft ED with focus on:</p> <ol style="list-style-type: none"> 1. Revised guidance for objectives and assumptions 2. “Per capita” issue 3. Initial discussion of: <ol style="list-style-type: none"> (a) Draft summary displays (b) Draft requirements for additional narrative and graphics. 	

Attachment 3

Milestones - Fiscal Sustainability Reporting

April 5, 2007	Task Force Meeting: Technical Experts
May 24, 2007	Board meeting: Recap of results of April 2007 task force meeting
June 19, 2007	Task Force Meeting: Financial Statement Users/Communications Experts
July 25-26, 2007	Board meeting: Survey of international reporting; recap of results of June 2007 task force meeting
September 19-20, 2007	Board meeting: Present options and proposals for reporting
December 4-5, 2007 *	Board meeting: Present draft ED for discussion
February 13-14, 2008 *	Board meeting: Continue discussion of draft ED
April 16-17, 2008	Board meeting: Discuss preballot draft ED
April 30, 2008	Ballot draft ED
May 15, 2008	Issue ED: Comments due August 15, 2008
August 20-21, 2008	Board meeting: Public hearing
October 22-23, 2008	Board meeting: Discuss ED comments and staff proposal(s)
December 17-18, 2008	Board meeting: Continue discussion of comments/proposal(s)
Jan/Feb 2009 TBA	Board meeting: Continue discussion of comments/proposal(s)
Mar/Apr 2009 TBA	Board meeting: Discuss Preballot draft SFFAS
May/June 2009 TBA	Board meeting: Ballot draft SFFAS
June/July 2009	Transmittal to principals; Begin 90-day review period
October 2009	End 90-day review period and issue SFFAS

* If desired, Task Force members may be invited to meet with the Board.

Attachment 4 – Illustrations of Challenges in Projecting Spending and Revenues

Challenges in Projecting Spending

1. Social Security - Social Security benefits are funded exclusively by the Old-Age and Survivors Insurance (OASI) Trust Fund (colloquially known as the “Social Security Trust Fund”), an earmarked fund that is often combined with the Disability Insurance (DI) Trust Fund and reported as OASDI. The OASI earmarked fund receives payroll taxes, interest revenue, and a portion of the income taxes levied on Social Security benefits.¹ Current law provides for scheduled benefits as well as a limitation that scheduled benefits may only be financed by current earmarked revenues and/or withdrawals from the OASI Trust Fund. These provisions are in conflict.

Projections such as those in the Social Security Trustees Report include a graph that displays two projections: the “scheduled but not payable benefits” projecting the current level of benefits, in addition to the benefits that would be payable under current law starting when the OASDI Trust Funds are projected to be exhausted.²

The Congressional Budget Office (CBO) long-term projections for Social Security explains both scenarios, but the majority of the CBO data tables and graphs display projections of scheduled benefits, with the assumption of “scheduled benefits” clearly specified in the titles and narrative.³

2. Expiring Mandatory Programs - Congress establishes mandatory programs and sets rules for eligibility and benefits. Many mandatory programs such as Medicare and Social Security are authorized by legislation that does not expire. However, some mandatory programs expire within the next ten years:⁴

a. The Food Stamp Program is scheduled to be re-authorized in 2007. The CBO’s baseline projections assume continuance of the program.⁵

b. Temporary Assistance for Needy Families (TANF) is currently authorized through 2010. The CBO’s baseline projection assumes that TANF will continue beyond 2010 at its most recently authorized level.

c. Federal Unemployment benefits and allowances (also known as trade adjustment assistance) are scheduled to be re-authorized in 2007. The CBO’s baseline assumes that they will be reauthorized in 2007.⁶

¹ A portion of the taxation on OASI benefits – over one-half and up to 85%- is credited to the Medicare HI Trust Fund. See “taxation of benefits,” 2007 Trustees Report, Glossary. Available at http://www.ssa.gov/OACT/TR/TR07/VI_glossary.html#wp1005808

² Graph available at http://www.ssa.gov/OACT/TR/TR07/II_project.html#wp105057

³ For example, see *Updated Projections for Social Security* June 2006. Available at <http://www.cbo.gov/publications/collections/socialsecurity.cfm>.

⁴ For an expanded list of expiring mandatory programs, see table 3-6 in CBO’s August 2007 *Budget and Economic Outlook: An Update*. Available at <http://www.cbo.gov/>.

⁵ *Ibid*, page 65.

⁶ *Ibid*.

Attachment 4 – Illustrations of Challenges in Projecting Spending and Revenues

3. Defense spending – Like other discretionary spending, most defense spending is controlled by annual appropriation acts and supplemental appropriation acts. From the late 1980s until 2001, defense spending declined sharply as a share of GDP. In 2002 and 2003, defense spending climbed as military operations began in Iraq and Afghanistan. From 2004 to 2006, defense spending rose more slowly.

CBO's baseline assumes that total discretionary spending will rise with inflation. However, CBO also presents two alternative paths, both of which show a slower-than-inflation increase in defense spending after 2007.

4. Discretionary spending (non-defense) - It might seem intuitive that most discretionary spending that provides services to the population would grow on a per capita basis, adjusted for inflation. However nondefense discretionary spending has historically grown faster than per capita and inflation, and closer to the growth of GDP. Accordingly, the President's budget assumes growth with GDP for the 5-year budget period. The GAO assumes growth at the rate of GDP growth for all discretionary spending, including defense spending.⁷

Challenges in Projecting Revenues

1. Individual income tax rates - "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. In their 2007 projections for periods after the 10-year CBO baseline period, the GAO departed from current tax law and instead assumed that taxes would remain at a constant share of GDP.⁸

2. Individual income tax and the Alternative Minimum Tax (AMT) - The AMT was originally intended to limit the extent to which higher income people could reduce their tax liability through the use of preferences in the tax code. Taxpayers subject to the AMT are required to recalculate their tax liability on the basis of a more limited set of exemptions. Unlike the regular income tax, the AMT is not indexed for inflation. As incomes rise each year, a larger number of taxpayers are subject to AMT. Legislation provided for higher exemption amounts but these higher amounts expired at the end of 2006.

In the GAO's *The Nation's Long-Term Fiscal Outlook: August 2007 Update*, the GAO's Alternative Simulation assumption was that the 2006 AMT exemption amount would continue for the next ten years. Thereafter, GAO assumed that overall revenues would revert to a constant share of GDP.⁹

⁷ GAO-07-1261R, *The Nation's Long-Term Fiscal Outlook: August 2007 Update*, page 9. Available at www.gao.gov

⁸ Either (a) CBO's projection in 2017 of 20.3% of GDP for the "Baseline Extended" projection, or (b) for the "Alternative Simulation," the 40-year historical average of GDP (18.3%). *Ibid.*

⁹ *Ibid.*

Statement of Principles

Indicators of Government Financial Condition

prepared by:
Public Sector Accounting Board

Comments are requested by December 10, 2007

PSAB

About Statements of Recommended Practice

The Public Sector Accounting Board issues Statements of Recommended Practice (SORPs) with respect to matters of reporting in the public sector. The objective of issuing SORPs is to enhance decision making and accountability by improving the understandability of reports issued in the public sector. SORPs address specific aspects of reporting on financial condition and financial and non-financial performance.

SORPs do not form part of generally accepted accounting principles. They are not prescriptive, but offer general guidance to encourage and assist public sector entities in effectively reporting relevant information that is useful in evaluating the entity's financial condition at the financial statement date and its financial and non-financial performance during the reporting period.

Compliance with SORPs is not mandatory but encouraged as they serve to improve and harmonize public sector reporting.

Commenting on this Statement of Principles

This Statement of Principles is issued by the Public Sector Accounting Board. The members of the Board are drawn from government, public accounting, business and academe. All members serve as individuals and not as representatives of their governments, employers or organizations.

Statements of Principles propose key principles and definitions that the Board expects to include in a future Exposure Draft.

Individuals, governments and organizations are invited to send written comments to the Board on the principles and definitions set forth. Comments are requested from those who agree with this Statement of Principles as well as from those who do not.

To be considered, comments must be received by December 10, 2007, addressed to:

**Tim Beauchamp, Director
Public Sector Accounting
277 Wellington Street West
Toronto, Ontario M5V 3H2**

**For ease of handling, we prefer comments to be sent by e-mail (in Word format), to:
ed.psector@cica.ca**

HIGHLIGHTS

The Public Sector Accounting Board (PSAB) proposes, subject to comments received on this Statement of Principles, to expose **INDICATORS OF GOVERNMENT FINANCIAL CONDITION**, as a new Statement of Recommended Practices (SORP). The SORP would apply to governments.

Main features

The main features of this Statement of Principles (SOP) are as follows:

- Government financial condition would be described using the elements of sustainability, flexibility and vulnerability. Describing each element includes reporting on specific indicators derived from information recognized in the financial statements of a government and other information related to the economy within which it operates.
- Reporting on indicators of government financial condition would include historical trend data and current period results.
- There would be an overall assessment of a government's financial condition based on whether the elements of financial condition are improving or deteriorating. The assessment would be supplemented by discussion of reasons for changes in financial condition over time, comparisons between planned and actual indicator results and significant events that affected government financial condition.

Background

There are many financial ratios, relationships, trend data and other statistics currently prepared by governments, bond raters, economists, analysts and others. Different methods of computation and a variety of labels are used for indicators that are intended to communicate essentially the same information. PSAB believes a core set of indicators common to all governments presented on a consistent basis can reduce the amount of subjective judgment needed to assess whether a government's financial condition is improving or deteriorating.

Governments in Canada currently do not have a set of common indicators they could use to describe their financial condition. Sovereign governments were the subject of a 1997 CICA Research Report, "Indicators of Government Financial Condition," which outlined an approach for describing financial condition using indicators. At that time, those governments were following a modified accrual accounting model. Local governments were not included in the CICA Research Report.

Since the publication of the CICA Research Report, the information in the financial statements of sovereign governments has changed. Sovereign governments now follow a full accrual reporting model and by 2009, local governments will follow the same approach. This offers new information that needs to be considered when reporting on financial condition.

Comments requested

PSAB welcomes comments on all aspects of the Statement of Principles. Comments are most helpful if they relate to a specific principle, paragraph or group of paragraphs, and, when expressing disagreement, they clearly explain the problem and indicate a suggestion, supported by specific reasoning, for alternative wording.

In particular, respondents are requested to provide responses to the following:

1. Are there more, or different, indicators that could be included in the SORP? In particular, for governments with net financial assets, what indicators would you recommend to describe their financial condition using the elements in this SOP?
2. What other risks, if any, would be measured and reported to support a discussion about vulnerability?
3. Do you agree with the definition of government financial condition? (Principle 3)
4. Do you agree that government financial condition can be described using the elements of sustainability, flexibility and vulnerability? Are there other elements? (Principle 4)
5. Do you agree that the indicators included in this Statement of Principles (Principles 7-9) appropriately describe the element of financial condition with which they are associated?
6. Are the indicators included in this SOP sufficient to support a whole-of-government discussion about:
 - (a) sustainability; (Principle 7)
 - (b) flexibility; (Principle 8) and
 - (c) vulnerability? (Principle 9)
7. Do you agree that economy-wide information could be included in a government's public report? (Principle 6, paragraph 32)
8. Do you agree that reporting on financial condition would include at least five years worth of historical trend data? (Principle 10)
9. Do you agree that a government's planning documents would include planned results for financial condition indicators? (Principle 11)
10. Do you agree that reporting on financial condition would include an assessment of whether financial condition has improved or deteriorated? (Principle 12)
11. Do you agree that it is important to present comparative information about financial condition from other jurisdictions? If not, why not? If so, are the factors described in paragraph 72 appropriate for identifying comparators? (Principle 13)
12. Do you agree that when a government chooses to report indicators of financial condition, it would acknowledge its responsibility for preparing and reporting the indicators, key assumptions made and methodologies applied? (Principle 14)

Indicators of Government Financial Condition

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PURPOSE AND SCOPE

- 1 This Statement of Principles (SOP)¹ proposes definitions and guidance for identifying and reporting a government's financial condition. Information about a government's financial condition provides important contextual information when assessing the extent to which its intended goals and objectives were achieved and at what cost. Practices related to explaining the extent to which intended goals and objectives were achieved and at what cost have been addressed in **PUBLIC PERFORMANCE REPORTING, SORP-2**.
- 2 Reporting on financial condition expands on and explains information contained in financial statements by measuring a government's financial condition not only on the basis of its financial position and changes in financial position, but also in the context of its overall economic and fiscal environment. Practices related to explaining and highlighting information underlying the statements of financial position and changes in financial position have been addressed in **FINANCIAL STATEMENT DISCUSSION & ANALYSIS, SORP-1**, and elsewhere in the CICA Public Sector Accounting Handbook.

Principle 1

Governments would provide information about their financial condition in a public report.

- 3 As described in **FINANCIAL STATEMENT CONCEPTS**, paragraphs PS 1000.07-.13, a government would report additional information beyond what is presented in its financial statements to support assessments of its financial condition. Such reporting adds further depth to the picture of financial performance illustrated in the financial statements and allows users to understand information that is seen as key in a form that is more understandable and useful to a wider audience than just those with technical expertise.
- 4 In addition, reporting on financial condition has the following objectives:
 - (a) helps users identify current foreseeable risks and trends;
 - (b) enlightens users about a government's fiscal stewardship;
 - (c) offers insights into the short-term and long-term implications of past and potential policy decisions;
 - (d) illustrates a government's financial ability to maintain the level and quality of its services and to finance new programs;
 - (e) illustrates a government's ability to meet its financial obligations, both short-term and long-term;
 - (f) enhances understanding of government policy and operating decisions; and
 - (g) provides a basis for any comparison with other similar jurisdictions.
- 5 Understanding and assessing financial condition involves making subjective judgments. For such judgments to be effective, a key success factor is the kind

¹ Throughout this SOP, terms that appear in bold type are defined in the Glossary.

and quality of information used. This involves gathering information from both a government's financial statements and other sources that helps describe its financial condition in the context of the economy within which it operates.

- 6 Governments currently do not have a common methodology they could use to describe their financial condition. For sovereign governments, a 1997 CICA Research Report, "Indicators of Government Financial Condition," offers an approach for reporting on financial condition using indicators. Some sovereign governments in Canada currently report some of the indicators described in the CICA Research Report. By establishing guidance for reporting on financial condition, consistency in the level and extent of disclosure by governments will increase.
- 7 Local governments were not included in the CICA Research Report. Since that report was published, some local governments have developed indicators to describe their financial condition. There is value in publishing and defining indicators of financial condition that all local governments could use to place the information presented in their financial statements into a broader context.

Principle 2

The proposed **Statement of Recommended Practice (SORP)** is intended to apply to governments.

- 8 This guidance is intended to support an overall assessment of financial condition. The extent to which any assessment is comprehensive is a matter of professional judgment.
- 9 When government organizations choose to report financial condition indicators as part of their public reports, the principles described here may be applicable. The nature and extent of public reporting by government organizations varies, so each would assess the applicability of this guidance based on its users' needs.

DEFINITION OF FINANCIAL CONDITION

Principle 3

Government financial condition is a government's financial health as assessed by its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

- 10 FINANCIAL STATEMENT CONCEPTS, PS 1000.08, states: "Financial condition is a broad, complex concept with both short- and long-term implications that describes a government's financial health in the context of the overall economic and financial environment." The definition in Principle 3 provides a practical foundation for putting this concept into practice.

- 11 The CICA's 1997 Research Report defines the financial condition of a government as its financial health, looked at in the context of the overall economic and financial environment, as measured by:²
- (a) **Sustainability** — the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy.
 - (b) **Flexibility** — the degree to which a government can increase its financial resources to respond to rising commitments by either expanding its revenues or increasing its debt burden.
 - (c) **Vulnerability** — the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence, both domestic and international.
- 12 The US Governmental Accounting Standards Board (GASB), during the project that led to the creation of its "Concepts Statement No. 44,"³ defined a government's economic condition as "a composite of its financial health and its ability and willingness to meet its financial obligations and commitments to provide services."⁴
- 13 GASB Concepts Statement No. 44 identifies information to include when reporting supplementary information designed to assist users with understanding and assessing a government's economic condition ("the statistical section"). The statistical section of a state or local government's Comprehensive Annual Financial Report (CAFR) needs to provide information in five categories:
- (a) Financial trends — to assist users in understanding and assessing how a government's financial position has changed over time. This is consistent with SORP-1.
 - (b) Revenue capacity — to assist users in understanding and assessing the factors affecting a government's ability to generate its own-source revenues.
 - (c) Debt capacity — to assist users in understanding and assessing a government's debt burden and its ability to issue additional debt.
 - (d) Demographic and economic — to assist users in understanding the socioeconomic environment within which a government operates and to provide information that facilitates comparisons of financial statement information over time and among governments.
 - (e) Operating — to provide contextual information about a government's operations and resources to assist readers in using financial statement information to understand and assess a government's economic condition.
- 14 In a 1992 Research Report prepared for GASB, financial condition was defined as "...the probability that a government will meet both its financial obligations to creditors, consumers, employees, taxpayers, suppliers, constituents, and others as

² Canadian Institute of Chartered Accountants, Indicators of Government Financial Condition, 1997, p. 5-6

³ Government Accounting Standards Board, Concepts Statement No. 44 — Economic Condition Reporting: The Statistical Section, 2005.

⁴ GASB, Statement No. 44, p. 21

they become due and its service obligations to constituents, both currently and in the future.”⁵

- 15 The Federal Accounting Standards Advisory Board (FASAB) of the United States currently has a project to develop fiscal sustainability reporting requirements. Generally, 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.
- 16 In Australia, local governments are exploring the development of “financial sustainability” indicators. “Financial sustainability” is deemed to be achieved when planned long-term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services.⁶ The indicators used to assess sustainability are similar to those described in the CICA Research Report and by GASB.
- 17 Generally, rating agencies define government financial condition as the ability of a government to pay its financial obligations in a timely manner.⁷ The approaches rating agencies use to assess government financial condition incorporate data that are generally similar to those described in the CICA Research Report and by GASB.
- 18 Based on the examples described in the preceding paragraphs, there appears to be consensus that examining and reporting on financial condition:
 - (a) Encompasses more than a government’s financial position — assessments of financial condition incorporate several elements. Different terminology or levels of detail may be applied but generally the elements commonly used are sustainability, vulnerability and flexibility.
 - (b) Involves multiple data sets — there is no single, “bottom-line” indicator that adequately describes a government’s financial condition. Data from a government’s financial statements, supplemented with other data, are necessary to create indicators that provide a plausible, evidence-based description of financial condition.
 - (c) Incorporates comparisons — assessing financial condition involves comparisons of current results to targets and to a government’s prior period results and could include comparisons with other jurisdictions.
 - (d) Provides information — assessing financial condition involves making subjective judgments. For that judgment to be applied effectively, a key success factor is the kind and quality of information used.

⁵ Robert Berne, The Relationships Between Financial Reporting and the Measurement of Financial Condition, Government Accounting Standards Board, 1992, p. 17

⁶ Local Government Association of South Australia, Information Paper 9 — Local Government Financial Indicators, 2006, p. 10

⁷ For example, see Fitch Ratings, “International Rating Methodology for Local and Regional Governments”, October 30, 2006, Dominion Bond Rating Service, “Methodology — Sovereign Ratings”, February 2006, or Moody’s, “Moody’s Rating System”, May 2006

- (e) Provides decision support — reports about financial condition offer insights into the actual or potential implications of decisions about government services and service levels, but they do not make judgments about government priorities or effectiveness.
- 19 Including historical information in an assessment of financial condition helps users understand the impact of past transactions and events on a government's financial condition. For governments that use data to assist in internal decision making and to manage for results, financial condition indicators are also important to help communicate, both inside the organization and to users, the potential impact of current period decisions.

ELEMENTS OF FINANCIAL CONDITION

Principle 4

Government financial condition would be described using the elements of sustainability, flexibility, and vulnerability.

Sustainability

- 20 Sustainability is the degree to which a government can maintain its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others without increasing the relative debt or **tax burden** on the economy within which it operates.
- 21 Sustainability is an important element to include in an assessment of financial condition because it describes a government's ability to manage its financial and service commitments and debt burden. It also describes the impact that the cost of servicing its debt could have on service provision. A government whose expenses grow at a faster rate than its revenues and/or whose debt charges consume an increasing proportion of its revenues increases the risk that service levels cannot be sustained.
- 22 Data about sustainability enhances discussions about a government's financial condition at a particular point in time. Similarly, trend data about sustainability over multiple periods provides information that enhances discussions about the eventual consequences of policy decisions.

Flexibility

- 23 Flexibility is the degree to which a government can change its debt or tax burden on the economy within which it operates to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.
- 24 Flexibility provides insights into how a government manages its finances. A government that increases its current borrowing reduces its future flexibility to

respond when adverse economic circumstances develop. Similarly, increasing taxation or user fees reduces its ability to do so in the future as a government approaches the limit that citizens and businesses are willing to bear.

Vulnerability

- 25 Vulnerability is the degree to which a government is dependent on sources of funding outside its control or influence or is exposed to risks that could impair its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.
- 26 Vulnerability is an important element of government financial condition because it provides insights into a government's reliance on funding sources outside its direct control or influence. A government whose vulnerability is relatively low has greater control over its financial condition.

Describing financial condition

- 27 Describing financial condition using the elements of sustainability, flexibility and vulnerability helps reduce the risk that the inherently subjective process of assessing government financial condition excludes key data that could materially influence a user's perception of a government's financial performance.
- 28 Describing financial condition using the elements of sustainability, flexibility and vulnerability provides a framework to support a variety of strategic and policy discussions. For example, descriptions of the elements of financial condition for a government at a particular point in time are useful for assessing accountability for the resources entrusted to it. The descriptions can also be useful for assessing the sufficiency and appropriateness of a government's revenue and debt management policies, its range of services and/or its service levels.
- 29 The elements of sustainability, flexibility and vulnerability are interrelated. For example, a government whose current financial condition is strong may be at risk of weakening its condition in the long run if its current service levels or quality are deemed to be low. If it decides to increase its service levels or quality, it could incur financial costs that reduce its flexibility and/or increase its vulnerability. This could negatively impact its long-term sustainability.
- 30 There is no single "right" or optimal result that could be applied to all governments. Determining what constitutes acceptable financial condition would vary according to several unique factors including, but not limited to the order of government, the scale/scope of services provided, local service standards and financial management policies. During the planning process, a government would consider these factors when establishing targets for indicators of financial condition.

INDICATORS OF FINANCIAL CONDITION

Qualitative characteristics

Principle 5

Indicators of government financial condition would support the objectives described in paragraph 4 and embody the basic qualitative characteristics of reliability and validity, relevance, fairness, comparability and consistency, and understandability.

- 31 The qualitative characteristics are essential for the effective communication and utility of information contained in a government's public report. While these characteristics are usually discussed in terms of financial statements, further guidance related to their application in other reporting formats has been established in FINANCIAL STATEMENT DISCUSSION & ANALYSIS, SORP-1, and PUBLIC PERFORMANCE REPORTING, SORP-2.

Quantitative characteristics

Principle 6

Indicators of government financial condition would be based on financial information presented in a government's financial statements and on other information relevant to understanding a government's financial condition.

- 32 Describing a government's financial condition involves multiple data sets. There is no single, "bottom line" indicator that adequately describes a government's financial condition. Data from a government's financial statements, supplemented with other data, are necessary to create a plausible, evidence-based understanding of financial condition. This means that there would be three types of data:
- (a) Government-specific indicators — indicators about government finances derived from its financial statements;
 - (b) Government-related indicators — indicators about government finances derived from a combination of information from its financial statements and from the economy within which the government operates; and
 - (c) Economy-wide information — data about the economy within which the government operates that have a direct impact on the financial condition of the government. There are no economy-wide indicators suggested as part of this SOP.
- 33 Government-specific and government-related indicators, because they incorporate information from a government's financial statements, are fundamentally important for providing a plausible, evidence-based description of financial condition.
- 34 Presenting information about government financial condition on a per capita or per household basis may be useful. However, it is important that there be a direct

relationship between the information from the financial statements and the denominator (for example, per person or per household).

Government-specific indicators

- 35 Financial statements for a government as a whole are prepared to provide an understandable overview of the full nature and extent of the financial affairs and resources which a government controls. Therefore, a government's public report would include indicators of financial condition based on all organizations within the government.
- 36 Linking the indicators of government financial condition to the financial statements has the following benefits:
 - (a) it provides users with contextual data that illuminates the relationships between information reported in the financial statements and helps them understand these relationships;
 - (b) it ties the information about government financial condition to the financial statement date to give users a snapshot view of a government's financial condition; and
 - (c) it facilitates comparability in reporting across governments.

Government-related indicators

- 37 Other indicators relevant to understanding a government's financial condition include quantitative data that describes the economic environment in which the government operates. When combined with information from the financial statements, such data provides context to connect a government's financial results with broader aspects of the economy in which it operates.

Applicability of indicators

- 38 There are fundamental differences between local governments and sovereign governments in the scale, scope and type of services provided, and in the sources of revenue available to fund them. Therefore, indicators of financial condition that may be appropriate for one order of government may not be appropriate for the other.
- 39 While this SOP includes some indicators that describe a government's sustainability, flexibility and vulnerability, there may be other indicators not described here that a government considers appropriate in its circumstances. If the other indicators meet the objectives described in paragraph 4 and reflect the qualitative characteristics as described in paragraph 34, nothing in this guidance would prohibit a government from reporting such indicators. For example, governments are exposed to various risks for which reporting specific indicators would be worthwhile.

Sustainability indicators

Principle 7

Reporting on sustainability includes specific indicators. This could include, but not be limited to, the following indicators:

- (a) assets-to-liabilities;
- (b) financial assets-to-liabilities;
- (c) net debt-to-total annual revenue;
- (d) net debt-to-GDP (sovereign governments); and
- (e) deficit-to-GDP (sovereign governments).

Government-specific indicators

- 40 The “assets-to-liabilities” indicator reports the ratio of a government’s financial and non-financial assets to its liabilities. This indicator supports a discussion about sustainability by illustrating the extent to which a government finances its operations by issuing debt. A ratio higher than one indicates that a government has accumulated surplus and has assets greater than debt. A ratio of less than one indicates that debt is greater than assets and that the government has been financing its operations by issuing debt. A trend in this direction may not be sustainable.
- 41 The “financial assets-to-liabilities” indicator reports the ratio of a government’s financial assets to its liabilities. A result lower than one indicates liabilities exceed financial assets (“net debt”) and future revenues will be required to pay for past transactions and events. A result higher than one indicates financial assets exceed liabilities (“net assets”) and financial resources are on hand that can finance future operations. A trend showing increases in net debt or reductions in net assets may not be sustainable.
- 42 The “net debt-to-total annual revenue” indicator measures government net debt as a percentage of total revenues. Net debt provides a measure of the future revenue required to pay for past transactions and events. A ratio that is increasing would indicate that more time to eliminate net debt will be necessary. A trend in this direction may not be sustainable.

Government-related indicators

- 43 **Gross domestic product** (GDP) is the total value of all goods and services produced within Canada during a given year. It is an appropriate denominator for sustainability indicators because it is accepted as a reliable measure of the output of an economy and it is readily available.
- 44 The “net debt-to-GDP” indicator measures a government’s net debt — the difference between its liabilities and financial assets — as a proportion of GDP. It shows the relationship between a government’s net debt and the income in the economy. If the ratio rises, government net debt is becoming more onerous on the economy which may not be sustainable. This may prompt a government to

decide whether to increase taxes, reduce program expenses relative to interest charges or increase borrowing further to service the debt. If the ratio declines, government debt is becoming less onerous on the economy. A stable net debt-to-GDP ratio indicates a government's overall fiscal policies have been sustainable, to the extent that the rate of economic growth in the economy within which it operates is the same as the growth in net debt.

- 45 The “deficit-to-GDP” indicator measures the difference between government revenues and expenses expressed as a percentage of GDP. There are two types of ratios — the actual deficit-to-GDP ratio and the stabilizing ratio. The first is the actual observable ratio, which shows how current period results influenced net debt. The second is the ratio that, at a particular level and given a particular rate of economic growth, would stabilize net debt-to-GDP. Calculating a stabilizing ratio makes it possible to estimate the balance between program spending and revenues that will be needed to stabilize net debt-to-GDP at a particular level.

Flexibility indicators

Principle 8

Reporting on flexibility includes specific indicators. This could include, but not be limited to, the following indicators:

- (a) public debt charges-to-revenues;
- (b) net book value of capital assets-to-cost of capital assets;
- (c) own-source revenues-to-GDP (sovereign governments); and
- (d) own-source revenues-to-taxable assessment (local governments)

Government-specific indicators

- 46 The “public debt charges-to-revenues” indicator measures public debt charges as a percentage of revenues. It illustrates the extent to which past borrowing decisions present a constraint on a government's ability to meet its financial and service commitments in the current period. Specifically, the more government revenues are used to meet the interest costs on past borrowing, the less will be available for program spending.
- 47 The public debt charges-to-revenues indicator is important because, when this indicator increases for an extended period of time, and assuming relatively stable interest rates, it means that the government has consistently chosen borrowing over increases in taxation or user fees to meet its financial and service commitments. This will eventually have an effect on its flexibility because once a government borrows, its first commitment must be to service its debt. Failing to do so would impair its future ability to borrow or to roll over its existing debt.
- 48 The “net book value of capital assets-to-cost of capital assets” indicator is important because it reports the extent to which the estimated useful lives of a government's tangible capital assets are available to provide its products and services. If a government's scale, scope and level of services remain unchanged

or grow, its asset base could eventually impair flexibility because of the impending future costs of capital asset repair or replacement.

Government-related indicators

- 49 The “own-source revenues-to-GDP” (sovereign governments) indicator is important because it shows the extent to which a government is taking income out of the economy in its jurisdiction, either through taxation or user charges.
- 50 The “own-source revenues-to-taxable assessment” (local governments) indicator is important because it shows the ratio of a local government’s own-source revenues to its tax base. A change in the size of a local government’s taxable assessment or a change in the rate of growth in assessment in relation to changes in own-source revenues could influence flexibility.
- 51 Over time, increases in these ratios suggest reduced flexibility. However, evaluating the extent to which flexibility is diminished by changes in these indicators is difficult. A government that has a lower own-source revenues-to-GDP or own-source revenues-to-taxable assessment figure compared to another does not necessarily have room to raise taxes or increase user fees. When combined with data about the willingness of taxpayers within a jurisdiction to change the level of taxation or user fees they are willing to pay, these indicators provide information that helps a government determine the extent to which it can access own-source revenues in the future.
- 52 While a more appropriate denominator for local governments to assess flexibility may be household income, this data may not be considered timely and may not be available for all jurisdictions. Taxable assessment is a traditional, familiar and understandable alternative that is readily available. As used here, taxable assessment is considered to be a reasonable, although imperfect, proxy measure of wealth and, therefore, ability to pay.

Vulnerability indicators

Principle 9

Reporting on vulnerability includes specific indicators. This could include, but may not be limited to, the following indicators:

- (a) government transfers-to-total revenues; and
- (b) net foreign currency debt-to-net debt.

Government-specific indicators

- 53 The purpose of reporting “government transfers-to-total revenues” is to show the proportion of revenues that provincial or local governments receive from other governments. This indicator offers a perspective on the degree of vulnerability a government faces as a result of its dependence on another level of government for revenues.

- 54 An increasing dependence on another level of government for revenues means that the receiving government is increasingly vulnerable to the fiscal decisions of another. Reduced dependence on government transfers may reduce vulnerability but it could also impair sustainability if a government's own tax base has to replace the revenues lost from a reduction in transfer payment(s). A government that reduces its dependence on government transfers and correspondingly reduces its spending may avoid impairing its sustainability, but it could produce dissatisfaction among constituents.
- 55 The purpose of reporting "net foreign currency debt-to-net debt" is to measure the amount of a government's net foreign currency debt relative to its total net debt. This helps illustrate the degree of potential vulnerability a government has to currency fluctuations.

PRESENTATION

Extent of measurement

Principle 10

Indicators of financial condition would include at least five years worth of historical trend data and current period results.

- 56 Including at least five years worth of historical trend data would help put short-term anomalies into context and present results that may reflect the actions of more than one government. Governments that choose to report less than five years worth of trend data would include an explanation for selecting the shorter period.
- 57 To understand a government's financial condition, current period data is important for two reasons. First, it provides static "point in time" information that sharpens the focus on key data. Second, when discussed in the context of changes from prior period results, it provides dynamic information that illuminates the rate of change and trends over time.
- 58 Reporting current period results would include a comparison between planned and actual results with explanations of significant differences. The comparison of actual to planned indicator results is a key component of reporting on financial condition. The explanation of variances would include a description of influencing factors within a government's control as well as those factors that the government could not control but nonetheless had an impact on its financial condition.
- 59 Analyzing the significance of changes in indicators of financial condition over time is easier to do when a government's **planning documents** include targets for the indicators. This also helps it monitor and assess progress throughout a reporting period.

- 60 Opportunities to assess stewardship are enhanced when a government establishes targets for indicators of financial condition in its planning documents. Establishing a minimum or expected result for each indicator of financial condition gives users access to information that will allow them to determine if the target for a particular indicator of financial condition is appropriate. The planning documents would describe these expected results in the context of a government's service commitments and financing obligations.
- 61 Reporting targets for indicators of financial condition helps users assess a government's actual financial condition compared to what was planned. Targets also provide information that promotes better understanding among users and within the government about the relationships between financial policies, service levels and results.

Principle 11

To support a discussion about its financial condition, a government's public report would compare and analyze indicators of financial condition derived from actual data with historical trends and planned results for the period.

- 62 Where differences between planned and actual indicators of financial condition exist, a government's report would focus on those factors that varied from the assumptions used to create the plan and had a significant impact on financial condition. Such disclosures provide users with a better appreciation of the challenges that were faced and help clarify why some plans proved more difficult to achieve or results were better than expected.
- 63 Reporting on indicators of financial condition using charts, graphs or lists of ratios facilitates comparisons between numbers and helps highlight data relationships. Professional judgment must be applied to ensure the form of presentation maintains the information's qualitative characteristics.
- 64 Reporting on indicators of financial condition involves more than simply publishing lists of ratios or graphs. Non-financial data (for example, key financial policies) and other information that helps users understand the elements of financial condition need to be described. For those users who want more details, information about how to obtain this data needs to be provided.
- 65 A government's public report should help users interpret the meaning and significance of government financial condition indicators and provide contextual information that illuminates how earlier decisions and policies affect financial condition.

Reporting

Principle 12

There would be an overall assessment of a government's financial condition based on whether the elements of financial condition have improved or worsened. The assessment would be supplemented by discussion of:

- (a) the reasons for changes in each of the elements of financial condition over time;
- (b) an analysis of significant events that occurred within a government's economic environment, presented in the context of their impact on government financial condition; and,
- (c) other information useful for understanding financial condition.

- 66 An overall assessment would provide a concise description and explanation of the significant events and conditions that influenced financial condition. It would include any major changes that occurred during the year, major unplanned events and any significant amounts related to assets, liabilities, revenues and expenses. A distinction between normal ongoing programs and infrequent or unusual events may be appropriate.
- 67 The public report would include a discussion of the potential future implications of a government's financial condition. Users need to have an understanding of the key factors that influence financial condition over time. This information helps users interpret the meaning and significance of the financial condition assessment and provides the context to understand the effects financial condition will have on the government.
- 68 Other relevant information a government would provide, either in the public report or through a reference to a companion document/website link includes:
 - (a) a description of the key assumptions used in preparing the financial condition assessment and whether any assumptions are susceptible to change;
 - (b) an explanation of the changes made to past assumptions used in previous assessments of financial condition;
 - (c) information about the effect of a change in the underlying assumptions used to prepare the assessment of financial condition;
 - (d) the sensitivity of the assessment of financial condition to changes in the assumptions used and the reason(s) for the sensitivity; and
 - (e) sources for the economic data used in its sustainability and vulnerability indicators. Where alternative methods for calculating economic data are available (for example, income-based or expenditure-based GDP), the government would indicate which method was used.

Principle 13

When providing comparative information, a government would ensure comparisons are based on consistent data, indicator definitions and, when presenting comparisons with other jurisdictions, other factors relevant for ensuring comparability.

- 69 Describing financial condition or indicators of financial condition involves comparisons of current results to a government's prior period results and may include comparisons with other jurisdictions. When providing comparative information, it is necessary to provide the data in a consistent manner.
- 70 When a change of methodology or measurement scale is deemed to be appropriate, disclosure of the effects of the change is necessary to maintain comparability. Where possible, prior period assessments would be restated for consistent comparison; otherwise, differences between current and previously reported assessments must be clearly articulated.
- 71 When comparative information is restated to reflect consistency with current period results, a government would explain the effect of changes made to the methodologies, measurement and reporting of financial condition or indicators of financial condition. Such explanations would provide a description of the nature and extent of the restatements, the reason(s) for the change(s) and an assessment of whether the methods, measures and/or reporting is now stable.
- 72 Comparisons with other jurisdictions are inherently difficult to make. Factors a government could consider when determining appropriate comparators include, but are not limited to, the following:
 - (a) the scale and scope of services available from the comparators are similar to the government's;
 - (b) revenue sources and financing policies are consistent with the government's;
 - (c) the key factors influencing a comparator's financial condition are similar to the government's; and
 - (d) the comparisons enhance the user's understanding of the government's financial condition.
- 73 Reporting comparisons with other jurisdictions would include a discussion about the rationale for selecting the comparators and the basis upon which comparisons were made. Such comparisons would be useful when they offer insights into the actual or potential financial implications of decisions about government services and service levels.

GOVERNMENT RESPONSIBILITY

Principle 14

When a government reports indicators of financial condition, it would acknowledge its responsibility for preparing and reporting the indicators, identify the information sources used, key assumptions made and methodologies applied.

- 74 Indicators of financial condition would provide information that supports assessments of a government's ability to meet its service commitments and financial obligations. Providing information as to who has prepared and who is responsible for the assessment of financial condition enhances the credibility of the information.
- 75 When indicators of a government's financial condition are based on the information reported in the financial statements, they supplement and complement a user's understanding of both the financial statements and a government's financial condition. Therefore, reference to the related statements would be clearly made.
- 76 A government would provide information as to what has been done to ensure the reliability of the financial condition assessment. Information about reliability may be integrated throughout the public report. Reliability may be demonstrated by including descriptions of financial systems and processes used for capturing information required for calculating indicators that is not subject to financial statement reporting controls.

APPENDIX A

GLOSSARY

Flexibility is the degree to which a government can change its debt or tax burden on the economy to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

Government financial condition is a government's financial health as assessed by its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

Gross domestic product (GDP) is the total value of all goods and services produced within Canada during a given year. It is a measure of the income generated by production within Canada.

Planning documents refers to a government's strategic plan and budget.

Statements of Recommended Practice (SORPs) are issued by PSAB with respect to matters of reporting in the public sector. The objective is to enhance decision making and accountability usefulness of financial reports by addressing specific aspects of reporting on financial condition and financial and non-financial performance. SORPs do not form a part of generally accepted accounting principles. They are not prescriptive, but offer general guidance to encourage and assist public sector entities in effectively reporting relevant information that is useful in evaluating the entity's financial condition at the financial statement date and its financial and non-financial performance during the reporting period.

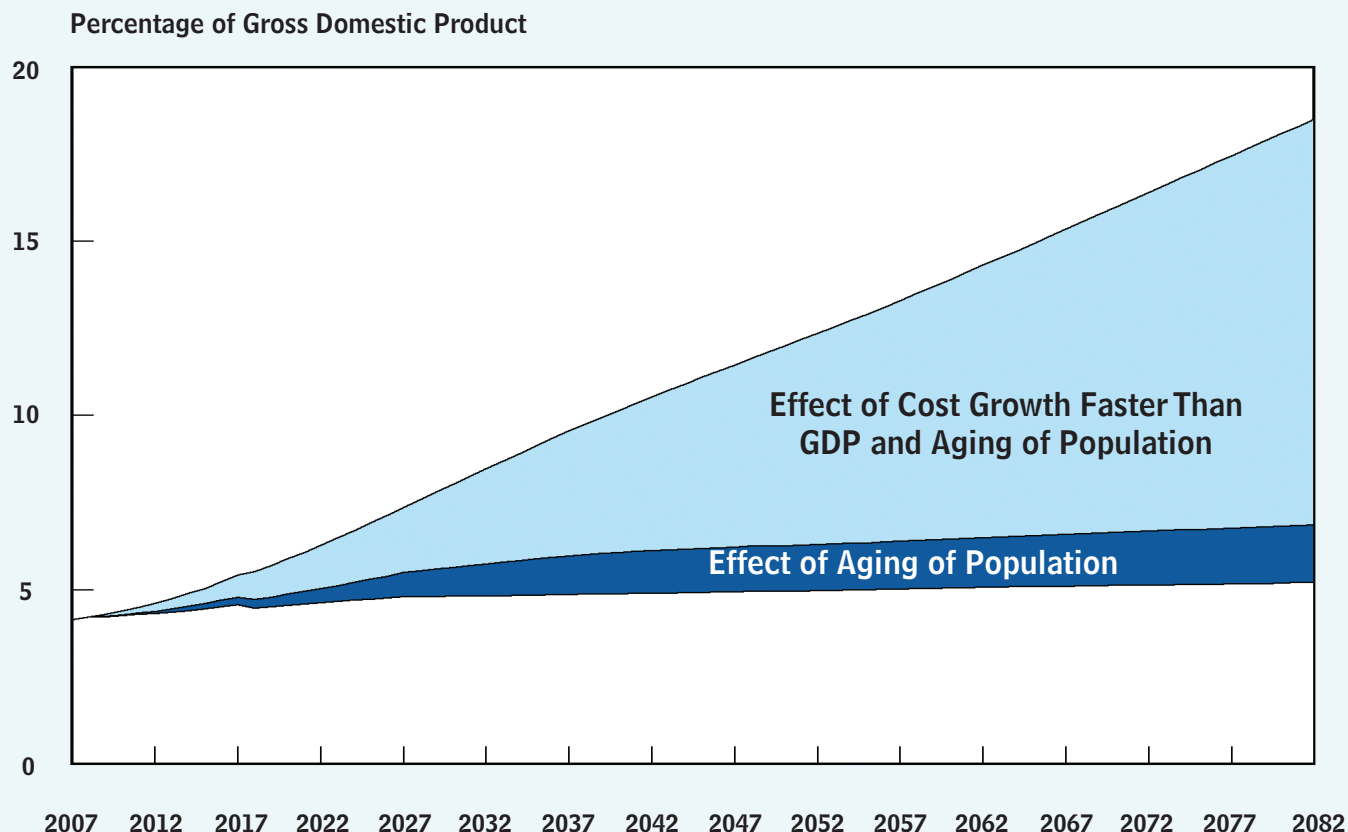
Sustainability is the degree to which a government can maintain its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others without increasing the relative debt or tax burden on the economy within which it operates.

Tax burden refers to the value of economic resources withdrawn from citizens and businesses through taxation or user fees.

Vulnerability is the degree to which a government becomes dependent on sources of funding outside its control or influence or is exposed to risks that could impair its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors.

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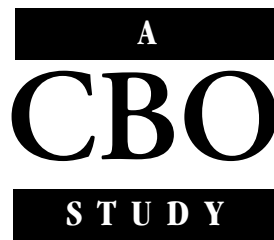
The Long-Term Outlook for Health Care Spending



Sources of Growth in Projected Federal Spending on Medicare and Medicaid



NOVEMBER 2007



The Long-Term Outlook for Health Care Spending

November 2007

Notes

Numbers in the text and tables may not add up to totals because of rounding.

The figure on the cover, explained in detail in Box 2, shows that the aging of the population accounts for only a modest fraction of the projected growth in federal spending on Medicare and Medicaid. The main factor is excess cost growth—or the extent to which the increase in health care spending exceeds the growth of the economy.



Preface

Spending on health care has been growing faster than the economy for many years, representing a challenge both for the government's two major health insurance programs, Medicare and Medicaid, and for the private sector. A prologue to the Congressional Budget Office's (CBO's) upcoming long-term budget outlook, to be released next month, this study presents the agency's projections of federal spending on Medicare and Medicaid and national spending on health care over the next 75 years. The goal of the projections is to examine the implications of a continuation of current federal law, rather than to make a prediction of the future. In reality, federal law will change; nevertheless, the projections provide a useful measure of the scope of the problem facing the nation under current law.

Noah Meyerson, Lyle Nelson, Michael Simpson, and Julie Topoleski of CBO's Health and Human Resources Division prepared the study, with valuable contributions from Ignaz Tristao. The study benefited from comments by Colin Baker, James Baumgardner, Thomas Bradley, Philip Ellis, Keith Fontenot, Matthew Goldberg, Arlene Holen, Joyce Manchester, William Randolph, Jonathan Schwabish, Sven Sinclair, Robert Sunshine, and Bruce Vavrichek of CBO. Members of CBO's Panel of Health Advisers also provided useful comments. (The assistance of external reviewers implies no responsibility for the final product, which rests solely with CBO.)

John Skeen edited the study, and Christine Bogusz proofread it. Maureen Costantino prepared it for publication and designed the cover. Lenny Skutnik printed the initial copies, Linda Schimmel handled the print distribution, and Simone Thomas prepared the electronic version for CBO's Web site (www.cbo.gov).



Peter R. Orszag
Director

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The Long-Term Outlook for Health Care Spending

Introduction and Summary

Spending on health care in the United States has been growing faster than the economy for many years, representing a challenge not only for the government's two major health insurance programs—Medicare and Medicaid—but also for the private sector. As health care spending consumes a greater and greater share of the nation's economic output in the future, Americans will be faced with increasingly difficult choices between health care and other priorities. However, a variety of evidence suggests that opportunities exist to constrain health care costs without adverse health consequences.¹

In December 2007, the Congressional Budget Office (CBO) will release new long-term budget projections, and spending on health care will play a central role in the fiscal outlook to be described in that report. This study presents CBO's projections of federal spending on Medicare and Medicaid and health care spending generally over the next 75 years. Despite the substantial uncertainties surrounding projections over that long a period, particularly ones involving the growth of health care costs, such a horizon is useful for illustrating the long-term fiscal challenges that this country faces.

The goal of the projections in this study is to examine the implications of a continuation of current federal law, rather than to make a prediction of the future. Under that assumption, however, federal spending on health care would eventually reach unsustainable levels. In reality, federal law will change in the future, ensuring that the basis for the projections will not turn out to be correct, but the projections nevertheless provide a useful measure of the scope of the problem facing the nation.

A simple extrapolation of historical growth rates in Medicare and Medicaid expenditures can illustrate paths for future spending on those programs.² That approach, however, implicitly allows the economic impossibility of having health care spending eventually exceed total national income and fails to allow the nonfederal components of the health system to respond to rising costs (as they probably would do even without a change in federal law). Those shortcomings are magnified as the projection period lengthens. This study describes an alternative approach in which the rising share of national income devoted to health care creates pressure on households and employers to take potentially painful steps to reduce the growth in health care spending.

Various plausible paths exist for how spending in the rest of the health care system would evolve over time in the absence of changes in federal law, and one innovation in the methodology presented here is to incorporate a specific metric for determining how that spending will grow. Many such metrics could be applied; the premise that CBO chose was that Americans will ultimately demand changes to the system to prevent their consumption of other goods and services from declining in real (inflation-adjusted) terms. In other words, CBO's projections assume that to avoid a reduction in real consumption of items besides health care, employers, households, and insurance firms will change their behavior in a variety of ways (potentially including higher cost sharing, increased utilization management, reduced insurance coverage by employers, and greater scrutiny of new technologies based on evidence of their comparative effectiveness) to slow the rate of growth of spending in the nonfederal part of the health system. The projections also assume that, even in the absence of changes in federal law, some of the measures adopted to slow growth in the rest of the health care system will moderate spending growth in Medicare

1. Statement of Peter R. Orszag, Director, Congressional Budget Office, *Health Care and the Budget: Issues and Challenges for Reform*, before the Senate Committee on the Budget (June 21, 2007).

2. Ibid.

2 THE LONG-TERM OUTLOOK FOR HEALTH CARE SPENDING

and Medicaid and that regulatory changes at the federal level and policy changes at the state level will help to slow cost growth in those programs.³

The results of CBO's projections suggest that in the absence of changes in federal law:

- Total spending on health care would rise from 16 percent of gross domestic product (GDP) in 2007 to 25 percent in 2025, 37 percent in 2050, and 49 percent in 2082.
- Federal spending on Medicare (net of beneficiaries' premiums) and Medicaid would rise from 4 percent of GDP in 2007 to 7 percent in 2025, 12 percent in 2050, and 19 percent in 2082.

Those results show significantly higher federal spending on Medicare and Medicaid under current law than other official projections do, which typically assume that spending on those programs grows much more slowly in the future than it has in the past. For example, although the projections by CBO and by the trustees of the Medicare program (under their intermediate assumptions) track each other relatively closely for the next two or three decades, by the end of 75 years, Medicare spending under CBO's projections is about 50 percent higher.

To be sure, significant uncertainty surrounds such projections, and the growth of spending on health care could turn out to be substantially higher or lower over the next 75 years than projected here. Like overall budget projections that show an exploding ratio of federal debt to GDP over the long term (which could not in all likelihood actually occur because, at some point, the government would not be able to sell additional debt to investors), the projections here of significant increases in health care spending and a sustained differential in the growth rates of Medicare and Medicaid relative to that of the rest of the health care system will almost certainly not occur, because current law will be changed to help prevent such outcomes. Nonetheless, the projections are useful in illustrating the implications of current law. The main message of this study is that, without changes in federal law, federal spending on Medicare and Medicaid is on a path that cannot be sustained.

3. Such changes that would also affect federal programs could include less rapid development and adoption of costly new technologies and changes in physicians' practice patterns.

In itself, higher spending on health care is not necessarily a "problem." Indeed, there might be less concern about increasing costs if they yielded commensurate gains in health. But the degree to which the system promotes the population's health remains unclear. Indeed, substantial evidence exists that more expensive care does not always mean higher-quality care. Consequently, embedded in the country's fiscal challenge is the opportunity to reduce costs without impairing health outcomes overall (see Box 1).

Overview of the U.S. Health Care System

Spending on health care in the United States is financed through a combination of private and public sources. Most Americans under the age of 65 have private health insurance obtained through an employer. According to CBO's estimates, about 63 percent of that population (161 million people) had employment-based coverage in 2006, while about 4 percent (10 million people) purchased private coverage directly from an insurer.⁴ The two main sources of public financing for health care are Medicare and Medicaid. Nearly 43 million elderly or disabled individuals were enrolled in Medicare in 2006, and nearly 61 million low-income individuals were enrolled in Medicaid for at least part of the year.⁵ About 43 million people (constituting 17 percent of the nonelderly population) were uninsured. (For more details on the Medicare and Medicaid programs, see Appendix A.)

In 2005, the most recent year for which data are available, national spending on health care totaled nearly \$1.9 trillion, or 14.9 percent of the nation's GDP.⁶ Some 55 percent of the total was financed privately, and the rest came from public sources (see Table 1). Payments by private

-
4. Those estimates are from CBO's health insurance simulation model. For a description of the model, see Congressional Budget Office, *CBO's Health Insurance Simulation Model: A Technical Description* (October 2007).
 5. Sixteen percent of Medicare beneficiaries were also enrolled in Medicaid.
 6. This study defines national spending on health care as total spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services. The figure cited is equal to total national health expenditures minus spending on research and development and construction.

Box 1.**What Policy Options Can Help Reduce Spending on Medicare and Medicaid?**

The analysis underlying the projections in this study, by design, keeps federal law unchanged. A result of that constraint is that Medicare and Medicaid grow more rapidly than the rest of the health system, which is unlikely to occur because federal law will change in the future. In other words, it is certain to change to prevent the scenarios presented here from being realized. So what types of federal policy options would help to reduce future spending on Medicare and Medicaid?

One type of change involves reducing payment rates in the two programs. For example, some analysts have proposed reducing payments to Medicare Advantage plans. Those private insurance plans, according to the Congressional Budget Office's estimates, are paid roughly 12 percent more than the cost of enrolling their beneficiaries in the traditional fee-for-service component of Medicare. Other proposals have involved reductions in reimbursement rates for specific types of services or providers.

A more fundamental set of federal policy changes may help to reduce not only federal spending but also health care spending overall. Indeed, given the interactions between federal programs and the rest of the health system, many analysts believe that significantly constraining the growth of costs for Medicare and Medicaid over long periods of time, while maintaining broad access to health providers under those programs, can occur only in conjunction with slowing cost growth in the health care sector as a whole.

Two potentially complementary approaches to reducing spending on Medicare, Medicaid, and health care generally—rather than simply reallocating spending among different sectors of the economy—involve generating more information about the relative effectiveness of medical treatments and changing the incentives for providers and consumers in the supply and demand of health care. The current financial incentives facing both providers and patients tend to

encourage or at least facilitate the adoption of expensive treatments and procedures, even if the evidence about their effectiveness relative to other therapies is limited. For doctors and hospitals, those incentives stem from fee-for-service reimbursement. Such payments can encourage health care providers to deliver a given service in an efficient manner but also provide an incentive to supply additional services—as long as the payments exceed the costs. For their part, insured individuals generally face only a portion of the costs of their care and thus have only limited financial incentives to seek lower-cost treatments. Private health insurers have incentives to limit the use of ineffective care but are also constrained by a lack of information about what treatments work best for which patients.

Many analysts believe that expanded research on “comparative effectiveness” offers a promising mechanism to address some of those concerns. Analysis of comparative effectiveness is simply a comparison of the impact of different options that are available for treating a given medical condition for a particular set of patients. Such studies may compare similar treatments, such as competing drugs, or they may analyze very different approaches, such as surgery in comparison to drug therapy. The analysis may focus only on the relative medical benefits and risks of each option, or it may go on to weigh both the costs and the benefits of those options. In some cases, a given treatment may be found more effective for all types of patients, but more commonly a key issue is determining which specific types would benefit most from it.

To affect medical treatment and reduce health care spending, the results of comparative effectiveness analyses would ultimately have to change the behavior of doctors and patients—that is, to get them to use fewer services or less intensive and less expensive services than are currently projected, which, for Medicare, would require changes to current law. The program has not taken costs into account in

Box 1.**Continued**

determining what services are covered and has made only limited use of data on comparative effectiveness in its payment policies. But if statutory changes permitted doing so, the program could use information about comparative effectiveness to promote higher-value care. For example, Medicare could tie its payment to providers to the cost of the most effective or most efficient treatment. If that payment was less than the cost of providing a more expensive service, then doctors and hospitals would probably elect not to provide it—so the change in Medicare’s payment policy would have the same practical effect as a coverage decision. Alternatively, enrollees could be required to pay for the additional costs of less effective procedures (although the impact on incentives for patients and their use of care would depend on whether and to what extent they had supplemental insurance coverage that paid some or all of Medicare’s cost-sharing requirements).

More modest steps that Medicare could be authorized to take would include smaller-scale financial inducements to doctors and patients to encourage the use of cost-effective care. Doctors and hospitals could receive modest bonuses for practicing effective care or modest cuts in their payments for using less effective treatments. Likewise, enrollees could be required to pay a portion of the additional costs of less efficient procedures (rather than the full difference in costs). Or Medicare could provide information to doctors and their patients about doctors’ use of various treatments, which would create some pressure for them to use more-efficient approaches. Adopting more modest measures to incorporate the findings of comparative effectiveness research, however, would probably yield smaller savings for the program.

Even in the absence of more information about comparative effectiveness, changes in incentives could help to control health care costs—but such measures would be more likely to maximize the health gains obtained for a given level of spending if they were

combined with improved information. On the provider side, greater bundling of payments to cover all of the services associated with a treatment, disease, or patient could reduce or eliminate incentives to provide additional services that might be of low value. Such approaches, however, can raise concerns about the financial risk that providers face and about incentives for them to provide too little care. On the consumer side, a landmark health insurance experiment by RAND showed that higher cost sharing reduced spending—particularly when compared with a plan offering free care—with little or no adverse effects on health.

The broad options of generating more information and of changing incentives do not represent an exhaustive list of proposals intended to reduce costs in Medicare and Medicaid. In addition, some analysts have advocated significant expansions of disease management and care coordination as mechanisms for reducing costs—proposals that reflect the increasing prevalence of many chronic conditions, the large share of health care spending attributable to those conditions, and the lack of systems to coordinate care in many public and private health insurance plans. For example, 25 percent of Medicare beneficiaries accounted for 85 percent of the program’s costs in 2001; more than three-quarters of those expensive beneficiaries had one or more of seven prominent chronic conditions (including coronary artery disease, diabetes, and congestive heart failure). However, the evidence to date—including the findings of several demonstration projects conducted under Medicare—suggests that disease management and care coordination may raise the quality of the health care provided but do not significantly reduce costs among a broad array of patients. As more evidence on the approaches is developed, identifying specific ways to reduce costs, especially for targeted subsets of beneficiaries, may become possible; for now, the possibility and scope of savings remain unclear.

Table 1.**National Spending on Health Care by Source of Funds, 2005**

	Billions of Dollars	Percent
Private Spending	1,013.5	54.5
Private health insurance	694.4	37.3
Out-of-pocket payments	249.4	13.4
Other private spending	69.8	3.7
Public Spending	847.3	45.5
Medicare	342.0	18.4
Medicaid ^a	311.0	16.7
Other public spending	194.3	10.4
Total	1,860.9	100.0

Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

a. Spending on Medicaid includes amounts spent by the federal government as well as by the states.

health insurers were the largest component of private spending, accounting for 37 percent of national health expenditures. Consumers' out-of-pocket expenses, which include payments for deductibles and copayments for services covered by insurance as well as payments for services not covered by insurance, accounted for 13 percent of national health expenditures.⁷ Other sources of private funds, from philanthropy and on-site clinics that some employers maintain for their workers, accounted for 4 percent of the total.

Federal spending on Medicare accounted for 18 percent of national health expenditures in 2005, while federal and state spending on Medicaid accounted for 17 percent. A variety of other public programs accounted for 10 percent of national health expenditures, including ones by state and local health departments, the Department of Veterans Affairs, and the Department of Defense; workers' compensation programs; and the State Children's Health Insurance Program.

7. Out-of-pocket payments do not include the premiums that people pay for health insurance. Premiums fund the payments by insurers, which are already included in the measure of private spending.

The American health care system also consists of a broad array of health care providers, manufacturers, and suppliers. Although 45 percent of the spending on medical care is financed publicly, most services are furnished by private providers. For example, Medicare and Medicaid beneficiaries receive most of their care from physicians, hospitals, and other providers that deliver services to the general population.

From 1975 to 2005, the share of national health expenditures that was financed privately fell slightly, from 59 percent to 55 percent, while the share that was financed publicly rose correspondingly, from 41 percent to 45 percent (see Figure 1). During that period, out-of-pocket payments fell from 31 percent of national health expenditures to 13 percent, while payments by private insurers rose from 25 percent to 37 percent. Although the share of national health expenditures that is financed by out-of-pocket payments has fallen substantially, such payments are still a significant burden for many families. According to one study, 4.3 percent of the nonelderly population (nearly 11 million people) lived in families that spent more than 20 percent of their after-tax income on out-of-pocket payments for medical care in 2003.⁸

Historical Growth of Health Care Spending

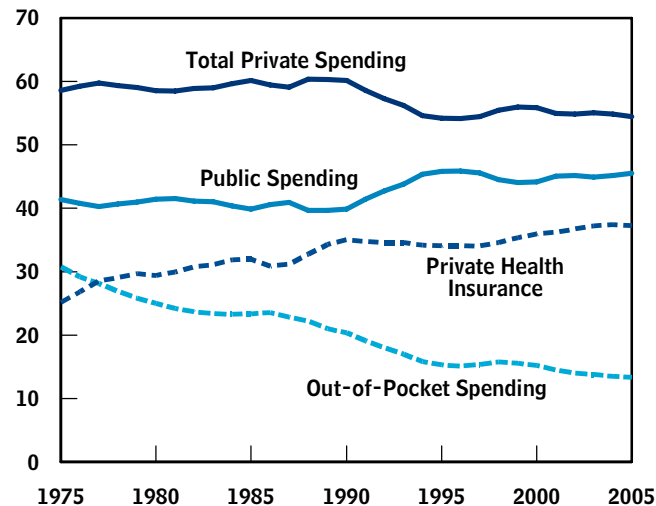
Total spending on health care in the United States, including both private and public spending, increased from 4.7 percent of GDP in 1960 to 14.9 percent in 2005, the most recent year for which data are available, rising steadily throughout most of that period (see Figure 2). A notable exception was the period from 1993 to 2000, when the share remained relatively stable. Many analysts have attributed that lull to a substantial increase in the number of people who were enrolled in managed care plans as well as to excess capacity among some types of providers, which increased health plans' negotiating leverage.⁹

8. Jessica S. Banthin and Didem M. Bernard, "Changes in Financial Burdens for Health Care: National Estimates for the Population Younger Than 65 Years, 1996 to 2003," *Journal of the American Medical Association*, vol. 296, no. 22 (December 13, 2006), pp. 2712–2719.

9. See, for example, Katharine Levit and others, "National Health Expenditures in 1997: More Slow Growth," *Health Affairs*, vol. 17, no. 6 (1998), pp. 99–110.

Figure 1.**National Spending on Health Care by Source of Funds, 1975 to 2005**

(Percent)



Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

Factors Underlying the Historical Growth in Health Care Spending

Most analysts agree that the most important factor contributing to the growth in health care spending in recent decades has been the emergence, adoption, and widespread diffusion of new medical technologies and services.¹⁰ Major advances in medical science allow providers to diagnose and treat illnesses in ways that were previously impossible. Many of those innovations rely on costly new drugs, equipment, and skills. Other innovations are relatively inexpensive but add up quickly as growing numbers of patients make use of them. Although technological innovation can sometimes reduce spending, in medicine such advances and the resulting changes in clinical practice have generally increased it.

10. See Joseph P. Newhouse, "Medical Care Costs: How Much Welfare Loss?" *Journal of Economic Perspectives*, vol. 6, no. 2 (Summer 1992), pp. 3–21; David M. Cutler, "Technology, Health Costs, and the NIH" (paper presented at the National Institutes of Health Economics Roundtable on Biomedical Research, Cambridge, Mass., September 1995); and Technical Review Panel on the Medicare Trustees' Reports, *Review of Assumptions and Methods of the Medicare Trustees' Financial Projections* (December 2000).

Other factors that have contributed to the growth of health care spending include increases in personal income and the growth of insurance coverage. Demand for medical care tends to rise as real family income increases. Moreover, the growth of insurance coverage in recent decades, as evidenced by the substantial reduction in the percentage of health care spending that is paid out of pocket, has also increased the demand for medical care, because coverage reduces consumers' cost of care. However, according to the best available evidence, increasing income and insurance coverage cannot explain much of the growth in health care spending in recent decades.¹¹

Another source of spending growth has been the aging of the population. Among adults, average medical spending generally increases with age, so as the population becomes older, health care spending per capita rises. However, over the past three decades, the effect of aging on health care spending has been relatively modest. The demographic effect will become more pronounced with the aging of the baby-boom generation, but it will continue to have a modest effect not only on national health care spending but also on federal spending on Medicare and Medicaid.¹²

Historical Trends

When analyzing historical trends in the growth of health care spending, it is useful to disaggregate the various components. Factors that affect spending on health care include general inflation; growth in the size of the population; and, to a lesser extent, changes in the age distribution of the population. Removing their effects reveals the amount of spending growth that is attributable to factors beyond inflation and demographics. There are at least two ways to measure such additional spending growth: as the increase in real annual health care spending for an average individual ("real per capita cost growth") or as the increase in health care spending for an average individual relative to the growth of per capita GDP.¹³ The latter measure is commonly referred to as "excess cost growth,"

11. Ibid.

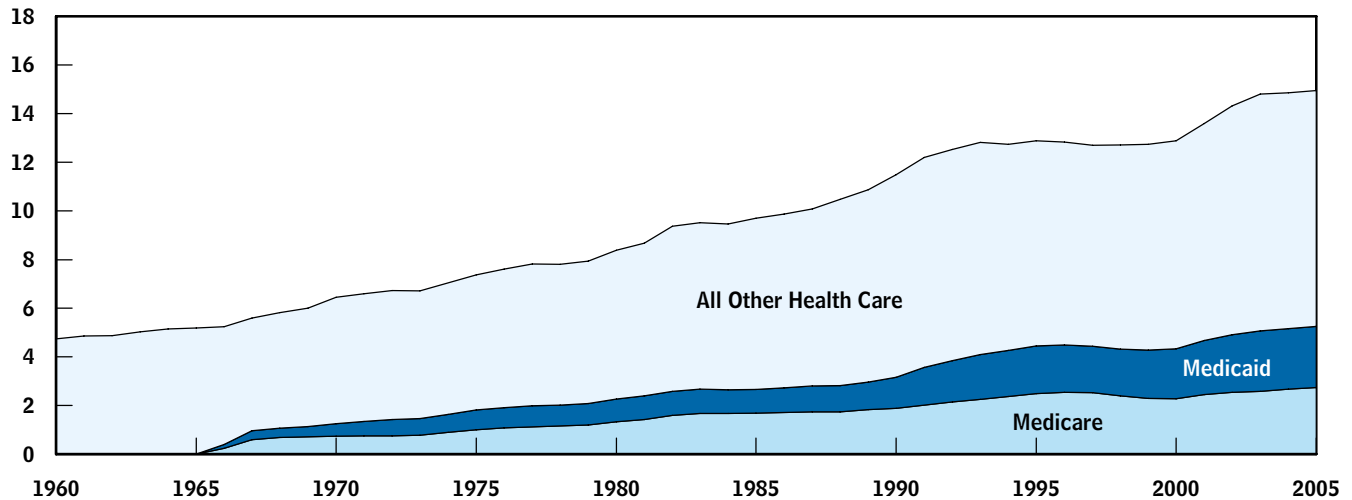
12. For the effect on Medicare, see Micah Hartman and others, "U.S. Health Spending By Age, Selected Years Through 2004," *Health Affairs*, Web Exclusive (November 6, 2007), available at www.healthaffairs.org.

13. The effect of general inflation is removed from the second measure because growth in spending on health care is measured relative to growth in per capita GDP, both of which are affected by general inflation.

Figure 2.

Spending on Health Care as a Percentage of Gross Domestic Product, 1960 to 2005

(Percent)



Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

Note: Amounts for Medicare are gross federal spending on the program. Amounts for Medicaid include spending by the federal government and the states.

signifying that it measures the extent to which growth in per capita spending on health care exceeds the growth in per capita GDP, after adjustments for changes in the age distribution of the population. (The phrase is not intended to imply that growth in per capita spending on health care is necessarily excessive. It simply measures that growth relative to the growth of the economy.) If per capita health care spending grows faster than per capita GDP, the share of the economy devoted to health care will rise.

Although real per capita cost growth is useful for short-term projections, excess cost growth is a more useful concept for long-term projections. From one year to the next, real per capita cost growth is the more reliable measure, because health care spending does not closely track annual economic trends. (Per capita health care spending does not usually fall in a recession or sharply accelerate during years of strong economic growth.) As a result, excess cost growth is often unusually low during periods of strong economic growth and unusually high during periods of slow growth. Over longer periods, though, growth in per capita health care spending is likely to

reflect changes in overall economic growth. As the baby-boom generation retires and the growth of the labor force slows, per capita GDP growth will probably slow from the rate experienced over the past 30 years, and growth in per capita spending on health care will probably slow as well. Because the projections contained in this study are long term, they are based on assumptions about future excess cost growth rather than real per capita cost growth.

In part, the projections are based on historical trends since 1975. The purpose of beginning in 1975 is to exclude the start-up period for Medicare and Medicaid; by that year, both programs had been in effect for nearly 10 years, and Medicare benefits had been available to nonelderly disabled people for two years.

The historical rates of cost growth that CBO used for Medicare and Medicaid remove the effect of growth in the number of beneficiaries. The calculation for Medicare also removes the effect of changes in the age composition of the population. For Medicaid, the computation removes the effect of changes in the composition of the

Table 2.

Real per Capita Cost Growth in Medicare, Medicaid, and All Other Spending on Health Care

(Percent)

	Medicare	Medicaid ^a	All Other	Total
1975 to 1990	5.4	5.4	4.8	5.1
1990 to 2005	3.8	3.3	3.1	3.4
1975 to 2005	4.6	4.4	4.1	4.2

Source: Congressional Budget Office.

Note: Figures are annual averages.

a. For Medicaid, data are available through 2004.

caseload: the portion of beneficiaries who are children, disabled people, elderly people, and other adults.¹⁴

From 1975 to 2005, real per capita spending on health care grew an average of 4.2 percent annually (see Table 2). During that period, per capita GDP grew at 2.2 percent, and excess cost growth amounted to 2.1 percentage points (see Table 3).¹⁵ Those measures capture the growth in total spending on health care, including payments from all private and public sources. Excess cost growth was somewhat higher during that period for Medicare (2.4 percentage points) and Medicaid (2.2 percentage points) and somewhat lower for all other health care spending (2.0 percentage points). Included in other health care spending are payments by private insurers, payments by people who lacked health insurance coverage, all other out-of-pocket payments by consumers, and health care spending by government programs other than Medicare and Medicaid. Consequently, the differences in excess cost growth between Medicare, Medicaid, and other health care spending should not be interpreted as meaning that Medicare or Medicaid is less able to control spending than private insurers.

14. That methodology is consistent with CBO's projections of future spending, which separately account for projected changes in the composition of the caseload.

15. Excess cost growth is not computed simply by subtracting per capita growth in GDP from per capita growth in health care spending but involves a more complex formula (see Appendix B).

Excess cost growth was higher during the earlier part of that period and slower during the second half. The slower growth in overall spending during the 1990s, though, may have reflected one-time changes (for instance, the spread of managed care) rather than a change in the underlying trend. In addition, rates of excess cost growth in Medicare and Medicaid are partly driven by changes in law and policy. Changes have included expansions of the programs as well as efforts to limit cost growth. Most notably, in 1983, Medicare introduced a prospective payment system, under which hospitals are paid a predetermined rate for each admission. The system reduced costs. Whether such changes will ultimately constitute one-time shifts or more permanent changes in cost growth rates is uncertain. As with other spending on health care, the rates of real per capita cost growth and excess cost growth for Medicare and Medicaid were lower from 1990 to 2005 than they were in the preceding 15 years. Because it is unclear whether the experience from the 1990s represented a one-time shift in the level of costs or a change in the underlying trend and because the entire 30-year period was marked by substantial year-to-year volatility without any apparent trend (as shown in Figure 3), CBO uses the average from 1975 onward as the starting point for the projections of the future.

Table 3.

Excess Cost Growth in Medicare, Medicaid, and All Other Spending on Health Care

(Percentage points)

	Medicare	Medicaid ^a	All Other	Total
1975 to 1990	2.9	2.9	2.4	2.6
1990 to 2005	1.8	1.3	1.4	1.5
1975 to 2005	2.4	2.2	2.0	2.1

Source: Congressional Budget Office.

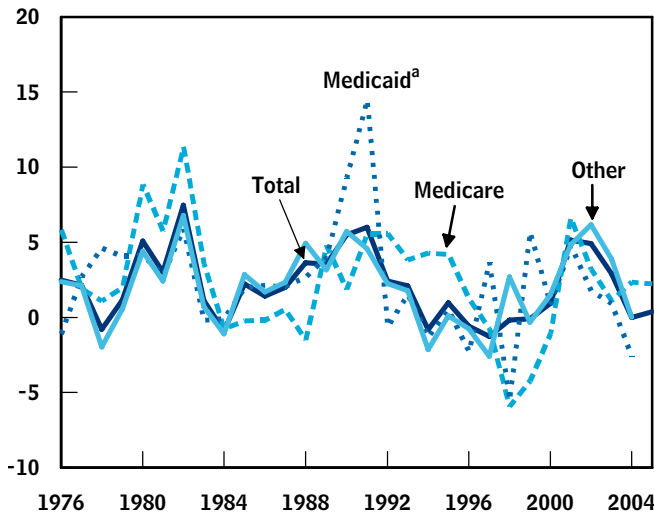
Note: Excess cost growth refers to the number of percentage points by which the growth of spending on Medicare, Medicaid, or health care generally (per beneficiary or per capita) exceeded the growth of nominal gross domestic product (per capita). Figures are annual averages.

a. For Medicaid, data are available through 2004.

Figure 3.

Excess Cost Growth in Medicare, Medicaid, and All Other Spending on Health Care

(Percentage points)



Source: Congressional Budget Office based on data on spending on health services and supplies, as defined in the national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services.

Note: Excess cost growth refers to the number of percentage points by which the growth of annual spending on Medicare, Medicaid, or all other health care (per beneficiary or per capita) exceeded the growth of nominal gross domestic product (per capita).

a. For Medicaid, data are available through 2004.

Projections of Health Care Spending

In the absence of an unprecedented change in the long-term trends, national spending on health care will grow substantially over the coming decades. The magnitude of that growth is highly uncertain, even over short periods, let alone a period as long as 75 years. CBO's projections show health care spending assuming no change in federal law affecting Medicare or Medicaid.¹⁶ Thus, they provide a measure of the scope of the potential problem posed by the rising costs but are not a forecast of future developments because the magnitude of the problem will ultimately necessitate changes in the government's programs. They are also subject to the inherent uncertainty sur-

rounding any long-term predictions, especially regarding health care.¹⁷ Nevertheless, they provide a useful reference in showing the consequences of current law and assessing the impact of changes in law.

CBO's Assumptions About Future Spending on Health Care

In CBO's projections, spending for Medicare and Medicaid over the next 10 years is based on the agency's March 2007 budget outlook.¹⁸ The projections for those programs in 2018 and later, as well as the projections for other health care spending, are based on the growth and aging of the population, growth in per capita GDP, and assumed rates of excess cost growth.

Short-Term Projections. For federal spending on Medicare and Medicaid, this study uses CBO's baseline budget projections for 2008 to 2017, which assume no change in current federal law.¹⁹ CBO's baseline budget projections do not include projections of total national spending on health care. Therefore, short-term projections of all other (non-Medicare and non-Medicaid) health care spending

16. The projections for Medicare assume that the program will continue to pay for benefits as currently scheduled, notwithstanding the projected insolvency of the Medicare Health Insurance trust fund. Moreover, CBO assumes that future Medicare spending will not be affected by the provision of current law that requires the Medicare trustees to issue a "Medicare funding warning" if projected outlays for the program exceed 45 percent of "dedicated financing sources," because the law does not require the Congress to respond to such a warning by enacting legislation that would reduce Medicare spending.

17. For simplicity, the projections assume that the projected growth in health care spending has no effect on the future growth of GDP.

18. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008* (March 2007) and *Detailed Projections for Medicare, Medicaid, and State Children's Health Insurance Program* (March 2007).

19. Appendix C presents projections under an alternative scenario that assumes a change in federal law to prevent the reductions that would otherwise occur in the fees that Medicare allows for physicians' services. That scenario assumes that those fees will be updated to account for inflation in the inputs used for physicians' services. In both that scenario and the one presented in the main text, projected outlays for Medicare over the next 75 years are similar because the assumption that Medicare's physician fees will be updated to account for inflation has a minor effect over the long term.

10 THE LONG-TERM OUTLOOK FOR HEALTH CARE SPENDING

were made using the same methods as those used for the long-term projections, as described below.

The Structure of Long-Term Projections. In its long-term projections, CBO combines an assumption about excess cost growth in the spending on health care with projections of the growth and aging of the population and of the growth in per capita GDP.

The agency develops separate projections for three categories:

- Federal spending on Medicare;
- Federal spending on Medicaid; and
- All other spending on health care, which includes private, state and local, and other federal health spending. (This category includes Medicare premiums, Medicare beneficiaries' cost sharing, and the states' share of Medicaid spending.)

CBO constrained Medicare premiums and cost sharing to grow at the same rate as federal spending on Medicare and constrained state Medicaid spending to grow at the same rate as federal Medicaid spending.²⁰

Assumptions About Initial Rates of Excess Cost Growth. Although all long-term economic and demographic trends are difficult to forecast, future excess cost growth in health spending during the next century may be particularly uncertain. Systems of health care and health care financing have existed in their current forms for only a few decades, and medical technology continues to evolve rapidly.

One simple projection methodology is to base excess cost growth in the future on the average rate in the past. CBO adopts that approach when selecting *initial* rates of excess cost growth. Specifically, the excess cost growth rate for each of the three categories (Medicare spending, Medicaid spending, and all other spending on health care) in

2018 is assumed to equal the average of the rates from 1975 to 2005 (as presented in Table 3). (As mentioned, for all other spending on health care, the same rate is also used for 2008 through 2017.)

Assumptions About Long-Term Rates of Excess Cost Growth. For later years, one option would be to adopt the historical averages indefinitely. Although that approach is attractive for its simplicity (the results from such an extrapolation are presented in Appendix D), it has significant shortcomings. For example, simply extrapolating prior growth rates would result in total spending on health care eventually exceeding 100 percent of GDP. Furthermore, even in the absence of changes in federal law, spending growth would probably slow eventually as health care expenditures continued to rise and displaced increasing amounts of consumption of goods and services besides health care. In other words, pressure to slow cost growth will mount as health care accounts for a larger share of the American economy.

In response to rising health care costs, various policy changes in the private sector and by state governments would be likely. Employers would probably intensify their efforts to reduce their own costs, by, for example, working with insurers to make health care more efficient or by reducing insurance coverage. They would also probably raise premiums and out-of-pocket charges. Employees would then react to the higher charges either by shifting to plans with lower premiums—and more restrictive coverage—or by limiting their consumption directly in response to the higher out-of-pocket charges.²¹

It is impossible to predict with certainty precisely how such a process would unfold and how much cost growth could slow. Among various plausible approaches, a simple and transparent one is to assume that within the projection period, households would not be willing to spend so much more on health care that, from one year to the next, the increase in such spending alone was greater than the total increase in productivity. Therefore, under the assumption that the consumption of items besides health care does not decline, at the end point of CBO's projec-

20. To apply those constraints, CBO initially projected total Medicare spending, gross of beneficiaries' premiums and including cost sharing by beneficiaries, and total Medicaid spending, including both state and federal spending. To separate out federal spending on Medicare and Medicaid, CBO then reclassified the projected Medicare premiums and cost sharing and state spending on Medicaid into the category that includes all other spending on health care.

21. In its projections, CBO assumes that the share of health care spending that will be in the form of premiums in employment-based plans—and thus is tax preferred—will remain at approximately 58 percent of non-Medicare, non-Medicaid spending on health care.

tion period, in 2082, per capita consumption would continue to grow because of increased productivity, but the additional economic resources would be devoted entirely to health care. That assumption, to be sure, is not the only reasonable one, and other assumptions could generate higher or lower amounts of spending on health care in the long term. The approach, though, has the virtue of considering future levels of spending on both health care and other goods and services.²²

Under the scenario that CBO presents, the slowdown in excess cost growth would not be painless and would not occur simply through improved efficiencies given the current structure of the health sector. Households would probably face increased cost sharing; new and potentially useful health technologies would be introduced more slowly or utilized at lower levels than would occur without a slowdown in excess cost growth; and more treatments or interventions might simply not be covered by insurance. Nevertheless, Americans would still face steadily increasing health costs. In other words, even though the growth rate might decline, the real level of health care costs would continue to rise—to the point of accounting for all of the increase in productivity. Therefore, real average consumption of goods and services other than health care would stagnate.

Such a slowdown in non-Medicare, non-Medicaid spending on health care may be particularly difficult to achieve in the absence of changes in federal law (as assumed in the projections). But at some point, the pressure on that portion of the system would probably become so severe that measures to slow growth would be taken. State governments and the private sector would almost certainly have more flexibility to respond to that pressure than the federal government would have without a change in federal law. The steps taken to slow growth in the non-Medicare, non-Medicaid sectors of the health system, in turn, would probably exert some downward pressure on growth rates in the public programs because they are integrated to a significant degree with the rest of the health

care system. To the extent that actions by individuals and businesses resulted in lower-cost “practice patterns” by physicians, slower development and diffusion of new technologies, and cost-reducing changes to the structure of the health care system, Medicare and Medicaid would experience some reduction in their own growth—but the extent of that spillover is uncertain.

Moreover, CBO assumes that under current law, the federal government would make regulatory changes aimed at slowing spending growth on federal health programs and that Medicare beneficiaries’ demand for health care services would decline as Medicare premiums and cost-sharing amounts consumed a growing share of their income. On the basis of discussions with health and policy experts, CBO assumes that—without changes in law—the combined effects of those factors would be to reduce Medicare’s excess cost growth by one-fourth of the reduction in the growth of non-Medicare, non-Medicaid spending on health care. In other words, in a scenario in which the growth rate of spending on health care outside Medicare and Medicaid declined from 2 percent to 1 percent per year, Medicare spending growth would decline from 2 percent to 1.75 percent per year. (As discussed below, it is perhaps unlikely that Medicare and Medicaid would actually experience a significantly higher growth rate than the rest of the health sector over an extended period of time, but changes in federal law would be necessary to avoid that outcome.)

CBO assumes that excess cost growth will decline more rapidly for Medicaid, which is a joint federal–state program, than for Medicare. In addition to the spillover effects and possible federal regulatory changes noted above, states are likely to take actions to reduce the growth of Medicaid spending even without changes in federal law. State governments would probably respond to growing fiscal pressures by limiting the services they chose to cover or by reducing their number of beneficiaries by tightening eligibility. In its projections, CBO assumes that the rate of decline in Medicaid’s excess cost growth will be 75 percent of the reduction in the growth of non-Medicare, non-Medicaid spending on health care. CBO’s projection methodology for excess cost growth from 2019 through 2082 is thus based on the following set of assumptions:

- Excess cost growth in 2018 for Medicare, Medicaid, and all other health care will equal the historical averages;

22. For related discussions, see Michael E. Chernew, Richard A. Hirth, and David M. Cutler, “Increased Spending on Health Care: How Much Can the United States Afford?” *Health Affairs*, vol. 22, no. 4 (2003), pp. 15–25; and Glenn Follette and Louise Sheiner, “The Sustainability of Health Spending Growth,” Finance and Economics Discussion Series No. 2005-60 (Washington, D.C.: Board of Governors of the Federal Reserve System, 2005).

Table 4.**Assumptions About Excess Cost Growth Over the Long Term**

(Percentage points)

	2018 Rate (Historical Average)	Annual Decline in Rate, 2018–2082 (Percent)	Average Rate, 2018–2082	Rate in 2082
Medicare	2.4	1.1	1.7	1.1
Medicaid	2.2	3.4	0.9	0.2
All Other Spending on Health Care	2.0	4.6	0.6	0.1

Source: Congressional Budget Office.

Note: Excess cost growth refers to the number of percentage points by which the growth of spending on Medicare, Medicaid, or health care generally (per beneficiary or per capita) is assumed to exceed the growth of nominal gross domestic product (per capita).

- Total real per capita consumption of goods and services besides health care will not decline during the 75-year projection period; and
- The annual reduction in excess cost growth in Medicare and Medicaid will be, respectively, one-fourth and three-fourths of that for all other health care.

Under those assumptions, the excess cost growth rate for non-Medicare, non-Medicaid spending on health care declines by 4.6 percent annually (see Table 4).²³ By 2082, that rate drops to 0.1 percentage point. For Medicare, excess cost growth declines to 1.1 percentage points that year, and for Medicaid, to 0.2 percentage points. The average rates for excess cost growth between 2018 and 2082 are 0.6 percentage points for non-Medicare, non-Medicaid spending, 1.7 percentage points for Medicare, and 0.9 percentage points for Medicaid.

It may be difficult to envision how per capita Medicare and Medicaid spending could continue to grow more rapidly than other health care spending over such a long period, but changes in federal law are probably necessary to avoid that outcome. Furthermore, actions to reduce spending growth in the private sector could attenuate the incentives for the development and diffusion of new medical technologies for nonelderly people while having little effect on new technologies focused on diseases principally affecting the elderly.

That aspect of the projections may appear unrealistic, but it highlights the core problem—the unsustainability of current federal law. (The inherent tension in making

long-term projections for a federal health care system that cannot be sustained in its current form must manifest itself in some way.) In reality, it is likely that changes in federal law as well as in practices in the private sector will slow the growth of health care spending such that growth in per capita Medicare and Medicaid spending does not diverge greatly from other spending on health care.

Projections of Health Spending

Over the past 30 years, total national spending on health care has more than doubled as a share of GDP. Under the assumptions described above, according to CBO's projections, that share will double again by 2035, to 31 percent of GDP. Thereafter, health care costs continue to account for a steadily growing share of GDP, reaching 41 percent by 2060 and 49 percent by the end of the 75-year projection period (see Figure 4).

Although the *rate* of cost growth slows over the projection period, the annual increase in the *level* would remain high. For example, for the five years beginning in 2007, CBO projects health care spending, measured as a share of GDP, to grow by 12 percent—from 15.5 percent of GDP to 17.4 percent. From 2070 to 2075, CBO projects, it will grow by only 4 percent, from 44.4 percent of GDP to 46.2 percent. From one perspective, the growth during the latter period is much slower. But in both periods, health care spending rises by about 2 percent of GDP.

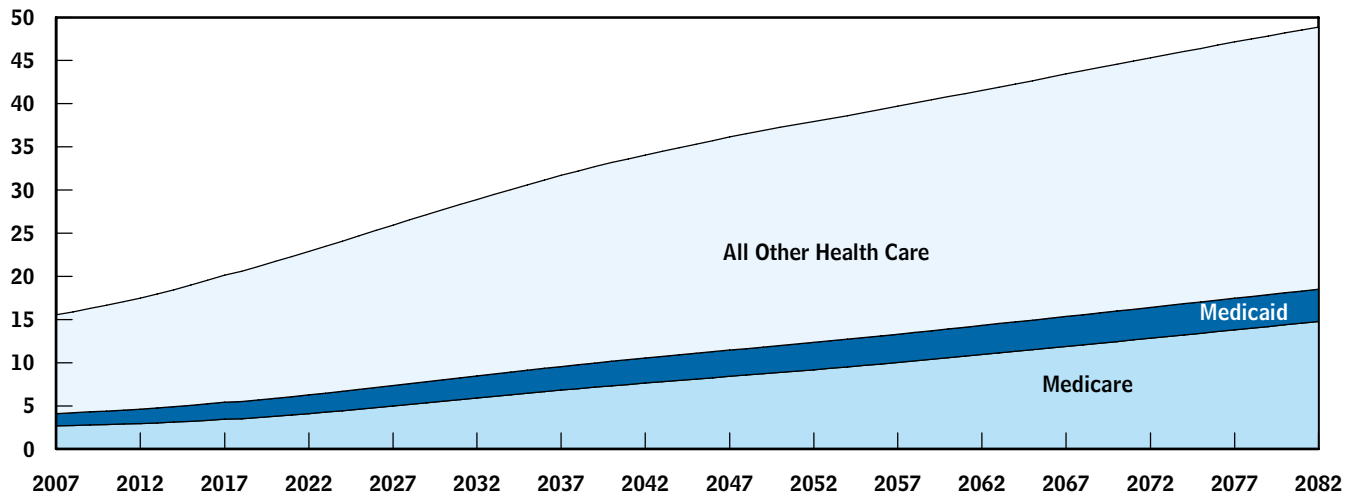
Spending on Medicare and Medicaid is projected to grow as a share of total spending on health care—as the assumed rates of excess cost growth for those programs under current federal law slow less quickly than does the rate for other spending on health care and as

23. Specifically, $ECG_y = ECG_{y-1} \cdot 0.954$.

Figure 4.

Projected Spending on Health Care as a Percentage of Gross Domestic Product

(Percent)



Source: Congressional Budget Office.

Note: Amounts for Medicare are net of beneficiaries' premiums. Amounts for Medicaid are federal spending only.

the population ages. Net federal spending on those programs now accounts for about 4 percent of GDP, or 26 percent of total spending on health care. By 2035, those figures grow to 9 percent of GDP, or 30 percent of total spending on health care, and by 2082, to 19 percent of GDP, or 38 percent of total spending.

Excess cost growth is the main factor responsible for the projected increase in both national spending on health care and federal spending on Medicare and Medicaid. By itself, the projected change in the age composition of the population has a modest effect on the future path of health care spending (see Box 2).

Consumption of Health Care and of Other Goods and Services

Historically, economic growth has been driven primarily by improved productivity. As the average worker is able to produce more, the average citizen can consume more. As the population ages and a smaller portion is employed, per capita GDP is likely to grow more slowly, but, on average, future generations will be substantially richer than Americans are today. In 2007, total per capita con-

sumption averages about \$27,000, of which about \$6,000 is for health care. Under CBO's projections, by 2035, per capita consumption would grow by over \$15,000 (in 2007 dollars), but more than three-quarters of that extra money would be spent on health care. While the consumption of other goods and services would grow by just 12 percent, the consumption of health care would triple.

In addition, although the consumption of goods and services besides health care would, on average, be stable at the end of the projection period, the effect would vary for different individuals. Lower-income people tend to spend fewer dollars on health care than average, but that spending represents a larger portion of their earnings than it does for others. Also, people generally have less flexibility about their spending on health care than on other things. For example, even in companies that offer multiple options for health insurance, premiums do not vary substantially. As a result, as costs for health care increased, higher-income people would generally still be able to increase their consumption of other goods and services,

Box 2.**The Effect of the Aging of the Population on Spending on Medicare and Medicaid**

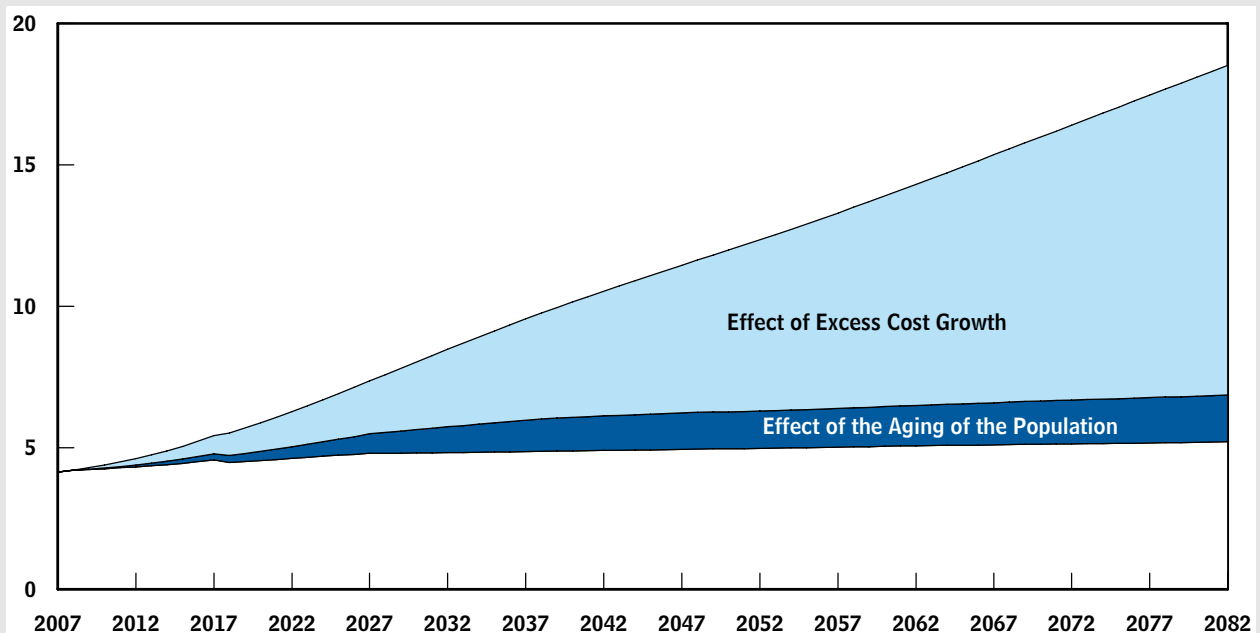
In coming decades, the share of the population that is covered by Medicare will expand rapidly as members of the baby-boom generation become eligible for the program, and the share that uses long-term care services financed by Medicaid will also probably increase. Although the aging of the population is frequently cited as a major factor contributing to the large projected increase in federal spending on those two programs, it accounts for a modest fraction of the growth that the Congressional Budget Office (CBO) projects. The main factor is excess cost growth—or the extent to which the increase in health care spending for an average individual exceeds the growth in per capita gross domestic product (GDP).

As shown in the figure, if the age distribution of the population were fixed—so that the average age did not increase over time—and there were no excess cost

growth, spending on Medicare and Medicaid as a share of GDP would remain essentially constant. That scenario is represented by the bottom line in the figure. The next line shows projected spending on Medicare and Medicaid if the age distribution of the population changes as expected—so that the average age of the population increases—but excess cost growth remains at zero. The difference between that line and the bottom line captures the effect of the aging of the population on projected federal spending on Medicare and Medicaid. The top line in the figure shows CBO's projection of spending on those programs, which includes the effects of the aging of the population and of excess cost growth. By itself, aging accounts for about one-quarter of the projected growth in federal Medicare and Medicaid spending through 2030. By 2050, that share has fallen to under 20 percent, and by 2082, to only about 10 percent.

Sources of Growth in Projected Federal Spending on Medicare and Medicaid

(Percentage of gross domestic product)

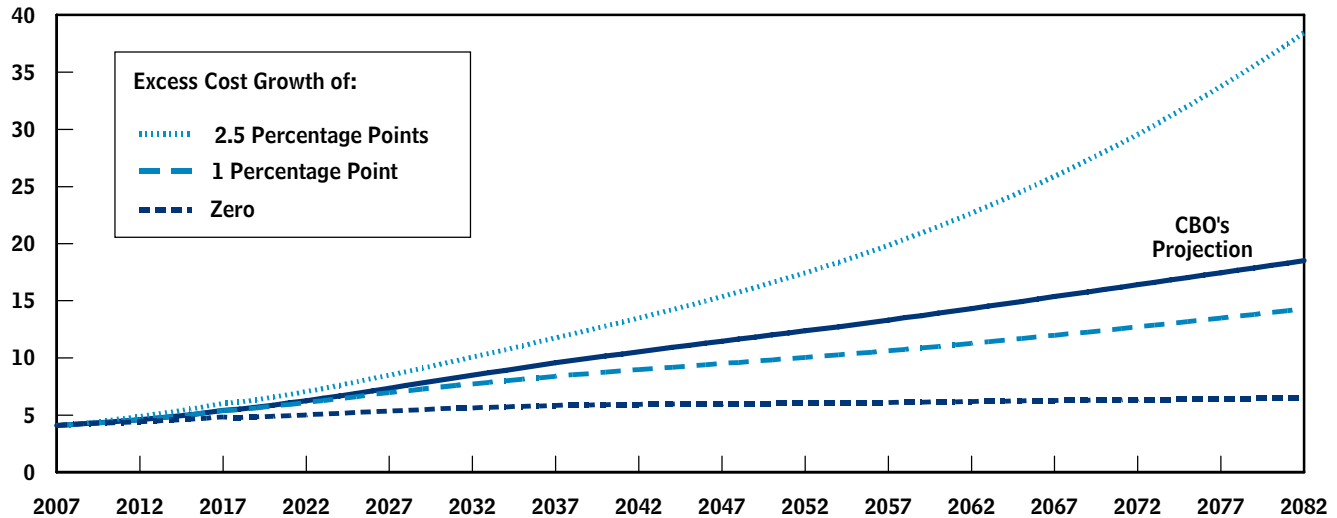


Source: Congressional Budget Office.

Figure 5.

Federal Spending for Medicare and Medicaid as a Percentage of Gross Domestic Product Under Different Assumptions About Excess Cost Growth

(Percent)



Source: Congressional Budget Office.

Note: Excess cost growth refers to the number of percentage points by which the growth of annual health care spending per beneficiary is assumed to exceed the growth of nominal gross domestic product per capita.

whereas poorer people would probably see their consumption of those items decline.²⁴

Projections Under Alternative Assumptions

Analysts working 75 years ago, in 1932, would have been extremely unlikely to correctly project the current share of the economy devoted to health care, and the projections in this study will undoubtedly prove to be inaccurate in one direction or another. It will be difficult to judge their accuracy even after the fact, because they assume no changes in federal law, and such changes are virtually certain to occur.

Even without those changes, though, actual spending on health care could be much lower or much higher. Past technological developments have generally resulted in

expanded treatment and higher total spending. Future innovations could accelerate that trend. Alternatively, if future research results in the development of inexpensive curative therapies, growth could slow.

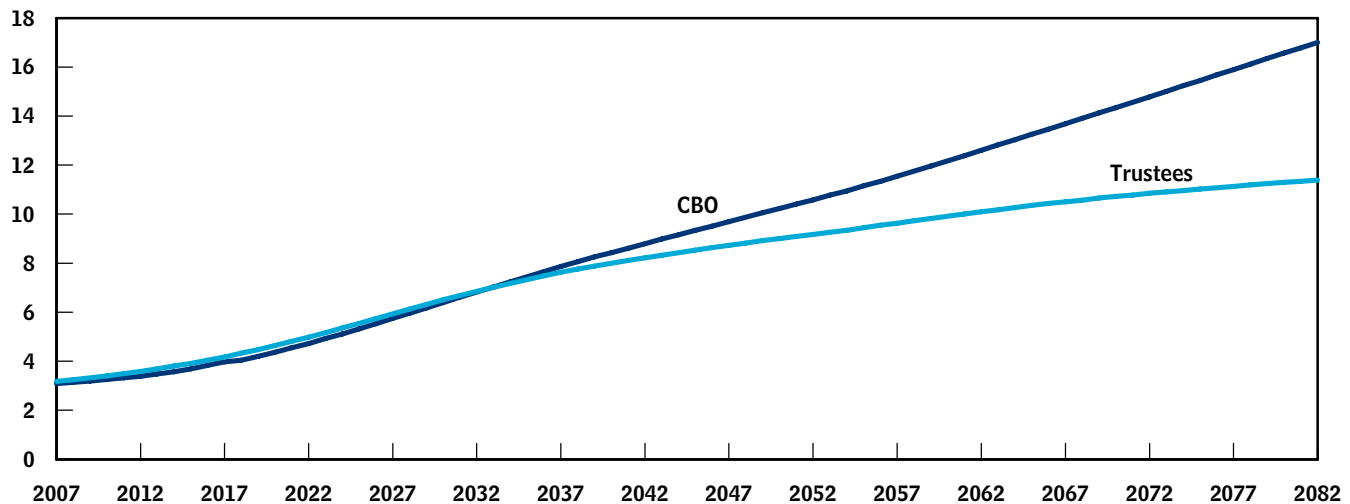
Among simple alternative scenarios for excess cost growth, one in which it is held constant at zero, while implausible, is useful because it isolates the effect of the aging of the population (see Figure 5). Aging alone is projected to increase federal spending on Medicare and Medicaid. Under that scenario, projected net federal outlays on the two programs would increase from 4 percent of GDP in 2007 to 6 percent of GDP by 2040 and then rise gradually to 7 percent by 2082.

Under a scenario in which excess cost growth for Medicare and Medicaid is 2.5 percentage points, which could be roughly interpreted as what would occur with no slowing of growth rates whatsoever, net federal spending on the two programs would grow to 13 percent of GDP in 2040 and 38 percent of GDP by 2082. (Appendix D shows a set of projections in which spending on Medicare, Medicaid, and other health care grows at their historical average excess growth rates from 1975 through 2005.)

24. For example, consider the simplified example of two coworkers with incomes of \$20,000 and \$80,000 who both get a 10 percent salary increase and devote their extra income to an increase of \$5,000 in health insurance premiums. The lower earner's income would increase by \$2,000, but his or her health care costs would be \$3,000 higher than that, forcing a real reduction in his or her consumption of other goods and services. The higher earner's income would increase by \$8,000, more than enough to cover the additional \$5,000 in health care expenses.

Figure 6.**CBO's and the Trustees' Projections of Spending on Medicare as a Percentage of Gross Domestic Product**

(Percent)



Source: Congressional Budget Office.

Note: Projections are of gross federal spending.

The projections presented in this study can also be compared to the Medicare trustees' projections of spending on the program.²⁵ For that comparison, CBO adjusted its projections to measure Medicare spending gross of the premiums paid by beneficiaries, which is the measure used by the trustees. (All of CBO's other projections of Medicare spending in this study are net of beneficiaries' premiums.) Both CBO and the trustees project that gross Medicare outlays will more than double from their current level of 3 percent of GDP to more than 7 percent of GDP in 2035 (see Figure 6). Under their intermediate

scenario, the trustees assume that excess cost growth will decline gradually from the 25th to the 75th year of the projection period but constrain total spending over the 75-year period to the result obtained by assuming excess cost growth to be a constant 1 percentage point in the 25th year and later. CBO's methodology does not impose that type of constraint. Consequently, the two sets of projections track each other relatively closely over the next two to three decades but then diverge significantly; the trustees project gross Medicare outlays to reach 11 percent of GDP by the end of the projection period, compared with CBO's 17 percent. In both sets of projections, however, the main message is that health care spending is projected to rise significantly and that changes in federal law will be necessary to avoid or mitigate a substantial increase in federal spending on Medicare and Medicaid.

25. See Department of Health and Human Services, Centers for Medicare and Medicaid Services, Office of the Actuary, *2007 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (April 23, 2007), pp. 160–162.

Medicare and Medicaid: An Overview

Medicare and Medicaid are the nation's main public health insurance programs and, after Social Security, are the largest federal entitlement programs. Together, they provide federally funded health insurance coverage to millions of low-income, disabled, or elderly beneficiaries.

The Medicare Program

The Medicare program was enacted in 1965 to provide health insurance coverage to Americans age 65 and over, and eligibility for the program was expanded in 1972 to include individuals under age 65 who qualify for Social Security disability benefits. People who are under 65 and disabled become eligible for Medicare 24 months after they become entitled to Social Security benefits. When Medicare was enacted, only about half of the elderly had any private health insurance, which generally covered only inpatient hospital costs, and even that coverage was often quite limited.¹ Much of the health care spending incurred by the elderly was paid out of pocket by the individual or family members.

Part A of Medicare, or Hospital Insurance, covers inpatient services provided by hospitals and skilled nursing facilities as well as hospice care. Part B, or Supplementary Medical Insurance, covers services provided by physicians and other practitioners, hospitals' outpatient departments, laboratories, and suppliers of medical equipment. Part B also covers a limited number of drugs, most of which must be administered by injection in a physician's office.² Depending on the circumstances, home health care may be covered by either Part A or Part B. The Medicare Prescription Drug, Improvement, and Modern-

ization Act of 2003 added a prescription drug benefit that became available in 2006 under a newly created Part D.

Part A benefits are financed primarily from a payroll tax. Premiums paid by beneficiaries cover about one-quarter of the cost of the Part B program, and the rest comes from general revenues.³ Enrollees' premiums under Part D are set at a level to cover about one-quarter of the cost of the basic prescription drug benefit, but receipts from premiums cover less than one-quarter of the total cost of the Part D program because some of the outlays for that program (such as subsidies for low-income beneficiaries and for employers that maintain drug coverage for their retirees) are not included in the calculation of premiums.

In 2006, Medicare spending totaled an estimated \$381.9 billion, of which \$374.9 billion (or 98 percent) covered benefits for enrollees. About 32 percent of the spending on benefits paid for inpatient hospital care, and 26 percent paid for services provided by physicians and other professionals as well as outpatient ancillary services (see Table A-1).⁴ About 15 percent of Medicare expenditures were for the Medicare Advantage program (discussed

1. See Amy Finkelstein, "The Aggregate Effects of Health Insurance: Evidence from the Introduction of Medicare," Working Paper 11619 (Cambridge, Mass.: National Bureau of Economic Research, September 2005).

2. Certain other drugs are also covered under Part B, including oral cancer drugs if injectable forms are also available, oral antinausea drugs that are used as part of a cancer treatment, and oral immunosuppressive drugs used after an organ transplant.
3. The standard Part B premiums are established each year to cover 25 percent of projected average expenditures in the Part B program. In 2007, the standard monthly Part B premium is \$93.50. Beginning in 2007, higher premiums are required of single beneficiaries with an annual income over \$80,000 and couples with an annual income over \$160,000. Those income thresholds will be indexed to inflation in future years. CBO estimates that about 4 percent of beneficiaries are paying the higher premiums in 2007.
4. Other professionals include physician assistants, nurse practitioners, psychologists, clinical social workers, and physical, occupational, and speech therapists. Outpatient ancillary items or services include durable medical equipment, Part B drugs, laboratory services, and ambulance services.

Table A-1.**Medicare Spending by Type of Service, 2006**

	Billions of Dollars	Percent
Inpatient Hospital Services	120.7	32
Physicians' and Suppliers' Services	86.1	23
Medicare Advantage Plans	55.9	15
Prescription Drug Benefits	32.0	9
Hospital Outpatient Services	20.1	5
Care in Skilled Nursing Facilities	19.5	5
Home Health Services	13.2	4
Hospice Services	8.6	2
Other Services	18.8	5
Total	374.9	100

Source: Congressional Budget Office.

below), and 9 percent paid for prescription drug benefits under Part D.

The Fee-for-Service Program

Most Medicare beneficiaries receive their Part A and Part B benefits in the traditional fee-for-service program, which pays providers for each covered service (or bundle of services) they provide. Beneficiaries must pay a portion of the costs of their care through deductibles and coinsurance. Unlike many private insurance plans, Medicare does not include an annual cap on beneficiaries' cost sharing. Nearly 90 percent of beneficiaries who receive care in the fee-for-service program, however, have supplemental insurance that covers many or all of Medicare's cost-sharing requirements. The most common sources of supplemental coverage are plans for retirees offered by former employers (held by 37 percent of beneficiaries in the fee-for-service program), individually purchased medigap policies (34 percent), and Medicaid (16 percent).⁵ The percentage of Medicare beneficiaries who have coverage as retirees, as well as the generosity of that coverage, is expected to decline in the future as employers respond to the financial stresses of rising health care costs. The evidence on trends in such coverage over the past decade is mixed: Some studies have found that the percentage of employers that offer the coverage has fallen during that

period, while other studies have found that that percentage has remained stable. However, in recent years, some employers have sought to reduce their future costs for health coverage for retirees by increasing premiums and cost-sharing requirements and eliminating coverage for future retirees.⁶

The Medicare Advantage Program

As of June 2007, 18 percent of Medicare beneficiaries were enrolled in private health plans under the Medicare Advantage program (also known as Part C of Medicare). Such plans submit bids indicating the per capita payment for which they are willing to provide Medicare Part A and Part B benefits, and the government compares those bids with county-level benchmarks that are determined in advance through statutory rules. Plans are paid their bids (up to the benchmark) plus 75 percent of the amount by which the benchmark exceeds their bids. Plans must return that 75 percent to beneficiaries as additional benefits (such as reduced cost sharing on Medicare services) or as a rebate on their Part B or Part D premiums.

Under current law, benchmarks are required to be at least as great as per capita expenditures in every county that are incurred in the fee-for-service portion of Medicare and are higher than those expenditures in many counties. For 2007, the Congressional Budget Office (CBO) calculates that benchmarks are 17 percent higher, on average, than projected per capita fee-for-service expenditures nationwide, and that payments to plans will be about 12 percent higher than per capita spending in the fee-for-service portion of the program.

The Medicaid Program

Medicaid is a joint federal-state program that pays for health care services for a variety of low-income individuals. The program was created in 1965 by the same legislation that created Medicare, replacing an earlier program of federal grants to states to provide medical care to people with low income. In 2006, federal spending for the program was an estimated \$180.6 billion, of which \$160.9 billion covered benefits for enrollees. (In addition to benefits, Medicaid's spending includes payments to

5. Medicare Payment Advisory Commission, *A Data Book: Health-care Spending and the Medicare Program* (June 2007), p. 61.

6. The Henry J. Kaiser Family Foundation and Hewitt Associates, *Retiree Health Benefits Examined: Findings from the Kaiser/Hewitt 2006 Survey on Retiree Health Benefits* (December 2006), available at www.kff.org.

Table A-2.**Medicaid Enrollees and Federal Benefit Payments, by Category of Enrollee, 2006**

	Enrollees		Federal Benefit Payments		Percentage of Benefit Payments for Long-Term Care
	Number (Millions)	Percent	Billions of Dollars	Percent	
Aged	5.5	9.0	36.7	22.8	70.6
Disabled	9.8	16.1	72.2	44.9	36.0
Children	29.5	48.4	31.1	19.3	7.7
Adults	16.0	26.3	20.8	12.9	1.9
Total	60.9	100.0	160.9	100.0	34.0

Source: Congressional Budget Office.

Note: Disabled enrollees include some people who are over age 65 or under age 18. Adult enrollees are adults who are not aged or disabled; they are primarily poor parents and pregnant women.

hospitals that treat a “disproportionate share” of low-income patients as well as costs for the Vaccines for Children program and administrative costs.) The federal government’s share of Medicaid’s spending for benefits varies among the states but currently averages 57 percent.

States administer their Medicaid programs under federal guidelines that specify a minimum set of services that must be provided to certain poor individuals. Mandatory benefits include inpatient and outpatient hospital services, services by physicians and laboratories, and nursing home and home health care. Groups that must be eligible (according to federal requirements) include poor children and families who would have qualified for the former Aid to Families with Dependent Children program, certain other poor children and pregnant women, and elderly and disabled individuals who qualify for the Supplemental Security Income program. In general, a Medicaid enrollee must have both a low income and a low level of assets, although the minimum financial thresholds vary depending on the basis for an enrollee’s eligibility.

Within broad statutory limits, states have the flexibility to administer the Medicaid program and determine its scope. Partly as a result, the program’s rules are complex, and it can be difficult to generalize about the types of enrollees who are covered, the benefits that are offered, and the cost sharing that is required. States may choose to make additional groups of people eligible (such as individuals with high medical expenses who have “spent down” their assets) or to provide additional benefits (such as coverage for prescription drugs and dental services) and

have exercised those options to varying degrees. Moreover, states often seek and receive federal waivers that allow them to provide benefits and cover groups that would otherwise be excluded under Medicaid. By one estimate, total spending on optional populations and benefits accounted for about 60 percent of the program’s expenditures in 2001.⁷

On the basis of administrative data, CBO estimates that about half of Medicaid’s 61 million enrollees in 2006 were poor children and that another one-quarter were either the parents of those children or poor pregnant women.⁸ Per capita costs for those groups are relatively low, though, while expenses are higher for elderly and disabled beneficiaries, many of whom require long-term care. Although the elderly and disabled constitute about one-quarter of Medicaid’s enrollees, they account for two-thirds of the program’s spending (see Table A-2). Overall, one-third of Medicaid’s spending in 2006 was for long-term care, which includes nursing home services, home health care, and other medical and social services for people whose disabilities prevent them from living independently.

7. See Kaiser Commission on Medicaid and the Uninsured, *Medicaid Enrollment and Spending by “Mandatory” and “Optional” Eligibility and Benefit Categories* (Washington, D.C.: Henry J. Kaiser Family Foundation, June 2005), p. 11.

8. The enrollment figure of 61 million includes all people who were enrolled in Medicaid at any time during 2006. About 46 million people were enrolled in the program in June of that year.

20 THE LONG-TERM OUTLOOK FOR HEALTH CARE SPENDING

About 45 percent of Medicaid beneficiaries are enrolled in managed care plans that accept a capitated payment (a fixed amount per enrollee) for providing a comprehensive set of benefits. Those arrangements are more common for families and children, although some states also enroll the elderly and the disabled. About 15 percent of beneficiaries are enrolled in an arrangement that provides what is termed primary care case management, in which enroll-

ees select (or are assigned) a primary care physician or group practice that is paid an additional fee for overseeing and coordinating their care. Many states also use “carve-out” arrangements, in which the states contract with organizations that assume the responsibility and financial risk for providing a subset of Medicaid benefits, such as dental services or mental health care.

Computing Historical Excess Cost Growth

To compute historical excess cost growth for Medicare, Medicaid, and total national spending on health care, the Congressional Budget Office (CBO) adjusted historical aggregate growth rates to remove the effects of changes in the population and per capita growth of gross domestic product (GDP).

The national health expenditure accounts, maintained by the Centers for Medicare and Medicaid Services, provide detailed historical data by both source of funds and type of expenditure. Total national health expenditures represent aggregate health care spending in the United States. The analysis in this study focuses on the consumption of health care, so instead of using those totals, it uses spending on health services and supplies, which includes all spending on personal health care, governments' administrative costs and public health activities, and the net costs of private health insurance.¹ That measure captures spending on all medical care provided in a given year. Spending on health services and supplies equals total national health expenditures minus amounts invested in research and in structures and equipment.

For this analysis, spending on health services and supplies is divided into three categories by source of funds: Medicare, Medicaid, and other. For the total and each category, CBO estimated historical excess cost growth, which measures the increase in per capita health care spending relative to the increase in per capita GDP, after removing the changes in spending that are associated with changes in the age composition of the population. The analysis

uses data from the national health expenditure accounts from 1975 through 2005.

Future health care costs are projected using the same general formula:

$$\begin{aligned} \text{HealthCostPerCapita}_t = & \\ & \text{HealthCostPerCapita}_{t-1} \times \frac{\text{GDPperCapita}_t}{\text{GDPperCapita}_{t-1}} \times \\ & \frac{\text{AgeCompIndex}_t}{\text{AgeCompIndex}_{t-1}} \times (1 + x_t), \end{aligned}$$

where x_t is excess cost growth in year t ; *HealthCostPerCapita* is nominal health expenditures per capita, *GDPperCapita* is nominal GDP per capita, and *AgeCompIndex* is an age-weighted health care cost index that is included in the formula to remove changes in health care spending attributable to changes in the age distribution of the population. Both *HealthCostPerCapita* and *AgeCompIndex* vary depending on which of the measures of excess cost growth is being calculated. Historical excess cost growth (x_t) is calculated as follows:

$$\begin{aligned} x_t = & \frac{\text{HealthCostPerCapita}_t}{\text{HealthCostPerCapita}_{t-1}} \times \\ & \frac{\text{GDPperCapita}_{t-1}}{\text{GDPperCapita}_t} \times \\ & \frac{\text{AgeCompIndex}_{t-1}}{\text{AgeCompIndex}_t} - 1 \end{aligned}$$

The approach for Medicaid is similar, but rather than an age composition index, an adjustment for type of beneficiary—children, disabled, aged, or other adult—is used.

Data on the total population and nominal GDP are available within the data on national health expenditures.

1. For a detailed description of national health accounts data, see Department of Health and Human Services, Centers for Medicare and Medicaid Services, *National Health Expenditures Accounts: Definitions, Sources, and Methods Used in the NHEA 2005*, available at www.cms.hhs.gov/NationalHealthExpendData/downloads/dsm-05.pdf.

Medicare

HealthCostPerCapita

For the equation to determine excess cost growth in Medicare, health costs per capita are nominal Medicare spending per beneficiary, available within the data on national health expenditures. The number of Medicare beneficiaries is from Medicare Enrollment Reports by the Centers for Medicare and Medicaid Services.²

AgeCompIndex

For Medicare, the age composition index in year t is:³

$$y_t = \left(\frac{N_{65-74}}{N_{65+}} \right) \times P_{65-74} + \left(\frac{N_{75-84}}{N_{65+}} \right) \times P_{75-84} + \left(\frac{N_{85+}}{N_{65+}} \right) \times P_{85+},$$

where N_a is the population in a given age group a in year t , and P_a is per capita personal health care expenditures in 1999 for age group a . Those expenditures are derived using the 1999 Medical Expenditure Panel Survey (MEPS), administered by the Agency for Healthcare Research and Quality within the Department of Health and Human Services.⁴

2. See www.cms.hhs.gov/MedicareEnRpts/Downloads/HISMI05.pdf.

3. The Medicare population also includes people who are under age 65 and have been collecting Social Security disability benefits for at least two years as well as nonelderly people with end-stage renal disease. Those groups are not included in the age composition index because of limitations in the available data.

4. See www.cms.hhs.gov/NationalHealthExpendData/downloads/agetables.pdf

Medicaid

HealthCostPerCapita

For the equation to determine excess cost growth in Medicaid, health costs per capita are nominal Medicaid spending per beneficiary.⁵

AgeCompIndex

For Medicaid, the age composition index in year t is:

$$y_t = \left(\frac{N_{Children}}{N_{Total}} \right) \times P_{Children} + \left(\frac{N_{Adult}}{N_{Total}} \right) \times P_{Adult} + \left(\frac{N_{Elderly}}{N_{Total}} \right) \times P_{Elderly} + \left(\frac{N_{Disabled}}{N_{Total}} \right) \times P_{Disabled},$$

where N is the number of beneficiaries of a given type in year t . The *Adult* category includes only nonelderly, non-disabled adults.⁶ P is per capita Medicaid expenditures in 1999 for the given type of beneficiary.

Overall Excess Cost Growth

HealthCostPerCapita

For the equation to determine overall excess cost growth, health costs per capita are nominal spending on health services and supplies divided by the total population.

5. Spending data are within the data on national health expenditures. Data on the number of beneficiaries by category and average per capita expenditures for each beneficiary type are from Centers for Medicare and Medicaid Services, *Health Care Financing Review, Medicare and Medicaid Statistical Supplement* (2005).

6. Counts of beneficiaries by type are available only through 2004, so all calculations for Medicaid are for 1975 through that year.

AgeCompIndex

The age composition index in year t is:

$$y_t = \left(\frac{N_{0-18}}{N_{Total}} \right) \times P_{0-18} +$$

$$\left(\frac{N_{19-44}}{N_{Total}} \right) \times P_{19-44} +$$

$$\left(\frac{N_{45-54}}{N_{Total}} \right) \times P_{45-54} +$$

$$\left(\frac{N_{55-64}}{N_{Total}} \right) \times P_{55-64} +$$

$$\left(\frac{N_{65-74}}{N_{Total}} \right) \times P_{65-74} +$$

$$\left(\frac{N_{75-84}}{N_{Total}} \right) \times P_{75-84} +$$

$$\left(\frac{N_{85+}}{N_{Total}} \right) \times P_{85+},$$

where N_a is the number of individuals in a given age group a in year t , and P_a is per capita personal health care expenditures in 1999 for age group a derived using MEPS data.⁷

Non-Medicare, Non-Medicaid Excess Cost Growth

Excess cost growth for non-Medicare, non-Medicaid spending is calculated as a dollar-weighted average of the cost growth rates for Medicare, Medicaid, and overall. Specifically,

$$a = x_t^{Overall} \times Cost_t^{Overall}$$

$$b = x_t^{Medicare} \times Cost_t^{Medicare}$$

$$c = x_t^{Medicaid} \times Cost_t^{Medicaid}$$

$$x_t^{NMNM} = \frac{a - b - c}{Cost_t^{NMNM}},$$

where x_t is annual excess cost growth for the indicated category, $NMNM$ is non-Medicare and non-Medicaid, and $Cost_t$ is the nominal dollars accounted for by that category.

7. See www.cms.hhs.gov/NationalHealthExpendData/downloads/agetables.pdf.

Projected Health Care Spending Under an Alternative Fiscal Scenario

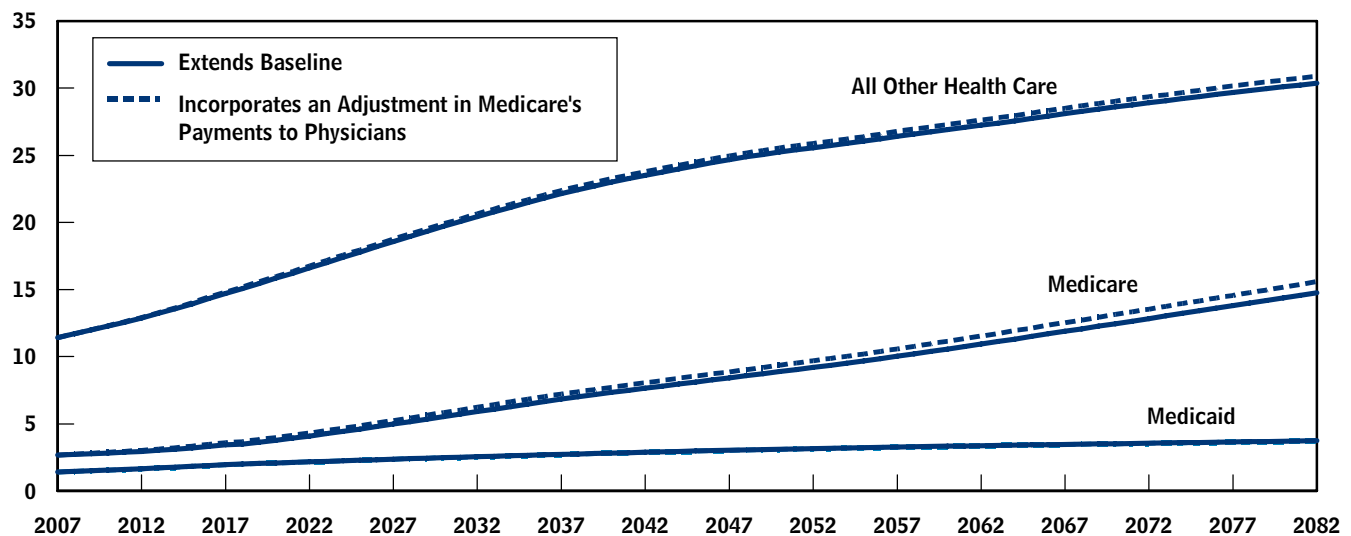
For the projections of federal Medicare spending in the main text, this study uses the Congressional Budget Office's (CBO's) baseline budget projections for 2008 to 2017, which assume no change in current federal law. Based on current law, CBO's baseline assumes that the sustainable growth rate (SGR) mechanism for updating Medicare's payment rates for physicians will reduce those rates by about 4 percent or 5 percent annually for at least the next several years. However, since 2003, the Congress has taken action to prevent the reductions in physician payment rates that would have occurred under the SGR. Therefore, CBO developed an alternative set of long-

term projections that assume that similar action will be taken for the next 10 years. Specifically, under that alternative scenario, Medicare's physician payment rates are assumed to grow with the Medicare economic index, which measures inflation in the inputs used for physicians' services. Projected outlays for Medicare over the next 75 years are similar in both that scenario and the one presented in the main text because the assumption that Medicare's physician fees will be updated to account for inflation has only a minor effect over the long term (see Figure C-1).

Figure C-1.

Comparison of CBO's Projections of Spending on Health Care: Extending the Baseline vs. Incorporating an Adjustment in Physician Fees Under Medicare

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Currently, a mechanism in federal law would reduce Medicare's fees for physicians' services. For its alternative scenario, CBO assumes that those fees are updated to account for inflation in the inputs used for physicians' services.



Projected Health Care Spending When Excess Cost Growth Is Assumed to Continue at Historical Averages

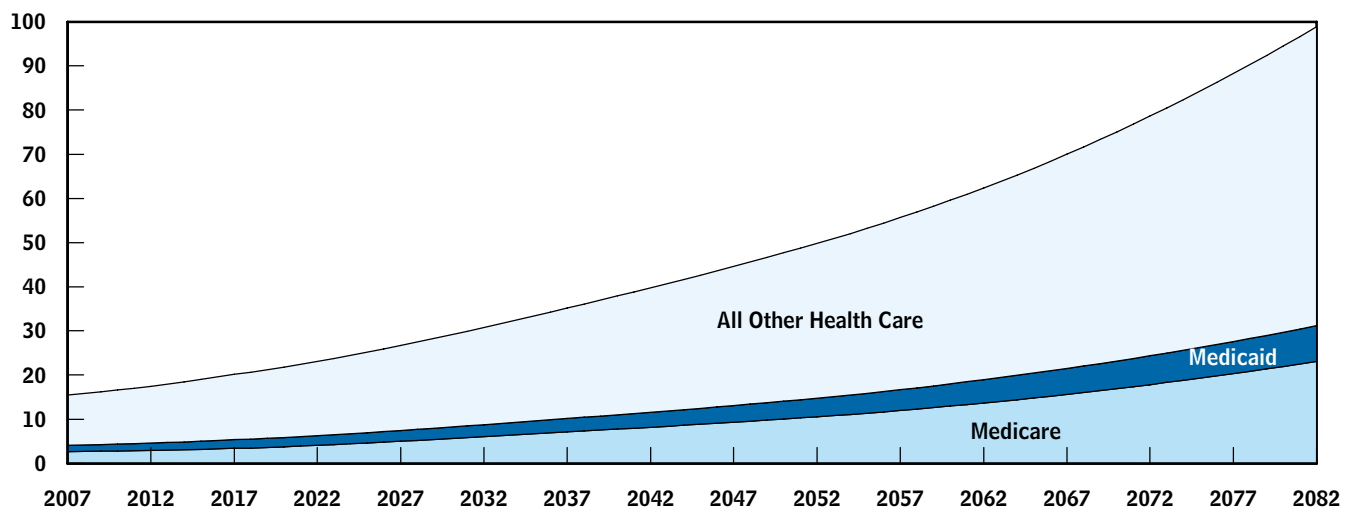
This appendix presents projections of health care spending under the assumption that the excess cost growth rates for spending on Medicare, Medicaid, and all other health care continue indefinitely at their average values from 1975 to 2005: 2.4 percentage points for Medicare, 2.2 percentage points for Medicaid, and 2.0 percentage points for other health care. Under that

assumption, federal spending on Medicare and Medicaid would reach 8 percent of gross domestic product (GDP) by 2030, 14 percent of GDP by 2050, and 31 percent of GDP by 2082 (see Figure D-1). Total national spending on health care would reach 29 percent of GDP by 2030, 48 percent of GDP by 2050, and 99 percent of GDP by 2082.

Figure D-1.

Projected Spending on Health Care Under an Assumption That Excess Cost Growth Continues at Historical Averages

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: Excess cost growth refers to the number of percentage points by which the growth of spending on Medicare, Medicaid, or health care generally (per beneficiary or per capita) is assumed to exceed the growth of nominal gross domestic product (per capita).

Amounts for Medicare are net of beneficiaries' premiums. Amounts for Medicaid are federal spending only.


**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

545 Fifth Avenue, 14th Floor
New York, New York 10017
Internet: <http://www.ifac.org>

Tel: (212) 286-9344
Fax: (212) 286-9570

Agenda Item **5**

DATE: 13 November 2007
MEMO TO: Members of the IPSASB
FROM: John Stanford
SUBJECT: Fiscal Sustainability

OBJECTIVE OF THIS SESSION:

To approve the Project Brief for the project on fiscal sustainability.

AGENDA MATERIAL
5.1 Draft Project Brief on Fiscal Sustainability.
BACKGROUND

At the Montreal meeting it was decided to initiate a project on long term fiscal sustainability information. This is to be part of a three-pronged approach to accounting for social benefits, which also includes:

- ED 34, “Social Benefits: Disclosure of Cash Transfers to Individuals and Households”; and
- The Consultation Paper, Social Benefits: Issues in Recognition and Measurement.

It was also agreed that the project brief would be issued together with the ED and the Consultation Paper and that comments would be invited. ED 34 and the Consultation Paper were issued at Agenda Item 6 on 5 November 2007.

The conceptual framework project will be considering whether long-term fiscal sustainability reporting is within the scope of general-purpose financial reporting in detail. Nevertheless, the direction at Montreal was that the scope of the long-term fiscal sustainability project was to be from a general-purpose financial reporting perspective and that it should not be limited to the general-purpose financial statements.

The US Financial Accounting Standards Advisory Board (FASAB) has initiated its own project on long-term fiscal sustainability. This has a challenging target of producing an Exposure Draft in 2008 proposing requirements for the US Federal Government’s consolidated financial statements with a full Standard to follow in 2009. The FASAB project does not envisage requirements for individual agencies. There has been tentative staff-level discussion of a joint project between the FASAB and the IPSASB on fiscal sustainability. IPSASB Staff’s view is that, given the fact that FASAB has already initiated their project, the timescales for the FASAB and the fact that FASAB meets much more regularly than IPSASB, a fully-fledged joint project will be difficult. However, Staff has had considerable informal discussion and has agreed to

share agenda materials and other papers. IPSASB Staff members attended the July meeting of the FASAB, at which fiscal sustainability was a major agenda item.

FASAB staff has assembled and analyzed comparative materials on approaches to fiscal sustainability in a number of Anglophone jurisdictions. These materials and the perceptions of FASAB staff have been particularly useful to IPSASB staff in the development of these agenda item materials and Staff is very grateful to FASAB staff for their openness and assistance. The current INTOSAI member is also a FASAB member and has facilitated these links. The expertise of FASAB staff will be valuable to this project.

OBJECTIVES OF THE PROJECT

The ultimate objective of the project is to produce a framework for the reporting and disclosure of information related to the long-term fiscal sustainability of governmental programs. As this is not a project directly related to the general purpose financial statements it is not feasible or appropriate to provide definitive final outputs at the initiation stage. Intermediate objectives are to produce a Consultation Paper and, dependent upon decisions following analysis of submissions on that Consultation Paper, an Exposure Draft and/or draft detailed Guidance. The Consultation Paper will highlight and analyze existing approaches in jurisdictions where fiscal sustainability reporting is a feature of governmental financial management as well as the approaches of supra-national bodies such as Eurostat and the IMF in making comparative fiscal projections.

ISSUES

The key issues identified by Staff are highlighted below.

i) Definitions

There is no globally accepted definition of fiscal sustainability or long term-fiscal sustainability, although a number of governments have developed formal or implied definitions of these terms or related terms. In some cases these definitions are located in the context of medium-term fiscal planning or budgetary frameworks, as when fiscal sustainability is linked to specific targets such as a pre-determined net debt/Gross Domestic Product (GDP) ratio or net debt/GDP per capita ratio; overall governmental spending is said to be fiscally sustainable if it is contained within these targets.

At a very high level, fiscal sustainability involves an assessment of the extent to which service delivery can be maintained at existing levels and the extent to which governmental obligations to citizens under existing legal frameworks can be met over a pre-determined future period. The analysis of fiscal sustainability therefore takes account of both current and future beneficiaries, regardless of whether present obligations to them, determined in accordance with accrual accounting principles, exist at the reporting date.

Fiscal sustainability is sometimes coupled with the broad concept of inter-generational equity, which evaluates the extent to which future generations of taxpayers will be affected by the fiscal consequences of current policies for the delivery of goods and services. Inter-generational equity therefore considers whether, and to what extent, the cost of current government operations is likely to be met by future generations of taxpayers, and the extent to which future taxpayers will receive service provision and benefits equivalent to current levels.

The reporting of fiscal sustainability is also commonly linked to frameworks involving targets and benchmarks requiring indicators such as:

- Net Debt;
- Net Debt/GDP;
- Fiscal Gap; and
- Fiscal Imbalance.

It will be necessary to consider which terms need to be defined and whether requirements should specify that a minimum set of indicators should be reported.

In developing its approach the FASAB has contrasted financial position, which is an entity-level attribute based on accrual-based principles and which is reported in the balance sheet (statement of financial position) and financial condition, which is a prospective and broader attribute that requires forward assumptions about both financial and non-financial data.

It is important to distinguish long-term fiscal sustainability and sustainability or environmental sustainability. This project is only dealing with long-term fiscal sustainability. However, there is a linkage between environmental sustainability and long-term fiscal sustainability because assumptions about environmental sustainability impact upon financial assumptions such as changes in GDP and demographic assumptions such as population growth, emigration and immigration.

ii) Mandatory/Discretionary Nature of Proposals and Requirements

The next question is whether the IPSASB should be developing mandatory or discretionary requirements i.e. should all entities within the scope be required to produce reports on long-term fiscal sustainability as a regular feature of their general-purpose reporting or should the scope be restricted by, for example:

- only applying to entities which elect to make their fiscal sustainability reports publicly available?; or
- only applying to entities that mention or discuss the fiscal sustainability report in the general-purpose financial statements?

In IPSAS 24, “Presentation of Budget Information in Financial Statements” the scope was limited to entities that make approved budgets publicly available. IPSAS 24 did not require that budgets be made publicly available. IPSAS 22, “Disclosure of Financial Information about the General Government Sector” only applies to governments that elect to disclose financial information about the general government sector in their consolidated financial statements. It does not require such disclosures to be made.

This will be the first time that IPSASB has developed requirements for any type of prospective reporting. This may suggest that, as a first step, a discretionary approach is sensible with the extension of that requirement to be considered in the future. However, the IPSASB’s view that long-term fiscal sustainability reporting is necessary to allow informed readers to assess the viability of governmental programs and to complement information in the general purpose financial statements may militate towards a mandatory approach.

The project will also examine whether requirements should apply to all entities or only to entities which have adopted the accrual basis of accounting. Long-term fiscal sustainability reporting involves the reporting of projected cash flows. Although it may be useful to be able to use items reported in the statement of financial position as a starting point in the estimation of key fiscal indicators involving net debt there is no intrinsic reason why requirements should only apply to entities already on the accrual basis. However, the range of assumptions required and the sophistication of estimation techniques militate towards excluding entities on the cash basis from the scope because of cost-benefit considerations.

iii) Reporting Entity for Long-term Fiscal Sustainability Reporting

The main issue is whether the requirements are to apply to all public sector entities; only government entities at the national level, to the whole-of-government level or to another level. The rationale for including all entities within the scope is that this is consistent with the entity-level approach that has characterized most IPSASB pronouncements. However, IPSAS 22 only applies to the consolidated financial statements of government, so there is a precedent for developing standards with requirements that do not apply to all public sector entities.

It is arguable that any requirements should only apply at the whole-of-government level because requiring individual entities to prepare and report information on the fiscal sustainability of operations is onerous and not proportionate to the benefit that users will derive from the information. Conversely, for nations with federalized structures, only developing requirements for part of the public sector may not satisfy user needs on the overall fiscal sustainability of the public sector: this particularly applies where the service delivery of significant public sector programs is the responsibility of entities at sub-national levels of government and where sub-national level entities have wide tax-raising powers.

This leads to the need for consideration of the linkage with statistical accounting approaches and in particular whether the general government sector (GGS) may provide the appropriate reporting boundary for fiscal sustainability reporting. The GGS encompasses all levels of government, regardless of whether control relationships exist, as well as social security funds and non-market non-profit entities controlled by government units. Under statistical accounting the public sector also comprises public financial corporations and public non-financial corporations. In contrast to the accrual basis the GGS does not consolidate controlled entities outside the GGS sector and does not therefore eliminate balances and transactions between entities in the GGS and other sectors. It treats controlling interests in entities outside GGS as investments. Statistical accounting is used as the basis for long-term fiscal sustainability reporting in a number of jurisdictions.

It will be necessary to determine the reporting entity for fiscal sustainability reporting and in so doing to analyze the advantages and disadvantages of reporting boundaries based on accrual and statistical approaches.

(iv) Interaction with Management, Discussion and Analysis

As indicated above, the IPSASB has decided that the project will deal with long-term fiscal sustainability from the broader perspective of general-purpose financial reporting rather than the

provision of information on the general-purpose financial statements. The IPSASB has decided to initiate a project on Management Discussion and Analysis (M, D &A otherwise known as management commentary, narrative reporting or the operating and financial review) in the first quarter of 2008. In some jurisdictions the M, D &A or equivalent is the main mechanism by which expected future trends and changing conditions to the operational environment and their potential impact on the reporting entity are highlighted for users. It will therefore be important to consider the extent to which the M, D & A should include details, and indicators of fiscal sustainability.

(v) Time Horizons

In jurisdictions which make long-term fiscal sustainability reports publicly available there is currently variability of the time horizon. For example:

- in its *Intergenerational Report* the Australian Commonwealth Government uses a 40 year horizon;
- in the *Statement of New Zealand's Long-Term Fiscal Position* a time horizon of at least 40 years is required;
- in its report, *The Long-Term Sustainability of Public Finances in The European Union*, published in 2006 the European Commission, used a time-horizon up until 2050;
- in its *Statement of Social Insurance* which is within the Consolidated US Financial Statements there is a time horizon of 75 years; and
- in its *Long-term Public Finance Report*, the UK Treasury uses a 50 year time horizon.

Obviously there is a relationship between the robustness of assumptions and the time horizon: the further the time horizon is from the reporting date the more fragile assumptions become. Whilst this consideration militates towards shorter- time horizons there is conversely what FASAB has termed a “moving window”: where events and modified trends just outside the reporting horizon might have a significant impact on reported information. This problem is potentially exacerbated by shorter time horizons.

The project will explore various time horizons and consider how prescriptive requirements should be.

(vi) Regularity of Reporting

Publication of the general-purpose financial statements is on an annual cycle. However, it is arguable whether the same frequency of reporting should be required for long-term fiscal sustainability reporting. This is both because of the costs of reporting and the fact that the key material policy, demographic and economic assumptions are unlikely to change sufficiently rapidly within a year to justify the costs of annual reporting. For example the Australian Intergenerational report is required every five years, whilst the New Zealand Statement on the Long-Term Fiscal position is required every four years. There is a need to consider whether there should be minimum intervals between reporting or whether any requirements should be more flexible, for example requiring reporting intervals to be disclosed with any changes to those intervals since previous reports were produced.

(vii) Assumptions and Sensitivity of Assumptions

Fiscal sustainability reporting entails use of a range of assumptions. These assumptions include:

- Policy assumptions;
- Demographic assumptions; and
- Economic assumptions.

The term *policy assumptions* refers to the basis on which future levels of service delivery will be determined. It is tentatively proposed that such assumptions should be on the basis of current legal frameworks. This is dealt with in more detail below (see section Tensions with Current Legal Frameworks).

Demographic assumptions include mortality and fertility projections, estimates of immigration and emigration and participation levels in the workforce and education

Economic assumptions include productivity changes, unemployment rates and participation rates in education and the workforce, and real and nominal economic growth rates.

It is not proposed that the IPSASB develop detailed requirements as to which assumptions should be used for long-term fiscal sustainability analysis. This will depend upon the portfolio area and the program. However, the project will consider the disclosure of such assumptions. Assumptions are inherently uncertain and changes in those assumptions can have a significant impact on projections: this is reflected in the fact that much current reporting devotes considerable attention to the sensitivity of those assumptions.

Assumptions also include discount rates. In order to determine the present value of future net cash-flows discounting is necessary. The selection of a discount rate can have a major impact on the amounts reported. Potential approaches include rates:

- Reflecting the time value of money;
- Reflecting a risk-free basis;
- Based on specified instruments;
- Based on expected return on assets to be used to meet future obligations or on future operating funds; and
- Based on future predicted economic growth rates.

(viii) Tensions with current legal frameworks

As a general principle IPSASs have adopted the tenet that transactions and elements are evaluated and determined within current legal frameworks. Such an approach has been adopted in ED 34, “Social Benefits: Disclosure of Transfers to Individuals and Households”. The view has been that the preparers of the financial statements should not predict governmental actions and that there should be no assumption that programs will terminate unless legislation to that effect has been enacted at the reporting date. If such a principle is adopted for long-term fiscal sustainability reporting the complementary approach to taxation would be that inflows should be determined using current legal requirements and taxation rates unless changes have been effected at the reporting date.

Issues arise as to the correct approach for projections under current frameworks where different legal obligations conflict or where projections are clearly unreasonable. Examples might be where:

- there is a legal requirement for a balanced budget and that requirement cannot be met under existing expenditure projections unless expenditure is reduced, benefits changed, contributions and taxation raised or through extensive disposals of assets: should balanced budget requirements take precedence over entitlements determined under existing legal frameworks or predicted growth trends?;
- where a program is operated on a segregated fund basis and benefits cannot be paid once the fund's earmarked assets have been exhausted and exhaustion is projected within the time horizon of the reporting framework; should the exhaustion of the fund be reflected in projections of outflows of benefits?; or
- projections require taxation levels or debt levels that are not "reasonably" feasible in a global environment.

In many instances legal obligations cannot be discharged unless annual appropriations are in place. However, limiting projections to appropriations would result in very short time horizons. The relationship between ongoing spending commitments and appropriation mechanisms will be examined.

(ix) Approach to Discretionary Programs

In broad terms, discretionary programs are programs which the government is not required to maintain under current legal requirements beyond a clearly specified period. In one jurisdiction discretionary programs are contrasted with mandatory programs which involve entitlements, with authorizations for discretionary programs being renewed on an annual basis. The main issue is whether expenditure projections should extend beyond the limit of current authorizations and, if so, how such expenditure projections are to be projected for such programs. A related issue is that discretionary programs are likely to expire before the time horizons used for reporting, so it is questionable whether an assumption should be made that such programs will be renewed on expiry.

A further issue is the appropriate assumption for making expenditure projections for discretionary programs. Such assumptions might include:

- use of 5-10 year trend information for extrapolation purposes;
- same projected growth rate as for GDP;
- a general or specific inflation index.

(x) Comprehensiveness of Reporting

The issue is whether all governmental programs should be considered or whether the scope should be restricted to only certain programs e.g. contributory programs or social insurance programs.

Action Requested: Confirm the key issues highlighted by Staff and **identify** any further issues that need to be added to the project brief.

COMMUNICATION

Staff has been impressed by the emphasis on communication in the FASAB project. A key component of the FASAB project has been to make information accessible understandable and meaningful to the public, using as a criterion the average citizen who has a reasonable understanding of governmental activities and is willing to study that information with reasonable diligence. The rationale is that there is already considerable and highly detailed information produced by a variety of bodies such as Office for Management and Budget, the Congressional Budget Office and the Government Accountability Office: developing requirements that simply lead to the provision of further detailed information or the reformulation of existing requirements in formats that are not easily comprehensible will not satisfy user needs.

This leads to the issues of whether a separate Communications Plan is required for this project and whether in conjunction with the issue of a Consultation Paper it would be worthwhile to hold forums or roundtables, which might include a variety of constituents including concerned citizen groups.

Action Requested: Provide views on whether a separate Communications Plan should be developed and preliminary views on whether a Roundtable should be planned in conjunction with the publication of Consultation Paper.

ARRANGEMENTS FOR OVERSIGHT AND DEVELOPMENT OF PROJECT

Staff considers that a Task Force comprising seven to nine members would be the appropriate way of progressing this project. It is important that the Task Force reflects both geographical balance and expertise from accounting standard-setters, preparers, statistical accounting, budget development and auditing. Whilst the main expertise for progressing the project is within the Board and its Technical Advisors and Observers consideration should be given to the appointment of external members. Staff has suggested that, in view of the FASAB project, it would be worthwhile to include a FASAB Staff Member in the Task Force. The project brief proposes the following composition:

- Two public sector standard-setters, one of which will have a current project in this area;
- One government entity preparer of general-purpose financial statements;
- Two statistical accountants with experience of preparation of long-term fiscal sustainability projections;
- One preparer of government budget reports;
- One legislative auditor;
- Two surrogates for users of financial statements (e.g. from the IPSASB Observer group, academics, member of legislative assembly).

It is envisaged that the Task Force will communicate generally by electronic means. Two face-to-face meetings are likely to be necessary: one during the Consultation Paper development stage and one during the stage to develop and ED and/or draft guidance. Task force membership will be determined by the Chair and Technical Director.

TIMETABLE

A detailed timetable is provided in the project brief. The main milestones are:

Consultation Paper to be approved: February 2009

Exposure Draft of Standard/Draft Guidance to be approved: June 2010

Final Standard/Final Guidance: June 2011



DRAFT

**INTERNATIONAL PUBLIC SECTOR
ACCOUNTING STANDARDS BOARD**

PROJECT BRIEF AND OUTLINE

1. Subject

Reporting on and making disclosures about the long-term fiscal sustainability of governmental programs.

2. Project Rationale and Objectives

During the development of its project on social benefits the IPSASB has formed a view that, regardless of the approach that is taken to the point at which a present obligation for different sorts of social benefits occurs and the view as to the extent of those present obligations and the resultant liabilities, the financial statements cannot satisfy all the needs of users in assessing the future viability of programs providing social benefits. The information in the financial statements needs to be complemented by information on the long-term fiscal sustainability of those programs.

a) Objectives to be achieved

The ultimate objective of the project is to produce a framework for the reporting and disclosure of information related to the long-term fiscal sustainability of governmental programs.

The initial intermediate objective is to produce a Consultation Paper. The Consultation Paper will highlight and analyze existing approaches in jurisdictions where fiscal sustainability reporting is a feature of governmental financial management as well as the approaches of supra-national bodies such as the European Commission and the International Monetary Fund in making comparative fiscal projections.

This is not a project directly related to the general purpose financial statements. It is therefore not feasible or appropriate to provide definitive final outputs at the initiation stage. Dependent upon decisions following analysis of submissions on a Consultation Paper, an Exposure Draft of a Standard and/or detailed Guidance will be developed.

b) Link to IFAC/IPSASB Strategic Plans

Link to IFAC Strategic Plan

Issuing requirements and guidance on public sector financial reporting issues is a primary role of the IPSASB. The development of such requirements and guidance supports IFAC's mission of

serving the public interest by contributing to its aim of becoming the international standard-setter for governmental financial reporting.

Link to IPSASB Strategy

This is an area which has become increasingly topical and relevant to the enhancement of public sector accountability. The absence of public sector specific guidance on fiscal sustainability reporting and disclosures is a ‘gap’ in the IPSASB literature which has become apparent during the IPSASB’s project on social benefits. It is consistent with IPSASB’s strategic theme of developing requirements and guidance on public sector specific issues.

3. Outline of the Project

a) Project Scope

The scope of the project is the long-term fiscal sustainability of governmental programs. The range of entities and levels of government to be within the scope of finalized outputs will be determined following analysis of submissions on a Consultation Paper.

Certain other issues relating to scope will be considered in the course of the project. These include whether:

- all governmental programs should be within the scope; or
- whether the scope should be restricted to only certain programs e.g. contributory programs or social insurance programs.

This project is only dealing with long-term fiscal sustainability and not environmental sustainability. However, there is a linkage between environmental sustainability and long-term fiscal sustainability, because assumptions about environmental sustainability impact upon financial assumptions such as changes in Gross Domestic Product (GDP) and demographic assumptions such as population growth, emigration and immigration. The project will acknowledge those linkages.

b) Major Problems and Key Issues that Should be Addressed

i) Definitions

There is no globally accepted definition of fiscal sustainability or long term-fiscal sustainability, although a number of governments have developed formal or implied definitions of these terms or related terms. In some cases these definitions are located in the context of medium-term fiscal planning or budgetary frameworks, as when fiscal sustainability is linked to specific targets such as a pre-determined net debt/Gross Domestic Product (GDP) ratio or net debt/GDP per capita ratio; overall governmental spending is said to be fiscally sustainable if it is contained within these pre-determined and publicly communicated targets.

At a very high level, fiscal sustainability involves an assessment of the extent to which service delivery can be maintained at existing levels and the extent to which governmental obligations to citizens under existing legal frameworks can be met over a pre-determined future period. The analysis of fiscal sustainability therefore takes account of both current and future beneficiaries,

regardless of whether present obligations to them, determined in accordance with accrual accounting principles, exist at the reporting date.

Fiscal sustainability is sometimes coupled with the broad concept of inter-generational equity, which evaluates the extent to which future generations of taxpayers will be affected by the fiscal consequences of current policies for the delivery of goods and services. Inter-generational equity therefore considers whether, and to what extent, the cost of current government operations is likely to be met by future generations of taxpayers, and the extent to which future taxpayers will be provided with services and benefits equivalent to current levels.

The reporting of fiscal sustainability is also commonly linked to frameworks involving targets and benchmarks involving such indicators as:

- Net Debt
- Net Debt/GDP
- Fiscal Gap
- Fiscal Imbalance

The project will consider which terms need to be defined and whether requirements/guidance should specify or recommend that a minimum set of indicators should be reported.

ii) Mandatory/Discretionary Nature of Proposals and Requirements

The project will consider whether the IPSASB should be developing requirements and if so, whether such requirements should be mandatory or discretionary i.e. should all entities within the scope be required to produce reports or disclosures on long-term fiscal sustainability as a regular feature of their general-purpose reporting or should the scope be restricted by, for example:

- only applying to entities which elect to make their fiscal sustainability reports publicly available?; or
- only applying to entities that mention or discuss the fiscal sustainability report in the general-purpose financial statements?

The project will also examine whether requirements should apply to all entities or only to entities which have adopted the accrual basis of accounting.

iii) Reporting Entity for Long-term Fiscal Sustainability Reporting

The main issue is whether the requirements and guidance are to apply to all public sector entities; only government entities at the national level, to the whole-of-government level or to another level.

It is arguable that any requirements should only apply at the whole-of-government level because requiring individual entities to prepare and report information on the fiscal sustainability of operations is onerous and not proportionate to the benefit that users will derive from the information. Conversely, for nations with federalized structures, only developing requirements for part of the public sector may not satisfy user needs on the overall fiscal sustainability of the sector: this particularly applies where the service delivery of significant public sector programs is the responsibility of entities at sub-national levels of government and where sub-national level entities have wide tax-raising powers.

The project will consider statistical accounting approaches and in particular whether the general government sector (GGS) may provide the appropriate reporting boundary for fiscal sustainability reporting. The GGS encompasses all levels of government, regardless of whether control relationships exist, as well as social security funds and non-market non-profit entities controlled by government units. Under statistical accounting the public sector also comprises public financial corporations and public non-financial corporations. In contrast to the accrual basis the GGS does not consolidate controlled entities outside the GGS sector and does not therefore eliminate balances and transactions between entities in the GGS and other sectors. It treats controlling interests in entities outside GGS as investments. Statistical accounting is used as the basis for long-term fiscal sustainability reporting in a number of jurisdictions.

It will be necessary to determine the reporting entity for fiscal sustainability reporting and in so doing to analyze the advantages and disadvantages of reporting boundaries based on accrual and statistical approaches.

(iv) Time Horizons

In jurisdictions which make long-term fiscal sustainability reports publicly available there is variation in the time horizons adopted-the period over which projections are made. There is a relationship between the robustness of assumptions and the time horizon: the further the time horizon is from the reporting date the less robust assumptions become. Whilst this consideration militates towards the adoption of shorter- time horizons, this increases the risk that events and modified trends just outside the reporting horizon might have a significant impact on reported information. The project will explore various time horizons and consider how prescriptive any requirements should be.

(v) Regularity of Reporting

Publication of the general-purpose financial statements is on an annual cycle. However, it is arguable whether the same frequency of reporting should be required or recommended for long-term fiscal sustainability reporting. This is both because of the costs of reporting and the fact that material policy assumptions, demographic assumptions and economic assumptions are unlikely to change sufficiently rapidly within a year to justify the additional costs of annual reporting.

The project will consider whether there should be minimum intervals between reporting or whether any requirements should be more flexible, for example requiring reporting intervals to be disclosed with any changes to those intervals since previous reports were produced.

(vi) Assumptions and Sensitivity of Assumptions

Fiscal sustainability reporting entails use of a range of assumptions. These assumptions include:

- Policy assumptions;
- Demographic assumptions; and
- Economic assumptions.

The term *policy assumptions* refers to the basis on which future levels of service delivery will be determined. It is tentatively proposed that such assumptions should be on the basis of current legal frameworks. This is dealt with in more detail below

Demographic assumptions include mortality and fertility projections, estimates of immigration and emigration and participation levels in the workforce and education

Economic assumptions include productivity changes, unemployment rates and participation rates in education and the workforce, and real and nominal economic growth rates.

The very preliminary view at the onset of the project is that the IPSASB should not develop detailed requirements as to which assumptions should be used for fiscal sustainability analysis. This will depend upon the portfolio area and the program. However, the project will consider the disclosure of such assumptions. Assumptions are inherently uncertain and changes in those assumptions can have a significant impact on projections: The project will also address the sensitivity of assumptions.

Assumptions also include discount rates. In order to determine the present value of future net cash-flows discounting is necessary. The selection of a discount rate can have a major impact on the amounts reported. The principles governing the selection of discount rates for long-term fiscal sustainability reporting will be explored.

(vii) Tensions with current legal frameworks

As a general principle IPSASs have adopted the tenet that transactions and elements are evaluated and determined within current legal frameworks. The view has been that the preparers of the financial statements should not predict governmental actions and that there should be no assumption that programs will terminate unless legislation to that effect has been enacted at the reporting date. If such a principle is adopted for long-term fiscal sustainability reporting the complementary approach to taxation would be that inflows should be determined using current legal requirements and taxation rates unless changes have been effected at the reporting date.

Issues arise as to the correct approach for projections under current frameworks where different legal obligations conflict or where projections are clearly unreasonable. Examples might be where:

- there is a legal requirement for a balanced budget and that requirement cannot be met under existing expenditure projections unless expenditure is reduced, benefits changed, contributions and taxation raised or through extensive disposals of assets: should balanced budget requirements take precedence over entitlements determined under existing legal frameworks or predicted growth trends?;

- where a program is operated on a segregated fund basis and benefits cannot be paid once the fund's earmarked assets have been exhausted and exhaustion is projected within the time horizon of the reporting framework; should the exhaustion of the fund be reflected in projections of outflows of benefits?; or
- projections require taxation levels or debt levels that are not "reasonably" feasible in a global environment, acknowledging that deterring "reasonableness" is highly problematic and risks questioning governmental policy intentions.

In many instances legal obligations cannot be discharged unless annual appropriations are in place; limiting projections to appropriations would result in very short time horizons. The relationship between ongoing spending commitments and appropriation mechanisms will therefore be examined.

(viii) Approach to Discretionary Programs

Discretionary programs are programs which the government is not required to maintain under current legal requirements beyond a clearly specified date. Discretionary programs may be contrasted with mandatory programs which involve entitlements. Authorizations for discretionary programs may be renewed on an annual basis.

The main issue is whether expenditure projections should extend beyond the limit of current authorizations and, if so, how expenditure projections are to be projected for such programs. A related issue is that discretionary programs are likely to expire before the time horizons used for reporting, so it is questionable whether an assumption should be made that such programs will be renewed on expiry.

A further issue is the appropriate assumption for making expenditure projections for discretionary programs. Such assumptions might include:

- use of 5-10 year trend information for extrapolation purposes;
- same projected growth rate as for GDP; or
- a general or specific inflation index.

4. Implications for Specific Groups

a) IASB

There is an indirect relationship with the IASB's Conceptual Framework project, although this is primarily addressed through the IPSASB's own Conceptual Framework project. The IASB also has a project on Management Commentary and issued a Discussion Paper in late 2005. The IASB will consider whether a project on Management Commentary should be added to its active agenda in December 2007. Whilst this project will primarily have an influence on the planned IPSASB project on Management's Discussion and Analysis it will be relevant indirectly to this project. In its Discussion Paper the authors of the IASB Discussion Paper proposed that in addition to taking a historical perspective the Management Commentary should take a prospective view in considering the main trends and factors likely to affect an entity's future development, performance and position.

b) Relationship to other IPSASB projects in process or planned

There are relationships with a number of current or planned IPSASB projects:

(i) *Social benefits*

The IPSASB has an ongoing project on social benefits. The IPSASB's deliberations on social benefits have been catalysts in the decision to initiate this project. The approach in ED 34, "Social Benefits: Disclosure of Transfers to Individuals and Households" is a bridge between accrual approaches and the development of fiscal sustainability information.

(ii) *Conceptual Framework*

A project to develop a public sector conceptual framework is underway. This is led by the IPSASB and carried out in collaboration with the national standard-setters. The components of this Project dealing with the scope of financial reporting, the reporting entity and the objectives of financial reporting are relevant to this project.

(iii) *Management's Discussion and Analysis*

The IPSASB has decided to initiate a project on Management's Discussion and Analysis (M, D & A otherwise known as management commentary, narrative reporting or the operating and financial review) in the first quarter of 2008. In some jurisdictions the M, D & A or equivalent is the main means by which expected future trends and changing conditions to the operational environment and their potential impact on the reporting entity are highlighted. Both this project and the separate M, D & A project will consider the extent to which the M, D & A should include details, and indicators, of fiscal sustainability.

c) Other

Reports on the long-term fiscal sustainability of governmental programs are made publicly available in a number of jurisdictions and supra-national bodies also make comparative analyses of the financial condition of nation states available.

Globally a number of public sector standard-setters are considering or developing requirements for narrative reporting in the public sector.

The Financial Report of the United States Government includes a Statement of Social Insurance (SOSI) which adopts a 75 year time horizon for specified programs. The US Financial Accounting Standards Advisory Board (FASAB) has a Standard, SFFAS 17, "Accounting for Social Insurance (Revised 2006)", which provides requirements for the SOSI. FASAB is also developing a Standard providing requirements for broader fiscal sustainability reporting.

5. Development Process, Project Timetable and Project Output

a) Development process

The development of outputs will be subject to the IPSASB's formal due process. The issuance of documents for public comment will be subject to the usual IPSASB voting rules. As the project progresses, regular assessments will be made to confirm the proposed path in the project timetable remains the most appropriate.

The initial output will be a Consultation Paper. Following analysis of submissions on the Consultation Paper a decision will be made on whether to develop an Exposure Draft of

Reporting Requirements and/or Guidance. An Exposure Draft and/or Guidance will also be subject to formal due process, including a consultation period of at least four months.

Project timetable

2007	
November	Project proposal approved
December	Task Force selected and confirmed
2008	
January-September	Task Force develops Consultation Paper
March	Update to Meeting of IPSASB
June	Update to Meeting of IPSASB
October	IPSASB reviews first draft of Consultation Paper
2009	
February	IPSASB reviews second draft of Consultation Paper and approves for publication
March	Publication of Consultation Paper
March-July	Exposure period for Consultation Paper
August-September	Staff analysis of submissions to Consultation Paper
October	IPSASB considers analysis of submissions to Consultation Paper and adopts approach for final stage of project
2010	
February	IPSASB reviews first draft of Exposure Draft (ED) and/or guidance
June	IPSASB approves ED and/or guidance
July	ED and/or guidance issued
July-November	Exposure period for ED and/or guidance
2011	
February	IPSASB considers analysis of submissions to ED/Guidance and provides directions for finalization of final stage outputs
June	IPSASB approves IPSAS and/or Guidance

b) Project output

The initial output will be a Consultation Paper. As indicated above definitive final outputs will be determined following analysis of submissions on the Consultation Paper. It is likely that the final output will be an Exposure Draft of a Standard and/or detailed Guidance.

6. Resources Required

a) Task Force

A task force is proposed with a membership of nine (including Chair) – a task force of this size is necessary to reflect a broad cross section of IPSASB constituents and to enable a range of points of view, technical expertise and discussion for the development of this project. However, a larger Task Force might prove unmanageable. Geographical representation is also important to ensure that insights and experience from all with experience of long-term fiscal sustainability reporting are obtained. It is likely that the Task Force will include both IPSASB representation-Members, Technical Advisers and Observers- and external members. The following approximate composition is envisaged:

- Two public sector standard-setters, one of which will have a current project in this area;
- One government entity preparer of general-purpose financial statements;
- Two statistical accountants with experience of preparation of long-term fiscal sustainability projections;
- One preparer of government budget reports;
- One legislative auditor;
- Two surrogates for users of financial statements (e.g.: from the IPSASB Observer group, Consultative Group, academics, members of legislative assemblies).

Selection of task force members will be made by the Technical Director and IPSASB Chair.

Communication will be primarily carried out electronically. The majority of meetings are expected to be by conference call. It is expected that there will be at least two face-to-face meetings.

It is the current intention that all project materials will be written by IPSASB staff.

b) Staff

It is envisaged that 0.75 Full Time Equivalent (FTE) resource (not dedicated) will be required to resource the project.

7. Important Sources of Information that Address the Matter being Proposed

- A number of governments and supra-national bodies publish reports on the long-term fiscal sustainability of programs.
- A number of standard-setters are developing approaches to public sector narrative reporting.
- Some standard-setters have developed, or are in the process of initiating development, of requirements for prospective reporting.

8. Factors that might add to complexity or length

The project addresses a large subject in an area which is outside the general-purpose financial statements. This is a new topic for the IPSASB and there are very few current pronouncements addressing this area and therefore little relevant experience to draw on. Decisions made following analysis of the initial consultation paper will also affect the length of the project, in particular whether it is decided to develop both requirements and guidance.

Prepared by John R. Stanford
(Senior Technical Manager IPSASB)

Date 12 November /2007

The following should be completed after board or committee approval and after revising the project proposal form to reflect any changes by the board or committee.

Approved by _____

Date _____

(Chair IPSASB)

COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board or committee proposing to undertake the project.

Technical Manager to the Compliance Advisory Panel

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the DNC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the SMPC

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IESBA

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAASB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the PAIB Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the IAESB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____

Technical Manager to the Transnational Auditors Committee

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____

Date _____