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Government Brief

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Tools to Answer the Question: Are You Depending on U. S. Federal Government Policies that May be Unsustainable?

By: D. Scott Showalter, CPA, CGFM

Let's face it; we all have a stake in the financial condition of the federal government. Most of us are not aware that the U.S. Department of the Treasury produces financial statements for the federal government every year or that these statements include bold conclusions such as:

> ….the projections in this report indicate that current policy is not sustainable. (Financial Report of the U.S. Government, Fiscal Year (FY) 2014)

One would not expect to find such a statement in corporate financial statements, let alone the federal government.

The Financial Report of the U.S. Government (FR) is prepared based on generally accepted accounting principles (GAAP) established by the Federal Accounting Standards Advisory Board (FASAB). FASAB promulgates Statements tailored to the federal government and provides information similar to that found in corporate financial reports. As such, the FR includes some traditional presentations, such as a balance sheet providing a report of assets and liabilities; however, it goes further in providing information needed to answer the important question of whether future budgetary resources are likely to be sufficient to sustain public services and to meet obligations as they become due.

Answering this question is of importance to all organizations and individuals and requires projections to answer. Projections on this scale are not traditionally included in corporate GAAP-based financial reports. To answer critical questions about sustainability, the FR provides a Statement of Long-Term Fiscal Projections. This Statement presents the U.S. Government's estimated future revenue and future expenditures, as well as the resulting debt.

The projections are based on a simple question: "What if current policy, without change to federal government public services and taxation, is continued in the future?" Therefore, the projections assume the public will continue to demand the same level of services it currently receives and to pay taxes at roughly the same level currently paid. This means the projections are not based on future changes to meet the policy goals of a particular administration. Instead, they are based on continuing along the current path and demonstrate how known demographic changes, expected health care cost increases, and other established policies may affect cash flows and debt.

The most important aspects to consider about these projections are that they:

- require assumptions about the future, and actual results will differ and may differ materially

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

Watch for the next report – covering FY 2015 – to be issued in late February 2016. As this is an election year, the information is relevant to all voters; however, the information has special relevance to finance professionals in all sectors. State and local governments rely on the federal government for approximately 30 percent of their funding and their needs rise in recessions (Fiscal 50: State Trends and Analysis, Pew Trust, December 10, 2015). For-profit enterprises do not receive federal government support like state and local governments but pay taxes, compete for federal contracts, and are impacted by general economic conditions, such as growth in gross domestic product (GDP) and interest rates.

The FR provides useful information for making plans for the future and should be shared and discussed with colleagues, state and local government officials, non-government organization executives, clients, friends, and family. As finance professionals, we are in a unique position to harness the revealing information provided in the FR.

The projections also include supplementary information explaining their effects on debt as well as the fiscal gap—that is, the size of the change in spending or receipts needed to maintain debt at or below an established goal. To make the FY 2015 FR information easier to understand, the remainder of this post describes the FY 2014 information and how it might be useful.

1. **Long-Term Projections of Federal Receipts and Non-interest Spending** – These projections serve as the basis for all the supplemental information that follows. Standing alone, they are of interest because they reveal the significant shortfall in receipts and changes in the composition of spending over time. Figure 1 below shows the fiscal years 2014 and 2013 results. The comparisons help identify areas that changed during the reporting period.

   It is rare to see financial results of this magnitude – hundreds of trillions of dollars on a present value basis. The simplest way to analyze the amounts is to focus on the percent of GDP in the columns to the far right. The percentages show how these receipts and activities relate to the U.S. economy as a whole and change over time.

   The highlighted cells for Social Security, Medicare, and Medicaid reveal the significance of these major programs. Further, the Social Security and Medicare amounts can be compared to the payroll taxes (receipts) intended to fund them. Spending on these two major payroll tax funded programs is projected to exceed these payroll taxes by 1.6 percent of GDP for Social Security and by 5.5 percent of GDP for Medicare.

Figure 1: Long-Term Fiscal Projections of Federal Receipts and Non-interest Spending

	75-Year Present Values [1]					
	Dollars in Trillions			%GDP [2]		
Receipts:	**2014**	**2013**	**Change**	**2014**	**2013**	**Change**
Social Security Payroll Taxes	$47.9	$ 46.1	$ 1.8	4.3	4.2	0.1
Medicare Payroll Taxes	16.1	15.4	0.7	1.4	1.4	0.0
Individual Income Taxes	117.1	113.2	3.9	10.5	10.4	0.1
Other Receipts	42.5	41.5	1.0	3.8	3.8	0.0
Total Receipts	**223.6**	**216.2**	**7.5**	**20.0**	**19.8**	**0.2**
Non-interest Spending:						
Social Security	65.5	62.4	3.0	5.9	5.7	0.1
Medicare Part A [3]	23.0	23.5	-0.5	2.1	2.2	-0.1
Medicare Parts B&D [4]	27.8	24.4	3.3	2.5	2.2	0.2
Medicaid	26.0	25.2	0.7	2.3	2.3	0.0
Other Mandatory	31.1	34.0	-2.8	2.8	3.1	-0.3
Defense Discretionary	26.9	23.1	3.8	2.4	2.1	0.3
Non-Defense Discretionary	28.1	27.4	0.7	2.5	2.5	0.0
Total Non-interest Spending	**228.4**	**220.2**	**8.2**	**20.4**	**20.2**	**0.3**
Non-interesting Spending less Receipts	$ 4.7	$ 4.0	$ 0.7	0.4	0.4	0.1

1 - 75-year present value projections for 2014 are as of 9/30/2014 for the period FY 2015-2089;

2 - The 75-year present value of nominal GDP, which drives the calculations above is $1,117.2

3 - Represents portions of Medicare supported by payroll taxes.

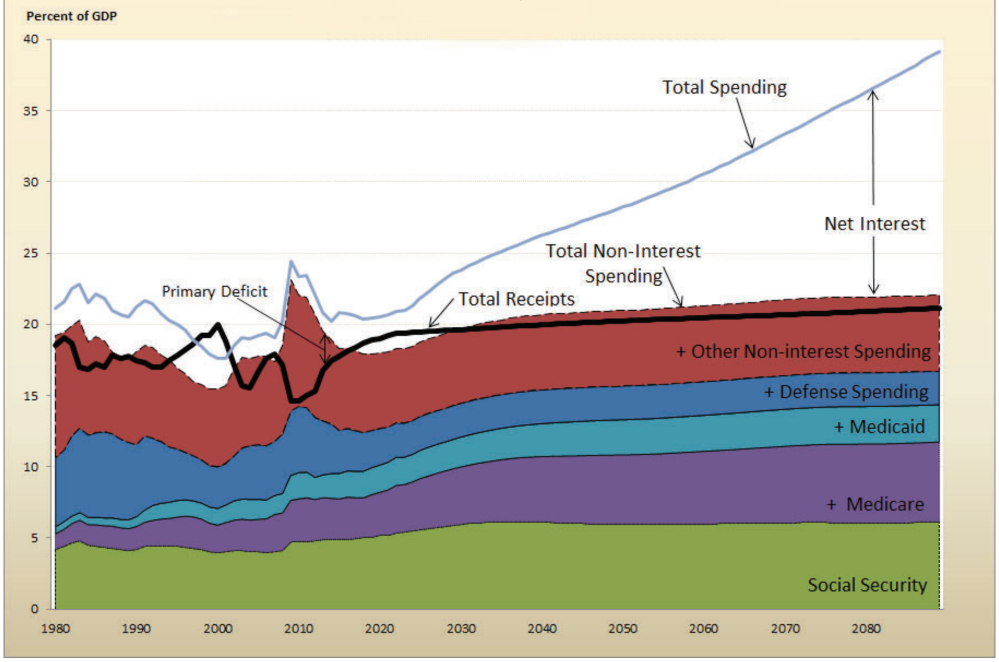
4 - Represents portions of Medicare supported by general revenues. Consistent with the President's Budget, outlays for Parts B & D are presented net of premiums.

NOTE: Totals may not equal the sum of components due to rounding.

[1] Source for all figures is the Fiscal Year 2014 Financial Report of the U. S. Government, Required Supplementary Information. See https://www.fiscal.treasury.gov/fsreports/rpt/finrep/finrep14/fr_index_new.htm.

Figure 2 below provides an annual perspective on the receipts and non-interest spending underlying these present value amounts, as well as the net interest cost that results. The graph provides the historical amounts, as well as future projections to show increases over time. The growth in Social Security, Medicare, Medicaid, and net interest appears to crowd out other non-interest spending, such as investments in research, education, and infrastructure. This information is relevant to everyone who relies on the receipt of these federal expenditures.

Figure 2: Historical and Current Policy Projections for Receipts, Non-interest Spending, Net Interest, and Total Spending 1980-2089



2. **The Debt** – The substantial imbalance in the budget revealed in the preceding projections results in steady increases in debt held by the public over time. The FR describes this as follows:

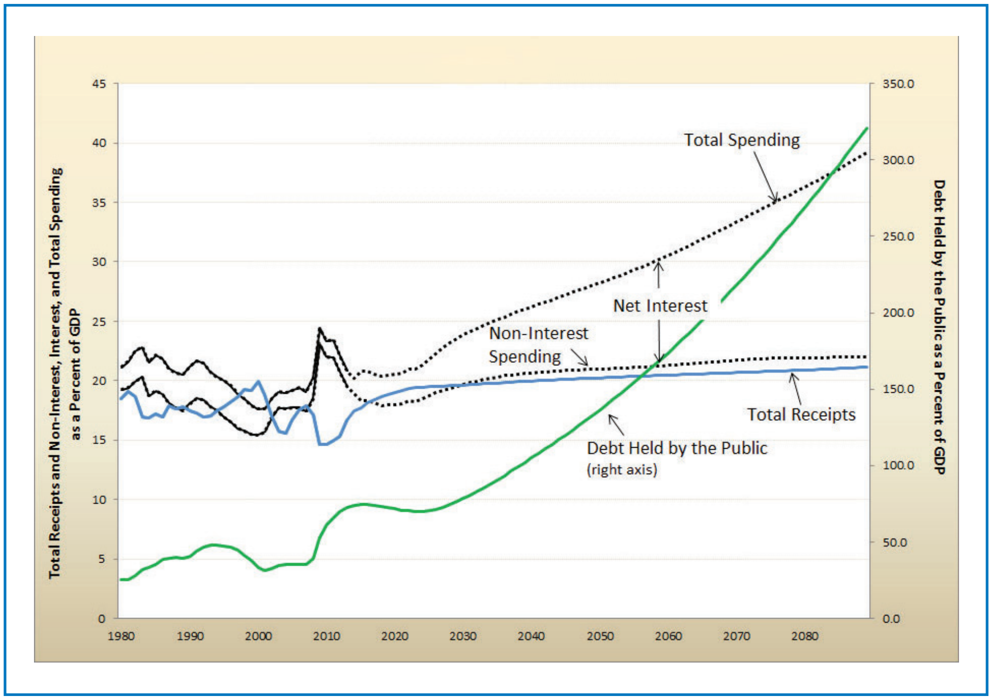
> The debt-to-GDP ratio was 74 percent at the end of FY 2014, and under current policy is projected to be 70 percent in 2024, 117 percent in 2044, and 321 percent in 2089. The debt-to-GDP ratio rises at an accelerating rate despite primary deficits that flatten out because higher levels of debt lead to higher net interest expenditures, and higher net interest expenditures lead to higher debt. The continuous rise of the debt-to-GDP ratio after 2024 indicates that current policy is unsustainable.

Perhaps the most compelling way to convey the above message is the FR's "History and Current Policy Projections for Total Receipts; Non-interest Spending, Net Interest, and Total Spending; and Debt Held by the Public," presented as Figure 3 below. The scale on the right axis of the chart is the debt as a percent of GDP. Few citizens are likely to believe that the nation can sustain debt in the 300 percent of GDP range. However, general agreement regarding the right target debt-to-GDP ratio is elusive. Suffice to say that "all else being equal, the larger a government's debt, the greater the risk of a fiscal crisis." [2]

A picture is worth a thousand words – so please consider sharing Figure 3 with everyone you know.

[2] Congressional Budget Office, THE 2015 LONG-TERM BUDGET OUTLOOK, June 2015.

Figure 3: History and Current Policy Projections for Total Receipts; Non-interest, Net interest, and Total Spending; and Debt Held by the Public, 1980-2089.



3. **Fiscal Gap –** The fiscal gap is the change in non-interest spending[3] and/or receipts necessary to maintain public debt at or below a target percentage of GDP. The fiscal gap can be expressed as a dollar amount in present value dollars, a percentage of the present value of GDP for the projected period, or as a percentage of the present value of projected receipts or projected non-interest spending.

   From the FY 2014 FR, we learn that the fiscal gap was estimated at 2.1 percent of GDP as of year-end and compared to 1.7 percent at the end of FY 2013. Note that the gap must be closed to hold the debt-to-GDP ratio to 74 percent, the ratio at the end of FY 2014.

   While the estimated fiscal gap of 2.1 percent of GDP does not sound incredibly foreboding, the FR explains that this equates to 10.3 percent of the projected receipts and 10.0 percent of the projected non-interest spending over the same period. While it is unlikely that the gap would be closed solely through an increase in receipts (taxes) or a decrease in spending, these relationships allow citizens and businesses to gauge the magnitude of changes needed in taxes or spending.

4. **Cost of Delay –** If the foregoing information has not persuaded you that the time to act is now, the FR also explains the impact of delaying action; that is, the cost of delay. This information engenders thoughts of our children and grandchildren. Inaction today has consequences for all of us, and the FR associates several outcomes with such delays.

The FY 2014 FR explains:

> The timing of changes to non-interest spending and receipts that close this "75-year fiscal gap" has important implications for the well-being of future generations.

[3] Non-interest spending is the difference between total budget expenditures and interest expenditures.

- For example, relative to a policy that begins immediately, if action is delayed by 10 years, it is estimated that the magnitude of reforms necessary to close the 75-year fiscal gap will increase by nearly 20 percent; if action is delayed by 20 years, the magnitude of reforms necessary will increase by nearly 50 percent.

- Future generations are harmed by a policy delay of this sort because, the higher are the primary surpluses during their lifetimes, the greater is the difference between the taxes they pay and the programmatic spending from which they benefit.

It appears this problem will not be swiftly resolved. Consider the statements included in the FY 2009 FR:

> **Financial Report of the U.S. Government, Fiscal Year 2009 …** Looking forward, in the absence of policy changes, large and growing primary deficits will increase debt held by the public and interest on that debt … These estimates illustrate that current policies are not sustainable … If policy changes are delayed, the magnitude of the policy changes that would be needed to stabilize the debt-to-GDP ratio would be greater.

Closing

As I begin my term as chairman of the FASAB, my hope is to make more people aware of the vital financial information provided annually by the U. S. Department of the Treasury on the U.S. Government's current financial position and condition, including fiscal sustainability. As finance professionals, we should consider sharing this information with key decision makers and our fellow citizens. In addition, we welcome your feedback regarding GAAP. Our website provides more information about FASAB and ways you can participate (www.fasab.gov).

Author's Bio

D. Scott Showalter, CPA, CGFM is a professor of practice at the Poole College of Management, NC State University and the chairman of the Federal Accounting Standards Advisory Board. Prior to joining NC State, Mr. Showalter was a partner at KPMG LLP, and retired in 2008 after a 33-year career. He has previously served on the Public Company Accounting Oversight Board's Standing Advisory Group and the Pathways Commission.

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