United States General Accounting Office

GAO

Report to the Chairman, Committee on the Budget, House of Representatives

January 2003

FISCAL EXPOSURES

Improving the Budgetary Focus on Long-Term Costs and Uncertainties

GAO
Accountability ★ Integrity ★ Reliability

GAO-03-213

January 2003

FISCAL EXPOSURES

Improving the Budgetary Focus on Long-Term Costs and Uncertainties

GAO Accountability•Integrity•Reliability

Highlights

Highlights of GAO-03-213, a report to the Committee on the Budget, House of Representatives

Why GAO Did This Study

GAO and other budget experts have discussed that the current time horizons and content of the federal budget could be enhanced to more comprehensively reflect the government's commitments or signal emerging problems. GAO was asked to (1) provide information on the range and nature of responsibilities, programs, and activities that may explicitly or implicitly expose the government to future spending and (2) present and discuss options for increasing the attention paid to these items in the budget and budget process.

What GAO Recommends

GAO recommends that OMB report annually on fiscal exposures. Where possible, OMB should report the estimated costs—"exposure level"—of certain activities in the Program and Financing schedules of the budget. In a few select areas, the ultimate objective might be to include costs directly in the budget when doing so would enhance up-front control of spending.

Congress may wish to consider exploring options for improving the budgetary information and the attention given to fiscal exposures. If more explicit congressional consideration is desired, as estimates improve, Congress may wish to develop budget process mechanisms that prompt more deliberation.

www.gao.gov/cgi-bin/getrpt?GAO-03-213.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Paul Posner at (202) 512-9573 or posnerp@gao.gov.

What GAO Found

The federal government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or simply create an expectation for spending. GAO uses the concept of "fiscal exposure" (risk) to provide a framework to consider these long-term costs and uncertainties.

Fiscal exposures vary widely as to source, extent of the government's legal obligation, likelihood of occurrence, and magnitude. These exposures include items such as retirement benefits, environmental cleanup costs, and future social insurance benefits. Given this variety, it is useful to think of a spectrum extending from explicit liabilities to implicit promises embedded in current policy or public expectations.

Fiscal exposures warrant budgetary attention and oversight. Demographic trends, in particular, argue for considering the long-term sustainability and flexibility of the government's fiscal position. Regardless of whether the government is legally required or simply compelled by circumstances, some exposures may encumber future budgets and constrain fiscal policy. Not capturing the long-term costs of current decisions limits Congress's ability to control the government's fiscal exposures at the time decisions are made.

Current budget reporting, however, does not always fully capture or require explicit consideration of some fiscal exposures. For some exposures, such as environmental cleanup costs, the government's commitment occurs years before the cash consequences are reflected in the budget. Other potential draws on future resources, such as life-cycle costs for fixed assets and disaster assistance, may not flow from commitments of a strictly legal nature but from public expectations.

Determining how to improve the budgetary attention to fiscal exposures is complicated by difficulties in (1) determining the scope of items to be considered and (2) estimating costs. The variety of fiscal exposures and the difficulties in estimating their costs suggest that an across-the-board approach may not be the best way to proceed. Improved supplemental information may be helpful to increase transparency without introducing additional uncertainty and complexities into the budget. In cases where the extent of the government's obligation or ultimate costs (or both) is unclear, supplemental reporting may be the most appropriate approach. Beyond increasing supplemental reporting, providing more opportunities to consider fiscal exposures in the budget process may help facilitate explicit consideration of certain exposures. Finally, in some cases where there is an explicit liability and accepted, reasonable cost estimates exist, additional steps may be taken to directly incorporate costs in the budget when doing so would enhance up-front control of spending.

Contents

Abbreviations

CBO	Congressional Budget Office
DOD	Department of Defense
GDP	gross domestic product
OMB	Office of Management and Budget

GAO Accountability ★ Integrity ★ Reliability

United States General Accounting Office
Washington, D.C. 20548

January 24, 2003

The Honorable Jim Nussle
Chairman
Committee on the Budget
House of Representatives

Dear Mr. Chairman,

As the central process by which the President and Congress select among competing demands for federal funds, the budget should provide complete cost information and adequate signals about emerging problems. For many programs, the current budget does this. It does not, however, always help policymakers consider the long-term costs associated with some activities that explicitly or implicitly commit the government to future spending or otherwise affect the long-term fiscal outlook of the nation. This may limit the attention given to the future sustainability and flexibility of the government's fiscal position and the cost effectiveness of existing programs.

You requested that we: (1) provide information on the range and nature of certain responsibilities, programs, and activities that may explicitly or implicitly expose the government to future spending and (2) present and discuss options for increasing attention paid to these items in the budget and the budget process. As discussed with your staff, this report covers a number of issues surrounding long-term costs and uncertainties that present risk for the fiscal future, including

- the concept and different dimensions of fiscal exposures (risks)
- the range and nature of specific fiscal exposures facing the federal government
- the complexities and challenges surrounding cost measurement and budgeting for fiscal exposures and
- approaches for increasing the attention given to fiscal exposures in the budget and the budget process.

Results In Brief

The federal government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or create an expectation for spending. In particular, demographic trends facing the nation argue for considering the long-term sustainability and flexibility of the government's fiscal position. Profound demographic changes, with the impending retirement of the baby boom generation, will have significant implications not only for the Social Security, Medicare, and Medicaid programs but also for the budget and the economy as a whole. The approaching demographic tidal wave also serves to reinforce the importance of looking beyond short-term budgetary consequences. The savings and loan crisis in the 1980s and the resulting multibillion dollar bailout serve as a vivid reminder of the shortcomings and consequences when the federal budget does not adequately signal emerging problems.

Current budget reporting, however, is not designed to promote the recognition and explicit consideration of some of these exposures. For some claims, such as environmental cleanup and disposal costs, the government's commitment occurs years before the cash consequences are reflected in the budget. Other potential draws on future resources, such as future social insurance benefits or disaster assistance, may not flow from commitments of a strictly legal nature but from expectations that the public holds about the government's responsibilities. For example, while the federal budget shows annual Social Security tax receipts exceeding annual cash benefit payments, the fiscal year 2001 consolidated *Financial Report of the United States Government* estimates the net present value of Social Security's negative cash flow over a 75-year period as $4.2 trillion.[1] Concerns have been raised that such potential draws on future federal resources extending beyond current budget time frames may not be readily apparent in current budget reporting and process.

Policy choices that may have significant implications for long-term budget flexibility and for which future growth paths are uncertain can affect either spending or revenue; thus, fiscal exposures could be thought of on several levels. Aggregate projections of the cost of the government's current programs and policies provide important context for decision making. This construct, however, may be too broad to highlight specific areas for reform. To help address this concern, this report looks below the aggregate level on

[1]Net present value of the negative cash flow is the current amount of funds needed to cover projected shortfalls, excluding trust fund balances, over a 75-year period. The trust fund balance at the beginning of the valuation period (January 1, 2001) was $1,049 billion. The net present value of negative cash flows shown in this report is from the fiscal year 2001 consolidated *Financial Report of the United States Government* and is a different measure from the actuarial balance in the Trustees' Report.

the spending side to provide insights on the range and nature of specific fiscal exposures.

In this report, we use the term "fiscal exposure" to provide a conceptual framework for considering the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending. The budget treatment of items that could be considered fiscal exposures varies—some have been captured in budget obligations and some have not. Fiscal exposures include not only liabilities,[2] contingencies,[3] and financial commitments[4] that are identified on the balance sheet or in the accompanying notes, but also responsibilities and expectations for government spending that do not meet the recognition and disclosure requirements for that statement. We use the term implicit exposures in this report to refer to exposures that stem not from a legal obligation of the federal government but rather from implied commitments embedded in the government's current policies or in the public's expectations about the role of government.[5]

Fiscal exposures vary widely as to source, extent of the government's legal obligation, likelihood of occurrence, and magnitude. Their ultimate costs may or may not be measurable. Given this variety, it is useful to think of fiscal exposures as falling on a spectrum extending from explicit liabilities

[2]For financial statement reporting, a liability represents a probable and measurable future outflow of resources arising from past transactions or events. A liability is recorded on the face of the balance sheet when an item is identifiable, its occurrence is probable, and its cost can be reasonably estimated.

[3]For financial statement reporting, a contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gains or losses. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Contingencies are disclosed in the notes of the financial statements if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss may have been incurred. Contingencies that are classified as remote are not required to be disclosed.

[4]For financial statement reporting, financial commitments refer to contractual obligations that require the future use of resources. For example, although a liability generally is not recognized on the balance sheet when a contract is signed because the contracted goods or services have not been delivered, this transaction may be recognized as a commitment in the notes. In contrast, budgetary accounting would record obligations at the time the government enters into a contract and allows for deobligation if the contract is not fulfilled. Budgetary accounting records obligations when an order is placed, contract awarded, service rendered, or similar transaction takes place that will require payment.

[5]Some of these implicit exposures, such as the costs of future social insurance benefits, are discussed in the stewardship section of the government's consolidated financial statement.

to the implicit promises embedded in current policy or public expectations. Some, such as environmental cleanup and disposal costs and postretirement benefits, are reported in the financial statements as liabilities. Some are reported as financial commitments—such as contracted goods or services that have not yet been delivered—or contingencies—such as insurance—that depend on future events. Others, such as future social insurance benefits, are not explicitly stated or reported as liabilities but rather are implied by current decisions or public expectations about the role of government and shown as stewardship responsibilities.

The budgetary treatment of these items varies—some have been included in the budget and some have not. Some liabilities reported on the financial statements, such as accounts payable and loan guarantees, are included in the budget because agencies must have budget authority to cover them. Others, such as environmental and disposal liabilities, are not included in primary budget data[6] beyond the amount for current cleanup activities. Some implicit exposures, such as the cost of future Social Security benefits, are not included in primary budget data for the budget year but are captured in long-range budget projections. Other implicit exposures, such as the risk assumed by insurance programs, may not be captured in either primary budget data or in long-range budget projections.

This variety increases the difficulty of determining how and to what extent fiscal exposures should be handled in the budget and budget process. Specifically, budgeting for fiscal exposures is complicated by difficulties in (1) determining the scope of programs that should be considered and (2) estimating costs. There is no technical definition of fiscal exposures and no universal agreement on which and to what extent specific activities should be considered fiscal exposures or how they should be treated in the budget and budget process. Further, the complexity and uncertainty surrounding some exposures creates significant cost estimation challenges, which in turn raises concerns about using these estimates as the sole basis of budget and other policy decisions. These issues need to be considered carefully to avoid subjecting the primary budget data to large and volatile reestimates. Nevertheless, information on the existence and estimated cost of fiscal exposures needs to be considered along with other factors when making policy decisions. Not capturing the long-term costs of

[6] In this report, primary budget data refers to budget authority, obligations, outlays, and the deficit/surplus.

current decisions limits Congress's ability to control the government's exposure at the time decisions are made.

The variety of fiscal exposures, the difficulties in estimating their costs, and the range of uncertainty surrounding such cost estimates suggest that an across-the-board approach may not be the best way to proceed and that approaches may evolve over time. A framework organized around possible objectives can facilitate consideration and analysis of various approaches to help improve the attention given to fiscal exposures. The three possible objectives used to structure this analysis are (1) improving transparency, (2) prompting more deliberation, and (3) improving budget incentives.

If the primary objective is to improve the transparency of fiscal exposures, then supplemental reporting would help promote this objective. One option for increased supplemental reporting would be to require, on an annual basis, a report on fiscal exposures. Another option would be to report, where appropriate, the future estimated costs of certain exposures as a new budget concept—"exposure level"—as a notational item in the Program and Financing schedule of the President's budget. If, however, the primary objective is to prompt more explicit deliberation of exposures, then budget process mechanisms could be designed to provide opportunities for such consideration—especially as the amount and quality of cost information is improved over time. For example, as more information on costs is provided, the budget resolution could include limits on creating new or expanding existing exposures, with points of order permitted against legislation violating such limits. Another option would be to establish triggers to signal when the costs of existing exposures exceed some predetermined amount. Any process mechanisms—whether points of order or triggers—would need to take into account the uncertainty inherent in all long-range estimates and be designed accordingly. Finally, if the primary objective is to change budgetary incentives, then estimates of the future costs of exposures might be included directly into the primary budget data. For example, accrual-based measurement could be used to record estimated costs when doing so would enhance obligations-based control by recognizing costs up front at the time decisions are made that might encumber future resources. The general approaches outlined and the various options for implementing them achieve the three objectives to differing degrees and also vary in the implementation challenges they present.

We are recommending that the Office of Management and Budget (OMB) report annually on fiscal exposures, including a concise list and description of such exposures, cost estimates, where possible, and an assessment of methodologies and data used to produce cost estimates for such exposures. In addition, where possible, OMB should report the estimated costs associated with certain exposures as a new budget concept—"exposure level"—as a notational item in the Program and Financing schedule of the President's budget. For select areas where an explicit liability exists and there are accepted cost estimation methodologies, the ultimate objective might be to include the accrual costs directly in the primary budget data when doing so would enhance obligation-based control. These steps should complement and support continued and improved reporting of long-range projections and analysis of the budget as a whole to assess fiscal sustainability and flexibility.

If more explicit congressional consideration of the potential costs of certain exposures is desired, Congress may wish, as estimates improve over time, to develop budget process mechanisms that prompt more deliberation about fiscal exposures while recognizing the uncertainty inherent in estimating some long-term costs.

Background

A primary focus of current federal budget reporting is the cash implications of the government's obligations over a period of 1 to 10 years. The federal budget is an obligation-based budget designed to ensure that agencies do not incur legal obligations unless and until Congress provides authority for that purpose. Obligation-based budgeting involves three stages (1) Congress must enact budget authority up front before government officials can obligate the government to make outlays, (2) government officials commit the government to make outlays by entering into legally binding agreements, and (3) outlays (cash disbursements) are made to liquidate obligations. However, with limited exceptions,[7] the amounts to be obligated are measured on a cash or cash equivalent basis and the unified budget deficit/surplus[8]—a key focus of the policy debate—represents the difference between cash receipts and cash outlays in a given year. As a result, the U.S. budget is often referred to as cash-based as well as obligation-based.

For many programs, the cash- and obligation-based budget provides sufficient information on and control over the government's spending commitments. However, this focus does not require explicit consideration of some responsibilities, programs, or activities that may result in future spending. For some programs, obligations and cash outlays do not reflect the magnitude of the government's commitment of future resources at the time decisions are being made. We and other federal budget experts have raised concerns that, in these cases, the current budget may neither adequately reflect the extent of the government's commitment nor signal emerging problems.

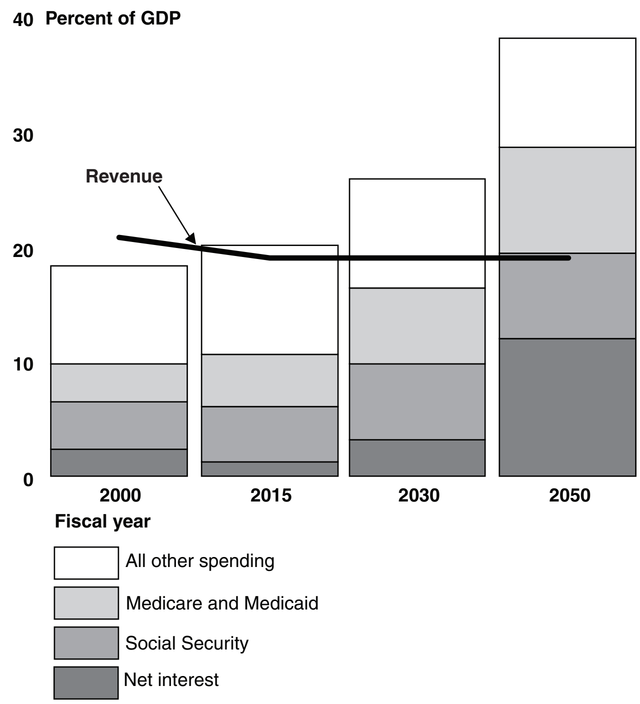
Demographic trends facing the United States argue for considering the long-term sustainability and flexibility of the government's fiscal position. Profound demographic changes with the impending retirement of the baby

[7]The U.S. budget uses accrual measures to recognize the government's cost for certain programs. One example is the treatment of credit programs for which budget authority, obligations, and outlays are measured on an accrual basis. Interest on Treasury debt held by the public is almost entirely on an accrual basis.

[8]Under the budget concepts set forth in the *Report of the President's Commission on Budget Concepts*, the unified budget is a comprehensive budget in which receipts and outlays from federal and trust funds are consolidated. When these fund groups are consolidated to display budget totals, transactions that are outlays of one fund group for payment to another fund group (that is, intrafund transactions) are deducted to avoid double counting.

boom generation will have significant implications not only for the Social Security, Medicare, and Medicaid programs but also for the budget and the economy as a whole. The share of the population that is age 65 or older is climbing and is expected to surpass 20 percent by 2035. Our recent simulations show that absent policy changes, social insurance and health programs will encumber an increasing share of the government's resources, thus restricting fiscal flexibility to address other needs. As shown in figure 1, our long-term budget simulations show that the aging of the baby boom generation and rising per capita health care spending will, absent meaningful reform, lead to massive fiscal challenges in future years. Assuming, for example, that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, by midcentury, federal revenues may only be adequate to pay Social Security and interest on the federal debt. As a result, major spending reductions, tax increases, or some combination of the two would be necessary to obtain balance.

Figure 1: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP and the Tax Cuts Do Not Sunset



Source: GAO's August 2002 analysis.

One need not look only to implications of the demographic shift to see the disconnection between how some exposures appear in the budget in the short term and the long term. The savings and loan crisis and the resulting bailout serve as a vivid reminder of the shortcomings of the federal budget in signaling emerging problems. During the 1980s, as hundreds of institutions became insolvent and the government's liabilities mounted, the federal budget failed to provide timely information on the rising deposit insurance costs accruing to the government. Although we and some industry analysts raised concerns about these rapidly increasing deposit insurance costs, corrective action was delayed and the government's total costs increased. Since the federal budget did not record outlays until the institutions were closed and depositors paid, it provided little incentive to act promptly. Indeed, budget treatment may have created incentives to delay closing insolvent institutions, which raised the government's ultimate costs. Delayed budget recognition obscured the program's, as well as the government's, underlying financial condition and limited the usefulness of the budget process as a means for Congress to assess the problem.

Recent performance reforms also reinforce the need for full cost information to assess and manage program performance. These reforms emphasize the need for complete cost information—not just cash flows—to assess and manage performance. However, for some activities, such as deferred compensation, the current budgetary focus on annual cash flows does not match full costs with the goods and services provided by the government. By making it more difficult to assess and compare the costs associated with a given level of performance, the failure to align budgetary cost recognition with the consumption of resources may hamper the government's performance and accountability reform efforts.

Objectives, Scope, and Methodology

The Chairman of the House Committee on the Budget asked us to (1) provide information on the range and nature of responsibilities, programs, and activities that may explicitly or implicitly expose the government to future spending and (2) present and discuss options for increasing attention paid to these items in the budget and the budget process. Although some tax preferences may have uncertain or accelerating future growth paths that have significant implications for the long term, this report deals only with spending.

To identify examples of programs and activities that may either directly obligate the government to future spending or simply create an expectation for such spending, we reviewed the consolidated *Financial Report of the United States Government*, relevant literature, the President's budget documents, and prior GAO work. To begin construction of the spectrum of fiscal exposures, we reviewed the generally accepted federal accounting standards, including the basis of conclusions for federal liabilities, contingencies, and stewardship responsibilities. Data on estimated exposures were drawn from the fiscal year 2001 consolidated *Financial Report of the United States Government*, agency financial statements, and the President's budget. Although we used generally accepted federal accounting standards as an initial framework in constructing the spectrum of fiscal exposures outlined in the report, we also considered additional items that may implicitly expose the government to future spending but may not be fully captured in the financial statements or the budget. In order to identify ideas and describe various approaches for improving the budgetary attention given to fiscal exposures, we reviewed relevant literature and our prior work, including discussions with budget experts. We also drew upon our previous work looking at the experiences of other nations with accrual budgeting[9] and the recognition of fiscal risks, such as federal insurance.[10]

[9]U.S. General Accounting Office, *Accrual Budgeting: Experiences of Other Nations and Implications for the United States*, GAO/AIMD-00-57 (Washington, D.C.: Feb. 18, 2000).

[10]U.S. General Accounting Office, *Budget Issues: Budgeting for Federal Insurance Programs*, GAO/AIMD-97-16 (Washington, D.C.: Sept. 30, 1997).

Our list of fiscal exposures is meant to be illustrative to provide perspective on the range and nature of responsibilities, programs, and activities that may explicitly or implicitly expose the government to future spending. It should not be interpreted either as all-inclusive or universally agreed upon. Further, although this report notes that the concept of fiscal exposure can be thought of broadly, its main focus is the long-term costs and uncertainties associated with certain items that may expose the government to future spending. Rather than looking at the broad fiscal outlook, it focuses only on certain parts of the spending side of the budget. As such, it does not consider all federal spending and general revenues that would need to be considered in order to assess long-term fiscal sustainability. We have discussed long-term fiscal sustainability issues in numerous reports and testimonies.[11] As part of this work, our simulations of the long-term economic impact of federal budget policy show that the nation's economic future depends, in part, upon today's budget and fiscal policy choices. This report builds on this previous work by looking below the aggregate level to the long-term costs associated with certain specific spending items.

Our work was done in Washington, D.C., in accordance with generally accepted government auditing standards. Comments on a draft of this report from OMB staff are discussed and incorporated as appropriate.

The remainder of this report discusses a number of issues, including

- the concept and different dimensions of fiscal exposures (risks)
- the range and nature of specific fiscal exposures facing the federal government
- the complexities and challenges surrounding cost measurement and budgeting for fiscal exposures and
- approaches for increasing the attention given to fiscal exposures in the budget and the budget process.

[11]For example, U.S. General Accounting Office, *Budget Issues: Long-Term Fiscal Challenges. Testimony before the Committee on the Budget, U.S. Senate*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002) and U.S. General Accounting Office, *Long-Term Budget Issues: Moving From Balancing the Budget to Balancing Fiscal Risk*, GAO-01-385T (Washington, D.C.: Feb. 6, 2001).

Fiscal Exposure Could Be Considered on Several Levels

We use the term fiscal exposure to provide a conceptual framework for considering the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending. The treatment of items that could be considered fiscal exposures in the current cash- and obligation-based budget varies—some have been captured in budget obligations and some have not. Fiscal exposures include not only liabilities, contingencies, and financial commitments that are identified on the balance sheet or accompanying notes, but also responsibilities and expectations for government spending that do not meet the recognition or disclosure requirements for that statement.[12] By extending beyond conventional accounting and fiscal analysis, the concept of fiscal exposure is meant to provide a broad perspective on long-term costs and uncertainties. The aim is not to provide strict definitional guidelines, but rather to improve understanding of the exposures associated with certain activities.

It is possible to think about fiscal exposure on several levels. Aggregate budget projections of the government's current programs and policies provide important context for considering the implications of specific decisions. For example, long-range (approximately 75 year) current service projections and simulations, such as those provided by our model and in the Analytical Perspectives of the President's budget, provide a broad context for considering the sustainability and flexibility of the government's future fiscal position. However, such constructs are likely to be too broad to highlight specific areas for reform. Further, the aggregate outlook is driven largely by Social Security, Medicare, and Medicaid. As a result, it provides little or no information to guide choices—or even signal growth—outside those areas.

[12] In this report, the term implicit exposures refers to exposures that stem not from a legal obligation of the federal government but rather from implied commitments embedded in the government's current policies or in the public's expectations about the role of government. Some implicit exposures, such as the costs of future social insurance benefits, are discussed in the stewardship section of the government's consolidated financial statement.

While Social Security, Medicare, and Medicaid are large drivers, there are other exposures and it is important for policymakers to have information on their long-term costs. The budgetary treatment of these exposures varies—some have been included in the budget and some have not. For some federal programs, the government's commitment or resource use occurs years before the cash spending consequences are reflected in the budget. Even though some of these exposures stem from liabilities and are reported in the financial statements, their recognition in the cash- and obligation-based budget may be delayed. Beyond explicit liabilities, there are implicit and/or contingent[13] exposures that may encumber future budgets or reduce fiscal flexibility. Including this range provides a more complete picture of the extent of exposure facing the government. For this report, we discuss fiscal exposures in terms of the long-term costs associated with certain spending items.[14]

In addition to the fiscal exposures from spending covered in this report, certain tax expenditures[15] may have uncertain or accelerating future growth paths that have significant implications for the long term. According to OMB, the largest reported tax expenditures tend to be associated with the individual income tax. For example, an exclusion is provided for employer contributions for medical insurance. In its special analysis on tax expenditures included in the Analytical Perspectives of the President's budget, OMB includes estimates of the revenue effects, outlay equivalents, and present value of revenue effects, but states that the meaningfulness of tax expenditure estimates is uncertain. OMB notes that estimates are uncertain because of the arbitrariness of the baseline and the fact that each estimate is calculated assuming that all other parts of the tax code remain unchanged.

[13]In this report, the term contingent exposures refers to exposures that are based on the occurrence or nonoccurrence of some future event.

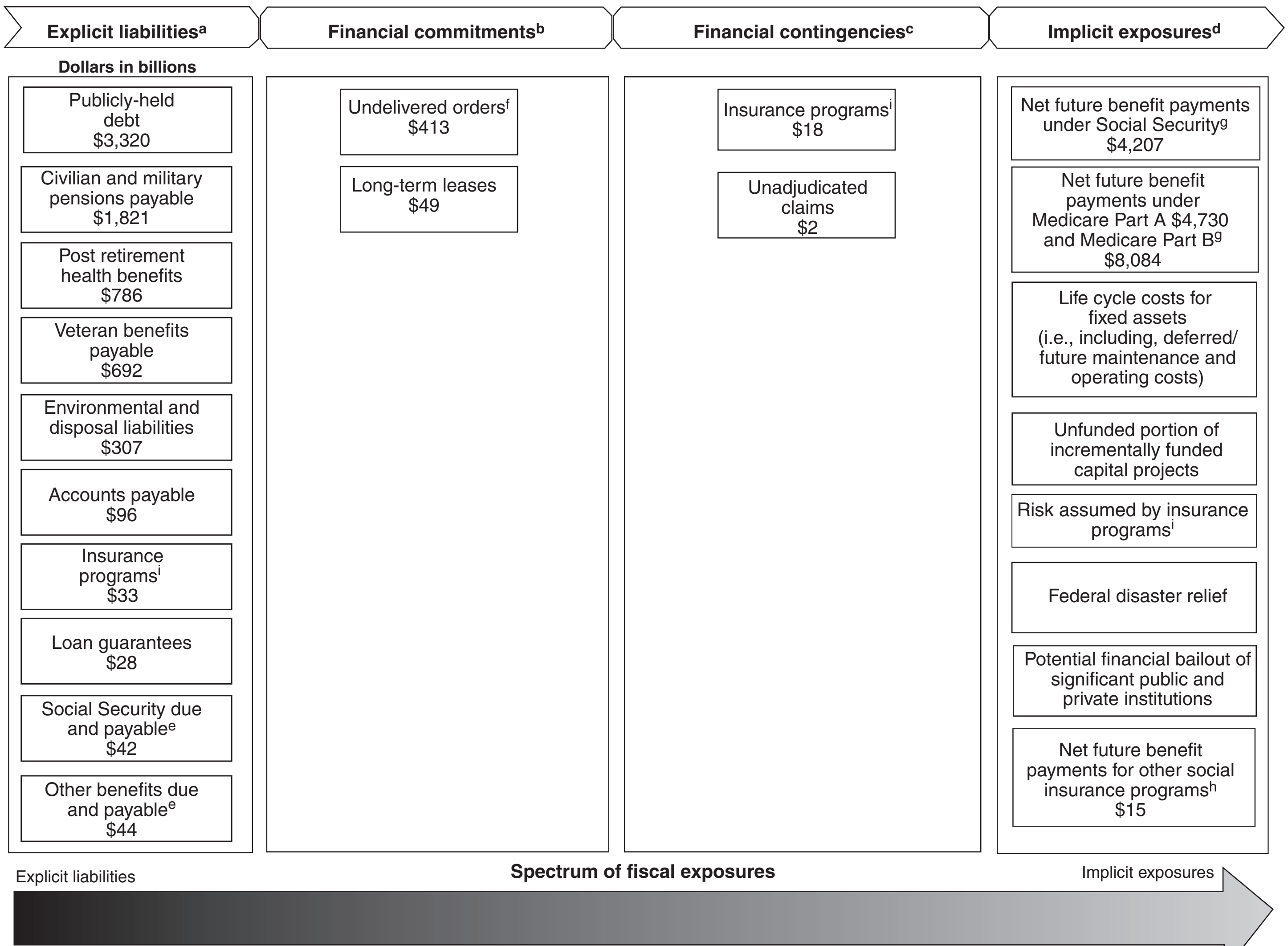
[14]For a more in-depth look at the fiscal exposure associated with environmental liabilities, see U.S. General Accounting Office, *Long-Term Commitments: Improving the Budgetary Focus on Environmental Liabilities*, GAO-03-219 (Washington, D.C.: Jan. 24, 2003).

[15] Tax expenditures are revenue losses attributable to a provision of the federal tax laws that allows a special exclusion, exemption, or deduction from gross income or that provides a special credit, preferential tax rate, or deferral of tax liability.

Fiscal Exposures are Wide-Ranging and Varied

The federal government undertakes a wide range of responsibilities, programs, and activities that may either obligate the government to future spending or create an expectation for such spending. Specific fiscal exposures vary widely as to source, likelihood of occurrence, magnitude, and strength of the government's legal obligation. They may be explicit or implicit; they may currently exist or be contingent on future events. Their ultimate costs may or may not be reasonably measurable. Given this breadth, it is useful to think of fiscal exposures as lying on a spectrum extending from explicit liabilities to the implicit promises embedded in current policy or public expectations. Figure 2 shows a spectrum of responsibilities, programs, and activities that may be viewed as fiscal exposures.

Figure 2: Spectrum of Fiscal Exposures



Source: GAO. Cost data from the *Financial Report of the United States Government*, fiscal year 2001.

[a.] A liability represents a probable and measurable future outflow of resources arising from past transactions and events. A liability is recorded on the face of the balance sheet only when an item is identifiable, its occurrence is probable, and its cost can be reasonably estimated.

[b.] Commitments refer to contractual obligations that require the future use of resources. For example, although a liability generally is not recognized on the balance sheet when a contract is signed because the contracted goods or services have not been delivered, this transaction may be recognized as a commitment in the notes. In contrast, budgetary accounting would record obligations at the time the government enters into a contract and allows for deobligation if the contract is not fulfilled. Budgetary accounting records obligations when an order is placed, contract awarded, service rendered, or similar trnsaction takes place that will require payment.

[c] A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gains or losses. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Contingencies are disclosed in the notes of the financial statements if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss may have been incurred. Contingencies that are classified as remote are not required to be disclosed.

[d] In this report, the term implicit exposures refers to exposures that stem not from a legal obligation of the federal government but rather from implied commitments embedded in the government's current policies or in the public's expectations about the role of government.

[e] Due and payable amounts are the benefits owed to program recipients as of the fiscal year end that have not yet been paid.

[f] Undelivered orders represent the value of goods and services ordered that have not yet been received.

[g] The term net future benefit payments is used in this report to represent the net present value of negative cashflow. Net present value of the negative cashflow is the current amount of funds needed to cover projected shortfalls, excluding trust fund balances, over a 75-year period. This estimate of cashflows is for an open system, meaning that it includes births during the period and individuals below the age of 15 as of January 1 of the valuation year. The valuation date for the amount included in the figure was January 1, 2001. The trust fund balances at the beginning of the valuation period that were eliminated for this consolidation were: $1,049 billion for Social Security, $177 billion for Medicare Part A, and $44 billion for Medicare Part B. This is a different measure from the actuarial balance in the Trustees' Report.

[h] Includes Railroad Retirement and Black Lung (Part C). See footnote g. Trust fund balances at the beginning of the valuation period that were eliminated for consolidation were: $19 billion for Railroad Retirement and a negative balance of $7.2 billion for Black Lung.

[i] Federal insurance programs are listed three times in figure 2. Under federal accounting standards, a liability is recognized based on insured events that have been identified by the end of the accounting period. The standard requires recognition of expected unpaid net claims inherent in insured events that have already occurred, including (1) reported claims, (2) claims incurred but not yet reported and (3) any changes in contingent liabilities that meet criteria for recognition. A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to a possible loss. Contingencies that do not meet the conditions for liability recognition are disclosed in the notes to the financial statements. Contingencies that are classified as remote are not required to be disclosed. The risk assumed by federal insurance programs represents the cost of claims inherent in the government's commitment. Estimation of the cost of the risk assumed by the federal government can be thought of as analogous to premium rate setting in that it would look at the long-term expected costs of the insurance commitment at the time the insurance commitment is extended. The risk assumed by the government is essentially that portion of the full risk-based premium not charged to the insured.

While our list of fiscal exposures provides some perspective on the range and magnitude of exposures facing the federal government, it is neither meant to be comprehensive nor to represent a universally agreed-upon list. The cost data should be viewed in a similar way. Although most of the cost data in this figure were drawn from the consolidated *Financial Report of the United States Government* for fiscal year 2001, they should be used with caution. In auditing these statements, we were unable to determine the reliability of significant portions of the government's assets, liabilities, and costs due to serious financial management weaknesses. These weaknesses may affect the reliability of estimates reported for certain exposures, such as military postretirement health benefits and environmental cleanup and disposal costs.

Along the spectrum of fiscal exposures there is great variation in the extent and magnitude of a government's legal obligation, the certainty of expected costs, their treatment in the budget, and the recognition of these items in the financial statements. Some, such as deferred employee compensation or environmental cleanup and disposal costs, are reported as liabilities on the balance sheet. For financial statement reporting purposes, liabilities are viewed as representing probable and measurable outflows of resources arising from past transactions and events. Others that relate to a past event but are contingent on future events, such as pending litigation, generally are disclosed as contingencies. Others, such as undelivered goods or services previously contracted for, are disclosed as financial commitments in the notes to the financial statements. Some, such as future social insurance benefits and some disaster assistance, do not flow from legal obligations but are implied by current policies and/or expectations about the role of government and are shown as stewardship responsibilities.[16]

In this report, we use the term implicit exposures to refer to the last category of exposures that stem not from a legal obligation of the federal government but rather from implied commitments embedded in the government's current policies or in the public's expectations about the role of government. While social insurance and health programs represent significant implicit exposures, other activities may also create expectations for future spending. For example, incrementally funded capital projects[17] create an expectation for future spending since there is an expectation that partially funded capital projects will be completed. In general, the decision to purchase a building or another fixed asset implicitly commits the government to the life-cycle costs associated with its future operation and maintenance. Further, the earmarking of taxes or the establishment of trust funds creates an expectation of future spending for the designated purpose. Even an activity that appears to decrease government involvement, such as privatization, may carry with it an implicit assumption that the government will step in if necessary to provide the service or good. Clearly, the range and nature of activities that may create an expectation

[16]Some implicit exposures, such as the costs of future social insurance benefits, are discussed in the stewardship section of the government's consolidated financial statement.

[17]An incrementally funded capital project is a project for which the budget authority provided is for only part of the estimated cost of the capital acquisition or part of a usable asset. For more information, see U.S. General Accounting Office, *Budget Issues: Incremental Funding of Capital Asset Acquisitions*, GAO-01-432R (Washington, D.C.: Feb. 26, 2001).

for future spending increase the difficulty of determining the parameters of what constitutes a fiscal exposure.

The budgetary treatment of these items varies—some have been included in the budget and some have not. Some liabilities reported on the financial statements, such as accounts payable and loan guarantees, are included in the budget because agencies must have budget authority to cover them. Changes in the debt level generally are reflected in the annual deficit or surplus. Others, such as environmental and disposal liabilities, are not included in primary budget data[18] beyond the amount for current cleanup activities. Some implicit exposures, such as the cost of future Social Security benefits, are not included in primary budget data for the budget year but are captured in long-range budget projections. Other implicit exposures, such as the risk assumed by insurance programs, may not be captured in either primary budget data or in long-range budget projections.

Despite the challenges of determining what should be considered a fiscal exposure, efforts to improve the information on and incentives to consider these exposures are important. Failure to understand and address fiscal exposures can have significant consequences. Even those exposures that are not legal obligations of the government may imply future government spending—and that should be considered in making a program or budget decision. Whether the government is legally required or simply compelled by circumstances to provide funding, these exposures can encumber future budgets and reduce fiscal flexibility. Understanding these items can also be important to efforts to improve government performance. For some items, such as deferred compensation, the budgetary focus on annual cash flows does not match the full costs of an employee with the services the employee provides. For example, federal employees earn their pension while they are working but receive pensions after they have stopped working. The accruing cost of the pensions earned by current employees is really part of the costs of the goods and services they provide, but the budget does not capture the full extent of these costs and total budget outlays include only the cash payments made to current retirees. By making it more difficult to assess and compare the costs associated with a given level of performance, the failure to align budgetary cost recognition with the consumption of resources may hamper the government's efforts to assess its performance.

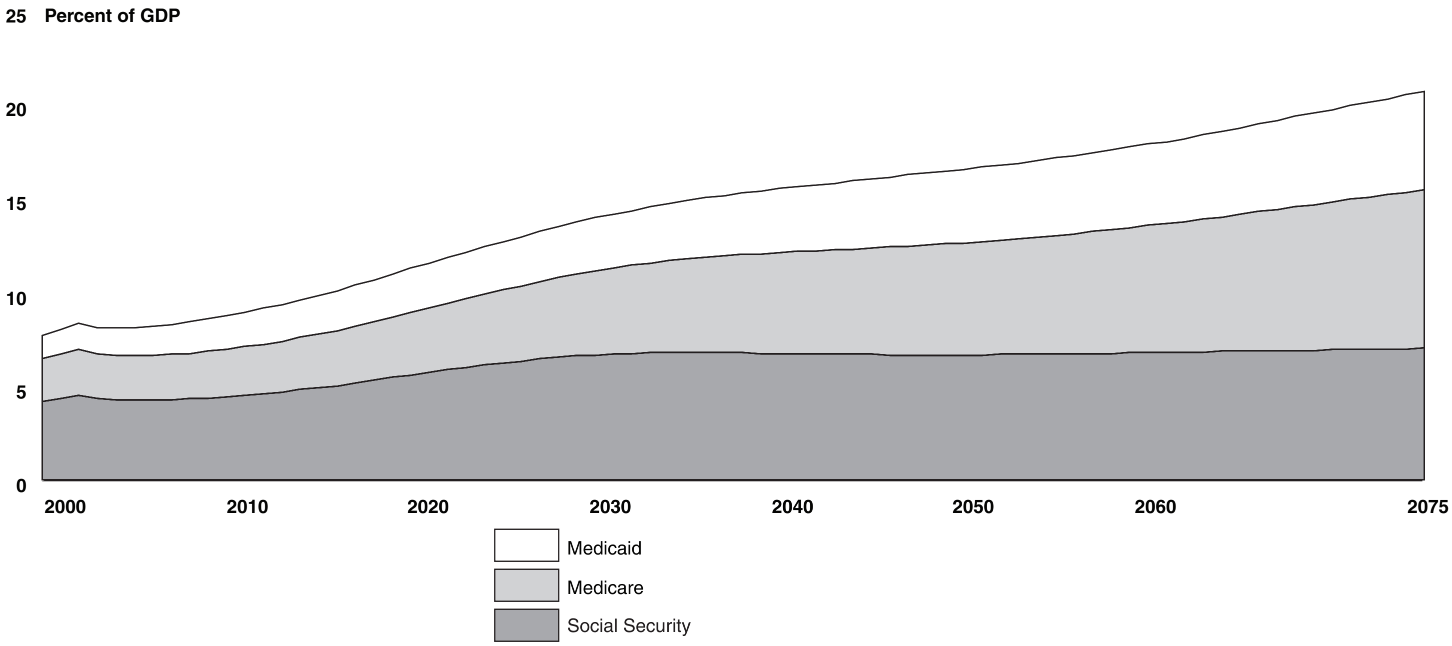
[18] In this report, primary budget data refers to budget authority, obligations, outlays, and the deficit/surplus.

Several exposures provide insight into challenges facing the government

A closer look at some fiscal exposures—although not necessarily representative of all fiscal exposures—provides a sense of the issues facing the government. For example, the government faces a large and rapidly growing exposure for certain social insurance and health programs. Social Security, Medicare, and the federal portion of Medicaid are expected to grow considerably in the future due to the aging of the population and impending retirement of the large baby boom generation. Figure 3 shows the total draw on the economy represented by federal spending on Social Security, Medicare, and Medicaid. Taken together, they represent an unsustainable burden on future generations. Although significant information is available on the estimated future costs of Social Security and Medicare, the annual budget is not currently structured to fully capture these growing costs. Current reporting of annual budget data focuses on cash to current beneficiaries and thus does not capture the funding shortfall for future benefits. For example, fiscal year 2001 Social Security tax receipts exceeded cash benefit payments by more than $94 billion and increased the unified federal surplus. The fiscal year 2001 consolidated *Financial Report of the United States Government*, however, shows the net present value of Social Security's negative cash flow over a 75-year period as $4.2 trillion.[19] Similarly, the budgetary treatment of Medicare focuses on the annual cash paid to current beneficiaries and cash revenues from current workers. As a result, Medicare's significant and growing actuarial shortfalls are not reflected in the annual budget.

[19] Net present value of the negative cash flow is the current amount of funds needed to cover projected shortfalls, excluding trust fund balances, over a 75-year period. The trust fund balance at the beginning of the valuation period (January 1, 2001) was $1,049 billion. The net present value of negative cash flows shown in this report is from the fiscal year 2001 consolidated *Financial Report of the United States Government* and is a different measure from the actuarial balance in the Trustees' Report.

Figure 3: Social Security, Medicare, and Medicaid Spending as a Percent of Gross Domestic Product



Source: Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and Congressional Budget Office.

Note: Projections based on intermediate assumptions of the 2002 Trustees' Reports and Congressional Budget Office's June 2002 long-term projections under midrange assumptions. Spending includes only the federal portion of Medicaid.

Pensions and retiree health care costs of civilian and military employees of the federal government and veterans' benefits payable comprise another large fiscal exposure. Together, these future benefits represent a liability of nearly $3.4 trillion for fiscal year 2001. Changes in benefits may result in long-term costs. For fiscal year 2001, a $293 billion increase in the military postretirement health benefits liability is attributed to provisions of the fiscal year 2001 National Defense Authorization Act (Public Law 106-398) that expand certain benefits to Medicare-eligible Department of Defense (DOD) retirees, their dependents, and survivors.

Some of the accruing costs of postretirement benefits are captured in the budget authority and outlays for agencies. The full cost of pension benefits was recognized in budget authority and outlays at the agency level beginning in 1985 for military personnel and for civilian employees hired since 1984. Beginning in 2003, DOD will budget on an accrual basis for the retiree health care costs for Medicare-eligible military retirees. In these cases, payments are made between accounts within the budget so that outlays are recorded as program costs but do not affect total budget outlays and the deficit/surplus. However, for most civilian employees hired before 1984, less than half the government's share of accruing pension costs are recognized in the budget and none of the accruing costs of retiree health benefits for civilian or military retirees under the age of 65 are recognized in the budget as earned. In an effort to improve the budgetary treatment of accruing employee benefits, the Administration proposed that agencies be required to request budget authority for the government's full share of the accruing costs of all pension and retiree health benefits for their employees and pay it to the benefit paying funds.

Environmental cleanup costs resulting from federal operations represent another fiscal exposure. These constitute an explicit liability since the federal government is legally required to clean up hazardous wastes that result from its operations. These costs, however, usually are not paid until many years after the government has committed to the operation generating the waste. As required under generally accepted federal accounting standards, the fiscal year 2001 consolidated financial statement reported a liability of $307 billion for estimated environmental cleanup and disposal costs.[20] Although a liability for future costs is reported on the financial statements, current budget guidance requires agencies to request only the budget authority expected to be obligated during the budget year for cleanup activities. As a result, these future costs are not shown in the budget and may not even be provided in backup materials to policymakers at the time decisions are being made to undertake the operations that may generate environmental cleanup costs. For example, when a weapon system using nuclear materials is built, there would be no disposal costs shown in the budget since the disposal would not occur until some time after that budget period.[21]

[20]About 98 percent of the $307 billion in environmental liabilities that were reported in fiscal year 2001 were associated with the Department of Energy and DOD. The Department of Energy, which received a clean opinion on its financial statements, reported environmental liabilities of $238 billion. DOD reported $63 billion in environmental liabilities. Auditors, however, were unable to render an opinion on DOD's fiscal year 2001 financial statements, in part, because of DOD's inability to comply with requirements for environmental liabilities.

[21]Unlike what is required in the budget, current federal accounting standards require agencies to estimate and report the full liability of cleanup costs for weapon systems when they are deemed probable and measurable.

Federal insurance is provided to individuals and businesses against a wide variety of risks, ranging from natural disasters under the flood and crop insurance programs to bank and employer bankruptcies under the deposit and pension insurance programs. While the face value of insurance overstates the likely cost to the government, these programs do expose the government to future, and potentially significant, draws on resources that may not be adequately reflected in the budget at the time the decision to extend the insurance is being made. We have previously reported[22] that current budget reporting may not signal policymakers to the risk assumed by the government at the time the decision to extend the insurance is made. For example, at the time budget decisions were being made for fiscal year 2003, the budget showed a positive budget estimate (i.e., revenues) for the Pension Benefit Guaranty Corporation of about $1.3 billion. The financial statements available at the same time showed an estimated liability for future benefits of $13.5 billion and a positive net position of about $7.8 billion. At the same time, OMB estimated the future cost of the risk assumed by the government for vested covered benefits as $51 billion.[23] Clearly, these different estimates provided significantly different pictures of the program's health and its potential draw on future resources.

[22]See GAO/AIMD-97-16.

[23]According to OMB, this estimate is for the future costs of vested covered benefits and does not assume future growth in such benefits.

The government's purchase and ownership of government-owned facilities and other assets may create an expectation for future spending. If budget authority for a capital project is not fully funded at the time the commitment to buy the asset is made, the government's costs will likely be understated. Future Congresses and administrations may be forced to choose between having an incomplete and unusable asset and continuing to fund the project. In cases where funding is provided for only part of a project and that part by itself is not usable, then policymakers may feel compelled to continue funding to complete the project.[24] Moreover, the total life-cycle cost of an asset includes not only all initial direct and indirect acquisition costs but also all periodic or continuing costs of operation and maintenance over the asset's expected useful life and any costs to decommission or dispose of the asset. While OMB requires agencies to develop capital asset plans for major acquisitions and encourages long-term agency capital plans—both of which should include life-cycle costs—these plans are not routinely provided to Congress. Budget authority generally is provided only for the acquisition costs associated with capital asset purchases, not for the life-cycle costs necessary to operate, maintain, and dispose of the asset. While this may be appropriate for budget control purposes, the result, in most cases, is that the budgetary focus is on the initial cost of assets even if this cost represents only a fraction of the total costs flowing from the purchase decision.

[24]As part of our prior work on incremental funding, we reviewed selected agency budget justifications and other agency data to identify the extent to which capital projects were incrementally funded. The 2001 report identified civilian nondefense capital projects with total estimated costs of $176 billion and determined that about $76 billion (44 percent) of total costs were incrementally funded—an amount that does not include high technology projects. Incremental funding can be justified for such projects because funding provided on an incremental basis can provide useful knowledge even if no additional funding is provided. This review also found that data supporting capital acquisitions in general may be incomplete and/or unclear, thus making it difficult to determine future costs or whether the funding provided would produce a usable asset. See GAO-01-432R.

Other exposures facing the government also present significant definitional and measurement challenges because (1) the existence and scope of the government's commitment prior to the occurrence of the underlying event is unclear, (2) the occurrence and timing of the underlying event is unknown, and (3) the ultimate costs are difficult to predict. Examples include the bailout of large institutions or disaster relief.[25] The extent of the government's commitment to cover these costs may not be explicitly stated before the event but rather may be implied by the role of government. Not only is the extent of the government's commitment unknown before the occurrence of the event, the timing and magnitude of these exposures are contingent upon the occurrence or nonoccurrence of some future event. For example, even in cases where it is not explicitly required by law, the federal government may be expected to provide for the financial losses that arise from catastrophes and major disasters such as earthquakes, hurricanes, terrorist attacks, and epidemics, the timing and magnitude of which are unknown until they occur. There may also be an expectation that the federal government would intervene to bailout the losses of state and local governments and large institutions of economic significance.

Fiscal Exposures Involve Complex Measurement and Budgeting Challenges

Determining the appropriate budgetary treatment for fiscal exposures is complicated by uncertainties. First, there is definitional uncertainty i.e., uncertainty about what constitutes an exposure certain enough to include as a claim on budgetary resources. In addition, there are difficulties in estimating future costs. The extent to which either or both of these factors contribute to the uncertainty about future costs varies among fiscal exposures. As a result, policymakers should consider both the degree of certainty of the government's obligation and the availability of reasonable cost estimates when weighing the trade-offs associated with various approaches to help increase the attention paid to particular exposures when making budget decisions.

[25]Another issue associated with implicit, contingent exposures, such as bailouts and disaster relief, is that recognition of these potential costs may create moral hazards in that private parties may make too little effort to diminish their risk.

Whether an exposure is certain enough to be included as a claim on budgetary resources is a key question. As noted earlier, the extent of the government's obligation varies along the spectrum of fiscal exposures. Some fiscal exposures are reported as liabilities of the federal government and represent legal obligations to make payments; others are not. For example, the $3.3 billion in publicly held debt is a clear financial liability. On the other hand, generally accepted federal accounting standards do not view future social insurance benefits as a liability, except for the amount due and payable at fiscal year end. The standard, however, also requires that supplementary stewardship information be reported to facilitate an assessment of the program's long-term sustainability and the ability of the program and the nation to raise resources from future program participants to pay for benefits.[26] The standard for social insurance is a compromise between parties with widely divergent views about the government's obligation to make future benefit payments. Proponents of the standard point out that the underlying laws establishing a claim to payment can (and have been) changed and there is no legal obligation by the government to pay benefits once the trust funds that finance these programs have been exhausted. Others, however, believe that a liability should be recognized for the net benefits expected to be paid in future periods to current participants. Any changes in budgetary treatment would require similar discussion and compromises concerning which items should be recognized as exposures. There may be further disagreement over which of these exposures should be directly recognized in the primary budget data.[27] Finally, even if agreement can be reached that an exposure theoretically should be included in the primary budget data, reasonable cost estimates may not be available. For some exposures, estimates could be generated given time and attention; for others that are contingent on future events, estimates are more problematic.

Several factors affect whether reasonable cost estimates are currently available or can be generated. The generation of reasonable cost estimates depends not only on the development of appropriate methodologies but

[26]For example, stewardship information generally includes narrative and/or graphic presentation of items including (1) long-range cashflow projections, (2) long-range projections of the ratio of contributors to beneficiaries and (3) actuarial present values of (a) future benefits for and (b) contributions and tax income from or on behalf of current and future program participants.

[27] In this report, primary budget data refers to budget authority, obligations, outlays, and the deficit/surplus.

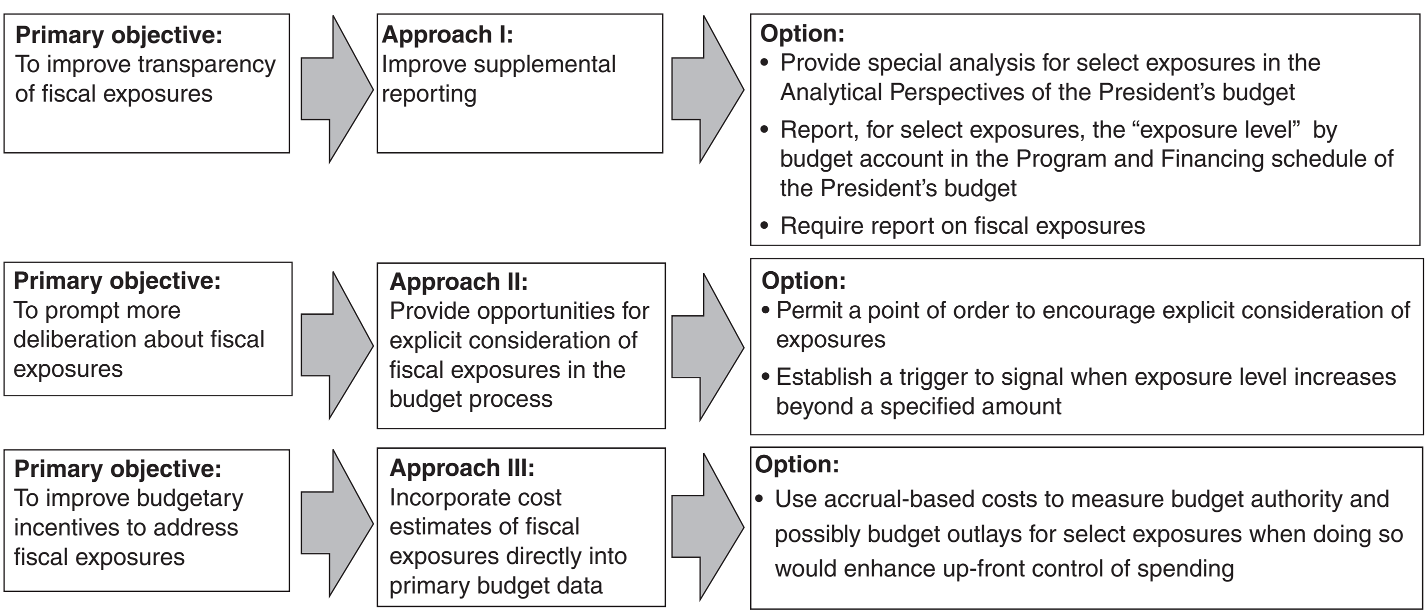
also on the acceptance and quality of underlying assumptions and data. Estimates for some exposures, such as pension benefits, are based on accepted methodologies and are reported as liabilities in financial statements. The future costs of some exposures are inherently more difficult to estimate than others. For example, some exposures, such as bank and pension insurance, are dependent on many economic and behavioral variables. Since these are inherently uncertain, there will always be some uncertainty surrounding the estimated future costs of such programs. Lack of adequate data may also be a factor in the reliability of cost estimates. For example, postretirement health benefits and environmental cleanup and disposal costs are reported as liabilities on the balance sheet because they are considered to meet the criteria of probable and reasonably measurable, but audits have revealed weaknesses that may affect the reliability of these reported amounts. The fiscal year 2000 liability for military postretirement health benefits could not be accurately estimated because some of the underlying costs and demographic and workload data used to develop the estimate were not reliable. The estimate for environmental cleanup costs is uncertain, in part, because the dimensions of the cleanup problem remain unclear and the technology to address the problem is evolving.

Generally speaking, the more direct and explicit the fiscal exposure, and thus the more certain the existence of a claim and its ultimate costs, the greater the suitability of including estimated costs directly into the primary budget data when doing so would enhance up-front control of spending. Even when agreement can be reached that an explicit liability exists, efforts may be needed to develop reasonable cost estimates. For exposures that are implicit and/or contingent on future events, cost estimation challenges and underlying questions about the existence of a government commitment raise substantial questions. Perhaps most challenging are those exposures that are both implicit and contingent on unknown events, such as bailouts or disaster relief. In these cases, the government may not have any current legal obligation and the magnitude and timing of the underlying event is unknown. These exposures are very difficult to estimate and uncertain as to whether they really represent claims to future resources.

Diversity of Fiscal Exposures Suggests that Tailored Approaches Would Be More Feasible than an Across-the-Board Approach

The variety of certainties (and uncertainties) associated with fiscal exposures suggests that no single approach to increasing attention to these future costs will work in all cases. Various approaches might be considered in a framework organized around three possible objectives: (1) improving the transparency of fiscal exposures, (2) prompting more deliberation about fiscal exposures, and (3) improving budget incentives to address fiscal exposures. Several broad approaches for helping to achieve these objectives discussed here are (1) improving supplementary reporting, (2) providing opportunities for explicit consideration in the budget process, and (3) incorporating the costs of fiscal exposures into the primary budget data. A number of options could be used to implement each of these approaches. Figure 4 displays how different approaches could be used to achieve a primary objective by providing illustrative options for implementing each approach. These options are meant to illustrate how different approaches may be used depending on the primary objective to be achieved and what may be feasible to implement. Not only do these approaches achieve the various objectives to differing degrees, but they also vary in the implementation challenges involved.

Figure 4: Overview of Possible Approaches



Source: GAO.

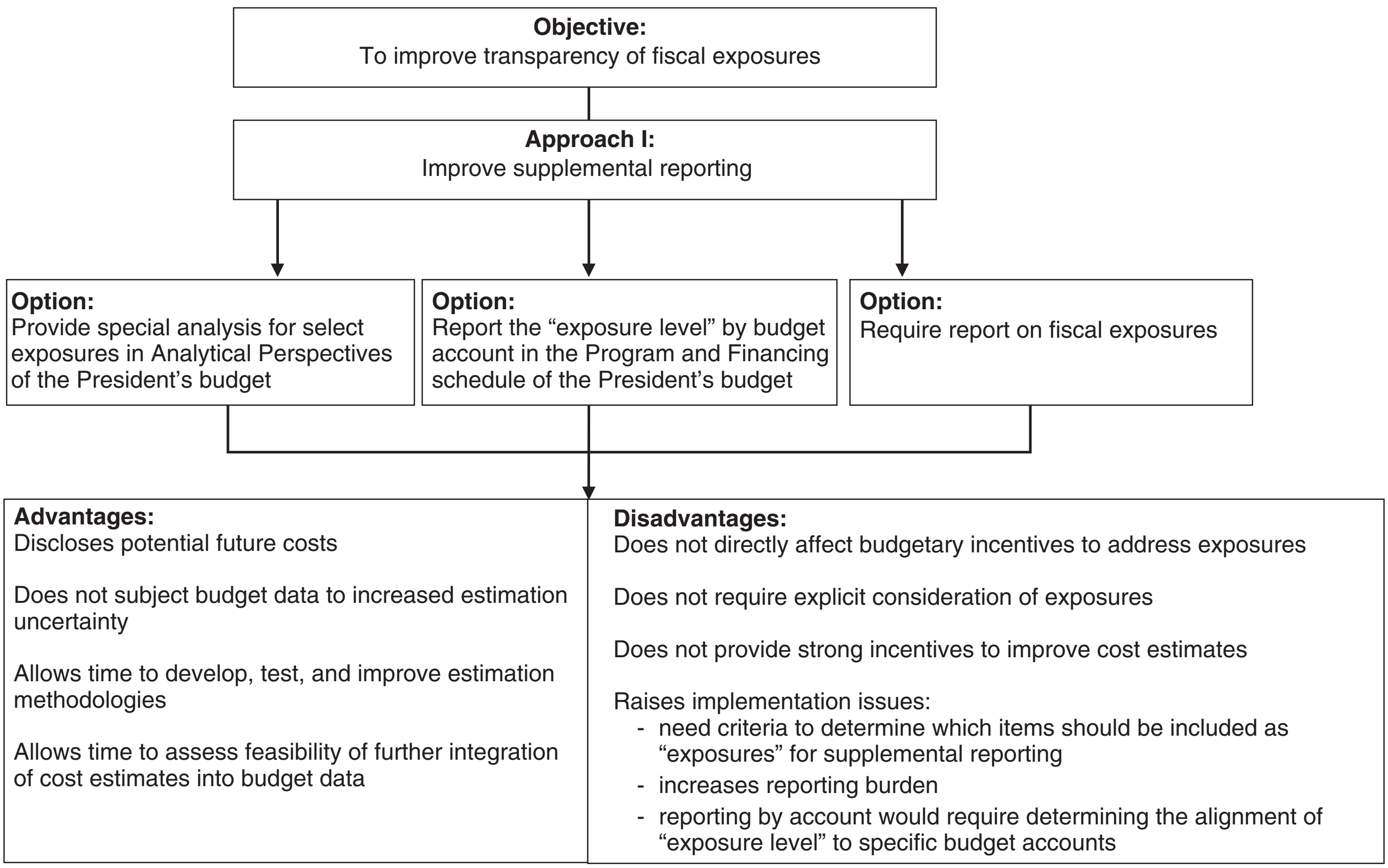
The diverse nature of exposures and the significant differences in the strength of the government's underlying obligation, combined with the varying quality and amount of cost information available outside the budget process, suggest that across-the-board changes in budget reporting or process would not be appropriate. Instead, targeted approaches for different types of fiscal exposures would be most useful for incorporating a longer-term perspective into the budget. Changes in the information provided, the budgetary process, or budgetary incentives could be tailored selectively for different categories of fiscal exposures to address specific budgetary objectives and implementation challenges. A discussion of each of the three approaches and related options follows.

Approach I: Improve Supplemental Reporting

Improved supplemental reporting on fiscal exposures would make information more accessible to decisionmakers without introducing additional uncertainty and complexity directly into the budget. With this approach, estimates of the government's exposure would be reported in various budget documents, but the current basis of reporting primary budget data—budget authority, obligations, outlays, and the deficit/surplus—would not be changed. This type of supplemental information is currently available in various places for some programs. For example, the stewardship section in the Analytical Perspectives of the President's budget has included long-range (75 year) budget projections assuming continuation of current policies as well as a discussion of the government's balance sheet, which includes some liabilities not yet included in the primary budget data. The stewardship section of financial statements contains information to facilitate the assessment of the long-term sustainability of social insurance programs. In some cases, improving supplemental reporting may simply be a matter of highlighting or expanding existing analytical work. For example, long-range projections and simulations of the budget as a whole could be continued and improved, including analysis to help assess driving factors, such as demographics and economic changes, and to improve understanding of the range and magnitude of alternatives.

As outlined in figure 5, improved supplemental reporting on fiscal exposures could be achieved in a number of ways. In addition to the continuation and further development of long-range projections of the budget as a whole, three options to consider include (1) providing special analyses for certain, significant fiscal exposures in the Analytical Perspectives of the President's budget, (2) reporting estimated costs of certain fiscal exposures as a separate notational line—"exposure level"—in the Program and Financing schedule of the President's budget, or (3) requiring a report on fiscal exposures.

Figure 5: Possible Options For Improving Supplemental Reporting



Source: GAO.

Federal government insurance programs provide a prime example of where special analysis of a particular type of exposure may be appropriate. Our previous work has shown that the current cash- and obligation-based budget generally provides incomplete or misleading information on the government's cost of federal insurance programs.[28] One reform option would be to require an estimate of the budget authority likely to be needed to cover an estimate of the cost of the risk assumed[29] by the government. However, given the difficulties in estimating the cost of risk assumed, we concluded that supplemental reporting of the cost of the risk assumed by federal insurance programs had several attractive features. It would allow time to (1) assess the reliability of cost estimates, (2) develop and refine estimation methodologies, and (3) formulate cost-effective reporting. As another example, supplemental analysis could be provided for uncertain exposures, such as future operation and maintenance costs associated with asset acquisitions.

[28]See GAO/AIMD-97-16.

[29]The estimation of the cost of the risk assumed by the federal government would be analogous to premium rate setting in that it would look at the long-term expected costs of the insurance commitment at the time the insurance commitment is extended. The risk assumed by the government is essentially that portion of the full risk-based premium not charged to the insured.

While providing a special analysis in the Analytical Perspectives would provide additional information, it is not as directly linked to specific budget proposals as is possible. Another option would be to routinely report the future estimated costs of certain exposures as a separate notational line in the Program and Financing schedule of the President's budget. This would move beyond the current budget practice of generally including only budget authority, obligations, and outlays for initial acquisition costs of an asset to adding a new measure that reports the "exposure level" as a notational item in the Program and Financing schedule. For example, an estimate of the future operating and maintenance costs associated with capital acquisitions could be reported as the "exposure level" in the Program and Financing schedule for capital accounts that include the initial capital acquisition costs. Similarly, the future funding needs associated with incrementally funded projects could be included in the Program and Financing schedule of the budget account that includes the capital acquisition. This type of notational approach in the Program and Financing schedule could also be used for future environmental cleanup costs associated with an asset acquisition. In these cases, the "exposure level" could be used to capture the exposure associated with the capital acquisitions in each year.[30] As opposed to cash, the "exposure level" might be reported in present value terms. Including exposure levels as part of the budget presentations at the account level directly in the budget documents would make such information available along with the initial acquisition costs, rather than in an additional document. Specifying the estimated potential future costs associated with current decisions would promote transparency.

Another approach, which could stand alone or be done along with including exposure levels in the Program and Financing schedule, would be to require a report on fiscal exposures. For example, such a report could provide a concise list and description of fiscal exposures, cost estimates, where possible, and an assessment of the methodologies and data used to produce cost estimates. Explicitly and directly integrating the report on specific fiscal exposures with long-range projections and analysis of the budget as a whole would increase its usefulness for assessing the potential implications for long-range fiscal sustainability and flexibility. If this type of report was issued as part of or near the time of the release of the President's budget, it could be used to help inform and provide long-term context to budget deliberations.

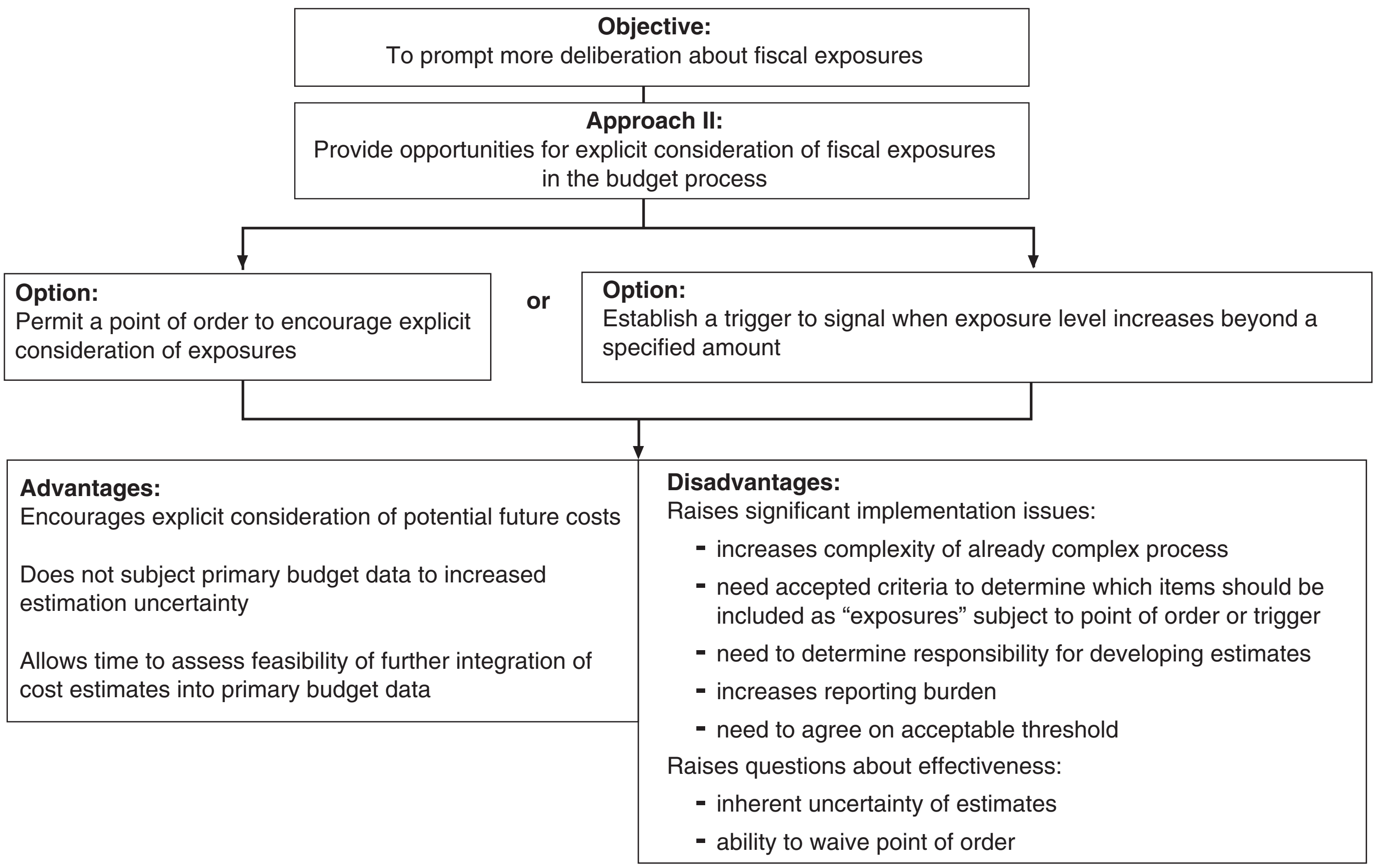
[30]See GAO-03-219.

These types of supplemental reporting have the advantage of providing policymakers with a long-term perspective when making current decisions and enabling those concerned about exposures to raise questions and challenges in the budget debate. However, they do not in themselves change incentives or require explicit consideration of costs. This is because estimates of future costs would not directly affect spending or the overall budget totals. Since this information would be excluded from the primary budget data, it may or may not be used in budget decisions. As a result, there may be little incentive to improve cost estimates or to fully consider these potential costs. However, the uncertainties around such cost estimates may argue for proceeding gradually with efforts to further incorporate them into the budget. Supplemental reporting would allow time to improve cost estimation methodologies and increase users' comfort levels with the estimates. Such reporting might then be seen as a first step toward more explicit consideration in the budget. In addition, because the primary budget data are not affected, this type of supplemental reporting would avoid increasing the gap between the deficit and borrowing needs.

Approach II: Provide Opportunities for Explicit Consideration of Fiscal Exposures in the Budget Process

Further along the continuum from supplemental reporting to including costs in the primary budget data are budget process changes. Budget process mechanisms would go beyond simply providing more information on fiscal exposures to establishing opportunities for explicit consideration of these exposures. Two possible options to consider are shown in figure 6. Congress could modify budget rules to provide for a point of order against any proposed legislation that creates new exposures or increases the estimated costs of existing exposures over some specified level. Alternatively, revised rules could provide for a point of order against any proposed legislation that does not include estimates of the potential costs of fiscal exposures created by the legislation. A second budget process option would be to establish triggers that require some action when the estimated future costs of a given exposure rise above some specified threshold.

Figure 6: Possible Options for Providing Opportunities For Explicit Consideration of Fiscal Exposures



Source: GAO.

A key advantage of permitting points of order with respect to fiscal exposures is that they could result in explicit consideration of these potential costs without subjecting the primary budget data to increased uncertainty from estimation difficulties. It would be similar to procedural rules for Social Security that permit points of order against the consideration of legislation that would weaken the program's financial condition. A different point of order method would be to permit a point of order that could block legislation lacking appropriate cost information about an exposure. This would be similar to unfunded mandates legislation that permits a point of order to be raised against proposed legislation that imposes mandates if a Congressional Budget Office mandates estimate has not been published in the committee report or the *Congressional Record*.[31] This alternative would provide a greater incentive to improve cost information than simply requiring supplemental information because it presents congressional members with an opportunity to challenge the creation of programs without sufficient information on long-term costs.

Despite the potential benefits of permitting some type of point of order, such a budget process change is not without significant implementation challenges. Criteria would have to be agreed on for determining which activities and programs would be considered as fiscal exposures subject to a point of order. Mechanisms also would need to be developed to deal with the uncertainties and volatility inherent in cost estimates associated with fiscal exposures. Further, this type of budget process change would increase the complexity of an already complicated process. Since many activities—including most capital acquisitions—routinely would result in exposures, such as life-cycle costs, a point of order may become burdensome and potentially ignored. Points of order also are limited because they apply only to new legislation and then only if raised. Further, they can be waived or overruled by a vote of the Members. Finally, a budget process change establishing a point of order would require an amendment to the Congressional Budget Act of 1974 or a change to committee rules.

[31]Unfunded Mandate Reform Act of 1995, Pub. L. 104-4, §423.

A different budget process approach would be to establish triggers that address the growth in existing exposures. In this case, triggers would be established to signal when the future costs of exposures rise above a certain level. Reaching the trigger threshold would require some action.[32] One possible trigger could be the future costs of a specific exposure exceeding a specified dollar amount, but other thresholds are also possible. For example, for the Medicare program, these might be a specified floor in the trust fund, such as the balance falling below 1-year's worth of payments, the percentage of gross domestic product devoted to Medicare, or program spending per enrollee. The use of triggers would require agreement not only on the limits but on what will happen when the limits are reached. A trigger could be "hard"—including specific provisions that would automatically go into effect if the trigger is reached—or "soft"—requiring some action to be taken to address costs or reaffirm acceptance of the increase in potential fiscal exposure.[33] For example, reaching a trigger could require the policymakers to propose how to deal with growth in the Medicare program. This type of "soft" trigger would help ensure that Congress and the President periodically review and decide how to address exposures.

Like a point of order, the key benefit of a trigger is that it would require explicit consideration of exposures facing the government without adding uncertainty to primary budget data. However, like points of order, establishing triggers would increase the complexities of an already complex budget process. Further, the implementation issues associated with determining the trigger threshold and the type of action required would have to be addressed.[34] A budget process change establishing a trigger would require an amendment to the Congressional Budget Act of 1974 or a change to committee rules.

[32]U.S. General Accounting Office, *Medicare Reform: Issues Associated With General Revenue Financing*, GAO/T-AIMD-00-126 (Washington, D.C.: Mar. 27, 2000).

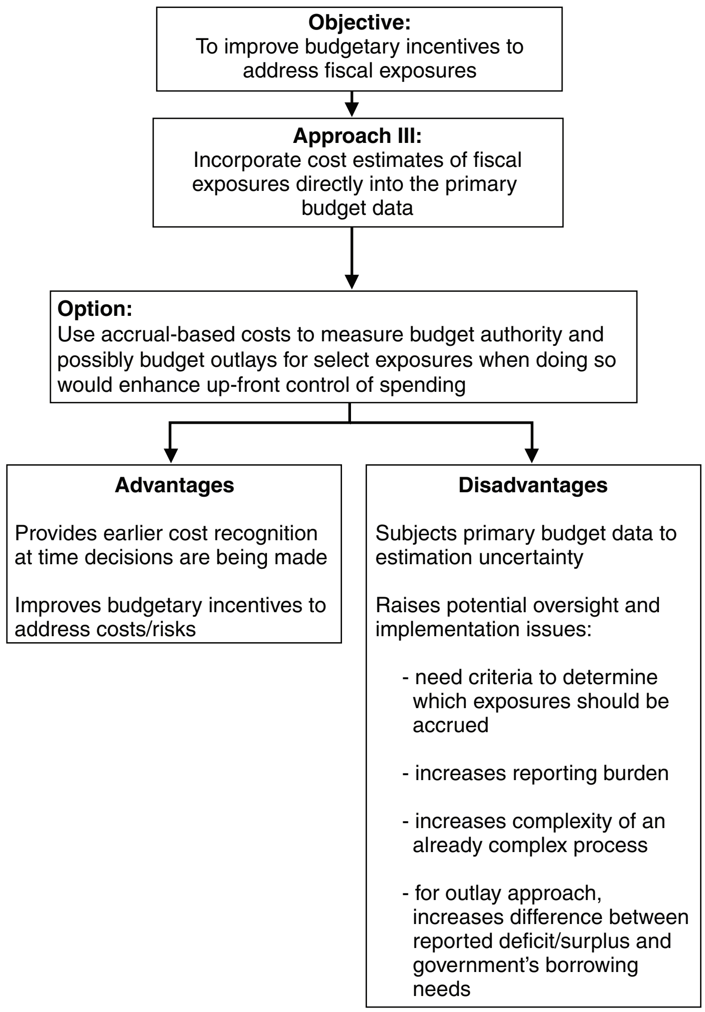
[33]Rules established by the current Congress can be changed by a subsequent Congress.

[34]Such a procedure would require some assurance of unbiased estimates.

Approach III: Incorporate Cost Estimates of Fiscal Exposures Directly into the Primary Budget Data

Incorporating the estimated future costs of fiscal exposures directly into the budget would represent the greatest change outlined in our spectrum. For example, as shown in figure 7, accrual-based costs could be used to measure budget authority needed and possibly outlays for select programs when doing so would enhance obligation-based control. Since estimated costs would be incorporated directly into the primary budget data, these options are most suitable for explicit exposures for which reasonable cost estimates are available.

Figure 7: Possible Options for Incorporating Costs Directly into the Primary Budget Data



Source: GAO.

The budget's measurement basis can greatly affect the timing of when a program or activity appears in the budget. Accrual-based measurement recognizes cost at the time the activity generating the revenue, consuming the resources, or increasing the liability takes place regardless of when the associated cash flows occur. Conversely, cash-based measurement recognizes receipts and outlays at the time cash is received or paid regardless of when the activity generating the revenue, consuming the resources, or increasing the liability occurs. The U.S. budget is neither accrual nor pure cash; it is obligation based. Obligation-based budgeting is designed to ensure that agencies do not incur legal obligations unless and until Congress provides authority for agencies for that purpose. However, with limited exceptions, the amounts to be obligated are measured on a cash or cash equivalent basis and the deficit/surplus—a key focus of the policy debate—represents the difference between cash receipts and cash outlays in a given year. As a result, the U.S. budget is often referred to as cash based as well as obligation based. Cash measurement for budgeting has the advantage of being recognized as an accepted measure of the government's impact on the economy, which is an important gauge of fiscal policy.

Although the current cash- and obligation-based budget has several benefits, the United States has recognized the contribution accrual-based measurement can make to budgeting. Since about 1955, interest has been accrued in the budget for Treasury securities held by the public. Even before 1955, a portion of the accruing costs for civilian employee pensions had been recognized in the budget. We have advocated the selective use of accrual measures in the budget to better reflect costs at the time decisions were made. The budget has been modified gradually to use accrual-based measurement for certain programs in areas where doing so would enhance up-front recognition of costs. For example, the accruing costs of military pension benefits have been included in the budget at the program level since 1985 and the Federal Credit Reform Act of 1990 changed the method of controlling and accounting for credit programs to an accrual basis to provide more timely recognition of their costs.

Prior to credit reform, obligations measured on a cash basis for credit programs sent the wrong signals about the government's exposure. The full amount of direct loans was reported as an outlay, ignoring the fact that many would be repaid. In contrast, for loan guarantees, initially no outlays were reported, ignoring the fact that some guaranteed loans would be defaulted upon and require budget outlays. Consequently, the use of cash-based measurement overstated the cost of direct loans in the year they were made and understated the costs of loan guarantees in the year they were issued. This deficient reporting skewed cost comparisons between credit and grant programs with similar purposes but different funding approaches. The relative cost of credit programs and other federal spending was misrepresented. Credit reform addressed the shortfalls of cash-based measurement for credit programs by requiring the budget to include the estimated cost to the federal government over the entire life of the loan or loan guarantee, calculated on a net present value basis. By incorporating accrual cost measures in the budget for credit programs, credit reform improved cost comparisons and better reflected the government's ultimate costs at the time decisions to extend the credit were being made.

Similar concerns about the shortcomings of cash-based measurements for other programs that involve cash flows over many years, such as pensions and insurance, stimulated interest in whether further incorporation of accruals in the budget would be useful. We reviewed the experiences of six countries that had adopted, or planned to adopt, accrual-based budgeting.[35] In this work, we noted that the use of accrual-based measurement selectively within the obligation-based budget would result in earlier cost recognition for some major exposures such as employee retirement benefits, insurance, and environmental clean-up costs. In these cases, if reasonable cost estimates are available, the use of accrual-based measurement would help reinforce the up-front control focus of the obligation-based budget.

However, we also noted some limitations and concerns. We pointed out that relative to the obligation-based budget, accrual-based measurement would delay cost recognition of capital assets by spreading the costs over the life of the assets[36] and for some government activities, such as salaries and grants, there generally would not be significant differences between cash and accrual amounts. Further, the use of accrual measurement needs to be considered carefully to avoid subjecting the primary budget data to large and volatile reestimates. We also pointed out that accrual budgeting based on current federal accounting standards would not recognize social insurance benefits because those standards do not view social insurance as a liability beyond the amount due and payable to current beneficiaries at the end of the period. We suggested alternative budgetary approaches could be used to recognize the future costs of Social Security benefits. For example, Social Security outlays could be recorded in the same amount as Social Security receipts to reflect the government's commitment to spend those amounts on benefits in the future. Such an approach may serve to prompt earlier recognition of future claims supported by earmarked

[35]See GAO/AIMD-00-57.

[36]Accrual budgeting for capital assets based on depreciation matches budget costs with the provision of goods and services but, without compensating controls, raises issues about up-front cost recognition and control over capital asset acquisitions.

receipts. On the other hand, this approach would represent a significant change in budgetary treatment and could reduce fiscal discipline for spending in programs financed by earmarked receipts.

Two methods could be used to incorporate accrual-based costs directly into the budget for fiscal exposures. One method (the aggregate outlay method) would be to use accrual-based measurement to recognize costs in both budget authority needed and net outlays. Under this method, the accrued cost of the fiscal exposure would be included in the budget totals and therefore in the budget deficit/surplus. This method is similar to that used for credit programs under credit reform. Another method (the aggregate budget authority method) would use accrual-based measurement to recognize costs in budget authority at the account level and in the aggregate budget totals. Accrued costs would also be reflected in net outlays at the account level but then would be offset by a transfer within the budget to another account. Aggregate net outlays and thus the deficit/surplus would continue to be reported on a cash basis. This is similar to the method currently used for some employee pension costs.

A key advantage of budgeting for the accruing costs of exposures is the recognition of the government's costs at the time decisions are being made to commit the government. This earlier recognition of costs improves the information available to policymakers about the costs associated with current decisions and may improve the incentives to manage these costs. However, this benefit is dependent on reasonable, unbiased estimates of the government's costs. For some programs, such as life insurance, reasonable cost estimates may be available, but for other programs such as deposit insurance, health care costs, or social insurance benefits, estimates are less certain. Because the future costs of some exposures are dependent upon many economic and technical variables that cannot be known in advance, there will always be uncertainty in cost estimates. Such uncertainty makes using accrual-based measurement directly in the budget more difficult. Budgeting for accruing costs may make sense for some exposures but not for others because the certainty of the government's commitment and the availability of reasonable, unbiased estimates varies across the different fiscal exposures.

Using accrual-based measurement in the budget has the potential to increase the complexity of the budget in several ways. Complexity may be increased through the use of (1) sophisticated estimation models, (2) multiple budget accounts and/or presentations to reflect cash flows and program reserves, and (3) procedures to handle reestimates of costs reported as budget authority and/or outlays. Although recognition of costs may be improved, general understanding of budget data and the budget process may decline. Further, if estimates are seen as short-term gaming or overly erratic, credibility is eroded. Stopping short of using accrual-based measurement for aggregate outlays and measuring only budget authority and agency outlays on an accrual basis would mitigate some of the potential problems associated with accrual budgeting while providing information on future costs. For example, if aggregate outlays remain on a cash basis and only budget authority and agency outlays are accrual based, there would be no need for nonbudgetary accounts[37] that are necessary to hold reserves under an aggregate outlay approach. This aggregate budget authority option also would avoid introducing estimation uncertainty into the budget deficit/surplus that with limited exception is calculated as net cash outlays. However, since the accrual-based cost would not be reflected in the budget deficit/surplus, it is unclear how much this approach would affect the budget decision-making process.

Conclusion

Today's budget decisions, in part, shape the choices and resources available to future decisionmakers and taxpayers. Accordingly, today's budget decisions involve tradeoffs between satisfying current needs and fulfilling stewardship responsibilities to future generations' budget and economy. The federal government undertakes a wide range of responsibilities, programs, and activities that may obligate the government to future spending or simply create an expectation for such spending. Current budget reporting, however, is not always designed to promote the recognition and explicit consideration of some of these "fiscal exposures." These exposures range from explicit liabilities to the implicit promises embedded in current policy or public expectations. Failure to understand and address these exposures can have significant consequences. Regardless of whether the government is legally required or simply

[37]Nonbudgetary accounts appear in the budget document for information purposes but are not included in the budget totals for budget authority or outlays. They account for transactions of the government that do not belong within the budget because they are a means of financing and do not represent a cost to the government.

compelled by circumstances to provide funding in the future, these exposures may encumber future budgets and constrain fiscal policy. Not capturing the long-term costs of current decisions limits Congress's ability to control the government's fiscal exposures at the time decisions are made.

The diversity of items that could be considered fiscal exposures increases the difficulty of determining which items should be considered and how and to what extent they should be handled in the budget process. Specifically, budgeting for fiscal exposures is complicated by difficulties in (1) determining which items should be considered fiscal exposures and (2) estimating their costs. Despite these challenges, the potentially significant effects of these items on the nation's future fiscal condition warrant efforts to improve disclosure and oversight.

The diversity of fiscal exposures suggests that across-the-board changes in budget reporting or process would not be the most appropriate way to proceed. Instead, it would be more useful to look at different types of fiscal exposures and tailor changes to address specific budgetary objectives and implementation challenges. Improved supplemental reporting would be helpful in increasing awareness without introducing uncertainty and complexity into the primary budget data. In cases where the extent of the government's obligation or ultimate costs (or both) is unclear, supplemental reporting may be the most appropriate approach. Beyond simply increasing awareness, adapting the budget process to facilitate explicit consideration of fiscal exposures might be possible. Finally, for exposures where the government's obligation is explicit and reasonable cost estimates are available, additional steps could be taken to directly incorporate costs in some primary budget data when doing so would enhance up-front control of spending. The direct incorporation of accrual-based measures in the budget may be appropriate for selected exposures where such treatment would enhance obligation-based control by prompting the recognition of expected future costs of decisions when they are made.

With complete and highly visible reporting of fiscal exposures, decisionmakers are better positioned to address future costs and to help prevent unexpected changes in fiscal policy. Since today's decisions affect the choices and resources available for the future, improvements in budgeting for fiscal exposures are critically important.

Recommendations for Executive Action

OMB should report annually on fiscal exposures, including a concise list and description of such exposures, cost estimates, where possible, and an assessment of methodologies and data used to produce cost estimates for such exposures. In addition, where possible, OMB should report the estimated costs associated with certain exposures as a new budget concept—"exposure level"—as a notational item in the Program and Financing schedule of the President's budget. For select areas where an explicit liability exists and there are accepted cost-estimation methodologies, the ultimate objective might be to include the costs directly in the budget when doing so would enhance obligation-based control. OMB also should ensure that agencies focus on improving cost estimates for fiscal exposures. These steps should complement and support continued and improved reporting of long-range projections and analysis of the budget as a whole to assess fiscal sustainability and flexibility.

Matters for Congressional Consideration

Congress may wish to consider exploring options for improving the information available and the attention given to fiscal exposures in the budget and budget process. If more explicit congressional consideration is desired, as estimates improve, Congress may wish to develop budget process mechanisms that prompt more deliberation about fiscal exposures while recognizing the uncertainty inherent in estimating some long-term costs.

Agency Comments and Our Evaluation

We provided a draft of this report to the Office of Management and Budget for comment. In consultation with OMB staff, they commended GAO for tackling the important problem of the government's exposure to future fiscal demands. OMB staff agreed that our concept of "fiscal exposure" is a valuable one, noting that it focuses attention on the fact that 1-year's surplus or deficit is not the only, or even the best, measure of the government's fiscal condition. They noted that the Administration endorses the view that long-range fiscal exposures should be more prominently highlighted in the budget documents and in the budget process, and noted that some of the specific recommendations are more or less consistent with legislation the Administration has proposed to Congress (accruals for pensions and retiree health care). OMB staff, however, raised two general concerns that are discussed below. First, they questioned whether the broad conceptual framework used to describe fiscal exposures had been fully developed to sufficiently cover all future spending. Secondly, they argued that the analysis of ideas for improving the recognition of fiscal exposures in the budget could be improved by more fully considering the various purposes of the federal budget, such as resource allocation and controlling spending. In addition, they provided specific comments that we have incorporated in the report as appropriate.

OMB staff stated that the term “exposure” is particularly laudable because it captures the contingent nature of some future budgetary requirements, which are critical to distinguish from the more definite, legally binding requirements that are categorized as “liabilities” on the financial statements. OMB staff also noted that the draft appropriately emphasizes that fiscal exposures lie along a continuum and recognized that this heterogeneity requires that different fiscal exposures be addressed in different ways for the budget documents. They, however, commented that the discussion of fiscal exposures could be improved by explicitly recognizing that in concept all, or virtually all, future spending appears on the continuum of fiscal exposure. For example, OMB staff pointed out that the Constitution establishes a responsibility to “provide for the common defense” and the authority for an Army and a Navy, and more than two centuries of experience have created an expectation that this responsibility will be met and the cost will be high. They stated that while the future costs of these functions do not appear in the financial statements, they are no less basic expectations of government than others that do appear there. We agree that it is important to model the long-term outlook for the budget as a whole at the macro level. Indeed, we have been doing such long-term modeling since 1992 and we commend OMB’s efforts to present long-term scenarios in the Analytical Perspectives of the President’s budget. While long-term modeling simulates the long-term implications of all current spending and revenue policies, the fiscal exposure concept is intended to highlight a discrete subset of programs and activities whose long-term costs and uncertainties warrant greater attention in current budgetary deliberations.

OMB staff also stated that a number of the ideas and recommendations in the draft are very good, and point to improvements that should be made in the budget. OMB staff, however, argued that the analysis of recommendations should more explicitly consider their effects on the main purposes of budgetingto allocate resources, control agency spending, and set aggregate fiscal policy. We agree that the various purposes of the budget should be considered in assessing the merits of approaches and options for improving the budget treatment of fiscal exposures. We did, in fact, structure our discussion of potential approaches for improving the budget treatment of fiscal exposures around objectives of budget reforms.

As part of our illustrative examples, we provided insights into the potential issues for the multiple, and sometimes conflicting, purposes of the federal budget. We agree, however, that these issues warrant further investigation if specific reforms are pursued.

As agreed with your office, unless you release this report earlier, we will not distribute it until 30 days from the date of this letter. At that time we will send copies to the Ranking Minority Member of the House Committee on the Budget and the chairmen and ranking minority members of the Senate Committee on the Budget. We are also sending copies to the Directors of the Office of Management and Budget and the Congressional Budget Office. Copies will also be made available to others upon request. In addition, the report is available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of Christine Bonham, Assistant Director, Strategic Issues, who may be reached at (202) 512-9576. Elizabeth McClarin was a major contributor to this report. Please contact me at (202) 512-9573 if you or your staff have any questions concerning this report.

Sincerely yours,

Paul L. Posner

Paul L. Posner
Managing Director, Strategic Issues
Federal Budget Analysis

United States
General Accounting Office
Washington, D.C. 20548-0001

Official Business
Penalty for Private Use $300

Address Service Requested

Presorted Standard
Postage & Fees Paid
GAO
Permit No. GI00

[redacted]