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# LONG-TERM FISCAL ISSUES

# Increasing Transparency and Reexamining the Base of the Federal Budget

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GAO

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Mr. Chairman, Senator Conrad, Members of the Committee:

I appreciate this opportunity to talk with you about our nation's long-term fiscal outlook and the challenge it poses for the budget and oversight processes. Today, I will first provide the committee with the results of our most recent simulations of the long term fiscal outlook, updating a model we initially developed for members of this Committee in 1992. I will also discuss some ideas for increasing transparency of the long-term costs of government commitments and the range of fiscal exposures—work we first did at the request of your counterparts in the House.[1] Finally, I will talk about a forthcoming report that we believe will help the Congress in dealing with a range of performance and accountability issues. As this Committee knows, we periodically pull together our work for the Congress in ways we hope will help in its budget and programmatic deliberations and oversight activities.[2] Our recently issued High-Risk update is the most recent example.[3] All of these are part of our periodic efforts to provide our professional insights about programs or operations needing oversight and review through such series as high risk and budget options reports.[4]

Next week we will issue another report that builds on our past and pending work—90 percent of which is requested by the Congress or required by law—to provide policy makers with a comprehensive compendium of those areas throughout government that could be considered ripe for reexamination and review based on our past work and institutional knowledge. This report is entitled *21st Century Challenges: Reexamining the Base of Government*. In this report we with present illustrative questions for policy makers to consider as they carry out their responsibilities. These questions look across major areas of the budget and federal operations including discretionary and mandatory spending, and tax policies and programs. These questions are intended as one input among many that Congress will receive as it decides what its agenda will be for oversight and program review through its various committees. Others

[1]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[2] See, for example, GAO, *Opportunities for Congressional Oversight and Improved Use of Taxpayer Funds: Budgetary Implications of Selected GAO Work*, GAO-04-649 (Washington, D.C.: May 7, 2004).

[3]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: Jan. 2005).

[4]Legislative Reorganization Act of 1970, 31 U.S.C. Section 717(b).

have formulated very detailed comprehensive agendas with specific policy proposals—the President's budget released yesterday is one very prominent example. We hope that this new report will be used by various congressional committees as they consider which areas of government need particular attention and reconsideration, recognizing that while answers to these questions may draw on the work of GAO and others, only elected officials can and should decide whether, how, and when to move forward.

The overall picture on the long term fiscal outlook is not news to this Committee. Simply put, our nation's fiscal policy is on an unsustainable course and our long-term fiscal gap grew much larger in fiscal year 2004. Long-term budget simulations by GAO, the Congressional Budget Office (CBO), and others show that, over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by future generations.

As this Committee knows, the long-term outlook challenges the budget process to provide more transparency about the specific exposures that will encumber our fiscal future. While the 10-year outlook is important, Congress may wish to think more about what metrics and measures need to be added to more clearly identify the long-term consequences of current proposals before legislative action is taken. In my view, elected representatives should have more explicit information on the present value dollar costs of major spending and tax bills—before they vote on them. In my testimony, I will discuss changes in the information provided and budgetary incentives that could improve transparency, prompting more deliberation about and improving budgetary incentives to address such bills.

Regardless of the assumptions used, all simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination of major spending and tax policies and priorities will be important to recapture our fiscal flexibility and update our programs and priorities to respond to emerging social, economic, and security changes. Ultimately, this reexamination will entail a national discussion about what Americans want from their government and how much they are willing to pay for those things. Many, if not most, current federal programs and policies, in fact, were designed decades ago to respond to trends and challenges that existed at the time of their creation. Our recent entry into a new century has helped to remind us of how much has changed in the past several decades—whether it be rapid shifts in the security threats facing the nation, the aging of our population, the globalization of economic transactions, the escalation of health care costs, increased environmental concerns, or the significant advances in technologies and transportation systems. This discussion will not be easy since there is no "low hanging fruit" in the budget, but acting sooner will enable us to avoid precipitous changes while providing more transition time.

## The Long-Term Budget Outlook

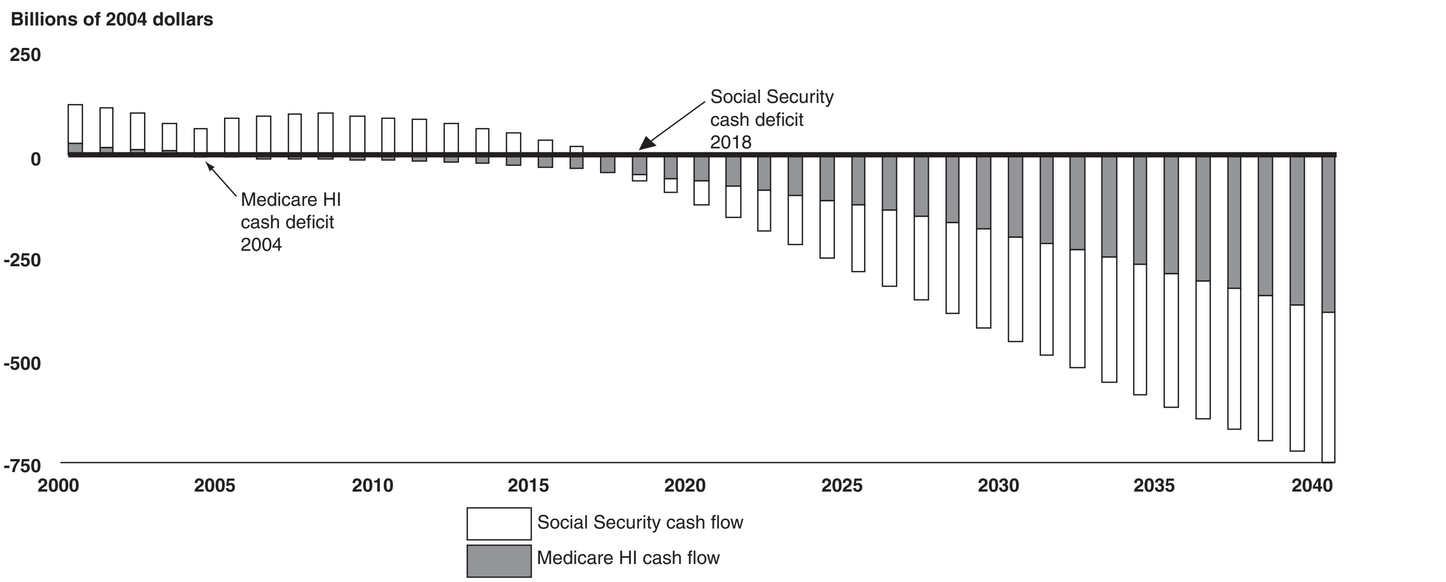
Three years ago when I appeared before this Committee, I spoke about a large and growing long-term fiscal gap driven largely by known demographic trends and rising health care costs.[5] Unfortunately, despite a brief period with budget surpluses, that gap has grown much wider. Last year's Medicare prescription drug bill was a major factor, adding $8.1 trillion to the outstanding commitments and obligations of the U.S. government in long-term present value terms. The near-term deficits also reflected-higher Defense, homeland security, and overall discretionary spending which exceeded growth in the economy, as well as revenues which have fallen below historical averages due to policy decisions and other economic and technical factors. While the size of the nation's long-term fiscal imbalance has grown significantly, the retirement of the "baby boom" generation has come closer to becoming a reality. Given these and other factors, it is clear that the nation's current fiscal path is unsustainable and that tough choices will be necessary in order to address the growing imbalance.

The cost implications of the baby boom generation's retirement have already become a factor in CBO's baseline projections and will only intensify as the baby boomers age. According to CBO, total federal spending for Social Security, Medicare, and Medicaid is projected to grow by about 25 percent over the next 10 years—from 8.4 percent of GDP in 2004 to 10.4 percent in 2015. Although the Trustees' 2004 intermediate

[5]GAO, *Budget Issues: Long-Term Fiscal Challenges*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002).

estimates project that the combined Social Security Trust Funds will be solvent until 2042,[6] program spending will constitute a rapidly growing share of the budget and the economy well before that date. Under the Trustees' 2004 intermediate estimates, Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin a permanent decline beginning in 2008. To finance the same level of overall federal spending as in the previous year, additional revenues and/or increased borrowing will be needed in every subsequent year. (See fig. 1.)

**Figure 1: Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits**




Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare and Medicaid Services.

Note: Projections based on the intermediate assumptions of the 2004 Trustees' reports.

By 2018, Social Security's cash income (tax revenue) is projected to fall below benefit payments. At that time, Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays exceeded cash income in

[6] Separately, the Disability Insurance (DI) fund is projected to be exhausted in 2029 and the Old-Age and Survivors' Insurance (OASI) fund in 2044. Using slightly different economic assumptions and model specifications, CBO estimated the combined Social Security trust fund will be solvent until 2052. CBO, *The Outlook for Social Security* (Washington, D.C.: June 2004).

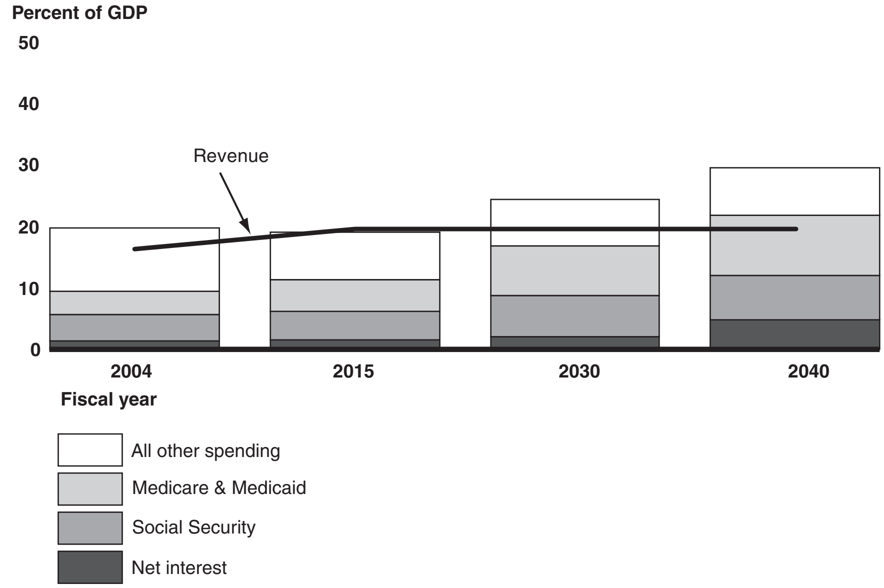
2004, as a net claimant on the rest of the federal budget. The combined OASDI Trust Funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. At this point, Treasury will need to obtain cash for those redeemed securities either through increased taxes, spending cuts, and/or more borrowing from the public than would have been the case had Social Security's cash flow remained positive.

Ultimately, the critical question is not how much a misleadingly labeled "trust fund" has in assets, but whether the government as a whole can afford the benefits in the future and at what cost to other claims on scarce resources. As I have said before, the future sustainability of programs is the key issue policy makers should address—that is, the capacity of the economy and budget to afford the commitment in light of overall current and projected fiscal conditions.

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. Figures 2 and 3 present these simulations under two different sets of assumptions. In the first, we begin with CBO's January baseline—constructed according to the statutory requirements for that baseline.[7] Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2015 level. In the second figure, two assumptions are changed: (1) discretionary spending is assumed to grow with the economy after 2005 rather than merely with inflation, and (2) the tax cuts are extended. For both simulations, Social Security and Medicare spending is based on the 2004 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2003 long-term projections under mid-range assumptions.

[7]The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, (Washington, D.C.: Jan. 2005).

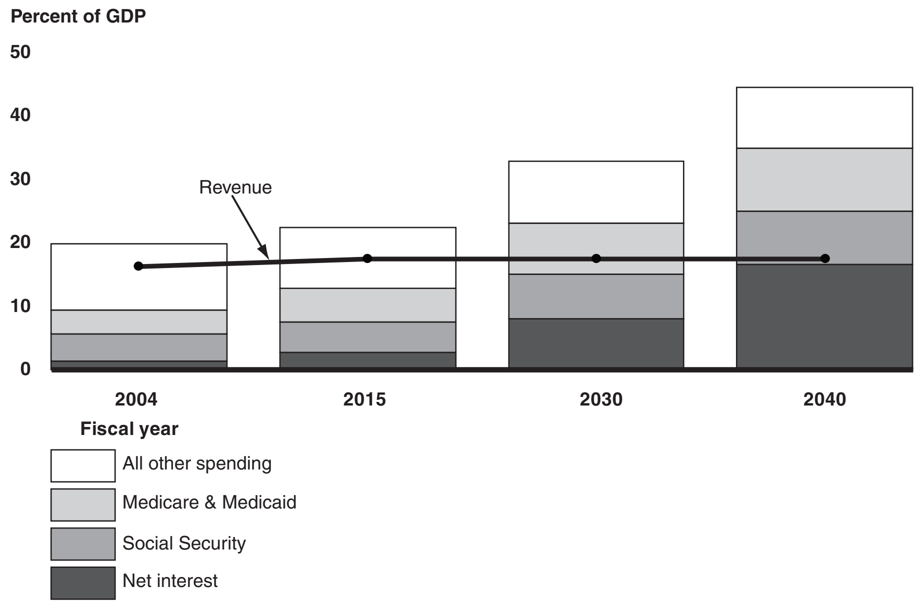
**Figure 2: Composition of Spending as a Share of Gross Domestic Product (GDP) Under Baseline Extended**




Source: GAO's January 2005 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the Alternative Minimum Tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

**Figure 3: Composition of Spending as a Share of Gross Domestic Product Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended**



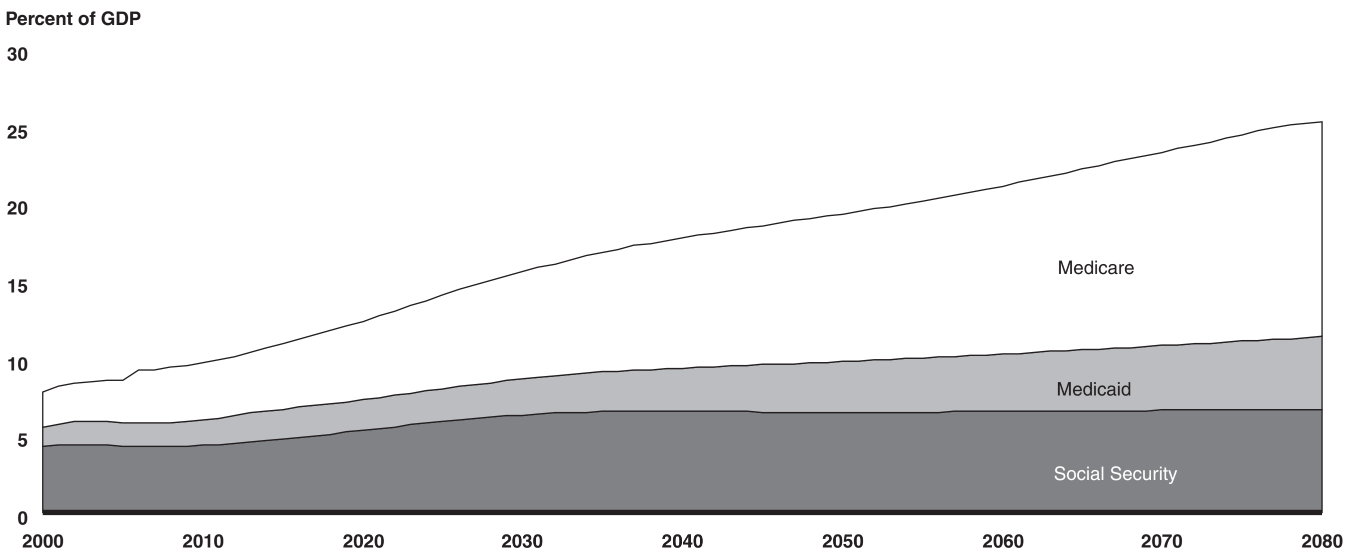

Source: GAO's January 2005 analysis

Note: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

As both these simulations illustrate, absent policy changes on the spending or revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on the federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, making no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes—and that seems implausible. Accordingly, substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility.

Although considerable uncertainty surrounds long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age. The aging population and rising health care spending will have significant implications not only for the budget, but also the economy as a whole. Figure 4 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

**Figure 4: Social Security, Medicare, and Medicaid Spending as a Percent of GDP**



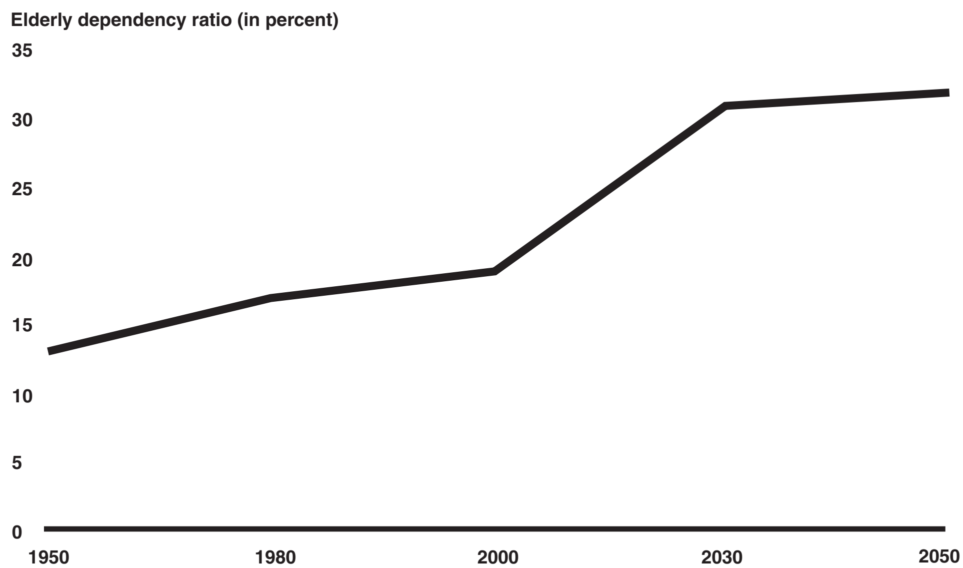

Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2004 Trustees' Reports. Medicaid projections based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

The government can help ease future fiscal burdens through spending reductions or revenue actions that reduce debt held by the public, saving for the future, and enhancing the pool of economic resources available for private investment and long-term growth. Economic growth is essential, but we will not be able to simply grow our way out of the problem. The numbers speak loudly: Our projected fiscal gap is simply too great. Closing the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act the better.

The retirement of the baby boom generation is not the only demographic challenge facing our nation. People are living longer and spending more time in retirement. As shown in figure 5, the U.S. elderly dependency ratio is expected to continue to increase.[8] The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost 1 elderly dependent for every 3 people of working age—a ratio of 32 percent. Additionally, the average life expectancy of males at birth has increased from 66.6 in 1960 to 74.3 in 2000, with females at birth experiencing a rise from 73.1 to 79.7 over the same period. As general life expectancy has increased in the United States, there has also been an increase in the number of years spent in retirement.

**Figure 5: U.S. Elderly Dependency Ratio Expected to Continue to Increase**

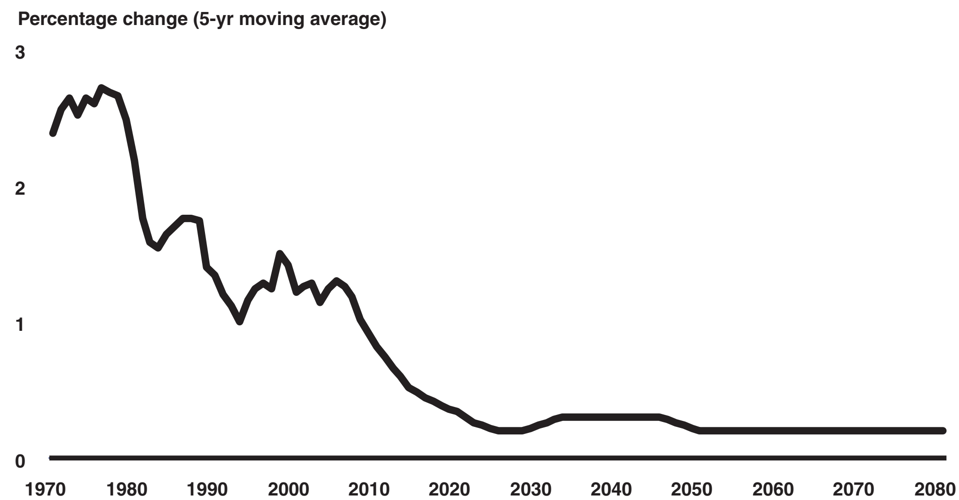



Source: Population division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision and World Urbanization Prospects: 2001 Revision. Data for 2030 - 2050 are projected.

[8]The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.

A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95. The combination of these factors means that annual labor force growth will begin to slow after 2010 and by 2025 is expected to be less than a fifth of what it is today. (See fig. 6.) Thus, relatively fewer workers will be available to produce the goods and services that all will consume. Lower labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

**Figure 6: Labor Force Growth Is Expected to Slow Significantly**

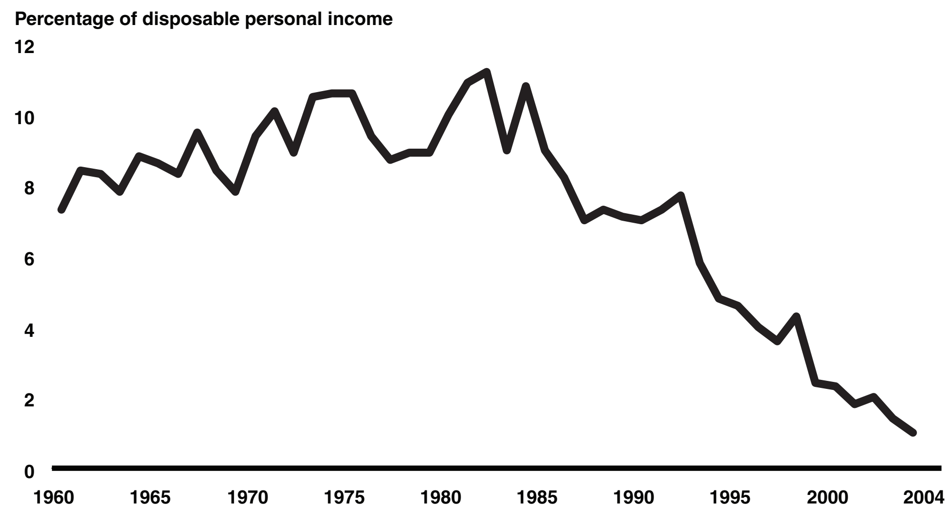



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: Percentage change is calculated as a centered 5-year moving average of projections based on the intermediate assumptions of the 2004 Trustees' Reports.

Increased investment could increase the productivity of workers and spur economic growth. However, increasing investment depends on national saving, which remains at historically low levels. Historically, the most direct way for the federal government to increase saving has been to reduce the deficit (or run a surplus). Although the government may try to increase personal saving, results of these efforts have been mixed. For example, even with the preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has steadily declined. (See fig. 7.) Even if the economic growth increases, the structure of retirement programs and historical experience in health care cost growth suggest that higher economic growth results in a generally commensurate growth in spending for these programs over the long run.[9]

**Figure 7: Personal Saving Rate Has Steadily Declined**




Source: Bureau of Economic Analysis.

In recent years, personal saving by households has reached record lows, while at the same time the federal budget deficit has climbed. Accordingly, national saving has diminished, but the economy has continued to grow, in part because more and better investments were made. That is, each dollar saved bought more investment goods, and a greater share of saving was invested in highly productive information technology. The economy has also continued to grow because the United States was able to invest more than it saved by borrowing abroad, that is, by running a current account deficit. However, a portion of the income generated by foreign-owned assets in the United States must be paid to foreign lenders. National saving is the only way a country can have its capital and own it too.

The persistent U.S. current account deficits of recent years have translated into a rising level of indebtedness to other countries. However, many other nations currently financing investment in the United States also will face

[9]Initial Social Security benefits are indexed to nominal wage growth, resulting in higher benefits over time.

aging populations and declining national saving, so relying on foreign savings to finance a large share of U.S. domestic investment or federal borrowing is not a viable strategy for the long run.

In general, saving involves trading off consumption today for greater consumption tomorrow. Our budget decisions today will have important consequences for the living standards of future generations. The financial burdens facing the smaller cohort of future workers in an aging society would most certainly be lessened if the economic pie were enlarged. This is no easy challenge, but in a very real sense, our fiscal decisions affect the longer-term economy through their effects on national saving.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window during which today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. We also lose the opportunity to reduce the burden of interest in the federal budget, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift. Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing.

## Fiscal Exposures

Although Social Security, Medicare, and Medicaid drive the long-term outlook, they are not the only federal programs or activities in which the federal government has made long-term commitments. At GAO, we are in the truth, transparency, and accountability business. A crucial first step is to insist on truth and transparency in government operations, including federal financial reporting, budgeting, and legislative deliberations. The federal government must provide a fuller and fairer picture of existing budget deficits, the misnamed "trust funds," and the growing financial burdens facing every American, especially younger Americans.

On the budget side, the current 10-year cash-flow projections are an improvement over past practices. But given known demographic trends, even these projections fail to capture the long-term consequences of today's spending and tax policy choices. In my view, elected representatives should have more explicit information on the present value dollar costs of major spending and tax bills—before they vote on them. We believe that members of Congress, the President, and the public should have information about any long-term commitments embodied in a current policy decision. Some years ago, we developed the term "fiscal exposures" 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.[10]

Fiscal exposures vary widely as to source, extent of the government's legal obligation, likelihood of occurrence, and magnitude. They 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. By extending beyond conventional accounting, the concept of fiscal exposure is meant to provide a broad perspective on long-term costs and uncertainties. Fiscal exposures include items such as retirement benefits, environmental cleanup costs, the funding gap in Social Security and Medicare, and the life cycle cost for fixed assets. Given this variety, 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. Table 1 shows some selected fiscal exposures.[11]

[10]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[11]While this list 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 agree-upon list.

**Table 1: Selected Fiscal Exposures: Sources and Examples 2004[a]**

| Type | Example (dollars in billions) |
| --- | --- |
| Explicit liabilities | Publicly held debt ($4,297)<br>Military and civilian pension and post-retirement health ($3,059)<br>Veterans benefits payable ($925)<br>Environmental and disposal liabilities ($249)<br>Loan guarantees ($43) |
| Explicit financial commitments | Undelivered orders ($596)<br>Long-term leases ($39) |
| Financial contingencies | Unadjudicated claims ($4)<br>Pension Benefit Guaranty Corporation ($96)<br>Other national insurance programs ($1)<br>Government corporations e.g., GinnieMae |
| Exposures implied by current policies or the public's expectations about the role of government | Debt held by government accounts ($3,071)[b]<br>Future Social Security benefit payments ($3,699)[c]<br>Future Medicare Part A benefit payments ($8,236)[c]<br>Future Medicare Part B benefit payments ($11,416)[c]<br>Future Medicare Part D benefit payments ($8,119)[c]<br>Life-cycle cost, including deferred and future maintenance and operating costs (amount unknown)<br>Government-Sponsored Enterprises, e.g., Fannie Mae and Freddie Mac |

Source: GAO analysis of data from the Department of the Treasury, the Office of the Chief Actuary, Social Security Administration, and the Office of the Actuary, Centers for Medicare and Medicaid Services.

[a]All figures are as of the end of fiscal year 2004, except Social Security and Medicare estimates, which are as of January 1, 2004.

[b]This amount includes $845 billion held by military and civiian pension and post-retirement health funds that would offset the explicit liabilities reported by those funds.

[c]Figures for Social Security and Medicare are net of debt held by the trust funds ($1,531 billion for Social Security, $256 billion for Medicare Part A, and $24 billion for Medicare Part B) and represent net present value estimates over a 75-year period. Over an infinite horizon, the estimate for Social Security would be $10.4 trillion, $21.8 trillion for Medicare Part A, $23.2 trillion for Medicare Part B, and $16.5 trillion for Medicare Part D.

As currently structured, these fiscal exposures constitute significant and in many cases growing encumbrances on the budgetary resources of the future. The current budget projections primarily focus attention on the 5-to10-year budget window. While this is an important and appropriate frame for assessing the impacts of federal fiscal policy on the economy, longer-term estimates and projections can also help provide important perspective. At the macro level, the long-term fiscal models we and CBO have developed should help frame the near-term choices we face by bringing in information on their long-term impact. At the micro level, better information on the longer-term costs of selected exposures—particularly those scheduled to grow rapidly—can help focus attention on those program commitments presenting significant fiscal burdens over the longer term.

For example, in considering the prescription drug legislation, much controversy was focused on the specific 10-year cost estimate that should be used in the congressional consideration of this new entitlement. However, comparatively little attention was paid to the long-term costs that this new commitment would pose for future generations over a 75-year period—$8.1 trillion in present value terms, net of premiums. Since the full costs of this new entitlement increase significantly over the longer term, decision makers need to be better informed about the growth path and the impact on the nation's finances beyond the 10-year window.

The President and the Congress face the challenge of sorting out the many claims on the federal budget without the budget enforcement mechanisms—discretionary spending caps and pay-as-you-go (PAYGO) discipline—or fiscal benchmarks that guided the federal government through the years of deficit reduction into a brief period of federal surpluses. While a number of steps will be necessary to address this challenge, truth and transparency in financial reporting and budgeting are essential elements of any attempt to address the nation's long-term fiscal challenges. The fiscal risks can be managed only if they are properly accounted for and publicly disclosed, including the many existing commitments facing the government. In addition, new budget control mechanisms will be required.

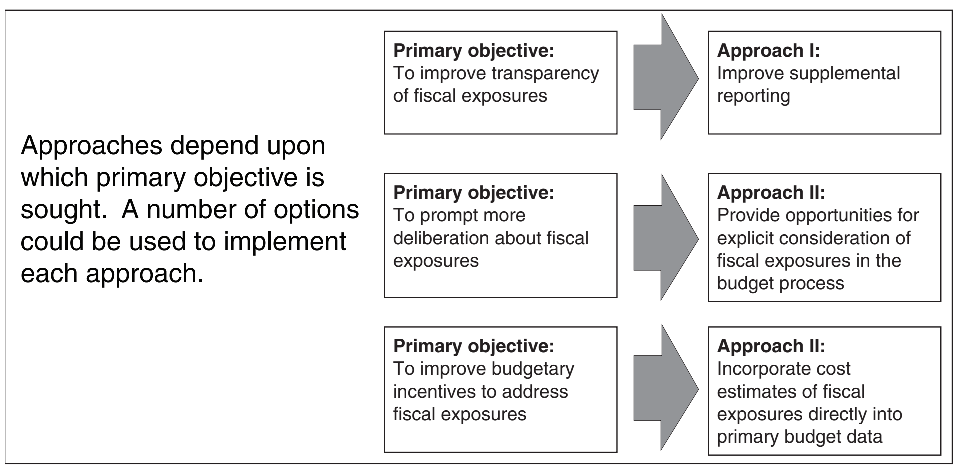
So what can we do to frame information and decisions so that decision makers can appropriately focus on fiscal exposures? The variety of certainties—and uncertainties—associated with fiscal exposures means that no single approach to increasing attention to them will work in all cases. Instead, targeted approaches for different types of fiscal exposures would, I think, be most useful for incorporating a longer-term perspective into the budget. Changes in the information provided, the budget process, or budgetary incentives could be tailored selectively for different categories of fiscal exposures to improve transparency, prompt more deliberation about them, or improve budgetary incentives to address them.

Several approaches that could be used, depending on the type of program and information available, are

- improve supplemental reporting,
- include fiscal exposures in the budget process, and
- include fiscal exposures in budget data.

Figure 8 shows these alternative approaches and relates them to the primary objective that each could help achieve. For example, approach III, in which fiscal exposure cost estimates are incorporated directly into budget data, would help achieve the objective of improving budgetary incentives to address the fiscal exposures. Each approach could be implemented in a number of ways, which I will briefly discuss.

**Figure 8: Alternative Approaches to Using Fiscal Exposure Estimates in Budget Decisions**




Source: GAO analysis.

## Approach I : Improve Supplemental Reporting

Improved supplemental reporting on fiscal exposures would make information more accessible to decision makers without introducing additional uncertainty and complexity directly into the budget. Estimates of the government's exposures would be reported in various budget documents, but the current basis of reporting primary budget data—budget authority, obligations, outlays, and deficit/surplus—would not be changed. In some cases, improving supplemental reporting may simply be a matter of highlighting or expanding existing analytical work, such as continuing and improving long-range projections and simulations of the budget as a whole. Other ways of providing additional supplemental information could be special analyses for certain significant fiscal exposures in the *Analytical Perspectives* of the budget or an annual report on fiscal exposures prepared by OMB. In the congressional budget process, greater focus could center on the long-term net present value of proposed new commitments for items where the 10-year estimate does not fully capture the dimensions of cost growth expected, similar to the Medicare prescription drug bill I mentioned earlier.

But another idea that we have discussed in the past[12] is to routinely report the future estimated costs of certain exposures as a separate notational line in the budgetary schedules in the President's budget. For example, an estimate of the future operating and maintenance costs associated with capital acquisitions could be reported as the "exposure level" for capital accounts that include the initial capital acquisition costs. Similarly, the future funding needs associated with incrementally funded projects could be included with the budget account that includes the capital acquisition. And future environmental cleanup costs associated with an asset acquisition could be handled the same way. The exposure levels might be reported in present value terms. Including them as part of the budget presentations at the account level would make such information available along with the initial costs rather than in an additional document and would clearly show the potential future costs associated with current decisions.

## Approach II: Include Fiscal Exposures in Budget Process

Budget process changes would go beyond simply providing more information on fiscal exposures to establishing opportunities for explicit consideration of these exposures. The 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. Or, 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.

[12]GAO-03-213.

A different budget process approach would be to establish triggers that address the growth in existing exposures. In that case, triggers would be established to signal when future costs of exposures rise above a certain level. Reaching the trigger would require some action. For example, the Medicare drug law enacted in December 2003 requires the Medicare trustees to estimate the point at which general revenues will finance at least 45 percent of Medicare costs. If two consecutive trustee reports estimate that this level will be reached within the next 6 years, the President is required to include a proposal in his next budget and submit legislation to change Medicare so that the 45 percent threshold will not be exceeded. Congressional committees must then report Medicare legislation by June 30. Like points of order, a trigger would require explicit consideration of exposures facing the government without adding uncertainty to primary budget data.

## Approach III: Include Fiscal Exposures in Budget Data

Incorporating estimated future costs of fiscal exposures directly into budget data by using accrual-based costs would represent the greatest change of the three approaches I have outlined today. Accrual-based costs could be used to measure budget authority and outlays for select programs when doing so would enhance obligation-based control. This approach is most suitable for explicit exposures for which reasonable cost estimates are available.

For some time we have advocated the selective use of accrual measures in the budget to better reflect costs at the time decisions are made.[13] For some major exposures, such as employee retirement benefits, insurance, and environmental clean-up costs, the use of accrual-based measurement would result in earlier cost recognition. This earlier recognition of costs improves information available to decision makers about the costs associated with current decisions and may improve the incentives to manage these costs. 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

[13]GAO, *Budget Issues: Budgeting for Federal Insurance Programs*, GAO/AIMD-97-16 (Washington, D.C.: Sept. 30, 1997); *Accrual Budgeting: Experiences of Other Nations and Implications for the United States*, GAO/AIMD-00-57 (Washington, D.C.: Feb. 18, 2000); *Long-Term Commitments: Improving the Budgetary Focus on Environmental Liabilities*, GAO-03-219 (Washington, D.C.: Jan. 24, 2003).

more difficult. It 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 vary across the different fiscal exposures.

## 21st Century Challenges: Reexamining the Base of the Federal Government

As I noted earlier, nothing less than a fundamental review, reexamination, and reprioritization of all major spending and tax policies and programs is needed. We at GAO believe we have an obligation to assist and support you in this endeavor. So I would like to take some time this morning to tell you more about the report we will soon be issuing on reexamining the base of government—both to tell you why we are issuing this report and to illustrate some of the specific questions we plan to raise. Having identified the large and growing fiscal challenges facing the nation and the other major trends and challenges facing the United States as outlined in our strategic plan for serving the Congress, we thought we should look to our work and provide examples of the kinds of hard choices stemming from those challenges—in the form of questions for policy makers to consider. These 21st century questions will cover discretionary spending; mandatory spending, including entitlements; as well as tax policies and programs—all in one accessible volume.

Mr. Chairman, we are talking about a major transformational challenge that may take a generation to resolve. Traditional incremental approaches to budgeting will need to give way to more fundamental and periodic reexaminations of the base of government. Many, if not most current federal programs and policies were designed decades ago to respond to trends and challenges that existed at the time of their creation. If government is to respond effectively to 21st century trends, it cannot accept what it does, how it does it, who does it, and how it gets financed as "given." Not only do outmoded commitments, operations, choices of tools, management structures, and tax programs and policies constitute a burden on future generations, but they also erode the government's capacity to align itself with the needs and demands of the 21st century.

Confronting the fiscal imbalance would be difficult enough if all we had to do is fund existing commitments. But a wide range of emerging needs and demands can be expected to compete for a share of the budget pie. Whether it be national or homeland security, transportation or education, environmental cleanup or public health, a society with a growing population—and ours is projected to grow by about 50 percent by the middle of the 21st century—will generate new demand for federal action on both the spending and tax sides of the budget. Reexamining older programs and operations may enable us to free up resources to address some of these emerging needs.

The specific 21st century questions were developed based on GAO's strategic plan, which identified major trends that will shape the federal role in the economy and our society going forward. (See table 2.)

**Table 2: Strategic Plan Themes**

| | |
|---|---|
| • Long-Range Fiscal Challenges | • Demographic Shifts |
| • Changing Security Threats | • Science and Technology Advances |
| • Increasing Global Interdependence | • Quality of Life Trends |
| • The Changing Economy | • Changing Governance Structures |

Source: GAO.

These trends, along with GAO's institutional knowledge and issued work, helped us identify the major challenges and specific questions. The specific questions were informed by a set of generic evaluation criteria useful for reviewing any government program or activity, which are displayed in table 3.

**Table 3: Illustrative Generic Reexamination Criteria**

| | |
|---|---|
| Relevance of purpose and the federal role | Does it relate to an issue of nationwide interest? If so, is a federal role warranted based on the likely failure of private markets or state and local governments to address the underlying problem or concern? Does it encourage or discourage these other sectors from investing their own resources to address the problem? |
| | Have there been significant changes in the country or the world that relate to the reason for initiating it? |
| | If the answer to the last question is "yes," should the activity be changed or terminated, and if so, how? If the answer is unclear as to whether changes make it no longer necessary, then ask, when, if ever, will there no longer be a need for a federal role? In addition, ask, would we enact it the same way if we were starting over today? Has it been subject to comprehensive review, reassessment, and reprioritization by a qualified and independent entity? If so, when? Have there been significant changes since then? If so, is another review called for? |
| | Is the current mission fully consistent with the initial or updated statutory mission (e.g., no significant mission creep or morphing)? Is the program, policy, function, or activity a direct result of specific legislation? |
| Measuring success | How does it measure success? Are the measures reasonable and consistent with the applicable statutory purpose? Are the measures outcome-based, and are all applicable costs and benefits being considered? If not, what is being done to do so? |
| | If there are outcome-based measures, how successful is it based on these measures? |
| Targeting benefits | Is it well targeted to those with the greatest needs and the least capacity to meet those needs? |
| Affordability and cost effectiveness | Is it affordable and financially sustainable over the longer term, given known cost trends, risks, and future fiscal imbalances? |
| | Is it using the most cost-effective or net beneficial approaches when compared to other tools and program designs? |
| | What would be the likely consequences of eliminating the program, policy, function, or activity? What would be the likely implications if its total funding was cut by 25 percent? |
| Best practices | If it fares well after considering all of these questions, is the responsible entity employing prevailing best practices to discharge its responsibilities and achieve its mission (e.g., strategic planning, organizational alignment, human capital strategy, financial management, technology management, acquisitions/sourcing strategy, change management, knowledge management, client/customer service, risk management)? |

Source: GAO.

In the report, we will describe the forces at work, the challenges they present, and the 21st century questions they prompt, in each of 12 broad areas based in large measure on functional areas in the federal budget, but also including governmentwide issues and the revenue side of the budget. Table 4 lists those 12 areas, which involve discretionary spending; mandatory spending, including entitlements; and tax policies and programs—all of them are a part of the base.

Table 4: Twelve Reexamination Areas

| | |
|---|---|
| • Defense | • Natural Resources, Energy & Environment |
| • Education & Employment | • Retirement & Disability |
| • Financial Regulation & Housing | • Science & Technology |
| • Health Care | • Transportation |
| • Homeland Security | • Improving Governance |
| • International Affairs | • Reviewing the Tax System |

Source: GAO.

Our forthcoming report contains over 200 individual illustrative questions in these 12 areas. But today I would like to highlight for you—to give you a flavor of what the report will contain—several of the challenges we have inventoried in 4 of these areas, as well as some of the questions those challenges prompt.

## Defense Challenges

In the past 15 years, the world has experienced dramatic changes in the overall security environment, with the focus shifting away from conventional threats posed during the Cold War era to more unconventional and asymmetric threats evidenced by the events of September 11, 2001. Concerns about the affordability and sustainability of the rate of growth in defense spending will likely prompt decision makers to reexamine fundamental aspects of the nation's security programs, such as how DOD plans and budgets; organizes, manages, and positions its forces; acquires new capabilities; and considers alternatives to past approaches. To successfully carry out this reexamination, DOD must overcome cultural resistance to change and the inertia of various organizations, policies, and practices that became well rooted in the Cold War era.

While DOD has taken steps to meet short term operational needs, it still faces the fundamental challenge of determining how it will meet the longer term concerns of reorganizing its forces and identifying the capabilities it will need to protect the country from current, emerging, and future conventional and unconventional security threats. As DOD seeks to meet the demands of the new security environment, it continues to bear the costs of the past by maintaining or continuing to pursue many of the programs and practices from the Cold War era. Moreover, DOD faces serious and long-standing challenges in managing its ongoing business operations. Complicating its efforts are numerous systems problems and a range of other long-standing weaknesses in the key business areas of strategic planning and budgeting, human capital management, infrastructure, supply chain management, financial management, information technology, weapon systems acquisition, and contracting. In fact, DOD alone has 8 of the 25 items and shares in the 6 cross-cutting ones on our recently-issued high-risk list.

One particular operational challenge involves managing large and growing military personnel costs, which comprise the second largest component of DOD's total fiscal year 2005 budget. The growth in military personnel costs has been fueled, in part, by increases in basic pay, housing allowances, recruitment and retention bonuses, and other special incentive pays and allowances. Health care costs have grown to comprise a larger share of the budget, reflecting expanded health care provided to reservists and retirees. As the total and per capita cost to DOD for military pay and benefits grows, we need to reexamine whether DOD has the right pay and compensation strategies to sustain the total force in the future in a cost-effective manner.

The foregoing challenges suggest certain key questions be considered by policy makers.

- How should the historical allocation of resources across services and programs be changed to reflect the results of a forward-looking comprehensive threat/risk assessment as part of DOD's capabilities-based approach to determining defense needs?

- What economies of scale and improvements in delivery of support services would result from combining, realigning, or otherwise changing selected support functions (e.g., combat support, training, logistics, procurement, infrastructure, health care delivery)?

- How might DOD's recruitment, retention, and compensation strategies, including benefit programs, be reexamined and revised to ensure that DOD maintains a total military and civilian workforce with the mix of skills needed to execute the national security strategy while using resources in a more targeted, evidence-based and cost-effective manner?

## Retirement and Disability Challenges

The challenges facing retirement and disability programs are long-term, severe, and structural in nature. For example, Social Security faces a large and growing structural financing challenge. Social Security faces this long-term financing shortfall largely because of several concurrent demographic trends—namely, that people are living longer, spending more time in retirement, and having fewer children. Social Security could be brought into balance over the next 75 years through changes in the program and related benefits and/or taxes; however, ensuring the sustainability of the system beyond 75 years will require even larger changes.

Beyond Social Security, our nation's retirement and disability programs are further challenged by serious weaknesses that have become manifest in our nation's private pension system. Despite sustained large federal tax subsidies, total pension coverage continues to hover at about half of the total private sector labor force. The number of traditional defined-benefit plans has been contracting for decades, and recently, plan terminations by bankrupt sponsors of large defined-benefit plans have threatened the solvency of the Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures certain benefits under such plans.[14] While growth in the number and coverage of defined contribution plans—where each worker has an individual account that receives contributions—has helped mitigate the decline of more traditional defined-benefit plans, these plans have also experienced problems. Policy makers will need to consider how best to encourage wider pension coverage and adequate and secure pension benefits, and how such pensions might best interact with any changes to the Social Security program.

Meanwhile, federal disability programs, such as those at the Social Security Administration (SSA) and the Department of Veterans Affairs (VA), are challenged by significant growth over the past decade that is expected to surge even more as increasing numbers of baby boomers reach their disability-prone years. Federal disability programs remain mired in concepts from the past and are poorly positioned to provide meaningful and timely support for workers with disabilities. Advances in medicine and science have redefined what constitutes an impairment to work, and the nature of work itself has shifted toward service and knowledge-based employment—these developments need to be reflected in agencies' eligibility and review processes.

[14] Recognizing the long-term challenges facing PBGC, GAO has placed PBGC's single-employer pension program on its high-risk list of programs needing further attention and congressional action. As of the end of fiscal year 2004, the agency's single-employer pension program registered a net negative accumulated position of $23.3 billion.

The mounting challenges faced by our national retirement and disability programs raise important questions. For example:

- How should Social Security be reformed to provide for long-term program solvency and sustainability while also ensuring adequate benefits and protection from disability (e.g., increase the retirement age, restructure benefits, increase taxes, and/or create individual accounts)?
- What changes should be made to enhance the retirement income security of workers while protecting the fiscal integrity of the PBGC insurance program?
- How can federal disability programs, and their eligibility criteria, be brought into line with the current state of science, medicine, technology, and labor market conditions?

## Health Care Costs, Quality, and Access Challenges

Overall health care spending doubled between 1992 and 2002 and is projected to nearly double again in the following decade to about $3.1 trillion. Despite consuming a significant share of the economy—over 15 percent of GDP—U.S. health outcomes lag behind other major industrialized nations. For example, the U.S. performs below par in infant mortality and life expectancy rates as well as premature and preventable deaths. At the same time, access to basic health care coverage remains an elusive goal for nearly 45 million Americans without insurance. Americans with good health insurance have access to advanced technology procedures and world-class health facilities, but clinical studies suggest that not all of this care is desirable or needed. Rising health costs are compelling both public and private payers to examine whether these procedures can continue to be financed without better accounting for their clinical effectiveness. Additional health care spending over time will draw resources away from other economic sectors and could have adverse economic implications for all levels of government, individuals, and other private purchasers of health care. Defining differences between needs, wants, affordability, and sustainability is fundamental to rethinking the design of our current health care system.

In the past several decades, the responsibility for financing health care has shifted away from the individual patient. In 1962, nearly half—46 percent—of health care spending was financed by individuals. The rest was financed by a combination of private health insurance and public programs. By 2002, the amount of health care spending financed by individuals' out-of-pocket spending—at the point of service—was estimated to have dropped to 14 percent. Tax preferences for insured individuals and their employers have also shifted some of the financial burden for private health care to all taxpayers. Tax preferences can work at cross-purposes to the goal of moderating health care spending. For example, the value of employees' health insurance premiums are permitted to be excluded from the calculation of their taxable earnings and are also excluded from the employers' calculation of payroll taxes for both themselves and their employees. These tax exclusions represent a significant source of foregone federal revenue.

Public and private payers are experimenting with payment reforms designed to foster delivery of care that is clinically proven to be effective. Ideally, identifying and rewarding efficient providers and encouraging inefficient providers to emulate best practices will result in better value for the dollars spent on care. However, the challenge of implementing performance-based payment reforms, among other strategies, on a systemwide basis will depend on system components that are not currently in place nationwide—such as compatible information systems to facilitate the production and dissemination of medical outcome data, safeguards to ensure the privacy of electronic medical records, improved transparency through increased measurement and reporting efforts, and incentives to encourage adoption of evidence-based practices. These same system components would be required to develop medical practice standards, which could serve as the underpinning for effective medical malpractice reform.

In meeting these pressing health care system challenges, the following questions might be considered.

- How can technology be leveraged to reduce costs and enhance quality while protecting patient privacy?

- How can health care tax incentives be designed to encourage employers and employees to better control health care costs? For example, should tax preferences for health care be designed to cap the health insurance premium amount that can be excluded from an individual's taxable income?

- How can "industry standards" for acceptable care be established, and what payment reforms can be designed to bring about reductions in unwarranted medical practice variation? What can or should the federal government do to promote uniform standards of practice for selected procedures and illnesses?

## Tax System Challenges

As I discussed earlier, the imbalance between federal revenues and expenditures, if allowed to persist long term, will affect economic growth and require greater scrutiny of both tax revenues and expenditures. The level and types of taxes have major impacts on the financing of government, as well as on the economy as a whole and on individual taxpayers, for both today and tomorrow.

The success of our tax system hinges greatly on the public's perception of its fairness and understandability. Compliance is influenced not only by the effectiveness of IRS's enforcement efforts, but also by Americans' attitudes about the tax system and the government. Disturbing recent polls indicate that about 1 in 5 respondents say it is acceptable to cheat on their taxes. Furthermore, the complexity of and frequent revisions to the tax system make it more difficult and costly for taxpayers who want to comply to do so, and for IRS to explain and enforce tax laws. Many argue that complexity creates opportunities for tax evasion—through vehicles such as tax shelters—which, in turn, motivate further changes and complexity in tax laws and regulations. The lack of transparency also fuels disrespect for the tax system and the government. Thus, a crucial challenge for reexamination will be to determine how we can best strengthen enforcement of existing laws to give taxpayers confidence that their friends, neighbors, and business competitors are paying their fair share.

The growing complexity of the tax system stems in part from the extensive use of tax incentives to promote social and economic objectives. The tax system includes hundreds of billions of dollars in such incentives—the same magnitude as total discretionary spending—yet relatively little is known about the effectiveness of tax incentives in achieving the objectives intended by the Congress. Furthermore, as you know, tax incentives are off the radar screen for the most part and do not compete in the budget process. They are effectively "fully funded" before any discretionary spending is considered. Incentives for savings are a particular concern: Private sector savings are near historical lows, and government savings, due to federal budget deficits, are negative. In addition, these incentives are complex, and although the issue is not completely settled, research has suggested that the incentives often do not stimulate much, if any, net new saving by individuals. As far back as 1994, we have reported that tax incentives deserved more scrutiny.

The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved using the current structure, which is heavily dependent on income taxes, or a fundamentally reformed structure, which might include more dependence on consumption taxes, a flatter rate schedule, and/or fewer tax preferences. Increasing globalization, which makes it easier to move assets, income, and jobs across international borders, is another motivator for the debate. As policy makers grapple with such issues, they will have to balance multiple objectives, such as economic growth, equity, simplicity, transparency, and administrability, while raising sufficient revenue to finance government spending priorities. The appropriate balance among these objectives may also be affected by (1) how, if at all, to take into account that, including both the employer and employee share, an estimated two-thirds of taxpayers would pay more in payroll taxes—which are levied to fund Social Security and Medicare benefits—than they would pay in income taxes in 2004 and (2) whether and how to tax wealth.

Today's pressing tax challenges raise important questions. For example:

- Given our current tax system, what tax rate structure is more likely to raise sufficient revenue to fund government and satisfy the public's perception of fairness?

- Can we increase compliance with tax laws and reduce the need for IRS enforcement through greater use of withholding and information reporting? Could increased disclosure and penalties reduce the use of abusive tax shelters?

- Which tax incentives need to be reconsidered because they fail to achieve the objectives intended by the Congress, their costs outweigh their benefits, they duplicate other programs, or other more cost effective means exist for achieving their objectives?

- Should the basis of the existing system be changed from an income to a consumption base? Would such a change help respond to challenges posed by demographic, economic, and technological changes? How would such a change affect savings and work incentives? How would reforms address such issues as the impact on state and local tax systems and the distribution of burden across the nation's taxpayers?

## Where Do We Go From Here?

Congress faces a challenge many would find daunting: the need to bring government and its programs in line with 21st century realities. This challenge has many related pieces: narrowing the long-term fiscal gap; adapting Social Security to meet the new demographic reality; tackling the challenge of health care access, cost and quality; deciding on the appropriate role and size of the federal government—and how to finance that government—and bringing the panoply of federal activities into line with today's world. We believe that we at GAO have an obligation to assist and support the Congress in this effort. The reexamination questions discussed today and the forthcoming report of which they are a part are offered in that spirit: they are drawn primarily from the work GAO has done for the Congress over the years. We have attempted to structure questions that we hope you will find useful as you examine and act on problems that may not constitute an urgent crisis but pose important longer term threats to the nation's fiscal, economic, security and societal future.

Although it is not easy, the periodic reexamination of existing portfolios of federal programs can weed out ineffective or outdated programs while also strengthening and updating those programs that are retained. Such a process not only could address fiscal imbalances, but also improve the responsiveness, effectiveness, and credibility of government in addressing 21st century needs and challenges. Given the unsustainability of our current fiscal outlook, the real question is not whether we will deal with the fiscal imbalance, but how and when.

Given the size of the long-term fiscal imbalances, all major spending and revenue programs in the budget should be subject to periodic reviews and reexamination. While it is important to consider the role and size of government, how we finance government, and the major programs driving the long-term spending path—Medicare, Medicaid, and Social Security—our recent fiscal history suggests that exempting major areas from reexamination and review can undermine the credibility and political support for the entire process.

We recognize that this will not be a simple or easy process—there are no "quick fixes." Such a process reverses the focus of traditional incremental reviews, where disproportionate scrutiny is given to proposals for new programs or activities, but not to those that are already in the base. Taking a hard look at existing programs and carefully reconsidering their goals and their financing is a challenging task. Reforming programs and activities leads to winners and losers, notwithstanding demonstrated shortfalls in performance and design. Given prior experience and political tendencies, there is little real "low-hanging fruit" in the federal budget. Across-the-board approaches to fiscal challenges may be easier in the short run, but they do not address the longer term fiscal cost drivers and cut both effective and ineffective programs alike.

Given the severity of the nation's fiscal challenges and the wide range of federal programs, the hard choices necessary to get us back on track in a sustainable manner may take a generation to address. Beginning the reexamination and review process now would enable decision makers to be more strategic and selective in choosing areas for review over a period of years. Reexamining selected parts of the budget base, over time rather than all at once, will lengthen the process, but it may also make the process more feasible and less burdensome for decision makers. And by phasing in changes to programs or policies that might otherwise have prohibitively high costs of transition, the impact can be spread out over longer time periods.

Although reexamination is never easy, the effort is not without precedent. The federal government, in fact, has reexamined some of its programs and priorities episodically in the past. Programmatic reexaminations have included, for example, the 1983 Social Security reform, the 1986 tax reform, and the 1996 welfare reform. They have also included reforms such as the creation of the Department of Homeland Security and, most recently, the ongoing reorganization of the U.S. intelligence community. From a broader fiscal standpoint, the 1990s featured significant deficit-reduction measures adopted by the Congress and supported by the President that made important changes to discretionary spending, entitlement program growth, and revenues that helped eliminate deficits and bring about budgetary surpluses. States and other nations also have engaged in reexamination exercises.

In our system, a successful reexamination process will in all likelihood rely on multiple approaches over a period of years. The reauthorization, appropriations, oversight, and budget processes have all been used to review existing programs and policies. Adding other specific approaches and processes—such as temporary commissions to develop policy alternatives—has been proposed.

Fortunately the Government Performance and Results Act (GPRA) of 1993 and other result-oriented management laws enacted over the last 12 years have built a base of performance information that can assist the Congress and the President in this effort. In the last few years, OMB has been working to rate the effectiveness of programs under the program assessment rating tool (PART). There are also many nongovernmental sources of program evaluation and analysis. And, finally, Congress has its own analytic support—your staff and that of the Congressional support agencies. As always, GAO stands ready to assist the Congress as it develops its agenda and to help answer any of the questions the Congress wishes to pursue.

Mr. Chairman, Senator Conrad, and Members of the Committee this concludes my testimony. I would be happy to answer any questions you may have.

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