

The Federal Government's Financial Health:

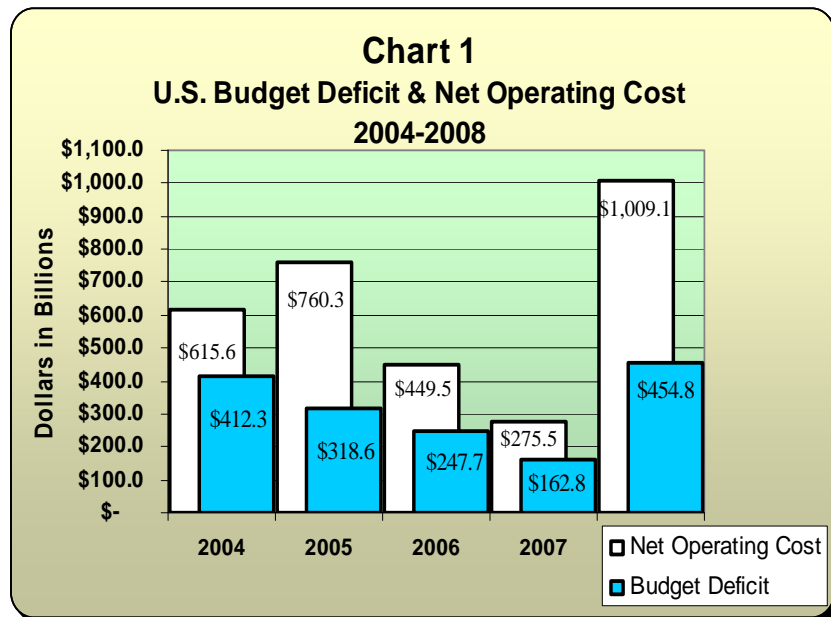
A Citizen's Guide to the Financial Report of the United States Government

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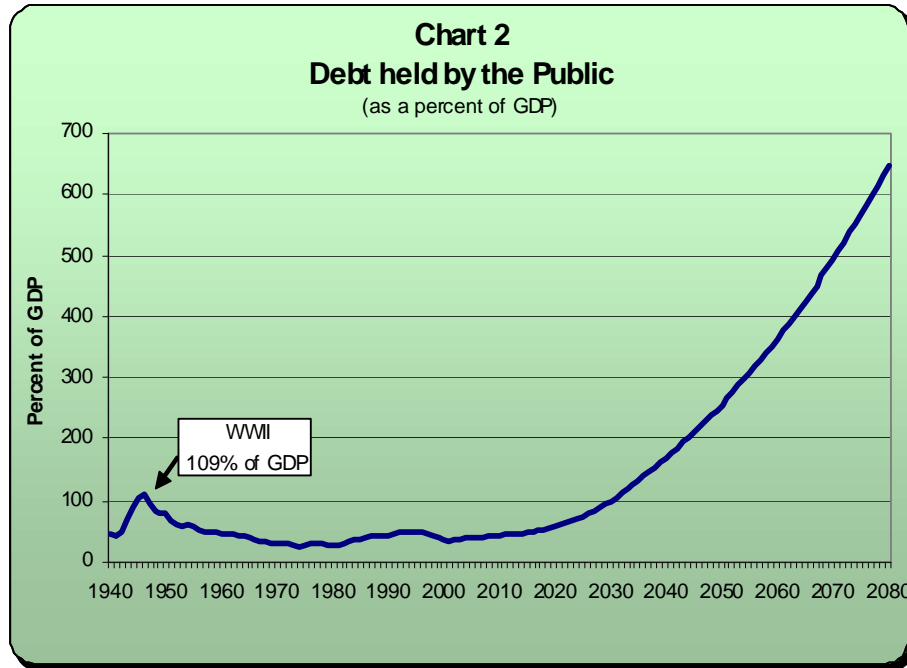
OVERVIEW

Fiscal Year (FY) 2008 was a year of unprecedented change in the financial position and condition of the U.S. Government, with potentially more changes in the near future. The Government's net operating cost and budget deficit both more than doubled during FY 2008. Chart 1 shows that the net operating cost increased from \$276 billion in FY 2007 to just over \$1 trillion in FY 2008, and the budget deficit jumped to \$455 billion, compared with a deficit of \$163 billion in FY 2007. These increases were due in part to the developing weakness in the economy throughout 2008 and to the Administration's response to that weakness. Due to the weakening economy, corporate tax revenues declined by \$68 billion. Net operating cost increased, mainly due to large increases in revaluations of long-term employee and veteran benefits payable. See *'Where We Are Now'*, p. iv.

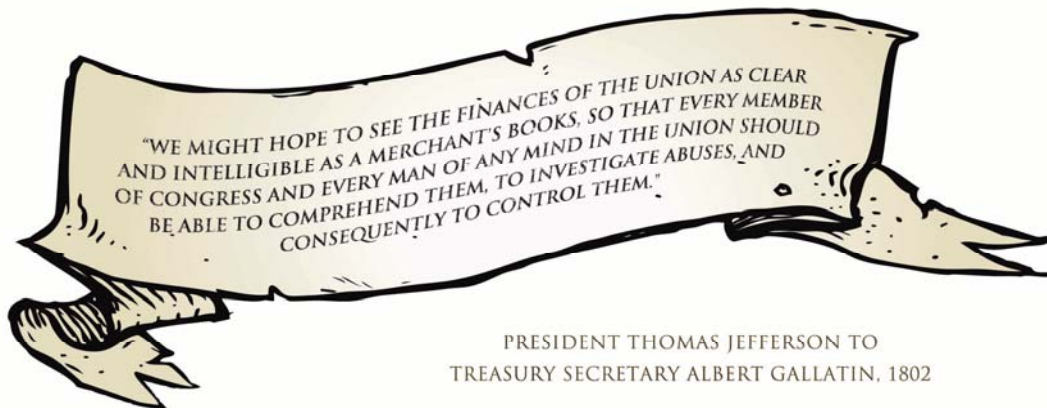


The unprecedented volatility in the Nation's mortgage and credit markets in 2008 has led to extraordinary actions by the Government intended to limit the extent of this turmoil. Congress passed and the President signed the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act of 2008 (EESA) in an effort to stabilize the financial sector and protect the economy. Other actions with large financial consequences have been taken by the Federal Reserve (Fed), the central bank of the United States. So far, the largest financial effects of these actions have not yet appeared in the financial statements or the budget, but they will show up in fiscal year 2009, and they will likely result in continued historically high budget deficit and net operating cost levels. See *'Government Acts to Address the Financial Crisis'*, p. vi.

The Government's immediate challenge is to deal with the current financial crisis and the resulting economic recession. Net operating costs and budget deficits are likely to remain elevated for some time as the Government works to restore market stability. If the Government is to retain the ability to manage a financial crisis such as the one today, it must eventually address the long-term fiscal imbalance resulting from Social Security, Medicare, and Medicaid. The Government's fiscal policies for these programs as currently structured are not sustainable. Without changes, spending for Social Security, Medicare, and Medicaid would permanently and dramatically increase the Government's budget deficit and debt leading eventually to renewed financial and economic instability. See *'Where We Are Headed'* p. viii.



This Citizen's Guide (Guide) highlights important information contained in the *2008 Financial Report of the United States Government*. The Secretary of the Treasury, Director of the Office of Management and Budget (OMB), and Acting Comptroller General of the United States believe that the information discussed in this guide is important to all Americans.



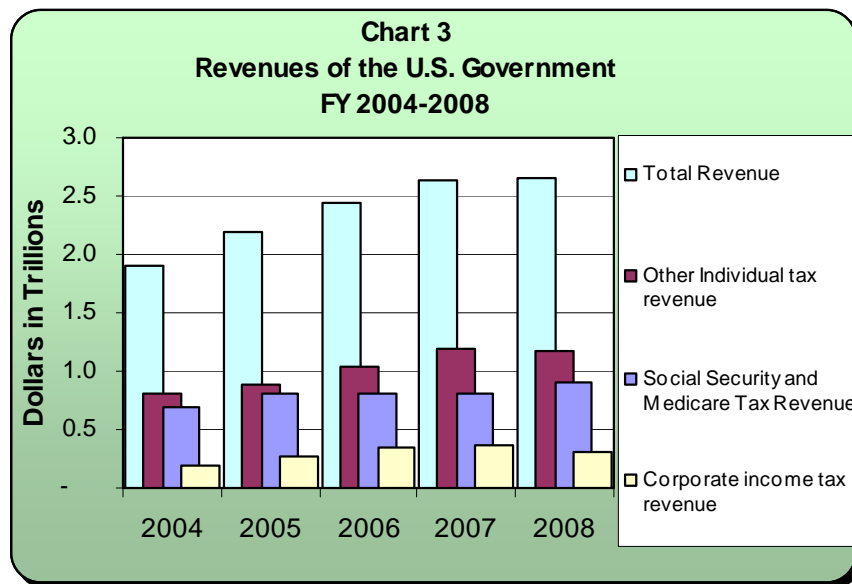
Where We Are Now

The Economy and the Deficit

The economy fell into recession in FY 2008. The ongoing slump in the residential homebuilding sector and the effects of record high energy prices and turmoil in financial markets dampened both consumer spending and private business investment. Employment declined steadily beginning in January 2008 with a loss of about 1 million jobs through the final quarter of FY 2008. Overall inflation accelerated through much of the year because of significant increases in energy and food prices, but the core inflation rate (which excludes food and energy) was more stable. Partly as a result of higher inflation, real wages fell through FY 2008. Corporate profits, outside the energy sector, weakened or declined. Federal tax receipts remained relatively constant, and spending growth accelerated. As a result, the 2008 budget deficit increased to \$455 billion – more than double the 2007 deficit of \$163 billion.

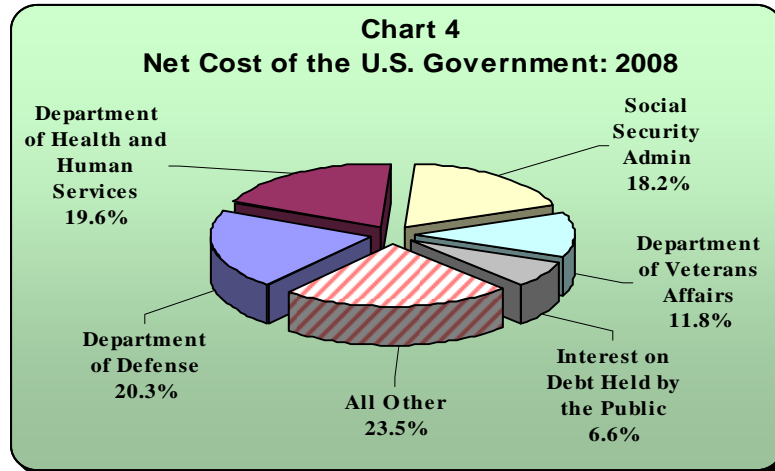
What Came In and What Went Out

What came in? In FY 2008, Government revenue totaled \$2.7 trillion. Chart 3 shows that total Government revenue remained relatively constant, compared to FY 2007, increasing slightly by \$34 billion or just over 1 percent. Individual income tax revenue increased by \$79 billion or almost 4 percent, but corporate income tax revenue substantially decreased by \$68 billion or 18.4 percent in FY 2008. The corporate revenue decrease is attributable largely to changing economic conditions as the economy entered a recession in December 2007. Social Security tax revenue of \$671 billion and Medicare tax revenue of \$197 billion accounted for approximately one-third of total revenues in FY 2008.



What went out? The Government’s net cost totaled \$3.6 trillion, an increase of \$731 billion or more than 25 percent over FY 2007. The Government’s “bottom line” net operating cost—the difference between revenue and net cost—exceeded \$1 trillion for the first time—more than triple the FY 2007 net operating cost of \$276 billion. Chart 4 shows that the largest contributors to the Government’s net cost include the Departments of Health and Human Services (HHS) and

Defense (DoD), the Social Security Administration, and the interest paid on debt held by the public. In FY 2008, the Department of Veterans Affairs' (VA) contribution to net cost increased from just over 2 percent or \$59.4 billion in 2007 to nearly 12 percent or \$430.4 billion, as shown in Chart 4 in FY 2008. This \$371 billion increase (in net cost) stems almost entirely from a \$339 billion increase in VA's estimated actuarial liabilities for veterans' benefits. This net cost increase was the largest by far at VA in recent years and accounted for more than half of the increase in total net cost across the Government. The substantial reestimation of VA's actuarial liabilities was driven largely by changes in the discount rates used and in revised estimates of the number of veterans that became eligible for and applied to receive benefits. The Financial Report contains additional information about these and other changes.



Cost vs. Deficit: What's the Difference?

In FY 2008, the Government's budget deficit of \$454.8 billion (budget basis reporting) was \$554.3 billion less than its net operating cost (from the Financial Report) of just over \$1 trillion. Table 1 shows that almost the entire difference between the Government's budget deficit and net operating costs in FY 2008 can be attributed to a \$550 billion increase in net accrued but unpaid Federal employee and veteran benefits. This amount is not included in the Budget, but is recognized as a cost and liability in the financial statements, because it is cost that has not yet been paid.

Dollars in billions	2008	2007
Budget Deficit	\$454.8	\$162.8
Change in:		
Federal Employee and Veteran Benefits Payable	\$549.8	\$90.1
Environmental & Disposal Liabilities	\$0.8	\$36.8
Capitalized Fixed Assets, Net	(\$46.6)	(\$2.6)
Other	\$50.3	(\$11.6)
Net Operating Cost	\$1,009.1	\$275.5

The *President's Budget* (Budget) is the Government's primary financial planning and control tool. It describes how the Government spent and plans to spend its money, comparing receipts, or cash paid to the Government, to primarily cash-based outlays, or payments to individuals, businesses or other parties. The *Financial Report of the United States Government* (Report) reports on the accrual-based cost of operations, the sources used to finance the Government's costs, how much the Government owns and owes, and the outlook for fiscal sustainability. It compares the Government's revenues, or amounts that the Government has collected and expects to collect, but has not necessarily received, to its costs to derive net operating cost. Together, the Budget and the Report present a complementary perspective on the Nation's financial health and provide a valuable management tool for the country's leaders.

The Debt

Historically, the Government has incurred debt: (1) when it borrows from the public to fund budget deficits, and (2) when Government funds invest excess receipts in government securities. However, in FY 2008, this relationship has changed, with Treasury borrowing \$300 billion to increase cash balances at the Fed to support the Fed's market stabilization efforts (discussed later in this Guide). The implementations of both HERA and EESA have the potential to increase future borrowings by more than \$1 trillion. Substantial borrowings in FY 2009 and beyond are expected to fund equity and other asset purchases in financial institutions and from the markets.

Of the Government's total debt of about \$10 trillion at the end of FY 2008, approximately \$5.8 trillion was debt held by the public in the form of Treasury securities, such as bills, notes, and bonds. The Public consists of individuals, corporations, state and local governments, Federal Reserve Banks, and foreign governments. The balance—more than \$4.2 trillion—was intragovernmental debt, which arises when one part of the Government borrows from another. It represents debt held by Government funds, including the Social Security (\$2.4 trillion) and Medicare (\$378 billion) trust funds. These Government funds are typically required to invest any excess annual receipts in Federal securities. When the Government borrows these excess receipts, it still has an obligation to repay them to the Government funds with interest.

Gross Federal debt (with some adjustments) is subject to a statutory ceiling (i.e., the debt limit), which has been recently raised to \$11.3 trillion.

If budget deficits continue, the Government will have to borrow more from the public in order to make benefit payments and to pay for other programs. This Guide examines these and other indicators of the challenges the Government will face in maintaining long term fiscal sustainability.

The Government Acts to Address the Financial Crisis

Falling asset values in the mortgage and credit markets sparked extraordinary events and actions involving many financial institutions in the United States in 2008. Much of the recent market instability can be attributed to the decline in the housing market aggravated by the recession that began in December 2007. Declines in the value of mortgage-backed securities (MBS) and sub-prime credit market debt precipitated significant portfolio losses across many financial and credit institutions that had invested heavily in these instruments in recent years. These losses led to financial market instability, forced mergers, and bankruptcies. A sharp reduction in credit availability resulted as banks and financial institutions struggled to maintain solvency in the face of these widespread losses. The large Government Sponsored Enterprises (GSEs)¹ Fannie Mae and Freddie Mac, which create and guarantee MBS, were placed into conservatorship. Other financial institutions required large infusions of Federal funds to remain in business.

Exhibit 1 on the following page summarizes significant actions taken by the Federal Government to respond to these events. Further information is reported in the 2008 Financial Report.

¹ GSEs are chartered by the Federal government and pursue a Federally mandated mission (e.g., Fannie Mae and Freddie Mac were created to provide stability and liquidity in the secondary mortgage market). However, Fannie Mae and Freddie Mac were both distinctly established as corporate entities – owned by shareholders of stock traded on the New York Stock Exchange. Their debt is not guaranteed by the Federal Government.

Exhibit 1 - The Fiscal Crisis at a Glance

The Federal Government is taking unprecedented actions, some of which are summarized below, to stabilize the economy. The impact of these actions will largely be reflected in the FY 2009 financial statements and beyond.

Housing and Economic Recovery Act (HERA) (July 2008) – HERA established a new regulatory agency, the Federal Housing Finance Agency (FHFA), with enhanced regulatory authority over the housing GSEs. HERA also authorized the Treasury Department to provide financial support for the housing GSEs. Treasury, in conjunction with the FHFA’s decision to place Fannie Mae and Freddie Mac into conservatorship, has agreed to: (1) provide capital of up to \$200 billion to Fannie Mae and Freddie Mac should it be needed and (2) purchase GSE-guaranteed MBS. As of September 30, 2008, the Federal Government’s financial statements recognized a liability for \$13.8 billion of capital to be paid to Freddie Mac, investments of \$3.3 billion for purchased MBS, and \$7 billion for preferred stock and stock warrants received from the GSEs. Additionally, Treasury established a facility to lend money to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, if requested. Also, the HOPE for Homeowners Program was established under HERA to help borrowers faced with foreclosure refinance through the Federal Housing Administration (FHA).

Emergency Economic Stabilization Act (EESA) (October 2008)– Under EESA, Treasury established the Troubled Asset Relief Program (TARP), which was authorized by the Act to purchase or insure up to \$700 billion of “troubled assets” to stabilize financial markets and support financial institutions. As of December 9, 2008, Treasury has used over \$200 billion in FY 2009 to purchase financial assets of qualifying entities. As FY 2009 unfolds, the disposition of the balance will be determined. Amounts expended have been and are expected to continue to be treated as either investments or loans. The Government expects a recovery of at least some of these funds and possibly even to earn a positive return on amounts spent as economic conditions improve. In the short term, Treasury will need to increase borrowings. As these borrowings take place, Treasury’s ability to borrow for other purposes may become more challenging. In addition, the Federal Deposit Insurance Corporation (FDIC) deposit insurance was temporarily increased from \$100,000 to \$250,000 per depositor.

Also, the FDIC implemented a temporary liquidity guarantee program for participating institutions to guarantee newly issued senior unsecured debt and provide full coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount. Further, through the Supplementary Financing Program, Treasury increased its deposit balances with the Federal Reserve (Fed) to support the Fed’s market stabilization actions, which resulted in an increase in cash and debt held by the public. As of September 30, 2008, the deposit balance was \$300 billion.

In addition to these actions, the Fed has been directly involved in addressing this financial crisis. They (1) have taken actions to support several prominent financial institutions, including Bear-Stearns, American International Group (AIG), and Citigroup; (2) have developed a program to support the commercial paper market; and (3) are formulating plans to lend support for new car, student, and small-business loans. The vast majority of Fed actions and transactions will not directly impact the Government’s financial statements since the Fed is an independent organization and not considered a part of the Federal reporting entity. As such, their financial results are not consolidated into the Government’s financial statements. However, there is a potential that reduced Fed earnings will be available in the future for transfer to the Government.

Information on these and the Government's other market stabilization efforts under EESA may be found at <http://www.treas.gov/initiatives/eesa/>

Where We Are Headed

As the first quarter of FY 2009 draws to a close, the Government is exploring a number of recovery strategies. Actions under HERA, EESA, and other initiatives are expected to restore confidence to lenders and consumers, and provide stability to the nation's economy. Regardless, the dramatic measures that the Government has already taken and may take in the future could in the long term significantly impact fiscal sustainability. Despite the urgency with which the Government must act in the short term to restore market stability and emerge from the current recession, it must not lose sight of other key issues such as the entitlement programs that continue to pose a challenge to future fiscal sustainability.

An Unsustainable Fiscal Path

The projected growth in entitlement spending under current law – chiefly for Social Security, Medicare, and Medicaid – will ultimately affect every citizen in the nation. Continued growth in health care costs is expected to cause government spending for its major health programs to grow faster than both the economy and Federal revenues over the next 75 years². Similarly, population aging is expected to cause the Government's Social Security and health program costs and expenditures to increase as a share of GDP over that period. Consequently, total Government expenditures are projected to exceed total assumed revenue throughout the projection period, with the fiscal imbalance – between spending and revenue – growing larger each year into the future.

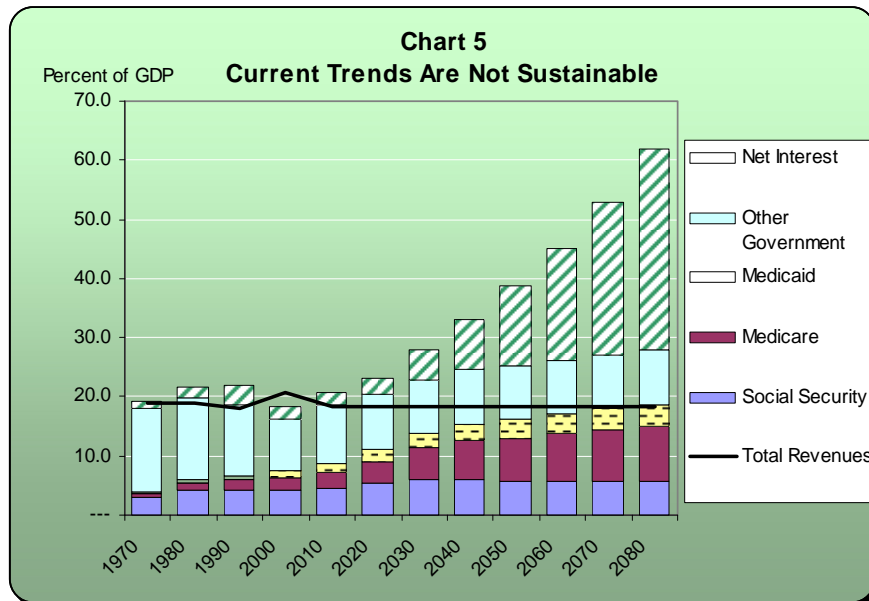


Chart 5 shows Government revenue and spending, expressed as a percentage of GDP, from 1970 through 2080.³ For most of the past several decades, revenue as a share of GDP has averaged around 18 percent, with little variation.⁴ For this reason, revenue is assumed to be about 18 percent of GDP throughout the projection period. Chart 5 also shows that by 2080,

² The FY 2008 Statement of Social Insurance may be found in the 2008 *Financial Report*.

³ Projected spending is based on scheduled Social Security and Medicare benefits and current spending trends.

⁴ GDP is one way of measuring the size of a nation's economy and is defined as the total market value of all final goods and services that the nation produces in a given period. The projection that the government's revenue as a percentage of GDP will remain relatively constant is based on historical data and trends that are not expected to change.

costs related to the currently scheduled benefits for the three major entitlement programs are projected to be about equal to total Government revenue. By 2060, total Government expenditures are projected to be 45 percent of GDP – levels unseen since World War II, when Government expenditures reached 44 percent of GDP. By 2080, expenditures could exceed 60 percent of GDP, more than three times the assumed revenues. These large and growing deficits could increase Government debt levels as a percentage of GDP to unprecedented and unsustainable heights – from 170% by 2040 to over 600% by 2080 – far exceeding the historical high of 109% that occurred immediately following WWII and far exceeding the Government’s ability to fund program expenditures. It is important to note that precise expenditure projections change with different forecasting assumptions (e.g., life expectancy increases and health care cost growth), but even under a wide range of reasonable assumptions, budget deficits and debt are projected to increase dramatically.⁵ Should such dramatic increases occur, interest costs would increase, making the Federal Government’s fiscal path even more unsustainable, and the Government’s ability to borrow from the public could be affected.

Preparing for the Future

With respect to entitlement spending, the nation must change course before the deficit and debt reach unprecedented heights. The Government must act to bring social insurance expenses and resources in balance. Delays will increase the magnitude of the reforms needed and will place more of the burden on future generations. There is no simple fix to the projected imbalance between social insurance expenditures and revenues. The precise amount of the Government’s future financial responsibilities is far from certain, as they are based on many complex calculations and assumptions. Nevertheless, the magnitude of these responsibilities and the pressing need to control their continued growth are evident.

The Government has made and is expected to continue to make a vast commitment of financial resources to establish and maintain stability in the credit markets. The Government expects that at least some of the financial assets acquired by the Government in its market stabilization efforts may eventually return full value to the taxpayer and possibly even earn a positive return on amounts spent as economic conditions improve. The Government has been able to take these stabilization actions because of the deep, liquid market for Treasury securities. The unsustainable growth in Social Security, Medicare, and Medicaid remains a long-term fiscal challenge to be addressed once the current credit crisis has passed and overall economic conditions have improved.

KEY SUSTAINABILITY DATES	
2008	Medicare Hospital Insurance benefits begin to exceed program tax revenues.
2017	Social Security benefits begin to exceed program tax revenues.
2040	Federal Debt held by the Public surpasses historic high of 109% of GDP.
2080	Total Government cost is more than 3 times revenue.*

*Revenue is assumed to be the historical average of about 18 percent of GDP.

⁵ Chart 5 includes projections of scheduled benefits for Medicare and Social Security. The Medicare Trustees' Report shows that, under current law, the Hospital Insurance Trust Fund will not have sufficient funds to pay scheduled benefits beginning in 2019. At that point, trust fund income would cover only 78 percent of scheduled benefits, falling to about 30 percent in 2082. The Social Security Trust Fund could encounter a similar problem. Under current law, trust fund income would cover only 78 percent of scheduled benefits in 2041 and only 75 percent by 2082.

Looking Ahead

The 2008 Financial Report of the United States Government, issued by the U.S. Department of the Treasury, is a comprehensive financial report that provides a backdrop for both the Government's current financial position and prospects for moving forward. It discusses the steps the Federal Government has taken to restore stability in the U.S. financial system. The issues discussed in the Citizen's Guide and the *Financial Report* affect, and should be of interest to, every citizen. The *Financial Report's* comprehensive reporting is intended to inform and support the decision-making needs of lawmakers and the public and to help keep the United States on solid financial ground.

Find Out More

You will find more detail on these matters in the *Financial Report*. You are encouraged to explore the information it contains and to ask questions about how the Government manages taxpayers' money. The *2008 Financial Report of the United States Government* and other information about the nation's finances are available at:

- U.S. Department of the Treasury's Financial Management Service, <http://www.fms.treas.gov/fr/index.html>;
- OMB's Office of Federal Financial Management, <http://www.whitehouse.gov/omb/financial/index.html>; and
- GAO, <http://www.gao.gov/financial/fy2008financialreport.html>.

This Citizens' Guide highlights information in the 2008 Financial Report. The Government Accountability Office's (GAO) complete audit report on the U.S. government's consolidated financial statements can be found beginning on page 165 of the Financial Report. For FY 2008 and FY 2007, GAO issued an unqualified or 'clean' opinion on the 2008 and 2007 Statements of Social Insurance. However, certain material financial reporting control weaknesses and other limitations on the scope of its work prevented GAO from expressing an opinion on the remaining financial statements.

The Government's Financial Position and Condition

The Financial Report of the U.S. Government (Report) provides the President, Congress, and the American people a comprehensive view of how the Federal Government is managing taxpayer dollars. It discusses the Government's financial position and condition, its revenues and costs, assets and liabilities, and other responsibilities and commitments, as well as important financial issues that affect the Nation and its citizens both now and in the future

The following table presents several key indicators of the Government's financial health, which are discussed in greater detail in the Report.

A Snapshot of			
The Government's Financial Position & Condition			
billions of dollars	2008	2007	2006
Gross Costs	\$ (3,891.6)	\$ (3,157.3)	\$ (3,127.7)
Earned Revenues	\$ 250.9	\$ 247.8	\$ 226.4
Net Cost	<u>\$ (3,640.7)</u>	<u>\$ (2,909.5)</u>	<u>\$ (2,901.3)</u>
Total Taxes and Other Revenues	\$ 2,661.4	\$ 2,627.3	\$ 2,440.8
Other	\$ (29.8)	\$ 6.7	\$ 11.0
Net Operating Cost	<u>\$ (1,009.1)</u>	<u>\$ (275.5)</u>	<u>\$ (449.5)</u>
Assets	\$ 1,974.7	\$ 1,581.1	\$ 1,496.5
Less: Liabilities, comprised of:			
Debt Held By the Public	\$ (5,836.2)	\$ (5,077.7)	\$ (4,867.5)
Federal Employee & Veteran Benefits	\$ (5,318.9)	\$ (4,769.1)	\$ (4,679.0)
Other Liabilities	\$ (1,023.1)	\$ (940.1)	\$ (866.4)
Total Liabilities	<u>\$ (12,178.2)</u>	<u>\$ (10,786.9)</u>	<u>\$ (10,412.9)</u>
Net Position (Assets Minus Liabilities)	<u>\$ (10,203.5)</u>	<u>\$ (9,205.8)</u>	<u>\$ (8,916.4)</u>
Sustainability Measures:			
The Statement of Social Insurance provides certain fiscal sustainability information concerning Social Security, Medicare, and other social insurance programs.			
Statement of Social Insurance: ¹			
Closed Group (current participants) ²	\$ (49,135)	\$ (45,062)	\$ (44,145)
Open Group (current + future participants) ³	\$ (42,970)	\$ (40,948)	\$ (38,851)
Budget Results			
Unified Budget Deficit	\$ (454.8)	\$ (162.8)	\$ (247.7)
<small>1 Present value of projected revenues and expenditures for scheduled benefits over the next 75 years of certain benefit programs that are referred to as Social Insurance (e.g., Social Security, Medicare). Not considered liabilities on the balance sheet.</small>			
<small>2 Includes current participants (i.e., receiving and/or are eligible to receive benefits) for the Social Security and Medicare programs ages 15 and over at the start of the 75-year projection period, except for the 2007 Medicare programs for which current participants are assumed to be at least 18 years of age at the start of the 75-year projection period.</small>			
<small>3 Includes all current and future projected participants over the 75-year projection period.</small>			