



CBO

**Director's Conference on
Budgeting and Accounting for
Long-Term Obligations**

The ABCs of Long-Term Budget Challenges

**Opening Remarks
by
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Good morning. Welcome to the Congressional Budget Office's (CBO's) annual Director's Conference.

In previous years, these conferences have addressed issues such as improving revenue estimation and strengthening the budget process. Today's conference focuses on the largest fiscal challenge facing the nation: the aging of the population and the growing cost of federal health and retirement programs.

The basic challenge is well-known. If current trends continue and current policies remain in place, federal spending will outstrip revenues in coming decades, even if tax reductions enacted over the past few years expire, as scheduled, at the end of 2010. Deficits will increase sharply, debt held by the public will grow faster than the economy, and interest payments will soar, undermining the government's finances and weakening the economy.

In short, the nation's fiscal policy is on an unsustainable path, posing a long-term threat to the well-being of the American people and the country's status in the world.

The reasons for that dire outlook are familiar but warrant repeating. Over coming decades, the aging of the U.S. population will slow the pace of economic growth—and the growth of tax revenues—at the same time that a combination of the aging population and rising health care costs will cause spending growth to accelerate.

Economic growth will slow because as workers age, they become less likely to participate in the labor market. Over the next decade alone, CBO estimates, that demographic effect will trim about 0.5 percentage points off of the annual growth of the labor force, and, as a result, decrease the potential real growth rate of the economy from the 3 percent that it has been, on average, since 1990 to 2.6 percent over the next 10 years.¹

At the same time, the aging population will place increased demands on Social Security. Spending for that program today amounts to about 4 percent of gross domestic product (GDP). If current trends continue, however, that spending will reach roughly 6 percent of GDP in 2030—and will continue to increase thereafter.²

Medicare and Medicaid pose an even greater challenge. Those programs face the same demographic pressures as does Social Security. However, Medicare and

1. Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2006).

2. Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005).

Medicaid also face the pressures of rapidly rising health care costs. Over recent decades, health care costs per beneficiary in those programs have grown an average of 2 percentage points to 3 percentage points faster than per capita GDP each year. Even if that extra growth slows to just 1 percentage point, spending on those programs will grow from roughly 4.6 percent of GDP today to more than 9 percent of GDP in 2030—and will continue to rise thereafter.³

To put those figures in context, keep in mind that federal spending today is slightly more than 20 percent of GDP. Social Security, Medicare, and Medicaid together amount to about 9 percent of GDP, slightly more than two-fifths of federal spending. By 2030, however, spending on those programs is projected to reach roughly 15 percent of GDP, equivalent to about three-quarters of current federal spending levels. If that increase happened and total spending was held at about today's level as a percentage of GDP, the rest of the budget would have to be cut by more than half.

Spending on Social Security, Medicare, and Medicaid will thus exert pressures on the federal budget that economic growth alone is unlikely to alleviate. Substantial reductions in the projected growth of spending and perhaps a sizable increase in taxes as a share of the economy will therefore be necessary to maintain fiscal stability in coming decades.

The challenges themselves are well-known, yet there is little evidence that they have yet had much influence on policy decisions. The goal of today's conference, therefore, is not only to document the challenges but, more importantly, to discuss how they might become more prominent in the policy process. That discussion has three components—the ABCs, if you will, of long-term budget challenges: how to account for long-term federal obligations, how to budget for them, and how to communicate about them.

Let me begin with the A, accounting.

The budget has long held the spotlight in discussions of fiscal policy. However, the federal government also keeps another set of books. That second set of books—the *Financial Report of the United States Government*—reports fiscal performance using financial accounting principles rather than budget accounting principles.

In this case, there is nothing sinister in keeping two sets of books. The budget and the financial report serve different purposes and therefore have different ways of reporting the government's fiscal condition. Neither provides all relevant information about federal finances.

3. Ibid.

The key difference between the two reports is the method of accounting used in each.⁴ With a few exceptions, the budget uses cash accounting; it measures cash flows in and out of the U.S. Treasury and reports them in the year they occur. The financial report, in contrast, uses accrual accounting; it recognizes expenses and revenues when economic events occur, rather than when the resulting cash flows take place.

The difference between cash and accrual accounting is particularly important when outlays and underlying economic events happen at different points in time. Retirement benefits for federal workers are a prime example. The budget reports outlays when benefit payments are made to retired workers. The financial statements, in contrast, record an operating expense for the estimated cost of those benefits as workers earn them.

The Federal Accounting Standards Advisory Board (FASAB)—the organization that establishes accounting standards for the federal government—is now grappling with the question of how to apply accrual accounting principles to programs like Social Security and Medicare.⁵ As one of our speakers will discuss, a majority of the board members favor an approach that would treat a large portion of future Social Security and Medicare benefits as current liabilities and that would recognize a large expense each year (measured in the hundreds of billions or perhaps trillions of dollars) to reflect increases in those obligations over time.

Thus, FASAB's efforts raise important questions about the appropriate accounting treatment for social insurance programs. The increasing attention being paid to FASAB and, more generally, to the financial report also raise a broader question of whether and to what extent budget policy should be informed by the accounting statements. (I should emphasize that FASAB standards apply only to the financial statements and, contrary to some media coverage, have no direct effect on the budget.)

That brings us to the B, budgeting.

As I noted, the budget is generally prepared on a cash basis. As a result, the impacts of long-term obligations appear in the budget in the years in which outlays eventually occur. That approach can create problems if significant effects occur beyond the standard five- or 10-year budget window.

Today, a 10-year window does include the beginning of the approaching fiscal challenges. As the leading edge of the baby-boom generation begins to retire and

4. For a detailed discussion of the similarities and differences between the budget and the financial reports, see Congressional Budget Office, *Comparing Budget and Accounting Measures of the Federal Government's Fiscal Condition* (December 2006).

5. The Congressional Budget Office has one of the 10 seats on the board.

health care costs continue to rise, spending on Social Security, Medicare, and Medicaid will rise from the roughly 9 percent of GDP that it is today to about 11 percent a decade later.⁶ But a 10-year window is far too narrow to capture the full magnitude of the looming spending increases. If the budget is to remain the primary mechanism for determining fiscal policy, it is important that we explore how it can best reflect the government's growing long-term obligations and how the budget process can be structured to facilitate efforts to deal with them.

As one of our speakers will discuss, one response to these concerns is to prepare budget projections over longer time periods. The Social Security and Medicare actuaries, for example, prepare detailed projections for those programs over the next 75 years; CBO prepares similar projections for 50 and 100 years. Those projections provide useful information—on the same cash basis as the regular budget—and, at times, have played a central role in policy deliberations (for example, during the discussions about Social Security that occurred in 2005). However, with one exception (a Senate point of order involving spending in any of the four 10-year periods after 2015), such projections or other estimates of long-term budget impacts have not yet had a formal role in the budget process.

A second response, endorsed by other speakers, would be to incorporate accrual measures of long-term obligations into the budget process. Such a change is not without precedent. Although the budget largely uses a cash basis, since the early 1990s an accrual approach has been used for credit programs such as ones providing loans and loan guarantees. That change addressed a clear weakness of prior approaches: many of the potential budget impacts of loans and loan guarantees fall outside the conventional budget windows, so cash-based budgeting provided incomplete and potentially misleading information about the ultimate effects on the budget. Applying the same logic to social insurance programs raises a host of conceptual, analytical, and political challenges: those programs are not contractual in nature; they stretch farther into the future than most credit programs; and, in the case of Medicare, the program has future costs that are much more uncertain. However, some change in budget concepts may be necessary if we are to address the federal government's fiscal challenges in a timely fashion.

Accounting and budgeting frameworks can provide useful structure for analyzing and planning for long-term obligations. Just as important, I believe, is the C, the way that we communicate about these challenges.

Over the past few years, increasing interest in long-term budget challenges has given birth to a plethora of different ways of characterizing them. At CBO, we typically focus on long-term projections of future outlays and report those future outlays relative to the future size of the economy. Other analysts employ similar projections, but report figures in terms of future flows of dollars. Still others use

6. Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2006).

projections and then discount them back to today as a net present value, either as a percentage of the present value of future GDP or in dollars. (As one of our speakers will explain, the latter approach can result in truly astronomical figures in the tens of trillions of dollars, particularly if one adopts an infinite horizon in order to avoid any effects resulting from the choice of a window.) Still others have adapted accrual accounting approaches to calculate annual measures of the increasing obligations in the social insurance programs. Finally, some begin with the regular budget as constructed today but emphasize measures such as the on-budget deficit rather than the unified budget deficit.

Observers differ on the analytic merits and potential usefulness of each of those approaches for the policy process. However, it is fair to say that each one conveys a perspective on long-run budget challenges.

The nation faces formidable fiscal challenges. To address them, we face difficult, important questions: How should we account for long-term obligations? How should we budget for them? How should we communicate about them? I hope that today's conference will shed light on those issues.

Thank you all for being here.