Facing Facts about America's True Financial Condition and Fiscal Outlook

THE OUTLOOK IS GRIM AND WILL GET WORSE UNLESS WE ACT SOON

By David M. Walker

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In addition to external security threats, America is threatened from within by growing fiscal imbalances. The combination of entitlement programs, demographics, and rising health care costs create the need to make choices that will only become more difficult the longer they are postponed. The difficulty of making such choices is magnified by inadequate information, unfunded commitments being an especially important example. Truth and transparency in government financial reporting is badly needed, and the public must be made aware of the magnitude of the problems that will be imposed by ever-increasing fiscal imbalances and must demand change.

Considerable attention has been focused lately on the war on terrorism. From the recent rail attacks in Spain to the continuing unrest in Iraq, it is clear that America and its allies confront increasingly diverse and diffuse security threats. But it would be wrong to conclude that the only threats to our way of life come from outside our borders. Here at home, we face a large and growing fiscal imbalance that, if left unchecked, will impede economic growth and imperil government programs that directly affect the well-being of the American people.

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It seems only yesterday that many economists and government officials were projecting surpluses for years to come. Several of the underlying conditions for a long-term structural deficit, however, existed even during the economic expansion of the 1990s. In particular, largely because of rising health care costs and a looming demographic tidal wave that is unprecedented in American history, we now face decades of deficits. Difficult choices are inevitable.

If we look at changes in federal spending over time, the powerful effects of long-term trends become clear. In 1964, more than two-thirds of the federal budget was discretionary, and nearly half was spent on national defense. In 2004, less than 40 percent of the federal budget is discretionary, and only 20 percent is spent on national defense. Steady growth in entitlement programs has crowded out other government expenditures: Two out of every five federal dollars are spent now on Social Security and Medicare.

The status quo, however, is unsustainable. Take Social Security, for example. In 1950, more than 16 workers were paying into the system for every retiree drawing benefits. By 2040, that ratio will have dwindled to two to one. Without changes to current policy, the twin burdens of paying for costly medical care and supporting a growing elderly population will put increasing pressure on the nation's spending and tax policies. I am reminded of the title of one of last year's hit movies—*Something's Gotta Give*.

Unfortunately, the way in which our government keeps score provides an incomplete and misleading picture of our true financial condition and fiscal outlook. For instance, the Congressional Budget Office's (CBO) "baseline" projections, which are designed to be a reference point against which to measure policy changes, are often misinterpreted as projections of likely budget outcomes. But CBO is required to assume that discretionary spending will rise at the rate of inflation, that recent tax cuts will be phased out, and that there will be no changes to current law. Historically, however, discretionary spending has generally exceeded the rate of inflation, and considerable support exists to extend at least some of the tax cuts passed in recent years. Moreover, spending pressures continue to mount for such big-ticket items as the war in Iraq and homeland security. On the revenue side, current law assumes that a growing number of taxpayers will pay higher taxes under the alternative minimum tax—an assumption that many taxpayers and elected officials are likely to take issue with.

Timely, reliable, and useful financial and management information on current government operations can also be difficult to come by. This year, my agency, the U.S. General Accounting Office (GAO), was unable for a seventh consecutive year to express an opinion as to whether the U.S. government's consolidated financial statements were fairly stated. The good news was that 20 of the 23 major federal agencies received an unqualified opinion on

TABLE 1

SELECTED FISCAL EXPOSURES: SOURCES AND EXAMPLES (END OF 2003)[a]

Type	Example (dollars in billions)
Explicit Liabilities	Publicly held debt ($3,913) Military and civilian pension and post-retirement health ($2,857) Veterans benefits payable ($955) Environmental and disposal liabilities ($250) Loan guarantees ($35)
Explicit financial commitments	Undelivered orders ($596) Long-term leases ($47)
Explicit financial contingencies	Unadjucated claims ($9) Pension Benefit Guaranty Corporation ($86) Other national insurance programs ($7) Government corporations e.g. Ginnie Mae
Implicit exposures implied by current policies or the public's expectations about the role of government	Debt held by government accounts ($2,859)[b] Future Social Security benefit payments ($3,699)[c] Future Medicare Part A benefit payments ($8,236)[c] Future Medicare Part B benefit payments ($11,416)[c] Future Medicare Part D benefit payments ($8,119)[c] Life cycle cost including deferred and future maintenance and operating costs (amount unknown) Government Sponsored Enterprises e.g., Fannie Mae and Freddie Mac

[a]All figures are for end of fiscal year 2003, except for Social Security and Medicare estimates, which are end of the year 2003.
[b]This amount includes $774 billion held by military and civilian pension funds that would offset 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 $104 trillion, $21.8 trillion for Medicare Part A, $23.2 trillion for Medicare Part B, and $16.5 trillion for Medicare Part D.

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 Medicaid Services.
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their individual financial statements. GAO was unable to express an opinion on the federal government as a whole, however, because of continuing financial management weaknesses at the Department of Defense, the government's inability to properly account for intra-governmental transactions, and various technical obstacles to preparing the consolidated financial statements. Ultimately, we should not settle for anything less than a "clean opinion" on these financial statements.

When it comes to federal financial reporting, too few agencies adequately show the results that they are getting with the taxpayer dollars they spend, and too many significant government commitments and obligations are not fully disclosed. Particularly troubling are the many promises for future spending made in connection with various programs and policies: Social Security and Medicare, veterans' health care, and contingencies arising from a range of government-sponsored activities and entities. (See Table 1.) Despite their sobering implications for future budgets, tax burdens, and spending flexibilities, these unfunded commitments are often minimized or even ignored in the government's financial statements and in budget deliberations.

The official U.S. gross debt now stands at about $7 trillion, which works out to about $24,000 for every man, woman, and child in this country. But if you factor in items such as unfunded promises for future Social Security and Medicare benefits, the burden for every American rises to more than $140,000. Our government has already committed itself to more than $40 trillion in IOUs in current dollars—an amount equal to 18 times the current federal budget or $3\frac{1}{2}$ times the current GDP. According to the most recent Medicare trustees' report, the cost of the new Medicare prescription drug benefit alone may exceed $8 trillion in current dollars over 75 years.

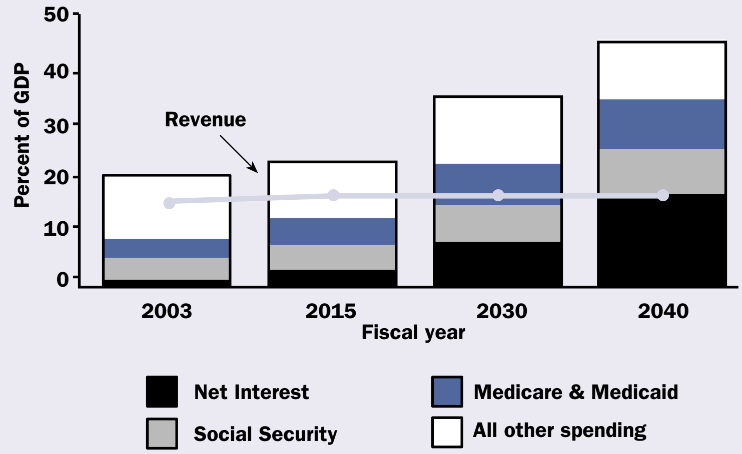
Although an improving economy will help, we will not be able to grow our way out of the problem. Closing our fiscal gap would require double-digit economic growth every year for the next 75 years. By any measure, that is unrealistic. Even during the boom years of the 1990s, the economy on average grew only 3.2 percent annually.

Long-term simulations from GAO paint a chilling picture. By 2040, if we continue on our present course, we will have to cut federal spending by more than half or raise taxes to more than two and a half times today's level to balance the budget. At that point, the federal government would be reduced to doing little more than paying off the interest on the national debt. (See Figure 1.)

FIGURE 1

COMPOSITION OF SPENDING AS A SHARE OF GDP

Assuming Discretionary Spending Grows with GDP after 2004 and all Expiring Tax Provisions are Extended



Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through year 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Source: GAO's March 2004 analysis.

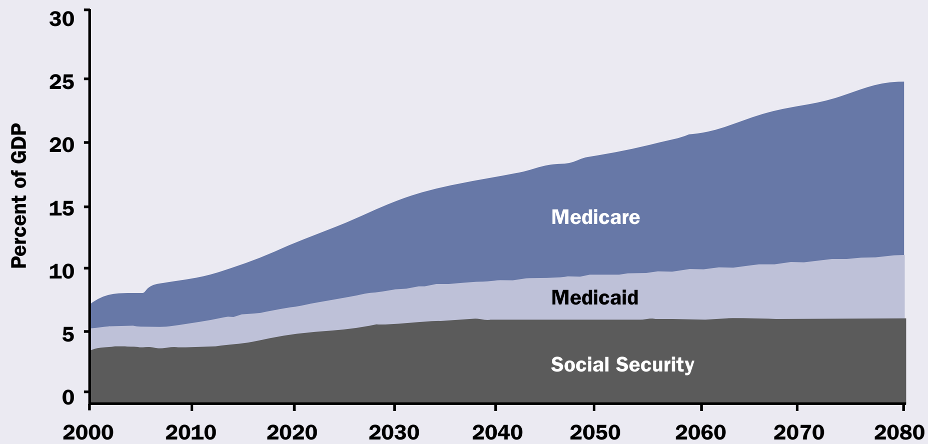
Despite the assertions by some, deficits do matter—in both the short and the long term. More immediately, if we fail to act, no one can predict how far interest rates will rise or whether or when foreign investors will lose confidence in U.S. securities as a safe haven. Further down the road, our government could face an unprecedented fiscal crisis.

It is time to recognize that we are in a fiscal hole and to stop digging. The sooner we get started, the better. Prompt action will reduce the need for drastic steps and give individuals more time to adjust to any changes. It will also allow the miracle of compounding to start working for us rather than against us. Perhaps most important, prompt action will help us to avoid a dangerous upward spiral of debt and inflation that would ultimately harm every American.

We can begin by insisting on truth and transparency in government financial reporting. More than 200 years ago, Thomas Jefferson wrote to his Secretary of the Treasury, "We might hope to see the finances of the Union as clear and intelligible as a merchant's books so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them, to investigate abuses, and consequently to control them." Today, consistent and accurate financial information can seem as elusive as it was in Jefferson's time. But the fiscal risks I have mentioned can be managed only if they are properly accounted for and publicly disclosed.

FIGURE 2

SOCIAL SECURITY, MEDICARE, AND MEDICAID SPENDING AS A PERCENT OF GDP



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

Source: GAO's 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.

A crucial first step is to identify the significant commitments facing our government. GAO and other budget experts continue to encourage reforms in the federal budget process to better reflect the government's commitments and to signal emerging problems. Among other things, GAO has recommended that the government issue an annual report on major fiscal exposures—explicit and implicit promises for future government spending.

We also need to revise current scorekeeping practices across government to emphasize the long-term implications of current policy choices. Too often, annual deficit forecasts and even 10-year budget projections fall short of capturing the long-term costs of federal programs and tax provisions. New budget metrics and mechanisms are needed to assess how spending and tax proposals are likely to play out over time and to manage those risks. For example, our elected representatives should have more explicit information on the long-term costs of pending legislation—including legislation with sunset provisions—on both the spending and the tax sides, before it is voted on. The time has also come to consider reinstating budget controls, such as spending caps or "pay-go" rules.

Some specific steps have already been taken to improve federal financial reporting. The latest annual report of the federal government focuses more on the nation's long-range fiscal imbalance. The President's Management Agenda, which closely reflects GAO's list of high-risk government programs, is bringing additional attention to troubled areas and is trying to better assess the results that agencies are getting.

The Federal Accounting Standards Advisory Board (FASAB), which sets accounting standards and principles for federal entities, is also making progress. For example, FASAB's beefed-up reporting requirements for social insurance programs such as Social Security and Medicare provide better information on the present value of the net long-term costs facing the federal government. FASAB is also working on enhanced disclosure requirements that would provide greater transparency on the collection, use, and remaining balance of "earmarked funds," such as airline ticket surcharges intended to fund improvements at the nation's airports and payroll taxes destined for the Social Security and Medicare trust funds.

I believe that a three-pronged approach based on sound financial information could make significant strides in closing our fiscal gap. First, we need to undertake a top-to-bottom review of government activities to ensure their relevance for the 21st century and to free up scarce resources. Members of Congress and other key policy makers need to determine which programs and policies remain priorities, which should be overhauled, and which have outlived their usefulness. Second, we need to revisit existing tax policy, including the hundreds of billions of dollars in annual tax preferences, and overall tax enforcement efforts. Third, entitlement reform is essential. We need to put Social Security and Medicare on a sound footing and make these programs sustainable for future generations. (See Figure 2.)

Actually, the problems with Social Security are not that difficult to solve. In fact, a window of opportunity now exists in which we can exceed the expectations of all Americans, regardless of whether they will be receiving benefits 20 days or 20 years from now. It will, however, take leadership, courage, and conviction to get the job done.

Addressing the challenges facing Medicare and Medicaid will be far more difficult. But beyond the problems affecting these programs, we also need to come to grips with the fact that our overall health care system is in critical condition. Medical expenses continue to skyrocket. Health care spending, which was about seven percent of GDP in 1970, is expected to reach 17 percent of GDP by 2010. At the same time, a growing percentage of Americans under age 65 is uninsured. More than 40 million Americans have gone without health insurance in recent years, and for the second year in a row we have seen a rising percentage of persons working for major companies who lack health insurance.

The situation is having far-reaching effects on our society: The rising cost of government health care programs is fueling deficits at both the federal and the state levels. The tax base is shrinking because more and more employee compensation is coming in the form of nontaxable benefits like health insurance. In addition, soaring health insurance premiums are contributing to company decisions to move offshore and to hire part-time rather than full-time workers.

Ultimately, we will have to undertake a comprehensive review and reform of how we deliver and finance medical care in this country—in all sectors of the economy. We will need to weigh needs, wants, and affordability and decide how to divide responsibility for health care among employers, individuals, and government. In the end, we may need to accept that although we aspire to a Cadillac standard of health care for everyone, our budget says Chevy.

To reach a political consensus and to avoid disruption in medical services, health care reform may need to be introduced incrementally. Ideally, any proposals should encourage providers and consumers to make prudent choices about coverage and medical treatment, foster transparency of the value and cost of care, and ensure that health plans and providers are accountable for meeting standards for appropriate use, quality, and cost.

The nation's growing fiscal imbalance is not a partisan issue. Regardless of the outcome of the November 2004 elections, the challenges I have described will face whomever is sworn in next January.

The understanding and support of the American people will be critical in providing a foundation for action. Members of the public need to become more involved in the debate over our fiscal future and to make their views known. Younger Americans, especially, need to become active in this discussion because they and their children will bear the heaviest burden if today's leaders fail to act. Educating the public about our true financial situation is, I believe, the best hope for meaningful change today.

The price of passivity is steep. The longer we wait, the more onerous our options become. To avoid shifting a crushing burden of debt onto future generations, we must act, and act soon. We should make every effort to leave our children and grandchildren a world that is financially better off than it was when we found it. Our legacy to future generations should be an America that is secure in both its borders and its finances. In my view, that is what statesmanship and stewardship are all about. ■