S. Hrg. 110–724

IN THE RED: ADDRESSING THE NATION'S FINANCIAL CHALLENGES

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

JUNE 26, 2008

Available via http://www.gpoaccess.gov/congress/index.html

Printed for the use of the Committee on Homeland Security and Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

44–120 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

JOSEPH I. LIEBERMAN, Connecticut, *Chairman*

CARL LEVIN, Michigan	SUSAN M. COLLINS, Maine
DANIEL K. AKAKA, Hawaii	TED STEVENS, Alaska
THOMAS R. CARPER, Delaware	GEORGE V. VOINOVICH, Ohio
MARK L. PRYOR, Arkansas	NORM COLEMAN, Minnesota
MARY L. LANDRIEU, Louisiana	TOM COBURN, Oklahoma
BARACK OBAMA, Illinois	PETE V. DOMENICI, New Mexico
CLAIRE MCCASKILL, Missouri	JOHN WARNER, Virginia
JON TESTER, Montana	JOHN E. SUNUNU, New Hampshire

MICHAEL L. ALEXANDER, *Staff Director*
BRANDON L. MILHORN, *Minority Staff Director and Chief Counsel*
TRINA DRIESSNACK TYRER, *Chief Clerk*

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY SUBCOMMITTEE

THOMAS R. CARPER, Delaware, *Chairman*

CARL LEVIN, Michigan	TOM COBURN, Oklahoma
DANIEL K. AKAKA, Hawaii	TED STEVENS, Alaska
BARACK OBAMA, Illinois	GEORGE V. VOINOVICH, Ohio
CLAIRE MCCASKILL, Missouri	PETE V. DOMENICI, New Mexico
JON TESTER, Montana	JOHN E. SUNUNU, New Hampshire

JOHN KILVINGTON, *Staff Director*
KATY FRENCH, *Minority Staff Director*
MONISHA SMITH, *Chief Clerk*

CONTENTS

	Page
Opening statements:	
Senator Carper	1
Senator Coburn	5
Senator Voinovich	6

WITNESSES

THURSDAY, JUNE 12, 2008

Gene Dodaro, Acting Comptroller General, U.S. Government Accountability Office	9
Daniel I. Werfel, Acting Controller, Office of Management and Budget	11
Kenneth E. Carfine, Fiscal Assistant Secretary, U.S. Department of Treasury	12
David M. Walker, President and Chief Executive Officer, Peter G. Peterson Foundation	30
Robert L. Bixby, Executive Director, The Concord Coalition	31
James Horney, Director, Federal Fiscal Policy, Center on Budget and Policy Priorities	33
Maurice P. McTigue, Vice President of the Mercatus Center, and Director, Government Accountability Project, George Mason University	35

ALPHABETICAL LIST OF WITNESSES

Bixby, Robert L.:	
Testimony	31
Prepared statement	124
Carfine, Kenneth E.:	
Testimony	12
Prepared statement	108
Dodaro, Gene:	
Testimony	9
Prepared statement	49
Horney, James:	
Testimony	33
Prepared statement	148
McTigue, Maurice P.:	
Testimony	35
Prepared statement	157
Walker, David M.:	
Testimony	30
Prepared statement	114
Werfel, Daniel I.:	
Testimony	11
Prepared statement	92

APPENDIX

Charts submitted by Senator Carper	45
Report entitled "The Federal Government's Financial Health, A Citizen's Guide to the 2007 Financial Report of the United States Government," submitted by Mr. Werfel	98
Questions and Responses for the Record from:	
Mr. Dodaro	162
Mr. Horney	183
Mr. McTigue	189

IN THE RED: ADDRESSING THE NATION'S FINANCIAL CHALLENGES

THURSDAY, JUNE 26, 2008

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, FEDERAL SERVICE,
AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:32 p.m., in room SD–342, Dirksen Senate Office Building, Hon. Thomas R. Carper, Chairman of the Subcommittee, presiding.

Present: Senators Carper, Coburn, and Voinovich.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. The Subcommittee will come to order, and on behalf of Dr. Coburn and myself, welcome to each of you. We are going to be joined by several of our colleagues as the afternoon goes on, and I suspect we will have some votes, although we do not know just when. And so we will take them as they come.

I asked our staff to put up the chart,[1] which indicates, if you will, a budget that combines the trust funds with our operating budget. We have, at least for 2007, some idea of how monies were being allocated, and I just want to draw our attention to the red part of the chart, which is part of Health and Human Services. It is mostly Medicare and Medicaid. It is about $556 billion last year, 2007, and there is a little pink area there that is right alongside of the red, which indicates that is the rest of HHS outside of Medicare and Medicaid. And then the blue right below the red, the blue there is Social Security Administration, a little over $600 billion. Again, that is 2007.

My staff was going over a couple of charts with me earlier this morning, and they said this is what it is in 2007. If we come back and visit this chart again about the middle of this century, in about 45 years or so, the red and the blue will crowd out everything else. That is just about what we will be able to do if we stay on the path that we are on. And I think we are realizing that is unacceptable, and part of the challenge for us, not just for Dr. Coburn and myself, but for our colleagues, for the House of Representatives, the Administration, whoever our Presidents are going to be in the years to come, it is up to us to make sure that—when we gather

[1] The charts referred to submitted by Senator Carper appears in the Appendix on page 45.

here, I will be long gone from the Senate in 45 years, although Dr. Coburn may still be around. He will still be delivering babies, wherever he is.

Senator COBURN. That is right.

Senator CARPER. But we can be blue States and red States, but we cannot afford to have a pie chart that is just blue and just red.

We have been joined by Senator Voinovich. Glad to have you here.

For the past 11 years, the Treasury Department has been required to prepare a financial statement for the Federal Government, as you know, and have it audited by the GAO. Every year, the information contained in this statement and the process used to prepare the statement has been so unreliable that GAO's audit team has essentially been unable to do its job. As such, GAO has been forced each year to issue a so-called disclaimer of opinion on the government's finances, which is really a nice way of saying that they will not attach their good name to the Treasury's work.

Fiscal year 2007 was, for the most part, little different from past years. However, let me just hasten to add, improvements have been made, and we look forward to hearing about some of those from this panel, and maybe from others as well. However, the major impediment to the Treasury Department receiving a clean opinion on our consolidated financial statements are largely the same as they have been for the past decade or more.

First, there are the longstanding financial management problems at the Department of Defense that we all know about. In part because of the significant amount of money that goes in and out of that Department, the government as a whole, our government as a whole, cannot get a clean opinion until they are also improving their financial statements as well.

Second, there is our inability, at a governmentwide level, to keep track of the money that individual agencies transfer to and from each other.

And, third, there is Treasury's inability to reliably sum up all the financial statements from across the government into a single set of consolidated financial statements.

In addition to these problems that we have known about and have been grappling with for some time, GAO has highlighted a handful of other financial-related internal control problems that we have yet to fully get our arms around. They are the inability of OMB and the agencies to determine the extent to which improper payments occur throughout government. Then there is our inability to manage and effectively execute tax collection activities so that we are collecting taxes from all of those who owe them. And then there is the problem that a number of agencies are unable to deal with their information security weaknesses.

I will note here that these three issues—improper payments, information security weaknesses, and the tax gap—are issues that this Subcommittee, Dr. Coburn and I and our colleagues, our staffs, have focused on a good deal, and we are going to focus on them some more. Based on our work, we share a deep concern for the potential growing risk that those three areas present to us.

I would like to point out, I think it is Article I, Section 9 of our Constitution reads, "A regular statement and account of the receipts and expenditures of all public money shall be published from time to time." It was probably easier to do when that was written than it is today. So when we ask for a clean financial statement from the Federal Government, we are not really asking for anything more than what was required of us some 217 years ago.

Yet, to this date, the average taxpayer or even a well-trained accountant, for that matter, cannot vouch for the accuracy of the Treasury's annual statements or gain any assurance from them that our tax dollars are well spent.

This situation would be maybe laughable if it were not so serious. Imagine what would happen if a major business' books were in this sort of shape. In fact, it is not so difficult to recall the corporate accounting scandals of just a few years ago. Businesses folded. People were fired. People went to jail. And while the Federal Government's repeated failings in the basics of financial management have not received the media attention that the failings of some private sector companies have received, I, for one, think the state of our Nation's finances should be seen as nothing less than a scandal.

I am not suggesting that anyone here get fired or go to jail, but we do need to take definitive action to provide the kind of quality financial management and transparency that the American people expect and I believe they deserve.

The Congress, and especially our next President, whoever that may be, need to play an important leadership role in this regard. Sometimes I think we sort of self-flagellate ourselves here in the Congress and say that it is all of our responsibilities. Any government entity that I have ever been a part of or had a chance to observe, whether it was the State level or whether it was the city level or county level, if you have a chief executive and a level of government where you have a legislative body of some kind, if you do not have strong leadership on fiscal issues from the chief executive, it is my experience it is not in the nature of a legislative body to provide that, absent the leadership from the top. And that is just an observation I would provide. So I do not just say this is the Congress' job. This is a shared responsibility, and the President has a large responsibility, too.

But among the problems highlighted by GAO's audit report is the fiscally unsustainable long-term path this Nation faces, and I am grateful to the GAO for taking on this important issue.

Now I am supposed to look to another chart to my right. Is that right? Is there another chart for me to look at? All right. I asked them to make sure to cue me about these charts.[1]

Major fiscal exposures or liabilities. Some of this print might be a little small, so I will just kind of walk us through it, if I could. We have some more explicit liabilities, including publicly held debt and military and civilian pensions and retiree health at the top. And if you come across to the right on our chart, we are looking at 2000, and there is a column there below the word "2000." We will look at commitments and contingencies and some implicit exposures. Then come over to the right a bit more from the 2000 column, we have the 2007 column, and then at the far right, the per-

[1] The chart referred to appears in the Appendix on page 46.

centage increase from 2007 over 2000. But the explicit liabilities are up by about 57 percent from roughly $7 trillion to $11 trillion. The commitments and the contingencies and things like Pension Benefit Guaranty Corporation and undelivered orders, that sort of thing, they are up by—they are small. They are only about—only about a trillion dollars, but up about almost 100 percent from 7 years ago.

The implicit—this is where the real money is, and this is the implicit exposures. We see for future Social Security benefits in 2000, we are looking at about $3.8 trillion, in 2007 up to $6.8 trillion. Not quite double, but close. Future Medicare Part A benefits, up in 2000 from $2.7 trillion, and by 2007 up to $12.3 trillion. That is an increase of, I think, about four-fold. Future Medicare Part B benefits, exposure in 2000 was roughly $6.5 trillion; more than doubled to $13.4 trillion in 2007. And the Medicare Part D prescription drug benefit, we did not have that in 2000, and starting in 2007 we are looking at an implicit exposure of about $8.4 trillion. And that is a program that is actually coming in under budget, at least so far, and we are still looking at that magnitude.

If you look at the totals, looking all the way down the column from 2000, we are looking at a total exposure or liability of a little over $20, $20.4 trillion. Moving over to the 2007 column and coming down to the bottom, exposure or liability, if you will, almost $53 trillion in 2007. And that is an increase of 158 percent. That is an increase in 7 years. We cannot afford another 7 years like that. God knows we cannot afford another 47 years like that, and part of our responsibility and hopefully part of this hearing is to help ensure that we do not continue down the road that is laid out there.

Let me conclude here, if I may, to observe that—one thing our next President has got to do, together with us, is to find a way to overhaul our entitlement programs so that they are not as much of a burden as our next generation. We are getting killed on health care costs, and Medicare and Medicaid especially. The Social Security Trust Fund I think is fixable. Medicare and Medicaid are a far bigger challenge. And I hope one of the things that we will accomplish before I leave here, I say this to my colleagues, Senators Voinovich and Coburn, one of the things I hope that we accomplish in the time that I am here in the Senate is to fix Social Security for the next several generations or more, and that would be a wonderful accomplishment. That is a lot easier, though, than Medicare and Medicaid, as we know.

But having said that, when Senator Voinovich and I were in our old jobs, we were able to cut taxes, balance budgets, make investments as were needed. Those were better economic times. But when things we thought were worthwhile, we paid for them. We actually paid for them. And that is a philosophy that we need to reembrace here in our Nation's capital.

I will close by mentioning PAYGO rules. Not everybody likes the PAYGO rules. I always like to quote the guy who used to be the Chancellor of the Exchequer, and he used to say, "When you find yourself in a hole, stop digging." That is the theory of holes. And I just think if things are worth having, we ought to pay for them. If they are not worth having, we ought not to pay for them. And the guy who really, I think, raises that as much as anybody I know is the fellow here to my right—and to my left, both of them. So in a sense, I am speaking to the choir on this stuff.

All right. That is what I wanted to say, and we look forward to hearing from all of you, and before we do that, I am going to ask Dr. Coburn to weigh in, and then Senator Voinovich, and then we will turn it over to our witnesses. Thank you all.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. Well, first of all, I thank Chairman Carper for having this hearing. Probably not many people are going to tune into C–SPAN on this hearing, and that is our biggest problem in the country, is people do not realize the significant difficulty we have in front of us.

I would point out on Senator Carper's chart—leave it up there for a second—that 60 percent of the increase in that is pure demographics. It is the aging of the population on programs we have already promised. Fifteen percent, as one person adamantly opposed to Medicare Part D, is because we added a new entitlement and did not figure out any way to pay for it. And so the other 35 percent of the increase in debt comes because Congress passed bills—not by themselves, with the President, but they passed the bills to increase that spending. So as we talk about these issues today, the responsibility lies both here and the Executive Branch. We hear a lot about the Executive Branch, but the Executive Branch cannot spend one penny that the Congress does not pass the money for. So it is a dual responsibility, and when there is a dual responsibility, then there is dual shared culpability in terms of association with that.

The pattern that most people do not understand is Medicare is not going to sink. Medicaid is not going to sink us. Interest is going to sink us. Interest is the thing that is going to sink us. You see the green in this chart as we go from 1970 to 2080, you see as a proportion of the budget, in 2080 65 percent of the budget is interest. And, that is common, basic math, we know. Albert Einstein said the most powerful force on Earth is not the atom. He said it is compound interest. And it can be a tool to help you, but it can be a tool that will greatly harm you. And what we are seeing manifested out is the irresponsibility of both Executive Branch and Congress, not just one but both, in terms of what we have got on the horizon.

There are a lot of reasons for that. Most of them are parochial, short-term thinking by Congress instead of long-term, hard-choice decisionmaking by Congress. But if we do not change that trend line, then what we will have done is abandon the heritage of this country for everybody else that follows us.

Put the other one up. Not that one, the next one.[1]

Here we look at the percentage of the GDP that is held by the public, but interesting to note, 50 percent of that money that is held out there is not held by Americans. It is held by non-Americans. So as we look at the oil crisis that is in front of us today, what we should duly note is because we have been fiscally irre-

[1] The chart referred to appears in the Appendix on page 45.

sponsible, 23 percent of the increase in the cost of oil is because of the devaluation of the dollar that is based directly on the fact that we are seen as irresponsible and possibly not capable of repaying our debt.

Now, it is not unfixable. It is fixable. Even with the demographic shifts that nobody here is responsible for other than me and you and our kids, even with the demographic shifts, we can fix it. And this is just one plan. It is put out by Paul Ryan, the Ranking Member on the Budget in the House. And if you look at his plan, it is not perfect, it is not everything I would do, but it is the first comprehensive plan that has been forwarded to fix this. So there is the debt, and you can see it will peak, but most of the time it is peaking is because we are having a demographic shift, not because we are acting irresponsibly.

Put the next chart up, please.[1]

And then government spending as a percentage of GDP, as you see what our current policy is, if we continue to do nothing—and I would tell you in the last 7 years, we have done nothing. What our current policy is we are going to go to 80 percent of GDP by 2078. That is absolutely unsustainable. We all know that. We will not recognize the country that we are in if we are in that shape.

So we have to have a plan, and you can see as a percentage of spending of GDP, if you just take Congressman Ryan, which, granted, is all going to be controversial, but at least somebody is out there with a comprehensive plan that addresses all these issues, you can see we can actually perform below the historical average of the last 50 years in terms of a percentage of GDP.

So the purpose of this hearing is to hear from you, one, on the magnitude of the problem and, two, some of the potential ways in which we can keep from ducking the hard choices. And that would be my hope, is that you really talk hard and straight with us about where we have failed, about what we need to do, and about the timeliness of what we do, because time, based on the most powerful ??? for on Earth, compound interest debt, is killing us.

Thank you, Mr. Chairman.

Senator CARPER. Thank you, Dr. Coburn. Senator Voinovich.

OPENING STATEMENT OF SENATOR VOINOVICH

Senator VOINOVICH. Thank you very much, both of you, for holding this hearing.

I look forward to hearing the witnesses today. I think we need to be reminded of the fiscal realities in which we find ourselves. We are operating in the red. The Federal Government's checkbook is not balanced. We cannot continue to live in the United States of Denial. Here we are, in denial. And I am glad to see that a couple of my friends—and all of you are my friends, but particularly two people that I have worked with for the last several years: David Walker and Bob Bixby are here today, and you are still at it, and you have not quit. That is wonderful.

In March 2007, they came out to Cincinnati on their Fiscal Wake-Up Tour, which was a huge success, and I do not think anyone has worked harder to make the public aware of the situation

[1] The chart referred to appears in the Appendix on page 48.

that both my colleagues have been talking about than the two of you.

The country needs to know the truth of the sad state of our finances. We are truly operating in the red. As of 2007, the national debt stood at almost $9 trillion. As of today, the national debt is $9.4 trillion, with each American owing more than $31,000. And the deficit for 2008 will be added to that number, including, on average, $273 billion a year in interest payments on this debt over the next decade.

But too many in Washington pretend this debt does not even exist, and perhaps even more concerning is that 51 percent of the privately owned national debt is being held by foreign creditors, as Senator Coburn has said, mostly central banks. That is up 37 percent just from 6 years ago. Foreign creditors provided more than 70 percent of the funds the United States has borrowed since 2001. Who are these foreign creditors? According to the Treasury Department, China, Japan, and the oil-exporting countries known as OPEC.

If these foreign investors were to lose confidence and pull out of the U.S. treasuries, "Katy, bar the door." Just talk to Alan Greenspan about that. Borrowing hundreds of billions of dollars from China and OPEC puts not only our future economy but also our national security at risk. It is critical that we ensure that countries that control our debt do not control our future. And with the baby-boomer generation coming into retirement, the costs of Social Security and Medicare start to soar. Our national debt is projected to explode if we do not do something now to change the path we are headed down.

The Federal Government's accumulated long-term financial obligations grew by $2.5 trillion last year, a result of the increase in the cost of Medicare and Social Security benefits as more baby-boomers retire. Taxpayers are on the hook for a record $57 trillion in Federal liabilities to cover the lifetime benefits of everyone eligible for Medicare, Social Security, and other government programs. That is nearly $500,000 per household.

I know too well the situation the Federal Government finds itself in, and I look forward to hearing the solutions you lay out for us today and continuing this conversation to raise the public's awareness of the looming crisis. We are in it now. It is going to get worse. And I am extremely interested in hearing your thoughts on two pieces of legislation that have been proposed to address the entitlement and tax reform problem: Securing America's Future Economy, or SAFE Act, and the Bipartisan Task Force for Fiscal Responsibility Act. Both bills create a bipartisan commission to look at our Nation's tax and entitlement systems and recommend reforms to put us back on a fiscally sustainable course and ensure the solvency of entitlement programs for future generations.

But it is time to act, and it would be wonderful if through this hearing and other hearings we could get the Presidential candidates to start talking about the national debt. When was the last time we heard the President of the United States talk about the national debt? When is the last time we really talked about it in Congress? And thank God you are doing this, and a couple of other committees. Maybe we can make some progress.

You know what would be nice? If we could get Senator Obama and Senator McCain to sign on to one of these bills and say, "If I get elected"—or "When I get elected, then I will appoint my Secretary of the Treasury, I will appoint my OMB Director to this, and we are going to get started. We are going to do something about this."

Thank you.

Senator CARPER. Thank you. Senator Voinovich, and thank you for the passion that you bring to this. My hope is that the next President will just bring at least a small measure of that passion to these issues.

Let me take a moment just to introduce our three witnesses for this panel, and then we will recognize you to speak.

Our first witness today is Gene Dodaro, the Acting Comptroller General of the United States. Mr. Dodaro took over in March of this year after the resignation of former Comptroller General David Walker, who is here today, and who we will be hearing from, I think, on our next panel. Previously, Mr. Dodaro spent—was it 9 years as Chief Operating Officer——

Mr. DODARO. Yes.

Senator CARPER [continuing]. For the Government Accountability Office, the No. 2 spot at GAO, as I recall.

Our next witness is Danny Werfel, the Acting Controller in the Office of Management and Budget. Mr. Werfel previously served in a host of positions at OMB, including the Chief of Financial Integrity in the Analysis Branch. Also, I think you worked as a trial attorney in the Department of Justice's Civil Rights Division. Is that correct?

Mr. WERFEL. That is correct.

Senator CARPER. And our third and final witness on this panel is Kenneth Carfine, Fiscal Assistant Secretary for the U.S. Department of Treasury, a job that you have held since your appointment in March 2007, a little more than a year ago. Mr. Carfine previously served as Deputy Assistant Secretary for Fiscal Operations and Policy, a position to which he was appointed in April 2003, and I am sure that was not his first job. He has done a lot of other things, and we will not go into all of those.

We are delighted that you are all here. We look forward to hearing your testimony. Your entire statements will be made part of the record, and just feel free to summarize. I would ask you to stay fairly close to 5 minutes. If you go over a little bit, we will not bang down the gavel. But try to stay fairly close to that if you would. Thank you.

Mr. Dodaro, welcome.

TESTIMONY OF GENE DODARO,[1] ACTING COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. DODARO. Thank you, Mr. Chairman. Good afternoon to you and Senator Voinovich. I appreciate the opportunity to be here today to discuss the results of GAO's audit of the consolidated financial statements for fiscal year 2007. As you noted in your opening statement, like prior years, we were unable to give an opinion

[1] The prepared statement of Mr. Dodaro appears in the Appendix on page 49.

on the accrual basis financial statements for a wide range of reasons which are documented in our report. The main three you also pointed out in your opening statement, which are the serious financial management problems at DOD, the inability to reconcile intragovernmental transactions among departments and agencies, and an ineffective process in compiling the financial statements by the Department of Treasury.

I would note, though, that there were three positive developments in this past year. First, we were able to give an opinion, an unqualified opinion, on the 2007 Statement of Social Insurance. Now, this statement is a very important statement as it discusses the difference between the scheduled expenditures for Medicare and Social Security programs compared to projected revenues. And it shows a $41 trillion gap of where there is fiscal exposure for the Federal Government similar to the exposure chart that you mentioned before. So that was a positive development because it provides greater reliability to that information and helps to put the spotlight on the government's long-term financial condition.

Second, Treasury and OMB published a summary Citizen's Guide this past year at the urging of former Comptroller General Walker, and in concert with the Joint Financial Management Improvement Program Principals.[1] That was a positive development. It is a very brief guide, but it highlights the long-term fiscal challenges facing the Federal Government.

Finally, if I could direct your attention to this past year, of the 24 agencies that are covered by the CFO Act, 19 of those agencies were able to get unqualified opinions. When the legislative requirement first came into place for fiscal year 1996, only 6 of the 24 agencies were able to get unqualified opinions. Although the Federal Government was late to the game with a requirement for audited financial statements, much later than the State and local governments, as well as the private sector, progress has been made. This needs to be sustained in the next Administration. The five agencies that did not receive unqualified opinions this past year are some large departments like DOD, Department of Homeland Security, NASA, Agriculture, and the State Department.

And the next chart shows the magnitude and the pervasive nature of DOD throughout the government's finances, with about 20 percent of net costs, 20 percent of liabilities, and almost half of the assets of the Federal Government.DOD needs to make major strides as it is the major critical path to an opinion on the consolidated financial statements of the Federal Government.

Now, in addition to being a good accountability tool, the financial statements are also beginning to shed more light on the long-range financial challenges of the Federal Government. This next chart shows the steadily increasing debt of the Federal Government from 2003 to 2007. This debt is growing both in debt held by the public as well as the debt the government owes itself regarding the later, the government borrowed about $200 billion in Social Security excess of revenues over projected benefits paid to help finance the rest of the Federal Government's costs. When such borrowings

[1] The report entitled "The Federal Government's Financial Health, A Citizen's Guide to the 2007 Financial Report of the United States Government," appears in the Appendix on page 98.

occur, they basically generate IOUs to the Social Security trust funds. So the total debt is going up. The debt ceiling has had to be raised three times in the last 4 years, and it is expected that the debt ceiling will have to be raised again, either the later part of this year or next year. So that issue will be confronting the Congress soon.

Now, our simulations are similar to the ones that you, and Dr. Coburn showed, where the total debt just skyrockets in the out-years based on the simulations. The next chart shows what some of the impact would be on this. Basically, if in the out-years revenue as a percent of gross domestic product is held at about 18.3 percent, which is about what it has been on average the last 40 years, by the year 2030 we will only have enough funds to pay interest on the debt, Medicare, and Social Security. We will not have any revenues left to pay for any part of the Federal Government that is remaining.

Obviously, this is not going to happen, but it shows the magnitude of the challenge confronting the Federal Government and the size and scope of the problem going forward. Simply put, the Federal Government is on an unsustainable path. It is a matter of the utmost importance to the country, and it really needs to be dealt with.

I commend you for holding this hearing and for maintaining the attention to these important issues, both from an accountability standpoint and from a government fiscal policy standpoint.

Thank you very much.

Senator CARPER. Thank you very much, and thank you again to you and the folks that you now lead. Thank you for your stewardship and for being there to help us be better fiscal stewards than would otherwise be the case.

Mr. Werfel, we are delighted that you are here. Please feel free to proceed.

TESTIMONY OF DANIEL I. WERFEL,[1] ACTING CONTROLLER, OFFICE OF MANAGEMENT AND BUDGET

Mr. WERFEL. Thank you, Chairman Carper, Ranking Member Coburn, and Senator Voinovich, for having this hearing today. We have heard so far today a lot about the rising cost of entitlement programs and the expected impact, the enormous impact it is going to have on the Federal Government and our fiscal health in the coming decades. What I would like to focus on—and we will certainly like to discuss those issues as well, but for the purpose of my oral statement, I would like to talk about the fact that this impending fiscal crisis really brings into sharp focus the need to meet our financial management goals because of the critical role that the financial management community plays in not only reporting on our fiscal situation but on controlling costs and making sure that we are operating an efficient and effective government.

When the CFO Act of 1990 was passed close to 18 years ago, Congress established three fundamental objectives for Federal financial management: Transparency, informing the public on the nature of our Nation's finances; internal controls was the second

[1] The prepared statement of Mr. Werfel appears in the Appendix on page 92.

objective, making sure that we are putting in the right people, process, and technology to track funds and mitigate financial risks; and, third, decision support, making sure we have the right financial information at the right time to inform agency decisionmaking.

Significant results are being achieved with respect to the reliability, timeliness, and readability of agency financial reports today. With respect to reliability, as Mr. Dodaro pointed out, 80 percent of CFO Act agencies achieved a clean audit opinion today. With respect to timeliness, all agencies are now reporting those audited financial statements with 45 days after the end of the fiscal year, and Treasury and OMB issues the governmentwide report only 30 days after that. And with respect to readability of our reports, through an OMB pilot program agencies are not producing summary documents to help readers digest hundreds of pages of detailed financial and performance information.

Attached to my testimony today is a great example of how we are working to make government financial reports more readable and transparent, "The Federal Government's Financial Health, A Citizen's Guide to the 2007 Financial Report of the United States Government" provides readers an eight-page, easy-to-read version of the larger, 182-page Financial Report.[1] The Treasury Department and OMB are very proud of the report, and I think GAO is as well, not only because it improves the presentation——

Senator CARPER. Let me just interrupt. Whose idea was that?

Mr. WERFEL. Whose idea? Well, it was Mr. Walker's——

Senator CARPER. David Walker.

Mr. WERFEL. Yes.

Senator CARPER. Thank you very much.

Mr. WERFEL. Do not ever say I do not give credit where credit is due.

We are proud of this report not only because it presents our financial information more effectively, but we are proud because of the clarity and transparency we are giving to the most significant fiscal challenge facing the government today, the one that we have talked about so far.

The Federal financial community plays an important role in fiscal sustainability issues. We are responsible for ensuring that the data and the analysis are clearly and effectively communicated, and the Citizen's Guide represents an important first step in this area. Also, as Mr. Dodaro mentioned, the clean opinion on our Statement of Social Insurance is another important step.

The Federal financial community is responsible for more than just reporting on the Nation's fiscal health. We play a critical role in developing and implementing strategies to control Federal spending and otherwise ensure that the fiscal health of the Federal Government remains sound. In areas such as improper payments, billions of dollars in error are being eliminated. In real property, billions of dollars in unneeded assets are being removed from our inventory.

Despite these results, more work needs to be done. While most of our major financial reports are passing audit scrutiny, too many

[1] The report entitled "The Federal Government's Financial Health, A Citizen's Guide to the 2007 Financial Report of the United States Government," appears in the Appendix on page 98.

of them are not. And to address this, we have sound corrective action plans in place to address financial management weaknesses, and these action plans are already leading to results. Trends are showing better audit results each year.

With the unprecedented challenge before us, we need to make sure that our Federal financial leaders are moving beyond the fundamentals of just audited financial statements. Do our financial reports contain the right information most relevant to important programmatic and business decisions that agencies are making?

As we approach the 20-year anniversary of the CFO Act, OMB looks forward to working with Congress and GAO to evaluate financial management requirements today to address these questions. We must ensure that the CFO Act and other relevant laws are best positioning the Federal CFO to help the government through the financial challenges that lay ahead.

At this time I am happy to answer any questions that you have. Thank you.

Senator CARPER. And I am sure we will have some. Thank you very much for that statement.

Mr. Carfine, you are the third witness, and we look forward to hearing what you have to say.

TESTIMONY OF KENNETH E. CARFINE,[1] FISCAL ASSISTANT SECRETARY, U.S. DEPARTMENT OF TREASURY

Mr. CARFINE. Mr. Chairman and Members of the Subcommittee, thank you for inviting me to this hearing to discuss the Financial Report of the U.S. Government for Fiscal Year 2007. Your interest in improving Federal financial management and, in particular, fiscal sustainability is greatly appreciated.

The Financial Report reflects Treasury's longstanding responsibility to provide the Congress and the public with timely and reliable information on the costs of the government's operations, the sources used to fund them, and the implications of the government's financial commitments. The Financial Report provides the net operating costs for fiscal year 2007, the net position of the government at the close of the fiscal year, and other critical information concerning the financial performance of the Federal Government.

The report also contains a Statement of Social Insurance, which shows the present value costs of the government's exposures of its social insurance programs, primarily Social Security and Medicare. The Statement of Social Insurance became the first and, to date, the only component of all the governmentwide financial statements to earn an unqualified audit opinion from GAO.

As you know, the retirement of the baby-boom generation will have a profound impact on the finances of Social Security and Medicare. There are currently 3.3 covered workers per Social Security beneficiary. That number will fall to 2.1 in 2034. Medicare faces the same demographic challenges as Social Security, but additionally must cope with the rapid expected growth in health care costs. While Social Security expenditures are expected to grow considerably over the next 75 years, Medicare obligations are expected

[1] The prepared statement of Mr. Carfine appears in the Appendix on page 108.

to dwarf those of Social Security. The 75-year present value of projected Medicare expenditures, less tax and premium revenue, is $34 trillion, while the 75-year present value of projected Social Security expenditures, less tax revenue, is $4.7 trillion.

The Financial Report shows that the Federal Government current policies are unlikely to be sustainable. Total expenditures, including interest, are expected to grow to 50 percent of GDP by 2070 and 60 percent by 2080. If revenues in the future continue at the historic average level of 18 percent of GDP, they will barely cover one-third of total government expenditures and would not be sufficient to cover the net interest on the government debt.

The consequences of the projected growing gap between revenues and expenditures would be a rapidly increasing debt-to-GDP ratio. By 2030, the need to fund government deficits will drive the debt-to-GDP ratio to 68 percent, far surpassing the non-wartime peak of 49 percent in 1993. By 2040, this ratio is projected to reach 128 percent, well above the World War II peak of 109 percent. Thereafter, the ratio of debt held by the public to GDP rises sharply to 300 percent by 2060, and doubling against to 600 percent by 2080.

It is important to note that these are merely projections based on a number of assumptions that can change and alter the outlook. Yet the projections provide an important signal about the difficulties that the government faces in attempting to sustain current policies. Avoiding the consequences of this fiscal path will require actions to bring program expenditures in line with available resources. How soon those actions are taken will greatly influence their ultimate impact on the Nation.

For fiscal year 2007, GAO was unable to express an opinion on the other financial statements in the Financial Report due to longstanding material weaknesses. I recognize that until our statements can withstand audit scrutiny, we will not benefit from the report's full value in informing the Congress and the public about the government's fiscal position and condition. We are working with OMB and the other Federal agencies to address these issues and are making significant progress.

A common critique of the financial report of the U.S. Government is that, despite the fact that it contains more than 180 pages of detailed information on the government's financial condition, it is not a practical document for communicating with the American citizen or the Congress. In response to this feedback, the Treasury Department and OMB, in cooperation with GAO, developed and issued the summary report that Mr. Werfel mentioned. This guide provides a summary of the key data and issues addressed in the full report in a manner that is user-friendly to the general public.

The process of preparing the Financial Report of the U.S. Government and the annual agency financial reports can have an impact on improving management and control of the government's finances. However, these reports are of limited or even minimal value if they go unread. As such, in addition to continuing to pursue resolution of the governmentwide reporting weaknesses, we will continue to focus on how to make the document and the information it contains more relevant and useful to the general public.

Thank you, Mr. Chairman. This concludes my formal remarks, and I look forward to your questions.

Senator CARPER. Well, gentlemen, thank you all for that testimony.

I say this to my colleagues, I am sitting here listening, and we are encouraged that for the first time, I think the first time ever, we actually have the Statement of Social Insurance that is done, signed off on, and I think it said about 80 percent of our 24 major Federal agencies have gotten clean audit opinions, and that is encouraging as well.

There is an irony, though, at least for me, that even as we have a better financial reporting that is beginning to occur, something we all welcome, the picture that is presented by that better financial reporting is bleak and very discouraging.

There is part of me that says—and I almost said it may be better if we did not know just what an awful situation we are in, but to be serious, we need to know. And the fact that we have actually information that is reliable, that has been documented, in the end that will be a good thing.

I do want to commend those whose efforts led us to really to achieve those benchmarks and milestones. Obviously, we are not done, but that is progress, and people are to be commended for that.

Let me just start with the Department of Defense and let's focus on their progress, or lack thereof. In addressing their financial management problems, I think they are having a big impact on our ability or our inability to obtain a clean opinion governmentwide. I would just ask this panel—I do not care who takes the first shot at it, but why is this the case? And what can be done further by you, by us, by the Administration to get a clean opinion at the Department of Defense?

Mr. DODARO. I will take the first shot at that. The Department of Defense——

Senator CARPER. I know you all have some ideas because I read them.

Mr. DODARO. Yes, I believe you did, Senator. Actually, the Department of Defense's problems are very serious ones. They comprise in whole or in part about 15 of the 28 areas that we have on our high-risk list at GAO that we have been maintaining since 1990. The problems fall into several different categories. One, for an enterprise as large as the Department of Defense and the fact there was no requirement for annual financial statements of the Federal Government prior to 1996, they had hundreds of systems that were in place that were developed in isolation of one another. So their financial systems and the volume of their transactions were enormous, and they are not well postured to bring those systems together to produce reliable financial statements.

Second, they have great difficulty accounting for financial statement purposes, for equipment, property, inventory given the volume of their activities going forward.

Third, they have enormous liabilities. Just pick one related to environmental clean-up. When they close a base or a facility, they have difficulty coming up with estimates that are auditable to be able to be in a position to know exactly what the size of those clean-ups were.

They have tried various improvement efforts over the years. They have made some incremental progress, but they still have a long way to go. They are trying right now to put in place a data structure so that they have a common set of requirements across the departments. They are going to try to go to a different approach to be prepared to be ready, to have auditable statements, but their current estimate is out into 2017 before that occurs. And if there is one recommendation I would have for this Subcommittee going forward, it would be to focus on the Department and have them here and to keep the sustained attention on their efforts to go forward.

A big issue now is leadership. We are about ready to change to a new Administration. This will only be the second new Administration since the CFO Act was passed. So it is really important that the momentum be changed. We have recommended that there be a Chief Management Officer at the Department of Defense that spans Administrations——

Senator CARPER. Let me just interrupt. Has the Department taken the position the Deputy Secretary should assume those responsibilities?

Mr. DODARO. That is their position.

Senator CARPER. Gordon England is highly regarded, certainly by me and I think by many others. But is the suggestion that this is just—given everything else that is on the Deputy Secretary's plate, this is probably not something that he or she has time to do well.

Mr. DODARO. That is correct. We have respect for Mr. England as well, but, there is a lot going on with the Department of Defense right now, and these are not the type of problems that can be solved within a year or two of attention. They are going to span a wide number of years, and somebody needs to focus on them full-time. That is the way some of the smaller departments and agencies have made progress, and that is why they are where they are today.

Senator CARPER. Do you envision this person being a political appointee who would come and go with the beginning or the end of an Administration? Or is this somebody who would be there like maybe even a career professional or somebody that would be there for an extended period of time?

Mr. DODARO. What we had envisioned was somebody that would have a 5- to 7-year term that would span Administrations, that would be able to work on these problems with a sustained improvement plan across time.

One of the other factors that occurs at the Department of Defense, and whether it is weapons systems development, or whatever, there is a lot of movement of leadership within the Department, and that has been one of the things that we pointed out over time. When you have these long-term efforts—and this is a long-term effort because you are talking about business management systems dealing with one of the largest entities in the world, you are not going to be able to do it on a part-time basis.

Senator CARPER. That reminds me, just checking in with my colleagues, when we observe all the folks that are nominated for positions in the Executive Branch for which they need Senate confirmation, the process that the folks go through, it is, as you know, time-consuming. Then the process of confirmation, going through the hearings, and then going to the floor, and avoiding holes, we end up going for extended periods of time with key positions not being filled. It is not a good situation.

Anyone else on this first question before I yield? Yes, Mr. Werfel?

Mr. WERFEL. Yes, I would like to add to Mr. Dodaro's comments. I have had the honor and the privilege of working with the Defense Department on their clean audit plans since 2003.

Senator CARPER. OK.

Mr. WERFEL. And one thing I can assure you of is that any lack of progress is not due to a lack of talent and dedicated professionals at the Pentagon.

Senator CARPER. That is good to hear.

Mr. WERFEL. They are a great group.

If you look over time, you see a lot of progress being made, and there are things that we can point to, more liabilities getting to audit readiness, more internal controls being improved, clean audits at some of the small services. The U.S. Army Corps of Engineers just recently achieved a qualified audit, which was a major milestone.

But what you have is—excuse the pun or metaphor, but a lot of it is trying to boil the ocean. The Department is so large and complex, so many thousands of transactions a minute going on, and so many different complexity to their organization——

Senator CARPER. Mr. Dodaro mentioned in 1996 all the different systems that did not talk with each other, and we have had 12 years to go beyond that. Is it as bad as it was? Any idea?

Mr. WERFEL. It is getting better, but it is a slow—it is like a glacier moving. It is an inch-by-inch process.

Senator CARPER. It is like turning an aircraft carrier? [Laughter.]

Mr. WERFEL. Well, we certainly do not turn on a dime in the government. But one of the things that I would like to share is that what we are starting to think more and more that will help the Defense Department is to start segmenting their milestones around objectives that do two things:

First of all, we can prioritize areas that are material to the consolidated financial statement, because what you have with the Defense Department is they are so big and so large that some of their line items are material to our line items at the consolidated—things like their cash and their plant, property, and equipment, and their environmental liabilities. So if we can target those components in particular and target those areas that have the greatest nexus today towards mission effectiveness at the Defense Department—because if you look totally at their clean audit action plan, you can start to prioritize. Well, if they did a better job with these things, that is really going to impact their mission and their ability to support the warfighter and do other things. And then you can look down the list and say, well, these are good things to do but less impact. I think we need to go through a prioritization exercise with the Defense Department along those lines.

And the last point I will make is one of the challenges is that, as you have heard me testify before, November 15 is a big day for the Federal agencies, the CFO community. We all sweat that one out as we wait for the auditors to come in and find out whether we got a clean audit opinion. And that type of pressure really motivates and generates a lot of accountability at the agencies.

The Defense Department does not have that type of November 15 because they are not getting an audit right now, and sometimes I have talked about it as there is no moment of truth in the near future from a public transparency standpoint. So as we think about prioritizing the Defense Department's efforts, we might also want to think about how can we create public transparency around how they are doing along these key milestones. So the next moment of truth is in 2017, and we are looking forward to working with GAO and Congress to think about how to implement that, assuming that is something that resonates with you.

Senator CARPER. Good. Thank you. I am about 2 minutes over my time.

Mr. Carfine, do you want to add anything or sort of underline anything that has been said by the first two witnesses?

Mr. CARFINE. The only thing that I want to mention is that the problems at the Department of Defense as well as the other material weaknesses related to the financial statements are difficult problems to address. And we are committed to supporting the recommendations that OMB has for addressing the Department of Defense and are willing to help in any way that we can in order to move that process along.

Senator CARPER. Good. Thanks so much. Dr. Coburn.

Senator COBURN. Well, thank you for your testimony. One of the things my staff did this spring is we took all the GAO reports, all the IG reports, all the CBO reports, and all the CRS reports on government waste, and we combined them. You know what the total came to on an annual basis? Waste and fraud, $300-plus billion a year.

Put up the supplemental.

If, in fact, we had Congress working as hard on waste as they work on earmarks, all these supplementals could have been paid for. That is the trend line on supplementals. Supplementals are borrowed—every penny of it is borrowed. Agree? Anybody disagree with that? Every penny of it is borrowed money. It is supplemental funding that we do not have outside of the budget 302s. It is money that we are going to go and borrow.

So had we worked—you all are doing the basic background of creating the systems and the measurement with which we can manage. But had we worked to not allow supplementals—in other words, to make the hard choice, what do we get rid of if we are going to spend, like we did in 2005, $140 billion of which $96 billion of that was on the war. But $54 billion was not on the war—$54 billion just was a way to get—Senator Carper mentioned PAYGO. If we really had PAYGO and we really enforced it—which we do not. We only enforce it when it is convenient politically. But if we really had PAYGO and we applied it to supplementals, what would happen is we would not see that and we would get rid of a good portion of the $300 billion worth of waste, fraud, and abuse because we would be forced to, kind of like when you are a governor and you have to operate under a Balance Budget Act.

So the question I have, and mainly it is directed to my favorite quarterback, Mr. Werfel, is this Administration refuses to force the

Congress to make hard choices on supplementals, and so they had——

Senator CARPER. Before you ask this question, let me say, won't it be a great day when that famous quarterback will at some time be mistaken for this guy?

Senator COBURN. I am sure he is all the time. [Laughter.]

Senator CARPER. And he will pretend he is here to try to get better rooms in hotels——

Senator COBURN. Look at him ruin my point. I do not even know where I was now. [Laughter.]

Senator CARPER. Your favorite quarterback.

Senator COBURN. But why is the Administration sending supplementals up here and saying, "I want this money spent outside of the budget," when they know this same number is $300 billion worth of waste, fraud, and abuse. Why not send a supplemental and say, "We want a supplemental within the budget"?

The last time Congress did a rescission was 1995. And the assumption behind that for the American people is everything is running efficiently, we do not have any waste, we do not have any fraud. And, by the way, if we have some hiccup come along, we are not going to make hard choices. We are just going to put a credit card in the machine and send it on down the road so that we go not from $9.8 trillion—by the way, the debt is rising $1.2 million a minute as we are sitting in here, $1.56 billion a day. Instead, we just do not make the hard choice.

Why do you keep sending requests up here for supplemental spending when you know there is waste there and you do not force the Congress to make the hard choices? You enable the Congress to fail by not requesting that it be within the budget guideline. That is a question.

Mr. WERFEL. OK. I am ready. Well, Senator, I would answer that by saying that I think the Administration's position is that what we are asking for in supplemental appropriations are funds that are absolutely necessary to meet obviously mission-critical priorities related to the current global war on terror and other priorities. And what we try to do is make sure that we are putting forward responsible plans that are meeting those needs. And those proposals to happen separately and apart from the President's budget which happens in February. And, again, with the President's budget, we are trying to do the same exact thing, is put forward a budget, a responsible budget that meets our needs.

I am not sure that—and it is possible that making sure that both of those things are happening on the same track will lead to the type of tough decisions that need to be made. But I think it is hard to go through both the President's budget and the supplemental that are submitted by the Administration and find things that are not critically important for the health and welfare of the American people.

Senator COBURN. Quite frankly, I will say that is a disappointing answer because every family in this country right now has supplemental emergency needs based on the price of gasoline. And you know what they are doing? They are making hard choices about priorities. And when the Administration knows that we have a supplemental request at least for $80 billion a year the last 5 years and does not put it in their budget, what they are saying is the rules do not apply to government that apply to every other taxpayer in this country. And I think it is almost criminal that we continue to say in something that we know is going to be at least $80 billion next year in the budget, that we put it outside of the budget so we do not have to do the hard work. And, unfortunately, there is not enough of us in Congress that want us to do that, and absent the leadership to that, what we are doing is we are continuing to waste the $300 billion a year.

And this Administration knows at least that $80 billion is going to get spent next year on the war. They knew that 3 years ago. And to not have that in the budget says the rules are different for the people who take your taxes than for the people who pay them. And the reason the American public has an 11-percent rating for Congress and slightly higher than that for the President is this very issue. There is a double standard. When OMB sends a budget up here and a request that is not within the confines of the reality that everybody else lives in, what we do is perpetuate—we can do all the work we want to do as far as GAO and OMB and the Treasury in terms of trying to fix the management, but when the underlying principle for that is we are going to spend it.

The other point I would make is every time we pass a supplemental, what does that do to the baseline? We all know the answer to that. The one that is getting ready to come is going to have over the next 2 years $60 billion in extra spending in it. The one that is going to hit the floor this week, $28 billion this year. That raises the baseline on every one of those programs so that we start at a higher level, $28 billion. If it is truly an emergency, then we ought to find some of the waste to get rid of it.

I know I am kind of preaching to the choir. I know you are not in opposition to that. But the point is if we are ever going to handle the big problems, the demographic problems, the Medicare problems, the Medicaid problems, the Social Security problems, the interest problems, we have to have the confidence of the American people that we are handling the small problems right. And I would put forward that we are not.

As a percentage—who had the chart on the percentage of qualified statements? Would you put that chart back up for a minute.

That is a percentage of the statements. That pie chart looks pretty good. But when you put it as a percentage of the total spending, what does it look like?

Mr. DODARO. Basically, the net costs combined by the red portions of the five agencies is about 28 percent of the total net cost.

Senator COBURN. OK. So it does reflect the net cost, not the percentage of agencies that have——

Mr. DODARO. No. This is for the agencies. My point——

Senator COBURN. That is showing 18 percent, right?

Mr. DODARO. Yes. My point with the chart, Senator was a couple-fold. I was under scoring the fact that we have 19 agencies right now that have unqualified opinions. In 1996, there were only six when we started.

Senator COBURN. Right.

Mr. DODARO. Point one is that it is important for the next Administration to continue to make progress and not slip back from the 19 there.

The second point is that the five that did not get there are large agencies, DOD being a particularly large one.

Senator COBURN. Agriculture.

Mr. DODARO. Agriculture, Department of Homeland Security, State Department, and NASA are the other four. They are all large agencies. This is not meant to represent the cost percentages.

Senator COBURN. Right, OK. First of all, thanks to Senator Carper, I am sure we are going to keep doing this. So no matter who the President is, I feel confident that we have an agreement that the pressure is going to stay on from this Subcommittee that we are going to keep looking at this and holding it accountable.

Rather than take more time, Mr. Chairman, I am going to submit a series of questions to each of you, if you wouldn't mind answering them, and a timely answer would be great so we can get it back.

I thank you very much for the time.

Senator CARPER. You bet. Thank you. Senator Voinovich.

Senator VOINOVICH. Yes, thank you. When do you think you are going to have an unqualified audit from the Defense Department?

Mr. DODARO. Senator, I really do not know. They are projecting 2017 that they believe they will be in a position to be ready. If they execute their plans and implement the proposals that they have going forward, that may be possible. But I would have to wait to see what kind of incremental progress they make each year.

Senator VOINOVICH. Have you looked at their plan in order to accomplish it and commented on whether you think it is a real plan or smoke?

Mr. DODARO. We have started to look at the new plan. We are going to spend more time focused on it and provide them some more detailed comments going forward. But, again, this plan has to be adopted by the next Administration and then executed going forward. And so our plan would be to try to put this on the radar screen of the new leadership of the Department, in addition to working with the current people until they leave, and to try to make sure that it gets implemented properly.

We have seen in a number of areas at the Department of Defense a lot of good plans over a wide range of issues, and I know you have been involved very heavily in some of the high-risk areas. Part of the problem is that they have a lot of good plans, but they are not executed very effectively. So, part of this is having a good plan. We will look at it. We will give them a lot of comments. But they are going to have to execute it.

Senator VOINOVICH. Well, I would like to suggest to this Subcommittee that GAO stay on it and that there be a comment on whether or not it is a real plan or not so that at least we can have metrics to stay on top of it to see if there is any progress that is being made.

Senator COBURN. Would you yield for a second?

Senator VOINOVICH. Sure.

Senator COBURN. You said they do not have any audit now, and the question was about an unqualified audit. In their plan, when will they get their first audit, real audit?

Mr. DODARO. Well, they have—and maybe Mr. Werfel will want to comment on this. They have parts of the Department being audited, but there is no——

Senator COBURN. Yes, but I mean a complete audit.

Mr. DODARO. No, they do not have a complete audit right now. Their plan calls for trying to have an unqualified opinion on the entire set of financial statements for the Department like the other ones we talked about by 2017.

Senator COBURN. I did not make my point clear. When will they have a complete audit of the thing, whether it is qualified or unqualified?

Mr. WERFEL. The action plan—it is called a FIAR plan, Financial Improvement and Audit Readiness—actually does not provide the level of specificity out in the 2014, 2015, 2016, 2017 range to indicate when at a consolidated level they will be ready for an audit opinion, whether that audit opinion is clean or qualified. So we do not have an answer.

One thing I would point out in the interest of looking at this glass as half-full is that when we started this process, at least when I got involved at the start of the Administration, the Defense Department was pointing to a fiscal year 2007 date as when they were going to get a clean audit opinion. But, of course, as you peeled back the onion on that, you could not find the path forward that would get them a clean audit opinion in 2007.

And so what we did was we worked with them, a lot of help from Congress putting pressure through legislation and GAO, to say put together a realistic plan, because right now you do not have a realistic one because there is no path to 2007. That is unrealistic.

What they came up with, the FIAR plan, puts it out to 2017. But there is a lot of detail at the start of that plan. If you look at the plan, there is a lot of detail between now and, let's say, 2012. But beyond that, it starts to get more and more white spaces in the pages as you go on.

But, I think there is a positive in that this is a more realistic time frame. Even though it is frustrating, we now have a realistic time frame of 10 years or about a decade, and can start to look for opportunities to accelerate within that. But when the plan was 2007, there was not a lot to work with.

Senator COBURN. Thank you.

Senator VOINOVICH. We need to know what the plan is. We need to look at metrics to determine whether or not there is progress on the plan. I would like to also know who is responsible for the plan in terms of people that are on civil service or how involved is someone that is going to be appointed.

That gets back to transformation of the whole Department, and I have been arguing, frankly, because of the recommendation from the Government Accountability Office of having a CMO over there and try to get Gordon England to do that. And I thought we were almost there, and then he chickened out, as far as I am concerned. And now we have somebody that is in charge of transformation, or a CMO, but there is no term connected with it, so you do not get the continuity. And anybody that knows anything about transformation, whether it be in a screwed up Department like Defense or another screwed up one like the Department of Homeland Security, knows that it is not going to happen overnight. And I would like you to comment on how important you think it is that we get involved here and get that CMO, give him or her a title, and have them be able to work on it.

Now, we have come a long way—I do not know if you know this or not. In the Department of Homeland Security, we now have a Deputy Secretary on the same level as the Deputy Secretary—one is management and one is operations. But that person that has got the management has no term. And so there is no chance—I mean, depending on how it all works out, we are not going to get—well, you comment. I would like to hear what you have to say about how important you think it is for us to get this change that we need to have here.

Mr. DODARO. I think for the Department of Defense and for the Department of Homeland Security, it is very important that these positions get enacted because you have basically huge management challenges in both of those Departments, and as you point out, they are not going to be solved overnight. They need sustained and full-time attention. You need to have a person that is going to span Administrations to basically solve these problems.

So we think it is critical. Not every Department needs that, but the large Departments that have these intractable problems definitely need it. We think it is very important.

Senator VOINOVICH. I would like to just comment also on what Senator Coburn was talking about, emergency spending. The ability to know how much money that you are going to spend on this war in Iraq is obvious, and you can get people right now that will sit down with you and tell you that even if we go down to 30,000 troops, it is going to cost us, I do not know, $100 billion a year. And we constantly keep getting requests and they are emergency, and I think, frankly, the reason for it is that they want to kind of hide the fact how much this is costing so that the budget is going to be—would show, the figures would show that the budget is a lot more in balance than what it does, and the way around that is just call it emergency spending.

It is the same thing when I came here in 1999, we had a big deal about the on-budget surplus and—what is it?—the uniform budget. And we started separating, letting folks know that the on-budget surplus includes the money we borrow from ourselves. Now, you just said $200 billion. That never shows up. The public does not understand just how much in debt that we are. And this year, if we keep going and look at all the things, it is going to be about $756 billion——

Senator COBURN. More than that.

Senator VOINOVICH. You think more—that is just going to go on the debt. And I think it is maybe too late for this Administration, but it seems to me that the next Administration ought to invoke a new policy.

I will never forget, we spent $3 billion for the Department of Homeland Security because everybody in the Senate was taking the heat because of the immigration bill, and it was a hot potato.

And so to make everybody feel good, they put another $3 billion into the Department of Homeland Security to take care of—what is it?—the CBP. And I got a hold on some folks over at OMB, and I said this is outrageous. You guys came in with a gigantic increase in your budget for the Department of Homeland Security. The committee that has that, the authorization committee, they increased it substantially over that. Unbelievable increase. And this thing, when you put the $3 billion, I think it is about a 52-percent increase. And they said, Well, we do not really like it, but you know what? It is emergency spending.

Now, pretty cynical. And I think part of the reason why we are in the jam we are in is that when it came time for controversial spending around here, we chalked it up on emergency spending. I really think that is the reason why we have not paid for this war, because we fool the American people, and not a dime—not a dime for the war. It has all been—most of it, emergency spending. Hide it from the public. Maybe what we should do is make this report mandatory to get out to every single citizen in the United States and maybe educate them about how bad the situation is, and maybe if they understand it, maybe we would start to see some action around here, both in Congress and with the Administration.

Senator CARPER. A couple of questions for this panel. And if Dr. Coburn and Senator Voinovich have questions, they are certainly welcome to ask them, and then we will excuse you and move to our second panel.

The three of us spent some time together yesterday. The full Committee on Homeland Security and Governmental Affairs was meeting, and we were conducting what we call a markup of a number of bills that were on the agenda. One of the bills that was on the agenda is something that Dr. Coburn and I and Senator McCaskill and our staffs and other folks, too, have worked on for some time, and that is to take the original improper payments legislation and to make it better. I always like to say if it is not perfect, make it better. Well, it is not perfect, and we are trying to make it better.

Dr. Coburn and I and Senator McCaskill, I think we actually had a pretty good bill, and there is one area that we have been still unable to close, completely come to agreement on, and I am just going to mention it to you and ask you all to put on your thinking caps and maybe not necessarily right here right now, but over the next week give us your ideas.

How do we make sure that agencies actually comply with the improper payments law? And some do. Too many do not. And Dr. Coburn came up with an idea to try to put in sort of an escalating schedule of compliance sticks, if you will, for those agencies that were not doing a very good job of complying. Keep me out of trouble on this, Senator Coburn, but the first year an agency did not comply, we would authorize them to move money around within their agency so they would have more money for financial management the first year. The second year without compliance, I think we said we mandated that they move money around within their agency to provide for better financial management. The third year if they still were not in compliance, we did, I think, up to 5 percent—yes, 5 percent of their budget would be moved over to help address their financial management deficiencies. And the fourth year would be—basically they would be pretty much out of business, and we would really hammer them bad, take away their ability to spend money for their mission.

There was unease in our Subcommittee, and outside of the Subcommittee. I think we talked with OMB and GAO about this as well. But there was some unease about pulling the trigger like that, especially in the fourth year. And what we are trying to come up with is an approach that will better ensure compliance and the status quo but maybe not in the terms of one of our colleagues who said—they called it, I think, the "death penalty," year four, would avoid the death penalty.

Put your hats on and think about that, and just come back to us within the next week or so, to our respective staffs, and give us some good ideas. If you will do that, when we have our next mark-up sometime by the end of July, we will be able to pass, I think, a very strong bill.

Another one, I think this may fall into your jurisdiction more, Mr. Carfine, than others, but Dr. Coburn and I have thought a whole lot about the idea that a bunch of folks owe taxes in this country and they are not paying them. Many of us are, but too many are not. And there is a big tax gap out there. Here is $300 billion or more per year, monies that are owed and not being collected. And I understand that—what can we do about it? What are you all doing about it, and what can we do to help you?

Mr. CARFINE. Well, the issue relating to——

Senator CARPER. Sort of like the flip side of the improper payments deal. It is on the revenue side. What can we do to help? What are you all doing, and what can we do to help?

Mr. CARFINE. Well, the issue regarding the tax gap is an important issue for all of us, and I know that the Department is working with the Internal Revenue Service on aggressively addressing the issues related to the tax gap.

There have been some proposals in the 2008 and 2009 budgets on how to deal with that. But I have to say this is a little bit out of my area of expertise. If you have some specific questions, I would be glad to take them back and get answers for you.

Senator CARPER. Good. Thanks. Mr. Dodaro.

Mr. DODARO. Basically, the tax gap is a very important issue. Right now the net estimated tax gap is $290 billion. I think that when decisions start being made to deal with some of the harsh fiscal realities that we have been talking about this afternoon, questions will come up about whether people are paying their fair share that they owe right now. We are doing a series of reports at GAO trying to identify different areas of noncompliance.

For a number of years, IRS was not doing the research necessary to understand the nature of the tax gap and the size of it. Now that they have done that, we are beginning to have the tools available to delve into these areas more, and determine whether it is sole proprietorships or different types of taxpayers, paying community, etc., and to dissect it a little bit better. I would be happy to provide for the record the work that we have done to date and what we are planning to do.

Senator CARPER. That is good. I do not know if we have scheduled it, but we were thinking about maybe having a roundtable as opposed to maybe a straight out hearing that would focus on the tax gap.

Mr. DODARO. Yes, I think that is very important.

Another area we have highlighted in the tax area are tax expenditures, which in any 1 year can be as large as the discretionary spending of the budget. The tax expenditures are largely off the radar screen for regular review. We think that this is another area that could need some attention as well.

Senator CARPER. Good. We would like to work with you on that. That is great. Thanks. Mr. Werfel.

Mr. WERFEL. I just wanted to supplement some of Mr. Carfine's comments, and I have a little bit more detail in the President's budget. We do have 16 targeted tax law change proposals in the President's budget that would close about $36 billion over the next 10 years of the gap, which is a healthy downpayment on the gap. And those proposals, just to give you an overview of them, they involve getting more information from taxpayers in terms of trying to validate that we are getting the right amounts. And there is always that balance between needing more information and imposing taxpayer burden. But we think that the proposals that we have chosen to promote in the President's budget achieve that balance.

Of course, we are always open to looking at additional proposals, and this is a very important issue and one that can have an impact.

Senator CARPER. We are told—and we have been holding a series of meetings within my own office and staff with different folks who have a lot of insight into the tax gap. And one of the things we have learned, in situations where there is withhold, there is actual withholding, there is about 99 percent compliance. In situations where there is reporting, a 1099, there is maybe 90 percent or better compliance. In situations where it is basically a cash economy, maybe 20 percent, if we are lucky.

One of the things that we have, I said a bit earlier in this hearing, my staff spent much of this morning trying to figure out what we need to focus on to get done in this year, before the Congress goes home and hang it up. But what do we absolutely want to get done? And one of the things we want to get done is to identify just a handful of niches, if you will, that fall within the tax gap umbrella that we can focus on.

Dr. Coburn and I focused on in the last couple years something called "cost-effective airlift in the 21st Century" and found out that we could actually save a couple billion dollars within the defense budget. And ultimately, I think with our encouragement, that actually took place. But we found a niche within the defense budget where we had some jurisdiction, and we worked with the committee of jurisdiction and got it done.

What I hope we will do is a similar kind of thing with respect to the tax gap, and not try to address it all—it is huge. It is too big for us—but to find some niches that work for us so we can just go after something, drill down and just not give up so that it is sort of unrelenting. And we look forward to working with you on that.

I have some other questions, and I will submit those for the record.

Senator CARPER. Let me just turn to my colleagues. Dr. Coburn, anything else you would like to ask these fellows before we excuse them?

Senator COBURN. No, I am fine. We really appreciate your service. I would just say that sometimes we get a little wound up because we have a certain amount of passion on what is getting ready to happen to the next two generations in this country. But without your service, we could not be doing what we are trying to do, and we know you are sitting there holding the line. So please continue what you are doing. Thank you.

Senator CARPER. I would certainly agree with that. Senator Voinovich, please.

Senator VOINOVICH. For several years now, I have been very disturbed with the way that we do our appropriations and have the omnibus appropriations bill. Would any of you like to comment on the negative impact that this way of operating has on the management perhaps of your own respective agencies or on other agencies? Because it is just mind-boggling to me that we do not do—and this year probably, people are coming to me and they want to know how much money am I going to have or how is it going to work out, and I tell them, according to the grapevine, we probably will not pass the omnibus appropriation bill. Maybe we will pass a couple of appropriations bills, but it will not happen until after the next President is sworn into office. So that means October, November, December, January, February, and I know—and I am sure—I was going to say Senator Carper agrees with me—as a governor that if we did not get our job done on time and pass our State budgets or as the mayor of Cleveland, if I did not get my appropriations and budget done on time, the people would have run me out of office. They would say this is outrageous. Every newspaper in the State would editorialize.

I would like your comments on it, what that does to try to manage properly.

Mr. DODARO. It makes it difficult to predict. From GAO's standpoint, over the last 10 years, in seven of those years we have operated for part of the year under continuing resolutions, some for a few days, some for several months. A lot depends on the nature of the continuing resolution and also whether or not there have been marks established with the Appropriations Committees ahead of time.

If you have some general idea where you think you are going to end up at the end of the day, you are in a better position to try to manage toward that than if you have no general idea. A lot depends on what the status was of the appropriations process prior to the execution of the continuing resolution.

But, in an optimal world, it is difficult to manage within any degree of uncertainty, and so it makes it a bit of a challenge. The extent of the challenge depends on the nature of the CR and what you know in advance.

Mr. WERFEL. I would agree with that. I do not think the metric exists, but a cost of operations that is incurred by a continuing resolution environment. I know from working with the Federal CFO community very closely, we see instances that are very upsetting to us, where we have to, for example, stop a contract that is flowing well and moving well and wait until the appropriation has been passed, then restart up again. And there is a tremendous cost that goes into that type of delay or pause in the action.

I think it is something that we hope we can get more transportation over time to Members of Congress that the continuing resolution environment is having negative impacts on the taxpayer.

Senator Carper, can I just clarify one point for the record?

Senator CARPER. Yes, sir.

Mr. WERFEL. Going back to the question on supplementals—and I do not pretend to have all the answers. But one point I did want to make, just to make sure that it is clear, is that government spending, whether through supplemental or otherwise, is captured in both the President's budget deficit total and the statement of net operating cost total that tracks funds going in and out. So at the end of the day, there is some transparency, important transparency, into what the government is spending versus what it is taking in that is capturing all outlays, whether they are occurring as a result of the supplemental or not.

Now, I am not saying that satisfies your question, which is a very good one, but I just want to point out that there is public transparency into all Federal funds that are flowing in and out of the government.

Senator COBURN. So in the budget request for the President this year, the cost of the war is included in that budget request, it is included in the supplemental and it—no, see, and that is my point. It is not transparent because that $80 billion, which is going to be $126 billion this year, is going to add to the debt. And that is not captured in the President's budget. And so, therefore, we are playing funny numbers with the American people. And we know that because that makes us look better when we do not put it in the budget.

I am not saying it is right or wrong. I am just saying if any other business had a recurring cost that they knew was going to be there and you went to your chief executive or the chief financial officer and said here is a cost, but, oh, this is not here, we do not want to show you that, we will look a whole lot better here. And that is exactly what we are doing with the American public.

So I am not saying there is an intentional sleight of hand. What I am saying is that it is a poor way to run the government.

Mr. WERFEL. And just a final point on that is the point that I was making is if the President sends a target to balance the budget by 2012, that accounts for any of the funds that are going out the door through the supplemental. But your point is well taken.

Senator CARPER. All right. I think your point is well taken, too. I am glad you made it twice. [Laughter.]

Senator COBURN. Sometimes points have to be made twice around here, and three times and four times and five times.

Senator CARPER. Before we excuse this panel, I also want to come back to a point that Senator Voinovich was making referring to our days in our last jobs in our respective States, and if we did not pass our budgets, if we did not get our budgets passed, then people would be looking for a new governor in our States.

The other thing that they would—if I as governor of Delaware, and I suspect as governor of Ohio, if we had come into the legislature and said this is our budget, it is way out of balance, this is what our spending plan is, you balance it, they would run us out of Dover and Columbus, respectively. That is just not the kind of leadership we need from the Executive Branch. Any time I have ever seen government bodies, small, local, State, Federal, actually be fiscally responsible, the chief executive—it just is inherent, it is incumbent that they provide the strong leadership, because it is not the nature of legislative bodies to just do it on our own, unfortunately.

Let me just say, Mr. Dodaro, have you testified before this panel before?

Mr. DODARO. Not this particular panel, but I have testified before Congress many times.

Senator CARPER. In a sidebar conversation, I said to Dr. Coburn, "That guy Dodaro is not bad, is he?" [Laughter.]

David Walker is a tough act to follow, but you did a nice job today. And, Mr. Werfel, you always do. Mr. Carfine, it has been a pleasure to have you before us as well. You may have some questions, some follow-ups from us, and maybe from some others that are not here, and we would just appreciate you giving it your attention and responding to us forthwith.

Last, on our improper payments legislation, we are trying to find a good compromise, something that will really help this work in terms of compliance. Help us with that within the next week or so, that would be much appreciated.

Senator COBURN. Both of us.

Senator CARPER. Yes.

Mr. DODARO. Will do.

Senator CARPER. Good Gentlemen, thank you all very much. You are excused.

Dr. Coburn has asked me if I know what our vote status is. Let me just take a moment just to share what I know, and I will look over here to John Kilvington for clarification. We are told there might be a vote on some judges between 4 and 4:30 p.m. Is there anything that changed that? So we are still looking maybe to have that. My hope is that we can hear from this panel before have to break for those judges and then come back.

Let me just briefly welcome our panel. It is great to see all of you again, and our first witness needs little introduction. David Walker, in addition to providing great leadership at GAO for many years, is today testifying as CEO and President of the Peter G. Peterson Foundation. He was our Comptroller General I think for—was it 10 years?

Mr. WALKER. Nine and a half.

Senator CARPER. Nine and a half. Well, we will round it up.

Mr. WALKER. Yes, that is right. Close enough.

Senator CARPER. Good to see you. Welcome back.

Robert Bixby, known to some as David Bixby?

Mr. BIXBY. Not by too many.

Senator CARPER. Not to be confused with. Now Executive Director of the Concord Coalition, a position he has held for over 10 years, I believe. And prior to his work with the Concord Coalition, Mr. Bixby practiced law and served as chief staff attorney of the Court of Appeals of Virginia.

Our third witness is James Horney—do I have that correct?

Mr. HORNEY. Yes.

Senator CARPER. All right. Director of Federal Fiscal Policy at the Center on Budget and Policy Priorities, and previously, I am told, you served as Deputy Democratic Staff Director at the Senate Budget Committee. Who was the chairman then when you were there?

Mr. HORNEY. Kent Conrad.

Senator CARPER. All right. Good. And as chief of the Projections Unit of the Budget Analysis Division of the Congressional Budget Office.

And last, but not least, the Hon. Maurice McTigue, Vice President of the Mercatus Center at the George Mason University, Director of the Center's Government Accountability Program. Prior to joining Mercatus, Mr. McTigue served as a New Zealand Member of Parliament, a cabinet member, and as the Ambassador to Canada. I would just say by way of introduction, at the Commonwealth Awards Dinner in Wilmington, Delaware, several months ago, your former Prime Minister was recognized. We recognized a number of people for their work in science, journalism, government, and so forth, and your Prime Minister who just stepped down in the last year was recognized and honored right there. Quite an impressive performance by the country of New Zealand. We are delighted that you are here.

Mr. MCTIGUE. Thank you.

Senator CARPER. With that, the bells just went off. It does not say there is a vote. It says we are in a quorum call. So, with that having been said, your entire statements will be made a part of the record. We invite you to summarize. Again, as I said to the first panel, if you can stick fairly close to 5 minutes, that would be good. If you cannot, try to stay fairly close. All right?

Welcome, one and all. We are delighted that you are here. Thank you for coming.

TESTIMONY OF DAVID M. WALKER,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, PETER G. PETERSON FOUNDATION

Mr. WALKER. Thank you, Chairman Carper, Dr. Coburn, and Senator Voinovich. It is a pleasure to be back before this Subcommittee, this time as a private citizen.

Before I address the Nation's fiscal challenge, I would like to reemphasize a couple of points with regard to the fiscal year 2007 financial statement audit, and I had the pleasure and the honor to sign the audit opinion on behalf of GAO. There were two noteworthy accomplishments.

First, it was the first time that an opinion has ever been expressed on any statement within the consolidated financial statements, namely, the Statement of Social Insurance, which has the largest numbers in the financial statements.

Second, the publication of the first Summary Annual Report, although personally I prefer this Summary Annual report, which

[1] The prepared statement of Mr. Walker appears in the Appendix on page 114.

every Senator and Member of Congress should have received a copy of by now. By the way, it fits in your coat pocket, so it is very easy to be able to take with you, and I encourage you to take it with you the next time you have a trip, because I think it will be illuminating.

As has been said, the Department of Defense is the tail on the dog, and ultimately, as I note in my statement, I think the GAO is going to have to assume responsibility for auditing the Department of Defense. They are going to need the help of the Inspector General. They are going to need contractor assistance. And they are going to need additional resources and support from the Congress in order to be able to do that.

This document, which is "The State of the Union's Finances," has a lot of nice-looking graphics in it. The problem is that it paints a very ugly fiscal picture. The problem is not the present. The problem is not the past. The problem is the future. And basically we are moving towards Third World status from the standpoint of debt to GDP unless we start making some touch choices soon.

As I note in my testimony, we need to improve transparency with regard to our current accounting and budgeting systems. We also need to change our financial reporting, and I have a number of specific recommendations in my testimony to that regard. We also need to reimpose tough budgetary controls from a statutory standpoint on both the spending and tax sides of the ledger. And in my view, we are going to need some type of capable, credible and bipartisan commission or task force to make recommendations to the next Congress and the next President, ideally for an up or down vote on at least four things: First, on statutory budget controls; second, on comprehensive Social Security reform; third, on round one of tax reform; and, fourth, on round one of health care reform.

I think if it is done the right way, you can achieve a $10 to $15 trillion downpayment on the $53 trillion imbalance. That is a pretty good downpayment. But that $53 trillion goes up by $2 trillion every year.

In addition to publishing this guide, the Foundation has also purchased a I.O.U.S.A documentary that will be coming to theaters in August of this year. We will have a private showing for Members of Congress on July 9 at the Library of Congress. All of you and a number of your colleagues will receive invitations. I urge you to attend. But, with your permission, Mr. Chairman, now that I have 2 minutes left, I have a 2-minute trailer on the film that I would like your permission to show.

Senator CARPER. That would be great.

Mr. WALKER. Thank you.

Senator CARPER. Thank you so much. So this is PG?

Mr. WALKER. This is PG. You are OK. [Laughter.]

Senator CARPER. That is good to know.

Mr. WALKER. Except for the numbers.

[Videotape shown.]

Mr. WALKER. Thank you, Mr. Chairman.

Senator CARPER. Thank you very much. I have been wondering for months who was going to portray you in this film. [Laughter.]

Mr. WALKER. I had a pretty realistic double.

Senator CARPER. I thought it might be Sting, but——

Mr. WALKER. As you know, we were born on the same day.

Senator CARPER. Same day, month, and year.

Mr. WALKER. Month and year, that is right.

Senator CARPER. And Sting's real name is David Walker—no, not really. All right. Thank you very much.

Mr. Bixby.

TESTIMONY OF ROBERT L. BIXBY,[1] EXECUTIVE DIRECTOR, THE CONCORD COALITION

Mr. BIXBY. Thank you. Well, that might be appropriate because Mr. Wakler has been described as the rock star of the Fiscal Wake-Up Tour, so maybe it is true.

Chairman Carper, Senator Coburn, and Senator Voinovich, thank you for inviting me to discuss the 2007 Financial Report of the U.S. Government and our Nation's long-term fiscal challenges. As has been observed, the good news in the 2007 report is that the Statement of Social Insurance received a clean opinion from the Government Accountability Office. That means the numbers are reliable. But, of course, that leads to the bad news, which is that the unqualified numbers paint such a stark picture of future promises that cannot be sustained by the level of dedicated revenues. The detailed numbers have already been laid out, so I need not go into those.

Why do we have this problem? Well, there are two basic facts, two basic factors that stand out: Demographics and health care costs. And these facts are not—it is not a matter of ideology. It is a matter of arithmetic. Over the next 30 years, the number of Americans aged 65 and over is expected to grow from about 13 percent today to about 20 percent. And as a result, the ratio of workers paying into Social Security and Medicare relative to the number of beneficiaries will fall by roughly one-third.

But demographics is only part of the problem. Rising health care costs is another big part of the problem, and actually a bigger problem as you go out in time. Health care costs have consistently outpaced economic growth by about 2.5 percentage points annually since 1960. If you assume that the same growth rate maintains over the next 40 years as has happened for the past 40 years, you would find that just two programs—Medicare and Medicaid—would take up about as much of our GDP as the entire Federal budget does today.

Now, some people will say that the government should be tax and spend at about 18 percent of GDP, and some people would say it would be acceptable to both tax and spend at about 30 percent, or 20 percent to 30 percent of GDP. No reasonable person would suggest that we could tax at 18 percent of GDP and spend at about 25 or 30 percent of GDP. And yet that is the track that we are headed on if we do not change course.

Improving this outlook will require hard choices on both spending and tax policy. As a framework for action, the Concord Coalition has recommended that the incoming President and the new Congress commit to a balanced budget; incorporate long-term projections and controls into the budget process; take steps to con-

[1] The prepared statement of Mr. Bixby appears in the Appendix on page 124.

strain the rising cost of heath care and retirement programs—Social Security and especially Medicare; and acknowledge that ultimately taxes cannot be cut unless programs are cut commensurately. There is no free lunch.

Just to say a word about each, balancing the budget would be a very good first step, but we have to keep in mind that even if we had a balanced budget, we would still have an unsustainable policy over the long term. So bringing a long-term perspective into the budget process is very important. One way to do that is we have recommended perhaps putting some long-term targets into the annual budget process. You could make that even stronger by adding some triggers that might automatically adjust spending or revenues or premiums for these programs if the targets were missed.

The Financial Report itself might also help to combat myopic budget planning by including a Statement of Fiscal Sustainability or other similar assessment of our long-term trends. The Statement of Social Insurance is very good, but it could go further with sort of an assessment of the long-term trends.

Entitlement reform is obviously very important. There is going to have to be some combination of scaling back the promises that were made or, if we do not do that, having to raise revenues to pay for them, because, again, there is no free lunch.

We cannot treat taxes and spending as separate deals. In the final analysis, government revenues must be sufficient to pay its costs.

I want to close by emphasizing the importance of public engagement. As you know, I have been out on the Fiscal Wake-Up Tour with David Walker; people from Brookings and Heritage have joined us on that. And we think that it is very important to get the public involved in this. We have been to your State, Mr. Chairman, and your State, Mr. Voinovich. And perhaps in 2009, we will be to your State, Dr. Coburn.

Senator COBURN. I have been on the Fiscal Wake-Up Tour for the past 3½ years.

Mr. BIXBY. Well, we disagree on some things, but we all agree that current fiscal policy is unsustainable, that there are no easy solutions to this, that the best way to make the hard choices is through a bipartisan process, that public engagement is very important, and, finally, and most importantly, we all agree that this is not about numbers. Fundamentally, it is a moral issue about the legacy that we will leave to future generations. Thank you.

Senator CARPER. Governor Voinovich said under his breath, as you made that last comment about a moral obligation, he said, "That is absolutely right. I agree."

Mr. Horney, please proceed. Thank you for coming.

TESTIMONY OF JAMES HORNEY,[1] DIRECTOR, FEDERAL FISCAL POLICY, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. HORNEY. Chairman Carper, Dr. Coburn, and Senator Voinovich, thank you for allowing me to come here today to talk about the long-term problem that is facing this Nation. And as a

[1] The prepared statement of Mr. Horney appears in the Appendix on page 148.

former staffer for Kent Conrad, I appreciate you making me feel at home with the budget charts.

I wanted to make four points here today, a couple of them that I do not need to say very much at all. The first one is that we are on an unsustainable path. The Center on Budget has produced detailed, long-term projections. We come to the same conclusion that GAO, CBO, and the Administration come to, which is eventually we would have debt rising so rapidly, it would do serious harm to the economy. Something has to be done about that.

The second point is that the real keys here are Medicare and Medicaid and revenues. The point has already been made that we have a demographic problem that drives Social Security, but that is much smaller than what is driving Medicare and Medicaid, which is a combination of demographics and, much more importantly, the per person growth of the cost of providing health care.

One point I do really want to make, though, is that the rising cost per person of Medicare and Medicaid is not due to any flaw in those programs, that basically for the last 30 years, that so-called excess growth in Medicare and Medicaid has mirrored the excess growth in the private health care system. And as CBO Director Peter Orszag has testified a number of times, the main reason for this growth is the advancement in medical technologies and medical treatments. That is not to say there are not some inefficiencies in the system, but the reason for the growth has been that we have all of these new drugs, treatments, and so on. And most experts think without changes in policies for the health care system, this is going to continue going forward. And, in particular, it makes the point that if we want to bring health care costs of Medicare and Medicaid under control without creating a dual system, we need to bring down the cost of health care, providing health care overall. I know David Walker, when he was Comptroller General and since, has made that point many times, and he is absolutely right.

Just very quickly, we have to keep in mind, as Bob Bixby said, revenues have to be part of the consideration here. Obviously, it is one-half of the deficit equation. We have got to raise money to pay for what we want to spend.

One thing I really do want to say—and, again, this mirrors some of what has already been said, which is it is absolutely going to take leadership from the President to make this happen. It is also going to take leadership from the bipartisan leadership in Congress. That is the only way we are going to make progress in this problem. They are going to have to work together, have to decide that deficit reduction is a very high priority, a high enough priority to give in and compromise on strongly held beliefs that people have against raising taxes and against cutting spending.

I do want to address one point that Senator Voinovich had asked in his opening statement about a commission and what we thought about a commission. And David Walker said a commission would be a good idea. I do not think there is any substitute for the President and the bipartisan leadership of Congress coming to the point where they think we have to make these tough choices and we have to be willing to compromise. I do not think establishing a commission or setting budget targets with automatic cuts will force them to do that.

Now, let me just give a couple of historical examples of why I think this is true.

In 1994, there was frustration, just like now, and certainly I sympathize with the frustration of everybody here with the unwillingness so far of the leaders in the Executive Branch and in Congress to address this problem. There was frustration that led to the appointment of the Kerrey-Danforth Entitlement Commission. But there was no consensus among the President, and leadership in Congress at that time in either party that this was a time to move forward, this was a time to make hard choices. And the Commission was a total failure. They could not agree on anything. They did not move the process forward.

Now, in contrast, people often point to the 1983 Social Security Solvency Commission and say, look, that is an example of a commission that worked. That is absolutely right. That was a very helpful commission, but it is important to remember in 1983, President Reagan, Speaker Tip O'Neill, and most of the bipartisan leadership in the House and Senate had already reached agreement that we needed to take some pretty serious steps to make Social Security solvent, we needed to address both revenues and spending, and they decided that a commission would be a useful way to negotiate the details of that and to help build public support for the plan. So the President, through an Executive Order—this was not legislation—through an Executive Order appointed a commission and then used the members of that commission—Bob Ball, Alan Greenspan, and others—to facilitate the negotiations and build support for this.

Now, one other important point about that was the proposal of the Commission was considered through the normal legislative process. It went through markups in the House and Senate; it went through the amendment process in the House and Senate. And that turned out to be very important because one of the key elements of the final plan that was enacted, which was moving back the normal retirement age for Social Security, was not in the proposal that came out of the Commission. It was added by an amendment on the floor of the House.

So you need to be careful, I think, of thinking that commissions can do too much. I also would urge you not to automatically accept that forcing Congress to take an up or down vote on whatever a commission puts out is the best way to go.

Just one more point, which is that in 1990, we had the current President's father and most of the bipartisan leadership of Congress decide we really need to do something about a deficit. They decided they did not need a commission. They decided they could go straight to negotiations face to face at Andrews Air Force Base. And they came together and they worked out a deficit reduction package that reduced deficits by $500 billion over 5 years—a very strong thing. So you need a consensus. We need to do everything we can, whether it is films, whether it is the Fiscal Wake-Up Tour, the papers that the Center on Budget writes, everything we can to convince the President and bipartisan leadership we need to take action. But we need to develop that consensus before we start putting in place commissions, procedures, or anything that might play a part in getting to where we want to go. Thank you.

Senator CARPER. Thank you very much. You gave us a lot to think about. Thank you.

Mr. McTigue, welcome. Please proceed.

TESTIMONY OF MAURICE P. MCTIGUE,[1] VICE PRESIDENT OF THE MERCATUS CENTER, AND DIRECTOR, GOVERNMENT ACCOUNTABILITY PROJECT, GEORGE MASON UNIVERSITY

Mr. MCTIGUE. Thank you, Mr. Chairman. and thank you for the invitation to be present in front of your Subcommittee once more.

Balancing the budget five times in 40 years by any reasonable person would be considered to be irresponsible behavior, and that is really the record of the U.S. Government over the last 40 years. That period spans seven Republican Administrations, five Democrat Administrations, and a House predominantly controlled by Democrats, but not all the time; a Senate split fairly evenly between Democrats and Republicans. So it is no good accusing other parties of being sinful. Everybody has been.

So where might we look for solutions? I have spent some time looking at other countries that have had a similar culture of overspending and they have cured that culture and reversed their process of overspending. I found three countries that are similar in background to the United States—New Zealand, Australia, and Great Britain.

The interesting thing that we can learn from these countries is that they have adopted a fairly similar philosophy to change their culture of overspending, and that philosophy is based around accrual accounting, making certain that the financial picture of the country is fully transparent, and statutes that define fiscal responsibility. In the case of New Zealand, it's new law was called the Fiscal Responsibility Act of 1994. In the case of Australia, it was the Budget Honesty Act. I like that term. And in the case of Great Britain, it was the Code of Fiscal Stability.

Interestingly, each of those countries, immediately on the implementation of those statutes, went to surplus. New Zealand is now in its 16th year of surpluses. Last year, its surplus amounted to 7.5 percent of GDP; the current year, 5.5 percent of GDP. When I was in the Cabinet we posted our first full accrual set of accounts, which actually disclosed that New Zealand had negative equity equivalent to about 20 percent of GDP. We thought that was sort of an esoteric figure that nobody would be interested in, except to our surprise the media and the public picked up on it and related to it as the Government of New Zealand being financially insolvent or bankrupt. And each succeeding year they watched that figure until it went from negative net worth to positive in 1996. And today New Zealand has positive net equity of about 67 percent of GDP.

When we look at Australia and Great Britain, they have been doing it for a shorter period of time. New Zealand, in my view, has been irresponsible in running surpluses that are far too high. But in Australia and the United Kingdom, they have settled on sur-

[1] The prepared statement of Mr. McTigue appears in the Appendix on page 157.

pluses that are around about the 1 percent of GDP. Australia has had an average since 1998 of about 1 percent surplus of GDP. It has retired a lot of its debt, and it has brought it down to a much lower level than the United Kingdom.

The United Kingdom has averaged around 0.1 of 1 percent of GDP, and it has determined that fiscal responsibility is a debt level around about 34 or 35 percent of GDP.

What actually caused these changes, in my view, is that no politician can afford to be portrayed as being fiscally irresponsible. And by setting down in statute what the criteria was for responsibility, then you actually made or created incentives that made politicians abide by those determinations of fiscal responsibility.

I have five recommendations that I think the U.S. Congress could do and do almost straight away.

The first is require that budgets and financial reports cover a much longer time horizon, at least 10 years forward, but preferably even more, say 15 or 20 years, and 4 or 5 years backwards, so that every time you look at the budget accounts you get a picture over time. One of the interesting things that the Government of Australia and the United Kingdom have done is that they have required of their government agencies what they call "intergenerational reporting." In the case of Great Britain, that means every 3 years they have to project forward 40 years and show what the consequences of current policy will be 40 years out. That is both in outcomes and in financial cost. In the case of Australia, the review is once every 5 years, and they go forward 50 years. Those are innovations that I think could easily be put in place.

The second is return the supplementary appropriation process to one that allows emergency spending only. That is in the hands of Congress. Define emergency. In my view, emergency should be defined as an unpredictable event. If the spending proposal is not something that occurred as a result of an unpredictable event, do not allow it. It is interesting to go back and look at war spending since the Second World War we see that nearly all of that spending was included in normal budgets, not supplementary budgets.

The third, pass a law that requires the American Government to operate in a fiscally responsible manner and define "fiscal responsibility."

The fourth, move the whole of the Federal accounting process to full accrual accounting.

And the fifth, introduce an appropriation process that is based upon the purchase of outputs designed to produce given outcomes instead of a process that is designed around allocating bulk funds of money to a particular issue with no real understanding of exactly what the government gets in return for those expenditures. Certainly at the time of appropriation, there is no indication that those expenditures will buy this reduction in hunger, this reduction in poverty, or this improvement in military superiority or readiness. Thank you, Mr. Chairman.

Senator CARPER. Thank you very much.

I am just going to start, if I could. Our vote has not started. We were expecting it to start by now. I am told we have two judicial votes, maybe more voters later tonight. But let's go as far as we can quickly.

Mr. McTigue, you shared with us there the advice to Congress in five pieces, and I think that was in your testimony. But I think those are much welcome, much appreciated. What advice would you have in terms of things that the Executive Branch needs to do?

Mr. MCTIGUE. The solution to this problem, in my view, does not belong with the departments or the agencies. The solution belongs on Capitol Hill and at 1600 Pennsylvania Avenue. Unless those two groups are prepared to buy into the solution, it is not going to happen.

Senator CARPER. I understand that, but the advice that you gave was directed to the Congress. What advice would you have for the chief executive?

Mr. MCTIGUE. Abide by those rules that the Congress will actually implement.

Senator CARPER. Should the chief executive's responsibilities include suggesting these rules or some variations of these rules, encouraging?

Mr. MCTIGUE. However you can get the job done, I would buy into it.

Senator CARPER. I would suggest that it would be helpful to have—when I look at Delaware's—we used to have the worst credit rating in the country, all the 50 States. We were the best in the country in terms of overestimating revenues and underestimating spending. I was in the Navy for 23 years. I have seen drunken sailors spend. And we were pretty much the counterpart of that in State government in my State. We had great leadership from our former governor, Pete du Pont, and working with the legislature, we are really providing strong moral suasions. So I keep coming back to that, I know, but I appreciate very much the advice you have given to the Congress. I would remind us all that it is helpful to have a chief executive who believes this stuff is important and pushes for it.

Let me just ask the other three panelists, react, if you will for us, to the list of recommendations that Mr. McTigue has been good enough to provide.

Mr. WALKER. I think they are generally consistent with some of the ones that I have in my testimony, and I also have an exhibit that has a number of other recommendations in it as well.

If you do not have a President that is going to provide leadership on this, you are not going to get much progress. I mean, the country only has one chief executive officer, and that is the President of the United States. The Congress is a co-equal branch of government, but it is a committee, and you cannot lead by committee. And, therefore, you need a President who will make it a priority, and you need them to be able to work on a bipartisan basis, and you have to have the support of bipartisan leadership. But you need a few people who care, and I think the three of you are it.

The last thing I would say is, we talk a lot about waste. We ought to define it. And after we define it, we can try to measure it, and then we can create more visibility. I would respectfully suggest that waste is the failure of the taxpayers as a whole to receive reasonable value for money due to an inappropriate act or omission by anybody with discretionary control over government resources. That could be a Member of Congress. That could be somebody in the Executive Branch. That could be a contractor. And if you define it on that basis, it accounts for a lot of money.

Senator CARPER. Thank you. Are there other comments on Mr. McTigue's suggestions? Please.

Mr. BIXBY. Just one of the things that he mentioned that I very much agree with is the idea of the long-term perspective on the budgets, and that was one of our recommendations as well, whether it is 50 years or whether you put a target on it or whether you do triggers or something, those are all details. But I think some mechanism of injecting the long-range view into the budget process is really very important.

Senator CARPER. Is there any disagreement on that point on this panel?

Mr. HORNEY. No. I think it is very important to look very hard at the long term. I would point out that, in fact, the President's budget already includes projections over the long term in the Analytical Perspectives Volume. Now, it does not get highlighted as much as it should, so perhaps one thing to do is just highlight that more. But it is in the President's budget. The Congressional Budget Office does long-term projections. They have been doing them every 2 years. I think Director Orszag has now committed that they will do those at least annually. So I think trying to highlight those long-term projections is a good idea.

Trying to build them into the budget process I think could present a lot of difficulties in the same way that trying to make the budget a fully accrual budget I think has some downsides that you need to be careful about.

My memory of that was in the fiscal year 1992 budget that OMB Director Darman proposed and got included in the President's budget a proposed change in the treatment of the Pension Benefit Guaranty Corporation to put it on a net present value or accrual basis, which certainly has some conceptual appeal to it. But what he did was he said let's change the accounting for PBGC; by the way, let's put in place some changes in PBGC that will start taking effect 10 or 20 years from now. And they save on a net present value, $1 billion. Oh, and by the way, that will pay for the tax cut that we want to put in place this year.

So just a warning that I think trying to integrate some of this stuff into the budget and scorekeeping process has some hidden problems that need to be very carefully considered.

Senator CARPER. Good. Thank you. Let me see if this is a vote starting. Yes, it is. All right. I have some other questions, but I want to yield to Dr. Coburn, if I may. Thank you.

Senator COBURN. Well, thank you for your testimony. I just finished reading an economic treatise on the percentage of GDP to government, what would have happened in this country if total government expenditure had been 20 percent instead of the 35 percent. We would have produced 65 more—we would have a GDP of $65 trillion right now, not $13 trillion. So I do not think it is as important that we have a percent. I think what is important is that we manage what we do.

Being an accountant, I cannot—even though it gets gamed—and you are very accurate in that. I can get gamed. But we game in everything now. Accrual accounting is the only way you can accurately reflect what is happening and what is going to happen. What we need to do is put in the—if we put in accrual accounting, make sure you cannot game it. That I think was basically your point. They used accrual accounting so they could look better to cut taxes. The point is we want accrual accounting so it accurately reflects where we are going and accurately measures where we have been.

I think what we have seen, both the Concord Coalition and several others do, along with David Walker, is raising the level of awareness in this country about the significance of our problems. Washington does not change until it is demanded to be changed by the American people. And I think you are on the right track in doing that. I am intrigued by Mr. McTigue's recommendations, especially the intergenerational report card, because that is part of that communication process. And I wonder what you all would think about that. I know what Mr. McTigue thinks.

Mr. WALKER. When I was Comptroller General, we recommended several years ago to create a new financial statement that would be for fiscal sustainability and intergenerational equity. And I think that is critically important because we are mortgaging the future of our kids and grandkids, and that is not only fiscally irresponsible, it is morally reprehensible.

Senator COBURN. OK. One of the things we hear all the time is what we cannot do because of the Budget Act and the rules and how we score it. What are your thoughts about dynamic scoring versus static scoring?

Mr. HORNEY. First of all——

Senator COBURN. You have a lot to say on that, I am sure.

Mr. HORNEY. It is something I have been involved in for a long time working at CBO and other places.

First of all, I just want to be clear that, in fact, both the Congressional Budget Office and the Joint Committee on Taxation do not do purely static scoring. They take behavioral effects into account, so they take into account that if excise taxes on cigarettes are increased, people will smoke less. So they take that into account.

What they do not do is take into account the macroeconomic effects. They assume that total GDP, real and nominal, is not changed. While conceptually everybody understands that the things we do can have effects on the macro economy, there are two big problems with trying to integrate that in.

One is the models are not very good about exactly what those effects are. They give you a wide range of results. They also generally show that on most of the kinds of changes that the Congress and the President are considering, the effects are pretty small.

The other thing is that it really depends on how they are paid for. For instance, the Treasury did a study last year of the macroeconomic effects of extending the President's tax cuts. They agreed, the same way that many other models do, that macroeconomic effect, is pretty small, but even that small effect they only got because they assumed that the extension of the tax cuts would be fully paid for by reductions in spending.

So in order to do it, you have to know what is going to happen—is it going to be paid for or not?—and then trying to figure out the exact models. And so people who say conceptually it makes sense, I think almost all the Joint Committee on Taxation and CBO, and I think even the Administrations in general have said it is not ready to be put into the scoring system. It is something, certainly, that should be considered when legislation, big major legislation is being considered.

Senator COBURN. That is a great comment, but I note with certain consistency how inaccurate CBO is when we see what their estimates were and then we look back and see the effect. So I do not know that we have got a good handle on that either historically or static or dynamically.

Mr. Walker.

Mr. WALKER. Obviously, you have to make a lot of assumptions when you do dynamic scoring. I think it is fine to use as a supplemental disclosure, but just understand that dynamic scoring can work for or against you.

For example, if you assume that we continue on our present path, tax at roughly the same percentage of GDP that we have been, and do not reform our entitlement programs, do not constrain spending, then that means that debt levels will mushroom, causing a drag on the economy, and causing upward pressure on interest rates. So dynamic scoring can work for you or against you.

The last thing I would say is that in order to achieve change, the pain associated with doing nothing has to be more acute than the pain incurred by doing something. And, therefore, one of the concepts that we are exploring at the Peterson Foundation is identifying all those members who are tacitly sponsors of the "do nothing" plan and to demonstrate what the "do nothing" plan will do to America. It's not a pretty picture.

Senator CARPER. Let me just interrupt for a moment. We have probably about 14 minutes to go before time runs out entirely, and if it is agreeable to my colleagues, we may want to consider concluding here, finish asking our questions, but yielding then to Senator Voinovich for his questions, and then complete this.

Senator COBURN. I will just have one more question.

Senator CARPER. Go ahead.

Senator COBURN. I read with interest, Mr. Horney, your statement on health care. The problem I have with that is, as I look at health care, I do not think we are spending too little on health care. I think we are spending too much. And I think when we look at the health care outside of the government as well as the health care inside the government, what we have is a model that is highly inefficient. There is no market forces that truly play because we do not have a true market anywhere in health care.

The other thing is nobody talks about health care from the prevention paradigm. We talk about it in terms of the treatment paradigm. And we will never get out of the problem of health care until we switch our paradigm to prevent the chronic diseases that consume 75 percent of our health care dollars.

So anything we do in terms of health care, we have to do two things: One, we need to let competitive forces work to allocate the resources better; but, two, we have to change our paradigm to where we emphasize prevention rather than emphasizing treatment. And in 15 years, we will start to see this tremendous—with the demographic shift, we will start to see this 9-percent average—or it may be less than that. You said 2.5 percent, I think, above—but, anyhow, the only thing that is above it is higher education. And it is the same thing. There is not a good enough competitive model there.

So my hope is that as you all carry this message, you incorporate the fact is that we have to change the paradigm under which we do health care in this country. And countries that have done that are achieving good savings today on the downside of that.

With that, I would end. Thank you.

Senator CARPER. Great questions. Senator Voinovich.

Senator VOINOVICH. How do we get the Presidential candidates involved, make it an issue in their campaigns about doing something about that entitlement?

Mr. BIXBY. Well, we have been to Iowa and New Hampshire and South Carolina and Florida and a lot of places like that. I think we put out a statement—the Fiscal Wake-up Tour did—of questions for the Presidential candidates that we brought to all of the media markets in those areas.

I mean, ultimately, you cannot force them to address this issue, but you can try to make it as much of a public issue as you can. I know that is what we are doing with the Fiscal Wake-Up Tour.

Mr. WALKER. One of the reasons that we are releasing the film in August is that it directly precedes the Presidential election cycle. We are also going to be part of film festivals at both the Democratic and Republican National Conventions. We are also going to release an 8-minute version that we are going to send to every political program to encourage them to use some of the material that is in it and to ask tough questions. We are going to send it to debate moderators. We are going to analyze all of the positions of the Presidential candidates on the issues of interest to the foundation, and we are going to publicize those results as well.

It is nice to be able to have a fair amount of money to be able to focus on some of these issues, because, frankly, having been involved in the Fiscal Wake-Up Tour for 2½ years, the American people are smarter than people give them credit for. When you state the facts and speak the truth, they get it. They get it pretty quick.

Senator VOINOVICH. Well, I am just saying—go ahead, Mr. Horney.

Mr. HORNEY. I would love to see a full-blown debate between Presidential candidates about what to do. I am not sure I think, given the way campaigns work, that is going to happen. My hope—and I think it is a little more realistic—is that neither candidate will take pledges, ironclad pledges that lock them into positions that make it hard to do what needs to be done after they are elected. I hope that at least.

Senator VOINOVICH. Yes. Well, one of the thoughts that I had was that we have—and I am running out of time, but Mr. Bixby and General Walker have been working on—we have the SAFE legislation over in the House, SAFE in the Senate, and we have the Commission on Fiscal Responsibility that Kent Conrad—and I know you do not like commissions, but the fact of the matter is that my thought is that if you could get us to form the commission that is made up of legislators but for two people in the commission, fiscal commission, legislation—I think SAFE has got a couple of other people on it.

I think the Government Accountability Office and—but, anyhow, the point would be that if you could get the Presidential candidates—they are both in the Senate—to sign onto this and say that if the commission is put in place, I will appoint my treasurer, I will put my head of OMB on there so we could get started with this. And then the neat thing about this is that you have expedited—you tell the people on the committee that if three-quarters of them agree that you get expedited procedure and you are going to get an up and down—now, maybe you could provide for some amendments or something like that. But nobody is going to really work on this unless they know that after they do their work, something is going to happen. And we do not want to have happen what happened to Connie Mack and to John Breaux where they went out and I think they did a halfway decent job—in fact, I am tempted to just take their work product and stick it in, just introduce it. There are some controversial things, but they did a great job. And it was dead on arrival at the White House after the White House had pledged themselves that they were going to do something about entitlements and about that.

You have to have something to force this to happen, or we will be here 5 years from now still talking about it. Mr. Walker.

Mr. WALKER. Let me say something quickly. I had the opportunity to testify before the House Budget Committee a couple of days ago, and one of the things that I was asked is what we should expect from the Presidential candidates. And I said five things that are in my testimony, one of which is that they should endorse a capable, credible, and bipartisan commission or task force to make recommendations to the next Congress and the next President. That also keeps them from being able to get too specific with regard to what proposals, but it provides a mechanism in which we hopefully can make some progress.

Thank you.

Mr. BIXBY. The dean at my law school once used to tell us that water does not run uphill without a pump, and cutting taxes—cutting these programs or raising taxes is sort of the equivalent of expecting water to run uphill.

So the purpose of the commission, I agree with Mr. Horney that if there is not a political consensus to address these issues, no commission is going to help. But I think there is a developing political consensus as we see on the Fiscal Wake-Up Tour, that there is a problem to be dealt with, and maybe the commission can help provide the pump for water to run uphill.

Senator CARPER. Mr. McTigue, just one minute and we need to go.

Mr. MCTIGUE. My very brief response to you, Senator Voinovich. Perhaps if somebody was to look at the British, the Australian, or the New Zealand legislation, introduce a bill shaped on that on fiscal responsibility, and invite the participation of the candidates, you might actually get them to take a position.

Senator CARPER. Good point.

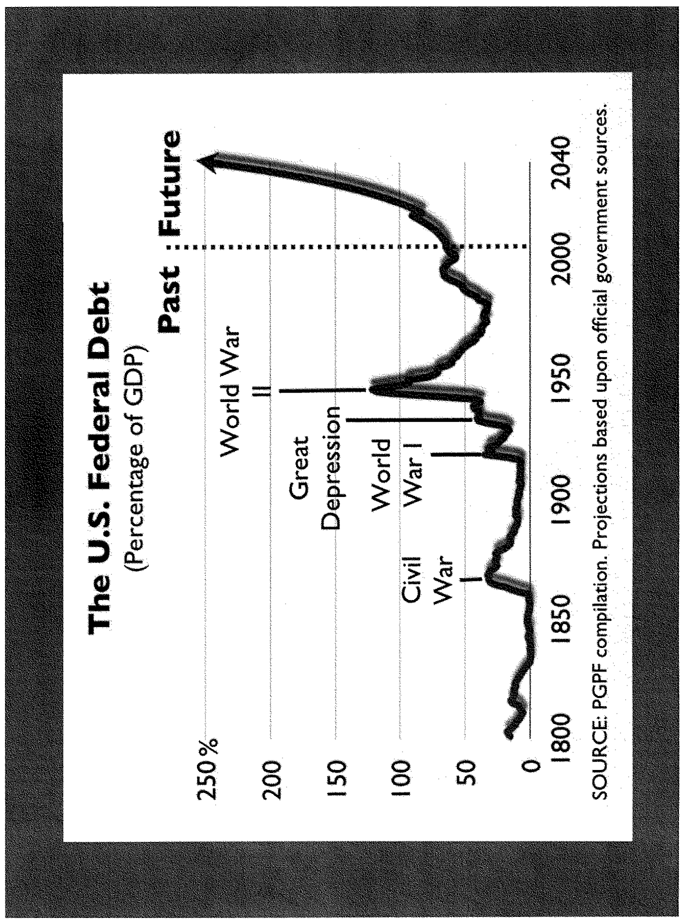
I just want to conclude. Sometimes we have these hearings, and we come to the conclusion, and we are ready to leave, and the witnesses are, too. In this case, I am not ready to leave, but we have other responsibilities that we need to meet.

I just want to say thank you for being part of this excellent session, and we know that you have been working these venues for a long time—frankly, so have we. We are going to continue to do our dead level best, and we know that you are as well.

Thank you so much for joining us today, and that said, this hearing is adjourned.

[Whereupon, at 4:50 p.m., the Subcommittee was adjourned.]

APPENDIX


The U.S. Federal Debt
(Percentage of GDP)
Past
Future
World War II
Great Depression
World War I
Civil War
250 %
200
150
100
50
0
1800
1850
1900
1950
2000
2040
SOURCE: PGPF compilation. Projections based upon official government sources.

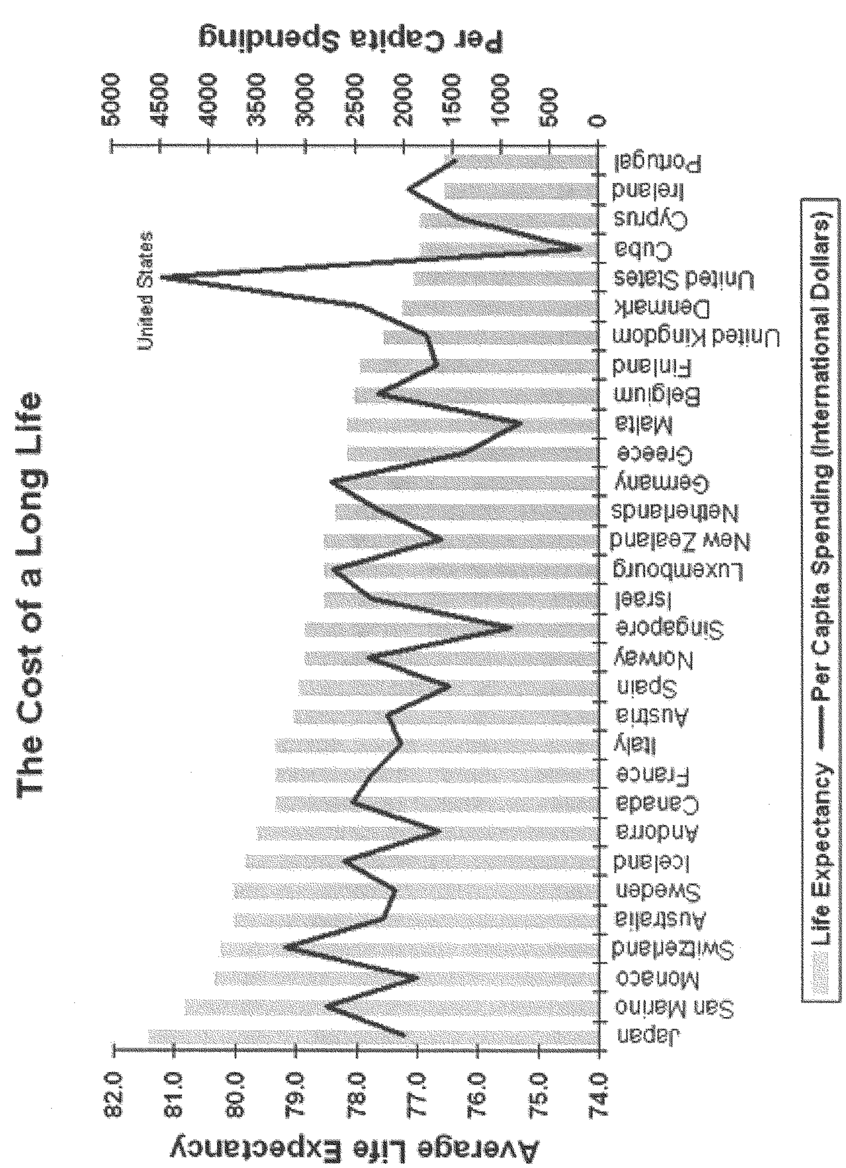
Major Fiscal Exposures

($ trillions)

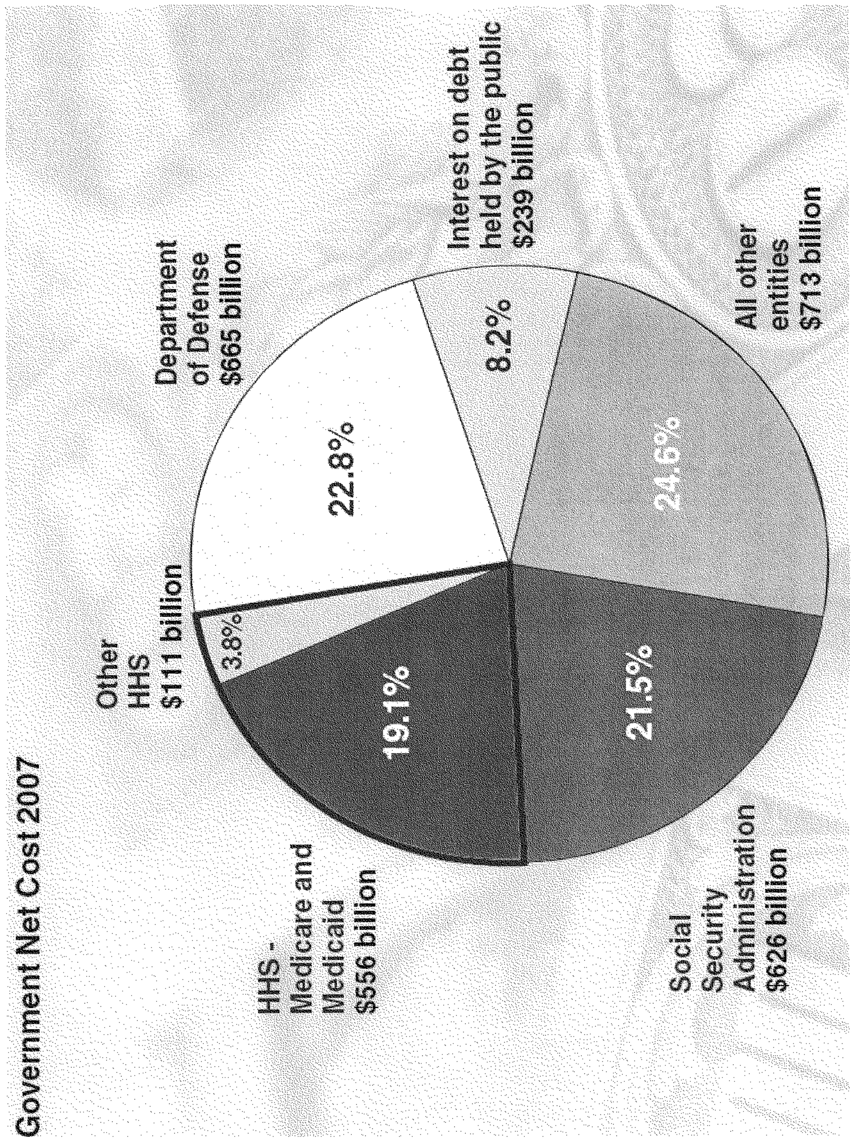
	2000	2007	% Increase
• **Explicit liabilities**	$6.9	$10.8	57
• Publicly held debt • Military & civilian pensions & retiree health • Other			
• **Commitments & contingencies**	0.5	1.1	97
• E.g., PBGC, undelivered orders			
• **Implicit exposures**	13.0	40.8	213
• Future Social Security benefits	3.8	6.8	
• Future Medicare Part A benefits	2.7	12.3	
• Future Medicare Part B benefits	6.5	13.4	
• Future Medicare Part D benefits	--	8.4	
Total	$20.4	$52.7	158

Source: 2000 and 2007 Financial Report of the United States Government.

Note: Totals and percent increases may not add due to rounding. Estimates for Social Security and Medicare are at present value as of January 1 of each year and all other data are as of September 30.



The Cost of a Long Life
Average Life Expectancy
82.0
81.0
80.0
79.0
78.0
77.0
76.0
75.0
74.0
Per Capita Spending
5000
4500
4000
3500
3000
2500
2000
1500
1000
500
0
United States
Japan
San Marino
Monaco
Switzerland
Australia
Sweden
Iceland
Andorra
Canada
France
Italy
Austria
Spain
Norway
Singapore
Israel
Luxembourg
New Zealand
Netherlands
Germany
Greece
Malta
Belgium
Finland
United Kingdom
Denmark
United States
Cuba
Cyprus
Ireland
Portugal
Life Expectancy
Per Capita Spending (International Dollars)


Government Net Cost 2007
HHS - Medicare and Medicaid $556 billion
Other HHS $111 billion
Department of Defense $665 billion
Interest on debt held by the public $239 billion
All other entities $713 billion
Social Security Administration $626 billion
19.1%
3.8%
22.8%
8.2%
24.6%
21.5%

United States Government Accountability Office

GAO

Testimony Before the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:30 p.m. EDT
Thursday, June 26, 2008

FISCAL YEAR 2007 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Financial Management Is Crucial to Improving Accountability and Addressing the Long-Term Fiscal Challenge

Statement of Gene L. Dodaro
Acting Comptroller General of the United States

GAO
Accountability * Integrity * Reliability

GAO-08-926T

June 26, 2008

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-08-926T, a testimony before the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The Congress and the President need to have reliable, useful and timely financial and performance information to make sound decisions on the current and future direction of vital federal government programs and policies.

Unfortunately, except for the 2007 Statement of Social Insurance, GAO was again unable to provide assurance on the reliability of the consolidated financial statements of the U.S. government (CFS) due primarily to certain material weaknesses in the federal government's internal control. GAO has reported that unless these weaknesses are adequately addressed, they will, among other things, (1) hamper the federal government's ability to reliably report a significant portion of its assets, liabilities, costs, and other related information; and (2) affect the federal government's ability to reliably measure the full cost as well as the financial and nonfinancial performance of certain programs and activities.

This testimony presents the results of GAO's audit of the CFS for fiscal year 2007 and discusses the federal government's long-term fiscal outlook.

What GAO Recommends

Over the years, GAO has made numerous recommendations directed at improving federal financial management, including ones regarding issues addressed in this testimony.

To view the full product, click on GAO-08-926T.
For more information, contact McCoy Williams or Gary T. Engel at (202) 512-2600 or Susan Irving at (202) 512-9142.

FISCAL YEAR 2007 U.S. GOVERNMENT FINANCIAL STATEMENTS

Sustained Improvement in Financial Management Is Crucial to Improving Accountability and Addressing the Long-Term Fiscal Challenge

What GAO Found

For the 11th consecutive year, three major impediments prevented GAO from rendering an opinion on the federal government's accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. In addition, financial management system problems continue to hinder federal agency accountability. Although the federal government still has a long way to go, significant progress has been made in improving federal financial management. For example, audit results for many federal agencies have improved and federal financial system requirements have been developed. In addition, GAO was able to render an unqualified opinion on the 2007 Statement of Social Insurance. Further, for the first time, the federal government issued a summary financial report which is intended to make the information in the *Financial Report of the U.S. Government* (*Financial Report*) more accessible and understandable to a broader audience.

It is important that this progress be sustained by the current administration as well as the new administration that will be taking office next year and that the Congress continues its oversight to bring about needed improvements to federal financial management. Given the federal government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting, can help increase understanding of the nation's long-term fiscal outlook.

The nation's long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path. Addressing this challenge will require a multipronged approach. Moreover, the longer that action is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing.

Finally, the federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. A broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Mr. Chairman and Members of the Subcommittee:

I am most pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2007 and 2006. I would like to thank you for holding an oversight hearing on this important subject. Your subcommittee's active involvement is critical to ultimately assuring the continued progress in improving federal financial management while enhancing public confidence in the government as a steward that is accountable for its finances. Such hearings play a vital role in ensuring that the federal government is held accountable to the American people.

In this testimony, I will discuss (1) the major issues relating to the consolidated financial statements for fiscal years 2007 and 2006, including progress that has been made toward addressing major impediments to an opinion on the consolidated financial statements; (2) financial management systems problems that continue to hinder federal agency accountability; (3) the challenges posed by the federal government's long-term fiscal condition and GAO's views on a possible way forward; and (4) the need for an improved federal financial reporting model. Until these issues are adequately addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Both the consolidated financial statements and our related audit report are included in the fiscal year 2007 *Financial Report of the United States Government* (*Financial Report*).[1] The *Financial Report* was issued by the Department of the Treasury (Treasury) on December 17, 2007.[2] In addition, for the first time, Treasury and the Office of Management and Budget (OMB) in coordination with GAO issued on February 14, 2008, a summary financial report entitled, *The Federal Government's Financial Health: A Citizens Guide to the 2007 Financial Report of the United States Government*. This guide is intended to make the information in the *Financial Report* more understandable and more accessible to a broader audience. The Director of OMB, the Secretary of the Treasury, and I

[1]Our audit work regarding the U.S. government's consolidated financial statements was conducted in accordance with U.S. generally accepted government auditing standards.

[2]Also, see GAO, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-05-958SP (Washington, D.C.: September 2005), which was prepared to help those who seek to obtain a better understanding of the *Financial Report*.

believe that the information discussed in this guide is important to all Americans. This is a good first step, and I am confident that the guide will evolve over time. Both of these reports are available through GAO's Internet site, at http://www.gao.gov/financial/fy2007financialreport.html and Treasury's Internet site, at http://www.fms.treas.gov/fr/index.html.

Summary

Certain material weaknesses[3] in financial reporting and other limitations on the scope of our work resulted in conditions that for the 11th consecutive year prevented us from providing the Congress and the American people an opinion on the federal government's financial statements, other than the Statement of Social Insurance, which are referred to as the federal government's accrual basis consolidated financial statements.[4] However, since the enactment of key financial management reforms in the 1990's, the federal government has made significant progress in improving financial management activities and practices. As shown in appendix III, for fiscal year 2007, 19 of 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements. In contrast, only 6 CFO Act agencies received unqualified audit opinions for fiscal year 1996. In addition, federal financial systems requirements have been developed. Also, accounting and financial reporting standards have continued to evolve to provide greater transparency and accountability over the federal government's operations, financial condition, and fiscal outlook. Further, fiscal year 2007 marked the second year in which the Statement of Social Insurance has been provided as a basic financial statement.[5] The

[3]A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

[4]Most revenues reported in the accrual basis consolidated financial statements are recorded on a modified cash basis.

[5]We disclaimed an opinion on the fiscal year 2006 consolidated financial statements, including the Statement of Social Insurance. Social insurance programs included in the Statement of Social Insurance are Social Security, Medicare, Railroad Retirement, and Black Lung.

Statement of Social Insurance displays the present value[6] of projected revenues and expenditures for scheduled benefits of certain benefit programs that are referred to as social insurance (e.g., Social Security, Medicare). Importantly, we were able to render an unqualified opinion on the 2007 Statement of Social Insurance—a significant accomplishment for the federal government.

The federal government, however, still has a long way to go to address several principal challenges to fully realizing strong federal financial management.[7] For example, three major impediments continue to prevent GAO from rendering an opinion on the federal government's accrual basis consolidated financial statements: (1) serious financial management problems at the Department of Defense, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Further, in our opinion, the federal government did not maintain effective internal controls over financial reporting and compliance with significant laws and regulations as of September 30, 2007, due to numerous material weaknesses. Moreover, financial management system problems continue to hinder federal agency accountability.

In our audit report, we also emphasized that the federal government's current fiscal path is unsustainable and that tough choices by the Congress and the President are necessary to address the nation's long-term fiscal challenge. The fiscal and cash flow implications of the federal government's large and growing Social Security and Medicare commitments will be felt as the large baby boom generation leaves the work force and collects benefits. In fact, the oldest members of the baby boom generation are now eligible for Social Security retirement benefits. The budget and economic implications of the baby boom generation's retirement will only intensify as the baby boomers age. Given these and other factors, it seems clear that the nation is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time. The issues raised by this long-term fiscal challenge are issues of significance that affect every American. Committed leadership and

[6]Present value is the discounted value of a payment or stream of payments to be received or paid in the future, taking into consideration a specific interest or discount rate.

[7]GAO, *Critical Accountability and Fiscal Stewardship Challenges Facing Our Nation*, GAO-07-542T (Washington, D.C.: Mar. 1, 2007).

sustained efforts by the Congress, the President, and other key individuals throughout the federal financial management community will be needed to put our nation on a more prudent and sustainable long-term fiscal path. Given the government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current results and future direction of vital federal government programs and policies are more difficult without such information. Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting can help increase understanding of the federal government's long-term fiscal outlook.

Finally, we believe the federal government should consider the need for further revisions to the current federal financial reporting model to recognize the unique needs of the federal government. The current reporting model recognizes some of these needs; however, a broad reconsideration of issues, such as the kind of information that may be relevant and useful for a sovereign nation, could lead to reporting enhancements that might help provide the Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Highlights of Major Issues Related to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2007 and 2006

As has been the case for the previous 10 fiscal years, the federal government did not maintain adequate systems or have sufficient and reliable evidence to support certain material information reported in the U.S. government's accrual basis consolidated financial statements. The underlying material weaknesses in internal control, which generally have existed for years, contributed to our disclaimer of opinion on the U.S. government's accrual basis consolidated financial statements for the fiscal years ended 2007 and 2006.[8] Appendix I describes the material weaknesses that contributed to our disclaimer of opinion in more detail and highlights the primary effects of these material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations.

[8]We previously reported that certain material weaknesses prevented us from expressing an opinion on the consolidated financial statements of the U.S. government for fiscal years 1997 through 2006.

The material weaknesses that contributed to our disclaimer of opinion were the federal government's inability to

- satisfactorily determine that property, plant, and equipment and inventories and related property, primarily held by the Department of Defense (DOD), were properly reported in the consolidated financial statements;
- implement effective credit reform estimation and related financial reporting processes at certain federal credit agencies;
- reasonably estimate or adequately support amounts reported for certain liabilities, such as environmental and disposal liabilities, or determine whether commitments and contingencies were complete and properly reported;
- support significant portions of the total net cost of operations, most notably related to DOD, and adequately reconcile disbursement activity at certain agencies;
- adequately account for and reconcile intragovernmental activity and balances between federal agencies;
- ensure that the federal government's consolidated financial statements were (1) consistent with the underlying audited agency financial statements, (2) properly balanced, and (3) in conformity with Generally Accepted Accounting Principles; and,
- identify and either resolve or explain material differences that exist between certain components of the budget deficit reported in Treasury's records, used to prepare the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities, and related amounts reported in federal agencies' financial statements and underlying financial information and records.

Due to the material weaknesses and the additional limitations on the scope of our work, as discussed in our audit report, there may also be additional issues that could affect the accrual basis consolidated financial statements that have not been identified.

In addition to the material weaknesses that contributed to our disclaimer of opinion, which were discussed above, we found three other material weaknesses in internal control as of September 30, 2007. These weaknesses are discussed in more detail in appendix II, including the primary effects of the material weaknesses on the accrual basis consolidated financial statements and on the management of federal government operations. These other material weaknesses were the federal government's inability to

- determine the full extent to which improper payments occur,
- identify and resolve information security control weaknesses and manage information security risks on an ongoing basis, and
- effectively manage its tax collection activities.

Further, our audit report discusses certain significant deficiencies in internal control at the governmentwide level.[9] These significant deficiencies involve the following areas:

- preparing the Statement of Social Insurance for certain programs, and
- monitoring and oversight regarding certain federal grants and entities that offer Medicare health plan options.

Individual federal agency financial statement audit reports identify additional control deficiencies which were reported by agency auditors as material weaknesses or significant deficiencies at the individual agency level. We do not deem these additional control deficiencies to be material weaknesses at the governmentwide level.

Regarding agencies' internal controls, in December 2004, OMB revised OMB Circular No. A-123, *Management's Responsibility for Internal Control*, which became effective for fiscal year 2006. In fiscal year 2006, agencies began to implement the more rigorous requirements of the revised OMB Circular No. A-123, which include management identification, assessment, testing, correction, and documentation of internal controls over financial reporting for each account or group of accounts, as well as an annual assurance statement from the agency head as to whether internal control over financial reporting is effective.

OMB recognized that due to the complexity of some agencies, implementation of these new requirements may span more than 1 year. Accordingly, certain agencies have adopted multiyear implementation plans. According to OMB's *Federal Financial Management Report for 2007*, 16 of the 24 CFO Act agencies have performed assessments required by OMB Circular No. A-123 for all key processes, while the remaining 8 CFO Act agencies are phasing in implementation of the requirements by testing a portion of the key processes and providing plans for testing the remaining processes within 3 years. Also, according to that report, to

[9] See page 182 of the *Financial Report* for more details regarding these significant deficiencies.

achieve its strategic goal of improving effectiveness of internal control over financial reporting, OMB has developed priority actions that include updating guidance, as necessary, based on lessons learned from agencies' implementation of the circular. It will be important that OMB continue to monitor and oversee federal agencies' implementation of these new requirements.

Addressing Major Impediments to an Opinion on the Accrual Basis Consolidated Financial Statements

Three major impediments to our ability to render an opinion on the U.S. government's accrual basis consolidated financial statements continued to be: (1) serious financial management problems at DOD, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Extensive efforts by DOD officials and cooperative efforts between agency chief financial officers, Treasury officials, and OMB officials will be needed to resolve these serious obstacles to achieving an opinion on the U.S. government's accrual basis consolidated financial statements.

Financial Management at DOD

Essential to further improving financial management governmentwide and ultimately to achieving an opinion on the U.S. government's consolidated financial statements is the resolution of serious weaknesses in DOD's business operations. DOD is one of the largest and most complex organizations in the world. Since the first financial statement audit of a major DOD component was attempted almost 20 years ago, we have reported that weaknesses in DOD's business operations, including financial management, not only adversely affect the reliability of reported financial data, but also the economy, efficiency, and effectiveness of its operations.

DOD continues to dominate GAO's list of high-risk programs designated as vulnerable to waste, fraud, abuse, and mismanagement, bearing responsibility, in whole or in part, for 15 of 27 high-risk areas.[10] Eight of these areas are specific to DOD and include DOD's overall approach to business transformation, as well as business systems modernization and financial management. Collectively, these high-risk areas relate to DOD's major business operations, including financial management, which directly support the warfighters, including their pay, the benefits provided to their

[10] GAO, *High-Risk Series: An Update*, GAO-07-310 (Washington, D.C.: January 2007).

families, and the availability and condition of equipment and supplies they use both on and off the battlefield.

Successful transformation of DOD's financial management operations will require a multifaceted, cross-organizational approach that addresses the contribution and alignment of key elements, including sustained leadership, strategic plans, people, processes, and technology. Congress clearly recognized, in the National Defense Authorization Act for Fiscal Year 2008,[11] the need for executive-level attention in ensuring that DOD was on a sustainable path toward achieving business transformation. This legislation codifies Chief Management Officer (CMO) responsibilities at a high level in the department—assigning them to the Deputy Secretary of Defense—and establishing a full-time Deputy CMO and designating CMO responsibilities within the military services. However, in less than a year, our government will undergo a change in administrations, which raises questions about the continuity of effort and the sustainability of the progress that DOD has made to date. As such, we believe the CMO position should be codified as a separate position from the Deputy Secretary of Defense in order to provide full-time attention to business transformation over the long term, subject to an extended term appointment. Because business transformation is a long-term and complex process, we have recommended a term of at least 5 to 7 years to provide sustained leadership and accountability.

Importantly, DOD has taken steps toward developing and implementing a framework for addressing the department's long-standing financial management weaknesses and improving its capability to provide timely, reliable, and relevant financial information for analysis, decision making, and reporting, a key defense transformation priority. Specifically, this framework, which is discussed in both the department's Enterprise Transition Plan (ETP)[12] and the Financial Improvement and Audit Readiness (FIAR) Plan,[13] includes the department's Standard Financial

[11]Pub. L. No. 110-181, § 904 (2008).

[12]The Enterprise Transition Plan is intended to describe how DOD will transition from its current or "as is" operational environment to its intended or "to be" operational capabilities. The Business Transformation Agency is the DOD agency responsible for DOD's business transformation and the development and implementation of the ETP.

[13]DOD's FIAR Plan, initially issued in December 2005 and updated each June and September, is intended to provide DOD components with a framework for resolving problems affecting the accuracy, reliability, and timeliness of financial information and obtaining clean financial statement audit opinions.

Information Structure (SFIS) and Business Enterprise Information System (BEIS). DOD intends this framework to define and put into practice a standard DOD-wide financial management data structure as well as enterprise-level capabilities to facilitate reporting and comparison of financial data across the department.

DOD's efforts to develop and implement SFIS and BEIS should help to improve the consistency and comparability of the department's financial information and reporting; however, a great deal of work remains before the financial management capabilities of DOD and its components' transformation efforts achieve financial visibility.[14] Examples of work remaining include data cleansing; improvements to current policies, processes, procedures, and controls; and implementation of fully integrated systems.

In 2007, DOD introduced refinements to its approach for achieving financial statement auditability. These refinements include the following:

- Requesting audits of entire financial statements rather than attempting to build upon audits of individual financial statement line items.
- Focusing on improvements in end-to-end business processes, or segments[15] that underlie the amounts reported on the financial statements.
- Using audit readiness validations and annual verification reviews of segment improvements to help ensure sustainability of corrective actions and improvements.
- Forming a working group to begin auditability risk assessments of financial systems at key decision points in their development and deployment life cycle to help ensure that the processes and internal controls support repeatable production of auditable financial statements.

We are encouraged by DOD's efforts and emphasize the necessity for consistent management oversight toward achieving financial management capabilities and reporting of meaningful and measurable transformation

[14]DOD defines financial visibility as providing immediate access to accurate and reliable financial information (planning, programming, budgeting, accounting, and cost information) in support of financial accountability and efficient and effective decision making through the department in support of the missions of the warfighter.

[15]DOD defines a segment as a component of an entity's business and financial environment. A segment can include (1) complete or partial business processes; (2) financial systems, business systems, or both; or (3) commands or installations. According to DOD, the environment's complexity, materiality, and timing of corrective actions are all factors that are taken into consideration when defining a segment.

effort benchmarks and accomplishments. We will continue to monitor DOD's efforts to transform its business operations and address its financial management challenges as part of our continuing DOD business enterprise architecture and financial audit readiness oversight.

Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of each fiscal year.

A substantial number of the agencies did not adequately perform the required reconciliations for fiscal years 2007 and 2006. For these fiscal years, based on trading partner information provided to Treasury via agencies' closing packages, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners as of the end of the fiscal year. Based on our analysis of the "Material Difference Reports" for fiscal year 2007, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses. For both fiscal years 2007 and 2006, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication when the differences will be resolved. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

In 2006, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* (Nov. 13, 2006), and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* (Nov. 15, 2006). This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners for certain intragovernmental transactions and called for the establishment of an Intragovernmental Dispute Resolution Committee.

OMB is currently working with the Chief Financial Officers Council to create the Intragovernmental Dispute Resolution Committee.[16] Treasury is also taking steps to help resolve material differences in intragovernmental activity and balances. For example, Treasury is requiring federal agencies to provide a plan of action on how the agency is addressing certain of its unresolved material differences. Resolving the intragovernmental transactions problem remains a difficult challenge and will require a strong commitment by federal agencies to fully implement the recently issued business rules and continued strong leadership by OMB and Treasury.

Preparing the Consolidated Financial Statements

Although further progress was demonstrated in fiscal year 2007, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP).[17] Treasury has showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data. During fiscal year 2007, Treasury, in coordination with OMB, continued to develop and implement corrective action plans and milestones for short-term and long-range solutions for certain internal control weaknesses we have reported regarding the process for preparing the consolidated financial statements. Resolving some of these internal control weaknesses will be a

[16]The U.S. Chief Financial Officers Council is an organization of the CFOs and Deputy CFOs of the largest federal agencies and senior officials of OMB and Treasury who work collaboratively to improve financial management in the U.S. government.

[17]Most of the issues regarding the preparation of the consolidated financial statements that we identified in fiscal year 2007 existed in fiscal year 2006, and many have existed for a number of years. In July 2007, we reported the issues we identified to Treasury and OMB and provided new recommendations for corrective action and discussed the status of certain previously issued recommendations in GAO, *Financial Audit: Significant Internal Control Weaknesses Remain in the Preparation of the Consolidated Financial Statements of the U.S. Government*, GAO-07-805 (Washington, D.C.: July 23, 2007).

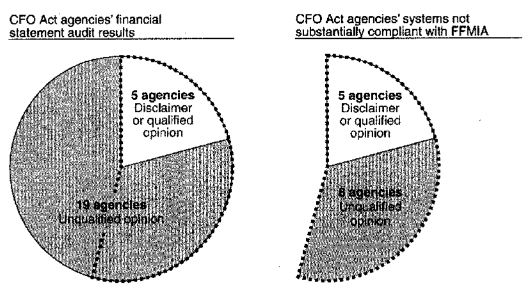
difficult challenge and will require a strong commitment from Treasury and OMB as they execute and implement their corrective action plans.

Federal Agencies' Financial Management Systems

Under the Federal Financial Management Improvement Act of 1996 (FFMIA), as a part of the CFO Act agencies' financial statement audits, auditors are required to report whether agencies' financial management systems comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. These factors, if implemented successfully, help provide a solid foundation for improving accountability over government operations and routinely producing sound cost and operating performance information.

As shown in figure 1, 19 out of the 24 CFO Act agencies received an unqualified opinion on their financial statements in fiscal year 2007; however, 8 of these 19 agencies' systems did not substantially comply with one or more of the three FFMIA requirements. This shows that irrespective of these unqualified "clean" opinions on the financial statements, many agencies still do not have reliable, useful and timely financial information with which to make informed decisions and ensure accountability on an ongoing basis.

Figure 1: Comparison of 2007 Financial Statement Audit Results to FFMIA Assessments



Source: CFO Act agencies.

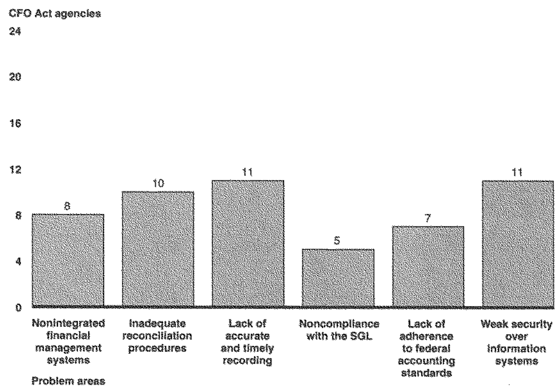
Note: Data are compiled from CFO Act agencies' Performance and Accountability Reports for fiscal year 2007.

The modernization of federal financial management systems has been a long-standing challenge at many federal agencies. As shown in figure 1, auditors reported that 13 of the 24 CFO Act agencies' systems did not substantially comply with one or more of the three FFMIA requirements for fiscal year 2007. This compares with 17 agencies for fiscal year 2006. Although the number of agencies reported as not substantially compliant has declined, the federal government's capacity to manage with timely and useful data remains limited, thereby hampering its ability to effectively administer and oversee its major programs.

For fiscal year 2007, noncompliance with federal financial management systems requirements was the most frequently cited deficiency of the three FFMIA requirements. One of the federal financial management systems requirements is for agencies to have integrated financial management systems. Based on our review of the fiscal year 2007 audit reports, we identified the lack of integrated financial management systems to be one of the six problem areas for the 13 agency systems that are reported as not being substantially compliant with FFMIA. Figure 2 summarizes these six areas and the number of agencies with problems reported in each area.[18]

[18]The same six types of problems have been cited by auditors although the auditors may not have reported these problems as specific reasons for the agency systems not being substantially compliant with the FFMIA requirements.

Figure 2: Number of CFO Act Agencies with Reported FFMIA Compliance Problems for Fiscal Year 2007



Source: GAO analysis based on independent auditors' financial statement audit reports prepared by agency inspectors general and contract auditors for fiscal year 2007.

The lack of integrated financial management systems typically results in agencies expending major time, effort, and resources, including in some cases, hiring external consultants to develop information that their systems should be able to provide on a daily or recurring basis. In addition, nonintegrated systems are more prone to error which could result in information that is not reliable, useful, or timely. Figure 2 also shows that auditors for 11 CFO Act agencies had reported the lack of accurate and timely recording of financial information as a problem in fiscal year 2007. Accurate and timely recording of financial information is essential for effective financial management. Furthermore, the majority of participants at a recent Comptroller General's forum[19] on improving financial management systems agreed that financial management systems are not able to provide, or provide little, information that is reliable, useful, and timely to assist management in their day-to-day decision making, which is the ultimate goal of FFMIA.

Participants at the forum also discussed current financial management initiatives and the strategies for transformation of federal financial management. To reduce the cost and improve the outcome of federal financial management systems implementations, OMB continues to move forward on a key initiative—the financial management line of business (line of business), by leveraging common standards and shared solutions. OMB anticipates that the line of business initiative will help achieve the goals of improving the cost, quality, and performance of financial management operations. OMB and the Financial Systems Integration Office have demonstrated continued progress toward implementation of the line of business initiative by issuing a common governmentwide accounting classification structure, financial services assessment guide, and exposure drafts of certain standard business processes. However, as we previously recommended,[20] OMB needs to continue defining standard business processes. A critical factor for success will be ensuring that agencies cannot continue developing and implementing their own stovepiped systems. Failure to do so may require additional work, increase costs to adopt these standard business processes, and further delay the transformation of federal financial management systems.

In a January 2008 memo, OMB recognized the risks associated with nonstandardized processes and updated its guidance on the line of business. Current plans are for the Financial Systems Integration Office to continue developing business standards and incorporate them into software requirements and permit agencies and shared service providers

[19]On December 11, 2007, the Comptroller General of the United States hosted a forum in Washington, D.C., attended by Chief Financial Officers, Chief Information Officers, Inspectors General (IG) from several of the 24 CFO Act agencies, and other knowledgeable officials in the public and private sector, to discuss issues related to effective financial management system implementation across the federal government and to address long-standing federal financial management issues. See GAO, *Highlights of a Forum: Improving the Federal Government's Financial Management Systems*, GAO-08-447SP (Washington, D.C.: Apr. 16, 2008).

[20]GAO, *Financial Management Systems: Additional Efforts Needed to Address Key Causes of Modernization Failures*, GAO-06-184 (Washington, D.C.: Mar. 15, 2006).

to utilize only the certified products as configured. Along with these changes, continued high-priority and sustained top-level commitment by OMB and leaders throughout the federal government will be necessary to fully and effectively achieve the common goals of the line of business and FFMIA.

The Nation's Long-Term Fiscal Challenge

The nation's long-term fiscal challenge is a matter of utmost concern. The federal government faces large and growing structural deficits due primarily to rising health care costs and known demographic trends. There is a need to engage in a fundamental review of what the federal government does, how it does it, and how it is financed. Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical to maintain fiscal flexibility so that policymakers can respond to current and emerging social, economic, and security challenges.

While some progress has been made in recent years in addressing the federal government's short-term fiscal condition, the nation has not made progress on its long-term fiscal challenge. However, even this short-term deficit is understated: It masks the fact that the federal government has been using the Social Security surplus to offset spending in the rest of government for many years. If the Social Security surplus is excluded, the on-budget deficit[21] in fiscal year 2007 was more than double the size of the unified deficit. For example, Treasury reported a unified deficit of $163 billion and an on-budget deficit of $344 billion in fiscal year 2007.

While the federal government's unified budget deficit has declined in recent years, its liabilities, contingencies and commitments, and social insurance responsibilities have increased. As of September 30, 2007, the U.S. government reported in the 2007 Financial Report that it owed (i.e., liabilities) more than it owned (i.e., assets) by more than $9 trillion. Further, the Statement of Social Insurance in the Financial Report disclosed $41 trillion in social insurance responsibilities, including Medicare and Social Security, up more than $2 trillion from September 30, 2006.

[21]The on-budget deficit includes all budgetary accounts other than those designated by law as off-budget. The off-budget accounts are the Postal Service and Social Security trust funds. The unified budget is a comprehensive measure of all federal activities, including those that are on-budget and off-budget.

Information included in the *Financial Report*, such as the Statement of Social Insurance along with long-term fiscal simulations and fiscal sustainability reporting can help increase understanding of the federal government's long-term fiscal outlook. Over the next few decades, the nation's fiscal challenge will be shaped largely by rising health care costs and known demographic trends. As the baby boom generation retires, federal spending on retirement and health care programs—Social Security and Medicare, and Medicaid—will grow dramatically.

The future costs of Social Security and Medicare commitments are reported in the Statement of Social Insurance in the *Financial Report*. We were able to render an unqualified opinion on the 2007 Statement of Social Insurance—a significant accomplishment for the federal government. The statement displays the present value of projected revenues and expenditures for scheduled benefits of social insurance programs. For Social Security and Medicare alone, projected expenditures for scheduled benefits exceed earmarked revenues (i.e., dedicated payroll taxes and premiums) by approximately $41 trillion over the next 75 years in present value terms. Stated differently, one would need approximately $41 trillion invested today to deliver on the currently promised benefits not covered by earmarked revenues for the next 75 years.

Table 1 shows a simplified version of the Statement of Social Insurance by its primary components.

Table 1: Simplified Statement of Social Insurance as of January 1, 2007

Dollars in trillions

	Social Security	Medicare Hospital Insurance (Part A)	Medicare Supplementary Medical Insurance (Part B)	Medicare Supplementary Medical Insurance (Part D)	Total
Present value of future revenue (earmarked contributions, taxes, and premiums)	$34	$11	$5	$2	**$52**
Present value of expenditures for scheduled future benefits[a]	41	23	18	11	**93**
Present value of future expenditures in excess of future revenue[b]	($7)	($12)	($13)	($8)	**($41)**

Source: The Department of the Treasury.

Notes: Data are from the fiscal year 2007 Financial Report. Totals do not necessarily equal the sum of the components due to rounding.

[a]These amounts include administrative expenses for the programs.

[b]Under current law, Social Security and Federal Hospital Insurance (Medicare Part A) payments are limited to amounts available to the respective trust funds.

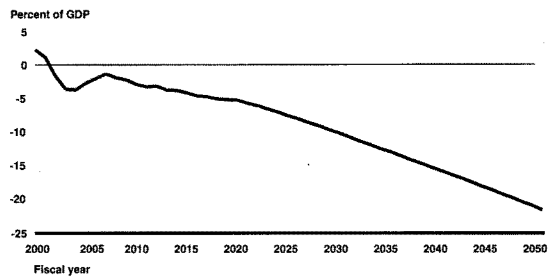
Although these social insurance commitments dominate the long-term outlook, they are not the only federal programs or activities that bind the future. GAO developed the concept of "fiscal exposures" to provide a framework for considering the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending.[22] In addition to the social insurance commitments, the federal government's fiscal exposures include about $11 trillion in liabilities reported on the Balance Sheet, $1 trillion of other commitments and contingencies, as well as other potential exposures that cannot be quantified. So beyond dealing with Medicare and Social Security, policymakers need to look at other policies that limit the federal government's flexibility—not necessarily to eliminate all of them but to at least be aware of them and make a conscious decision to reform them in a manner that will be responsible, equitable, and sustainable.

Long-term fiscal simulations of future revenues and costs for all federal programs offer a comprehensive assessment of the federal government's long-term fiscal outlook. Since 1992, GAO has published long-term fiscal simulations of what might happen to federal deficits and debt levels under varying policy assumptions. GAO's simulations—which are neither forecasts nor predictions—continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control. The timing of deficits and the resulting debt buildup varies depending on the assumptions used. For example, figure 3 shows GAO's simulation of the deficit path based on recent trends and policy preferences. In this simulation, we start with the Congressional Budget Office's (CBO) baseline and then assume that (1) all expiring tax provisions are extended through 2018—and then revenues are brought to their historical level as a share of gross domestic product (GDP) plus expected revenue from deferred taxes—(2) discretionary spending grows with the economy, and (3) no structural changes are made to Social Security, Medicare, or Medicaid.[23]

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

[23]Social Security and Medicare spending are based on the 2008 Trustees' intermediate projections. Medicare spending is adjusted using the Centers for Medicare and Medicaid Services' estimates assuming that physician payments are not reduced as required under current law. Medicaid spending is based on CBO's December 2007 long-term projections adjusted to reflect excess cost growth consistent with the Trustees' intermediate projections. Additional information about GAO's simulation model, assumptions, data, and results can be found at http://www.gao.gov/special.pubs/longterm/.

Figure 3: Unified Surpluses and Deficits under GAO's Alternative Simulation



Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

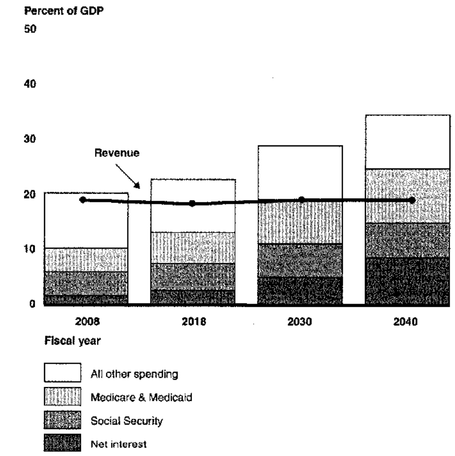
Over the long term, the nation's fiscal challenge stems primarily from rising health care costs and, to a lesser extent, the aging of the population. Absent significant changes on the spending or revenue sides of the budget or both, these long-term deficits will encumber a growing share of federal resources and test the capacity of current and future generations to afford both today's and tomorrow's commitments.

Figure 4 looks behind the deficit path to the composition of federal spending. It shows that the estimated growth in the major entitlement programs leads to an unsustainable fiscal future. In this figure, the category "all other spending" includes much of what many think of as "government"—discretionary spending on such activities as national defense, homeland security, veterans health benefits, national parks, highways and mass transit, and foreign aid, plus mandatory spending on the smaller entitlement programs such as Supplemental Security Income, Temporary Assistance for Needy Families, and farm price supports.[24] The growth in Social Security, Medicare, Medicaid, and interest on debt held by the public dwarfs the growth in all other types of spending. A

[24]Discretionary spending refers to spending based on authority provided in annual appropriations acts. Mandatory spending refers to spending that the Congress has authorized in legislation other than appropriations acts that entitles beneficiaries to receive payment or that otherwise obligates the federal government to make payment.

government that in one generation does nothing more than pay interest on its debt and mail checks to retirees and some of their health providers is unacceptable.

Figure 4: Potential Fiscal Outcomes under GAO's Alternative Simulation: Revenues and Composition of Spending as Shares of GDP



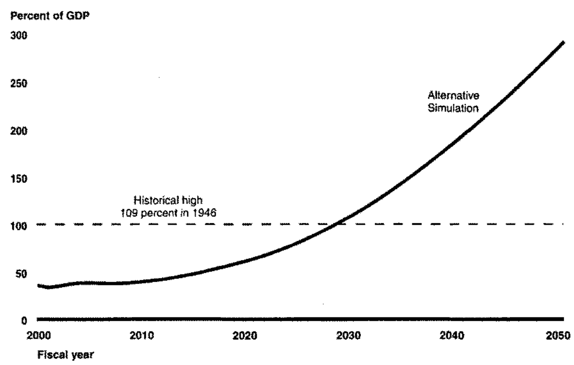
Source: GAO's April 2008 analysis.

Note: Discretionary spending grows with GDP after 2008. Alternative minimum tax exemption amount is retained at the 2007 level through 2018 and expiring tax provisions are extended. After 2018, revenue as a share of GDP returns to its historical level of 18.3 percent of GDP plus expected revenues from deferred taxes, (i.e., taxes on withdrawals from retirement accounts). Medicare spending is based on the Trustees' 2008 projections adjusted for the Centers for Medicare and Medicaid Services' alternative assumption that physician payments are not reduced as specified under current law.

The federal government's increased spending and rising deficits will drive a rising debt burden. At the end of fiscal year 2007, debt held by the public exceeded $5 trillion. Figure 5 shows that this growth in the federal government's debt cannot continue unabated without causing serious harm to the economy. In the last 200 years, only during and after World War II has debt held by the public exceeded 50 percent of GDP.

But this is only part of the story. The federal government for years has been borrowing the surpluses in the Social Security trust funds and other similar funds and using them to finance federal government costs. When such borrowings occur, Treasury issues federal securities to these government funds that are backed by the full faith and credit of the U.S. government. Although borrowing by one part of the federal government from another may not have the same economic and financial implications as borrowing from the public, it represents a claim on future resources and hence a burden on future taxpayers and the future economy. If federal securities held by those funds are included, the federal government's total debt is much higher—about $9 trillion as of the end of fiscal year 2007.

Figure 5: Debt Held by the Public under GAO's Alternative Simulation

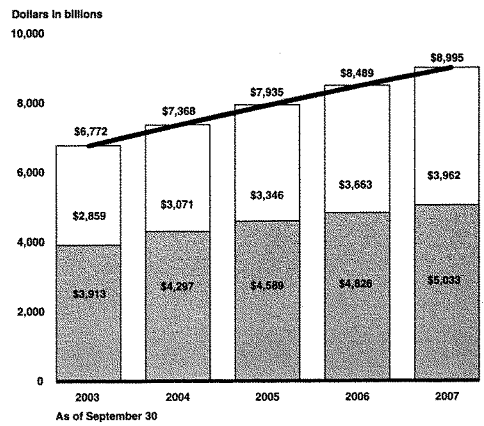


Source: GAO's April 2008 analysis.

Note: Assumes currently scheduled Social Security and Medicare Part A benefits are paid in full throughout the simulation period.

As shown in figure 6, total federal debt increased over each of the last four fiscal years.[25]

Figure 6: Total Federal Debt Outstanding



Source: The Department of the Treasury.

On September 29, 2007, the statutory debt limit had to be raised for the third time in 4 years in order to avoid being breached; between the end of fiscal year 2003 and the end of fiscal year 2007, the debt limit had to be increased by about one-third. It is anticipated that actions will need to be taken in fiscal year 2009 to avoid breaching the current statutory debt limit of $9,815 billion.

[25]The Schedule of Federal Debt managed by Treasury's Bureau of the Public Debt reports essentially all of the total debt of the federal government. Beginning with fiscal year 1997, the Schedule of Federal Debt has annually been audited and received an unqualified opinion.

A quantitative measure of the long-term fiscal challenge measure is called "the fiscal gap." The fiscal gap is the amount of spending reduction or tax increases that would be needed today to keep debt as a share of GDP at or below today's ratio. The fiscal gap is an estimate of the action needed to achieve fiscal balance over a certain time period such as 75 years. Another way to say this is that the fiscal gap is the amount of change needed to prevent the kind of debt explosion implicit in figure 5. The fiscal gap can be expressed as a share of the economy or in present value dollars.

Under GAO's alternative simulation, closing the fiscal gap would require spending cuts or tax increases equal to 6.7 percent of the entire economy over the next 75 years, or about $54 trillion in present value terms. To put this in perspective, closing the gap would require an increase in today's federal tax revenues of about 36 percent or an equivalent reduction in today's federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled) to be maintained over the entire period.

Policymakers could phase in the policy changes so that the tax increases or spending cuts would grow over time and allow people to adjust. The size of these annual tax increases and spending cuts would be more than five times the fiscal year 2007 deficit of 1.2 percent of GDP. Delaying action would make future adjustments even larger. Under our alternative simulation, waiting even 10 years would require a revenue increase of about 45 percent or noninterest spending cuts of about 40 percent. This gap is too large for the federal government to grow its way out of the problem. To be sure, additional economic growth would certainly help the federal government's financial condition and ability to address this fiscal gap, but it will not eliminate the need for action.

Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical to the nation's future. As we reported in December 2007,[26] several countries have begun preparing fiscal sustainability reports to help assess the implications of their public pension and health care programs and other challenges in the context of overall sustainability of government finances. European Union members also annually report on longer-term fiscal

[26]GAO, *Budget Issues: Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting on Our Nation's Longer-Term Fiscal Challenge*, GAO-08-206 (Washington, D.C.: Dec. 20, 2007).

sustainability. The goal of these reports is to increase public awareness and understanding of the long-term fiscal outlook in light of escalating health care cost growth and population aging, to stimulate public and policy debates, and to help policymakers make more informed decisions. These countries used a variety of measures, including projections of future revenue and spending and summary measures of fiscal imbalance and fiscal gaps, to assess fiscal sustainability. Last year, we recommended that the United States should prepare and publish a long-range fiscal sustainability report.[27] I am pleased to note that the Federal Accounting Standards Advisory Board (FASAB) will soon issue a draft of a proposed standard on fiscal sustainability reporting.

Here in the first half of 2008, the long-term fiscal challenge is not in the distant future. In fact, the oldest members of the baby boom generation are now eligible for Social Security retirement benefits and will be eligible for Medicare benefits in less than 3 years. The budget and economic implications of the baby boom generation's retirement have already become a factor in CBO's 10-year budget projections and that impact will only intensify as the baby boomers age.

The financial markets also are noticing. Earlier this year, Moody's Investors Service issued its annual report on the United States. In that report, it noted that absent Medicare and Social Security reforms, the long-term fiscal health of the United States and the federal government's current Aaa sovereign credit rating were at risk. Likewise, Standard and Poor's noted in a recent report that Medicare and Social Security reform is necessary to prevent a much worse long-term fiscal deterioration. These comments serve to note the significant longer-term interest rate risk that the federal government faces absent meaningful action to address these long-range challenges. Higher longer-term interest costs would only serve to complicate the nation's fiscal, economic, and other challenges in future years.

At some point, action will need to be taken to change the nation's fiscal course. The sooner appropriate actions are taken, the sooner the miracle of compounding will begin to work for the federal budget rather than against it. Conversely, the longer that action to deal with the nation's long-

[27] GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls Are Needed,* GAO-07-1144T (Washington, D.C.: July 25, 2007), and *Long-Term Budget Outlook: Deficits Matter—Saving Our Future Requires Tough Choices Today,* GAO-07-389T (Washington, D.C.: Jan. 23, 2007).

term fiscal outlook is delayed, the greater the risk that the eventual changes will be disruptive and destabilizing and future generations will have to bear a greater burden of the cost. Simply put, the federal government is on an imprudent and unsustainable long-term fiscal path that is getting worse with the passage of time.

A Possible Way Forward

Meeting this long-term fiscal challenge overarches everything. It is the nation's largest sustainability challenge, but it is not the only one. Aligning the federal government to meet the challenges and capitalize on the opportunities of the 21st century will require a fundamental review of what the federal government does, how it does it, and how it is financed.

In addressing the growing costs of the major entitlement programs and reexamining other major programs, policies, and activities, attention should be paid to both the spending and the revenue sides of the budget. Programs that run through the tax code—sometimes referred to as tax expenditures[28]—must be reexamined along with those that run through the spending side. Moving forward, the federal government needs to start making tough choices in setting priorities and linking resources and activities to results.

Meeting the nation's long-term fiscal challenge will require a multipronged approach bringing people together to tackle health care, Social Security, and the tax system as well as

- strengthening oversight of programs and activities, including creating approaches to better facilitate the discussion of integrated solutions to crosscutting issues; and
- reengineering and reprioritizing the federal government's existing programs, policies, and activities to address 21st century challenges and capitalize on related opportunities.

Regarding the tax system, although tax reform may need to play a role in meeting our challenges, any system will need to include design features and reasonable service and enforcement efforts to maximize compliance. Under the current system, the tax gap—the difference between the tax amounts taxpayers pay voluntarily on time and what they should pay

[28]In addition to the reported net cost, the federal government foregoes tax revenues as a result of preferential provisions, such as tax exclusions, credits, and deductions. These revenue losses are referred to as tax expenditures.

under the laws—contributes to the nation's long-term fiscal challenges and can undermine compliance if those who comply see their friends, neighbors, and business competitors avoiding their tax obligations. According to the latest Internal Revenue Service (IRS) estimates for tax year 2001, the federal government falls $345 billion short of collecting all of the taxes owed before voluntary late payments and IRS enforcement actions and $290 billion afterwards. Although the extent to which we can reduce the tax gap is unknown, meaningful reductions can contribute resources to dealing with our long-term challenges.

There are also some process changes that might help the discussion by increasing the transparency and relevancy of key financial, performance, and budget reporting and estimates that highlight the fiscal challenge. Stronger budget controls for both spending and tax policies to deal with both near-term and longer-term deficits may also be helpful.

In summary, to effectively address the nation's long-term fiscal challenge, tackling health care cost growth and other existing entitlement programs will be essential. However, this entitlement reform alone will not get the job done. The federal government also needs to reprioritize and constrain other spending and consider whether revenues at the historical average of 18.3 percent of GDP will be sufficient—that may involve discussion of the tax system. I am pleased that GAO has been able to offer you specific analysis and tools to assist you in this important work. However, only elected officials can and should decide which issues to address as well as how and when to address them. Addressing these problems will require tough choices, and the fiscal clock is ticking.

The Federal Financial Reporting Model

The Financial Report provides useful information on the government's financial position at the end of the fiscal year and changes that have occurred over the course of the year. However, in evaluating the nation's fiscal condition, it is critical to look beyond the short-term results and consider the overall long-term financial condition and long-term fiscal challenge of the government—that is, the sustainability of the federal government's programs, commitments, and responsibilities in relation to the resources expected to be available.

The current federal financial reporting model does not clearly, comprehensively and transparently show the wide range of responsibilities, programs, and activities that may either obligate the federal government to future spending or create an expectation for such spending. Thus, it does not provide the best possible picture of the federal government's overall performance, financial condition, and future fiscal outlook.

Accounting and financial reporting standards have continued to evolve to provide adequate transparency and accountability over the federal government's operations, financial condition and fiscal outlook. However, after 11 years of reporting at the governmentwide level, it is appropriate to consider the need for further revisions to the current federal financial reporting model, which could affect both consolidated and agency reporting. While the current reporting model recognizes some of the unique needs of the federal government, a broad reconsideration of the federal financial reporting model could address the following types of questions:

- What kind of information is most relevant and useful for a sovereign nation?
- Do traditional financial statements convey information in a transparent manner?
- What is the role of the balance sheet in the federal government reporting model?
- How should items that are unique to the federal government, such as social insurance commitments and the power to tax, be reported?

In addition, further enhancements to accounting and financial reporting standards are needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. For example, the federal government's financial reporting should be expanded to disclose the reasons for significant changes during the year in scheduled social insurance benefits and funding. It should also include (1) a Statement of Fiscal Sustainability[29] that provides a long-term look at the sustainability of social insurance programs in the context of all federal programs, and (2) other sustainability information, including intergenerational equity.[30] The Federal Accounting Standards Advisory

[29]The Statement of Fiscal Sustainability would show the relationship between the present value of projected revenues and outlays for social insurance and for all other federal programs.

[30]Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

Board is currently considering possible changes to social insurance reporting and has initiated a project on fiscal sustainability reporting.

Engaging in a reevaluation of the federal financial reporting model could stimulate discussion that would bring about a new way of thinking about the federal government's financial and performance reporting needs. To understand various perceptions and needs of the stakeholders for federal financial reporting, a wide variety of stakeholders from the public and private sector should be consulted. Ultimately, the goal of such a reevaluation would be reporting enhancements that can help the Congress deliberate on strategies to address the federal government's challenges, including its long-term fiscal challenge.

Closing Comments

In closing, it is important that the progress that has been made in improving federal financial management activities and practices be sustained by the current administration as well as the new administration that will be taking office next year. Across government, financial management improvement initiatives are underway, and if effectively implemented, they have the potential to greatly improve the quality of financial management information as well as the efficiency and effectiveness of agency operations. However, the federal government still has a long way to go before realizing strong federal financial management. For DOD, the challenges are many. We are encouraged by DOD's efforts toward addressing its long-standing financial management weaknesses, but consistent and diligent management oversight toward achieving financial management capabilities, including audit readiness is needed. Federal agencies need to improve the government's financial management systems. The civilian CFO Act agencies must continue to strive toward routinely producing not only annual financial statements that can pass the scrutiny of a financial audit, but also quarterly financial statements and other meaningful financial and performance data to help guide decision makers on a day-to-day basis.

Addressing the nation's long-term fiscal challenge constitutes a major transformational challenge that may take a generation or more to resolve. GAO is committed to sustained attention to this fiscal challenge to help ensure that this is not the first generation to leave its children and grandchildren a legacy of failed fiscal stewardship and the hardships that would bring. Given the size of the projected deficit, the leadership and efforts of many people will be needed to put the nation on a more prudent and sustainable longer-term fiscal path.

Given the federal government's current financial condition and the nation's long-term fiscal challenge, the need for the Congress and federal policymakers and management to have reliable, useful, and timely financial and performance information is greater than ever. Sound decisions on the current and future direction of vital federal government programs and policies are more difficult without such information. We will continue to stress the need for development of more meaningful financial and performance reporting on the federal government. Until the problems discussed in this testimony are effectively addressed, they will continue to have adverse implications for the federal government and the taxpayers.

Finally, I want to emphasize the value of sustained congressional interest in these issues. It will be key that, going forward, the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving the remaining problems and that they support improvement efforts.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

GAO Contacts and Acknowledgments

For further information regarding this testimony, please contact McCoy Williams, Managing Director; and Gary Engel, Director; Financial Management and Assurance at (202) 512-2600, as well as Susan Irving, Director; Federal Budget Analysis, Strategic Issues at (202) 512-9142. Key contributions to this testimony were also made by staff on the Consolidated Financial Statement audit team.

Appendix I: Material Weaknesses Contributing to Our Disclaimer of Opinion on the Accrual Basis Consolidated Financial Statements

The continuing material weaknesses discussed below contributed to our disclaimer of opinion on the federal government's accrual basis consolidated financial statements. The federal government did not maintain adequate systems or have sufficient reliable evidence to support information reported in the accrual basis consolidated financial statements, as described below.

Property, Plant, and Equipment and Inventories and Related Property

The federal government could not satisfactorily determine that property, plant, and equipment (PP&E) and inventories and related property were properly reported in the consolidated financial statements. Most of the PP&E and inventories and related property are the responsibility of the Department of Defense (DOD). As in past years, DOD did not maintain adequate systems or have sufficient records to provide reliable information on these assets. Other agencies, most notably the National Aeronautics and Space Administration, reported continued weaknesses in internal control procedures and processes related to PP&E.

Without reliable asset information, the federal government does not fully know the assets it owns and their location and condition and cannot effectively (1) safeguard assets from physical deterioration, theft, or loss; (2) account for acquisitions and disposals of such assets; (3) ensure that the assets are available for use when needed; (4) prevent unnecessary storage and maintenance costs or purchase of assets already on hand; and (5) determine the full costs of programs that use these assets.

Loans Receivable and Loan Guarantee Liabilities

Federal agencies that account for the majority of the reported balances for direct loans and loan guarantee liabilities continue to have internal control weaknesses related to their credit reform estimation and related financial reporting processes. While progress in addressing these long-standing weaknesses was reported by certain federal credit agencies, certain deficiencies in the Department of Agriculture's credit reform processes contributed to its auditor being unable to obtain sufficient, appropriate evidence to support related accounts. As such, for fiscal year 2007, we have added this area to the list of material weaknesses contributing to our disclaimer of opinion on the accrual basis consolidated financial statements.

These issues and the complexities associated with estimating the costs of lending activities significantly increase the risk that material misstatements in agency and governmentwide financial statements could occur and go undetected. Moreover, these weaknesses continue to adversely affect the federal government's ability to support annual budget requests for federal lending programs, make future budgetary decisions, manage program costs, and measure the performance of lending activities.

Liabilities and Commitments and Contingencies

The federal government could not reasonably estimate or adequately support amounts reported for certain liabilities. For example, DOD was not able to estimate with assurance key components of its environmental and disposal liabilities. In the past, DOD could not support a significant amount of its estimated military postretirement health benefits liabilities included in federal employee and veteran benefits payable. These unsupported amounts related to the cost of direct health care provided by DOD-managed military treatment facilities. This year, the auditor's report on the financial statements that include the estimated military postretirement health benefits liabilities had not been issued as of the date of our audit report.[1] Further, the federal government could not determine whether commitments and contingencies, including those related to treaties and other international agreements entered into to further the U.S. government's interests, were complete and properly reported.

Problems in accounting for liabilities affect the determination of the full cost of the federal government's current operations and the extent of its liabilities. Also, weaknesses in internal control supporting the process for estimating environmental and disposal liabilities could result in improperly stated liabilities as well as affect the federal government's ability to determine priorities for cleanup and disposal activities and to appropriately consider future budgetary resources needed to carry out these activities. In addition, if disclosures of commitments and contingencies are incomplete or incorrect, reliable information is not available about the extent of the federal government's obligations.

Cost of Government Operations and Disbursement Activity

The previously discussed material weaknesses in reporting assets and liabilities, material weaknesses in financial statement preparation, as discussed below, and the lack of adequate disbursement reconciliations at certain federal agencies affect reported net costs. As a result, the federal

[1]The auditor's report on these financial statements was issued subsequent to the date of our audit report. The auditor continued to report issues related to the cost of direct health care provided by DOD-managed military treatment facilities.

government was unable to support significant portions of the total net cost of operations, most notably related to DOD.

With respect to disbursements, DOD and certain other federal agencies reported continued weaknesses in reconciling disbursement activity. For fiscal years 2007 and 2006, there was unreconciled disbursement activity, including unreconciled differences between federal agencies' and Treasury's records of disbursements and unsupported federal agency adjustments, totaling billions of dollars, which could also affect the balance sheet.

Unreliable cost information affects the federal government's ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required. If disbursements are improperly recorded, this could result in misstatements in the financial statements and in certain data provided by federal agencies for inclusion in *The Budget of the United States Government* (hereafter referred to as "the President's Budget") concerning obligations and outlays.

Accounting for and Reconciliation of Intragovernmental Activity and Balances

Federal agencies are unable to adequately account for and reconcile intragovernmental activity and balances. OMB and Treasury require the chief financial officers (CFO) of 35 executive departments and agencies to reconcile, on a quarterly basis, selected intragovernmental activity and balances with their trading partners. In addition, these agencies are required to report to Treasury, the agency's inspector general, and GAO on the extent and results of intragovernmental activity and balances reconciliation efforts as of the end of the fiscal year.

A substantial number of the agencies did not adequately perform the required reconciliations for fiscal years 2007 and 2006. For these fiscal years, based on trading partner information provided to Treasury via agencies' closing packages, Treasury produced a "Material Difference Report" for each agency showing amounts for certain intragovernmental activity and balances that significantly differed from those of its corresponding trading partners as of the end of the fiscal year. Based on our analysis of the "Material Difference Reports" for fiscal year 2007, we noted that a significant number of CFOs were unable to adequately explain the differences with their trading partners or did not provide adequate documentation to support responses. For both fiscal years 2007 and 2006, amounts reported by federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. In addition, a significant number of CFOs cited differing accounting methodologies, accounting errors, and timing differences for their material differences with their trading partners. Some CFOs simply indicated that they were unable to explain the differences with their trading partners with no indication when the differences will be resolved. As a result of the above, the federal government's ability to determine the impact of these differences on the amounts reported in the accrual basis consolidated financial statements is significantly impaired.

Preparation of Consolidated Financial Statements

While further progress was demonstrated in fiscal year 2007, the federal government continued to have inadequate systems, controls, and procedures to ensure that the consolidated financial statements are consistent with the underlying audited agency financial statements, properly balanced, and in conformity with U.S. generally accepted accounting principles (GAAP). In addition, as discussed in our scope limitation section of our audit report, Treasury could not provide the final fiscal year 2007 accrual basis consolidated financial statements and adequate supporting documentation in time for us to complete all of our planned auditing procedures. During our fiscal year 2007 audit, we found the following:

- Treasury has showed progress by demonstrating that amounts in the Statement of Social Insurance were consistent with the underlying federal agencies' audited financial statements and that the Balance Sheet and the Statement of Net Cost were consistent with federal agencies' financial statements prior to eliminating intragovernmental activity and balances. However, Treasury's process for compiling the consolidated financial statements did not ensure that the information in the remaining three principal financial statements and notes were fully consistent with the underlying information in federal agencies' audited financial statements and other financial data.
- At the federal agency level, for fiscal year 2007, auditors for many of the CFO Act agencies reported material weaknesses or other significant deficiencies regarding agencies' financial reporting processes which, in turn, could affect the preparation of the consolidated financial statements. For example, auditors for several agencies reported that a significant number of adjustments were required to prepare the agencies' financial statements. These and other auditors are also required to separately audit financial information sent by the federal agencies to Treasury via a closing package. In connection with preparing the consolidated financial statements, Treasury had to create adjustments to correct significant errors found in agencies' audited closing package information.

- To make the fiscal years 2007 and 2006 consolidated financial statements balance, Treasury recorded net decreases of $6.7 billion and $11 billion, respectively, to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled "Other – Unmatched transactions and balances."[2] An additional net $2.5 billion and $10.4 billion of unmatched transactions were recorded in the Statement of Net Cost for fiscal years 2007 and 2006, respectively. Treasury is unable to fully identify and quantify all components of these unreconciled activities.

- The federal government could not demonstrate that it had fully identified and reported all items needed to reconcile the operating results, which for fiscal year 2007 showed a net operating cost of $275.5 billion, to the budget results, which for the same period showed a unified budget deficit of $162.8 billion.

- Treasury's elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions. As previously discussed, amounts reported for federal agency trading partners for certain intragovernmental accounts were not in agreement by significant amounts. This resulted in the need for intragovernmental elimination entries by Treasury that recorded the net differences between trading partners as "Other – Unmatched transactions and balances," in order to force the Statements of Operations and Changes in Net Position into balance. In addition, differences in other intragovernmental accounts, primarily related to transactions with the General Fund, have not been reconciled, still remain unresolved, and total hundreds of billions of dollars. Therefore, the federal government continues to be unable to determine the impact of unreconciled intragovernmental activity and balances on the accrual basis consolidated financial statements.

- We have consistently reported that certain financial information required by GAAP was not disclosed in the consolidated financial statements. In 2006, the Federal Accounting Standards Advisory Board issued a new standard that eliminated or lessened the disclosure requirements for the consolidated financial statements related to certain information that

[2]Although Treasury was unable to determine how much of the unmatched transactions and balances, if any, relate to net operating cost, it reported this amount as a component of net operating cost in the consolidated financial statements.

Treasury had not been reporting.[3] While Treasury made progress in addressing some of the remaining omitted information, there continue to be disclosures required by GAAP that are excluded from the consolidated financial statements. Also, certain material weaknesses noted in this report, for example, commitments and contingencies related to treaties and other international agreements, preclude Treasury from determining if a disclosure is required by GAAP in the consolidated financial statements and us from determining if the omitted information is material. Further, Treasury's ability to report information in accordance with GAAP will also remain impaired until federal agencies, such as DOD, can provide Treasury with complete and reliable information required to be reported in the consolidated financial statements.

- Other internal control weaknesses existed in Treasury's process for preparing the consolidated financial statements, involving inadequate or ineffective (1) documentation of certain policies and procedures; (2) management reviews of adjustments and key iterations of the financial statements, notes, and management discussion and analysis provided to GAO for audit; (3) supporting documentation for certain adjustments made to the consolidated financial statements; (4) processes for monitoring the preparation of the consolidated financial statements; and (5) spreadsheet controls.

- The consolidated financial statements include financial information for the executive, legislative, and judicial branches, to the extent that federal agencies within those branches have provided Treasury such information. However, as we have reported in past years, there continue to be undetermined amounts of assets, liabilities, costs, and revenues that are not included, and the federal government did not provide evidence or disclose in the consolidated financial statements that the excluded financial information was immaterial.

- As in previous years, Treasury did not have adequate systems and personnel to address the magnitude of the fiscal year 2007 financial reporting challenges it faced, such as weaknesses in Treasury's process for preparing the consolidated financial statements noted above. We found that personnel at Treasury's Financial Management Service had excessive workloads that required an extraordinary amount of effort and dedication

[3] SFFAS No. 32, *Consolidated Financial Report of the United States Government Requirements: Implementing Statement of Federal Financial Accounting Concepts 4 "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government"* (Washington, D.C.: Sept. 28, 2006).

to compile the consolidated financial statements; however, there were not enough personnel with specialized financial reporting experience to help ensure reliable financial reporting by the reporting date. In addition, the federal government does not perform quarterly compilations at the governmentwide level, which leads to almost all of the compilation effort being performed during a condensed time period at the end of the year.

Components of the Budget Deficit

Both the Reconciliation of Net Operating Cost and Unified Budget Deficit and Statement of Changes in Cash Balance from Unified Budget and Other Activities report a budget deficit for fiscal years 2007 and 2006 of $162.8 billion and $247.7 billion, respectively.[4] The budget deficit is calculated by subtracting actual budget outlays (outlays) from actual budget receipts (receipts).

For several years, we have been reporting material unreconciled differences between the total net outlays reported in selected federal agencies' Statement of Budgetary Resources (SBR) and Treasury's central accounting records used to compute the budget deficit[5] reported in the consolidated financial statements. OMB and Treasury have continued to work with federal agencies to reduce these material unreconciled differences. However, billions of dollars of differences still exist in this and other components of the deficit because the federal government does not have effective processes and procedures for identifying, resolving, and explaining material differences in the components of the deficit between Treasury's central accounting records and information reported in agency financial statements and underlying agency financial information and records. Until these differences are timely reconciled by the federal government, their effect on the U.S. government's consolidated financial statements will be unknown.

In fiscal year 2007, we again noted that several agencies' auditors reported internal control weaknesses (1) affecting the agencies' SBRs, and (2) relating to monitoring, accounting, and reporting of budgetary

[4]The budget deficit, receipts, and outlays amounts are reported in Treasury's Monthly Treasury Statement and the President's Budget.

[5]See GAO's audit report on its audit of the federal government's fiscal year 2006 financial statements that was incorporated in the *2006 Financial Report of the U.S. Government* published by Treasury. Also, see GAO, *Financial Audit: Process for Preparing the Consolidated Financial Statements of the U.S. Government Needs Improvement*, GAO-04-45 (Washington, D.C.: Oct. 30, 2003).

transactions. These weaknesses could affect the reporting and calculation of the net outlay amounts in the agencies' SBRs. In addition, such weaknesses also affect the agencies' ability to report reliable budgetary information to Treasury and OMB and may affect the unified budget outlays reported by Treasury in its Combined Statement of Receipts, Outlays, and Balances,[6] and certain amounts reported in the President's Budget.

[6]*Treasury's Combined Statement of Receipts, Outlays, and Balances* presents budget results and cash related assets and liabilities of the federal government with supporting details. Treasury represents this report as the recognized official publication of receipts and outlays of the federal government based on agency reporting.

Appendix II: Other Material Weaknesses

The federal government did not maintain effective internal control over financial reporting (including safeguarding assets) and compliance with significant laws and regulations as of September 30, 2007. In addition to the material weaknesses discussed in appendix I that contributed to our disclaimer of opinion on the accrual basis consolidated financial statements, we found the following three other material weaknesses in internal control.

Improper Payments

Although showing progress under OMB's continuing leadership, agencies' fiscal year 2007 reporting under the Improper Payments Information Act of 2002 (IPIA)[1] does not reflect the full scope of improper payments. For fiscal year 2007, federal agencies' estimates of improper payments, based on available information, totaled about $55 billion.[2] The increase from the prior year estimate of $41 billion[3] was primarily attributable to a component of the Medicaid program reporting improper payments for the first time totaling about $13 billion for fiscal year 2007, which we view as a positive step to improve transparency over the full magnitude of improper payments.

Major challenges remain in meeting the goals of the act and ultimately better ensuring the integrity of payments.[4] For fiscal year 2007, four agency auditors reported noncompliance issues with IPIA related to agencies' risk assessments, sampling methodologies, implementing corrective action plans, and recovering improper payments. We also identified issues with agencies' risk assessments such as not completing risk assessments of all programs and activities or not conducting annual reviews of any programs

[1] Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002). The IPIA requires federal agencies to review all programs and activities, identify those that may be susceptible to significant improper payments, estimate and report the annual amount of improper payments for those programs, and implement actions to cost-effectively reduce improper payments.

[2] The $55 billion includes 19 newly reported programs with improper payment estimates totaling about $16 billion. Of the 19 programs, 5 reported zero improper payment estimates for fiscal year 2007.

[3] In their fiscal year 2007 Performance and Accountability Reports (PAR), selected federal agencies updated their fiscal year 2006 improper payment estimates to reflect changes since issuance of their fiscal year 2006 PARs. These updates decreased the governmentwide improper payment estimate for fiscal year 2006 from $42 billion to $41 billion.

[4] GAO, *Improper Payments: Agencies' Efforts to Address Improper Payment and Recovery Auditing Requirements Continue*, GAO-07-635T (Washington, D.C.: Mar. 29, 2007).

and activities. OMB's current guidance allows for annual risk assessments to be conducted less often than annually (generally every 3 years) for programs where baselines are already established, are in the process of being measured, or are scheduled to be measured by an established date. For fiscal year 2007, we noted that 4 agencies were implementing a 3-year cycle for conducting risk assessments. Furthermore, select agencies have not reported improper payment estimates for 14 risk-susceptible federal programs with total program outlays of about $170 billion for fiscal year 2007. Lastly, we found that major management challenges and internal control weaknesses continue to plague agency operations and programs susceptible to significant improper payments. For example, in the Department of Education's fiscal year *2007 Performance and Accountability Report*, the Office of Inspector General reported that its recent investigations continue to uncover problems, including inadequate attention to improper payments and failure to identify and take corrective action to detect and prevent fraudulent activities by grantees.

Information Security

Although progress has been made, serious and widespread information security control weaknesses continue to place federal assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. GAO has reported information security as a high-risk area across government since February 1997. During fiscal year 2007, federal agencies did not consistently implement effective controls to prevent, limit, or detect unauthorized access to computing resources. Specifically, agencies did not always (1) identify and authenticate users to prevent unauthorized access; (2) enforce the principle of least privilege to ensure that authorized access was necessary and appropriate; (3) apply encryption to protect sensitive data on networks and portable devices; (4) log, audit, and monitor security-relevant events; and (5) restrict physical access to information assets. In addition, agencies did not consistently configure network devices and services to prevent unauthorized access and ensure system integrity, such as patching key servers and workstations in a timely manner; assign incompatible duties to different individuals or groups so that one individual does not control all aspects of a process or transaction; and maintain or test continuity of operations plans for key information systems. Such information security control weaknesses unnecessarily increase the risk that the reliability and availability of data that are recorded in or transmitted by federal financial management systems could be compromised. A primary reason for these weaknesses is that federal agencies have not yet fully institutionalized comprehensive security management programs, which are critical to identifying information security control weaknesses, resolving information security problems, and managing information security risks on an ongoing basis. The administration has taken important actions to improve information security, such as issuing extensive guidance on information security and requiring agencies to perform specific actions to protect certain personally identifiable information. However, until agencies effectively and fully implement agencywide information security programs, federal data and systems, including financial information, will remain at risk.

Tax Collection Activities

During fiscal year 2007, material internal control weaknesses and systems deficiencies continued to affect the federal government's ability to effectively manage its tax collection activities, an issue that has been reported in our financial statement audit reports for the past 10 years. Due to errors and delays in recording taxpayer information, payments, and other activities, taxpayers were not always credited for payments made on their taxes owed, which could result in undue taxpayer burden. In addition, the federal government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government. Moreover, the federal government did not have cost benefit information, related cost-based performance measures, or a systematic process for ensuring it is using its resources to maximize its ability to collect what is owed and minimize the disbursements of improper tax refunds. As a result, the federal government is vulnerable to loss of tax revenue and exposed to potentially billions of dollars in losses due to inappropriate refund disbursements.

Appendix III: Fiscal Year 2007 Audit Results

Table 2: CFO Act Agencies: Fiscal Year 2007 Audit Results and Principal Auditors

CFO Act agencies	Opinion rendered by agency auditor	Agencies' auditors reported material weaknesses or noncompliance[a]	Principal auditor
Agency for International Development	Unqualified		OIG
Agriculture	Qualified	√	OIG
Commerce	Unqualified	√	KPMG LLP
Defense	Disclaimer	√	OIG
Education	Unqualified	√	Ernst & Young, LLP
Energy	Unqualified		KPMG LLP
Environmental Protection Agency	Unqualified	√	OIG
General Services Administration	Unqualified		Pricewaterhouse Coopers LLP
Health and Human Services	Unqualified	√	Pricewaterhouse Coopers LLP
Homeland Security	[b]	√	KPMG LLP
Housing and Urban Development	Unqualified	√	OIG
Interior	Unqualified	√	KPMG LLP
Justice	Unqualified		KPMG LLP
Labor	Unqualified	√	KPMG LLP
National Aeronautics and Space Administration	Disclaimer	√	Ernst & Young, LLP
National Science Foundation	Unqualified		Clifton Gunderson LLP
Nuclear Regulatory Commission	Unqualified	√	R. Navarro & Associates, Inc.
Office of Personnel Management	Unqualified		KPMG LLP
Small Business Administration	Unqualified	√	KPMG LLP
Social Security Administration	Unqualified		Pricewaterhouse Coopers LLP
State	Disclaimer	√	Leonard G. Birnbaum and Company, LLP
Transportation	Unqualified	√	OIG
Treasury	Unqualified	√	KPMG LLP
Veterans Affairs	Unqualified	√	Deloitte & Touche LLP

Source: GAO.

[a]Reported noncompliance with applicable laws and regulations and/or substantial noncompliance with one or more of the Federal Financial Management Improvement Act requirements.

[b]For fiscal year 2007, only the Consolidated Balance Sheet and the related Statement of Custodial Activity of the Department of Homeland Security were subject to audit; the auditor was unable to express an opinion on these two financial statements.

Testimony of Daniel I. Werfel
Deputy Controller
Office of Management and Budget

before the
Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security
Senate Homeland Security and Governmental Affairs Committee

June 26, 2008

With the rising cost of entitlement programs expected to create an unprecedented and enormous fiscal imbalance for the Federal Government in the coming decades, achieving our financial management goals is more critical today than any other time in our nation's history. The financial management community is not only responsible for reporting on the extent and nature of our fiscal challenges, it also plays a critical role in developing and implementing strategies to control Federal spending and otherwise ensure that the fiscal health of the Federal Government remains sound.

We must ensure that the Federal financial community is well positioned to meet these challenges. Clear financial management goals are in place, including the attainment of clean financial statement audit opinions[1], elimination of material weaknesses in internal controls[2], issuance of timely financial reports, disposal of unneeded real property, and the elimination of improper payments. To build on the recent and unprecedented results achieved by Federal agencies in each of these areas, Federal managers must:

- strengthen accounting practices in high-risk areas such as inventory and fund balances;
- strengthen internal controls in areas where mission and organizational risks are highest;
- issue more transparent, readable, and relevant financial reports for both public stakeholders and agency decision-makers; and
- improve the integrity and accuracy of Federal payments and eliminate other forms of waste, such as the misuse of government charge cards.

In addition, the Office of Management and Budget (OMB), the Government Accountability Office (GAO), and Congress must work together to ensure that the financial management requirements we impose on Federal agencies strike an appropriate balance between the costs of agency efforts with the benefits they ultimately deliver for the taxpayer. The approaching twenty-year anniversary of the Chief Financial Officers (CFO) Act of 1990 provides an opportunity for a thorough evaluation of the current legislative and regulatory requirements and identification of alternative approaches that improve the value of Federal financial activities.

---

[1] A clean audit opinion serves as an indicator that the financial statements of that Federal department or agency are reliable and can be depended upon to communicate the true nature of that department's/agency's financial position.
[2] A material weakness occurs when the underlying processes and systems supporting the financial statements do not adequately mitigate the risk of presenting unreliable and flawed financial information.

Status of Federal Agency Financial Reporting

In fiscal year (FY) 2007, Federal agencies improved the readability, validity, and timeliness of their financial information. To enhance readability, OMB conducted a pilot where participating agencies explored different formats for enhancing the presentation of financial and performance information contained in their consolidated Performance and Accountability Reports (PAR). One of the more successful products of the pilot was a "Highlights" document that contained performance and financial information in a brief, user-friendly format. We intend to make further improvements to the pilot in FY 2008 by initiating a three-tiered reporting structure:

- A two-page summary that provides the reader with a quick snapshot of agency results;
- A 25-page Citizens' Report that, while still a summary, provides a more comprehensive view of agency mission, key goals, how funds are spent, performance relative to goals, and actions they plan to take to build on successes or address shortcomings; and
- The comprehensive PAR, which provides exhaustive and complete details on relevant financial and performance data.

Federal agencies are also making progress in improving the reliability and timeliness of the financial information being reported. Specifically, the following results were achieved in FY 2007:

- Of the 24 major Federal agencies, 80 percent received clean audit opinions.
- For the third consecutive year, all major Federal agencies issued their audited financial statements 45-days after the end of the fiscal year, compared to the previous five month (150 days) reporting deadline.
- The total number of material weaknesses government-wide declined from 41 to 39. This is the fourth year in a row that material weaknesses have declined, with a more than 35% decrease in weaknesses since 2001.
- Five additional agencies received a clean audit opinion with no material weaknesses which brings the total number of agencies realizing this important accomplishment to 13, up from just seven in 2001.[3]

To ensure that all agencies are on a path to financial management excellence, we continue to monitor Federal agencies' progress in eliminating material weaknesses and improving other critical financial management processes. OMB works with the Department of Defense, the Department of Homeland Security and other agencies with significant financial management challenges to ensure that they are making steady progress on sound corrective action plans with clear goals and milestones for success. Even so, several areas continue to pose accounting challenges for agencies including fund balance with Treasury,[4] property, plant, and equipment,

[3] The thirteen agencies are the Departments of Justice, the Interior, Energy, Commerce, Education, Labor, the Small Business Administration, the Environmental Protection Agency, the General Services Administration, the National Science Foundation, the Office of Personnel Management, the Social Security Administration, and the U.S. Agency for International Development.

[4] Similar to checking accounts at banks, the Agencies' Fund Balance with Treasury accounts represents the status of funds agencies have with the U.S. Treasury for which they are authorized to make payments against (i.e. the net effect of all collections and disbursements).

and inventory. The proper accounting and reporting of this financial information enables agencies to better manage costs and resources for accomplishing their programs and mission. Further, it provides a clear and reliable picture of the agencies' fiscal health to the Congress, public, and other stakeholders.

Status of Government-Wide Financial Reporting

Over the past several years, OMB and the Treasury Department have made progress in improving the reliability and readability of the Financial Report of the United States Government ("Financial Report"). The Financial Report aggregates financial information from individual Federal agencies and reports the financial statements for the Federal government as a whole, including the government-wide balance sheet[5] and the Statement of Social Insurance (SOSI).[6] Because the Financial Report is one of the primary government reports providing information on the long-term fiscal impacts of rising entitlement costs, it is a top priority of OMB and the Treasury Department to ensure the public can both understand and trust the information contained in the Financial Report.

Similar to the "Highlights" documents created by agencies under the PAR pilot, OMB and the Treasury Department issued a summary version of the Financial Report for the first time in FY 2007. *The Government's Financial Health: A Citizen's Guide to the 2007 Financial Report of the United States Government*[7] provides readers an eight-page version of the larger, 182-page Financial Report. The Citizen's Guide is an easy to read overview of the U.S. government's short-term and long-term financial outlook and serves as a reference tool for key data and findings in the Financial Report.

This past year, an important milestone was also achieved regarding the reliability of the information contained in the Financial Report – a clean audit opinion on the SOSI. The SOSI is the first of the six principal financial statements to achieve this milestone. This statement, along with the Fiscal Stewardship discussion, are the Report's primary sources for information on the long-term fiscal impact of Medicare and Social Security costs.

OMB and the Treasury Department are making important progress toward achieving a clean audit opinion on the remaining statements and addressing concerns raised by GAO in its audit of the Financial Report. GAO has identified three critical areas for improvement – eliminating intra-governmental imbalances, improving the process for preparing and consolidating the Financial Report, and working with the Department of Defense to ensure that its net cost of operations and material items on the agency's balance sheet, such as inventory, fund balance with Treasury, and environmental liabilities are reliable and ready for audit. Progress is being

---

[5] The balance sheet is a financial statement that depicts what is owned (assets) and owed (liabilities) by the reporting entity.

[6] The Statement of Social Insurance is a financial statement that depicts the long-term sustainability of social insurance programs by comparing the projected inflows (taxes and other contributions) and outflows (benefit payments) of those programs.

[7] The Citizens Guide to the Financial Report is available at http://www.fms.treas.gov/frsummary/frsummary2007.pdf. A copy of the Citizen's Guide is also attached to this testimony.

made in each of these areas, including OMB's implementation of an intra-governmental "watchlist" where agencies worked together in FY 2007 to resolve more than half of the $24 billion in unreconciled items included on the original watchlist.

Other Initiatives and Focus Areas

Improvements in financial reporting often translate into measurable results in improving the way the government is managed and taxpayer monies are spent. These benefits are most evident in the areas of improper payments, real property, and charge cards. OMB often refers to these as "areas of public trust" as they serve as a critical indicator for citizens to gauge how well the Federal government is acting as a steward of taxpayer dollars.

Reducing Improper Payments

In the four years of reporting under the Improper Payment Information Act of 2002, the Federal government has demonstrated measurable improvements in reducing improper payments. Notably, the error rate for programs first reporting in FY 2004 declined from 4.4 percent to 3.1 percent (a $7.9 billion reduction) in FY 2007 and programs first reporting error rates in FY 2005 and 2006 cut improper payments in half by FY 2007 (a $2.3 billion reduction). To ensure continued success, OMB has proposed a series of legislative reforms that, in total, would generate an estimated $18 billion in error reduction and savings over 10 years. We applaud the Congress for taking the first step toward enacting some of these key reforms by including discretionary funding (above the "cap") for activities with a proven track record of reducing error and generating program savings in the most recent budget resolution. It will be important for Congress to ensure that these activities are funded in the final FY 2009 appropriations bills and that other legislative proposals for reducing error are enacted.

Managing Federal Real Property

In February 2004, the President issued Executive Order (E.O.) 13327, "Federal Real Property Management" to improve oversight of the $1.5 trillion in Federal assets. E.O. 13327 is designed to hold agencies accountable for maintaining their real property portfolios at the right size, right condition and right cost. As of December 2007, agencies had disposed of $7 billion worth of unneeded assets, making significant progress towards meeting the government-wide goal of disposing $15 billion by fiscal year 2015. However, legislative reform is critical if we are to continue to make progress in this area. As I testified before the House Subcommittee on Government Management, Organization, and Procurement in April, we applaud and support Congress' effort to enact real property reform through the introduction of H.R. 5787. This bill would provide a financial incentive for agencies to dispose unneeded assets and provide funding for agencies to invest in repairing and maintaining existing assets, an important step towards addressing the billions in repair backlog as reported by the GAO.

Ensuring Proper Charge Card Use

More than 3.1 million charge cards are in use today across the Federal Government. In FY 2007 alone, more than $27 billion was spent using these charge cards to purchase goods and services, pay for government employee travel and travel-related expenses, and to acquire fuel and maintenance services for government vehicles, aircraft, and other equipment. Overall, the Charge Card Program has resulted in approximately $1.8 billion in annual savings compared to the prior, paper-based, procurement processes. However, a recent GAO report (GAO-08-333) was published highlighting instances of misuse of the Federal charge card. This is a very serious issue that breaches the trust of the taxpayers as well as diminishes the significant benefits that are achieved through the Federal charge card program. OMB is in the process of updating its guidance (Appendix B to Circular No. A-123) to address the GAO findings. However, we believe misuse of the Federal charge card is the exception rather than the rule, and most Federal employees are using government charge cards responsibly.

Looking Ahead

When the CFO Act of 1990 was enacted close to 18 years ago, Congress established three fundamental objectives for Federal financial management:

(1) ***Transparency*** – effective reporting of agency finances to the public, including information on the sustainability of government operations and a user-friendly presentation of the cost effectiveness of government programs.
(2) ***Targeted Internal Controls*** – policies and procedures that mitigate the most significant areas of financial risk in the organization.
(3) ***Decision Support*** – personnel at all levels in the organization with financial information to manage risk and drive better program results.

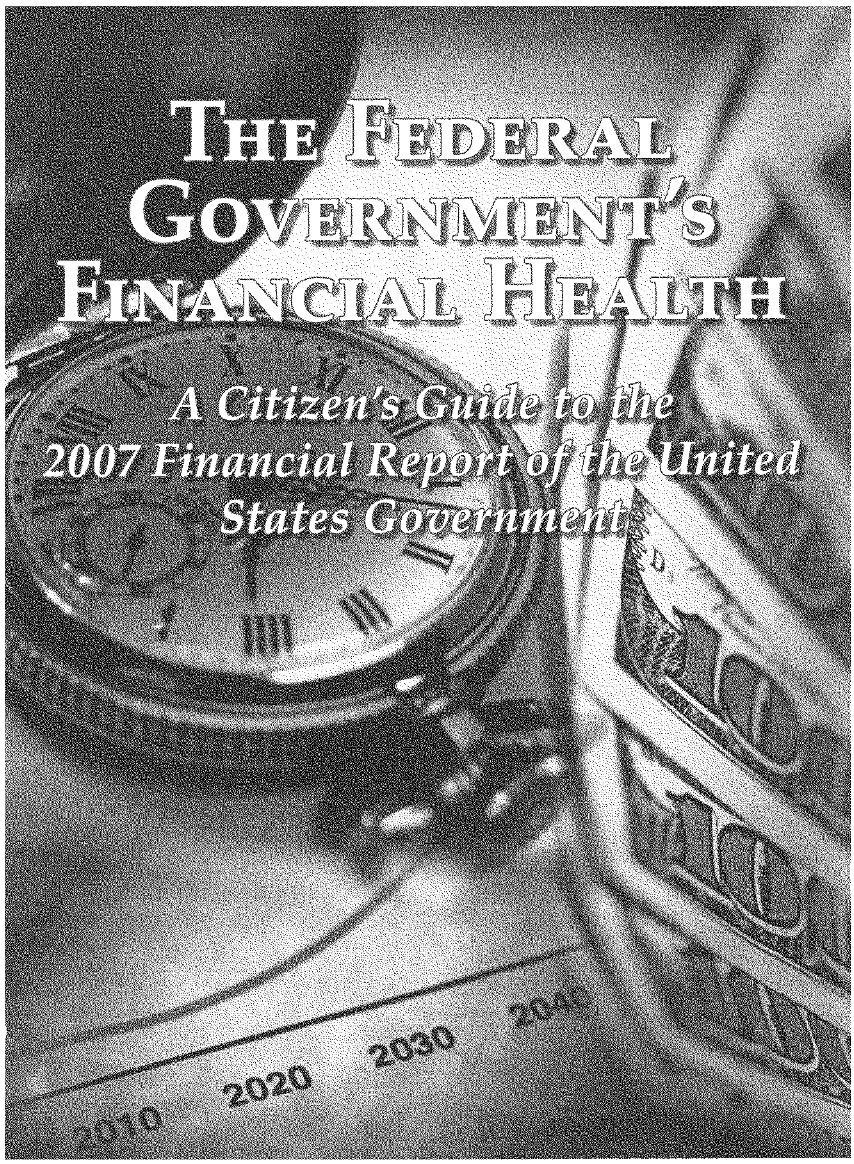
To lay a foundation for these objectives, the Act required Federal agencies to annually publish audited financial statements and established the position of agency CFO to lead these efforts. As exemplified by results achieved in FY 2007, the Federal CFOs have come a long way towards putting this foundation in place. However, much work remains as the Federal financial community moves beyond the fundamentals of audited financial statements to achieving the broader objectives of the Act.

Transparency. In the realm of public reporting, the Citizens Guide and the PAR pilot represent an important first step in improving the readability of our financial reports. In addition, OMB is working with the Treasury Department, GAO, and the Federal Accounting Standards Advisory Board to refine and improve reporting on the impending fiscal challenges brought on by growing entitlement costs. Specifically, a new financial statement for the Financial Report is under development that would expand on current information in the SOSI, providing a comprehensive picture of fiscal sustainability.

Targeted Internal Controls. Through the revisions to the OMB Circular No. A-123, Management's Responsibility for Internal Control and the creation of its Appendix A that is specific to the internal controls over financial reporting, agencies have implemented a more rigorous assessment process and devoted resources to testing and correcting deficiencies in internal control over financial reporting. This process has yielded favorable results within Federal agencies. As we look for additional opportunities to further improve financial management, we plan to explore possibilities for leveraging the Appendix A framework for financial reporting to focus on other significant risk areas (e.g., programmatic, mission, administrative) within Federal agencies and government-wide.

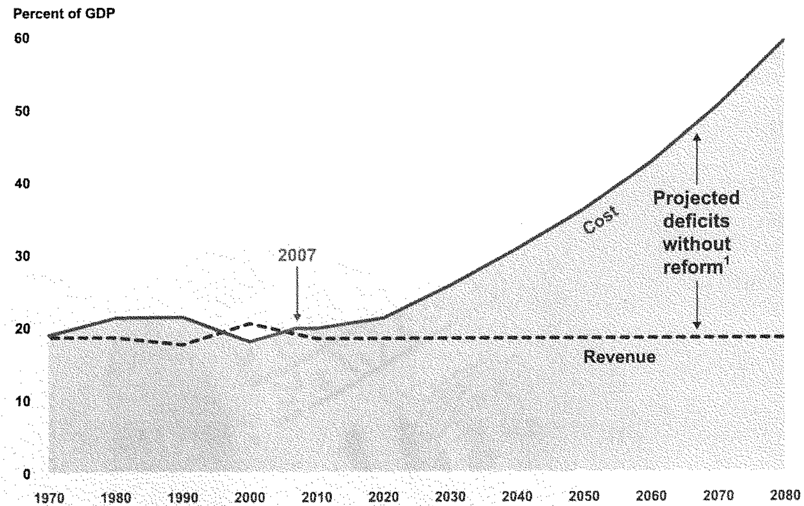
Decision Making. As agencies continue to improve their internal controls to support timely and reliable financial information and report that information in the most transparent and digestible format, we also need to ensure that the financial information is relevant and available to Federal managers for day-to-day decision making. While the private and public sectors continue to debate the utility and format of financial statements, the underlying financial information and fiscal disciplines to produce those statements should remain constant. We need to explore opportunities in this area to ensure that the underlying financial information and fiscal disciplines are sound, appropriate, and flexible to not only produce external financial statements, but to also provide relevant financial information to allow Federal leaders to more efficiently manage the day-to-day operations of the government.

As we approach the 20^{th} anniversary of the CFO Act, it is evident that we have come a long way. But we should not stop here. Every tax dollar is too precious not to make well-informed decisions. We will continue to seek opportunities, look at the tools in place for financial reform, and refine the path we are taking as necessary. We look forward to continuing our partnership with Congress and the Government Accountability Office in pursuing fiscal health by holding agencies accountable, improving financial management, addressing our long-term fiscal challenges, and striving for stronger, smarter, and sustainable accountability.


THE FEDERAL GOVERNMENT'S FINANCIAL HEALTH
A Citizen's Guide to the 2007 Financial Report of the United States Government
2010
2020
2030
2040

The Government Is On An Unsustainable Fiscal Path

Chart 1: The Government Is On An Unsustainable Fiscal Path



Key dates

2007 Medicare Part A benefit payments began to exceed the program's tax revenue.

2017 Social Security benefit payments will begin to exceed the program's tax revenue.

2019 Medicare Part A Trust Fund assets will not be enough to pay full benefits. Under current law, benefits would be reduced to 79 percent of scheduled benefits in 2019, declining to 29 percent by 2081.

2040 Federal debt held by the public will exceed the historical high of 109 percent of GDP.

2041 Social Security Trust Funds' assets will not be enough to pay full benefits. Under current law, benefits for all retirees would be reduced to 75 percent of scheduled benefits in 2041, declining to 70 percent by 2081.

2080 Total government cost will be more than three times revenue.

Notes:

1. Projected deficits represent projected cost in excess of revenue, where revenue as a percent of gross domestic product (GDP) is set equal to its historical average and projected cost is based on scheduled Social Security and Medicare benefits and current cost trends. While the precise amounts of the government's financial responsibilities are far from certain—they are based on many complex calculations and assumptions, including life expectancies and health care cost—their magnitude and the need to control them are evident.

2. The dates and events presented above are taken from the 2007 Annual Reports of the Social Security and Medicare Boards of Trustees and the *2007 Financial Report of the United States Government*.

Overview

This Citizens' Guide (guide) highlights important information in the *2007 Financial Report of the United States Government.*[1] The Secretary of the Treasury, Director of the Office of Management and Budget (OMB), and Comptroller General of the United States believe that the information discussed in this guide is important to all Americans.

While attention has been recently focused on addressing emerging challenges in today's economy, the last 3 years show economic growth and improvement. Revenue went up, deficits went down, and cost stayed fairly constant. But as you can see in chart 1, the government faces a huge fiscal challenge in the years ahead. This year, 2008, is the year in which the first of the approximately 80 million baby boomers—those born between 1946 and 1964—become eligible to draw Social Security benefits. Scheduled Social Security and Medicare benefits together with other federal programs' projected long-term cost are much greater than the resources (revenue and borrowings) available to pay for them.[2] Unless action is taken to bring program cost in line with available resources, the coming surge of entitlement spending will end in a fiscal train wreck that will have an adverse effect on the U.S. economy and on virtually every American.

Where We Are Now

- Strong growth in individual incomes and corporate profits contributed to 4 consecutive years of tax revenue growth—revenue was up by 46 percent since 2003 to $2.6 trillion in 2007.[3] Social Security and Medicare tax withholdings accounted for almost a third of total revenue in 2007.
- Social Security Trust Funds' revenue exceeded what the government paid out in benefits by $186 billion in 2007. This surplus was credited to the Trust Funds.
- The government's total operating cost remained relatively constant—$2.9 trillion in 2006 and in 2007.
- Revenue increases and relative cost stability resulted in a drop in the government's net operating cost—to $276 billion—and a decline in the unified budget deficit (budget deficit)—to $163 billion in 2007.
- To fund cumulative budget deficits, the government has borrowed a total of $5 trillion from the public as of the end of fiscal year 2007. The government has also borrowed excess annual cash flows from the Social Security and Medicare Trust Funds and similar funds to finance other government cost. Including interest, the government owes $4 trillion to these funds, which is backed by the full faith and credit of the government, resulting in total federal debt of $9 trillion.

Where We Are Headed

- As baby boomers retire and health care cost continue to rapidly rise, the cost of the Social Security, Medicare, and Medicaid programs will account for a growing portion of government cost.

---

[1] The administration annually issues two complementary reports on the government's finances. *The Financial Report of the United States Government (Financial Report)*, issued by the Department of the Treasury, analyzes how revenue was spent in the fiscal year on programs and services and discusses the government's resulting financial position. Cost is reported at the time an obligation to pay arises rather than when payments are made. The *President's Budget* is the government's primary tool for financial planning and control. It focuses on taxpayers' dollars the government collects, how it uses them to support programs and services, and whether this use results in a surplus or deficit.

[2] This calculation assumes future government revenue as a percent of GDP is at its average historical rate of about 18 percent, and uses current spending trends to project the cost of federal programs other than Social Security and Medicare.

[3] The government's fiscal year begins October 1 and ends September 30.

- Absent reforms, the Social Security Trust Funds will be exhausted in 2041 and the Medicare Part A Trust Fund will be exhausted in 2019. Revenue dedicated to these entitlement programs under current law will not be enough to pay for scheduled Social Security and Medicare Part A benefits.
- The projected cost of all federal programs will exceed available resources. Unless the government brings program cost in line with available resources, resulting budget deficits will be so large that the government will not be able to borrow enough to fund them.
- Our children and grandchildren will bear a greater burden of the cost if we delay in implementing fundamental reforms.

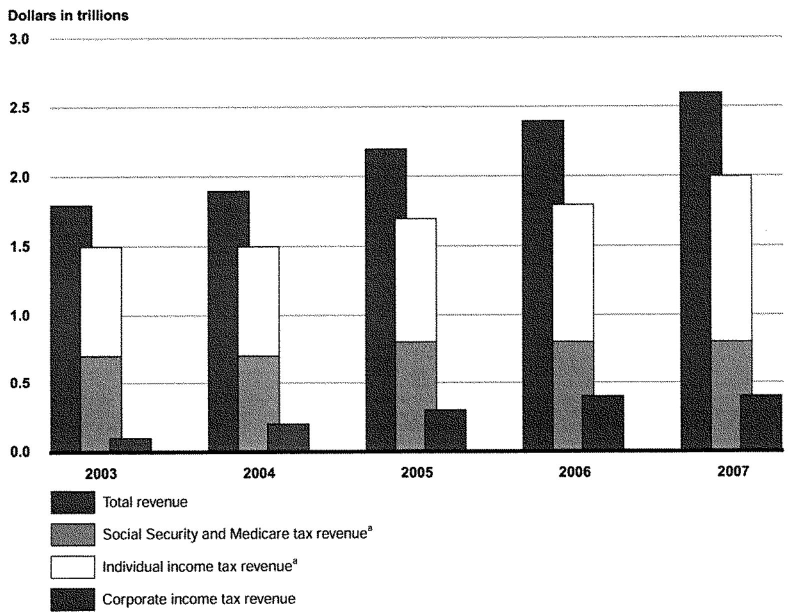
Where We Are Now

What Came In and What Went Out

What came in? In 2007, government revenue totaled $2.6 trillion. What went out? The government's operating cost totaled $2.9 trillion. The "bottom line" net operating cost—the difference between revenue and cost—was $276 billion—a $174 billion decrease from 2006. It is also more than $100 billion greater than the unified budget deficit, as it includes approximately $90 billion in accrued, but as of yet unpaid, post-employment benefits to the millions of people who are part of the government's current and retired civilian and military workforce. The budget deficit is the amount by which the government's spending exceeds its revenue, and thus, is a measure of how much the government has to borrow from the public. The budget deficit decreased $85 billion to $163 billion in 2007.

In 2007, a growing U.S. economy led to record revenue of $2.6 trillion. Chart 2 shows that government revenue increased steadily from 2003 through 2007, largely because of taxes on increasing individual incomes and corporate profits. Social Security tax revenue of $648 billion and Medicare tax revenue of $200 billion accounted for almost a third of total revenue. The recent slowing of U.S. economic growth will have an effect on 2008 revenue.

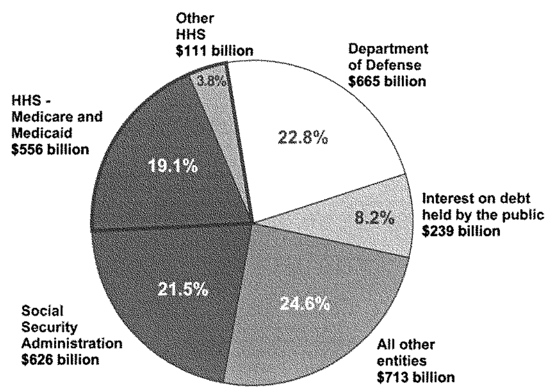
Chart 2: Government Revenue 2003-2007



[a]In the *Financial Report*, Social Security and Medicare tax revenue are combined with individual income tax revenue.

The government's net cost in 2007 was relatively constant compared to 2006. Chart 3 shows that in 2007, the Department of Health and Human Services (HHS), Department of Defense, and Social Security Administration, plus interest on debt held by the public, accounted for approximately three-fourths of the government's total net cost. Medicare cost of $368 billion and Medicaid cost of $188 billion accounted for more than 80 percent of HHS' total net cost in 2007.[4]

Chart 3: Government Net Cost 2007



The Debt

The government incurs debt when it borrows from the public to fund its budget deficits. The government also incurs debt when government funds invest their excess receipts in government securities. Of the government's total debt of about $9 trillion at the end of 2007, approximately $5 trillion was debt held by the public in the form of Treasury securities, such as bills, notes, and bonds. The public includes individuals, corporations, state and local governments, Federal Reserve Banks, and foreign governments.

The balance of the debt—nearly $4 trillion—was intragovernmental debt. This represents debt held by government funds, including the Social Security ($2.2 trillion) and Medicare ($359 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. If expected budget deficits continue, as the government funds redeem the federal securities to pay for benefits or other program cost, then additional borrowing from the public will likely be required.

[4]Medicare cost is net of related premium revenue.

Where We Are Headed

An Unsustainable Fiscal Path

The projected growth in spending for Social Security and Medicare benefits affects every citizen in the nation.[5] Scheduled benefits under these programs are expected to exceed dedicated revenue (e.g., payroll taxes and premiums) by more than $40 trillion (present value) over the next 75 years, under current laws and policy.[6] The fiscal imbalance is even larger looking beyond 75 years.[7] Moreover, without reform

- In **2007**, Medicare Part A benefit payments began to exceed the program's tax revenue.
- In **2011**, the Medicare Part A Trust Fund begins to decline as benefits exceed payroll taxes and trust fund interest.
- In **2017**, Social Security benefit payments will begin to exceed the program's tax revenue.
- In **2019**, Medicare Part A Trust Fund assets will not be enough to pay full benefits. Under current law, benefits would be reduced to 79 percent of scheduled benefits in 2019, declining to 29 percent by 2081.
- In **2027**, Social Security Trust Funds begin to decline as benefits exceed tax revenue and trust fund interest.
- In **2040**, federal debt held by the public will exceed the historical high of 109 percent of GDP.
- In **2041**, Social Security Trust Funds' assets will not be enough to pay full benefits. Under current law, benefits for all retirees would be reduced to 75 percent of scheduled benefits in 2041, declining to 70 percent by 2081.
- In **2080**, total government cost will be more than three times revenue.

[5]The dates and events described in this section are taken from the 2007 Annual Reports of the Social Security and Medicare Boards of Trustees and the *2007 Financial Report*.

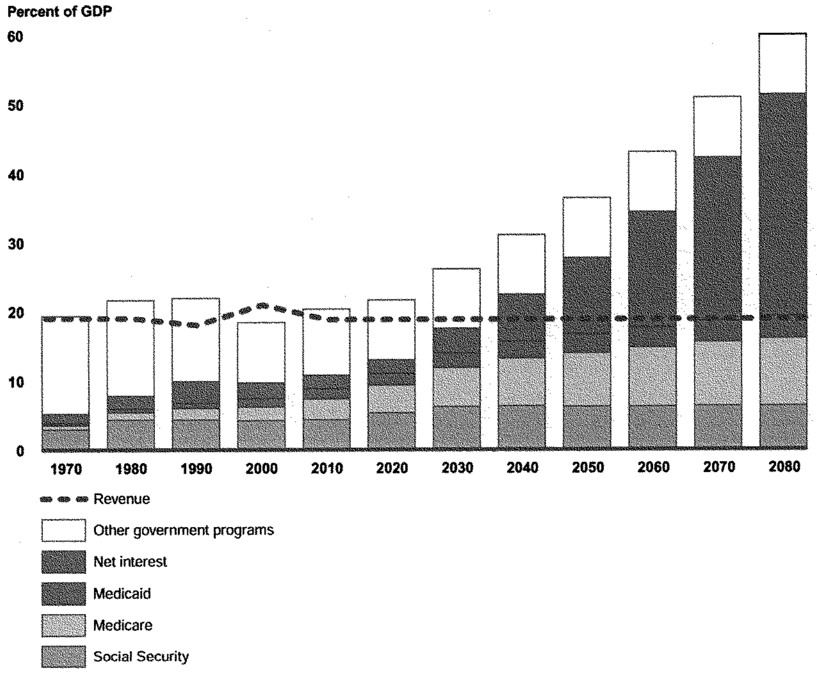
[6]This estimate, included in the fiscal year 2007 Statement of Social Insurance, may be found in the *2007 Financial Report*.

[7]The 75-year horizon includes the revenue from people working in the latter part of the 75-year period but not the associated benefits that will be paid when these same people retire after the end of the 75 years.

Fundamental Reforms Are Needed Now

Chart 4 shows government revenue and spending as a percent of GDP from 1970 through 2080.[8] Since World War II, federal revenue as a share of GDP has been roughly constant at around 18 percent.[9] Whenever taxes rose, policy actions tended to pull them back.

Chart 4: Government Revenue and Cost 1970-2080



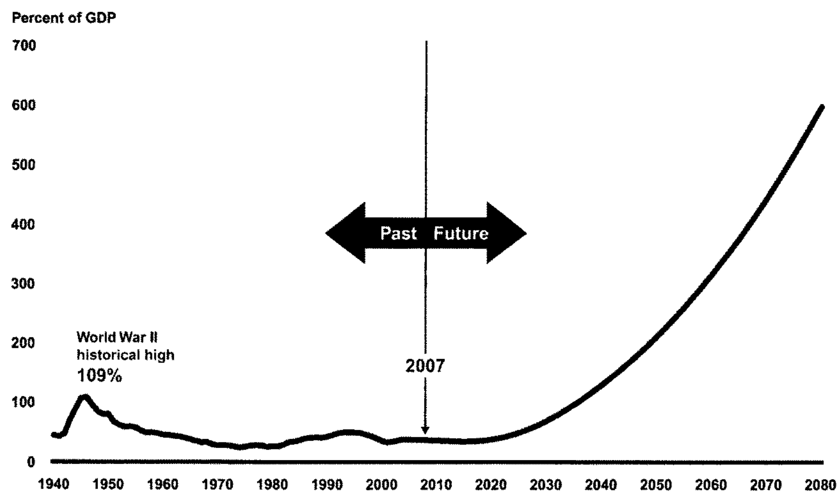
If revenue is held constant at about 18 percent of GDP (the historical average level), government spending will eventually exceed the government's ability to pay. By 2070, total government cost is projected to be 50 percent of GDP mainly because of mounting interest cost. Cost-to-GDP ratios have not been this high since World War II, when cost briefly reached 44 percent of GDP. By 2080, cost reaches nearly 60 percent of GDP, more than three times the average historical level of revenue as a percent of GDP. The dates and numbers would change with different forecasting assumptions, but under a wide range of reasonable projections, the increases in budget deficits will be dramatic.

[8]Projected spending is based on scheduled Social Security and Medicare benefits and current spending trends. Revenue as a percent of GDP from 2010 to 2080 is assumed to equal its historical average.

[9]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 the nation produces in a given period. The projection that the government's revenue as a percent of GDP will remain relatively constant is based on historical data and trends that are not expected to change.

Chart 5 shows the extreme effect on the debt of projected budget deficits indicated in chart 4. These combined trends will cause government debt levels to more than triple by 2040 and to more than double again by 2060. The nation's debt could approach 600 percent of GDP by 2080. This far exceeds the historical high of 109 percent of GDP that occurred during World War II.

Chart 5: Federal Debt Held by the Public 1940-2080



The nation must change course before the deficit and debt reach unprecedented heights. The government must bring program cost in line with available resources. Delays in taking this action will increase the magnitude of the reforms needed and will place more of the burden on our children and grandchildren.

While the precise amounts of the government's financial responsibilities are far from certain—they are based on many complex calculations and assumptions, including life expectancies and health care cost—their magnitude and the need to control them are evident.

Looking Ahead

In the *2007 Financial Report*, the Secretary of the Treasury indicates that the nation must look to the future, particularly the spending demands of Social Security and Medicare, and squarely face the need for fundamental reform if these programs are to be sustained. The government must strive to make all disclosures transparent, provide all points of view with relevant data, and expand financial and fiscal reporting in order to explain why estimates of future Social Security and Medicare costs increase year after year.

The issues discussed in this guide 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.

Finding 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 *2007 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/fy2007financialreport.html.

This guide can be obtained on-line at the above Web sites.

This Citizens' Guide highlights information in the *2007 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 159 of the *Financial Report*. For 2007, for the first time, GAO issued an unqualified or "clean" opinion on the Statement 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.

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

Embargoed Until 2:30 a.m. (EDT), June 26, 2008
Contact Jennifer Zuccarelli, (202) 622-2960

FISCAL ASSISTANT SECRETARY KENNETH E. CARFINE TESTIMONY BEFORE THE SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY

WASHINGTON – Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me to this hearing to discuss the Financial Report of the United States Government (Financial Report) for Fiscal Year 2007. Your interest in improving Federal financial management and, in particular, fiscal sustainability is appreciated. The Financial Report, incorporating the consolidated government-wide financial statements, is designed to report on the financial position and condition of the federal government pursuant to generally accepted accounting principles (GAAP).

The Financial Report reflects Treasury's long-standing responsibility to provide the Congress and the public with timely, reliable, and useful information on the cost of the government's operations, the sources used to fund them, and the implications of the government's financial commitments. It is designed to encompass and does substantially cover the financial results of all three branches of the federal government. Treasury constantly strives to improve the utility and value of the Report as well as the process by which it is produced.

This year, all 24 CFO Act agencies published their audited financial statements by November 15, and we issued the government-wide Report approximately a month later on December 17. These timely submissions are evidence that both the Federal agencies and Treasury continue to improve their systems and processes. As I will discuss, these improvements notwithstanding, due to long-standing material weaknesses, the Government Accountability Office again issued a disclaimer of opinion on most of the statements in the Financial Report. However, this year's report brings with it two significant achievements: 1) an unqualified audit opinion on the Statement of Social Insurance and 2) the issuance of a Citizen's Guide to the Report.

Highlights from the Financial Report

As Treasury and OMB reported in October, for Fiscal Year 2007, revenues increased to a record level of $2.6 trillion—an 8 percent increase over the previous fiscal year. Consequently, the 2007 federal net operating cost of $276 billion was better than anticipated and was a significant improvement over the 2006 net operating cost of $450 billion.
The Government's balance sheet shows that its liabilities exceed its assets by more than $9 trillion dollars. Much of this difference is attributed to: 1) the government's debt to the public of more than $5 trillion and 2) another nearly $5 trillion in anticipated federal employee and veterans postemployment benefits and commitments for which funding (i.e., employee and employer contributions) has not yet been obtained. The Statement of Net Cost presents cost by agency.

Because the Budget Deficit is such a well-publicized and generally-accepted figure, we provide two statements that facilitate the comparison and reconciliation of the government's activity. The Reconciliation of Net Operating Cost and the Unified Budget Deficit statement ties the more widely recognized budget results (e.g., $163 billion unified budget deficit) to the government's net operating cost of $276 billion.

The budget deficit and net operating cost differ because the government uses a different basis of accounting for each. The budget is prepared generally on a cash basis, which more appropriately pertains to the inflow and outflow of funds during the fiscal year, regardless of the amount or nature of the transaction. By comparison, the government's audited financial statements are prepared generally on the accrual basis pursuant to GAAP promulgated by the Federal Accounting Standards Advisory Board. Accrual accounting recognizes revenues when earned—not necessarily collected; and expenses when incurred—not necessarily expended. The bulk of this difference is due to the inclusion of actuarial increases in both federal employee pension and health liabilities, and environmental liabilities in net operating cost, but not in the budget deficit.

The Report also contains a Statement of Social Insurance (SOSI), which shows the present value cost of the government's exposures of its social insurance programs, primarily Social Security and Medicare. As indicated earlier, the SOSI became the first and, to date, the only government-wide financial statement to receive an unqualified audit opinion from the Government Accountability Office (GAO).

The FY 2007 Report adds new information related to fiscal sustainability. It provides a discussion of the extent to which the government will be able to financially support its critical programs in the near and distant future. This discussion is largely based on the information contained in the SOSI as well as the government's stewardship report (which is drawn from the Social Security and Medicare Trustees Reports).

Regarding the Social Security program, an important milestone was reached this year when the first baby boomers began drawing retirement benefits from Social Security. The retirement of the baby boom generation will have a profound impact on the finances of Social Security and Medicare. There are currently 3.3 covered workers per Social Security beneficiary; that number will fall to 2.1 by 2034. Medicare faces the same demographic challenges as Social Security, but

additionally must cope with the rapid expected growth in health care costs. While Social Security expenditures are expected to grow considerably over the next 75 years, from 4.3 percent of GDP in 2007 to 6.3 percent of GDP in 2081, Medicare's expenditure growth is expected to increase from 3.2 percent of GDP in 2007 to 11.3 percent of GDP in 2081.
From a government-wide perspective, Medicare obligations are expected to dwarf those of Social Security. The 75-year present value of projected Medicare expenditures less tax and premium revenue is $34 trillion (4.7 percent of the present value of GDP), rising to $36 trillion in the 2008 report, while the 75-year present value of projected Social Security expenditures less tax revenue is $4.7 trillion (0.6 percent of GDP).

The Financial Report shows that the Federal Government's current policies, particularly with respect to Social Security and Medicare, are unlikely to be sustainable. Total expenditures, including interest, are expected to grow to 50 percent of GDP by 2070 and 60 percent by 2080. Such spending levels have only been witnessed once before—during World War II, when Government expenditures reached a then-record high of 44 percent of GDP. If revenues in the future continue at the historical average level of 18 percent of GDP, they will barely cover 1/3 of total government expenditures and would not be sufficient to cover the net interest on the Government's debt.

The consequence of the projected growing gap between revenues and expenditures would be a rapidly-increasing debt-to-GDP ratio. By 2030, the need to fund government deficits will drive the debt-to-GDP ratio to 68 percent—far surpassing the non-wartime peak of 49 percent in 1993. By 2040, this ratio is projected to reach 128 percent, well above the World War II peak of 109 percent. Thereafter, the ratio of debt held by the public to GDP rises sharply to 300 percent by 2060, doubling again to 600 percent by 2080. A rapidly rising debt-to-GDP ratio creates uncertainty over the form of future government financing, portends adverse long-run consequences for the economy and could impact other countries' willingness to lend money to or invest in the United States.

As noted earlier, these are merely projections based on a myriad of assumptions that can change and alter the outlook. Yet, the projections provide an important signal about the difficulties that the Government faces in attempting to sustain current policies. The Government can neither reasonably grow into nor tax its way back to sustainability. Nor can it realistically expect to continue to borrow without incurring a substantial negative impact on the economy. Avoiding the consequences of this fiscal path will require actions to bring program expenditures in line with available resources. How soon those actions are taken will greatly influence their ultimate impact on the Nation.

Addressing the Auditor's Findings

For Fiscal Year 2007, GAO was unable to express an opinion on the financial statements, due to long-standing material weaknesses. I recognize that until our financial statements can withstand audit scrutiny, we will not benefit from the Report's full value in informing the Congress and the Public about the Government's fiscal position and condition.

We agree with GAO on the following three principal material weaknesses:

1. Serious financial management control issues at the Department of Defense,
2. The government's inability to properly eliminate transactions between agencies, and
3. The government's deficiencies in the process for preparing the consolidated financial statements.

GAO raised many valid points in its audit, and there is no one more than I who would like to see a "clean" audit opinion on the consolidated financial statements. Across government, we have been addressing the weaknesses relating to the elimination of intragovernmental balances and the report preparation process, and are making progress.

We concur with GAO that the out-of-balance condition, resulting from intragovernmental transactions, continues to represent a significant material weakness. This occurs when two agencies conducting business with each other as trading partners record and report the same transaction differently. We are addressing this issue in several ways:

- We have started requiring significantly greater detail from the agencies. In addition, we have developed tools to track the imbalances, identify the problems, analyze the data, and implement solutions. We have also formed inter-agency groups to examine each pair of related transactions to resolve the imbalances.

- Partnering with OMB, we developed a method and vehicle to report these inter-agency transactions throughout the government. Agencies use these reports, which are posted on the Web, to analyze their transactions and balances. We have also worked with OMB to develop a "watch list" of agencies with the largest intragovernmental differences.

- We worked with the CFO Council to develop new intragovernmental transaction "business rules," which are helping to bring about more consistent accounting among business partners. Finally, we require agency auditors to review the intragovernmental balances in the hope that greater auditor involvement will encourage agencies to accurately record these transactions and correct the imbalances.

These and other actions have reduced the differences in reporting intragovernmental transactions from $86 billion in FY 2006 to approximately $67 billion in FY 2007.

We continue to address the report preparation issues by developing and following corrective action plans, which include strategies for short-term and long-term solutions. At the beginning of this fiscal year, there were 81 outstanding recommendations from GAO for improving the internal controls over the report preparation process. This year, we closed out 35 recommendations relating to prior year's reports. Based on the audit of the 2007 report, GAO identified an additional 10 recommendations for improving the report preparation process bringing the current total recommendations to be resolved to 56. Our plan is to resolve 8 of the 10 new recommendations by the end of the fiscal year and continue to aggressively address the 46 prior years' findings and recommendations.

We have strengthened our report preparation processes, by enhancing our data collection systems to meet disclosure requirements prescribed by generally accepted accounting principles. We have also focused our attention and resources on improving and fully documenting our standard operating procedures to increase the efficiency and effectiveness of our processes. Additionally, we have continued to enhance and clarify our guidance to federal program agencies for accurate and complete information and to ensure consistency of agency information for the Financial Report.

The Federal Government's Financial Health: A Citizen's Guide

A common critique of the Financial Report of the U.S. Government is that, despite the fact that it contains more than 180 pages of detailed information on the government's financial position and condition, it is not a practical document for communicating with the American citizen or the Congress. At a minimum, the Report should provide an opportunity for all interested parties to easily gain an understanding of the significant fiscal challenges that the federal government faces now and in the future. In 2005, the Treasury Department consulted with a number of communication and accountability reporting experts (including some international colleagues) to identify ways to improve the Report's informative value and, more importantly, its ability to communicate with the general public.

In response, for the first time, the Treasury Department and OMB, in cooperation with GAO developed and issued a summary report entitled, The Government's Financial Health—A Citizen's Guide to the Financial Report of the U.S. Government. This Guide provides a summary of the key data and issues addressed in the full report in a "user-friendly" manner to the general public. We attempted to minimize the use of detailed technical and political jargon to make it easy to read. We have made a point of sharing this document not only with members of Congress, but also educational institutions around the country and in public professional forums. The document is eight pages in length and while printing was limited, it is freely accessible on the Internet. We have received valuable feedback, thus far, and are looking forward to improving on the Guide in subsequent editions.

As the primary investors in our country, U.S. citizens are entitled to, and our government is obligated to provide, up-to-date financial performance results about the government's current and future financial health. It is our hope that this document is the first of many of its kind—and that it sparks interest not only among committee members but the general public and encourages continued discussion of these important issues.

Outlook for Financial Reporting

I am committed to working with OMB and the Chief Financial Officers Council on developing the government's financial management strategy for the near future. The improvements in financial systems and business processes that many agencies have made as a result of audited financial statements and accelerated timelines has led to better underlying financial data. We are now looking toward improving efficiency through standard systems and processes and a common language and structure for exchanging information and financial data among agencies and between agencies and Treasury.

Conclusion

The process of producing the Financial Report of the U.S. Government and annual agency financial reports and the reports themselves can have an impact on improving management and control of the government's finances. However, these reports are of limited or even minimal value if they go unread. As such, in addition to continuing to pursue resolution of the Government's financial reporting weaknesses, this year, the Treasury focused on how to make the document and the information that it contains more relevant and useful to the general public. We believe that the Citizen's Guide is a solid first step and hope that its visibility will inspire the public to ask questions about the government's and our own financial future.

Thank you, Mr. Chairman. This concludes my formal remarks. I look forward to your questions.

Senate Governmental Affairs Subcommittee on Financial Management
June 26, 2008
By: Hon. David M. Walker
President and CEO, Peter G. Peterson Foundation,
and Former U.S. Comptroller General

Dear Chairman Carper, Dr. Coburn and Members of the Subcommittee, I appreciate the opportunity to appear before you again – this time as a private citizen and as the President and CEO of the newly established Peter G. Peterson Foundation. As you know, I've changed my position on the battlefield for America's future. However, in my new position, I'm still very much concerned about our nation's financial condition, fiscal outlook and the other serious sustainability challenges we face.

My statement includes comments on four key issues: 1) the progress made in connection with the Fiscal 2007 Consolidated Financial Report and the future outlook; 2) the Foundation's new citizen's guide to "The State of the Union's Finances"; 3) the need for selected reforms and a fiscal future commission; and, 4) some of the Foundation's plans for the future.

Before I address our fiscal challenge, I will briefly touch on the results of the fiscal 2007 financial report and audit. As you know, I signed the report in my capacity as Comptroller General of the United States and head of the U.S. Government Accountability Office (GAO). Fiscal 2007 was noteworthy for at least two reasons. First, GAO was able to express an opinion on the Statement of Social Insurance. This statement includes the largest numbers in the federal government's financial report. Second, the Treasury Department issued the first Summary Annual Report for the U.S. Government. Special thanks go to Treasury Secretary Paulson, Treasury Undersecretary Steele and GAO Chief Accountant Bob Dacey in this regard.

While the above represent noteworthy accomplishments, it is unlikely that significant additional progress will be made in the near future. In fact, the Department of Defense (DoD) recently revised their estimated timeframe for achieving an opinion of the Defense Department's consolidated financial statements until 2017. In my view, this is too far out to be acceptable. As you know, my term as Comptroller General was set to end in October of 2013.

With regard to the Defense Department audit, in my view, the GAO should ultimately assume responsibility for the DoD audit. They will need to partner with the Defense Department's Inspector General and make extensive use of contractor support from one or more CPA firms to do so. They will also need additional resources which should be funded by DoD with the cooperation and consent of the Congress.

Now back to the bigger picture, just two days ago, the Foundation issued a publication entitled "The State of The Union's Finances". This citizen's guide provides a clear and compelling picture of our nation's true financial condition and longer-range fiscal outlook. Every member of the Congress, all Cabinet members, and each of the major Presidential candidates will be provided with a printed version of the Guide. It is also available electronically online at www.pgpf.org.

While the graphics and tables in the Guide look nice visually, they present an ugly picture fiscally. As the cover graphic depicts, based on historical tax levels and absent meaningful entitlement, spending and tax reforms, the United States will face debt burdens in the future that would make a third-world nation look thrifty. Furthermore, our related debt/GDP ratios escalate dramatically after the 2040 date shown in the graphic because we will have passed a tipping point by then. Furthermore, as one table in the guide notes, we are currently in a $53 trillion fiscal hole. This hole gets deeper by $2-$3 trillion a year on autopilot. We need to stop digging and start figuring how we are going to start climbing out of it. The time for merely saying how one will pay for new spending increases or tax cuts is over.

What do we need to do? First, as I have testified before, we need to provide more transparency in connection with our current accounting and budgeting systems. For example, steps need to be taken to provide a fuller and fairer disclosure of where we stand financially and where we are headed fiscally. The Congress needs to consider the affordability and sustainability of major entitlement, spending and tax proposals over the longer term before they are passed into law. Congress must never allow what happened in connection with the Medicare prescription drug bill to happen again.

Federal financial reporting should, among other things, place more emphasis on fiscal sustainability and inter-generational equity. In addition, a Summary Annual Report should be issued every year. Furthermore, a longer-range Fiscal Sustainability Report should be issued by our federal government every four years, as is the case in several other industrialized nations. I have included in Appendix I of my testimony a summary of the types of reforms I advocated as Comptroller General of the United States. My views of these issues have not changed just because I'm in a new position. These reforms need to be aggressively pursued and acted upon.

In addition to the above steps, we need to re-impose tough statutory budget controls on both the spending and tax side of the federal ledger. After all, both sides of the books contribute to our nation's bottom line. Unfortunately, as we have seen in recent years, Washington still has not learned the first rule of holes: "When you're in a hole, stop digging." This must change, and the sooner the better.

In my view, the regular order for legislation is not adequate to deal with the number and magnitude of the reform efforts we must undertake if we expect to return to a more prudent and sustainable fiscal path. As a result, I support the need to establish a capable, credible and bipartisan commission to address at least four issues: statutory budget controls, comprehensive Social Security reform, and round one of comprehensive tax and health care reform. The SAFE Commission Act that is co-sponsored by Congressmen Cooper and Wolf in the House is intended to do just that. Similar proposals have been discussed by Senators Conrad, Gregg, Voinovich and others. In my view, if properly structured and staffed, such a commission could make at least a $10-$15 trillion down payment on our $53 trillion federal fiscal imbalance. This would be a significant accomplishment toward addressing our nation's financial challenge, as well as a positive step that would help improve both the confidence in and the credibility of the Congress in the eyes of the American people.

I believe that such a commission will likely be necessary in order to achieve timely action in connection with several of the major reform efforts that lie ahead. At the same time, we need to more proposals from individual members of the Congress and major Presidential candidates to help increase public awareness and stir debate.

We must keep in mind that, while Washington is a "lag indicator", gridlock in Washington is not good when we face a range of serious sustainability challenges that grow with the passage of time. The truth is that there are a number of very disturbing parallels between the factors that contributed to our recent mortgage-related sub-prime crisis and our nation's federal finances. These parallels have gone largely unnoticed. However, absent meaningful and timely action, we are likely to see an economic crisis that will make the current sub-prime challenge look like a bump in the road.

The parallels between the mortgage related sub-prime crisis and our federal financial sub-prime challenge include: 1) a disconnect between the parties who benefit from current practices and those who bear the risk; 2) a lack of adequate transparency and understanding regarding the nature and magnitude of related risks; 3) a re-enforcement of the importance of maintaining lender confidence and adequate cash flow as well as the limitations of credit ratings, and; 4) an illustration of what can happen when there is a lack of effective oversight and action to address large, known and increasing risks before a crisis occurs. These parallels are real. What is Washington waiting for?

Given the importance of our sustainability challenges, we at the Foundation believe it is important to find new ways to communicate the various sustainability challenges we face as a nation. We also believe that in this great nation, it is "We the People" who are responsible for what does or does not happen in capitals around the country. At the same time, the people cannot be expected to act if they don't have the facts, haven't been told the truth, or don't understand the consequences of failing to act.

As a result, in addition to publishing the new citizen's guide, the Foundation has decided to support the distribution of a feature documentary entitled I.O.U.S.A. This film addresses four key deficits facing America -- our budget, savings, balance of payments/trade and leadership deficits. It also highlights the efforts of the Fiscal Wake-up Tour in which representatives of the Concord Coalition, the Brookings Institution, the Heritage Foundation and I continue to participate. This film will be released in August in selected cities around the country, including the Washington, D.C. area. However, we believe that the film's message is so important, the Foundation has decided to hold a private showing of the film for members of Congress and selected other invitees on the evening of Wednesday, July 9 at the Library of Congress. I hope that all of you will be able to attend and that you will encourage your colleagues to do so.

Mr. Chairman, I have a DVD that includes a two-minute promotional trailer of the film you have kindly authorized me to show. Before I do, thank you again for the opportunity to testify. I look forward to answering any questions that you or the other members of the Committee may have.

Appendix: Transparency in Accounting and Budgeting

Appendix. GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls are Needed (Appendix I)*, Statement of David M. Walker, Former Comptroller General of the United States, GAO-07-1144T (Washington, DC: July 25, 2007)

Appendix I:
Transparency in Accounting and Budgeting: Legislative Recommendations of the Comptroller General

Supplemental Reporting in the President's Annual Budget Submission

- Produce as supporting information to the budget an annual Statement of Fiscal Exposures, including:
  - a concise list, dollar estimates, and descriptions of exposures, including—
  - information from Consolidated Financial Statements of the U.S. Government on total liabilities, contingencies, commitments, and net present value of social insurance program payments, and
  - long-term cost (> 40 years) of major tax expenditures, presented together with related spending or credit programs in the same policy area , if appropriate
  - dollar estimate of the effect on these exposures of all major spending or tax proposals
  - an assessment of methodologies and data used to produce such cost estimates
  - a graphic presentation of the dollar amounts of exposures presented as percentage of GDP for each year covered
  - Budget horizon expanded to cover 10 fiscal years
  - President shall include in the budget a statement of the President's budgetary goals for a 10-year period in terms of surplus or deficit and in terms of surplus or deficit as a percentage of GDP

Summary Financial Report for the General Public

- Pursuant to OMB form and content guidance, Treasury shall annually publish a summary financial report on the U.S. Government derived from the information in the audited annual Consolidated Financial Statements of the U.S. Government.
  - Report shall be in format and of length, content and sophistication for general American public
  - Report shall include condensed summary of CG's audit report on the CFS
- First annual report due no later than January 30, 2008 [Note: This requires an amendment to GMRA (31 USC 331(e)(1)) to make audited CFS due by January 15 each year and an amendment to the Accountability for Tax Dollars Act (31 USC 3515(a)) to make agency financial statements due by November 30 each year.]

Statement of Fiscal Sustainability

- Pursuant to OMB form and content guidance, Treasury to prepare and make public every four years an assessment of the long-term sustainability of all major federal programs and activities. Statement of Fiscal Sustainability shall include:

- PV of projected receipts and outlays of federal programs and activities for 75-year and infinite horizons, including separate reporting for social insurance programs
- Statement of annual cash flows for programs and activities
- Reconciliation of changes from prior period Statement
- Presentation of information using different measures of sustainability and estimates of financial burden on different age cohorts and other demographics
- Explanation of assumptions used and sensitivity analyses
- First Statement of Fiscal Sustainability due no later than March 31, 2008

Additional Cost Information on Legislative Proposals before Adoption

- Before a Member of the House or Senate calls up for consideration on the floor of either House a bill or joint resolution or an amendment thereto that contains a proposal that would result in a significant increase or decrease in revenues or in mandatory spending, that Member shall obtain from CBO a statement of the long-term costs of such bill, joint resolution, or amendment.
  - CBO and Budget committees to jointly define "significant" for each Congress
  - "Long-term costs" are those financial costs over at least a 40-year period
- The statement from CBO shall be provided to the Members of either House, as applicable, and shall be published in the Congressional Record

GAO Report on the Financial Condition of the U.S. Government

- The Comptroller General shall annually report to the Congress his assessment of the financial condition of the U.S. Government. Report shall include analyses of—
  - the Consolidated Financial Statement (CFS) and the Summary Financial Report
  - results of GAO's latest long-term fiscal simulations
  - the President's Statement of Fiscal Exposures
  - the adequacy of information regarding long-term cost implications of existing and proposed policies
  - the Statement of Fiscal Sustainability
  - statutorily-required CBO and JCT reports for the prior fiscal year
- First annual report due no later than January 31, 2009

Senate Governmental Affairs Subcommittee on Financial Management
June 26, 2008
By: Hon. David M. Walker
President and CEO, Peter G. Peterson Foundation,
and Former U.S. Comptroller General

Dear Chairman Carper, Dr. Coburn and Members of the Subcommittee, I appreciate the opportunity to appear before you again – this time as a private citizen and as the President and CEO of the newly established Peter G. Peterson Foundation. As you know, I've changed my position on the battlefield for America's future. However, in my new position, I'm still very much concerned about our nation's financial condition, fiscal outlook and the other serious sustainability challenges we face.

My statement includes comments on four key issues: 1) the progress made in connection with the Fiscal 2007 Consolidated Financial Report and the future outlook; 2) the Foundation's new citizen's guide to "The State of the Union's Finances"; 3) the need for selected reforms and a fiscal future commission; and, 4) some of the Foundation's plans for the future.

Before I address our fiscal challenge, I will briefly touch on the results of the fiscal 2007 financial report and audit. As you know, I signed the report in my capacity as Comptroller General of the United States and head of the U.S. Government Accountability Office (GAO). Fiscal 2007 was noteworthy for at least two reasons. First, GAO was able to express an opinion on the Statement of Social Insurance. This statement includes the largest numbers in the federal government's financial report. Second, the Treasury Department issued the first Summary Annual Report for the U.S. Government. Special thanks go to Treasury Secretary Paulson, Treasury Undersecretary Steele and GAO Chief Accountant Bob Dacey in this regard.

While the above represent noteworthy accomplishments, it is unlikely that significant additional progress will be made in the near future. In fact, the Department of Defense (DoD) recently revised their estimated timeframe for achieving an opinion of the Defense Department's consolidated financial statements until 2017. In my view, this is too far out to be acceptable. As you know, my term as Comptroller General was set to end in October of 2013.

With regard to the Defense Department audit, in my view, the GAO should ultimately assume responsibility for the DoD audit. They will need to partner with the Defense Department's Inspector General and make extensive use of contractor support from one or more CPA firms to do so. They will also need additional resources which should be funded by DoD with the cooperation and consent of the Congress.

Now back to the bigger picture, just two days ago, the Foundation issued a publication entitled "The State of The Union's Finances". This citizen's guide provides a clear and compelling picture of our nation's true financial condition and longer-range fiscal outlook. Every member of the Congress, all Cabinet members, and each of the major Presidential candidates will be provided with a printed version of the Guide. It is also available electronically online at www.pgpf.org.

While the graphics and tables in the Guide look nice visually, they present an ugly picture fiscally. As the cover graphic depicts, based on historical tax levels and absent meaningful entitlement, spending and tax reforms, the United States will face debt burdens in the future that would make a third-world nation look thrifty. Furthermore, our related debt/GDP ratios escalate dramatically after the 2040 date shown in the graphic because we will have passed a tipping point by then. Furthermore, as one table in the guide notes, we are currently in a $53 trillion fiscal hole. This hole gets deeper by $2-$3 trillion a year on autopilot. We need to stop digging and start figuring how we are going to start climbing out of it. The time for merely saying how one will pay for new spending increases or tax cuts is over.

What do we need to do? First, as I have testified before, we need to provide more transparency in connection with our current accounting and budgeting systems. For example, steps need to be taken to provide a fuller and fairer disclosure of where we stand financially and where we are headed fiscally. The Congress needs to consider the affordability and sustainability of major entitlement, spending and tax proposals over the longer term before they are passed into law. Congress must never allow what happened in connection with the Medicare prescription drug bill to happen again.

Federal financial reporting should, among other things, place more emphasis on fiscal sustainability and inter-generational equity. In addition, a Summary Annual Report should be issued every year. Furthermore, a longer-range Fiscal Sustainability Report should be issued by our federal government every four years, as is the case in several other industrialized nations. I have included in Appendix I of my testimony a summary of the types of reforms I advocated as Comptroller General of the United States. My views of these issues have not changed just because I'm in a new position. These reforms need to be aggressively pursued and acted upon.

In addition to the above steps, we need to re-impose tough statutory budget controls on both the spending and tax side of the federal ledger. After all, both sides of the books contribute to our nation's bottom line. Unfortunately, as we have seen in recent years, Washington still has not learned the first rule of holes: "When you're in a hole, stop digging." This must change, and the sooner the better.

In my view, the regular order for legislation is not adequate to deal with the number and magnitude of the reform efforts we must undertake if we expect to return to a more prudent and sustainable fiscal path. As a result, I support the need to establish a capable, credible and bipartisan commission to address at least four issues: statutory budget controls, comprehensive Social Security reform, and round one of comprehensive tax and health care reform. The SAFE Commission Act that is co-sponsored by Congressmen Cooper and Wolf in the House is intended to do just that. Similar proposals have been discussed by Senators Conrad, Gregg, Voinovich and others. In my view, if properly structured and staffed, such a commission could make at least a $10-$15 trillion down payment on our $53 trillion federal fiscal imbalance. This would be a significant accomplishment toward addressing our nation's financial challenge, as well as a positive step that would help improve both the confidence in and the credibility of the Congress in the eyes of the American people.

I believe that such a commission will likely be necessary in order to achieve timely action in connection with several of the major reform efforts that lie ahead. At the same time, we need to more proposals from individual members of the Congress and major Presidential candidates to help increase public awareness and stir debate.

We must keep in mind that, while Washington is a "lag indicator", gridlock in Washington is not good when we face a range of serious sustainability challenges that grow with the passage of time. The truth is that there are a number of very disturbing parallels between the factors that contributed to our recent mortgage-related sub-prime crisis and our nation's federal finances. These parallels have gone largely unnoticed. However, absent meaningful and timely action, we are likely to see an economic crisis that will make the current sub-prime challenge look like a bump in the road.

The parallels between the mortgage related sub-prime crisis and our federal financial sub-prime challenge include: 1) a disconnect between the parties who benefit from current practices and those who bear the risk; 2) a lack of adequate transparency and understanding regarding the nature and magnitude of related risks; 3) a re-enforcement of the importance of maintaining lender confidence and adequate cash flow as well as the limitations of credit ratings, and; 4) an illustration of what can happen when there is a lack of effective oversight and action to address large, known and increasing risks before a crisis occurs. These parallels are real. What is Washington waiting for?

Given the importance of our sustainability challenges, we at the Foundation believe it is important to find new ways to communicate the various sustainability challenges we face as a nation. We also believe that in this great nation, it is "We the People" who are responsible for what does or does not happen in capitals around the country. At the same time, the people cannot be expected to act if they don't have the facts, haven't been told the truth, or don't understand the consequences of failing to act.

As a result, in addition to publishing the new citizen's guide, the Foundation has decided to support the distribution of a feature documentary entitled I.O.U.S.A. This film addresses four key deficits facing America -- our budget, savings, balance of payments/trade and leadership deficits. It also highlights the efforts of the Fiscal Wake-up Tour in which representatives of the Concord Coalition, the Brookings Institution, the Heritage Foundation and I continue to participate. This film will be released in August in selected cities around the country, including the Washington, D.C. area. However, we believe that the film's message is so important, the Foundation has decided to hold a private showing of the film for members of Congress and selected other invitees on the evening of Wednesday, July 9 at the Library of Congress. I hope that all of you will be able to attend and that you will encourage your colleagues to do so.

Mr. Chairman, I have a DVD that includes a two-minute promotional trailer of the film you have kindly authorized me to show. Before I do, thank you again for the opportunity to testify. I look forward to answering any questions that you or the other members of the Committee may have.

Appendix: Transparency in Accounting and Budgeting

Appendix. GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls are Needed (Appendix I)*, Statement of David M. Walker, Former Comptroller General of the United States, GAO-07-1144T (Washington, DC: July 25, 2007)

Appendix I: Transparency in Accounting and Budgeting: Legislative Recommendations of the Comptroller General

Supplemental Reporting in the President's Annual Budget Submission

- Produce as supporting information to the budget an annual Statement of Fiscal Exposures, including:
  - a concise list, dollar estimates, and descriptions of exposures, including—
  - information from Consolidated Financial Statements of the U.S. Government on total liabilities, contingencies, commitments, and net present value of social insurance program payments, and
  - long-term cost (> 40 years) of major tax expenditures, presented together with related spending or credit programs in the same policy area , if appropriate
  - dollar estimate of the effect on these exposures of all major spending or tax proposals
  - an assessment of methodologies and data used to produce such cost estimates
  - a graphic presentation of the dollar amounts of exposures presented as percentage of GDP for each year covered
  - Budget horizon expanded to cover 10 fiscal years
  - President shall include in the budget a statement of the President's budgetary goals for a 10-year period in terms of surplus or deficit and in terms of surplus or deficit as a percentage of GDP

Summary Financial Report for the General Public

- Pursuant to OMB form and content guidance, Treasury shall annually publish a summary financial report on the U.S. Government derived from the information in the audited annual Consolidated Financial Statements of the U.S. Government.
  - Report shall be in format and of length, content and sophistication for general American public
  - Report shall include condensed summary of CG's audit report on the CFS
- First annual report due no later than January 30, 2008 [Note: This requires an amendment to GMRA (31 USC 331(e)(1)) to make audited CFS due by January 15 each year and an amendment to the Accountability for Tax Dollars Act (31 USC 3515(a)) to make agency financial statements due by November 30 each year.]

Statement of Fiscal Sustainability

- Pursuant to OMB form and content guidance, Treasury to prepare and make public every four years an assessment of the long-term sustainability of all major federal programs and activities. Statement of Fiscal Sustainability shall include:

  - PV of projected receipts and outlays of federal programs and activities for 75-year and infinite horizons, including separate reporting for social insurance programs
  - Statement of annual cash flows for programs and activities
  - Reconciliation of changes from prior period Statement
  - Presentation of information using different measures of sustainability and estimates of financial burden on different age cohorts and other demographics
  - Explanation of assumptions used and sensitivity analyses
- First Statement of Fiscal Sustainability due no later than March 31, 2008

Additional Cost Information on Legislative Proposals before Adoption

- Before a Member of the House or Senate calls up for consideration on the floor of either House a bill or joint resolution or an amendment thereto that contains a proposal that would result in a significant increase or decrease in revenues or in mandatory spending, that Member shall obtain from CBO a statement of the long-term costs of such bill, joint resolution, or amendment.
  - CBO and Budget committees to jointly define "significant" for each Congress
  - "Long-term costs" are those financial costs over at least a 40-year period
- The statement from CBO shall be provided to the Members of either House, as applicable, and shall be published in the Congressional Record

GAO Report on the Financial Condition of the U.S. Government

- The Comptroller General shall annually report to the Congress his assessment of the financial condition of the U.S. Government. Report shall include analyses of—
  - the Consolidated Financial Statement (CFS) and the Summary Financial Report
  - results of GAO's latest long-term fiscal simulations
  - the President's Statement of Fiscal Exposures
  - the adequacy of information regarding long-term cost implications of existing and proposed policies
  - the Statement of Fiscal Sustainability
  - statutorily-required CBO and JCT reports for the prior fiscal year
- First annual report due no later than January 31, 2009

Statement of Robert L. Bixby
Executive Director, The Concord Coalition

In the Red: How to Address Our Nation's Fiscal Challenges

Senate Homeland Security and Government Affairs Committee
Subcommittee on Federal Financial Management, Government Information, and International Security

June 26, 2008

I. Introduction

Chairman Carper, Senator Coburn, and members of the Subcommittee, thank you for inviting me to discuss the *2007 Financial Report of the United States Government* and our nation's fiscal challenges. The *Financial Report* raises important issues for the future health of the economy, generational equity, government accountability, transparency of obligations, and the prospect for all Americans to enjoy rising standards of living. There is very little dispute that current fiscal policies are unsustainable and that future generations are the most at risk from inaction. Yet, too few leaders in Washington are willing to acknowledge the seriousness of the long-term fiscal problem and even fewer are willing to put it on the political agenda. By focusing attention on this critical issue you are setting a very positive example.

I am here representing The Concord Coalition, a nonpartisan organization dedicated to sound and sustainable fiscal policy. Concord's co-chairs are former senators, Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). They, along with Concord's President former Commerce Secretary Peter G. Peterson and our nationwide membership, have consistently urged Washington policymakers to adopt credible policies for achieving fiscal sustainability.

Since its inception, The Concord Coalition has strongly supported efforts to better inform the public about the huge unfunded obligations that this generation is leaving to future generations — primarily as the result of projected cost growth in Medicare and Social Security. To help raise awareness, we have organized a nationwide series of public forums known as the "Fiscal Wake-Up Tour," which includes former Comptroller General of the United States David M. Walker[1] and fiscal policy experts of differing perspectives from the Brookings Institution and the Heritage Foundation.

Our experience with the Fiscal Wake-Up Tour, which has now visited more than 40 locations in 26 states, is that the public is hungry for a nonpartisan dialogue on the fiscal challenge. When presented with the facts, they appreciate that each of the realistic options comes with economic and political consequences that must be carefully weighed, and that there must be tradeoffs. Information contained in the *Financial Report*, particularly the Statement of Social Insurance (SOSI), and the extent to which it is conveyed to the public can help to clarify those trade-offs and better inform the process for resolving them.

II. The 2007 Statement of Social Insurance — Unqualified and Unsustainable

How the nation's fiscal commitments are communicated to and understood by the public is of vital importance. Without greater understanding of the problem among the public, community leaders, business leaders and home state media, elected leaders are unlikely to break out of their comfortable partisan talking points — and unlikely to find solutions.

For many years, The Concord Coalition expressed frustration that estimates of the unfunded obligations of Social Security and Medicare were not generally available to the public and almost never discussed. In recent years, that has changed. Pursuant to Federal Accounting Standards Advisory Board (FASAB) standards, the *Financial Report* now includes estimates of unfunded benefit obligations in the Statement of Social Insurance (SOSI). Moreover, FASAB has given these estimates more prominence by classifying them as "basic financial" rather than "supplementary stewardship" information. The President's Budget and the Social Security and

[1] David Walker is now President and CEO of the Peter G. Peterson Foundation, an organization dedicated to finding consensus solutions to the nation's fiscal challenges and other unsustainable policies. Mr. Walker remains active in the Fiscal Wake-Up Tour.

Medicare Trustees' Annual Report have also begun to publish estimates of the programs' unfunded obligations.

This new openness about social insurance costs is welcome. The usual measures of 10-year budget projections and 75-year trust fund "solvency" say little about two key issues: sustainability and generational equity. By contrast, the SOSI takes a more comprehensive view of the commitments being made relative to dedicated resources — primarily payroll taxes and premiums.

A five or 10-year budget window may have been adequate when most federal spending was appropriated annually. It is insufficient now that so much of the budget consists of entitlement programs set on a rising autopilot. A window of 30 or 40 years is needed to establish a reasonable expectation that our fiscal policies are sustainable.

Trust fund accounting is an even less reliable gauge of future commitments. Under this method, Social Security appears to be on solid ground until 2041 and Medicare through 2019. This presents a far more benign view than is warranted because it ignores the growth of these programs relative to the size of the economy, which is substantial, and the huge general revenue subsidies that both programs must draw on to remain "solvent."

Trust-fund accounting assumes that surpluses accumulated in prior years can be drawn down to defray deficits incurred in future years. However, the trust funds are bookkeeping devices, not a mechanism for savings. The special issue U.S. Treasury bonds they contain represent a promise from one arm of government (Treasury) to satisfy claims held by another arm of government (Social Security or Medicare.) They do not indicate how these claims will be satisfied or whether real resources are being set aside to match future obligations. Thus, their existence does not, alone, ease the burden of paying future benefits. The real test of fiscal sustainability is the projected gap between outlays and dedicated resources as they accumulate over time.

Social Security's cash flow turns negative in 2017. By 2040, the annual general revenue subsidy needed to satisfy the trust fund obligations will be about 1.3 percent of the Gross Domestic Product (GDP) — more than last year's deficit for the entire federal budget. For Medicare, the drain on general revenues will be far worse. Medicare Part A is already running a small cash deficit that will grow to nearly half a percentage point of GDP by 2019 when the trust fund is tapped out. In the case of Medicare Parts B and D, trust fund solvency is a meaningless concept because both programs have an open pipeline to the U.S. Treasury for 75 percent of program costs. Taken together, Medicare's annual gap between dedicated resources and benefits is projected to reach 5 percent of GDP by 2040.

The good news in the 2007 *Financial Report* is that the SOSI received an unqualified, or "clean," opinion, from the Government Accountability Office (GAO). This means that the numbers are reliable. The bad news is that these unqualified numbers paint a stark picture of future promises that cannot be sustained by the level of dedicated revenues.

According to the SOSI, over the next 75 years, the present value of promised benefits for Social Security and Medicare ($93 trillion) exceeds the present value of earmarked revenues and premiums ($52 trillion) by $41 trillion. This huge imbalance, not the current debt held by the public ($5.3 trillion), best demonstrates the magnitude of the nation's fiscal challenge. All told, the *Financial Report* shows current and future "fiscal exposures" with a present value of $53 trillion.[2]

III. Why Are We in This Fiscal Hole?

It is often said that our political system only responds to a crisis. If that turns out to be true, our children and grandchildren are in big trouble. The question you are posing at this hearing is whether we, as a nation, will face up to these challenges and fulfill our generational stewardship obligation or instead put the future at risk by waiting for a crisis.

The economic and moral case for fiscal policy reform is clear. An unprecedented demographic transformation is taking hold against the backdrop of steadily rising health care costs and steadily falling national savings. This is a dangerous combination for the future health of the economy.

[2] This includes $11 trillion of explicit liabilities, such as debt held by the public, the implicit exposures for social insurance $41 trillion and other contingencies and commitments of $1 trillion.

The baby boomers' imminent retirement is ushering in a permanent shift to an older population and a permanent rise in the cost of programs such as Social Security, Medicare and Medicaid, which already comprise 42 percent of the federal budget. There is no plan to pay for it all other than running up the national debt.

No one can say when all this might end up in a crisis, nor what a crisis would look like. Indeed, there may be no crisis at all — just a long slow erosion in our nation's standard of living. In either case, it is a dismal prospect and doing nothing now to avoid it would be an act of fiscal and generational irresponsibility.

The basic facts are a matter of arithmetic, not ideology. Two factors stand out: demographics and health care costs.

Over the next 30 years, the number of Americans aged 65 and up is expected to grow from 13 percent of the population to 20 percent. The working age population will grow by only 14 percent over this time, shrinking from 60 percent of the population to 55 percent. As a result, the ratio of workers paying into Social Security and Medicare relative to the number of beneficiaries will fall by roughly one-third.
At the same time, one of the major engines of economic growth — an expanding workforce — will slow substantially due to the large exodus of older workers from the labor force and lower birth rates following the baby boom.

Even without a fiscal crisis, future standards of living are at risk. As Federal Reserve Board Chairman Ben Bernanke has observed, "the aging of the population is likely to lead to lower average living standards than those that would have been experienced without this demographic change."[3]

Demographic change, however, is only part of the problem. Health care costs have consistently outpaced economic growth by about 2.5 percentage points annually since 1960. If this

[3] Remarks before The Washington Economic Club, Washington, D.C. October 4, 2006.

phenomenon persists, it will greatly compound the growing fiscal problems attributable to the rising number of aged.

Assuming that the growth rate of health care costs does not slow, Medicare and Medicaid will grow by roughly four times as a share of the economy (GDP) by 2050. They will absorb nearly as much of our nation's economy by 2050 as the entire federal budget does today. More than half of that increase would come from the rising cost of health care rather than demographics alone.

Many economists recommend increasing our low level of national savings to better fund productive investments that will help grow a larger economy in the future. A larger economy would make the looming fiscal burden more affordable. Unfortunately, Americans' personal savings rate as a percentage of disposable income has steadily declined from over 7 percent in the early 1990's to essentially zero today. Net national saving (private and public) has plummeted from 8.5 percent of our gross national income 25 years ago to less than 2 percent in 2007.

The savings gap can, and has, been filled with capital from abroad. The portion of the government's privately held debt owned by foreign investors has risen dramatically since 2001 -- from 37 percent to 54 percent.[4] This, however, acts as a growing mortgage on future national income. No nation can prosper without investing, nor can it invest for long without saving, nor can it save for long without a responsible fiscal policy.

All of this has ominous implications for the size of government relative to the size of the economy. By the time today's 20-year olds reach retirement age, the overall cost of government as a share of the economy is on track to reach levels not seen since World War II — the big difference being that instead of spending the money on a life and death struggle against totalitarian aggression we would be spending it on an ever-rising stream of benefit payments.

Today, federal government spending absorbs 20 percent of the economy.[5] At the high end of what the nonpartisan Congressional Budget Office (CBO) sees as a possible range, federal

[4] Measured from June 30, 2001 through December 31, 2006. Table OFS-2 U.S. Treasury, Monthly Treasury Bulletin, March 2007.

[5] The average over the past 40 years is 20.6 percent of GDP. The post-WWII high was 23.5 percent in 1983.

spending could rise to 42 percent of GDP in 2050. In contrast, federal spending never went above 44 percent of GDP throughout World War II.

This raises some obvious questions:

- Are all these future benefit promises affordable?
- Who's going to pay the bill, and how?
- What resources will be left for other priorities?
- What steps could we take now to change course?

Borrowing our way through the problem is not a viable option because the rising cost of Social Security and Medicare is not a temporary blip. It gets bigger with time. Incurring permanently rising debt would result in staggering interest costs and ultimately a total debt burden that would crush the economy.

The real choices require scaling back future health care and retirement benefit promises, raising revenues to pay for them, or most likely, some combination of both.

If we are to face these choices honestly, the magnitude of the gap must be clearly understood. It goes far beyond what minor tweaks can cure. Raising revenues to cover projected spending would require an increase over today's level from between one-third to one-half by 2030 depending on the growth of health care costs. On the other hand, if we try to keep revenues at today's level and pay for the increase in Social Security, Medicare and Medicaid by reducing spending on other programs, it would require a cut of between one-half to four-fifths by 2030, again depending on the path of health care spending. With a fiscal "reality gap" of this size, it seems highly unlikely that it can be filled entirely with spending cuts or entirely with revenue increases. [6]

Beyond fiscal imbalance, the policies embedded in today's budget threaten to place ever tighter constraints on the ability of future generations to determine their own fiscal priorities or to meet

---

[6] These measurements are expressed as a share of the economy (GDP).

challenges that cannot be foreseen. As the share of federal resources pledged to retirement and health care benefits grows, it will leave shrinking amounts for all other purposes.

Some people may believe that the federal government should both tax and spend at about 18 percent of the GDP, while others may find it acceptable to tax and spend at about 30 percent of GDP. No reasonable person, however, would argue that the government should tax at 18 percent and spend at 30 percent. The resulting annual deficits and accumulated debt would shatter the economy. Yet, this is the future we will get if we try to fund the spending required by current law with today's level of taxation.

Generational fairness requires a change in course. The choices we make *today* will determine what kind of society our children and grandchildren inherit 20 and 30 years from now. There is little time for political gridlock. With the first of the 77 million baby boomers on the verge of retirement, the window of opportunity to act is rapidly closing. [7]

The sooner we get stated the better. Inaction now increases the prospects of severe changes later. By contrast, even modest changes in retirement and health care programs, enacted promptly and phased-in over many years, could have a substantial impact in bringing future costs down to a more sustainable level. Similarly, eliminating or even reducing the budget deficit over the next few years would lower government borrowing from the financial markets, provide a much needed boost in national savings and reduce our reliance on foreign lenders. Acting sooner would also reduce interest costs and permit the "miracle" of compound interest to work for us rather than against us. When it works against us, as it does now, it is more of a nightmare than a miracle. Anyone who has tried to live on rising credit card debt knows the difference all too well.

IV. What Can Be Done?

Improving the nation's long-term fiscal outlook will require hard choices on spending and taxes. Policymakers must acknowledge the magnitude of the problem, the need for trade-offs and the

[7] The oldest segment of the baby boom generation began drawing "early retirement" Social Security benefits this year. In 2011, they will be eligible for Medicare.

necessity for prompt action. Vague promises of "fiscal responsibility" are not enough. Comprehensive solutions may take considerable time to develop, and once implemented should be subject to periodic review. However, as a framework for action, Congress and the next President should:

- Commit to a balanced budget
- Incorporate long-term projections and controls into the budget process
- Take every reasonable step to constrain the rising cost of heath care and retirement programs—Social Security and, most especially, Medicare
- Make clear to Americans that ultimately taxes cannot be cut unless programs are cut commensurately

Commit to a balanced budget. This is a good first step. Restoring a balanced budget would increase national savings, lower future interest costs, signal to world financial markets that we are serious about getting our fiscal house in order, and reduce our dependence on foreign lenders. The best fiscal policy is one that aims to *prevent total spending, taxes, or debt from reaching levels that could reduce economic growth and future standards of living*. Yet, even with a near-term balanced budget plan, current fiscal policy would remain unsustainable over the long term. That is why even strict compliance with the pay-as-you-go rule (paygo) for entitlement expansions and tax cuts is not sufficient. Assuming that all new initiatives are "paid for" we would still be left with the unsustainable fiscal outlook we already have — a reality that the new Congress and President will be confronted with in 2009.

Incorporate long-term projections and controls into the budget process

The budget process itself is stacked against long-term planning. Nothing requires Congress to review the current-law outlook beyond the next few years, much less take corrective action. Every corporation in America must account for and defray the cost of its long-term commitments. But the federal government does not, even though its commitments are thousands of times larger than those of any corporation.

To remedy this situation, The Concord Coalition has recommended that Congress establish long-term targets for revenues and outlays by major spending category as part of the annual budget resolution. Congress should note how major legislative proposals assumed in the resolution would affect these targets and how the targets differ, if at all, from current law as projected by the Congressional Budget Office (CBO). Separate targets could be established, as a share of GDP at five-year intervals through 2040, for total revenues, defense spending, domestic discretionary spending, Social Security, Medicare, Medicaid, other entitlements, and net interest.

An alternative idea, which is even stronger, is one that I recently joined in publishing with 15 other veteran federal budget experts from across the political spectrum. In "Taking Back Our Fiscal Future"[8] we recommended that Congress and the president should establish explicit, sustainable, budgets for the three leading cost drivers — Social Security, Medicare and Medicaid — stretching out for at least 30 years. Limits would be placed on automatic spending growth to reduce the favorable treatment these programs receive relative to other programs. Once the budgets are set, periodic reviews every five years would determine whether the programs were within budgeted levels.

To protect against significant long-term deviations from the budget and the political incentives to avoid difficult choices, a trigger device would also be enacted making automatic adjustments to benefits, premiums, provider payments or other revenues. Such adjustments could be over-ridden only by an explicit act of the president and Congress.
This would not end the entitlement status of any program, but it would shut off the autopilot and compel some hard decisions that are now being avoided.

While there is ample room to debate the details, the main purpose of both proposals is to inject some needed transparency and accountability into the budget process. Without a mechanism to establish priorities on the record, everyone can continue to ignore the long-term consequences of current policy. With it, they must begin to talk concretely about the size and shape of the government they want and to budget accordingly.

---

[8] Available at http://www.concordcoalition.org/doc/080331-Taking-Back-Our-Fiscal-Future.pdf.

Over the years, several developed countries have added "automatic stabilizers" to their public pension systems that build in cost restraint rather than cost growth. The first to pioneer this approach was the UK, which in the early 1980s switched the default indexation of its basic public pension system from wages to prices. Since the mid-1990s, a number of other countries have followed suit. Italy, Sweden, Germany, and Japan have all added stabilizers to their public pension systems that are expressly designed to offset demographically driven cost growth. The reforms differ in the mechanisms they employ. What they have in common is that they are all self-adjusting

Several of the countries that have implemented automatic pension stabilizers—most notably, Germany and Sweden—have large and popular welfare states that have historically proved resistant to cost-containment. Retirees in these countries receive almost all of their personal income from public pensions, which are considered cornerstones of social democracy. This is not true in the United States. Why then have they been able to grapple with the long-term cost challenge while the United States has not?

Part of the explanation may be that the challenge appears more urgent. America's age wave still lies mostly in the future. Europe's and Japan's more rapidly aging populations are already overwhelming public budgets, forcing up payroll tax rates, and slowing economic growth. Part of the explanation lies in the nature of the reforms themselves. The incremental benefit cuts triggered by the automatic stabilizers are small in any given year, which has made it easier to defuse the public's opposition. Leaders also seem to perceive an advantage in passing self-adjusting reforms that may spare them the need to revisit a divisive political issue in future years.

As policy experts in America look for ways to regain control over our fiscal future, the best way to do this may be to replace the automatic cost escalation built into today's entitlement system with automatic cost constraint.

The *Financial Report* itself might also help to combat myopic budget planning by incorporating a Statement of Fiscal Sustainability, or other similar assessment of long-term trends. As a matter of sound policy planning and generational equity, we must know if we are on a sustainable fiscal path. The Concord Coalition thus supports a government wide Statement of Fiscal Sustainability as required supplementary information to the government's financial statements. This new statement, in conjunction with the current SOSI, would highlight the nature and magnitude of the federal government's long-term fiscal condition in a comprehensive and contextual manner.

The most valuable contribution of a SOFS would be to show long-term year-by-year cash flow projections under various assumptions regarding spending and taxes. A close look at the unfunded obligations in the SOSI leaves no doubt that the nation faces a huge cost challenge. No single present value number, however, can give a complete and accurate picture of the magnitude of the long-term fiscal challenge or the required response. Present value numbers say nothing about annual spending levels, and hence when the cost burden will become acute. Nor do they tell us the government's annual borrowing needs, and hence its impact on U.S. savings, investment, and living standard growth.

A major limitation of long-term summarized figures is that they can conceal a roller coaster fiscal path and thus obscure the pros and cons of different reform approaches.

Consider two reform plans: one that first allows Social Security and Medicare spending to rise above today's level, then cuts it beneath today's level, and a second that keeps spending from rising in the first place. The impact on the programs' unfunded obligations might be similar, but not the impact on the budget or the economy. It's a bit like wading out to a sand bar. The present value calculation says that you'll be safe and dry once you get there. You need annual budget projections to tell you whether you're going to drown on the way.

There is no doubt, however, that a well-designed fiscal sustainability statement — one that includes annual cash flow projections — would help awaken America to the long-term fiscal challenge. It would provide useful indicators of fiscal sustainability and generational inequity under various scenarios and act as a helpful guide to reform efforts — not by prescribing options but by showing the magnitude and timing of the challenge.

Take every reasonable step to constrain the rising cost of heath care and retirement programs—Social Security and, most especially, Medicare

The most effective long-range solutions would be to *constrain the rising cost of heath care and retirement programs—primarily Medicare and Social Security.* This will require politically difficult choices regarding who should receive benefits, what level of benefits can be provided, and how those benefits should be delivered.

Regarding Social Security, The Concord Coalition believes that reforms should be aimed at three fundamental objectives: 1) fiscal sustainability; 2) increased national savings; and, 3) generational equity. Reform options that could accomplish these objectives include raising the eligibility age to reflect demographic changes, better targeting benefits to those who rely on them most, and adding fully funded mandatory savings accounts to the system. Whatever the mix of options, however, there should be no preconditions for bipartisan negotiations.

Medicare is a much bigger problem than Social Security, not just fiscally but also politically and ethically. Its costs are projected to grow faster than the economy, and faster than can be reasonably supported by the federal budget.

Some people seem to believe that there are simple fixes to Medicare that will not require anyone to give up anything. Just clamp down on "fraud and abuse," or cut back on excessive paperwork, and the problem will be solved. Health policy experts see it differently. Pure waste is no easier to pinpoint in the health system than it is in the federal budget. And, even if we could identify and eliminate all of it, the underlying cost drivers—from technology to expectations of good health to aging—would soon cause spending to grow again as fast or faster than before.

The hard truth is that there are only two direct ways to reduce the growth in Medicare costs: pay health care providers less, or reduce the amount of health care that patients consume. Although both political parties agree that the goal is to deliver better quality of care while controlling costs, that goal is much easier enunciated than achieved.

Spending on health care for the elderly will continue to grow far faster than the economy so long as we pretend that costs can be controlled without any sacrifice. Costs are not rising because of the proliferation of completely useless medical services. They are rising because medical science can do more for more people—and because what it can do is often very expensive, even if the benefit is incremental.

Ultimately our nation must decide what level of health care we wish to provide as an entitlement and how much we are willing to pay for it. Setting limits in Medicare may mean moving toward a whole new paradigm—one in which prospective budgets at the program level and capitation at the beneficiary level finally compel us to make trade-offs between health care and other national priorities.

In short, Medicare should be put on a budget. If program costs exceed targeted levels, Congress and the president should be required to take corrective action. If they decide that program costs should be permitted to increase (for example, by filling the prescription drug "doughnut hole" or by adding long-term care coverage), then the demands of fiscal responsibility require that they identify a commensurate stream of revenue to pay for the expanded coverage or a reduction in other services.

Make clear to Americans that ultimately taxes cannot be cut unless programs are cut commensurately

Treating taxes and spending as "separate deals" is an economic fantasy. To be sure, low taxes theoretically encourage economic growth by providing incentives for work, saving, and investment. However, if taxes fall too far below spending for too long, the resulting deficits will eventually cancel out any positive economic gains. In the final analysis, government revenues must be sufficient to pay its costs. Tax cuts make attractive campaign rhetoric, but unless they are accompanied by reduced spending over the long-term, we are merely shifting the tax burden from ourselves to our children. Debt is not a painless alternative to taxation.

While reforms should be enacted that would substantially reduce the long-term growth in federal spending, it is unlikely that any realistic array of reforms will allow an aging society to hold spending to today's level. Economic efficiency requires that taxes be held relatively stable at a level sufficient to pay for public spending in all future years, regardless of whether this leads to surpluses or deficits in any given year. It makes no sense to cut taxes today if that cut will only necessitate raising taxes tomorrow.

In that regard, The Concord Coalition believes that tax cuts scheduled to expire should not be permanently extended absent a plan for long-term fiscal sustainability.

V. The Importance of Public Engagement

The choices that must be debated involve vitally important issues, such as the future of Social Security, Medicare and taxes. For that reason, the active involvement of the American people is critical.

In this regard, the experience of The Fiscal Wake-Up Tour may prove useful. In our public presentations we explain in plain terms why budget analysts of diverse perspectives are increasingly alarmed by the nation's long-term fiscal outlook.
Our emphasis is on the key areas in which we have found consensus, such as:

- The overall dimensions of the problem;
- The nature of the realistic trade-offs that must be confronted in finding solutions;
- The adverse and inequitable consequences for future generations if we fail to make serious changes, sooner rather than later.

We try our best to cut through the usual partisan rhetoric and stimulate a more realistic public dialogue on what we want our nation's future to look like, along with the required trade-offs. The public has been very receptive to this approach, as has the local media in the 40 locations we have visited.

Participants in the Fiscal Wake-Up Tour do not necessarily agree on the ideal levels of spending, taxes and debt. However, we do agree on the following key points:

- Current fiscal policy is unsustainable.
- There are no easy solutions, such as cutting waste fraud and abuse or growing our way out of the problem.
- The best way to make the hard choices is through a bipartisan process with a willingness to consider all options.
- Public engagement and understanding is vital in finding solutions.
- This is not about numbers. It is a moral issue.

We do not recommend specific policy solutions. Indeed, we are upfront about the fact that we do not necessarily agree on solutions. However, we remind audiences that each of the realistic options comes with economic and political consequences that must be carefully weighed, and that there must be tradeoffs.

Those who want to raise taxes are asked to explain what level of taxation they are willing to support and the manner in which the new revenue should be raised. Those who argue that spending must come down from projected levels are asked which programs they would target and how the savings would be achieved. Those who are unwilling to do either are asked how much debt they are willing to impose on future generations.

Our experience is that when audiences are told the facts, and shown that if they demand their "rights" to programs or policies it will have damaging economic effects to other groups or generations represented in the audience, they begin to accept the need for tradeoffs.

In addition to the Fiscal Wake-Up Tour, the same group of analysts from The Concord Coalition, The Heritage Foundation and The Brookings Institution have been working with Public Agenda and ViewPoint Learning, (both chaired by Dan Yankelovich) on a project called "Facing Up To The Nation's Finances. It is designed to provide insight into how attitudes evolve as people discuss difficult trade-offs with regard to long-term fiscal policy. A report issued by the Facing Up Project in December 2006 made the following observations:

- The public is strongly averse to big increases in the size of the national debt and, with the right kind of leadership, is prepared to accept sacrifices to avoid it.
- For most people, the overriding concern is not resistance to taxes but a profound lack of trust in government. People are willing to pay for what they want so long as they can be satisfied that government will spend the money wisely and for the purposes intended.
- Americans are willing to make changes in entitlements, but again on condition that trust and accountability exist.
- While there is continued strong support for defense spending, it is accompanied by the widespread perception that funds are misallocated and often wasted.
- Americans want to be engaged in addressing these issues and are frustrated by the lack of engagement that contributes to their mistrust of government

VI. Does it Take a Commission?

Partisan divisions in Washington have become so wide that a special task force or commission may now be the only way forward on this issue. If everyone insists on only changing someone else's priorities, talk about fiscal sustainability will remain just that. The best way to end this standoff is to agree on an open, credible process without preconditions — including entitlement and tax options —and negotiate the necessary trade-offs.

Since the regular legislative process has been incapable of dealing with the impending fiscal crisis, a different route makes sense as a means of jump-starting serious action. The Dean of my law school had a saying that seems apt to the political task ahead. When referring to unlikely solutions to tough problems he would remind us that, "Water doesn't run uphill without a pump."

Reducing promised benefits or raising taxes strikes me as the political equivalent of expecting water to run uphill. It goes against nature and is unlikely to happen without some intervening force. One such force would be a crisis. A far better one would be a bipartisan process to act in advance of a crisis — provided that it is implemented in a way that recognizes fiscal and political realities.

In The Concord Coalition's view, any non-traditional effort to bring about action, whether through a congressional task force as your colleagues Kent Conrad (D-ND) and Judd Gregg (R-NH) have proposed (S. 2063) or a commission as proposed by Representatives Cooper (D-TN) and Wolf (R-VA) in the SAFE Act (H.R. 3654), would need five elements to succeed:

- **First, it must be truly bipartisan.** Any perception that the purpose is to facilitate swift enactment of a partisan agenda would doom it to failure. It should have bipartisan co-chairs and equal representation. Doing otherwise in the current partisan environment would be a waste of time and money.

- **Second, it must have a broad mandate.** While it is critical to control the growth of entitlements, particularly Medicare and Social Security, the task force or commission should examine all aspects of fiscal policy.

- **Third, there must be no preconditions.** If either side sets preconditions, the other side will not participate.

- **Fourth, it must engage the public.** In Concord's experience, when people are armed with the facts and given the opportunity for honest dialogue, they are willing to set priorities and make hard choices. Moreover, it seems highly unlikely that the public would react well to a reform package for which it was unprepared.

- **Fifth, its recommendations should be voted in Congress.** Absent this element, the report would likely join many others on a shelf.

A process with these attributes would give all parties the political cover they need to tackle the tough choices and develop a bipartisan consensus for solutions. This would be invaluable regardless of who controls Congress or the White House in 2009.

VII. Conclusion

If nothing changes, future taxpayers will be forced to pay far higher taxes than we pay today, or they will either have to accept much lower spending for all other public purposes--including national defense, homeland security, and education--or face rapidly escalating deficits and the resulting negative consequences for the economy and future standards of living.

We could cross our fingers and hope that the U.S. economy is sufficiently resilient to overcome anticipated fiscal challenges without any change to current policies. However, that outcome is highly unlikely. Wishful thinking is not a sound fiscal strategy. A far more prudent and secure path to bettering the fiscal outlook would be to reassert budget discipline.

Daunting as the long-term projections for the U.S. economy are, there is nothing inevitable about a fiscal crisis. The problems we face—essentially a structural imbalance between what government promises and how much it collects in taxes to pay for those promises—is one that can be cured if we begin to address it now. Fundamentally, this is not about numbers. There are basic philosophical questions:

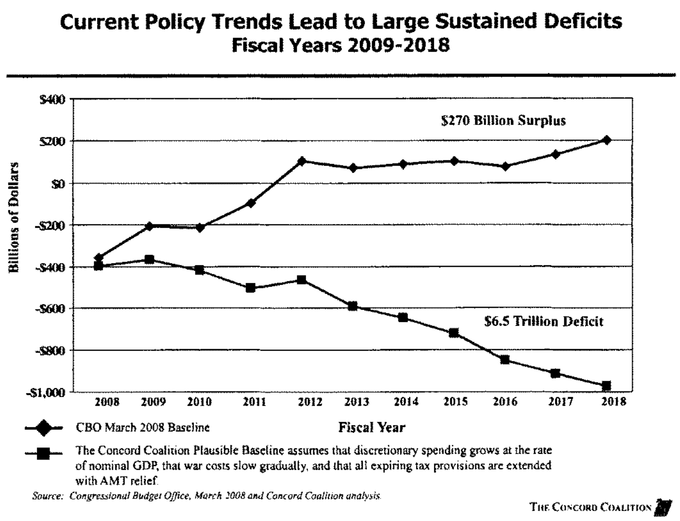
- Is it morally acceptable to pursue a fiscal policy that threatens to place ever-tighter constraints on future generations' ability to determine their own priorities or to meet new challenges?

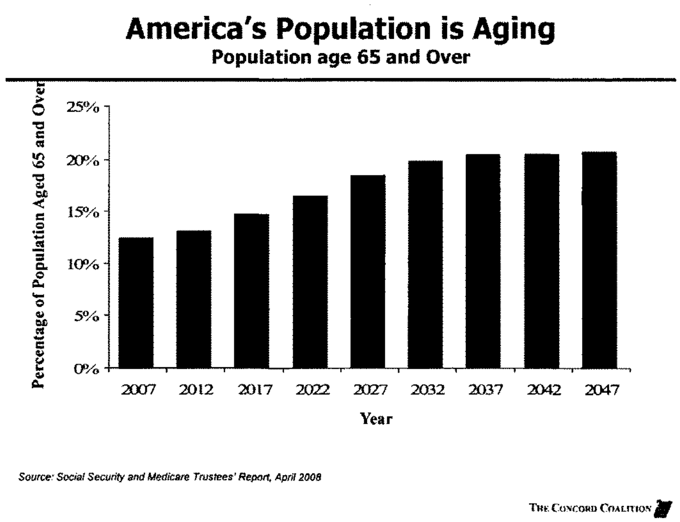
- Have we become so insistent on our own claims to government benefits, regardless of need, that we have forgotten about the well-being of the very people we expect to pay for those benefits—our children and grandchildren?

- Can any modern media–dominated society, fixated on the short–term and the next election, deal on a timely basis with silent, slow–motion, long–term challenges, or is a costly crisis needed to spur action?

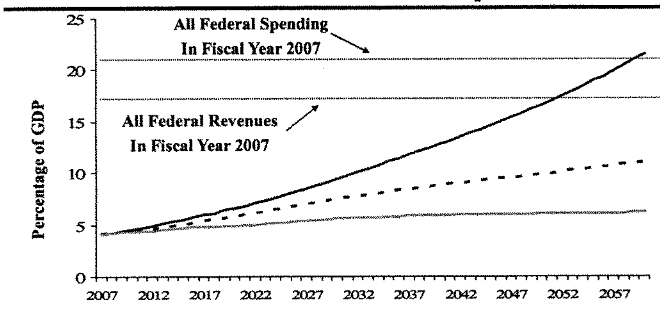
These are not easy questions, but they are ones that all of us should confront, publicly and explicitly.

Charts:


Current Policy Trends Lead to Large Sustained Deficits
Fiscal Years 2009-2018
$270 Billion Surplus
$6.5 Trillion Deficit
Billions of Dollars
$400
$200
$0
-$200
-$400
-$600
-$800
-$1,000
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018
Fiscal Year
CBO March 2008 Baseline
The Concord Coalition Plausible Baseline assumes that discretionary spending grows at the rate of nominal GDP, that war costs slow gradually, and that all expiring tax provisions are extended with AMT relief.
Source: Congressional Budget Office, March 2008 and Concord Coalition analysis.
The Concord Coalition


America's Population is Aging
Population age 65 and Over
Percentage of Population Aged 65 and Over
25%
20%
15%
10%
5%
0%
2007 2012 2017 2022 2027 2032 2037 2042 2047
Year
Source: Social Security and Medicare Trustees' Report, April 2008
The Concord Coalition

Health Care Costs are Rising Faster Than the Economy



Assumes that health care cost growth will not exceed GDP growth.

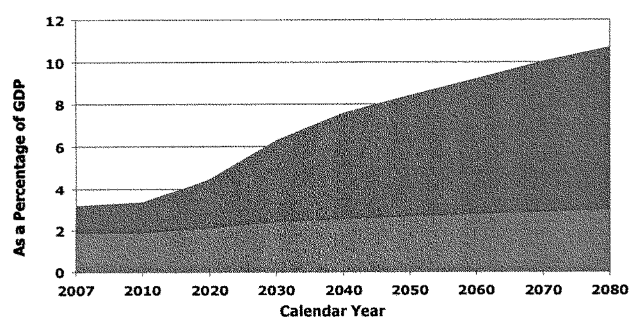
Assumes that health care cost growth continues at the average rate for the past 40 years (2.5 percentage points greater than GDP growth.)

Assumes that health care cost growth rate declines to 1.0 percentage point greater than GDP growth—consistent with the assumption used by the Medicare Trustees.

Source: Congressional Budget Office, December 2007

THE CONCORD COALITION

Medicare Costs Soar in the Coming Decades



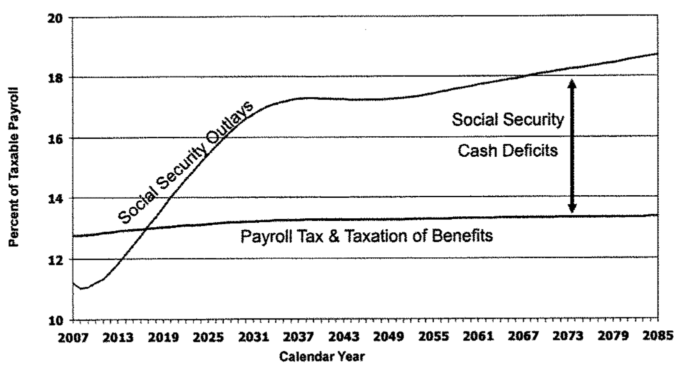
General Revenues required to fund the program

Income from dedicated taxes, premiums, and state transfers

Source: Medicare Trustees' Report, 2008

THE CONCORD COALITION

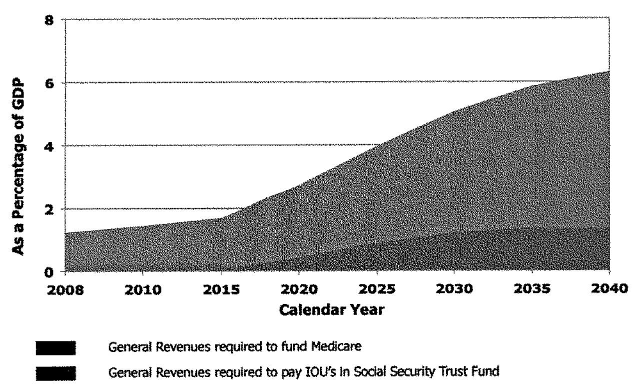
Benefits promised far exceed dedicated tax revenues



Source: Social Security Trustees' Report—April 2007 (Intermediate Projections)

THE CONCORD COALITION

General Revenue Transfers to Social Security and Medicare in the Coming Decades

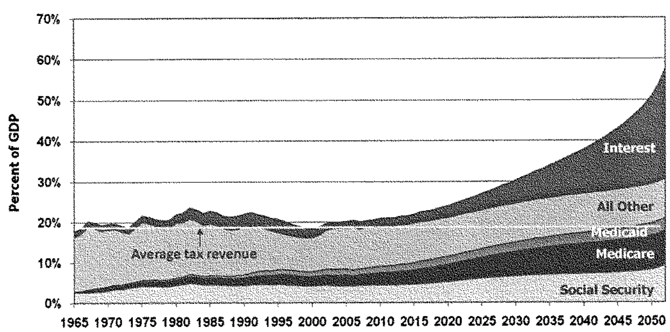


Source: Medicare Trustees' Report, 2008

THE CONCORD COALITION

Current fiscal policy is on an unsustainable path

Federal Outlays as a Percent of GDP, 1965-2052



Source: Government Accountability Office, March 2008

THE CONCORD COALITION

Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

TESTIMONY OF JAMES HORNEY
DIRECTOR OF FEDERAL FISCAL POLICY
CENTER ON BUDGET AND POLICY PRIORITIES

BEFORE THE

SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY

OF THE

SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

IN A HEARING TITLED

"IN THE RED: HOW TO ADDRESS OUR NATION'S FISCAL CHALLENGES"

JUNE 26, 2008

Chairman Carper, Senator Coburn, Members of the Committee, thank you for the opportunity to appear here today to talk about the long-term fiscal problems facing the United States.

My name is James Horney. I am the Director of Federal Fiscal Policy at the Center on Budget and Policy Priorities, which is a non-partisan, non-profit research institute with a particular interest in programs that assist low- and moderate-income Americans. The Center receives no funds from the federal government. I should note that in a previous job I was responsible for coordinating the Congressional Budget Office's baseline budget projections.

I also should note that the Center also has a strong interest in and long history of promoting fiscally responsible federal budget policies, in part because of our concern that, if such policies are not implemented, future resources to fund programs we believe make a vital contribution to the social fabric of the nation will be severely limited.

I want to make four points here today:

- First, as suggested by the Statement of Social Insurance included in the *2007 Financial Report of the U.S. Government*, the federal budget is on a path that will eventually lead to unsustainable increases in debt;
- Second, the keys to the long-term federal budget problem facing us are the growth of federal expenditures for health care and the level of revenues available to finance federal programs;
- Third, the key to bringing federal health care expenditures under control is limiting the growth of health care costs system wide – private as well as public; and,
- Fourth, that real progress toward sustainable fiscal policies will require a bipartisan consensus about the priority of deficit reduction, and the willingness of the President and members of both parties in Congress to put everything on the table – revenues and program spending – and negotiate balanced deficit reduction packages.

Let me explain why I come to these conclusions.

Current Policies Will Eventually Lead to Unsustainable Increases in Debt

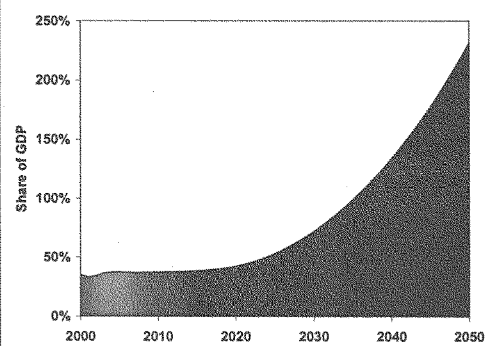
Although the Statement of Social Insurance is limited to just a few programs (most importantly, Social Security and Medicare), the message one takes from the statement – current policies are unsustainable – is consistent with the conclusions of other analyses that take a more comprehensive approach in addressing the long-term prospects of the entire U.S. budget. Those analyses – including those undertaken by the Congressional Budget Office, the Office of Management and Budget, the Government Accountability Office, and the Center on Budget and Policy Priorities – conclude that unless current policies are changed, total federal spending is likely to exceed total federal revenues by growing amounts in coming decades, eventually leading to an explosion in debt that would seriously harm the economy. All of the institutions that have undertaken these analyses have noted the high level of uncertainty about projections of federal spending and revenues over a period of thirty to fifty years and more, but they all agree that it would be highly imprudent for policymakers to maintain current policies in the hope that outcomes will be substantially more favorable than these current projections suggest.

Figure 1 shows the growth of federal debt held by the public as a share of Gross Domestic Product (GDP) in long-term projections the Center published in January 2007.[1] (We are in the process of updating the projections, but are confident that the basic conclusions will not change.) The projections show that if current polices are continued (e.g., if current laws governing Medicare, Social Security, and other programs remain unchanged, the 2001 and 2003 tax cuts are made permanent, and relief from the Alternative Minimum Tax is continued), deficits will reach about 20 percent of GDP by 2050, and the national debt will climb to about 230 percent of GDP by that year, or more than twice the size of the U.S. economy. Debt-to-GDP ratios in this range are unprecedented in the United States. At the end of World War II, the national debt was only slightly above 100 percent of GDP.[2]

Projections by others such as CBO and GAO differ in detail from ours, but the overall conclusion is the same. Without changes in current policies, the path of the federal budget is unsustainable: growing deficits will push the debt-to-GDP ratio ever higher. The President and the Congress need to take action to prevent this from happening. As CBO concluded in its most recent report on the long-term problem, "To prevent deficits from growing to levels that could impose substantial costs on the economy, revenues must rise as a share of GDP, or projected spending must fall – or some combination of the two outcomes must be achieved."[3]

FIGURE 1

National Debt will Reach 231% of GDP by 2050



Source: CBPP projections based on CBO data.

One thing I would like to note, however, is that the rapid increase in the national debt is not projected to occur until after 2020. We are not facing an immediate budget "crisis," but beginning to deal with the long-term problem in a serious way as soon as possible is highly desirable. Having said this, we also should remember that there is time to make sure that we take a sensible ***and sustainable*** approach to deficit reduction. The world will not come to an end if we do not take steps in the next year or two that promise to fully eliminate the long-term fiscal imbalance. We need to be

[1] Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, "The Long-Term Fiscal Outlook is Bleak: Restoring Fiscal Responsibility Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System," Center on Budget and Policy Priorities, January 29, 2007.

[2] Moreover, the debt at the end of WWII was held almost entirely by Americans — almost none was held by foreign governments or foreign citizens — and mush of the debt had been borrowed at a 2 percent interest rate and so was a far smaller burden than it would otherwise have been.

[3] "The Long-Term Budget Outlook," Congressional Budget Office, December 2007, p. 1.

careful not to adopt hastily considered measures that may prove unsustainable or unwise in later years.

Rising Health Care Costs and the Level of Revenues Are Key

Some budget observers have suggested that the long-term problem is the result of an "entitlement" crisis. This is misleading both in suggesting that entitlement program spending *in general* is projected to rise rapidly in coming decades and in implying that revenue policies do not play a role in the long-term problem.

Health Care, Not Entitlements in General or Even Social Security, Drive Big Increases in Spending

The Center projects that, under current policies, entitlement spending will grow significantly faster than the economy over the next 40 years and beyond. But entitlement spending *outside* of Social Security, Medicare, and Medicaid is projected to grow *more slowly* than the economy over that period.[4] This is consistent with CBO's most recent 10-year baseline projection that spending for all other entitlements – i.e. other than the "Big Three" – will shrink from 2.7 percent of GDP in 2008 to 2.0 percent in 2018.

It is worth noting also that long-term projections by the Center and others assume that discretionary spending for defense and domestic programs will not grow faster than the economy. This means that Social Security, Medicare, and Medicaid are responsible for *all* of the projected growth of non-interest spending relative to the economy in coming decades (actually more than all in the Center's projections, since other spending is expected decline as a percent of GDP under current policies).

As almost everyone knows, the projected growth of Social Security expenditures is an important contributor to the long-term problem. With the retirement of the baby-boom population, the number of Social Security beneficiaries is expected to grow to about 86 million by 2030 according to CBO, up from about 50 million today. As a result, Social Security spending is expected to rise from 4.3 percent of GDP in 2007 to 6.1 percent of GDP by 2030 according to CBO. The trend will level off in subsequent years, so that expenditures for Social Security are then expected to rise only to 6.4 percent of GDP by 2082.

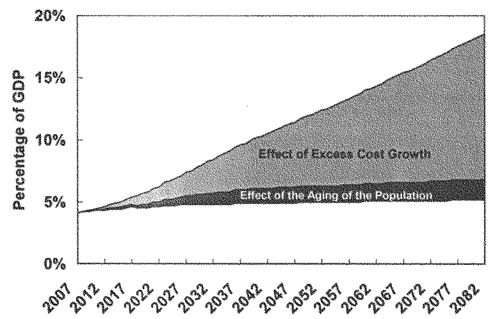
The increase in Social Security spending by an amount equal to nearly 2 percent of GDP over the next two decades or so is a problem for the budget, but Medicare and Medicaid have a larger impact on the budget because spending for those programs is expected to increase by more than 2 percent of GDP by 2030 and is expected to continue to grow significantly faster than GDP in years after that. CBO projects that Medicare and Medicaid spending could grow from 4 percent of GDP in 2007 to 19 percent of GDP in 2082.

[4] See Richard Kogan and Aviva Aron-Dine, "There is No General "Entitlement Crisis": In Coming Decades, Medicare, Medicaid, and Social Security Will Grow Rapidly, But Other Entitlements Will Shrink As a Share of the Economy," Center on Budget and Policy Priorities, January 29, 2007.

The reason that Social Security poses less of a challenge than Medicare and Medicaid is that the growth in Social Security spending relative to GDP is driven entirely by demographics – by the increase in the number of beneficiaries relative to the number of working-age Americans (which is a key determinant in the growth of GDP). The demographic pressures subside with time, and Social Security spending then begins to grow more in line with the economy.

FIGURE 2

Sources of Growth in Projected Federal Spending on Medicare and Medicaid



Source: Congressional Budget Office, "The Long-Term Outlook for Health Care Spending," November 2007, p. 14.

Medicare and, to a lesser extent, Medicaid (because only a portion of Medicaid spending goes for care of the elderly), are subject to these same demographic pressures. But they are subject to another, stronger force – the rising per-person cost of providing health care in the United States. CBO estimates that real per capita spending on health care – private as well as public – grew at an average annual rate of 4.2 percent over the thirty years from 1975 to 2005, significantly faster than the growth of the economy.[5] CBO estimates that, on average, total per capita spending on health care grew 2.1 percentage points a year faster than GDP over this period. Medicare and Medicaid expenditures grew at about the same rate as overall health care costs, with "excess growth" averaging 2.4 percentage points for Medicare and 2.2 percent for Medicaid.

After considering the factors contributing to the growth of overall health care costs over the last three decades, CBO concludes that:

> "The most important factor contributing to the growth of health care spending in recent decades has been the emergence, adoption, and widespread diffusion of new medical technologies and services. Major advances in medical science allow providers to diagnose and treat illnesses in ways that were previously impossible. Many of those innovations rely on costly new drugs, equipment, and skills. Other innovations are relatively inexpensive but add up quickly as growing numbers of patients make use of them. Although technological innovation can sometimes reduce spending, in medicine such advances and the resulting changes in clinical practice have generally increased it."[6]

CBO and almost all other health care and budget experts assume that, without significant changes in the U. S. health care system, these forces will continue to cause the growth of per capita

[5] "The Long-Term Outlook for Health Care Spending," Congressional Budget Act, November 2007.
[6] Ibid, p. 6.

health care spending to exceed the growth of GDP. Figure 2 shows clearly how much impact this has on projected Medicare and Medicaid costs relative to the demographic effects of the aging of the population.

Revenues

In claiming that the growth of entitlements is the cause of the long-term fiscal problem, some commentators seem to suggest that revenues are not a major factor in long-term deficits. But deficits obviously are the result of revenues that fall short of expenditures just as much as they are the result of expenditures that exceed revenues. It is also important to note that the President and the Congress will be faced in the next two years with a decision about revenues that will have a major impact on the size of the long-term problem.

As everyone is well aware, the 2001 and 2003 tax cuts are scheduled to expire under current law at the end of 2010. The decision whether to extend some or all of them, and whether to pay for the cost of any tax cuts that are extended, will have a big effect on projected deficits. One measure of the size of the long-term deficits is the so-called "fiscal gap," which is the net present value of past deficits and projected future deficits excluding payments of interest on the debt. (The fiscal gap tells you how much, on average, spending must be reduced, or revenues increased, or some combination of the two, in order to keep the budget on a sustainable path over the period for which the gap is measured.) The Center's long-term projections in 2007 produced an estimated fiscal gap for the period through 2050 equal to 3.2 percent of GDP if the tax cuts are made permanent without any offsets, relief from the Alternative Minimum Tax continues to be granted, and other policies remain unchanged, as described above. According to estimates by the Joint Committee on Taxation and CBO, the cost of extending the 2001 and 2003 tax cuts without any offsets would be equal to 2 percent of GDP. Thus, not extending the tax cuts – or paying for any extensions with increases in other taxes or cuts in spending – would reduce the size of the fiscal gap through 2050 by more than half. I should note that, because of the continued growth of health care costs after 2050, the fiscal gap is larger over any measured period that extends beyond 2050. Although the amount of revenue associated with the 2001 and 2003 tax cuts is much smaller than the anticipated growth over time in expenditures for federal health care programs, the fact that the decision on the fate of the tax cuts affects revenue levels by a full 2 percent of GDP starting in the next few years, rather than by an amount that is initially small and grows gradually, means that the added revenue would produce interest savings that would compound from an early date.

I am not trying here to start a debate about whether the tax cuts should be extended, but I do want to make it clear that that decision as well as other decisions about taxes will have a major impact on long-term deficits. Revenues definitely must be part of the debate over the long-term budget. I believe it will be impossible for the federal government to meet crucial existing and future needs without revenue levels above what has generally been collected over recent decades. It is important to note that revenues at the average level experienced over the previous 30 years — 18.4 percent of GDP (which is higher than CBO projects for the next 10 years if the 2001 and 2003 tax cuts and AMT relief are extended) — would have been insufficient to balance the budget in any of the last 30 years.

System-Wide Health Care Reform is Necessary

As indicated above, the "excess growth" of Medicare and Medicaid spending has closely tracked that of total health care spending, both public and private. That shows that the growth of those programs is not the result of any flaws in the structure or administration of those programs, but is instead the result of fundamental features of our whole health care system and of changes in medical knowledge and technology.

This also makes clear that slowing the growth of Medicare and Medicaid – which is ultimately crucial in dealing with the long-term budget problem – cannot sensibly and fairly be accomplished without making system-wide changes that slow the growth of private and public spending.

In his previous role as Comptroller General of the United States, David Walker said:

> "[F]ederal health spending trends should not be viewed in isolation from the health care system as a whole. For example, Medicare and Medicaid cannot grow over the long-run at a slower rate than cost in the rest of the health care system without resulting in a two-tier health care system."[7]

CBO Director Peter Orszag agrees with that assessment:

> "Many analysts believe that significantly constraining the growth of costs for Medicare and Medicaid over long periods of time, while maintaining broad access to health providers under those programs, can occur only in conjunction with slowing cost growth in the health care sector as a whole.
>
> Ultimately, therefore, restraining costs in Medicare and Medicaid requires restraining overall health care costs."

This does not imply that no steps should be taken to reduce Medicare and Medicaid costs until major changes in the health care system have been completed. It would make sense, for instance, to immediately enact the Medicare reforms that have been recommended by Congress's Medicare Payment Advisory Commission (MedPac), including the recommendation to level the playing field by eliminating overpayments to Medicare Advantage providers (which alone would save an estimated $150 billion over 10 years). There is also the potential for Medicare to take the lead in some cost-saving efforts that would then be adopted in the private sector. But it is clear that it will not be possible to reduce the growth of Medicare and Medicaid spending anywhere close to as much as is needed to help solve the long-term problem and maintain the important role those programs play in providing care to the elderly and the needy without making system-wide cost-saving changes in the way we deliver and finance health care.

---

[7]Comptroller General David Walker, "Long-Term Fiscal Issues: The Need for Social Security Reform," Testimony before the Committee on the Budget, U.S. House of Representatives, February 9, 2005, p. 18.

Solutions Must Be Balanced, Fair, and Bipartisan

The task of putting the federal budget on a sustainable course is daunting, but not impossible. It will, however, require a bipartisan consensus among the President and Congressional leaders of both parties that making the changes needed to curb the deficits we are facing under current policies is a high priority – a high enough priority that it is worth compromising on other strongly held goals in order to achieve fiscal sustainability. Progress has been made in the past – for instance, with the 1983 reforms that made Social Security solvent for about 60 years and the 1990 negotiations that led to deficit reduction of nearly $500 billion over five years – when the President and Republicans and Democrats in Congress were willing to put everything on the table – taxes and programs – and compromised on a balanced set of policies that increased revenues and reduced programs. Those compromises did not totally suit anyone, but they moved the country in a fiscally responsible direction.

There is no substitute for the commitment to work together in a balanced way to reduce projected deficits. Suggested shortcuts, such as establishing a blue-ribbon deficit-reduction panel and forcing Congress to vote up-or-down on its recommendation or putting so-called triggers and automatic cuts in place to try to force policymakers to address the problem, are no substitute for the commitment of a wide array of policymakers to work together to accomplish the goal.

The 1983 Social Security commission – the Greenspan commission – is often cited as a commission that was successful in achieving a difficult fiscal goal. But it is important to remember that the commission did not convince policymakers to compromise. President Reagan, House Speaker Tip O'Neill, and other Congressional leaders were already committed to working together to extend the solvency of Social Security when the commission was appointed (by executive order after consultation with Congressional leaders, not by statute) specifically to facilitate the negotiations needed to develop a bipartisan plan and to help build public support for the eventual plan. It is also important to remember that the commission's recommendation went through the normal Congressional process, with committee markups and floor amendments considered and adopted in the House and Senate. In fact, one of the key elements of the plan ultimately enacted – delaying the normal retirement age – was not in the commission proposal, but was added in an amendment adopted in the House.

It is also important to remember the failed history of attempts to put in place automatic budget procedures that are intended to force the President and the Congress to work together to enact deficit reduction whether they are committed to doing that or not. The 1985 enactment of the Gramm-Rudman-Hollings fixed deficit targets (with a balanced budget required by 1991) enforced by automatic cuts in federal spending was intended to force the President and Congress to address the large deficits facing the nation at that time. In a 1993 report, CBO explained what actually happened:

> "... agreement could not be reached on enough real, permanent deficit reduction to lower the deficit to the statutory level. Instead, the legal requirement to meet the targets was satisfied by using overly optimistic economic assumptions and outright

> budget gimmickry, such as shifting military pay dates between fiscal years and moving costly spending off budget."[8]

The actual deficits exceeded the targets by growing amounts every year. In 1990, the last year the deficit targets were in effect, the actual deficit exceeded a revised target enacted in 1987 by $121 billion. Gramm-Rudman-Hollings was repealed in 1990 and replaced by the Budget Enforcement Act procedures. That Act included a statutory pay-as-you-go rule and discretionary caps, which were intended to keep the President and Congress from undoing the deficit reduction they had enacted in the same bill. Those new budget procedures were ***not*** intended to force them to reach an agreement in the future. In its 1993 report, CBO concluded:

> "The experience under Gramm-Rudman-Hollings demonstrated that if the President and the Congress are unwilling to agree on a painful deficit reduction package, it is unlikely that any budget procedure can force them to agree. Instead, budgetary legerdemain is likely to be used to meet the letter of the law, and the hard decisions that would achieve real, permanent deficit reduction will still be avoided."[9]

Since there is no substitute for the strong commitment of the President and leaders of both parties in Congress to work together to put the country on a fiscally sustainable path, every effort should be made to help engender such a commitment by educating policymakers and the public on the need to make tough choices rather than spending time considering and enacting new commissions or budget procedures that may give the false impression of progress toward the goal of fiscal responsibility but are doomed to failure if policymakers are not ready to make them work.

[8] Congressional Budget Office, "The Budget Process and Deficit Reduction," Chapter Six of *The Economic and Budget Outlook: Fiscal Years 1994 – 1998*, January 1993, p. 87.
[9] Ibid.

MERCATUS CENTER
GEORGE MASON UNIVERSITY

TESTIMONY

From

The Hon. Maurice P. McTigue, Q.S.O.
Vice President of the Mercatus Center
Director, Government Accountability Project

For

Senate Homeland Security and Governmental Affairs Committee's Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security

June 26th 2008

On

"In the Red: How to Address our Nations Fiscal Challenges?"

Mr. Chairman and members of the sub-committee, I am delighted to be invited to give testimony on the important issue of deficit financing. My learned colleagues also giving testimony this afternoon will give you much information about the gravity of the problem, the causal factors of the increase in America's debt and its rate of escalation. I am going to take the opportunity to examine the experiences of other developed nations and the actions taken by their governments to try and discipline their governments spending.

The Mercatus Center at George Mason University where I work has been advancing the principles of transparent and accountable government at the state and federal level for over a decade. During my time as an elected member of the New Zealand Parliament and a member of the New Zealand Cabinet, the government implemented a series of reforms that dramatically increased the government's transparency and resulted in better government, heightened prosperity, and improved public approval ratings for government organizations. This is the philosophy driving

Mercatus's Government Accountability Project, which strongly advocates reforms that make government more open, transparent, and accountable to the people.

The research done at the Mercatus Center at George Mason University and other organizations over the last ten years shows a very strong linkage between high levels of transparency and disciplined decision-making. However, the effectiveness of transparency mechanisms is very dependant on the quality of the information available. For transparency to be effective, the information released must enable the reader to easily and accurately develop an informed opinion of the state of affairs in the subject area under consideration.

Currently, in my opinion, the American federal government system of accounting does not allow the public to readily attain real knowledge of the state of the finances of its government. In this day and age, and with the sophistication of our society, it is unacceptable for the government to use cash accounting as the basis for its disclosure to the public. According to laws passed by Congress, the performance of all activities in our economy must be disclosed to the public on a full accrual basis. ***It is time the federal government impose on itself the same standards of disclosure and accountability as it demands of the non-government sector and adopt a full accrual accounting standard for government.***

Why do I place such high value on accrual accounting? The answer is personal experience. In 1987, the New Zealand government was one of the first in the world to fully convert its government accounting procedures over to full accrual accounting. I would be the first to admit that this was a difficult and time consuming process that took about five years to complete. One of the greatest difficulties of the transition was educating elected members of the parliament to cope with financial information and government accounts in a totally different format than they had used for decades. However, the value of disciplining public behavior was enormous.

The first full set of accrual accounts were presented to the public in 1992. The balance sheet for the government of New Zealand showed that the government had negative equity equivalent to about 20% of GNP. It was surprising to us in government that the media and the public focused on this figure and described the government of New Zealand as being technically insolvent. In succeeding years, this was the figure that attracted the most public comment.

Coincidentally, 1993 was the first year that the government declared a fiscal surplus after twenty-three successive years of deficits and accumulated debt equaling 68% of GDP, a position about equivalent to that of the United States today. New Zealand is now in its 16th successive year of surpluses. By 1996, the New Zealand accounts showed that the government had positive equity, and there has been improvement since then. New Zealand has devoted almost all of the surpluses to debt reduction and repaid all foreign denominated public debt and virtually all locally denominated public debt. It is now one of the few debt-free nations. At the same time, the New Zealand government used a significant portion of recent surpluses to pre-pay the New Zealand equivalent of Social Security, which is currently paid through about 2025.

What altered public opinion about the acceptability of continuous deficits?
What changed the behavior of politicians to move away from deficit financing?
What created the discipline among politicians not to spend surpluses but rather to invest them in debt reduction and a strategy of limiting future liabilities?

In my view these changes were, in large part, a result of the transparency of the parlous situation of the New Zealand government when it became evident that the government's liabilities exceeded the nation's assets.

Along with fiscal transparency, the New Zealand government also passed a law in 1994 called the Fiscal Responsibility Act. New Zealand's Fiscal Responsibility Act was passed as an answer to the fiscal recklessness that led to a national economic crisis. The Act requires the government to transparently disclose (at regular intervals and before elections) its total revenues, total expenses, net worth, debt, tax policy, and the plan for managing fiscal risk. The Act also requires the government to publish economic forecasts every six months and use accrual accounting to manage its books. The Act established five principles for responsible fiscal management that governments are expected to follow:

1) Reduce total debt to prudent levels.
2) Manage debt by ensuring that, on average, total operating expenses do not exceed total operating revenues.
3) Achieve levels of government net worth that provide a buffer against future shocks.
4) Manage risks facing government prudently.
5) Pursue policies that provide a reasonable degree of predictability about the level and stability of tax rates.

In addition, this Act required the government to prevent future debt by allowing full transparency to act as a constraint to political action. The main features of these provisions are:

- The government, prior to incurring a deficit, must go to Parliament and seek permission from Parliament to go into debt.
- The request must identify the cause of the projected deficit.
- The request must identify how long the government will be in debt.
- The request must identify the amount of accumulated debt that will be incurred.
- The request must also identify how the government intends to repay the accumulated debt and over what period of time.

The net result of these requirements is that no government has sought permission to go into debt, and the country has a history of balanced budgets where surpluses are a regular feature of government fiscal management.

New Zealand is not alone in seeking greater transparency as a means of producing fiscal responsibility. The Australian Government passed a law called The Charter of Budget Honesty Act.

Australia's Charter of Budget Honesty Act, passed in 1998, is also grounded in transparency. The purpose of the legislation is to improve fiscal policy outcomes by requiring the government to adhere to responsible fiscal policy management principles and making fiscal policy and performance very open to the public. Like New Zealand's Fiscal Responsibility Act, the Charter requires the government to publicize a fiscal strategy statement and an economic outlook report with each budget. The New Zealand government must release an economic outlook report half way through the year and before general elections. Additionally, the government must release a budget outcome report within three months of the fiscal year's end.[1]

In a similar manner, the Government of Great Britain pursued a process of increased transparency to try and improve fiscal responsibility. The British initiative was enshrined in a code of practice, The Code for Fiscal Stability. Britain formulated its framework for fiscal policy in 1998, and the Code was given the force of law in the 1998 Finance Bill. The Code states explicitly that its purpose is to improve the quality of information provided to the public, the "lack of which in the past was an important factor underlying policy mistakes."

Five key principles of fiscal management are central to Great Britain's legislation: transparency, stability, responsibility, fairness, and efficiency. The Code also includes stringent reporting requirements: the government must report on its short and long term fiscal policy objectives and justify any deviations. The government must release a financial and economic report prior to the budget and after the budget is adopted. Finally, the government must publish a report indicating how they plan to manage their debt. All of these reports must be fully accessible to the public. [2]

The Australian and British governments have also taken initiatives to move towards some form of intergenerational accountability. Every five years, the Australian government requires government agencies to make an assessment of the consequences of current policies fifty years forward. In the case of the British government, the requirement is for government agencies to assess the consequences of current policies forty years forward every three years. The purpose of these initiatives is to identify policies or policy changes that may appear affordable in the short term but have disastrous consequences for future generations.

In addition, countries like Singapore and Hong Kong have, for many years, operated under a system of balanced budgets.

---

[1] http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/framelodgmentattachments/1AF58228894[illegible]466CA[illegible]F710051FA64?OpenDocument

[2] http://www.hm-treasury.gov.uk./media/2/9/fiscal_stability.pdf

So, what can we learn from the actions taken by other national governments? First they are all struggling with similar problems concerning fiscal responsibility. Second they seem to have settled on increased transparency as the mechanism to help discipline spending behavior by governments. Third they seem to have also settled on some type of legislative action as the means of ensuring disclosure that will discipline spending behavior.

Now to consider the American deficit and accumulating debt problem. Over the last forty years, the federal government has produced surpluses in only five years: 1969, 1998, 1999, 2000, and 2001. The federal government did not use these surpluses to retire debt but were soon extinguished by increased spending. Given current policy mixes, the likelihood of surpluses in the near future is highly improbable.

American accumulated debt is growing steadily as a proportion of GNP save policy decisions already taken and future demographic factors will dramatically worsen the situation in the future.

Congress has developed a very undesirable practice of using Supplementary Appropriation Bills as a mechanism for making spending decisions on items that are clearly not of an emergency nature. It must be assumed that this is a device to minimize scrutiny of items that might otherwise be controversial. Congress needs to clarify and restrict the definition of emergency spending to a mechanism that will allow emergency spending only to be included in these bills.

With an election imminent, it appears neither candidate nor political party places a high priority on fiscal responsibility or deficit reduction. This indicates that either the fiscal situation of the American government is not a high priority in the minds of American citizens, or they are not aware of the deteriorating financial situation of their government.

POSSIBLE SOLUTIONS

What might Congress do to return the United States's budgets to surplus as a norm?

- Require that budgets and financial reports cover a much longer time horizon of at least ten years forward.
- Return the supplementary appropriation process to one that accommodates emergency spending only.
- Pass a law that defines fiscal responsibility and requires the United States government to operate in a fiscally responsible manner.
- Move the whole of the federal accounting process to full accrual accounting.
- Introduce an appropriation process based upon the purchase of outputs designed to produce given outcomes.

Yours respectfully,

Hon. Maurice P. McTigue

Post-Hearing Questions for the Record Submitted to Gene Dodaro, Acting Comptroller General, U.S. Government Accountability Office

Senator Carper's Questions and GAO's Responses

1. *A number of agencies continue to blame their non-compliant systems for the lack of progress on eliminating other material weaknesses and impediments to clean audit opinions. Isn't the reconciliation of the data unavoidable, and in fact, considered better not to wait and to have cleaned up before new systems are brought on-line? Is OMB ensuring that progress is continuing despite the continued need for new systems in some cases?*

The ongoing reconciliation of financial data is a necessary and valuable internal control in a sound financial management system to ensure the integrity of the financial records. Reconciliations are performed to verify the completeness and accuracy of the accounting records by comparing them with related records at regular intervals. Reconciliation efforts are especially important when agencies do not have integrated financial management systems that allow transactions to be recorded once for a variety of purposes. In circumstances that require data entry two or more times, it is critical to have and effectively implement reconciliation efforts to detect and correct any inaccurate recording of data. Thus, reconciliations help ensure that conflicting data are not maintained on separate sets of records, which could result in misstatements in the financial statements and other reports. Auditors reported that of the 13 Chief Financial Officers (CFO) Act agencies whose systems were not in substantial compliance with one or more of the Federal Financial Management Improvement Act (FFMIA) requirements for fiscal year 2007, 10 had inadequate reconciliation procedures.

Reconciliations are also an essential activity prior to a system conversion. In its white paper on financial system data conversion,[1] the Joint Financial Management Improvement Program (JFMIP) identified data conversion[2] as one of the critical tasks necessary to successfully implement a new financial system. Data conversion involves, among other things, performing data cleanup and validation, including reconciling transactions. Reconciliation and adjustment to correct identified errors in data in the legacy system are essential prerequisites to successful conversion.

On the other hand, converting data incorrectly or entering unreliable data from a legacy system has long-term repercussions. For example, in September 2004, we reported potential problems with the Department of Health and Human Service's (HHS) data conversion to its Unified Financial Management System.[3] Three years later, in fiscal year 2007, HHS's auditors reported[4] that serious financial system issues continue as a result of conversion problems; HHS had to manually record more than 800 adjusting entries exceeding $170 billion into the system; and a cumbersome, manual process is used to compile HHS's financial statements. Furthermore, HHS's auditors found that reconciliation processes were not adequately performed to ensure that differences in general ledger account balances were properly identified, researched, and resolved in a timely manner.

---

[1]Joint Financial Management Improvement Program, *White Paper: Financial Systems Data Conversion–Considerations* (Washington, D.C.: Dec. 20, 2002).

[2]Data conversion is defined as the modification of existing data to enable them to operate with similar functional capability in a different environment.

[3]GAO, *Financial Management Systems: Lack of Disciplined Processes Puts Implementation of HHS' Financial System at Risk*, GAO-04-1008 (Washington, D.C.: Sept. 23, 2004).

[4] Department of Health and Human Services, *FY 2007 Agency Financial Report* (Washington, D.C.: Nov. 15, 2007).

With regard to the Office of Management and Budget's (OMB) oversight role, OMB stated in its Federal Financial Management Report for 2008 that the Office of Federal Financial Management (OFFM) will work with agencies to continue to address financial systems material weaknesses. In the same report, OMB stated that OFFM's ongoing work with the Chief Financial Officers Council and the President's Council on Integrity and Efficiency (PCIE)[5] is critical to ensuring that the framework for improving financial performance, including financial systems, is effective. In assessing an agency's overall progress, OMB analyzes and reports information provided by agencies on their financial management system implementation and other information technology (IT) project planning, execution, and performance activities. Each quarter, OMB reports and identifies projects with planning weaknesses in its Management Watch List. In addition, OMB reports and identifies projects requiring special attention from oversight authorities in its High Risk List.

OMB has stated that in addition to these oversight activities, it continues to assist agencies in developing sound financial management practices under its Financial Management Line of Business (line of business) initiative. Since launching this initiative in March 2004, OMB has continued to make incremental progress toward the line of business goals, which include (1) reducing costs by providing a competitive alternative for agencies to acquire, develop, implement, and operate financial management systems through shared service solutions and (2) standardizing systems, business processes, and data elements. However, additional efforts are

[5] Under Public Law No. 110-409, enacted on October 14, 2008, the PCIE and Executive Council on Integrity and Efficiency (ECIE) are being replaced by a single, independent Council of the Inspectors General on Integrity and Efficiency.

needed to address recommendations included in our March 2006 report regarding key aspects of this initiative, such as developing an overall concept of operations, identifying and defining additional standard business processes, and ensuring that agencies do not continue to develop and implement their own stove-piped systems.[6] We are currently reviewing the status of the line of business initiative and OMB's progress toward addressing our prior recommendations.

2. *Reconciliation of intragovernmental activity is a government-wide material weakness and the report states that some agencies failed to even provide explanations for the differences between their records and the records of those agencies they do business with. When can we expect the necessary central leadership to resolve these issues between agencies and the elimination of this material weakness on the consolidated financial statements?*

Based on our audit of the U.S. government's consolidated financial statements for fiscal year 2007, we noted that OMB and Treasury have undertaken steps to address GAO's recommendations to improve the reconciliation of intragovernmental activities and balances. For example, OMB issued Memorandum No. M-07-03, *Business Rules for Intragovernmental Transactions* on November 13, 2006, and Treasury issued the Treasury Financial Manual Bulletin No. 2007-03, *Intragovernmental Business Rules* on November 15, 2006. This guidance added criteria for resolving intragovernmental disputes and major differences between trading partners and called for the establishment of an Intragovernmental Dispute Resolution Committee, which is to provide a mechanism for the resolution of disputes or major differences among federal agencies when reconciling

---

[6] GAO, *Financial Management Systems: Additional Efforts Needed to Address Key Causes of Modernization Failures*, GAO-06-184 (Washington, D.C.: Mar. 15, 2006).

intragovernmental balances and transactions with each other. To date, OMB has also taken steps to:

(1) Define recommended systems changes, if needed.

(2) Reconvene discussions with chief financial officers and continue publishing a "Watch List" that includes federal agencies with large imbalances between each other. The Watch List was developed to facilitate progress on some of the largest intragovernmental imbalances, bring federal agency reporting into alignment with the Intragovernmental Business Rules, bring the appropriate representatives together from the respective agencies, and document the issues and resolutions.

(3) Complete a standardized intragency agreement template for agencies to use as part of defining standard business processes for reimbursable activity.

Currently, GAO has six open recommendations to OMB and Treasury related to the intragovernmental differences and reconciliations area. Some of these recommendations address issues such as enforcement of OMB's Business Rules, resolution of significant differences between trading partners, creation of balanced intragovernmental elimination entries, and implementation of a process by Treasury and OMB to obtain information from individual federal agencies regarding their out-of- balance condition.

Resolving the intragovernmental transactions problem remains a difficult challenge requiring strong sustained commitment by federal agencies and leadership by OMB and Treasury. We will continue to monitor actions taken to address the intragovernmental transactions problem and report on the effectiveness of these actions in connection with our audit of the U.S. government's consolidated financial statements.

3. *A growing number of agencies are now getting clean opinions on their own financial statements. How is it, then, that so many problems arise when it comes time for Treasury to create the consolidated government-wide financial statements? This seemingly elemental problem has been unsolved for years. When do you expect a remedy?*

Although many federal agencies are receiving unqualified audit opinions on their financial statements, several key agencies are not yet in a position to receive unqualified ("clean") opinions. The Department of Defense (DOD), Department of Homeland Security, Department of State, and National Aeronautics and Space Administration all received disclaimers of opinion on all of their fiscal year 2007 financial statements.[7] These agencies comprise a significant portion of the government's reported total assets and net cost.

In addition to these agencies' significant problems, there are numerous continuing control deficiencies related to Treasury's processes for preparing the consolidated financial statements. Further, Treasury's elimination of certain intragovernmental activity and balances continues to be impaired by the federal agencies' problems in handling their intragovernmental transactions, which were discussed in question number 2 above. For fiscal year 2007, as we had in previous years, we reported that Treasury lacked adequate systems and personnel to address the magnitude of the

[7] For the Department of Homeland Security, only the Consolidated Balance Sheet and the Statement of Custodial Activity were subjected to audit, and both these statements had a disclaimer of opinion.

financial reporting challenges it faced.[8] We have made numerous recommendations to address the deficiencies related to Treasury's processes for preparing the consolidated financial statements.[9] It is difficult to reasonably predict when Treasury and applicable federal agencies will resolve deficiencies with respect to (1) material weaknesses in internal control that have contributed to certain key agencies' inability to obtain an opinion on their financial statements and (2) the control deficiencies related to the preparation of the federal government's consolidated financial statements. Sustained, strong commitment by the respective federal agencies and Treasury will be essential to their resolution.

4. *With a major contributor to the adverse opinion on internal controls now including tax collection activities, are there financial management and enforcement tools needed by the IRS to address tax activity management issues that do not require changes to the tax code that you recommended?*

As part of our audit of the Internal Revenue Service's (IRS) fiscal year 2007 financial statements, we reported that IRS's internal controls over financial reporting and compliance with laws and regulations were ineffective due to material internal control weaknesses.[10] Specifically, we found that control and system deficiencies resulted in errors and delays in IRS's recording of taxpayer information, payments, and other activities. These deficiencies adversely affect IRS's ability to routinely report reliable information without substantial manual adjustments, and also result in

---

[8] Treasury, 2007 *Financial Report of the United States Government* (Washington, D.C.: 2007).

[9] See our report to the Secretary of the Treasury and Director of the Office of Management and Budget: *Financial Audit: Material Weakness in Internal Control over the Processes Used to Prepare the Consolidated Financial Statements of the U.S. Government,* GAO-08-748 (Washington, D.C.: June 17, 2008) for the status of open recommendations.

[10] GAO, *Financial Audit: IRS's Fiscal Years 2007 and 2006 Financial Statements,* GAO-08-166 (Washington, D.C.: Nov. 9, 2007).

(1) taxpayers not always being credited for payments they have made on taxes owed and (2) delays in releasing tax liens filed against taxpayers' property. Additionally, we reported that IRS lacked cost-benefit information and related cost-based performance measures to enable its managers to assess the effectiveness of its existing enforcement programs and to make informed decisions regarding how best to allocate its limited resources among these programs. We have made numerous recommendations to address these issues.[11]

Regarding enforcement tools, there are many improvements that IRS could employ to enhance collections without changes to the internal revenue code.

In our work, we have found that IRS does not always make effective use of the full array of enforcement tools currently available to it.[12] For example, we have reported that IRS

(1) does not appropriately track the causes for noncompliance with the tax laws, or have an enforcement strategy to address those causes;

---

[11] GAO, *Internal Revenue Service: Status of GAO Financial Audit and Related Financial Management Report Recommendations*, GAO-08-693 (Washington, D.C.: July 2, 2008).

[12] GAO, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes,* GAO-08-617 (Washington, D.C.: July 25, 2008); *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2008); *Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap,* GAO-05-753 (Washington, D.C.: July 18, 2005); *Tax Debt Collection: IRS Needs to Complete Steps to Help Ensure Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 (Washington, D.C.: Sept. 29, 2006); *Tax Gap: Actions That Could Improve Rental Real Property Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008); *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season,* GAO-08-567 (Washington, D.C.: Mar. 13, 2008); *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated,* GAO-08-38 (Washington, D.C.: Nov. 15, 2007).

(2) utilizes a tax collection approach that focuses on voluntary compliance, even in cases of egregious payroll tax offenders;

(3) lacks a tax gap strategy that addresses sole proprietor noncompliance and the many options that could address it;

(4) does not always timely file tax liens or assess penalties to individuals who fail to remit business payroll taxes due;

(5) lacks performance measures to set goals related to payroll tax collection and the prevention of unpaid payroll taxes, and to track performance against such goals;

(6) does not know the population of paid tax return preparers assisting taxpayers and does not have adequate information to identify poorly performing paid preparers to target outreach, education, and enforcement efforts to improve paid preparers' performance;

(7) could take a number of steps to better ensure that taxpayers with rental real estate more accurately report their income and expenses;

(8) does not know the benefits, in terms of processing costs and improved enforcement, of having all return information available electronically; and

(9) does not know at what point it is cost effective to capture tax return information electronically.

We have also identified instances in which IRS could partner with states to improve the effectiveness of some of its enforcement tools, particularly with respect to levying assets of egregious tax debtors to collect outstanding taxes owed. We have made recommendations to IRS to address these matters and will continue to follow up on the progress IRS has made in addressing them.[13]

[13] GAO-08-617.

5. *Should more specific deadlines be imposed by Congress with regard to the DOD's current roadmap for success called the Financial Improvement and Audit Readiness (FIAR) Plan, such as mandating when DOD will begin undergoing the actual DOD-wide audit so that they begin being subjected to this annual drill that has been successful in pushing so many agencies to a clean opinion government-wide? What can be done to accelerate efforts to get a clean opinion at DOD?*

Given the size and complexity of DOD's financial management operations and its dependency on people, processes, and systems from operating activities outside the control of its CFO, it is difficult to estimate a meaningful deadline by when the department should achieve financial statement auditability. Calling for such a deadline and holding DOD accountable for meeting that deadline may result in an increased focus on improving systems and implementing more disciplined financial management processes across DOD.

As the auditor responsible for auditing DOD's financial statements, the DOD Inspector General annually reports on process, control, system, and other deficiencies that impede its ability to opine on the department's statements. To assist the department in obtaining a clearer understanding of its financial management impediments and actions needed to address them, the DOD Inspector General also performs more in-depth reviews of specific financial management or impediment areas, such as property, plant, and equipment. In response to a congressional mandate to DOD to address its financial management challenges, the department issued its FIAR Plan in December 2005. This plan outlines DOD's strategy for addressing its financial management challenges and achieving clean audit opinions.[14]

The effectiveness of DOD's FIAR Plan will ultimately be measured by sustained improvements in the department's ability to provide timely, reliable, and useful information for day-to-day management and decision making. With the upcoming change in administration, congressional leadership and oversight of DOD's efforts to address its financial management challenges and achieve financial statement auditability are crucial in ensuring that sustained improvements are implemented.

Pursuant to your oversight and continuing interest in DOD's progress toward resolving its long-standing financial management problems and achieving financial accountability, we have started the first of a series of reviews to evaluate DOD's efforts in this area. At your request, our first review will assess DOD's (1) process for defining its critical path for achieving financial statement auditability and (2) oversight and monitoring process and controls for ensuring progress toward achieving and sustaining financial statement auditability.

[14] The National Defense Authorization Act for Fiscal Year 2006, Pub. L. No. 109-163, § 376, 119 Stat. 3136, 3213 (Jan. 6, 2006) and John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, § 321, 120 Stat. 2083 (Oct. 17, 2006) extended the written determination (the FIAR Plan) to fiscal year 2007.

Senator Coburn's Questions and GAO's Responses

1. *You testified recently that "by definition something that is unsustainable will stop." Would you characterize the federal government's current budget as "unsustainable?"*

The current long-term path of spending and revenues is unsustainable. The federal government faces large and growing structural deficits, which are driven on the spending side primarily by rising health care costs and known demographic trends.

a. *Why does Congress continue to ignore the coming fiscal crises that we face from our budget choices?*

Attention is now understandably focused on serious challenges with financial markets and a broad economic slowdown. Once these issues are addressed, our nation's new and returning policymakers need to turn their attention to the serious long-term fiscal challenges with the same intensity being devoted to short-term problems.

Bringing spending and revenue to a sustainable path will require tough choices and difficult decisions on entitlement spending, discretionary spending, and revenues. GAO's work looking at other countries' experiences suggests that reform of entitlement programs is difficult, but possible.[1]

[1] GAO, *Entitlement Reform Process: Other Countries' Experiences Provide Useful Insights for the United States,* GAO-08-372 (Washington, D.C.: Jan. 18, 2008).

Several countries more advanced in population aging and facing greater demographic challenges than the United States have successfully undertaken reforms of major entitlement programs. Since the 1980s, almost all of the Organisation for Economic Co-operation and Development (OECD) countries have restructured their public pension programs; disability, unemployment, and other programs have also been reformed. Many reform efforts began or accelerated in an environment of economic and fiscal crisis. Other prompts included longer term concerns about population aging and economic competitiveness, and supranational factors such as a desire to meet the fiscal criteria for entry into the European Union.

In many countries, reform occurred despite political processes that made it difficult. Consensus had to be built in coalition governments, and leaders had to work across parties to achieve a broad consensus for reform. Commissions were helpful in developing proposals, but this was only one stage in the reform process. Leaders needed to define the problem, persuading others that reform was needed and urgent. The challenge was to build a broad coalition to assure the reform's permanency while preserving the main policy initiatives sought in the reform process.

b. Is there a quantifiable way to gauge the price the next generation will have to pay for each year Congress is derelict in its duty to cease and desist from stealing from our children and grandchildren?

One way to measure this is to use "fiscal gap"—a measure of what would be needed to close the gap between projected spending and revenues over a certain time period. Under our alternative simulation, closing the fiscal gap would require noninterest spending cuts or tax increases equal to 6.7 percent of the entire economy over the next 75 years, or about $54 trillion in present value terms.[2] To put this in perspective, closing the gap would require an (1) increase in today's federal tax revenues of more than one-third or (2) equivalent reduction in today's federal program spending (i.e., in all spending except for interest on the debt held by the public, which cannot be directly controlled) or an equivalent combination of revenue increases and spending decreases, and maintained over the entire period. Alternatively, policymakers could phase in the policy changes so that the tax increases or spending cuts would grow over time and allow people to adjust. However, delaying action would make future adjustments even larger.

Understanding and addressing the federal government's financial condition and the nation's long-term fiscal challenge are critical. As we reported in December 2007,[3] several countries have begun preparing fiscal sustainability reports and European Union members annually report on longer term fiscal sustainability. The goal of these reports is to increase public awareness and understanding of the long-term fiscal outlook in light of escalating health care

[2] For more information about GAO's fiscal simulations see GAO, *The Nation's Long-Term Fiscal Outlook: April 2008 Update*, GAO-08-783R (Washington D.C.: May 2008).

[3] GAO, *Budget Issues: Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting on Our Nation's Longer-Term Fiscal Challenge*, GAO-08-206 (Washington, D.C.: Dec. 20, 2007).

cost growth and population aging, to stimulate public and policy debates, and to help policymakers make more informed decisions. These countries used a variety of measures, including projections of future revenue and spending and summary measures of fiscal imbalance and fiscal gaps, to assess fiscal sustainability. Last year, we recommended that the United States prepare and publish a long-range fiscal sustainability report.[4] To that end, the Federal Accounting Standards Advisory Board (FASAB) has recently issued an exposure draft on fiscal sustainability reporting[5] that would require that the consolidated financial report of the U.S. government present information addressing the fundamental question of whether the government can sustain public services and meet its obligations as they come due. Written comments are requested by January 5, 2009.

c. *How much more painful will it be for our children and grand children to fix the mess we are making?*

Albert Einstein said the most powerful force in the universe is compound interest, and today the miracle of compounding is working against the federal government. Bringing spending and revenue to a sustainable path will require tough choices and difficult decisions on entitlement spending, discretionary spending, and taxes. However, it is important to remember that millions of people are dependent on Social Security, Medicare, and Medicaid for income

[4] GAO, *Long-Term Fiscal Challenge: Additional Transparency and Controls Are Needed,* GAO-07-1144T (Washington, D.C.: July 25, 2007), and *Long-Term Budget Outlook: Deficits Matter—Saving Our Future Requires Tough Choices Today,* GAO-07-389T (Washington, D.C.: Jan. 23, 2007).

[5] *Reporting Comprehensive Long-Term Fiscal Projections for the U.S. Government; Statement* of *Federal Financial Accounting Standards Exposure Draft* (Sept. 2, 2008).

and health care. The longer reform is put off, the larger the benefit and tax adjustments will need to be. Acting sooner rather than later would give people time to prepare for and adjust to any changes in benefits.

2. *In order for policy makers to embark on a significant change in the nation's long term fiscal challenge, it is imperative that reliable, useful and timely financial and management information be readily available in financial statements and reports.*

    a. *In your opinion, is the federal government unable or unwilling to make that information available?*

As we testified, the federal government has been unable to provide reliable, useful, and timely financial and management information for the government as a whole.[6] Three major impediments continued to prevent the federal government from receiving an opinion on its fiscal year 2007 accrual basis financial statements: (1) serious financial management problems at DOD, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies, and (3) the federal government's ineffective process for preparing the consolidated financial statements. Further, the federal government has not developed the managerial accounting and information systems required to generate reliable, useful, and timely financial and management information for decision-making purposes, either internally or for external reporting and oversight. While there has been a series of legislation calling for the capacity to do this, in many

[6] GAO, *Fiscal Year 2007 U.S. Government Financial Statements: Sustained Improvement in Financial Management is Crucial to Improving Accountability and Addressing the Long-Term Fiscal Challenge*, GAO-08-926T (Washington, D.C.: June 26, 2008).

cases it is not yet a reality. Based on the scope of these problems and progress to date, they are not likely to be resolved in the short term.

Significant progress has been made in improving federal financial management. For example, audit results for many federal agencies have improved and federal financial systems requirements have been developed. In addition, across government, financial management improvement initiatives are underway which if effectively implemented have the potential to greatly improve the quality of financial management information available for decision makers. However, the federal government still has a long way to go.

Our recently issued 12th annual report on compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996 concluded that significant financial management systems issues persist.[7] Based on agency inspectors general and independent accounting firm reports, 13 of the 24 Chief Financial Officers (CFO) Act agencies' systems were not in substantial compliance with one or more of the three FFMIA requirements for fiscal year 2007.

b. *What will it take for the federal government to make the information available?*

Sustained and concerted efforts by many individual federal agencies, in coordination with Treasury and OMB, will be needed to resolve the above noted serious obstacles preventing the federal government from receiving an

---

[7] GAO, *Financial Management: Persistent Financial Management Systems Issues Remain for Many CFO Act Agencies*, GAO-08-1018 (Washington, D.C.: Sept. 30, 2008).

opinion on its accrual basis consolidated financial statements and establishing and maintaining systems that can routinely generate reliable and timely financial data.

Further, the federal government should consider the need for enhancements to the current federal financial reporting model to recognize the unique needs of the federal government. A broad reconsideration of issues, such as the kind of information that may be more relevant and useful for a sovereign nation such as how certain items like social insurance commitments and the power to tax should be reported, could lead to reporting enhancements that might help provide Congress and the President with more useful financial information to deliberate strategies to address the nation's long-term fiscal challenge.

Moreover, further enhancements to federal accounting and financial reporting standards may be needed to effectively convey the long-term financial condition of the U.S. government and annual changes therein. For example, as noted in our response to question number 1b above, the federal government's financial reporting could be enhanced by following the lead of certain European countries by including (1) a Statement of Fiscal Sustainability[8] that provides a long-term look at the sustainability of social insurance programs in the context of all federal programs and (2) other sustainability information, including intergenerational equity.[9]

[8] The Statement of Fiscal Sustainability would show the relationship between the present value of projected revenues and outlays for social insurance and for all other federal programs.

[9] Intergenerational equity assesses the extent to which different age groups may be required to assume financial burdens to sustain federal responsibilities.

It is important that the progress that has been made in improving federal financial management activities and practices be sustained by the new administration that takes office next year and that Congress continues its oversight to bring about needed improvements to federal financial management. Given the federal government's current financial condition and the nation's long-term fiscal challenge, Congress' need for reliable, useful, and timely financial and performance information is greater than ever.

3. *Improper payments: fiscal year 2007 government-wide report estimated $55 billion were lost in improper payments—billions of dollars that could have gone towards financial management for decreasing improper payments or could have been deposited back into the Treasury to bring down the size of the government and pay off its massive debt. Why do you think so many in the federal government are hostile to not just reporting but also reducing improper payments?*

We are unaware of any instances in which federal agencies have been hostile to addressing the requirements of the Improper Payments Information Act (IPIA), including reducing improper payments. However, as we previously testified, concerted efforts are needed because measuring improper payments and designing and implementing actions to reduce them are not simple tasks or easily accomplished.[10] These activities become even more challenging for grant programs that rely on administration efforts at the state level. For example, since IPIA implementation, the Department of Health and Human Services (HHS) has been unable to report improper payments for some of its state-administered programs.[11] Instead, HHS generally reported on its various pilot reviews in these programs to

[10]GAO, *Improper Payments: Status of Agencies' Efforts to Address Improper Payment and Recovery Auditing Requirements*, GAO-08-438T (Washington, D.C.: Jan. 31, 2008).

[11] These include the Child Care and Development Fund, the State Children's Health Insurance Program, and the Temporary Assistance for Needy Families program.

show that efforts are underway to fully address IPIA reporting requirements. However, HHS expects to report estimated improper payment rates for these programs as part of its fiscal year 2008 IPIA reporting. Statutory or regulatory barriers are another challenge that agencies reported limited their ability to reduce improper payments. Examples of these barriers include regulations that restrict an agency's ability to recover improper payments and legislation that precludes data matching against tax return information.

While federal agencies continue to face major challenges in meeting the goals of IPIA and ultimately improving the integrity of payments, we reported in January 2008 that agencies have made progress in estimating and reducing improper payments.[12] For example, for fiscal year 2007, 19 agency programs and activities reported improper payment estimates for the first time, including the Medicaid program which reported $13 billion, which we view as a positive step to improved transparency over the full magnitude of federal improper payments. Similarly, federal agencies continued to report that they had made progress in reducing improper payments. Of the 39 agency programs reporting improper payment error rates since IPIA implementation (2004 through 2007), 23 of the programs, or about 59 percent, reported reduced error rates when comparing each program's fiscal year 2007 error rate to the initial or baseline error rate reported for fiscal year 2004. In a similar analysis comparing fiscal year 2007 and fiscal year 2006 error rates, we found that 34 of the 53 reporting programs reported reduced error rates. However, we also identified indicators that some

[12]GAO-08-438T.

federal agencies may not yet have fully identified and reported on the full extent of their improper payments.

4. *Earmarks: The U.S. Government has earmarked $18 billion for pork-barrel projects this year. What impact do earmarks have on increasing the discretionary spending of the federal budget each year?*

"Earmarks" constitute a congressional directive on how appropriated funds should be spent.[13] As such, they affect the allocation of such funds rather than the total amount of discretionary spending.

[13] For an explanation of the different meanings of the term "earmark," see GAO, *Congressional Directives: Selected Agencies' Processes for Responding to Funding Instructions*, GAO-08-209 (Washington, D.C.: January 2008).

Post-Hearing Questions for the Record
Submitted to James Horney, Budget Director
Center on Budget and Policy Priorities

From Senator Thomas R. Carper

"In the Red: How to Address our Nation's Financial Challenge"
June 26, 2008

1. Does the recently developed and audited Statement of Social Insurance (SOSI) go far enough in creating the transparency needed to understand the financial implications of the Social Security, Medicare, Medicaid and related programs? How do you see the roles of Congress, the agencies, and accounting standards setting bodies in changing how the SOSI information is presented, and the presented results used?

   Answer: The information provided in the Statement on Social Insurance (SOSI) about the long-term costs of Social Security and Medicare is certainly important to any understanding of the very serious long-term budget problem facing the United States. The SOSI stresses the importance of going beyond the trust fund perspective on Social Security and Medicare to understand how those programs fit into and affect the governmentwide budget outlook. I agree with that, which is why I think that analyses that incorporate long-term projections of Social Security and Medicare spending and revenues into long-term projections of the rest of the budget, such as the long-term projections made by the Congressional Budget Office, the Government Accountability Office, the Office of Management and Budget, and the Center on Budget and Policy Priorities, are more useful in portraying the nature of the long-term budget problem facing us and how social insurance programs affect the long-term budget. From the perspective of one who is interested in focusing more attention on how we should begin to deal with the long-term budget problem, I am more interested in trying to focus attention on such projections of the overall long-term budget problem — and the key role that rising health care costs, including the costs of Medicare play in that problem — than in changing the presentation or the use of the information provided in the SOSI.

2. Problems with the escalating costs of Social Security, Medicare, and Medicaid are partially attributable to the special treatment of these trust funds, rules that allow for these programs to be written a "blank-check" and remain on "auto-pilot." Please explain how some other countries have dealt with social insurance funding issues through self-adjusting cost stabilizers, cost indexing or other tools that might be beneficial in managing these programs.

Answer: I do not believe it is accurate to describe Social Security, Medicare, and Medicaid as being given a "blank check" or being on "auto-pilot" (and it certainly is not any special status as "trust fund" programs that would have this effect in any case, since Medicaid does not have a trust fund and some programs that do have a trust fund — such as the highway program — are subject to annual appropriations decisions). Although Social Security, Medicare, and Medicaid are not subject to annual appropriations, the Congress has over the last 25 years made many changes that affect those programs. In particular, cuts in Medicare spending have been a major component of every significant deficit reduction package during that period.

I also believe that it is important that social insurance programs like Social Security, Medicare, and Medicaid not be subject to annual decisions about how much to spend on them. It is important that Social Security recipients know well in advance how much they are due to receive (that is why the major changes made to the program in 1983 and all of the changes in benefits proposed by policymakers in recent years are phased in over time) and that Medicare and Medicaid beneficiaries and providers know that care and reimbursement will be provided as promised in the coming year even if the cost of those programs for a year is higher than had been estimated.

I also believe that self-adjusting automatic stabilizers intended to ensure that costs are constrained are likely either to be ineffective or harmful. The obvious example of that is the Sustainable Growth Rate (SGR) rules enacted in 1997 to limit the growth of Medicare physician payments. The SGR rules set targets for total Medicare physician-related costs, and provided that if those costs exceed the targets, physician reimbursement rates will be reduced to bring the costs back down to the target. Because the SGR and other Medicare rules did not provide real incentives or other policy changes that would reduce the demand for or incentives to provide physician services, or the growth in the cost of providing such services, the target was exceeded by 2002. One round of cuts in Medicare physician reimbursement rates went into effect in 2002, but Congress has since taken steps that have provided temporary overrides of the cuts required by the SGR mechanism. (Most recently, Congress overrode a Presidential veto in July to cancel physician payment cuts scheduled for this year and next, but left in place the SGR rules that provide for a 21 percent reduction in payment rate in 2010 if no further action is taken).

3. What are your thoughts on the recommendation by Mr. McTigue that we adopt full accrual accounting like New Zealand and other nations have? How would a move in this direction affect the way we do things?

Answer: I do not think it would be appropriate for the federal government to adopt full accrual accounting for the federal budget. I believe that the federal government is fundamentally different from a business, and that trying to apply accrual concepts that are appropriate in determining whether a business is making or losing money in a given year to the federal government would be inappropriate.

In a number of cases, however, an accrual concept is useful in the federal budget. In some cases, an accrual approach has already been instituted in a manner that affects the budgets and decision-making of individual agencies. For instance, agency budgets and appropriations reflect the accrual of federal employee retirement benefits (although retiree health care benefits are not fully reflected), although once all transactions and transfers are taken into account, the bottom-line effects of retirement effects on the whole budget are shown on a cash basis.

In addition, the federal government in 1990 adopted an accrual-type treatment of federal loans and loan guarantees, showing only the subsidy cost of new loans and loan guarantees — not the annual cash flows — in the budget results for the year in which commitments are made.

In addition, because the federal government is different from a business, it would be difficult to determine how appropriately to apply accrual concepts to the federal budget. For instance, how should the costs of defense procurement be recorded under an accrual approach Furthermore, some proponents of accrual budgeting believe that promised future benefit payments by Social Security and other social insurance programs should be shown on an accrual basis (New Zealand and other countries generally do not show social insurance on an accrual basis). But unlike pension payments promised by businesses Social Security and other benefit payments are not required by any legally binding contract — the Congress is free to change those payments at any time if it determines that is in the national interest. Since the federal government is no less committed to providing for the national defense in the future than it is to paying Social Security benefits, it does not seem to make sense to me to devise a budget that treats such commitments differently (and I believe the current treatment of both is the appropriate treatment).

4. As you know, we often pass supplemental spending bills that include a great deal of so-called, "emergency spending" that, in many cases, is not for emergencies at all. In Delaware, we take a different approach. We're actually required to set aside money in a rainy day fund for emergencies that is actually pretty difficult to dip into. How would you change the way we handle emergency and supplemental spending here at the federal level?

Answer: The most important step is to develop a consensus among policymakers, that an emergency designations of new spending should be reserved for true emergency needs. For most of the 1990s, when there was a strong bipartisan commitment to abiding by statutory discretionary caps, emergency designations were almost entirely limited to appropriations of funds to meet true emergency needs, such as responses to hurricanes and earthquakes. When the consensus to abide by the caps broke down in the late 1990s — the result both of the development of budget surpluses and the establishment of new, unrealistic discretionary caps in the 1997 Balanced Budget Act — Congress began applying the emergency designation as a way to evade caps that policymakers were no longer committed to. In the absence of a strong commitment by policymakers to abide by agreed-upon limits on discretionary spending (whether set in statute or by a budget resolution), no process mechanism can prevent the use of a claim of emergency needs to try to evade such limits.

This does not mean that budget leader should not try to make the process of providing funding for emergency needs more transparent, for instance by trying to ensure that the President requests and the Congress provides appropriations for the Federal Emergency Management Agency, firefighting accounts at the Department of Interior and other agencies, and other programs that regularly respond to natural and other kinds of disasters at levels that reflect the average needs of such programs. This would reduce the need to provide supplemental, emergency funds except when hurricanes or other events inflict a higher-than-average level of damage.

MERCATUS CENTER

GEORGE MASON UNIVERSITY

Post-Hearing Questions for the Record
Submitted by Maurice McTigue, Director,
Mercatus Center, George Mason University

For Senator Thomas R. Carper

"In the Red: How to Address our Nation's Financial Challenge"
June 26, 2008

1. Does the recently developed and audited Statement of Social Insurance (SOSI) go far enough in creating the transparency needed to understand the financial implications of the Social Security, Medicare, Medicaid and related programs? How do you see the roles of Congress, the agencies, and accounting standards setting bodies in changing how the SOSI information is presented, and the presented results used?

I have looked at the Statement of Social Insurance (SOCI) and also the Reports of the Trustees for Social Security, Medicare, and Medicaid. These documents are very well prepared and exhibit a high level of professionalism. They also accurately outline the state of the trusts and the long-run problems for the trusts given no change to current policy.

In my view, the problem does not lie with the content of these reports—it lies with the failure of Congress to act on the advice of the trustees and take some remedial action to place these policies on a fiscally responsible long-term viability path. That said, if changes to the reporting process were to be made, I would advocate that the trustees use more blunt language in their reports so that it is more difficult to ignore the advice being given.

Another possible change would be to make it mandatory that the appropriate congressional committees hold annual hearings on the status of these trust funds examining their viability looking forward at least fifty years. Currently, Congress is just passing the problems of these entitlement spending programs on to future generations with high expectations of the benefits to be provided, which will probably not be met.

2. Problems with the escalating costs of Social Security, Medicare, and Medicaid are partially attributable to the special treatment of these trust funds, rules that allow for these

programs to be written a "blank-check" and remain on "auto-pilot." Please explain how some other countries have dealt with social insurance funding issues through self-adjusting cost stabilizers, cost indexing or other tools that might be beneficial in managing these programs.

The management of trust funds does require a commitment to the title "trust funds" so that the principles of trustee management are indeed applied to the monies held in trust. The "blank check" and "auto-pilot" problems can best be controlled by a process that links benefits to some major economic indicator. The New Zealand government at one time adjusted benefits in these funds by linking them to both the consumer price index (CPI) and to the national average wage. In the early 1990s, this linkage was changed as entitlements had grown rapidly through this dual linkage. The new process linked adjustments to the CPI only but also contained a guarantee that benefits would not fall below 62 percent of the national average wage. Over time, the single indicator linkage saw benefits fall from about 84 percent of the average wage to somewhere around 64 percent of the average wage. A useful mechanism to provide early warning to both Congress and the public would be to have budget documents include the mandatory expenditures of Social Security, Medicare, and Medicaid that showed out years five, ten and twenty years ahead and the likely budget consequences in those future years. Such a disclosure system would act as a cautionary principle for Congress to prepare for the day when expenditures are not covered by the trust funds.

3. In your testimony you recommended that we adopt full accrual accounting like New Zealand and other nations have? What would be presented differently? Overall, how would a move in this direction affect the way we do things?

The benefit of full accrual accounting is it can provide a much clearer picture of the government's fiscal position with a significantly diminished opportunity to distort fiscal outcomes, such as by bringing forward revenues while delaying payments or other actions that are frequently used in cash-accounting systems to avoid disclosing embarrassing fiscal outcomes. The process of implementing full accrual accounting is well known and well documented with a large number of governments now using at least some form of accrual accounting. However, the process does involve a very large workload and a significant cost in technology and adjustments to data collection and presentation. It took the New Zealand government four fiscal years to fully implement accrual accounting. The process was managed on the basis of converting those departments and agencies that were relatively easy to convert in stage one and phasing in the rest of the agencies and departments according to the difficulty of adjustments, with the last of the agencies and departments required to meet the standards of full accrual accounting by stage four. Politically and publicly, the most astounding result of this process was the impact on the public and the media when the government's balance sheet prepared on a full accrual basis showed that the government had negative net worth somewhere in the vicinity of 20 percent of GDP. The net worth figure was the measure that was sought by the media and the public each year as the accounts were published and became the measure of success or failure of the government. And today, some 16 years later, the government balance sheet shows a positive net worth of somewhere in the vicinity of 60 percent of GDP. This public focus on what was perceived in 1990 as the government being bankrupt allowed the government and the legislature to insist on much greater fiscal restraint and prompted the government's fiscal move from twenty-three years of deficits to now sixteen years of surpluses.

4. As you know, we often pass supplemental spending bills that include a great deal of so-called, "emergency spending" that, in many cases, is not for emergencies at all. In Delaware, we take a different approach. We're actually required to set aside money in a rainy day fund for emergencies that is actually pretty difficult to dip into. How would you change the way we handle emergency and supplemental spending here at the federal level?

The question of using supplementary spending bills for non-emergency spending raises a larger issue: that in my view, the United States Congress needs to pass a new statute that defines fiscally responsible behavior by the government and requires a much higher level of transparency surrounding the budget and appropriations process. That legislation should also define what constitutes emergency spending and should statutorily bar the inclusion of supplemental spending that is not emergency in nature or can and should be predicted and funded in the formal budget document. The process of deferring known expenditure items from the main budget with the intention of including that expenditure in future supplemental spending is a device to avoid accountability and transparency, is intended to disguise the true level of the deficit, and contributes to the cynical view that the public has of the congressional appropriations process. That cynicism will only be eliminated by a process that is openly transparent and honest and gives to the public the clear picture of the fiscal state of the nation.

MERCATUS CENTER
GEORGE MASON UNIVERSITY

Post-Hearing Questions for the Record
Submitted by Maurice McTigue
To Senator Tom Coburn

"In the Red: Addressing our Nation's Financial Challenges"
(June 26, 2008)

1. **National Debt Endgame:** Should the federal government be unable to find private sector buyers for its securities there would be two possible outcomes. First, the federal government would simply be unable to meet all of its obligations. Second, and the more likely of the two, rather than allow the federal government to default, the Federal Reserve would buy those securities. If it does come to that, the threat would not be one of government insolvency, but rather of inflation. Can you comment on the endgame to the unsustainable course of our debt?

    a. What consequences does this have for the economy?

    b. How does this translate into the lives of American families?

    c. Are we looking at another 1930's Great Depression, or worse?

While there are clearly major differences conceptually, the management of debt in the public sector is the same as the management of debt in the private sector. In either case, if the debt moves beyond sustainable levels, catastrophe will be the end result. In the private sector, that of course would be bankruptcy. In the public sector the cost would be paid by the citizens through lower levels of prosperity, slower economic growth, and higher taxes. In its most extreme cases, this debt could indeed lead to recession or depression where these events are defined as zero or negative growth over a considerable period of time. Currently the risk to the American people lies in the lack of full disclosure in budget documents. Budget documents are what the public most frequently uses to make judgments about whether the government is acting in a fiscally responsible manner. Adjusting financial reporting laws to require full disclosure in budget, debt, liabilities, guarantees, and contingent liabilities would allow a better-informed public judgment of the level of fiscal responsibility being exercised by its government.

2. Another troubling aspect of our debt is the growing holdings of it by foreigners. Foreign ownership of debt has increased by just over $1 trillion to more than $2.3 trillion in the past 5 years. Many observers fear that if foreigners suddenly decided to stop holding U.S. Treasury securities or decided to diversify their holdings, the dollar could plummet in value and interest rates would rise. Others are concerned that China's accumulation of hard-currency assets will allow it to undertake activities in the foreign affairs and military realms that are not in the U.S. interest. Can you comment on the implications of our debt in context of foreign relations?

- Could a China or other hostile country leverage their holdings of our debt to receive concessions on matters of national security that we would otherwise not concede?

The growing level of government debt being bought by foreign persons and foreign nations is really a direct response to the very low savings ratio among the American public, forcing the treasury to sell its instruments to off-shore buyers. While those buyers are required to and will meet the contractual obligations that go with that debt, there is a risk that, for whatever reason, those foreign purchasers might become more reluctant to buy U.S. Treasury securities. The real risk in this whole process is the American government's unwise dependence on continuously raising debt to meet its fiscal outlays. In my view, the ownership by foreign persons or countries of this debt does not really pose a security or trade risk to the American economy as the owners of the debt would have to sustain extremely heavy financial loses to be able to use those financial instruments in a manner harmful to the United States.

3. **Healthcare:** One of the biggest budget concerns is Medicare and Medicaid. It even trumps concerns about Social Security. There are many examples of how technology has improved medicine and the quality of life, but the cost of these technologies has exploded. Do you think there is a way to limit cost explosions in healthcare and maintain the excellent improvements that we have seen in recent years? Why or Why not?

    a. If there any way we can truly fix our fiscal crisis without addressing the broken Medicare and Medicaid system?

    b. Other than shifting the burden for our mistakes onto the taxpayers with higher taxes, what should Congress be prepared to do?

There is, in my view, no option but to face up to the need for a very substantial review of the management processes that relate to Medicare and Medicaid. While it would be possible to fund the current policies under the current management systems for a period of time by increasing taxes, that option would not address the fundamental problems of unrealistic expectations and cost escalation. It would only delay the decisions and exacerbate the problem. The policy issues and entitlement on the Medicare and Medicaid systems are issues that need to be addressed by politicians and I won't comment on those. Any management system that divorces the paying process from the consumer of services inevitably will lead to cost escalation, ineffective treatment, and overuse of the system. Managerial reform of these entitlements should be designed to ensure that 1) there is clear choice between providers for consumers, 2) that there is a clear linkage between the consumer and the payment process, and 3) that there are rewards for consumers who manage to use their entitlements more effectively and more efficiently.

4. **Broken Authorization Process:** There are many programs and activities that Congress funds that are no longer authorized. At the same time, Congressional Appropriators routinely waive authorizations and other laws in order to appropriate without restrictions. How does our broken authorization and appropriations process contribute to our current fiscal crisis?

a. If the Appropriators actually paid attention to what is authorized compared to what is available to spend, do you think this would help solve part of the problem?

Authorization and reauthorization constitute one of the fundamental legislative roles of the Congress. The concept of reauthorization clearly indicates that the originators of these laws strongly believed that the policy should be reviewed periodically and changed or amended to reflect the needs of an evolving society. Setting aside or delaying that reauthorization process denies both Congress and the public the right of review which is in their best interest. A refusal to proceed with reauthorization because the issues are difficult, complex, and politically divisive is not acceptable. Reauthorization is a congressional duty and that duty should be discharged in a timely manner. Many other jurisdictions have incorporated in their process statues that clearly say that the law dies unless it is reauthorized by the due date and that the legislature has no right to spend money on those laws if the law is defunct. Some of those other jurisdictions even go to the extent of not allowing continuing resolutions that would save those laws but require that the primary authorization to have taken place. In terms of the fiscal crisis, the re-examination by Congress that is at the heart of the requirements of reauthorization should and would examine many aspects of the law that would clearly have a material effect on the effectiveness of the statute concerned. In the absence of that examination process taking place, it must be presumed that the result for the American people is less than optimal.

5. Your testimony mentions your experience in the New Zealand parliament that fully converted its old government accounting standards to full accrual accounting. It was a long and complex process, but clearly it was worth it since New Zealand is now one of the few debt-free nations and has pre-paid their equivalent to Social Security through 2025.

    a. What were some of the hurdles that you were forced to overcome in dealing with policy makers that were sticklers for the old ways of government accounting? What role did earmarks play then, and does New Zealand still have an earmark problem?

    b. How did you deal with policy makers that wanted to continue profiting both personally and politically from the old way of New Zealand's accounting?

    c. What advice can you give to those in the U.S. Congress who are unwilling to change their ways towards a better government both for the economy and morally speaking?

The benefit of full accrual accounting is to provide a much clearer picture of the government's fiscal position. It also significantly diminishes the opportunity to distort fiscal outcomes by bringing forth revenues, delaying payments, or other actions that are frequently used in cash-accounting systems to avoid disclosing embarrassing fiscal outcomes. The process of implementing full accrual accounting is well known and well documented with a large number of governments now using at least some form of accrual accounting. However, the process does involve a very large workload and a significant cost in technology and adjustments to data collection and presentation processes. It took the New Zealand government four fiscal years to fully implement accrual accounting. The process was managed on the basis of converting those departments and agencies that were relatively easy to convert in stage one and phasing in the rest of the agencies and departments according to the difficulty of adjustments, with the last of the agencies and departments required to meet the standards of full accrual accounting by year four. Politically and publicly, the most astounding result of this process was the impact on the public and the media when the government's first accrual balance sheet showed that the government had negative net worth somewhere in the vicinity of 20 percent of GDP. The net worth figure was the measure of fiscal success that was sought by the media and the public each year as the accounts were published. Today, some sixteen years later, the government balance sheet shows a positive net worth of somewhere in the vicinity of 60 percent of GDP. This public focus on what was perceived in 1990 as the government being bankrupt allowed the government and the legislature to insist on much greatest fiscal restraint prompted the government's fiscal move from twenty-three years of deficits to now sixteen years of surpluses.

To address your first sub-question, it was necessary to embark upon a major education program for existing members of parliament to understand the new accounting system. Even without that education program, many members were angry and frustrated that their old knowledge now had no value. However, the public demand for greater transparency and accountability offset the angst of those members of the legislature.

Your query about earmarks does not really apply to parliamentary systems because the administration and cabinet are made up of members of the legislature—who remain members of the legislature—who also act as the ministers of the different portfolios. This means that the government virtually always holds a majority in the legislature and will thus eliminate spending designed to gain personal benefits.

Your last two sub-questions, in my view, can best be answered by saying that the three likely motivators to shift members to supporting these initiatives are:

(1) increased levels of transparency,
(2) improved quality of publicly disclosed information, and
(3) public cynicism about performance of the legislature.

To be perceived as someone who is supportive of greater secrecy and less disclosure is almost certain to be politically detrimental to members who subscribe to that position.

○