

# MERCATUS CENTER

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## George Mason University

### TESTIMONY

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Before the House Committee on Oversight and Government Reform, Subcommittee on  
Government Management, Organization, and Procurement Hearing entitled,  
“Oversight of Federal Financial Management”

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America’s financial situation is unsustainable. In 2009 the federal government spent \$3.5 trillion but collected only \$2.1 trillion in revenue. The result was a \$1.4 trillion deficit, up from \$458 billion in 2008. That’s 10 percent of gross domestic product (GDP), a level unseen since World War II. The Congressional Budget Office (CBO) projects that we will be running large deficits for the foreseeable future. According to its data, the annual deficits could average \$1 trillion during the next 10 years.

While these figures are dramatic, they pale in comparison to what the federal government owes to foreign and domestic investors. According to the CBO, in 2009 America’s debt held by the public reached \$7.5 trillion, or 53 percent of GDP, the highest it has been in 50 years. In 2010

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<sup>1</sup> The author would like to thank Dan Rothschild and Jakina Debnam for their invaluable help compiling and analyzing the data.

the debt will cross the 60 percent threshold, a level at which many economists believe a country is putting itself in financial peril.

Maybe more importantly, the financial accounting of our financial troubles can lead us to underestimate the gravity of the situation. For instance, while the Department of Treasury's *Financial Statement of the United States* depicts the financial situation of the country much more accurately than the Office of Management and Budget's *Budget of the United States*, it leaves out some important elements that could hinder lawmakers' realization of the urgency to address our financial situation. For instance, it accounts accurately for the IOUs in the Social Security Trust Fund, however, fails to account for how the federal government will pay its debt to social security and what it means for our debt levels.

## Section 1: Our Financial Situation

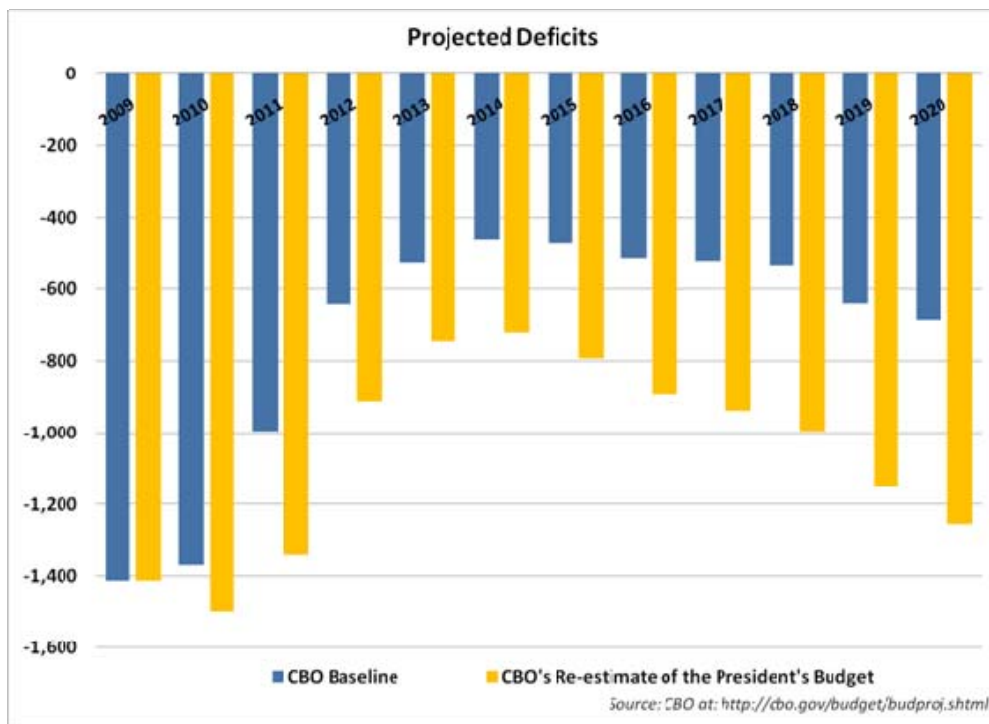


Figure 1: Comparison of the CBO projections of Annual Deficits for the Next Ten Years – Before and After the President's FY 2011 Budget Released.

In 2009 the federal government spent \$3.5 trillion but collected only \$2.1 trillion in revenues. The result was a \$1.4 trillion deficit, up from \$458 billion in 2008. That's 10 percent of GDP, a level unseen since World War II. Figure 1 shows that the Congressional Budget Office (CBO) projects that the country will face large deficits for the foreseeable future. They will average \$1 trillion annually over the next 10 years.

The situation is deteriorating rapidly. Figure 2 compares the CBO's long-term public debt projections from 2010 with long-term projections calculated in 2007. Three years ago, the CBO projected that the debt held by the public would not surpass 60 percent of GDP until 2023.

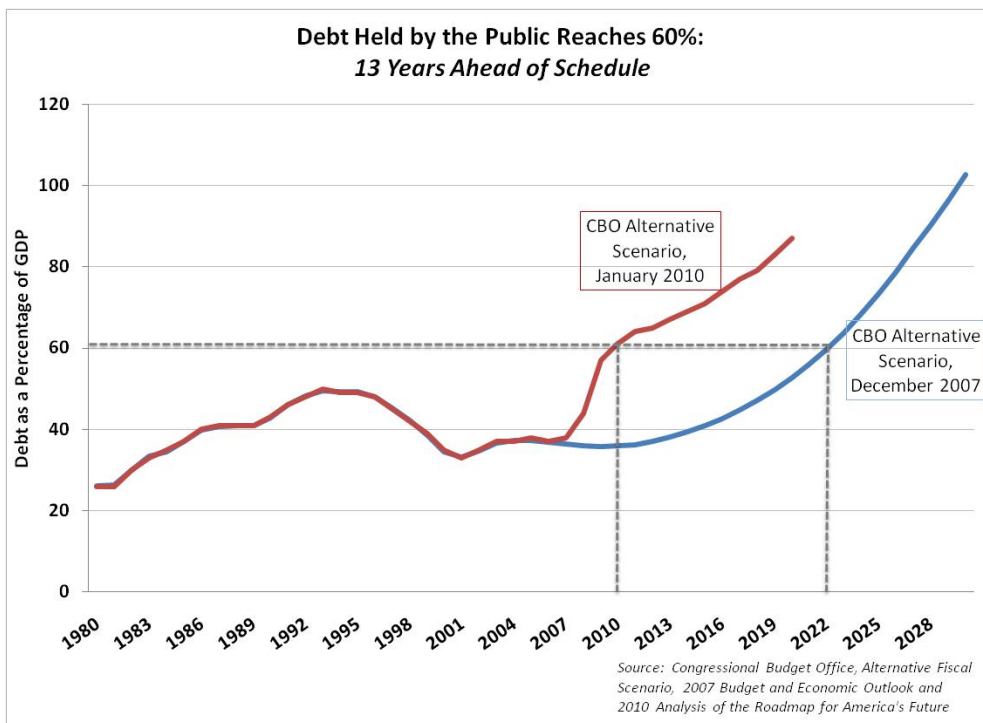
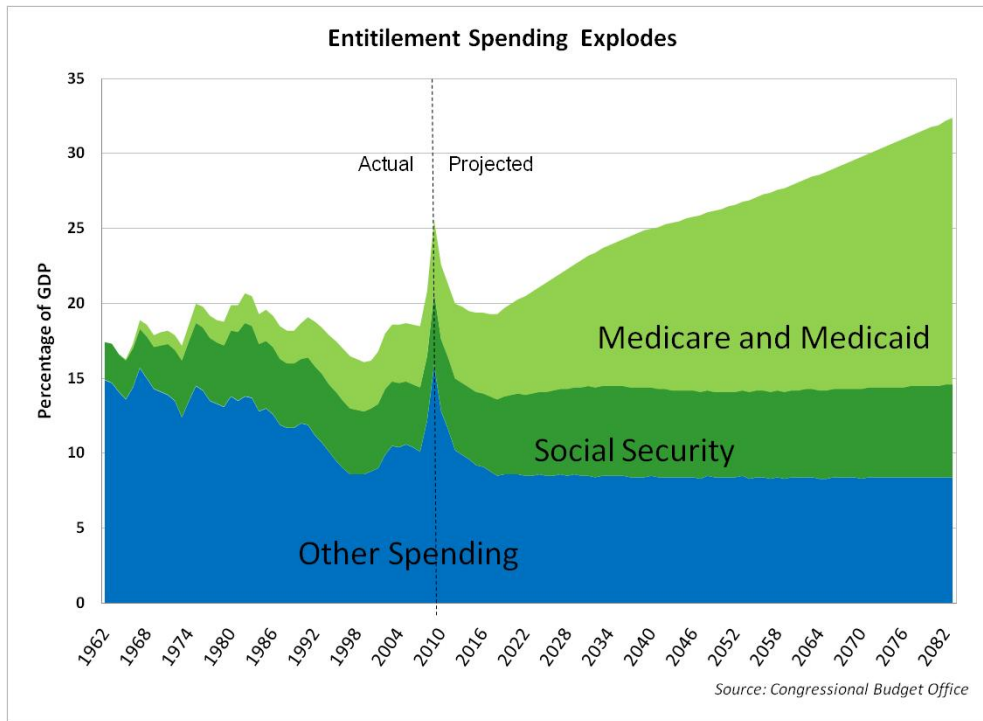


Figure 2: Debt Held by the Public as Projected by CBO in 2007, 2010.

What accounts for our current situation? Deficits and debt are mainly the product of spending. Figure 3 illustrates the Congressional Budget Office's long-term baseline projections of federal spending. Colored segments represent the relative contributions of Medicare and Medicaid, Social Security, and other spending to the overall composition of long-term federal outlays. Importantly, Congressional Budget Office *baseline* projections, which are based on existing law, have been used for this illustration. Projections which incorporate policy changes and likely

extensions of existing policy scheduled to expire show even greater long term spending in all areas.



*Figure 3: Long-Term Projections of Social Security, Medicare and Medicaid, and Other Spending, as Projected by CBO*

Government spending is projected to grow faster in the future than its historical average; entitlement spending is projected to grow substantially faster than future government spending. Over the last 50 years, overall government spending as a percentage of GDP has grown 0.7% annually; in the next 50 years the CBO projects that government spending will grow 30% faster than this historical average. According to CBO’s baseline, over the next 50 years, entitlement spending is projected to grow at 1.4% annually, twice the historical rate of increase in government spending.

Medicare spending growth is the primary driver of the explosion in entitlement spending. The President’s FY 2011 Budget estimates \$451 billion in Medicare spending in FY 2010, a 6% increase in Medicare outlays over 2009, as a percentage of GDP. In the long-term, CBO’s baseline projects that Medicare spending will grow by 2.6% annually. Moreover, under the CBO’s alternative scenario, which includes likely policy changes, Social Security, Medicare and

Medicaid and net interest spending combined are projected to exceed *total federal revenue* by 2028.

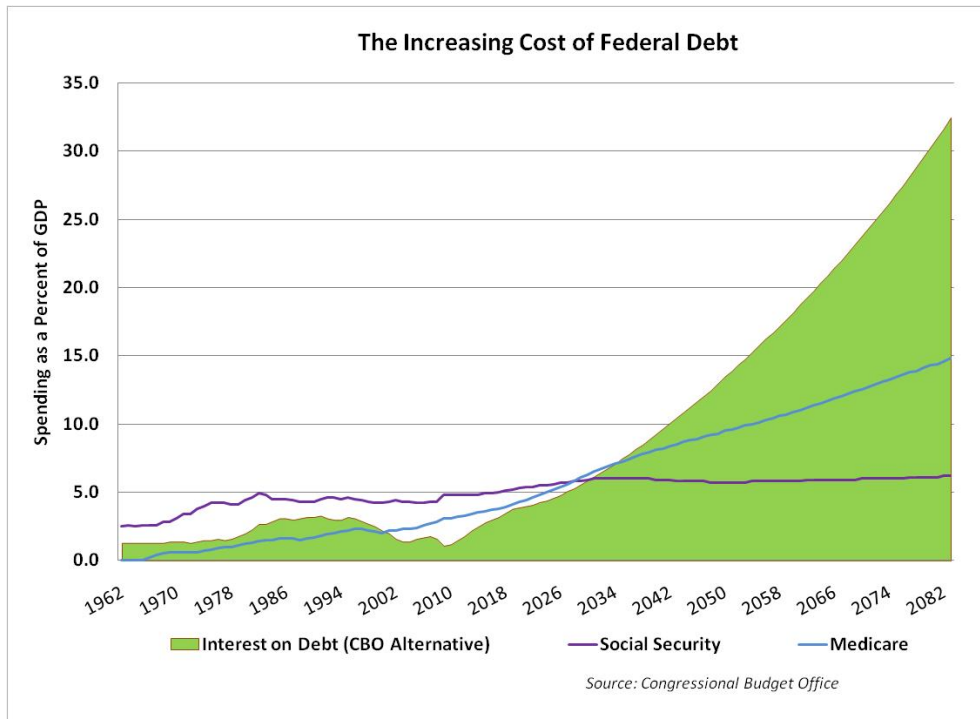
As entitlement spending increases, the indebtedness of the Medicare and Social Security trust funds Programs will increase as well. Over the next 75 years, the federal government has promised benefits for these two programs in excess of anticipated payroll tax revenues equal to \$7.7 trillion and \$38 trillion, respectively.

The Treasury Department estimates Social Security's deficit at 1% of GDP over the next 75 years and Medicare's deficit at 4.8%. With federal revenues estimated to be about 19% of GDP in the long run under current law, taxes would have to rise by about one-third to pay all the promises that have been made for just these two programs.

The Office of Management and Budget estimates that in the absence of massive cuts in Social Security, Medicare and other programs, or an equally massive tax increase, the national debt will rise to 77% of GDP in 2020, 100% of GDP in 2030 and more than twice GDP by 2050.

## **Section 2: Six Reasons Why Deficits and Debt Matter**

There are many reasons why these deficits and debt matter. I have listed six of them here: First, debt is very expensive. Our nation is in debt and faces trillions of dollars in additional projected federal budget deficits over the next decade. The more we borrow, the higher the cost of borrowing. Figure 4 shows the projected interest the government will pay on the federal debt as a percentage of GDP between 1962 and 2082. Based on [Congressional Budget Office data](#), it represents the interest the government paid on the federal debt as a percentage of GDP between 1962 and today and the projected debt service payments up until 2082. The projections are illustrated under the CBO alternative, more realistic, scenario. For comparison, the graph also shows CBO's projections for the cost of Medicare and Social Security as a percentage of GDP. Notice that under either of CBO's scenarios, the net interest payments, or the costs of the debt, rival the cost of two of our nation's most expensive social programs.

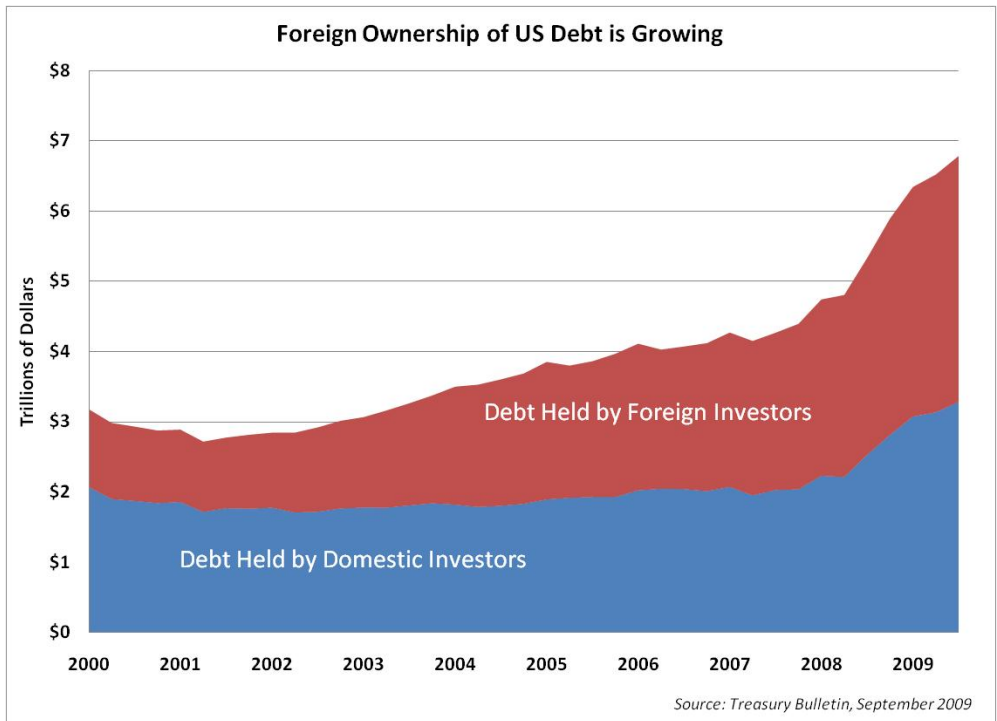


*Figure 4: Interest Paid on the Federal Debt Annually, With Annual Spending on Social Security and Medicare, From CBO*

Today the United States pays \$700 billion to pay interest on our debt. By 2020 the federal government will spend a projected \$900 billion. That's more than what the U.S. spends right now on two wars, plus the Departments of Defense, Education, Energy, and Homeland Security combined.

Second, large and sustained deficits and debt inevitably cripple economic growth. The money the federal government borrows and the money that private investors borrow to invest in the private sector's growth both come from Americans' savings. Unfortunately, if the federal government keeps growing its debt and need for borrowed funds there might come a point where there could simply just not be enough savings to satisfy both the private and the public sectors' borrowing needs.

Third, our growing debt means the federal government has to rely increasingly on foreign investors to pay its bills. Figure 5 shows America's debt held by the public divided into domestic and foreign debt.



*Figure 5: Debt Held by the Public Divided Into Foreign Owned and Domestically Owned Components*

This reliance can give significant bargaining power to individual foreign governments, such as China, in their diplomatic negotiations with Washington. According to a recent *National Affairs* article by Donald Marron, an economist at the Georgetown Public Policy Institute, countries such as China and Japan have been the largest buyers of Treasury securities. They believe, Marron writes, “that their willingness to finance our debt gives them leverage in negotiations about other issues, ranging from nuclear proliferation to human rights. Such leverage cannot be beneficial for America's competitive or strategic interests.”<sup>1</sup>

Fourth, a growing debt sends signals to investors that we are becoming riskier borrowers. What happens when you max out all your credit cards and still don't have enough money to pay your bills? One thing you could do is get another credit card and roll over the balance. But how long will it be until no one gives you another credit card? How long before your interest rate goes from 12 percent to 30 percent?

This is what the federal government is doing right now. It is constantly rolling over short-term debt. However, there might be a point where our lenders reassess the credit risk that the federal government represents and start applying rates to reflect the risk the government has become. When that time comes access to capital will become harder for everyone. It will be more expensive to buy a house, fund a business, or save for the future.

This development fuels a fifth concern: inflation. To get deficits under control the federal government could cut spending, increase taxes, or do some of both. Neither of these policies is popular; hence the temptation to print money (or “monetize the debt”) to pay the bills. The resulting inflation would reduce the value of each dollar, and it would introduce high levels of uncertainty into the economy. Imagine what it would be like to try to calculate the net present value of your investment in an environment where you can’t predict what your dollars will be worth tomorrow. Such circumstances mean less innovation and less entrepreneurship, and therefore less economic growth and more hardship.

Marron argues that the Federal Reserve is probably unwilling to take the inflationary route today.<sup>2</sup> But investors know that other central banks have done so in the past and that such a scenario could happen again. In exchange for extending more loans to a federal government that has become a riskier borrower, lenders will ask for an inflation premium. American families and businesses will pay those prices, further hindering economic growth.

If these growing deficits aren’t addressed immediately, we are about to embark on the most massive transfer of wealth from younger taxpayers to older ones in American history. It will not only be unprecedented but will also be unfair. As economists have noted, if we borrow to make investments—medical research, infrastructure or otherwise—future generations will be able to reap the benefits of these investments. In fact, these benefits might even offset the costs of paying down the debt accumulated to make these investments. However, when the federal government borrows money to pay for its daily consumption, there is no benefit for the future generations.



### **Section 3: Even Best Accounting Practices Underestimate Our Situation**

According to the Government Accountability Office,<sup>3</sup> “Long term, the federal government faces huge structural deficits driven by rising health care costs and demographics. Focused attention from Congress and the administration is needed to address these problems and put the government on a more sustainable path.”

Focused attention is required. However, while the GAO report<sup>4</sup> claims that the federal government is able to make a fair representation of Statement of Social Insurance (Social Security and Medicare), I would like to assert that some elements of the report still underestimate the urgency to address our financial situation.

The Treasury’s *Financial Statement of the United States* gives us a more complete representation of our financial troubles than the *Budget of the United States* or other Congressional documents, because it includes pension liabilities, intergovernmental lending between Social Security and Medicare accounts. It also provides a statement of liabilities in terms of net present value, which allows us to understand future liabilities in today’s context.

*The Budget of the United States*, for instance, utilizes certain methods that make it hard for taxpayers and lawmakers to have a clear idea of what our financial situation actually looks like. A widely accepted method for instance, consists of keeping spending off of the official federal budget. Some off-budget items, such as the U.S. Postal Service and the Social Security and Medicare trust funds, are off-budget by law. However, lawmakers have also made a habit of keeping other spending items off the record informally. According to the Congressional Budget Office (CBO), the government sponsored enterprises Freddie Mac and Fannie Mae are on track to cost taxpayers \$64 billion between 2011 and 2020, on top of the \$110 billion in taxpayer money they have already spent. But none of this spending is included in the official budget.

Also, federal employee retirement funds are among the largest off-budget accounts, and the financial commitment they represent is never publicized. If the federal government had accounted, as a private firm would, for its future pension liabilities, there never would have been a budget surplus at the end of the 1990s. What’s more, the off-budget game takes advantage of

the fact that most government trust accounts bring in more than they spend in the short term, while having substantial unfunded liabilities in the long run.

The use of delayed payments is another common timing trick. Large payments to contractors or vendors due by the end of the fiscal year (September 30) are often paid on October 1—the next fiscal year. That lets Congress “save” money in the current year, though at the cost of having to double up on expenses the year after. This practice of hiding costs one year does not dispense the federal government from paying its debt the following year. However, it will unlikely be prepared to do so.

Another accounting trick is the use of advance appropriation, also called forward funding. This practice provides spending for a future fiscal year without counting it in any year’s budget. For the last 20 years, about \$20 billion of “forward funding” per year has paid for everything from housing vouchers to education programs such as Head Start. Basically, it means that Congress can in effect accrue the obligation now without having to pay for it in the budget until later. This maneuver allows Congress to spend more than it should under budget rules.

Also, as professor Cheryl D. Block of Washington University of Saint Louis explains in her article *Budget Gimmicks* “these strategies can become addictive. When you put off today’s budget spending though an advance appropriations, the budget invoice arrives tomorrow. To make good on the promise to score the budget expenditure against tomorrow’s budget means to even further restrict tomorrow’s spending.”<sup>5</sup>

However, the biggest flaw with the way the *Budget of the United States* accounts for its spending and receipt is by using cash flow accounting rather than accrual accounting. Cash-flow accounting simply records revenue in the fiscal year that they received and expenses in the fiscal year that they are paid. In contrast, accrual accounting records items by income and expenses when the rights to receive and obligations to pay arise, even if no funds were received or paid at that time. Accrual accounting is forward looking and gives a much more accurate idea of our financial situation.

Block notes that “[Accrual accounting] takes into account today the present value of future receipts and subtracts today the present value of future liabilities. Accrual accounting is viewed in the accounting community as so far superior to cash-flow accounting as an accurate measure of financial health and public and private companies are required to use it under generally accepted accounting principles (GAAP) established by the Financial Standards Board (FASB).”<sup>6</sup>

Congress does not hold itself to any formal, defined set of accounting standards and does not require accrual accounting for budget purposes. In fact, both, the Office of Management and Budget and the Congressional Budget Office’s bottom line assessments of federal deficits are done using cash-flow accounting.

By these standards the annual *Financial Report of the United States Government* is clearly using superior accounting<sup>7</sup> methodology. This report is prepared by the Department of Treasury and uses accrual accounting. It records today expenses that will occur in the future.

As such, this chart, based on the Treasury’ report data, illustrates more accurately our financial position. It compares the year-over-year change in the United States’ end-of-year net position. Net position is calculated by netting the government’s assets against its liabilities, as recorded in the United States Government Balance Sheet. Just as in the financial statement of a company, this metric provides a general picture of the fiscal situation in the United States. In 2009, the net position of the United States was -\$11.5 trillion, a 12% deterioration from 2008.

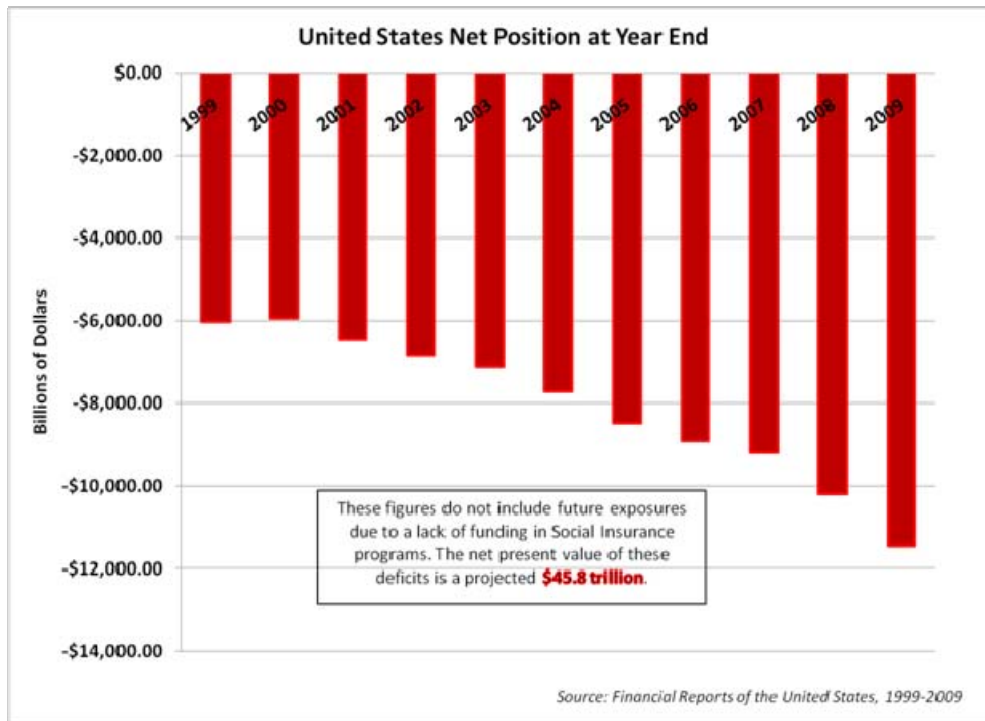


Figure 6: The Net Position of the United States from 1999 to 2009

Net position has been steadily declining since 2000; while the image depicted above is dramatic, the true situation is far worse - exposures for future Medicare and Social Security expenditures are not taken into account in the calculation of net position.

Obviously, the urgency that our nation faces to fix our financial situation is more fully understood when this data is coupled with the data put forward by OMB and CBO about the country's deficits. However, there is another aspect of our financial situation which is being seriously underestimated, even in the Financial Statement of the United States. And that is the projection of our debt held by the public.

As we mentioned earlier, the debt held by the public is the debt that the federal government incurs when it borrows from the public (domestic or foreign) to finance its budget deficits. The debt held by the public totaled approximately \$7.6 trillion in FY2009, and was held in Treasury securities, such as bills, notes, and bonds, and accrued interest payable.

As noted in the Financial Statement of the United States<sup>8</sup>, “In addition to debt held by the public, the Government has outstanding nearly \$4.4 trillion of intragovernmental debt, which arises when one part of the Government borrows from another. It represents debt held by Government funds, including the Social Security (\$2.5 trillion) and Medicare (\$372 billion) trust funds. These Government funds are typically required to invest any excess annual receipts in Federal debt securities. Because these amounts are both liabilities of the Treasury and assets of the Government trust funds, they are eliminated in the consolidation process for the Government-wide financial statements. When those securities are redeemed, e.g., to pay future Social Security benefits – the Government will need to obtain the resources necessary to reimburse the trust funds.”<sup>9</sup> In other words, in order to reduce this intragovernmental debt our debt held by the public will have to grow. Yet, this fact is not obvious to most, and is not reflected in the projections of the debt held by the future.

Let’s take the example of the Social Security Trust Fund. The Social Security system is primarily a pay-as-you-go system, meaning that payments to current retirees come from current payments into the system. In the early 1980s, the financial projections of the Social Security Administration indicated near-term revenue from payroll taxes would not be sufficient to fully fund near-term benefits (thus raising the possibility of benefit cuts). The federal government appointed the National Commission on Social Security Reform, headed by Alan Greenspan (who had not yet been named Chairman of the Federal Reserve), to investigate what changes to federal law were necessary to guarantee the fiscal health of the Social Security program.

The changes to federal law enacted in 1983 pursuant to the recommendations of the Greenspan Commission increased the Social Security payroll tax so that revenues derived from the tax would exceed the amounts needed to fully fund current benefits, thus causing a reserve to accumulate, which could be drawn upon when necessary.<sup>10</sup> In theory, the resulting surplus is accounted for in the Social Security Trust Fund.

As of the end of calendar year 2009, the accumulated surplus stood at just over \$2.5 trillion. This amount is represented as an asset by many economists. However, unlike a typical private pension plan, the Social Security Trust Fund does not hold any marketable assets to secure workers' paid-

in contributions. Instead, it holds non-negotiable United States Treasury bonds and U.S. securities backed "by the full faith and credit of the government".

The Office of Management and Budget has described the distinction between a typical private pension plan and Social Security as follows: "These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures - but only in a bookkeeping sense.... They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits."<sup>11</sup>

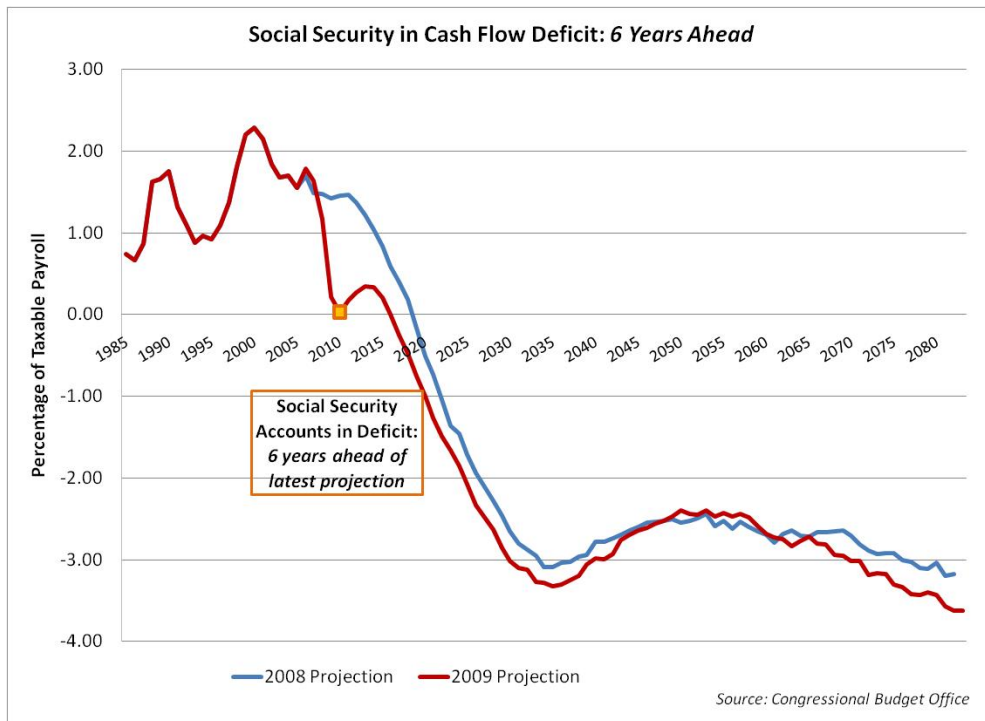


Figure 7: End-of-Year Balance of Social Security Accounts, as Projected in 2008 and 2009

In theory, when social security starts registering a cash deficit (paying out more than it receives in taxes), the shortfall is supposed to be made up by withdrawals from the Trust Fund assets. In addition, in spite of the cash flow deficit, the Trust Fund will continue to show net growth until 2025 because of the interest generated by its bonds.

Also, in theory, the cash flow deficit means that the Trust Fund should gradually be drawn upon to cover the difference between tax receipts and benefit payments. It will be completely depleted by 2037 (according to the Social Security Administration).<sup>12</sup>

The above chart looks at the Social Security trust Fund cash flow surplus and deficit and tracks its evolution. It compares the Congressional Budget Office's (CBO's) projections for the end of year balance of Social Security accounts from 2008 and 2009. These balances are presented as a percentage of taxable payroll, a weighted average of taxable wages and taxable self-employment income which provides an estimate of the earnings subject to payroll taxation each year. For perspective, in 2010 taxable payroll is projected to be \$5.6 trillion.

Concretely, when the balance of these accounts becomes negative, Social Security is paying out more in benefits than it collects in payroll taxes in a given year. In 2008, the CBO projected that outlays would exceed revenues for the first time in 2019, and in 2009 CBO projected that this threshold would be crossed in 2016. In reality, Social Security is on track to pay out more in benefits than it collects in 2010. While part of the acceleration in the onset of Social Security deficits is due to the impact of the recession on taxation, by all projections, unsustainable deficits in Social Security accounts will continue into the future.

While this seems to be cause for alarm, not everyone agrees. Some observers argue that the situation is not that bad because in spite of the cash flow deficit, the Trust Fund is really in the black because of interest generated by its bonds. For instance, in a recent article for *Fiscal Times*, Brookings Institution economist Henry Aaron wrote that “Social Security derives revenues from three sources: payroll taxes levied on covered earnings, earmarked income taxes levied on benefits, and interest earnings on reserves. According to the Social Security Trustees' [annual report](#), released in May 2009, revenues from these sources in calendar year 2010 were projected to be, respectively: \$701 billion, \$26 billion, and \$120 billion, for a total of \$848 billion. Expenditures were anticipated to be \$709 billion.”<sup>13</sup>

Aaron, who endorses the data as presented in the *Financial Statement of the United States*, agrees that without the interest payments, the trust fund is running a deficit today.

Sadly, there is a strong case to be made that that the trust fund and the interest payment it receives are simply accounting fiction. The surplus payroll tax revenues that taxpayers have been paying for years to build the trust fund have, in fact, been used and spent by the federal government on other things such as wars, education or homeland security. In other words, the federal government has been using the money to pay for its daily consumption rather than in future investment.

The Trust Fund is made of IOUs from the federal government. Put differently, Social Security is drawing interest from money that was already consumed. To think of an analogy, your bank account credit is lent out to others and stays in your account as an IOU, on which the bank pays you interest. The difference is that a bank lends your money to profit-making enterprises that pay the bank interest, out of which the bank pays your cut.

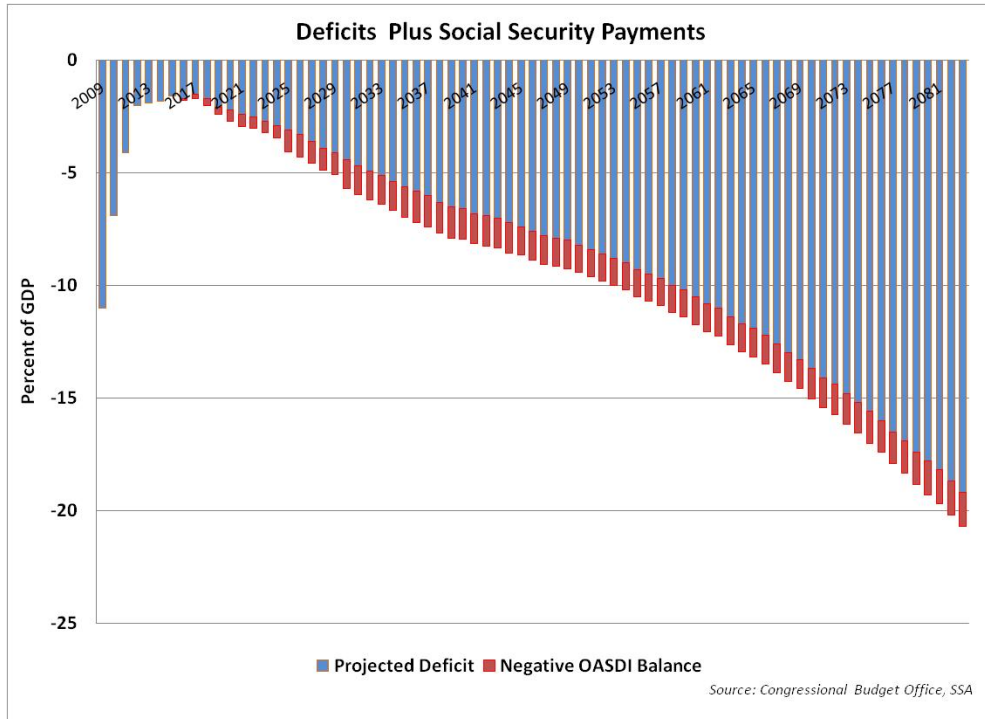
It is not the case for the federal government, where daily consumption needs to be paid for by borrowing money from the public. Put simply, the federal government pays interest to Social Security by borrowing funds from the public. More importantly, the interest that the federal government owes Social Security are also paid for in the form of IOUs .

The only way Social Security will not go into the red this year is if the federal government borrows money from the public. (See this March's [CBO projections](#) here and back out the interest payments to get the true position of the country.) As CBO numbers show, the shortfall this year is \$29 billion, or 4 percent of Social Security's budget.<sup>14</sup> The shortfalls get smaller in 2011-13 and turn into small surpluses until things start to go into the red again in 2016, after which the numbers get much worse. A better-than-expected recovery could make these numbers better, but only for a little while.

It is a reality that the Trust Fund and the assets that it owes do not really exist unless the federal government borrows the money or increases taxes. In other words, it is wrong to assume that the trust fund's is made of \$2.5 trillion in accumulated assets that can be retrieved easily and that won't be exhausted until 2037.



If the government chooses to increase the tax rates to raise revenue in order to reimburse the Social Security Trust Fund, it will have a serious impact on economic growth. If the federal government chooses to borrow all the money needed to pay back the Social Security Trust Fund as soon as it starts running a cash flow deficit, our financial situation and the fiscal implications for our country will be made worse than what we presented earlier. The chart below illustrates this point.



*Figure 8: Long-Term Deficit Projections Plus Projected Deficits in Social Security Accounts*

Furthermore, since Medicare surpluses have also been re-allocated through intragovernmental lending, it can be shown through analogous arguments that the deficit should be increased even more to reflect reality.

What might happen when the Federal government can't pay back its debt to the Trust Fund? To escape paying either principal or interest on bonds held by the trust funds, the government would have to default on these obligations. An alternative would be for Congress to simply cap Social Security spending at a level below that which would require the bonds to be redeemed. Again, this would be politically risky, but would not require a "default" on the bonds.

## Conclusion

As I've shown, the fiscal path of this country is simply unsustainable. The less-than transparent ways in which the federal government goes about accounting for its assets and liabilities does not allow policymakers and agency decision-makers to make informed decisions about the nation's true fiscal position. I thank you again for the opportunity to testify on this most important topic, and look forward to answering your questions.

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<sup>1</sup> Office of Management and Budget at <http://budget.gov/budget>.

<sup>2</sup> Donald Marron, "America in the Red," *National Affairs*, Issue Number 3, Spring (2010), <http://nationalaffairs.com/publications/detail/america-in-the-red>.

<sup>3</sup> Donald Marron, *Ibid*.

<sup>4</sup> Government Accountability Office, *A Citizen's Guide to the 2009 Financial report of the U.S. Government*, (Washington DC, 2010).

<sup>5</sup> Cheryl D. Block (2008), "Budget Gimmicks," In *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy*, Cambridge University Press, p. 55.

<sup>6</sup> Cheryl D. Block (2008), "Budget Gimmicks," In *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy*, Cambridge University Press, p. 51.

<sup>7</sup> U.S. Department of the Treasury, *Financial Statement of the United States Government: 2009*, (Washington DC, 2010).

<sup>8</sup> U.S. Department of the Treasury, *Ibid*.

<sup>9</sup> Government Accountability Office, *Ibid*, p 5.

<sup>10</sup> Advisory Council On Social Security, *1996 OASDI Trustees Report: Appendix I*, (Washington DC, 1996), <http://www.socialsecurity.gov/history/reports/adccouncil/report/append1.htm>.

<sup>11</sup> Office of Management and Budget, *Budget of the United States, FY 2000 Budget, Analytical Perspectives*, p. 337, (Washington DC, 1999).

<sup>12</sup> Social Security Administration, *2009 OASDI Trustees Report*, (Washington DC 2010).

<sup>13</sup> Henry Aaron, "Social Security: Getting the Facts Straight," *The Fiscal Times*, March 28, 2010, [http://www.thefiscaltimes.com/Blogs/2010/03/30/~/\\_/link.aspx?\\_id=051F8AD4CBFB460CA9299EDA7F214366&\\_z=L](http://www.thefiscaltimes.com/Blogs/2010/03/30/~/_/link.aspx?_id=051F8AD4CBFB460CA9299EDA7F214366&_z=L).

<sup>14</sup> Douglas Elmendorf, "Social Security Trust Funds," *CBO Director's Blog*, March 31, 2010, <http://cboblog.cbo.gov/?cat=15>.