United States Government Accountability Office

Report to the Chairman, Committee on the Budget, House of Representatives

October 2013

FISCAL EXPOSURES

Improving Cost Recognition in the Federal Budget

GAO-14-28

GAO Highlights

Highlights of GAO-14-28, a report to the Chairman, Committee on the Budget, House of Representatives

Why GAO Did This Study

The federal government's long-term fiscal imbalances are driven on the spending side by the effects of an aging population and rising health care costs on Social Security and major federal health programs. However, GAO identified a variety of other fiscal exposures—responsibilities, programs, and activities that may legally commit or create the expectation for future federal spending—that vary as to source, extent of the government's legal commitment, and magnitude. A more complete understanding of these other fiscal exposures can help policymakers anticipate changes in future spending and enhance control and oversight over federal resources.

GAO was asked to provide information on risks facing the federal budget. This report (1) examines selected programs that create a fiscal exposure, including the extent and estimated magnitude of the government's legal commitment; and (2) assesses how fiscal exposures could be better recognized in the budget. Based on its review of budget and financial data, GAO selected nine programs, including federal employee benefit programs, insurance programs, and the stock purchase agreements with Fannie Mae and Freddie Mac, and drew upon previous work to discuss potential approaches for improving budgetary attention to fiscal exposures.

What GAO Recommends

GAO is not making new recommendations but this analysis provides additional support for past recommendations to improve budget recognition of fiscal exposures by, for example, expanding the availability and use of information on expected future spending arising from commitments made today.

View GAO-14-28. For more information, contact Susan J. Irving at (202) 512-6806 or irvings@gao.gov.

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FISCAL EXPOSURES

Improving Cost Recognition in the Federal Budget

What GAO Found

Fiscal exposures may be explicit in that the federal government is legally required to pay for the commitment; alternatively, it may be implicit in that the exposure arises from expectations based on current policy or past practices. The nine programs GAO examined illustrate the range of federal fiscal exposures (see figure) and how they can change over time. Also, some programs may have elements of both explicit and implicit exposure. Federal insurance programs, for example, fall across the spectrum: if an event occurs, some payment is legally required—an explicit exposure. However, there may be an expectation that the government will provide assistance beyond the amount legally required—that is an implicit exposure. Prior to 2008, securities issued by Fannie Mae or Freddie Mac were explicitly not backed by the U.S. government. However, in response to the financial crisis, the government's agreement to provide temporary assistance to cover their losses up to a set amount created a new explicit exposure. The amount of future spending arising from federal fiscal exposures varies in the degree to which it is known and can be measured.

Figure: Selected Programs Illustrate the Range of Fiscal Exposures

Explicit exposures	Implicit exposures
Federal insurance programs • Crop insurance • Flood insurance • Pension insurance **Purchase agreements with Fannie Mae & Freddie Mac** **Federal employee benefit programs** • Civilian pensions • Civilian post-retirement health benefits • Military pensions • Military post-retirement health benefits • Veterans compensation	• Claims in excess of program limits for flood insurance • Claims in excess of available resources for pension insurance • Assistance beyond scope of current agreements with Fannie Mae & Freddie Mac

Source: GAO.

For some exposures GAO found that the budget provided incomplete information or potentially misleading signals regarding the full cost of the commitments made today. A uniform across-the-board approach to make fiscal exposures more apparent when making budget decisions may not be appropriate given their varying characteristics. Several factors need to be taken into account in selecting an approach to better recognize fiscal exposures in the budget: the extent of the government's legal commitment; the length of time until the resulting payment is made; and the extent to which the magnitude of the exposure can be reasonably estimated. Expanding the availability and use of supplemental information, including measures that can signal significant changes in the magnitude of fiscal exposures, would be an important first step to enhancing oversight over federal resources and can aid in monitoring the financial condition of programs over the longer term. Incorporating measures of the full cost into primary budget data would provide enhanced control over future spending, which can help both improve the nation's fiscal condition and enhance budgetary flexibility.

Contents

Abbreviations

CBO	Congressional Budget Office
CSRDF	Civil Service Retirement and Disability Fund
CSRS	Civil Service Retirement System
DOD	Department of Defense
DHS	Department of Homeland Security
FCIC	Federal Crop Insurance Corporation
FEHB	Federal Employee Health Benefits
FEMA	Federal Emergency Management Agency
FERS	Federal Employee Retirement System
FHFA	Federal Housing Finance Agency
Financial Report	*Financial Report of the United States Government*
GSEs	government-sponsored enterprises
MERHCF	Medicare-Eligible Retiree Health Care Fund
NDAA	National Defense Authorization Act
NFIP	National Flood Insurance Program
OMB	Office of Management and Budget
OPM	Office of Personnel Management
PBGC	Pension Benefit Guaranty Corporation
RMA	Risk Management Agency
TFL	TRICARE for Life
Treasury	Department of the Treasury
TSP	Thrift Savings Plan
VA	Department of Veterans Affairs

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

October 29, 2013

The Honorable Paul D. Ryan
Chairman, Committee on the Budget
House of Representatives

Dear Mr. Chairman,

Our simulations of the federal government's long-term fiscal outlook lead to an overarching conclusion: current fiscal policy is unsustainable over the long term. In these simulations debt held by the public continues to grow over the coming decades as a share of gross domestic product. This growth is driven by a fundamental imbalance between revenue and spending, which on the spending side, is driven by the aging of the population and rising health care costs. Absent reform of federal retirement and health programs—including Social Security, Medicare, and Medicaid—federal budgetary flexibility will become increasingly constrained. In recent years, emerging issues and unanticipated events have increased awareness of additional pressures on current and future federal budgets; addressing the federal government's fiscal sustainability challenges is important for maintaining the budget flexibility to respond quickly and adequately to them. As we have reported before, understanding the longer-term budget implications of policy decisions at the time decisions are made permits more informed discussion of both overall program and specific design features. Addressing the fiscal challenges of the future will require looking at the entire range of federal activities and making difficult choices in setting priorities and linking resources to results. Consideration of the tradeoffs inherent in these decisions can be facilitated if there is comparable information on both the near-term and long-term budget implications of existing programs.

Our past work identified a variety of fiscal exposures—responsibilities, programs, and activities that may either legally commit[1] the federal government to future spending or create the expectation for future spending.[2] Fiscal exposures vary widely as to source, extent of the

[1]For purposes of this report, the term legal commitment refers to the government's responsibility for future financial obligations.

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

government's legal commitment, and magnitude. Further, some of these factors may change over time. For example, the government's response to an event or series of events can strengthen expectations that the government will respond in the same way to similar events in the future. The magnitude of the exposure in a given area may also change: for example, increased population density in coastal areas may increase the magnitude of exposures from natural disasters. A more complete understanding of the sources of fiscal exposures and the way they are changing can provide enhanced control and oversight over federal resources. Policymakers can then respond to any changing risks as they deem it appropriate.

You asked that we provide information on identifying, monitoring, and measuring new or evolving risks facing the federal budget. In this report, we (1) describe selected programs that create a fiscal exposure, including the extent and estimated magnitude of the government's legal commitment, and discuss the implications of these fiscal exposures for the budget,[3] and (2) assess how fiscal exposures could be better recognized during the budget process.

Many activities can be thought of as fiscal exposures. This report focuses on a subset of fiscal exposures that represent legal commitments for future spending. We do not discuss the major social insurance programs (Social Security, Medicare, and Medicaid) and other exposures, such as disaster assistance to state and local governments or the costs of maintaining federal infrastructure, where future spending stems all or in part from implied commitments embedded in current policies or past practices.

To identify programs for our analysis, we reviewed budget and financial data from 2001 to 2012 and past work on fiscal exposures. We identified a number of programs for in-depth review that legally require the government to make payments in the future, including those where payments may be contingent on the occurrence or nonoccurrence of a given event. From that group, we selected programs in which the cost reported in the *Financial Report of the United States Government (Financial Report)* was typically greater than the amount reflected in the

[3]The term "budget" can refer to a variety of plans, including the President's budget, the congressional budget resolution or an agency's budget documents. In this report, we focused on reporting in the President's budget. *See*, 31 U.S.C. § 1105.

budget.[4] In addition, to facilitate an assessment of current budget treatment, we selected programs for which the outlays and dedicated receipts could be easily identified in budget accounts.

The fiscal exposures we discuss in this report are:

- federal crop insurance;
- national flood insurance;
- pension insurance;
- stock purchase agreements with Fannie Mae and Freddie Mac;
- civilian pension benefits;
- civilian post-retirement health benefits;
- military pension benefits;
- military post-retirement health benefits; and
- veterans compensation.

For each of these programs, we examined the extent of the government's legal commitment and estimated magnitude of the exposure by reviewing the budget, the *Financial Report*, agency documents and financial reports, and our related reports. For the federal crop insurance program, we compared outlays with resources available to the program for fiscal years 2001 to 2012. For the National Flood Insurance Program (NFIP) administered by the Federal Emergency Management Agency (FEMA) and pension insurance administered by the Pension Benefit Guaranty Corporation (PBGC), we compared the cash flows recorded in the budget account with reported changes in the net position (the difference between the program's assets and liabilities) for fiscal year 2001 to 2012. For Fannie Mae and Freddie Mac, we compared the outlays from the Department of the Treasury (Treasury) to these government-sponsored enterprises (GSEs)—as directed under the terms of the stock purchase agreements—with estimates of the government's likely commitment, as reported in the *Financial Report* for fiscal year 2008 to 2012. For federal employee benefit programs, we compared past spending and revenue data by budget account in the President's budget with estimates of costs incurred based upon the liabilities and expenses reported in the *Financial*

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[4]The *Financial Report* is prepared by the Department of the Treasury, in coordination with the Office of Management and Budget (OMB). Generally, a cost is recorded in the *Financial Report* on an accrual basis—when the obligation is incurred rather than when it is paid; as such costs for some programs are recognized earlier than in the budget, which generally measures outlays on a cash or cash-equivalent basis.

Report or agency financial reports from fiscal years 2001 to 2012, when available.[5] For programs funded by a trust fund, we compared trust fund balances reported in the budget to estimates of the net present value of future benefits for the program, as measured by its liability in the *Financial Report*.[6] To analyze the current budget treatment of the exposures and how the budget recognition could be improved, we drew upon our body of work on fiscal exposures, including work on federal insurance and environmental disposal liabilities,[7] other nations' use of accrual budgeting to better recognize the full cost of government programs and activities,[8] and on the budget process and mechanisms to control spending and manage fiscal exposures.[9] While changes to the budget reporting may suggest the need for policy changes, our focus is on providing better information to make policy choices, not on what those choices should be.

We determined that the data from the budget were sufficiently reliable for representing the costs recognized in the budget. In our audit of the *Financial Report*, we were unable to determine the reliability of significant portions of the government's assets, liabilities, and costs, including the reliability of estimates reported for the military postretirement health

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5The budget reflected contributions to a trust fund from the Department of Defense for TRICARE for Life as of 2003.

6Federal trust funds are used to link earmarked receipts with the expenditures of those receipts for a dedicated purpose. For example, monies in the Civil Service Retirement and Disability Fund and Military Retirement Fund are dedicated to fund long-term pension commitments. Fund balances stem from a combination of receipts and appropriated contributions from the general fund, which include interest payments and the employer share of federal employee pension costs. See GAO, *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions,* GAO-01-199SP (Washington, D.C.: Jan. 2001). Data for civilian pension liabilities were obtained from the Office of Personnel Management's (OPM) financial reports.

7GAO, *Long-Term Commitments: Improving the Budgetary Focus on Environmental Liabilities,* GAO-03-219 (Washington, D.C.: Jan. 24, 2003) and *Budget Issues: Budgeting for Federal Insurance Programs,* GAO/AIMD-97-16 (Washington, D.C.: Sept. 30, 1997).

8GAO, *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. 2007); and GAO, *Accrual Budgeting: Experiences of Other Nations and Implications for the United States,* GAO/AIMD-00-57 (Washington, D.C.: Feb. 18, 2000).

9GAO, *Mandatory Spending: Using Budget Triggers to Constrain Growth*, GAO-06-276 (Washington, D.C.: Jan. 31, 2006); and GAO, *Budget Policy: Issues in Capping Mandatory Spending*, GAO/AIMD-94-155 (Washington, D.C.: Jul. 18, 1994).

benefit liability used in this report. However, we determined the data from the *Financial Report* were sufficiently reliable for representing the estimated magnitude of future spending arising from commitments incurred today. To assess the reliability of the data collected from agency financial reports for pension insurance and civilian pension liabilities, we reviewed the independent audit reports on PBGC and Office of Personnel Management's (OPM) financial statements; the auditors determined that financial information was fairly presented and therefore we determined that the data were sufficiently reliable for illustrating the programs' financial conditions.

We conducted this performance audit from September 2012 to October 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

We developed the conceptual framework for fiscal exposures in 2003, in order to facilitate the discussion of long-term costs and uncertainties that present risks for the federal budget in the future.[10] Fiscal exposures vary widely as to source, extent of the government's legal commitment, and magnitude. Figure 1 illustrates the range of the legal commitment. Fiscal exposures may be explicit in that the government is legally required to fund the commitment, or implicit in that an exposure arises not from a legal commitment, but from current policy, past practices, or other factors that may create the expectation for future spending. Some exposures present elements of both explicit and implicit exposures. Insurance programs are a key example. If an event occurs, some payment is legally required; this represents an explicit exposure. There may be an expectation that the government will provide assistance beyond the program's total available resources or budget authority (e.g., flood insurance payments made in response to a major disaster): this expectation represents an implicit exposure.

[10] GAO-03-213.

Figure 1: Spectrum of Fiscal Exposures

Explicit exposures	Implicit exposures
Payments the government is legally required to make either immediately or in the future.	Payments the government may be expected to make based on the government's current policies or past practices.

Source: GAO.

The amount of future spending arising from these exposures varies in the degree to which it is known and can be measured. For example, federal employee pension benefit payments can be reasonably estimated; accrued liabilities for earned benefits that will be paid in the future are reflected in the *Financial Report*. However, future payments to cover insured losses for events, such as terrorist attacks or catastrophic weather-related events, are more difficult to estimate due to uncertainty over whether the events will occur, when they will occur, and their severity. Estimates for some programs are further complicated when past experience indicates significant variability in payments.

Some of the largest fiscal exposures facing the federal government are the future payments for social insurance and health programs, particularly Social Security, Medicare, and the federal portion of Medicaid, which largely stem from the expectation that commitments embedded in current policies will continue.[11] Spending for these programs is expected to grow considerably in the future due to the nation's aging population and rising health care costs. Our April 2013 simulations show that spending on these programs will increase under a range of assumptions. For example, assuming current law is generally continued, spending would increase

[11]Social insurance programs are generally defined as government programs intended to protect households or individuals against certain social risks including loss of income. In contrast to other federal insurance programs, these programs are generally viewed as transfer payments, which are benefits provided without requiring the recipient to provide current or future goods or services of equivalent value in return. In this respect, they are different from pension and other employee compensation that is provided in exchange for services.

from 10 percent of GDP in 2010 to 13.6 percent of GDP by 2030, absorbing an increasing share of federal revenue and reducing future budget flexibility.[12] Should the amounts of funding needed to cover future benefits exceed the amounts available in corresponding trust funds, there may be an expectation that the government will use federal funds to pay the difference, even though there would be no legal commitment on behalf of the government to do so. Significant information on the estimated future spending for Social Security and Medicare is available; in addition to our long-term fiscal simulations, the Congressional Budget Office (CBO) and the administration regularly publish long-term fiscal simulations, which illustrate the expected growth in spending for these programs.[13]

Future spending for other implicit exposures can be more difficult to estimate. For example, the frequency and magnitude of declared disasters has increased in recent decades, resulting in billions of dollars of supplemental appropriations. FEMA has obligated over $80 billion in federal assistance for disasters declared during fiscal year 2004 through 2011. The unpredictable nature of such events makes estimating future spending difficult.

In some instances, current budget treatment does not fully capture or facilitate explicit consideration of some fiscal exposures at the time policy or program design decisions are made because some primary budget data—receipts and outlays—are generally measured on a cash or cash-equivalent basis—that is, when cash is received or paid, rather than when costs are incurred. For programs where the time between the incurrence of a cost and resulting payment is relatively short, the budget often provides sufficient information on and control over the government's spending commitments. However, for some programs, where cash flows to and from the government span many budget periods, or where the government legally obligates itself to make future payments or incur

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[12] GAO, *The Federal Government's Long-Term Fiscal Outlook: Spring 2013 Update,* GAO-13-481SP, (Washington, D.C.: Apr. 11, 2013). These figures also include spending for other federal health programs delivered through the states – the Children's Health Insurance Program and the subsidies available to assist individuals to purchase insurance coverage through the American Health Benefit Exchanges.

[13] See Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (Washington, D.C.: Jun. 5, 2012) and Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2014* (Washington, D.C., Apr. 10, 2013).

losses if an event occurs in the future, the generally cash-based measures used in the budget do not reflect the magnitude of the government's legal commitment of future resources at the time decisions are being made. If the full cost of a spending decision is included in the budget when the decision is made, then decision makers can consider the total costs when setting priorities, comparing the cost of a program with its benefits, or assessing the cost of one method of reaching a specified goal with another. Decision makers' ability to make informed choices would be improved by increased transparency regarding the impact of policy decisions on the expected path of spending and revenue.

Expected future spending arising from some exposures is recognized in the financial statements, which report costs on an accrual basis. Generally, under financial accounting standards, liabilities are recorded for probable and measureable outflows of resources arising from past transactions and events. Also, under accounting standards, the cost of claims for federal insurance programs that are deemed probable and measurable is considered a liability; reasonably possible losses are disclosed in the notes to the financial statements. Therefore, some measures reported in the government's financial statements can be useful indicators of future spending arising from certain fiscal exposures.

The Budget Provides Incomplete Information about Some Fiscal Exposures

The nine programs we examined illustrate a range of fiscal exposures in which the extent of the government's legal commitment varies (see figure 2).[14] For example, civilian pension benefits are explicit exposures because the government has a legal commitment to pay pension benefits earned by current employees who will receive benefits in the future and to pay retirees who currently receive benefits. Other fiscal exposures, such as federal insurance programs, fall across the spectrum. For example, if extreme weather causes crop losses, the government is legally required to provide funds to cover associated crop insurance claims. However, there are some insurance programs—such as pension insurance—for which the government is not legally required to cover claim losses in excess of available resources. Pension insurance claims up to the statutory limit are explicit exposures; losses in excess of PBGC's available resources represent an implicit exposure for the federal

[14]See appendix I for information on the extent and estimated magnitude of these fiscal exposures.

government to the extent there is an expectation that the government would step in and cover losses beyond the program's reserves.[15]

Figure 2: Selected Programs Illustrate Range of Fiscal Exposures

Explicit exposures	Implicit exposures
Federal insurance programs • Crop insurance • Flood insurance • Pension insurance **Purchase agreements with Fannie Mae & Freddie Mac** **Federal employee benefit programs** • Civilian pensions • Civilian post-retirement health benefits • Military pensions • Military post-retirement health benefits • Veterans compensation	• Claims in excess of program limits for flood insurance • Claims in excess of available resources for pension insurance • Assistance beyond scope of current agreements with Fannie Mae & Freddie Mac

Source: GAO.

For some exposures, the extent of the government's legal commitment has changed over time. For example, the fiscal exposure created by Fannie Mae and Freddie Mac changed in recent years as the government responded to the financial crisis. Prior to 2008, securities issued by Fannie Mae and Freddie Mac were explicitly not guaranteed by the federal government and the government had no legal responsibility to provide support to these GSEs. However, in response to the financial

[15]PBGC is a wholly-owned corporation of the U.S. government. Its financial activities are included in the federal budget and consolidated financial statement of the U.S. government. PBGC is required to be self-financing and does not receive funds from the general fund of the Treasury. See appendix I for more details.

crisis, the government placed them into conservatorship and agreed to provide temporary assistance, creating a new explicit exposure.[16]

The budget does reflect some or all of the cost of the government's legal commitment for some exposures. For example, for crop insurance, budget authority[17] is provided to cover the cost of premium subsidies, claims payments, and administrative expense subsidies. For military and civilian pensions, agencies are required to make contributions out of current budget authority to cover some of the costs of civilian and military pension benefits earned by current employees. These contributions reduce the funds available to each agency to fund other activities. However, the recognition is incomplete because the contributions are not set to cover the full cost. In addition, we found that the budget provides incomplete information or potentially misleading signals about today's legal commitments for some other exposures as well. Our selected fiscal exposures generally demonstrate one or more of the following characteristics:

The full cost of commitments incurred today is not recorded in the budget until the corresponding outlays are made in the future. For example, for veterans compensation and civilian post-retirement health benefits, the budget reflects benefit payments in a given year, instead of capturing the cost of benefits earned today that will need to be paid in the future.

Similarly, the cost of pension insurance accrued in a given year is not reflected in the budget; rather, premiums are shown as receipts when they are collected and payments are shown as outlays when they are made. This focus on annual cash flows does not reflect the government's cost for pension insurance because the time between the extension of the insurance, the receipt of premiums and other collections, the occurrence

16The Federal Housing Finance Regulatory Reform Act of 2008 established the Federal Housing Finance Agency (FHFA), which was created to enhance authority over these GSEs and provide the Secretary of the Treasury with certain authorities intended to ensure the financial stability of these GSEs. Treasury entered into a Senior Preferred Stock Purchase Agreement (hereafter referred to as the agreements) with each GSE. The agreements, which have no expiration date, provide that Treasury will disburse funds to these GSEs if at the end of any quarter the FHFA determines that the liabilities of either GSE exceed its assets.

17Budget authority is the authority to incur obligations and pay expenses.

of an insured event, and the payment of claims may extend over several decades. Rather, the cost of pension insurance can be measured by the portion of risk assumed by the government that is not charged to the beneficiary—a “missing premium.”[18] This subsidy is not recognized in the budget when the insurance is extended.

The current budget treatment results in both incomplete information with regard to any missing premium, and in potentially misleading information about the program’s financial condition. For example, at the time budget decisions were being made for fiscal year 2013, the budget showed a positive budget estimate (i.e., net revenues) for PBGC of about $1.6 billion, suggesting that the program would help decrease the federal budget deficit that year. However, the financial reports available at the same time showed the program’s net position worsened by about $8 billion from the year before, principally as the result of incurred losses that are not yet reflected in the budget. These estimates provide significantly different pictures of the program’s health and its potential draw on future budget resources. While PBGC can legally only pay claims up to the amount of resources available in its revolving funds, in the face of major pension fund failures there might be an expectation that the government would pass legislation allowing PBGC to cover some or all of the gap.[19]

Dedicated resources are estimated to be insufficient to pay for the associated commitment. Some programs set aside amounts out of current budget authority to cover benefits earned today but payable in the future. For example, agency contributions and Treasury payments to cover military pension benefits accrued during the year are deposited in a budgetary trust fund; however, the trust fund balance is significantly less than expected future benefits payments, as measured by the accrued liability (see appendix I, figure 9). As such, the trust fund’s balance can

[18]For more information on this concept, see GAO/AIMD-97-16 or GAO, *Budget Issues: Budgeting for Federal Insurance Programs*, GAO/T-AIMD-98-147 (Washington, D.C.: Apr. 23, 1998).

[19]PBGC operates two insurance programs—one for single employer plans and another for multiemployer plans, which are created by collective bargaining agreements and include more than one employer. Operations are financed by premiums, assets from terminated plans, and investment income. While the single employer program is supported by both premiums and an asset base, the multiemployer program is supported mainly by premiums and a relatively small asset base. Because of long-term challenges related to PBGC’s governance and funding structure, PBGC’s financial future is uncertain. See GAO, *High-Risk Series: An Update*, GAO-13-283 (Washington, D.C.: Feb. 2013).

provide a signaling function of future spending but does not necessarily represent the full cost of those legal commitments.[20]

Furthermore, some insurance programs do not have sufficient dedicated resources to cover expected costs. For example, the NFIP historically insured many properties at a subsidized rate.[21] In addition, overall flood insurance premiums were designed to permit the program to cover losses and expenses in an "average historical loss year," but not to cover high-loss years. Instead, the program was given the authority to borrow from the Treasury in such years, with the expectation that low-loss years would allow the program to repay any borrowed funds. With the exception of years involving catastrophes, annual losses and receipts have generally evened out since 1978, but NFIP has been unable to repay the amounts borrowed in response to catastrophic events, such as Hurricane Katrina in 2005. This funding structure is one of the reasons the program was added to our High Risk List in 2006.[22]

Increasing amounts of future spending may be required or expected based both on recent trends and events—and on the government's response to those events. For example, weather-related events have cost the nation tens of billions of dollars in damages over the past decade. The exposure from weather-related events increases with changes in population density as well as increased frequency and severity of the events. This is one reason we added the federal government's fiscal exposure created by climate change to our 2013 High Risk List.[23] Through federal programs like flood and crop insurance, these events pose significant financial risks for the federal government.

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[20]GAO, *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions*, GAO-01-199SP (Washington, D.C.: Jan. 2001).

[21]The Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. No. 112-141, requires the subsidized premiums be eliminated and actuarially sound premiums phased in.

[22]GAO, *GAO's High Risk Program*, GAO-06-497T, (Washington, D.C.: March 15, 2006).

[23]GAO-13-283.

Approaches to Better Recognize the Programs that Create Fiscal Exposures in the Budget

Given the variation in fiscal exposures, when making budget decisions, a uniform, across-the-board approach to make fiscal exposures more apparent may not be appropriate. Several factors need to be taken into account in selecting an approach to better recognize fiscal exposures in the budget: the extent of the government's legal commitment; the length of time until the resulting payment is made; and the extent to which the magnitude of the exposure can be reasonably estimated. We previously recommended to OMB and Congress two general approaches: reporting supplemental information in budget documents to increase attention to fiscal exposures, and incorporating costs into primary budget data to allow for better comparisons among programs.

Reporting Supplemental Information Can Increase Attention to Fiscal Exposures

Supplemental reporting involves including information about the financial state of programs in addition to that which is available in primary budget data. Improved supplemental reporting in budget documents on fiscal exposures would make information more accessible to policymakers without introducing additional complexity and uncertainty directly into the budget. With a supplemental reporting approach, the current basis of reporting primary budget data would not be changed. Instead, the supplemental information would be used along with budget data to identify important signals that could be used to monitor fiscal exposures. For example, the Appendix Volume in the President's budget includes a balance sheet for some federal insurance programs that shows the program's net position (assets minus liabilities), providing valuable information about the program's affect on future budget resources. For the Federal Crop Insurance budget account, a supplemental table includes the cost of the premium subsidy provided by the government. In 2003, we recommended that OMB create an annual report on fiscal exposures providing a concise list and description of such exposures, cost estimates (where possible), and an assessment of methodologies and data used to produce cost estimates for such exposures. We further recommended that OMB report estimated costs of certain exposures as a new budget concept—"exposure level"—as a notational item in the Program and Financing schedule of the President's budget, though the recommendation was not implemented.

In some cases, improving supplemental reporting in key budget documents may simply be a matter of expanding program analysis and making existing analytical work more readily available. For example, CBO regularly prepares 10-year budget projections for several programs in our review. While this time period is helpful for many programs, longer-term projections would be helpful for those programs—such as federal employee pensions and retiree health—where the time between the legal commitment and payments can extend over several decades. Further, significant changes in expected spending (or differences between actual and estimated spending) should prompt analysis, including consideration of the nature and source of the change.

Identifying meaningful measures that would provide signals about the changing nature or magnitude of the exposure might offer another means to focus policymaker attention on fiscal exposures. For example, trust fund balances can serve as a signaling function for decision makers about underlying fiscal imbalances in covered programs.[24] A gap between the projected fund balance and expected spending can signal that the fund, either by design or because of changes in circumstances, is collecting insufficient monies to finance future payments. Also, the repeated use of borrowing authority[25] could be an indicator that the magnitude of the exposure has changed. Specifically, NFIP was expected to borrow in “above-average claim” years and repay that borrowing in “below-average claim” years. In years with extraordinarily high claims resulting from catastrophes like Superstorm Sandy and Hurricane Katrina, NFIP has used the borrowing authority repeatedly. The program currently has an outstanding debt to the Treasury of $24 billion. The program’s inability to cover claims in excess of premiums led to the passage of legislation in 2012 that altered the design of the program, including a key provision that NFIP raise premium rates to reflect true flood risk and make the program more financially stable.[26] These signaling devices can provide policymakers with information regarding the full costs involved in budget decisions and enable those concerned about exposures to raise questions and challenges in the budget debate and to prompt action.

24GAO-01-199SP.

25Borrowing authority permits an agency to borrow money, usually from the Treasury, then obligate against amounts borrowed.

26Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. No. 112-141, § §100205, 100207.

Incorporating the Full Costs of Legal Commitments Incurred Today into Primary Budget Data Would Allow for Better Comparisons among Programs

A second potential approach to improving recognition of fiscal exposures is incorporating full costs into primary budget data. This method would allow for better comparisons among competing priorities and between different methods for achieving program goals. In certain cases, including credit programs and government employee pensions, accrual accounting methods are already used to some extent in budgeting. For example, credit reform in 1990 permitted more accurate comparisons among direct loans, loan guarantees, and other types of tools for achieving a program's objectives. Some other countries, such as Canada and Iceland, also use accrual budgeting selectively to increase recognition of future cash requirements related to service provided during the year; officials from these countries generally said that accrual budgeting contributed to improved resource allocation and program management decisions in these specific areas. We have recommended that Congress expand the use of accrual budgeting to other budget program areas where it would enhance upfront control, such as insurance and environmental liabilities.[27] While it has not been expanded to these areas, proposals addressing broader budget process reform have included accrual budgeting. As seen in the implementation of credit reform, including estimates of full costs in primary data may also lead to the development of better estimates of future spending, though it would require the development of methodologies appropriate to the nature of the exposure.

Because the cost to the government varies according to the specific program's design and characteristics, different types of cost estimates could be incorporated into primary budget data in order to better recognize the government's fiscal exposure. For example,

- **Normal cost:** For retirement benefit programs, such as pension or retiree health, the normal cost is the actuarial present value of the benefits to be paid in the future that are attributable to employees' current year of service. As such, it is one measure of an accrual cost for a particular year.

[27] GAO-08-206. Other countries we reviewed—Australia, New Zealand, the Netherlands, and United Kingdom—use accrual budgeting more extensively to support broader efforts to improve the efficiency and performance of the public sector. However, none of these other countries used accrual budgeting for social insurance programs.

- **Risk-assumed cost estimates:**[28] For insurance programs, key information is whether premiums will be sufficient to pay for covered losses under existing policies. The portion of risk assumed by the government that is not charged to the beneficiary—the "missing premium" or subsidy cost—is essentially the difference between some measure of the full premium and the actual premium charged to the insured. This cost measure has been used since 1991 for credit programs.

All estimates of future spending introduce some degree of additional uncertainty into the budget and the ease of implementation differs. Some measures may already be used widely in other forms of reporting, whereas others are relatively new concepts for federal budget reporting and may involve developing new models and technical skills. Despite any implementation challenges, approximate estimates of the full cost to government may be preferable to some current measures that are incomplete or potentially misleading. Further, a requirement to produce estimates for budget reporting may help improve the quality of estimates by drawing more attention to them. Although using estimates may introduce uncertainty in primary budget data, it would result in earlier cost recognition in the budget. This would help reinforce up-front controls in the budget process.

Concluding Observations

Over the past decade, the magnitude of some fiscal exposures has grown and the extent of the government's commitment for some exposures has changed due to events and trends and the government's response to them. These fiscal exposures will require future federal spending and will absorb resources available for other activities. The federal budget both allocates and controls resources, but does not provide complete information about some significant fiscal exposures. Therefore, we continue to support many past recommendations to improve budget recognition of these fiscal exposures, both to increase the attention given to them and also to allow for more comparable cost information for decision makers to consider when determining the best way to achieve various policy goals or to design a program. Expanding the availability and use of supplemental information—including measures that can signal the significant changes in the magnitude and nature of fiscal exposures

[28]The risk assumed can be difficult to measure for many federal activities, but is most clearly identifiable in federal insurance programs.

facing the federal government—would be an important first step toward enhancing control and oversight over federal resources and can aid in monitoring the financial condition of programs over the longer term. Incorporating measures of the full cost into primary budget data would provide enhanced control over future spending. This can both improve the nation's fiscal condition and enhance the budgetary flexibility for responding to unexpected or emerging challenges.

Agency Comments and Our Evaluation

We provided a draft of this report to the Office of Management and Budget and the agencies responsible for administering the programs we reviewed. Those agencies are the Risk Management Agency (RMA) in the Department of Agriculture; the Federal Housing and Finance Administration; Department of Defense (DOD); Department of Homeland Security (DHS); Department of Veterans Affairs (VA); the Office of Personnel Management; and the Pension Benefit Guaranty Corporation (PBGC). RMA, DOD, PBGC, and the Federal Emergency Management Agency in DHS provided technical comments that were incorporated in the report as appropriate. The Chief of Staff of VA provided comments that are discussed below and reprinted in appendix II.

VA generally agreed with our findings and stated that current budget reporting provides adequate information for determining the resources necessary to pay benefits for current veterans and survivors. While we agree that the budget records the outlays associated with benefits paid in a given year, we maintain that current budget reporting provides incomplete information about the costs incurred for benefits earned during the year that will be paid in the future.

We are sending this report to relevant agencies and congressional committees. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report please contact me at (202) 512-6806 or irvings@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

Sincerely yours,

Susan J. Irving
Director for Federal Budget Analysis
Strategic Issues

Appendix I: Information on Selected Fiscal Exposures

This appendix describes the extent and estimated magnitude of the fiscal exposure created by nine programs:

- federal crop insurance;
- national flood insurance;
- pension insurance;
- stock purchase agreements with Fannie Mae and Freddie Mac;
- civilian pension benefits;
- civilian post-retirement health benefits;
- military pension benefits;
- military post-retirement health benefits; and
- veterans compensation.

Federal Crop Insurance

Background

Farming has always been vulnerable to risks from natural causes such as drought, excessive moisture, hail, wind, frost, insects, and disease. Farmers are also exposed to financial losses from price risk. The federal government helps mitigate the impact of these risks on farm income through the federal crop insurance program. Crop insurance is sold and serviced by 17 approved private companies. Under the provisions of these agreements, the private companies both bear a percentage of any loss and reap a percentage of any gain associated with the policies over the course of the year. The federal government subsidizes the premiums paid by farmers and acts as primary reinsurer for the private companies that underwrite the policies. The federal government also makes payments to insurance companies that are intended to cover administrative expenses for selling and servicing crop insurance policies. Federal crop insurance is not intended to be self-financing through premiums; a permanent, indefinite appropriation covers any payments that are needed to cover losses and other expenses.

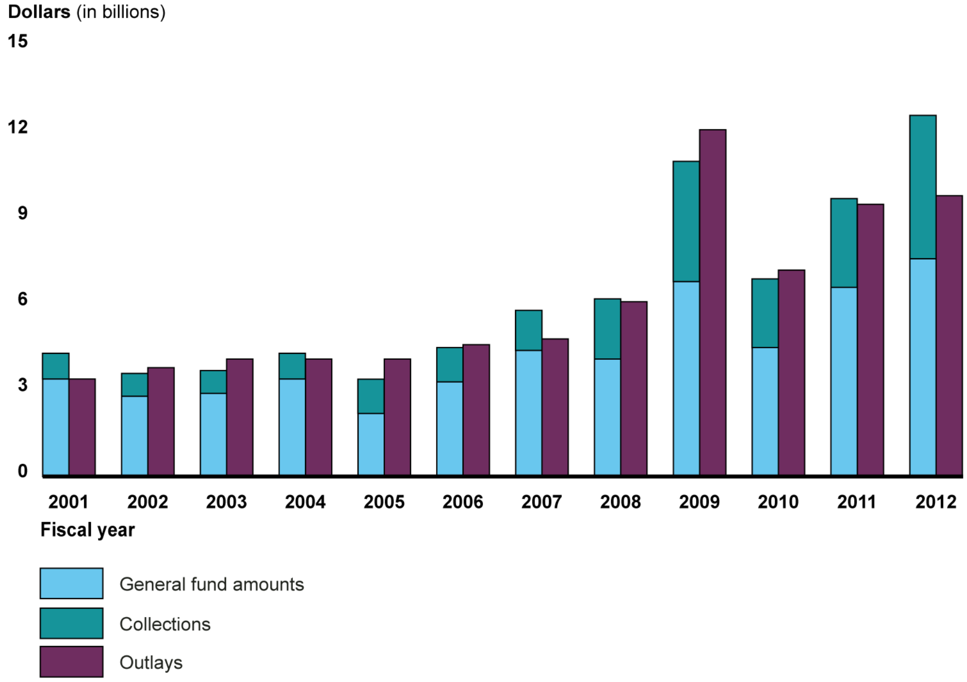
Extent and Estimated Magnitude of the Exposure

The government's legal commitment to pay crop insurance policyholder claims when losses occur makes the program an explicit exposure. The amount of federal spending resulting from this exposure depends on the extent of losses incurred by farmers.

The federal crop insurance program's costs increased sharply in recent years. An indicator of the government's exposure is the increase in appropriations drawn from the general fund,[1] which have grown from $3.4 billion in fiscal year 2001 to $7.6 billion in fiscal year 2012 as shown in figure 3.

[1]We use the term general fund to refer to the account in the U.S. Treasury holding all federal money not allocated by law to any other fund account and from which appropriations are generally drawn.

Figure 3: Federal Crop Insurance Corporation, Outlays and Resources, Fiscal Years 2001 through 2012



Source: GAO analysis of OMB data.

Note: Data from the President's Budget Appendix. General fund amounts, collections, and outlays from the Program and Financing Schedule. Amounts received by the Crop Insurance Corporation through the general fund are appropriated and represent premium subsidies as authorized by section 508(b) of the Federal Crop Insurance Act, as amended. Collections primarily come from premiums paid by farmers. Outlays primarily represent payments for indemnities to insured farmers and administrative expenses for approved insurance providers.

Budget Treatment of the Exposure

Figure 3 shows outlays and resources available to the program, the combination of the general revenue funds, and collections (primarily premiums) received. Outlays, which reflect claims payments and other associated costs, doubled from $3 billion in 2001 to $6 billion in 2008, and then doubled again in 2009 to $12 billion. Premiums received do not fully cover the program's costs; general revenue funds make up more than half of the program's available resources and are used in part to provide premium and administrative expense subsidies. Therefore, the full cost of the crop insurance subsidies and administrative costs is reflected in the budget.

Key Factors to Consider

Anticipating the future budget exposure presented by crop insurance is complicated by the potential impact of climate change and changes in program design. Our March 2007 report assessing the financial risks to the Federal Crop Insurance Corporation (FCIC) found that its exposure to weather related losses had grown substantially. At that time, we found that little had been done to develop the kind of information needed to understand FCIC's long-term exposure to climate change and that FCIC had not analyzed the potential impacts of an increase in the frequency or the severity of weather-related events on its operations. Since then, a study examining the potential impact of climate change on the federal crop insurance program was prepared for the Risk Management Agency (RMA), which administers the program. According to RMA officials, the overall impact of climate change is not clear, given the uncertainty of various climate change scenarios and the potential adaptive responses by growers and the crop insurance program. Reflecting these uncertainties and the significance of this issue, we included a discussion of the crop insurance program in a high risk designation related to the fiscal exposure of climate change in our High Risk List in 2013.[2]

[2] GAO-13-283.

National Flood Insurance

Background

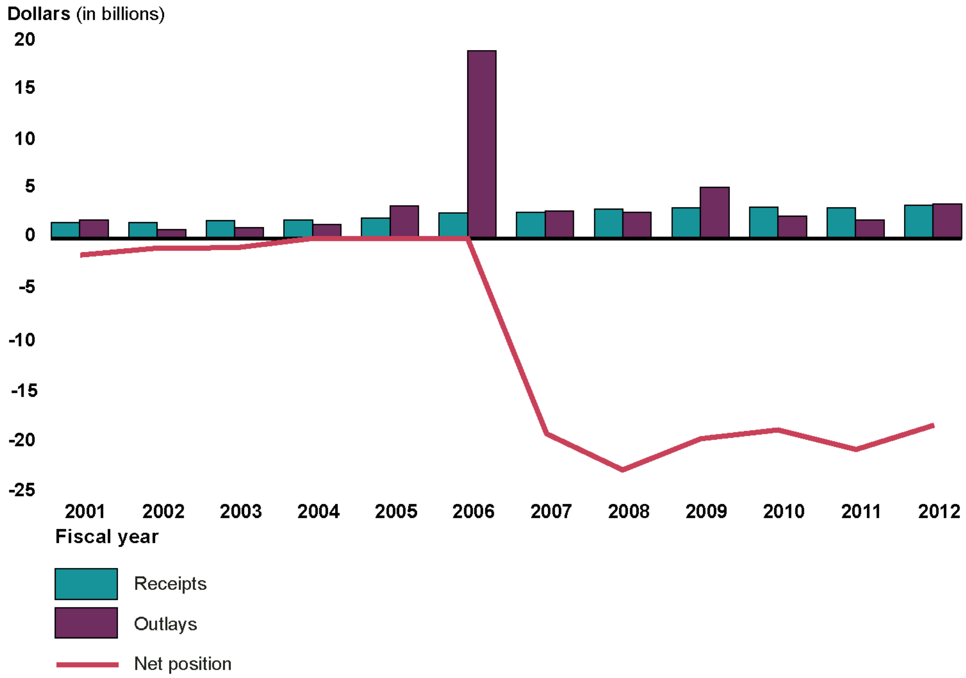
The Federal Emergency Management Agency (FEMA) within the Department of Homeland Security operates the National Flood Insurance Program (NFIP) to provide flood insurance to residential and commercial property owners. Flood insurance is funded primarily through premium collections. The premiums were designed to permit the program to cover losses and expenses in an "average historical loss year," but not to cover high-loss years. Instead, the program has statutory authority to borrow from the Treasury in such years with the expectation that low-loss years would allow the program to repay any borrowed funds. While not always the case, since 1978 annual losses have generally evened out with receipts over normal years but borrowing authority has been accessed and increased in recent years, in response to catastrophic events such as Hurricane Katrina in 2005.

Extent and Estimated Magnitude of the Exposure

NFIP presents a range of exposures to the federal government. The government's legal commitment to pay flood insurance policyholder claims when losses occur makes the program an explicit exposure. The amount of federal spending resulting from this exposure depends, in part, on the frequency of weather-related events and their severity. If total claims exceed amounts available from premium collections, NFIP may access available borrowing authority to cover excess claim amounts. To the extent there is an expectation that the federal government cover claims exceeding the amount that NFIP has been authorized to borrow from the Treasury, NFIP represents an implicit exposure. NFIP received increased borrowing authority in 2013 to cover loss claims related to Superstorm Sandy. Including the $16.8 billion NFIP borrowed to cover claims primarily from Katrina, the program's reported total outstanding debt had increased to $24 billion as of March 31, 2013.

One measure of the government's exposure is the extent to which claims exceed available resources. One indicator of the exposure is NFIP's net position—the residual difference between the program's total assets and liabilities.[3] NFIP's liabilities include outstanding debt to the Treasury. As shown in figure 4, the program's reported net position declined dramatically from fiscal year 2006 to fiscal year 2007 as NFIP borrowed from the Treasury to pay claims related to Hurricane Katrina. At the end of fiscal year 2012, the program's net position was negative $19 billion; this did not reflect the additional borrowing in 2013.

Figure 4: National Flood Insurance Receipts, Outlays, and Net Position, Fiscal Years 2001 through 2012



Source: GAO analysis of OMB data.

Note: Data from the President's Budget Appendix. Receipts and outlays from the Program and Financing Schedule; GAO analyzed supplemental balance sheet information on assets and liabilities to determine the net position.

[3] The President's Budget Appendix reports supplemental information for federal insurance programs, including a balance sheet for NFIP. NFIP's net position is recorded in the balance sheet.

Budget Treatment of the Exposure

Figure 4 also shows how the program is reflected in primary budget data. NFIP is reflected on a cash basis: premium collections are recorded as receipts in the year they are received and claims payments are recorded as outlays in the year they are made. The balance sheet for NFIP is also included in the budget as supplementary information. However, the budget has not reflected the subsidy cost—or “missing premium”—embedded in NFIP’s program design. The subsidy can be measured as the portion of risk assumed by the government that is not charged to the beneficiary.

Key Factors to Consider

NFIP was first added to our High Risk List in 2006 because of concerns about financial solvency. The program was highlighted again in 2013 when we added the fiscal exposure of climate change to the High Risk List.[4] In 2007, we found that more information was needed to understand and manage the program’s long-term exposure to climate change and analyze the potential effects of an increase in the frequency or in the severity of weather-related events on their operations, which in turn affects the fiscal exposure to the government. In June 2013, AECOM released a FEMA-sponsored study to investigate the potential impacts of climate change and population growth on the NFIP.[5] Recent legislation may address some of these concerns. In 2012, NFIP was required to set actuarially sound premium rates and phase out the premium subsidy on certain properties, as well as establish a reserve fund to cover catastrophic losses.[6] We have reported that the financial reforms included in the Biggert-Waters Act could go a long way toward reducing the fiscal exposure created by the program, but they will be phased in over time and it is too early to make conclusions.

[4] GAO-13-283.

[5] AECOM, *The Impact of Climate Change and Population Growth on the National Flood Insurance Program Through 2100,* (June 2013).

[6] The Biggert-Waters Flood Insurance Reform Act of 2012, Pub. L. No. 112-141.

Pension Insurance

Background

The Pension Benefit Guaranty Corporation (PBGC) is a wholly-owned government corporation established under the Employee Retirement Income Security Act of 1974[7] to protect the pension benefits of American workers. PBGC operates two insurance programs—one for single employer plans and another for multiemployer plans, which are created by collective bargaining agreements and include more than one employer. While the single employer program is supported by both premiums and an asset base, the multiemployer program is supported mainly by premiums and a relatively small asset base. As of the end of fiscal year 2012, PBGC insured the benefits for nearly 43 million workers, retirees, and beneficiaries participating in about 26,000 private sector defined benefit pension plans. PBGC is required to be self-financing and does not receive any funds from general revenue. It funds its operations through insurance premiums paid by companies that sponsor defined benefit pension plans, investment income, and assets from terminated plans. Premiums charged are set by law. PBGC's financial activities are included in both the federal budget and consolidated financial statements of the U.S. government.

Extent and Estimated Magnitude of the Exposure

Pension insurance presents a range of exposures to the federal government. PBGC's legal commitment to pay pension benefit guarantees when losses occur makes the program an explicit exposure for the government.[8] While the federal government may not cover losses related to failed pension plans in excess of PBGC's available resources, the extent to which there is an expectation (under some circumstances) that the federal government would step in and change the law to make all or some of such payments represents an implicit exposure.[9]

[7]Pub. L. No. 93-406, § 4002(a)

[8]Generally speaking, a claim occurs when a plan sponsor with an underfunded plan goes bankrupt and the plan is terminated.

[9]Congress recently repealed section 4005(c) of the Employee Retirement Investment Security Act, which provided authority for the PBGC's federal line of credit up to $100 million. *See* the Moving Ahead for Progress in the 21st Century Act (MAP-21), Pub. L. No. 112-141, § 40234 (a).

One measure of the magnitude of the government's fiscal exposure is PBGC's net position, which represents the residual difference between PBGC's total assets and liabilities. As figure 5 shows, PBGC's net position generally declined from a $7.8 billion surplus in 2001 to a $34 billion deficit in fiscal year 2012. However, PBGC estimated that its financial risk for potential termination of underfunded plans sponsored by financially weak firms to be almost $300 billion. Although PBGC's annual receipts currently exceed its outlays, its overall financial position is weaker than would be indicated by these annual receipts and outlays.

Figure 5: Pension Benefit Guaranty Corporation Net Position and Revolving Fund Cash Flows, Fiscal Years 2001 through 2012

Source: GAO analysis of OMB and PBGC data.

Notes: Receipts and outlays from the President's Budget Appendix. Net position from PBGC's financial reports.

Budget Treatment of the Exposure

PBGC is an example of a program for which cash-based budgeting provides potentially misleading information. Premiums are shown as receipts when they come into the Treasury and payments are shown as outlays when they are made; the time lag between these events means that an increase in PBGC premiums would appear in the budget as an increase in revenues. The budget does not reflect the “missing premium”—the portion of a full risk-based premium not charged to the insured, which could be a signal of the expected cost of the program.

Key Factors to Consider

In 2013, we reported that plan terminations and insolvencies threaten PBGC’s ability to pay pension guarantees for retirees. In the event that the agency were to exhaust all of its assets and become insolvent, the agency would only have premium revenue to rely on to make its benefit payments.[10] As a consequence, PBGC would be forced to seek additional federal funding, dramatically cut benefit payments to participants, or ask Congress to raise premiums significantly to meet its benefit commitments.[11] We, along with PBGC, have expressed concerns that the current level of premiums and assets will not be sufficient to cover expected claims in the future.[12] PBGC has been on our High Risk List since 2003. Because of long-term challenges related to its governance and funding structure, PBGC’s financial future is uncertain. While Congress and PBGC have taken steps in recent years to address these challenges, PBGC continues to face the risk of significant increases in liabilities and inadequate sources of revenue to finance future claims.

[10]For further discussion, see GAO, *Private Pensions: Timely Action Needed to Address Impending Multiemployer Plan Insolvencies*, GAO-13-240, (Washington, D.C.: Mar. 28, 2013).

[11]GAO, *Pension Benefit Guaranty Corporation: Redesigned Premium Structure Could Better Align Rates With Risk From Plan Sponsors*, GAO-13-58, (Washington, D.C.: Nov. 7, 2012) and Pension Benefit Guaranty Corporation, *Excellence in Customer Service: Annual Report 2012*, (Washington, D.C.: Nov.14, 2012).

[12]GAO-13-58.

Stock Purchase Agreements with Fannie Mae and Freddie Mac

Background

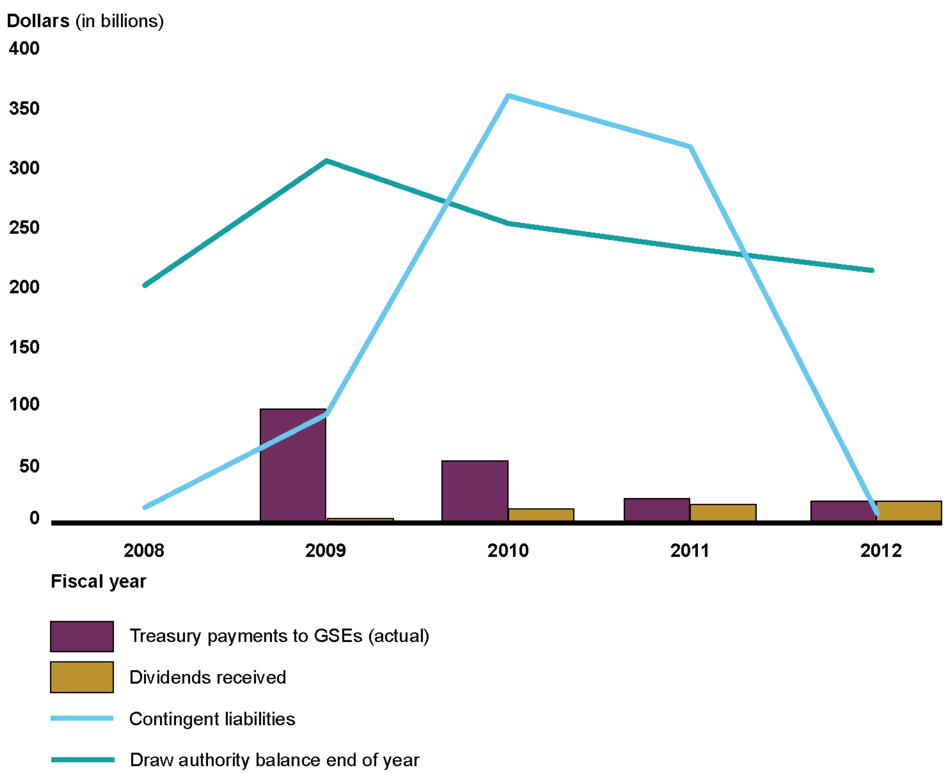
Congress established Fannie Mae and Freddie Mac as government-sponsored enterprises (GSEs) in the housing finance market to support the supply of mortgage loans; securities issued by these GSEs were not backed by the full faith and credit of the government. In 2008, in response to the financial crisis, Treasury entered into Senior Preferred Stock Purchase Agreements (the agreements) with Fannie Mae and Freddie Mac to preserve the assets and mitigate systemic risks that contributed to market instability. Under the agreements, Treasury would purchase these GSEs' senior preferred stock and make funds available on a quarterly basis, to be recovered by redemption of the stock or by other means. While the initial funding commitment for each enterprise was capped at $100 billion, Treasury increased the cap to $200 billion per GSE in May 2009 to maintain confidence in these GSEs. In 2012, the caps were replaced with a formulaic cap allowing these GSEs to make quarterly draws based upon their net position, or if the liabilities of either GSE, individually, exceed its respective assets.

Extent and Estimated Magnitude of the Exposure

The purchase agreements with Fannie Mae and Freddie Mac illustrate how an exposure can change over time. Prior to 2008, these GSEs represented an implicit fiscal exposure to the government because the securities they issued were explicitly not guaranteed by the full faith and credit of the U.S. government. The 2008 stock purchase agreements, while temporary, created a new explicit exposure for the federal government to provide immediate financial support to Fannie Mae and Freddie Mac. At the end of any quarter in which either Fannie Mae's or Freddie Mac's balance sheet reflects that total liabilities exceed total assets, the GSEs have 15 business days to request funds under the terms of the agreements. Treasury then has 60 days to provide the funds, as necessary, up to the maximum amount of the funding commitment. The federal government is not obligated to provide additional assistance beyond the scope of the agreements, but the government's response may influence expectations related to future support. This expectation represents an implicit exposure.

One measure of the magnitude of the exposure to the government is the liability reported in the 2012 *Financial Report of the United States Government (Financial Report)* of $9 billion, reflecting Treasury's best estimate at the time of likely draws over the remaining duration of the agreements. The liability was significantly reduced in 2012 (see figure 6). This reduction was in part due to a revision to the agreements that is expected to reduce the amount of future draws, and also to the improved housing market, which contributed positively to the GSEs financial results. Another possible measure of the exposure is the remaining draw authority available to these GSEs, which was about $258 billion as of January 1, 2013. This represents the maximum amount of future spending under the current agreement. In considering the exposure under either measure, any amounts received related to the federal government's investment in the GSEs' stock—which had a reported fair value of $109.3 billion in the 2012 *Financial Report*— would reduce the federal government's exposure.

Figure 6: Treasury Agreements with Fannie Mae and Freddie Mac, Fiscal Years 2008 through 2012



Source: GAO analysis of data from OMB, Treasury, and Fannie Mae and Freddie Mac.

Note: Treasury payments to GSEs based on data from the President's Budget Appendix. Contingent liabilities from the *Financial Reports*. Dividends and draw authority balances based on data from Fannie Mae and Freddie Mac.

Budget Treatment of the Exposure

Figure 6 also shows the Treasury payments to these GSEs and draw authority balance at the end of the year as recorded in primary budget data. The Administration considers Fannie Mae and Freddie Mac to be outside of the budget; therefore payments to them are recorded as outlays. Since 2008, Fannie Mae and Freddie Mac have drawn a total of $187.5 billion and draws have decreased each year—from a high of $95.6 billion in fiscal year 2009 to $18.5 billion in fiscal year 2012. The draw authority balance remaining at the end of each fiscal year is reflected as an unobligated balance.

Under the terms of the agreements, the cost of the government's commitment is offset by dividend payments from these GSEs to Treasury.[13] As figure 6 shows, in fiscal year 2012 Treasury made payments to these GSEs of $18.5 billion but these GSEs made $18.4 billion in dividend payments to the Treasury. Including $14.6 billion in dividend payments due as of September 2013, the aggregate dividend payments to Treasury from Fannie Mae and Freddie Mac totaled about $146 billion.

Key Factors to Consider

We, federal regulators, researchers, and others have long argued that, despite the federal government explicitly not guaranteeing the enterprises' debt or including them in the federal budget, Fannie Mae and Freddie Mac had financial incentives to engage in risky business practices to strengthen their profitability in part because of the financial benefits derived from an implied federal guarantee on their financial obligations. In 2009, we reported that excluding Fannie Mae and Freddie Mac from federal budget totals leads to limited transparency about these GSEs' risks and potential costs to taxpayers.[14] This is in contrast to the budget treatment for direct federal loan and loan guarantee programs,

[13]Dividends received by Treasury under this agreement are reflected in the general fund.

[14]GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-term Structures,* GAO-09-782, (Washington, D.C.: Sept. 10, 2009).

which record associated costs in the federal budget.[15] The future structures of these two GSEs and the roles they will serve in the mortgage market must still be determined and will affect future decisions about budget treatment.

15Pub. L. No. 101-508. Under the Federal Credit Reform Act of 1990, the credit subsidy cost of direct loans and loan guarantees is the net present value of the estimated long-term cost to the government at the time the credit is provided of such programs, less administrative expenses. The act was intended to improve disclosures about the risks associated with government direct loans and guarantee programs and assist Congress in making budget decisions about such programs.

Civilian Pension Benefits

Background

Most federal civilian employees are covered by one of two pension plans, depending largely on when they began their federal service: those hired before 1984 are covered by the Civil Service Retirement System (CSRS) while most employees who entered federal service after 1983 are covered by the Federal Employee Retirement System (FERS).[16] The difference between the design and structure of these two plans affects the extent and magnitude of the fiscal exposure each presents to the government.

CSRS is a stand-alone defined benefit plan enacted in 1920.[17] CSRS employees do not pay Social Security payroll taxes and they do not earn Social Security benefits for their CSRS-covered service.[18] FERS has a small defined benefit portion—the FERS annuity—which supplements Social Security, and a voluntary defined contribution portion, the Thrift Savings Plan (TSP).[19] Defined contribution plans do not represent a fiscal exposure to the government because benefits in retirement are based on contributions and investment returns in these accounts. The analysis in this report covers CSRS and the FERS annuity—the defined benefit

16CSRS was authorized by the Civil Service Retirement Act of 1920 (Pub. L. No. 66-215) and FERS was established by the Federal Employees' Retirement System Act of 1986 (Pub. L. No. 99-335).

17In a defined benefit plan, the retirement benefit typically is based on a formula specified in the plan, which will often be based on factors such as an employee's years of service, age at retirement, and wages or salary. For a civilian employee retiring after 30 years of federal service, a CSRS annuity will be equal to 56.25 percent of the average of the highest three consecutive years of basic pay. A FERS employee retiring at the age of 62 with 30 years of service will receive a FERS annuity equal to 33 percent of the average of the highest three consecutive years of pay.

18Some CSRS employees will have paid or will pay Social Security for employment outside the federal government.

19The TSP is a defined contribution retirement plan similar to the 401(k) plans provided by many employers in the private sector. The income that a retired worker receives from the TSP will depend on the balance in his or her account. Contributions of up to 5 percent of pay made by FERS employees are matched by the federal government. CSRS employees can contribute to the TSP, but they receive no matching contributions. The TSP is non-budgetary and agency matching contributions are recorded as outlays.

portion of FERS—which constitutes the government's exposure arising from the two civilian pension plans.

Both agency and employee contributions toward CSRS and the FERS defined benefit annuity are paid to the Civil Service Retirement and Disability Fund (CSRDF), the trust fund in the budget dedicated to funding civilian pension benefits. The CSRDF also receives some payments from the Treasury's general fund account (largely intended to amortize and pay interest on the previously accumulated CSRS liability) and the CSRDF is credited with interest (investment income) on the Treasury securities it holds.[20]

Extent and Estimated Magnitude of the Exposure

Civilian pension benefits are explicit exposures because the government has a legal commitment to pay pension benefits earned by current employees who will receive benefits in the future and retirees who currently receive benefits.

From a government-wide perspective, the magnitude of the exposure can be estimated by the accrued liability for defined benefit civilian pensions, which at the end of fiscal year 2012 was estimated to be $1.8 trillion, up from $1.2 trillion in 2001. Most of the accrued pension liability is the cost of CSRS and FERS benefits earned but not yet paid to date.[21] The composition of the civilian pension liability has changed and will continue to change over time because the extent and magnitude of the government's exposure are different for CSRS and FERS. This reflects both the transition from CSRS to FERS in the mid 1980s, and the differences in their benefit structure.

- Since employees hired after 1984 are covered by FERS, that liability is growing faster than the CSRS liability, which should diminish as

[20]All CSRDF investments are in U.S. Treasury and Federal Financing Bank securities and are therefore classified as intragovernmental. The government does not set aside assets to pay future benefits or other expenditures associated with designated funds. Throughout this report, we refer to all funds generated through the investment of assets as investment income.

[21]According to the 2012 *Financial Report*, other significant civilian pension plans include those of the Coast Guard, Foreign Service, Tennessee Valley Authority, U.S. Postal Service, and the Department of Health and Human Services.

more CSRS employees retire and the vast majority of the civilian workforce is covered by FERS.[22]

- The CSRS liability is greater largely due to the difference in size of the benefit, not the number of participants. Specifically, the cost to the government for CSRS is greater than for FERS, which provides a smaller defined benefit plan that is augmented by Social Security and the TSP.[23]

- Although agencies and employees both make contributions for CSRS, it was largely designed as a pay-as-you-go program. Agency and employee contributions were not set at a level to cover the full cost of benefits as they are earned—even with investment income.[24] CSRS employee and agency contributions are each set at 7 percent of pay for a total 14 percent contribution. However, for fiscal year 2012, the Office of Personnel Management (OPM) estimated that the amount required to fully fund future CSRS benefits—the normal cost—is 32 percent of pay.[25]

- The FERS defined benefit annuity is designed to be fully funded by employee and agency contributions and investment income. Agency

[22]FERS currently covers the majority of active civilian employees. As of fiscal year 2012, there were 323,000 active employees covered by CSRS compared to 2,493,000 active FERS employees.

[23]According to the Congressional Budget Office, in fiscal year 2012 the average monthly benefit for FERS annuitants was $1,147 compared to an average monthly benefit of $3,123 for CSRS annuitants. Congressional Budget Office, March 2012 Baseline for the Civil Service Retirement and Disability Fund.

[24]The U.S. Postal Service is an exception. Separate CSRS funding provisions were enacted under Pub. L. No. 108-18, requiring the Postal Service to contribute the normal-cost percentage to CSRS, which means the entry-age normal cost computed by the Office of Personnel Management in accordance with generally accepted actuarial practice and standards (using dynamic assumptions) and expressed as a level of percentage of aggregate basic pay. The Postal Service was also required to finance any unfunded liabilities. Under the Postal Accountability and Enhancement Act, Pub. L. No. 109-435, the Postal Service, beginning in 2017, must amortize any additional unfunded actuarial liabilities which may arise. Currently, Postal CSRS employees contribute 7 percent of pay.

[25]Normal cost, an actuarial concept used in pension and other post-retirement benefit cost calculations, is the discounted present value of the cost to pay benefits in the future attributable to employees' current year of service. If the normal costs for specific beneficiaries are accumulated during all years of service in which benefits are earned, and all actuarial assumptions are met, the sum accumulated will pay for the benefits as they come due.

contributions for FERS employees are based on annual calculations of the amount required to fully fund future benefits (normal cost) less the employee contribution rate. Employee contributions are calculated differently for FERS than for CSRS: FERS employees essentially pay the difference between the CSRS employee contribution rate of 7 percent and the Social Security employee payroll tax rate, currently 6.2 percent, for an employee contribution rate of 0.8 percent. However, in 2012, the employee contribution was increased to 3.1 percent of pay for employees hired after December 31, 2012, effectively reducing the agency contribution.[26]

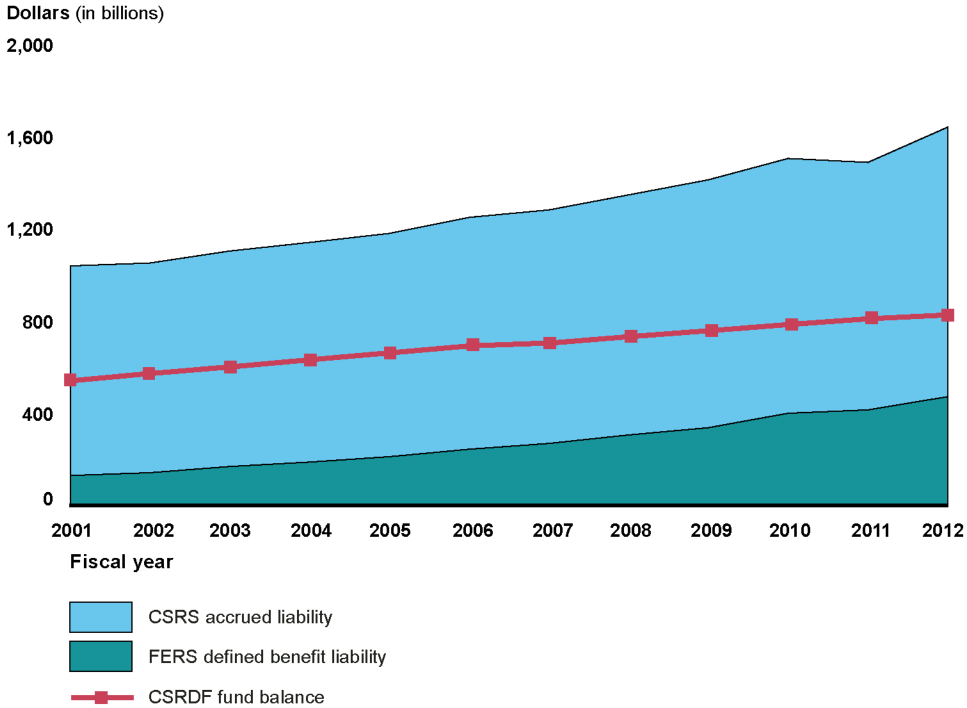
The transition from CSRS to FERS and the difference in program design have implications for understanding the size and path of the exposure. As shown in figure 7, as of September 30, 2012, the CSRS accrued liability is estimated at $1.2 trillion and the FERS accrued liability is $484 billion. Because of the manner in which CSRS costs are determined and funded, the system has accumulated a sizeable unfunded liability.[27] However, the unfunded liability is dealt with by the FERS Act,[28] which provides for annual credits made to the CSRDF (out of any money in the Treasury general fund not otherwise appropriated) to amortize any supplemental liability of the CSRDF with respect to current or former federal employees. Figure 7 also shows the balance of the CSRDF, which grew from $543 billion at the end of fiscal year 2001 to $820 billion at the end of fiscal year 2012.

26The Middle Class Tax Relief and Job Creation Act of 2012 (Pub. L. No. 112-96) provided for increased employee contributions of 3.1 percent of pay to the CSRDF for employees hired after December 31, 2012.

27The term “unfunded liability” has been used to refer to gaps between the projected financial commitment to a program or expenditure and the earmarked revenues that are expected to be available to fund that commitment. However, no federal obligation can be truly considered “unfunded” because of the government’s sovereign power to tax to meet its obligations.

28Pub. L. No. 99-335

Figure 7: Accrued Defined Benefit Pension Liability and Trust Fund Balance, Fiscal Years 2001 through 2012



Source: GAO analysis of OPM and OMB data.

Notes: Data on liabilities from OPM's financial reports. Data on CSRDF fund balances from the President's Budget Appendix.

Budget Treatment of the Exposure

Benefit payments for both CSRS and the FERS defined benefit annuity are made from the CSRDF, which has permanent, indefinite budget authority to pay benefits. Agencies pre-fund employee pensions by deferring some of their budget authority to the CSRDF, where it remains available to pay pensions to retired workers. The Treasury credits the CSRDF with budget authority in the form of special-issue securities that are backed by the full faith and credit of the U.S. government that earn interest equal to the average rate on the Treasury's outstanding long-term debt. These securities are then redeemed to make payments to retirees and survivors.

Employee contributions to the CSRDF are recorded as receipts and count as revenue to the Treasury. Payments to retirees are recorded as outlays and affect the government-wide deficit. Agency contributions are made from their appropriations and so payments toward the normal cost are visible to the individual agency, but are not reflected in the government-wide deficit because agency payments to the CSRDF are intragovernmental—that is, they are recorded as outlays by one agency and receipts by the trust fund. Treasury also makes annual payments to the CSRDF from the general fund to amortize the previously accumulated unfunded liability and to fund the difference between the CSRS employee and agency contributions and the amount that would be required to fully fund future CSRS benefits. Since no cash actually leaves the government, both agency contributions and Treasury payments to the CSRDF do not affect the government-wide deficit.

Key Factors to Consider

While the long-term exposure to the federal budget arising from civilian pension benefits is large, it is on a path to decline over time. This trend reflects both the transition from CSRS to FERS in the mid 1980s and the change to a defined contribution design and funding structure in FERS.

Civilian Post-Retirement Health Benefits

Background

Civilian annuitants are generally eligible to receive continued subsidized health benefits such as those received over the course of their working years. The Federal Employee Health Benefits program, implemented in 1960, is operated through two revolving trust funds: the Employees Health Benefits Fund and the Retired Employees Health Benefits Fund.[29] The two funds are reported jointly as the Federal Employee Health Benefits (FEHB) account in the federal budget. Under the FEHB program, the federal government pays a share of the monthly premium. The government shares the cost of the monthly premium with employees.[30]

Extent and Estimated Magnitude of the Exposure

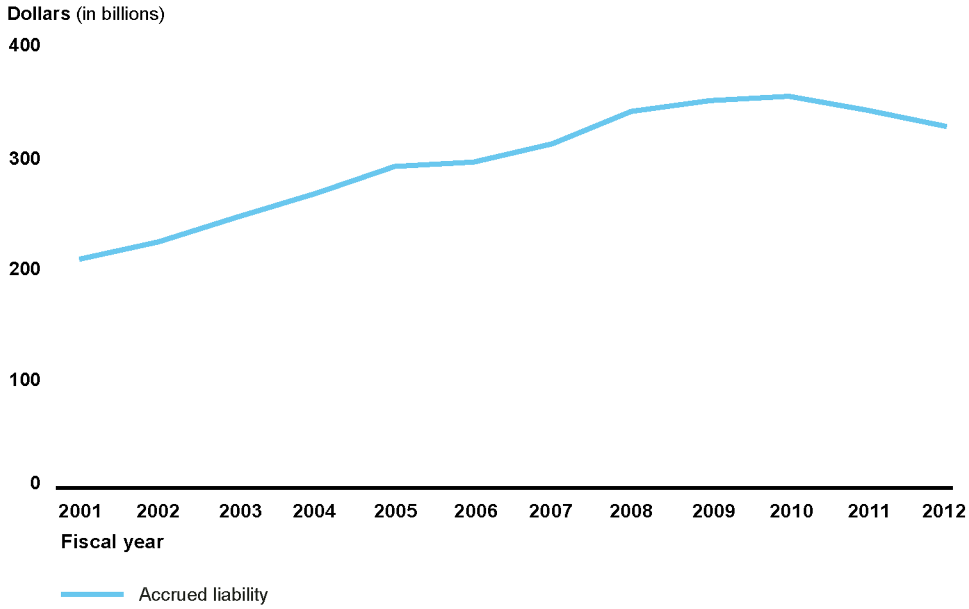
The government's legal commitment to pay a share of the monthly premium for eligible retirees makes civilian post-retirement health benefits an explicit exposure.

The magnitude of the exposure can be estimated by the accrued liability for civilian post-retirement health benefits, which at the end of fiscal year 2012, was estimated to be $328 billion. The liability is an estimate of the government's future cost of providing post-retirement health benefits to current employees and retirees. Figure 8 shows the exposure generally grew through 2010 before declining in 2011 and 2012. As is the case with health care costs in general, estimates depend on many factors, including assumptions about utilization and health care costs far into the future and as a result, can be difficult to estimate. These variables in turn can vary with changes in covered services and participants' choice of plans.

29After age 65, the retirees' FEHB benefits are coordinated with Medicare benefits.

30The government's share for annuitants and current employees is 72 percent of the weighted average of the premiums for all participating plans, with a cap of 75 percent of the total premium.

Figure 8: Accrued Liability for Civilian Post-Retirement Health Benefits, Fiscal Years 2001 through 2012



Source: GAO analysis of Treasury data.

Notes: Data from the *Financial Reports*.

Budget Treatment of the Exposure

The FEHB Program is classified as a mandatory program and is funded through a permanent indefinite appropriation. The budget reflects payments made in the current year for both active employees and retirees. Although active and retired employees pay premiums, they do not cover the full cost. Agencies make payments to the Employees Health Benefits Fund at OPM for their share of the FEHB premiums for current employees. However, with some exceptions, the budget does not reflect the estimated costs of future payments associated with the federal government's active employees' post-retirement health benefits.[31]

Key Factors to Consider

Federal health care spending as a whole has been growing faster than the economy and is expected to continue to do so. As such it will be important to find ways to minimize costs while maintaining quality for civilian employees and retirees.

[31]The U.S. Patent and Trademark Office is an exception; since 2005 it has made accrual payments to the FEHB fund associated with its active employees' post-retirement health benefits. In addition, since 2006, the U.S. Postal Service is required to make scheduled prefunding contributions to the Postal Service Retiree Health Benefit Fund in the budget. However, the Postal Service has not made required payments of $11.1 billion due in fiscal year 2012. See GAO, *U.S. Postal Service: Proposed Health Plan Could Improve Financial Condition, but Impact on Medicare and Other Issues Should Be Weighed Before Approval*, GAO-13-658 (Washington, D.C., July 18, 2013) and *U.S. Postal Service: Status, Financial Outlook, and Alternative Approaches to Fund Retiree Health Benefits*, GAO-13-112 (Washington, D.C., Dec. 4, 2012).

Military Pension Benefits

Background

Members of the military are eligible for a defined benefit, noncontributory pension after 20 years of active service. Active duty personnel become eligible for retirement by completing 20 years of service, regardless of age.[32] The military retirement system provides inflation-protected monthly compensation and other benefits after an active reserve or military career.[33] The system does not provide for gradual vesting; service personnel who separate prior to completing the minimum 20 years of service generally receive no retirement benefits.[34]

Since 1985, the program has operated through the Department of Defense (DOD) Military Retirement Fund and has three sources of income.[35] The first is payments from the military personnel accounts to cover most of the accruing costs of future retirement benefits being earned by today's service members (i.e., the normal cost). The second source is investment income on Treasury Securities the fund holds. The third source is made up of payments from Treasury's general fund to cover a portion of the normal cost and a portion of the previously accumulated unfunded liability, including the liability for concurrent

[32]Members of the reserves may retire after 20 qualifying years of creditable service, but reserve retired pay is not payable until age 60, with some exceptions.

[33]Since 2001, service members also have been eligible to participate in the federal Thrift Savings Plan, the defined-contribution plan available to civilian employees, although generally without any matching contributions from the government.

[34]The military retirement system applies to members of the Army, Navy, Marine Corps and Air Force. Most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Homeland Security), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (administered by the Department of Commerce).

[35]Pub. L. No. 98-94 provided for accrual funding of the military retirement system and for the establishment of a Department of Defense Military Retirement Fund in 1985.

payments to those receiving both military retired pay and disability compensation paid by the Department of Veterans Affairs (VA).[36]

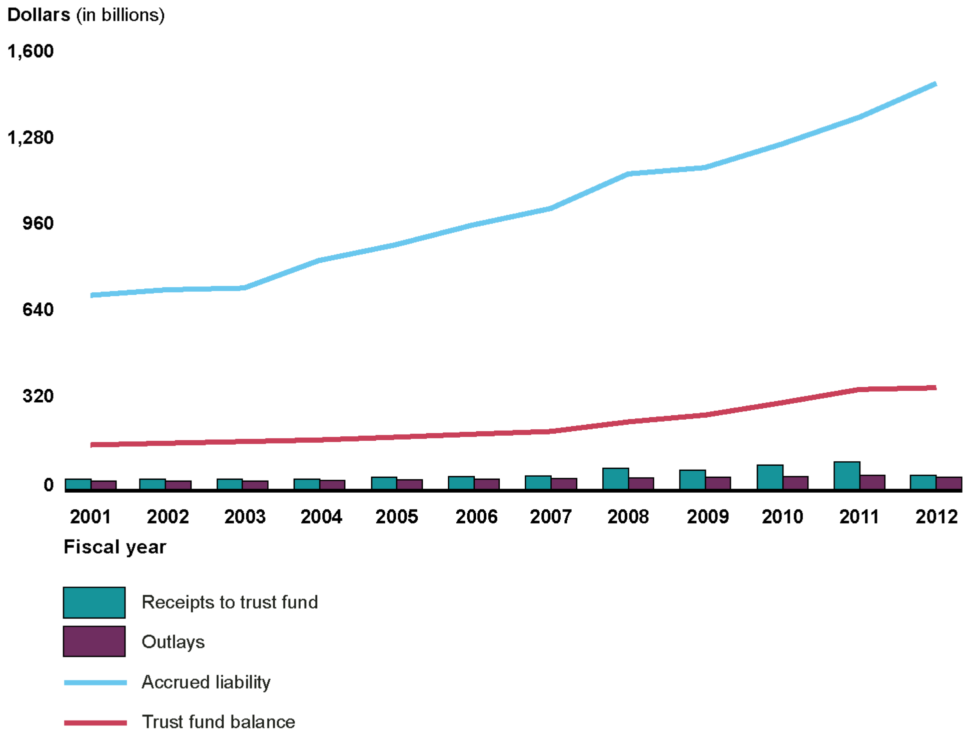
Extent and Estimated Magnitude of the Exposure

The government's legal commitment to pay benefits to those retirees who reach 20 years of active service makes military pension benefits an explicit exposure.

From a government-wide perspective, the magnitude of the exposure can be estimated by the accrued liability for military pensions, which at the end of fiscal year 2012 was estimated to be $1.5 trillion, up from $708 billion in 2001 (see figure 9).

[36]Concurrent receipt refers to the simultaneous receipt of military retired pay and VA disability compensation. Prior to 2004, the law required that military retired pay be reduced dollar-for-dollar by the amount of any VA disability compensation received (e.g. an offset). The 2004 National Defense Authorization Act (Pub. L. No. 108-136) authorized concurrent receipt of both amounts without a required offset for certain military retirees.

Figure 9: Military Pension Benefits Accrued Liability and Budgetary Resources in the Military Retirement Fund, Fiscal Years 2001 through 2012



Source: GAO analysis of OMB and Treasury data.

Notes: Data on receipts to the trust fund, outlays, and trust fund balances from the President's Budget Appendix. Data on liabilities from the *Financial Reports*.

Budget Treatment of the Exposure

Figure 9 also shows the Military Retirement Fund's outlays and receipts as reported in primary budget data. Outlays reflect benefit payments to current retirees, which totaled $49 billion in 2012, up from $34 billion in 2001. Receipts to the trust fund capture the intragovernmental contributions from the services to fund future benefits earned today, Treasury general fund payments, and investment income on the Treasury Securities the fund holds. The Military Retirement Fund had assets of $376 billion as of September 30, 2012.

Beginning in 1985, military pension costs have been partially visible to DOD since it makes contributions to cover the costs as they accrue, but the normal cost is not reflected in the unified budget because the payments are intragovernmental—that is, they are recorded as outlays by one agency and receipts by the trust fund. Since no cash leaves the government, there is no effect on the government-wide deficit.

Key Factors to Consider

DOD's military compensation system, including pension benefits, is an important tool to attract and retain the number and quality of active duty servicemembers it needs to fulfill its mission. Comprehensive information about the total cost of compensation, including benefits earned today that will be paid in the future, is important for future decisions about military compensation in a constrained fiscal environment.

Military Post-Retirement Health Benefits

Background

TRICARE is DOD's managed health care system for active duty and retired uniformed service members and their families.[37] TRICARE consists of multiple plan options, a number of which cover active duty personnel, their dependents, and retirees under age 65.[38] Prior to 2001, TRICARE beneficiaries would lose their TRICARE coverage when they reached age 65, and Medicare—the federal health insurance program that provides medical benefits to elderly and disabled Americans—would become their primary health insurer. However, in 2001, the Congress expanded TRICARE by authorizing the continued provision of TRICARE benefits after age 65. The program is known as TRICARE for Life (TFL).[39] TFL provides supplementary health care coverage for TRICARE beneficiaries who are eligible for Medicare (e.g. those aged 65 or older) and pays for many services that Medicare only partially covers.[40] Non-Medicare-eligible military retirees are not eligible for TFL and are covered by one of the other TRICARE programs.

In addition to expanding the benefits available to Medicare-eligible retirees, the 2001 National Defense Authorization Act (NDAA) required that DOD accumulate funds in a governmental trust fund to finance the future cost of additional health benefits for Medicare-eligible retirees. This

[37]The uniformed services include the U.S. Army, U.S. Air Force, U.S. Navy, U.S. Marine Corps, U.S. Coast Guard, the Commissioned Corps of the Public Health Service, and the Commissioned Corps of the National Oceanic and Atmospheric Association.

[38]DOD provides health care benefits to its non-Medicare-eligible beneficiary population through several TRICARE options.

[39]The National Defense Authorization Act for Fiscal Year 2001, Pub. L. No. 106-398 established the Department of Defense Medicare-Eligible Retiree Health Care Fund, administered by the Secretary of the Treasury.

[40]While TRICARE beneficiaries over age 65 do not have to pay for their TFL coverage, they must be eligible for Medicare Part A and elect to carry Medicare Part B. Retired TRICARE beneficiaries are required to pay premiums for Medicare Part B, which covers certain physician, outpatient hospital, laboratory, and other services. TFL covers out-of-pocket costs incurred by beneficiaries for care over the sum of the amount paid for under Medicare.

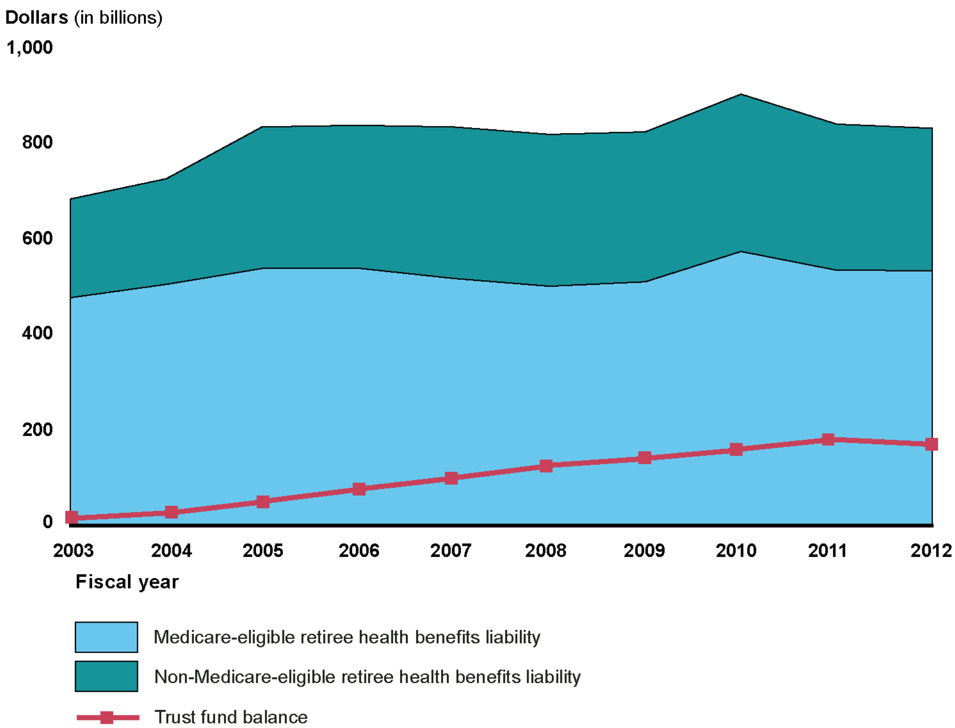
fund was started in reaction to rapidly rising health care costs. The Medicare-Eligible Retiree Health Care Fund (MERHCF) is financed through annual transfers from DOD for the future health care benefits earned by active military in that year (i.e., normal cost contributions); payments from the Treasury general fund toward the previously accumulated unfunded liability for past service; and any gains on investment income from Treasury Securities the fund holds.

Extent and Estimated Magnitude of the Exposure

The government's legal commitment to provide post-retirement medical benefits to eligible retirees makes the benefits an explicit exposure.

From a government-wide perspective, the magnitude of the exposure can be estimated by the accrued liability for military post-retirement health benefits, which at the end of fiscal year 2012 was estimated to be $833 billion. The retiree health liabilities for military personnel, shown in figure 10 as the accrued liability, represents the estimated total cost of benefits earned to date for both non-Medicare eligible and Medicare-eligible retirees, as well as a portion of future benefits for those in active military service. Figure 10 also shows the balance of the MERHCF, which had assets of $176 billion at the end of fiscal year 2012.

Figure 10: Military Post-Retirement Health Liability and Medicare-Eligible Retiree Health Care Fund Balance, Fiscal Years 2003 through 2012



Source: GAO analysis of DOD and OMB data.

Notes: Trust fund balances from the President's Budget Appendix. Data on liabilities from the *Financial Reports*.

Budget Treatment of the Exposure

Beginning in 2003, current costs for Medicare-eligible military retirement benefits have been visible to DOD, since it makes contributions to cover the costs for those benefits as they are earned by current servicemembers, and the uniformed services reflect these normal cost contributions in their budgets. The Treasury also deposits funds towards the unfunded liability. Since no cash actually leaves the government from these contributions to the MERHCF, there is no effect on the government-wide cash deficit. Assets accumulating in the MERHCF are only used to pay benefits for Medicare-eligible retirees, and there is an effect on the government-wide deficit as benefits are paid from the MERHCF. In contrast, the cost of pre-Medicare-eligible post-retirement health benefits is not reflected in the uniformed services' budget data as these benefits are earned. Rather, the cost of pre-Medicare-eligible health care is paid for on a cash basis from DOD's annual Operations and Maintenance appropriation.

Key Factors to Consider

We have highlighted a range of long-standing issues surrounding DOD's Medical Healthcare System. As health care consumes an increasingly larger portion of the defense budget, DOD leadership has recognized the need to reduce duplication and overhead to operate the most efficient health system possible. In 2012, we reported that DOD had identified initiatives aimed at slowing its rising health care costs, but its ability to implement and monitor these initiatives and achieve related costs savings is limited.[41]

[41]GAO, *Defense Health Care: Applying Key Management Practices Should Help Achieve Efficiencies within the Military Health System*, GAO-12-224 (Washington, D.C.: Apr. 12, 2012).

Veterans Compensation

Background

The federal government provides benefits to eligible veterans and their survivors to compensate for the loss of potential earnings due to service-connected disability or death. Entitlement to compensation depends on the veteran's disabilities having been incurred in, or aggravated during, active military service; death while on duty; or death resulting from service-connected disabilities.[42] These benefits can be in place of (or in combination with) the DOD military retired pay.[43]

Extent and Estimated Magnitude of the Exposure

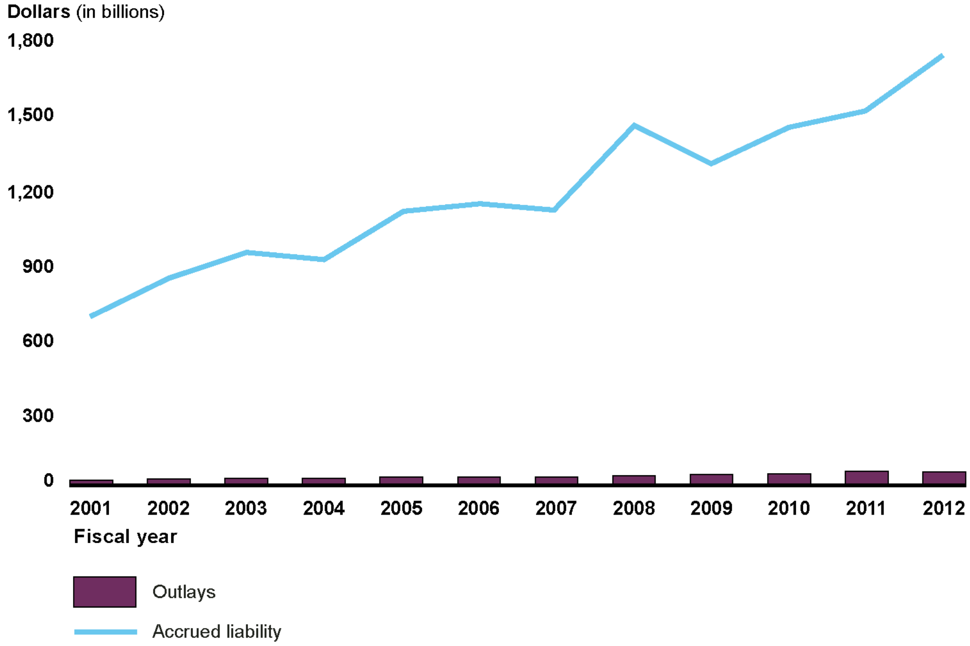
The government's legal commitment to provide compensation to eligible veterans makes veterans compensation payments an explicit exposure.

The magnitude of the exposure can be estimated by the accrued liability, which at the end of fiscal year 2012 was estimated to be $1.8 trillion. This measure reflects the present value of expected future payments to current veterans already receiving compensation payments, to veterans who are not currently receiving compensation but will in the future, and to a portion of those in active military service assumed by the VA to become eligible for compensation in the future. Figure 11 illustrates the growth in this exposure, which more than doubled between 2001 and 2012—from $692 billion to $1.8 trillion—and represents the fastest rate of growth among the compensation programs we examined in this report. The annual growth of the accrued liability, which averaged about $97 billion from fiscal years 2001 to 2012, reflects increases in the number of veterans as a result of wars and other conflicts, the aging of the veteran population, and changes in the benefits and services provided to veterans.

[42]Burial benefits are also provided and include a burial and plot or internment allowance payable for a veteran who, at the time of death, is qualified to receive compensation or pension, or whose death occurred in a VA facility.

[43]Prior to 2004, the law required that military retired pay be reduced dollar-for-dollar by the amount of any VA disability compensation received (e.g. an offset). The 2004 National Defense Authorization Act (Pub. L. No.108-136) authorized actual concurrent receipt, or the simultaneous receipt of military retired pay and VA disability compensation for certain military retirees.

Figure 11: Veterans Compensation and Pensions Liability and Annual Outlays, Fiscal Years 2001 through 2012



Source: GAO analysis of OMB and Treasury data.

Note: Outlays in this figure from the President's Budget Appendix and reflect not only payments for veterans compensation but also veterans pension benefits and burial benefits. Pension and burial benefits represent a relatively small portion of outlays. Data on liabilities from the *Financial Reports*.

Budget Treatment of the Exposure

Veterans Compensation and Pensions annually receives no-year funds through regular appropriations. Figure 11 also shows the program's annual outlays as reported in primary budget data. Outlays, which increased from $21 billion in fiscal year 2001 to $55 billion in fiscal year 2012, reflect payments made to current veterans. However, the budget does not reflect the estimated costs of future payments earned by current service.

Key Factors to Consider

The VA's Veterans Compensation and Pensions account funds one of the largest federal disability programs. In the years ahead, enrollment in the VA's disability compensation program could increase given the conflicts in Iraq and Afghanistan and as more Vietnam veterans—a significant portion of the total veteran population—further age into disability-prone years.[44] These trends directly affect the extent and magnitude of the government's fiscal exposure arising from veterans compensation. Further, since 2003, veterans compensation and other federal disability programs have been on our High Risk List, due in part to challenges agencies face in keeping their criteria for evaluating disability and determining compensation consistent with advances in medicine, technology, and changes in the labor market and society.[45]

[44]GAO, *VA Disability Compensation: Action Needed to Address Hurdles Facing Program Modernization*, GAO-12-846 (Washington, D.C.: Sept. 10, 2012).

[45]GAO-13-283.

Appendix II: Comments from the Department of Veterans Affairs

DEPARTMENT OF VETERANS AFFAIRS
Washington DC 20420

September 23, 2013

Ms. Susan J. Irving
Director
Federal Budget Analysis
Strategic Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Irving:

The Department of Veterans Affairs (VA) has reviewed the Government Accountability Office's (GAO) draft report, ***"FISCAL EXPOSURES: Improving Cost Recognition in the Federal Budget"*** (GAO-14-28). VA generally agrees with GAO's findings.

The enclosure contains general comments related to the draft report. VA appreciates the opportunity to comment on your draft report.

Sincerely,

Jose D. Riojas
Chief of Staff

Enclosure

Enclosure

Department of Veterans Affairs (VA) Response to
Government Accountability Office (GAO) Draft Report
"FISCAL EXPOSURES: Improving Cost Recognition in the Federal Budget"
(GAO-14-28)

General Comment:

The Department of Veterans Affairs (VA) is committed to transparency and welcomes suggestions to further enhance the information that is available for stakeholders to make effective policy decisions. The Compensation and Pension mandatory account is a 1-year appropriation with the authority to obligate until expended. The Compensation and Pension budget model uses historical trends, economic assumptions, and other various assumptions in developing and forecasting out-year estimates. The current budget reporting for this account identifies and provides adequate information and serves the function and purpose of ensuring sufficient funding is available to make benefit payments to Veterans and Survivors. Please note: VA currently maintains the Contingent Liability Model in accordance with the Statement of Federal Financial Accounting Standards (SFFAS). The SFFAS states that long-term, other post-employment benefit liabilities should be measured as the present value of future payments. The model calculates the present value of future compensation payments and projects future compensation payments using the current level of payments and assumptions to estimate future compensation claims, mortality rates, and cost-of-living allowances. The model then calculates a present value by discounting the projected future payments to the valuation date.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Susan J. Irving, (202) 512-6806 or irvings@gao.gov

Staff Acknowledgments

In addition to the contacts named above, Melissa Wolf (Assistant Director), Margaret McKenna Adams, Dean Campbell, Darryl Chang, Jeremy Choi, Robert F. Dacey, Felicia Lopez, Donna Miller, Susan Offutt, Frank Todisco, and Katherine Wulff made key contributions to this report.

(451001)

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