

Foreword

Why This Report Matters to You

The White House does *not* want you to read this book. Although federal law compels U.S. Treasury officials to publish the information in this Financial Report, they hope you will not see it. That's why they issued this shocking news just before a major holiday without a press conference or even a press release. They succeeded. There was no media coverage.

The Bush Administration had a similar reaction to the *9/11 Commission Report*. But that document, compiled by an able independent group, became a national bestseller anyway. People demand the truth.

Apparently, the White House does not think that you can handle the truth about the various financial threats facing America. I think the White House is underestimating you. Your future—and your family's future—depends on what you do with this information. I think you can handle it.

This book is the “annual report” for America, using the format and accounting methods familiar to the shareholders of all stock-exchange companies. Sadly, very few people in government know this Financial Report even exists, much less what it contains, although it can be said to complement the U.S. Constitution itself. That magnificent document is the charter of the world's only superpower; this Report tells you how America is doing financially 219 years later. The Constitution is about governance; this Report is about operations. Isn't it time you got the facts?

You already get your favorite company's annual report, why not your favorite country's? While you've been pledging allegiance,

politicians have been pledging your assets. So, let's salute the flag and scrutinize the financials. You are citizen-shareholders because, as President Lincoln said, our government is "of the people, by the people, and for the people." You also pick up the tab when your elected leaders pledge the "full faith and credit" of the United States.

Your most important investment occurs when you pay your taxes every year. We live in the greatest nation on earth, but we must work hard to keep it that way. This Report is the best way to check on your investment, just as reading Warren Buffet's famous annual report is the best way to keep up with Berkshire Hathaway.

This Financial Report for America is full of surprises. **WARNING:** it flatly contradicts most of the speeches that Washington politicians make. For example, according to the federal government's own financial statements for 2005,

- The "true" 2005 deficit was **\$760 billion**, not the \$318.5 billion that is usually reported—a whopping \$441.5 billion difference
- The deficit is not 2.6% of Gross Domestic Product (GDP) and shrinking, as we are frequently told, but **6.2% of GDP and growing rapidly**
- **President Bush's promise to cut the deficit in half in five years did not refer to this "true" deficit**
- The news is **much worse if you count the unfunded commitments of Social Security and Medicare**
- America's debts and commitments do not total \$8.3 trillion, as commonly reported, but **\$49 trillion**

- In 2000, our total **debts and commitments** totaled \$20 trillion, but they have more than **doubled in the last five years**
- The 2003 Medicare **drug bill** alone added over \$8 trillion in unfunded commitments to American taxpayers
- **Giant tax loopholes**, or tax expenditures, are also at fault
- America's **top auditor is unable to give an opinion** about our nation's finances due to, in his words, "**material weaknesses**" and America's "**broken business model**"
- The federal agency that keeps **the worst books** is the Department of Defense; and
- This Report **doesn't even cover problems with Fannie Mae, Freddie Mac**, or other government-sponsored enterprises with widely reported financial problems

Economists politely call many of these trends "unsustainable." I call them the road to ruin. And the following information is not a partisan attack; this is *an official document of the U.S. Government issued by the Bush Administration itself*.

It's not all bad news. The Report also gives you interesting information about your birthright as an American.

- **How much gold** do we own in Fort Knox or elsewhere, and how is it valued?
- How many items are in the **Smithsonian Museum**?
- How much **government land** is there, and how much is still forested?

This is the *only* book that gives you the answers you need to your questions about America's financial position. Non-government reports often lack credibility; other government reports are inadequate. This is the only government-wide report that uses modern accounting to tell how America is doing. And yet, the Bush Administration does not want you to read it.

Don't take my word for it. This year, the Budget Committee of the U.S. House of Representatives voted unanimously to require this Report to be used in next year's presidential and congressional budget process. Although Democrats and Republicans usually agree on very little, they agreed that we should be using the numbers in this Report to help guide our nation. But don't get your hopes up. The White House and congressional leaders will figure out a way to dodge the requirement. You'll have to watch closely this year to see who kills the proposal and with what weapon.

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What about the President's Budget that we hear so much about? Doesn't it contain the same information? Can't the average citizen learn about government finances from it? Not really. The Budget that receives all the political and media attention every year is comprised of several volumes, four inches thick, and costs \$285 from the Government Printing Office. It is hand-delivered to every office on Capitol Hill. The Report you hold in your hands now is far more accessible: it doesn't weigh as much as a stack of phone books, costs less than fifteen dollars, is more comprehensive although less detailed, and is distributed wherever books are sold.

But inaccessibility isn't the only problem with the President's Budget. Standing alone, the Budget is also grossly misleading. Look at how much it differs from the Financial Report. It's hard to

believe that the two documents are describing the same nation in the same year. Does the column on the right look like America, or Argentina?

	President's Budget	Financial Report
2005 Deficit:	\$318.5 Billion	\$760 Billion
National Debt & Commitments:	\$8.3 Trillion	\$49 Trillion
Your Share:	\$28,000	\$156,000

Again, remember, the Financial Report is an official U.S. government document. When historical, official numbers are this far apart, it is difficult to have a realistic debate about the future—particularly if you talk, as Congress does, only about the smaller numbers. No wonder budget debates in Washington are so confusing and unrealistic. If you don't know where you are, how can you know where you are going?

According to the Budget, every man, woman, and child in America is already obligated to pay \$28,000, that is, if we ever plan to reduce our national debt. But it's really much worse than that. The Financial Report indicates that each citizen "owes" \$156,000. For every *working* American, the total is a whopping \$375,000. And this assumes that Congress stops making promises!

It's not surprising that the Administration is covering up the fact that, as a working American, your personal share of federal debt and obligations is so huge. It's tough to tell you that you already owe your government the equivalent of a luxury home—only you don't get to live in it. You just get the mortgage. And that's on top of the mortgage you are already paying on the home you live in, in addition to all your other living expenses.

During the five years of the Bush Administration, your share

of the government's liabilities and commitments has *more than doubled*, from \$165,000 in 2000 to \$375,000 today. It took 214 years of American history (from George Washington through Bill Clinton) for our elected officials to burden you with \$165,000 in government obligations, but only five years of the George W. Bush Administration to double that number. At this rate, you and your family will soon "owe" well over a million dollars to the U.S. Government.

Of course, the most painful part of any debt is making the monthly interest and principal payments. In order to service a \$375,000 debt, you must pay \$1,400 a month in interest *forever* even at the low government interest rate of 4.5%. To make typical 30-year, level principal-and-interest payments in order to pay down the debt, your monthly payments would be \$1,900. Where are you going to get that kind of money? Most Americans are already stretched financially. The national savings rate has recently declined to below zero. We are spending more than we earn. That cannot last.

Our government paid \$327 billion in interest in 2005 just to carry the debts we already have, without making any effort to reduce them. This was money that could not be spent on schools, parks, roads, or homeland security because it had to satisfy our creditors. As our debts mount, our interest costs are predicted to rise higher than \$400 billion annually—more money than is spent by Congress on all of our normal domestic needs (i.e. what is technically called "non-defense, non-homeland-security, domestic discretionary spending"). *In a few years, it will be a better financial deal to be a creditor of America than a citizen.* Even that might not be much of a problem if we had borrowed the money from our own citizens, because we would be paying the interest to our-

selves. But the low national savings rate means that we have had to turn to foreign lenders.

Today, America is borrowing more money from foreigners than ever before, resulting in more and more interest payments to Japanese, Chinese, British, and other lenders. During the last five years, President Bush has borrowed more money abroad than all previous American presidents *combined*. Many of these countries are not close allies. China holds roughly \$300 billion of our debt. Russia, Iran, and Venezuela are becoming major creditors. And remember, interest payments to these nations are given priority over all other government spending, even national defense.

If you had been able to read a book like this earlier, you might have been able to help slow our massive borrowing and reduce our dependence on foreign capital. But it's not too late to stop the government from sinking deeper into debt.

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Every businessman and woman in America knows the importance of keeping honest books. If they budgeted the way the U.S. Government does, they'd be in jail.

Wharton School Professor Kent Smetters testified to Congress that "current federal budgetary practices would be illegal in the private sector." Another expert has said that "the size of this accounting distortion makes Enron look like a minor accounting error."

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How could the President's Budget and the Financial Report be so different? The answer is different yardsticks. The Budget measures government by looking at cash and obligations, i.e. primarily

when dollars are received and spent. The Financial Report, on the other hand, uses the same measuring method that all large American businesses are required to use—“accrual” accounting. Both ways of measuring are important, if you want a clear understanding of your financial position.

Although the word accrual may be unfamiliar to some readers, it should not be confused with the word *cruel* (which is an easy mistake to make when looking at such negative numbers). Not only is it spelled differently, it is different. Accrual accounting means recognizing income when it is *earned* and expenses when they are *incurred*, not just when cash changes hands. This is a vital distinction. Not only is accrual accounting not cruel, you could say that it is, in many circumstances, the kindest form of accounting because it remembers your loved ones. It helps you better understand the bills that you have committed your children and grandchildren to pay.

In our credit-card world, we need to make forward-looking measurements such as are possible with accrual accounting. This is particularly important in the budgeting process for our nation. Ironically, budgeting is the one area where Congress has *not* been using accrual techniques.

As **Alan Greenspan**, former Chairman of the Federal Reserve Board, testified,

Scoring the budget on an accrual basis—the private sector norm and, I believe, a sensible direction for federal budget accounting—would better underscore the tradeoffs we face. Under accrual accounting, benefits would be counted as they are earned by workers rather than when they are paid out by the government.

Don't you want to know how America looks under both cash and accrual measurements so that you can get a better perspective? Isn't it important to see both a current financial snapshot and the long-term picture? A nation that is 219-years-old needs to use bifocals: reading glasses for counting cash, and different lenses to see our long-term obligations—the same way any corporation or business views its own finances.

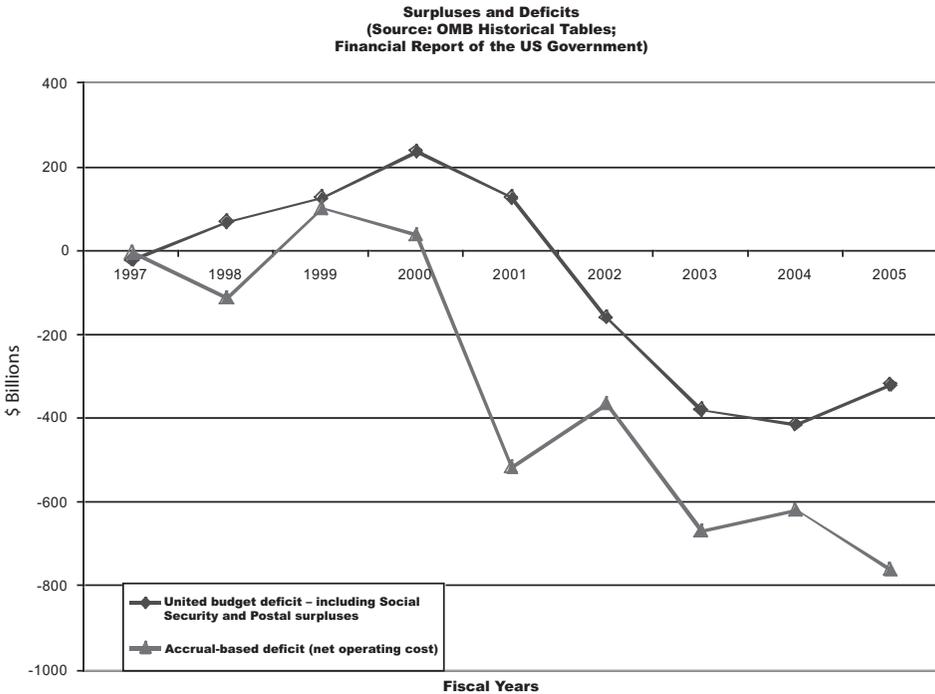
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Why didn't you know about this Report before now? Why doesn't your Congressman or Senator know about it? True, the numbers have been hidden, but Congress has not been looking very hard. It's been a game of hide and *no seek*.

Beginning in the mid-1990s, the U.S. Treasury was required by federal law to prepare consolidated financial statements for the U.S. Government. These Reports have been gradually improving in their presentation, content, and methodology. Fortunately, due to the excellent work of the Financial Accounting Standards Advisory Board (FASAB), we are now able to measure government activity much more fairly and more completely than before, although more work remains to be done.

The Report is also increasingly important because its bottom line has begun to diverge significantly from the Budget's. The graph on the following page shows the relationship between the Report's bottom line and the Budget's for the last nine years.

Trends like these are causing the leading bond-rating agency, Standard & Poor's, to project that the United States could lose its AAA credit rating by 2012, and fall "below investment grade" by 2025. Today's policies are literally destroying America's credit.



Notice the last year on the chart: 2005. Not only is the “net operating cost”—the technical term for the accrual deficit—over twice as large as the Budget deficit, it seems to be growing larger, not smaller, as the Bush Administration claims. Growth in veterans’ benefits and civil service retirement obligations has caused this divergence. Notice also that the “net operating cost” varies more than the cash deficit numbers because assumptions can change about accrued expenses. The trends in the accrual numbers are undeniably worse than the cash deficits, although both trends have turned negative since 2001.

Critics of the Financial Report will use a variety of arguments to downplay its importance. Their main objection is not to accrual

budgeting itself, at least when considered parallel to cash budgeting, but to the size of the deficits it reveals. These critics don't believe that you will react responsibly to the higher deficit figures, so they prefer to keep you in the dark about the existence of this Report. They feel that their favorite programs may be threatened if government tightens or rearranges spending. They may be right. But those programs are living on borrowed time anyway because, whether measured in cash or by accrual, eventually the government has to pay its bills. I would argue that the best way to save deserving programs is to recognize their true costs now so that we can prepare to fund their needs.

Some critics will raise technical objections, criticizing or at least obscuring the trustworthiness of accrual accounting.

Is accrual easier to manipulate due to the assumptions that must be made regarding interest rates, life expectancy, health costs, and retirement expenses? I don't think so. With transparency and supervision, we can keep the numbers honest. Cash accounting is also easy to manipulate.

Are the time horizons too long for accuracy when you are estimating 75 years out? It is difficult to estimate, but we must try. The alternative is to send children born today into an even more uncertain financial future. Given longer life expectancy, 75 years is often not long enough.

Finally, is it fair to apply accrual accounting to government, which is non-profit? Certain modifications have been made in order to estimate, for example, the value of our military equipment and its depreciation. But with such adjustments, the method is fair and very revealing.

The most common objection that I've heard from colleagues is that "I've made so many speeches using the President's Budget

numbers, I don't want to change now." Old habits die hard. All I advocate is adding a new habit to your old one: keep one eye on your cash accounts and the other on your accruals.

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When you read the Financial Report, you will be surprised to see that it describes all of the federal government in only five pages of financial statements. This condensed view of our massive \$2.8 trillion government is a remarkable technical accomplishment, especially since it was compiled within 75 days after the end of the fiscal year. It is a veritable Rosetta Stone, enabling us to translate how agencies ranging from the Department of Defense to the U.S. Postal Service do their jobs. Together with the Notes describing line items, these five pages give the most complete and concise view available anywhere of America's finances. And it is presented in a language that the average small businessman or woman understands.

To make the five pages of financials easier to digest, they are preceded by "Management Discussion and Analysis," just as you would find in any corporation's annual report. This explanation tends to be a bit self-serving, but is helpful in placing the numbers in context. For example, a crucial paragraph on page 22, entitled "Other Responsibilities," helps us begin to understand how Social Security and Medicare could fit into the accrual budget.

When you look at the Balance Sheets for America, don't be alarmed because it shows a negative "Net Position" of \$7.7 trillion. Although such a huge liability on the net equity line of a corporate balance sheet would bankrupt any corporation in the world, nations can live quite well with large negative net positions.

America is obviously a going concern. Our assets are probably worth far more than the financials indicate, and the government's ability to raise revenue is considerable.

It would be interesting, and probably scary, if the federal government were required to include the "Risk Factors" section that is required of all publicly-traded companies. Then, Americans could see, in plain English, the threats that each administration fears. Even Stephen King and Wes Craven might shudder at some of the lurking dangers.

An unaudited section on "Stewardship" of national assets and responsibilities helps readers begin to quantify the gigantic out-year promises that have been made, but not funded, using our national credit card. These obligations are not accrued into our financials the way veteran's benefits and civil service retirement benefits are, because they are not legally binding obligations of the U.S. Government. They are "scheduled" in the bureaucratic parlance of Washington and must be better understood. Here the Financial Report borrows heavily from the Social Security and Medicare Trustees Report, which projects 10-year, 75-year, and even "infinite" outlooks for the benefits of each program.

Finally, the Financial Report contains letters from America's top auditor, David M. Walker, the Comptroller General of the United States, and head of the U.S. Government Accountability Office (GAO). One letter is only six pages long, the other twelve. They, with their supporting documents, contain some of the most devastating analyses of America's current financial position, including his conclusion that America has a "broken business model."

Walker points out how many agencies with giant budgets simply cannot account for the taxpayer money they receive.

The Pentagon is the worst offender, even during peacetime. But most agencies have significant accounting problems. We know, for example, that the government made \$38 billion in improper payments in 2005, and that over \$20 billion cannot be properly accounted for. **So, we've paid \$38 billion to the wrong people, and completely lost another \$20 billion!** It's time that more taxpayers knew about this abuse and forced their government to do something about it.

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What about *your* Social Security benefits? What about *your* Medicare benefits? Almost all seniors feel strongly that Washington should not tamper with Social Security or Medicare. So do workers paying their part of today's 12.4% and 2.9% payroll taxes. This Financial Report gives a much clearer picture of those benefits than is available from a cash budget, or is available from the Social Security Trustees (although the Trustees have begun quietly including some more helpful information in their reports).

You will see that for all the President's efforts to reform Social Security in 2005, Medicare is in much worse shape. You will also see that unless reform efforts on both programs are undertaken very soon, experts estimate that (a) benefits will have to be cut in half, (b) payroll taxes doubled, or (c) some combination of the two. All of these choices are unacceptable to voters. Therefore, structural reforms of both programs are necessary, *right now*. President Bush called for a high-level entitlement reform commission in his January 2006 State of the Union Address, but as of June, had yet to appoint a single commissioner.

Foreign policy expert Michael Mandelbaum has written in

his new book, *The Case for Goliath: How America Acts as the World's Government in the 21st Century*, that the greatest single long-term threat America faces is not from terrorists, a belligerent China, or a resurgent Russia, but from our own Medicare program.

One of the chief sources of confusion is the large amount of money that the Bush Administration (and every president since Reagan) borrows from Social Security every year. In 2005, the Bush Administration borrowed \$173 billion from Social Security. In 2006, it will borrow another \$180 billion. This does not mean that anyone misappropriated any money owed to beneficiaries. But it does mean that we are misleading ourselves when we reduce the publicly reported deficit by that amount. Under current law, the U.S. Government is able to borrow this money from Social Security because buying Treasury bonds (i.e. lending money to Uncle Sam) or other U.S. Government-backed securities is the only investment allowed to the Social Security Trustees. The result is that the true size of the federal budget deficit is downplayed, even within the guidelines of cash budgeting.

In 2005, the federal budget deficit was reported as \$318.5 billion, but the government borrowed \$570 billion that year from lenders here and around the world, and from our own trust funds. Our net cash deficit was \$318.5 billion, but the gross deficit was \$570 billion. Why is the larger number rarely reported? Because Uncle Sam has its own captive lender in Social Security. Many economists believe that, because “the government is borrowing from itself,” you don’t have to report the gross figure. My view is that if you believe that you must repay Social Security just as faithfully as you do foreign lenders, you should report the larger figure. Both are strict obligations of the U.S.

Government. Having a captive lender does not reduce the amount of the borrowing.

Under accrual accounting, the government must keep track of every expense it incurs, including the retirement costs of those government workers who are paying into a legally-binding retirement fund. Here is where many of our nation's seniors—including federal employees hired after 1984—are in for a nasty surprise. Veterans and older federal employees are earning such benefits, but Social Security, Medicare, and younger federal employee beneficiaries are not, because theirs are not considered to be contractual benefits. Under the 1960 U.S. Supreme Court ruling in *Fleming v. Nestor*, these seniors can have their future benefits reduced by Congress at any time without recourse in the courts.

Every living politician has made countless speeches about “the nation’s commitment to seniors” or “our sacred obligation” to them. As an employee, you get an annual statement from the Social Security Administration listing the payroll taxes you have paid along with your expected benefits. Yet, this statement includes the warning that the Social Security trust funds lack the money to pay all these benefits. Legally, the benefits you expect are only “scheduled,” not contractual—but who reads the fine print? As such, they are not included in accrual accounting.

Fortunately, the Report details the government’s responsibility for these benefits in the “Stewardship” section, almost as if they were legally-binding obligations. Here, the Report goes beyond accrual accounting to give us a clearer picture of our nation’s promises, which total \$49 trillion, not the \$8.3 trillion commonly reported. The \$49 trillion is a present-value number, meaning that we need to find \$49 trillion today and invest it wisely, in order to

have enough money to pay the Social Security and Medicare bills of babies born today. Forty-nine trillion dollars is roughly the annual earnings of everyone and every company on earth. In other words, if we confiscated all wages, salaries, and profits worldwide for one year, we might have enough money, if it were invested prudently, to cover the shortfall in America's two major entitlement programs.

These staggering out-year commitments are hard for anyone to comprehend, so it may be helpful to see five different definitions of the single-year 2005 deficit so that you can pick your favorite and understand its size.

"True" 2005 Deficit?	Definition of Deficit	Size Comparison
\$318.5 Billion (cash accounting)	"Unified," After Borrowing \$173 Billion from Social Security & Postal Service	Austria's Gross National Product
\$494 Billion (cash accounting)	"On Budget," Excluding Social Security & Postal Service Surpluses	Switzerland's <u>and</u> Israel's GNP
\$760 Billion (accrual accounting)	"Net Operating Cost" of Federal Government, Not counting Social Security or Medicare Promises	Russia's GNP
\$2.2 Trillion (<u>"accrual+"</u> accounting)	"Net Operating Cost," plus 2005 Increase in Social Security Promises	United Kingdom's GNP
\$3.3 Trillion (<u>"accrual+"</u> accounting)	"Net Operating Cost," plus 2005 Increase in Social Security and Medicare Promises	China's <u>and</u> India's GNP

The last two deficit numbers, which include Social Security and then both Social Security and Medicare, I owe to Professor Howell Jackson of Harvard Law School. He estimated the annual increments of our two largest entitlement programs, then added them to the \$760 billion accrual deficit, in order to show how rapidly our fiscal gap is widening. The result is harrowing.

These larger deficit numbers are startling because they mean that the real deficit is probably *10 times larger than you have been told*, even if you are the most diligent watcher of C-SPAN, or work in the White House. They also mean that, unless we radically change our deficit calculations, we are not preparing to honor the commitments we have made to American workers.

Another reason these numbers are shocking is that the cost of one year's delay in addressing these problems is over \$3 trillion. Costs are mounting at \$347 million an hour, or \$95,000 a second.

In Washington, the common assumption is that Congress will work less in 2006 because of the upcoming elections in November. Congress is scheduled to work fewer days than any time since 1948, or fewer than 90 days. President Truman called the 1948 Congress the "Do Nothing Congress." Such a short schedule allows little time for solving our fiscal problems, but lots of time for campaigning. We don't know who will win the election, but we do know that when Congress returns to its duties in January, 2007, our obligations will be \$3 trillion larger than they are today. Time is of the essence.

History will not be kind to officeholders who persist in believing, despite the availability of modern accounting techniques, that their annual deficits are only one-tenth their true

size. Voters should not be kind either. You should make the numbers in this Report a major issue in the coming election.

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It is not too late for our nation's first president with an MBA degree to champion equal consideration of accrual numbers. If you want government to be run more like a business, you have to use business-like budgeting. The House Budget Committee's unanimous March, 2006, vote to require inclusion of accrual budgeting is a sign that bipartisan pressure may be building for modern budgeting techniques in government.

A more radical thought is to require congressmen and senators to sign our country's financial statements just as corporate executives must sign their annual reports, on penalty of personal criminal liability. That would ensure that Congress members do not ignore our nation's accounts.

At a minimum, it is time for the White House and U.S. Treasury Department to stop hiding this crucial information in plain sight. It is also time for federal candidates to declare whether they believe America should budget using both cash and accrual numbers.

Here is a simple test: If they say the "true" deficit for 2005 was

1. \$318.5 billion, then they favor the *status quo* (using cash budgeting only and hiding our borrowing from Social Security)
2. \$760 billion, then they favor real change (using accrual budgeting as well as cash budgeting), but if they say
3. \$3.3 trillion, then you might actually get real change, instead of a nice speech