The Financial State of the Union

Next week, President Barack Obama will deliver the "State of the Union" (SOTU) speech to the Congress of the United States.

Here are four questions to consider ahead of the speech:

> Why do presidents give "State of the Union" speeches?
>
> Do government finances matter for the "State of the Union?"
>
> What will President Obama say about our nation's finances?
>
> What *should* the President say about our nation's finances?

Presidents do not give State of the Union speeches simply to sell themselves every year. Presidents give State of the Union messages because the U.S. Constitution tells them to. Government finances not only matter for the State of the Union, they are *central* to the state of the Union. Unfortunately, our presidents provide inadequate annual reports on the financial state of the Union. Next week, President Obama will likely continue to fall short in this area, as he and previous presidents have for decades. President Obama, and future presidents, can do a much more careful job describing financial developments in the State of the Union.

The "State of the Union" Message

The State of the Union information plays an important role, in theory, in securing accountability in our republic.

The United States Constitution outlines the powers, duties, and constraints for the President of the United States in Article II. The first clause in Article II, Section 3 states:

> He shall from time to time give to the Congress Information on the State of the Union, and recommend to their Consideration such Measures as he shall judge necessary and expedient;

Drafted in 1787, the Constitution was ratified in state conventions over the next several years. In 1790, George Washington delivered the first "State of the Union" message to Congress. Washington delivered the first message in a speech, as he did in all 8 years of his presidency. Washington's annual speech established a precedent for what "from time to time" means, and the State of the Union message has been delivered annually for over two hundred years.

But not always orally.

The second U.S. president, John Adams, also delivered the message in a speech, and in all four years of his presidency (1797 to 1800).

The third president, Thomas Jefferson, parted with this practice. Jefferson expressed concern that a speech from the President to the Congress was a little too close to practice in monarchies, like England, where the King delivered edicts to the Parliament, as opposed to the "Measures" to be "recommended" to the Congress. Jefferson's "State of the Union" messages from 1801 to 1808 were all written, not spoken. And Jefferson's content included lengthier -- and more responsible --financial reporting.

Presidents then gave written messages to the Congress for over one hundred years. The messages grew more thorough over time. The early-1900s messages prepared by William Howard Taft were particularly noteworthy for their depth.

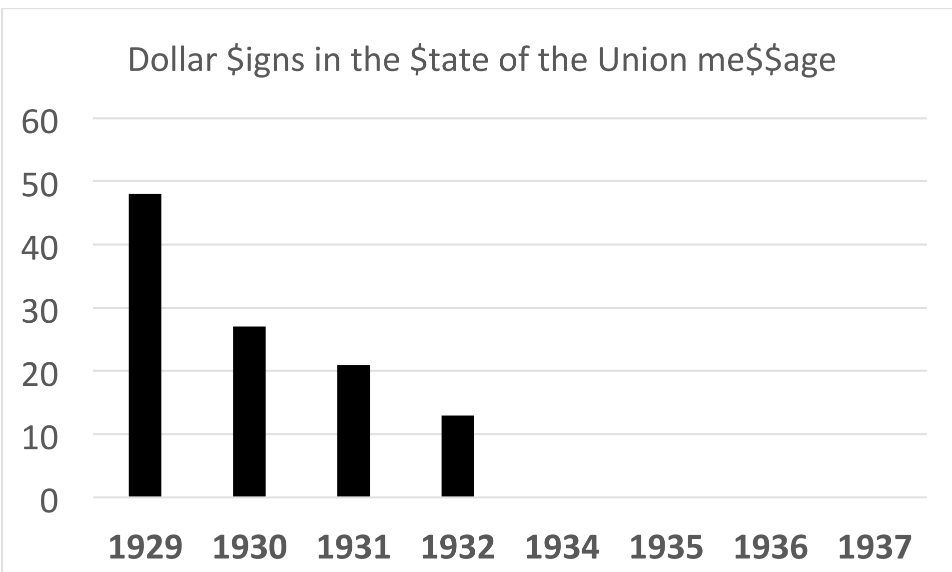
Then, 1913 arrived, and the world changed. The United States instituted an income tax, created a central bank, and an ambitious federal government entered a growth spurt. Meanwhile, a new President sharply curtailed financial reporting in the State of the Union message.

Woodrow Wilson was a vigorous advocate for executive branch authority and government solutions generally, and he broke with State of the Union tradition. In

1913, he gave his first message in a speech to the Congress, as he did in all eight years of his presidency.

Wilson cut sharply back on the length of the State of the Union message, as well as the discussion of financial matters – amidst a jump-shift in government ambition and spending. And since 1913, the State of the Union messages have always been delivered in speeches.

Wilson wasn't alone in growing government and not talking a lot about how much it cost. Franklin Delano Roosevelt's administration(s) presided over perhaps the greatest expansion in federal government scale and scope in US history. The chart below shows the number of times that a dollar sign ($) appears in the State of the Union messages in the four years for the Herbert Hoover administration (1929—1932) and the first four years of FDR's presidency.



As the United States embarked on the expensive New Deal, dollar signs disappeared from the State of the Union message -- completely.

Government Finances and the "State of the Union"

Governments need money. Governments get money, governments spend money, and governments print money and manage money systems. Governments theoretically exist to serve and protect, and their money management matters for the general welfare.

Our Constitution established a federal United States of America, with authorities and responsibilities for a national government as well as the states. For the national government, the Constitution established a scheme with three branches holding overlapping powers and responsibilities.

The Constitution included spending, taxing and borrowing provisions in Article I, which lists the powers, duties, and constraints for the Congress. But for the State of the Union information, the Constitution directed the *President* to report on matters for which it gave the *Congress* primary authority.

The Constitution calls for not one, but two, reports to be given "from time to time." In addition to the State of the Union information, another directive appears in the "Statement and Account Clause," which is included in the Article I, Section 9 provisions for the *Congress*. Clause 7 states:

> No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of Receipts and Expenditures of all public Money shall be published from time to time.

So, from "time to time," the Constitution calls for the President to deliver information about the State of the Union to the Congress. At the same time, the Constitution also directs the Congress, from "time to time," to see that an "account of receipts and expenditures of all public money shall be published. …"

Since 1792, the report prepared under the Statement of Account Clause has been the "Combined Statement of Receipts, Outlays, and Balances." From the late 1700s to the early 1900s, presidents frequently referenced results from this report in their State of the Union messages, and presidential discussion of financial results tended to grow in length and specificity over time, peaking with William Howard Taft's presidency. Then, Woodrow Wilson's first State of the Union speech took the message down to 4,500 words, from Taft's 23,000. The speeches have ranged from roughly 5,000 to 7,000 words since then.

The transition to shorter messages beginning with Wilson was certainly not driven by a slimmer, trimmer federal government. In 1913, our ship of state left the dock on its voyage to Titanic proportions. Unfortunately, our ship captains began giving us increasingly vague and empty messages about the sea into which they were navigating.

Presidents offering less-thorough discussions of finances in the State of the Union message also tend to preside in periods with greater growth in government, and government debt. There are exceptions, but that appears to be the tendency.

For example, four other presidencies presiding over relatively rapid growth in spending and/or the national debt included Franklin Delano Roosevelt, Lyndon Baines Johnson, Ronald Reagan, and George W. Bush. And the length, depth, and specificity of the financial content in their State of the Union messages fell significantly from prior administrations.

It should be noted, of course, that lengthier discussions are not necessarily more thorough or accurate. Informative financial reporting can be made in shorter messages, as well.

The reader is invited to explore Appendix I, and form their own conclusions.

How Much Debt Does the U.S. Have, Mr. President?

The Financial Report of the U.S. Government has been prepared and reported since 1998. It includes a balance sheet with assets, liabilities, and a net position. In fiscal 2013, the latest year available, the balance sheet reported $19.9 trillion in total liabilities, including $12.0 trillion in "federal debt securities held by the public and accrued interest."

Here are the 9 liability line items, listed from top to bottom in terms of their dollar amounts (in billions):

1.	Federal debt securities held by the public and accrued interest	$ 12,028.4
2.	Federal employee and veterans benefits payable	6,538.3
3.	Other liabilities	532.1
4.	Environmental and disposal liabilities	349.1
5.	Benefits due and payable	174.3
6.	Insurance and guarantee program liabilities	130.0
7.	Accounts payable	66.2
8.	Loan guarantee liabilities	59.2

Two line items dominate the list – federal debt securities held by the public and accrued interest (for Treasury notes, bills, and bonds, about $12 trillion worth), and federal employee and veterans benefits payable (almost $7 trillion).

Unfortunately, the latest Financial Report of the U.S. Government may have a balance sheet, but this is only a start on the hunt for the current debt of the U.S. Government. For one thing, this is a balance sheet for the fiscal year ended September 30, 2013 – over a year ago.

At the other end of the scale, at least in terms of timeliness and apparent precision, the U.S. Treasury also reports an "official" national debt number at its "Debt to the Penny" website. This number is updated daily. The "total debt" reported there recently tipped the scales at over $18 trillion ($18,098,260,560,760.30). This is in line with the $19.9 trillion in total liabilities reported on the balance sheet in the Financial Report of the U.S. Government (give or take a trillion dollars or two), but it gets there in a very different way.

The "Total Debt" reported at Debt to the Penny includes two main categories – "Public Debt" and "Intragovernmental Holdings." The Public Debt is more formally called "Debt Held by the Public," and is made up of all the Treasury debt securities issued and outstanding – bills, notes, bonds, and TIPS ("Treasury Inflation Projection Securities") are the largest slices of that pie. The "Debt Held by the Public" label can be a bit misleading, in part because some of the biggest owners of the Treasury Securities include the Federal Reserve Banks, entities that some people argue should be consolidated in the federal government's balance sheet.

The latest "Debt to the Penny" calculations have about $13 trillion in "Public Debt," and $5 trillion in "Intragovernmental Holdings." Intragovernmental holdings include special Treasury securities issued to government trust funds, including Social Security and Medicare. This can lead some to believe that the $5 trillion does not belong in an "official" debt calculation, given that this is money the government "owes to itself," but that interpretation implies the government does not ultimately owe people the amount of money implied in the trust fund, which of course is ludicrous.

Unless it isn't.

That is because the Government doesn't include the present value of future Social Security and Medicare payments as liabilities on its balance sheet! And the reason the Government cites for choosing not to do this? Because the Government can change the programs, and not pay the benefits in the future!

Do you see the little "Benefits due and payable" line item the balance sheet above? The teeny little $174.3 billion? That is where Social Security and Medicare show up in the balance sheet – and while this is really a big number, it is a grain of sand on a beach when compared to the present value of future benefit payments.

So, when it comes to the "official debt" as reported at Debt to the Penny, if you believe, as we do, that future Social Security and Medicare benefits should indeed enter into a "true debt" figure, than the "Total Debt" reported at "Debt to the Penny" should indeed include "Intragovernmental Holdings." In turn, consider what this implies about the consistency, or lack thereof, in governmental financial reporting. The Treasury includes "Intragovernmental Holdings" in "Total Debt," but it also prepares a balance sheet that does not include Social Security and Medicare liabilities beyond the benefits currently "due and payable."

As noted above, the total debt reported at Debt to the Penny includes $13 trillion in debt held by the public, and $5 trillion in intragovernmental holdings. The former category appears at the top of the list of liabilities on the balance sheet of the U.S. Government, but intragovernmental holdings do not. To get to the $20 trillion in total liabilities on the balance sheet, the balance sheet adds $6.5 trillion in employee and veteran retirement benefits, and about $1 trillion in other liabilities.

But the $20 trillion in total liabilities on the balance sheet are far from the whole picture, in light of the social insurance (Social Security and Medicare) obligations.

The table below shows our own compilation of the net position of the United States Government as of year-end calendar (not fiscal) 2014. Where the government's own balance sheet showed a net position (assets less liabilities) at a negative $16.9 trillion in (fiscal) 2013, we calculate a much higher (negative) number – over $80 trillion.[1]

Assets		3.3
Liabilities		
	Social Security	27.2
	Medicare	37.8
	Pension/Retiree Benefits	6.7
	Publicly-Held Debt	13.0
	Other Liabilities	1.5
Total Liabilities		86.2
Net Position		82.9
	(in trillions of dollars)	

[1] **Social Security Benefits.** We use the Statements of Social Insurance, in the Financial Statements section of the Financial Report of the U.S. Government. We use the 75-year present value of future expenditures net of revenue for current (not future) participants. **Medicare.** We use the Statements of Social Insurance, in the Financial Statements section of the Financial Report of the U.S. Government. We use the 75–year present value of future expenditures net of revenue for current (not future) participants, for Medicare Parts A, B, and D. We adjust the total for the addition implied by the "Illustrative Alternative Scenario" presented in Footnote 24, "Social Insurance."

Where Else Does Debt "Lie" in U.S. Financial Statements?

Two basic financial statements include the income statement and the balance sheet. An income statement provides a "video" of performance of an entity over time, while a balance sheet provides a "snapshot" at a point in time.

Income statements include earned revenue and expenses. Subtracting the latter from the former leads to a bottom line called "net income" (in the private sector) or "change in net position" (in government).

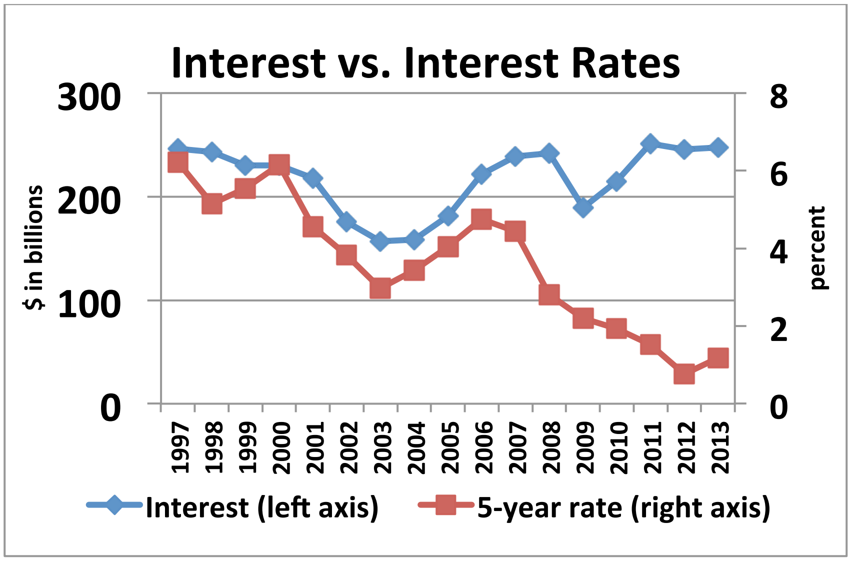
A balance sheet includes assets and liabilities. Subtracting the latter from the former leads to another bottom line, called "shareholder equity" (in the private sector) or "net position" (in government).

Debt shows up in both the income statement and the balance sheet. The income statement may include the cost of debt in interest expense, while debts are included among liabilities on the balance sheet.

What does the U.S. Government's income statement show for interest expense?

The "Statement of Net Cost" provides an "income statement" for the federal government. It includes gross cost, earned revenue, and net cost for a wide variety of government agencies. Most of the reported amounts are totals by agency.

One line item is "Interest on Treasury Securities Held by the Public." In 2013, the federal government reported $245.4 billion in gross cost for this item – a larger amount than the total gross cost reported for 34 of the 37 entities included on the statement. Gross cost for interest has not been rising significantly in the last two decades, but interest rates have been declining dramatically. Gross cost for interest tracked changes in interest rates from 1997 to 2006, but then stayed stubbornly high despite an 80% decline in longer-term Treasury rates from 2006 to 2013. There will be significant challenges if interest rates rise in the future.



The Financial Report of the U.S. Government includes more than one income statement. The "Statement of Operations and Changes in Net Position" starts with general revenue sources not included on the statement of net cost, and subtracts "net cost," along with one other item, to get to "total net cost" of operations. That other line item is "Intragovernmental Interest." In 2013, intragovernmental interest was reported at $119.6 billion, about one-half the gross cost for interest on Treasury securities.

Does it Matter When Presidents Give the State of the Union Speech?

In recent decades, Presidents have given the message at the beginning of new Congressional sessions, in January or February each year.

The timing of the SOTU speech matters, from a financial perspective, because the federal government's fiscal year-end is September 30 every year. September 30 is not the date the Financial Report of the U.S. Government is released, of course. It takes time to prepare, and audit, this massive report. The accounting standards leading to the financial statements in this report have room for improvement, but it still provides a useful starting point for any appraisal of trends in the federal government's financial condition.

Yet in recent years, the President has occasionally given the SOTU before Financial Report of the U.S. Government is available to the public. This is a bit like Warren Buffett writing a letter to shareholders about the financial performance of Berkshire Hathaway without delivering audited financial statements with the message.

Below is a table showing two dates for fiscal years 1998-2013 -- the date on the audit opinion letter for the report, and the date of the State of the Union speech following that fiscal year. Years in which the audited Financial Report of the U.S. Government were publicly available at the time of the State of the Union speech are highlighted in yellow.

Fiscal Year	**GAO Letter**	**SOTU Speech**
1998	March 31, 1999	January 19, 1999
1999	March 28, 2000	January 27, 2000
2000	March 30, 2001	February 27, 2001
2001	March 29, 2002	January 29, 2002
2002	March 31, 2003	January 28, 2003
2003	February 27, 2004	January 20, 2004
2004	December 14, 2004	February 2, 2005
2005	December 14, 2005	January 31, 2006
2006	December 15, 2006	January 23, 2007
2007	December 17, 2007	January 28, 2008
2008	December 15, 2008	February 24, 2009
2009	February 26, 2010	January 27, 2010
2010	December 21, 2010	January 25, 2011
2011	December 23, 2011	January 24, 2012
2012	January 17, 2012	February 12, 2013
2013	February 27, 2013	January 28, 2014

Coincidentally, or not, President Obama's discussion of the nation's finances were overly brief, in our view, in both the 2009 and the 2013 State of the Union addresses.

Obama's discussions of finances haven't always been brief, or overconfident. He has sounded some alarm bells that weren't being rung in the George W. Bush years. But this year, once again, he may be challenged for some raw material.

A Recent Exception to the Post-WWI Rule

State of the Union messages have grown increasingly blander, more general, staged and less informative about the Nation's finances since the early 1900s. There are exceptions, of course, and one of them provides a valuable example for future practice.

The peanut farmer.

In his 1977–1980 presidency, Jimmy Carter continued the practice of delivering speeches to Congress for the State of the Union. Alone among post-Woodrow Wilson presidents, however, Carter also attached a more thorough, written State of the Union message, dealing much more thoroughly with financial results.

Coincidentally, or not, the national debt / GDP ratio contracted through the Carter administration, then began a longer-term climb beginning in the Reagan years, accelerating in the recent Bush II and Obama administrations.

What Will President Obama Say Next Week about the Nation's Finances?

If last year's State of the Union address is a guide, he won't say very much. The President's discussion of the nation's finances was relatively brief, compared to earlier years as well as what should be expected for the chief executive of a massive enterprise. This could be due to the fact that the Financial Report of the US Government was delivered later than usual. Unfortunately, the Combined

Statement of Receipts, Outlays and Balances is running late again this year, which could foreshadow another surface, vapid, uninformative report, at least on the nation's finances.

What *Should* the President Say about the Nation's Finances?

The president should say what he wants to, of course. He earned that right, given that he was elected. But we do have some suggestions. President Obama could usefully address the following questions:

- How much debt does the United States Government have? Is that different from the amount the Government reports in its financial statements?
- Why has it been taking longer for the government to report the Combined Statement of Receipts, Outlays and Balances, and the Financial Report of the U.S. Government, in recent years?
- Shouldn't these reports be available for the annual State of the Union message?
- In recent State of the Union messages, why have our recent presidents said so little about the impending fiscal crisis implied by our Social Security, Medicare, and Medicaid programs, and in light of the other spending the government has chosen to undertake?
- What is the cost of waiting to resolve these real, but down-the-road, fiscal crisis? Should that cost be accrued as an expense in current financial reports of the U.S. Government?
- How well did the recent "Cromnibus" spending bill address these longer-term issues?

- Why does the federal government define the word “liability” the way it does, for the purposes of federal government accounting standards? Is this a defensible position?

- Our government calls Social Security, Medicare, and Medicaid “entitlement” programs. If citizens are “entitled” to these programs, aren’t their future payments to citizens obligations of the government – obligations that belong as on the financial statements as liabilities?

- Are you comfortable with the reason the chief actuary of the Social Security Administration offers for not including future Social Security benefit payments among the liabilities reported on the U.S. government’s balance sheet?

- How rapidly has defense spending grown in recent decades? Is this spending sustainable, in light of the financial crisis facing our entitlement programs? Do we count “defense” spending well when so much related spending arises outside the Defense Department budget? Can we ever rely on the Defense Department to meet audit requirements?

- How rapidly has the Federal Reserve System grown in the last decade? How well does the Federal Reserve report its own financial condition? Should the Federal Reserve Board of Governors be in charge of setting, and changing, accounting standards for the Federal Reserve Banks as it sees fit? Should Reserve Banks’ financial statements be consolidated with the rest of the federal government?

- How rapidly have other Federal Government lending and insurance programs grown in the last decade? For example, consider student and other education loans. Is this growth sustainable? How well does the government account for the income and risk in student lending programs?

- Are you comfortable with how the accounting works for the contingent liabilities discussed in the Financial Report of the U.S. Government? Should contingent liabilities be included on the face of the balance sheet of the U.S. Government?

- Does the federal government possess the "sovereign powers to tax, and set monetary policy," as asserted in the Financial Report of the U.S. Government? If so, should the present value of future tax revenue be reflected on the balance sheet of the U.S. government as an asset? Or are the people the real sovereign, in the United States?

In turn, President Obama shouldn't just *talk* about the nation's finances in the State of the Union message. As noted, he could provide a more complete written report, consistent with practice in Jimmy Carter's administration. This report could discuss the inconsistency in the timing of the release of the two reports – the "Combined Statement of Receipts, Outlays and Balances" and the "Financial Report of the U.S. Government" in recent decades, and how that inconsistency matters for the quality of the financial information in the State of the Union message.

To improve their State of the Union financial reporting, President Obama, and future presidents, can look to other examples as well. For example, consider a corporate perspective. Our presidents could usefully learn from the annual messages that Warren Buffett delivers to Berkshire Hathaway's shareholders. Buffett's (written) messages are thorough, carefully documented, engaging, and far more informative about relevant financial developments than the financial information that our presidents provide in their State of the Union messages.

What might Buffett's example specifically inspire, in terms of presidential behavior? For one thing, presidents could rise above simply parroting the "facts" flowing out of our federal accounting and reporting standards. Federal financial reports provide the raw material for delivering good independent judgment – including judgment about the quality of government accounting. Buffett regularly discusses how to interpret financial results in light of accounting issues. Our presidents can do a better job giving us their judgment, not just repeating the "facts" reported out of the bureaucracy – and in recent decades, our Presidents haven't even measured up to the "facts" standard.

We'd like to see the president discussing the financial statement preparation and audit process directly, as well. In every presidency since Gerald Ford in the early 1970s, no president has ever discussed the Government Accounting Office (now, the Government Accountability Office), or GAO. And the Federal Accounting Standards Advisory Board (FASAB) goes similarly unmentioned, ever since it was established in the 1990s. This despite the fact that the GAO has refused to offer an opinion on the Financial Report of the U.S. Government for over 15 years, citing deficiencies in accounting and control processes in the government.

Conclusion

The Constitution does not provide for State of the Union information as an advertising opportunity, or as a tool for growing presidential power. Done well, this message can help secure accountability in the system of checks, balances, and shared authority in our government. That authority is shared among the three main branches of government, and the states. In turn, our state and federal governments report to the ultimate sovereign – We the People.

The State of the Union can give the Congress, and the nation, a valuable sounding board. Unfortunately, the sounding board has grown old and out of tune in recent decades. It now provides a symptom of our deteriorating national finances. Better financial reporting, in the State of the Union message and elsewhere, can help keep our Titanic ship of state afloat as we navigate icebergs in the years ahead.