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Speaking of Accounting Scandals. . .

by Jagadeesh Gokhale

The terrorist attacks on and after September 11, the antiterror war in Afghanistan and elsewhere, the Enron–Andersen implosion, intensified conflict in the Middle East and now South Asia have yanked our attention from the prior, seemingly more serene debate over the future of Social Security and Medicare. One year ago, we were congratulating ourselves on a job well done in turning the federal budget away from generating deficits each year. Then, we were debating not whether, but how to secure budget surpluses for our future needs. Now, however, fiscal resources must be reallocated toward combating terrorism, improving defense capabilities, and providing fiscal stimulus packages to prop up the economy. The new post–September 11 and post-Enron realities may prove costly in the long term, both directly by sucking up scarce budgetary resources and indirectly as they divert policymakers' attention from developing urgently needed reforms of public retirement and health programs.

The misrepresentation by Enron's executives of their firm's balance sheet and the ongoing debate about the correct accounting treatment of stock options have cast a bright spotlight on financial (mis)reporting and its consequences. Two key questions have surfaced in the aftermath of the scandal: Are current accounting standards adequate to ensure accurate representations of firms' financial conditions, and will adopting different standards affect investor behavior?

Both questions, it turns out, are also relevant to the debate about the future of Social Security and Medicare. For one, how should the value of Social Security and Medicare's implicit liabilities be estimated? Second, to what extent do incorrect estimates, misrepresentations, or the complete elimination of such items from the government's financial reports affect the decisions of policymakers and individuals and, by implication, the economy?

The federal government reports its assets and liabilities in the annually released *Budget of the United States* and also projects how revenues and expenditures will affect its balance-sheet position over the next five years.[1] Social Security and Medicare obligations to retirees beyond the five-year horizon, net of the taxes available to pay them, are not reported. Is this appropriate? This *Economic Commentary* suggests that the failure to appropriately account for the net implicit liabilities of Social Security and Medicare may be distorting lawmakers' allocation of scarce federal tax dollars today, and it may have induced them into promising more generous benefits than can be financed from tax dollars available tomorrow.

The better the information stockholders have about a firm's prospective finances, the better their decisions on investing their money productively. The same is true of lawmakers' decisions on how to allocate public funds. As the Enron– Andersen debacle has made so abundantly clear, murky financial reporting can lead to devastating consequences. Is something similar happening with the way government finances are reported—especially with regard to Social Security and Medicare?

What's at Stake?

The *Budget of the United States,* usually released early during each calendar year, includes the administration's spending and revenue proposals that are the basis for congressional debates on budget priorities and options for the next fiscal year. A simplified version of the federal government's budget and debt report is given in table 1.

The budget statement shows annual flows of receipts and outlays. The last row in the table shows how annual flows affect outstanding federal debt. The budget indicates that federal indebtedness to the public at the end of fiscal year (FY) 2002 amounted to $3,477 billion. If the budget totals for FY2003 are realized, federal indebtedness will increase $93 billion to $3,570 billion—about a third of projected U.S. GDP in fiscal year 2003.

Just as the federal government is obligated to service its outstanding debt, however, it is also bound by law to pay Social Security and Medicare benefits to eligible individuals. Although the government could legally change existing laws to abrogate all or most Social Security and Medicare benefits, the likelihood of this is extremely small—about the same order of magnitude as the likelihood that the government would repudiate its explicit debt. Under current tax laws, payroll tax revenues are projected to be insufficient to fully pay promised benefits. Although Social Security and Medicare benefits may be trimmed, the reductions are unlikely to be sufficient to preclude future tax hikes—especially as aging baby boomers exert substantial political pressure to preserve benefit levels.

Outstanding Treasury securities imply that all past federal expenditures were not paid for by taxes; some were financed through debt issues, which must be serviced. Future taxes must exceed future spending to accommodate the debt service. In like manner, the fact that Social Security and Medicare benefits paid to retirees in the past

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exceeded their payroll tax payments, taxes on future workers will have to be larger than the benefits they receive to make up the difference. This "implicit" liability now manifests itself as an excess of projected benefits relative to assets plus projected payroll tax revenues. Paying Social Security and Medicare benefits at or near currently promised levels implies higher future taxes. So the two types of federal obligations are similar in their impact on future taxpayers.Therefore, both should receive similar treatment in reports of federal financial health. Nevertheless, official federal budgets and balance sheets do not contain estimates of the sizes of Social Security's and Medicare's net implicit liabilities.

TABLE 1 THE FEDERAL BUDGET (billions of dollars)

	FY2002	FY2003
Total receipts	**1,946**	**2,048**
Individual and corporate income taxes	1,151	1,212
Social insurance taxes	708	749
Old age, survivors, disability, and hospital insurance	657	669
Excise and other taxes	87	87
Total outlays	**2,052**	**2,128**
Discretionary and emergency	740	789
Social Security	456	472
Medicare	223	231
Net interest	178	181
Other outlays	455	456
Surplus/deficit (–)	**–106**	**–80**
Other borrowing requirements	**–51**	**–13**
Debt held by the public (end of year)	**3,477**	**3,570**

NOTE: Totals may not add up due to rounding.
SOURCE: *Budget of the United States Government*, fiscal year 2003.

The Need for Truth in Advertising

When confronted with this argument, supporters of the status quo in Social Security accounting point out that Social Security and Medicare trustees already publish detailed reports of those programs' financial condition, including 75-year-ahead projections of revenues and outlays. But whether the information contained in those reports reliably portrays the true financial condition of these programs is debatable. A case in point is the reported size of the "actuarial balance" of the Social Security and Medicare programs—which most observers cite as the core message of the trustees' reports.

The long-term actuarial balance of Social Security, for example, is derived from outlay and revenue projections expressed as a percentage of projected payroll over a horizon of 75 years. We learn from the 2002 Social Security trustees' report that the "summarized cost rate" of the program over the next 75 years is 15.59 percent. This rate is the ratio of the present value of total outlays to the present value of total payroll during the next 75 years. Total outlays include benefit payments, administrative expenses, scheduled transfers to other trust funds, and a target value of the trust fund at the end of 75 years equal to projected benefit payments in the 76th year. We also learn that the "summarized income rate" over the next 75 years will be 13.72 percent, where income includes revenues from payroll taxes and taxation of Social Security benefits. Note, however, that income also includes the nonmarketable Treasury securities held in the Social Security trust fund.

The shortfall of the income rate over the cost rate, 1.87 percentage points, is the "summarized actuarial balance." The report highlights this number as representing the "actuarial deficit" during the next 75 years, assuming Social Security pays benefits over this time span according to current law. Many observers and analysts readily interpret this number as implying that taxes would have to rise today by a mere 1.87 percentage points of payroll to restore the program to financial solvency.

Closer examination reveals several problems with this method of representing Social Security's financial shortfall. First, it is clear from the method of calculating the summarized income rate that the term "Social Security trust fund" is a misnomer. Because the trust fund exclusively holds specially issued Treasury securities, it merely represents an accounting mechanism indicating the amount of past Social Security surpluses that were deposited with the Treasury. Second, the availability of Social Security surpluses enables politicians to increase government spending without incurring the political cost associated with raising non–Social Security taxes to pay for it.

The function of the so-called "trust fund," then, is only to indicate the extent to which Social Security is authorized to siphon future tax dollars from the Treasury to pay Social Security's expenses. It does not represent a claim against an independent, nontax source of income based on claims against real invested capital. When it becomes necessary to reclaim dollars from the Treasury, the outflow must be financed by levying *additional* (nonpayroll) taxes or by cutting non–Social Security outlays. This situation will arise in 2017, much earlier than the widely advertised date of trust fund insolvency—2041.

How much extra taxes must be levied (or outlays cut) to redeem the trust funds' Treasury securities can be gauged by the difference between the summarized income rate (13.72 percent) and the current statutory payroll tax rate (12.4 percent) plus the rate of benefits taxation (0.69 percent). This difference equals 0.63 percentage point of annual payroll. Hence, the *total* change in payroll taxes (or benefits) required to achieve actuarial balance over the next 75 years is not 1.87 percentage points, but that plus 0.63 percentage point—or 2.5 percentage points.

This shows that the Social Security Administration's method of reporting the shortfall in tax revenues is incomplete, at best. First, the true nature of the trust fund—an accounting mechanism for authorizing and legitimizing future tax increases, not a repository of claims on income-generating assets—is camouflaged in the arcane language of summarized income, cost, and actuarial balance rates. Second, the payroll tax hike required to meet future benefit obligations is understated by about a quarter of the total.

Troubling aspects of Social Security's accounting do not end here. Note that the projection horizon extends only

75 years. A quick look at revenue and outlay projections shows that surpluses will occur during the first few years (until 2016) and will be followed by deficits extending beyond the 75-year horizon. So, over time, successive 75-year projections will show the system's financial condition deteriorating as additional deficit years enter the summarized income and cost calculations. Indeed, the record of the past 30 years provides evidence of precisely this process at work: Although the 1983 Social Security reforms left the system with a slight actuarial surplus over the next 75 years, the program's actuarial deficits have worsened considerably since.

If we implement a tax hike equivalent to 2.5 percentage points of payroll to restore Social Security's finances for the next 75 years, the condition of Social Security finances will appear just as it does today, say, 30 years hence. We will find ourselves faced with the need to hike taxes again and re-engaged in the same old Social Security reform debate. How high must taxes be hiked to permanently eliminate Social Security's financial shortfall? One estimate places Social Security's actuarial deficit through the infinite future at 4.7 percentage points (Goss 1999). That means the tax hike required to permanently cure Social Security's financial ailment is slightly over 5.33 percentage points—a far cry from the 1.87 percentage points highlighted in the trustees' reports.

Remedies?

Most would agree that greater transparency in accounting practices would improve the allocation of scarce investment funds. There seems no reason why this principle is not just as applicable to the accounting of public funds as to private ones. Some of the nation's top economic gurus advocate reforming private accounting standards to better reflect items such as employee compensation through stock options, liabilities of partner firms, and the like. Recent research suggests that including such information in companies' annual reports influences firms' stock prices in the expected direction (see Aboody, Barth, and Kasznik 2001, for example). That is, properly declaring assets and liabilities induces decisionmakers (investors, legislators, voters, etc.) to better evaluate the costs and benefits of alternative resource allocations, and better resource allocation helps make the economy more efficient.

This reasoning dictates that federal liabilities should be declared fully and as transparently as possible so that lawmakers and the public can make fully informed decisions. Should information about future federal obligations be cloaked, as it is today, in the language of actuarial calculations, or should it be made comparable to other information that people already understand and use—such as the magnitude, in today's dollars, of explicit federal debt? It seems crucially important to appropriately estimate and officially report Social Security's future net liabilities in the government's fiscal statements.

If total net indebtedness on account of Social Security and Medicare were included in the federal budgets and balance sheets, what would the numbers look like?

Extending the 75-year projections for Social Security and Medicare and calculating the present-value difference between revenues and outlays using a real 3.5 percent discount rate—the rate the government pays to borrow funds from the public—yields the following estimates: Under intermediate economic and demographic assumptions, Social Security's net implicit liability amounts to $8.5 trillion dollars. That of Medicare turns out to be a whopping $22 trillion dollars. Their combined net liability, then, is $30 trillion—or three times current annual U.S. GDP. Keep in mind, too, that additional net implicit liabilities are associated with the provision of other benefits and public goods through programs such as food stamps, Aid to Dependent Children, public employee pensions, national defense, and others.

Will It Make a Difference?

At issue here is not whether Social Security and Medicare face financial shortfalls (they do), but whether explicitly acknowledging the shortfalls in official federal budgets and balance sheets would make any difference. More precisely, what can we say about the likely impact of alternative accounting conventions on politicians' current resource-allocation decisions? Does it matter whether the federal government's accounts are presented with or without explicit acknowledgment of future Social Security and Medicare liabilities?

The correct answer here is "we don't really know." However, a claim that it will matter does not seem entirely unjustified.

For one, a better-informed public might exert political pressure to reform these programs earlier than otherwise. Second, lawmakers may exert greater caution before making costly benefit promises and spending commitments if they are made aware of the true magnitude of the existing funding shortfalls in easily comprehensible terms. After all, past legislative history contains hints that lawmakers are more fiscally disciplined during times when reported deficits are high and rising, and less so during times of reported surpluses. Politicians have shown themselves to be more likely to control their appetite for spending when Social Security surpluses are small and cannot be used to mask the size of overall federal budget deficits.

Federal budget history during the last two decades shows that during the early and mid-1980s, federal "on-budget" deficits were very large, but Social Security surpluses were barely positive. Budget projections indicated growing deficits and induced Congress to enact the Balanced Budget and Emergency Deficit Control Act in 1985 in an attempt to control large and soaring federal deficits. Although many serious budgeters believe this act proved ineffective, federal deficits did fall for a few years after it was enacted. Moreover, past budget data show cuts in discretionary nondefense outlays—which fell as a share of GDP—may have contributed to lowering federal deficits.

Social Security surpluses became larger during the late 1980s, reducing pressure on lawmakers to continue with stringent cuts in nondefense spending. Furthermore, overall deficits resumed their upward course after 1989, prompting the introduction of a multiyear deficit-reduction package and the enactment of the Budget Enforcement Act (BEA). The BEA placed stringent caps on discretionary spending and imposed pay-as-you-go financing constraints on revenues and mandatory outlays. The BEA was subsequently renewed twice, extending it through fiscal year 2002. With the end of the Cold War in 1990, however, defense spending could be retrenched more rapidly to meet the BEA's spending caps, and pressure to further reduce nondefense spending remained weak. Although total discretionary spending declined as a share of GDP, none of it resulted from cuts in nondefense outlays.

More recently, projections of gigantic federal surpluses, together with a greater need for spending on national defense, mean that the BEA is unlikely to be extended further. Rather, federal outlays are now guaranteed to scale new heights. As the size of the federal government expands, prospects that the earlier projected federal surpluses will ever materialize are growing dimmer. In this environment, a system of public accounting that clearly acknowledges the size of outstanding net federal liabilities, both implicit and explicit, might lend greater foresight and temper lawmakers' appetite for ever-larger increases in federal spending.

Conclusion

Current debates about reforming accounting conventions in the private sector seem just as applicable to the issue of accounting in the public sphere. In particular, current official reports on federal finances do not appropriately and explicitly acknowledge the size of Social Security and Medicare's net implicit liabilities. These are gigantic and should be incorporated in our calculus for balancing today's desires against tomorrow's needs.

Footnotes

1. See *Budget of the United States Government, Fiscal Year 2003*, summary table 2, Washington, D.C.: Government Printing Office.

Recommended Reading

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