Comments on "Accounting for Social Security, Revised"

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I am commenting as an academic economist with research interests in federal budgeting and budget accounting. As I am neither an accountant nor a lawyer, my focus is on the economic insights obtainable from accounting statements, on not legal rules or accounting conventions. I believe economics deserves significant consideration in this context, because FASAB standards are centrally about economic concepts—liabilities, cost, and present values. The value of the resulting financial statements to most users is directly related to well the statements capture economic reality.

To anticipate, I will suggest an approach that differs from both the Primary and the Alternative View. However, regardless which view ultimately prevails, my greatest concern about the proposed Views is that a disputed standard would seriously damage the credibility and public acceptance of the U.S. government's Financial Statements. While I believe that certain changes in the accounting for social security are warranted, I urge you not to change the main financial statements until a specific set of changes commands broad public, political, and professional support. When in doubt, changes are better introduced as supplemental information. This comment is intended to suggest principles and measurements that will hopefully facilitate a search for a consensus.[1]

[1] My comments are based, in part, on: Henning Bohn, 1992, Budget Deficits and Government Accounting, Carnegie-Rochester Conference Series on Public Policy 37, December 1992, 1-84. This paper provides federal government balance sheets and income statements from 1947 to 1989, and it includes a section on whether or not social security constitutes a liability.

In summary, I will argue that Social Security and Medicare Part A create pension-type liabilities, but the amounts are significantly less than proposed in the Primary View. Medicare Part B and Part D do not create comparable liabilities.

Relevant Principles

Government accounting is most informative if it adheres to accounting rules that are already well known and generally accepted in private sector. General rules are also more credible than special, government-specific rules and they provide the most accountability to the public. The items currently recorded on the U.S. government balance sheet have private sector counterparts, notably public debt and federal employee pension benefits. Social Security and Medicare are unfortunately exceptions. The principle of adhering to private sector rules cannot be applied because Social Security and Medicare are mandatory programs that do not have counterparts in the private sector.

Government accounting is also most informative if economically equivalent activities are recorded in the same way, even if their legal status differs. From an economic perspective, Social Security redistributes resources from working-age to retired cohorts in a way that is equivalent to rolling over a public debt. Social security provides a retirement income similar to a retirement income provided by private savings. Hence payroll taxes can be interpreted, in part, as contributions to a mandatory retirement savings plan.[2] Indeed, government officials have long encouraged social security participants to treat social security as core component of retirement income and to think of payroll "taxes" as "contributions" to their retirement. For

[2] Only part of payroll taxes can be interpreted as contributions because, in a mature unfunded social security system, payroll taxes typically exceed the present value of benefits. The excess is best interpreted as a tax that pays for debt service on the unfunded liabilities.

these reasons, the principle of recording economically equivalent activities in the same way strongly supports the view that Social Security creates liabilities. These liabilities are created when contributions are made.

The main objections to this line of argument appear to be legal. The U.S. Supreme Court has ruled that social security contributions do not establish a legal right to benefits (Flemming v. Nestor 1960). Moreover, the Social security administration mails out annual statements to participants ("Your Social Security Statement") reminding them that

> *"Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time."*

This provides a legal case against recognizing future Social security benefits as liabilities.

Conflicts between legal and economic reasoning are not uncommon in private-sector accounting. Because the recognition of corporate promises as liabilities is often based on legal arguments, the legal case against recognizing a Social security liability deserves some respect. The accounting profession has long recognized, however, that legal arguments are not absolute and must be set aside when legally permitted choices are practically infeasible or highly unlikely. And feasibility and likelihood are judged, in large part, by economic arguments.

This interaction of legal and economic reasoning applies to retirement plans in particular. Notably, corporate pension obligations in ongoing plans are generally computed on the basis projected benefits rather than accumulated benefits. Projected benefit calculations involve economic assumptions about likely future payments and they often yield obligations much greater than the company's legal obligations in case of a plan termination. Even when companies retain the right to terminate their pension plans, accounting rules require the use of projected benefit obligations. The legal option of termination is in effect presumed irrelevant for accounting purposes unless and until a plan is actually terminated. The same reasoning applies to Social Security.

For Social Security, and especially for extending the argument to Medicare, the economic rationale for recognizing projected benefits is important. The key argument is that the cost of labor is best measured by total compensation. Pension accruals are a component of total compensation. This means that employer contributions are in effect made by employees who accept that part of their compensation is deferred. The same rationale applies to retiree health benefits promised to active employees as part of their compensation package.

Social Security raises the same economic and legal issues as corporate pensions promises in excess of accumulated benefits (excess pensions for short). Both social security benefits and excess pension benefits can be repudiated unilaterally by the sponsors. Social security benefits and excess pensions are also similar in that attempts to terminate them trigger adverse responses from disappointed beneficiaries that make terminations difficult (e.g., morale problems in firms, a voter revolt in case of public benefits). On the corporate side, many defined-benefit plans have actually been terminated in recent years, yet termination is deemed sufficiently unlikely that ongoing plans are still valued at projected benefits. For Social Security, a "termination" is widely viewed as totally unrealistic. While politicians and economists have discussed social security reform for decades, the reform debate has been extremely respectful of accrued benefits. There are no serious proposals to cut off benefits to current retirees, nor any proposal that would pay current middle-aged contributors less than their (reasonably measured) accrued benefits. In more formal terms, standard median voter theory indicates that a continuation of the U.S. social security system will retain majority support against termination-type alternatives.[3]

Arguments analogous to Social Security apply to Medicare Part A, which is also financed through payroll taxes. Medicare Part B and Part D, however, are not financed through payroll taxes and hence cannot be interpreted as savings-type plans. Promises of unilateral future government subsidies are commonly interpreted as non-binding, both in law and in economics. Hence estimated future payments for Medicare Parts B and D do not create liabilities. By the same reasoning, supplemental statements should either omit Medicare Parts B and D, or present them as distinct from Social Security and Medicare Part A. Only Social Security and Medicare Part A create pension-like obligations.

Measurement Issues

The arguments for recognizing Social Security and Medicare Part A liabilities do not support the Primary View of recognizing liabilities after 40 quarters. Participation for 40 quarters is a legal requirement, subject to change and without economic relevance. An appeal to the 40-quarters rule is indeed logically inconsistent and counterproductive because the rationale for

[3] See, e.g., Henning Bohn, 2005, "Will Social Security and Medicare Remain Viable as the U.S. Population is Aging? An Update" in: Robin Brooks and Assaf Razin (eds.), The Politics and Finance of Social Security Reform, Cambridge University Press, 44-72. This paper examines a voting model for Social Security and Medicare and concludes that majority voting for a continuation of both programs is a sequential voting equilibrium under a wide range of economic, demographic, and programmatic assumptions.

recognizing a liability based on the notion that economic reality overrides legal formalities. For Medicare, the 40-quarter rule would have the bizarre implication that lifetime benefits are recognized all at once. The economic argument for recognizing Social Security and Medicare Part A liabilities implies that such liabilities must be recognized gradually over the work life of each participant.

Two further complications arise in determining the value of accrued liabilities. One issue involves discounting, which is conceptually straightforward but practically challenging. Promised future benefits and expected future payroll tax revenues are in various ways contingent on future wages, future inflation, and (in case of Medicare) future medical cost. From an economic perspective, it is incorrect to use bond rates as discount rates on contingent claims. Recent work by Geanakoplos and Zeldes suggests that a proper contingent claims approach would yield reduced estimates for Social Security.[4] I recognize, however, that fixed discount rates are common in corporate pension accounting. I would find it acceptable therefore if FASAB justified a simplified approach to discounting by invoking the principle of following private sector accounting principles.

The second issue involves possible limits on liabilities. One may argue that the federal government has in effect given notice to social security participants that payments will be limited to trust fund assets plus payroll tax revenues at current tax rates. This intent is expressed quite clearly in the "Your Social Security Statement" mailed annually out by the

[4] See Geanakoplos and Zeldes, The Market Value of Accrued Social Security Benefits, mimeo, Yale University and Columbia University.

Social Security administration to current contributors. After noting that Congress may change the laws (cited above), the statement continues:

> *"The law governing benefits may change because, by 2040, the payroll taxes collected will be enough to pay only about 74 percent of scheduled benefits."*

In analogy to a corporate plan, a notice of modification in plan conditions would make the previously projected benefits inapplicable as measures of liability. Instead, the liability would be defined by the new promises, i.e., here limited to tax collections plus trust fund balances. The limit would complicate the computation of present values attributable to current and past contributions, but the calculations are conceptually straightforward.[5]

Similarly, benefits paid under Medicare Part A have historically been adjusted whenever they threatened to exceed the payroll tax revenues dedicated to the program. Because Medicare cost rates are projected to rise sharply, the limited liability argument is likely to produce much smaller estimated Medicare Part A liabilities than the projected benefits approach. Liabilities would be limited to the fraction of Medicare taxes to be spent on currently accrued benefits.

Note that medical cost estimates per se are problematic. Most long-run estimates of health insurance cost assume a high rate of medical cost inflation and they assume coverage for all available medical treatments, including ones yet to be invented. For Medicare, the resulting projected costs are so high that they are implausible as estimates of what the government will actually pay. This problem applies already to the Medicare estimates in the

[5] Quantitatively, limited liability is arguably a small issue for Social Security because the trust fund exhaustion date is far in the future. The principle is important, however, because it applies analogously to Medicare where it is quantitatively important.

current Statement of Social Insurance, and it would be reinforced if such estimates were moved onto the balance sheet. The limited liability interpretation naturally corrects such unreasonably high estimates. More broadly, I believe some method must be found—either limited liability or some other approach[6]—to avoid vastly inflated, and hence not credible, estimates of medical liabilities. If current Medicare estimates were moved onto the balance sheet, as proposed by the Primary View, I would find it difficult to take the resulting financial statements seriously.

Conclusions

In summary, by the standards that apply to similar activities outside the federal government, Social Security and Medicare Part A do create balance sheet liabilities. The federal government's legal right to terminate these programs is immaterial unless and until the federal government actually exercises its rights. For Medicare Part B and Part D, in contrast, there is no liability until payments are due and payable.

The analysis of measurement issues suggests a "limited liability" approach to valuing Social Security and Medicare obligations. Social Security liabilities are the lesser of projected benefits and benefits that can be financed from trust fund balances plus payroll taxes at current tax rates. For Medicare Part A, liabilities are recognized similarly and also limited by payroll taxes. These points about measurement apply not only to the proposed balance obligations, but also to the current Statement of Social Insurance and to the statements proposed by the Alternative View.

[6] In Bohn 1992, op. cit., I suggested limiting the recognized social security liability to previous contributions plus interest. Analogous reasoning applied to Medicare would also produce reasonable liabilities for Part A, and no liabilities for Parts B and D. However, the 1992 paper was written before the Social Security administration started mailing annual statements that imply a different limit.