Comment on Exposure Draft: Accounting for Social Insurance, Revised
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This exposure draft proposes a compromise between the Primary and Alternative views as detailed in the previous ED.

The key step proposed in "recognizing" social insurance "liabilities" is to report the closed group measure as an additional line item on the government-wide balance sheet. Many arguments favoring such a compromise are presented in the current ED and Appendix C provides an example of the reporting format to be used.

Although the ED poses several questions to be answered by commentators, my comments are organized in a different manner. However, they essentially address all of the issues raised in the questions.

The closed group measure included in Appendices B and C is described as "Net present value of future cash flow for current participants."

1. By that definition, the social insurance (program's) trust fund's value is not subtracted from the present value of future cash flows. If this is correct, the proposed measure does not correspond to the traditional definition of the closed group measure, which nets out the trust fund.

Under the traditional measure, the definition would be: "Net present value of cash flows for *past and current* participants."

The reason to include past and current participants is that past net contributions of both of these groups are embedded in the trust fund and cannot be easily separated. The net results of past transactions 1) of past generations and 2) of currently alive generations should be accounted for to comprehensively to characterize their net benefits under "current policies."

(As the Board is aware, the term "current policies" is discussed in detail in FASAB ED on the project on government-wide sustainability reporting.)

The closed group measure defined in the ED does not accurately capture the total net "liability" that would be transferred to future generations under "current policies" because it ignores the bequest (net "asset" or "liability") being transferred on account of past transactions of those two groups. As such, the ED's closed group measure is an incomplete representation of the total "liability" created by current generations. It is also an incomplete representation of the total "liability" that would be bequeathed by past and current generations to future generations under continuation of "current policies."

2. The ED proposes to include the open group "liability" measure only in the SOSI. The reasons for excluding the open-group "liability" measure from the balance sheet display (Appendix C) appear inadequate to me. The open-group measure should be included in the balance sheet along with the closed group measure by adding the line "Net present value of cash flows for all participants, past, current, and future." My preference for the extended balance sheet table, is as follows:

   *Net present value of:*

   a) *past cash flows: past and current generations (trust fund value)*
   b) *future cash flows for current generations*
   c) *all cash flows: past and current generations [closed group: (b)–(a)]*

   d) *future cash flows: future generations*
   e) *all cash flows: all generations (past, present, and future) [open group (c)+(d)]*

This would *complete* the description of the social insurance (program's) financial condition within the balance sheet: the asset, liability, and net asset position would show the current financial position and the extended, forward looking closed and open-group measures would show the long-term financial condition under "current policies."

There should be a disclaimer about liability recognition attached to the extended section—it should explicitly indicate the uncertain nature of the long-term projections, but also indicate that these measures represent the best estimates of the "future implications of continuing current policies." Such a complete display would

f) account for "future committed revenues" – the trust fund,

g) indicate the full extent of the financial shortfall under "current policies" on account of all participants, *****

h) indicate the full extent of fiscal burdens being transferred to future generations under "current policies" via the closed group measure

It would also

i) indicate the extent by which delaying policy adjustments by one year would change (usually increase) the total size of social insurance (program's) unfunded obligations and show the increase in past and current generations' net benefits – which is the implied fiscal burden on future generations defined relative to the current year as opposed to the previous year.

j) provide a powerful tool-kit to policymakers to show available tradeoffs: Evaluating the two measures under a new policy would indicate the reduction in total social insurance (program's) unfunded obligations (change in the open group measure) and show how the reduction would be distributed across current and future generations (change in the closed group measure).

I believe it's crucial to provide a complete and forward-looking accounting of social insurance unfunded obligations under "current policies" *and that it be presented along with the balance sheet, including in the executive summary section of the U.S. Financial Statement/Report.*

The current compromise proposal makes progress toward providing such information (in Appendices B and C), but it does not present the complete set of unfunded obligation measures in the MD&A and the balance sheet. Even in the SOSI, the measures proposed are incomplete and do not clearly depict the total fiscal burdens being transferred to future generations under "current polices."

The main reason offered for not providing the open group measure in the balance sheet and MD&A appears to be the uncertainty associated with making very long-term projections—beyond the standard 75-year time horizon. This concern is expressed via the requirement that the "liability" be "reasonably measurable."

But ignoring very long-term "liabilities" has its own pitfalls: *It could be construed by readers to imply that the social insurance (program's) post-75 year finances are balanced*—which is less "reasonable" compared to reporting the *best available estimate* of the post-75th year financial imbalance under continuation of current policies.

In making projections over 75 years, there are implicit assumptions about the prevailing demographics in the 75th year. *Conditional on those demographics*, it appears more natural and correct to project and calculate a deficit/surplus for the 76th year than to assume, implicitly, that the 76th year's amounts are zero. Obviously, this argument can be extended to years beyond the 76th indefinitely.

The standard advice to households regarding future uncertainty is not to ignore it but to insure against it. The same seems appropriate for the government reporting for informing policymakers.

Indeed, according to recent estimates of Social Security's trustees, considerably more than one-half of that program's total (infinite-horizon) "liability" arises *after* the next 75 years. That means the implicit assumption of a zero liability after the next 75 years is likely to be further away from the "true but unobservable" liability value under current policies compared to the best estimate of that liability.

Some analysts focus on the high variability of post-75th year estimates to parametric assumptions on discount rates and economic growth rates. With reference to discount rate responses, more volatility in the estimates for a given discount rate variation indicates that there is a larger problem lurking after the 75th year. Thus greater parametric sensitivity of the estimate should be a reason to include rather than exclude the estimation and reporting of post 75th year imbalances.

Understating the total "liability" by accounting for just the 75-year "liability" leads to the well known rolling window problem: the liability grows larger as additional deficit years are included in the 75-year horizon—making it difficult to judge the progress of reforms for restoring financial sustainability to social insurance (program's).

In addition, the understatement of the total net "liability" because the post-75th-year "liability" is ignored introduces an undesirable "short-term" bias in policymaking—as detailed by the author in *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities* (AEI Press, 2003).

Issues about the reporting of social insurance liabilities have been thoroughly discussed for a number of years by academic economists and other scholars of the subject. The key basic measures for social insurance programs that should be *prominently* reported include the open- and closed-group net "liability" measures with appropriate discussion of the methodology of deriving them and their significance. Neither measure by itself is sufficient, but the two measures together provide complete and consistent information about the evolving financial condition of social insurance programs under existing policies.

Minor comments:

Para A69:

"The closed group measure represents a reasonably good estimate of the net responsibility of future taxpayers, under current laws, to pay benefits to current participants."

This statement could be misconstrued: No law states that future generations are responsible for the tab of past and current generations that is unpaid to date.

The closed group measure simply indicates the "net benefits of current generations" ***<u>under the assumption that</u>*** those laws would be applied to current generations throughout their lifetimes.

Para A70 (and in general):

In most places where the program's revenues or income is discussed, "interest income" should be explicitly excluded if the program's trust fund is netted out when calculating the "open" or "closed" group unfunded obligation measures. This is consistent with the standard, traditional definition of the closed group measure. From the way it is defined in Appendix C (last line) it appears that the trust fund is not netted out.

Para A81:

"With respect to the balance sheet, the Board proposes to present new information on the balance sheet below assets, liabilities, and net position and not included in the totals for these classifications rather than to change the due and payable measure of the social insurance liability or change the basis for social insurance expense recognition."

"…the Board is proposing to add to the reporting model to require the closed group measure to be presented on the balance sheet but not included in the amounts in the totals for assets, liabilities, and net position…"

For a social insurance program, a long-range perspective on its finances appears to be more important—from a policymaking perspective compared to a snapshot of its current assets, liabilities and net assets. Therefore, I recommend that the former should be reported first: the assets, liabilities, and net position report should be placed ***after*** reporting both open- and closed-group measures. If possible, report both measures in a clearly demarcated section of the table because the new information is not integrated with the balance sheet totals.

Para A82:

Annual cash in- and out-flows associated with the *closed* group measure can be depicted separately. Could that also be a part of the social insurance RSI?