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Wendy Comes,
Executive Director,
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Dear Ms. Comes,

Thank you for the opportunity to provide comments on FASAB's "Preliminary Views, Accounting for Social Insurance" document. I attach below my integrated response and comments on the Primary and Alternative Views included therein.

Sincerely Yours,

Jagadeesh Gokhale
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A Note on FASAB's "Preliminary Views, Accounting for Social Insurance" document
By Jagadeesh Gokhale, Senior Fellow, Cato Institute

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Recent studies on federal budget reporting have emphasized the need for forward-looking fiscal measures. Traditional fiscal measures such as outstanding debt held by the public and annual deficits are backward looking because they result from past government transactions with the public in the form of government taxes and expenditures.

The government is in principle an everlasting entity.[1] Ensuring proper fiscal management to maintain continuity of government operations requires forward-looking fiscal measures. Such measures should indicate whether existing government policies are sustainable and how the fiscal burdens of paying for government spending on public goods under those policies would be distributed within and across generations and over time. The measures should be easy to communicate and should facilitate analysis of the tradeoffs involved under alternative policy changes.

Adopting the Primary View proposal would not introduce any new fiscal measures, but it would alter the content and sizes of traditional measures – national debt, annual budget deficits, and net operating costs. Hence judgment ought to be based upon whether adopting the Primary View proposal would enhance the quality and

[1] History suggests that no government is everlasting and one may conjecture that the current U.S. government would eventually be replaced by an extra-constitutional regime. However, that possibility cannot be admitted when defining and measuring government commitments to provide public services with the objective of managing the government's finances to ensure its continuity.

informational content of traditional measures. My answer to this question is in the negative.

A Critique of the Primary View Proposal

The quality of traditional measures would not be enhanced by the change proposed under the Primary View. According to economic theory, any fiscal policy (or policy change) must be defined in terms of its impact on the resources of private economic agents – individuals and firms. Changes to private agents' budgets caused by taxes and transfers are likely to alter their economic choices. Under this perspective, if changes in government taxes and expenditures do not alter private budget options and choices, those changes do not constitute a real change in fiscal policy.

Recent studies have shown that traditional cash flow measures of fiscal policy – government debt, deficits, and net operating costs – are *neither necessary nor sufficient* as descriptions of real underlying fiscal policies. Hence, by implication, those measures are not capable of consistently reflecting the government's financial condition, its sustainability, and its performance as an economic steward. Consider that any given debt and deficit series may be consistent with many alternative real fiscal policies. For example, balanced budget increases in taxes on workers and transfers to the retirees would deliver a different real underlying fiscal policy but would not, by construction, alter reported deficit or debt levels in any future period. Furthermore, a given real fiscal policy may be consistent with alternative debt and deficit series. For example, investment of government funds in private securities (or, alternatively, sale of government assets) coupled with a cut (alternatively, an increase) in capital income taxes could be designed to leave the government's "stake" in the economy's profits unchanged and, therefore, may not alter private agents' budgets. However, such a change in the government's asset portfolio and future taxes would produce a different time series of deficits and net current operating cost. Adopting the Primary View proposal would not fundamentally change these rather severe shortcomings of traditional fiscal measures. Hence, it would deliver no improvement in the quality of recognized government liabilities.

The Primary View proposal also does not significantly advance the informational content of traditional fiscal measures. Eligibility for Social Security and Medicare benefits depends on several factors. The Primary View holds that the acquisition of 40 quarters of covered earnings is a watershed eligibility requirement for Social Security and Medicare. Achieving "qualified" status under this rule, according to the Primary View, leads to a claim on future benefits that should be recognized to be just as inviolable as the contractual agreement to service and repay outstanding government bonds. However, because eligibility for social insurance benefits is contingent on several additional conditions, defining this particular eligibility condition as being more critical than others seems arbitrary. That's especially true because like other conditions, this particular eligibility condition could, by law, be altered by Congress at any time and retroactively.

The inclusion of future benefits accrued through past and current transactions but not those that would accrue through future transactions appears similar to setting an arbitrary time horizon (say, of 75 years) over which to evaluate Social Security's and Medicare's financial condition under current policies. Because the government would always remain in operation, and because social insurance policies are inertial – that is, the likelihood that future benefit accruals would occur under rules roughly similar to current ones is quite high – it appears unreasonable to make the implicit assumption that all accruals from future employment under current policies would be zero.[2] Recognizing liabilities based on the achievement of "qualified" status does not introduce a sufficiently forward-looking element to outstanding debt and deficits (or net cost) as fiscal measures. That means two critical shortcomings of traditional measures are preserved: First, implicitly ignoring future accruals of government commitments makes those measures incapable of communicating information on the sustainability of current policies. Second, traditional measures do not identify the distributional implications of current policies – an important item for providing a complete and consistent description of real underlying fiscal policies. Without these informational attributes, the objective of communicating relevant information about the government's financial status would remain unfulfilled.[3]

General Comments

- Drawing a strict distinction between "recognized liabilities" and "other commitments" appears quite beside the point when in fact the degree of commitment attaching to various federal government expenditures is a continuum. The government's spending commitments include very firm ones – inflation-protected Treasury bonds, inflation-indexed social insurance benefits to current retirees, the commitment to defend the country against foreign aggression, etc.; less firm commitments include nominally denominated Treasury bonds, future social insurance

[2] Note that, by assumption, fiscal policies would be changed appropriately in the future to ensure continuity of government. This is the condition of *ex post* government sustainability.

[3] See "Fiscal and Generational Imbalances: New Budget Measures for New Government Priorities" by Jagadeesh Gokhale and Kent Smetters, AEI Press: Washington, 2003.

commitments to middle-aged workers, welfare assistance to immigrants, etc.; and very weak commitments include funding science research, build a war memorial, and so on. And this continuum in the degree of commitments does not correspond monotonically to the distinction between contractual to non-contractual obligations: Some contractual payment commitments – nominally denominated Treasury bonds, for example – may be weaker in terms of real purchasing power delivered than some non-contractual ones – inflation indexed social insurance benefit payments to current retirees.

- Although *measurement* of current accrued Social Security and Medicare benefits is not sufficiently forward looking (future accruals under current policies are ignored), it is more consistent with a forward-looking approach than the current "due and payable" standard for liability recognition. But the *recognition* of current accrued benefits as "government liabilities" may place political and legal limitations on the choices available to future policymakers. Such potential constraints are unlikely to be consistent with FASAB's objective of proper management of federal resources for ensuring continuity of the federal government. The measurement and prominent display of *all* government commitments under current policies, including those to accrue in the future under existing policies, would not create such limitations but would more fully characterize the government's fiscal stance and financial condition.

- The measurement of accrued benefits based on the earnings records of "qualified" workers would also depend on other liability-triggering conditions that may or may not be currently satisfied: For example, the "qualified" worker may be already married for 10 years or more and the spouse could claim dependent and survivor benefits in the future based on the "qualified" worker's earnings record. Those future dependent and survivor benefits should be counted as accrued liabilities today under the Primary View proposal. However, those benefits may not actually be claimed by the spouse in the future if the spouse also earns qualified status and accrues larger benefits based on his or her own earnings record. Thus, calculations of accrued benefits in future periods must be adjusted to extinguish the earlier qualification for dependent and survivor benefits based on the worker's record.[4] Indeed other events such as a future completion of 10 years of marriage to a qualified worker, future marriages, divorces, births, deaths, disability, etc. would also trigger additional future benefit accruals, earlier benefit claims, or extinguish past accrued benefits under the Primary View proposal. Such complications in the evolution of "recognized liabilities" under the Primary View proposal could cause considerable errors in measuring accrued liabilities and make the statements of liabilities and net costs unreliable as indicators of the federal government's financial condition.

- Irrespective of its merits or demerits, however, implementing the Primary View proposal – of boosting the amount recognized as liabilities on the government's books – could constitute a useful experiment for economists. It would allow us to gauge whether financial market participants consider a quantum increase in the nation's recognized liabilities – one not accompanied by any real policy change – as new

[4] Alternatively, future liability recognition on the basis of the spouse acquiring "qualified" status should take account of only the excess of her own benefits over the dependent and survivor benefits to which she is already eligible.

information and whether it would cause an immediate and appreciable adjustment in Treasury interest rates.

Conclusion

The primary focus in accounting and reporting on the federal government's financial condition should not be placed on simply distinguishing between "true-blue" liabilities and other commitments. Such distinctions are inherently arbitrary and fiscal measures based on them do not consistently reflect the real nature or changes in underlying fiscal policies. Various types of government obligations fall along a wide continuum in terms of how firm they are perceived to be. Because the government itself is infinitely lived in principle, it would be better to focus on prominently reporting sustainability and stewardship implications of *current policies*. That requires placing much greater emphasis on forward-looking fiscal measures – that include the government's current *and future* payment commitments under existing policies. Such actuarial measures would consistently reflect the future implications of existing policies and policy changes over time and for different population groups. However, they do not currently receive the prominence they deserve and, therefore, are not adequately considered in public reform debates and in the fiscal policymaking process.

For the reasons given above, I do not support the Primary View proposal. I support the Alternative View proposal to add reports on sustainability and stewardship information. I would recommend that such reporting be integrated into the current statement of net cost and balance sheet information under the heading "Future Implications of Current Policies," and that this information be prominently displayed in the Executive Summary of the United States' Financial Report. Moreover, the narrative in the Management's Discussion and Analysis should provide a consistent framework for explaining relevance and importance of such information. That explanation should articulate the unique features of government entities that compel a forward-looking perspective, specify a consistent framework for assessing policy sustainability and economic stewardship, and explain how the report's estimates should be interpreted. Supplementary notes should provide details on the assumptions and construction of sustainability and stewardship indicators.