Written Statement of Professor Howell E. Jackson[*]
FASAB Public Hearing on Social Insurance
Wednesday, May 23, 2007

Room AN37
Government Accountability Office Building
441 G Street, NW
Washington DC 20548

I am delighted to appear before the Federal Accounting Standards Advisory Board (FASAB) this afternoon and to discuss with Board members its October 23, 2006, Preliminary Views on revising federal accounting standards for social insurance. I begin my remarks with several general comments about the issues before the Board today and then turn to the specific questions on which the Board has requested comment.

General Comments

1. The Goal of Accounting Standards for the Federal Government: Federal accounting standards should be measured by the extent to which they communicate to the general public and our political leadership a) an accurate picture of the state of the nation's fiscal affairs and b) the manner in which that state is changing over time. In the context of today's hearing, the question is whether the Financial Report of the United States Government, as currently structured, satisfies these two criteria for our principal social insurance programs, most notably Social Security and Medicare. A key weakness of existing reporting standards is that they do not recognize the substantial retirement benefits that current law promises both retirees and the aging baby boomer generation. Nor do these standards capture the rate at which these promises are accumulating each year or the dramatic increase in social insurance commitments of the sort occasioned by the adoption of a Medicare prescription drug benefit in 2003. The fiscal burden that the growth of our social insurance programs imposes on future generations is many times greater than the growth of our public debt or net operating costs as currently reported in the Financial Report of the U.S. Government.[1] Accordingly, one can only applaud all of FASAB members and the Board's staff for working so hard to come up with ways to improve the federal government's financial reporting standards in this area.

2. The Special Nature of the Government and its Capacity to Change Legal Requirements.

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[1] For a detailed review of this issue for the first five years of this decade, see Howell E. Jackson, "Counting the Ways: The Structure of Federal Spending," in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY (Elizabeth Garrett, Elizabeth Graddy, & Howell E. Jackson, eds.) (forthcoming Cambridge University Press 2007) (avail. as John M. Olin Center Working Paper No. 583 at http://www.law.harvard.edu/programs/olin_center/papers/583.php).

One of the complexities of establishing accounting standards for the federal government is the unique capacity of the sovereign state to change legal requirements. With respect to social insurance programs, there is no doubt that the federal government has reserved the right to alter benefit payments for all participants and beneficiaries, even the elderly or those close to retirement who have made payroll tax contributions over their entire working lives. But the federal government's power to rescind legal obligations is much broader than that. Under the doctrine of sovereign immunity, the federal government could theoretically repudiate other obligations, including the public debt. Or Congress could simply repeal all appropriations for funding contract disputes or tort claims against the federal government or eliminate the obligations of federal instrumentalities to comply with environmental laws. In a host of ways, the federal government could take actions that could alter the nature of financial obligations currently reflected in the Financial Statements of the U.S. Government. For this reason, the legal capacity of the federal government to amend current law does not provide a particularly useful test for distinguishing bona fide liabilities of the federal government from lesser forms of financial commitment. Rather one must rely on a combination of pragmatic considerations, including the requirements of current law as well as an assessment of economic and political realities to define appropriate accounting standards for the federal government.

3. The Relevance of Open-Ended Appropriations. One legal consideration that might be useful for the Board to consider in its review of its social insurance proposal is the relevance of open-ended appropriations for funding certain of our social insurance programs.[2] One of the distinguishing features of Social Security, for example, is that Congress has adopted a permanent appropriation for the program that appropriates a combination of payroll taxes, certain income taxes, and interest on trust fund investments for the payment of Social Security benefits. Based on current projections, these revenue streams will be sufficient to support all Social Security benefits through 2041 but thereafter a substantial fraction of scheduled benefits. The existence of open-ended appropriations of this sort is, in my view, of critical importance to the Board's analysis, because it puts certain social insurance programs on automatic pilot. If Congress does nothing until 2040, all Social Security benefits will be paid as currently scheduled. While some other federal spending programs (like interest on the public debt) have similarly permanent appropriations, the vast majority of other kinds of federal programs do not. It is the combination of scheduled benefits based on past employment coupled with open-ended appropriations sufficient to fund full benefits for many decades to come that distinguishes Social Security and other social insurance programs from defense and other forms of discretionary spending.

4. The Importance of Consolidated Articulation: At the heart of the disagreement between the Primary and Alternative Views is, I think, the question of whether some measure of implicit obligations associated with social insurance programs should be combined with the principal

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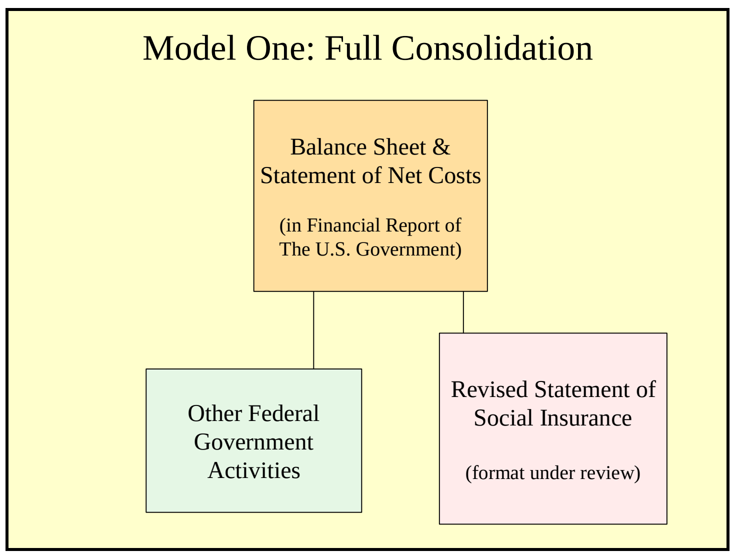
[2] For an overview of this issue, see William Fay & Michelle Rodgers,"Appropriations for Mandatory Expenditures" (May 11, 2006) (Briefing Paper No. 17) (avail. at http://www.law.harvard.edu/faculty/hjackson/MandatoryExpenditures_17.pdf).

accounting statements of the Financial Report of the U.S. Government.[3] Putting aside technicalities of how social insurance obligations should be measured, I believe that it is imperative for the federal government to provide some sort of consolidated financial statement encompassing one of several plausible ways of estimating accrued social insurance obligations.[4] In brief, the advantages of a consolidated approach are:

- Consolidation facilitates comparisons of the country's explicit debts and its implicit social insurance obligations.
- Consolidation encourages politicians to undertake entitlement reform promptly, both by emphasizing the speed with which social security obligations are now growing (a stick) and providing rewards for reducing consolidated fiscal burdens or at least the growth of consolidate fiscal burdens within two and four year election cycles (a carrot).
- Consolidation offers a more accurate view of entitlement reforms (like individual accounts of some forms of medical savings accounts) that incur current costs in exchange for a reduction in future scheduled benefits.

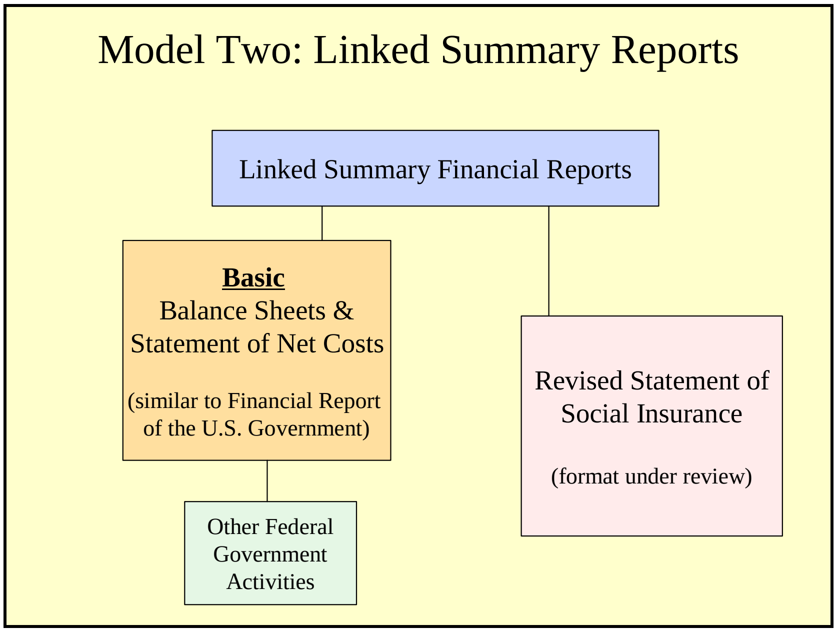
5. Two Models of Consolidation. Having stressed my view of the importance of consolidated articulation, let me now suggest that there is more than one way to achieve this goal. As illustrated in the attached figure, one approach would be full consolidation, in which the operations of social insurance programs (measured under some system of accrual accounting) would be combined with all other federal government activities. This is the approach adopted in both the Primary and the Alternative Views. An alternative approach – labeled linked summary reports in the second figure – would largely retain the current structure of the Financial Statements of the U.S. Government as a "basic" statement and provide a separate statement of social insurance, appropriately revised. What would then be added would be a relatively small number of linked summary reports into which the two basic statements would be combined. This second model represents something of a compromise position between the two positions articulated in the Board's Preliminary Views. First,



[3] The Preliminary View terms this issue "linkage" or "articulation."

[4] For an overview of my thoughts on the subject, I am attaching as Appendix A to my Statement a copy of a presentation I made to a CBO Conference on Accrual Accounting last December. For a more complete presentation of my views (and related commentary), see Howell E. Jackson, *Accounting for Social Security and Its Reform*, 41 HARV. J. LEGIS 59 (Winter 2004).

it retains a greater degree of separation between the implicit liabilities of social insurance and the other obligations of the federal government, while at the same time it provides through the summary financial reports the principal advantages of consolidated articulation outlined in the previous paragraph. To the extent that members of the Board are concerned about retaining financial statements that are roughly comparable to those of other jurisdictions, the preservation of Basic Balance Sheets and Statements of Net Costs would accomplish that goal.[5] In addition, this approach would presumably pull out of the Basic Balance Sheet & Statement of Net Costs treasury debt held by social insurance programs, thereby recognizing these obligations as liabilities of the federal government on the Basic Balance Sheets and Statement of Net Costs. (Strikingly, the FY2006 version of the Financial Report of the U.S. Government made an initial step towards a model of linked summary reports when it aggregated in table four on page 6, the net position of the U.S. government with estimates of the closed group liability of Social Security and Medicare.) Within the confines of this testimony, I will not explore exactly how such a system of linked summary reports might be framed, but, if the Board is interested in pursuing this possibility, I would be happy to discuss the matter with the staff or interested members of the Board.[6]



5. The Irrelevance of Unsustainability. Some critics of new accounting treatments for social insurance programs argue that these measures are inappropriate because many of our social insurance programs are manifestly unsustainable at current benefit and funding levels. This

5 While I have reviewed several of the comments from multilateral organizations, I personally would not be troubled if the FASAB were to chart a new course for social insurance programs. For one thing, the Board has given the issue considerably more attention and thought than comparable bodies in other jurisdictions. Moreover, I think that it is quite likely that the legal structure of entitlement spending in the United States – particularly their connection to wage history and the presence of open-ended appropriations – distinguishes our approach to social insurance programs from that of other countries.

6 Among other things, the Board would need to consider the extent to which the administrative agencies overseeing social insurance programs should be included in the Basic Balance Sheets and Statement of Net Costs, as opposed to the insurance functions of these programs.

argument is, in my view, profoundly misguided. For many years now, social insurance experts have understood the problems facing Social Security and Medicare. These experts and the reports they have produced have thus far failed to convey the seriousness of this problem to the general public or most politicians. The Board's efforts to reform federal accounting for social insurance program are important precisely because the reforms offer hope that the unsustainability of Social Security and Medicare might be more effectively conveyed to the general public and politicians. As is often the case, the purpose of recognizing a new form of liability is to highlight its significance and allow leaders to manage its growth. In short, the unsustainability of our social insurance programs is actually an argument in favor of moving towards an accounting standard that conveys both the magnitude and rate of increase in our social insurance obligations in order to help the country enact the legislative changes necessary to move these programs to a more sustainable path.[7]

Specific Responses to Questions from FASAB Preliminary Views

Question 1: Which obligating event do you believe creates a liability and expense that should be recognized? Please provide the rationale for your answer.

In my view, the Board should evaluate recognition rules against three criteria. First, the rule should produce a liability estimate of sufficient magnitude to communicate unambiguously the significance of the social insurance obligations that current law provides as compared with the federal government's other liabilities. Second, when applied over time, the rule should convey the significant rate at which our social insurance obligations are growing through the accrual of new benefits, the accretion of implicit interest on existing obligations, and the adoption of new statutory commitments. Third, the rule should be based on objective principles that are comprehensible to an informed member of the general public and that are based on the current statutory basis of our social insurance programs and consistent with economic reality.

Arguably, a number of recognition rules could satisfy these three criteria and invariably experts will differ in their preferences among the various possibilities. As explained below, I

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[7] Critics also sometimes suggest that the recognition of substantial social insurance obligations will somewhat make it more difficult to enact reforms. I also find this claim implausible. All reports on the financial condition of Social Security and Medicare are based on scheduled benefits and scheduled revenues. Estimating current liabilities based on scheduled benefits is no different. In terms of engendering strong reliance interests on the part of the general public, the Social Security Statements sent each year to most American workers and including projected individual benefit levels are much more likely to cause misunderstanding. In that context, disclaimers that the program benefits might change are generally thought to be adequate to prevent confusion on the part of the general public. See Howell E. Jackson, "Accounting for Social Security Benefits," in BEHAVIORAL PUBLIC FINANCE (2006) (Edward J. McCaffery & Joel Slemrod, eds) (previously released as John M. Olin Center Working Paper No. 520)(available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=839246). *A fortiori*, similar disclaimers for the total liabilities of social insurance programs included in the Financial Report of the U.S. Government should be sufficient to prevent unjustified reliance on schedule benefits.

believe that the approach proposed in the Primary View satisfies these standards. I also believe that one variant on the Primary View's approach might provide a modest improvement at least in my view. In addition, a recognition principle based on closed group measures would also satisfy my three criteria and might provide a plausible compromise position attractive to all members of the Board. An inferior, but not wholly implausible approach would be based on recognition when participants reach retirement age. In short, there are several different but reasonable solutions to this problem. What's important is that the Board adopt one, and then the general public and our political leadership will be able to use the rule to evaluate the scope and growth of our social insurance obligations and consider the impact of proposal for entitlement reform.

1. The Primary View Proposal: Recognition Based on a 40-Quarter Vesting Rule and Accrual of Benefits Under Statutory Formulae. The Primary View's approach clearly satisfies my three criteria. It would generate a social insurance liability number of significant magnitude and that liability number would grow over time to reflect implicit interest charges and the enactment of new statutes. Being so closely tied to statutory requirements, it also satisfies the requirement that it conform to an objective principle that can be explained to the general public. In my view, the only defect of the Primary View's approach is the accrual of full Medicare benefits at the end of the 40-quarter vesting period. While this recognition rule follows statutory provisions, one could quibble that as a matter of economic reality workers earn their Medicare benefits over their full working careers and not upon the completion of 40 quarters of covered employment. I do not regard this issue as disqualifying, and the effect of discounting does mitigate the problem somewhat by reducing the reported size of Medicare obligations to younger workers. But I do regard this aspect of the Primary View as a modest negative.

2. A Variant of the Primary View Based on 40-Quarter Vesting and Normal Cost Allocation over Projected Working Life. A variant of the Primary View would be to use a normal cost technique to spread the accrual of Medicare benefits over the working life of workers. From the Preliminary Views document, I gather the Board and its staff considered this alternative, but I do think further thought on this option might be useful. Especially as actuarial adjustments and programmatic changes in the Medicare Program are likely to occur with some frequency, a normalized cost approach will be a bit less volatile than full vesting after 40-quarters. This normal cost variant would satisfy my criteria of producing substantial liabilities and producing increased liabilities over time. It does, however, probably fare a bit less well than the Primary View's approach in being less tied to statutory standards (as it takes a cost approach rather than benefit approach) and in being more difficult to describe to the public. Moreover, the variant would pose a question of whether Social Security benefit should also be accrued on a normal cost approach, to provide consistency across programs.[8] Were the Board to go down this path, my personal preference would be to impose a normal cost standard on both programs, but I think it is a close question.

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[8] The progressive nature of the Social Security benefit formula will cost benefits to accrue quickly for younger workers and thus will generate an accrual formula that is front loaded. This effect may be somewhat undesirable on the economic reality dimension because it is more likely that a younger worker will experience changes in their benefits.

3. Recognition at the Attainment of Retirement Age. Another alternative mentioned in the Board's Preliminary Views document would be to make the attainment of retirement age – that is 62 or 65 – as the obliging event. This approach is plausible, but it has some substantial drawbacks. On the plus side, the present value of accrued social insurance commitments to retirees is substantial (though only a fraction of the key programs' total liabilities). Reporting liabilities based on this recognition would be sufficient to demonstrate the rough magnitude of our social insurance obligations and would generate substantial annual increases, many hundreds of billions of dollars. The problem with this approach is that it is not well grounded on an objective statutory criteria nor does the approach match any sense of economic reality. Our politicians routinely promise not to make any adjustments in retirement benefits for those in the 50's or even younger, and a recognition principle that fully ignored these participants would be deficient. Moreover, to the extent that a new accounting approach might offer politicians some sort of political carrot for taking bold action to reform our entitlement programs and thereby reduce the fiscal burden on future generations, a recognition principle based on retirement age would wholly miss the impact of reforms affecting younger workers.

4. Recognition Based on a Due and Payable Rule (the Alternative View). This approach fails on all three of my criteria. It will not recognize a substantial liability for our social insurance programs; it will not generate any significant annual increases in reported liabilities from year to year; it will not pick up implicit interest costs, the accrual of benefits under statutory formulae, or the effect of legislative changes; and it is wholly inconsistent with current statutory requirements and the economic reality of our country' social insurance commitments.[9]

5. An Alternative Approach Based on 40-Quarter Vesting and Closed Group Obligations. Having reviewed the Board's Preliminary Views and a number of the public comments, I would like to suggest for the Board's consideration an alternative approach to recognition that would retain the 40-quarter vesting requirement but then recognize liabilities based on the closed group obligation of all vested participants and retirees. This approach is also based on current statutory requirements, but it views the social insurance commitments as a life-long contract on which vested participants are required to make additional contributions in exchange for the statutory entitlement to certain benefits. Thus, the measure reflects the economic realities of the government's net commitments to vested participants and retirees. This approach satisfies my requirements of recognizing substantial liabilities (albeit somewhat smaller liabilities than under the Primary View) and would also generate significant annual increases in reported liabilities, both from implicit interest and legislative changes and also from the addition of new cohorts of vested workers each year. The approach also reflects a wholly defensible view of the economic reality of social insurance obligations and is analogous to the accounting treatment of certain financial instruments under GAAP. The approach is also consistent with the level of Social Security benefits reported in individual Social Security Statements, albeit reduced by the amount of future participant tax payments. In addition, this

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[9] By way of comparison, it would be implausible to delay recognition of liabilities on zero coupon bonds until payment became due and payable, which is exactly the treatment the Alternative View proposes for social insurance.

approach offers certain advantages over the alternatives discussed above:

A. Several commentators have expressed that social insurance obligations should be offset, to some degree, by future taxes. The closed group measure addresses this concern by factoring in the project future taxes of current participants (or at least of vested participants). The resulting net obligations is thus arguably a more accurate measure of the fiscal burden being passed on to future generations than alternative measures of accrued liabilities.

B. By reflecting future tax obligations of vested participants under current law, this approach would also do a better job of reflecting legislative changes that adjust future tax rates. Under other approaches described above, payroll tax changes would not reduce recognized liabilities even though such changes arguably effect the economic reality of our social insurance program commitments.

C. Another potential advantage of using a recognition principle based on the closed group measure is that it links back to concepts commonly used by both the actuarial profession and the economics community. Thus this recognition principle would connect to the two other disciplines that have been most influential in studying social insurance. For example, leading economists like Gokhale and Smetters commonly distinguish Generational Imbalance (GI), which is a closed group measure, from total Fiscal Imbalance, which combines closed group and open group infinite horizon measures. The Social Security and Medicare Trustees Reports also routinely reports closed group measures (albeit typically truncated to 75 years and including unvested participants). While I would not consider this consideration dispositive, I do think that there are some advantages of utilizing common measures.[10]

D. Another advantage of the closed group measure is that it is well-suited for decomposing closed group obligations into generational cohorts – that is, the closed group obligations of participants aged 15 to 24, those aged 25 to 34, etc. Particularly to the extent that the Board's accounting principles are used to structure pro forma analyses of entitlement reform proposals, distinguishing generational cohort may help illustrate the impact of alternative reforms.[11] In addition, readers of the Financial Statements of the U.S. Government may have different interpretations of the social insurance obligations and would find it useful if the obligations owing various cohorts were reported separately.

E. Finally, as I discussed in a recent article, relying on a closed group measure for Medicare may allow for more accurate accounting for the fact that a portion of Medicare funding has traditionally come from general revenues and not dedicated payroll taxes or

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[10] If the Board were to adopt this approach, I do think that it would be useful to require disclosure of the kinds of information about accrued statutory benefits presented in Appendix B to the Preliminary Views. I would simply recommend that the linkage into the Financial Statements be based on the closed group measure. For considerations similar to the ones outlined above, this is the approach I utilized in my article on Accounting for Social Security. *See* Jackson, *supra* note 4.

[11] I am currently working on an illustration of such a pro forma approach to Social Security reform and would be happy to share the results of my work on this project with FASAB staff.

premiums.[12]

Question 2: Do you believe that the Social Security and Medicare obligations are measurable for purposes of recording a liability after 40 quarters or equivalent of work in covered employment as proposed in the Primary Views? Please provide the rational for your answer?

Yes. One of the most attractive features of the Primary View proposal is that it relies on many fewer assumptions about future demographic changes and economic projections than do the 75 year projections typically included in other financial reports on social insurance. The liabilities are limited to accrued benefits on past work under current statutory formula. The alternative closed group measure suggested above requires more assumptions as to future work patterns for vested participants, but is still substantially easier to estimate than open group measures that include future generations.

Question 3.1 Do you believe that the Primary View proposal to add line items to the SOSI that tie the revised expense and liability amounts reported on the statement of net costs and the balance sheet, respectively, should be adopt?

Yes. As mentioned above, I think this is the most important aspect of the Primary View's proposal. I do, however, think that much of the benefit could be accomplished through linked summary reports, while retaining a distinct Basic Balance Sheet and Statement of Net Costs.

Question 3.2 Do you believe that the reasons for changes in SOI amounts during the reporting period should be reported and, if so, do you favor the reporting (1) as proposed by the Primary View, (2) as reported by the Alternative View, or (3) some other approach? Please provide the rationale for your answers.

I do think that it is critical that the SOSI include a statement of changes as one of the principle functions of financial statements for social insurance should be to communicate to the general public and politicians how our social insurance obligations are increasing over time. I believe the approach suggested by the Primary View much better accomplishes this goal, as it conforms to more generally accepted and understood models of financial reporting and produces a bottom line that can quite easily be linked to components of the Financial Report of the U.S. Government.

The approach suggested in the Alternative View strikes me as much less useful. To begin with, it does not follow the familiar structure of financial statements – for example, lacking an measure of implicit interest or newly accrued benefits. In addition, as best I can understand, the

[12] *See* Jackson, *supra* note 1 (discussing adjusted closed group obligation for Medicare and adapting methodology proposed by Auerbach, Gale & Orszag).

Alternative View proposes to use the 75-year open group liability measure as its bottom line. This measure is a highly idiosyncratic estimate, which is less easy to measure and incommensurate with other liabilities measures typically included in financial statements. Finally, the alternative view approach is largely (if not entirely) redundant with information already included in existing financial reports. These reporting conventions have already proved themselves incapable of stimulating public support for entitlement reform.

Question 4. Do you believe the [Alternative View] proposal [on fiscal sustainability] should be adopted? Please provide the rationale for your answer.

I have not formed views on this question, but I do think the issue of fiscal sustainability is broader than the question of social insurance and requires consideration of a full range of government programs. As such, I think the matter should be considered in a separate project.

Question 5. Do you believe the Board should consider recognizing deferred revenue for earmarked renveues in excess of related program costs? Please provide the rationale for your answer.

While this is an interesting suggestion, I would not favor it for two reasons.

First, in principle, this proposal is a poor solution for the problem the Preliminary Views document is intended to address. The goal here is to devise an appropriate measure of the obligation's associated with our social insurance programs. As explained above, there are a number of plausible ways to resolve this issue, but all are based on some estimate of the obligations due to beneficiaries. The deferred revenue approach is a measure of excess taxes over benefit payments – basically the accumulated balances in social insurance trust funds. This figure is no ways corresponds to the obligations owing under social insurance programs. After all, if the trust fund balances equaled total obligations our social insurance programs would be fully funded.

A second, more pragmatic problem with the deferred revenue approach is the perverse effects that would result were we to switch to this accounting systems just as the trust funds were about to draw down their reserves. Since 1983, trust fund surpluses have been used to offset deficits in other government accounts. Were the deferred revenue approach were adopted, a restatement would (I assume) create a large deferred revenue liability to reflect past excess taxes. Then, as benefits exceed taxes and the trusts funds are drawn down, the deferred revenue would be shifted into income. At least in terms of reports of annual net costs for the U.S. Government, the same revenue would then have been recognized twice – once before the restatement occurred and once afterwards. In my view, that can't be a sensible result.

Question 6. Please offer any comments that you wish to make on the Primary View provisions or the Alternative View provisions.

A final key advantage of the Primary View is that it offers a single, sensible bottom line for social insurance obligations and suggests a way in which that measure can be tied into the activities of the rest of the operations of the federal government to provide a unified an comprehensible view of our country's fiscal affairs. While I have offered a few suggestions about how this measure might be adjusted and how the linkage might be structured, my principal recommendation is that the Board not stray from these central virtues.

The chief problem with the Alternative View is that it does not offer this single sensible measure that provides linkage to the rest of government's financial affairs. Instead, by combining multiple open group and close group measures, the Alternative View risks confusing the general public and reducing the likelihood that politicians will be able to address the difficult challenge of entitlement reform before the inevitable adjustments become so painful and disruptive as to cause genuine hardship and social upheaval.

Appendix A

How Accrual Accounting Could Facilitate Entitlement Reform

Howell E. Jackson*

December 4, 2006

As a prelude to our discussions at the CBO Director's Conference this Friday, I have taken my hand at summarizing what I see are the major advantages of accrual accounting for entitlement reform. I also address several potential distractions and make one modest proposal. The figures cited in this memorandum are my own estimates of recent growth in the unfunded obligations of Social Security and Medicare. My methodology is less sophisticated than the one recently proposed by the Federal Accounting Standards Advisory Board (FASAB), but produces roughly similar results.

Five Important Advantages

1. A Scorecard for Annual Performance. Accrual accounting highlights the annual impact of new social insurance commitments on the fiscal burdens of future generations. Cash flow accounting ignores these mounting obligations. So, for example, in 2005, when the Social Security trust funds reported a cash surplus of hundreds of billions of dollars, the program incurred an accrual accounting loss of $1.5 trillion dollars, once one takes into account new statutory obligations incurred over the course of the year. Medicare in the same year incurred another $1.0 trillion in estimated losses. These annual shortfalls represent the amount by which the implicit debt of these programs for future generations increased in 2005 alone, and are massively more significant than the federal deficit in FY05 ($315 billion). See Table One.

2. A Measure of Implicit Debt of Social Insurance Programs. Accrual accounting also provides a common metric for assessing the accumulated implicit debt of social insurance programs and reveals how that implicit debt has been increasing over time. For example, between 2001 and 2005, the implicit debts of Social Security and Medicare grew by nearly fifty percent, from $17.5 trillion to $26.1 trillion. This growth in fiscal burden is much greater than the increase in public debt during the same period and represents the nation's most significant fiscal challenge. See Table One.

3. Identify Long-Term Fiscal Implications of Pending Legislation. Another important advantage of

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* James S. Reid, Jr., Professor of Law, Harvard Law School. A number of the points made here are developed in the attached chapter from "Counting the Ways: The Structure of Federal Spending," in Fiscal Challenges: An Interdisciplinary Approach to Budget Policy (Elizabeth Garrett, Elizabeth Graddy, & Howell E. Jackson, eds.) (forthcoming Cambridge University Press 2007). See also Howell E. Jackson, *Big Liability: Social Security, Medicare, and Accounting*, THE NEW REPUBLIC ONLINE (July 12, 2006) (avail. at http://www.tnr.com/docprint.mhtml?i=w060710&s=jackson071206), and Howell E. Jackson, *Accounting for Social Security and Its Reform*, 41 HARV. J. LEGIS 59 (Winter 2004) (avail. at http://www.law.harvard.edu/students/orgs/jol/vol41_1/).

Table One (Table Nine in Counting the Ways)

Alternative Presentations of Overall Fiscal Policies

(billions of dollars; Calendar Years for Social Security and Medicare)

	2001	2002	2003	2004	2005
Annual Impact of Fiscal Policies					
Total Budget Deficit or (Surplus) as Reported	-$128	$158	$378	$413	$318
Change in Other Net U.S. Operating Cost	$643	$207	$287	$203	$442
Change in Social Security Closed Group Liability	$675	$526	$810	$1,031	$1,517
Change in Medicare Adjusted Closed Group Liability	$544	$908	$2,225	$572	$1,027
Total Annual Impact	$1,734	$1,799	$3,700	$2,218	$3,304
Total Annual Impact as % of GDP	17.2%	17.3%	34.1%	19.2%	26.9%
Accumulated Burdens from Past Fiscal Policies					
Public Debt Outstanding	$3,320	$3,540	$3,913	$4,296	$4,592
Net U.S. Position Minus Public Debt Outstanding	$3,139	$3,280	$3,191	$3,414	$3,867
Closed Group Liability of Social Security	$11,216	$11,742	$12,552	$13,583	$15,100
Adjusted Closed Group Liability of Medicar	$6,298	$7,206	$9,431	$10,003	$11,030
Total Accumulated Burden	$23,973	$25,768	$29,088	$31,295	$34,589
Total Accumulated Burden as % of GDP	238.3%	248.0%	268.3%	270.9%	281.4%

accrual accounting is that it can identify the long-term fiscal implications of proposed legislation. In 2003, for example, accrual accounting would have clearly revealed that the enactment of a new prescription drug program would increase the unfunded obligations of Medicare by trillions of dollars. Accrual accounting, moreover, would have located the costs of the program in 2003 when Congress was reviewing the legislation and could have considered different kinds of benefits and alternative funding mechanisms. Current budget accounting rules focus only on short-term fiscal impacts.

4. Set Reform Targets within Politically Relevant Time Frames. Accrual accounting could also be used to set reform targets over the next few years. For example, one could easily extrapolate the growth in the government's fiscal burdens shown in Table One through the end of this decade and also project the ratio of fiscal burden to GDP in 2010, most likely well in excess of 300 percent. Experts could be invited to propose entitlement reform proposals that would reduce the projected level of fiscal burdens to some lower target, say 200 or 225 percent of GDP in 2010. The country could then debate the relative merits of various plans to achieve this goal, and politicians could then be held responsible for adopting and implementing reforms that would achieve the targeted levels within the next four years. Whereas recent debates over entitlement reform have focused on trust fund depletion dates in 2040 and beyond, accrual accounting would locate the problems of our entitlement programs in promises being made today and would point to reforms that could be implemented within one or two congressional election cycles.

5. Enhance Range and Presentation of Reform Proposals. Accrual accounting could also facilitate entitlement reform. For example, by clarifying that reforms will not reduce current obligations to vulnerable

beneficiaries such as the elderly or low-income beneficiaries, accrual accounting might help assuage some groups that have traditionally resisted entitlement reform. In addition, by distinguishing between benefits that have accrued under current statutory formulae and those that have not, accrual accounting may make it easier to adjust certain benefits. Finally, accrual accounting concepts could be employed to change the structure of appropriations for social insurance programs.

Four Potential Distractions

6. The Special Status of the Federal Government. Some critics of accrual accounting suggest that the federal government does not need to recognize its long-term obligations because the government, unlike private corporations, has the power to raise taxes in the future. The existence of the taxing power does not, however, imply that the federal government should not keep track of its financial obligations as they arise. Indeed, by failing to track the growth of federal entitlement programs, we run the risk of incurring unfunded obligations that will be difficult to resolve in the future, either through increased taxes or benefit reductions.

7. The Capacity of Congress to Amend Social Insurance Programs. A related criticism is that the federal government does not need to recognize unfunded obligations of social insurance programs because Congress could, in theory, eliminate those programs through future legislation. But the law as currently enacted does guarantee these benefits, and at least for Social Security, permanent appropriations are currently on the books that provide for payments over the next three decades. Political support for these entitlements is also extremely strong. The economic and political reality is that these social insurance programs represent substantial obligations of the federal government, and an accounting system that ignores these obligations until the date they become payable is seriously misleading.

8. Questions About Other Possible Extensions of Accrual Accounting. In public discussions of accrual accounting for social insurance, critics often raise questions about the appropriate accrual accounting treatment of other kinds of obligations – from future spending on transportation to potential liabilities associated with global warming or shifting national security concerns. While these questions pose interesting theoretical challenges, they are an unnecessary distraction in discussions about social insurance programs. There is an expert body – the Federal Accounting Standards Advisory Board – that is charged with developing accrual accounting standards for the federal government. Over the past few years, that Board has carefully considered its treatment of accrual accounting for social insurance and a majority of the Board now favors the recognition of social insurance costs when beneficiaries become entitled to receive benefits under current statutory requirements, based on years of work and payroll taxes. In time, the Board will no doubt consider other topics for potential reform, but the Board members have quite sensibly given primacy to social insurance – both because of the nature of the obligations these programs entail and their significance for the fiscal well-being of the federal government.

9. Stein’s Law: “Things That Can’t Go On Forever, Won’t.” A final response to estimates of the mounting unfunded obligations reported in Table One is to invoke Stein’s Law as if this aphorism were a license to ignore unsustainable programs. But Stein’s Law is not an excuse to ignore difficult public policy problems. It is a prediction that unsustainable programs will eventually be altered. The value of accrual accounting is that it helps politicians and the general public to appreciate the magnitude of the commitments we are currently making. Accrual accounting may also suggest politically viable reform proposals. Stein’s Law depends upon policy analysts to attack hard problems not to ignore them.

One Proposal

10. Testing the Value of Accrual Accounting. The true measure of any accounting system is whether it offers a useful tool to understand and manage financial activities. For several years, I have been arguing that accrual accounting could help reform Social Security and other entitlements. The endorsement of accrual accounting for social insurance by a majority of the FASAB Board reflects a similar view. But the proof of the pudding is still in the tasting. To this end, I propose that the Congressional Budget Office host a conference in one year's time at which leading experts would be invited to present proposals for Social Security and Medicare reform that are presented in terms of their impact on the unfunded obligations of the federal government, distinguishing as appropriate among classes of beneficiaries. CBO staff and the Office of the Chief Actuary would be invited to participate in these analyses. We will then have the opportunity to see whether these new accounting treatments actually can facilitate public debate and assist the country in reaching a consensus on the appropriate path for fiscal reform.