Executive Summary
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Time for the Federal Budget Process to Include Unfunded Entitlement Obligations

Alison Acosta Fraser

Federal spending grew to $20,705 per household in 2004—the highest level since World War II and an increase of $3,000 per household over the average spending during the 1990s. After passage of the omnibus spending bill, discretionary spending was projected to increase 8.7 percent in 2005.

This is worrisome enough, but it pales in comparison to the fiscal nightmare of the Medicare prescription drug benefit, which increased the government's unfunded obligations by $8.1 trillion over the next 75 years.

One reason for this spending growth is that the budget process does not force lawmakers to recognize the long-term costs of policy choices. The budget process should be changed to include a measure of the federal government's long-term liabilities and obligations—especially those of entitlement programs such as Medicare and Social Security. This would force Congress to acknowledge the fiscal threat that these obligations pose and begin to deal with them.

Today's taxpayers are paying the cost of entitlement obligations entered into by lawmakers many years ago. Total "mandatory" spending now constitutes 54.3 percent of total federal spending, most of which is devoted to entitlement programs, which already consume 6.8 percent of gross domestic product (GDP)—8.2 percent when net interest is included—and will require far more resources in the future.

By 2050, spending for Social Security and Medicare is expected to increase sharply to nearly 25 percent of federal spending as baby boomers begin to retire, and total federal spending could consume nearly one-third of the national economy. According to David Walker, Comptroller General of the United States, the debt from these and other programs translates to a burden of $350,000 for every worker in America. As Walker notes:

> Without reform, known demographic trends, rising health care costs, and projected growth in federal spending for Social Security, Medicare, and Medicaid will result in massive fiscal pressures that, if not effectively addressed, could cripple the economy, threaten our national security, and adversely affect the quality of life of Americans in the future.

Fixing a Dysfunctional Process

In the private sector, future obligations require regular payments or are at least disclosed on a company's annual balance sheet, but because the federal budget process excludes any measure of

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entitlement obligations and does not require that money be set aside to finance them, lawmakers continue to ignore the harsh fiscal reality that entitlements impose.

In fact, under the current budget process, Members of Congress and the President have every incentive to increase future commitments for these programs and no incentive to provide for their payment. The recent Medicare drug bill is an excellent example of this dysfunctional process. The amount budgeted for the Medicare prescription drug benefit over the next 10 years was only the tip of the iceberg. Its real cost is an $8.1 trillion increase in unfunded entitlement obligations.

The private sector, by contrast, has a regimented process that requires a business to record and report its obligations on its financial statements each year as they are incurred, even if these obligations are to be paid in the future. This gives key decision makers such as shareholders, investors, and oversight entities a more complete and accurate assessment of a business's financial condition.

Amending the federal budget process to include this principle of planning for future obligations would:

- **Impose responsible fiscal management on the budget process.** Significant policy undertakings such as the Medicare drug benefit should contain a sound financial plan and make an annual allocation toward any liability or obligation.
- **Require recognition of future liabilities and obligations in annual budget planning.** The budget is now written on a cash basis and does not plan for the huge liabilities and obligations that will come due in the future. This would provide Congress with a long-term budgetary context for proposals to fix entitlement programs within which new costs would be evaluated against future savings.
- **Force lawmakers to recognize the true cost of proposed future entitlements in the annual federal budget.** This would require Congress to begin to rein in the federal government's commitments that will come due in the future and discourage lawmakers from voting for new benefits and passing on the cost to future Congresses.

Conclusion

Congress should include a formal measure of liabilities and obligations in the budget process to present a realistic assessment of the huge fiscal challenges confronting the nation. While this action alone would not be a panacea for fiscal responsibility, entitlement reform, or the preservation of pro-growth tax policies, Congress needs a strong warning mechanism as it makes budget and policy decisions.

The ultimate success of such a change will depend on other steps taken to control the federal budget and whether Congress reacts in a wise way. One thing is clear, however: The United States cannot afford to ignore the real threat to its fiscal health. A budget process that would force Congress to take action on entitlements now is vital to protecting future generations from inheriting a debt that they cannot afford.

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Time for the Federal Budget Process to Include Unfunded Entitlement Obligations

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Federal spending has grown at an alarming rate in recent years. In just a few years, however, even this high level of spending will be dwarfed when the heavy cost of paying for the baby-boom generation's retirement entitlements begins to hit the federal budget's bottom line.

In the private sector, future obligations require regular payments or are at least disclosed on a company's annual balance sheet. However, because the federal budget process excludes any measure of entitlement obligations and does not require that money be set aside to finance them, lawmakers continue to ignore the harsh fiscal reality that entitlements impose.

In fact, under the current budget process, Members of Congress and the President have every incentive to increase future commitments for these programs and no incentive to provide for their payment. The recent Medicare drug bill is an excellent example of this dysfunctional process. The amount budgeted for the Medicare prescription drug benefit over the next 10 years was only the tip of the iceberg. Its real cost is an $8.1 trillion increase in unfunded entitlement obligations.

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Talking Points

- Entitlement programs are financed on a pay-as-you-go basis that allows lawmakers to ignore the costs of these promised commitments; many businesses have similar obligations, but FASB rules have prompted them to establish means to cover these liabilities.
- The underlying principles of financial reporting in the private sector should be applied to the federal budget process to present policymakers and the public with a clearer picture of the nation's fiscal health.
- This would force lawmakers to begin to tackle entitlement problems sooner, when they are less costly, rather than later when they will be virtually insurmountable.
- It would also give Congress an equal basis for comparing the existing costs of benefit promises with the costs and savings of plans to fix these programs. If benefits are changed by future Congresses, the fiscal impact of these changes can easily be reflected in the financial statements as is done in the private sector.

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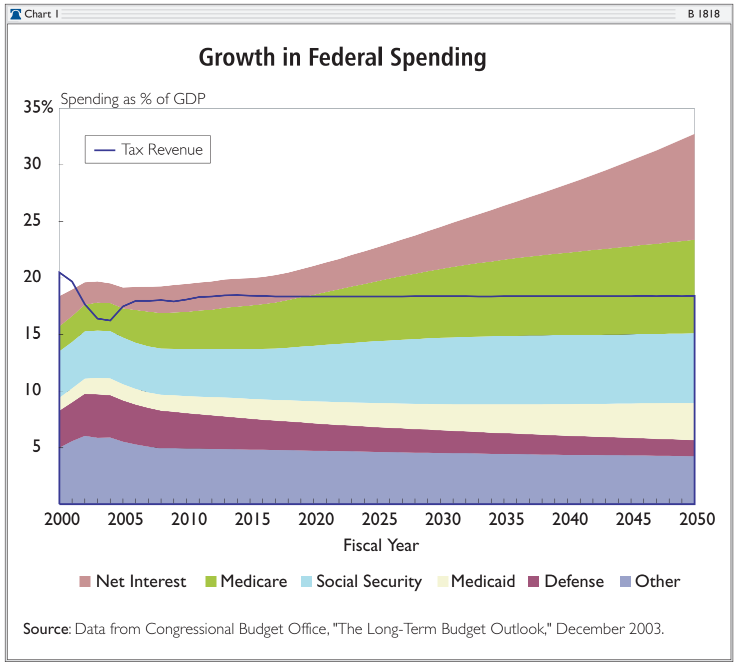


- **Force lawmakers to recognize the true cost of proposed future entitlements in the annual federal budget.** This would require Congress to begin to rein in the federal government's commitments that will come due in the future and would discourage lawmakers from voting for new benefits and passing on the cost to future Congresses.

A Budget Process Run Amok

Federal spending grew to $20,705 per household in 2004—the highest level since World War II and an increase of $3,000 per household over the average spending during the 1990s. After passage of the omnibus spending bill, discretionary spending was projected to increase 8.7 percent in 2005.[1]

This is worrisome enough, but it pales in comparison to the fiscal nightmare of the Medicare prescription drug benefit, which increased the government's unfunded obligations by $8.1 trillion over the next 75 years.[2]

Today's taxpayers are paying the cost of entitlement obligations entered into by lawmakers many years ago. Total "mandatory" spending now constitutes 54.3 percent of total federal spending.[3] Most of this spending is devoted to entitlement programs such as Medicare and Social Security, which already consume 6.8 percent of gross domestic product (GDP)—8.2 percent when net interest is included—and will require far more resources in the future.[4]

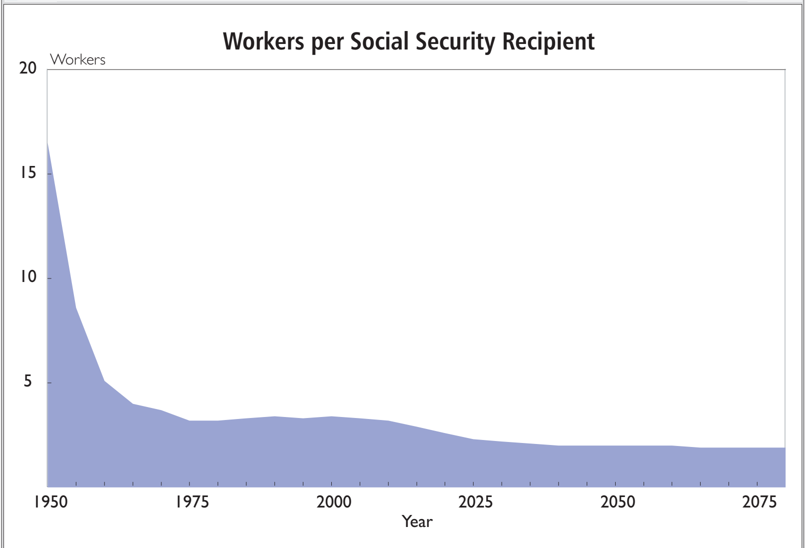
By 2050, spending for Social Security and Medicare is expected to increase sharply to nearly 25 percent of federal spending as baby boomers begin to retire, and total federal spending could consume nearly one-third of the national economy.[5] As David Walker, Comptroller General of the United States, has noted:

1. Heritage Foundation calculations from Office of Management and Budget, *Mid-Year Review: Budget of the United States, Fiscal Year 2005*, p. 23, and data provided by the U.S. Census Bureau.
2. Centers for Medicare and Medicaid Services, *2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplemental Insurance Trust Funds*, March 23, 2004, p. 108, at *www.cms.hhs.gov/publications/trusteesreport* (June 30, 2004).
3. Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2004, pp. 4, 10.
4. *Ibid.*

Without reform, known demographic trends, rising health care costs, and pro-jected growth in federal spending for Social Security, Medicare, and Medicaid will result in massive fiscal pressures that, if not effectively addressed, could cripple the economy, threaten our national se-curity, and adversely affect the quality of life of Americans in the future.[6]

Demographic changes explain much of this bleak financial future. As more and more baby boomers retire and start to receive benefits, there will be proportionally fewer workers to pay for their benefits. (See Chart 2.)

Chart 2 B 1818



Source: 2004 Annual Report of the Social Security Trustees, Table V.A.2.

With the costs of these programs set to explode, there are only a few ways to close the ensuing budget gap—and all are unpleasant. Specifically, the choices Congress faces are:

- **Cut other programs.** Entitlement spending will crowd out the rest of the budget, necessitating huge cuts irrespective of lawmakers' priorities and threatening all political agendas from taxes to education. Given entitlements' share of the budget, however, spending cuts alone are unlikely to cover the entire budget gap.
- **Increase taxes.** Payroll taxes would have to more than double to cover just the Medicare shortfall, placing a huge new burden on businesses and families. The resulting additional tax burden would be $2,227 in 2010 and would grow quickly to $12,000 in 2030.[7]
- **Accept huge deficits.** Without cuts or tax increases, lawmakers could borrow money to pay for benefits, but the scope of entitlement spending is so large that this would mean running deficits of 8 percent of the economy for the Medicare shortfall alone on a permanent basis.[8] By comparison, the deficit in 2004 was 3.6 percent.[9] Put differently, every full-time worker would have to pay $350,000 today to satisfy the nation's total debts and obligations.[10]

How Cash-Basis Budgeting Leads to Credit Card Financing

Congress has allowed these long-term obligations to grow for many decades and has exacerbated the problem by increasing benefits and enacting new ones. This is possible because the current budget process does not require lawmakers to address

5. Congressional Budget Office, "The Long-Term Budget Outlook," December 2003, and Heritage Foundation calculations.
6. U.S. Department of the Treasury, Financial Management Service, *2004 Financial Report of the United States Government*, p. 30, at *www.fms.treas.gov/fr/index.html* (December 14, 2004).
7. Daniel J. Mitchell, "Medicare: A Ticking Time Bomb for Tax Increases," Heritage Foundation *WebMemo* No. 462, March 31, 2004, at *www.heritage.org/Research/HealthCare/wm462.cfm*.
8. *Ibid.*
9. Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2004, p. 4.
10. U.S. Department of the Treasury, Financial Management Service, *2004 Financial Report of the United States Government*, p. 30.

Credit Card Spending Versus Prudent Fiscal Planning

The cases of two newlywed couples illustrate the difference between credit card spending and prudent fiscal planning.

The first couple set up their household using a credit card to buy essentials. So far, so good, since in theory they can easily pay off these purchases over several months. However, since the minimum monthly payment required is artificially low, they rationalize excessive spending on items that, while desirable, are incompatible with their monthly income and budget.

The second young couple buy only the bare necessities to start their lives together. They establish a frugal household budget that is compatible with their income, save a down payment, and obtain a mortgage to purchase a modest starter home after considering their incomes and budget.

Obviously, the first (credit card) couple has failed to consider the true extent of their obligations. To pay off their debt, they will need to make principal and interest payments that are much larger than the artificially low minimum payments upon which they have based their excessive spending. Otherwise, they will face enormous financial problems in the future. This will require them to make tough choices, prioritize their spending, and stop using this kind of scheme to finance their purchases. If they do not do so, they will face a huge outstanding debt that they cannot pay off without substantial sacrifices. In fact, if this couple had been forced to plan for the true cost of these purchases, they might never have made them.

The second (mortgage) couple, on the other hand, knowingly undertook a long-term financial commitment that required them to consider the total cost, with interest, of their purchase and an amortized payment schedule that they then could evaluate in the context of their monthly budget.

Unfortunately for future taxpayers, Congress follows a budget process more like the first couple's. The budget process contains no requirement to measure or pay off the full costs of federal liabilities and obligations; thus, lawmakers have no reason or incentive to control spending. The Medicare prescription drug benefit is just one example of this kind of fiscal mismanagement.

existing commitments in a serious way. Instead, it relies on estimates of revenues and expenses as they flow into and out of the U.S. Treasury.

The federal budget is an annual cash-basis budget in which estimates are based on when cash is expected to change hands. There is no budgetary consideration of the actual financial commitments resulting from policy changes enacted by Congress because they are paid well into the future. As a result, lawmakers have a strong incentive to be "magnanimous" and yield to special-interest pressures by expanding or adding entitlement programs because the true costs of these policy changes are not disclosed or even identified during budget deliberations.

Conversely, lawmakers have no incentive to address the extensive fiscal problems of these systems. Solutions appear costly—even unnecessary—because they are not compared with the existing liabilities and commitments already incurred under this myopic method of budgeting. The result is "credit card spending" at the federal level, but without even a minimum payment toward the balance. (See text box, "Credit Card Spending versus Prudent Fiscal Planning.")

The current budget process does require the Congressional Budget Office (CBO) to prepare fiscal estimates for new laws for 10 years into the future. This gives the appearance that lawmakers are considering long-range implications of their actions when, in fact, the full impact of most entitlement programs is not felt until well after the 10-year budget window.

For example, it was initially estimated that the Medicare prescription drug benefit would cost some

$395 billion.[11] However, to keep costs within the 10-year target of $400 billion, Congress simply decided that the full drug benefit would not become effective until 2006. With the legislation cleverly crafted in this way, the 10-year cost measure ceased to be a restraint, illustrating how easily the cash-flow basis of budgeting can be made irrelevant. Of greater concern than these accounting tricks, however, is the impact this new entitlement will have on Medicare's long-term liability.

The real cost increases from the drug benefit will come into play as large numbers of participants pour into the Medicare system when the bulk of baby boomers begin to retire—*after* the 10-year budget period. With health care costs continuing to grow faster than the economy, and with prescription drug costs growing even faster than health care costs, the net debt for this massive benefit is now estimated at $8.1 *trillion* in current dollars, and Congress has no plan to pay this "credit card" bill when it comes due.

Congress Lacks Proper Financial Tools

Policymakers were generally aware of the new Medicare drug program's long-term financial implications and, further, that Medicare and Social Security face insolvency in less than a generation. Adding a huge new benefit without a way to pay for it obviously only deepened the meltdown. However, lawmakers were not forced to confront or plan for the damage done to the fiscal health of the nation, for two reasons:

- Cash-basis budgeting does not require it, and
- Cash-basis budgeting does not provide the proper tools to make such assessments.

Just as the first newlywed couple discussed in the text box above failed to consider the financial impact of commitments they were incurring, cash-basis budgeting does not recognize the true costs of operating the federal government. Hence, lawmakers do not have the financial tools necessary to make prudent decisions. Cash-basis accounting conveniently allows lawmakers to embark on spending sprees like those of recent years while ignoring the looming deficits of Social Security, Medicare, and other programs.

Budgeting in the Private Sector

Private-sector accounting, by contrast, uses a more complete method of accounting to report its financial activities and position. One central tenet requires recognizing obligations as they occur, even if they are paid well into the future. This is known as accrual-based accounting, and its standards and guidelines are highly regimented.

Accrual accounting is widely recognized as providing information that is superior to cash-basis recordkeeping and is used in business precisely because it forces firms to recognize and plan for future obligations.[12] It is the required standard of financial reporting for the private sector and is defined by Generally Accepted Accounting Principles (GAAP). By recognizing obligations when they occur, accrual accounting provides information about the size and scope of liabilities and assets that cash accounting cannot provide. Being armed with a more complete and transparent assessment of a business's financial condition enables its management, board of directors, oversight entities, shareholders, and potential investors to make appropriate and timely decisions.

Accrual accounting and reporting imposes tight requirements on the private sector. The Financial Accounting Standards Board (FASB) is the private-sector entity designated by the Securities and Exchange Commission to establish standards for financial accounting and reporting.[13] The FASB regularly issues new standards and updates existing ones in an ongoing effort to improve the usefulness of financial information and reflect current

11. See Congressional Budget Office, "Estimate on Effect on Direct Spending and Revenues of Conference Agreement on H.R. 1," letter to House Committee on Ways and Means Chairman Bill Thomas from Douglas Holtz–Eakin, Director, CBO, November 20, 2003.

12. See Appendix 1, "How Accrual Accounting Works."

13. See Appendix 2, "Financial Accounting Standards Board."

trends in technology and the business environment. According to the board:

> Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.[14]

Table 1 B 1818

United States Government Balance Sheet as of 9/30/2004 and 9/30/2003

	2004	2003
	$ in billions	
Assets	1,397	1,405
Liabilities	9,107	8,499
Net Position (Assets minus Liabilities)	(7,710)	(7,094)

Source: *2004 Financial Report of the United States Government*, p. 64.

Private-sector practices for programs similar to Social Security and Medicare, such as retiree benefits, demonstrate the understanding that such commitments can have major long-term consequences for a business's well-being. Thus, the FASB has gone to great lengths to ensure that reporting on private-sector pension and post-retirement health care plans provides a thorough assessment of their effect on a company's financial position through regimented disclosure requirements on the balance sheet *and* on annual operating costs.

Just as any bank would look at the overall commitments and liabilities of the newlywed couples and not just their cash-flow budgets, federal policymakers cannot make prudent financial decisions without considering the full extent of the government's obligations.

How the Federal Government Ignores Its Obligations

The public sector is undergoing a transition from cash-basis to accrual-basis accounting, but the federal government is still behind the private sector in its ability to prepare financial statements that fully disclose the nation's financial position. Moreover, the annual federal budget does not currently incorporate meaningful accrual features that disclose the full cost of federal obligations.

The Department of the Treasury has published financial statements for the U.S. government for nearly 30 years. Reports were initially cash-basis, but recognizing the need for accurate and complete financial information, Congress established the Federal Accounting Standards Advisory Board (FASAB) to develop federal GAAP-based accounting standards and concepts in a manner similar to the one employed by the private sector's FASB. Congress also required annual, accrual-based financial statements, audited by the General Accounting Office (now known as the Government Accountability Office), beginning in 1997.[15]

These statements give the only complete picture of the nation's financial position by presenting critical information about liabilities, obligations, and assets that shows the implications of budget and policy decisions—information missing from cash-basis budgeting.[16] Regrettably, however, they have virtually no role in the budget process.

14. Financial Accounting Standards Board, "FASB Facts," at *www.fasb.org/facts* (June 30, 2004).

15. U.S. Department of the Treasury, Financial Management Service, *2003 Financial Report of the United States Government*, p. 27, at *www.fms.treas.gov/fr/index.html* (June 30, 2004). The CFO Act of 1990 established the FASAB; the Government Management Reform Act of 1994 required audited financial statements from most agencies and an audited consolidated financial statement.

As Table 1 shows, the federal government owes nearly $8 trillion—three times more than it spent in 2003 and four times more than it received in revenues.[17] However, this is still a grossly incomplete picture of the nation's financial health. The *real* fiscal danger for future taxpayers stems from obligations for entitlement programs that are not formally recognized on the balance sheet. These obligations are excluded because they are not "true" liabilities in a contractual sense and current FASAB accounting standards therefore do not permit them to be accrued.[18]

Actually, this standard was not established without disagreement. In the public debate and comment over proposed financial reporting for these social insurance programs, two strong preferences emerged: one that would not recognize any long-term commitment and another that would accrue the long-term obligations of social insurance programs such as Medicare and Social Security. In a compromise, the FASAB decided[19] to require that the financial statement show these obligations as additional responsibilities, recognizing that these and similar programs constitute promises on which millions of Americans rely for their long-term financial well-being.[20]

As Table 2 shows, when the "true" liabilities are combined with these additional "responsibilities," an alarmingly different picture emerges that shows the federal government to be nearly $46 trillion in the hole.[21] While no business could ever survive such an insolvent financial position, the federal government's unique role enables it to continue to operate through its sovereign ability to tax, borrow, and create money.

However, the failure to recognize and plan for program commitments has set up a perilous

Table 2 B 1818

Federal Balance Sheet and Additional Responsibilities

	Balance Sheet	2004 Additional Responsibilities ($ in billions)	Total
Assets	1,397	-	1,397
Liabilities and Net Responsibilities			
Liabilities			
Federal employee and veterans pensions benefits	(4,062)		(4,062)
Federal debt held by public	(4,329)		(4,329)
Other liabilities	(716)		(716)
Subtotal Liabilities	(9,107)		(9,107)
Social Insurance			
Medicare	-	(24,615)	(24,615)
Social Security	-	(12,552)	(12,552)
Railroad Retirement	-	(112)	(112)
Subtotal Social Insurance	-	(37,279)	(37,279)
Other responsibilities	-	(903)	(903)
Total Liabilities and Net Responsibilities	**(9,107)**	**(38,182)**	**(47,289)**
Balance	**(7,710)**	**(38,182)**	**(45,892)**

Source: *2004 Financial Report of the United States Government*, p. 11.

16. For the most recent report for fiscal year 2004, see U.S. Department of the Treasury, Financial Management Service, *2004 Financial Report of the United States Government*.
17. *Ibid.*
18. *Ibid.*, p. 6; Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives,* p. 185.
19. Debate on these accounting treatments continued, however. FASAB board members were concerned that calling critical information about these programs "supplemental" and displaying it in several different places would impede understanding of the federal financial statements and reduce their credibility. Hence, in July 2003, the FASAB modified its position on reporting and disclosing social insurance obligations. Effective for federal fiscal year 2005, in conjunction with development of audit standards, social insurance obligations will be disclosed in much the same way as other assets and liabilities in a separate Statement of Social Insurance (SOSI) in addition to the traditional balance sheet. Moreover, the SOSI will be audited, increasing the meaningfulness of the financial statements and these disclosures.
20. Federal Accounting Standards Advisory Board, "Statement of Recommended Accounting Standards Number 17," August 1999, p. 19.

dynamic in which budgetary decisions are made with blind faith that sufficient revenues can be raised to pay off these obligations at some distant point in the future. This allows policymakers to perpetuate ill-conceived spending plans—increasing the size, cost, and debts of government—and ignore the clear threat of tax increases, spending cuts, and/or huge deficits in the future.

What Happens with Entitlement Retirement Programs in the Federal Budget?

In contrast to the orderly private-sector budgeting practices, federal budgets are prepared using cash flow projections. There is no attempt to record the obligation for future payment of Social Security or Medicare, despite the fact that workers will earn an additional year's worth of these benefits even though they are in excess of the contributions made through payroll taxes. Indeed, quite the opposite is true.

When writing the budget, Congress both ignores the mounting obligations of these entitlements and actually uses the cash flow "surplus" to fund the operations of the federal government.[22] Not only does Congress completely ignore the real, annual accrual-based cost of these programs when deciding how much it will spend in any given year,[23] but it also gives the false impression of short-term fiscal health by showing such "surpluses" in the first place. Then it compounds the problem by spending these "surpluses" on other government programs and issues intergovernmental bonds that are shown as assets in the trust funds. This is made possible only by using cash-flow budgeting. If some measure of net costs were accrued instead, the budget would reflect a shortfall for these programs, presenting a quite different financial picture.

Private-sector businesses are required to make regular contributions to pension and health care funds in order to build up assets that will be used to pay future retiree benefits. FASB rules provide the basis for reporting these contributions, while Congress regulates the level of funding that a business's retirement plan must maintain. These contributions are held as cash or invested in stocks or bonds.

The Social Security and Medicare programs, however, have no assets that are set aside to pay for future benefits. The trust funds contain only IOUs made by one part of the federal government to another that it will pay promised benefits when they come due. These IOUs represent only the future tax increases or spending reductions Congress will need to pass in order to pay for them, not real assets.

Building real assets for these programs in the way that the private sector does presents extreme challenges. Holding equities, as is done in the private sector, has potentially ominous features. As the Congressional Budget Office has noted, "Government ownership of stocks could affect corporate decision making, interfere with the nation's competitive market system, and impede the efficient operation of financial markets—potentially limiting economic growth."[24]

Building a mechanism for accumulating real assets to pay for future benefits constitutes one of

21. In order to disclose obligations that are most comparable to the liabilities formally included on the balance sheet, such as those for the federal pension systems, only the net obligations for Medicare and Social Security current retirees and current workers are included in this calculation. When the net obligations for future workers are included, the net present value of the unfunded liability changes to $5.2 trillion for Social Security and $27.9 trillion for Medicare, including the $8.1 trillion liability from the Medicare drug benefit.

22. The Social Security surplus comes from the "contributions" (payroll taxes) collected from workers and their employers, which are greater than current benefit payments to retirees. Such a cash-flow analysis ignores the net present value of the unfunded liability associated with these current workers' future benefit payments.

23. For a discussion of such costs, see Appendix 1, "How Accrual Accounting Works."

24. Congressional Budget Office, "Acquiring Financial Assets to Fund Future Entitlement," *Long Range Policy Brief* No. I, June 16, 2003.

the key challenges of budget process reform. Such a change must be meaningful and not full of the empty promises that the Social Security and Medicare trust funds now contain.

Accruing the annual net cost of Social Security and Medicare would require estimating future benefits earned in the current year, the interest costs associated with paying those benefits in the future, and the earnings associated with the plan assets. It is entirely possible to calculate this cost using actuarial techniques and the benefit laws governing Social Security, current discounting assumptions, and the earnings of trust fund assets. In Medicare, there are additional challenges, but it is still possible to make such calculations. In fact, the trustees' reports for these two programs already make a number of similar calculations.[25]

Time to Amend Federal Budget Rules

Given that information exists on the obligations of major entitlement programs, some sort of measure should be included in the federal budget process for them. Both policymakers and the public need financial statements that clearly show the size and scope of the government's net commitments so that they have the tools necessary to evaluate these obligations.

Equally important, including a liability measure in the budget process would force lawmakers to recognize the true cost of proposed future entitlements in the annual federal budget and discourage them from creating new benefits and then passing on the cost to future Congresses. This idea is not a novel concept. As Federal Reserve Board Chairman Alan Greenspan has noted:

> Scoring the budget on an accrual basis—the private sector norm and, I believe, a sensible direction for federal budget accounting—would better underscore the tradeoffs we face. Under accrual accounting, benefits would be counted as they are earned by workers rather than when they are paid out by the government.[26]

Changing the Budget Process to Reflect Liabilities and Obligations

As noted, entitlement programs are financed on a pay-as-you-go basis that allows lawmakers to ignore the costs of these promised commitments. The result is huge obligations and no plan to pay for them when they come due. By contrast, many businesses have similar obligations, but FASB rules have prompted them to establish means to cover these liabilities.

The underlying principles of financial reporting in the private sector should be applied to the federal budget process to present policymakers and the public with a clearer picture of the nation's fiscal health. This should not be construed as a means of guaranteeing the same level or even format of benefits in the future. Rather, this would serve as a warning light, requiring Members of Congress to recognize and tackle the problem now and discouraging them from creating new commitments.

This would force lawmakers to begin to tackle entitlement problems sooner, when they are less costly, rather than later when they will be virtually insurmountable. It would also give Congress an equal basis for comparing the existing costs of benefit promises with the costs—and savings—of plans to fix these programs. If benefits are changed by future Congresses, the fiscal impact of these changes can easily be reflected in the financial statements as is done in the private sector.

This could be done in many different ways. The following three options are by no means an exhaustive list of what is possible. Furthermore, any such changes should be accompanied by other budget reforms such as strong, enforceable limits on spending.[27]

25. See Appendix 3, "Medicare and Social Security Trustees' Reports," and Appendix 4, "Technical Issues in Measuring Social Insurance Obligations."

26. Testimony of Chairman Alan Greenspan before the Committee on the Budget, U.S. House of Representatives, September 12, 2002, at *www.federalreserve.gov/boarddocs/testimony/2002/20020912/default.htm*.

27. See Appendix 5, "Answers to Common Concerns."

OPTION #1: Accrue, rather than disclose, net unfunded entitlement obligations in the federal financial statements.

An easy first step would be to recognize these obligations formally on the federal balance sheet. No additional work would be required since they are already shown as "promises" in the financial statements. The government should acknowledge that they are obligations today, not just some potential problem to be faced in the distant future. Moving the Statement of Social Insurance (SOSI) to the audited financial statements from the supplemental stewardship information is a good beginning.

OPTION #2: Limit growth in federal liabilities and obligations.

It is reasonable for the federal government to have liabilities. Most businesses, governments, and households have debt. Used responsibly, debt facilitates the acquisition of things that otherwise would not be affordable: A newlywed couple, for example, can use a mortgage to purchase their home, or a government entity can finance a building by issuing bonds.

The risk from any liability comes from its size and growth relative to resources available to pay it off. Recognizing liabilities and obligations in annual financial decisions is the key to managing risk. Lawmakers should be able to address national priorities as they deem appropriate, but they should not add untenably to the nation's obligations in the process.

Adopting a budget, or a limit, for liabilities and obligations as part of the budget process would allow lawmakers to make policy changes while also requiring them to live within the limits established by a liability budget. Any new spending policy would have to be evaluated in light of the liability it creates on a long-term basis. This would provide policymakers with a measure of full disclosure and transparency that they now lack when making financial decisions. To live within the "budget," liability increases would be "paid for" by cutting other obligations.

For example, the debt ceiling is a form of liability limit. Congress limits the amount of debt that can be issued by the Treasury, and Congress must either ensure that spending policies do not force debt above that limit or take the political heat for raising the limit. One possible measure for a liability budget would be to add the entitlement obligations from the financial statements or trustees' reports to the debt ceiling. A liability budget could be allowed to grow in tandem with broad economic indicators such as population and/or inflation. The key aspect of this type of limit is to evaluate spending policy changes over the long term in a liability context as opposed to the short-term cash-flow context that is now used. This would also put the costs of reform proposals on an equal basis with existing obligations, making comparisons more meaningful.

The Medicare drug benefit would most likely have failed under such a requirement, given its $8.1 trillion price tag. If lawmakers had evaluated this plan on the basis of its obligations, as opposed to an arbitrary 10-year cash-flow analysis, they would have been forced to acknowledge its astounding cost. The requirements of a liability budget would have been exceedingly difficult to meet and would have resulted in a slimmed down, affordable plan.

OPTION #3: Add a payment plan for liabilities and obligations to the annual budget.

Adding a measure for liabilities and obligations to the annual budget would force Congress to acknowledge the true cost of federal obligations and begin to reduce spending growth to balance near-term spending with long-term fiscal realities. This would work by including an "annual payment" of federal obligations, calculated under an amortization schedule, in the budget resolution.

In times of budget deficits, this annual payment would require policymakers to budget more responsibly by reserving resources that they would otherwise spend, although it would not directly reduce total liabilities and obligations. In years with a budget surplus, resources would be reserved to pay down liabilities such as federal pension liabilities or debt held by the public. This measure would work best in tandem with strong, enforceable spending limits to prevent lawmakers from merely increasing deficits.

Although this would not directly improve the viability of the Social Security or Medicare programs, it would improve the bottom-line position of the federal government and free other resources to be used for these programs. The payment plan could be calculated in a number of ways:

- **Amortize** liabilities and obligations, including entitlements, over some period of time—for example, the 75-year time frame currently used to calculate entitlement obligations—to calculate the annual payment.
- **Amortize** non-entitlement liabilities over an appropriate time frame.
- **Accrue** the annual growth in Social Security and Medicare costs "earned" by Americans each year in a manner similar to the way a business accrues the value of retirement benefits.
- **Calculate** a "minimum payment," consisting of the change in net liabilities and obligations—or bottom line—as reported in the annual federal financial statement, similar to the minimum payment required on a credit card.

Conclusion

Congress should include a formal measure of liabilities and obligations in the budget process to present a realistic assessment of the huge fiscal challenges confronting the nation. While this action alone would not be a panacea for fiscal responsibility, entitlement reform, or the preservation of pro-growth tax policies, Congress needs a strong warning mechanism as it makes budget and policy decisions.

The ultimate success of such a change will depend on other steps taken to control the federal budget and whether Congress reacts in a wise way. One thing is clear, however: The United States cannot afford to ignore the real threat to its fiscal health. A budget process that would force Congress to take action on entitlements now is vital to protecting future generations from inheriting a debt that they cannot afford.

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APPENDIX 1
HOW ACCRUAL ACCOUNTING WORKS

Employers, or businesses, are required to contribute regularly to post-retirement plans, such as pension and health plans, in order to accumulate the assets necessary to fund current and future benefit payments. However, these contributions do not necessarily reflect the actual *cost* incurred during a year. Financial Accounting Standards Board standards require specific accounting procedures in order to properly reflect a business's financial position associated with its commitment to the plan.

First, the FASB defines this cost as *net cost*, an aggregate of several components that includes:

- **Service cost**, which is the actuarial present value of benefits attributed by the pension benefit formula to employee service during the period;
- **Interest cost**, which is the increase in the plan obligation that occurs over the passage of time; and
- **Actual return on plan assets**, which is the net earnings or loss from investing plan assets.[28]

The FASB then lays out steps to report the employer's net cost and commitments to the plan. If the net cost is more than the employer contributed to the plan during the year, the employer has incurred a liability that must be recognized.

- Net cost is recorded (accrued) as an expense on the employer's income statement, and a corresponding liability is recorded on the balance sheet. This net cost accrual is a vital acknowledgement of the change—normally an increase—in the obligation that the employer has to its employees and properly reflects the fact that employees have earned more benefits during the year. Because it appears in the income statement, it is part of the company's annual budget and therefore affects payments to shareholders. Thus, accruing net cost effectively reserves resources reflected on the income statement that might go to other uses.
- The amount contributed to the plan during the year is recorded by reducing the liability and reducing cash. The net result of these entries represents the incremental change the employer has experienced in its liability. In other words, if the net cost is more than the amount contributed, the employer's liability will grow; if less, it will shrink.[29]

In private-sector accounting, net cost represents the essence of accruing an employer's obligation for employee retirement costs. Calculating this cost requires making assumptions about the timing and amount of future benefit payments in addition to defining a method for attributing the cost of benefits to each year of service.

While assumptions are never without risk, actuarial practices are reasonably able to estimate these costs. FASB standards require that costs attributed to a specific period be calculated by considering relevant factors detailed in the provisions of the retirement or health care plan. These provisions represent the implicit agreement between the employer, who will provide retirement benefits, and the employee, who will provide years of service in exchange for these benefits.

For pension plans, these provisions include benefit formulas upon which the pension benefit will be based and include such things as years of

28. Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 87," p. 4, at *www.fasb.org/st/*.

29. These reporting requirements are necessary to disclose the financial results from operating any retirement plan on the *employer's* financial statements. It is important to note that the plan's financial activities, including its assets, are reported in an entirely separate entity owned by the plan's participants.

30. Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 106," p. 14, at *www.fasb.org/st/*.

service, age, average final pay, vesting requirements, and numerous other factors. For health care plans, they include other plan factors, such as the type of future medical benefits, cost sharing with retirees and deductibles, and various other assumptions about utilization and participation.[30] Estimating retirement costs based on these factors, though not precise, is vastly superior to ignoring them.

APPENDIX 2
FINANCIAL ACCOUNTING STANDARDS BOARD

Regulation of Private-Sector Accounting

The Securities and Exchange Commission (SEC) has long been charged by Congress with overseeing the accounting methods, format, and content of financial statements filed by public companies to ensure that investors have access to meaningful and complete information that will allow them to make prudent investment decisions. The SEC traditionally has looked to the private-sector entities that set accounting standards and principles.

Since 1973, the Financial Accounting Standards Board (FASB) has been the body designated by the accounting profession to set accounting standards for the private sector. The SEC has sanctioned FASB pronouncements as the authoritative source of accounting principles standards for publicly traded companies.

Following the corporate accounting scandals epitomized by Enron, the Sarbanes–Oxley Act of 2002 revised the securities laws to establish specific criteria for an accounting standard-setting entity to qualify as the authoritative body. This act neither prevents the SEC from developing its own accounting principles nor limits the number of private-sector entities it may recognize.

The SEC determined in 2002 that the FASB satisfies the criteria in the Sarbanes–Oxley Act and designated the FASB as a private-sector standard setter. This determination was reaffirmed in 2003, and all publicly traded companies are thus required to follow the standards contained in FASB pronouncements.

FASB Standards

Defined benefit pension plans and post-retirement health care plans are the private-sector equivalents of Medicare and Social Security. FASB accounting standards for these kinds of retirement benefits are based on the concept that an employee provides service to the employer in exchange for a paycheck as well as retirement benefits such as a pension and health care. These retirement benefits are part of an employee's total compensation arrangement with the employer and, although they will be paid in the future, are nonetheless a real obligation of the employer. In other words, in addition to their regular paychecks, employees gradually earn future retirement and health benefits as they work.[31]

In keeping with the fundamental concepts of accrual accounting, FASB accounting standards require employers to recognize these obligations as they *occur*, not when they are *paid*. In this case, the obligation occurs gradually as the employee earns the retirement benefit, so the obligation is accrued over time.

FASB standards require that the expected cost of these benefits be fully accrued by the time the employee is fully eligible to receive them. In this context, accrual accounting goes well beyond the scope of cash-basis accounting by recognizing the financial impact of non-cash transactions and events as they occur. Recognizing the accrued obligation for retirement benefits gives various users of financial statements the opportunity to assess the financial impact of the employer's retirement compensation decisions.[32]

Accounting for these kinds of retirement benefits has continued to evolve for some 50 years. In the area of retirement health care plans, limited historical data and uncertain economic trends cause concern about the reliability of calculating the benefit obligation. As a result, actuarial practices in this area are still evolving. However, even given these concerns, the FASB board decided that the benefits of such information outweigh the risks

31. Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 87" and "Statement of Financial Accounting Standards No. 106."

32. Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 106."

and therefore justify the use of accrual accounting for retirement benefits in financial reporting:

> [M]easurement of the obligation and accrual of the cost based on best estimates are superior to implying, by a failure to accrue, that no obligation exists prior to the payment of benefits. The Board believes that failure to recognize an obligation prior to its payment impairs the usefulness and integrity of the employer's financial statements.[33]

33. *Ibid.*, p. 5.

APPENDIX 3
MEDICARE AND SOCIAL SECURITY TRUSTEES' REPORTS

The annual trustees' reports for Medicare and Social Security contain a wealth of information about the financial condition of these programs that could easily be used in federal budget planning. Program costs and revenues are laid out in several ways:

- Historical performance,
- Current-year results,
- Short-term (10-year) projections, and
- Long-term (over 75 years) horizon projections.

These projections provide a good basis for understanding the long-term viability of social insurance programs and the looming obligations associated with them. There are strong similarities between these projections and the actuarial forecasts used by the private sector. While there is more uncertainty and complexity involved in these calculations given the magnitude and intricacy of these programs, the strong parallels provide a model for developing options to incorporate a measure of their obligations into the budget process.

The long-term horizon provides a reasonable time frame in which unfunded obligations illustrate the financial challenges that these programs will face in the same way that a business evaluates the condition of its post-retirement plans. The long-term net unfunded obligation of each program, expressed in current dollars, shows how much more will be paid in future benefits than will be collected in taxes. In 2004, the net present value for Social Security's unfunded liability is $5.2 trillion; for Medicare, it is $28.0 trillion, including the prescription drug benefit.[34] In other words, Congress would have to invest $33.2 billion today to pay promised benefits in the future.

The differences between accrual accounting and net-present-value measures stem from their time horizons. Accrual accounting liabilities are based on obligations stemming from past transactions. Net present value includes shortfalls from both past and future transactions as projected under current rules.

34. Centers for Medicare and Medicaid Services, *2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplemental Insurance Trust Funds*, p. 182.

APPENDIX 4
TECHNICAL ISSUES IN MEASURING SOCIAL INSURANCE OBLIGATIONS

Measuring long-term obligations depends on many different assumptions about various demographic and economic changes. There are also different bases for measuring these obligations.

Accrual accounting is based on measuring obligations as they are incurred. For liabilities such as retirement programs, obligations are measured gradually as employees earn their benefits. In this regard, these liabilities are backward-looking: They indicate nothing about how much more will be owed to these employees in the future as they continue to earn more benefits.

Net present value is another way to calculate the cost of obligations. This is a forward-looking measure of the value, in current dollars, of all receipts and expenditures expected in the future. Discounting the value of future cash flows provides a consistent way to make financial comparisons. This net present value—the difference between the present value of anticipated receipts and disbursements—indicates whether or not a program is sustainable under current policies. For Social Security and Medicare, it also gives a measure of how large the imbalance for these obligations is in today's dollars.

Net-present-value calculations can be made over different time horizons, and for Social Security and Medicare, the **75-year time horizon** measure has been widely used. Although financial results over long periods are inherently uncertain, these estimates do provide a broad picture of the financial condition of these programs. However, using a 75-year projection can be somewhat misleading because these programs are expected to continue indefinitely. For example, the 75-year measure credits all payroll tax revenues from individuals alive during this period but includes only the payments that will actually be made to them during this time. It does not include the full benefits that will be due to them beyond the 75-year horizon, thus making the problem seem less serious than it is.

To address the problem of analyzing obligations over an arbitrary timeline, the Social Security trustees introduced a net-present-value measure calculated over an **infinite time horizon** in their 2003 annual report. The Medicare trustees did the same in the 2004 Medicare annual report. This measure addresses the substantial imbalance between revenues and expenditures projected beyond the 75-year period. While measuring obligations over such a time frame is riskier, it does eliminate both the bias introduced by an arbitrary time period and incorrect perceptions over proposed policy changes.

APPENDIX 5
ANSWERS TO COMMON CONCERNS

Even though it is widely acknowledged that the nation faces vast challenges from Social Security and Medicare, some concerns have been raised over how to treat these liabilities in the federal budget.

Concern #1: "Booking" unfunded obligations is misleading and will raise expectations of guaranteed levels of benefits.

Answer: Expectations over benefit levels are conflicting; for example, many younger people feel that they will never see one penny of their Social Security benefits, while expectations for health coverage under Medicare and Medicaid are growing. Recognizing the level and growth of these programs each year would highlight their huge cost and serve to temper unrealistic expectations in a more direct way than ignoring them does. It would also force reluctant policymakers to acknowledge the depth of this "fiscal imbalance" between existing resources and growing spending.

Concern #2: Private-sector accounting concepts do not translate completely into public policy promises because they are always backed by the power to tax.

Answer: While the government can always increase taxes to pay for programs, it is folly to rely blindly on that power when making policy and budgetary decisions. Long-run financial implications of such decisions should be regularly evaluated and measured in an orderly, disciplined way to determine whether the nation can afford them. Taxes would have to increase to levels never before seen in this country in order to pay for current levels of entitlement benefits, and this would have serious negative consequences on the economy. This in turn would drive down the very tax revenues that are expected to pay for government programs in the same way unreasonable price increases for a private business would cause its revenues and profits to fall, thus harming its viability.

The private sector instituted its accounting practices so that businesses would make better long-term decisions for their stockholders, employees, and retirees. This is precisely why these common-sense private-sector concepts should be applied to public policy. Practices need not be applied lock, stock, and barrel but should be adapted to fit within the public policy framework.

Concern #3: There is much uncertainty in forecasting the costs of these programs. Acting on such inexact estimates is irresponsible. Likewise, this uncertainty poses the possibility that the assumptions used in forecasting might be "gamed" for politically expedient reasons, like increasing current spending, thereby making the resulting fiscal imbalance greater.

Answer: The same could be said of forecasting obligations for private-sector post-retirement benefit plans. However, an imprecise measure is better than no measure. The private sector determined that disclosing costs based on reasonable estimates was far superior to ignoring them and presenting potentially misleading financial statements to shareholders, potential investors, and management. Likewise, avoiding such measures because of the possibility of manipulation is equally misleading.

Congress should follow the private sector's lead and stop ignoring the huge, looming entitlement obligations by bringing them into annual budget deliberations. Nonpartisan organizations such as the Congressional Budget Office or the trustees for Social Security and Medicare, or even a consortium of such entities, could make these forecasts in order to minimize concerns over manipulation. These forecasts should be open and transparent to the public so that the assumptions and methodology used could be evaluated and critiqued, which would expose any gaming.

Concern #4: These are not true liabilities because Congress can change and has changed benefits, and they therefore should not be accrued.

Answer: The FASAB defines liabilities as probable and quantifiable future outflow or other sacrifice of resources as a result of past transactions or events.[35] Certainly, Social Security and Medicare fit this definition of liabilities. Given that most participants rely on these programs for their retirement and feel strongly that they are *entitled* to them, it is reasonable to measure the cost of benefits that will be paid in the future according to current law. Future payments can be reasonably quantified, as is done in the trustees' reports.

Ironically, the FASAB definition of liabilities is currently used to exclude entitlements from true liabilities on the financial statement; however, new FASAB reporting standards will considerably improve the disclosure of these obligations. If Congress were to change benefits in the future, as businesses often do, those changes could easily be incorporated into the budget and financial statements. Ignoring these costs in the budget process just because they can be changed in the future is irresponsible.

Concern #5: The federal government does not have the ability to "hold" money and should not invest funds in stocks and bonds.

Answer: This is true. However, it is the bottom line that is important. Liabilities now shown on the balance sheet pale in comparison to the obligations that are omitted. Adding entitlement obligations to the budget process and using funds to pay off debt held by the public would reduce total net liabilities and obligations. This would free resources that could then be used for entitlements or other spending, much as paying off credit card debt frees money for a balloon payment on a mortgage.

35. U.S. Department of the Treasury, Financial Management Service, *2002 Financial Report of the United States Government*, at *www.fms.treas.gov/fr/02frusg.htm* (June 30, 2004).