

Executive Memorandum

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Federal Budget Should Include Long-Term Obligations from Entitlement Programs

Alison Acosta Fraser

The federal government spent \$2.5 trillion in 2005: about 20 percent of gross domestic product (GDP) and 33 percent more than it spent in 2001. However, the bigger concern is that Social Security, Medicare, and Medicaid spending will explode when the baby boomers retire, doubling the total federal budget to nearly 50 percent of GDP by 2050.

Congress has no plan to pay for these promises, and the budget rules actually hide the total cost from Congress and the voters. In 2005, unfunded Social Security and Medicare obligations totaled \$36 trillion. When public debt and other traditional federal liabilities are included, the total U.S. federal debt is over \$46 trillion—the equivalent of a \$375,000 home mortgage for every full-time worker in America, but without the house. According to the U.S. Comptroller General, this figure was only \$165,000 in 2000. Yet Congress, rather than confront this growth, has chosen to compound it with the Medicare drug benefit.

Hiding the Problem. The federal budget works on a pay-as-you-go system based on when money is paid out and tax revenues received. The cost of legislation is measured using arbitrary five-year and 10-year budget windows, with no analysis of the size or change in long-term obligations. Ironically, Congress requires every person taking out a mortgage to sign a disclosure indicating that he or she understands the

total cost of the loan, including interest. Yet the annual budget deliberations do not include a similar requirement, even though every taxpayer is affected. Congress and the President therefore have every incentive to expand entitlements because the true costs are paid well beyond their near-term time horizon. Conversely,

lawmakers have no incentive to fix entitlements because the budget process makes solutions appear costly in the short term and ignores long-term savings.

For example, when Congress was considering the Medicare drug benefit, its projected cost of

\$400 billion over 10 years seemed affordable, but many Members were unaware of the true \$8 trillion “present value” cost (the amount that must be invested today to meet all future promises) for this long-term commitment. By contrast, during the Social Security reform debate, up-front “transition costs” made reform appear unaffordable because long-term savings were never considered.

How Business Treats Liabilities. Unlike the

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- Unfunded Social Security and Medicare obligations total \$36 trillion, bringing the total U.S. federal debt to over \$46 trillion.
 - Congress should impose the same discipline on itself that it requires of businesses for similar liabilities.
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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

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federal government, the private sector is required by law to disclose future obligations, such as pension and retiree health care plans, and to make annual payments to satisfy them. The private sector must comply with the Generally Accepted Accounting Principles (GAAP) issued by the Financial Accounting Standards Board (FASB, the nonprofit organization that fulfills Congress's requirement for financial reporting standards in the business world). GAAP establishes a regimented process for recording and reporting financial obligations each year as they are incurred, even if the payments are deferred well into the future. These accounting standards are complemented by federal laws that govern the funding and measurement of company pension plans. Companies like General Motors have been forced to talk with stockholders and unions about the huge retirement liabilities in their financial statements and to begin making the tough decisions necessary to fulfill their obligations while preserving the company. Congress, however, while recognizing the need for the private sector to consider liabilities, has imposed no such requirements on itself.

As Washington ignores its financial obligations, state and local governments have been reporting pension liabilities in their financial statements since 1998 and are now beginning to incorporate liabilities for retiree health care into their financial statements. The Governmental Accounting Standards Board, FASB's sister organization, will start phasing in new financial reporting requirements for these programs in two years. As a result, some cities and states will face much more scrutiny from the bond market when they try to issue new debt or maintain their credit ratings. Others, such as New York City, have been forced to face the fact that they cannot pay what they have promised and must begin the difficult task of identifying solutions.

What Congress Should Do. The financial reporting principles used by the private sector and by state and local governments should be applied to the federal budget to give policymakers a clearer picture of the nation's financial health. Federal liabilities and obligations increased by \$3 trillion in 2005 alone—more than the entire federal budget. Congress should act now by:

- **Imposing responsible fiscal management on the budget process.** Annual federal financial

statements should fully disclose the unfunded obligations of entitlement programs, not just the debt and other traditional liabilities. Federal financial statements reveal \$4.6 trillion in public debt and \$6.2 trillion in additional liabilities, such as federal employee and veterans retirement costs, but leave out Social Security and Medicare obligations that bring the total debt burden to over \$46 trillion.

- **Requiring that annual budget planning recognize changes in long-term liabilities and obligations.** Proposals to add or expand entitlement programs should include a measure of the long-term budgetary implications. Proposals to fix entitlement programs should also include a long-term measure so that new costs can be evaluated against future savings. In other words, Congress should disclose the same information to taxpayers that it requires corporations to disclose to stockholders.
- **Adopting a limit for federal liabilities and obligations.** This would work like the debt limit, which lets Congress incur public and intergovernmental debt (e.g., the Social Security Trust Fund) up to a limit. A liability budget would start with public debt, add federal liabilities such as federal employee pension costs, and include total long-term Social Security and Medicare obligations rather than cash flow borrowings from the trust funds. Spending proposals would be evaluated on the basis of the long-term obligations and savings that they would create. Liability increases for new or expanded programs would be paid for by reducing obligations from other programs. This would allow lawmakers to make policy changes while requiring them to live within established limits and providing a measure of full disclosure. Unlike the debt limit, a vote to increase the liability budget should be a stand-alone vote, not buried in other legislation.

Conclusion. Congress should change the federal budget process to reflect changes in long-term liabilities and obligations as the first step in addressing \$36 trillion in unfunded entitlement obligations.

—Alison Acosta Fraser is Director of the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.