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THE CASE AGAINST INTERGENERATIONAL ACCOUNTING

The Accounting Campaign Against Social Security and Medicare

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Introduction

We are told that "future unfunded entitlements" will bankrupt the U.S. government as the baby boomers retire. Social Security and Medicare have always had enemies, closely allied to private insurance companies who would like the business, and to fund managers and others who would profit from privatization of the associated revenue streams. But recently, these enemies have been given a boost by the creation of "intergenerational accounting," an economic method that purports to calculate the debt burden our generation will leave for future generations.

In intergenerational accounting, federal government revenue and expenditure streams are compared over very long periods. "Deficit gaps" are then used to measure the financial burden of these commitments, and therefore the alleged solvency or insolvency of the government. Discounting the sum of the differences back to the present permits infinite sums to be translated into very large, but finite, numbers. The results, amounting to tens of trillions of dollars, are headline-grabbing and scary-looking.

Now the Federal Accounting Standards Advisory Board (FASAB)[1] is proposing to subject the entire federal budget to such accounting. It has issued two "exposure drafts" titled "Comprehensive

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Long-Term Projections for the U.S. Government" (ED 1) and "Accounting for Social Insurance, Revised" (ED 2), and is soliciting comments on its recommendations.

In this brief, we argue that these proposals are not only wrongheaded but also dangerous. We examine the purpose of budgeting at the federal government level and explain why government should not be subject to the same sort of accounting and financial constraints that apply to private households or business firms. We conclude that intergenerational accounting should play no role in federal government budgeting, and that arguments based on this concept do not support a case for cutting Social Security or Medicare.

General Principles of Federal Budget Accounting

Even though some principles of accounting are universal, federal budget accounting has never followed, and should not follow, the exact procedures adopted by households or business firms. There are several reasons why this is true.

First, the government's interest is the public interest. There is no correlation between this interest and a position of surplus or deficit, nor of indebtedness, in the government's books.

Second, the government is sovereign and has the power to tax and to issue money. The power to tax means that government does not need to sell products and the power to issue currency means that it can make purchases by dispensing IOUs. Indeed, taxation creates a demand for public spending in order to make available the currency required to pay the taxes.

The federal government's spending (by cutting checks or directly crediting private banks) is not constrained by revenues or borrowing. Unlike private firms, the federal government maintains no stock of cash-on-hand and no credit balance at the bank, and there is no operational limit. Moreover, spending has exceeded tax revenues, with only brief exceptions, since the founding of the United States. There is no evidence, nor any economic theory, behind the proposition that federal government spending ever needs to match tax receipts.

These factual statements are very poorly understood and imply that federal budgeting is different from private budgeting and should be considered in its proper, public context.

The difference between microeconomic and macroeconomic accounting is also pertinent. An individual household or firm has a balance sheet that consists of assets and liabilities, and spending is constrained by its income and balance sheet—by its ability to sell assets or to borrow against them. But if we take households or firms as a whole, the situation is different. The private sector's ability to spend *more* than its income depends on the willingness of *another sector* to spend less than its income. For one sector to run a deficit, another must run a surplus (saving). In principle, there is no reason why one sector cannot run perpetual deficits, so long as at least one other sector wants to run surpluses.

In the real world, we observe that the federal government tends to run persistent deficits. This is matched by a persistent tendency of the nongovernment sector, which includes the foreign sector, to save. Its "net saving" is equal (by identity) to the government's deficits, and its net accumulation of financial assets (or "net financial wealth") equals, exactly, the government's total net issue of debt—from the inception of the nation. Debt issued between private parties cancels out, but that between the government and the private sector remains, with the private sector's net financial wealth consisting of the government's net debt.

Since the United States has in recent decades run persistent current account deficits, the foreign sector has been accumulating net financial claims in dollars—thus the role of dollar-denominated securities as reserve assets. It is identically true that U.S. government deficits equal nongovernment surpluses, and U.S. government debt equals nongovernment net financial wealth.

Do the FASAB Exposure Drafts Recognize the General Principles of Federal Budget Accounting?

The reporting proposed by the FASAB exposure drafts does not appear to recognize the fundamental differences between public and private budgets. There are numerous problems in the drafts: Some of the most basic principles of accounting are neglected. Key terms are left ill defined or undefined. Projections are misused. Unjustified policy prescriptions are slipped into the drafts in the guise of accounting standards. And revenues are matched to spending for parts of the federal budget—notably, Social Security and Medicare—in ways that have no economic justification.

A Basic Principle: Liabilities and Assets

The FASAB drafts are intended to be "statements of financial condition" for "the government" and for "the nation." These two concepts—government and nation—are not interchangeable. In our understanding, a statement of "financial condition" is, in general, a balance sheet of liabilities and assets. This very basic principle is no different for the public sector, or for the nation as a whole, than it is for private sector accounting.The "nation's financial condition" is a combination of the financial condition of the government and that of its citizens. Yet the proposed "federal financial reporting" contains no mention of the assets that correspond to the liabilities that would be reported when accounting for "the nation." For example, it would treat the obligations of the Social Security system as a liability. That same Social Security benefit liability is, of course, an asset to the public, and any financial statement for "the nation" should reflect it.

The picture is further confused by treating the forecast difference between Social Security benefits and FICA tax revenues, projected over time and discounted to the present, as a "net liability" of the government—and, by implication, "the nation." In this way, intergenerational accounting purports to show an "unfunded burden" on the government, for the benefit of the future retired population. This overlooks the fact that today's workers will become, eventually, tomorrow's retirees. It is therefore hard to see why workers should object if the burden of payroll taxes does not, in present value terms, equal the value of Social Security benefits.

Here, our point is a matter of accounting: the asset of payroll tax revenues to the government is just a liability to the working population, just as the liability of future benefits is an asset to the public. In both cases, the books balance between the public and private sectors; that is, "the nation." Just as the public debt can be eternal and need never be paid off, a net debt position for Social Security and Medicare can likewise be eternal, since the government's net deficit is balanced by the nongovernment sector's net surplus. Detailing the balance sheet in full for "the nation" would be good financial-reporting practice. And, in this case, it would usefully reduce the "scare" content of claims that focus on liabilities without acknowledging the corresponding assets.

Ill-defined Terms: What Is a "Budgetary Resource"?

The exposure drafts are concerned that "budgetary resources" be sufficient to "sustain public services and meet obligations as they come due." But there is no clear definition of what "budgetary resources" means.

If what is meant is *tax revenue* (as demonstrated above), the definition is totally inappropriate. The government has run significant surpluses for only seven very brief periods in the history of the nation, each of them producing a depression or a recession. This is why we have a national debt to begin with, and the federal government has never defaulted on its obligations, including making all interest payments on its debt. If what is meant is *tax revenues and public borrowings*, this, too, is inappropriate. The standard in that case would appear to be intended to inform the public about the borrowing capacity of the government of the United States. Yet the procedures contain no information about and no guidance as to how to assess this question.

We cannot imagine that the U.S. domestic sector will reach a point such that it will refuse to accumulate dollar claims on our government in the form of currency and interest-bearing government bonds. Low long-term interest rates tell us that the markets are not troubled by this possibility, and that the U.S. government is not now facing financial concerns (not even due to the current global crisis!). The drafts presume that financing of Treasury spending could at some time become problematic but do not explain, operationally, how problems could arise—particularly given that we now have two centuries' experience of accumulated tax shortfalls with, predictably, no suggestion of government insolvency.[2]

On the assumption that what is termed "budgetary resources" by the FASAB includes public debt issue, the proposed procedure betrays a false supposition that there is some economic limit to the nominal value of the bonds that can be issued by the U.S. Treasury. The reality is, no such limit exists. Nor does the government have to issue securities, operationally, in order to spend. The function of Treasury sales is to substitute bonds for reserves; Treasury spending cannot be constrained by nongovernment unwillingness to lend. The exposure drafts appear to wish to resolve problems that do not, and perhaps cannot, exist. At the same time, they ignore some real problems, to which we now turn.

Misuse of Economic Projections and Assumptions

The exposure drafts provide no guidance on the choice of economic assumptions to be used in making projections. Past performance is characteristically ignored and future projections are systematically pessimistic with respect to past performance. There have been repeated, systematic revisions of the financial projections for Social Security that are always in the direction of rolling back the projected dates when benefits exceed payroll taxes and the so-called OASDI Trust Fund is exhausted. FASAB guidance on this point should specifically address two issues: the proper relationship of economic projections to generally accepted accounting principles, and the appropriate ways in which to factor into projections the effect of policy changes on economic performance.

One cannot assess the "impact on the country of the government's operations and investments" without assessing the *economic effects* of such operations and investments. The procedures in the exposure drafts explicitly propose to ignore those effects, and serve only to confuse public debate and to obstruct, rather than advance, public purpose.

The actions of the government sector taken as a whole cannot be assessed in isolation from their consequences for the nongovernment sector and the performance of the economy. For example, the government sector might want to run a surplus, but it cannot achieve this unless the domestic nongovernment sector and/or the foreign sector runs a deficit.

The consequence of excess government spending is a possible devaluation of the dollar and a possible decline of the country's real terms of trade. But this possibility is also ruled out by the FASAB's proposed assumption of unchanged economic conditions, which fails to promote understanding of the nation's financial condition. Unlike the nonissues discussed above, this is a real concern.

Note also that, in recent months, even as the U.S. budget deficit has grown and as the possibility of a large fiscal package implies much larger future deficits, interest rates have fallen and the dollar has appreciated. Clearly, the low short-term interest rates are due to a Federal Reserve decision to lower them, and nothing else. The rise in the dollar, despite sharply lower interest rates, is due to the fact that the rest of the world has run to the world's safest asset, U.S. Treasuries—driving down long-term U.S. interest rates. The two exposure drafts do not consider these matters, nor do they provide any guidance regarding how to consider the U.S dollar's role as an international reserve asset.

Backdoor Policymaking: What Is the "Fiscal Gap," and What Does "Fiscal Sustainability" Mean?

In the exposure drafts, the FASAB introduces the concept of a "fiscal gap" and states as a policy norm that it would be desirable to "maintain public debt at or below a target percentage of gross domestic product." To set a target for the debt-to-GDP ratio, which implies that public debt can grow alongside GDP, recognizes that public deficits, rather than balanced budgets, are normal.[3] Yet there is no justification in law or theory to legislate an accounting standard with a debt-to-GDP ratio as a target for economic policy. Further, the exposure drafts fail to distinguish between total public debt, public debt held by the public, guaranteed agency debt, and implicit liabilities in the form of guarantees. As such, the measure of the so-called "fiscal gap" is essentially meaningless.

The concept of "receipts" in the calculation of the fiscal gap should also be clarified. Putting issues of bonds and also reserves and currency into the total for receipts, of course, would make clear that the *concept* of fiscal gap, as well as its measure, is meaningless, since tax receipts plus "receipts from borrowing" (broadly defined as new issues of currency, reserves, and bonds) are by accounting identity equal to total spending. But, the exact ratio between federal government spending and any one of the items on the other side of that equation is largely determined by spending and portfolio decisions of the nongovernment sectors.[4]

The exposure drafts define "fiscal sustainability" as a condition of policy under certain arbitrary economic assumptions such that "public debt does not rise continuously as a share of GDP." The difficulty here is that the assumption of a stable inflation rate under hypothetical conditions of excessive fiscal expansion is untenable (e.g., the *inflation tax* is an automatic stabilizer and vitiates the problem of "fiscal sustainability" as defined in ED 1).

Dividing Up the Budget in Arbitrary Ways

The FASAB's basic financial statement would show Medicare and Social Security as entities separate from all other government programs. This reflects a substantial misunderstanding of the purposes of federal budgeting. The purpose of a program budget is to discipline the program. However, there is little public or government interest in reporting long-range projections of the "fiscal balance" of particular portions of the budget, and there is little public purpose and no economic interest served by reporting the after-the-fact fiscal balance of particular portions of the federal budget (e.g., the success of a transportation project should not be measured by the ex post balance between total spending and total tax receipts related to transportation over the course of an arbitrarily chosen period).

By extension, the long-term success of Social Security should not depend on, nor be assessed by, the government's matching spending on that program against some portion of federal tax revenue. Whether we are setting fuel taxes or payroll taxes, the tax rate should be administered in such a manner that it achieves the public interest, not with a view to matching spending in any particular federal program.

The "basic financial statement" proposed in the exposure drafts defies understanding. We naturally oppose the inclusion of "scare" charts such as those included in the drafts.

Arbitrary, Capricious, and Misleading Time Horizons

The FASAB's proposed time horizons are so long that they will involve making assumptions that are, in the nature of things, impossible. An example is the assumption of current Medicare forecasts that health care costs will continue to rise indefinitely and more rapidly than nominal GDP, so that the share of health care in GDP rises without limit.

For Social Security and other permanent programs, what matters for long-range projections of future real burdens are demographics, technology, and economic growth.[5] By contrast, financing is virtually irrelevant. Indeed, all plausible projections of demographic trends show only gradual and moderately rising real burdens on those of normal working age in terms of number of dependents (aged plus young) per worker. Moreover, in economic terms a rise in this burden is substantially less worrisome when considered in the context of a falling stock market and its effect on the wealthier elderly.

The current crisis drives home the necessity of having the Social Security leg of the retirement stool—a leg that promises to deliver benefits no matter how poorly the economy performs. The other legs of the retirement stool (private pensions and individual savings) cannot guarantee that the real needs of elders will be met. Indeed, it is precisely the ability of Social Security to increase the share of output going to beneficiaries that will be required as the nation ages. Finally, if all of our projections turn out to be incorrect, Social Security benefits can be changed as a matter of public policy rather than as a result of the performance of financial markets.

The growing "real burden" of providing for an aging population is captured by the projection that, while we have three workers today "supporting" each beneficiary, the number will fall to only two workers sometime around midcentury. If worse comes to the worst, so that we have fewer workers per beneficiary and no increase in productivity in 2050, then taxes will have to be raised or benefits cut—or some combination of the two—to apportion the pain of lower living standards. But it is best left to voters in 2050 to make such a decision.

In short, it serves no useful purpose to project financial shortfalls for Social Security and Medicare into a far distant future, and no purpose whatever to revise those programs today on the basis of such projections. First, Social Security spending need not be politically constrained by tax receipts from any particular source. Second, so far as fiscal impacts on the economy go, what matters is the overall fiscal stance of the government, not the stance attributed to one part of the budget. Third, the most important factors determining future real burdens are demographics, technology, and economic growth. Uncertainties about their trends increase exponentially as the length of the projection period increases. Fourth, if we do face problems in the distant future due to aging of the population, they will not be financial problems. The federal government will always be able to make all benefit payments as they come due; the only question is whether the payments correspond to an appropriate share of total product at the time.

Conclusion: The Folly of Intergenerational Accounting

Many of the FASAB's proposed procedures appear to rely on the notion of intergenerational accounting. This exercise attempts to assess financial burdens through time, especially with a view to claiming that financial decisions taken in one generation can impose burdens on another. But this argument is specious. It refuses to count as real assets the infrastructure and other national assets that the current generation will leave for future generations. And it does not understand that federal government debt never needs to be retired, any more than private sector net saving needs to be eliminated.

In real terms, there obviously are no intergenerational transfers, except for the knowledge, physical assets, and larger environment that the present leaves to the future. The real goods produced in 2050 will be distributed to those alive in 2050, regardless of the public debt in existence at that time. Then, just as now, the deficits of the state will fund the nominal savings of the nongovernment sectors. In short, intergenerational accounting is a deeply flawed, experimental, and unsound concept. It should not be included in any government accounting.

In general, the FASAB's exposure drafts have not made a persuasive argument about basic matters of accounting. The Board should work on getting these matters straight and stay very far away from the additional challenges of determining public policy.

Federal spending can, and almost always does, exceed tax receipts. And that is almost always a good thing because it provides the wherewithal to allow the nongovernment sector to save in the form of highly desired, safe, dollar-denominated financial assets. Further, there is an important counterbalancing asset to the government's liability: the accumulated financial, physical, and human capital of our nation that could be mobilized to serve the public purpose.

The notion that there is some "unfunded liability" amounting to tens of trillions of dollars is hogwash. There cannot be any "underfunding." The U.S. government always has the operational ability to make all payments as they come due.

We fear the FASAB has been led astray by intergenerational warriors, who must not be allowed to take control of our federal budgetary process. The danger is, of course, very real, for the application of "intergenerational accounting" to Social Security and Medicare can only mean the gutting of these vital programs, which are the mainstays of life security for America's elderly—and for the working population that hopes to be elderly some day.

Notes

1. According to its website, fasab.gov: "The mission of the FASAB is to promulgate federal accounting standards after considering the financial and budgetary information needs of citizens, congressional oversight groups, executive agencies, and the needs of other users of federal financial information. Accounting and financial reporting standards are essential for public accountability and for an efficient and effective functioning of our democratic system of government. Thus, federal accounting standards and financial reporting play a major role in fulfilling the government's duty to be publicly accountable and can be used to assess (1) the government's accountability and its efficiency and effectiveness, and (2) the economic, political, and social consequences of the allocation and various uses of federal resources."
2. Looking overseas, it might be interesting, for example, to know whether there is a point at which, despite continuing surpluses in China's trade with the United States, the People's Bank of China might become unwilling to add to its stock of U.S. Treasury bonds (and whether, if that were to happen, it would matter). There is no mention, let alone analysis, of the policies of the People's Bank in these documents. Indeed, we note that all indications of the intention of the People's Bank are to the contrary: China continues to pursue policy that will allow it to accumulate dollar reserves and bonds.
3. Thus, if the public debt is 50 percent of a $16 trillion GDP and the nominal growth rate is 5 percent, it would be normal under the proposed guideline for deficits to equal $400 billion per year. Recognizing this would certainly represent progress when compared to a desire to balance the budget. It is obvious, though, that this implicit recommendation conflicts with the main thrust of the exposure drafts.
4. In fact, it is the Federal Reserve's job to accommodate these decisions as part of interest rate targeting, through what it calls "offsetting operating factors."
5. In an open economy, imports of goods and services are also relevant for the support of retirees. Even if the ratio of retirees to workers is rising in the United States, the real burden of providing for Social Security beneficiaries need not rise if foreigners want to sell their output to the United States in exchange for reserves.

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