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COMMITTEE ON FINANCE

WASHINGTON, DC 20510–6200

April 20, 2007

Wendy M. Comes, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW, Suite 6814
Washington, DC 20548

Dear Ms. Comes:

This letter responds to the request for public comments on the proposed Statement of Federal Financial Accounting Standards, "Accounting for Social Insurance, Revised."

The unique characteristics of the two largest social insurance programs, Social Security and Medicare, preclude the recognition of a liability beyond the amount due and payable.

These unique characteristics include the fact that current law expressly reserves the right to alter, amend, or repeal any provision of these programs.[1] While such action may be politically untenable, the U.S. Supreme Court has upheld the right to reduce or eliminate benefits, even for those already receiving them.[2] Moreover, the legal authority to pay benefits is limited by the balance of government securities held by the respective trust funds.[3] Should these balances become exhausted, benefits could no longer be paid in full or on time.[4]

The current due and payable standard is consistent with the definition and characteristics of a liability contained in the Financial Accounting Standards Board's Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, December 1985—

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

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[1] 42 U.S.C. § 1304
[2] Flemming v. Nestor, 363 U.S. 603 (1960) and Richardson v. Belcher, 404 U.S. 78 (1971)
[3] 42 U.S.C. § 401(h) and § 1395(h)
[4] 31 U.S.C. § 1341

Application of the current standard under current law supports the following conclusion. The government has an obligation ("present duty") to pay benefits to qualified individuals ("other entities") following a determination of eligibility ("specified event [that] has already happened"). Once all of the eligibility conditions have been met, individuals are entitled to receive benefits ("no discretion to avoid") as long as they remain qualified.[5]

Benefits beyond the current period of entitlement depend on continuing eligibility and are subject to statutory change. Thus, only those benefits that are due and payable – essentially one month of Social Security benefits and any outstanding payments to Medicare providers for services previously rendered – are fully consistent with all of the characteristics of a liability as enumerated above.

Rather than accept the fact that social insurance programs do not fit the current definition of a liability, those who hold the Primary View appear to believe the preferred course of action is to change the definition. Indeed, FASAB is currently engaged in a related project that could result in an entirely new and expanded definition of a liability sufficient to encompass social insurance programs.[6] While the authority to take such action is clearly within the discretion of the Board, such action would lack credibility. It is disingenuous to claim that a liability exists on the basis of a definition that was changed solely for the purpose of making such claim.[7]

Moreover, those who hold the Primary View insist "the existence of an obligation is determined by the provisions of current law…future events – including potential changes in law – do not trigger or prevent expense and liability recognition."[8] But, they conveniently ignore the provision of current law that precludes the payment of benefits beyond the balance of government securities held by the respective trust funds.[9] Thus, even if one accepts the proposed definition of a liability, the proposed measurement of the liability is flawed because it does not reflect current law.

Under current law, future Social Security and Medicare Part A benefit payments cannot exceed the sum of payroll taxes, income taxes on Social Security benefits, voluntary Part A premiums, and interest credited to the respective trust funds.

Providing the public with useful information about our nation's financial condition is an important goal. However, government activities do not readily conform to private sector accounting concepts. Instead of redefining these concepts in order to force social

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[5] Goldberg v. Kelly, 397 U.S. 254 (1970) "Welfare benefits are a matter of statutory entitlement for persons qualified to receive them and procedural due process is applicable to their termination."
[6] Federal Accounting Standards Advisory Board, Exposure Draft: Definition and Recognition of Elements of Accrual-Basis Financial Statements, June 7, 2006
[7] Federal Accounting Standards Advisory Board, Accounting for Social Insurance, Revised, Preliminary Views, October 26, 2003, Appendix A, pp. 56-57.
[8] Ibid.
[9] See Footnotes 3 and 4 above.

insurance programs into existing balance sheet categories and misleading the public, FASAB should focus its efforts on revising and expanding the statement of social insurance.

The current statement of social insurance shows the present value of Social Security and Medicare cash-flows that are projected to occur over the next 75-years under the Trustees' intermediate assumptions.[10] These numbers are deficient in several respects.

Summarized numbers, in discounted dollars over a 75-year period, do not accurately convey the cost of future benefits in a readily understandable manner. Historically, social insurance programs have been financed through payroll taxes on a pay-as-you-go basis. Thus, the projected cost of future benefits should be shown as a percentage of taxable earnings.[11] These figures would clearly illustrate the rising cost of benefits relative to the resources available to pay for them.

Second, social insurance programs have never been fully funded, but some of them could be. Thus, the projected cost of future benefits should also be shown on a "forward funded" basis. This measure would reflect a blend between the infinite horizon and sustainable solvency.

As presented in the 2006 annual trustees report, the present value of Social Security benefits minus Social Security taxes over the infinite horizon is 4.1 percent of taxable payroll.[12] In other words, to forward fund the projected cost of future benefits, current and future workers would need to pay an additional 4.1 percent of taxable wages each and every year, forever. Admittedly, some people find the concept of eternity unsettling.

The concept of sustainable solvency, developed by the Social Security actuaries in the mid-1990s to evaluate reform proposals, seeks to address the problem that 75-year solvency is unsustainable because the 75-year projection period moves forward each year dropping a surplus year and adding a deficit year. Thus, the goal of sustainable solvency is to achieve a trust fund ratio that is level or rising in the 75th year.[13]

The concept of forward funding proposed here differs from the infinite horizon because it does not include changes in economic and demographic assumptions beyond the 75th year. It differs from sustainable solvency because it does not include the beginning trust

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[10] These projections are based on scheduled benefits and do not reflect the impact of trust fund exhaustion on the legal authority to pay future benefits.

[11] Taxable earnings are the best metric for comparison to current law. A broader measure, such as GDP, should be used when analyzing proposals that change the taxable wage base. However, GDP is not the ideal metric because it includes many items that are non-taxable, such as non-profit institutions and the imputed rent on owner-occupied housing. Other metrics should be considered, such as total labor compensation.

[12] The 2006 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, May 1, 2006, page 60, Table IV.B7. The 4.1 percent figure excludes the beginning trust fund balance.

[13] The trust fund ratio is defined as the trust fund assets at the beginning of a year divided by the cost of benefits in that year.

fund balance, but it does specify an ending investment fund balance. These differences are designed to address the concern that the far distance future is unknowable and that the trust fund is not a real asset from a unified budget perspective.[14]

The concept of forward funding would reflect the sum of the current 75-year present value projection plus the present value of the 75th year divided by the assumed ultimate interest rate. The results of this calculation, as shown in the table below, would indicate that current and future workers would need to contribute an additional 2.95 percent of taxable wages each year in order to build and maintain an investment fund that would generate sufficient earnings to cover the remaining cash-flow shortfall in the 75th year.[15]

Illustrative Calculation for Forward Funding Social Security

	PV in Trillions of Dollars	Income	Cost	Taxable Payroll
1	2006-2080	$31.9	$38.3	$243.2
2	2080	$0.2	$0.3	$1.8
3	Ultimate Interest Rate	5.8%	5.8%	5.8%
4	Line 2 divided by Line 3	$4.1	$5.8	$30.9
5	Forward Funding (1+4)	$36.0	$44.1	$274.1

Unlike Social Security, which is relatively "well behaved" from an actuarial perspective, Medicare is exceedingly problematic. Historically, per capita Medicare costs have risen significantly faster than per capita Gross Domestic Product (GDP). If this trend were to continue, Medicare would eventually exceed GDP. To avoid showing this result, the Medicare trustees arbitrarily assume Medicare growth will subside. There is no basis for this assumption other than Herb Stein's axiom, "If something can't go on forever, it will probably stop." The future cost of Medicare is unknown and therefore not measurable, which is yet another reason to reject the Primary View.[16]

However, for the purpose of a revised and expanded social insurance statement, it would be highly instructive to present two estimates. The first estimate would assume historical trends. The second would assume per capita Medicare growth equal to per capita GDP growth. These estimates would isolate the effects of excess medical cost growth from other economic and demographic assumptions. These estimates should be presented in the same manner as the Social Security estimates described above.

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[14] The beginning trust fund balance could be viewed as an asset of the Social Security program in the narrow legal sense that it provides the authority to pay benefits. But, it could also be viewed as a liability of the government in the broader economic sense that it is a claim on future resource. These two views cancel each other out in a unified federal budget.

[15] These calculations are based on Tables VI.F6 and VI.F9 of the 2006 Social Security trustees report. ($44.1 - $36.0) / $274.1 = 2.95%

[16] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, December 1985, paragraph 47 "Particular items that qualify as assets or liabilities under the definitions may need to be excluded from formal incorporation in financial statements for reasons relating to measurement, uncertainty, or unreliability,..." [emphasis added]

The primary goal of a revised and expanded social insurance statement should be to identify the potential cost of future benefits, as well as the potential resources available to fund these costs. These costs and resources can only be accurately assessed within the context of the entire federal budget. FASAB has sensibly chosen to appoint a Fiscal Sustainability Task Force to consider these issues. Any changes to the social insurance statement should await the results of this task force. In the meantime, the Board should reject any effort to redefine social insurance programs as a liability beyond the amount due and payable.

Sincerely,

Chuck Grassley

Charles E. Grassley
Ranking Member