May 2, 2007

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

Dear Ms. Comes:

Thank you for the opportunity to comment on the Federal Accounting Standards Advisory Board's (FASAB) Preliminary Views, Accounting for Social Insurance, Revised. The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(c)(3). It is privately supported and receives no funds from any government at any level, nor does it perform any government or other contract work. The views I express in these comments are my own and should not be construed as representing any official position of The Heritage Foundation.

FASAB has taken an important step to examine financial reporting for social insurance to ensure that lawmakers, citizens, and markets have adequate, clear, and transparent information about the nation's financial position. Though there is disagreement on how best to make improvements among board members, it is important that those supporting both views agree that better information is necessary to improve understanding about the nation's finances.

Medicare and Social Security are the largest of the social insurance programs and are widely recognized as being both unsustainable and a threat to the nation's prosperity. Spending on these two programs alone is projected to mushroom from 7.7 percent of GDP in 2007 to 12.7 percent in 2030 and 15.2 percent in 2050. This does not compare well with the historical tax level of 18.3 percent of GDP. It is imperative that the nation better understand the full extent of the costs of these programs over the long term. Clear, transparent, and consistent disclosure of the nation's current financial position and long-term condition are essential to achieving that understanding. Experiences of states and other nations show that better disclosure has pushed lawmakers to come to terms with policies and practices that are politically attractive in the short term but unaffordable over the long-term. This should be one key goal when accounting for social insurance.

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The biggest difference between the two preliminary views is when, exactly, a liability should be recognized for social insurance. Both views propose further disclosure about the sustainability of these programs, though they do so in different ways. The Primary View would make fundamental changes to reporting on social insurance programs, most notably by accruing future benefits as liabilities once workers complete 40 quarters of qualified work. The Alternative View would continue the current practice of recording benefits when they are due and payable, maintain the "Statement of Social Insurance" (SOSI), and expand disclosure by adding a "Statement of Change in Social Insurance." Overall, the Alternative View would present a more representative position of the nation's social insurance programs.

Recording a Liability for Benefits

As the Primary View notes, there are some similarities between private-sector retirement benefits and social insurance programs which, in their view, the quasi-exchange features of work, payroll taxes, and benefits in these programs constitute a semi-exchange that results in a liability that will be paid in the future. The Primary View cites the Financial Accounting Standards Board's (FASB) Statements of Financial Accounting Standards (SFAS) as a basis for its consideration of liabilities for Medicare and Unemployment Insurance and the proposed accounting treatment. However, despite some similarities, there are strong and important differences.

Social insurance programs are fundamentally different from the post-retirement employee benefits for which FASB and the Governmental Accounting Standards Board (GASB) set accounting standards. As noted in the Alternative View, Social Security and Medicare are not employee benefits, nor are they the result of a voluntary transaction in the same way post-retirement employee benefits are—a fact that should give serious pause when considering whether future costs constitute a traditional liability for financial statement purposes.

Nor are social insurance benefits immutable. Congress can change benefits at any time, and, as affirmed by the 1960 Supreme Court decision in *Flemming v. Nestor*, these benefits are not contractual or "locked-in." This is very different from pension benefits, whether private- or public-sector, which can only be changed prospectively unless done through bankruptcy. As noted by the Alternative View, according to GASB's exposure draft "Elements of Financial Statements," a liability is "a duty or responsibility to sacrifice resources or future resources that the entity has little or no discretion to avoid." Under this definition, classifying future social insurance benefits as liabilities would be misleading.

Better disclosure and transparency of social insurance in financial statements is necessary to prompt serious debate and discussion about reforming these programs. In that debate, language is important, and it is critical not to miscast the nature of these benefits as something that cannot be changed in the future. In the minds of many, simply calling future benefits "liabilities" conveys that there is nothing that can be done to restructure them to make them more affordable. Since perception is reality, this central feature of the Primary View would be a harmful step backwards in disclosure.

Recording an Asset for Payroll Taxes

The Primary View bases its proposal on the view of a quasi-exchange feature of social insurance between a worker and the government, with the worker completing a required 40 quarters of service to qualify and note the relationship to wages, social insurance benefits, and payroll taxes paid. In that regard, there are some similarities between private- and public-sector post-retirement employee benefits, as noted above, and the Primary View's treatment of social insurance future cash outflows drawn from FASB and GASB. Those models also draw upon a benefit plan's net funding position, which takes the cost of paying current and future benefits into account, as well as assets such as employee and employer contributions and investment earnings.

However, the Primary View's proposal would not book an asset for future payroll taxes. This would present a misleading picture of the current position and long-term sustainability of social insurance programs. This is especially true since payroll taxes are dedicated to financing Social Security and Medicare. Recording just benefit liabilities without reference to dedicated revenue sources presents an incomplete and inaccurate view of those programs. Further, this would be unlike any other discussion of the long-term condition of these programs and would cause substantial confusion.

Social Insurance Statements

The Alternative View's treatment would keep the SOSI, which presents the 75-year present value of future benefits and revenues, as an audited financial statement. It would add a "Statement of Change in Social Insurance." This new statement would be an important addition to the financial statements and would facilitate debate about the long-term viability of these programs. It could also provide a model for analyzing the effects of reform proposals. FASAB should also consider presenting these changes over the infinite time horizon, in addition to the 75-year time horizon, to ensure that the full effects of revenue and benefit changes are disclosed.

The Alternative View would also add a "Statement of Fiscal Sustainability" that would analyze current and projected levels of federal spending, revenues, and debt as a share of GDP over the 75-year and infinite time horizon. Social insurance programs would be a key feature of this statement. This would also entail projecting spending and taxes for the rest of the federal budget. The Alternative View rightly notes that there is a limit on what the nation can tax in order to provide government services and service debt and that too much of both will harm economic growth. Social Security and Medicare are governed by perpetual laws that do not sunset or expire, and they do not require annual appropriations decisions by Congress. Thus, the existing extensive analyses of long-term revenues and costs for these programs have the necessary rigor and integrity for financial statements.

Other federal programs, from defense and education to highways and welfare, require authorization on a regular basis. Many programs are further reliant on annual appropriations decisions made by Congress. Since the fiscal future of other federal programs is highly speculative, such projections would lack the rigor and integrity of Social Security and Medicare and may not be ideally suited for the financial statement. These measures could also serve to lock in expectations over future levels of revenues. FASAB should consider using a historical benchmark for taxes when measuring fiscal sustainability.

Liabilities and Social Insurance Responsibilities

Whatever standard FASAB adopts, it should provide a clear basis for evaluating the position of these programs in the long term and short term together. The Executive Summary of the 2006 Financial Report presents a clear, transparent picture of combined Net Position (assets net of liabilities) along with social insurance responsibilities in one table. FASAB should ensure that this presentation is consistently featured in the financial report. FASAB may want to consider a different term to describe long-term costs over revenues.

Liability for Deferred Revenues

FASAB should also give careful consideration to recording a liability for excess earmarked revenue, as discussed in the Alternative View. These excess revenues are a liability in the form of special U.S. Treasury bonds that will likely have to be paid in the future, in which case recognizing a liability would be appropriate. But this could seem to be at odds with the view that future benefits are not due and payable. Further discussion of this in another forum, as recommended, would be appropriate.

Conclusion

The Primary View has thoughtfully laid out a case for making fundamental changes to accounting for social insurance, but this approach would recognize only the liability from future benefit payments and not the asset from future revenues, which would result in unnecessary confusion and misrepresent the current position and long-term sustainability of the programs. In the eyes of many, labeling future benefits as intractable liabilities would make necessary reforms all the more difficult, and this must be avoided. Overall, the Alternative View would present a more accurate and complete picture of social insurance benefits and could be used to create a mechanism in the budget process to require analysis and recommendations for change.

Thank you for the opportunity to comment on the thoughtful work done by FASAB.

Sincerely,

Alison Acosta Fraser
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Economic Policy Studies

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