

It's Even Worse Than You Think

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Last week the federal government ended the fiscal year with a reported deficit of approximately \$400 billion, pushing the federal debt held by the public to nearly \$4 trillion. Sobering though these numbers are, they actually understate the problem. Through an accounting sleight of hand with far greater consequences than the corporate scandals of recent years, the federal government distorts public debate, threatens social programs and impoverishes future generations.

What's missing from the \$400 billion figure is an accurate recognition of the mounting obligations of the Social Security system. Under current practices, Social Security reports its financial performance on a cash-flow basis: it compares annual revenues to annual costs and reports a surplus or a deficit. Last year, Social Security enjoyed a surplus of roughly \$160 billion. The government used this money to mask what would otherwise have been a \$560 billion federal deficit.

But even if the Social Security surplus were not used to disguise the deficit, the budget would still ignore the substantial growth in commitments to current workers and retirees. Under current law, Social Security participants and beneficiaries earned hundreds of billions of dollars of additional benefits last year. Even though future generations will almost certainly have to pay for these additional obligations, the federal budget pretends that they don't exist.

Were the federal government to account for its Social Security obligations under the rules of accrual accounting, which govern public companies, its financial outlook would be far worse. By the end of last year, the Social Security system owed retirees and current workers benefits valued at \$14 trillion. The system's assets, in contrast, were only \$3.5 trillion. These assets include not only the trust funds' current reserves (\$1.4 trillion), but also the present value of the taxes that current workers will pay over the remainder of their working lives (\$2.1 trillion).

In other words, the system's current shortfall — its assets minus its liabilities — is \$10.5 trillion. Unless Congress chooses to rescind Social Security benefits that have already been earned, this shortfall must be shouldered by future generations. This implicit debt of the Social Security system is more than two and a half times larger than the government's public debt.

What's more, the magnitude of the Social Security shortfall grew immensely last year. At the beginning of 2002, the trust fund's deficit was \$10.1 trillion. Under a system of accrual accounting, Social Security would have had to report a loss of approximately \$370 billion. If this figure — and not the trust fund's annual cash-flow surplus — were added to other federal accounts, the federal government would have reported a \$930 billion deficit last week. Add in similar adjustments for Medicare and other retiree benefits, and the flow of red ink last year surges even higher.

The federal budget's treatment of Social Security and other entitlements for the elderly is deeply misleading. Just as investors should be able to rely on the accounting statements of public companies, the public is entitled to statements of federal accounts that

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THREE VIEWS OF THE FEDERAL DEFICIT

Deficit as reported:

\$400 billion

Deficit without Social Security cash-flow surplus:

\$560 billion

Deficit with increase in Social Security shortfall:

\$930 billion

Note: First two figures from Congressional Budget Office for fiscal year 2003. Third figure based on author's calculations.

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clearly report the growth of the government's financial obligations each year. The current federal budget does no such thing.

The current accounting system for Social Security is also unfortunate for the program itself. For more than a decade, experts have been warning that the Social Security system needs major reform. Commissions have convened and conferred, but nothing has happened. Part of the problem is that the Social Security "crisis" is always described as decades away, when the baby boomers are retired, far beyond the concerns of current politicians. Indeed, for at least the next 10 years, under current accounting practices, Social Security will continue to run a surplus.

But this surplus is a cash-flow surplus, which politicians are happy to use to cover the costs of other federal programs. Everything about the current accounting system conspires to prevent action today, when relatively painless solutions are still possible.

If Social Security were to present its finances on the basis of accrual accounting, the public would have to face the hard truth that the system is insolvent — and its deficit is increasing by hundreds of billions of dollars a year. Politicians would have more incentive to act. Indeed, voters might even insist that Congress and the president reduce the Social Security shortfall to a reasonable size.

Accrual accounting is the gold standard for the private sector because it forces long-term liabilities to be recognized when they are incurred and can be controlled. The federal government is increasingly in the business of making long-term promises to its citizens. Until the federal government adopts principles of accounting that recognize these promises, the federal budget will remain the most misleading document in Washington. And that's saying a lot.

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