The Federal Government should learn some lessons from its investigation and prosecution of Arthur Anderson and Enron for creative and false accounting, particularly regarding the handling of “special purpose entities or subsidiaries.” Part of Enron’s problem is that apparently its balance sheet and income statements were misleading due to the existence of these “off balance sheet” operations. Ironically, our government engages in some of the same accounting chicanery. The unified budget surplus and deficit measures that are widely reported can be quite misleading.

Most of us can remember the “good old days” of 1998, 1999 and 2000. The federal government reported that it ran surpluses in those years of $69 billion, $126 billion, and $237 billion respectively. Common sense says that surpluses correspond to a reduction in debt outstanding, whereas deficits mean that the total debt is increasing. But the total debt of the United States went up by approximately $260 billion between the beginning of 1998 and the end of 2000. Just to summarize, in three years we ran a cumulative surplus of about $430 billion at the same time our total debt increased by $260 billion. The discrepancy is a whopping $690 billion.

How can these facts be reconciled? The total debt consists of debt held by the public and debt held by “special purpose entities” or Trust Funds. The debt held by the public decreased by more than $360 billion, but the debt held in Federal Government Accounts (i.e. Trust Funds) went up by more than $620 billion (for a net increase of $260 billion). The federal government bonds held by the Trust Funds for Social Security and Medicare went up by more than $425 billion and the rest of the increase was in other Trust Funds for military retirees, civil service retirees, highway construction and airport construction.
The real question is whether the debt held in these Trust Funds (special purpose entities) should count as real liabilities or not. My view is that if the bonds are to be treated as assets by the Trust Fund agencies, then they must be treated as legitimate liabilities for the rest of the government and the taxpayers. The agencies themselves, such as Social Security, seem to think that they represent real assets. The bonds are backed by the full faith and credit of the United States Government and are treated as completely safe investments. Social Security claims that its pile of bonds will extend the life of the system by at least twenty years. But, the unified surplus (which is probably the only surplus measure you ever have heard about) ignores the accumulation of liabilities for future taxpayers. Because the concept is one of unified or consolidated accounts, it treats the assets being accumulated by the Trust Funds and the liability to pay the interest and principal due on these outstanding liabilities as an expense. One way to look at it is that in the years 1998-2000, the Trust Fund agencies ran surpluses that were larger than the unified surplus. That is, the rest of the government ran a deficit. The numbers are shown in the graph below. In 1999, the announced (or unified) government surplus was $126 billion while the Trust Funds gained $213 billion.

The only way a surplus could be announced was to count the gain in the accounts earmarked for Social Security, Medicare, military retirees, etc. Other than these special purpose accounts, the government actually was running an $87 billion deficit in 1999. Today the announced surpluses have turned into announced deficits. The Trust Funds are still running surpluses, meaning that the rest of the government has a much larger (by roughly $200 billion) deficit than commonly understood.

Steps that would improve the surplus and deficit measures include consistently treating the Trust Funds as separate from general operations of the U.S. federal government. For instance, the cash flow surplus of Social Security and Medicare should count as an increase in the assets of those programs, but should not be treated as revenue available for the general spending needs of the government. Similarly, the government should record as an expense the interest payments that it owes on the previously acquired assets of the Trust Funds. As we just saw, these steps would increase the reported deficit by roughly $200 billion per year. They would also bring the announced deficit much closer to the increase in total debt that occurred during the year. While we are only talking about accounting changes, I believe more accurate accounts and the enlarged deficit that they would show would change the willingness of Congress and the President to pass new spending programs and tax reductions.

Social Security and Medicare are the biggest Trust Funds and the unified surplus and deficit measures have hidden their very precarious financial outlook. While the Trust Funds have government bonds in them, the bonds do not honestly represent a down payment on the future financial problems. The bonds are treated merely as a bookkeeping entry, reminding us that these programs have turned a lot of money over to the rest of the government.

The government has spent the money that was turned over from Social Security and the other trust funds, not saved it. In the final 15 years of the 20th Century, the debt held by the public went up by roughly $2 trillion at the same time that Trust Fund assets also went up by $2 trillion. If the Trust Fund assets represented real saving on the part of the government, the $2 trillion accumulation in the funds would have been matched by a reduction in the publicly held debt by a like amount. We have not been making progress on future financial problems. We have saved in some accounts while spending all of that money and more in other accounts. All of this is obscured by the government’s Enron-like accounting practices.

How might this affect you personally? The government’s financial situation is going to significantly worsen when the baby boomers begin to retire in large numbers in about a decade. This retirement wave has been foreseeable for at least fifty years. But, we haven’t done much to alleviate the financial strain on Social Security, Medicare and more importantly on the next generation of workers. The result of this is that the benefits from these programs are less secure than they would have been with more accurate accounts and more prudent financial behavior on the part of the government. You should be more than a little bit skeptical when you are told that Trust Fund assets are going to extend the life of Social Security and other entitlement programs. If you are relatively young, the only thing you can do is to discount the support you can count on from these government programs and save more for your own future needs. You can also do what every market participant is doing – demanding higher quality accounting from entities in which you have a stake. We all are stakeholders in the U.S. government. We deserve better accounts.
The real question is whether the debt held in these Trust Funds (special purpose entities) should count as real liabilities or not. My view is that if the bonds are to be treated as assets by the Trust Fund agencies, then they must be treated as legitimate liabilities for the rest of the government and the taxpayers. The agencies themselves, such as Social Security, seem to think that they represent real assets. The bonds are backed by the full faith and credit of the United States Government and are treated as completely safe investments. Social Security claims that its pile of bonds will extend the life of the system by at least twenty years. But, the unified surplus (which is probably the only surplus measure you ever hear about) ignores the accumulation of liabilities for future taxpayers. Because the concept is one of unified or consolidated accounts, it treats the assets being accumulated by the Trust Funds and the liability to pay the interest and principal on those assets as netting out to nothing. The idea is that we "owe it to ourselves."

This treatment inflates the reported surplus. The unified surplus includes the excess cash flow coming into the Trust Funds as part of the national surplus and it ignores the interest payments that it pays on the $2.2 trillion dollars of assets held by these entities. That is to say, it doesn’t record the interest cost on these outstanding liabilities as an expense. One way to look at it is that in the years 1998-2000, the Trust Fund agencies ran surpluses that were larger than the unified surplus. That is, the rest of the government ran a deficit. The numbers are shown in the graph below. In 1999, the announced (or unified) government surplus was $126 billion while the Trust Funds gained $213 billion.

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