

Recognition of Government Pension Obligations: A Comment

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Introduction

1. In his contribution to this electronic discussion group, Brian Donaghue analyzes the treatment of government obligations for pensions other than pensions for its employees (referred to here as public pensions). He concludes that, in contrast to the position of current macroeconomic statistical manuals,¹ a liability should be recognized on the part of governments for public pensions, although it is a constructive rather than a legal liability. He does not distinguish between the treatment of pensions arising from social security schemes and pensions arising from social assistance schemes. He also considers the question of when the liability for the pensions arises and how to estimate the liability. He concludes that the liability begins to accumulate when a person reaches working age, which he sets at 18, and that the liability should be the present value of the future benefits that actual and prospective pensioners have already earned according to existing laws and regulations.

2. While this author is broadly in agreement with Donaghue's views, the subject is complicated and deserves extensive discussion. This note attempts to amplify some of Donaghue's points and raise some qualifications. The intent is to broaden the discussion and to encourage other contributions. In particular, some discussion of (a) the borderline between an actual and contingent liability for government as opposed to private business, (b) when the pension rights are acquired, and (c) what flows are necessary once the liabilities are recognized may usefully add to the debate.

Discussion

Summary of the SNA treatment of social security and social assistance pensions

3. The definition and treatment of social security schemes is identical in all macroeconomic statistical manuals. Social security schemes are defined in the SNA as "social insurance schemes covering the community as a whole or large sections of the community that are imposed and controlled by government units. They generally involve compulsory contributions by employees or employers or both, and the terms on which benefits are paid to recipients are determined by government units. The schemes cover a wide variety of programmes, providing benefits in cash or in kind for old age, invalidity or death, survivors,

¹ The manuals most concerned with government pension obligations are *System of National Accounts 1993 (SNA)*, *Government Finance Statistics Manual 2001 (GFSM)*, and *European System of Accounts 1995*.

sickness and maternity, work injury, unemployment, family allowance, health care, etc. There is usually no direct link between the amount of the contribution paid by an individual and the risk to which that individual is exposed.” [SNA 4.111]² In addition to contributions by employees and/or employers, receipts of social security schemes “may also include transfers from other government funds.” [SNA 8.64]

4. The definition of a social insurance scheme is discussed in detail in a separate note available on this electronic discussion group and will not be reviewed in detail here. Briefly, a social insurance scheme is a collectively organized insurance scheme in which employees and/or others are obliged or encouraged to spread risk by taking out insurance against certain social risks. Social insurance schemes require contributions, actual or imputed, to secure entitlement to social benefits. The social risks typically covered by social insurance schemes include the risk of a “reduction in income as a result of not being able to work, or not being able to work full-time... People may be prevented from working for various different reasons, in particular: (i) Voluntary or compulsory retirement” [SNA 8.56] One social benefit that might be paid upon retirement is a pension.³

5. A social assistance scheme can provide the same range of social benefits as a social insurance scheme, but the benefits “are provided outside of an organized social insurance scheme and are not conditional on previous payments of contributions.” [SNA 8.7] Thus, social assistance schemes do not involve contributions or assets restricted for the payment of social benefits. Instead, social assistance benefits are financed from general government resources.

6. A social insurance scheme will often be preferred to a social assistance scheme for providing pensions. The amount of an individual pension usually is a function of the individual’s years of employment and levels of compensation. Although there may not be a direct link between the contribution paid by an individual and the risk to which that individual is exposed, fairness suggests that those receiving larger pension payments should contribute more to their financing. This goal generally requires a contributory scheme, with the contributions based on the amount of compensation received. In principle, however, pensions can be provided by both social insurance and social assistance schemes.

² References to statistical manuals will identify the manual and state the chapter and paragraph numbers. For example, SNA 4.111 refers to paragraph 111 of chapter 4 of the SNA. “An” will refer to an annex.

³ A pension is a fixed sum paid regularly to a worker following retirement from service or to surviving beneficiaries. Social insurance schemes may also pay other types of social benefits after retirement, but such schemes are more complex. This note is restricted to pensions paid in cash.

7. If a pension scheme other than a social security scheme is funded, then a liability is recognized in the SNA with respect to the present value of pensions that have been earned to date. The equivalent liability is not recognized for social security schemes: “Social security schemes may be either funded or unfunded. Even where separate funds are identified, they remain the property of the government and not of the beneficiaries of the schemes.” [SNA An4.13] In part, public pension liabilities are not recognized because “institutional arrangements in respect of social security differ from country to country... The amounts raised, and paid out, in social security contributions and benefits may be deliberately varied in order to achieve objectives of government policy that have no direct connection with the concept of social security as a scheme to provide social benefits to members of the community. They may be raised or lowered in order to influence the level of aggregate demand in the economy, for example.” [SNA 4.112]

8. Because no liabilities are recognized for public pensions, the flows recorded in the SNA are relatively simple.

- Payments of social security contributions by employers on behalf of their employees are shown as payable by the employer to households as an element of compensation of employees [SNA transaction code D.121].
- Employers' social security contributions [code D.6111 but identical in value to D.121], social security contributions by employees [D.6112], and social security contributions self- and non-employed persons [D.6113] are shown as current transfer payments by households to government (or the rest of the world if to a foreign government).
- Social security pension payments are shown as current transfer payments by government (or the rest of the world if from a foreign government) to households (social security benefits in cash—D.621).
- Social assistance pension payments are shown as current transfer payments by government (or the rest of the world if from a foreign government) to households (social assistance benefits in cash—D.624).
- If the social security scheme is organized as a separate institutional unit (it is then called a social security fund) then the assets of that unit and the property income earned from the investment of those assets are determined just as they would be for any other institutional unit. A social security fund has no liabilities for insurance technical reserves other than benefits that are due for payment but have not yet been paid and typical accounts payable incurred by any institutional unit.

In summary, all social security contributions and all public pension payments are recorded as current transfer payments, even when the contributions entitle the contributor to a pension in the future.

9. In GFSM, it is recognized that governments sponsoring a social security pension scheme have at least a conditional obligation. To acknowledge this obligation, a memorandum item is added to the balance sheet with a value equal to “the present value of social security benefits that have already been earned according to the existing laws and regulations but are payable in the future...calculated in a manner similar to the liabilities of an employer retirement scheme” [GFSM 7.145 and GFS code item 6M5]

The definition of a liability in the government context

Comparison of statistical and accounting definitions of liabilities

10. Liabilities are defined in the SNA only as the counterpart of financial claims. A financial claim is “an asset that entitles its owner, the creditor, to receive a payment, or series of payments, from the other unit, the debtor, in certain circumstances specified in the contract between them.” [SNA 10.4] The same definition is used in other statistical manuals. As the counterpart to a financial claim, a liability obligates the debtor to make a payment, or a series of payments, to the creditor in the circumstances specified in the contract between them. In other words, liabilities are unconditional obligations to make payments to the parties holding the claims.

11. Obligations that are contingent because an event has not yet occurred are not recognized in the SNA. For example, a manufacturer may be statistically certain that it will have to make payments to repair defective products already sold, but until the defects become evident and demands for repair are made there is no liability.

12. Generally, stocks and flows in the SNA are associated with specific units. With insurance and pensions, this association is tenuous. A defined benefit pension scheme is obligated to pay pensions to all participants in the scheme and the value of the obligation to each individual is the present value of the future payments that have already been earned from past events. Estimating those payments normally depends on future events, such as how long the participant will live. While feasible to do on an individual basis, these estimates are typically made on a group basis because the degree of accuracy of the total is much higher than of the individual components. Thus, the liability of a pension scheme is attributed only to the households sector, not to individual households.

13. The Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) defines liabilities for governments as “present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.”⁴ Several words in this definition need some elaboration.

⁴International Federation of Accountants, Public Sector Committee, *Glossary of Defined Terms in IPSAS 1 to IPSAS 18*, (available at www.ifac.org).

14. An *obligation* is a duty or responsibility to perform in a certain way. Many obligations are legally enforceable as a consequence of a binding contract or statutory requirements. Other obligations arise from the normal operating practices of the entity. Two of the primary functions of governments are (a) to provide services to the public for free or prices that are not economically significant and (b) to redistribute income. When fulfilling these functions, governments frequently make unilateral promises that create obligations. For example, it may promise to provide health care to indigent people. When someone receives the care, the government incurs a liability to pay for it. If a government has been paying social security pensions according to a well-defined formula for many years, it may be considered to have created an obligation to continue paying them on the same basis until a policy change is clearly announced with sufficient advance notice.

15. The notion of an obligation arising from an entity's actions rather than from a contract is known as a *constructive obligation*. It is defined by the PSC as "an obligation that derives from an entity's actions where (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities."⁵ Constructive obligations are not currently recognized in statistical manuals. Public pensions are constructive obligations.

16. The obligation must be a *present* requirement to perform a promise rather than a future commitment to perform the promise. Contracts that are mutual promises to perform, such as a purchase order issued by one enterprise and accepted by a second enterprise generally do not impose an obligation on either party in the sense used here. Instead, such contracts are future commitments to perform a promise if the other party performs its promise. Until one enterprise delivers the product as specified in the contract, the other party has no obligation to pay for it. Present obligations do not necessarily imply the existence of a liability. A loan guarantee is a present obligation to fulfill a promise if the debtor defaults. Fulfillment of the promise will require an outflow of economic resources, but generally the likelihood of such an event is sufficiently small that no liability is recognized. A letter of credit is a present obligation to provide economic resources to a third party under certain conditions, but there is no expected outflow of resources. Public pensions are present obligations to the extent that the eligibility criteria to receive the pensions have already been fulfilled.

17. Liabilities result only from *past obligating* events. For example, the receipt of goods or the use of services requires payment. The acceptance of a loan requires its repayment. The statistical certainty that events will occur in the future that will require outflows of resources does not mean that a liability for those outflows should be recognized. An enterprise that

⁵ International Federation of Accountants, Public Sector Committee, International Public Sector Accounting Standard 19, *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 18 (available at www.ifac.org).

earned taxable income last year has an obligation to pay the tax. Even though it is virtually certain that the same enterprise will earn taxable income in the current year, the enterprise should not recognize a liability to pay the tax until the income has in fact been earned. Public pensions are normally earned over time through employment or age. To the extent that employment has been performed or an age attained, a portion of the pension that will eventually be received has been earned through a past obligating event.

18. Finally, there must be an *expected* outflow of economic resources. With legal obligations, the probability of the outflow is certain, unless there is a bankruptcy or other exceptional event. With constructive obligations, including public pensions, there is some likelihood that the pensions will not be paid or not be paid in the amount currently expected. The most likely event causing a cancellation or a reduction in pensions is a change in the law governing the scheme. Thus, it is a matter of judgment how likely it is that such a change might occur. Depending on that judgment, any amount could be recognized for the liability from zero to the entire amount based on the current law.

Reasons to recognize a liability for public pensions

19. There is a genuine obligation. In most cases, there is no question that according to current laws and regulations, people who have been participating in a public pension scheme have earned rights to a pension. Typically, the right to a pension and its amount are based on years of service, levels of compensation, and/or amounts of contributions. If the applicable laws and regulations do not change from now until the participant is eligible to start receiving the pension, then, even if the participant is not employed in the future and makes no further contributions, the participant has earned a pension and will receive it.

20. The government cannot realistically avoid payment. If a public pension system has been in operation for a number of years and payments have been made on a regular basis, households plan their retirement and make other economic decisions based on the assumption that they will receive the pensions they have earned and expect to receive or continue to receive. It generally is not politically feasible to “change the rules after the fact” for a large group of participants. History shows that governments either change public pension programs only in a way that affect benefits not yet earned or that affect benefits already earned very marginally. The public has a valid expectation that the government will pay the benefits that have been earned.

21. The present value of the benefits that have been earned can be estimated reliably. The procedures for computing actuarial estimates of the present value of pension benefits that have already been earned but will be received in the future are well established. Private enterprises with pension schemes for their employees make similar estimates routinely. Estimating the present value of similar public pensions may be somewhat more involved because the eligibility rules and the rules determining the amount of a pension are likely to be more complex. This complexity, however, is at the margin and does not prevent a reliable estimate.

22. Fiscal policies will be more transparent. Recognizing the liability will provide additional information about the true state of obligations that have been incurred by the government and the assets on which households are basing their decisions. By itself, it will not indicate future cash flows and government demand for credit, but it will provide the database from which such estimates can be made. The value of the government liability for public pensions can change dramatically if the government were to make a unilateral change in the applicable laws and regulations. Such a change, however, is an effect of government fiscal policy and not a defect of recognizing the liability. The need to include explicitly the effect of such a change should be interpreted as an addition to fiscal transparency.

23. Comparability would be enhanced. Several countries have “privatized” all or part of their social security schemes. In general, “privatization” does not change the true net worth of the government, but the balance sheet of a government with a social security scheme is nonetheless very different from the balance sheet of a government that has “privatized” its scheme and recognized its public pension liabilities. Recording the liabilities for public pensions would remove this incompatibility between countries and for one country over the period of its “privatization”.

Reasons not to recognize a liability for public pensions

24. The liability is not a legal obligation. The government has promised only to make periodic payments if a person is of a certain age and certain other conditions have been fulfilled. The government likely has reserved the right to revoke its promise at any time before a payment is due. A liability does not exist until the payment becomes a legal obligation, which is when it is due to be paid. The nature of the obligation is different from pension obligations to employees, which usually are legal obligations part of a negotiated compensation package. They cannot be changed without the consent of employees and/or their unions. Public pension schemes can be changed by the government through amending legislation without the consent of third parties. As stated in the previous section, however, there are practical limitations on the retroactive changes a government can implement.

25. One government cannot commit a future government to action. Despite the common practice of implementing government expenditure programs that are clearly intended to extend over several years, a generally accepted practice is that expenditures in the current fiscal year must be authorized by the appropriate legislative procedure for that fiscal year. Many governments devise procedures to work around this type of limitation.

26. Social security and social assistance are more than pensions. In many cases, social security and social assistance schemes cover a wide variety of social risks, including disability income, survivors’ benefits, death benefits, medical benefits, and others. Some programs may be jointly operated with state or local governments. Some benefits may be provided on a short-term basis as a part of the government’s fiscal policy. The ministry operating the scheme may perform closely related administrative functions using the information available from the database of the scheme, such as assisting tax administrators or

maintaining birth and death registries. It may be difficult to disentangle the current program costs and benefits from the pension scheme.

27. Expenses should be matched with revenue. Governments have the power to levy taxes and can vary the amount collected to match the expenses of the same period. Thus, the recognition of liabilities can reasonably be deferred until the payment is required. If the liabilities were to be recognized many years before payment is due, governments may feel obliged, or even required, to raise taxes to meet those liabilities. Large demographic changes, however, could imply a larger tax increase than is politically feasible.

28. The net worth of government will be unrealistically understated. The liability for public pensions will never have to be liquidated as long as the pension scheme remains in effect; it will only change size somewhat as the demographic structure of the population changes. As a permanent debt, its cash flow and liquidity requirements are different from other debt.

29. The value of the liability is subject to large estimation error. Small changes in discount rates, life expectancy, or retirement ages can cause large changes in the value of the liability. A large estimate subject to large changes is of limited analytical usefulness.

Assessment

30. The arguments in favor of recognizing liabilities for public pensions outweigh the arguments against recognizing them. Governments have constructive obligations for the future public pension payments that they have little practical ability to avoid. The present value of the claims to such benefits that have already accrued by potential claimants can be determined with acceptable accuracy using well-established actuarial and accounting techniques. Statistics are intended to show the economic reality of a situation rather than just legal arrangements. In this case, household and government behavior is influenced by the constructive obligations for public pensions and the belief that the pensions will be received.

31. Any recognition of public pension liabilities applies equally to social security and social assistance schemes. The existence of the liability and the strength of the constructive obligation are the deciding criteria in recognizing the liability, not the organization of the scheme.

32. These conclusions are tentative. The structure and operation of social security and social protection schemes are more complex and varied than pension schemes sponsored by employers. Additional research is needed to confirm that it is feasible to estimate the stocks and flows of public pension schemes with sufficient accuracy so that including them in the core set of accounts will improve the utility of the statistics. Until then, provisional satellite accounts showing how the accounts would be modified if liabilities for public pensions were to be recognized should be constructed.

Flows implied by recognition of the liability for public pensions

When to accrue the liability

33. Donaghue recommends that an individual's right to a public pension should begin to accrue when the person begins his working life. He suggests that 18 years of age is a practical compromise to use for everyone. An alternative preferred here is to use the eligibility formula embedded in the scheme. If the pension is based on the years of employment and the average wages earned, then the pension rights would begin to accrue when employment covered by the scheme starts. If an old age pension were granted to everyone who reaches a given age regardless of employment or wages, then the pension rights would begin to accrue at birth.

The classification of social security contributions

34. The liability for public pensions increases each year because the people eligible for the pensions engage in the events that by current law increase their benefits, such as being employed. If the pensions are provided through a social security scheme, then participants in the scheme make social security contributions and/or their employers make contributions on their behalf. Because social security schemes are sometimes used as a part of a government's fiscal policy, the amount of actual contributions may not be closely related to the true increase in the liability, either in the aggregate for all participants or for subgroups. Any increase in the liability greater than the sum of the actual contributions is an expense of the government. It would be recorded as a current transfer to households and then as an additional social security contribution.

35. As a social insurance scheme, social security contributions would be recorded in the SNA both as the incurrence of a liability by the government and as a current transfer. In GFSM, the contributions would be recorded only as the incurrence of a liability. For a social assistance scheme, there are no actual contributions. An expense would have to be imputed for the entire increase in the liability. As with social security schemes, this expense would be recorded as a current transfer to households and then as a social contribution. The imputation of a contribution to a social assistance scheme converts the scheme to a social security scheme and all of its transactions should be classified as social security.

Interest cost

36. The liability at any given time is equal to the discounted present value of the benefits that have already been accrued as a result of past events. As with several other liabilities, property income will be earned on the liability, which can be estimated using the same discount rate that was used to compute the liability. In this case, the amount of the property income is added to the existing liability. This transaction is analogous to the SNA transaction, property income attributed to insurance policy holders (code D.44).

Other changes in the value of the liability

37. The government may unilaterally increase or decrease the pension benefits promised. If so, the liability will change correspondingly. The change in the liability is an other change in the volume of assets as described in SNA 12.53.

38. Any estimate of the liability for public pensions will require several estimates, such as the expected longevity of the beneficiaries and the discount rate. When the actual events turnout differently than had been estimated or when the estimates are revised, then the liability will change. This change in the liability should be recorded as a valuation change.

Pension payments

39. As with social contributions, payments of public pension are recorded in the SNA as both current transfer payments and reductions in the liability. In GFSM, the payment would be recorded only as a reduction in the liability.

Adjustment for the change in net equity of households in pension funds

40. Because social contributions to pension schemes are recorded in the SNA as current transfers and as financial transactions and pension payments are recorded as current transfers and financial transactions, there is a dual recording. To maintain a balance in the accounts, a transaction, the adjustment for the change in net equity of households on pension funds (code D.8) is recorded that offsets the net effect of the current transfers. The same adjustment transaction would be necessary for public pension schemes.

Net acquisition of insurance technical reserves

41. The total liability for public pensions would be recorded in the SNA as insurance technical reserves, a category of financial assets. A subcategory might be usefully added for public pensions. Within that category, social security and social assistance liabilities could be distinguished.

Conclusions

42. Although there are reasons for and against recognizing a government's liability for public pensions, the balance of these reasons suggest the liability should be recognized in macroeconomic statistics, for both social security and social assistance pensions. Recognizing this liability would be a major change in these statistics and the actual implementation is likely to encounter difficulties caused by the greater complexity of public pension schemes compared to employer pension schemes. Hence, satellite accounts should be constructed for a period to both demonstrate the feasibility and utility of the change and to develop solutions for unexpected problems.

43. The liability for public pensions is a constructive liability. Governments can change the benefits unilaterally, but are unlikely to change them retroactively. If the liability were

recorded, then demonstrating the magnitude of a change in benefits should be viewed as useful for policy analysis rather than a reason not to recognize the liability.

44. The liability should be accrued based on the criteria that determine eligibility for the pensions and the amount of the pensions earned. In most cases, this period will be the years during which a participant in employed in a job covered by the scheme.

45. The amount of liability should be determined by the same actuarial and accounting techniques as are used to determine the liability of employers for pensions. These techniques involve many tenuous estimates, but they are no more tenuous than the parallel estimates used for private pension schemes. The assumptions underlying the estimates need to be reviewed periodically, which may lead to a valuation change in the amount of the liability.

46. If the liability were to be recognized, then several types of flows will also have to be recorded, some of them imputed flows, to provide integrated information on all sources of changes in the liability. These flows are similar to the flows for other social insurance pension schemes.