

**Comments on “Recognition of government pension obligations”
by external fiscal experts of the panel of the
Fiscal Affairs Department (IMF)**

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Barry Bosworth

I thought the paper on the budgetary treatment of pensions was very interesting, but I don't favor the author's suggested treatment. As I understood the proposal, it would shift to accrual accounting instead of the current emphasis on cash flow, and it would extend the concept to pensions and other government programs where the future commitment is less than contractual. That is, the public pension system would be treated as though it was run through a private entity: government tax revenue (contributions) would be entered as in the cash budget; but the expenditure side would be accrued pension liabilities. The accrued charge is an amount sufficient to induce a private entity to accept responsibility for the increment to future pension benefits. Current benefit payments would therefore be excluded from the budget. The accrued benefit charge would normally exceed current benefits because of anticipate aging and population growth. Accrual accounting is equivalent to the practice of some private firms who purchase annuity contracts from private insurance companies as a means of meeting their pension obligations.

The appropriate budget treatment depends upon the uses that will be made of the budget. There is no single budget framework that is appropriate for all purposes. At the national level, I believe there is still a substantial interest in cash flow accounting to measure the short-term economic effects of fiscal actions. While there is interest in the long-term budget issues as reflected in the discussion of sustainable policies and inter-temporal budget constraints, I don't believe it has progressed to the point that we would like to make such frameworks the dominant perspective. Instead, these alternative uses can be represented, as in the national accounts, by the construction of satellite accounts.

This is particularly true for public pension systems. Obviously there is a considerable unfunded liability that is being built up; but its magnitude is far less certain than implied by accrual accounting. Governments have initiated major changes in the magnitude of scheduled pension benefits. That is evident in the large revisions to the U.S. program in the 1970s and early 1980s, the changes in Japan in the last two 5-year reviews, and the recent changes in the German system.

I think it makes a lot of sense to project the liabilities and record them on the public balance sheet; but replacing current benefit payments, with an estimate of the accrued annual liability in the income

statement strikes me as going one bridge too far. How would we treat revisions to the plans as they affect past accrued obligations? Would that be a capital transfer? What about changes in the underlying economic and demographic assumptions? Private firms game the system by choosing among about 15 different formulas for measuring the accrued liability. I assume the public sector would do the same. How would we deal with anticipated price changes in estimating the future liability?

Furthermore, if governments wished to shift to accrual accounting, I see no reason to limit the change to public pensions. The same should be done for public provision of medical care and other services. Societies make many inter-temporal and intergenerational bargains of both a formal and informal nature. The effort to reflect the future implications of these arrangements in the budget is likely to covert it into a document of limited practical value. It also gives political leaders too much discretion in how to record budgetary costs and outcomes. Won't we just end up in a big debate over current versus capital expenditures where some people will push to recognize the future revenue gains of today's 'capital investment' in education and health care?

I had a few questions about the paper itself.

- 1) p. 2. It is much more difficult to distinguish social insurance from social assistance than this paragraph would suggest. What is a guaranteed minimum pension, as in Chile? Nor does it help to try to differentiate them on the basis of eligibility conditions.
- 2) P3. I don't understand the 2nd full paragraph about present value of future pensions. Why is this front loaded? Why is it not a useful alternative?
- 3) P. 5. Governments have often changed benefits for existing retirees. It is often the case that this is asymmetric, although Japan has changed its benefits for near retirees.
- 4) The effort to draw a firm line between defined-contribution and defined benefit, as on page 9, seems dated once we recognize the changing rules on vesting, and the growth of cash balance plans.
- 5) The discussion of defined contribution schemes on page 10 confused me because I did not see why the interest and dividend income of the fund would be relevant to computing the charge to the government. Why is it not just the contribution?

In general, I thought it was a clear and interesting paper, even though I don't think the procedure is quite ready for prime time. I believe an interesting experiment is taking place in Australia where the accrual accounts are being reported; but they still seem to place a great deal of emphasis on the cash-flow version when it comes to pension programs.

Barry Bosworth
The Brookings Institution

Murray Petrie

Some comments on the paper "Recognition of Government Pension Obligations" by Brian Donaghue, dated September 2002.

I have a number of difficulties with the arguments used to support the conclusion in the paper that (some) social security pension obligations should be recognized as liabilities in the financial statements of governments. These problems include:

a. The main criteria used to assess the desirable accounting treatment appears to be that "the financial impact of government policies should be recognized when those policies were in effect." (P. 3) This is indeed a desirable feature, creating positive incentive effects, and resulting in the financial effects of decisions being transparent at the time they are made. However, it is far from being the sole criteria by which to judge the appropriate accounting treatment. Another key accounting concept is that of reliability. An obligation must be capable of being reliably measured before it meets the accountant's threshold of recognition. In a number of places the paper seems to ignore this point, and seems to see the ability to measure, to quantify, or to place a valuation on an obligation as being sufficient to justify recognition. For instance, "...governments can make, and in fact have made, adjustments to pension entitlements. However, this should not be used as an excuse to avoid valuing government pension obligations...". See also footnote 7. Valuation or quantification is not the same as recognition; and the fact that governments can and often do make changes to schemes that change their obligations is one reason why it is debatable whether they should be recognized.

b. The counterfactual against which the paper judges the desirability of recognition of pension payments as liabilities is inadequate (it seems to be no disclosure at all). Page 1 says the paper is not concerned with projections of future obligations. Page 7 says current PAYG schemes do not show in government fiscal data. And p.11 says under current treatments the economic burden on future generations is to a large degree invisible; and that it is not clear how disclosure would differ from recognition. However, it is simply not true to say that "fiscal data" do not show information on PAYG schemes. Many OECD countries present detailed supplementary information in fiscal documents on future pension obligations (some, such as the USA, have long done so). And it is not possible to assess the desirability of recognizing pensions as liabilities without assessing the costs and benefits of recognition against the most feasible alternative. In my view, the appropriate counterfactual is supplementary reporting in notes to the financial statements and/or in some other format.

c. The paper fails to justify why pensions should be recognized when contingent liabilities should not. Contingent liabilities can also be measured or valued - that is, an economist can compute an expected cost, and this could be recognized as an expense. The key issue is the reliability with which the obligation can be measured, which is the same issue as for pensions. It would have been interesting to consider the accrual accounting treatment of contingent liabilities: when it is considered less than probable that the contingency will arise, it is not recognized, and is instead reported in supplementary notes. However, if it is considered probable the contingent event will occur, the full cost of the contingency is recognized as a liability. This "all or nothing"

treatment reflects aversion to putting unreliable "guesstimates" into the body of the financial statements. Economists often find this frustrating. But the issue cannot be judged in isolation. The concern is with the reliability of the financial statements taken as a whole as an indication of an entity's financial position and financial performance. This is probably why, to the best of my knowledge, no country that has adopted accrual reporting has to date recognized pension obligations as liabilities (aside from civil service pension obligations). This leads to the next concern.

d. The paper does not consider the practical effect of recognition on the value of the financial statements to users. The very large size of a typical government's pension obligations, together with the fact that an accrual treatment would see the annual revaluations going through the operating statement, means that the change in the government's deficit would often be driven by pension revaluations. Revaluations reflect real economic changes (such as an expected increase in long term interest rates). But they can add a lot of "noise" to the financial statements, especially when they are as large as these will often be. I would expect that well-informed users would quickly strip out the "pension effect" and calculate some kind of "underlying deficit." In which case, what has been gained? Less well-informed users will find the reported deficit measure less informative.

e. More importantly, there is arguably far less information disclosed from simple recognition on its own compared to the kind of detailed information that can be provided through supplementary reporting. Recognition on its own would result in a single number being added to the government's liabilities, and an annual revaluation going through the operating statement. In contrast, supplementary reporting (whether in notes to the financial statements or in some other form) can disclose a great deal of additional information relevant to fiscal and pension policy, including long term demographic projections, a variety of pension (and other policy) scenarios around a central projection of future cash flows, with sensitivity analyses, and the effects of various reform options also disclosed. The USA and Australia both legally mandate the publication of long-term projections of government pensions, and many other countries also choose to disclose them. Of course, under a recognition regime, there is no reason why such additional information could not also be presented. And in fact, under the form of recognition recommended in the paper - only currently accrued obligations - a large part of the future cash flows would not be recognised, and would presumably have to be disclosed through some other means anyway? But, with an "underlying deficit" measure, and additional reporting of pension information, how different, in practice, would the form of recognition proposed in the paper be from supplementary reporting?

f. The paper fails to convincingly justify recognition of pensions and the PAYG treatment of health expenditures. The same sort of microeconomic considerations the paper advances for pensions apply (government health benefits are a substitute for private health insurance). They raise similar issues of long term "covenants" between citizens and governments, and are similarly very difficult to change. They are also often financed from dedicated earmarked taxes (with records of individual contributions).

In fact, there is arguably more similarity (in terms of recognition) between health benefits and pensions when both are financed by individually earmarked contributions, than between a pension scheme financed by earmarked contributions and a pension scheme financed by "imputed contributions" or out of general taxation. The latter type of scheme poses a particular problem for reliable measurement of the government's liability.

There is a danger in the partial use of accounting concepts to assess the desirable accounting treatment of specific transactions or events. The best way forward may be one in which the accounting standard setters consider this one in detail, within the full and coherent framework of the principles of accrual accounting, and come to a considered view on the recognition issue (which will involve balancing some principles against others). To do this properly, however, they would in my view need to develop a fully specified supplementary reporting regime as a basis for judging the merits of recognition. That supplementary reporting regime would obviously benefit greatly from the incorporation of macroeconomic and fiscal policy perspectives. A reporting standard would require consideration of the period to be covered by long term projections, the scope and form of coverage of future cash flows (just pension spending, or all future cash outflows and inflows), the periodicity of publication, the assumptions to be disclosed, the types of sensitivity and scenario analysis to be included, and possible mechanisms to ensure independence and professionalism in the production of the projections. Perhaps IFAC should be encouraged to put out a discussion document that compares and contrasts different approaches to pension obligations, rather than an exposure draft of a standard they are heading towards. This might facilitate the combining of accounting, economic and statistical perspectives that seems likely to be required to deal with this issue satisfactorily.

Henry Aaron

I have written on this on at least two occasions, first in a piece that Gary Burtless and I co-authored in the American Economic Review papers and proceedings many years ago, and later in comments on generational accounting.

The proposed modification is incomplete and misleading. It is misleading because, as the author says, pension obligations are not like debt, because pension can be changed by statute at any time. Moreover, they ARE changed whenever it is necessary to make sure that accounts balance and revenues are not going to bear the whole burden of the adjustment.

It is incomplete because the obligation to pay pensions is no greater than the obligation to pay health bills, build road, fund national defense, or staff the courts. Nor are any of these spending obligations any greater than the commitment to collect personal income taxes, value-added taxes, and corporation income taxes.

Why stop with pension outlay obligations? There is no good reason, and, in fact, the author's paper contains many reasons why one should not stop there. But, if one does everything, one

is fully into generational accounts, with all of the analytically intractable problems relating to discount rates, assumed growth rates, etc.

Preparation of such accounts is great analytical exercise, but it is a quite dreadful way to muck up government budget accounts. Stick with what is legally required, such as paying debt, and recognize that outlays and taxes that are subject to statute will be changed as needed to keep things in balance and that it is misleading to assume that something that can't possibly happen will happen.

Henry J. Aaron
The Brookings Institution

Edwards Gramlich

I generally tend to think that more disclosure is better than less. If certain items being disclosed are misleading because of x , disclose x too. In general that seems a safer way to proceed.

Concerning Social Security, far and away the most useful Social Security document is the Annual Report of the Trustees of SS and Medicare, published by the Treasury Dept usually in March of a given year. These are the official forecasts of the 75 year imbalance. They use the open format (that is, they not only project out presently accrued liabilities but they project out future accrued liabilities and income) and are in flow terms. The most useful number is their payroll tax gap -- the amount we'd have to raise payroll taxes immediately to cover projected net liabilities for 75 years. Right now the gap is about 2 percent of payrolls. One could question whether 75 years is long enough, but I think internationally you'd settle for that. One could also raise other technical questions, but the numbers are solid, the assumptions are realistic, and the guys doing the work are careful.

The US govt does have a stock number that corresponds to this flow number. I've never found it very useful but it is available. One can get an exact transformation to the above flow number from the open liabilities, right now about \$3 trillion. This report also gives the closed liabilities, the liabilities that we've accrued already and would have if the world stopped today. That number is about \$10 trillion. I can see someone calling this number alarmist, because there will be future payroll tax infusions, but the number is there and knowledgeable people can make the conversion. I've never actually used these stock numbers and am not sure where to get them, but the GAO has an annual report called the Financial Report of the US Government that I think has them.

Robert Palacios

My initial and general reaction is that the proposal is on the right track, but falls far short of providing strong guidance on how to proceed. As you know from my other work in this area, I am supportive of reporting a gross measure of unfunded public pension liabilities using a consistent and reasonable

methodology that can be applied to most if not all countries. However, I am keenly aware of how difficult this would be.

The author does not discuss any of the problems that would be encountered in measuring pension liability. For example, many countries use ad hoc rules for indexing benefits. How should this be treated? Also, many countries have large informal sectors. At any given time, a snapshot of the current contributors to the scheme would not capture a large part of the liability that continues to accrue in the form of individuals that are currently out of the formal sector, but may one day return and claim benefits. Assuming, as I do, that a reasonable approach could be developed and that with sufficient resources the necessary information could be gathered for a significant group of countries, another type of uncertainty is still present as has been shown in studies by Lee and others using stochastic techniques to illustrate how wide the confidence interval for pension system projections is likely to be. Finally, we know that there are other missing liabilities in the government's balance sheet and inclusion of pensions, while a correct step in my view, would not lead to a complete presentation. (In fact, I believe the author should begin by citing that literature and make a case for why so much attention should be given to pensions). **All of this leads me to advocate the "memorandum item" treatment of unfunded pension liabilities.**

Now, on the issue of gross versus net presentation. According to your note below, some analysts are concerned about showing large gross liabilities because it might make even balanced PAYG schemes look problematic. I have argued that the problems associated with measuring the stream of revenues are insuperable for many reasons. Predicting future coverage paths is one strong reason. A second problem with trying to look at revenues is that so many countries use a mix of payroll and other taxes, with many of the latter being effectively earmarked. Finally, I think that the gross presentation allows data users to simply normalize by the appropriate indicators such as the covered wage bill or the overall tax base. Presenting the net figure would lead to unnecessary misinterpretation in my view. Therefore, I advocate a gross liability presentation, probably of the ABO/PBO type to which this paper seems to be referring.

A final comment is that the author (perhaps he is from New Zealand) appears to be thinking in terms of demogrant terms. He focuses on the "passage of time" as the determinant of accruing liabilities. In fact, for most countries, the relevant indicator is the accumulation of periods that earn DB rights, mostly in the form of contribution periods. The figure needed for a decent calculation for the active population at any given time then is the change in the total number of contribution (or equivalent) years per age cohort by sex for all single-year age cohorts in the country.

Robert Holzmann

Overall, I support analysis, conclusions and suggestions of the paper. This may not come to a surprise as the suggested measure for liability/implicit debt is equivalent, or at least very close to the one we have been suggesting for some time.

(i) A few conceptual remarks

While I agree with the general approach, on some of the leading-up analyses and comments I would give a different spin. But this is almost inconsequential for the proposed outcome and is just for the records:

@ Definition of social protection: What he refers to is social security (i.e. social insurance plus social assistance). Social protection is social security plus labor market interventions.

@ I do not think is correct or useful to explain the difference between social insurance and social assistance by the nature of the risk covered. One more useful approach to differentiate between both is, that social insurance are risk management instruments to mitigate the risk effects ex-ante while social assistance are SRM instruments made available for coping with the realized risk, i.e. after the shock has happened.

@ SI and SA programs are easily distinguished for polar cases - e.g. mandated DB pension system fully contribution financed versus mean-tested cash benefits. If one takes for example a universal pension financed for general revenue (a la NZ), it can be interpreted both as SI or SA. My take is that what matters is the credibility of the scheme/restrictions for politicians to alter the commitment. If it is firm, it is equivalent to a SI system, if not, it is closer to SA.

@ The credibility will also depend on the legal status of the benefits. (And here I think the author is wrong to say that "in any event does not usually confer legal rights on the recipient". There are many examples in Latin America (Brazil), Western Europe (Germany or France), and Eastern Europe (Hungary) where constitutional court restricted the capacity of government to curtail the benefits (based on past contribution)).

@ BUT I agree with the baseline statement, that retirement provision cannot be changed as easily because the long term nature of the commitment (by the government) and the lacking capacity of individuals to react to cuts, and this make changes politically much more difficult. **And for this very reason should the liability of public pension scheme and their changes be estimated and published in public accounts.**

(ii) Evaluating the suggestions

@ I agree with the suggestion to use the accrued-to-date liability or terminal value as the estimate for the government commitment. Beside the conceptual arguments used in the paper, we have used those and produced others. The latter include issues of operationality, including minimizing the number of assumptions and avoiding to get into issues of estimating revenues.

@ As a minimum, the liabilities for all pension schemes should be estimated and added as a memorandum item to public accounts. The paper concentrates essentially on social security schemes. I/we would argue that (contingent) liabilities resulting from guarantees for private schemes are also important now and are likely to get more important in the future (for details see references). But compared to estimating the accrued-to-date liability of a social security scheme, the estimation of guarantees and related liabilities is much more difficult (or less consensus on the methodology has been developed).

@ I agree with the basic proposal to have the liabilities fully recognized, i.e. to have a change in the stock (of implicit gross pension debt) reflected also in flows (i.e. income account of public and private sector). In my view, the objective is essentially two-fold: (1) To have a better information on asset/liability and income position of the different sectors to allow for a better assessment of sustainability, or the lack thereof; and (ii) to allow for better modeling of macroeconomic aggregates and their interactions. If the liability is a true liability, then changes due to reforms, aging etc. should have an impact on other variables, such as risk premia of government bonds. And to capture this well requires both stock and flows information and considerations.

@ Introducing changes in stocks and flows of liabilities is needed to make the distinction between expenses and financing of benefits, but also transactions and other flows. They are crucial for a better understanding of the economics of retirement income financing - i.e. they establish the

accounting of sound pension policy and help thus prevent politicians to make unsustainable promises.

(iii) Some comments on FAD internal different positions

@ PAYG system in equilibrium: A liability remains a liability even if future revenues are available to fully finance. But these future revenues are creating also new liabilities. If the system were to be in perfect equilibrium, then this would be expressed by no change in the liability position (relative to GDP, e.g.) and the impact on flows would be essentially zero.

@ Accrual-to date and not yet accrued liabilities: It is not the predictability which matters, but whether accrued rights have already been established and need to be serviced (at least partially), or new rights can be prevented by a system change.

Nicholas Barr

1) The quantum of future assets and liabilities has considerable uncertainty

(a) Future liabilities can change (i) with changes in life expectancy: longer life in old age will increase liabilities; however if the extra life is only in middle years then liabilities are unchanged but future assets higher. Liabilities can also change (ii) because the state can alter the terms of its pensions promise, as for example in the UK over the past 15 years (to say nothing of Argentina recently).

(b) Future assets can change, depending inter alia on the buoyancy of the contributions base, which in turn depends on trends in (i) income and (ii) life expectancy in middle age.

2) Any attempt to give a forward look to the public accounts needs to cover:

(a) Future assets as well as future liabilities

(b) Why just pensions? One could make the same case for projecting future net liabilities in respect of health care and education. In most countries those liabilities are implicit, though no less real for that, but in some countries, where there is a constitutional guarantee, the liability, at least qualitatively, can be explicit.

3) The previous 2 sets of points suggest that there is a large 'funnel of doubt' about the future net pension liabilities. Thus there might be a case for giving a range of estimates (e.g. a middle-estimate together with a more optimistic and more pessimistic estimate).

4) In some cases, it MIGHT be possible to reduce the funnel of doubt by estimating not the TOTAL net liability of a pension scheme, but the likely CHANGE in the net liability resulting from a particular reform proposal.

5) The draft (p. 11, last but one para.) talks about the 'burden' of public pensions. But the real resource burden is the same whether the liability to pay pensions rests in the public sector or the private sector.

Richard Disney

The issue is what exactly is the obligation that the government has taken on board in a PAYG scheme.

I suggest that there are two basic issues:

- i) what exactly is the obligation? This must revolve around the distinction between accrued and projected liabilities.
- ii) what is the parallel? Think of the issue of government (paper) debt - I (a government) issue a piece of paper and promise to redeem it in the future. What exactly is the legal position of that promise? That a government can retrospectively change its pension obligations is always the case (although historically, with the exception of indexation procedures, governments have been happy to tinker with projected rights - much less so with accrued rights). But governments can also renege on paper rights e.g. debt issue. In general governments would be foolish to adopt the latter strategy, not least for the response from the IMF. But governments have occasionally done so - in which case why is the pension 'promise' any different from the promise of debt redemption?

The real issue in all this is not the principle but the measurement of accrued liabilities. Governments generally issue cash flow statements + projected liabilities - the accrued value of rights is equivalent to the private sector termination value and this is not usually calculated by governments. If this implicit debt becomes explicit however, governments will find all sorts of strange ways of reducing the book value of this debt e.g. the EU Stability Pact. So you have to have something like the European Commission strategy of insisting that valuations/projections are done according to parameters laid down externally. This of course induces much negotiation and backsliding.

I've written about this in a paper in a book edited by Tito Boeri et al (et al includes myself) for Kluwer in 2001 titled Pensions: More Information, Less Ideology. Our main point being that sensible analysis of this question, or indeed any other in pensions, requires better information than we mostly have at present.