LESSONS FROM THE OECD WORKSHOP ON "ACCOUNTING FOR IMPLICIT PENSION LIABILITIES" (Paris, June 4, 2004)

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The proposals by a national accounts international task force (also called "EDG", led by the IMF) to extend the borderline of the recognition of liabilities in the core system of national accounts to "implicit" or "quasi liabilities" of unfunded pension schemes has major implications, in particular for general government accounts. Headline aggregates, such as the net lending/borrowing of the general government would be significantly changed. As the national accounts framework is more and more used for the monitoring of public finances, especially in Europe, it is essential that these proposals are presented and discussed by the economists who are the main users of these data. The workshop organized by the OECD on June 4, 2004 had precisely this objective.

The workshop began with several presentations: (1) a summary of the new principles proposed by national accountants and of the implementation issues linked to these principles (joint presentation by OECD-STD and IMF-STA), (2) a summary of the views of public accountants (presentation by the OECD Public Governance Directorate), (3) the principles of business accounting illustrated in the case of the UK FRS 17 (presentation by the chair of the UK ASB), (4) a summary of the ongoing discussions among the members of the IFAC-PSC (oral presentation by the chair of IFAC PSC), (5) a discussion of the principles by economists (OECD Economics Directorate). I would like first to thank all the presenters. The presentations are available on the OECD web site.

The reactions of the economists to the proposals were quite varied, with many of them doubting that the proposals of the task force were realistic. However, some of them supported the proposed changes. The objective of this personal memo is to forward to the community of statisticians the reactions of these users, and to propose a set of possible solutions to accommodate the main criticisms that were expressed.

These solutions are based on two major new personal proposals that I submit to the statistical community: (1) abandon the idea of separating the cases of "employer schemes" and "social security schemes" and try to include both systems in the new proposals; (2) avoid including the massive imputations, implied by the proposals, in the core accounts by developing special tables devoted to the treatment of these quasi-liabilities.

The first new proposal is essential to maintain a minimum of international comparability. The second one will be seen by some as a bad half-baked compromise that will satisfy neither of the parties. However, I think it answers a strong message from economists not to introduce too many imputations in the core national accounts. Both these solutions have as their main objective to allow for national accounts to be more comparable on an international basis, which is obviously one of our main concerns at the OECD.

I. The current proposals of the task force.

The new principles proposed for implementation in the next SNA (scheduled for 2008) can be summarized by the following bullet points:

1. Abandon the criterion of funded/unfunded to recognize the pension liability in the SNA
2. Replace it with the concept of "constructive obligation" as the basis for the recognition of a liability. This concept lies between contractual liabilities and contingent liabilities. It is directly inspired by business accounting standards (IAS 19).
3. At present, the task force proposes to separate the case of employer schemes (which includes the general government as an employer) and the case of collective schemes, often called "social security schemes": recognize, in a first step, the liabilities of the former; discuss, in a second step, the recognition of the liabilities of the latter. This two-step procedure obviously allows for the situation that the second step would not result in the recognition of liabilities for social security schemes. This is the main proposal that I suggest, in the present paper, to modify.
4. Record contributions and property income flows generated by the recognition of the liability on an actuarial basis.
5. Allocate net assets of pension schemes to the sponsor.

Even when restricted to employer schemes (but including general government schemes) these proposals lead to changes of between 0.5 to 2% of the net lending/borrowing of the general government for countries where unfunded schemes are the rule for civil servants. In Europe, this would obviously need an adaptation of the Maastricht criterion of 3% government deficit to GDP.

II. Main reactions by economists

Participants at the workshop included many representatives of the OECD Economics Directorate's network of experts on the impact of ageing populations. Their reactions were split into two groups. The first one, including representatives from continental Europe, was strongly opposed (Belgium) or very prudent (France) regarding the proposals. It is fair to say that the EU DG-ECFIN share very serious concerns about the proposals, as is the case with some economists from the OECD Economics Directorate. The second group includes countries such as Australia, USA, and Norway who support the change.

The main arguments from the critical camp were:

1. Official economists from OECD countries already make, under the aegis of the OECD network on ageing, complete projections to analyze the impact of aging on the sustainability of government pension and social security schemes. These projections are significantly richer, in terms of informational content, than what is proposed for the national accounts. They include the timing, year by year, of the potential problems. They include future obligations, while national accountants limit themselves to the

present value of future benefits created by past obligations. What is, in this context, the usefulness of the proposed change in the national accounts?

2. Can one consider that there is a real liability for pension obligations when these obligations can be changed by a reform? Such reforms were made recently in France and Belgium. They resulted in changing future benefits of past services. It was not therefore a liability, by definition.
3. There is no difference for a government between future pension obligations and future health cost obligations. What is the rationale that allows national accounts to focus on the first and ignore the second?
4. The proposed recording of pay as you go schemes as if they were a saving scheme introduces an asymmetry between the recognition of the liability (the future benefits) and the non recognition of an asset (the future contributions or taxes).
5. The proposal could lead to a difference in the treatment of "social security systems" and "employer schemes", and in particular general government employer schemes. This difference appears artificial in countries such as Belgium or France. All recent reforms concerned government employees and employees of the private sector who participate in the social security scheme. In fact, in some cases, it is difficult to find any difference between the commitments to pay future benefits in the two cases. This means that simple administrative changes, for example changing the administrative arrangement of the general government employer scheme to make it part of the social security system, would have the strange impact of eliminating the very large liabilities that were recorded when it was an "employer scheme". This could indeed call for creative accounting, making the headline aggregates of the national accounts useless for policy monitoring.
6. The actuarial estimations would introduce into the national accounts estimates of a very doubtful quality, subject to arbitrary big changes. This could lead to economists demanding data excluding these estimates. A solution would be to avoid affecting the core accounts with these estimates, but reserve them for satellite tables.

III. Discussion of some of the criticisms

I will discuss now what are, in my view, the three main criticisms: (1) point # 2, (2) point # 5, and (3) point # 6.

 # 2: Are liabilities that can be changed real liabilities?

The discussion showed that national accountants should clarify the precise situation when they would want to recognize a liability. Some experts, as reported by the OECD Public Governance directorate, interpret "accrual" accounting (the SNA is supposed to be an accrual accounting system; accrual accounting means accounting for rights and obligations as they occur) as only recognizing as liabilities those obligations that are *enforceable by law and/or those where individual rights cannot be changed retroactively, but only for future periods*. Under this interpretation of liabilities, the pension obligations of the French government to its civil servants are not liabilities, as they have been changed recently (changes were made to

future obligations resulting from past rights). With this interpretation, the amount of recorded liabilities would be narrow.

Should that be the view adopted by national accounts? I think not. First, this interpretation is not the one adopted by private business accounting. The recognition of a liability in the balance sheet of private business does not depend on whether the obligation can or cannot be changed retroactively. There are even clauses in the accounting standards that precisely describe what to do when there is a change of the benefits structure (i.e. generating a change of the liability). The second argument is that the narrow definition would introduce a too "legalistic" criterion in the compilation of national accounts. National accounts are not completely bound by legalities. To confirm that such and such an obligation can be enforceable before a court, would put national accountants in the situation of legal experts, and thus would be difficult to implement. It would also probably put in danger the international comparability of the accounts, as some minor differences in legal arrangements would dominate the choice of whether or not to recognize a liability. It is better to adopt a more economic criterion.

This criterion proposed is the concept of "constructive obligation". It is inspired directly by the concept used in the international accounting standards (IAS 19). A constructive obligation is "*an obligation that derives from an enterprise action where: (a) by an established pattern of past practices, published policies, or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and, (b), as a result, the enterprise has created a valid expectation on the part of other parties that it will discharge these responsibilities*." This definition is less narrow than the one based purely on legalities. It does not exclude those liabilities which may change in value over time by a reform. Under such a definition, the pension obligations of the French government, even if changeable through reform, would be recorded as liabilities. Seen from a macro-economic point of view and also in terms of international comparability of households' assets, this seems a reasonable result.

In any case, whether they accept or not this definition, national accountants should clarify their position on this criterion.

 # 5: Is it appropriate to separate employer schemes from social security schemes?

It appears to me that there are two extreme groups of OECD countries regarding the organization of pension schemes. The first one comprises countries such as the USA, Australia, Canada, UK, the Netherlands, where the pension arrangements are centered on employer schemes, with, in addition, a 'safety net' collective system called "social security".

By construction, these countries have no second thoughts about the current proposal of the national accounts task force to (potentially) limit the recognition of liabilities to "employer schemes". It seems normal for them to record all the liabilities of employer schemes, including the general government as an employer, and, possibly, to not recognize the liability of the so-called "social security" which could be considered in fact "social assistance".

At the extreme opposite, there are countries such as Belgium and France where the global pension arrangements are based on one major collective system. This system is also called "social security", but it is not the same as the one for the first group of countries. In this second group of countries, pure employee schemes are minor (except for general government). In a country such as France, all private employees are part of the social security system that can be seen therefore as a global multi-employer scheme, but organized within the control of the general government. Because of history, only government employees' pension obligations are organized outside the social security system.

It therefore appears strange to these countries to recommend recognition of the quasi liabilities of the employer schemes but not those of social security schemes. This would mean that the civil servants would be shown as having an asset but not private employees. The situation would look even more arbitrary within general government, because central government employees are all in an employer scheme and some local government employees are attached to the social security system.

As can be seen, for the second group of countries, the borderline between "social security" and "employer schemes" is not the same as it is for the first group. In this context, "social security" is a poor and insufficiently precise terminology for systems that differ in their content. In the first group, there is a difference in content and in commitment between employer-based pension schemes and social security schemes. In the second group, the difference between the two is based on administrative arrangements. It is not impossible, for example, that the French government could decide to create a special unit, attached to the social security system, to administer the pensions of its employees. This would mean that, if the national accounts were to have a borderline for liability recognition based on "employer scheme" versus "social security", it would result, as if by a miracle, in the disappearance of a massive public debt (civil servants pension debt is estimated to be 50% of annual GDP).

It is unsustainable to introduce such an arbitrary borderline in the national accounts. This arbitrary borderline would also seriously hamper international comparability of the macro accounts, because it is based on administrative arrangements and not on the commitment of the sponsors vis à vis the beneficiaries.

I think therefore that the current strategy of two steps (the first on employer schemes and the second on social security) is inappropriate. My proposal is to link the two steps, <u>and to accept from the start an extension of the borderline to include the liabilities of social security schemes</u>.

The proposal can be expressed as: base the recognition of the liability on the existence of "constructive obligations" whether or not this obligation is organized under a pure employer system, or a multi-employer system called "social security". Some may consider that this is too ambitious, and that this extension would unduly include in the borderline obligations for which the commitment of the sponsor is really too low. It is possible to imagine better definitions of the borderline. One possibility may be to record all obligations linked directly (through an employer scheme) or indirectly (through a collective system or multi employer

scheme) to the deferment of employee compensations. But, in any case, the strategy to accept potentially that “employer schemes” and “social security schemes” be treated separately is unsustainable.

My solution is to encompass all systems in the proposed change. It will increase by an enormous amount the pension liabilities in the macro-accounts. But its advantage is a better rationale and better international comparability.

 # 6: Should these liabilities be recorded in the core accounts?

The impact of the envisaged change for countries with big unfunded employer schemes can be massive: the amount of unfunded general government implicit liabilities reaches, for example, 20% of annual GDP in Australia and Canada, and 50% for France. If, as proposed in the previous section, the borderline is extended to all schemes, including social security, the numbers become frightening, something from 200% to 400% of annual GDP!

This therefore focuses attention on the quality of these estimates and their reliability. The discussions at the workshop showed that, first, the estimates depended on parameters that can be arbitrary (discount rate) and/or not fully mastered (population of beneficiaries, life expectancies, etc.). There is therefore a real concern regarding the quality of the flows that will be recorded in the accounts.

There will be two major non-financial flows affected by the change: (1) the actuarially based contributions, (2) the imputed property income (obtained as the stock of debt multiplied by the nominal interest rate). It may be seen as very disturbing to put these estimates on the same level as flows that are really observed, with the implications that it could have on the credibility of the headline aggregates of the national accounts, in particular for general government. Of course, when the actuarial calculations are made by professional actuaries, national accountants would be on a safer ground. But this will not happen immediately for all schemes, and in particular for social security schemes.

It would be therefore more prudent to separate the entries that would result from the new proposals from the core accounts. The idea is not however to consider that these calculations would be pure memorandum items. The problem with memorandum items is that they are generally not compiled by national accountants (in fact, the current SNA already recommends to compile implicit liabilities of unfunded defined benefits schemes as memorandum items, but nobody does it).

My proposal is a mixture of core financial accounting, by creating a specific category of “pension quasi liabilities” in the core financial accounts, and of satellite accounting, by creating a special table, below the line of net lending/borrowing, where the flows linked to the newly created “pension quasi liabilities” would be recorded completely separately. Such a system would have the advantage of being able to deliver to economists both sets of data, the one excluding “pension quasi liabilities” and the one including “pension quasi liabilities”.

Other presentations are possible, including the one which would create completely parallel accounts, one in "cash" accounting and one in "accrual" accounting.

This proposal may be seen as a bad, half-baked compromise, which finally does not decide on what is the really "good" treatment. However, it addresses a strong message in the workshop which asked statisticians to avoid including too many imputations in the core accounts or, at least, to allow economists to be able to "debundle" the two types of figures. Also, my proposal includes the creation of new balancing items which would be strictly equal to those generated by a fully-fledged recognition of pension liabilities, thus satisfying those who think it is the way forward. These figures would be preferable for international comparability than the existing ones.

I give below two examples of the recording under the system that I propose. The first one covers the example of an unfunded employer system, where the pension scheme is non autonomous. Its accounts are therefore embedded in the employer's accounts. The second one covers the case of a pay as you go social security system. Both these examples use the same basic data. They illustrate a case where the current cash flows (contributions, pensions) underestimate the "accrual" flows, thus a situation of greater deficit in "pure accrual" accounting.

Case 1: unfunded employer system

The first table illustrates the current SNA accounting framework for an unfunded employer scheme.

The account starts by the employer "paying" an imputed pension contribution of 11 (D122). This amount is included in the compensation paid to its employees (households). These employees pay back to the employer (i.e. in fact to the embedded pension scheme of the employer) this contribution (D612) and also their own "employee" contribution (D6112). The employer then pays the pensions of 11[1]. The net lending/borrowing (B9A) of the scheme is a "cash" figure, equal to -9.5. In the financial accounts, only one entry is recorded: the corresponding cash movements (pensions paid (11) minus employee contributions (1.5)).

The second table illustrates my proposal. All flows above B9A are strictly equal to the previous ones. Thus net lending/borrowing is not changed compared to the current SNA, it remains a "cash based" net lending/borrowing. But I create, below the line of B9A, a "special account for pension quasi liabilities". In this account, one finds on the use side the amounts that correspond to full accrual accounting regarding the quasi-liabilities. First an amount of 14 for actuarial contributions, which is here superior to actual pension paid, illustrating the

[1] One can note that, in this example, I have taken the imputed contributions (D122) as equal to pensions paid (D62). However, this is not an important assumption in the context of this account. I could have taken another amount. The result would have been the same on net lending borrowing because D122 is mechanically compensated by D612.

change in the demographics of this pension scheme. Then there is an amount of 6 for the imputed property income, which is generated by the existence of the pension quasi-liability. On the resources side of the account, one finds an "adjustment for cash recording" which corresponds to the opposite number of the cash-based B9A.

I introduce a special balancing item (B9S) for this special account. This item exactly corresponds to the addition to the net lending borrowing of the change in the pension quasi liabilities.

In the financial accounts, one records a specific line which I called "F6X" which corresponds to the estimate of the change of the pension quasi liability towards households. Its value is equal to accrued rights (14) + reinvestment of imputed property income (6) + employee contributions (1.5) – payments of pensions (11).

The financial accounts end with two balancing items: the traditional one, B9B, excluding quasi liabilities, and a new one, B9X, which is equal to the sum of the cash B9B and the quasi-liability B9S. One can note that B9S is exactly equal to the net lending borrowing that would result from the implementation of the proposed changes in the core accounts. The advantage of this presentation is that economists have both sets of numbers at the same time: the traditional one, excluding quasi-liabilities, and the new ones, including quasi-liabilities.

Case 2: pay as you go social security.

Case 2 illustrates, using more or less the same numbers, a pure pay as you go social security system. This unit receives contributions from employers[2] and employees, and pays pensions. The "cash" net lending/borrowing of the scheme, as recorded in the current SNA, is equal to +1.5, the difference between the actual flows received and the pensions paid.

I show then the new accounts, under my proposal. As in the previous case, nothing is changed above the line of B9A: the numbers remain "cash" accounting. As in the previous case, a special account for pension quasi liabilities is created. It includes, on the use side, the amount of "actuarial addition to cash contributions" (i.e. the difference between the current contributions and the actuarial contributions), which is equal to 3 in my example (14-11), and the amount of imputed property income generated by the recognition of the quasi liability (6). On the resource side, appears the number opposite to the "cash" B9. The balancing item B9S shows a deficit of 10.5, corresponding to the increase in the debt in pension quasi liabilities. The financial accounts record the cash movements, and the line F6X, the change in pension quasi liabilities, which is obtained exactly as in the employer's scheme example. The accounts show the new balancing item B9S, equal to -9, the sum of the "cash" surplus of the social security (+1.5) and the "pure accrual deficit" of -10.5.

[2] In this system, employers have completely discharged their debt on pension by paying their contribution.

Why is this number (-9) different from the first case (-20)? The answer is that we have here separated the unit organizing the system from its "sponsors". The implicit net lending borrowing of the sponsors is equal to 11, the amount of employers' contributions. If we add both deficits, thus consolidating the accounts, we obtain -20.

Case 1. Unfunded employer system.

Current SNA recording

	Imputed flows are in italics	**Employer**	
		Uses	Resources
D122	*Imputed employer contributions*	*11*	
D6112	Employee contribution		1.5
D612	*Employer contribution*		*11*
D62	Pensions	11	
B9A	**Net lending/ net borrowing**	**-9.5**	
	Financial accounts	*ΔAssets*	*ΔLiabilities*
AF2	Cash	-9.5	
B9B	**Net lending/ net borrowing**		**-9.5**

New recording

	Imputed flows are in italics	**Employer**	
		uses	Resources
D122	*Imputed employer contributions*	*11**	
D6112	Employee contribution		1.5
D612	*Employer contribution*		*11**
D62	Pensions	11	
B9A	**Net lending/ net borrowing**	**-9.5**	
	Special account for pension quasi liabilities		
	Adjustment for cash recording		*9.5*
	Actuarial contributions	*14*	
	Imputed property income	*6*	
	B9S	*-10.5*	
	Financial accounts	*ΔAssets*	*ΔLiabilities*
AF2	Cash	-9.5	
F6X	Pension quasi liabilities		10.5 (14+6+1.5-11)
B9B	**Net lending/ net borrowing excluding quasi liabilities**		**-9.5**
B9X	**Net lending borrowing including quasi liabilities**		**-20 (-9.5-10.5)**

* I have avoided to record as the imputed contributions the actuarial contributions of 14, to avoid complicating the debate. However, it is possible to record 14 here rather than 11. This does not change anything in the financial accounts or for net lending borrowing. It would raise GDP in the case the employer is the government, and reduce gross operating surplus in the case of private business.

Case 2: social security system

Current SNA recording

	Imputed flows are in italics	**Social security**	
		Uses	Resources
D6112	Employee contribution		1.5
D612	Employer contribution		11
D62	Pensions	11	
B9A	**Net lending/ net borrowing**	**+1.5**	
	Financial accounts	*ΔAssets*	*ΔLiabilities*
AF2	Cash	+1.5	
B9B	**Net lending/ net borrowing**		**+1.5**

New recording

	Imputed flows are in italics	**Social security**	
		uses	Resources
D6112	Employee contribution		1.5
D612	Employer contribution		11
D62	Pensions	11	
B9A	**Net lending/ net borrowing**	**+1.5**	
	Special account for pension quasi liabilities		
	Adjustment for cash recording		*-1.5*
	Actuarial additions to contributions	*3*	
	Imputed property income	*6*	
	B9S	*-10.5*	
	Financial accounts	*ΔAssets*	*ΔLiabilities*
AF2	Cash	+1.5	
F6X			10.5 (14+6+1.5-11)
B9B	**Net lending/ net borrowing excluding quasi liabilities**		**+1.5**
B9X	**Net lending borrowing including quasi liabilities**		**-9.0 (+1.5-10.5)**