“Issues to consider: the federal Unified Budget Act and the lack of following Generally Accepted Accounting Principles and implications for future liabilities”

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ARTICLE INFO	Paul F. Gentle, Terri R. Jett, José B. Falck-Zepeda, Tao Chen and Hong Ming (2013). Issues to consider: the federal Unified Budget Act and the lack of following Generally Accepted Accounting Principles and implications for future liabilities. *Banks and Bank Systems*, *8*(4)
RELEASED ON	Wednesday, 18 December 2013
JOURNAL	"Banks and Bank Systems"
FOUNDER	LLC “Consulting Publishing Company “Business Perspectives”

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Abstract

The United States Unified Budget Act (UBA) was implemented in 1969. Subsequently, all federal revenues, even those designated as going to trust funds, were used to determine each current fiscal year's Unified Budget's size of the surplus or deficit. Social Security and other trust funds are held in trust and by mandate and all are used to hold Treasury securities. The time period of data used in this paper is from 1940 through 2012. Any domestic or foreign holders of U.S. Treasury bonds need to have a complete picture of the financial status of the United States federal government. China and Japan hold more U.S. Treasury securities than any other foreign country. Yet most of the debt is held domestically in the USA. The UBA employs a cash accounting system, instead of an accrual system. In order for the public to have a more complete picture of future federal obligations, we propose this level of transparency. In addition to presenting the UBA cash accounting system dollar amounts, both the Congressional Budget Office and the President's Office of Management and Budget should publicly provide estimated accrual accounting system dollar amounts. Any reputable, large business firm does so and even some small business firms do.

Keywords: United States Treasury securities, Unified Budget Act, Chinese and Japanese holdings of United States debt.
JEL Classification: E66, H10, H60.

Introduction

Starting with fiscal year 1969, the United States President and Congress, through the Unified Budget Act, have portrayed each fiscal year's federal budget as being balanced, or having a deficit, or a surplus of a certain quantity. From 1935 to 1968, because Social Security funds had a "separate function" in the federal budget, Social Security trust funds were "off budget" (Erdevig, 1990; Social Security, 2006). The UBA changed the federal budget into a cash basis accounting system, as opposed to accrual accounting, that had been the practice, before fiscal year 1969 (Erdevig, 1990; U.S. Treasury, 2002; Social Security, 2006; Averkamp, 2008). By enacting that legislation those Representatives and Senators, which form the U.S. Congress and the President decided that Social Security, Medicare, the Highway Trust Fund, the Airport and Airway trust funds, as well as all other federal trust funds are no longer treated as separate items from the unified federal budget. Furthermore any balances in any federal trust fund can only be used to hold U.S. Treasury securities.

1. Treasuries

In evaluating a government's fiscal position, economists often use the ratio of the government debt to the nation's gross domestic product (Mankiw, 2012). If this ratio becomes too high, there can be an effect on future public and private borrowing ability and economic growth for both the private and public sectors. The projected ratio for debt to GDP debt is projected at 73 percent at the end of fiscal year 2012. It is projected to be 78 percent in 2023 and 99 percent in 2040 (Korgan et al., 2013). In August, 2011, Standard and Poor's (S&P), a major ratings agency, downgraded the credit rating for U.S. Treasury securities from AAA to AA+. And S&P took this action to bring attention the need for both Congress and the President's Administration to better face up to fiscal challenges. Furthermore "more broadly, the S&P downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges" (Swann et al., 2011). At the end of June 2013, foreign holders of U.S. Treasury securities held $5,600.6 billion worth of such securities, with China and Japan being the two countries with the largest holdings, at $1,275.4 billion and $1,083.4 billion respectively (U.S. Treasury International Capital System, 2013). The U.S. Defense Department has stated that China's holding large amounts of Treasury securities is not in any way a threat to the USA's national security (Rapoza, 2013). Indeed China knows that if it sells off large amounts of U.S. Treasury bonds, then the value of China's own portfolio of U.S. Treasuries would sink by a great amount since the securities markets are influenced by supply and demand. Chinese Premier Wen states that the USA and China have a trade partnership (Jackson, 2008; Yan, 2008; Yu and Ming, 2008). The U.S. should be mindful that if foreign investors do not buy sufficient Treasury securities and if there is insufficient domestic demand, then of course there will be a greater need to monetize more debt, through sales of Treasury securities to the Federal Reserve (Bonner, 2009; Powell, 2009; LaBonte, 2012). The total USA federal debt is $16.35 trillion (OMB, 2013). Most of the USA government debt is held domestically. A detailed analysis of foreign exchange disputes between any countries is beyond the limited scope of this paper. Let it suffice to say that the British journal, *The Economist* (2011) states that the World Trade Organization (WTO) should adjudicate such disputes, without unilateral action on the part of any country.

2. Consequences of not using GAAP

By not following Generally Accepted Accounting Principles (GAAP), in showing the accrued liabilities, the reported federal budget basically reflects a cash accounting system, as opposed to an accrual accounting system (U.S. Treasury, 2002). With cash budget accounting, there is no regard for indicating future fiscal year expenditures (Cunningham, 1989; U.S. Treasury, 2002; Averkamp, 2008). The Unified Budget deficit is the most widely quoted measure of the federal budget, including any surpluses or deficits (Garner, 1989). The federal debt is the accumulated deficits and surpluses from all the current and previous fiscal years. There can be no doubt that the President, the Senators and the Representatives know their figures differ from that of the United States Treasury, when the President (OMB) and Congress (CBO) agreed to cash budgets versus what the U.S. Treasury estimates are in terms of an accrual budget (Office of Management and Budget, 2013; Congressional Budget Office, 2010; U.S. Treasury, 2002; Lewis, 2006). In the future, as the United States is faced with entitlement programs, such as Social Security and Medicare, perhaps the options for continuing the programs, include increasing the retirement age, increasing relevant taxes, decreasing benefits or some combination thereof. Another option concerns the U.S. Treasury securities which all U.S. Trust Funds are, by law, held. As Social Security and Medicare Funds must be used, these U.S. Treasury securities must be redeemed. Social security trust funds accumulate to provide retirement to participating workers, as well as their dependents, and also to provide disability income. Social Security has raised the standard of living of elderly people through lowering what would be a higher incidence of poverty compared to other groups of the population (Rivlin et al., 1990). Amendments to the Social Security Act in 1983, included a number of changes to increase program revenues (Erdevig, 1990). The amendments from the 1983 Commission, were based on recommendations from the National Commission on Social Security Reform. Increases in Social Security payroll taxes and the steps of increases in retirement age were intended to strengthen the financial strength of the Social Security program (Carlson, 1991; Anderson, 2005). Also, the effective dates for scheduled tax rate increases in the prior law for employees and employers were advanced, and self-employment tax rates were permanently increased for upper income beneficiaries. Furthermore, up to one-half of the benefit amount was included in taxable income. Revenues resulting from income taxes on benefits are appropriated back to the Social Security trust fund (Erdevig, 1990). Cox and Archer (2012) give an estimated Social Security and Medicare liability of $87 trillion in the next seventy-five years.

Consolidating Social Security and Medicare program temporary surpluses with other federal receipts and outlays is in accordance with the government reduction targets of the “Balanced Budget Reaffirmation Act of 1987,” commonly known as the Gramm-Rudman-Hollings Act (Garner, 1989). So this Unified Budget Act was further enshrined in to the way presidents, senators and representatives would try to get the public and the media to perceive what the deficit is and the magnitude of that deficit. The purpose of building reserves in the Social Security trust funds was not to keep the rest of the federal budget from “something approaching (a) balance” on a cash budget basis (Rivlin et al., 1990). Certainly the use of Social Security trust funds to purchase Treasury securities can create a public misconception of the seriousness of the federal debt (Cunningham, 1989; Webb, 1991).

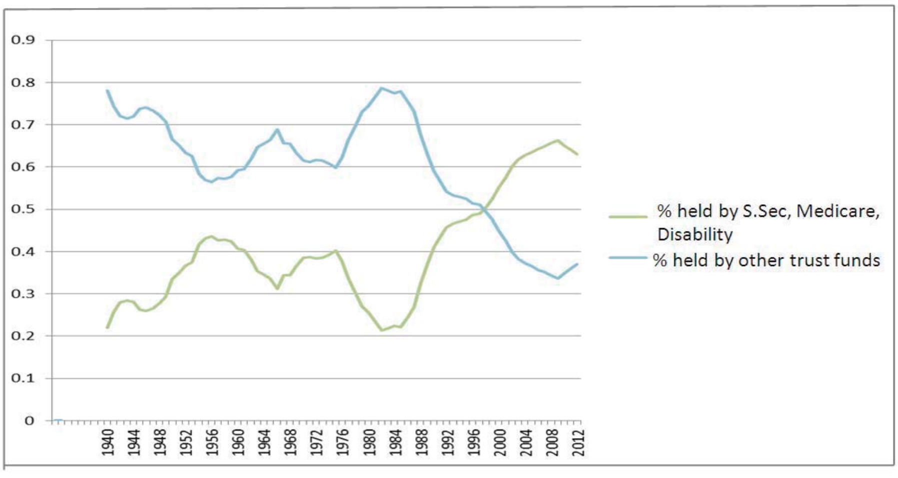
As more Americans retire from the baby boomer generation, the Social Security Administration and Medicare will find itself in a situation of having to sell U.S. Treasury securities (Cunningham, 1989; Erdevig, 1990). The baby boomer generation refers to those people born between 1946 and 1964, inclusive. Investing in foreign assets by the Social Security trustees is not advisable, since they are not as reliable as U.S. Treasury bonds. Indeed, it may actually be better for Social Security trustees to continue purchasing U.S. Treasury securities with the intention of selling them abroad in the future in order to eliminate the risk of accumulating unreliable foreign assets. However, counting on the rest of the world to be willing to purchase U.S. Treasury securities in the middle of the next century may only be reasonable if the federal budget is brought under enough control to ensure investors from foreign capital markets that the U.S. will be capable of standing behind U.S. Treasury securities (Cunningham, 1989).

Furthermore, many disagree with any investing of the Social Security surpluses in common stocks, as some have proposed because they do not see the positive balance as a surplus, since it is pledged for future obligations and investing trust fund balances in the “equity market would boost the Treasury’s need for funds by the equivalent amount” (Forsyth, 1996). Former Fed Chairman Alan Greenspan shares this viewpoint and has made it widely known. Also, despite the sometimes higher rates of return on financial securities from the private sector, this is concomitant with higher risk, something to be avoided for Social Security trust funds. The National Bureau of Economic Research found no certainty in improving the finances of the Social Security Trust fund through an investment in common stocks instead of Treasury bonds (McCurdy and Shoven, 1999).

In the future, the federal government will be faced with both having to take care of the federal debt, and having to repay the money borrowed from the Social Security trust funds. Then the government budget will have to raise taxes, or reduce expenses, or borrow from other loanable funds, probably private and foreign, which will increase the demand for private loanable funds. If tax rates are increased to repay the money borrowed from the Social Security trust funds, this could mean that people who later become Social Security beneficiaries will also pay proportionately higher taxes (Erdevig, 1990). Whether the federal budget deficit is addressed now or later, the choices are the same as they are now. These choices are to cut expenses, raise taxes, or borrow from other sources (Erdevig, 1990; Regalia, 1995). Although it is known that the Social Security system as we know it is unsustainable in the long run, recognition has yet to yield any concrete action. Meddling with the system can end a political career (Altig and Gokhale, 1996). Probably the most important consideration for the future is that "major spending and tax decisions should be made with reference to a time period longer than the traditional five-year budget window, such as the 30-year time frame" (Bipartisan Commission, 1995). The two funds in the Social Security System are the one that pays benefits to retirees and survivors and the other fund that pays benefits to the disabled. In terms of matters related to the federal budget, it is common practice to combine these two trust funds under the title of Old-Age, Survivors, and Disability Insurance (OASDI). Included in the trust funds for OASDI are payroll tax receipts, interest income from U.S. Treasury securities invested by Social Security and any other income. Payments out of OASDI and Medicare go towards retirement, disability, Medicare benefits, as well as to pay operating expenses of the Social Security Administration (Erdevig, 1990). Of course, Social Security and Medicare trust funds constitute all the federal trust funds and are used to try to "balance" the Unified Budget. Other important trust funds include the Airport and Airway Trust Fund, and Federal Civilian Retirement Fund (Jackson, 2006; Orszag, 2007; Office of Management and Budget, 2013).

3. Graphical analyses

At the end of fiscal year 2012, the various trust funds of the USA Federal government held 4.8 Trillion dollars worth of USA Treasury securities (This of course does not include any holdings by the U.S. Fed, which buys and sells U.S. Treasury bonds, as part of the implementation of the Fed's monetary policy). It is a fact that the U.S. Government trust funds hold more U.S. Treasury Securities than any foreign country. Figure 1 illustrates the trust fund holdings of USA Treasury securities. The ratio of the sum of Social Security, Medicare and Disability Trust Funds total to the total of Federal Trust Funds is the dark line. One can see that as a percent of the total trust funds, this has increased as time has gone by. In addition, this graph plots the other trust funds total and divides that by the total federal trust funds total. In analyzing what main point this graph tells us, we can see that Social Security, Medicare and Disability balances have increased over time compared to other trust fund balances. In particular, one can see that in fiscal year 1982, Social Security, Medicare and Disability Trust Funds total took a marked upturn. That is significant. They are increasing in size in preparation for the Baby Boomer generation. Note that the time period of this graph is from 1940 through 2012. There is plenty of data here to make our point that taken as a whole, balances in Social Security, Medicare and Disability are very important in creating the picture that the Unified Budget is closer to being balanced than it would be without the Unified Budget Act in force.



Source: Authors' estimations from the Office of Management and Budget, Executive Office of the President, Historical Tables for the budget of the United State Government, Fiscal Year 2013, Washington, D.C.: U.S. Government Printing Office.

Fig. 1. Federal trust funds holding U.S. Treasury bonds: broken down by percentage held by Social Security, Medicare and Disability versus percentage held by other trust funds – for period from 1940 through 2012

Conclusions

The United States government has never defaulted on a Treasury security. That is why those who hold U.S. debt think it is a good place to keep their money. Yet all people should have a complete idea about the financial status of the United States, both in terms of the present and the future, which would be more in keeping with the current political focus on transparency, that reformers are trying to achieve. It is not the authors' intent to decide the merits of any federal program. So details about individual programs and recommended fiscal policies of taxing and spending are beyond the scope of this paper. Debt monetization is also not discussed. This paper is a starting point to explain about the UBA accounting methods to more people. An accrual method that follows. Generally Accepted Accounting Principles (GAAP) is available from the U.S. Treasury deficit and debt figures. The chances may be remote that the U.S. Congressional Budget Office (CBO) and the U.S. Office of Management and Budget (OMB) would follow suit with what the U.S. Treasury practice of including both the cash and the accrual accounting estimates of the national debt.with an accrual method of accounting. However, both the U.S. Congressional Budget Office (CBO) and the U.S. Office of Management and Budget should be required in addition to presenting the UBA cash accounting system dollar amounts, to publicly provide estimated accrual accounting system dollar amounts. Then the public will have a more complete and transparent picture of future federal obligations. In comparison, the reputable businesses produce and use both accrual and cash budgets together, in order to assess the financial health of their firms.

Acknowledgement

We appreciate valuable comments especially from Fred Engst, Brook Lide and also from Ram Archarya, Patricia Duffy, Ed Gentle, James Novak, Krishna Paudel, Mark Thornton, Kamal Upadhyaya, and Chris Westley on a much earlier edition of this paper.

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