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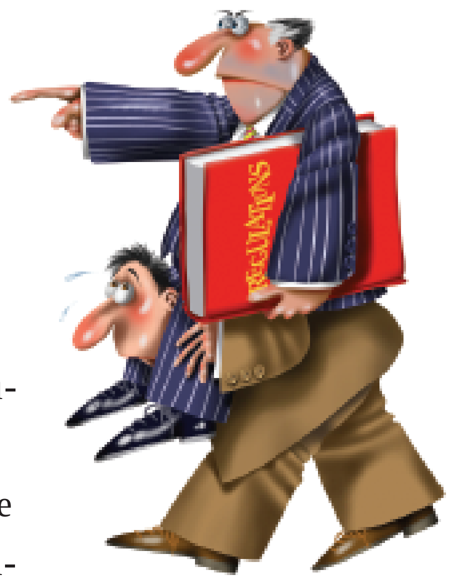
Politicians Need Ethical Financial Managers



As is the case with CEOs of for-profit enterprises, perhaps the most important task the leaders of our municipalities, states, and the federal government undertake is to manage the financial affairs of their respective entities. Of course, all CEOs can either rely on decision-support information provided by ethical financial managers or choose to ignore it. Citizens demand numerous governmental services while at the same time insisting they be provided with prudent efficiency and economy. As experts in the highly relevant subjects of budgeting, forecasting, control, and financial analysis, management accountants and financial managers play a key role in providing financial support information for key decisions.

In spite of the fact that the term "accounting smoke and mirrors" was coined some years ago to describe the financial shenanigans used by governmental bodies to balance annual budgetary spending with anticipated income, its use seems to be expanding in recent times. Although most news headlines involve discussions at the federal level, the practice is alive and well at the state and local levels as well. Examples abound of transactions that solve short-term financial crunches but merely delay the recognition of revenue shortfalls or excessive spending.

One example of short-term thinking at the cost of long-term solvency is the 2004 sale (really a 99-year lease) of the Chicago Skyway Toll Road by Chicago Mayor Richard Daley to a consortium of foreign investors. Of the $1.37 billion the city received, "most of the loot is likely to be gone in a few years," according to the November 22, 2004, *Crain's Chicago Business*. In the same article, Moody's says it is maintaining its "negative outlook on Chicago debt," apparently reflecting a structural deficit. In addition to higher taxes for Chicago residents due to the resulting higher interest rates on Chicago bonds, travelers are faced with higher tolls, which were announced shortly after the deal closed. This transaction represents another example of foreign entities owning a greater share of American assets.

States around the country are extending maturities of existing debt, paying only interest in early years and back-loading repayment of principal in order to balance current cash outflows with expected income. Particularly ingenious was Illinois's plan in 2003 to solve past underfunding of pension obligations. According to the January 5, 2004, *Crain's Chicago Business*, the state "borrowed $10 billion in the bond market, booked an assumed $2 billion investment gain on the proceeds, and put the state agencies and their pension funds into the position of figuring out how [to generate enough cash] to pay off the bonds and meet future pension obligations."

Interestingly, the Illinois "solution" seems very similar to the Social Security reform package being

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advanced by U.S. President and CEO George W. Bush, yet it is also very different from the reform plan. The similarities entail significant borrowing and the recognition that past funding strategies have been inadequate or are no longer appropriate.

The differences between the state and federal strategies are more pronounced. The Illinois plan is essentially a funding mechanism and transparent to the worker. Thus, the administrative costs of portfolio maintenance, investment risks, and investment responsibilities are retained by the state. Under the Bush partial privatization proposal for Social Security, these matters would be shifted from the payer, the federal government, to individual workers. It appears that workers would each be responsible for deciding how much to save, selecting their portfolio from an approved menu, paying investment and administrative costs, and assuming the risks of market downturns, all while making sure the assets in their personal accounts last throughout their lifetime. The President wants workers to "own" some of their retirement funds so that any residual not spent for retirement could be passed along to survivors or charity.

The major issue for the ethical financial analysis of Social Security reform is that, according to the U.S. General Accountability Office, privatization will exacerbate and not, as implied by the President, "permanently" solve the funding difficulties anticipated in 2042, 2052, or later, depending on actuarial assumptions. Putting payroll taxes into personal accounts instead of the Social Security Trust Fund leaves less funds available for benefits to retirees.

This is a strong argument that any discussion of privatization should be held off the table until a funding solution is devised. Discussion of a solution to possible future insolvency must of necessity involve one or more of the following actions: reduce benefits, increase either the rate or the base for payment of payroll taxes, extend the Social Security program to all government workers, or divert general tax revenue.

Another important issue raised by partial privatization is whether individuals can be depended on to always take a long-term view toward retirement with their invested funds instead of invading them for another worthy goal, such as bankruptcy avoidance. Although designated for retirement use, IRA funds currently can be invaded without penalty for purposes of higher education and home ownership.

If it's helpful to discuss both privatization and funding reform at the same time, there should be clear awareness that privatization would make fundamental strategic changes in the Social Security program. Even partial privatization would alter the basic premise upon which Social Security was founded—to provide a safety net so that low-income elderly could avoid poverty after their retirement. Making Social Security partially a defined contribution plan with some benefits related to the amount of worker contributions would help to finance the comfortable retirement of more well-to-do employees. But this has never been considered part of the mission of Social Security. Benefits have always been calculated so they rewarded lower-income beneficiaries at the expense of those with higher income who welcomed a basic benefit but almost always had other opportunities to provide additional retirement funding on their own, like an IRA or 401(k).

For example, using the Social Security benefit calculator, under the current rules a worker earning $60,000 annually over their lifetime would receive a retirement benefit only 1.9 times larger than a worker earning $20,000 annually. Thus, over a third of the three-times-larger amount of payroll taxes paid by or on behalf of the higher-paid worker goes to others.

Additionally, in later years, Social Security assumed responsibility to provide preretirement income to younger disabled persons not able to work. Funding to support these benefits would have to be found, as partial privatization wouldn't afford these beneficiaries an opportunity to accumulate invested funds on their own.

The President has stated that he would "provide political cover" to support a Congressional decision to make systemic changes in Social Security. This is not an adequate substitute for a detailed, well-reasoned, fully documented proposal for making such a significant change in American governmental philosophy. Because the financial analysis and supporting rationale provided for Bush's proposal so seriously omits critical financial issues, we would have to give it a failing ethics grade. The IMA Standards of Ethical Conduct are an excellent benchmark.

The IMA Standards state that management accountants and financial managers must perform their tasks with both integrity and objectivity. Integrity requires them to communicate unfavorable as well as favorable information and professional judgments or opinions. Objectivity requires management accountants and financial managers to

continued on page 61

communicate information fairly and impartially. It also requires full disclosure of all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented.

The current administration appears to avoid the disclosure of any information that doesn't support their chosen course of action directly. While this could be rationalized as utilitarian ethics, democracy demands an informed electorate that is able to knowledgeably advise its elected representatives on all major issues.

Members of IMA should ask their elected senators and representatives to address at least the following questions concerning a decision to privatize Social Security:

1. How much will partial privatization reduce currently projected Social Security retirement benefits?
2. How much administrative cost will taxpayers have to bear during the transition to privatization?
3. What amount of additional borrowings will be required during the transition?
4. How will the safety net for low-income and disabled beneficiaries be financed?
5. What safeguards will be in place to protect funds invested in personal accounts for retirement use only? ■

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