In the next year, lawmakers will consider different options for Social Security reform. In order to adopt the best policies, they must have all the facts. Unfortunately, much rampant confusion exists about how the Social Security trust funds operate. Some question whether the bonds held as assets in the trust funds are “real,” while others misleadingly claim that the existence of trust funds means that Social Security does not face a financial problem. The truth is while the trust funds hold real assets, Social Security also faces real financial problems.

SOCIAL SECURITY BASICS

At its conception in 1935 and for almost 50 years following that, Social Security was a pay-as-you-go program. Each year, the government paid retirees Social Security benefits with the money it had collected from the Social Security taxes of current workers. However, at the beginning of the 1980s, the amount of taxes collected was not enough to cover the benefits of all retirees. Social Security was out of balance.

Congress appointed several commissions to fix the program. It charged the one headed by former Federal Reserve Chairman Alan Greenspan to focus on short-term fixes. The Greenspan Commission recommended increasing the taxes funding the programs, increasing the retirement age, and other revenue-saving measures. Accordingly, Congress changed the law in 1983 so that in any given year, current taxpayers would pay more in taxes than the program needed to pay all the benefits. Social Security would then invest the difference, or surplus, into trust funds, which would pay the benefits when program outlays exceed payroll tax receipts.

SOCIAL SECURITY TRUST FUNDS AND THEIR FINANCING

Two trust funds currently provide benefits to about 54 million people. The Old-Age and Survivors Insurance (OASI) trust fund provides benefit payments to retired workers, their
spouses, some children, and the survivors of deceased workers. The Disability Insurance (DI) trust fund provides benefits to disabled workers, their spouses, and children. Social Security paid out $706 billion in benefits during fiscal year 2010, one-fifth of the entire federal budget. Of these benefits, 82 percent came from the OASI trust fund and 18 percent from the DI trust fund.

As mentioned earlier, the trust funds are primarily financed by a tax on covered wages, currently 12.4 percent up to $106,800 for 2010. Employees pay 6.2 percent, and employers pay 6.2 percent, though the entire burden of the tax falls on workers. The trust funds receive additional revenue from income taxes on benefits (a backdoor type of means testing) and interest paid on the bonds held in the trust fund (a form of intragovernmental transfer). Total revenues into the trust funds in fiscal year 2010 were $670 billion.

ARE THE TRUST FUNDS FINANCIALLY SOUND?

According to the Social Security Trustees, after 2014 the program will face a permanent cash flow deficit and will have to start drawing on the assets in the trust funds. They project that the combined OASI and DI trust funds will then “become exhausted and thus unable to pay scheduled benefits in full on a timely basis in 2037.” Separately, the OASI trust fund will run out in 2040, but the DI trust fund will run out in 2018. The past five Trustee reports have estimated that the combined trust funds will be exhausted between 2037 and 2041.

Social Security does not have borrowing authority, so when it exhausts the trust funds, the program will only pay out in benefits what it receives in tax revenue. That’s different from bankruptcy, which would imply that the program cannot pay benefits anymore. However, unless Congress takes action to reform Social Security, the program will only be able to pay approximately 75 percent of estimated benefits when the trust funds run out of assets in 2037. For DI, trust fund exhaustion in 2018 will reduce the payout to about 80 percent of scheduled benefits.

ARE THE BONDS HELD IN THE TRUST FUNDS REAL ASSETS?

By law, Social Security has to invest its surpluses in special issue Treasury bonds only available to Social Security. It cannot buy or hold other financial assets, such as stocks, mutual funds, or corporate bonds. Like other government-issued bonds, these bonds pay interest and are backed by the full faith and credit of the United States government. These bonds are real assets.

However, the way the federal government accounts for the trust funds masks the true size of costs passing on to future generations. While bonds are real assets to the private market, future generations of taxpayers or borrowers will have to cover the future redemptions of bonds issued today because the federal government has used the money it has received from Social Security to pay for education, wars, and other items. In other words, the government has already spent the money it received in exchange for the IOUs. This is explained in the president’s 2011 federal budget: “The existence of large trust fund balances, therefore, does not, by itself, increase the government’s ability to pay benefits.”

FIGURE 1: SOCIAL SECURITY CASH FLOW DEFICIT STARTS AFTER 2014

Source: Congressional Budget Office, Long-Term Projections for Social Security.
Finally, in spite of the similarities, the government trust funds are meaningfully different from private sector ones. In a private trust, the beneficiaries legally own the income from it. That is not the case with a government trust fund.13

DOES THIS MEAN THAT THE GOVERNMENT IS “RAIDING” SOCIAL SECURITY?

Not technically. By law, Social Security can only invest in Treasury Bonds. It cannot buy or hold other financial assets, such as stocks, mutual funds or corporate bonds. And it is true that the federal government has spent the tax revenues allegedly collected to pay for future benefits. However, the Treasury bonds are guaranteed by law. This means that beginning in 2025,14 when Social Security starts redeeming Treasury bond holdings in the trust funds to pay scheduled benefits, the government will have to borrow from the public, raise taxes, or cut spending to finance those redemptions.

PUBLIC VERSUS GROSS DEBT

Government accounting hides the true costs of Social Security by reporting on the public debt, rather than the gross debt (see figure 2). Debt held by the public represents the obligations the United States has to private investors and other governments. Total, or gross debt, is the debt held by the public plus the intragovernmental debt, i.e. the Social Security bonds. Gross debt represents the entire fiscal borrowing position of the U.S. government and its total debt obligations.

If the government funds redeemed Treasury bonds through additional borrowing or taxes, this will add to the overall financial burden of the government, demonstrating why total debt is a better measure of fiscal position than just debt held by the public. No one knows whether the government will respond by raising taxes, cutting benefits, or increasing the publicly held debt, or what the implications of its actions on financial markets and economic growth will be.

POLICY IMPLICATIONS

This issue is important beyond the problem of solvency of the Social Security program. Investors assess the risk a country represents based on its perceived ability to pay back its obligations. That perception is based upon the level of debt a country has and its anticipated future needs for more financing. Investors also rate countries on a curve relative to one another. As such, it makes a difference whether investors look at the level of debt the United States currently owes, or whether investors look at the debt the country will owe, and based on this measure, how it stacks up against other countries.

After 2014, tax revenue alone will be insufficient to cover Social Security’s cost. The government will have to borrow money from the private sector to continue paying interest on the bonds held in the trust funds. Then, starting in 2025, Social Security will begin to redeem the trust fund bonds, at which time the government will have to borrow even more from the private markets. Though the borrowing need will increase gradually, the need to borrow an additional $2.5 trillion from the private market will be harder and harder over time.

Additionally, Social Security is not the only entitlement program facing financial difficulty. Of the $13.5 trillion in gross federal debt, Social Security holds $2.5 trillion of the total $4.54 trillion in government-held debt. The additional $2 trillion in debt from other government obligations will also have an effect on the nation’s ability to borrow from the private markets.

The Medicare program faces a funding shortfall that could equal or exceed that of Social Security.15 Though Social Security will redeem the trust fund bonds gradually, the increased borrowing needs of the federal government to finance the nation’s entitlement programs will expand dramatically. The financing needs of the Medicare program will compete with the funding needs of the Social Security system, further straining the country’s ability to borrow money from the private sector.

CONCLUSION

Trust funds hold real assets, but Social Security faces a real financial problems nonetheless. Saying that these assets are real does not imply that future beneficiaries have a right to these assets or that future beneficiaries should not worry about the program until 2037. When the program runs a permanent cash flow deficit after 2014 and the federal gov-
ernment starts redeeming the bonds held in the trust funds, the federal government will have to borrow money from the private markets or raise taxes, which will have implications not only for financial markets, but also for future generations asked to bear the burden of future benefit reductions and/or tax increases.

There are, however, many reform options that will help achieve sustainable solvency and do not raise taxes. For example, Congress can increase the retirement age, link benefits increases to longevity, and account better for automatic adjustments to the benefit formula for changes in price inflation.

Dismissing the real and current fiscal challenges facing the Social Security system and kicking the reform can further down the road will only increase the severity of the burden associated with reforms when they inevitably must take place. In order to ensure that Social Security remains solvent and continues to provide retirement security for generations to come, while minimizing the burden on current and future generations, reforms must happen sooner rather than later. As the Social Security Trustees state, “projected trust fund shortfalls should be addressed in a timely way so that necessary changes can be phased in gradually and workers can be given time to plan for them.”

ENDNOTES


4. For more information, see Social Security Online, “Trust Fund Data,” http://www.ssa.gov/OACT/ProgData/allOps.html.


6. Ibid., 4.

7. Ibid., 3.

8. Ibid.

9. Ibid. At a minimum, a reallocation of the payroll tax rate between OASI and DI would be necessary, as was done in 1994. This would require an approximate shift from 1.80 percentage points of the 12.4 to 2.2.


11. The numeric average of the 12 monthly interest rates for 2009 was 2.917 percent. The annual effective interest rate (the average rate of return on all investments over a one-year period) for the OASI and DI trust funds, combined, was 4.860 percent in 2009. This higher effective rate resulted because the funds hold special-issue bonds acquired in past years when interest rates were higher.


13. Ibid.


17. Ibid., 3.

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