

JUST THE FACTS

On Retirement Issues

OCTOBER 2000, NUMBER 2

CENTER FOR
RETIREMENT
RESEARCH
AT BOSTON COLLEGE

SOCIAL SECURITY AND THE FEDERAL BUDGET

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Introduction

The relationship between Social Security and the rest of the federal budget is complicated and frequently misunderstood.¹ This brief explains: 1) how Social Security's finances relate to the rest of the budget; 2) the future financing challenge posed by an aging population; and 3) the budgetary implications of selected reform proposals.

Social Security Financing and the Federal Budget

In fiscal year 2000, Social Security's projected expenditures are about \$400 billion and its projected revenues — mostly from payroll taxes — are about \$550 billion.² This excess of revenues over spending would produce a Social Security trust fund surplus of \$150 billion. The rest of the federal budget is projected to run a surplus of \$84 billion. Together, these two figures result in a total federal budget surplus of \$232 billion.³ Until recently, this total budget figure was the one most frequently cited by the media and used in public discussions of the

government's finances. But, as the large budget deficits of the 1980s and early-mid 1990s disappeared, policymakers began to focus more on the bottom line excluding Social Security's trust fund. This decision largely reflects a bipartisan agreement that the budget's non-Social Security accounts should be in balance, which means that the government does not rely on the trust fund's surpluses to cover spending on other programs.

Social Security has been running significant surpluses since the mid-1980s as a result of tax and benefit changes made in the late 1970s and early 1980s to rescue the fund. By law, trust fund surpluses are invested in a special type of Treasury bond, and the trust fund receives interest on these investments in the form of additional Treasury bonds.⁴ It is important to understand what these bonds represent, because their role is often misunderstood.

From the standpoint of Social Security, the bonds are assets that can be readily exchanged for cash if needed to pay benefits. For example, in the

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¹ Social Security is comprised of two separate trust fund budget accounts: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). These accounts are commonly combined in discussions of Social Security and will be treated as a single trust fund in this brief.

² Over 80 percent of Social Security revenues come from payroll taxes. The trust fund also receives revenue from income taxes paid on Social Security benefits and interest income from the Treasury.

³ Budget estimates are from the Congressional Budget Office. The slight discrepancy in the figures is due to rounding and to the inclusion of the Postal Service budget, which, like Social Security, is often treated separately from other federal budget accounts.

⁴ The trust fund's special Treasury bonds cannot be sold on the open market, but they can be redeemed before maturity without penalty if needed to pay benefits. Technically, the trust fund holds other types of Treasury obligations as well, but, for the purposes of this brief, all Treasury obligations will be referred to simply as bonds. In addition to Treasury obligations, the trust fund is also permitted to invest in securities issued by other entities, such as the Government National Mortgage Association, that are considered to be backed by the U.S. Treasury. However, in practice, virtually all trust fund assets are in Treasury obligations.

early 1980s, Social Security was running deficits, so it cashed in some of its Treasury bonds to help finance benefit payments. These transactions occurred automatically; no action was necessary on the part of policymakers. As long as the trust fund has assets in its account, it has the authority to issue checks to recipients and the Treasury is obliged to cover them.

From the standpoint of the federal budget as a whole, Social Security's bonds represent a claim upon the Treasury — just like Treasury bonds held by private investors. To redeem bonds, the Treasury must obtain the money either by spending less on other programs, taxing more, or borrowing from the public. Failing to redeem Treasury bonds would create a tremendous loss of confidence in the federal government and, therefore, would be extremely unlikely. In fact, the federal government has never defaulted on bonds held either by Social Security or private investors. Therefore, the real issue for the future is not whether the Treasury will honor the trust fund's bonds, but rather how it will obtain the necessary cash to cover them.

A second issue that often causes confusion is the way that Social Security surpluses are used by the Treasury. When the rest of the federal budget is in deficit, the Treasury automatically uses any surplus payroll taxes from Social Security to cover spending on other federal programs. If, instead, the rest of the budget is in balance or surplus, the Treasury automatically uses Social Security surpluses to reduce debt held by the public (i.e., debt held by investors outside of the federal government). In short, the Treasury simply uses whatever cash is available to pay the government's bills and applies any extra cash to debt reduction.

Some have expressed concern that if trust fund surpluses are used to pay for spending on other programs, Social Security will somehow be worse off. This concern is largely misplaced. The trust fund holds the same amount of bonds regardless of how the Treasury uses the money that it receives from Social Security. Therefore, whether the Treasury uses trust fund surpluses to buy weapons, feed the hungry, or reduce debt held by the public makes little difference to Social Security. It does make a difference, however, to the

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government's overall financial situation and to the U.S. economy. For example, using Social Security surpluses to reduce debt held by the public has major budgetary and economic advantages. For the federal government, lower debt means reduced interest costs, which increases budgetary flexibility and makes it easier to borrow in the future if necessary. For the economy,

less federal debt frees up money for private investment, which in turn leads to higher productivity and stronger economic growth.

To encourage the use of Social Security surpluses for debt reduction, many policymakers have embraced the idea of a Social Security “lockbox.” In its basic form, the lockbox is simply a budget rule aimed at balancing the non-Social Security part of the budget. If successful, a lockbox would make it difficult for policymakers to use trust fund surpluses to finance spending on other programs or tax cuts.⁵ Instead, these surpluses would be used to reduce federal debt held by the public.

While the lockbox is often touted as a way to help strengthen Social Security, it actually only addresses the government's non-Social Security budget. A lockbox alone does not directly improve Social Security's current or future financial

⁵ With most lockbox proposals, the rule could be waived with the approval of the House Rules Committee, a majority of members of the House, and three-fifths of the members of

the Senate. For more details on lockbox proposals, see Horney and Greenstein (2000).

condition; it does not increase the program’s revenues or cut its spending. And it does not add to the balance of Treasury bonds held by the trust fund. However, by promoting debt reduction and a stronger economy in the long term, a lockbox would likely have some indirect effects on Social Security.

Financing Social Security for an Aging Population

As the population ages, Social Security faces a long-term financing challenge. In 2015, under the current “best guess” estimates of the Social Security Trustees, the trust fund’s tax revenues will no longer be sufficient to cover projected spending. In 2025, all trust fund revenues, including interest, will fall short of projected spending. If no changes are made, the trust fund is projected to exhaust its assets in 2037. At this point, the program’s projected tax revenues would cover only about 70 percent of total benefits.

When spending begins to exceed tax revenues in 2015, the trust fund will, in effect, have to exchange some of the interest credits that it receives in Treasury bonds for cash to pay benefits. When spending exceeds both tax revenues and interest in 2025, the fund will have to begin drawing on its accumulated stock of Treasury bonds. From the standpoint of the overall federal budget, 2015 is the key date because that is when the Treasury must begin redeeming the trust fund’s bonds. From Social Security’s perspective, 2015 has less significance because, including interest income, the program would still be running a sizable surplus (see Table).

To cover the redemption of Social Security bonds, the government would need to raise taxes, cut spending in other programs, or borrow more from private investors.⁶ The amounts needed to redeem the bonds would be relatively modest at first, but would escalate quickly. In 2025, Social Security’s cash shortfall would exceed 1 percent of the nation’s gross domestic product, a common measure of the size of the economy.

TABLE: PROJECTED SOCIAL SECURITY TRUST FUND FINANCES IN SELECTED YEARS (BILLIONS OF DOLLARS)

	2015	2025
Spending	1,045	2,066
Revenue (excluding interest)	1,035	1,650
Cash Surplus/Deficit (excluding interest)	-11	-416
Amount of Treasury Bonds Cashed in to Pay Benefits	11	416
<i>Memorandum:</i>		
Total Surplus/Deficit (including interest)	270	-40

Source: 2000 Social Security Trustees’ Report, intermediate assumptions.

Budgetary Implications of Social Security Reform Proposals

While a bipartisan consensus has emerged that Social Security surpluses should not be used for tax cuts or spending on other programs, policymakers have different views on how to meet the program’s future financing challenges. This section considers only the likely budgetary effects of selected reform approaches; it does not address the relative merits of these approaches.

One suggested approach would commit Social Security’s surpluses to debt reduction and then transfer general revenues — primarily income taxes — to the trust fund to help cover future benefits. The amount of the transfers would be based, initially, on the interest savings from using Social Security surpluses to reduce debt held by the public. To the extent that these transfers would not be needed to pay current benefits, they would be invested in Treasury bonds — just like current trust fund surpluses — and would be available to further reduce debt held by the public.⁷ The transfers would give the trust fund additional Treasury bonds, increasing its assets and extending the program’s solvency. Redeeming these bonds would increase the government’s need to raise taxes, cut spending on other pro-

⁶ If the government were still running total budget surpluses at this time, it could use some or all of these surplus funds to cover Social Security benefits.

⁷ In a variation of this proposal, some of the transfers would be invested in corporate equities.

grams or borrow from private investors.

Another suggested approach would use some portion of current payroll taxes to establish individual accounts. Under this type of plan, individuals would have some control over how the accounts are invested, and the account balances would provide a source of retirement income. In addition, under most of these plans, individuals would continue to receive some guaranteed benefits from Social Security. Shifting revenue into individual accounts would reduce the amount currently going into the trust fund account. To help offset the current and future budgetary impact of this reduction, many proposals would rely on general revenues and/or reductions in the guaranteed portion of Social Security benefits.

Conclusion

Understanding the relationship between Social Security and the rest of the budget can help to clarify the program's current and future financial situation. The trust fund's Treasury bonds are tangible assets for the program, but their redemption will require other budgetary tradeoffs. Lockbox proposals such as the ones proposed in Congress could help promote overall fiscal discipline, but would have no direct effect on Social Security. As the debate over Social Security reform continues, it is important to consider the effects of various proposals on both the program's finances and the rest of the federal budget.

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