



Key Points

- Since the enactment of the Social Security program in 1935, dedicated payroll tax revenues have been placed into the trust funds and benefit payments have flowed only out of those trust funds.
- The trust funds have several functions, including: tracking resources dedicated to Social Security, keeping payroll tax rates level over time, connecting the benefits to taxes paid and requiring their long-run balance. Notably, the trust funds are not allowed to borrow.
- Social Security revenue exceeded cost between 1984 and 2009, leading to a buildup of \$2.7 trillion in trust fund assets. Under current law, these assets are projected to be redeemed over the next two decades. The anticipated redemption of those assets has led to an ongoing debate over whether the assets are “real.”
- The perceived significance of the trust fund assets largely depends on the context in which they are viewed: the Social Security system, the unified federal budget, or the whole economy.

Significance of the Social Security Trust Funds

Social Security is designed primarily as a pay-as-you-go system. After an initial start-up period, its trust funds¹ generally have contained only modest contingency reserves to cover short-term fluctuations in income and outgo.² However, in each year from 1984 until 2009, tax revenues exceeded program costs.³ As a result, the trust fund assets grew to a historically high level of \$2.7 trillion at the end of 2011. Sizeable trust fund balances are a temporary feature of the program and were never intended to be an important source of the program’s long-term economic viability.

Program costs exceeded tax revenues in 2010 and negative net cash flows are projected to continue in all future years. These annual deficits will be offset by redeeming trust fund assets until the trust fund assets are eventually exhausted. In anticipation of the redemption of trust fund assets, an ongoing debate has intensified over whether those assets are “real”—whether they are a store

¹The “trust funds” considered in this issue brief are the Old-Age and Survivors Insurance (OASI) trust fund and the Disability (DI) trust fund. They are two separate funds—the OASI trust fund was established 1937 and the DI trust fund in 1957—but for many purposes they can be analyzed together as the trust funds supporting the entire OASDI system. Except when referring to years prior to the introduction of DI, this brief makes no distinctions between the two trust funds and all stated amounts refer to the combined OASDI trust funds.

²The combined OASI and DI trust funds held assets equal to less than one year’s program cost in all years from 1971 to 1992 and less than one-and-a-half year’s program cost in all years from 1962 to 1996.

³“Costs” when used in this brief, has the same meaning as in the Trustees Report and includes scheduled benefit payments, administrative expenses, net interchange with the Railroad Retirement program, and payments of vocational rehabilitation services for disabled beneficiaries paid from OASDI trust funds.

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of value that can be drawn on to pay future benefits or whether they are an accounting device without significance.

Since the program's enactment, dedicated payroll tax revenues have been placed into the trust funds and benefit payments have flowed only out of the trust funds. The trust funds are legal entities—established, in part, to preclude political interference with the program. The trust fund structure also serves other functions:

- Tracking—serves as a record of claims to a share of resources dedicated to Social Security.
- Smoothing—enables Social Security to be financed as a level percentage of payroll across generations.
- Social contract—enhances the legitimacy of beneficiaries' claims to benefits.
- Governance—places constraints on the benefits Congress can promise by limiting the funds available to pay those benefits.

The economic and fiscal consequences of the trust funds can be analyzed from various perspectives, such as:

- Social Security system perspective—Social Security holds financial assets backed by the full faith and credit of the U. S. government. Those assets are the only legal source of benefit payments, so the trust fund assets have real and tangible consequences.

- Unified budget perspective—The federal government is one fiscal entity. The securities in the Social Security trust funds are both assets of the trust funds and liabilities to the Treasury's general fund.⁴ The assets and liabilities offset each other, and therefore have no effect on the government's net balance sheet.
- The whole economy perspective—Whether the trust funds have macroeconomic consequences depends primarily on whether they affect national savings. They may also affect the distribution of after-tax income as they shift the tax burden between payroll and income taxes over time.

Whether the trust funds are seen as “real” depends largely on the perspective from which this question is approached. The debate over the nature of the trust funds can become a distraction from the long-term fiscal issues facing Social Security. In an effort to lay this debate to rest, this issue brief explains how the Social Security trust funds can be understood from each of these three perspectives.

Background

The Old-Age, Survivors, and Disability Insurance (OASDI) trust funds, also known as Social Security trust funds, are accounts managed by the Department of the Treasury and designated to be used only for payment of Social Security benefits and administrative costs.

⁴“The general fund of the Treasury” is the common term for the funds held by the Treasury of the United States, other than receipts collected for specific purpose (such as Social Security) and maintained in a separate account for that purpose.

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Social Security taxes are required by federal law to be deposited into the trust funds and invested in interest-bearing securities backed by the full faith and credit of the U.S. government.⁵ In recent years⁶, all trust fund investments have been made in special-issue Treasury securities. Special-issue securities differ from Treasury securities issued to the public in two ways: they can be redeemed at par⁷ at any time, and they cannot be traded in the financial markets.⁸ The law stipulates a formula that sets the interest rate applicable for securities issued in a given month to the average market yield (rounded to the nearest eighth of a percent) on marketable interest-bearing securities of the federal government which are not due or callable until after four years from the last business day of the prior month.

Trust fund assets are invested and redeemed regularly to cover fluctuations in cash flows as revenues come in, old securities mature, and benefit payments and other expenses become due. Most of these trust fund operations are carried out with little public attention, but the net change in the trust funds from year to year is usually much more notable. When Social Security tax revenues and interest on the trust funds exceed benefits and administrative costs over a given period, the trust funds grow, and when costs exceed income, the trust funds are drawn down (redeemed). The trust funds are not authorized to borrow, so their net assets cannot be less than zero.

Social Security was designed to be essentially a pay-as-you-go system, with a trust fund⁹ required to maintain a modest contingency reserve because the program is not allowed to borrow. When the program was new, with few people receiving benefits, the trust fund grew large relative to the annual benefit cost, but small compared to the gross domestic product (GDP).¹⁰ As the program matured, in the 1960s and 1970s, the trust funds only held assets sufficient for approximately one year of benefit payments and administrative costs.

However, the legislative changes implemented by the 1977 and 1983 Social Security amendments reduced Social Security benefits and increased the Social Security retirement age and tax revenues in anticipation of a greatly increased number of beneficiaries relative to workers when members of the baby boom generation began retiring, which was then about 25 years in the future. In particular, tax rates were scheduled to increase in advance of the expected baby boomers' retirement wave, and to remain constant thereafter. For the next 26 years, from 1984 to 2009, tax income consistently exceeded program expenses. These sustained surpluses have led, as of December 2011, to the accumulation of \$2.7 trillion in the trust funds—enough to fund the system for nearly four years even in absence of any further tax revenue.

Now that the baby boomers have begun to retire, expenses have begun to overtake tax in-

⁵Social Security Act, Title II, Sec. 201(d) [42 U.S.C. 401]

⁶It has been Treasury Department policy for over 20 years to invest trust fund assets only in special-issue Treasury securities. The DI trust fund still contains some publicly-issued marketable government bonds. For more information, please see this link: <http://www.ssa.gov/OACT/NOTES/note2000s/note145/note145.html>:

⁷Par Value is the value printed on the face of a security. For both public and special issues held by the trust funds, par value is also the redemption value at maturity.

⁸The trust funds can redeem securities before maturity only when needed to pay program costs, not to reinvest in securities earning a different interest rate. Even when cash flows are positive, short term fluctuations in revenue can require that bonds be redeemed before maturity. The Secretary of the Treasury determines the need for asset redemption.

⁹Initially only the OASI trust fund was established (1937) and the DI trust fund was later established (in 1957).

¹⁰For example, in 1944, trust fund assets were 20 times the annual cost of the program, but less than 3 percent of GDP. Also, program cost was rising rapidly in its early years, so those assets could have financed only the next seven years of actual benefit costs. For comparison, trust fund assets at the end of 2010 were about 18 percent of GDP.

come, leading to a gradual drawdown of the trust funds and their eventual exhaustion over the next few decades.¹¹ Without further tax increases or reductions in scheduled benefits, the trust funds are projected to eventually run out of assets under most projection scenarios.¹²

As the focus has shifted to the drawdown of the trust funds, their nature and significance have become a contentious issue in public policy debates. In a 2000 presidential debate, Vice President Al Gore promised to “keep Social Security in a lockbox,” while Governor George W. Bush responded that “what he’s doing is loading up I.O.U.’s for future generations.” This exchange illustrates the politically charged policy debates that have developed over the past few years. Versions of these arguments have been repeated many times, revealing deep differences in views about the nature of the trust funds. Some perceive the assets in the trust funds as a source of advanced funding for future benefits, while others see those assets as nothing more than accounting illusion.

Social Security is treated as an “off-budget” item for the purpose of federal budget reporting—that is, it is considered an entity separate from the “on-budget” part of the government, which comprises the bulk of government agencies (other than Social Security and the U.S. Postal Service). This separation means that Social Security’s past surpluses have not offset the government’s reported deficits, nor will benefit payments in excess of dedicated payroll tax income in the future add to the government’s deficits. In addition, the Treasury securities held by the trust funds are treated as part of the federal government’s debt.

The Office of Management and Budget also

publishes, separate from its officially reported budget, a “unified budget,” which encompasses all government programs, including Social Security. The unified budget is used primarily for long-range planning purposes.

When Social Security was running a surplus, the trust funds relieved the Treasury of the need to cover a portion of the government’s deficit through the sale of debt securities to investors outside the government. When benefit payments exceed payroll tax income in the future, the need for outside securities sales will increase as the securities held in the trust funds are redeemed.

Regardless of accounting conventions, the accumulation of Social Security trust funds reflects the fact that, from 1984 to 2009, some part of revenues dedicated to Social Security was invested in government securities, that is, loans to the Treasury. As those loans were available to finance other government expenditures, actual on-budget government spending in those years required less revenue from other taxes (mainly individual and corporate income taxes) and/or less borrowing from the public than would have been the case without the Social Security surpluses. The securities held in the trust funds are certificates of that lending/borrowing relationship between Social Security and the general fund of the Treasury. All lending/borrowing arrangements involve a reallocation of resources over time. Early on, the borrower consumes more, and the lender less, than their respective incomes; later, the reverse occurs. As a result, during the period the securities in the trust funds are redeemed, other sources of Federal revenue will finance part of Social Security benefit

¹¹Expenses overtook tax income in 2010 and are projected to remain higher than tax income indefinitely under the Trustees’ intermediate assumptions. The trust fund assets, however, are projected to keep increasing until 2023 due to interest income.

¹²The Social Security trustees project the finances of the system under three sets of assumptions: intermediate, high-cost, and low-cost. Under the low-cost assumptions, the trust funds are not projected to run out of assets over the 75-year projection period. Under the other sets of assumptions, as well as under the Congressional Budget Office (CBO)’s assumptions, the trust funds are projected to run out of assets.

payments. This will not be an unprecedented situation. From 1957 to 1965, redemptions of trust fund assets financed a portion of Social Security costs in every year. In 1959, interest and asset redemptions paid for more than 17 percent of the program's cost.

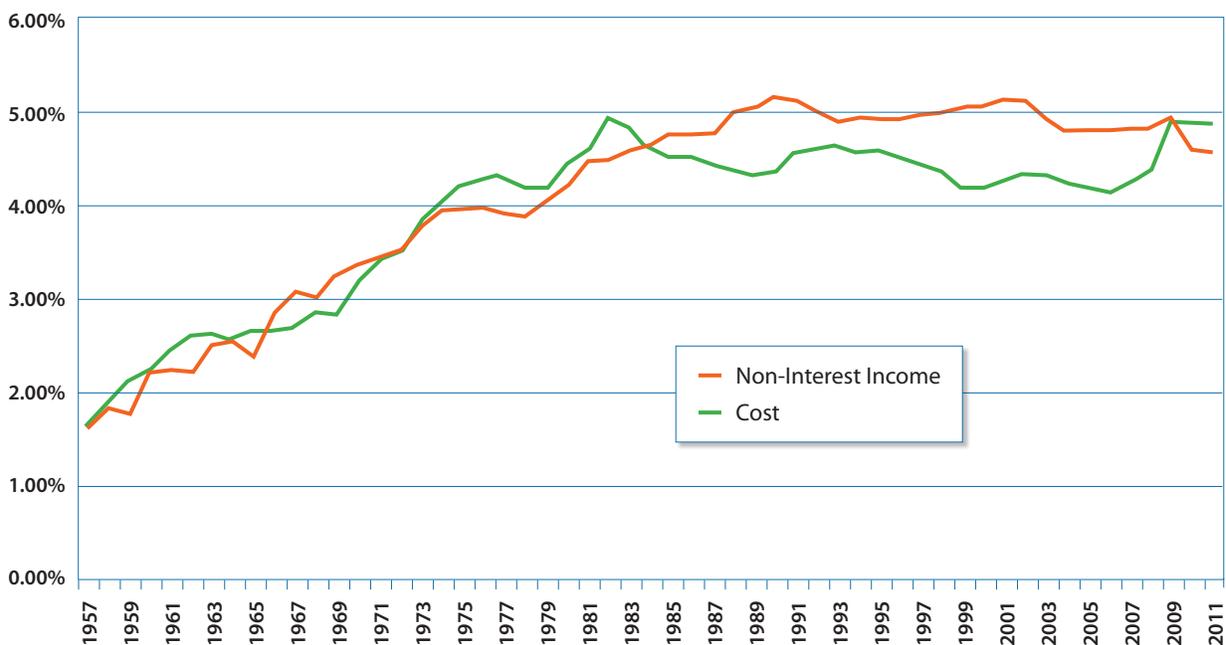
Assuming no changes in the law, as the ratio of benefit recipients to workers increases over the next two to three decades, the proportion of benefits not financed from current Social Security taxes will increase, reducing the trust fund assets until they are eventually exhausted. Just before that happens, approximately one-fourth of the benefit payments will come from redemptions of trust fund securities by the general fund of the Treasury. Once the trust funds are exhausted, Social Security will not have authority to pay more than it collects in dedicated taxes, and the program will face a shortage, initially equal to the amount of the latest repayments from the general fund.

The Trust Funds' Many Purposes and Consequences

The original designers of Social Security had specific reasons for financing the program by a dedicated tax and segregating the income from that tax into trust funds separate from the government's other assets. Over the years, the trust funds came to serve additional purposes. Those who are focused on the different functions of the trust funds, or their consequences in different areas, may easily reach different conclusions about the trust funds' relevance.

From one perspective, the trust funds are an accounting mechanism serving a useful tracking function—as a record of claims to a share of resources dedicated to Social Security through cumulative Social Security taxes. This is necessary because dedicated revenues do not exactly match the program cost in each year, so the

Social Security Non-Interest Income and Cost as a Percentage of GDP, 1957–2011



trust funds lend the excess revenue (surplus) to the general fund of the Treasury in some years, and require repayments of such loans in other years when there is revenue shortfall (deficit).

From another perspective, the buildup of the trust funds serves a distributional or smoothing function. The trust funds enable Social Security to be financed as a level percentage of payroll across generations. For a quarter century ending in 2009, Social Security taxes continually exceeded program outgo and, on a unified budget basis, Social Security surpluses were adding to government financial resources. Going forward, that flow will reverse and Social Security will reduce government financial resources.

The trust funds provide a direct connection between the payroll taxes that finance Social Security and the benefits provided by the system. This connection fosters a widely held perception that the benefits are earned and thus makes rescinding or reducing them politically difficult. In this way the trust funds can be seen as an element of a social contract between the workers and the government.

Finally, an important feature of the trust funds is that they are not allowed to borrow. Thus they set a limit on the amount the program can spend. In this manner, the trust funds perform a governance function by providing a brake on any temptation for Congress to raise benefits to levels not supported by commensurate taxes.

There are at least three perspectives from which economic consequences of the trust funds can reasonably be examined. First, one can focus specifically on the Social Security (OASDI) system. This is the most common perspective of actuarial analysis and particularly useful when analyzing the program's finances, especially its solvency. Second, one can take the perspective of the federal government as a whole. This is consistent with the focus on overall government revenues and outlays, and

the resulting unified budget surplus or deficit. Finally, one can take the very broad perspective of the entire economy, focusing on aggregate national savings, capital accumulation, and output (gross domestic product). The following sections elaborate on these three perspectives.

The OASDI System Perspective

When focusing on the ability of Social Security to pay scheduled benefits, the trust funds' role in receiving and holding dedicated tax revenue and disbursing benefits is highly important. Under current law, the trust funds are the only source available to the program for benefit payments, and if they became exhausted, the Social Security program would have no legal authority to pay benefits until the funds are replenished by additional tax revenue. If revenue were then not sufficient to pay all benefits as they become due, the Social Security Administration would have to delay payments until the necessary resources became available. If this situation were to continue, benefit payments would fall further and further behind. From this perspective, the trust fund assets have very real and tangible consequences.

Social Security usually is thought of as a defined benefit pension program because its benefits are determined by a formula based on individual earnings and years of work. However, its financing has more in common with defined contribution pensions, since contributions are a fixed percent of workers' earnings rather than an amount derived from an actuarial calculation of the program's annual cost. Such a combination of defined benefits and defined contributions can be sustained for a long period if the ratio of workers to beneficiaries is stable (i.e., its age distribution and other characteristics do not change over time). When the population ages and benefit

costs increase relative to contributions, this arrangement produces imbalances between contributions and payments. Thus, Social Security is viewed as storing its positive imbalances (surpluses) as trust fund assets, to be used as a temporary supplement to payroll tax revenue when the imbalances between benefits and contributions turn negative (deficits). Such use of trust fund assets was expected and intended, as well as significant for the program's ability to pay benefits regularly when due.

Like all Treasury securities, the special-issue securities held by the trust funds are backed by the "full faith and credit of the United States". There has never been a substantive default on U. S. government obligations, and investors seem confident that one will not happen in the future, as evidenced by yields on U.S. Treasuries that are regularly lower than on any other debt securities of comparable maturity. The securities in the Social Security trust funds are considered safe, like other Treasury securities.

It could be argued that, even though the securities in the trust funds are backed by the full faith and credit of the U. S. government, the trust funds themselves were created by statute, and that new laws can change their claims on any property or even conceivably abolish the entire Social Security program. While this is true, such radical acts of legislation are extremely unlikely and, in any case, a similar scenario would be equally possible if the trust funds held different types of assets. Assuming that Social Security worked entirely through individual accounts, for example, new laws could drastically reduce net benefits by raising taxes on distributions from those accounts.

The Unified Budget Perspective

Trust Fund Investments as Both Assets and Liabilities

Regardless of how the federal budget is reported, Social Security is a part of the federal government. The unified budget perspective considers the totality of government finances rather than distinguishing between those parts that are on-budget and off-budget, or viewing one government program in isolation from all other government programs. The federal government can only spend as much money as it collects in taxes and borrows from the public.¹³ When one part of the government borrows from another part, the government's debt to outside parties does not change and as a result, the aggregate amount that it can spend is unchanged.

When focusing on the finances of the government as a whole, it is easy to see how the trust funds might appear as an accounting artifact. The government owes to itself, so its capacity to pay for its programs is unaffected. When Social Security redeems a Treasury bond, the general fund of the U.S. government pays cash to Social Security, and that amount becomes unavailable for other programs. If the government was going to spend that money on something else, it now has to forgo that spending, or borrow from the public, or raise taxes. In that sense, whether the trust funds exist makes no difference, since the government can effectively "decide" to pay scheduled Social Security benefits. In addition, if increased taxes are used to raise cash for redeeming the securities held in the trust funds, it would make no difference to the government's unified budget whether the Social Security tax or other taxes were raised. No

¹³Strictly speaking, that is an incomplete list, because the federal government can also finance its spending by seignorage ("printing money"). However, in the US, seignorage has never been a large source of government finances. Central banks of developed countries tend to restrain seignorage because excessive seignorage can lead to hyperinflation.

matter how the internal accounting works, for each dollar of spending, the government has to collect a dollar through some combination of taxes and/or borrowing.

Conversely, when considering the trust funds' buildup phase from a unified budget perspective, Social Security taxes during that period may be viewed as not really dedicated to financing of Social Security benefits. They instead were partly financing other government programs.

From the unified budget perspective, the trust funds have no effect on the government's aggregate finances in the short run. While some trust fund features can have a significant effect on the Social Security program—if there is no money in the trust funds, benefits cannot be paid even should the rest of the government be flush with surpluses—that is because federal law prevents the use of the government's general fund to pay Social Security benefits. From a unified budget perspective, however, this law can always be changed or, if not changed, the constraint can be avoided by an ad hoc transfer of assets from the general fund to the trust funds.¹⁴

Trust Funds' Budgetary Effects in the Long Term

The dynamics of the trust funds may affect other government budgetary choices. At one extreme the on-budget deficit (or surplus) may be assumed to be completely independent from Social Security finances so that every dollar of Treasury securities issued to the

trust funds means one dollar less borrowed from the public. Based on this point of view, it would follow that the trust fund accumulation has reduced public debt dollar for dollar. Few economists believe that this scenario is fully correct. An opposite view assumes borrowing from the public to be fixed—limited by investors' willingness to buy government securities in the market—so that the ability of the general fund to borrow from the trust fund enables the government to run larger on-budget deficits, dollar for dollar. Most analysts believe that the reality is somewhere between those two assumptions.¹⁵

Although researchers have tried to estimate the effect, if any, that the trust funds have had on the federal budget, such measurement is complicated by the dynamic nature of the legislative process and a legitimate difference in opinion exists among experts. The selection of assumptions about economic, legislative, and political changes the government would have employed will lead to different outcomes.

The Whole Economy Perspective

National Savings

An argument often heard in debates about Social Security is that saving for retirement should be real saving that would contribute to total national savings. According to standard macroeconomic theory, sustained higher national savings leads to more investment, which in turn results in more capital and, hence, higher future economic output or GDP.¹⁶ Fo-

¹⁴This analysis abstracts from another important legal matter: The Budget Enforcement Act of 1990 actually requires that Social Security be treated as off-budget, which means that the unified view of whole-government finances could be at odds with legal definitions of budgetary terms. Nevertheless, abstractly speaking, if one takes a view that “the government” is a black box such that only outside cash flows are observable, and all inner workings—including legislative and regulatory action—can be assumed to be hidden inside, such abstractions are a consistent part of the model. Simplifications of this kind are common, and often useful, in economic models. As with any assumptions, their justification in any specific case is open for discussion, but such discussion is beyond the scope of this brief.

¹⁵Even the two idealized cases may not span the full range of opinions. Smetters (AER, 2004) and Nataraj and Shoven (NBER, 2004) have suggested that running surpluses in Social Security trust funds may have increased even the unified deficit. The theoretical idea is that the added layer of accounting complexity enables legislators to game the public by avoiding casting unpopular votes and picking the set of numbers that make them look good to their partisan base.

cusing on the macroeconomic aspects of retirement savings, the most important question about the trust funds is whether they have an effect on the overall level of national savings.

National savings equals private savings minus government deficits.¹⁷ Therefore, for national savings to increase, private savings must increase or government deficits must decrease. The savings levels of governments and the private sector often change in opposite directions. For example, if the government increases income taxes without increasing spending, deficits will decrease. But if individuals react to their lower after-tax income by saving less, national savings will increase less, or not at all. A tax cut, conversely, is likely to increase private savings, but it also increases government deficits—and the effect on national savings is the net of the two effects.

If the Social Security trust funds affect government deficits (a possibility discussed in the previous section), the private sector response is likely to be partially offsetting. The trust funds' effect on national savings, therefore, is likely to be equal in direction and smaller in magnitude than the effect on the whole of government finances. Any effect on national savings is likely to be small.

Another way to think about national savings is that, with a given level of economic output, aggregate savings can be increased only by reducing aggregate consumption. The only way a society can save more is if it spends less now. It does not matter whether the saving is done primarily through government or private actions. This makes it clear that the trust funds do not directly change national savings. They may create expectations that induce individu-

als to change their savings behavior, but they do not directly contribute to national savings.

Distributional Aspects

Social Security payroll tax is a level percent of earnings up to the taxable maximum. Income tax, in contrast, is progressive—lower-income individuals pay lower taxes not only in absolute dollars, but also as a percent of their incomes. Consequently, overall taxation is less progressive when Social Security is running a surplus—and the excess payroll tax income finances a portion of other government expenditures—than it would be if those expenditures were financed by higher income taxes. Conversely, overall taxation would tend to become more progressive when all payroll tax income must be used immediately to pay benefits, especially if income taxes were raised to cover all or part of Social Security's annual funding shortfalls. Changes in the level of government borrowing from the public can have similar distributional effects, but the analysis is more complicated.

Individuals at different income levels react to changes in their after-tax incomes by different relative adjustments to their consumption and savings. While the net effect of those differences on national savings is likely to be small, the effect on individuals may be important, particularly to those individuals who perceive themselves adversely affected by any resulting redistribution of wealth. To the extent the build-up and subsequent drawdown of the Social Security trust funds influence how the burden of taxation is distributed among taxpayers at different income levels, affected individuals may find the trust funds very real indeed.

¹⁶This view that higher savings leads to more investment is more generally applicable to the long term. In the short term, investment is less directly related to savings. For example, in a recession, with businesses having a pessimistic outlook because of depressed demand, additional savings might have no positive effect on investment and even may have the opposite effect by further depressing aggregate demand.

¹⁷A textbook definition would be the sum of private savings and government surplus, but deficit is simply negative surplus, and governments more often run deficits than surpluses so we rephrase the identity in more familiar terms.

No Net Wealth: Not Unique to the Trust Funds

Since the trust funds do not represent net economic wealth to the society, it would be understandable to conclude that, from the perspective of the entire economy, they are not “real.” By the same criteria, however, Treasury securities held by the public would also not be “real” and, moreover, corporate bonds

and other debt securities would equally not be “real”. This is because any debt security represents an asset to one party of the transaction, in this case the federal government, and a liability of exactly offsetting value to the other, that is, the bondholders. The conclusion that trust fund assets do not represent net wealth for society therefore would not change if the trust funds were invested in many private securities.¹⁸

Some Common Questions and Answers About the Trust Funds

Q: *Why have the trust funds grown to such a large size?*

A: When the trust funds were originally created, they were intended to hold only a small amount of assets – enough to pay benefits for a few months – to act as a buffer against short-term fluctuations in tax receipts and benefit payments. This is called “pay-as-you-go” or “PAYGO” financing. As part of a package of reforms enacted in 1983 to place the system into 75-year actuarial balance (through 2058), Congress set a level tax rate beginning in 1990, even though it was well known that benefit payments would rise steeply when the baby boom generation began retiring. This policy decision is understandable given the political liabilities involved with raising taxes. The accumulation of a large trust fund is an unintended consequence of this policy decision.

Q: *Have Social Security trust funds been raided and spent on other government programs?*

A: The trust funds hold Treasury debt securities. This means their excess revenue has been lent to the general fund of the Treasury. The federal government has used the borrowed revenue to finance its expenditures, as any borrower does and, like any borrower, is legally obligated to repay the trust funds when needed for benefit payments. The question of the government’s overall spending is unrelated to the purpose and use of the Social Security trust funds.

Q: *Would the trust funds be more real if they were invested in private-sector stocks and bonds?*

A: All securities are financial claims on a share of real resources. Payments in any given year must come from total resources available in the economy that year. This fact does not depend on whether those payments are financed in that year with current taxes, government borrowing, or sale of private securities. The means of financing would make some difference in who bears how much of the cost, but not in what the total cost is.

Q: *Why can’t Social Security save for its future beneficiaries like a family saves for a future expense like a car or college tuition?*

A: Analogies between individuals or companies on one hand and governments or nations on the other are often of limited use because the differences are too great. In a reasonably stable economy, families or businesses can save and expect to use their savings in the future because they are small relative to the capital markets and the economy. But in a national context—the only way to secure future resources is by investing in productive activities that lead to economic growth. Social Security, of course, is not the whole economy, so it can “save” to the extent of accumulating calls on future revenue from the Treasury (and does so, as evidenced by the accumulated trust funds), but it is a large enough fraction of GDP that both the accumulation and dissipation of its savings have an impact on the rest of the economy.

Q: *How do the trust funds fit into policy decisions about Social Security’s future?*

A: The past cannot be undone, so any policy decisions about Social Security’s future must take into account the trust funds as they exist today. Beginning in about 2050, the cost of the system is expected to level off at just under 6 percent of GDP. At that point, the system could theoretically return to PAYGO financing with a tax rate about a third higher than the current tax rate. The transition from now to then could be financed by a combination of drawing down the trust funds while gradually increasing the tax rate. Alternatively, benefits could be reduced so that the current tax rate, in combination with the trust funds, would be sufficient to keep the system solvent indefinitely. A multitude of intermediate solutions involving both tax increases and benefit reductions is available. The ultimate level of Social Security taxes and benefits is a policy decision which will be based on what share of the nation’s resources we as a society are willing to devote to Social Security. In any likely scenario, the impact of the trust funds will be temporary and not critical to this decision.

Even though debt creates both liabilities and assets, it can, of course, lead to wealth creation if it is put to productive use. Capital for productive economic development generally can be increased only through investment based on higher current savings and, hence, lower near-term consumption. With government expenditures, it is not always easy to tell what is consumption and what is investment. For example, road construction and other government-financed infrastructure can increase productive capital of businesses, and education can increase future productivity of the labor force. It is in this respect—with the complexities of evolving technology, economic cycles, international flows of consumption, and investment patterns; political trends; and tax policy—that government policies must balance operating to meet public needs with maximizing long-term sustained economic growth.

Whether Social Security contributes to economic growth or not, it can reasonably be argued that it is not an appropriate role for Social Security to function as an instrument of growth. On the other hand, it would be difficult to ignore that economic growth is a crucial factor in the ability of Social Security or, indeed, any retirement program, to provide income to participants after they have stopped working. This is because most goods, and practically all services, can only be consumed when they are produced or shortly thereafter, so current consumption of goods and services cannot deviate greatly from current production for a long period. In the near term, government policy—or even market forces—can only change how the existing pie is sliced. In the longer term, however, policies that encourage a reasonable balance among

consumption, savings, and investment can promote economic growth and a larger pie for the future.

Conclusion

Because its income exceeded outgo from 1984 to 2009, Social Security has accumulated much larger trust funds than was usual in its history. In recent years, the nature of those trust funds has become a contentious issue in policy debates, with one side viewing the assets in the trust funds as a tangible store of value and the other describing them as an accounting illusion.

When the special Treasury securities held by the Social Security trust funds are redeemed, the U. S. Treasury will need to pay for those securities from the general fund. In those years, the federal government will need to finance those redemptions by borrowing more from the public, spending less or collecting more in taxes. Whether that poses a difficult budgetary dilemma will depend on whether the rest of the federal government is running a sufficient surplus. The existence of the trust funds, per se, is not responsible for this circumstance, as the increase in program cost relative to tax revenue over the next 25 years will be due to the reduction in the ratio of workers to beneficiaries. This downward trend is due to demographic changes within the population, including a declining birth rate and an increasing number of retirees from the baby boom generation.

In many instances when debate ensues over whether the Social Security trust funds are “real”, differences can be semantic. The significance of the trust funds depends on the context in which they are viewed. From the viewpoint of Social Security’s ability to pay benefits,

¹⁸To some extent, the same argument may also apply to equities; for example, merely buying or selling a stock does not create wealth. However, the change in the value of equity over time represents the market’s valuation of the real underlying assets. There is no counterparty whose wealth decreases as a result of equity gaining value.

given the existing design of the program and the legal context in which it operates, the trust fund assets have concrete and easily recognizable consequences. From the viewpoint of total government finances, trust fund assets may be considered irrelevant, although that would require an assumption that scheduled benefits would be paid regardless of the ability of the trust funds to finance the payments. From the viewpoint of the entire economy, trust fund assets represent no net wealth, but the same is true for many other securities, public and private. More importantly, the trust funds are unlikely to have a significant effect on national savings and hence on economic growth. Even so, there are ways in which trust fund dynamics may affect the distribution of income and wealth—so in some contexts the trust funds can also be relevant from the whole economy’s perspective.

The simple question, “Are the trust funds

real?” is likely to lead to misunderstanding because its meaning is so dependent on the often unstated context. A better understanding of the trust funds would probably stem from a more productive discussion focused on specific functions and consequences of the trust funds. Even if there were a universal agreement on the nature of the trust funds, differences in matters of policy would remain, since, under current projections, the trust funds provide only a temporary buffer against future increases in program cost, and benefit cuts or tax increases will ultimately become necessary if the system is to remain solvent. Finally, regardless of the financing mechanism, each future year’s benefits ultimately are provided out of that year’s total economic output. A society always has to decide how to allocate resources, including the trade-offs between work and leisure and the effects on both tangible and intangible standard of living.



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