

ARE THE SOCIAL SECURITY TRUST FUNDS MEANINGFUL?

BY ALICIA H. MUNNELL*

Introduction

Social Security traditionally has operated on a pay-as-you-go basis — that is, current taxes pay for current benefits. The 1977 and 1983 Amendments to the Social Security Act provided for a temporary departure from this approach — with the buildup of a significant trust fund. Currently the Social Security trust funds hold \$1.7 trillion in special Treasury bonds. The question is whether this buildup of assets has been economically meaningful. Has it increased national saving and investment and thereby created additional future income? In some sense this may seem like an antiquated question since 2016 is the last year when annual cash surpluses are expected to contribute to fund balances. But, in fact, the question is still very relevant because any attempt to restore solvency will likely again produce large surpluses for several decades.

This *brief* explores the effectiveness of building up assets in the Social Security trust funds. It first describes the economic rationale for such a buildup. It then looks at the debate about whether the accumulation of assets in the trust funds since 1983 has increased national saving. The final section explores ways that could make the accumulation of assets more effective — changing the budget treatment, restricting trust funds' investment in Treasury debt, and, finally, personal accounts.

Why Build up Trust Fund Assets?

The goal of accumulating assets in any pension program is to reduce the burden on future generations of paying benefits to future retirees. Since it is not possible to stockpile soup cans and clothing for tomorrow's elderly, the only way to save in advance is to accumulate financial assets. How can the accumu-

AN ISSUE IN BRIEF
CENTER FOR
RETIREMENT
RESEARCH
AT BOSTON COLLEGE

MAY 2005, NUMBER 30

INTRODUCTION	I
WHY BUILD UP TRUST FUND ASSETS?.....	I
WHAT DOES THE TRUST FUND BUILDUP MEAN?.....	2
BETTER WAYS TO SKIN THE CAT	3
CONCLUSION	5
ENDNOTES	6
REFERENCES	6

*Alicia H. Munnell is the director of the Center for Retirement Research (CRR) at Boston College and the Peter F. Drucker Professor in Management Sciences at Boston College's Carroll School of Management. The author wishes to thank Peter Diamond for his helpful comments.

lation of assets really reduce the burden on future workers of providing Social Security and other retirement benefits? It reduces the burden by increasing the nation's saving.¹ More saving means more investment, increased productivity growth, and a bigger economic pie. With a bigger pie, future workers will have more stuff left over after they meet the claims of the elderly.

In other words, the burden on future workers will depend on two factors. The first is the portion of the economic pie needed to support the retired. The second is the size of the pie. The portion of the pie going to the elderly, in say 2040, will be determined by the size of their claims either in the form of Social Security benefits or other assets.² The size of the pie in 2040 can be affected by building up assets in advance, such as through the Social Security trust funds.

For the accumulation of trust fund assets to increase the size of tomorrow's pie, the current generation of workers will have to forego more current consumption than is required to cover today's benefits. In other words, saving for tomorrow is not costless.

What Does the Trust Fund Buildup Mean?

As part of efforts to restore balance to the Social Security program in 1977 and 1983, Congress moved up scheduled tax increases. This movement, combined with other changes, meant that for several decades the program would bring in more money than it paid out (see Figure 1). Indeed, today the Social Security trust funds hold \$1.7 trillion in assets — roughly three times the annual outflow from the program. The assets are invested in special issue Treasury securities.

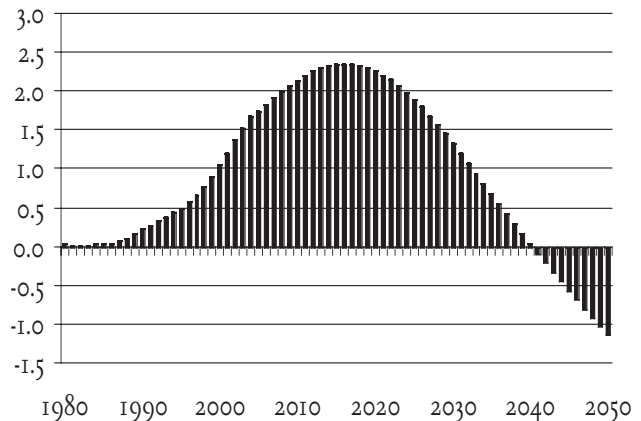
No one disputes that the Social Security trust funds hold \$1.7 trillion of Treasury debt, but debate rages about what these assets mean in economic terms. The debate centers on two interrelated questions. Did the buildup actually increase national saving? And what happens when Social Security redeems the assets in the trust funds to pay benefits?

Did the Buildup Actually Increase National Saving?

Whether the accumulations in the Social Security trust funds really added to national saving is a very important issue. Large deficits in the overall budget

FIGURE 1. SOCIAL SECURITY IS BUILDING UP ASSETS THAT WILL BE DRAWN DOWN IN THE FUTURE

OASDI Trust Fund Assets, 1980-2050, Trillions of Dollars



Source: Social Security Online: Actuarial Publications: Trust Fund Data (2005); and Social Security Trustees Report (2005).

since the 1980s have led some critics to contend that surpluses in Social Security simply go to cover deficits in the rest of the budget, and have no impact on government or national saving. That criticism is too simplistic. The issue is not whether the non-Social Security budget was in surplus or deficit, but rather did Congress change its behavior and spend more on other programs or raise less income taxes than it would have in the absence of the Social Security surpluses. If Congress did change its behavior, then the buildup in the trust funds would not have added to national saving.³

This argument is impossible to settle definitively. The best that can be done is to summarize what others have concluded, and then offer a personal opinion. Some analysts note that policymakers' efforts to rein in large deficits over the past two decades have generally targeted the total budget, which made the task somewhat easier than it would have been if the Social Security surpluses were not counted. Building on this notion, a couple of econometric studies conclude that the accumulated Social Security surpluses may have added nothing to national saving.⁴ But critics of these studies point out that the results are extremely sensitive to the variables included and the time period used for estimating the equations.⁵ Other commentators rely more on an assessment of the political and budget process. On that basis, some conclude that only a modest fraction of the Social

Security surpluses added to saving; others, a large fraction.⁶ Thus, the debate remains unresolved.

For what it is worth, my view is as follows. The 1980s began with large federal tax cuts, rising entitlement spending, and a buildup of defense that created large unified budget deficits. The deficits were enormous even after 1983 when surpluses began to emerge in the Social Security program. Almost from the beginning, the challenge was to restore fiscal discipline. After several failed attempts to rein in the deficit, the first major successful step in that direction was a balanced budget package in 1990 under President Bush. Two additional packages in 1993 and 1997 under President Clinton plus a strong economy moved the unified budget to balance. In the late 1990s, both the non-Social Security and Social Security portion were in surplus. My judgment is that neither administrations nor Congress pushed less hard to restore balance on the non-Social Security side because of the surpluses in the trust funds. In short, the accumulation of assets in the Social Security trust funds probably increased national saving significantly prior to 2000.

After 2000, the picture is more mixed. In 2000, the Congressional Budget Office projected surpluses in both Social Security and the government's other accounts large enough that the government would be able to buy back the entire publicly-held national debt (see Figure 2). Large projected surpluses were just too tempting for the President and Congress, particularly as the economy slipped into recession. The President proposed, and Congress enthusiastically endorsed, a large tax cut that was enacted in 2001.

In 2003, the projections showed large deficits in the non-Social Security portion of the budget that were partly offset by Social Security surpluses (see Table 1). In this case, the moderating impact of the Social Security surpluses may have made it easier to justify the tax cut legislation passed in 2003. In other words, some offsetting behavior on the part of Congress and the administration may have undermined at least some of the effectiveness of the buildup in the trust funds.

The Implications of Redeeming Trust Fund Debt

Some claim that the buildup in the trust funds has had no economic impact because in 2017 when the trust funds redeem some bonds, the Treasury will have to raise taxes, lower other spending, or increase borrowing. This is not a meaningful argument. Consider the case of private defined benefit pension plans, where most people think that pre-funding adds

to national saving. These plans hold \$62 billion in Treasury securities. When the plan sponsors redeem these assets to cover benefit payments, the Treasury will have to raise the money through higher taxes, lower expenditures, or more borrowing. The point is that those actions will be less painful because the accumulation of assets in personal defined benefit plans has increased national saving, capital, and output. The same argument holds for Social Security. The key question is whether pre-funding of Social Security added to national saving — not the fact that the Treasury has to take some action when the securities are redeemed.

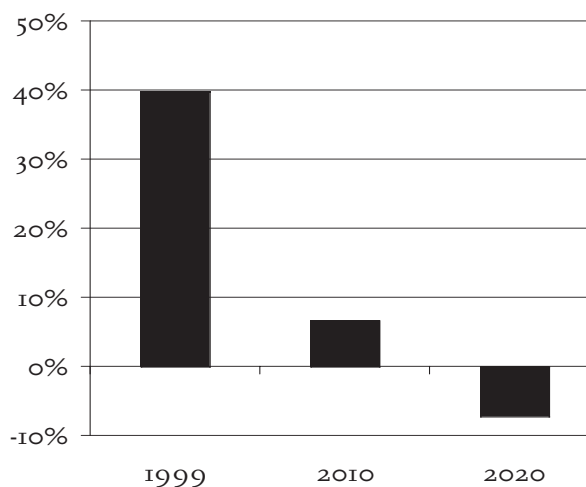
Better Ways to Skin the Cat

Given that the goal of trust fund buildup is to increase saving, and the current approach is at least questionable, how can it be done more effectively? The problem with the existing arrangement is that it allows surpluses in the Social Security trust funds to mask deficits in the non-Social Security accounts and produces a more favorable fiscal picture than actually exists.

A number of options come to mind: 1) change the budget treatment; 2) limit trust fund investment in Treasuries; and 3) save through personal accounts. The easiest way to think about these options is in the context of new surpluses generated in the process of closing the program's 75-year deficit.

FIGURE 2. IN 2000, ANALYSTS PROJECTED THE ELIMINATION OF FEDERAL DEBT

Debt Held by the Public, as a Percent of GDP



Source: Congressional Budget Office (2000), Table IV.

Take Social Security Out of the Unified Budget

Technically, the Social Security trust funds are already "off-budget."⁷ The Social Security Amendments of 1983 officially reversed the reliance on the concept of the unified budget which combines Social Security with the rest of the budget. The difficulty is that the budget numbers reported by the Administration, Congress, and the press generally focus on budget totals that include the balances in the trust funds. Thus, separating Social Security from the rest of the budget requires changing culture more than changing legal requirements.⁸

Removing all Social Security revenues and expenditures from the budget documents and the annual budget process would focus public discussion, analyses, and budget balancing efforts on the non-Social Security part of the budget. It would make it very difficult to justify general tax cuts on the basis of surpluses in non-reported accounts. Would it work? Would it really be possible to evaluate the budget without considering the Social Security surpluses? Comparisons of the federal government with the states are always tricky, but states generally have been successful in this endeavor. They accumulate reserves in their pension plans but usually present their budgets excluding the retirement systems. Their non-retirement budget balance has remained positive, while annual surpluses in their retirement funds have hovered around 1 percent of GDP. Thus, states appear to be adding to national saving through the accumulation of pension reserves. With a commitment to balance the non-Social Security portion of the budget, the same should be achievable at the federal level.

Restrict Trust Fund Investments in Treasuries

By law, the trust fund's surpluses are invested in a special type of Treasury bond, and the trust funds receive interest on these investments.⁹ When the rest of the budget is in deficit, the Treasury automatically uses any surplus payroll taxes from Social Security to cover spending on other federal programs. Thus, even if the trust funds were off-budget, the annual surpluses would still provide a ready source of cash to cover general expenditures. Therefore, it may be useful to combine the change in budget treatment with restrictions on investments in Treasuries.

Prohibiting Social Security from investing future surpluses in Treasuries would mean that the Federal government would have to borrow from the public to cover deficits in the non-Social Security portion of the budget. Ireland, which accumulates reserves in its social security system, has such a prohibition.¹⁰

Preventing investment in Treasuries would require policymakers to specify what the trust funds could hold. Under current law, they are already permitted to hold securities issued by other entities, such as the Government National Mortgage Association, that are considered to be backed by the U.S. Treasury. Shifting to these assets would require no new legislation. Other options include corporate bonds or an assortment of fixed income securities. A more controversial proposal would be to allow the trust funds to invest in equities. Several proposals along this line emerged in the 1990s. These proposals typically involved indexing trust fund equity investments to a broad market average to avoid picking individual stocks, and establishing an expert investment board with fiduciary responsibilities to

TABLE I. SOCIAL SECURITY SURPLUSES PARTIALLY OFFSET DEFICITS IN OTHER ACCOUNTS

Surpluses/Deficits 2003-2013, Billions of Dollars

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
General Government	-361	-319	-268	-228	-205	-185	-165	-145	-26	134	177
Social Security*	162	174	195	212	231	250	268	286	303	317	330
Total Surplus/Deficit	-199	-145	-73	-16	26	65	103	141	277	451	507

Source: Congressional Budget Office (2003), Table I.1

* Also includes the postal system.

select the index, choose private portfolio managers for the accounts, and monitor the performance of the managers. To ensure that government ownership did not disrupt corporate governance, most proposals required that voting rights be given to the asset managers, not voted at all, or voted in the same fashion as the other shareholders.¹¹ Canada, which has a social security system very similar to that in the United States, has invested a portion of its assets in equities and it appears to be working effectively.¹²

In any event, preventing the Social Security surpluses from serving as an easy source of cash for other federal expenditures would help these surpluses to increase national saving.

For surpluses to be economically meaningful, they must add to national saving.

Saving through Social Security Personal Accounts

Some view personal accounts as the best way to save through Social Security.¹³ These personal accounts can either be "carved out" of the existing payroll tax or added on top. The carve out approach does not fit into the framework described above, because it does not generate new surpluses to close the program's 75-year deficit. Nevertheless, supporters claim that introducing these accounts will rein in congressional spending because the government's budget scoring agencies will treat the diversion of funds as an expenditure, making deficits appear larger.

An exercise more consistent with the framework discussed above is a proposal from the 1994-96 Social Security Advisory Council to raise the payroll tax by 1.6 percentage points and deposit the funds in personal accounts.¹⁴ The direct effect of raising the payroll tax would be to increase national saving, regardless of whether the monies were put into the trust funds or into personal accounts. The advantage of putting the money into personal accounts, according to supporters, is that it would not mask deficits in the rest of the budget and thereby not encourage the Administration and Congress to increase spending or reduce taxes.

Conclusion

Any proposal to restore Social Security solvency that involves an immediate increase in revenues or decrease in benefits will extend the period of substantial surpluses. For those surpluses to be economically meaningful and reduce the burden on future generations of workers, they must add to national saving. Greater national saving means more capital, higher levels of productivity, and more output in the future. Greater future output means that tomorrow's workers will have more left over for themselves after they transfer a portion to retirees.

Critics of the current arrangement question whether surpluses in the trust funds actually increase saving. Under the unified budget, surpluses in the Social Security program mask deficits in the rest of the budget. This more benign budget outlook can lure politicians and the public into supporting spending increases or tax cuts even when the non-Social Security portion of the budget shows deficits as far as the eye can see. The mandate that the Social Security trust funds invest in Treasury securities also makes Social Security a ready source of cash for other programs.

Taking Social Security out of the budget is an essential first step to enhancing the likelihood that trust fund accumulations translate into national saving. Broadening trust fund investments — a more controversial proposal — would reinforce the separateness of the program and could further the goal of greater saving. Personal accounts that reflect new revenues are another option that could increase national saving.

Endnotes

¹ For more details on the relationship between national saving and Social Security reform, see Eschtruth and Triest (2005).

² Note that it does not matter from an economic perspective whether the elderly's claims on output in 2040 are in the form of accrued rights under Social Security, under employer defined benefit pension plans, or in the form of purchasing power gained through the sale of assets accumulated in 401(k) plans. Given the size of the total national output, the question is simply how much the working population in 2040 will have to transfer to the elderly and how much of total output will be left over for their own consumption. See Thompson (1998).

³ If the buildup has not added to national saving, then the only effect has been a change in the composition of revenues. That is, workers' payroll contributions would have paid for general expenditures since 1983, and taxpayers in the future would cover Social Security benefits through the income tax. Diamond (2003) makes an even more sophisticated point that the shift in tax burden could increase national saving. That is, shifting the financing of general expenditures from the income tax to the payroll tax increases the burden on low and middle-income workers (who save little) and reduces the burden on high income people (who save a lot).

⁴ Nataraj and Shoven (2004) and Smetters (2003).

⁵ Orszag (2004).

⁶ Samwick (1999), Schieber and Shoven (1999), Feldstein and Liebman (2001), and Greenspan (2005) argue that the Social Security surpluses have had only a small or modest impact on saving. Diamond (2003), and Diamond and Orszag (2004) suggest that the effects have been much more substantial.

⁷ The Social Security Amendments of 1983 provided for the conversion to off-budget status by 1993, and the 1985 Balanced Budget Act changed the effective date to 1985.

⁸ See Keith (1997).

⁹ The trust funds' 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 funds hold other types of Treasury obligations as well, but, for the purposes of this brief, all Treasury obligations are referred to simply as bonds. In addition to Treasury obligations, the trust funds are 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.

¹⁰ Palacios (2002).

¹¹ For more details on the implications of investing trust fund surpluses in equities, see U.S. General Accounting Office (1998).

¹² Canada Pension Plan Investment Board (2001).

¹³ Samwick (1999).

¹⁴ 1994-96 Advisory Council on Social Security (1997).

References

Advisory Council on Social Security. 1997. *Report of the 1994-1996 Advisory Council on Social Security*. Washington, D.C.: U.S. Government Printing Office.

The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. 2005. Washington, D.C.: U.S. Government Printing Office.

Canada Pension Plan Investment Board. 2001. *Canada Pension Plan Investment Board Annual Report 2001*. Toronto, ON: CPP Investment Board.

Diamond, Peter A. 2003. "Social Security, the Government Budget, and National Savings." Unpublished mimeo. MIT, March 24.

Diamond, Peter A. and Peter R. Orszag. 2004. *Saving Social Security: A Balanced Approach*. Washington, D.C., Brookings Institution Press.

Eschtruth, Andrew and Robert Triest. 2005. *National Saving and Social Security Reform*. Just the Facts 18. Chestnut Hill, MA: Center for Retirement Research at Boston College.

Feldstein, Martin S. and Jeffrey B. Liebman. 2001. "Social Security." National Bureau of Economic Research Working paper 8451 (September).

Greenspan, Alan. 2005. "Economic Outlook and Current Fiscal Issues." Testimony before the Committee on the Budget, U.S. House of Representatives. (March 2).

Robert Keith. 1997. "Budget Enforcement Procedures: Application to Social Security Revenues and Spending." Washington, D.C.: Congressional Research Service, February 11.

Nataraj, Sita and John B. Shoven. 2004. "Has the Unified Budget Undermined the Federal Government Trust Funds?" Paper presented at "The Future of Social Security" Conference: Washington D.C., August 12-13.

Orszag, Peter R. 2004. Comments on Sita Nataraj and John B. Shoven. "Has the Unified Budget Undermined the Federal Government Trust Funds?" at "The Future of Social Security" Conference: Washington D.C., August 12-13.

Samwick, Andrew A. 1999. "Social Security Reform in the United States." National Tax Journal Vol. LII No. 4 (December).

Schieber, Sylvester J. and John B. Shoven. 1999. *The Real Deal: The History and Future of Social Security*. New Haven, CT: Yale University Press.

Smetters, Kent. 2003. "Is the Social Security Trust Fund Worth Anything?" Unpublished mimeo.

Palacios, Robert. 2002. *Managing Public Pension Reserves. Part II: Lessons from Five Recent OECD Initiatives*. World Bank.

Thompson, Lawrence. 1998. *Older and Wiser*. Washington, D.C.: The Urban Institute Press.

United States General Accounting Office. 1998. "Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy." GAO/AIMD/HEHS-98-74.

CENTER FOR
RETIREMENT
RESEARCH
AT BOSTON COLLEGE

About the Center

The Center for Retirement Research at Boston College was established in 1998 through a grant from the Social Security Administration. The Center's mission is to produce first-class research and forge a strong link between the academic community and decisionmakers in the public and private sectors around an issue of critical importance to the nation's future. To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

Affiliated Institutions

American Enterprise Institute
The Brookings Institution
Center for Strategic and International Studies
Massachusetts Institute of Technology
Syracuse University
Urban Institute

Contact Information

Center for Retirement Research
Boston College
Fulton Hall 550
Chestnut Hill, MA 02467-3808
Phone: (617) 552-1762
Fax: (617) 552-0191
E-mail: crr@bc.edu
Website: <http://www.bc.edu/crr>

The Center for Retirement Research thanks its research partners for support of this project: CitiStreet, Prudential Financial, AMVESCAP, New York Life Investment Management, AARP, TIAA-CREF Institute, AXA Financial, and Standard & Poor's.

© 2005, by Trustees of Boston College, Center for Retirement Research. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that the author is identified and full credit, including copyright notice, is given to Trustees of Boston College, Center for Retirement Research.

The research reported herein was supported by the Center's Partnership Program. The opinions and conclusions expressed are solely those of the author and should not be construed as representing the opinions or policy of the Corporate Partners or the Center for Retirement Research at Boston College.