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Fixing Social Security: Is the Surplus the Solution?

by David E. Altig and Jagadeesh Gokhale

On certain topics, confusion perpetually reigns. Everyone has a personal list, of course, but somewhere near the top of most is what to make of any debate that includes the words "Social Security." As the seeds of Social Security reform, planted in President Clinton's January 1999 State of the Union address, begin to flower in the early heat of the political spring, we can expect the surrounding discussion to yield its fair harvest of muddled thinking, mixed messages, and mistaken claims.

One year earlier, the President proposed that "we devote every penny of every future surplus" to saving Social Security. Although recent events in Yugoslavia will inevitably dent the surplus projections calculated prior to the crisis in Kosovo, the President's recommendation remains the front-runner in the race to address anticipated problems in financing future Social Security benefits.

This *Economic Commentary* evaluates the Administration's recent proposal to restore solvency to the U.S. Social Security system by using projected federal budget surpluses.[1] Our central message is quite simple: Such an action may seem attractive, but it would obscure the essential trade-offs that we face as a society when addressing the topic of Social Security reform. In particular, we note (as have others) that proposals of this type are largely changes in the accounting treatment of surpluses and deficits. As such, they cannot resolve the fundamental imbalance in our most basic public pension program. Ultimately, hard choices must be made that involve either raising taxes or cutting government expenditures.

Some Simple Accounting: The Unified Budget

To make sense of a complicated proposal, it always helps to strip the problem to its essentials. So we'll construct a very simple example to illustrate the relevant aspects of the accounting.

Here's what we will assume:

- In the current period—let's call it "this year"—the government collects $100 in payroll taxes (which are labeled as contributions to the Social Security system). In addition, the government collects another $100 in revenue from sources other than payroll taxes (the income tax, for instance).

- On the expenditure side, the government requires $75 to pay this year's Social Security benefits, and $125 for all other forms of spending.

So far, there is nothing too complicated here. The government collects $200 in revenues and has $200 of outlays. On the basis of the *unified budget*—the accounting convention that lumps Social Security revenues and expenditures with all other categories—the federal budget is in balance, with neither deficit nor surplus.

It may seem an attractive proposal—the Administration's plan of using projected budget surpluses to restore Social Security's finances—but it obscures the real trade-off we face in tackling this problem. The proposal is essentially a change in the accounting treatment of surpluses, deficits, and debt held by the public and in the Social Security Trust Fund. It would in no way alter the fundamental imbalance that afflicts the nation's most basic pension program.

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In the world of federal budgeting, however, Social Security is considered an *off-budget* item. In our simple example, it is the only such item, and all other revenues and outlays are termed *on-budget*.[2] There are thus two sets of accounts. The deficit or surplus of each is the difference between the receipts and outlays for the categories of spending identified for that account. In our example, the on-budget account is in deficit by $25 ($100 of income-tax revenues less $125 of non-Social Security spending) and the off-budget in a $25 surplus ($100 of payroll tax receipts less $75 of Social Security benefit payments).

■ Surplus Mythology I

In principle, it would be possible to completely separate the activities associated with the on- and off-budget accounts. Those responsible for the on-budget account in our example would simply issue enough debt to cover the excess of expenditures over receipts for the current period. In the future, when the debt comes due, the principal plus the interest would be paid out of income tax revenues. On the other hand, the surplus from the off-budget account would be used to retire any accumulated off-budget debt or simply saved (in some form) to finance prospective shortfalls in off-budget receipts over outlays—that is, shortfalls in financing the Social Security system.

In practice, no such separation exists. In the real world of U.S. fiscal policy, the Social Security trust fund must invest in Treasury securities—the debt issued to cover on-budget shortfalls. Thus, the appropriate concept is the unified budget, which completely commingles the on- and off-budget receipt and outlay items. It is true that a paper transaction occurs when taxes collected for Social Security are used to finance general outlays; in effect, the Treasury gives the Social Security accounts an IOU in exchange for the surplus. However, it is clear that nothing is made available to finance future benefit payments but the flow of prospective revenues on the unified budget.

In our example, the Social Security "trust fund" would receive an accounting entry indicating that payroll taxes of $25 are being diverted to the on-budget account. Presumably, this $25 will later be repaid with interest to the off-budget account, but where will the funds for repayment come from? Unless the Social Security system itself remains in surplus, there is only one available source: general revenues. In fact, this is exactly what the Social Security Trust Fund represents—an extension of the tax base for financing Social Security benefits to include income taxes.

One might argue that this is entirely appropriate. The extent to which future Social Security benefits are paid for out of future general revenues is limited to the amount that contributors to the system extend to pay for current government spending. The problem with this argument is that current government spending largely represents current consumption that is enjoyed by *current* generations. But *future* generations are the ones that pay the taxes. In this case, paying future Social Security benefits to today's generations out of future general revenue amounts to forcing future generations to finance today's public goods and services.

■ Surplus Mythology II

This, then, is the main lesson of our example: The device of the trust fund simply permits current generations to stake a claim on future generations' general tax payments while reaping the benefit of current government spending on public goods and services financed by Social Security surpluses. The IOUs from the Treasury to the trust fund represent nothing more than the promise to pay for prospective Social Security benefits from the income tax.

But how does this help us understand proposals to restore solvency to the Social Security system by using on-budget surpluses? The answer is straightforward. An IOU written to the Social Security Trust Fund represents exactly the same transaction whether it derives from on-budget surpluses or off-budget surpluses. In either case, it is just a promise to use future general revenues.

To appreciate this point, consider a slight variation of our previous example. In particular, suppose that when "next year" rolls around, the situations of our first scenario are exactly reversed:

- Just as it did this year, the government collects $100 in payroll taxes (designated as Social Security contributions) and $100 in income taxes.
- On the expenditure side, the government requires $125 to pay this year's Social Security benefits. Non-Social Security expenditures are $75, but IOUs to the trust fund require that $25 be transferred to Social Security accounts. (For simplicity, we assume that these IOUs bear no interest.)

As before, the unified budget is exactly in balance: The federal government collects $200 in revenues ($100 each from the payroll and income tax) and has an outgo of $200 ($125 for public pension benefits and $75 in other expenditures). The paper transaction of retiring the IOUs from the income tax is precisely the act of paying for promised benefits from the income tax that we have been emphasizing.

But now contemplate a situation in which next year's scenario is expected to persist indefinitely. In that case, the Social Security system is "broke": The contributions of workers (payroll taxes) are forever insufficient to cover the expected flow of Social Security benefits. The rest of the government, however, is in surplus and (in our simple example) by just the amount of Social Security's deficit. We can rectify this problem in the Social Security system, of course, by using on-budget surpluses to pay Social Security benefits. But in that event, all we'll really have done is raise the revenues received by the public pension system by tapping the income tax.

Our point is not that the decision to "set aside" current and prospective surpluses for paying future Social Security benefits is irrelevant. In a world where interest costs are non-zero, using surpluses to retire debt rather than increase spending

TABLE 1: SUMMARY OF BUDGET PROPOSALS, 2000–2014 (trillions of dollars)

Item	On-Budget	Off-Budget
Sources		
Own surplus	2.1	2.7
Receipt/transfer from on-budget		2.8
Total sources	**2.1**	**5.5**
Uses		
Transfer to off-budget	2.8	
Pay off debt held by the public		2.7
Defense and other spending plus financing costs	1.4	
Medicare spending	0.7	
Total uses	**4.9**	**2.7**
Sources minus uses	**–2.8**	**2.8**

SOURCE: Derived from *Budget of the United States Government, Fiscal Year 2000*. Washington, D.C.: U.S. Government Printing Office, 1999.

or reduce taxes obviously decreases the amount of revenues needed to service that debt. This allows revenues to be diverted for paying accumulated Social Security liabilities, with no attendant increase in overall revenue collection.

Still, the essential fact remains: The policy commits general revenues to pay for pension entitlements. Exploiting unified budget surpluses may make using general revenues for Social Security easier (and less transparent—after all, this particular solution requires no explicit action to increase tax rates or cut benefits), but doing so does not eliminate the system's prospective liabilities. In the end, the policy represents a decision to maintain the path of Social Security benefits and pay for them out of future income taxes collected by the federal government.

Surplus Mythology III (The Final Chapter)

Thus far, we have emphasized two essential facts. First, when thinking about the Social Security system and its future, we should consider all potential solutions in the context of the overall or unified federal budget. Surpluses allocated through the trust fund to future benefit payments—whether they originate off- or on-budget—represent nothing more than claims to future income tax revenues. (Again, we are ignoring the "privatization" elements of proposed solutions.) Second, allotting additional IOUs to the trust fund does not expand the universe of policy actions available for fixing Social Security.

These facts about budget mechanics can now be applied to the specific proposal alluded to in President Clinton's 1999 State of the Union address and described in the budget for fiscal year 2000 (the implications of which are shown in table 1). According to this proposal, the nation would allocate 62 percent of prospective federal surpluses to paying the Social Security benefits promised under current law. The total budget surplus projected over the next 15 years is $4.8 trillion. Of this, $2.1 trillion arises in the on-budget account.

On the spending side, the Administration's budget for fiscal year 2000 proposes to allocate $1.4 trillion for additional on-budget initiatives: $481 billion for defense spending, $536 billion for establishing Universal Saving Accounts, and $387 for associated financing costs. In addition, $686 billion would be devoted to funding Medicare benefits. That is, the entire on-budget surplus over the next 15 years is to be spent.

The off-budget surplus of $2.7 trillion is to be devoted to paying down debt held by the public. Note, however, that this surplus will generate additional IOUs with the trust fund, committing future general revenues to funding Social Security benefits. It therefore amounts to substituting debt held by the trust fund for debt held by the public. The Administration's proposal to address prospective Social Security shortfalls consists of a transfer, *in addition to the allocations mentioned above*, of IOUs worth $2.8 trillion to the Social Security Trust Fund, thus increasing the commitment of future general revenues for Social Security. However, this transfer only implies that general revenues beyond the 15-year budget horizon would be devoted to Social Security, extending its financing to general revenues after 2014.

What to make of these numbers? First, the Administration's envisioned allocation of funds to finance future Social Security benefits and other federal spending programs will require tax increases or other spending reductions which are not yet articulated in current laws or budget proposals. (The same point has been made by several other analysts.) Second, the proposal does not represent a solution to Social Security's long-term imbalance in that it does not alter any of the difficult choices (cutting benefits or increasing taxes) that we, as a nation, confront.

Conclusions

Our intent in this *Commentary* has been to illustrate that policies using unified budget surpluses to finance the liabilities of the U.S. Social Security system would not produce any magic solutions. In these policies, Social Security benefits compete with all other legitimate claims to federal revenues (including taxpayers' claims to simply have the funds returned to them). There is no such thing as a free lunch. The options available to us remain the same as ever and require making the same hard choices. In the end, taxes must rise, other government spending must fall, or benefits must be cut. End of story.

Elsewhere, we advocate maintaining the stream of promised benefits to "older" generations and simultaneously reducing the benefits of young and future generations, coupled with mandatory private saving plans.[3] We argue that this approach can be designed in a way that assures retirement security for younger generations, given the benefit reductions or tax increases that must inevitably be imposed to bring the system into balance. Whether or not such a plan ultimately emerges as a solution, in evaluating alternatives it is crucial to appreciate the very clear, very tough trade-offs that we collectively confront.

Footnotes

1. This refers to the total projected surplus on the unified federal budget between 2000 and 2014. The President's proposal would allow the trust fund to invest a portion of its holdings in equities and has called for a bipartisan effort to provide additional fiscal reforms.

2. In reality, the off-budget account includes the Postal Service Account. Because this account is much smaller than Social Security, ignoring it does not materially alter the analysis.

3. See David E. Altig and Jagadeesh Gokhale, "Privatizing Social Security: One Plan," *Cato Project on Social Security Privatization*, no. 9 (May 29, 1997).

David E. Altig is a vice president at the Federal Reserve Bank of Cleveland, and Jagadeesh Gokhale is an economic advisor there.

The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

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Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

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