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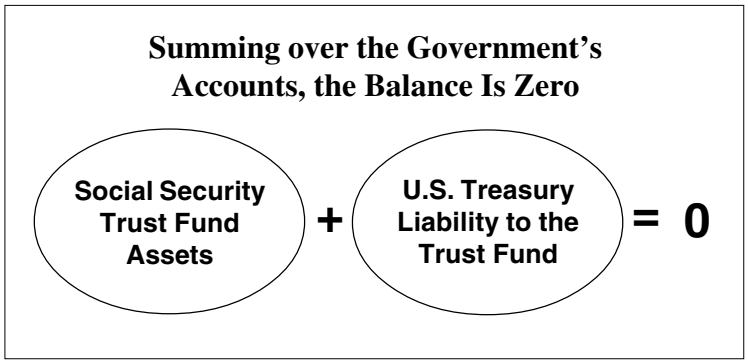
Straight Talk about the Social Security Trust Fund

By Matt Moore and John C. Goodman

President Bush has appointed a bipartisan commission to study reform of Social Security. But the response to the commission's first report reveals that most Americans — and many members of Congress — do not understand how Social Security works.

What Is a Pay-As-You-Go System? Like most government-sponsored retirement programs in the world today, our Social Security system is pay-as-you-go. All payroll tax revenues are spent — the very minute, the very hour, the very day they are received by the U.S. Treasury. Most of these revenues are spent on benefits for current retirees. Any additional amount is spent in other ways. But there is no funding of future benefits. No money is being stashed away in bank vaults. No investments are made in real assets.



Pay-as-you-go schemes are sometimes derisively referred to as a "chain-letter" approach to retirement, or as "Ponzi schemes." But unlike private sector schemes — which are illegal — the government forces everyone to join. That's why Nobel Laureate economist Paul Samuelson once described Social Security as "a Ponzi scheme that works."

Are There Alternatives to Pay-As-You-Go? Almost two dozen former British colonies (most notably Singapore) have set up funded pension systems, called "provident schemes." In these systems, workers are forced to save and invest to fund their own retirement. Britain's own (second-tier) social security system is also based on the principle of forced saving and (private) investment.

Following the lead of Chile, a number of Latin American countries have converted from pay-as-you-go systems to funded systems. In addition to Britain, several developed countries — Sweden, Australia and most recently Germany — have created funded private pensions as a partial substitute or as an addition to pay-as-you-go social security. And several start-up systems are based on the new Chilean model, including systems in Hong Kong, Hungary, Poland and Kazakhstan.

What Happens When Social Security Has Surpluses and Deficits? These are normal features of any pay-as-you-go system. In the United States, payroll tax collections have exceeded benefit payments since the mid-1980s, and will continue to do so until 2016, when Social Security will begin running deficits again. For example:

- In 2001, the government will collect $604.3 billion from workers through the Social Security payroll tax and will spend $438.9 billion on Social Security benefits; thus the Social Security surplus in 2001 will be $165.4 billion.
- At the end of 2001, the accumulated value of all the previous years' surpluses will total more than $1.2 trillion.
- By 2016, the government will have collected more than $5.4 trillion in Social Security surpluses.

But where is all this money going? In the years Social Security runs a surplus, amounts not used to pay benefits to current retirees are spent by the federal government on other programs or (very recently) to pay down publicly-held government debt. Conversely, in years when the system runs a deficit, more is being spent on benefits than is being collected in payroll taxes. In this case, the government must use other tax revenues (mainly individual and corporate income taxes) or borrow to make up the difference.

What Is the Social Security Trust Fund? Most pay-as-you-go systems do not have trust funds, since there are no investments for the trust funds to make. In the U.S., we have trust funds — but they serve an accounting function, not a financial function. For example, the Social Security (OASI) trust fund keeps track of surpluses and deficits in retirement, spousal and survivors benefits over time. The Disability Insurance

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(DI) Trust Fund tracks disability benefits. And the Health Insurance (HI) Trust Fund keeps track of Medicare Part A benefits and the payroll tax that funds those benefits.

But these trust funds do not collect taxes. Nor do they disburse benefits. Every payroll tax check sent to Washington is written *to* the U.S. Treasury. Every Social Security benefit check is written *on* the U.S. Treasury.

Doesn't the Trust Fund Hold Government Bonds? Yes and no. Technically, the trust fund holds bonds that represent the cumulative surplus (payroll tax collections minus benefit payments). But these bonds are only important for accounting purposes. They have no financial significance. They are like bookkeeping entries, without any market value. The annual reports of the Social Security trustees list the yields and maturity dates of the special-issue bonds in the Social Security trust fund. But these special-issue bonds are not the same as the bonds held by the public. They are not part of the official outstanding debt of the U.S. government. They cannot be sold on Wall Street or to any foreign investors. And they cannot be used to pay benefits.

Moreover, the Social Security trust fund exists within the U.S. Treasury — not as an independent entity. Thus the issuer of the bonds (the U.S. Treasury) and the holder of the bonds (the Social Security trust fund) are the same entity. As a result, the trust fund's special-issue bonds are actually nothing more than IOUs the government writes to itself.

On paper, the trust fund has enough IOUs to "pay" Social Security benefits for about 28 months on any given day. In reality, it cannot pay anything. Every asset of the trust fund is a liability of the Treasury. Summing over all government accounts, the balance is zero. [See the diagram.] For the Treasury to write a check, it must first tax or borrow.

The actual certificates for the trust fund's special-issue bonds are held in government filing cabinets in Parkersburg, W.Va. But if a fire were to burn down the building tomorrow, or if thieves were to take the filing cabinets away, there would be no harmful consequences for retirees. Similarly, if the trust funds themselves were simply abolished, real economic activity would be unaffected. No private bondholders would suffer. The government would not be relieved of any of its existing obligations or commitments. Alternatively — as the late economist Robert Eisner suggested — with the stroke of a pen, we could double or even triple the number of IOUs the trust fund holds. Either option would allow us to dispense with artificial crises and address the real problem: How is the Treasury going to pay the government's bills?

Why Is There So Much Confusion about How Social Security Works? Since Social Security's inception, the program's managers have tried to convince the public that it is a funded system — even though the system is really pay-as-you-go. This message is frequently conveyed by the Social Security Administration itself. For example:

- A widely circulated booklet, *Your Social Security*, says "people pay Social Security contributions which are pooled in special trust funds. When earnings stop … monthly cash benefits are paid to replace part of the earnings the family has lost."
- Every qualifying American receives a *Social Security Statement*, which says, "Social Security now takes in more than it pays out in benefits. The excess funds are credited to Social Security's trust funds, which are expected to grow over $4 trillion before we need to use them to pay benefits."

If these statements were made by a private company, it would probably constitute fraud and violate all manner of federal financial regulations.

What's the Problem? Social Security will begin running annual deficits by 2016. At that time, the value of all the IOUs held in the trust fund will total $5.4 trillion. Where will the government get the extra $5.4 trillion to pay back the IOUs? Congress will have only three options to raise the additional funds: Raise taxes, cut benefits or borrow. Ironically, these are the same choices the government would face if there were no trust fund at all.

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