National Center for Policy Analysis

BRIEF ANALYSIS
No. 509
For immediate release:
Monday, March 21, 2005

Answering the Myths about Social Security

by Thomas R. Saving, Ph.D.

Social Security reform is at the top of President Bush's second term agenda — and for good reason. In the next decade, two monumental shifts will occur: 1) the first of the 77 million baby boomers will start drawing benefits and stop paying payroll taxes, and 2) funds available to pay Social Security and Medicare benefits will fall increasingly short of promises we have made.

A great deal of misinformation is being spread in the debate over the need to reform our elderly entitlements programs. The record needs to be set straight.

Myth 1: The Trust Funds can help pay benefits. All payroll tax checks from employers are written to the U.S. Treasury. All Social Security and Medicare Hospital Insurance (Part A) checks received by seniors are written on the U.S. Treasury. The Social Security and Medicare Trust Funds neither receive funds nor disburse them. So why have trust funds?

The Social Security Trust Fund serves an accounting function, not an economic function. It works like this: When payroll tax revenues exceed expenses, the government prints special bonds to keep track of the surplus. These bonds cannot be bought and sold in the marketplace (all the surplus payroll tax dollars are spent on other things). They are printed and placed in filing cabinets in Parkersburg, West Virginia. When revenues fall short of expenses, this process will be reversed: the bonds will be taken out of the filing cabinet and retired through redemption by the Treasury.

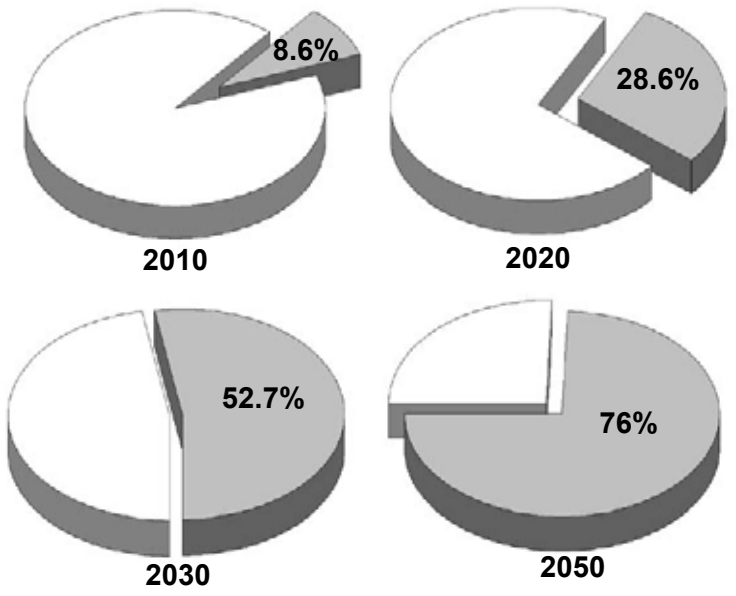
The Social Security Trust Fund currently holds about $1.6 trillion of these bonds. But they cannot pay benefits. Although they are treated as assets of the trust fund, they are also liabilities of the Treasury. Summing over both agencies of government, assets plus liabilities net out to zero.

The special bonds in the Trust Fund are very different from traditional Treasury bonds held by individuals and corporations. Traditional bonds are purchased in the marketplace (exchanged for cash). They can be resold in the marketplace to obtain cash. If the federal government had purchased assets with the Social Security surpluses, the Trust Fund would today represent real economic value. Instead, the funds were spent in other ways and the government essentially wrote IOUs to itself.

If a fire were to destroy the filing cabinets in Parkersburg, this would in no way diminish the capacity of the federal government to pay benefits. Alternatively, if with the stroke of a pen we doubled or tripled the number of bonds in those filing cabinets, it would in no way increase our ability to pay benefits. If we could create value by writing IOUs to ourselves, Social Security would have no financial problems. Unfortunately, the Trust Fund provides no new revenue to the Treasury.

Myth 2: The financial problems of Social Security and Medicare are in the distant future. The problem is upon us right now. Although Social Security is running a

Percent of Federal Income Tax Revenues Needed to Fund Social Security and Medicare Deficits



Sources: Andrew J. Rettenmaier, Ph.D., and Thomas R. Saving, Ph.D., "The 2004 Medicare and Social Security Trustees Reports," National Center for Policy Analysis, Policy Report No. 266, June 2004; and the 2004 Annual Reports of the Board of Trustees of Social Security and Medicare.

surplus, Medicare is running an even bigger deficit. One way to think about this is to realize that Social Security's extra revenues are being used to cover Medicare's shortfalls, and even that is not enough.

This year, for the first time in more than two decades Social Security and Medicare together will spend more than the payroll taxes they collect and require almost 4 percent of federal income tax revenues. That figure will double in the next five years and double again in the five years after that.

- By 2010, the federal government will spend 8.6 percent of federal income tax dollars to pay benefits, assuming no increase in taxes. [See the Figure.]
- By 2020, after Social Security slips into deficits, elderly entitlements will consume one-in-four income tax dollars.
- By 2030 they will consume one of every two.

To put that in perspective, in less than 30 years the federal government will have to reduce by half its spending on other programs that are funded by income taxes, or increase income taxes by 50 percent.

As the years roll by, the financial picture will become bleaker. By mid-century, when today's college students retire, we will need three-fourths of all federal income taxes to pay their retirement benefits at current tax rates. Eventually, retirement benefits paid to the elderly will consume the entire federal budget, crowding out every other spending program.

Myth 3: The funding problem is minor. One way to assess the problem is to calculate the present value of the difference between expected expenses and revenues. Present value calculations tell how much the government would need in the bank — invested at the government's borrowing rate — to pay a cost over a specified period of time. Last year, for the first time, the Trustees reported such calculations for both Social Security and Medicare and the numbers are startling:

- Over the next 75 years, scheduled benefits exceed dedicated revenues by $33 trillion, measured in current dollars.
- Looking indefinitely into the future, the present value of the additional revenues required by Social Security and Medicare total almost $74 trillion.

To put that number in perspective, obligations to the elderly are more than six times the size of the economy and 18 times the size of the outstanding federal debt.

For many years, the Trustees Reports adopted a 75 year time horizon. But it is now understood that looking only 75 years into the future gives a misleading picture. Consider a worker who will retire in year 76. A 75 year horizon counts all of the taxes this worker will pay over the course of a lifetime, but ignores the benefits. To avoid this problem, the Trustees Reports now include calculations that look indefinitely into the future.

The unfunded liability under Medicare is almost six times larger than under Social Security, but the two programs are connected: Any reform that puts one program on a sounder footing helps the other. Indeed, the strongest agreement for the reform of Social Security is the existence of Medicare.

What does it mean to have a $74 trillion revenue shortfall? It means that in order to pay benefits to current and future generations without using general revenues or cutting benefits, we need $74 trillion on hand right now, invested at the government's borrowing rate. Because we don't have $74 trillion invested today, next year the liability will be even larger. The year after that it will be larger still.

Myth 4: Personal Retirement Accounts won't help. The underlying cause of our financial problems is that our elderly entitlement programs are based on pay-as-you-go finance. Every dollar of payroll taxes we collect, we spend — the very day it comes in the door. This is no saving and no investment. As a result, each generation pays taxes, not to fund its own benefits, but to finance the benefits of the previous generation. When today's workers retire, they will have to depend on future workers' willingness to pay much higher taxes if their benefits are to be paid. The alternative to a pay-as-you-go system is a funded system. Ultimately, if benefits are funded, each generation will pay its own way.

People may have honest disagreements about the best way to move to a funded system (for example, whether we should have individual accounts or have government make the investments). But, there should be no disagreement about our need to move to a new system of finance as quickly as possible, and personal accounts is one way to do that, although not the only way.

Dr. Thomas R. Saving is a Senior Fellow at the National Center for Policy Analysis and the Director of the Private Enterprise Research Center at Texas A&M University.