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THE GREAT SOCIAL SECURITY SURPLUS HOAX

Peter J. Ferrara
John M. Olin Fellow

INTRODUCTION

The Social Security system finally has begun accumulating surpluses and likely will do so for the next two decades given current economic policies. Properly measured, these surpluses will be close to 1 percent of gross national product (GNP), or about $40 billion this year.

Predictably, a number of Washington policy makers see this surplus as a mountain of cash and they have begun to devise ways to spend it. Some suggest that the surpluses are so enormous that they will lead to decades of total federal budget surpluses and ultimately will pay off the national debt.

Mythical Cash Mountain. It would be marvelous, of course, if these suggestions could be adopted. The trouble is that there is and will be no cash mountain. Those who think there will be have been misreading United States government Social Security projections and do not understand federal budget accounting. The disappointing truth is, Social Security surpluses will become large deficits in about 25 years. Unless policy makers recognize this, they will lose what may be a unique opportunity to improve the Social Security system. If policy makers assume that such surpluses will eliminate federal budget deficits and pay off the national debt, they are likely to abandon attempts to balance the budget, spend billions

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The author is an Associate Professor of Law at George Mason Law School,.

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of dollars of anticipated that they will never receive, and plunge the nation into financial catastrophe.

Though it would be nice if it were true, the projection of Social Security surpluses should be rejected. Instead, the retirement system should be reformed to avoid future bankruptcy.

THE REAL SURPLUS

The true annual net surplus in Social Security trust fund taxes over expenditures, under the most widely cited, intermediate government projections, will be about 0.8 percent of gross national product (GNP) from now until 2005. After that, the annual net surpluses start declining. Deficits will begin in 2013. While annual surpluses until 2005 are substantial, they are only a fraction of the large total federal deficits of recent years, and consequently not nearly enough by themselves to eliminate annual budget deficits, much less generate federal budget surpluses large enough ultimately to pay off the national debt.

The projected surpluses are due to demographic factors. As the huge baby boom generation is entering its prime earning years, it swells Social Security tax payments. The relatively small generation born during the Great Depression and World War II, meanwhile, will soon be retiring. This minimizes Social Security obligations over the next decade. Over the long term, however, Social Security becomes subject to a demographic wind shear, as these demographic trends suddenly and dramatically reverse. The huge baby boom generation ultimately will retire, resulting in enormous benefit obligations. When they retire, the work force will be comprised of the relatively small generation born in the low fertility years since the mid-1960s. This small work force will have to pay the taxes to cover the retirement obligations for the baby boomers.

Boosting FICA 50 Percent. The result: the trust fund deficit starting in 2013 will grow rapidly, reaching close to 3 percent of GNP by 2035. To meet all Social Security obligations to today's workers would require a 50 percent increase in the rate of tax withheld from an employee's wages and matched by the employer under the Federal Insurance Contributions Act (FICA) – to 23 percent for employer and employee combined, compared to 15 percent today.

As a practical matter, the Social Security trust funds themselves are not bank accounts in which the surpluses pile up. The trust funds are nothing more than a statement of the legal authority Social Security has to draw from U.S. Treasury general revenues. There is no real money sitting in an account. The trust funds "loan" their annual surpluses to the federal government, which then immediately spends them on other programs. In return, the Social Security trust funds receive new, specially issued federal bonds. These trust funds actually are part of the gross national debt, which grows as the trust funds grow.

Half-Million Extra Jobs. The good news about the projected Social Security surpluses is that the payroll tax rate increases that took effect this January and are scheduled for January 1990 can be repealed and the system will remain sound for the next 30 years. If the U.S. is spared this hefty tax, the economy will create an additional half-million jobs,

generating economic growth and more general revenue. To save the Social Security system in the long term, alternative pension plans, such as tax-deductible individual retirement accounts, and other major reforms of the system will be necessary.

BASIC ERRORS

A recent publication from the California consulting firm of A.B. Laffer and Associates states that under current law projected annual Social Security surpluses not only will eliminate the annual federal budget deficits but produce a stream of total federal budget surpluses for 20 years or more beginning in 1994.[1] These annual budget surpluses, the publication says, will enable Congress to pay off the national debt and even run a public surplus early in the next century.[2] Yet this analysis, and similar statements by political analyst Irving Kristol and New York Democratic Senator Daniel Patrick Moynihan, [3] are based on several fundamental errors involving a misreading of U.S. government projections and a lack of understanding of federal budget accounting.

$5 Trillion Outlays. The analysis is based on government projections of Social Security financing over the next 75 years in nominal dollars (that is, dollars not adjusted for inflation or other variables). The analysis fails to add any adjustment for inflation or the relative effect of economic growth over time. This leaves a badly distorted impression of the relative magnitude of the projected dollar amounts. For example, the Laffer publication[4] states that the Social Security trust funds will total $12 trillion in 2030. But under the same projections, GNP in that year will be $54 trillion. A total federal budget of the same size relative to GNP as today would be about $12.5 trillion. Total expenditures out of all the trust funds will be $5 trillion, exceeding Social Security tax receipts in just that year by $1.4 trillion.

Kristol rightly terms the nominal projections "bizarre," indicating skepticism, but accepts the idea that they mean that the total national debt will be paid off by the 2020s. Kristol does not consider that an assumed inflation of 4 percent per year, plus economic growth, could have a powerful, distorting, relative effect over the years. He and others do not seem to appreciate effects of geometric compounding of inflation and economic growth over time.

The analysis also fails to include the large projected deficits in the Hospital Insurance (HI) trust fund, focusing only on the other Social Security accounts. The HI program pays for hospital costs of Social Security retirees; because of rapidly rising health care costs, it will begin running major deficits in the 1990s, growing each year. Analysis of likely future budget deficits and surpluses must include all of the accounts in the federal budget which are now projected, not just those which are in surplus.

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1 Stuart J. Sweet "Growing Year-by-Year: The Incredible Social Security Surplus Emerges" A.B. Laffer Associates, Lomita, CA, February 18, 1988, pp. 1, 10.

2 *Ibid.*, p. 3.

3 Irving Kristol, "That Bizarre Social Security Surplus," *Wall Street Journal*, June 17, 1988, p. 26; Daniel Patrick Moynihan, "Conspirators, Trillions, Limos in the Night," May 23, 1988, p. A19.

4 Sweet, *op.cit.*, p. 1.

From One Pocket to Another. The analysis by Laffer and others also treats interest on the Social Security trust fund bonds, received by the fund when it "lends" its surpluses to the federal government, as income that the federal government can use to reduce the budget deficit and even pay off the national debt. But the Social Security trust funds hold federal government bonds exclusively, and consequently, the interest they earn is a federal government expenditure as well as federal government income. In the entire federal budget, therefore, the interest "earned" by the Social Security trust fund does not reduce the federal deficit, but is cancelled out as an intragovernmental transfer. It is what economists call a "wash"; to non-economists, it is the equivalent of an individual transferring his money from one pocket to another.

Consequently, to determine the impact of Social Security on the federal budget, the interest on the Social Security trust fund bonds must be subtracted from Social Security income; only the surplus of Social Security tax revenues over expenditures must be calculated. The analysis of the Laffer publication and others fails to do this.[5]

Gramm-Rudman-Hollings. Their analysis also is based on the argument that the Gramm-Rudman-Hollings federal deficit reduction measure will require the federal budget, excluding Social Security, to be balanced by 1993. The Social Security surpluses thereafter would then amount to a surplus in the entire federal budget every year after 1994, reducing and ultimately eliminating the outstanding national debt. But Gramm-Rudman-Hollings requires a balance in the entire federal budget including Social Security and its surpluses, not a balance in the budget excluding Social Security. So Gramm-Rudman-Hollings does not imply that the Social Security surpluses will amount to surpluses in the total federal budget.

THE TRUE SURPLUSES

Correcting the errors made in the Laffer study, the annual Social Security surpluses and deficits as a percentage of GNP are shown in the table in the Appendix. The table presents the projected annual surplus or deficit of tax revenue over program expenditures for all of the Social Security trust funds combined, including the hospital insurance trust fund, under the most widely cited, intermediate assumptions concerning inflation, GNP growth, and other economic and demographic factors. These are the so-called Alternative IIB projections used by the Social Security Administration (SSA).

Substantial Surpluses, But Not Sufficient. The results show that the annual net surpluses in trust fund taxes over expenditures will be less than 1 percent of GNP, ranging from 0.7 percent to about 0.8 percent, until 2005 when it starts declining, going into a deficit in 2013. This compares to annual federal budget deficits reaching levels of 5 percent to 6

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5 The Laffer publication claims to recognize this, but its quantitative statements show no adjustment for it. In particular, this interest income is included in the cumulative trust fund totals which the publication repeatedly cites without adjustment.

By bringing in more revenue, the Social Security surpluses this year are reducing the federal deficit by about $40 billion. (This assumes that other federal spending has not been increased under the cover of the Social Security surpluses, for with such surpluses other federal spending would increase by an equivalent amount each year without increasing the deficit.) But the primary factors bringing down the deficit from its peak of 6 percent of GNP in 1983, which would be $300 billion today, have been sustained economic growth and overall spending restraint imposed by the Gramm-Rudman-Hollings deficit reduction formula and by Reagan Administration growth policies. The remaining federal deficit is likely to close rapidly over the next few years due primarily to these factors. Indeed, the projections in the table show that the maximum real effect of the Social Security payroll tax surplus in reducing the deficit each year already has occurred: the surplus already is 0.8 percent of GNP. It will remain at or near that level through 2005, declining thereafter.

The Social Security surpluses clearly are not large enough to cause annual surpluses in the total, unified federal budget. Without such a total budget surplus, there can be no reduction in the outstanding national debt held by the public. To the extent that the trust fund surpluses reduce the deficit, and other federal spending is not simply allowed to grow higher because of the offsetting surpluses (which seems likely over the long run), the surpluses will slow the rate of growth in the national debt.

DEMOGRAPHIC WIND SHEAR

The root cause of these trust fund surpluses is demographic. During the 1990s, the huge baby boom generation will be growing into its prime earning years, swelling Social Security tax payments. At the same time, the relatively small generation born during the Great Depression and World War II will be entering retirement, imposing relatively smaller benefit obligations on the Social Security system.

Baby Boomers Retire. After a couple of decades of these favorable population trends, Social Security will face a demographic wind shear, as the underlying trends will reverse far more powerfully. The huge baby boom generation will begin entering retirement, dramatically increasing benefit demands on the system. At the same time, the relatively small generation born during the low fertility years following the baby boom will be in the work force, producing relatively small amounts of revenue.

As a result, the table shows that the surplus of trust fund tax revenues over expenditures becomes a deficit by 2013, growing to about 1 percent of GNP by 2019. By 2035, when today's young workers begin retiring, the deficit will be close to 3 percent of GNP, continuing at that level until 2060 when the projections stop. As a percent of GNP, these latter deficits are more than three times as large as the earlier surpluses, and would alone create annual federal deficits for each of these years as large as current federal deficits.

The entire combined Social Security system, including hospital insurance, would run short of funds to pay promised benefits by 2030.[6] Thereafter, to pay all benefits promised to today's young workers would require a 50 percent increase in current payroll tax rates, to 23 percent for employers and employees combined compared to 15 percent today.[7]

THE ROLE OF THE REAGAN RECOVERY

Without a continuation of the superior economic performance and sustained economic growth of the Reagan years, the annual trust fund surpluses shown in the table will not continue, despite the favorable demographics. The Social Security Administration makes an alternative projection, labelled Alternative III, which assumes weaker economic performance and renewed inflation and recession cycles, as experienced in the 1970s. Over the long run, it also assumes lower fertility and birth rates and slightly longer life expectancies than the more optimistic projections.

Under these projections, the annual Social Security surpluses fall to trivial amounts by 1995 and turn into deficits by 1997.[8] The trust fund deficits starting in 1997 reach about 1 percent of GNP in 2009, about 7 percent in 2035, and about 8.5 percent in 2060.[9] As a percent of GNP, the trust fund deficits after 2035 alone would create total federal budget deficits two to three times as large as current deficits. The entire system would run short of funds to pay promised benefits by 2011.[10] Paying all benefits promised to today's young workers would require today's total payroll tax rate to more than double, to about 35 percent of their wages.[11]

THE MEANING OF THE TRUST FUNDS

The meaning of the Social Security trust funds themselves, and the balance accumulated in them over the years due to the projected annual trust fund surpluses, have been seriously misunderstood. As long as there is not a surplus in the entire federal budget, Social Security surpluses are loaned to the federal government. In return, the Social Security system receives specially issued, interest-bearing federal bonds. The federal government spends the borrowed funds on other programs.

In the process, outstanding federal debt held by the public is not bought up by Social Security or reduced in any way. Outstanding federal debt can only be reduced when there is a surplus in the entire, unified federal budget. With no real prospect of such total budget

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6 *Ibid.*

7 *1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Washington, D.C., April 29, 1988 (hereafter *1988 OASDI Trustees Report*), Appendix G.

8 Calculated from *1988 OASDI Trustees Report*, Appendix G, and *1988 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*, Washington, D.C., April 29, 1988 (hereafter *1988 HI Trustees Report*).

9 Calculated from *1988 OASDI Trustees Report*, Appendix G and *1988 HI Trustees Report*.

10 *Ibid.*

11 *1988 OASDI Trustees Report*, Appendix G.

surpluses on a sustained basis, there is no chance that Social Security will buy up all or most outstanding federal bonds or that these bonds will be otherwise retired, regardless of the accumulated balance of the Social Security trust funds.

Only a Paper Claim. When Social Security income falls short of expenditures, the trust fund bonds are returned to the federal government for the cash needed to finance benefits. The trouble is (and this is not widely understood) the federal government holds no cash or other assets to back up the Social Security bonds. The Social Security trust fund assets are just another paper claim against the federal government that will have to be financed out of federal revenues or borrowing when they are cashed in to finance Social Security benefits. When the Social Security system cashes in its bonds, the federal government can redeem them only by using funds collected as taxes or by borrowing.

The trust fund bonds in fact are part of the gross national debt, and this gross debt grows as the trust funds grow. The net national debt held by the public remains unchanged. [12] The Social Security trust fund balance, therefore, does not in any sense represent an offset to the national debt. The outstanding national debt can only be reduced by running a surplus in the entire, unified federal budget, not in the Social Security accounts alone.

As a practical matter, Social Security trust funds are nothing more than a statement of the legal authority that Social Security has to draw from general revenues in the future. Meaning: the larger the trust fund balance the more Social Security has a claim against income tax revenues as well as payroll tax revenues.

No Real Assets. When it is said that the trust funds will accumulate $12 trillion, this does not mean that the federal government will be rolling in money. Quite the contrary, it means that Social Security will have an additional $12 trillion claim against federal taxpayers, besides their payroll tax liability. Because the Social Security trust funds do not hold any real assets, but just a claim against future revenues, a growing trust fund by itself does not mean that paying for the retirement of future generations will be any easier economically than it would be otherwise. It just means that more of this burden will be met out of income taxes and federal borrowing rather than payroll taxes.

SHORT AND LONG TERM REFORM

Given the true financial prospects of the Social Security system, policy makers must begin taking some important actions. In the short run, the payroll tax rate increases that took effect this January and are due for January 1990 should be repealed. As a result, instead of a 15.3 percent total payroll tax rate, the rate would be 14.3 percent, a reduction of 6.5

12 The trust fund bonds indeed will add to the net national debt held by the public if the federal government does not have the tax revenues to redeem them when they are turned in to finance future benefits and has to borrow to pay them.

percent. Under the Social Security Administration's intermediate Alternative IIB projections, Social Security will be able to pay all promised benefits, including hospital insurance benefits, for the next three decades, until about 2020, without the 1988 and 1990 tax increases.[13]

Lifting a Burden. Such tax rate reduction would free today's young workers from an unnecessary tax burden. It also would add half a million new jobs to the U.S. economy.[14] This would increase GNP growth, which is necessary to sustain the Social Security system, and would bring more revenue into the system from the new workers.[15]

In the long term, without more fundamental reform, payroll taxes will have to rise to much higher levels to pay all promised benefits to the baby boom generation and today's young workers. Even with the 1988 and 1990 tax increases the program will run short of funds to pay promised benefits by 2030, just before today's young workers will retire. Eliminating these tax increases would merely accelerate that date to 2020.

To make the tax reductions permanent, and avoid otherwise necessary tax increases, Congress should adopt reforms now that would allow the baby boom generation to rely more on the private sector for retirement income and less on Social Security and Medicare. For example, workers and their employers could be allowed income tax credits for contributions to private savings, insurance accounts, and individual retirement accounts, which would substitute for a portion of their Social Security benefits, depending on the amount of their contributions over the years.[16] As a result, the Social Security spending burden could be reduced sufficiently to avoid the need for any future payroll tax increases. Indeed, if enough workers exercised the private option, Social Security spending could be reduced sufficiently to allow room for further payroll tax cuts.

Below Market Return. The justification for such a private option is far broader than just the need to avoid the long-term financing problems of Social Security. Payroll taxes are now so high that even if today's young workers received all currently offered benefits, the benefits would represent a low, below market return, or effective interest rate, on taxes paid into the system over their careers. These workers could now receive higher returns and benefits if the same money were invested in the private sector.

Private options, of course, also give workers more freedom of choice and control over their contributions, investments, and pattern of benefits. Through the private accounts, each worker also would have greater opportunity to accumulate substantial real capital,

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13 Calculated from *1988 OASDI Trustees Report*, Appendix G, *1988 HI Trustees Report*.

14 Aldona and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," *Economic Report* No. 39, Institute for Research on the Economics of Taxation, Washington, D.C., February 3, 1988.

15 For further discussion, see Peter J. Ferrara, "Upcoming Social Security Tax Hikes May Threaten Retirement Benefits," Heritage Foundation *Backgrounder* No. 597, August 5, 1987.

16 For further discussion of this proposal, see Peter J. Ferrara, *Social Security: Prospects for Real Reform* (Washington, D.C., Cato Institute, 1984), Chapter 11; Peter J. Ferrara, "Intergenerational Transfer and Super IRAs," *Cato Journal*, Spring/Summer, 1986, pp. 195-220.

representing a direct ownership stake in America's business and industry. Such private options have recently been adopted in Britain and Chile, and have proved very popular, with the overwhelming majority of workers choosing the private alternative.[17]

CONCLUSION

Fundamental miscalculations have led to much confused and erroneous commentary regarding the future of Social Security financing. While Social Security is projected to run substantial surpluses over the next two decades, these surpluses are not large enough to create surpluses in the federal budget and ultimately pay off the national debt. As long as there is not a surplus in the total, unified federal budget, the growing Social Security trust funds will not buy up outstanding federal bonds, but will receive newly issued bonds in return for lending the surpluses to the federal government to spend on other programs.

The true Social Security surpluses are due to demographic factors which will reverse far more powerfully after the baby boom generation retires, leading to annual Social Security deficits more than three times larger than earlier surpluses.

The projected surpluses would allow the 1988 and 1990 payroll tax rate increases to be repealed while still leaving the system able to pay all promised benefits for the next 30 years.

Reducing Reliance on Social Security. But more fundamental reforms are needed to avoid payroll tax increases to much higher levels after the baby boom generation retires. Workers and their employees should be allowed the choice of substituting private savings and insurance accounts for future Social Security benefits. This could reduce reliance on Social Security in the future sufficiently to avoid the need for any tax increases, and even possibly create sufficient room for further payroll tax relief.

Such long-term reform would modernize and liberalize the current Social Security system, allowing workers more freedom of choice and flexibility, greater control over their own resources, broader opportunity to participate in the economy as investors and owners, and the chance for a better deal in the private sector than currently offered to them by the outdated Social Security system. The reform would shift functions from a coercive public sector monopoly to a competitive private market based on economic freedom where the functions can now be better served, sharply reducing unnecessary government spending in the process. Policy makers truly concerned about the future of the retirement system should reject erroneous calculations and address the need for real reform.

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17 John Goodman and Peter Ferrara, "Private Alternatives to Social Security Around the World," National Center for Policy Analysis, Dallas, Texas, April, 1988.

Appendix
Annual Surplus or Deficit of Trust Fund*
Tax Revenues over Expenditures as a Percent of GNP
Intermediate Alternative IIB Projections

Calendar Year		Calendar Year		Calendar Year	
1988	0.85%	2013	-0.01%	2038	-2.86%
1989	0.81%	2014	-0.11%	2039	-2.86%
1990	0.85%	2015	-0.22%	2040	-2.87%
1991	0.81%	2016	-0.44%	2041	-2.87%
1992	0.80%	2017	-0.63%	2042	-2.88%
1993	0.80%	2018	-0.81%	2043	-2.88%
1994	0.79%	2019	-0.96%	2044	-2.88%
1995	0.78%	2020	-1.10%	2045	-2.88%
1996	0.78%	2021	-1.31%	2046	-2.90%
1997	0.78%	2022	-1.50%	2047	-2.92%
1998	0.78%	2023	-1.67%	2048	-2.93%
1999	0.77%	2024	-1.82%	2049	-2.94%
2000	0.77%	2025	-1.95%	2050	-2.95%
2001	0.76%	2026	-2.10%	2051	-2.98%
2002	0.75%	2027	-2.23%	2052	-3.00%
2003	0.74%	2028	-2.35%	2053	-3.01%
2004	0.73%	2029	-2.46%	2054	-3.03%
2005	0.72%	2030	-2.55%	2055	-3.04%
2006	0.65%	2031	-2.62%	2056	-3.05%
2007	0.58%	2032	-2.68%	2057	-3.07%
2008	0.52%	2033	-2.74%	2058	-3.08%
2009	0.47%	2034	-2.78%	2059	-3.09%
2010	0.42%	2035	-2.83%	2060	-3.09%
2011	0.26%	2036	-2.84%		
2012	0.12%	2037	-2.85%		

*Includes the Old-Age and Survivors Insurance, Disability Insurance, and Hospital Insurance Trust Funds.

Source: Calculated from *1988 Annual Report of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Appendix G, and *1988 Annual Report of the Hospital Insurance Trust Funds.*

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