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# THE CASE FOR KEEPING SOCIAL SECURITY IN THE BUDGET

## INTRODUCTION

Social Security is the federal budget's second largest program, exceeded only by national defense. Roughly 20 percent of all federal spending is allocated for Social Security benefit payments, while about one-quarter of all federal revenues are raised through the Social Security payroll tax.

Because the system's revenues are projected to outpace payments substantially for about the next fifteen years, there has been growing concern that Congress will spend these retirement surpluses on other federal programs, as it has been doing in recent years, rather than prudently placing workers' contributions to the system in safe, interest-bearing investments. Pressure understandably thus is growing in Washington to insulate the entire Social Security program from the rest of the federal budget. This would be accomplished by establishing an off-budget "Social Security reserve" to be drawn down when the baby-boom generation reaches retirement age.

In theory, the idea may have some appeal. In the hard reality of Washington, however, it would fail. The reason: moving Social Security permanently off-budget would not deter Congress from continuing to raid the trust fund.

**Conflicting with a Unified Budget.** In addition, the proposal would create a wide range of new problems. It would conflict, for instance, with the longstanding principle of maintaining a unified federal budget for measuring the impact of federal fiscal policy on the United States economy. Since Social Security taxes are part of total federal revenues and Social Security expenditures are part of total federal outlays, the program should be included in the budget and thus in calculating the deficit. Failure to do so would render the deficit meaningless as a measure of the gap between taxes and spending.

Lawmakers during the last eight years wisely have been shifting all off-budget federal spending back on-budget. This process should not now be reversed.

**Massive New Pressures.** If Social Security is removed from the budget, moreover, the pressures to spend the temporary fund surplus on higher retirement benefits or on government-sponsored "investment" programs – such as education, infrastructure, and health care – would be irresistible politically. Assigning to Congress the task of managing a reserve fund that is increasing at the rate of $40 billion to $50 billion each year would be inviting a massive increase in such spending. At the same time, it would unleash massive new pressures to raise general taxes. The reason: moving Social Security off-budget would increase the "official" deficit by the amount of the current Social Security surplus, or $40 billion to $50 billion per year. This artificially higher deficit would be used by liberals to argue that the budget cannot be balanced without a major new tax increase.

If Social Security were removed permanently from the budget, therefore, federal spending and taxes likely would rise substantially. Just as important, by instilling within the public a false sense of security that with a mere accounting change the pension program would be permanently safe from political tampering, the proposal to create an off-budget Social Security reserve fund would impede those Social Security reforms necessary to ensure that today's workers actually receive their promised pension benefits.

## HOW SOCIAL SECURITY IS INCLUDED IN THE BUDGET

Though Social Security today is technically "off-budget," it is so only in the sense that it is listed separately in the unified federal budget. In accordance with the 1985 Gramm-Rudman-Hollings Balanced Budget Act, all final budget totals must include Social Security and all other trust fund programs, like the highway trust fund. This means that the annual budget deficit figure reported by the press includes the Social Security surplus.

The surplus in the Social Security program currently reduces the total federal deficit by a substantial sum each year (though not by the overwhelming margin sometimes erroneously suggested).[1] In the current fiscal year, taxes in the entire Social Security system, including the Hospital Insurance Trust Fund, will exceed the system's expenditures by about $40 billion. This amounts to 0.8 percent of the Gross National Product (GNP) and thus reduces the total federal deficit by this amount. Under the most widely cited intermediate projections of the Social Security Administration (SSA), the program will continue to reduce the total federal deficit by about 0.8 percent of GNP each year for about the next fifteen years.[2] After that, the amount of Social Security taxes in excess of expenditures will start declining, turning into a deficit by 2013.

As a result of current Social Security surpluses, together with modest recent spending restraints in the remainder of the budget and the normal growth of revenues through strong economic growth, the federal budget deficit has declined from 6.2 percent of GNP in 1983

1 Peter J. Ferrara, "The Great Social Security Surplus Hoax," Heritage Foundation *Backgrounder* Number 662, July 11, 1988.
2 *Ibid.*

to about 3 percent of GNP, or about $150 billion, for fiscal 1988. Moreover, the fiscal outlook is projected to continue improving. By 1993 the deficit will fall to about 2.0 percent of GNP, according to the Congressional Budget Office.[3]

## THE ARGUMENT FOR MOVING SOCIAL SECURITY OFF-BUDGET

Critics of the current system of budget accounting for Social Security argue correctly that the Social Security surpluses are not being saved, but rather are funding other federal programs. The 1983 amendments to the Social Security Act, intended to place the system on a sound financial footing, assumed that Congress would build up large reserves in the Social Security Trust Fund over the next two decades, while the proportion of Americans in the labor force was large, so that retirement funds would be available for the baby-boom generation when it entered retirement age. Building these reserves was said to be necessary, because while today there are 3.3 workers supporting every retired person, by the year 2030 there will be only 2.0 workers for every Social Security recipient.

This mounting surplus, however, is not kept separate, nor is it likely that the cash will be available when it is needed. Legislators have been spending today's Social Security surplus on current federal programs. Spending on these programs can increase precisely because any surpluses in the Social Security trust fund, by law, must be invested in Treasury bonds. The federal Treasury simply records an IOU to the Social Security system when it spends the surpluses. This interfund accounting procedure enables Congress to use the Social Security trust fund surpluses to reduce federal borrowing requirements and thus the deficit. Ultimately, this allows new spending to take place without an increase in the deficit.

**Trillion Dollar IOUs.** The problem is that, if this practice continues, the Treasury — or more accurately tomorrow's taxpayers — will owe the Social Security system an estimated $7 trillion by the year 2015 and $12 trillion by the year 2030. Hence a sizable tax hike will be necessary to pay the retirement benefits owed to today's workers, despite recent payroll tax hikes. The only alternative would be for Congress to slash promised retirement benefits, or to take other such steps as raising the retirement age, when these trillion dollar IOUs come due.[4]

A number of Washington scholars and policy makers believe that Congress would be prohibited from spending the Social Security surpluses if a separate off-budget "Social Security reserve fund" were created. Brookings Institution Economist Henry Aaron, for instance, advocates separating Social Security from the budget and using the surpluses to increase the stock of national savings.[5] Removing Social Security from the budget, the argument goes, would place the system back on financially sound footing because after 20 or 30 years, when today's young workers retire, the Social Security Administration would have huge asset reserves — in contrast to paper IOUs from the already debt-ridden Treasury.

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3 Congressional Budget Office, *The Economic and Budget Outlook: An Update*, August 1988.

4 Another method of avoiding the crash in Social Security is for the U.S. to allow entry to substantially more immigrants, who are net contributors to the Social Security system.

5 Henry Aaron, "Social Security and the Trust Fund Surplus," testimony before the National Economic Commission, September 7, 1988.

One result of this, of course, would be to increase immediately the official federal deficit by $40 billion to $50 billion, rising to about $100 billion in 1993 (in current dollars), because the reported deficit would no longer include any surplus or deficit in Social Security.

**Accounting Trick.** If the entire Social Security system, including the Hospital Insurance trust fund, were removed from the federal budget, the total reported federal deficit would increase each year for the next fifteen years or so by about 0.8 percent of GNP, or the equivalent of roughly $40 billion this year. Many of those who advocate separating Social Security from the budget only propose to remove the Old Age and Survivors Insurance and Disability Insurance trust funds, which are projected to be heavily in surplus, while leaving the Hospital Insurance trust fund, projected to run big deficits, on-budget. This would increase the total reported federal deficit by about 0.9 percent of GNP by 1995, 1.0 percent of GNP by 2000, and 1.07 percent of GNP by 2005, or the equivalent of about $50 billion in 1988 dollars.

Proponents of this accounting change maintain that this would be a more appropriate measure of the deficit, because the excess of Social Security taxes over outlays is not actually a program surplus but a reserve to pay future retirement obligations. The objective of shifting Social Security off-budget, therefore, is to achieve a balanced budget for all programs exclusive of Social Security and to create large and mounting reserves in the "off-budget" Social Security system.

## REASONS FOR KEEPING SOCIAL SECURITY IN THE UNIFIED BUDGET

The arguments in favor of a new budgetary treatment of Social Security are based upon the admirable goal of restoring the integrity of the Social Security system. On first examination, those arguments are appealing. Closer examination reveals four flaws.

### 1) It would distort the impact of federal fiscal policy on the economy.

The only economically meaningful calculation of the federal budget deficit is total federal revenues minus total federal expenditures. This indicates the amount the federal government must borrow from the private sector during the fiscal year, which is what most Americans assume the deficit measures.[6] Social Security taxes are part of federal revenues and Social Security expenditures are part of total federal spending. If Social Security taxes

6 The most accurate account of the impact of government fiscal policy on the capital markets would be a Public Sector Borrowing Requirement (PSBR), as is used in Britain. This would measure the net borrowing requirements of all levels of government in the U.S. — local, state, and federal — and any government-owned corporation or organization. In the absence of such a policy variable, the federal deficit figure is a second-best measure of just the federal government's impact on the economy.

exceed program expenditures, then the federal government as a whole has to borrow less from the private sector.[7] Thus excluding the Social Security surplus from the budget would give an inflated picture of the government's borrowing needs. The Congressional Budget Office (CBO) analysis of the budget treatment of Social Security agrees with this assessment. In its 1988 report entitled *The Economic and Budget Outlook*, CBO states: "Excluding Social Security — or any other government program — from the [budget] totals would distort the government's impact on the economy and misrepresent its borrowing needs."[8]

**2) It would hinder efforts to establish budget priorities.**

Removing Social Security from the budget would be inconsistent with a second important function of the federal budget: to provide a framework for setting national spending priorities. It is no secret among lawmakers that the main motive for moving programs off-budget is to shield them from the budget process and thus from the forces of spending restraint. Postal workers, for instance, recently demonstrated, demanding that the U.S. Postal Service be moved off-budget so that Congress could not cut its budget. Experience teaches that moving programs outside the restraint of the normal budget process typically produces runaway spending in these programs.[9] This almost certainly would be the case with Social Security if the program were moved off-budget, because Congress could easily respond to pressures to add new benefits by increasing expenditures without pushing the program into visible deficit.

**Avoiding Hard Decisions.** Some lawmakers say that, since Social Security benefits are a vital source of income to many elderly, they should be protected from the budget process. But this would imply that Social Security is somehow more essential to the nation's well-being than national defense, education, the federal criminal justice system, or entitlement programs for the poor — all of which must each year contend with other federal programs for federal funding. The fact is that a key function of Congress is to make the hard decisions about such difficult spending practices.

Nor is it accurate to grant special budget status to Social Security because the program is a self-contained trust fund with its own revenue source. There is at best a weak relationship between the Social Security payroll taxes that young workers pay today and the Social Security benefits they receive in 30 or so years. In fact, the Social Security program in effect is an income transfer from workers to retirees. And unlike private pension programs, workers have no legal claim to certain levels of future benefits based upon what they have paid into the system. The Supreme Court has expressly given Congress the right to "alter, amend, or repeal" any provisions of the Social Security Act.[10]

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7 Even if the Social Security Administration (SSA) were to invest its trust fund surpluses in private securities, rather than federal government bonds, this would not alter the analysis. If the SSA invested $40 billion in private securities the federal government would have to borrow an additional $40 billion to $50 billion from private sources. But the federal government's SSA would be lending $40 billion to $50 billion to the private sector, so the net effect on the capital markets would be zero.

8 Congressional Budget Office, *op. cit.*, p. 62.

9 Thomas J. DiLorenzo, "Putting Off-Budget Federal Spending Back on the Books," Heritage Foundation *Backgrounder* No. 406, January 30, 1985.

10 Fleming v. Nestor, 363 U.S. 603 (1960).

**3) It would encourage Congress to raise taxes enormously.**

Despite the impression given by the media and many in Congress, the federal tax burden today is near an all-time high. Total federal taxes in 1987 consumed 19.4 percent of gross national product, well above the post-World War II average of just over 18 percent. The danger of moving Social Security off-budget is that the burden of Social Security taxes would be ignored by Washington politicians. Budget figures excluding Social Security would then be used to argue that the tax burden has declined and that Americans can afford a tax hike. These claims would seem credible on the surface because the government's official federal revenue estimates no longer would include the Social Security tax, which consumes about 15 percent of the average worker's pay check (including the tax paid for him by the employer), and 7 percent of GNP. But the Social Security payroll tax is as much or more of a burden on the average American family as other forms of taxation, such as personal income taxes and excise taxes.

**4) Even with Social Security removed from the budget, Congress would continue to spend the program's surpluses.**

There is widespread anxiety about the current practice of borrowing Social Security surpluses for current spending. A mere accounting change is unlikely to alter this practice. By its inherent nature, Congress has the political incentive to spend the Social Security surplus on current programs that yield immediate political benefits, rather than prudently saving for worker's retirement 20 to 30 years in the future.

Even if Social Security were transformed into a separate reserve fund, Congress would continue to manage the fund and thus could devise schemes to spend the tens of billions of dollars of annual surpluses. Examples: legislators could raise benefit levels or spend the surpluses on new programs for the elderly, such as long-term nursing home care. More likely, Congress could divert the surpluses into spending categories, which it deceptively could label "national investments" — including such expenditures as education, housing, or infrastructure repair. This new spending would arouse little political resistance because technically it would not increase the deficit; it would simply spend down an off-budget surplus. Proposals to spend the Social Security surplus as soon as it is moved off-budget are in fact already circulating on Capitol Hill. Senator Terry Sanford, the North Carolina Democrat, for example, is proposing spending the surpluses on a public infrastructure revitalization program.

**Swedish Scenario.** It has been said that Congress could be prohibited by law from spending the surpluses by requiring that the surplus funds be invested in the stock market or other private investments.[11] But investing Social Security funds in the stock market would mean that the government eventually would own a huge proportion of the nation's industry and commerce, threatening the foundation of the U.S. economic system. And such investments could be used to reward politically influential special interest groups (such as declining industries in politically sensitive states) or to increase the regulation of the private

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11 Stuart J. Sweet, "The Incredible Social Security Surplus — Growing Year By Year," A.B. Laffer Associates, 1988.

sector by imposing conditions of investment (such as adoption of comparable worth pay scales or parental leave policies).

This scenario already has happened in Sweden. Writes Irving Kristol of New York University Graduate School:

> The Swedish surplus is invested in four streams: government bonds, housing bonds, "long term capital projects," and new issues of common stock. In effect, the socialist governments of Sweden have socialized the investment process while refraining from outright nationalization of the "means of production." It is, of course, not socialism in any meaningful sense of the term but simply collectivism, "statism." It is not a scenario likely to be attractive to the American people.[12]

## ROLLING BACK THE SOCIAL SECURITY PAYROLL TAX

According to a recent study by the Institute for Research on the Economics of Taxation (IRET), the Social Security payroll tax hikes of 1988 and 1990 will increase the tax burden of working Americans by one-half trillion dollars over the next fifteen years. These tax hikes will cost the economy an estimated one-half million jobs and will reduce GNP and capital stock by $100 billion.[13] Repealing these hefty anti-growth payroll taxes should be a major goal of the Bush Administration, as a prelude to structural reform of the Social Security system.[14]

It could be argued that moving Social Security out of the budget will make cutting the program's payroll taxes politically more feasible. According to the Social Security Administration's intermediate projections, the substantial Social Security payroll tax increases could be repealed, and the program still would be able to pay all promised benefits for the next 30 years. And with Social Security off-budget, these payroll tax cuts could be enacted without increasing the reported deficit. But the other side of the political coin is that moving the program off-budget also would mean that surpluses could be spent without adding to the deficit. A successful effort to reduce payroll taxes needs time to develop grass-roots support, while Congress is already looking at ways to spend off-budget Social Security surpluses.

## HOW TO PREVENT CONGRESS FROM SPENDING THE SOCIAL SECURITY SURPLUS

A simple accounting change will not prevent Congress from spending Social Security taxes on other programs. Moving Social Security out of the budget does not address the inherent problem with Social Security -- which is mainly one of demographics. The 1983

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12 Irving Kristol, "That Bizarre Social Security Surplus," *The Wall Street Journal*, June 17, 1988, p. 26.

13 Aldona Robbins and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Institute for Research on the Economics of Taxation, *Economic Report* No. 39, 1988.

14 Peter J. Ferrara, "Upcoming Social Security Tax Hikes Can Threaten Retirement Benefits," Heritage Foundation *Backgrounder*, Number 597, August 5, 1988.

Social Security "fix," predicated on the principle of building large government reserves for 20 to 40 years, was sensible in theory. It has been fatally flawed in practice, proving defenseless against pressures in Congress to spend.

There are, however, genuine solutions to the problem of congressional squandering of today's workers' retirement incomes. One is to place the Social Security program back on a "pay-as-you-go" basis (with contingency reserves for a recession), so that annual payroll taxes are set only at the level necessary to pay current benefits. This would allow reductions of about 10 percent in payroll taxes today, lasting through the year 2005.[15] When the baby-boom generation retires, Social Security payroll taxes would have to rise to a high of about 16 percent. This would, of course, be a burdensome tax rate to place on the next generation of workers, but it would be only about 2 percent higher than today's payroll taxes. More important, the current buildup of IOUs in the Social Security trust fund will have to be paid off by means of a tax hike in any case. And if the retirement age were raised slightly at that time, to reflect longer life expectancies, the tax would not have to be raised that high. Finally, if today's taxes are cut, private savings will rise, the economy will grow faster, and today's workers will bequeath a stronger economic base to their children.

**Substituting IRAs.** Another solution to the problem of Congress spending today's Social Security payments is to allow workers to place all, or a portion, of their earnings into individual retirement accounts (IRAs), as a substitute for paying into Social Security.[16] The many variations of this plan all share the common virtue of allowing workers to build up personal retirement accounts, rather than assigning Congress the responsibility for managing huge collective retirement reserves.

An IRA-type plan can be devised so as to assure current retirees that they will continue to receive full program benefits. One way to ensure this would be to collect sufficient payroll taxes to pay benefits, but rather than collecting taxes sufficient to build a surplus, allow workers to invest their surplus contributions into individual accounts, which they could not draw upon until they reached retirement age. This proposal would solve the congressional spending problem with respect to Social Security, because if Congress never received surplus retirement contributions, it could not spend them on other programs.[17]

## CONCLUSION

Moving Social Security off-budget might be appealing in theory, but removing 20 percent of federal spending and nearly 25 percent of federal revenues from the federal budget would distort seriously public understanding of the true federal deficit and its impact on the nation's economy. This, in turn, would mean that America's economic policy making would be based on a faulty picture of the public sector.

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15 David Koetz, "Social Security: Its Funding Outlook and Significance for Government Finance," Congressional Research Service, No. 86-674 EPW, 1986.

16 Ferrara, *op. cit.*; Sweet, *op. cit.*

17 One model of this sort, called the Federal Employees Thrift Savings Plan, already exists. It allows federal employees to place portions of their group federal retirement contributions into individual savings plans. It might be appropriate to extend this newest feature of the federal employees retirement system to all Americans covered by Social Security.

**Heading Toward Insolvency.** Moving Social Security completely off-budget also is a sure prescription for a major increase in general taxes on top of recent and scheduled hikes in the Social Security payroll tax. Meanwhile, Congress no doubt quickly would discover a method to spend the off-budget Social Security surpluses.

In the end, taxes would be higher, spending would be greater, and the Social Security system still would be on a course heading for 21st century insolvency.

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