COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Social Security and the Budget
March 24, 2011

There has been a good deal of discussion recently over Social Security's effect on the federal budget. Some argue that Social Security is an independent and self-financing program which does not add a dime to the deficit, while others suggest that it is the largest government program and—because it spends more than it raises—contributes to overall budget deficits.

In reality, both perspectives are correct, depending on how you view the program. It is legitimate to consider Social Security either as an independent (off-budget) and self-financed program or as part of the overall (unified) federal budget.

From the first perspective, Social Security can finance its costs for another 25 years through a combination of dedicated revenue and trust fund assets. True, the trust funds are invested in government bonds – but since Social Security essentially lent to the rest of the government over the past two decades, it is entitled to collect on those loans.

From the second perspective, Social Security is already adding to the deficit today since benefits exceed dedicated revenues, and will do so by increasing amounts in the coming years. Currently, the program consumes about 20 percent of the budget and 4.8 percent of the economy. But its costs will grow to over 6.1 percent of the economy over the next quarter century, while its dedicated revenues will actually fall somewhat. This gulf will substantially add to the budget deficit and debt.

Either of these frameworks is sensible. Ironically, though, both frameworks should lead policymakers to the same conclusion: whether for its own sake or for the country's fiscal viability, Social Security must be reformed; and the sooner we act, the better.

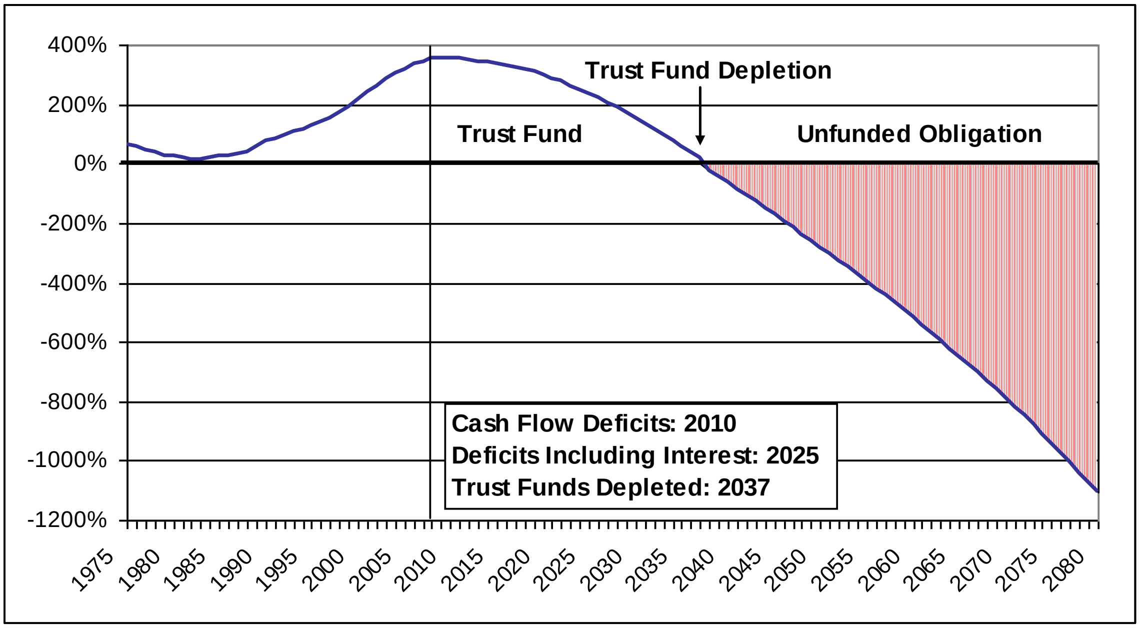
View 1: Independent Program

The first way to view Social Security is as an independent program, financed from its own trust funds and dedicated revenues.

1899 L Street NW • Suite 400 • Washington, DC 20036 • Phone: 202-986-2700 • Fax: 202-986-3696 • www.crfb.org

Because Social Security has been collecting more in revenues than it has been paying in benefits over the last two decades, the trust funds have built up substantial reserves. Today, it holds about $2.6 trillion in special issue government bonds, the equivalent of about 3.5 years worth of benefits. Though the system is now collecting a little bit less in revenue than it pays out, the existence of these bonds (and the interest they generate) will allow Social Security to pay full benefits for the next quarter century.

Fig. 1: Trust Fund Ratio (Percent of Annual Benefits)



Social Security nonetheless faces a serious solvency problem. The trust funds have already begun to fall relative to annual benefits, and will decline in nominal terms by 2025 or earlier. By 2037, the trust funds will run out of money and the program will only be able to pay benefits based on revenue received—meaning an across-the-board and immediate 22 percent cut in benefits for all beneficiaries, including those who will have already retired.

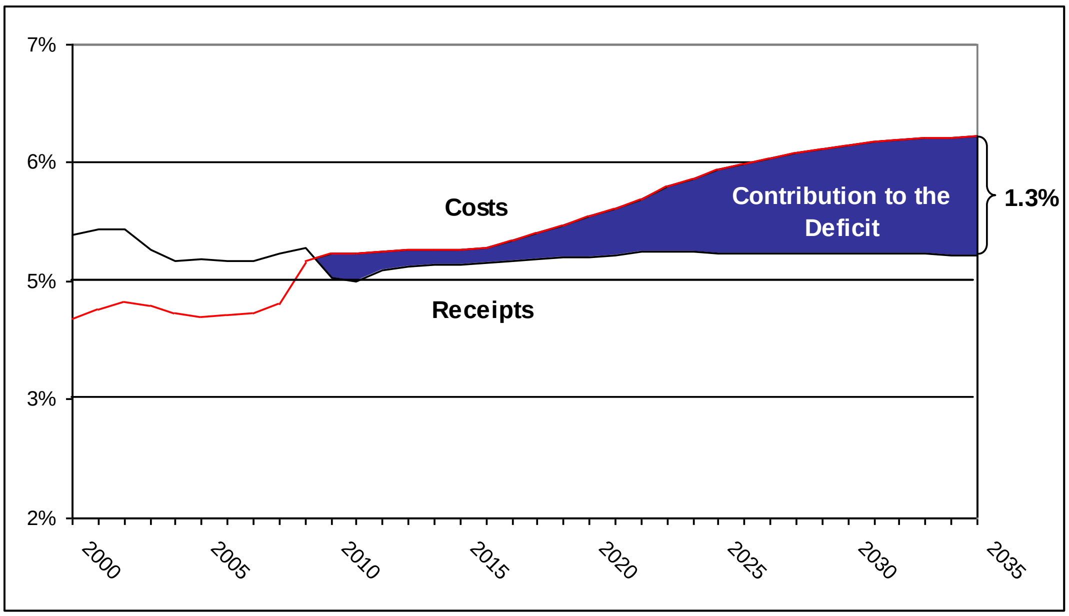
Avoiding this for the next 75 years would require closing an actuarial gap of 0.7 percent of GDP (1.92 percent of payroll). Making the program sustainably solvent—so that it does not fall out of solvency outside the 75-year budget window—would require also closing the vast majority of the 1.4 percent of GDP (4.12 percent of payroll) cash-flow deficits in the 75th year.

View 2: Part of the Overall Budget

An alternative way to view Social Security is as part of the overall budget. Currently, one out of every five dollars the government spends goes to Social Security—and a similar amount of the government's financing (revenues plus borrowing) comes from the Social Security payroll tax and the taxation of Social Security benefits.

Under this approach, the Social Security program is already contributing to the deficit today. Any time the program's costs exceed its revenues, it must withdraw from either the interest from or the principle of its trust funds. Yet these trust funds are invested completely in government bonds and thus must be repaid from general revenues, or the rest of the budget.

Fig. 2: Social Security Costs and Receipts, Excluding Interest (Percent of GDP)



Source: Congressional Budget Office and Social Security Administration.

Putting aside the issue of whether or not past surpluses have been "saved" in an economic sense,[1] it is important to recognize that the government must produce the cash to repay the trust fund assets. Absent other tax or spending changes, this will mean going on the open market to borrow the funds.

Social Security's negative cash balance will become an increasing burden to the rest of government, *adding nearly $600 billion to the deficit from 2011 through 2021 alone*. As population aging causes the program's costs to grow as a share of the economy (and

[1] Some experts have argued that by reducing past deficits, Social Security surpluses have in some sense been "saved" so far as they have reduced public debt and resulting interest costs (see Diamond, Social Security, the Government Budget and National Savings). However, a large body of evidence suggests that in reducing the unified deficit, Social Security's surpluses have led to higher general spending and lower general taxes than would have otherwise occurred – and as a result some or all (or more than all) of the surpluses have been "spent" (see Smetters, Is the Social Security Trust Fund Worth Anything?).

revenues to shrink somewhat as workers retire), the net effect of the program will be to increase the unified budget deficit by 0.4 percent of GDP in 2020 and 1.3 percent in 2035 (excluding interest). Failure to close this gap will mean either permanently higher budget deficits, or else will require other tax provisions and spending programs to be modified more significantly in order to subsidize Social Security.

Box 1: Does Social Security Add to Deficits and Debt?

Whether Social Security adds to the deficit and debt depends on which of the two perspectives above one subscribes to. But it also matters *which* measure of deficit and *which* measure of debt one relies on. The government, in fact, keeps two sets of books—offering two different measures of deficits and debt.

Those who view Social Security as a stand-alone program (View 1) are implicitly accepting the idea that it is "off budget." Under this approach, what matters for Social Security are its trust funds, and what matters for the rest of government is the "on-budget deficit"—the amount it is borrowing outside of Social Security. Using this approach requires a focus on *gross debt*—which includes not only what the government has borrowed from the public, but also what it has borrowed for the Social Security trust funds. As the program withdraws these funds, it will convert "intragovernmental debt" into "debt held by the public," but have no effect on gross debt.

Fig. 3: Various Budget Statistics under Each Approach (2010)

	View 1: Off-Budget Approach	**View 2: Unified Budget Approach**
Federal Debt	$13.5 trillion 93% *of GDP* *(gross debt)*	$9.0 trillion 62% of GDP *(debt held by the public)*
Budget Deficit	$1.4 trillion 9.4% of GDP *(on-budget deficit)*	$1.3 trillion 8.9% *of GDP* *(unified deficit*)
Social Security Balance	$82 billion <u>surplus</u> *(surplus including interest)*	$37 billion <u>deficit</u> *(primary deficit)*
First Year of Social Security Deficits	2025 *(deficit including interest)*	2010 *(primary deficit)*
Insolvency Date	2037	N/A

Source: Congressional Budget Office and Social Security Administration.

Those who view Social Security as part of the overall budget (View 2) tend to focus on the "unified budget" approach, in which on-budget deficits and Social Security deficits are added together. Those who rely on this approach tend to focus on "debt held by the public," which most experts believe to be the more *economically* meaningful (though not necessarily the more legally or morally meaningful) measure of our debt burden because it reflects what the nation must borrow on the open market. Cash deficits in the Social Security program, under this approach, add to public debt over time.

Under the latest projections—which CBO has released since the 2010 Social Security Trustees report—Social Security is now projected to be in permanent deficit. These deficits will grow over time, adding trillions of dollars to future deficits.

Fig. 4: Cumulative Social Security Deficits Each Decade

Decade	Cash Balance	
	Trillions of 2010 Dollars	Percent of GDP
2001-2010	$0.67	0.5%
2011-2020	-$0.40	-0.3%
2021-2030	-$1.90	-0.9%
2031-2040	-$3.15*	-1.3%*
2041-2050	-$3.48*	-1.2%*
2051-2060	-$4.01*	-1.1%*
2061-2070	-$5.05*	-1.2%*
2071-2080	-$6.56*	-1.3%*

Source: Congressional Budget Office, Social Security Administration, and CRFB calculations.
*Assumes Social Security pays full benefits beyond trust fund insolvency.

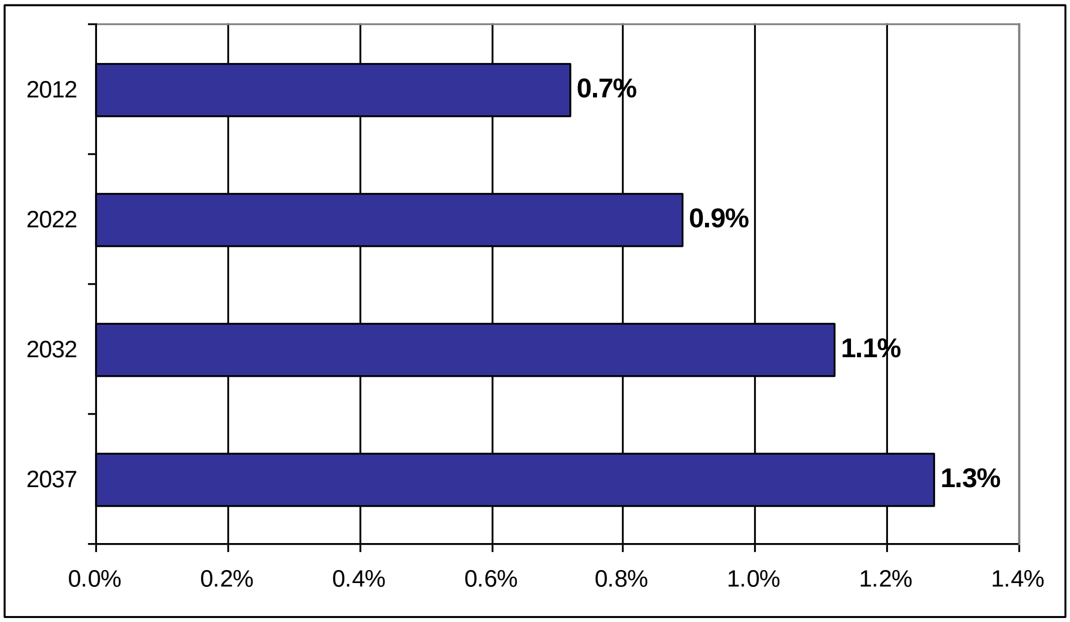
Two Views Lead to the Same Conclusion

Regardless of how you view the program, the sooner we make policy changes to the program, the better.

Viewed as its own separate program, the need for Social Security reform is quite compelling. Social Security is on a road toward insolvency and is projected to run out of money by 2037—at which point current law calls for a 22 percent across-the-board benefit cut. Making the system solvent for the next 75 years will require making changes equal to 0.7 percent of GDP (1.92 percent of payroll). It will also require getting the program into eventual cash balance (or close to it) to make sure solvency is *sustainable* and will not be undermined by a one-year change of the valuation period.

The longer we wait to enact changes, the larger those adjustments will need to be to make the system solvent. For example, the current actuarial shortfall through 2085 is roughly 0.7 percent of GDP. Waiting ten years would increase the size of the shortfall (through 2085) to 0.9 percent of GDP, and waiting until 2037 would increase it to 1.3 percent. In other words, the longer we wait, the larger the necessary adjustment to achieve solvency through 2085.

Fig. 5: Actuarial Shortfall through 2085 from Various Start Dates (Percent of GDP)



Source: Social Security Administration and CRFB calculations.

For those who regard Social Security as part of the budget, putting the program into cash flow balance is important and would help alleviate pressure on the rest of the budget. Not only is it the single largest government program, and thus an important part of any meaningful budget fix, its costs will increase by 1.3 percent of GDP by 2035 (it has already grown by 0.7 percent of GDP since 2000).

Unfortunately, getting to immediate cash flow balance would be extraordinarily difficult given current demographic pressures and the political problems associated with significantly cutting benefits for current retires. However, making gradual changes starting now can lead to significant savings over time and put the program back on a path toward cash-flow balance.

No matter how you look at it, Social Security is in dire need of reform. The program's trustees continue to warn us that changes need to be implemented as soon as possible. By acting now, we can implement changes in thoughtful ways and protect those who depend on the program the most. We can also institute tax and benefit changes gradually, giving current workers plenty of time to adjust their retirement planning decisions.

Whether for the health of the budget or for its own sake, it's time to reform Social Security.