Financial Aspects of the Social Security "Problem"

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There is a widespread belief that the Social Security Trust Fund is going bankrupt. Thus, while OASDI is currently accumulating large financial surpluses, the fear is that Social Security faces a financial crisis because post-2020 program expenditures are expected to exceed the revenues that will be generated from a shrinking tax base.[1] The solution, many argue, is to "use" (current and future) budget surpluses to "save" Social Security from financial collapse.[2] The idea, according to these "saviors," is that by "depositing" the surpluses into a Trust Fund, the Treasury can be prevented from "spending" them. These "saviors" typically also insist that the rest of the government's budget must remain balanced, for otherwise the Treasury would be forced to "dip into" Social Security reserves. We examine these points by first providing an analogy.

Can a trust fund help to provide for future retirees? Suppose the New York Transit Authority (NYTA) decided to offer subway tokens as part of the retirement package provided to employees—say, 50 free tokens per month (for life) upon retirement. Does this mean that the City should attempt to run an annual "surplus" of tokens (on average collecting more tokens per month than are paid out) in order to accumulate a trust fund to provide for future NYTA retirees? Of course not. When tokens are needed to pay future retirees, the City will simply issue more tokens at that time. Not only is it unnecessary for the City to accumulate a hoard of tokens, but it will not in any way ease the burden of providing subway rides to future retirees. Whether the City can meet its *real* obligation (to convert tokens into rides) will depend solely on the future carrying capabilities of the transit system. Its

financial commitment, in contrast, can always be met merely by issuing tokens to future retirees as benefits come due.

Note, also, that the NYTA does not currently attempt to run a "balanced budget," and, indeed, consistently runs a subway token deficit. That is, it consistently pays-out more tokens than it receives, as riders hoard tokens or lose them. Attempting to run a surplus of subway tokens would eventually result in a shortage of tokens, with customers unable to obtain them. Instead, the transit system always sets its price (say, $1.50 per token) and lets the quantity of tokens it issues "float".[3] Again, this typically results in a deficit, as the NYTA issues more tokens than it receives, but this practice does not in any way impinge on the its ability to make token payments in the future. Moreover, it would be impossible for the NYTA to consistently run surpluses because the only revenue source of tokens is the NYTA's own "spending" of tokens.

Just as an accumulation of subway tokens cannot help to provide subway rides for future retirees, neither can the Social Security Trust Fund help provide for the (real) consumption needs of babyboomer retirees. Whether their future consumption needs are realized will depend solely on society's ability to produce real goods and services (including subway rides) at the time that they will be needed. Thus, an accumulation of credits to a Social Security Trust Fund is neither necessary nor efficacious. Moreover, as was the case in the NYTA analogy, it does no good to run a budget surplus—which simply reduces the demand for currently produced goods. Just as a NYTA token surplus would generate lines of token-less people wanting rides, a federal budget surplus will generate jobless people desiring the necessities of life (including subway rides).

While the analogy with a subway token retirement system is not a perfect one, it does make the important point that the *issuer* of the token (or dollar) never needs to collect tokens (dollars)

before making payments. Indeed, it cannot initially—as a simple matter of logic—do so. It must first "emit/issue" (spend) before it can "collect" (tax). This also means, as a matter of logic, that it makes no sense to attempt to accumulate a trust fund for the purpose of paying-out tokens (dollars) in the future.

How well do the "Saviors" Understand the Fundamentals?

The above is intended to clarify two points, which, if misunderstood, preclude any sensible discussion of Social Security. The first point concerns the building up of financial resources as a *means* of providing for the needs of future retirees. This, as we argued, is both unnecessary and ineffectual since the availability of *financial* resources by no means guarantees the availability of sufficient *real* resources.[4] Second, it makes no sense to support balanced budgets (much less surpluses) as a means of "protecting" the trust fund since this, also, does nothing to augment real resources. That this is not understood, even by those who ought to have a better grasp of the fundamentals, is evidenced in an excerpt from a document issued by the U.S. House of Representatives Budget Committee, which states that:

> Every **penny** that is taken out of America's paychecks for Social Security should be **locked** in a safe-deposit box so it can only be **used to pay for** Social Security benefits. [Penner et al. 1999, 1; emphasis added]

Three fundamental misconceptions, each indicated in boldface, exist in the above.

If the safe-deposit box is meant to represent the Social Security Trust Fund (and we believe it is), then the first misconception is revealed. There are no **pennies**—or nickles, dimes, quarters, or bills of any denomination, for that matter—in the Trust Fund; it is not a piggy bank

and should not be likened to a safe-deposit box. Eisner recognized this, calling the Trust Funds "merely accounting identities" [1998, 80]. What these accounting identities actually represent are non-marketable US Treasury liabilities that have been credited to the Social Security Trust Fund (a US Treasury asset). In other words, the Trust Funds are recorded *on the same balance sheet* as both an asset *and* a liability—an unconventional accounting practice to be sure. Putting it somewhat crudely, the Trust Funds are an accounting gimmick.

The second misconception follows from the idea that payroll taxes that are taken out of current workers' paychecks must be **locked up** the so that they will be available when it is time to pay out benefits in the future. In fact, in practice, the goal is to collect and "lock up" *more* funds than are "needed" to service current commitments. The idea is that by "advance funding" the system, the surplus can be drawn down as the number of retirees begins to swell. The problem with this argument, as we have already argued, is that the ability to pay out benefits does not depend upon the balance in the Trust Fund.

The government makes payments to retirees in the same way that it pays a postal worker for her services or Alan Greenspan for his—by writing a check on one of the Treasury's accounts at the Federal Reserve. Figure 1 shows the balance sheet entries that correspond to the payment of Social Security benefits and the collection of payroll taxes.

Figure 1

Step A: Withholding Payroll Taxes in Excess of Benefits Paid

NON-BANK PUBLIC

- Balance at Commercial Banks[a]	
+ Balance at Commercial Banks[b]	

COMMERCIAL BANKS

- Balance at Federal Reserve	- Balance owed to Non-Bank Public
+ Balance at Federal Reserve[c]	+ Balance owed to Non-Bank Public

TREASURY

+ Balance at Federal Reserve	
- Balance at Federal Reserve[d]	

FEDERAL RESERVE

	- Balance owed to Commercial Banks
	+ Balance owed to Commercial Banks

Step B: "Disposition" of the Surplus

FEDERAL RESERVE

	+ Balance owed to Banks
	- Balance owed to Treasury

COMMERCIAL BANKS

- Marketable Government Securities	
+ Balance at Federal Reserve[e]	

TREASURY

- Balance at Federal Reserve	- Marketable Government Securities
+ Social Security Trust Fund	+ Non-marketable Government Securities

a: The deposits of bank customers decline as taxes are paid.
b: The deposits of bank customers rise as Social Security checks are deposited.
c: The net effect is a decline in aggregate bank reserves because we are assuming current withholdings exceed current benefits.
d: The budget surplus results in a net increase in the Treasury's balance at the Federal Reserve.
e: When Treasury debt is retired, the banking system recovers lost reserves.

As this figure indicates, our payroll taxes are not credited to any trust fund, nor are our benefit checks drawn on any such fund. Benefit checks are always drawn on one of the Treasury's accounts at the Federal Reserve, and payroll taxes are received into one of the Treasury's accounts. Thus, with our government currently running a surplus, mainly due to the "advance funding" of Social Security, there will be a *net* increase in the Treasury's balance at the Fed. This is the case in Step A. At this point, the additional balances could simply be left in the Treasury's account. But, if the goal is to "lock up" some portion of the surplus in order to "shore up" Social Security, then the Federal Reserve, which is charged with managing the Treasury's outstanding debt, will arrange for some portion of the Treasury's maturing obligations to be retired. Simultaneous with the *reduction* of privately held (marketable) Treasury bonds, as shown in Step B, the Treasury will issue *additional* (non-marketable) debt to be held by the Social Security Trust Fund.

But what so all of these balance sheet entries really mean? In short, they show that the Treasury has traded a portion of its balance at the Federal Reserve for credits to the Social Security Trust Fund (i.e. it has swapped one asset for another) and it has traded marketable debt for non-marketable debt (i.e. it has swapped one liability for another). Is this balance sheet adjustment really necessary in order to ensure the survival of the Social Security program? The answer, of course, is no.

Unfortunately, our government seems to misunderstand that as long as it retains certain powers (e.g. the power to tax, the power to declare public receivability, the power to create and destroy money and the power to buy and sell bonds), it can never be constrained in its

ability to make money payments. This means that the government never needs to collect a surplus of dollars today in order to make money payments in the future. As the monopoly issuer of dollars, the government will always be able to make Social Security payments as required under the law.

Finally, there is a misconception that follows from the belief that withheld payroll taxes can be **used** to finance retirees' benefits. While it is certainly true that withholdings are credited to one of the Treasury's accounts, it would be highly deceptive, in a world where money has been effectively divorced from commodities, to suggest that the money that is transferred from the private to the public sector can be "used" to pay (current or future) benefits. A careful analysis of the accounting reveals this deception.

First, it must be recognized that Federal Reserve notes (and reserves) are booked as liabilities on the Fed's balance sheet and that these liabilities are extinguished/discharged when they are offered in payment to the federal government. In other words, the collection of payroll taxes leads, through the clearing process, to a loss of bank reserves and a concomitant destruction of Federal Reserve liabilities. Second, it should be recognized that as the liabilities of the Federal Reserve are discharged, both narrow money and high-powered money are destroyed—narrow money (M1) is destroyed when demand deposits are used to pay taxes, and high-powered money is destroyed as the funds are placed into the Treasury's account at the Fed. Clearly, then, it would be impossible to "use" payroll tax receipts to pay for retiree's benefits.[5]

The "Problem" With Social Security and its Popular Reform Proposals

The philosophy behind the current wave of hysteria surrounding Social Security is based on the belief that the program faces a long-range financing problem. Since the problem is perceived to be a financial one, the goal of most reform proposals is to prolong the 'day of reckoning'—the day the OASDI trust funds become "insolvent." Unfortunately, most of these analyses, including those published by the Trustees, have confused financial issues with the real burden of caring for retirees in the future. Indeed, as we have argued, the US government can always meet its obligation to make money payments. The real concern is whether, as a consequence of our shrinking workforce, our society faces any "real" production problems in the future. If we do, then this can be resolved only by increasing productive capacity between today and the future. Let us move to an examination of some of the more popular proposals on the reform agenda to see whether any of them are likely to ease the real burden that future workers might face.

We begin with President Clinton's plan. The President has proposed that $2.8 trillion, or 62% of the $4.5 trillion in projected budget surpluses over the next 15 years, be "used" to shore up the OASDI Trust Fund. The plan consists of taxing current workers about 2 percent more than they would forfeit under a pay-as-you-go system. Unless a larger Trust Fund is likely to augment our productive capabilities, however, the President's plan will do nothing to ease the "real" burden of providing for the consumption needs of retirees. Thus, a reasonable justification for building up the Trust Fund today (i.e. "advance funding" Social Security) is a belief that the increased national savings will stimulate investment demand. However, for reasons that are familiar to all Institutionalists, the notion that saving determines investment is logically flawed; saving is only the pecuniary accounting of investment [Foster 1981]. Moreover, it makes no sense to penalize current workers simply to allow the government to increase its debt to itself in

order to maintain the subterfuge that it is necessary to save dollars today in order to pay out dollars in the future. In fact, we believe that current workers could enjoy a tax cut now and that this would have no impact whatsoever on the government's ability to finance Social Security in the future.

Next, we consider the proposal to privatize the Trust Funds. The belief is that by allowing workers to invest (all or part of) their withheld payroll taxes in the stock market, they would earn higher returns. Again, notice that the goal of this proposal is to augment "financial" resources. The "real" burden placed on future generations would remain unchanged unless privatization somehow increased the economy's long run growth rate. As Eisner has argued, however, privatization is likely to have "little or no real effect on the economy" because, in the end, "it would merely change the identity of those who hold government bonds as against stocks" [1998, 84].[6]

Finally, we consider a host of cost-reducing reforms such as: reducing cost-of-living-adjustments, increasing the retirement age, cutting benefits payments and adopting means-testing criteria. These reforms share a common theme—each seeks to reduce the volume of benefits payments relative to contributions. However, none of these proposals is likely to improve society's productive capabilities. Instead, they are designed to help the government cope with a perceived "financial" problem, which we have already argued is a fiction.

Thus, none of the major Social Security reforms advocated—whether by the President or by his critics—will significantly reduce the real burden that future workers might face. Indeed, many of these proposals would merely increase the burden on today's workers and retirees without reducing the future burdens at all.

Recommendations

At best, the reforms advocated by Social Security "saviors" have an ambiguous probability of easing the "real" burden that may be experienced in the future. This is because most proposals focus on increasing the size of the Trust Fund (by some combination of reduced benefits or increased tax rates) or increasing the rate of growth of the Fund (for example, by investing it in the stock market). As we have already argued, the current philosophy behind the operation of OASDI is the belief that a large Trust Fund can help to ease the burden created by demographic changes combined with slow projected growth of taxable real wages. But, as we have said, the availability of financial resources in no way ensures the availability of sufficient real resources.

Thus, rather than adopting policies that are designed to deal with a perceived financial problem, we make the following recommendations:

(1) OASDI should be returned to a pay-as-you-go system. We see no reason to suppose that the burden of providing for the real consumption needs of future retirees will be eased by accumulating an enormous Trust Fund.

(2) We should reconsider immigration policy. As our nation moves to negative natural population growth, we may wish to significantly increase the numbers of legal immigrants in order to provide us with a growing labor force.

(3) General fiscal policy should be biased to encourage faster growth, greater employment, and higher labor force participation (especially for women).

Finally, we believe that reforms such as increased taxation, privatization, reduction of benefits, or an extension of the retirement age have no place in the reform of Social Security. Appropriate policies to cope with the demographic changes that will be experienced in the coming years must not be motivated by concerns over the availability of financial resources.

ENDNOTES

1. Each year the trustees of the Social Security Trust Funds (Old-Age and Survivors' Insurance Fund and Disability Insurance Fund, or OASDI) make three sets of projections: high cost, intermediate cost, and low cost. According to their low-cost projection in 1999, the estimated income rate (revenue from payroll taxes expressed as a percentage of taxable payroll) will exceed the estimated cost rate (payments to beneficiaries expressed as a percentage of taxable payroll) over the next 25-year, 50-year, and 75-year periods. The intermediate-cost projection anticipates sufficient revenues over the 25-year period and a shortfall of income thereafter, while the high-cost estimate projects a shortfall even in the first 25-year period. These projections provide the basis for the current claim that Social Security faces a financial crisis. Although it is fair to question the (perhaps overly pessimistic) assumptions underlying the projections, it must be emphasized that even under the most pessimistic assumptions there would be no "financial" crisis. We will return to this point.

2. 2. As Wray [1999] points out, however, the surpluses that are anticipated through 2008 will be achieved mainly thanks to huge "off-budget" surpluses – $119 billion in 2003 and $159 billion in 2008 – that will be run by Social Security!

3. Although the federal government does not generally exercise the right to set prices, it certainly could do so. The NYTA is, in effect, buying dollars (i.e. selling subway tokens for dollars). The difference between the NYTA and the federal government is that the former sets the price it is willing to pay for dollars (i.e. 1 subway ride per 1.5 dollars) and lets the quantity of tokens it issues float, while the latter sets the quantity of dollars that will be issued (via the Congressional budget) and lets the price of the goods and services it buys float (via market determination). The government's power to set prices is discussed in Wray 1998.

4. Foster recognized this point, stating that "[t]he community at large cannot 'save money'; it can save only by investing, and its savings are constituted by that investment" [1981, 967-968].

5. Payroll taxes are not unique here. Personal income taxes, quarterly business taxes, the proceeds from bond sales, etc. are equally ineffectual in this regard. None are capable of providing the government with money that can be 'used' to finance future spending. In fact, the government actually finances all of its spending through the direct creation of new (high-powered) money. For more on this, see Bell 2000.

6. We might add that it is unnecessary to seek higher returns from the stock market since the government can always *choose* to pay a higher return on its non-marketable securities (i.e. the government could credit the Trust Funds with a higher interest rate). Although this would resolve the accounting "problem" that may be faced twenty years from now, it, too, would accomplish nothing in "real" terms.

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