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Has the Unified Budget Undermined the Federal Government Trust Funds?

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A key element of the 1983 Social Security Reforms involved setting the Social Security payroll tax rates above the level required to pay current benefits. The plan was for Social Security to depart from pay-as-you-go financing and to partially pre-fund the retirement costs of the baby boom generation. By forcing workers in 1984-2015 to pay higher payroll taxes than required to finance current retirement benefits, the hope was to ease the burden of baby boomers' retirement on workers in the 2016-2050 era. The trust fund buildup and subsequent spend down would spread the burden of these baby boomer retirements over 65 years rather than 30 years. Similar reforms were enacted in the 1980s to pre-funding the military and civil service retirement programs, again with the intent to relieve the burden on future generations. As a result of these various reforms, the trust funds have been operating in surplus, and have accumulated almost $3 trillion in assets between 1985 and 2004.

Despite this success in building up the assets of the trust funds, it is not obvious that the intended intergenerational burden sharing will take place. In order for the trust funds to actually assist future generations of workers, they must increase total national saving, presumably by raising government saving. The only way to assist future workers is to leave them more wealth. However, current federal budget policies treat the surplus of trust fund revenues over expenditures, and the interest received by the trust funds, as part of the unified budget. Moreover, the focus on balancing the unified budget may serve as an invitation for the rest of government (referred to as the federal funds) to offset the trust fund surplus through increased spending and reduced taxes in other parts of government. Thus the budget process – by focusing on the unified budget – may undermine the attempt to raise government saving and build resources for future workers.

This paper examines whether the shift from pay-as-you-go financing to partially funded Social Security (and the corresponding shift in the funding of military and civil service retirement plans) actually increased national saving, or whether it was offset by decreased saving (deficit spending) in other parts of government. Our primary result is that increases in the aggregate surplus of the trust funds have been offset – perhaps completely – by enlarged deficits for the rest of the government.

Figure 1 shows the real (inflation adjusted to 2000 dollars) trust funds and federal funds surpluses (or deficits) from 1949 through 2009. The 2004-09 figures are OMB projections from the 2005 U.S. Budget. The raw data shown in figure 1 are highly suggestive of this offsetting effect, and the offset is confirmed in our empirical analyses.

We maintain that it is the existence of a unified budget that produces this offset. Attempts to save in the trust funds treat the trust funds as real government assets. But this is inconsistent with the use of a unified budget because the unified surplus treats the trust funds surplus as money that is currently available to spend, rather than money that has been earmarked for saving. The picture that emerges from our empirical analysis is that the trust funds surpluses during the 1980s gave the government more flexibility to increase other spending and cut taxes while still meeting target levels of the unified budget.

In other words, when the government focuses on balancing the unified budget, attempts to save in the trust funds are undermined.

One implication of this finding relates to individual accounts. Suppose, for example, that the increased payroll tax receipts had been used to fund individual accounts, rather than savings in the Social Security trust fund. At first glance, the money available to the rest of the government would be unchanged. However, the amounts deposited in individual accounts, and the investment returns earned in the individual accounts, would almost certainly not be counted as "surplus" in the unified budget. Thus the excess payroll tax revenues received would be far less likely to be offset by increased spending or reduced taxes by the rest of government. A similar outcome could be achieved without individual accounts; what would be required is separating the trust fund accounts from the rest of the budget and reporting the federal funds budget as the primary target for balancing. Currently, however, attempts to balance "the budget" have focused almost exclusively on the unified budget.

If the focus had been on balancing the federal funds budget instead of the unified budget and if the government had been successful with that balancing, the total debt of the government and the publicly held debt would have been $3 trillion lower. Future generations would have been $3 trillion wealthier and the vision of the 1983 Social Security reforms would have been at least partially fulfilled. Of course, the focusing on the federal funds budget would have revealed a number of things. First, the large surpluses that we enjoyed in 1998-2000 never really existed, at least according to the federal funds accounts. Second, the 2004 budget deficit is roughly $200 billion higher than reported and, third, the tax cuts, which may have been necessary for business cycle reasons, were not merely a rebate of sizable surpluses.

There is considerable debate as to whether the crisis in the financing of Social Security occurs in roughly 2017 when payroll tax receipts are insufficient to finance benefits or in the 2040s when the Social Security trust funds are projected to be exhausted. From the perspective of Social Security, the trust fund does represent real claims on the rest of the government. Thus, the presence of the trust fund may prolong the life of Social Security beyond the date at which tax receipts fall short of benefits payments. However, from the perspective of future generations of workers, the trust funds do not represent incremental wealth. Even if Social Security's life is lengthened, workers 15 years from now will have to pay off the obligations in the trust fund through increases in other taxes and cuts in other government services. The trust funds themselves do not provide any assistance to future generations of workers in coping with the inadequate income of Social Security to pay the legislated benefits.

The full working paper is available on our website, www.nber.org/programs/ag/rrc/books&papers.html as paper NB04-02 and as NBER Working Paper #10953.

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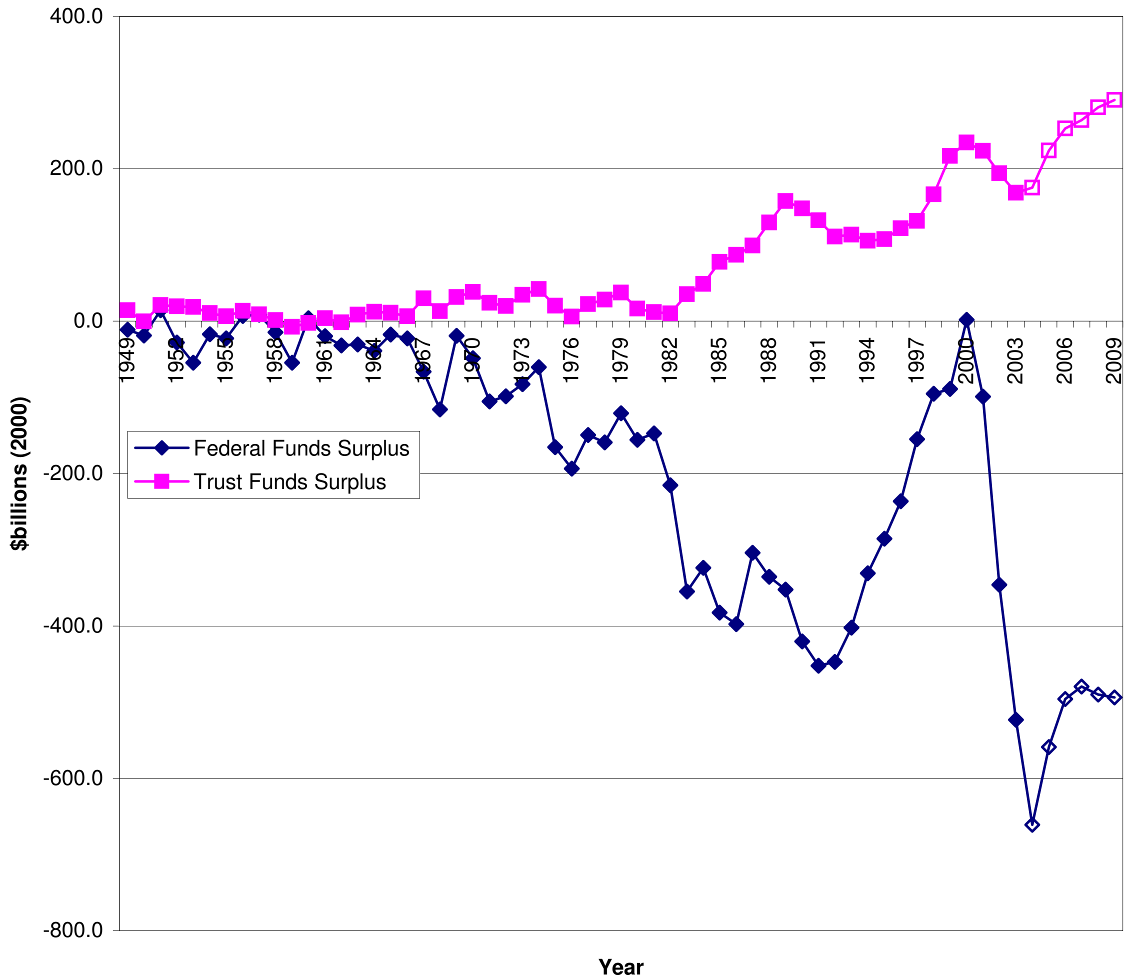
FIGURE 1: REAL TRUST FUNDS AND FEDERAL FUNDS SURPLUSES, 1949-2003

ESTIMATED REAL TRUST FUNDS AND FEDERAL FUNDS SURPLUSES, 2004-2009



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