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DOES SOCIAL SECURITY FACE A CRISIS IN 2018?

by Jason Furman

A recently leaked White House memo indicates that the first phase of the Administration's strategy to sell individual accounts will be to convince Americans that the Social Security system is "heading for an iceberg."[1] The President frequently cites 2018 as the beginning of a Social Security crisis that, he says, will leave the system bankrupt.[2] Others claim that Social Security will hit a crisis in 2018 when, to pay benefits, the system will become dependent upon what they describe as "worthless IOUs."

These statements seriously misrepresent Social Security's financing and the challenges the program faces. Furthermore, even if one were to grant the President's arguments, they would make the individual-accounts plan he is considering *less* attractive. Under the principal plan the President's Social Security Commission designed, the milestone that the President cites as a major turning point for Social Security — the point at which Social Security benefit costs will start to exceed Social Security tax revenue — would be reached twelve years *sooner*, in 2006 rather than 2018.

Here are the key facts:

- The Social Security actuaries project that in 2018, Social Security's trust fund will hold \$5.3 trillion in assets, in the form of U.S. Treasury bonds. Starting in that year, Social Security payroll tax collections will not be sufficient to cover the cost of all Social Security benefits, so the Social Security system will start to use a portion of the interest the trust fund earns on its bonds to cover the remaining benefit costs. The rest of the interest the trust fund earns will be reinvested in the trust fund. The actuaries project that as a result of these interest earnings, the trust fund's assets will increase by another \$1 trillion in the decade after 2018 and reach \$6.6 trillion by 2028.[3]

- Treasury bonds are the world's most secure investment. They are the instruments that investors large and small, at home and abroad, turn to for safety, secure in the knowledge that the United States has never in its history defaulted on its bonds.

[1] Peter Wehner, "Some Thoughts on Social Security," available at http://online.wsj.com/article_email/0,,SB110496995612018199-Ihjg4Nhlah4m5uma3uGaayGm4,00.html.

[2] For example, in his December 11, 2004 radio address, President Bush stated, "In the year 2018, for the first time ever, Social Security will pay out more in benefits than the government collects in payroll taxes. And once that line into the red has been crossed, the shortfalls will grow larger with each passing year. By the time today's workers in their mid 20s begin to retire, the system will be bankrupt, unless we act to save it."

[3] Social Security Trustees' projections by single year, available at http://www.ssa.gov/OACT/TR/TR04/lr6F9-2.html.

- The notion that the Treasury bonds which the trust fund holds are nothing but paper IOUs that may not be honored does not withstand scrutiny. Failure to honor Treasury bonds would result in a U.S. government default, and that likely would trigger an international financial crisis. As the *New York Times* editorialized on January 10, "If the trust fund's Treasury securities are worthless, someone better tell investors throughout the world, who currently hold $4.3 trillion in Treasury debt that carries the exact same government obligation to pay as the trust fund securities."

- The Social Security Trustees, a group that includes Treasury Secretary Snow and other Cabinet officials, project that the Social Security trust fund will be able to pay full benefits until 2042. At that point, the trust fund will be exhausted — that is, all of its bonds will have been redeemed. The Congressional Budget Office projects the trust fund will be able to pay full benefits until 2052.[4]

- When the trust fund is exhausted, the Social Security system will *not* be "bankrupt." It will continue to collect both payroll taxes and the income taxes levied on a portion of Social Security benefits. With these revenues, it will be able to pay about 70 percent of benefits according to the Social Security Trustees, and about 80 percent of benefits according to CBO.

- Finally, if one believes that Social Security faces a crisis in 2018, then converting part of Social Security to individual accounts would accelerate that crisis. According to the Social Security actuaries, the major individual account plan proposed by the President's Social Security Commission (which is reported to be the principal plan the President is considering) would advance the date at which Social Security's benefit costs exceed its non-interest income from 2018 to 2006. In other words, under that plan, Social Security would have to rely on interest from the trust fund to pay benefits starting *next year*.[5]

  Furthermore, according to the actuaries, that plan would increase the federal debt by $10 trillion by 2030, an amount equal to 28 percent of GDP, substantially increasing the volume of Treasury bonds that the government has to finance.

Detailed Discussion

The Social Security system currently takes in more money from payroll taxes and other sources than it pays out in benefits. These surplus funds are used to purchase Treasury bonds. The bonds earn interest that goes back into the trust fund and is used to purchase additional Treasury bonds. And at a future date, the bonds can be redeemed for cash to help pay benefits.

Although Social Security is legally allowed to purchase the same marketable Treasury bonds that are sold to the public, in practice the vast majority of Social Security's investments are in "special issue" Treasury bonds that are superior to standard Treasury bonds, because they are redeemable at par at any time and thus do not fluctuate with changes in interest rates.

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[4] Social Security Trustees, *The 2004 OASDI Trustees Report* and CBO, *The Outlook for Social Security*, June 2004.

[5] Social Security Actuaries, "Estimated Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," 1/31/2004, page 39.

According to the Social Security Trustees, "Just as in the case of marketable Treasury securities held by the public, all of the investments held by the trust funds are backed by the full faith and credit of the U.S. Government."

The Treasury bonds that the Social Security trust fund holds have the same legal status and priority as the Treasury bonds held by anyone from individual investors in Chicago to the central bank of China. Throughout its history, the U.S. government has never defaulted on its bonds.

To be sure, without changes in policy, the nation faces very large budget deficits in future decades. But this does not mean the Treasury will fail to honor its bonds. The United States government has run deficits in 72 of the last 100 years yet has honored all of its bonds.

Moreover, Social Security will contribute only modestly to the deficits the nation will face in the years after 2018. For example, the difference between Social Security benefit costs and Social Security non-interest revenues will account for less than 10 percent of the projected budget deficit in 2025. The Administration's tax cuts, if made permanent, and the prescription drug benefit will cost five times more than Social Security in that year. [6]

The Trust Fund's Bonds

As of December 31, 2003, the Social Security trust fund held $1.5 trillion in special issue Treasury bonds, including, for example, $20 billion in bonds redeemable in 2007 and paying 7.375 interest, $38 billion in bonds redeemable in 2010 and paying 6.5 percent interest, and $68 billion in bonds redeemable in 2016 and paying 5.625 percent interest.

Every year from now up until 2018, the Social Security system will collect more in non-interest income than it pays out in benefits. The surpluses will be deposited in the Social Security trust fund, along with interest on the balance of the trust fund, and the trust fund will use these resources to add to its stock of Treasury bonds. In 2018, for the first time, Social Security's non-interest income will fall short of the total benefits it pays, and a portion of the interest the trust fund earns will be used to help pay for benefits. The remaining interest will be used to increase the trust fund still further.

Table 1 presents the Social Security actuaries' projections of what will occur in 2018. As the table shows, the bulk of the interest that the trust fund earns that year will be reinvested, and the trust fund's assets will reach $5.3 trillion at the end of the year. This process will continue every year for the following decade, with the trust fund increasing by an average of more than $100 billion a year over this period and reaching $6.6 trillion in assets in 2028.

After that date, Social Security will start to redeem its bonds to meet its benefit obligations. According to the Social Security Trustees, the trust fund is expected to redeem all of its bonds by 2042. After that date, if no additional general revenue is available, Social Security's

[6] The unified deficit is projected to reach 7.5 percent of GDP in 2025, assuming the tax cuts are extended and millions of Americans are not forced onto the Alternative Minimum Tax (AMT). The Social Security deficit in that year – excluding interest income – is 0.6 percent of GDP according to comparable projections by CBO. The tax cuts and the prescription drug benefit cost 3 percent of GDP in that year, again excluding interest costs.

Table 1

Operations of the Trust Fund in 2018	
Trust Fund in 2017 (end of year)	$5.0 trillion
Non-interest income in 2018	+$1.1 trillion
Interest income in 2018	+$0.3 trillion
Costs in 2018	-$1.1 trillion
Subtotal, Net Increase in 2018	*+$0.3 trillion*
Trust Fund in 2018 (end of year)	$5.3 trillion

tax revenue would be sufficient to pay 73 percent of scheduled benefits in 2043, falling slightly to 68 percent of scheduled benefits in 2078.

The Congressional Budget Office projections are somewhat more optimistic. CBO projects that the trust fund will not be exhausted until 2052 and that payroll taxes will be sufficient to cover 81 percent of scheduled benefits in 2053, falling gradually to 71 percent of scheduled benefits in 2100.

Commission Proposal Would Make the Challenge More Daunting

As noted, those who argue that Social Security faces a near-term crisis argue that the system will hit a major crisis point in 2018 when Social Security benefit costs first exceed the program's non-interest income. Yet creating individual accounts by diverting payroll taxes out of Social Security would reduce the revenue available to pay Social Security benefits and thereby *advance* the date when the program's benefit costs exceed its non-interest income. The Social Security actuaries have estimated that the Model 2 plan developed by the President's Commission would advance the date at which costs exceed non-interest income to 2006.[7]

If this plan were enacted, then starting next year, the government would need to use interest the trust fund earns on its bonds to pay Social Security benefits. In addition, the trust fund would have to start redeeming its bonds in 2014, rather than in 2028 as under current law. If the trust fund really is comprised of "worthless IOUs," this presents a serious challenge for individual-accounts plans under which Social Security would have to start drawing on these IOUs in the next few years.

Not only would such individual-account plans advance the date at which the trust fund must start using a portion of its interest income to pay Social Security benefits, but they also would add to the debt held by the public, unless they were fully and contemporaneously financed by offsetting tax increases or reductions in other government programs. Under the Commission plan, the debt would be $10 trillion higher in 2030 than it otherwise would be, an increase equal to 28 percent of GDP. That increase is nearly as large as the total current federal debt, measured as a share of the economy. If anything, this would make it harder for the government to meet its commitment to Social Security, not easier.

[7] This assumes 100 percent participation in the accounts, the assumption made by CBO. If only two-thirds of people choose to participate then the date would be 2010.