CBO

A series of issue summaries from the Congressional Budget Office

AUGUST 1, 2002

Social Security and the Federal Budget: The Necessity of Maintaining a Comprehensive Long-Range Perspective

By law, the Social Security program is treated as an "off-budget" entity, and its financial figures are displayed separately from the rest of the budget. The separate display, along with the use of trust funds as an accounting device, is a means of distinguishing the program's finances from those of other government activities. However, the distinction can be confusing when it leads people to think of Social Security as an independent financial entity. Social Security is a federal program, and as such, all of its taxes are received by and its outlays dispensed from the U.S. Treasury.

Focusing on an accumulating balance in the Social Security trust funds can also be misleading. The only economically significant way that the government has a surplus is if there is a unified budget surplus—when total receipts are greater than total outlays. Although separate taxes are collected for Social Security, the money left over after benefits are paid is used to fund other government programs or to pay down the debt held by the public. Moreover, in the future, those separate tax receipts will become insufficient to maintain the program once the post-World War II baby-boom generation begins drawing federal entitlement benefits. Social Security and other entitlement programs will then be dependent on the federal government to cover their costs—at the same time that the government must pay for its many other functions.

Regardless of how any federal program is financed and accounted for—and whether it is presented as on- or off-budget—a full understanding of the government's looming fiscal strains and the potential economic impact of its fiscal condition requires that all government functions be considered together. It is the federal government's total claims on the nation's resources that affect the economy—not the individual components that make up those claims.

The Utility of a Comprehensive Budget Display

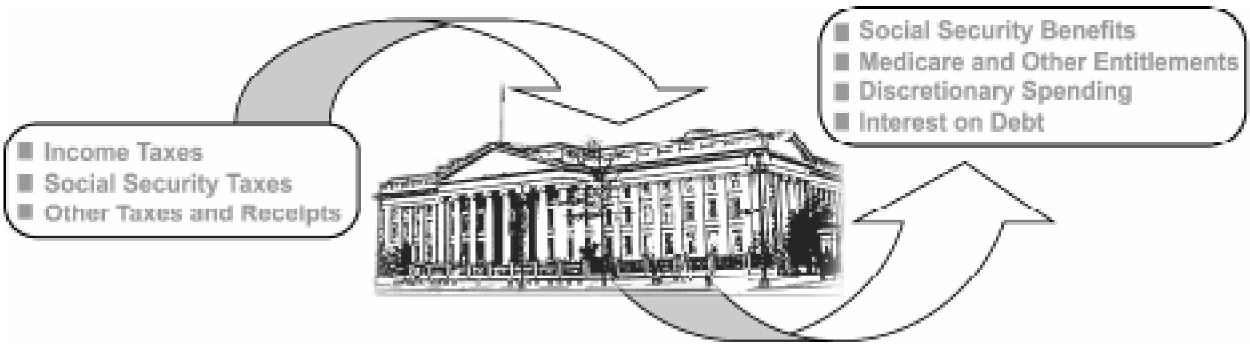
The government's fiscal condition has a significant impact on the economy, and that impact is most effectively summarized by the aggregate flows of money to and from the U.S. Treasury. It is the difference between the government's total receipts and total spending, including Social Security's, that determines how much the government needs to borrow from the financial markets or how much it can repay. Social Security benefits alone account for one-fifth of federal spending, and payroll taxes for the program account for one-fourth of federal revenues. Therefore, most economists, credit market participants, and policymakers, when they seek to gauge the government's role in the economy and its effect on the credit markets, look at the total budget figures, including the figures for Social Security.

Treating some federal programs as off-budget can obscure the government's total financial picture and its impact on the economy. And fragmentation of the budget can restrict the range of budget choices for policymakers and can complicate the public's understanding of the government's long-range fiscal condition.

Social Security as a Separate Display and as Part of the Totals

In summary tables of the budget prepared by the Congressional Budget Office and the Office of Management and Budget, Social Security's trust fund income and outlays (and the net transactions of the Postal Service) are routinely shown both separately and as part of the total budget. Those various displays, as well as the concepts of "off-budget" and "on-budget," are often confusing. Few people can understand how Social Security can be off-budget and part of the budget at the same time. To reflect it as off-budget is to suggest that it is an independent financial entity, which it is not. The money received for and dispensed by the program flows to and from the federal Trea-

All Federal Income and Expenditures Flow Into and Out of the U.S. Treasury



sury, as it does for all other federal programs. More important, Social Security is a federal program by design: participation in it is mandated by federal law; all Social Security tax and benefit levels are set by federal law; and only the Congress and the President can alter the program through legislation.[1]

The concept of federal "trust funds" also contributes to misunderstanding. The conventional view of private trust funds leads many people to believe that the government takes an arms-length approach to the management of federal trust funds—that somehow trust fund money is kept separate from that for the rest of the government. To the contrary, while the accounting for such federal programs is distinct, their cash flow is not segregated.

There are reasons for Social Security to be separately displayed in budget documents: notably its size, the level of taxes it requires, and the program's significance to the American public. In recent years, some observers have suggested that, with Social Security separate from the budget, the surplus recorded to its trust funds resulted in higher national savings. They argued that the separation protected the surplus from being used to offset other government spending or tax cuts and thereby dedicated the money to retiring the government's outstanding publicly held debt. That use, in turn, increased the amount of resources available for investment and spurred economic growth.

However, government savings are not determined by the finances of any one federal program regardless of how it is displayed in the budget. Even though Social Security's surplus funds have been off-budget for nearly two decades, the effect on the net amount of government savings is uncertain. In fact, overall budget deficits characterized most of the period. Even when a clear consensus exists to put surplus federal revenues toward debt reduction—whether they are attributed to Social Security or any other federal program—that posture can be difficult to sustain, as recent experience has shown. Unexpected events, such as a war or recession; new spending priorities; and concerns about tax burdens make it difficult to maintain debt reduction as the government's highest fiscal priority.

Moreover, having Social Security appear in this fashion, as if it was a separate financial entity, may encourage others to pursue the same treatment for other government functions, particularly those accounted for through trust funds —as shown by recent efforts to take both the Medicare and transportation trust funds off-budget. Such a proliferation of off-budget programs could complicate the public's understanding of the government's overall financial condition.

1. Although often described as such, Social Security does not represent a "contract" in the conventional sense in that neither party has entered into an agreement establishing enforceable obligations.

The Shifting Long-Range Context

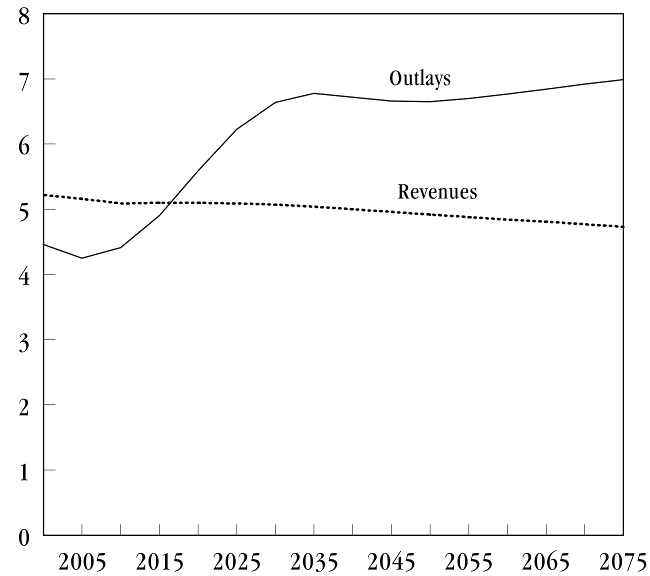
In the context of long-range fiscal policy, setting Social Security aside from the rest of the budget can obscure the strain that the program may eventually create. Today, the focus of policymakers is on the surplus of Social Security taxes over outlays and how to protect it. That excess of what comes into the Treasury over what goes out, however, is expected to be short-lived as the benefit rolls swell and costs escalate rapidly and permanently with the retirement of the post-World War II baby boomers and the aging of the population. Under the Social Security Board of Trustees' projections, the excess disappears in 2017 and is replaced by a negative cash flow that is uninterrupted until 2041 (see Figure 1 and Table 1).[2] At that point, the balance of the Social Security trust funds is depleted, causing the program to lose its legal authority to pay full benefits.[3]

A similar story can be told about Medicare. The balance of the trust fund for the Hospital Insurance part of the program is projected to become depleted in 2030, sooner than that of the Social Security trust funds. The financing for the Supplementary Medical Insurance part of the program is automatically adjusted each year, so the depletion of its trust fund is not an issue. But roughly three-fourths of its expenditures are paid for with the government's general revenues, contributing to the long-range fiscal pressure that Medicare will pose. Taken together, both parts of Medicare are already incurring a negative cash flow—more is going out of the Treasury for them than is coming in—and the difference only grows larger with time (see Figure 2 and Table 1).[4]

Figure 1.

Social Security's Revenues and Outlays

(As a percentage of GDP)



Source: Social Security Administration, *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 26, 2002).

Note: Revenues exclude intragovernmental credits to trust funds.

Budget and Policy Linkages

To focus policy on the segregation of Social Security and other trust funds ignores the significant linkages that exist between them and the rest of the budget. The level of Social Security benefits directly affects spending under the means-tested Supplemental Security Income and Food Stamp programs. Payroll taxes on employers reduce income tax collections. The earned income tax credit, which lowers income taxes, was motivated by the desire to reduce the impact of payroll taxes on lower-income workers. And Social Security and Medicare, by their size, are poised to crowd out other government spending and limit the availability of funding for other government functions. If one assumed that the benefit commitments now embedded in current law were to be fully met, Social Security and

2. See Social Security Administration, *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 26, 2002).

3. To illustrate the difference between the revenues and spending prescribed under current law, the figures and table in this policy brief do not reflect the lower payments that would result from the depletion of the trust funds. The trust funds are credited with federal securities when income is recorded to them, and those securities are written off when benefits and other expenditures are paid from the Treasury. Under the law, as long as a balance is posted to the trust funds, the Treasury has the legal authority to continue paying benefits. However, if the balance fell to zero (as is projected for 2041), the program's spending authority would end or be constricted because only incoming receipts would be available to make the payments.

4. Revenues for both Social Security and Medicare combined fall below the programs' outlays in 2010 and remain so thereafter.

Medicare expenditures together would increase as a percentage of gross domestic product (GDP) from 7 percent today to 12 percent in 2040 and 15 percent in 2075. However, the separate revenues for the programs would remain at around 7 percent of GDP. Absent a policy change, the money to cover the difference would have to come from other government receipts or borrowing.

The future of Social Security and Medicare depends on the capacity of the federal government to cover their costs while paying for its many other functions. Viewing them and other federal programs as separate from the rest of the government's finances will only obscure the looming fiscal strain. ■

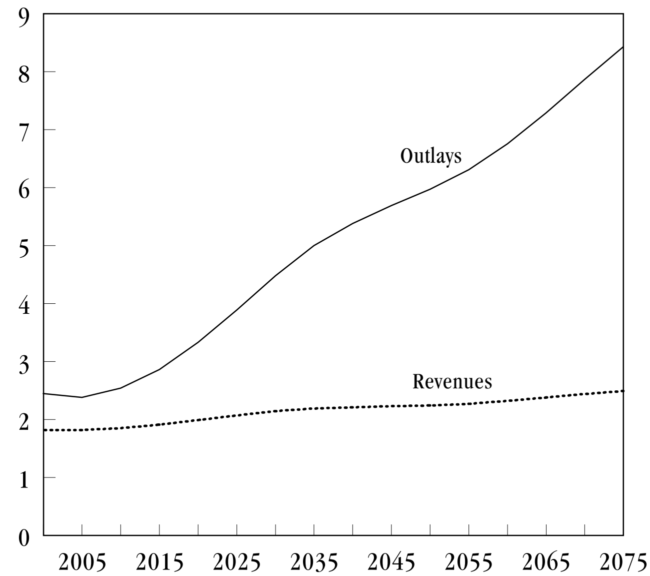
Related CBO Publications: *Social Security: A Primer* (September 2001); *A 125-Year Picture of the Federal Government's Share of the Economy, 1950 to 2075*, Long-Range Fiscal Policy Brief (July 3, 2002); and *The Looming Budgetary Impact of Society's Aging*, Long-Range Fiscal Policy Brief (July 3, 2002).

Contacts: This policy brief was prepared by Dave Koitz and Melissa D. Bobb. It and other publications by CBO are available at the agency's Web site: **www.cbo.gov**.

Figure 2.

Medicare's Revenues and Outlays

(As a percentage of GDP)



Source: Department of Health and Human Services, Centers for Medicare and Medicaid Services, Office of the Actuary, *2002 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (March 26, 2002).

Note: Revenues exclude intragovernmental credits to trust funds.

Table 1.

Social Security's and Medicare's Projected Revenues and Outlays, 2002 to 2075

(As a percentage of GDP)

	Social Security		Medicare[a]		Social Security and Medicare Combined[a]	
Calendar Year	Revenues	Outlays	Revenues	Outlays	Revenues	Outlays
2002	5.2	4.5	1.8	2.5	7.0	6.9
2010	5.1	4.4	1.8	2.5	6.9	7.0
2020	5.1	5.6	2.0	3.3	7.1	8.9
2030	5.1	6.6	2.1	4.5	7.2	11.1
2040	5.0	6.7	2.2	5.4	7.2	12.1
2050	4.9	6.7	2.2	6.0	7.2	12.6
2060	4.8	6.8	2.3	6.8	7.2	13.5
2070	4.8	6.9	2.4	7.9	7.2	14.8
2075	4.7	7.0	2.5	8.4	7.2	15.4

Sources: Social Security Administration, *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 26, 2002); Department of Health and Human Services, Centers for Medicare and Medicaid Services, Office of the Actuary, *2002 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (March 26, 2002); and supplemental data from both agencies.

Note: Numbers in the table may not add up to totals because of rounding.

a. The information on Medicare covers both the Hospital Insurance and Supplementary Medical Insurance (SMI) parts of the program. For this presentation, Medicare premiums are displayed as revenues rather than as offsets to spending. Revenue figures for the program include payroll taxes and income taxes on benefits and premiums but not intragovernmental credits to the trust funds, such as interest and contributions to SMI from the Treasury's general fund.