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Social Security and the General Treasury: Who's Raiding Whom?

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In this article, Viard criticizes the use of general revenue to finance Social Security.

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Throughout its history, the Social Security program has been marketed as a program financed by earmarked taxes. This arrangement has protected Social Security from being cut in the service of general deficit reduction, but it is also intended to limit benefits to the amount that can be financed by the program's earmarked taxes. Unfortunately, this delicate balance has been upset by policies that have effectively allowed Social Security to raid the general treasury. In 2009 and 2010 Congress enacted four provisions authorizing implicit or explicit transfers of general revenue to the Social Security Trust Fund, continuing a pattern set by earlier provisions.

Social Security's raid on the general treasury has largely escaped attention. Indeed, in a startling inversion of reality, the general treasury is often accused of raiding Social Security, based on the premise that the $1.7 trillion of surplus Social Security taxes collected from 1984 to 2014 have been looted from the program. In reality, current law provides that the surplus taxes will be paid back to Social Security more than fourfold (reflecting compound interest), enabling the program to pay $7.2 trillion of benefits in excess of taxes from 2015 to 2037.

Although general revenue financing averts Social Security tax increases and benefit cuts, it forces larger tax increases and spending cuts in the remainder of the federal budget. Using the general treasury as a piggy bank for Social Security distorts the budgetary process by giving the program the best of both worlds. Social Security receives political protection from tax increases and benefit cuts on the grounds that it is a self-supporting program financed by earmarked taxes, but it is not required to actually live within its earmarked revenue. General revenue financing is simply one more way to camouflage the hard choices that will ultimately have to be made to reform Social Security, taking its place alongside myths about the pessimism of the trustees' projections and free-lunch fantasies about privatization.

Congress should either turn Social Security into a general revenue program with no earmarked taxes or make it a genuinely self-supporting program that receives no general revenue transfers. The latter approach is preferable, because it allows the linkage between each worker's taxes and her benefits to be preserved. Ending general revenue transfers will allow decisions about Social Security reform to be made in an open and transparent manner without draining resources from the remainder of the government.

To examine these issues, I first explain the relationship between the Social Security Trust Fund and the general treasury.[1]

Social Security Trust Fund and General Treasury

Most federal spending programs are financed from the general treasury rather than from earmarked taxes. Likewise, most federal revenues flow into the general treasury, rather than being set aside for specific programs. In some cases, however, Congress earmarks revenues to particular programs.

Social Security, which pays old age, survivor, and disability benefits, is the largest federal program financed by earmarked taxes. The program's primary revenue sources are a 6.2 percent employee payroll tax imposed by section 3101(a), a 6.2 percent employer payroll tax imposed by section 3111(a), and a 12.4 percent tax on self-employment earnings imposed by section 1401(a).[2] Under sections 3121(a)(1) and 1402(b)(1), the taxable amount of each individual's wages and self-employment earnings cannot exceed the ceiling prescribed by 42

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[1] In this section, I draw on my article, "The Social Security Surplus, the Trust Fund, and the Federal Budget," *Tax Notes*, Feb. 18, 2002, p. 891, *Doc 2002-4083*, or *2002 TNT 34-59*.

[2] As discussed below, the employee payroll tax rate is reduced to 4.2 percent and the self-employment tax rate is reduced to 10.4 percent in 2011.

U.S.C. section 430, which is $106,800 in 2011. Also, as discussed below, the trust fund receives the majority of the revenue obtained from the individual income taxation of Social Security benefits.

Earmarking does not require year-by-year balance between Social Security benefits and Social Security taxes; the program need not cut benefits when recessions reduce tax revenue. Instead, earmarking requires that taxes equal benefits in present discounted value. Benefits may exceed taxes in some years if taxes exceed benefits in other years; imbalances in different years may offset each other, with interest.[3]

The overall federal government — Social Security plus the remainder of the government — faces a similar budget constraint. Overall taxes (Social Security taxes plus other taxes) must equal overall non-interest spending (Social Security benefits plus other non-interest spending) in present discounted value. Taxes need not equal non-interest spending each year, but any differences must be offset in other years, with interest. The overall budget constraint is not a legislative rule, but an economic reality imposed by the fact that the government's outside creditors are unwilling to make gifts to it.[4] If Social Security taxes and benefits are equal in present value, as required by earmarking, the government's overall budget constraint implies that taxes and non-interest spending are also equal in present value for the remainder of the government.[5]

To ensure that the present-value equality holds for Social Security, taxes and benefits must be tracked over time. The accounting mechanism that tracks these amounts is called the ''trust fund.'' The use of the trust fund mechanism does not change the total resources available to the overall government. Instead, the trust fund keeps track of which resources belong to Social Security and which belong to the remainder of the government.[6]

The trust fund balance was zero when the Social Security program began in January 1937. Social Security taxes are credited to the trust fund, and benefits and administrative costs are charged against the fund. The trust fund is also credited with interest on its balance. The requirement that the program cannot pay benefits when the trust fund balance falls to zero effectively requires that benefits not exceed taxes in present discounted value.[7]

At any point in time, the Social Security Trust Fund balance measures the accumulated surplus of past Social Security taxes over past Social Security benefits, plus interest. It also measures the amount by which the earmarking rule allows the present value of future Social Security benefits to exceed the present value of future Social Security taxes. The accumulated surplus is effectively lent to the remainder of the government, to later be repaid with interest.[8]

The program's recent operations and the trustees' projections of its future operations under current law provide a concrete example of how this works.[9] Social Security taxes exceed benefits in each year from 1984 through 2009 and 2012 through 2014. The trust fund balance at the end of 2014 is $3.1 trillion, reflecting $1.7 trillion of cumulative surplus taxes from 1984 through 2014 (net of benefits in excess of taxes paid in 2010 and 2011), plus accumulated interest of $1.4 trillion. From 2015 onward, tax revenue will be insufficient to finance the full benefits that recipients are scheduled to receive under the program's benefit formula. Nevertheless, the program will pay full scheduled benefits from 2015 to 2037, first by drawing on the interest income credited to the trust fund and then by drawing down the fund's balance. During that interval, the program will pay $7.2 trillion of benefits in excess of taxes, reflecting the $3.1 trillion trust fund balance at the end of 2014 plus $4.1 trillion of additional interest income.

The collection of $1.7 trillion of taxes in excess of benefits in 1984 through 2014 will enable the program to pay $7.2 trillion of benefits in excess of taxes from 2015 through 2037. Sometime in 2037, however, the trust fund balance will fall to zero. The program will thereafter be allowed to pay only those benefits that can be financed by contemporaneous tax revenue, initially about 79 percent of scheduled benefits.

[3]*See* Viard, *supra* note 1, at 906-907.

[4]*Id*. at 895.

[5]*Id*. at 907.

[6]*Id*. at 907-908. There are actually two trust funds, one for old age and survivor benefits and one for disability benefits. Because the two funds have been allowed to borrow from each other in the past, I follow the common practice of treating them as a single combined fund.

[7]Viard, *supra* note 1, at 906 n.90, which notes that the actual requirement can be more stringent than present-value balance in some circumstances but that those circumstances do not apply to the Social Security program.

[8]As a matter of form, the trust fund holds bonds issued by the general treasury in an amount roughly equal to the fund's balance. Despite heated rhetoric about these bonds, they are of little importance to the accounting mechanism. *See* Viard, *supra* note 1, at 907-908.

[9]The analysis relies on the intermediate assumptions in the August 2010 trustees' report, *available at* http://www.ssa.gov/OACT/TR/2010/tr2010.pdf, and the accompanying single-year tables.

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Because scheduled benefits exceed taxes in present value, the earmarking rule will not allow all future scheduled benefits to be paid. As discussed below, legislative measures are likely to be adopted before 2037 to bring scheduled benefits and taxes into present-value balance, which is referred to as restoring the program's solvency. Those measures would avert the need to cease full payment of scheduled benefits in 2037.

Earmarking and the Budget Process

Earmarking has two important implications for the treatment of Social Security in the budget process. On the one hand, Social Security benefits are limited to the revenue raised by its earmarked taxes, so that any decision to increase benefits requires an increase in the earmarked taxes and any decision to reduce the earmarked taxes requires a benefit cut. National defense, Medicaid, and other general revenue programs face no such constraints. On the other hand, Social Security is viewed as a self-supporting program and therefore enjoys political protection from being cut for general deficit reduction. Because the revenue raised by its earmarked taxes ''belongs'' to Social Security, the program is allowed to spend that revenue (either immediately or, as explained above, later with interest) without having to compete against other programs. Defense, Medicaid, and other general revenue programs do not enjoy this protection; because they have no revenue of ''their own,'' they must compete against other programs in the budgetary process.

The political protection enjoyed by Social Security is illustrated in the fiscal plan recently approved by an 11-member majority of the National Commission on Fiscal Responsibility and Reform, which expressly urged Congress to ''reform Social Security for its own sake and not for deficit reduction.''[10] Numerous commentators have recently attacked proposed changes to Social Security by citing the program's self-supporting status.[11] After President Obama called for action to restore Social Security solvency in his January 25 State of the Union address, his aides assured reporters that the administration did not want Social Security reform to be a ''deficit-cutting exercise.''[12] The reform proposals are intended only to bring taxes and scheduled benefits into present-value equality and thereby avert the need to cease full payment of scheduled benefits in 2037.

In principle, then, earmarked programs face one form of fiscal discipline (inability to spend beyond earmarked revenue), and other programs face a different form of discipline (competition with other programs in the budget process). In practice, however, Congress has freed Social Security from either form of discipline by authorizing implicit or explicit transfers of general revenue to the trust fund, thereby allowing the trust fund to raid the general treasury.

Raids on the General Treasury

Two measures authorizing general revenue transfers were adopted as part of the February 2009 stimulus package, and two other measures were adopted in 2010. As detailed below, both of the stimulus package measures involved implicit general revenue financing, while the two measures adopted in 2010 involved explicit general revenue financing.

The stimulus package provided one-time $250 ''economic recovery payments'' in 2009 to individuals who were eligible to receive benefits from Social Security, Railroad Retirement, Supplemental Security Income, or specified veterans' programs for any month from November 2008 to January 2009. An individual eligible for more than one program could receive only one $250 payment.[13] The payments had an estimated cost of $13 billion, largely attributable to the payments to Social Security recipients.

For recipients drawing only Social Security, the payments clearly constituted a one-time increase in Social Security benefits. (For recipients drawing benefits from one or more of the other programs as well as Social Security, there is some ambiguity about which program provided the payment.) Yet, the legislation treated the payments as being outside the Social Security program and therefore suitable for general revenue financing. Because this arrangement provided benefits to Social Security recipients beyond what can be financed from earmarked taxes, it was an implicit transfer of general revenue to Social Security.

The amount of money involved in the one-time payments was significant, but not huge. The other

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[10]National Commission on Fiscal Responsibility and Reform, ''The Moment of Truth,'' 16 (Dec. 2010), *Doc 2010-25486, 2010 TNT 231-35*.

[11]*See* discussion by Charles Blahous, ''Dispelling the Myth of 'Targeting Social Security,''' Economic Policy for the 21st Century Commentary Series (Dec. 22, 2010), *available at* http://economics21.org/files/pdfs/commentary/12_22_2010_Myth.pdf. Blahous noted that existing proposals do not actually cut Social Security by more than is required to restore equality between its earmarked taxes and its scheduled benefits.

[12]Mike Allen, ''Obama Speech Aims to Smoke Out Republicans,'' *Politico*, Jan. 26, 2011, *available at* http://www.politico.com/playbook/0111/playbook1310.html.

[13]The American Recovery and Reinvestment Act of 2009, P.L. 111-5, section 2201.

implicit general revenue transfer in the stimulus package was far larger. The stimulus law enacted section 36A, which provided a fully refundable income tax credit called the Making Work Pay credit in 2009 and 2010. The credit equaled 6.2 percent of earned income, as defined in section 32(c)(2), with a maximum of $400 for unmarried taxpayers and $800 for married couples. The credit was phased out, starting at modified adjusted gross income of $75,000 for unmarried taxpayers and $150,000 for married couples. The credit's budgetary cost over its two-year life was estimated at $116 billion, consisting of a $79 billion revenue reduction and $37 billion in outlays (reflecting credits paid to households with no income tax liability and payments to residents of the overseas possessions).[14]

Obama proposed the credit as a permanent measure (with somewhat larger benefits) during his 2008 campaign. In his May 2009 budget plan, he called for permanent extension of the credit. In his February 2010 budget plan, however, he proposed only a one-year extension, through the end of 2011. Congress ultimately did not extend the credit, and it expired at the end of 2010.

Because the credit was ostensibly part of the individual income tax, it, like the economic recovery payments, was viewed as being outside the Social Security system and therefore suitable for general revenue financing. Yet, the credit was intended as an offset to the Social Security employee payroll tax, which has the same 6.2 percent rate as the credit. Treasury, in its explanation of the administration's May 2009 proposal to make the credit permanent, said that it ''offsets the regressivity of the payroll tax.''[15] Certainly, for those workers with payroll tax liability but with no income tax liability, the credit looked much more like payroll tax relief than income tax relief. To be sure, the credit did not constitute payroll tax relief for the small number of workers whose wages are exempt from Social Security taxes, primarily civilian federal government employees hired before 1984 and some state and local government employees.

In line with the Obama administration's description of the credit, many commentators and media reports described it as payroll tax relief. *The New York Times* referred to the credit as a ''new payroll tax credit for low- and middle-income families,''[16] *Politico* referred to it as ''the president's payroll tax relief,''[17] and Bloomberg.com referred to it as ''a payroll tax cut.''[18] *Congressional Quarterly* referred to the credit as a ''payroll tax credit,''[19] a ''payroll tax credit for individuals and couples,''[20] and a ''credit to offset payroll taxes'' and ''credit for Social Security taxes.''[21] *The Wall Street Journal* referred to the credit as a ''payroll tax holiday,''[22] a ''personal payroll tax credit'' a ''payroll-tax holiday for workers,''[23] and a ''payroll-tax cut for workers.''[24] Paul Krugman, the 2008 Nobel economics laureate, referred to the credit as a ''payroll tax cut.''[25]

Because the credit was largely viewed as relief from Social Security taxes, a large portion, although not all, of its cost should have been charged to the trust fund. Because the credit reduced the perceived cost of Social Security without reducing the resources available to pay benefits, it constituted an implicit transfer of general revenue to the trust fund.

The two provisions adopted in 2010 involved explicit transfers of general revenue. The jobs bill adopted in March 2010 enacted section 3111(d), under which employers who hired qualified individuals were exempted from the 6.2 percent employer Social Security tax on wages paid to those individuals from March 19 to December 31, 2010. Among other requirements, qualified individuals had to begin employment after February 3, 2010, and before January 1, 2011, and had to certify that

[14]Joint Committee on Taxation, ''Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the 'American Recovery and Reinvestment Tax Act of 2009,''' JCX-19-09 (Feb. 12, 2009), *Doc 2009-3215*, *2009 TNT 28-17*.

[15]Treasury, ''General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals,'' 1 (May 2009), *Doc 2009-10664, 2009 TNT 89-44*.

[16]Jackie Calmes, ''Obama, Breaking from a 'Troubled Past,' Seeks a Budget to Reshape U.S. Priorities,'' *The New York Times*, Feb. 27, 2009.

[17]David Rogers, ''Conrad Carves Up Obama's Budget,'' *Politico*, Mar. 25, 2009.

[18]Matthew Benjamin and Julianna Goldman, ''Obama's Economic Stimulus Bill Most Ambitious Since Roosevelt,'' Bloomberg.com, Feb. 17, 2009.

[19]David Clarke and Joseph J. Schatz, ''The Devil's in the Stimulus Plan Details,'' *Congressional Quarterly Weekly Report*, Jan. 12, 2009, at 77.

[20]Schatz and Richard Rubin, ''House Democrats Pass Stimulus,'' *Congressional Quarterly Weekly Report*, Feb. 2, 2009, at 254.

[21]Schatz and Clarke, ''Congress Clears Stimulus Package,'' *Congressional Quarterly Weekly Report*, Feb. 16, 2009, at 352.

[22]Greg Hitt and Elizabeth Williamson, ''Stimulus Bill Near $900 Billion,'' *The Wall Street Journal*, Jan. 28, 2009.

[23]Hitt and Jonathan Weisman, ''Congress Strikes $789 Billion Stimulus Deal,'' *The Wall Street Journal*, Feb. 12, 2009.

[24]Sudeep Reddy, ''Economy to Receive Less Support in Short Term,'' *The Wall Street Journal*, Feb. 12, 2009.

[25]Paul Krugman, ''Ideas for Obama,'' *The New York Times*, Jan. 12, 2009.

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they had been employed for no more than 40 hours during the 60 days before beginning employment.[26] The tax exemption had an estimated $8 billion revenue loss.[27]

Because the employer payroll tax exemption directly affected Social Security, the impact on the trust fund could be offset only through an explicit general revenue transfer. Congress chose exactly that path, appropriating to the trust funds ''amounts equal to the reduction in revenues to the Treasury by reason of'' the tax exemption and providing that those amounts ''shall be transferred from the general fund at such times and in such manner as to replicate to the extent possible'' the money the trust fund would otherwise have received.[28]

The three measures discussed above have run their course. The one-time benefit payments occurred in 2009, and the Making Work Pay credit and the employer payroll tax exemption expired at the end of 2010. Just when one might have thought that the trust fund was about to become self-sustaining, however, a fourth general revenue transfer, almost as large as the Marking Work Pay credit, was adopted as part of a sweeping bipartisan compromise.

The December 2010 tax reduction law lowers the employee payroll tax rate from 6.2 percent to 4.2 percent and the self-employment tax rate from 12.4 percent to 10.4 percent, during 2011.[29] Like the employer payroll tax exemption, this tax reduction directly affects Social Security's earmarked tax revenue. Using language identical to that in the March 2010 law, Congress provided for an explicit general revenue transfer to the trust fund.[30] The one-year tax reduction, viewed by some as a replacement for the Making Work Pay credit, has an estimated revenue loss of $111.7 billion.[31]

Any or all of these four benefit payments and tax reductions may have been desirable. But the integrity of earmarking required that they be financed within the Social Security system rather than from general revenue.

Unfortunately, general revenue financing for Social Security is not a new practice.[32] For example, the current treatment of the interaction of the income tax system with Social Security provides implicit general revenue financing to the trust fund.

First, consider the income tax treatment of Social Security benefits. When Congress enacted what is now section 86(a)(1) in 1983, taxing up to 50 percent of Social Security benefits for recipients above specified income thresholds, it earmarked the resulting revenue to the Social Security Trust Fund. When Congress enacted section 86(a)(2) in 1993, taxing up to an additional 35 percent of benefits for some of those recipients, it earmarked the additional revenue to the Medicare Part A trust fund. In 2009 the Social Security fund received $22 billion of income taxes collected on Social Security benefits, and the Medicare fund received $12 billion.[33] Taken alone, the earmarking to Medicare Part A is a loss to the trust fund.

The picture changes, however, when we consider the income tax treatment of Social Security taxes. Because individual income tax is imposed on employee compensation net of employer payroll tax payments, employer payroll taxes — half of all payroll taxes — are effectively deducted from individual income tax. Section 164(f) also allows half of self-employment taxes to be deducted. A rough estimate suggests that the deductions for employer payroll taxes and half of self-employment taxes reduced income tax revenue by at least $67 billion in 2009.[34] That revenue loss is borne by the general treasury.

Relative to a benchmark in which the trust fund receives all revenue from taxation of benefits and bears the loss from the deductibility of Social Security taxes, therefore, Social Security receives a net $55 billion subsidy from the remainder of the government. The $67 billion subsidy from the treatment of Social Security taxes outweighs the $12 billion loss from the treatment of Social Security benefits.

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[26]The Hiring Incentives to Restore Employment (HIRE) Act, P.L. 111-147, section 101(a).

[27]JCT, ''Estimated Revenue Effects of the Revenue Provisions Contained in an Amendment to the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 2847, the 'Hiring Incentives to Restore Employment Act' Scheduled for Consideration by the House of Representatives on March 4, 2010,'' JCX-6-10 (Mar. 4, 2010), *Doc 2010-4676*, *2010 TNT 43-15*.

[28]HIRE Act, section 101(c).

[29]The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, section 601(a).

[30]Tax Relief Act, section 601(e)(1).

[31]JCT, ''Estimated Budget Effects of the 'Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,'Scheduled for Consideration by the United States Senate,'' JCX-54-10 (Dec. 10, 2010), *Doc 2010-26482*, *2010 TNT 238-73*.

[32]In this discussion, I draw on another of my articles, ''Social Security: We Need a Solution, Not a Shell Game,'' *Tax Notes*, Mar. 17, 2008, p. 1252, *Doc 2008-5271*, or *2008 TNT 53-42*.

[33]Social Security report, Table III.A.3, p. 29; Medicare Trustees report, Table III.B.1, p. 58, *available at* https://www.cms.gov/ReportsTrustFunds/downloads/tr2010.pdf.

[34]The trust fund received $667 billion of payroll and self-employment taxes in 2009. The estimate in the text assumes that half of these taxes were deducted at an average marginal income tax rate of 20 percent, which is probably lower than the actual average marginal tax rate.

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Other provisions have authorized past or present transfers of general revenue to the trust fund, typically in small amounts. 42 U.S.C. section 428(g) provides explicit general revenue financing for special benefits paid to some individuals who reach age 72 without qualifying for regular benefits. 42 U.S.C. section 431 provides explicit general revenue financing for special benefits paid to Japanese-Americans who were interned during World War II because of their ancestry. 42 U.S.C. section 429(b) provided explicit general revenue financing for special benefits based on non-contributory military wage credits. Section 45B provides implicit general revenue financing by granting an income tax credit for some employer payroll taxes on tip income.

Two laws adopted in 2002 provided for explicit general revenue transfers to offset any incidental loss to the trust fund from the tax changes adopted in the laws.[35] Also, in 1998 the trust fund was allowed to retain excess interest paid by the general treasury because of an error in applying the statutory interest formula.[36] In contrast, when it was discovered in 2006 that the trust fund had made overpayments to the general treasury (relating to voluntary income tax withholding on Social Security benefits) from 1999 to 2005, the House and Senate unanimously enacted legislation to restore the loss to the trust fund.[37]

The trust fund received implicit, but undisguised, general revenue financing in 1984 through 1989 in the form of income tax credits to offset Social Security tax increases. An income tax credit equal to 0.3 percent of taxable wages was granted in 1984 to offset an increase in the employee payroll tax rate. Income tax credits equal to 2.7 percent of taxable self-employment earnings in 1984, 2.3 percent in 1985, and 2 percent in 1986 through 1989 were granted to offset increases in the self-employment tax rate.[38] For administrative purposes, payroll and self-employment taxes were simply collected at the net-of-credit rates.

[35]Victims of Terrorism Tax Relief Act of 2001, P.L. 107-134, section 301(b); Job Creation and Worker Assistance Act of 2002, P.L. 107-147, section 501(b).

[36]Daniel Tyson, ''Social Security Safe From Treasury Multibillion-Dollar Miscalculation,'' *Tax Notes*, Dec. 28, 1998, p. 1594, *Doc 98-37944*, *98 TNT 245-3*.

[37]The Social Security Trust Funds Restoration Act of 2006, P.L. 109-465 (enacted Dec. 22, 2006). As the Congressional Budget Office explained in its cost estimate, Treasury had already reimbursed the 2002-2005 overpayments, but new legislation was required to reimburse the 1999-2001 overpayments. CBO, ''S. 4091, Social Security Trust Funds Restoration Act of 2006'' (Jan. 4, 2007), *Doc 2007-423, 2007 TNT 4-35*.

[38]The Social Security Amendments of 1983, P.L. 98-21, sections 123(b) and 124(b).

Arguably, part of the costs of the earned income tax credit should also be charged to the trust fund because the credit is often advertised, although not to the same extent as the Making Work Pay credit, as a way to offset the payroll tax burden. Even setting that question aside, however, general revenue financing of Social Security has clearly been a common practice.

The Nonexistent Raid on Social Security

Social Security's past and present raids on the general treasury have largely escaped public attention. Instead, political debate is filled with mistaken accusations that the general treasury has raided Social Security and that politicians have used Social Security to fund other programs. These accusations are often accompanied by complaints that members of Congress do not pay Social Security taxes, even though they have actually paid them since January 1984.[39]

The accusations are based on the fact, discussed above, that Social Security is collecting $1.7 trillion more in taxes than it is paying in benefits from 1984 to 2014. This money is said to have been looted from the trust fund. As discussed above, however, current law provides that the trust fund will be fully repaid, with $5.5 trillion interest. The repayment will enable the program to pay $7.2 trillion of benefit payments, in excess of taxes, from 2015 to 2037. Although the surplus taxes are not being used to pay Social Security benefits when they are collected, they will be used (with interest) to pay future Social Security benefits and have therefore not been diverted from Social Security.[40]

That the surplus taxes have not been looted from Social Security must be distinguished from the completely separate question of whether the surplus taxes have been saved. As discussed below, it is quite possible that some of the taxes have not been saved. But none of them has been looted.

Whether the surplus taxes have been saved depends on how they have affected Congress's fiscal decisions. To the extent that the availability of the surplus taxes has prompted Congress to cut taxes or increase spending (relative to what would otherwise have occurred) elsewhere in the budget, the

[39]Because of changes made by section 101(b)(1) of the Social Security Amendments of 1983, 97 Stat. 69, there is no Social Security tax exemption for federal employees hired in or after 1984. Although section 3121(b)(5) generally exempts civilian federal employees hired before 1984, section 3121(b)(5)(F) denies even this exemption to members of Congress.

[40]People complaining about the alleged raid on Social Security sometimes assert that the general treasury will not repay the trust fund. As my article, *supra* note 1, at 916-917 explains, the legislation required to cancel repayment would never be approved by Congress.

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surplus taxes have not been saved. To the extent that Congress has *not* done this, the surplus taxes have reduced the overall budget deficit, thereby lowering the federal government's debt to its outside creditors, and have been saved.

We do not know whether the surplus taxes have been saved because we cannot observe what would have happened without those taxes.[41] Statistical evidence on this question is mixed. Three early statistical studies concluded that little, or none, of the surplus taxes were saved,[42] but a more recent study argues that the earlier studies were flawed and finds results consistent with all of the surplus taxes having been saved.[43] Intuitively, it seems plausible that part, but not all, of the surplus taxes have been saved, but intuition can hardly be conclusive. Although observers point to various factors to argue that the taxes have, or have not, been saved, none of the factors actually resolves the issue.[44]

For present purposes, however, the saving question can be set aside. Regardless of whether the surplus taxes were saved, there has been no transfer of wealth from Social Security to the remainder of the government, because the trust fund will be repaid with interest. If Smith lends to Jones and is repaid with interest, she suffers no "raid" on her wealth, regardless of whether Jones consumes or saves. If Jones consumes the borrowed money, it simply means that he will have to make future sacrifices to repay the loan to Smith.

One common question should be addressed. Suppose, hypothetically, that the surplus taxes have triggered fully offsetting tax cuts and spending increases, so that none of them has been saved. How can those taxes finance $7.2 trillion of additional Social Security benefits from 2015 to 2037 when they also finance $1.7 trillion of tax cuts and spending increases elsewhere in the budget from 1984 to 2014? After all, each dollar can be spent only once. Closer examination dispels the mystery. If the surplus taxes prompt the remainder of the government to adopt tax cuts and spending increases today that it would not otherwise have adopted, the remainder of the government must raise taxes or cut spending in the future (beyond what it would otherwise have to do) to repay the trust fund. The surplus taxes collected by Social Security today *plus* the future fiscal sacrifices in the remainder of the budget are *together* sufficient to finance both the fiscal largesse in the remainder of the budget today and the future Social Security benefits.[45]

Public and political concern about the possible failure to save all the surplus Social Security taxes is warranted. But this should not be transmuted into concern about a nonexistent raid by the general treasury on Social Security when the actual raid has gone in the opposite direction.

Budgetary Implications

General revenue financing of Social Security is politically attractive because it averts benefit reductions and payroll and self-employment tax increases. The costs of general revenue financing are less visible, but equally real. To begin, note that using general revenue to finance Social Security does not increase the federal government's overall budgetary resources. Because the budget constraint requires that taxes equal non-interest spending in present discounted value for the overall government, general revenue financing triggers tax increases or spending cuts elsewhere in the budget. While Social Security tax increases and benefit cuts are averted, other taxes, such as individual and corporate income taxes, must be raised and other programs, such as national defense, Medicare, Medicaid, anti-poverty programs, and government operations, must be cut.

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[41]Viard, *supra* note 1, at 899. *See also* Harvey S. Rosen and Ted Gayer, *Public Finance* 240-241 (9th ed. 2010); and Jonathan Gruber, *Public Finance and Public Policy* 376-377 (3d ed. 2011).

[42]Kent Smetters, "Is the Social Security Trust Fund a Store of Value?" 94 *Am. Economic Rev. Papers & Proc.* 176 (2004); Barry Bosworth and Gary Burtless, "Pension Reform and Saving," 57 *Nat'l Tax J.* 703 (2004); Sita Nataraj and John B. Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds?" National Bureau of Economic Research Working Paper 10953 (Dec. 2004).

[43]Thomas Hungerford, "The Social Security Surplus and Public Saving," 37 *Pub. Fin. Rev.* 94 (2009).

[44]As I observe, *supra* note 1, at 902-903, that Congress has a fiscal goal for the overall (unified) budget deficit does not necessarily mean that the surplus Social Security taxes are not saved, because without the surplus taxes Congress might have set a less ambitious goal or been less successful in meeting it. As noted by me, *supra* note 1, at 903-905, that the overall budget is in deficit does not necessarily mean that the surplus Social Security taxes are not being saved, because the deficit might be higher if the surplus taxes did not exist. Conversely, that the overall budget was in surplus during fiscal 1998 through 2001 does not necessarily mean that the surplus Social Security taxes were saved in those years, because the same overall surpluses might have been achieved if those taxes had not existed. Viard, *supra* note 1, at 917-919, explains that having the trust fund hold stocks or other outside assets would not guarantee that the surplus taxes would be saved; the saving impact would still depend on whether the existence of the surplus taxes prompted Congress to increase spending or cut taxes elsewhere in the budget.

[45]Of course, if the surplus taxes have been saved and used to reduce the government's debt to its outside creditors, the remainder of the government need not raise future taxes or cut future spending to repay the trust fund. Instead, it can make the repayment with the money that it would otherwise have paid to outside creditors.

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We do not know the precise consequences of the general revenue transfers, because we cannot observe the tax and spending decisions Congress would have made without the transfers. If general revenue financing of Social Security causes the curtailment of wasteful defense and non-defense programs and unwarranted tax preferences, most Americans would cheer. I, for one, would be pleased if it causes farm subsidies, Medicare, or the mortgage interest deduction to be restricted. But I would be concerned if it triggers cutbacks in essential defense projects or vital anti-poverty programs or results in heavier taxation of saving and investment.[46]

In any case, the federal government confronts a severe long-run fiscal imbalance, which will ultimately require Congress both to restrain entitlement growth, relative to current law, and to raise revenue, as a share of GDP, above historic levels.[47] Given the grim fiscal outlook facing the entire government, it is unrealistic to think that revenue can be painlessly drained from the general treasury to finance Social Security.

Whatever judgments we may make about the merits of these budgetary shifts, it is important that budgetary decisions be made in a transparent manner. This cannot be done if Social Security is spared from political scrutiny on the grounds that it is self-supporting while also being allowed to spend beyond its earmarked resources.

In essence, general revenue financing offers the illusion that we can painlessly avoid Social Security benefit cuts or tax increases. It is not the first illusion to play this role. Some observers claim that the Social Security trustees' intermediate projections have consistently been too pessimistic, a claim unsupported by the historical record.[48] They promote unfounded optimism as the solution, overlooking the recent consequences of that optimism for housing and financial markets and the economy. Other observers claim that Social Security privatization offers a free lunch that will allow benefit cuts and tax increases to be averted, a fantasy that is easily refuted by straightforward economic analysis.[49] Interestingly, some versions of the free-lunch privatization myth specifically rely on general revenue financing.

The Way Forward

Transparency in the budgetary process requires that the reality and appearance of Social Security financing be brought into alignment with each other. As always in these situations, we can do this either by changing the appearance to conform to the reality or by changing the reality to conform to the appearance.

If desired, we can abandon the appearance of earmarking and turn Social Security into just another general revenue program. The program's spending would no longer be limited to the revenue from particular taxes, but it would have to compete with other programs for budgetary resources. Alternatively, we can maintain Social Security as an earmarked program but make the earmarking real by ending general revenue transfers to the trust fund.

Many Social Security advocates are vehemently opposed to making Social Security a general revenue program. Indeed, some of them fear that the 2011 payroll tax cut may result in Social Security being viewed as a general revenue program, particularly if the tax cut is extended. Dean Baker of the Center for Economic Policy and Research warns that general revenue financing of Social Security ''opens a new line of attack on the program'' by weakening the link between workers' taxes and their benefits.[50] Other organizations and policymakers, including the National Committee to Preserve Medicare and Social Security, Social Security Works, Sen. Bernard Sanders, I-Vt., and House Ways and Means Committee member Jim McDermott, D-Wash., have raised similar objections.[51] On

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[46]As I noted in Viard, *supra* note 32, general revenue financing is likely, on balance, to reduce national saving. Social Security benefits have the potential to substitute for private saving in a way that other programs, which are likely to be cut in their place, do not. And payroll taxes generally exempt the return to saving, unlike the corporate and individual income taxes, which are likely to be raised in their place.

[47]For further discussion, see Alan D. Viard, ''Four Long-Term Fiscal Realities,'' 44 *Bus. Econ.* 143 (2009).

[48]For a careful review, see Charles Blahous and Robert Greenstein, ''Social Security Shortfall Warrants Action Soon,'' Pew Foundation Fiscal Analysis Initiative report (Nov. 2010), *available at* http://www.pewtrusts.org/uploadedFiles/www.pewtrusts.org/Reports/Economic_Mobility/PEW-Social-security-paper.pdf.

[49]For the basic analysis, see Jason L. Saving and Alan D. Viard, ''Social Security and Medicare: No Free Lunch,'' Federal Reserve Bank of Dallas, *Southwest Economy* (Jan./Feb. 2005), *available at* http://dallasfed.org/research/swe/2005/swe0501b.pdf.

[50]Dean Baker, ''Social Security Tax Cut: A Deal Breaker,'' *The Hill*, Dec. 9, 2010, *available at* http://thehill.com/blogs/congress-blog/economy-a-budget/132919-social-security-tax-cut-a-deal-breaker.

[51]Nicola M. White, ''Payroll Tax Holiday Plan Draws Criticism From Left,'' *Tax Notes*, Dec. 20, 2010, p. 1304, *Doc 2010-26477*, *2010 TNT 238-5*; Michael M. Gleeson, ''Dems: Tax Cut Package Will Kill Social Security,'' *The Hill*, Dec. 18, 2010, *available at* http://thehill.com/homenews/house/134339-dems-tax-cut-package-will-kill-social-security; Stephen Ohlemacher, ''Payroll Tax Cut Worries Social Security Advocates,'' Associated Press, Dec. 12, 2010, *available at* http://abcnews.go.com/Business/wireStory?id=12375374; *Congressional Quarterly* staff,

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the other hand, *Washington Post* columnist Ezra Klein downplays these concerns.[52]

Although I start from a different perspective than these observers, I agree that earmarking should be preserved because it helps maintain the current-law linkage between each worker's individual taxes and her individual benefits. Under 42 U.S.C. section 415, each worker's primary insurance amount, which controls her monthly benefit, depends on the average monthly earnings on which the worker has paid Social Security taxes. To be sure, the connection between benefits and taxes is not extremely close. For one thing, taxes rise proportionately with taxable earnings while benefits rise less than proportionately. If Smith earns twice the wages and pays twice the taxes of Jones, Smith receives a higher monthly benefit than Jones, but less than twice as high. Also, the formula includes other subtleties, such as spousal benefits, the adjustment of each year's earnings to reflect growth in national average earnings, and the dropping of each worker's lowest-earnings years.

Nevertheless, the formula creates a contributory program in which each worker's benefits have some link to taxes paid. The benefit formula would probably be dramatically restructured if the program were no longer financed by earmarked taxes. Any such change would have disruptive effects on current retirees and workers and would upend public perceptions of the program. Ending the link between taxes and benefits might also increase work disincentives.

The best approach, therefore, is to continue to finance Social Security with earmarked taxes but to restore the integrity of earmarking by ending general revenue transfers. Given that the primary purpose is to improve future budget decisions, it is probably unnecessary to take the drastic step of undoing the past transfers to Social Security. Still, it would be desirable to charge the costs of the 2011 payroll tax reduction to the trust fund. In the future, there should be no more explicit transfers of general revenue to the trust fund, and any measures that are perceived as raising Social Security benefits or lowering Social Security taxes should be charged to the trust fund.

The most important step is an ongoing change in accounting for the interaction between Social Security and the income tax system. On the one hand, the trust fund should be allowed to keep all of the income tax revenue from the income taxation of benefits and should no longer have to share that revenue with the Medicare Part A trust fund. On the other hand, the trust fund should be charged for the much larger revenue loss from the income tax deductibility of employer payroll taxes and self-employment taxes.

Unfortunately, President Obama's fiscal 2012 budget plan proposes another round of $250 one-time payments to Social Security and other program recipients in 2011, financed by general revenue. If those payments are made, the trust fund should be charged for the costs related to Social Security.

My proposed reforms will accelerate, relative to the currently projected 2037 date, when the trust fund balance reaches zero. With Social Security no longer propped up by general revenue, the hard choices on how to reform the program will have to be made and implemented earlier. Many options will be on the table, such as cutting benefits in various ways, raising tax rates, and increasing or eliminating the ceiling on taxable earnings. The debate about these options will be intense. We cannot predict the final outcome, which will reflect the value judgments made by the American people and their elected representatives. But by eliminating general revenue financing, we can ensure that the decisions are made in an open and transparent manner, without draining resources from the remainder of the government.

"Tax Deal Affects Social Security," Dec. 15, 2010, *available at* http://www.congress.org/news/2010/12/15/tax_deal_affects_social_security.

[52]Ezra Klein, "The Payroll Tax Cut and Social Security," *The Washington Post*, Dec. 10, 2010.

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