



## Press Statement

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## Mr. President, This is How the 21st Century Economy Works

Washington, DC – The following is the text of a statement from economist Dean Baker, co-director of the Center for Economic and Policy Research (CEPR).

“On Tuesday, April 5, 2005, President George W. Bush visited the Bureau of Public Debt, which stores the \$1.8 trillion in government bonds currently held by the Social Security trust fund. The apparent purpose of this visit was to raise doubts about the reality of the Social Security trust fund. In a speech delivered in West Virginia just after his visit, President Bush flatly stated, ‘There is no trust fund, just IOUs that I saw firsthand.’

“That is an amazing, and probably unprecedented, statement. It is unlikely that any prior U.S. president ever called the integrity of government bonds into question. The United States has never defaulted on its obligations, which are backed by the ‘full faith and credit’ of the government. Investors and economists routinely cite U.S. bonds as one of the safest possible investments.

“President Bush could not honestly have expected to find vast stores of gold or silver

hoarded in the trust fund. As the President surely knows, our economy is no longer based on physical stores of wealth. Almost every modern claim to wealth, such as stock investments or bank accounts, is represented by bookkeeping entries on sheets of paper or digital files.

“What may be more alarming, however, is if the President is hinting that Congress should consider defaulting on the bonds held by Social Security. Under the law, the general fund is obligated to repay Social Security; Congress would have to vote to default on the bonds to change that.

“The bottom line: A default on the Social Security bonds in 2018 would transfer over \$1 trillion from the bottom 80 percent of households to the richest 5 percent. The payroll tax funding Social Security falls largely on low- and middle-income workers, since it exempts investment income and all wages above \$90,000 a year. This regressive tax is justified by Social Security’s progressive benefits, which are weighted toward lower-income retirees. On the other hand, the general fund that is legally required to repay Social Security’s bonds is funded through income taxes that fall largely on wealthy Americans. In the event of a default, either workers would have their benefits cut or the regressive payroll tax would need to replace revenue that would otherwise have been provided by the trust fund bonds.

“If the President is serious about proposing default as a policy option, then he should be explicit that this is his intention. Otherwise, he should stop scaring people by questioning the integrity of the trust fund.”

For more information on the implications of a default, see CEPR’s paper, “[Defaulting on the Social Security Trust Fund Bonds: What It Would Mean and How It Would Be Done.](#)”

*The Center for Economic and Policy Research is an independent, nonpartisan think tank that was established to promote democratic debate on the most important economic and social issues that affect people's lives.*

# **Defaulting on the Social Security Trust Fund: What It Would Mean, and How It Would Be Done**

**By Dean Baker<sup>1</sup>**

**March 9, 2005**

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<sup>1</sup> Dean Baker is the co-director of the Center for Economic and Policy Research. Marcellus Andrews, Debayani Kar, Patrick McElwee, David Rosnick, Diane Schwartz, and Mark Weisbrot gave helpful comments on earlier drafts of this paper. Megan Quirk assisted with the research.

## Executive Summary

Many politicians and commentators raise 2018 as the year when Social Security will first face budgetary problems. In fact, under current law, this date holds no particular importance for the program. While the Social Security trustees project that annual benefit payments will exceed annual tax revenue in that year, the program is projected to hold more than \$3.6 trillion (in 2005 dollars) in government bonds, which can be used to cover this shortfall for the next 24 years.

Since the trustees' projections show the program to be fully solvent until 2042, under the assumption the bonds will be honored, those who hold up the year 2018 as a crisis point for Social Security are either explicitly or implicitly advocating that the government default on the bonds held by the trust fund. This paper examines the implications of this proposal.

It notes that:

- 1) A default on the bonds held by the trust fund would result in a large upward redistribution of wealth – from the low and middle-income earners who pay the bulk of Social Security taxes, to high income earners who pay the bulk of the individual and corporate income taxes. A default in 2018 would redistribute \$1.1 trillion (in 2005 dollars) from the bottom 80 percent of households to the richest 5 percent, with \$840 billion going to the richest 1 percent. The average loss to a household in the bottom 80 percent would be more than \$10,000, while the average gain to a household in the top 1 percent would be more than \$800,000.
- 2) While it is legally possible to default on the bonds held by the trust fund without defaulting on all U.S. government bonds, such a default is still likely to have substantial political economic consequences. Specifically, such a default may seriously undermine the government's legitimacy in the eyes of many citizens. This in turn can lead to far lower levels of compliance with the tax code and many other rules and regulations.
- 3) Insofar as the loss of the annual Social Security surplus of tax revenues over benefit payments poses a problem for the federal budget, this is an issue having to do with overall government tax and spending policy. Social Security is the lender, not the borrower; if the reduction in its lending creates problems, then the implication is that we are spending too much and/or taxing too little. This is not a problem for Social Security's finances.
- 4) The year 2018 has no special significance for the federal budget. The amount of budgetary strain depends on the size of the annual reduction in the Social Security surplus (or increase in the deficit), not the absolute level of the surplus or deficit. The peak year for the size of the annual Social Security surplus was 2002. The falloff in the size of this surplus from 2002 to 2003 is larger than the projected

falloff in 2018 or any other year. In other words, the reduction in the size of the Social Security surplus in 2003 put more strain on the U.S. budget than will the projected switch from annual surpluses to deficits in 2018.

Since many politicians and political commentators seem to view a default on the government bonds held by the Social Security trust fund as a serious option, it is important that policy makers gain a fuller understanding of the implications of such a default.

## Introduction

According to the most recent Social Security trustees' report, the Social Security program can pay all promised benefits until 2042, 37 years from now. However, in the debate over the future of Social Security, many politicians and commentators have focused on the year 2018 as the date when the program first faces serious problems. While the trustees project that annual benefit payments will exceed annual tax revenues in 2018, they also project that the Social Security trust fund will hold more than \$3.6 trillion (in 2005 dollars) in government bonds in 2018. Since Social Security is projected to hold enough bonds to cover its shortfall for more than two decades after that year, the program would only be confronted with a financial problem in 2018, if the government defaulted on the bonds held by the trust fund.

Those who raise 2018 as the date when Social Security first faces a funding problem either implicitly or explicitly assume that the government will default on these bonds.<sup>2</sup> While such a default is theoretically possible, it is important to assess the implications of a default, in order to determine its desirability and plausibility. This paper briefly examines some of the issues that would be raised by a default on the bonds held by the trust fund.

## The Trust Fund Under Current Law

Much of the debate on Social Security has focused on the year 2018. This is the date when the Social Security trustees project that Social Security benefit payments will first exceed annual tax income.<sup>3</sup> The focus on 2018 has important implications; specifically it assumes that the government will partially or completely default on the government bonds held by the trust fund.

Under the law, the date 2018 poses no problem for the Social Security program, since the trust fund is projected to have more than \$3.6 trillion (in 2004 dollars) in government bonds at the time (Social Security Trustees Report, 2004, table VI.F8). These bonds are backed by the "full faith and credit of the United States government," just like any other U.S. government bond.<sup>4</sup> The program will be able to use the interest and principal from these bonds to meet annual benefit payments until the trust fund is projected to be depleted in 2042.<sup>5</sup>

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<sup>2</sup> For example, House Speaker Dennis Hastert was recently quoted as saying that Social Security "isn't going to work 12 to 14 years from now," ("Hastert Cautions Bush About Social Security Plan," *Washington Post*, 2-12-05; A5) implying that the program will not be able to rely on its trust fund. Peter Peterson, a former Secretary of Commerce and founder of the Concord Coalition has repeatedly asserted that the trust fund does not exist [see Appendix, page A-3].

<sup>3</sup> The most recent projections from the Congressional Budget Office (CBO) put this date as 2020 (CBO, 2005. Budgetary Perspectives On the Outlook for Social Security," CBO Testimony Before the Committee on the Budget, U.S. House of Representatives, February 9, 2005.)

<sup>4</sup> This description of the securities held by the Social Security trust fund can be found in the Social Security Act, Section 201 [42 U.S.C. 401] (d) [[http://www.ssa.gov/OP\\_Home/ssact/title02/0201.htm](http://www.ssa.gov/OP_Home/ssact/title02/0201.htm)].

<sup>5</sup> The projected date of trust fund depletion is 2052 in the CBO analysis.

As long as there are sufficient assets held by the trust fund, the law requires Social Security to pay full benefits. The law governing Social Security payments in this respect is exactly the same as the law governing the Medicare program, which has been drawing on its bonds since 2004 (Medicare Trustees Report, Table II.B5). The fact that current tax revenue might not be as large as current benefit payments is irrelevant, if the trust funds still hold assets in the form of government bonds.

In fact, the situation facing the program in 2018 is not an accident: it was part of the explicit design of the program. The 1983 Social Security commission, headed by Alan Greenspan, raised the payroll tax in the eighties by much more than was necessary to meet current benefits. The intention was to deliberately build up a large surplus, which could later be used to help defray the costs of supporting the baby boomers' retirement.

Since the law governing Social Security benefit payments is clear, those who focus on the date 2018 as a problem point for Social Security must explicitly or implicitly intend for the government to default on the bonds held by the trust fund.

### **Defaulting on the Trust Fund – Economic Aspects**

While many advocates of defaulting on the trust fund have implied or explicitly claimed that the issue is simply one of shifting money from one pocket to another, this is not true. Under the law, Social Security is financed exclusively through a payroll tax and the money indirectly derived from this tax through interest on the bonds held by the trust fund.<sup>6</sup> The payroll tax is extremely regressive, since it only applies to wages, and it is capped – currently applying to just the first \$90,000 of wages. According to current law, Social Security benefits are paid if, and only if, the trust fund has sufficient funds to pay benefits.

In fact, it only makes sense to speak of a Social Security shortfall – or “crisis” – if one adheres to the current law, under which the tax provides a distinct source of funding for Social Security. If payments for Social Security could come from other revenue sources (or different pockets) then it would be impossible for Social Security to face a shortfall, just as it is impossible for the Defense Department to face a shortfall. Social Security would be simply a program that is projected to cost more in the future, like many other programs. Anyone who refers to a projected Social Security shortfall implicitly recognizes that the program has a distinct source of funding.

The regressive tax structure of the Social Security tax is justified by the fact that the payback structure is very progressive. Workers who earn lower wages receive a much higher percentage of their average earnings back in benefits. As a result, the program is on net progressive.<sup>7</sup>

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<sup>6</sup> It is also credited with a small amount of income tax revenue from taxes paid on Social Security benefits.

<sup>7</sup> Cohen, L., C. Steurele, and A. Carasso. 2003. *Redistribution Under OASD: To Whom and How Much?*, Washington, D.C.: Urban Institute [<http://www.urban.org/url.cfm?ID=1000596>].

It is important to understand the redistributive aspects of a default on the trust fund in this context. The government has already collected the regressive tax. The point of the surpluses currently being run by the system was to effectively prepay for a portion of the costs of the retirement of the baby boom generation. These taxes were to be repaid from general revenue. The vast majority of general revenue is collected from highly progressive personal and corporate income taxes.

If the government defaults on the bonds held by the trust fund, it would effectively mean that Social Security taxes – instead of income taxes – had been used to finance the government during the years when Social Security was running an annual surplus. This is a transfer from the low- and middle-income workers who pay Social Security taxes to the higher income taxpayers who pay the bulk of the personal and corporate income tax. If the default took place in 2018, then it would imply a transfer of \$ 1.1 trillion (all numbers are in 2005 dollars) from the bottom 80 percent of households to the richest 5 percent, with \$840 billion of this money going to the richest 1 percent of households.<sup>8</sup>

On a per household basis, the average cost of this default to a family in the bottom 80 percent of households is \$10,100. The gain to an average household in the top 5 percent is \$226,900. The average gain to household in the top 1 percent is \$814,100. Clearly, this is a substantial upward redistribution of wealth. Defaulting on the trust fund is not simply a question of which pocket the Social Security money is paid from, it is a question of money leaving the pockets of lower and middle-income families and going into the pockets of wealthier taxpayers.

### **Defaulting on the Trust Fund – Political Aspects**

While the bonds held by the Social Security trust fund are honored by the “full faith and credit” of the United States government, it would be legally possible for the government to default on these bonds while still meeting all its obligations to other bondholders. This is presumably the intention of most of those proposing default on the bonds held by the trust fund – they do not want the federal government to default on its debt in general, they only want it to default on its debt to Social Security.

However, the fact that a limited default is legally possible does not mean that it would be politically feasible. By 2018, more than one-third of the voting age population is projected to be age 55 or older, which means that they will either be getting Social Security at the time, or likely to be collecting it in the near future. Since older people are more likely to vote than younger people, the influence of older workers and retirees in elections is likely to be even larger.

If members of Congress at that time argue that the government lacks the money to repay the bonds held by the Social Security trust fund, and that it is not possible roll over these

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<sup>8</sup> Baker, D. 2001. “Defaulting on the Social Security Trust Fund Bonds: Winners and Losers.” Center for Economic and Policy Research [[http://www.cepr.net/Social\\_Security/defaulting\\_ss.htm](http://www.cepr.net/Social_Security/defaulting_ss.htm)].

bonds by borrowing from other sources, nor to raise taxes and/or cut spending enough to meet these obligations, then it is likely that many older workers and retirees will insist that Social Security not be forced to bear the full effects of a default alone. Given the structure of the electorate at the time, it is certainly possible that they would demand that any default be applied across the board, with all of the government's creditors forced to accept less than full repayment on their bonds. While a general default on the federal government's debt would raise many difficult legal and economic issues, the politics of the time may make a default restricted exclusively to the bonds held by Social Security impossible.

As a political matter, it is not clear what argument could be made as to why workers alone, through cuts to their Social Security benefits, should be forced to suffer from the government's failure to pursue responsible fiscal policies. In contrast to private investors, who freely choose to buy government bonds in full recognition of the risk involved, workers were legally required to pay into the Social Security system. It is not clear how politicians would argue that Social Security beneficiaries should be hit by a government default, while other investors are protected.

Such a default could also raise serious questions of legitimacy for the government. For example, tax collection in the United States, like most countries, relies to a large extent on voluntary cooperation. While tax evasion is always a problem, a default on the bonds held by the Social Security trust fund could cause evasion to become more widespread, if many taxpayers viewed this default as unfair. Currently, the United States government enjoys a relatively high degree of voluntary compliance with its tax code compared to some other rich countries and especially compared with countries in the developing world.

There are many other areas in which a loss of governmental legitimacy could reduce the extent to which the public is willing to voluntarily cooperate with various governmental rules and regulations. Voluntary compliance is important in everything from building and vehicle registration to fulfilling contractual obligations for military service. If the government lost legitimacy in the eyes of a large segment of the population, it is possible that the extent of compliance with rules and regulations would decline in many areas. Therefore, it would be wrong to assume that a default on the bonds held by the trust fund had no economic consequences, even if it did not cause investors to change their assessment of the creditworthiness of the United States government.

### **The Trust Fund and the Budget**

In addition to being misled about the meaning of a default on the bonds held by the trust fund, the public has also been misled about the budget arithmetic surrounding the 2018 date. First, it is essential to remember that Social Security is the lender in this story, not the borrower. If a politician or journalist raises the loss of the annual Social Security surplus as a problem, then he/she is referring to the problems with the federal deficit, not problems with Social Security, even if this may not be the intention. If the fact that the

federal government will be able to borrow less from Social Security in the future than it did in the past poses a problem for the overall federal budget, then it may be necessary to re-evaluate tax and spending policies. This does not imply that Social Security has a problem.

Many politicians, commentators, and reporters have spoken of 2018 as the date when the federal government will first feel the budgetary strains of paying Social Security benefits for the baby boom cohort. In fact, this is due to mistaken arithmetic – the federal budget is already feeling the effects of the aging baby boom generation. While this effect will grow larger from this point forward, the year 2018 has no particular significance in this context.

The key point in correctly understanding how the Social Security surplus affects the overall budget is recognizing that the rate of change in the size of the surplus is what determines the extent of the budgetary strain, not the absolute level. In other words, if the Social Security program ran a surplus of taxes over benefits last year of \$50 billion, and it runs a surplus of \$60 billion this year, then it is the difference – the additional \$10 billion – that is in principle available to the government to finance additional spending and/or tax cuts.<sup>9</sup> What matters on a year-to-year basis is the change in the surplus, not the level.

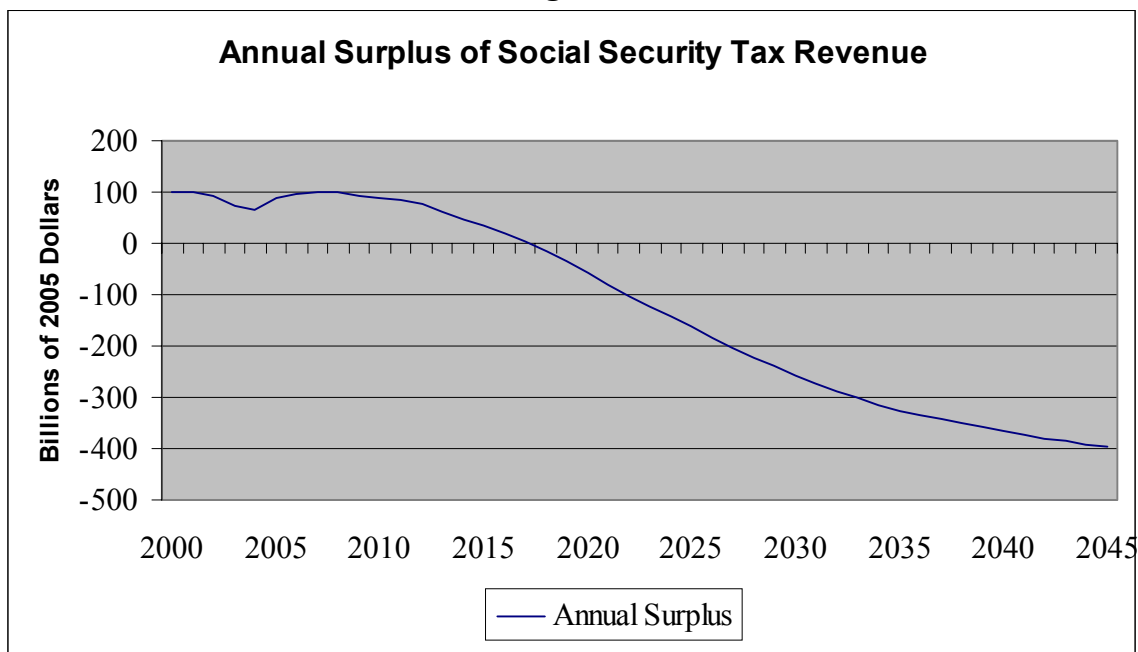
The exact same logic applies on the other side. The strain for the government results from a reduction in the size of the surplus, not its absolute level. This means that the budget will first feel a strain associated with the impact of the baby boomers on Social Security as soon as the annual surplus peaks. In fact, this date has already passed. In 2001, the surplus of Social Security taxes over benefits was \$82.5 billion, or 0.82 percent of GDP. In 2005, the surplus is projected to be just \$71.4 billion or 0.58 percent of GDP. This means that if everything else had been held constant over the last four years, the federal government would have been forced to make up for this \$11.1 billion decline in the surplus either with reduced spending, higher taxes, or increased borrowing from sources other than Social Security.

This is exactly what will happen in most years until the trust fund is projected to be depleted in 2042. Each year the Social Security surplus will be smaller than in the prior year, or the deficit will be larger. The switch from an annual surplus to a deficit in 2018 has no meaning whatsoever for the fiscal position of the U.S. Treasury.

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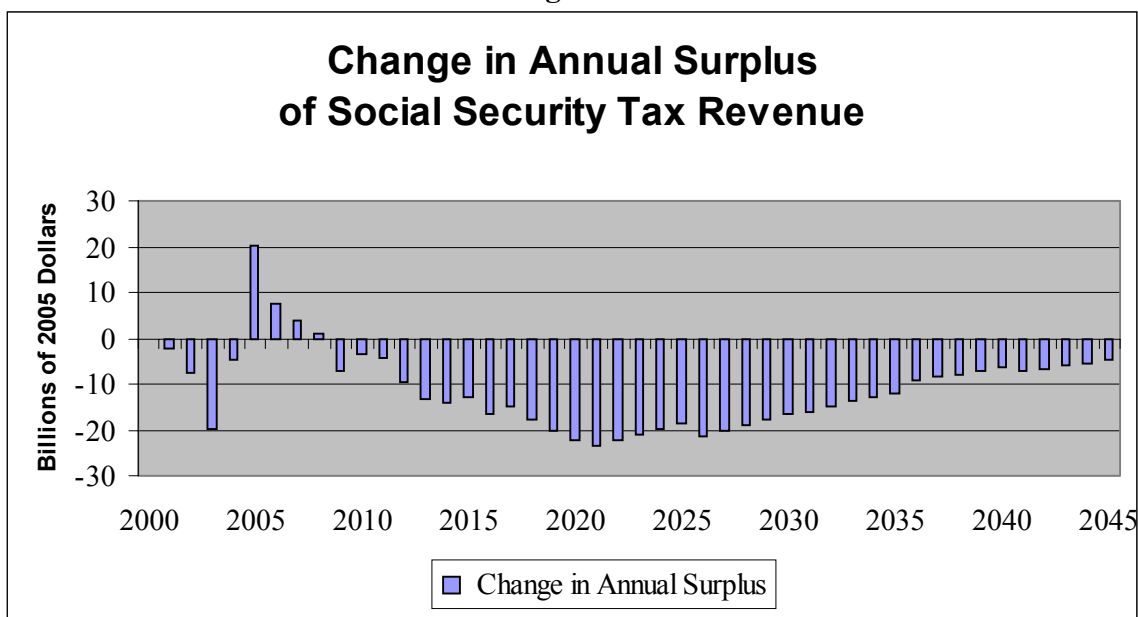
<sup>9</sup> It is important to remember that this only refers to the unified budget, which as an accounting tool treats Social Security revenue and spending just like any revenue and spending. From the standpoint of the “on-budget” budget, borrowing from Social Security is just like borrowing from any other source. From this standpoint, when the trust fund begins to redeem its bonds, if the government borrows to make the payments, it is simply replacing one type of bond (non-marketable bonds held by the trust fund) with another type of bond (publicly traded bonds). This switch does not lead to a net increase in the government debt.

Figure 1



Source: Social Security Trustees' Report and author's calculations.

Figure 2



Source: Social Security Trustees Report and author's calculations.

Figure 1 shows the annual surplus/deficit in the program as projected by the Social Security trustees. Figure 2 shows the change in the annual surplus (or deficit). This is the money that the federal government must make up each year due to the fact that the surplus is getting smaller or the deficit is getting larger. As can be seen, the year 2018 has no special importance in this picture. The projected \$14 billion deficit in 2018 is a shift of approximately \$18 billion from the \$4 billion surplus projected for 2017. This change is smaller than the \$20 billion decline in the annual Social Security surplus experienced in 2003, and far smaller when expressed relative to the size of the economy. (The decline in the surplus in 2003 was equal to 0.18 percent of GDP; the projected decline for 2018 is equal to 0.10 percent of GDP.) In other words, the budgetary pressure imposed by the shift from an annual surplus in 2017 to an annual deficit in 2018 will be less than the pressure that resulted from the decline in the size of this surplus in 2003.

### **Conclusion**

There has been considerable confusion surrounding the key dates for the Social Security program. The people in the debate who have sought to highlight the year 2018, the year when the program is projected to first draw on the interest from the bonds held by the Social Security trust fund, are either explicitly or implicitly suggesting that the government will default on these bonds. If the government does not default on these bonds, then the date has no meaning whatsoever for Social Security and there would be no reason to mention this date in a public debate.

If default on the bonds held by the Social Security trust fund is to be considered as a serious option, then it is important that there be a full discussion of the consequences of such a default. This paper is an effort to begin this discussion.

## Appendix: Explicit or Implicit Proponents of Default

Under the law, Social Security is first projected to face a funding shortfall in 2042 according to the Social Security trustees' projections, or 2052 according to the projections from the Congressional Budget Office. However, many political figures have focused on 2018 as the date when Social Security first will face a problem. This would only be true if the government defaults on the bonds held by the trust fund. The list below includes some of the prominent figures who have explicitly or implicitly raised the prospect that the government will default on these bonds.

### **President George W. Bush:**

"As a matter of fact, in 2018, the system goes into the red. And by the way, there's not a Social Security trust."

"President Discusses Strengthening Social Security in New Hampshire," *U.S. Fed News*, February 16, 2005.

"Some in our country think that Social Security is a trust fund -- in other words, there's a pile of money being accumulated. That's just simply not true. The money -- payroll taxes going into the Social Security are spent. They're spent on benefits and they're spent on government programs. There is no trust. We're on the ultimate pay-as-you-go system -- what goes in comes out. And so, starting in 2018, what's going in -- what's coming out is greater than what's going in. It says we've got a problem."

"The Amazing Disappearing Trust Fund," Dan Fromkin, *WashingtonPost.com*, February 11, 2005.

### **Rep. E. Clay Shaw, Jr. (R-FL),** Member of the House Ways & Means Subcommittee on Social Security:

"The biggest lie that is being told in this whole thing -- and it is a lie -- is that there is plenty of money in the Social Security Trust Fund to carry this thing through to 2050. It's a lie. There is no money in the trust fund."

- "Face to Face: A Conversation With E. Clay Shaw," Interview with Douglas Lyons, *Sun-Sentinel*, February 13, 2005.

### **Rep. Dennis Hastert (R-IL),** Speaker of the House:

"Look, you can't jam change down the American people's throat unless they perceive there really is a problem, that there's something there that isn't going to work 12 or 14 years from now, and it's going to be a catastrophe when we reach that point."

- "Hastert Cautions Bush About Social Security Plan," Mike Allen, *Washington Post*, February 12, 2005, Page A05.

**Senator Rick Santorum (R-PA):**

“A solid majority believe that there is a problem with Social Security that crops up with us, not in 40 years, but in about 13 years. That number will continue to increase as the facts are made known to the American public.”

- Transcript of a Media Stakeout following Senate Republican Policy Luncheon, March 1, 2005.

**Senator John McCain (R-AZ):**

“Well, if you call stopping payments to retirees out of the Social Security system as when we're in a crisis situation, I think that's the -- I mean, that's not accurate in my view.

Most people view 2018 when we stop taking in more money than we are paying out as a crisis point.”

Transcript from "Hannity & Colmes." Fox News. March 2, 2004.

**Senator Johnny Isakson (R-GA):**

“So many people have forgotten the fact that just because 2042 is the year everybody's heard, 2018 is the year. That's 13 years from now. That's when we have a problem. That's when the Treasury starts writing checks to pay the Social Security system back. That's when we compound the deficit of this country. That's when we destroy the future of my grandchildren, if you want to know the truth, unless we do something.”

- Transcript of a Media Stakeout following Senate Republican Policy Luncheon, March 1, 2005.

**Rep. Chris Chocola (R-IN):**

“The problem, [Rep. Chocola] said, is that Social Security will start to show a negative cash flow by 2018, paying out more than it takes in, and that the annual shortfall will reach \$500 billion by 2054.”

- Wensits, James, “Second Ad targets Chocola,” South Bend Tribune, February 15, 2005.

**Allan Hubbard, Assistant to the President for Economic Development:**

“In 13 years, the Social Security system begins paying out more money than it takes in. This presents a choice of raising taxes, borrowing money or cutting spending.”

- Letter to the Editor, *New York Times*, February 24, 2005.

**Karl Rove**, Deputy Chief of Staff to the President of the United States:

"In 2018, we begin spending more than we're taking in on Social Security. Social Security is a pay as you go program. The payments made by current workers support the payments of current retirees. And in 2018, we start going into the red. Each year we begin spending increasingly more than we are taking in.

- "Social Security: Thomas Means a One-way Street" *The Hotline*, February 10, 2005.

**Allan Sloan**, Wall Street Editor, *Newsweek* Magazine:

"You see that Social Security is now taking in more cash than it spends. ... Ok, let's fast-forward to 2018, when Social Security is projected to take in \$23 billion less cash than it spends. By then, the trust fund would have more than \$5 trillion of Treasury IOUs in it. So it would be a piece of cake to cover a crummy \$23 billion, right? Wrong. ... The fund's irrelevant, folks. It's an accounting entry, not real money."

- "Social Security: A Daring Leap," *Newsweek*, February 14, 2005.

**Pete Peterson**, Former Commerce Secretary, Founder of Concord Coalition:

"The Social Security trust fund is what I call a fiscal oxymoron. It shouldn't be trusted and it's not funded. And whether you have one or not you still have to go out and do the same thing three things. You either have to try to borrow the money or you're going to increase taxes or you are going to cut the benefits. We've spent [the money in the trust fund]. We may have told the American people that we were setting it aside in a quote, 'trust fund.' We spent it on other subjects. Shock of all shocks."

- Quoted in "Bush: What's My Deal?" *The Hotline*, January 13, 2005.