DEMYSTIFYING SOCIAL SECURITY FINANCING AND THE GENERAL FUND

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I want to talk to you today about vision – not the kind involving leaders who are far-sighted, but the simple, though often elusive kind of vision that involves seeing clearly what is right in front of you.

When you examine the federal budget as a unified whole, what you see is money flowing into the government and various expenditures flowing out. This perspective is useful for analyzing broad fiscal policy. But seeing only the unified budget hides from view a clear understanding of Social Security and how it relates to the general fund.

When all you see is a collection of expenditures and revenues, many essential features of Social Security appear inexplicable. For example, the deduction on your pay stub labeled "federal income tax" can be used for any purpose Congress wants, limited only by the Constitution. But, the law requires that the deduction labeled "Social Security" or "FICA" be used only for Social Security. From the unified-budget perspective, the distinction is mystifying.

Even more mystifying, the law requires that the U.S. Treasury issue to Social Security an interest-bearing certificate of indebtedness or bond for income not currently needed for benefits. There are several dozen civil service employees involved in issuing these bonds, redeeming them, and keeping track of the associated interest. The maturity dates of these bonds range from next June 30 all the way to 2024, the interest rates range from 2.75 percent for those bonds just purchased to 7.25 percent for bonds purchased years ago when interest rates were higher, and the par values of these bonds vary enormously. If one sees only the unified budget, this detailed and elaborate accounting is baffling.

So let's demystify what is going on by removing the unified-budget blinders and seeing more clearly. As we all know, people faced with the possibility of a loss can protect themselves against the financial consequences of that loss by banding together with others who face the same risk. This is done by having each member of the group contribute an amount of money related to the average likelihood that the loss will occur. Each group member is protected from a large possible loss by making a smaller but certain contribution.

This financial exchange is the essence of insurance and it is the essence of Social Security. Like other insurance programs, Social Security is an arrangement where workers trade periodic payments for protection against the risk of a particular, defined loss. In the case of Social Security, the risk is the loss of wages to support oneself and one's family in the event of disability, death, or old age. The periodic payments are the FICA payments deducted from wages and matched by employers.

Although FICA today is commonly referred to as a payroll tax, the acronym stands for the Federal Insurance Contributions Act. That title is no political spin. Congress enacted FICA in 1939, well before the current fashion of euphemistic legislative titles like “No Child Left Behind,” “the Patriot Act,” and the “Defense of Marriage Act.” In stark contrast, Franklin Roosevelt named his bills plainly and straightforwardly. His tax bills were labeled Revenue Acts, his legislation to ensure the rights of workers to unionize, “the National Labor Relations Act,” and his Federal Insurance Contributions Act specifies the contributions workers must make in exchange for life insurance, disability insurance and old-age annuities.

When we clearly see Social Security as the insurance it is, the structure of FICA suddenly makes sense. If you see FICA as a payroll tax, you may wonder why a liberal Franklin Roosevelt would ever propose to pay for Social Security with a regressive tax on workers, where the highest paid pay a lower effective tax rate than everyone else. But, when you see FICA clearly as the insurance premium it is, the paradox of a liberal politician proposing a regressive tax disappears. FICA premiums are based only on wages up to a maximum, because those wages and only those wages are the wages that are insured against loss. Those wages and only those wages form the base for calculating benefits. It makes perfect sense for a worker earning exactly the maximum amount on which FICA is imposed –$106,800 this year -- to contribute the same dollar amount as her twin earning ten times more. After all, the twin earning $106,800 and the twin earning $1,068,000 are eligible for exactly the same dollar Social Security benefit; consequently, they are charged the same dollar amount for that protection. This is perfectly normal and routine. Just as with their Social Security premiums, the higher and lower-earning twins pay the same dollar amount if they buy the same food, same cars, private life insurance coverage, or any other economic good or service. Like private insurance, Social Security premiums are based on cost, not ability to pay.

The mystery of those bonds now clears up, too. All insurers keep reserves to ensure that they can cover the cost of benefit payouts. From its start, Social Security has maintained a reserve. But in recognition that Social Security must be cautious and trustworthy with the contributions of American workers, the law has required, from the beginning, that those reserves be invested only in the safest, most secure investment on Earth -- interest-bearing obligations backed by the full faith and credit of the United States.

Seeing Social Security as insurance clears up yet another mystery. For budget purposes, five years is a reasonable time horizon, and anything over ten years is quite distant. In contrast, because insurers typically face a time lag -- often, a substantial time lag -- between the receipt of premiums and the expenditure of benefits, they must, to be prudent, employ lengthy periods of valuation, well beyond ten years. As a responsible insurer, Social Security’s Board of Trustees employs over 40 actuaries whose job it is to project the program’s income and outgo for the next 75 years. The projections appear in a report that the Trustees present each year to the Congress.

So, what is revealed in the most recent Trustees Report, issued just last May? If Social Security were a private insurance company, its shareholders would be pleased.

Social Security ran a surplus of $180 billion last year and had accumulated a reserve of $2.4 trillion. The Report does project that for the entire 75 year valuation period, Social Security faces a shortfall but it is of quite manageable proportions. Even with no action to eliminate it, benefits can continue to be paid in full until 2037.

What would happen after that if Congress didn't act? Here is perhaps the biggest blind spot of all caused by the unified-budget blinders. Generally lost in the unified-budget fog is any recognition that Social Security is incapable of contributing to the federal deficit. Like private insurance companies, Social Security cannot pay benefits unless it has the funds to do so. In short, Social Security is currently running a surplus and it is prohibited by law from going into debt.

Past Congresses have appropriately worked very hard to keep the premiums of the American workers and the related income clearly distinct and separate from the federal government's general fund and related budget. Social Security's monies are segregated in a trust, apart from the general fund. The law requires Social Security to be displayed off-budget. The Budget Act expressly prohibits changes to Social Security from being part of any budget reconciliation process. And this is how it should be.

Social Security's income and assets should never be part of a broad deficit-reduction effort. Diverting these funds from their intended purpose is legally and morally wrong. Indeed, the irresponsible rhetoric about an entitlements crisis and cavalier tone of policymakers, calling obligations of the United States, "worthless IOUs," is a serious disservice to the American people.

At his confirmation hearing last week, Ben Bernanke urged Congress to cut Social Security to reduce the general fund deficit. He defended his recommendation by explicitly invoking and quoting approvingly the moral exemplar of Willie Sutton, a notorious bank robber, who, when asked why he robbed banks, replied, "because that's where the money is." What a revealing picture – bank robbers, Ben Bernanke and like-minded politicians, all eager to get their hands on the money that hardworking Americans trustingly hand over to what they believe is a safe institution.