Commentary

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The US Social Security Trust Fund

The US Social Security system is a social transfer arrangement that is based on intergenerational transfer financing. Current payroll tax income is used mainly to pay current benefits; the trust fund is merely a short-term reserve fund that serves to stabilize the necessary payroll tax rate at a fixed level and provide a small buffer between cash flow income and cash flow outgo. There are in fact two separate trust funds; one is for old-age and survivors insurance (OASI) and the other is for disability insurance (DI). The combined trust funds are relatively small in relation to the scheduled benefits payable over the official 75-year projection period, although they are seemingly large in terms of the dollar value of their assets. The system operates essentially on a modified pay-as-you-go basis; future scheduled benefits are not pre-funded as is the typical practice for employer-sponsored defined benefit pension plans in the public and private sector. According to the 2011 Trustees Report, the assets held in the OASDI trust funds at December 31, 2010 amount to $2.61 trillion, representing a multiple of 3.53 times the expected benefit and expense payments for 2011. Future payroll tax receipts, together with interest income and the proceeds from assets held in the trust fund, are approximately equal to the value of the expected payments for scheduled benefits and expenses over the next twenty-five years. The solvency of the system is 100% over this 25-year period in cash flow terms. However, the program in its present form is projected to generate deficits of 10% over 50 years and 13% over 75 years.

The assets of the trust fund are invested in special US Treasury securities that are issued at current market interest rates and have a specified maturity date when the US Treasury repays the principal amount to the trust fund. The interest rate on new issues of these special obligations is computed as the average market yield on all outstanding marketable US obligations that are due or callable more than four years in the future. The trust fund currently comprises a laddered portfolio of fixed income Treasury bonds with maturities occurring in each year from 2011 to 2025 and carrying annual interest rates between 2.875% and 7.00%. The average rate of interest earned on the assets for 2010 was 4.6% for the OASI trust fund and 4.9% for the DI trust fund; the total interest income for 2010 amounted to $117 billion. The issuance and maturity of these special issue Treasury securities is a routine process that operates continuously and smoothly; the US Treasury regularly meets its obligations for interest payments and scheduled principal payments as the securities reach their respective maturity dates. In this respect, these special issue Treasury securities operate in the same fashion as for other US Treasury bonds. The Social Security system is a lender to the US Treasury; it does not borrow money and it does not have any debt; it is a separate entity financed by payroll taxes and holds its assets in the form of securities that are an obligation of the US Treasury. Future projected deficits in the cash flow of the system beyond 25 years will require some relatively modest adjustments to be made to the payroll tax rate or the benefit provisions to ensure that the trust fund remains viable. The viability of the Social Security system requires careful attention to the management of its solvency and sustainability, while recognizing the reality of the financial impact of demographic changes that result in an ageing population and the need for increasing subvention to maintain the system.

There are many common misperceptions and misunderstandings regarding the role and nature of the Social Security trust fund. Some are due to a genuine misunderstanding of the facts and some are attributable to misrepresentation. A common mistake is to ignore the trust fund assets and interest income and simply compare payroll tax income to benefit outgo as a mistaken measure of financial weakness. A recent example of misrepresentation is a statement that creates an impression that Social Security has to borrow money from China to pay its benefits. Another source of misunderstanding arises from a viewpoint that, instead of recognizing the reality of the system as a social transfer system, evaluates it as though it were a pre-funded system, and then declares that the excess theoretical reserves that the system should hold if it were in fact pre-funded represent a debt or liability of the system. The reality is that the Social Security system has worked efficiently over the last 75 years and has provided an invaluable service to beneficiaries; it can be readily maintained in its present form with only minor modifications to its established financial transfer arrangements so as to eliminate projected long-term deficits.

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