Commentary

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A View from the Treasury: Part Four

The U.S. Treasury has issued the fourth in its series of Issue Briefs on Social Security. This latest Issue Brief is concerned with mechanisms for achieving true pre-funding of Social Security. The main thesis of this Issue Brief is that making Social Security fair to future generations requires building up and safeguarding resources in the near term that can be used to fund future benefits. According to the Treasury view, if no attempt is made to pre-fund future benefits and safeguard the accumulated funds, then it will require higher contributions from future cohorts to pay for the benefits of earlier cohorts. This represents a problem when the size of the funding cohort relative to the beneficiary cohort is declining due to demographic forces such as declining birth rates and increasing longevity.

In order to assess how possible Social Security reform proposals allocate funding across birth cohorts, Treasury has developed a measure of the cohort lifetime net benefit rate that is defined as the present value of net lifetime Social Security benefits, comprising benefits less taxes, as a percentage of the present value of the cohort's lifetime wages. According to Treasury, pre-funding is an effective financing strategy provided that the near-term surplus revenues are safe-guarded in a way that allows them to be used to pay future benefits. The present Social Security system accumulates surplus revenues in the trust funds. These surpluses increase the government's capacity to pay benefits in the future only to the extent that they result in smaller amounts of public debt issuance than would occur if there were no surpluses. The existence of near-term Social Security surplus affects the non-Social Security budget; the unified budget process absorbs the current Social Security surplus that otherwise would require more current debt issuance. The result is that there is, in effect, an intergenerational transfer of the funding of today's non-Social Security budget deficit to be paid by future generations. This deficit funding transfer is not caused by the Social Security system; it is due entirely to the excessive deficit spending in the non-Social Security budget.

Federal finances in the 2006 fiscal year are divided into a Social Security component and a non-Social Security component. The 2006 unified budget deficit was $248 billion, comprising a $433 billion non-Social Security deficit and a $185 billion Social Security surplus. Debt held by the public at the beginning of 2006 was $4.6 trillion, comprising a $6.4 trillion non-Social Security obligation and a Social Security credit of $1.8 trillion. The non-Social Security deficit of $433 billion comprised $324 billion of interest and $109 billion of additional deficit spending. It is important to note that the $185 billion Social Security surplus was not funded by current public debt issuance and that this amount will require a subsequent swap into public debt issuance that will become due and payable from future cohorts.

The fourth Treasury Issue Brief considers four strategies to increase the likelihood that planned Social Security pre-funding represents real pre-funding. These four strategies are: Pre-fund in full-service personal accounts; Pre-fund in bare-bones accounts administered by a quasi-governmental entity; Invest the Social Security trust funds in private-sector assets; Invest the Social Security trust funds in marketable federal debt. Introducing personal accounts to Social Security would effectively convert the special-issue government securities into publicly held debt. Adding personal accounts to a reform plan would cause near-term unified deficits and publicly held debt to increase representing a "transition debt" that substitutes publicly held debt for an existing implicit debt. Treasury supports individual accounts with the following statement: "The essential point of making personal accounts part of Social Security is to better reveal the state of the government's budget so that more prudent fiscal policy decisions are made outside of Social Security. Specifically, by transforming implicit promises to pay future Social Security benefits into explicit quantities of publicly held debt, personal accounts could result in smaller non-Social Security fiscal deficits today."

It seems that Treasury believes it can ameliorate a problem with the funding of the non-Social Security deficits by adopting a change from a defined benefit system to a defined contribution system. According to Treasury, "what distinguishes privately owned accounts from trust fund purchases of private-sector assets is the implication each proposal would carry for the time path of government financial net worth; privately owned accounts increase publicly held debt, thereby reducing the time profile of government financial net worth and widening the unified deficit; investing the trust fund in private-sector assets increases the government's financial assets and its financial liabilities by the same amount, and hence has no effect on its financial net worth." However, the Treasury Issue Brief does not address the concept of social adequacy that is one of the fundamental pillars upon which the system is built.

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