Social Security's Effects on the Federal Budget Deficit:
Economics and Politics

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What is the effect of Social Security's financing on the federal government's overall finances?

Ideas about how Social Security's finances affect the federal budget as a whole influence opinions about major controversies such as whether Social Security "reform" should be pursued as part of current budget politics, and whether the payroll tax "holiday" supported by President Obama threatens future ability to pay benefits.
The payroll tax reduction has bitterly divided Democratic policy experts and activists, who worry that it will harm Social Security even as the Obama administration insists it has no effect at all on the program's ability to pay benefits. Meanwhile, the administration and its supporters dispute with both Republicans and many avowed centrists whether Social Security needs to be part of current budget politics.

There are four common ways to view the question. The first, or *trust fund* view, is the liberal conventional wisdom and legal perspective on the trust funds. It is modestly flawed. The second, or *cash flow* view, has become a conservative and establishment conventional wisdom, and is fundamentally wrong. The third, or *economic capacity* view, is promoted by eminent economists, modestly true, but somewhat beside the point. The relationship between Social Security and the federal budget is best understood in terms of how Social Security's financing affects the federal government's *fiscal capacity*.

How Social Security affects the federal government's fiscal capacity is a matter of both economics and politics. The key economic issue is how a government can save for future expenses. The key political issue is how policies about one part of the budget influence action on other parts of the budget.

This report begins by reviewing how Social Security is financed. The two longest sections next discuss the economic questions and then the political questions about this structure. This analysis is based on policy and experience from 1935 through 2010. At the end of 2010, however, President Obama, in collaboration with congressional Republicans and to the dismay of many congressional Democrats, took steps that violated the basic logic of the fiscal capacity view. The report therefore concludes by suggesting how the administration might have addressed the conflict between immediate macroeconomic reasons for stimulus and the need to preserve the ways that Social Security's dedicated financing improves the government's fiscal capacity.

To summarize:

* The centrist conventional wisdom, which dismisses accumulations in the Social Security trust funds as meaningless, is largely wrong – a misguided analysis of both economics and politics.

* The more liberal conventional wisdom, which views Social Security as entirely separate from the rest of the budget, is much more justified but at best incomplete.

* The payroll tax "holiday" violated the major arguments for taking Social Security's separate financing seriously, so threatens the long-term political basis for the program.

PART I: The Social Security Trust Funds

Social Security is actually two legally distinct programs: Old Age and Survivors Insurance (OASI) and Disability Insurance (DI). Each program has dedicated revenues which flow into legally constituted "trust funds": the OASI and DI trust funds. Revenues that flow into the funds are invested, on a daily basis, in "special issue" U.S. government securities. These securities are much like other federal bonds, except that they can be redeemed at any time. All benefits are paid from these funds, by redeeming the securities.[2]

By far the largest source of income for the OASI and DI funds ($637 billion out of $781 billion in 2010) is a payroll tax on wage earnings. [3] The tax applies to wages up to a maximum amount (the payroll tax cap), which was $106,800 in 2009, 2010 and 2011. By the program's normal law (we'll ignore 2011 for now), half of this amount is collected from a worker's wages and the other half is paid directly by employers; the rate is currently 10.6% of wages up to the cap for OASI and 1.8% for DI.

The second largest source of income in 2010 was interest on the accumulated fund balance: the combined balance of $2,540 billion at the end of 2009 yielded $117.5 billion in interest in 2010. Other sources are much smaller, the next largest in 2010 being $24 billion from income tax on Social Security benefits.

Payroll tax and interest earnings accounted for 96.5% of income in 2010. The interest earnings are essentially caused by the payroll tax: collecting more taxes than needed in earlier years created interest earnings, which then compounded on themselves, in later years. Thus, it is fair to say that the balance in Social Security's two trust funds in 2010 was essentially created by collecting more payroll tax in previous years than was needed to pay for annual benefits.

The combined numbers, however, mask the fact that the DI trust fund has most recently been declining, as the combination of other revenues and interest has been less than expenses. It lost nearly 12% of its value in 2010, declining from $203.5 billion to $179.9 billion. The program actuaries projected in 2011 that the DI trust fund balance would most likely decline to zero by 2018.[4] Under the law, each trust fund (OASI and DI) can borrow from the other, if necessary. Nevertheless, if we are to take the trust funds seriously, current trends suggest that DI will need legislation to fix its balance of revenues and benefits fairly soon.

How soon? Congress and the President can wait until the trust funds are empty or nearly empty, and then replenish them in various ways, including appropriating general revenues or borrowing from other government funds – as occurred in 1983.[5] If we assume DI will borrow from the OASI fund, then the intermediate projections in 2011 said that Social Security would have the revenues to pay all promised benefits through 2036.[6] If we assume the two funds should be treated separately, DI needs refinancing by 2018, and if that occurred OASI would have until 2038.

The Social Security Trustees and many others, however, argue that acting sooner is more responsible and will enable less drastic change than if policy-makers were to wait until the trust funds were exhausted: "(i)mplementing changes sooner would allow the needed revenue increases or benefit reductions to be spread over more generations." If the goal were to fund all spending through 2085, for example, the 2011 estimate was that taxes could be raised by a bit over 2% of payroll immediately or, instead, by 3.77% in 2035 and slightly more later.[7]

The merits of acting sooner in fact depend on two factors. First is whether you believe the trust fund accumulations are "real." If so, then early action to raise revenues can build up funds so revenues do not have to be raised as much in the future. Or, earlier spending cuts also will lead to larger trust funds, so less need to cut in the future. But if the trust fund does not count, acting sooner has no financial advantage.

Assuming one believes that trust fund accumulations matter, whether quick action is better than slower action then depends on who is hurt by each set of choices. As the Trustees reported, quicker changes "spread" the pain, which is not quite the same as reducing it. The incidence of effects is very complicated because the program affects people from the time they begin to work until the time they die. Imagine, for example, that the choice is between raising taxes now or cutting benefits in 2035. *Much of the effect will fall on the same people: the choice for them is largely between paying taxes now and receiving fewer benefits later.*[8]

In practical politics, much of the debate about how quickly to act to improve Social Security's financing involves the policy choices that are likely to be made at different times. Few elected officials will admit they want to cut the program for people who currently are receiving benefits. It is much easier to propose cuts far in the future.[9] In general, raising taxes to pay for benefits is more popular than cutting Social Security benefits.[10] Yet under current political circumstances, with one party seemingly unalterably opposed to tax increases and willing to filibuster to avoid them, quick action to improve Social Security's finances seems highly likely to emphasize benefit cuts. For example, the supposedly centrist proposal from the leaders of the National Commission on Fiscal Responsibility and Reform ("Bowles-Simpson Commission") relied on benefit cuts for about two thirds of its savings[11] -- and still received little support from Republicans in Congress. Under these circumstances, there is good reason to expect that benefits will be cut less if action is taken closer to the date when the trust funds must be replenished, rather than in the current political environment.

One further background point is crucial to understand the policy debate. Social Security's payroll taxes have been presented as dedicated to funding the program, and for no other purpose. That is why they are deposited directly into trust funds. The program was designed and presented as social insurance, in which individuals make contributions to fund their own benefits, these benefits are insurance against economic risks associated with living beyond a normal working age, and having paid in gives "contributors a legal, moral, and political right to collect their pensions."[12]

This approach should make taxes for Social Security more popular than other taxes for two reasons. First, if the funds are only used for Social Security, nobody can imagine the money is going for the government programs they don't like (e.g. foreign aid, occupying Iraq, or agriculture subsidies) – unless they're among the small minority of voters who don't like Social Security. Second, voters have good reason to believe much of their taxes will be used for them and people they care about, rather than for strangers.

All available evidence suggests that voters do think of Social Security taxes in these terms. Between 1950 (when the system began to mature) and 1983 (when legislation began buildup of the large trust fund) tax rates were raised eleven times, often in conjunction with benefit increases.[13] Tax increases are normally not so easy. They can and have been relatively easy for Social Security, however, because the money is dedicated to purposes voters strongly support. In a 2009 survey, for example, 72% of respondents agreed that, "I don't mind paying Social Security taxes because I know that I will be receiving the benefits when I retire. 75 percent agreed because, "I know that if my parents, grandparents, or other family members did not receive Social Security, I would have to support them in their retirement." And 87 percent agreed that they did not mind paying Social Security taxes because, "it provides security and stability to millions of retired Americans, the disabled, and children and widowed spouses of deceased workers."[14] Over many decades, polls have overwhelmingly showed that few voters think spending on Social Security is excessive, and many more think it should be increased.[15]

Social Security's direct link of contributions to benefits therefore has three important effects. First, it means voters are much more willing to raise Social Security taxes than other taxes. Second, it means charges that funds are being "diverted" or "wasted" will particularly bother voters. Third, it gives voters reason to believe that they have "earned" their future benefits.

Part II: Economics, or (How) Can a Government Provide for Future Expenses?

Two Conventional Wisdoms

In the logic of trust fund accounting, excess revenues are deposited in the funds; these earn interest; and so the fund itself represents accumulation of money to pay for future expenses. This is clearly true in the legal sense: money in the OASI or DI trust funds is automatically available as budget authority to pay for future expenses, so already obligated for that purpose. Moreover, Social Security can only pay expenses from the budget authority in the trust funds.[16] The trust fund view emphasizes the legal obligations and structures associated with the trust fund mechanism.

From this perspective, because Social Security can only spend revenue received from the trust funds or as annual taxes, it cannot run a deficit. If it cannot run a deficit, then it cannot contribute to the federal deficit. Therefore it is unfair and unnecessary to cut Social Security as part of deficit-reduction efforts. More precisely, there is no issue until the time when the trust fund is projected to be exhausted; one can argue that policy-makers should plan for that event, but it is a quarter century in the future and almost any other aspect of the federal budget deserves more attention at present. Hence Senate Majority Leader Harry Reid (D-NV) argued that, "Social Security has contributed not a single penny to the deficit." OMB Director Jacob Lew declared that, "looking to the next two decades, Social Security does not cause our deficits."[17]

The cash flow view was neatly expressed by economics columnist Allan Sloan when he described the Social Security trust funds as "Useless."[18] As Sloan and many others explain, if at any point the Social Security program draws money from the trust funds, it is making a claim on the Treasury. The Treasury must get the money somewhere. Since it has been forbidden to invest surpluses in the private economy, it can only get money from taxes or borrowing on the market.[19] Expenses are financed from taxes and borrowing whether there is a trust fund or not. Therefore the trust fund makes no difference. By this perspective Social Security can only be funded by the cash flow from annual taxes or (if this were allowed) earnings on investments in the private economy.

The different views can be illustrated by asking if Social Security was "contributing to the federal deficit" in 2010. The standard trust fund accounting includes revenues from payroll tax, taxation of benefits, marginal miscellaneous revenues, and interest on the trust fund assets. By this account, Social Security (OASDI)[20] in 2010 had $781.1 billion in revenues, $712.5 billion in expenses, and so a surplus ("increase in assets") of $68.6 billion. But these revenues included $117.5 billion in interest on existing assets. If that figure is excluded, total revenues of $663.6 billion were $48.9 billion less than program expenses – and so the program increased the unified budget deficit by $48.9 billion.[21]

In the cash flow view, the "fact" that Social Security in 2010 was contributing to current deficits made it both fair and necessary to include cuts (or perhaps, to a lesser extent, tax increases) in any deficit reduction package. Based on this perspective, former Senator Alan Simpson and Erskine Bowles, co-chairs of the Fiscal Responsibility Commission appointed by President Obama and the congressional leadership, included major Social Security cuts in the deficit-reduction plan that a portion of the membership endorsed and that is widely promoted in current budget debate.[22] Budget hawk organizations like the Committee for a Responsible Federal Budget prioritize what they call the "compelling" need for Social Security "reform."[23] Former Comptroller General David Walker has argued that "Social Security is now adding to the federal deficit, since it currently pays out more than it takes in." President Bush's Commission to Strengthen Social Security reported that, "Non-Partisan Experts Agree: Social Security Trust Fund Not an Asset to Government."[24]

On balance, what passes for responsible, centrist opinion in U.S. policy debate is defining the trust fund accounting perspective as "partisan" or even dishonest, and the cash flow perspective as "non-partisan" and so objective – even though the latter is promoted by Republicans at every opportunity. Factcheck.org branded the Democratic position untrue.[25] The *Washington Post*'s Lori Montgomery quoted Senator Reid saying that, "Social Security does not add a single penny, not a dime, a nickel, a dollar to the budget problems we have. Never has and, for the next 30 years, it won't do that." Then she went on to report that, "Such statements have not been true since at least 2009, when the cost of monthly checks regularly began to exceed payroll tax collections."[26]

Each side appears certain that it is correct. In fact, neither view captures the relationship between Social Security finance and the federal budget.

The trust fund accounting perspective says that the balance in the Social Security trust funds is just as real as the balance in any other portfolio of U.S. national government debt instruments. In response to the *Washington Post* article cited above, the Center for Budget and Policy Priorities objected that the *Post* "ignores a huge source of income to Social Security – the interest on its portfolio of Treasury bonds – to make it sound like the program faces an imminent crisis. It doesn't."[27] The problem with this view is, it begs the question. Simply stating it does not explain how trust fund surpluses help the federal government pay benefits. Why are the critics wrong, if the money has to come from the Treasury either way?

The cash flow view is wrong because it provides an inaccurate account of how policies at one time can improve ability to pay expenses in the future. The Treasury is more able to pay because of the previous surpluses, even though the trust funds are not a separate pot of money. There are two arguments about why this is true; we will start with the weaker effect because it is more widely promoted in the academic literature.

The *Economic Capacity Perspective*: Financing by Growing the Economy

Since around the mid-1980s, economists have developed an extensive literature regarding Social Security's effects on national savings and so the size of the economy. In Alicia Munnell's words, the accumulation of assets in the Social Security trust funds "reduces the burden" of future retirement costs on future taxpayers "by increasing the nation's saving. More saving means more investment, increased productivity growth, and a bigger economic pie. With a bigger pie, future workers will have more stuff left over after they meet the claims of the elderly."[28] To Peter Diamond, similarly, the key question about the trust fund buildup is the "impact on national capital."[29] In Henry Aaron's pithy summation, paying attention to taxes was like paying attention to the "hole in the donut"; people could live with a bigger hole if the donut was bigger, and a bigger economy would be like a bigger donut.[30]

Although this argument has been extremely attractive to economists fixated on national savings and ways to increase it, it has always made limited sense as a claim about future politics.[31] It seems highly unlikely that workers in 2030 will happily pay higher payroll taxes just because someone tells them that the Social Security legislation in 1983 has increased their incomes in 2030 beyond what they would have been otherwise. The money might be in the economy, but that doesn't mean the government could collect it.

The larger economy could still improve the balance of payroll taxes and benefit costs, because better economic growth normally improves program finances.[32] Better economic growth should also improve the government's overall finances. The economic capacity argument also makes the important point that voters and especially people who claim to be policy analysts should focus on the actual economic impacts on citizens, rather than the government share of GDP. Nevertheless, the economic capacity effects would only modestly reduce the amount that revenues would need to be raised or benefits reduced in order to balance Social Security's finances.[33] Hence the economic capacity perspective is best viewed as a modest supplement to the fiscal capacity effect.

The *Fiscal Capacity Perspective*: Financing By Reducing Other Expenses

One way to think about the trust funds is to consider what could be done with surpluses. Ordinarily, a saver might invest assets in many ways, such as stocks, corporate bonds, municipal bonds, real estate, derivatives that hardly anyone understands, or U.S. Treasury securities. Under current law, Social Security is not allowed to invest surpluses in anything other than Treasury securities. According to critics, this is "fake" because the government only "owes money to itself."

What, however, would happen if the fund could be invested differently? Paul Van de Water explains that, "if the Social Security trust funds were to invest $100 billion in corporate stock, the Treasury would need to finance the non-Social Security deficit by borrowing $100 billion more in private credit markets. As a result the private sector would hold $100 billion less in equities and $100 billion more in government debt. Neither the government nor the private sector would be better or worse off."[34]

From the standpoint of the national economy, there is no change at all – just different holders of the same assets. From the perspective of the government as an organization, a new asset (the equities) has been balanced by a new liability (the extra borrowing). At the time of the switch they are of equal size, so the federal government's financial position is the same: it can claim $100 billion from somewhere in the rest of the world, but it also owes $100 billion somewhere in the rest of the world.

One can have policy disagreements about the best investment strategy. Because the value of equities over the long run tends to appreciate at a rate higher than the interest on federal debt, a fund of equities would grow more quickly, on average. But, as might be noticed after the past decade or so, the value of such a fund may be unpleasantly variable, and could fall suddenly and precipitously. I have argued elsewhere that, given the federal government's other sources of money, diversifying a small part of Social Security financing through equity investment (rather than the current use of surpluses) is marginally advantageous.[35] But this is just a choice between two investment strategies, not a situation in which one strategy is "useless" and the other useful.

Why, then, do the two balance sheets look so different to so critics of the trust funds? The reason is, they think the only way an organization can invest for the future is by arranging a flow of cash from outside itself. To see why this is wrong, consider how a household or firm could prepare to meet future expenses.

There are two basic ways to prepare to pay for a future expense. The first is to ensure further income in the future. The second is to reduce other future costs. A person who is preparing for retirement could invest so that future unearned income could replace earned income. But she could also pay off her mortgage, reducing future housing expenses.

That is a close analogy to what the federal government does if it uses Social Security surpluses to reduce federal borrowing. Nobody would say that paying off the mortgage is "useless" as a way to prepare for retirement. Other things being equal, *the balance in the Social Security trust funds reports the amount of debt that is not owed to the public because of the history of Social Security surpluses.* The interest earnings on those funds each year represents the federal budgetary equivalent of mortgage payments that have been avoided.

With this in mind, we can rephrase the disagreement about 2010. *Accounting for the effect of previous surpluses on interest payments*, Social Security was not "contributing to the deficit." Interest payments to the public in 2010 were reduced by $117.5 billion; this effect was offset partially by the $48.9 billion more spent than collected in taxes; but the net effect still was that Social Security reduced the federal deficit in calendar year 2010 by $68.6 billion – the recorded increase in trust fund assets.

This description of how the trust funds work is nothing new. In 1938 the first Advisory Council on Social Security considered the issue of trust fund assets being held as Treasury securities, and unanimously reported that,

> "The United States Treasury uses the money realized from the issuance of these special securities by the old-age reserve account in the same manner as it does moneys realized from the sale of other Government securities. As long as the budget is not balanced, the net result is to reduce the amounts which the Government has to borrow from banks, insurance companies, and other private parties. When the budget is balanced, these balances will be available for the reduction of the national debt held by the public.
>
> "Members of the Advisory Council are in agreement that the fulfillment of the promises made to the wage earners included in the old-age insurance system depends upon, more than anything else, the financial integrity of the Government. The members of the council, regardless of differing views on other aspects of the financing of old-age insurance, are of the opinion that the present provisions regarding the investment of the moneys in the old-age reserve account do not involve any misuse of these moneys or endanger the safety of these funds."[36]

What the Advisory Council called "financial integrity" is the same thing as fiscal capacity. A perspective that focuses only on cash flow considers only part of the story.

If the money had been invested in private assets, the fund would have accumulated, earnings each year would have been reinvested, and nobody would have doubted that it was appropriate, at some point, to use fund earnings or eventually cash in the principal to pay benefits. Regardless of whether the federal budget was in deficit or surplus at the time, however, using the money in that way would have increased the federal debt (either because the government would have had to borrow more or, at a time of surplus, could have retired less). Interest would have been paid on that debt, requiring more debt. From this perspective, as the Center on Budget and Policy Priorities argued, the choice to use the funds to reduce other federal borrowing is just a choice about investment, and spending both the interest earnings and principal from the trust funds is equivalent to spending interest earnings and principal from funds of private assets.

A somewhat more fiscally conservative variant. Both the mortgage analogy and the normal patterns of federal borrowing could be used to argue that the fiscal effects of the trust funds are far more positive than in the cash flow view, but that only some of the trust fund balances should be used to pay benefits.

If we think of the trust funds as representing savings from paying off the mortgage, then a portion of the accumulated balance in the funds can be seen as equivalent to the original principal paid for the house. At some point, therefore, cashing in the trust fund balance seems a bit like buying the house again. Following this analogy, the money would not be available for other expenses. But how much?

In an earlier analysis I expressed the most fiscally conservative view that takes the trust funds seriously. I argued that the trust funds should be stabilized at their maximum value, so that only interest earnings are used to pay benefits. [37] By this standard there would be a need for new revenues, or benefit reductions, in 2023 – the last year, in the 2011 Trustees projections, that the sum of other revenues and interest income exceeds expense.[38] This approach is best viewed, however, as the minimum reach of the trust fund logic. It seems excessive because the total in the trust funds in 2023 represents not the value of the original "house" but also the equivalent of earnings from investment of the savings from not having had to make mortgage payments in the past.

A similar concern can be raised from more of a public finance perspective. The balance in the trust funds at any time represents an amount that the federal government does not owe to the public because of previous surpluses, and therefore for which it neither has to pay interest nor pay back the principal. Thus there are savings from not having to pay back the principal. But governments do not normally pay back principal; declines in the nominal (unadjusted for inflation) cash value of debt (meaning annual surpluses) are not the norm. Even the balanced budget norm does not call for actually reducing debt. Normally governments reduce debt burdens as a share of GDP by having deficits that are small enough so the debt grows more slowly than the GDP. If you think that paying back principal is unusual then borrowing from the public to pay social security benefits by reducing trust fund balances can seem more like borrowing that is not offset by lower expenses on the debt management side of the general fund. As with the mortgage analogy, however, simply objecting to any paydown of the trust fund balances once they peak can be viewed as too strict. The fact that money was not borrowed from the public before did have benefits, both in terms of economic capacity and because of the fact that interest did not have to be paid.

Neither of these arguments changes the fact that trust fund balances represent the amount of extra debt that would be owed to the public if Social Security surpluses had been invested in private instruments instead. From this perspective, the case for spending down the balances is the same as the case for spending the balance in any fund of private assets. In each case there is an argument for retaining some fund, and thus a flow of earnings, rather than going down to zero. The more skeptical versions of the fiscal capacity view do, however, give extra reason to believe the fiscal capacity benefits of earlier surpluses are maximized if the trust fund balance is stabilized at its peak, rather than being allowed to decline from its peak.

The fiscal capacity perspective does not invalidate the case for the trust fund as a legal obligation. As a rough approximation, over about a thirty-year period, the baby boomers will have paid higher Social Security taxes than necessary from a cash flow perspective, in order to improve fiscal capacity to pay for their benefits. The legal obligation is also a moral obligation. People have not only relied on a promise, but they have fulfilled their part of the deal. The balance in the trust funds represents, other things being equal, the effect of the excess tax payments (unnecessary payments from the cash flow perspective) from 1983 to the present.

The cash flow perspective is, other things being equal, simply wrong. It amounts to saying the extra taxes that created the current trust fund balances did not occur. It says that reducing some future expenses does not help you pay for other future expenses. Both statements are absurd – other things being equal.

Part III: Deficit Politics and the Claim That Social Security Surpluses Were "Wasted"

Both the fiscal and economic capacity arguments, however, are subject to the same concern: that other things are not equal and the extra savings (either for the economy or the government) did not actually occur.

A Hypothesis About Politics

In Alicia Munnell's words, "(l)arge deficits in the overall budget since the 1980s have led some critics to contend that surpluses in Social Security simply go to cover deficits in the rest of the budget, and have no impact on government or national saving."[39] In one common example, Eugene Steuerle argued that a candidate who compared Social Security to a "Ponzi scheme" was right, "in the sense that there's really no significant savings in the system." The surplus in the trust funds, Steuerle claimed, did not count because it helped encourage bigger spending by the rest of the government.[40]

Although this claim is very popular with people who want to cut Social Security benefits, it has also been promoted by supporters of Social Security, such as many of the economists who were focused on deficit reduction and politicians such as the late Senator Daniel Patrick Moynihan.[41] This likely explains why experienced Washington journalists see the claim that surpluses were "wasted" as nonpartisan and objective.

The Clinton administration may have inadvertently encouraged this belief by arguing, once budget deficits disappeared, that the general fund should be balanced and Social Security surpluses used to retire federal debt. This position made policy sense for the federal budget: it provided a rationale to resist tax hikes and so contributed to the reduction in federal debt that occurred during Clinton's second term. But the argument could easily be interpreted as meaning that not having done that in the past, and not to do that in the future, would somehow misuse the surpluses. Vice-President Gore's and other politicians' claim that Social Security surpluses should be put in a "lockbox" so they could not be misused could be interpreted the same way.[42]

The political logic for the idea that Social Security surpluses have caused greater deficits in the rest of the budget has the following steps:

1) Assume policy-makers (or voters; it doesn't really matter whether politicians deceive themselves or the voters) want some level of deficit.

2) Assume the deficit to which they pay attention is the unified federal budget deficit, which includes the Social Security trust funds.

3) Then any surplus in the Social Security funds reduces the changes in general fund revenue or spending needed to meet the target. Creating a $100 billion surplus would

enable politicians to raise spending and/or reduce taxes on the rest of the budget in a way that costs $100 billion.

The key idea here is that, by putting Social Security on the unified budget in 1968, politicians diverted attention from the deficit on the rest of the budget. So, if Social Security had a surplus, they had to do that much less to "balance the budget."
In short, *if this is true, looking at the unified budget rather than the general fund means that Social Security surpluses disguise the need for more budget constraint in other accounts.*

If federal budgeting actually worked this way – with decisions made each year about the target for deficits or surpluses, *those decisions being implemented each year*, and decision-makers being confused about how to measure the deficit – this theory might be plausible. There are good reasons to think it is not.

The most obvious problem with this theory is how to specify the people who are fooled. The theory could refer to the President and members of Congress – yet, in fact, the two different versions of deficit figures have regularly been part of official reports.[43] Policy-makers have all the information they need to avoid being fooled. They might, instead, use unified budget figures to try to fool the public into thinking that the budget situation is more satisfactory than it really is. That argument, however, would require that public opinion about the deficit depends on the actual numbers, however they might be measured.

The evidence that voters tend to understand any public policy at this level of detail is, to put it mildly, limited. Voters are rarely asked to say how big the deficit is, but a careful study by Alan Blinder and Alan Krueger yielded results which are unlikely to surprise any public opinion specialists. In the Spring of 2003 deficit estimates were moving, so the authors "decided to count any number between $246 billion and $310 billion as correct." But the median response was $90 billion.[44] If voters don't know the numbers, it's hard to see how they could be fooled by misleading numbers.

Nevertheless, the Committee for a Responsible Federal Budget reports that, "a large body of evidence suggests that in reducing the unified deficit, Social Security's surpluses have led to higher general spending and lower general taxes than would have otherwise occurred – and as a result some or all (or more than all) of the surpluses have been 'spent'."[45]

The next section of this essay reviews that evidence, and the following section looks at other evidence.

Econometric Evidence

The "large body of evidence" consists of a few econometric analyses, especially work by Kent Smetters.[46] I will focus on the Smetters work because it was emphasized by an advocacy group that wants to cut Social Security in order to reduce the deficit, but all analyses of this sort face similar problems.

Smetters did time series analyses to relate the surplus or deficit of the Social Security trust funds to the balance in the rest of the federal budget. He controlled for changes over time in the size of the economy by dividing all totals by that year's potential GDP; includes controls for GDP and wages and salaries to control for the effects of economic trends on both Social Security and other aspects of the budget (i.e. that a good economy should improve the balance in both, so they ought to be positively correlated, as they are in raw data without controls[47]); and looked at trends from 1949 -2002, 1949-1969, and 1970-2002.

His conclusions, if true, would be stunning. In the specification he considers most relevant, "a one dollar increase in off-budget surpluses is correlated with a roughly $2.76 increase in on-budget deficits – and, hence, a $1.76 decrease in the unified surplus." He adds that, "each dollar of Social Security surplus appears to have actually increased the debt held by the public in the past by $1.76." Moreover, Smetters finds that there is no relationship between trust fund surpluses and the rest of the federal budget before creation of the Unified Budget (1968), and a strong negative relationship between the two balances afterwards.

At first glance," he notes, "this dramatic overspending of Social Security surpluses seems entirely implausible." Yet, he argues, it can be explained by "a simple game theory model."[48] In this presumed game, each party's constituents wants something – say, $1 more spending for Democrats and $1 lower taxes for Republicans. But voters also want the deficit not to increase. A dollar is made available through a Social Security surplus. Assume the parties agree to a dollar of what each wants. So the on-budget deficit is two dollars more. But the public only notices the unified deficit, which has only increased by a dollar. It blames each party equally (50 cents each) but each party's supporters give it credit for a full dollar of extra benefits. So each party comes out ahead.

Smetters' theoretical game is very clever, but unrealistic at many levels. As a description of politics, it assumes away the fact that most voters are partisans, so there are few voters who would blame both parties for equal amounts of deficit. As a description of budgeting, the game described here is one in which decisions about changes are made simultaneously (an increase in the Social Security surplus is essentially "spent" twice, with something for the Republicans and something for the Democrats). This is not an accurate description because most aspects of the budget are not subject to change in a normal year. Decisions to change the Social Security balance, for example, occur quite rarely,[49] while many of the movements in the overall budget balance are not due to decisions in the same year. Smetters' game also ignores the fact that Congress, except in very rare cases, has enacted budget legislation designed to create deficits that stayed within the parameters of the President's proposal. Therefore, for the kind of bipartisan trade that Smetters suggests to have the effect on totals that he suggests, it would have to occur within the monopartisan administration.

Moreover, Smetters' game theory does not fit the basic argument about why trust fund surpluses could reduce balances in the rest of the budget. That argument suggests that before the 1983 Social Security legislation the political system already had excessive deficits, and that the trust fund surpluses made it easier for politicians to do less than they "should" have about the deficits. Smetters, however, is claiming that in specific years after Social Security surpluses were created politicians would have claimed credit by increasing spending or cutting taxes.[50]

There is a more plausible alternative explanation of Smetters' results: they are "entirely implausible" because his statistical analysis is misguided. The most basic problem is that sequential years can be autocorrelated because of a shock at one point in time. Therefore, analyses that are based on levels from year to year are subject to a variety of statistical flaws. Smetters (and others) claim to have controlled for these flaws but, Thomas Hungerford argues, used inappropriate tests. When he re-estimated Smetters' and others' equations with the same data, he found significant unit root and autocorrelation problems.[51]

These statistical difficulties can be avoided by analyzing year-to-year differences, rather than focusing on levels. Under most circumstances, focusing on year-to-year changes is not appropriate for time-series analysis. But budgeting is usually in terms of year-to-year increments, with the "base" normally not up for dispute.[52] Moreover, if budget decisions were made as part of fiscal policy, that by definition focuses on year-to-year increases or decreases in aggregate demand. So, for the decisions being modeled, a focus on differences from year to year seems more appropriate than a focus on levels. When Hungerford analyzed in terms of annual changes rather than levels, the coefficient estimates of the effects of the trust fund balance on the balance outside the trust funds changed from negative to positive, though they also were not statistically significant. He found the same positive relationship before and after the move to a unified budget. He also found that adding just four years (2003-2006) to Smetters' database cut some of Smetters' coefficient estimates in half – which does not say much for the robustness of Smetters' modeling.[53]

Hungerford's modeling choices fit better with the processes of federal budgeting. Yet the problem with Smetters' and others' focus on levels is even more fundamental. Hungerford writes that, "trust fund surpluses were very small prior to 1983 and began to grow after the Social Security amendments of 1983. Consequently, a single event could be driving the variation in the OASDI surplus variable."[54] In fact there were two, associated events: the budget decisions of 1981, with the large tax cut and defense buildup, creating structural deficits in the overall budget, and the Social Security amendments, which created the trust fund buildup. These two decisions dominate the trends in the data.

We can see what was happening from simple inspection of the raw data. Figure 1 shows trust fund and non-trust fund figures for the full period covered by the Smetters analysis, plus the years added by Hungerford. Each is expressed in constant 2002 dollars.[55] Figure 2 displays the data in another way, closer to how Smetters and Hungerford did their final calculations. They converted dollar figures into shares of GDP in order to make figures comparable over time, but use potential GDP as the denominator so that the variations would be less affected by how economic cycles change the denominator. Figure 2 updates the figures into the Obama administration, but begins only in 1971. It shows the trends as percentages of potential GDP, uses fiscal year figures instead of calendar year, and covers the entire period of large Social Security surpluses.[56]

The basic story is the same in both figures. During most of the period of Social Security surpluses, deficits in the rest of the budget were much higher than during the period when there were no or very small Social Security surpluses. So it should be no surprise that over the course of time Social Security surpluses appear to be associated with more negative balances for the rest of the budget. Moreover, given the much larger increases in the non-Social Security deficit than in the Social Security surplus, the fact that Smetters' analysis of levels finds a negative coefficient greater than 1.0 is not surprising. Figure 2 shows further that on-budget deficits varied widely during the last decade of the series, a period when Social Security surpluses varied little. This is not an indicator that the two figures are related.

The figures, then, support the original explanation of why causal inference from Smetters' results is extremely implausible. The two big shocks to the system are clearly evident in the figures. Yet the shift to much larger deficits outside Social Security came first, so could hardly have been caused by the Social Security surpluses that developed in the mid-1980s.

If Social Security surpluses are not to blame, why were the deficit-creating decisions of 1981 not reversed? In this situation there is a much simpler "game" to explain what happened: we can call the game, "impose pain," and politicians who play it lose. Smetters' game would be about credit claiming,[57] but deficit reduction is about blame avoidance, and that's hard to do. As Paul Pierson nicely sums up what nearly all budgeters know, "the politics of retrenchment is typically treacherous because it imposes tangible losses on concentrated groups of voters in return for diffuse and uncertain gains."[58] In short, budgeting became a retrenchment situation at the same time as Social Security became a steadily-increasing surpluses situation. There was no reason to reduce the Social Security surpluses, but it was very politically difficult to enact retrenchment.[59] These two events were independent; one did not cause the other. The fact that, over a long period of time, both deficits in the rest of the budget and surpluses for Social Security were much higher than normal during the period after the mid-1980s will result, in a regression model, in coefficients that could be mistaken for causation. In fact, it is only an association.

Contrary to the Committee for a Responsible Federal Budget's assertion, statistical analysis does not offer credible evidence that Social Security surpluses were offset or more-than-offset by increased deficits in the rest of the budget. Yet that in itself does not mean the argument is untrue. Lets turn, then, to a closer look at budget politics.

The Budget and Social Security Through 1980

In order to more carefully evaluate the claim that surpluses were "wasted", we should recognize that there are two budgetary worlds: pre-1981, and from 1981 onward. There is good reason to view the world pre-1981 as irrelevant to the question of whether the current Social Security trust fund balance has been offset by less constrictive choices about the rest of the budget. So readers might skip to the next heading. Yet the first period has been cited by scholars including myself to warn that, as I put it, there can be a difference between payroll tax increases and net tax increases.[60]

There *can* be situations in which measures to improve the financing of Social Security are accompanied by measures that worsen the balance of the rest of the budget. In 1977-78 the Carter administration (and much of Congress) urgently sought to improve Social Security's financing because the trust funds, which at that point were supposed to be a contingency reserve and margin for safety, were being rapidly depleted. New estimates of economic and demographic trends, combined with a "technical flaw" in the indexing provisions adopted in the 1972 amendments that would lead to much higher benefits than intended, had led to a quick deterioration in the program's fiscal prospects.[61] After a complicated battle in which much of the Carter administration's proposed fix was rejected, Congress enacted legislation that cut the future benefits and also raised taxes significantly.[62]

This battle occurred at a time of economic sluggishness for which Democrats thought stimulus, largely in the form of tax cuts, was necessary. Yet the immediate effects of the Social Security Amendments would have been to contract the economy. The Carter Administration (following the logic of the unified budget) wanted the Social Security financing steps, which were made necessary by the trust fund logic, to fit into overall fiscal policy. This is an example of precisely why the unified budget was adopted: if fiscal policy had been based only on decisions about the rest of the budget, and Social Security financing simultaneously tightened, fiscal policy would have been vitiated.

Therefore the President "postponed his long-awaited tax package until 1978 so that it could reflect the impact of pending Social Security and energy legislation, as well as the need for stimulus tax cuts."[63] The President announced his stimulative tax cut proposals on the same day as he signed the Social Security legislation, and they were large enough to provide the desired stimulus net of the contraction from the Social Security Amendments. [64] One could hardly find a better example to seem to confirm the claim that policies to finance Social Security by building up the trust funds are "fake" because they are offset. Yet even this seemingly powerful example does not fit the logic.

First, it is not a budget illusion at all. Policy-makers were making an explicit and conscious choice, based on worries about the contractionary short-term effect of extra Social Security revenues. There is a policy contradiction between concern about "saving" and occasional need for short-term fiscal stimulus. So sometimes the short-term policy case for reducing saving can trump the long-term case for improving fiscal capacity by increasing saving. But that would not be a general pattern by any means.[65]

Second, there was little explicit attention in 1977 to "building up the trust funds." Martha Derthick's study of the program's politics does not mention that goal. A summary from the Social Security Administration said the law would "gradually build the OASDI trust funds up to acceptable contingency-reserve levels," which is hardly the same as a plan to pre-fund benefits.[66]

Third, the policy changes in 1977 included far more than the immediate budgetary effects in the first few years. It is simply not true to argue that anything close to the full set of measures to improve Social Security balances was offset by the tax cuts in 1978 – even though the short-term improvements were offset.

Hence the offset that did occur, quite explicitly, through the 1978 tax cuts does not fit the theory of a policy illusion, nor of an offset of the entire effect – never mind the idea that the improvement in Social Security's balance would have caused Congress and the President to therefore worsen the condition of the rest of the federal budget by 2.7 times as much (Smetters' estimate).[67]

Aside from 1977 there *is* a pattern of taxes on lower-income Americans and on corporations, over time, being reduced in a way that roughly offset the increases in Social Security payroll taxes. One account claims that the Earned Income Tax Credit, in particular, is "intended in part to offset the Social Security tax bite."[68] But the EITC wasn't even invented until 1975, and even if Social Security payroll tax increases were offset in part by other tax reductions, that does not mean that budget policy was being distorted.

Four major secular trends are relevant to the relationship between Social Security and the Budget over the period from 1949 to 1983. Social Security spending grew as the program matured. Its taxes were increased. Much of these tax increases were offset by reductions in other taxes. But this did not have major effects on the deficit because of the long-term secular decline in defense spending. Taxes that paid for defense spending were reduced as defense spending declined; taxes that paid for Social Security were raised as Social Security grew. Deficits did burgeon in the 1970s – but that was mainly because of economic bad news, compared to the good times of the previous two decades, and because by the late 1970s there was no longer support for cutting the military much further.

To summarize: in the budgetary environment through 1980 there is one case in which the primacy of fiscal policy meant that an explicit choice was made to offset the increased savings from improving Social Security's trust fund balance. This was not due to an illusion, but to an explicit choice to prioritize increasing economic demand. It does not appear to have been a general pattern.

As noted above, however, this whole discussion of budgeting before 1981 could be dismissed as irrelevant. The issue is whether Social Security surpluses have been "wasted," and whether the trust fund balance that exists today is "real." From 1981 through 1983 the assets in the OASDI trust funds totaled an average of less than $25 billion. In 2010 they were $2,609 billion. The surpluses were created since 1983; therefore empirical analysis should focus on budgeting since 1983.

The Budget and Social Security, 1981 – 2011.

Consider, then, budget politics in the 1980s. If the budget deficit was "hidden," it was not hidden very well. As Robert Reischauer and Phil Joyce expressed the situation in 1992, "public policy has been dominated by explicit or implicit efforts to reduce the deficit. Budget considerations have even constrained legislation that has little to do with the economy or the budget."[69] The deficit dominated national politics from 1980 through 1997.[70] It persisted not because it was ignored, but because majorities could not agree that any package of spending cuts and revenues large enough to eliminate it was not worse than the deficit itself.

As former Congressional Budget Office Director Rudolf Penner wrote, the political question, properly phrased, is whether, in the absence of Social Security surpluses, Congress and the President would have agreed on larger reductions in spending or other programs or higher increases in other taxes.[71]

Those who assume a positive answer are saying politicians would have done more if the problem seemed bigger. In reality, the only way politicians could agree on action was to make it smaller.[72] **Every deficit-reduction package from 1982 on was created by defining the problem as something smaller than how to balance the budget!** The Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984 were both described as down payments on deficit reduction. In 1990, President Bush and the Democratic Congress first had to settle on a target they thought they had a prayer of hitting. They settled on $500 billion at the Democrats' insistence, and nobody talked in terms of balancing the budget.[73] President Clinton promised in his 1992 campaign to cut the deficit in half by 1996. On closer look, however, that seemed too difficult; so his economic advisers settled on a $140 billion reduction of the deficit projected for 1997, on the grounds that a reduction of that size would satisfy the financial markets.[74] In 1995 Congressional Republicans did set a balanced budget as their target, but they promised balance only seven years in the future, in order to reduce the needed policy change to what they hoped would be a politically manageable level.[75]

Making the deficit-reduction target smaller allowed politicians to claim an accomplishment (meeting the target, making some progress) to justify the political pain of the steps they took. Politicians are not evil, but they are not saints either: if they are going to ask for trouble, they want some reward. Making the problem seem bigger would have made it harder, not easier, for them to claim they had accomplished anything. A senior Senator expressed the logic nicely in a confidential interview back in 1986. "Once the deficits got as big as they did," he explained, "no one thing would make a perceptible difference. If abolishing the Marine Corps would end the deficit, then Congress would abolish the Marine Corps. But if you abolished the Marines, you'd have $210 billion left to go and all the Marines mad at you."

Each incremental dollar of deficit reduction adds political pain – perhaps each dollar adds proportionately more pain (on the theory that politicians will do whatever is easier first). Larger deficit reduction packages anger and upset larger coalitions. The public generally disapproves of deficits, but disapproves of them on the whole and in principle. Making the deficit look bigger doesn't reduce the pain of any particular set of measures, but it does reduce the likely credit that can be gained from that amount of deficit reduction, by making it look smaller relative to the problem.

In everyday life, we do not assume that making a task harder causes people to do more. Sometimes they will quit, instead. I doubt that Social Security surpluses had any effect on the amount of deficit reduction, because that was determined mostly by the political pain of specific measures. But if Social Security surpluses made the problem look smaller, that was more likely to help than hurt. The tactics policy-makers used to pass deficit reduction packages fit much better with the argument that deficit-reduction is made easier by making the problem look smaller.

The political costs of deficit reduction are hard to miss. The tax reform of 1986 and Medicare Catastrophic Coverage law were designed to reflect worries about the deficit – causing policy-makers to choose approaches that brought them political pain (and, in the latter case, led to repeal of the law).[76] The first President Bush campaigned on a promise not to raise taxes. But, worried about the deficit, he broke his promise. He also alienated his base, presided over a disappointing economy (apparently not helped by the 1990 deficit reduction package) and was a one-term President. Bill Clinton then saw his stimulus and job-creating agendas blocked by deficit worries. His health-care reform prospects were badly hamstrung by deficit concerns. He did pass a major deficit-reduction law, and the Democrats lost control of the House for the first time in forty years (Senate too) in part because of that legislation. Why would anyone think Bush or Clinton could have done more? Why would anyone think the Social Security surplus was the reason they did not do more?

The argument that Social Security surpluses caused less action on the deficit during this period does not stand up to investigation, Its supporters need to explain in what year, in what way, Congress and the President would have done more. Throughout the period from 1981-1997, therefore, it seems fair to say that the Social Security surpluses created by the 1983 legislation reduced federal deficits by about the amount of the surpluses.

After 1997, the federal budget went into surplus. The Clinton administration then set as a target moving the budget to a position in which the general fund was balanced or in surplus. And that was, in fact, the situation as of 2000. So surely one cannot argue that during the second Clinton term the Social Security surpluses were offset by decisions about the rest of the budget.

What, then, of the Bush 43 administration? That administration and its congressional allies took steps that eliminated the inherited surpluses and turned them into deficits. The standard budget reports, because they included the Social Security surpluses, reported a smaller deficit than would have been reported without the Social Security surpluses.

Yet any remotely sophisticated politician by this point could not have been confused, as all CBO reports included the figures with and without the trust funds. Moreover, the Bush 43 administration's big tax cut in 2001 cannot be explained by any budget illusion created by the Social Security surpluses because projections at the time it passed, in early June, still showed a remaining on-budget surplus over ten years, as *Congressional Quarterly* reported, of "about 1.38 trillion, according to the current Congressional Budget Office forecast."[77]

The budgetary situation at the beginning of 2003 was quite different. CBO was projecting deficits even counting the trust funds through 2006.[78] One could have argued that this wasn't so bad because the budget (because of the trust fund "illusion") was then projected to go back into surplus. The Bush Administration's FY2004 Budget, however, did not take that stance. First, it argued (I think rightly) that 10-year forecasts are misleading and forecasts should be for five years.[79] Yet instead of therefore emphasizing deficit reduction, the administration called for large new tax cuts and a new Medicare drug benefit. It argued that, "a recession and war we did not choose have led to a return of deficits,"[80] and did not propose to pay for the war (it never included the war spending in its budgets). It declared that, "limiting and reducing the federal debt remains a priority for this Administration. But it is not the sole or even the top priority. Ahead of it comes national security and economic security,"[81] and thus the need for unfinanced wars and new tax cuts. The administration also argued that the actual deficits were not that large by historical standards (which was true); that the economy needed further stimulation; and that the responsibility of its policies was shown by the "extraordinarily low interest rates" of the time.[82]

A few fiscally conservative Republican Senators did force their partisan colleagues to cut the administration's tax cut in half.[83] But by August, CBO was forecasting unified budget deficits through 2011 – and that did not stop the governing coalition from passing the Medicare drug benefit in November.[84] In short, the Bush administration and its Congressional allies made clear policy choices, based on their own values, and there is little if any reason to believe trust fund illusions influenced the choices.

In fact, aside from asserting that the deficits in their budgets were not so bad, there is little evidence that the Bush administration thought in terms of specific deficit targets. If policy-makers do not think in terms of targets for the deficit, it is hard to see why how the deficit is measured would affect policy. The evidence that the Bush administration was not focused on the specific level of the deficit includes but goes well beyond Vice President Cheney's famous comment that, "Reagan proved deficits don't matter." When budget projections showed big surpluses, the Bush 43 administration wanted to cut taxes to give their money back to the people. When projections worsened, it wanted to jump start the economy by giving their money back to the people. Its official position was that paying for the "war on terror" by raising taxes would just increase the damage done by terrorism because of the economic "deadweight loss" from higher taxes.[85] It chose not to work the costs of the war in Iraq into its budget projections. In 2005 the administration pushed for Social Security "reform" that would have significantly increased deficits for decades.

This public record is matched by interviews I did in 2008 with current and former OMB staff about the presidential budget process during the Bush years. A very senior political official expressed how the budget was formulated one year. In his account, they focused on, "what is appropriate, needed and fair for nonsecurity… We ended up with some increase, just below inflation, and building from that. So then you ask what is the increase on the security side, you build in that. Then there is DOD, and you can imagine there were discussions on that. *There was no magic in the top line, it's just the sum of the parts*." In other words, there was no policy about the deficit total! This account fit the perceptions of senior career officials, who reported that arguments about the proper number for the deficit per se were rarely if ever made.

In short, there is no reason to think the Bush 43 administration thought in terms of the proper level of deficit; therefore its policies could not have been distorted by a policy illusion created by Social Security surpluses. The most basic assumption behind the argument that Social Security surpluses cause higher deficits in the rest of the budget, namely that budgets are made according to some view about the proper deficit, does not appear to have been true for the Bush 43 administration.

As for the Obama administration, all its budgeting has been in the context of a massive financial crisis that led to historically gigantic deficits. It defies credibility to suggest that the Social Security surpluses, which are much smaller than the effects of the financial crisis and the responses to the crisis, had any effect on the decisions about the size of stimulus policies.

Conclusion

It is possible in theory that Social Security surpluses could have led politicians to accept larger deficits in the rest of the budget than they would have done without the surpluses. It appears unlikely, however, that this occurred either in the Reagan, Bush 41, Clinton, Bush 43, or Obama administrations.

Therefore the policies that created Social Security surpluses since 1983 have in fact helped improve ability to pay for Social Security in the future. The argument that the surpluses have been "wasted" because they caused policy-makers to be less fiscally responsible about the rest of the budget has no support.

The idea that the trust funds are "fake" is simply wrong. It is bad accounting because it does not acknowledge how reducing future expenses can improve a balance sheet. It is bad political analysis because it does not stand up to investigation.

Policy Implications and the Payroll Tax "Holiday"

From a strict legal perspective, the Social Security trust funds are real because the law says they are. But from a fiscal capacity perspective, the trust funds are real because they represent an accumulation of extra revenues, which were made possible because the American public is much more willing to pay taxes that are dedicated to financing Social Security than taxes for the general operations of the federal government. Almost anyone can think taxes are too high when they are used for a wide variety of programs, because most people can think of programs that they don't like so could be cut. Only voters who object to Social Security can, logically, object to taxes dedicated to that program.[86]

The problems with the payroll tax cut

This is why the payroll tax cut enacted first in December of 2010 is so questionable. When President Obama and Congress at the end of 2010 chose to stimulate the economy by temporarily reducing the payroll tax on employees from 6.2% to 4.2%, they included a provision crediting the trust funds with all the missing revenue. This is phrased as a transfer from general revenues and it means that the trust fund balances are, in a legal sense, unchanged. FactCheck.org therefore reported that Congresswoman Michelle Bachmann's claim that the payroll tax cut "denied $111 billion to the Social Security trust fund" was "false."[87]

Yet the payroll tax cuts undermined the fiscal capacity logic. First, the "general revenue" credited to the trust fund during the years of the payroll tax holiday is, without question, borrowed money. During these years, nobody can logically argue that the trust fund is being built up from taxes that voters are willing to pay for Social Security but not for other purposes. Second, by treating dedicated taxes and general revenue as interchangeable, the payroll tax cut challenges the whole idea of dedicated revenues creating a special claim to benefits. As one report put it, "Social Security advocates may have a harder time arguing that seniors' benefits were bought and paid for by their payroll taxes."[88] One can argue that the payroll tax cut is a temporary measure, but *if Social Security's payroll tax really is special, then the logical thing to do is stimulate the economy by cutting other taxes*.

Pro-Social-Security advocacy groups therefore were horrified when the payroll tax cut was proposed in 2010.[89] They argued that the payroll tax cut was a convenient way to stimulate demand, and better than nothing, but that other methods were available. They especially supported an extension of the "Making Work Pay" tax cut that was part of the 2009 stimulus legislation and that, if a bit less easy to implement, was also easier to target to people who were more likely to spend.[90] Or, as Dean Baker commented, the government could just have cut everyone's income tax by the same amount as the payroll tax cut.[91] Even some Republican Senators showed more concern for the principle of dedicated funding by suggesting an alternative tax credit.[92]

Social Security advocates as well as some budget hawks have also been especially worried that it will be much harder to restore the payroll tax to its original levels than to reduce it. Therefore nearly a third of House Democrats in July of 2011 wrote to the President in 2011 to say they were "gravely concerned" about possibly extending the payroll tax cut, arguing that this "may be used as the first step in a larger battle to fundamentally dismantle Social Security." One reason is that the economic conditions that created pressure for stimulus are not likely to improve quickly. "Imagine that next December the unemployment rate is 8 percent and a year later it's 7.4 percent," Social Security trustee Robert Reischauer commented in December. "We'll still be trying to stimulate employment and terminating the payroll tax holiday will be a big hit on most families, one that will hurt job growth."[93] As Robert Kuttner wrote in January, "progressive critics" of the payroll tax cut argue that, "it will never be a good time politically for either party to raise Social Security taxes on working people."[94]

During the payroll tax cut debate of 2011, in fact, President Obama and his allies continually described restoring the payroll tax to its normal level as a tax increase on the middle class.[95] In doing so, the President risked redefining Social Security taxes from the contribution we make to earn our benefits, to a tax on hard-working middle-class Americans.

Many members of the Social Security advocacy community grudgingly backed the payroll tax cut anyway. They believed that the economy needed to improve for the president to get reelected, and that the danger from redefining the payroll tax was less than the danger from electing any of the possible Republican presidents. They also, however, were frustrated by being put in this position, and debated whether it was created by incompetence (the president's economic advisers not understanding the political basis of the program), ill intent (actual desire to cut Social Security), or just desperate political maneuvering in the face of the combination of economic and political pressures.[96]

The logical question, then, is whether the Obama administration could have found a way to cut taxes without endangering the fiscal capacity rationale that justifies using contributions to build up a trust fund.

Alternative approaches

It would have been better for Social Security if fiscal stimulus were pursued by reducing other revenues, as in 1978. Yet the approach taken by the Obama administration (and Congressional Republicans in 2010) was not entirely unprecedented.

The 1935 Social Security Act planned to build up trust funds to help finance future expenses; it therefore increased taxes, without compensating benefits, during the very fragile recovery from the Great Depression. The economy slumped badly in 1937, as those taxes were being implemented. In part in response to the slump, the 1938 Advisory Council recommended, and the government adopted, a change in policy in the 1939 amendments. Trust-fund buildups were postponed by both reducing the scheduled payroll taxes and beginning benefit payments more quickly.

Hence there is precedent for deciding that macroeconomic management goals, particularly in a severe crisis, should trump Social Security finance goals. There has to be a healthy economy from which to finance benefits. The 1939 policy change, however, was within a framework of careful attention (based on available information) to the long-term financing challenge. So what would a similar policy have looked like in 2010, or today?

One approach would be to focus on the dedicated revenues for Social Security, and say that any reduction in those revenues in the short-term should be more than offset by increases in future revenues. It would be perfectly reasonable, from a demand management perspective, to cut the payroll tax in the current emergency but, in the same legislation, plan increases in future years. In order to smooth out effects, for example, the “holiday” could have been structured as follows:

Combined OASI and DI Payroll Tax Rate for Individuals

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
6.2%	4.2%	4.6%	5.0%	5.6%	6.2%	6.3%	6.4%	6.5%	6.6%	6.7%	6.8%	7.0%

In this scenario, the employer contribution would also be raised to match the new, higher employee rates, beginning in 2016.

The combination of cuts followed by increases could legitimately be explained as serving both the goals of stimulating the economy in a crisis and making Social Security’s finances, in fiscal capacity terms, more secure. The numbers here are what would have made sense in 2010, but the idea could be adjusted to fit the situation at any given point in time. Advocates for Social Security who believe in the trust fund logic would have supported the payroll tax holiday with much more enthusiasm if it had been structured this way. The Republicans presumably would have opposed it – but then they could not have claimed they were trying to defend Social Security by doing so.

The second approach that the Obama administration and its allies could take would be to separate out the DI financing shortfall and address it -- as soon as possible. If there are two separate trust funds, then each should be solvent. Addressing DI quickly would respond to budget hawks on their strongest ground. It would have to include increased revenues and/or lower spending before 2018, when the DI fund would otherwise hit zero, and so would have to improve overall budget conditions by and after that time.

DI is a complex program with difficult issues about eligibility terms, eligibility determination, and benefit levels.[97] While some people might favor simply raising revenues, there are legitimate reasons to consider the benefit side. This is precisely the kind of issue for which an advisory commission makes sense, and the President or Social Security Administration should appoint one, requiring both that it hold hearings to learn from all possible interested parties and prepare a report with policy options by sometime in 2013. The goal should be to include a DI "fix" in the budget deliberations for 2014. This should have been done earlier. Action would have to improve federal fiscal capacity, while making necessary decisions about dedicated funding for a major program.

These two approaches are not mutually exclusive. The increased revenues in 2016-18, for example, could be dedicated entirely to DI; and any spending reductions in DI (if desirable) are not excluded by the revenue increases (which OASI could use). Both of these approaches, however, would not preclude immediate stimulus by reducing Social Security payroll taxes, while maintaining the legitimate fiscal capacity logic for the trust funds. In fact, if short-term cuts were offset by long-term payroll tax increases, that would confirm public support for financing Social Security.

The Bottom Line

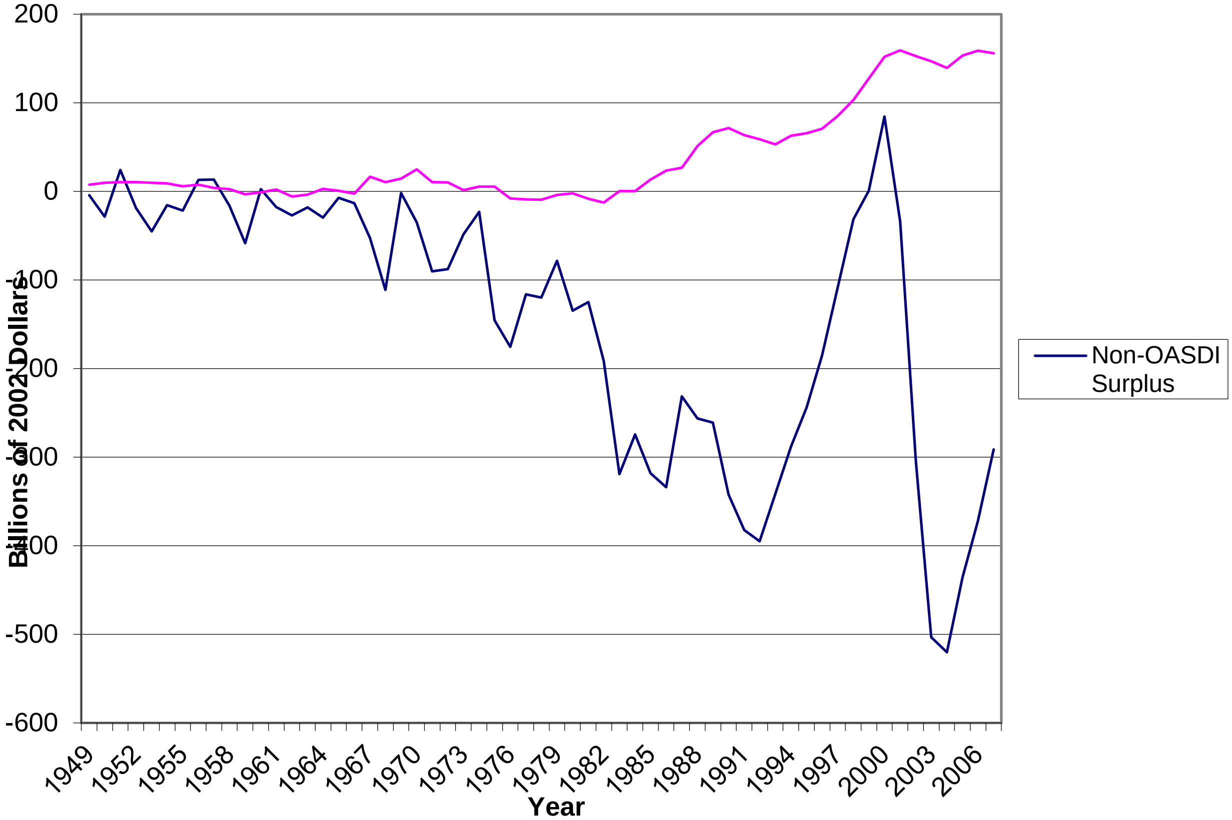
Building up Social Security trust funds is good policy. For nearly thirty years it actually has improved the ability to finance Social Security spending in the future. Both the economic and political criticisms from the "cash flow" perspective are unfounded.

For the fiscal capacity perspective to remain correct, however, advocates for Social Security must follow its logic. That means they should be pushing to address DI's problems sooner rather than later. It would be better if economic stimulus did not include cutting Social Security payroll taxes. But if stimulus does use cuts to the payroll tax, it should be offset with later increases that exceed the cuts.

Figure 1

Social Security and Non-Social-Security Deficit or Surplus

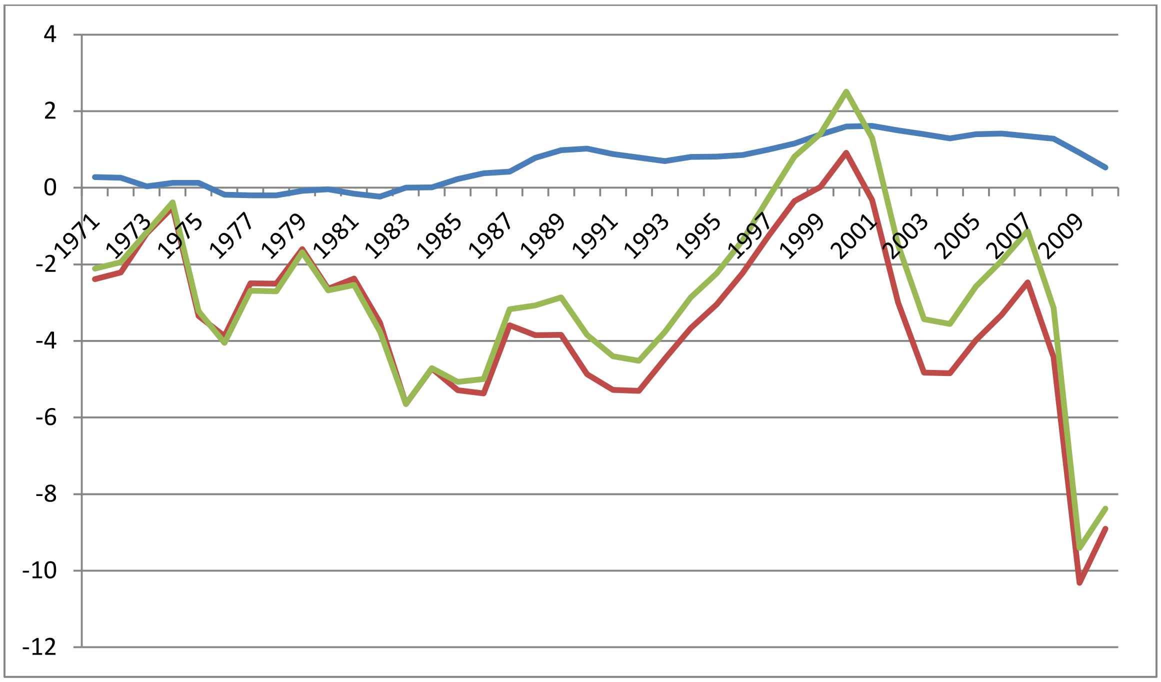
(Including Interest Payments to the Trust Funds)



Source: Data Supplied by Dr. Thomas Hungerford

Figure 2

OASDI, On-Budget, and Unified Budget Deficits/Surpluses
As Percent of Potential GDP
Fiscal Years 1971-2010



Vertical Axis: % of Potential GDP
Horizontal Axis: Fiscal Year

On-Budget Surplus or Deficit as % of Potential GDP

Social Security Surplus or Deficit as % of Potential GDP

Unified Budget Surplus or Deficit as % of Potential GDP

Source:
Data from U.S. Congressional Budget Office, The Budget and Economic Outlook, Fiscal Years 2011-2021,
Historical Tables E-1 and E-11, http://cbo.gov/ftpdocs/120xx/doc12039/HistoricalTables[1].pdf

Notes

[1] The first version of this paper was presented at the 2011 meeting of the Association for Budgeting and Financial Management. I would like to thank Dean Baker and Dennis Ippolito for commenting on that draft. I presented a revision to the political science research working group of Case Western Reserve University, so benefited from comments by Andrew Barnes, Karen Beckwith, Justin Buchler, Karl Kaltenthaler and Kelly McMann. I then circulated a draft to experts in the fields of budgeting or Social Security, so thank Barry Clendenin, Ted Marmor, Roy Meyers, Irene Rubin and James D. Savage for their critiques. I especially thank Justin Buchler for his advice on statistical issues, and Thomas Hungerford for sharing data and reviewing one of the drafts. After so much good advice, clearly only I bear responsibility for any flaws in this work. This paper may be cited so long as it is referred to as a draft.

[2] For a brief explanation, see http://www.ssa.gov/oact/progdata/fundFAQ.html Downloaded 11 January 2012.

[3] See Social Security and Medicare Board of Trustees, *Status of the Social Security and Medicare Programs: A Summary of the 2011 Annual Reports* at http://www.ssa.gov/oact/TRSUM/index.html. The following figures about trust fund flows in 2010 are taken from the same source.

[4] The projection is in a table in the 2011 Trustees Report, Table IV.A.2, at http://www.ssa.gov/oact/TR/2011/IV_A_SRest.html#342941 The actuaries make "High-cost," "Intermediate," and "Low-cost" projections; it is standard to focus on the "intermediate" projection, as I do here.

[5] As explained in "Frequently Asked Questions" at http://www.ssa.gov/oact/progdata/fundFAQ.html

[6] 2011 Trustees Report, Table II.D.1 http://www.ssa.gov/oact/TR/2011/II_D_project.html#105724

[7] The figures depend on how you define sufficient funding. The projected amount needed to pay all benefits through 2085 was 2.08% of taxable payroll, so a tax increase of that amount. But "actuarial balance" is defined as having a cushion of one year's spending in the combined OASI and DI trust funds, and that would require a 2.22% of taxable payroll increase. See the 2011 Trustees Report page 12, http://www.ssa.gov/oact/tr/2011/tr2011.pdf. If nothing were done beforehand, an increase of 3.77% would be needed in 2035, but that doesn't include creating the margin of error. This figure then declines slightly through 2070, before rising to 4.24% in 2085. Therefore there would be some accumulation of surplus between 2035 and 2070 which, by trust fund logic, would reduce the size of the tax increases needed between 2070 and 2085. For these estimates, see Table VI.F2 at http://www.ssa.gov/oact/tr/2011/VI_F1_OASDHI_payroll.html#151594.

[8] I am assuming people prefer being beneficiaries to being dead; readers may have different views.

[9] We haven't the space for a full review of Social Security politics. But readers may note that Republican proposals to privatize Social Security or cut benefits normally claim they will not harm current beneficiaries, or those who are planning to retire in the relatively near future (e.g. age 55 or over). Similarly, the largest benefit cut in the 1983 refinancing legislation was an increase in the Normal Retirement Age from 65 to 67. This benefit cut, however, did not begin to take effect until 2003, and will not be completely implemented until 2027. For good political reasons, one aspect of the 1983 reform was counted as a benefit cut by Republicans and a tax increase by Democrats. This was elimination of part of previous law that excluded Social Security benefits from taxation. For accounts of the 1983 reform, see Paul Light, *Artful Work: The Politics of Social Security Reform* (New York: Random House, 1985) and Joseph White and Aaron Wildavsky, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and New York: The University of California Press and The Russell Sage Foundation, 1991).

[10] Or less unpopular. For example, in polls in 1998-99, 2005, and 2011, respondents were asked if it were more important to avoid "any Social Security tax increases for workers and employers" or "any future cuts in Social Security benefit amounts." Between 30 and 34% said it was more important to avoid tax increases; between 53 and 60% said it was more important to avoid benefit cuts. See The Pew Research Center For The People & The Press, "Public Wants Changes in Entitlements, Not Changes in Benefits," July 7, 2011 p. 23. Downloaded 12 January 2012 from http://www.people-press.org/files/legacy-pdf/7-7-11%20Entitlements%20Release.pdf

[11] Kathy Ruffing and Paul N. Van de Water, "Bowles Simpson Social Security Proposan Not a Good Starting Point for Reforms, Center on Budget and Policy Priorities, 17 February 2011, downloaded 12 January 2012 from http://www.cbpp.org/cms/index.cfm?fa=view&id=3402.

[12] The quote is from President Franklin Delano Roosevelt, according to his adviser Luther Gulick. Quoted many times, including in Brian Faler, "Payroll Tax Cuts Seen by Some Obama Allies as Undermining Social Security," Bloomberg Business News 5 December 2011, downloaded that day from http://www.bloomberg.com/news/2011-12-05/payroll-tax-cuts-seen-by-some-obama-allies-as-undermining-social-security.html

[13] I am counting 1950, 1954, 1956 (when DI was created), 1958, 1961, 1965, 1967, 1972, 1973, 1977 and 1983; for descriptions see Geoffrey Kollmann, "Summary of Major Changes in the Social Security Cash Benefits Program: 1935 – 1996. CRS Report for Congress 94-36 EPW, 20 December 1996. This count does not include times when the amount of earnings subject to tax was raised, or when new categories of workers were included in the program. These increases were normally scheduled for future years, rather than immediate.

[14] National Academy of Social Insurance, "Public Opinions on Social Security," downloaded 12 January 2012 from http://www.nasi.org/learn/social-security/public-opinions-social-security

[15] Benjamin Page and Lawrence Jacobs, "Understanding Public Opinion on Deficits and Social Security," Roosevelt Institute Working Paper No. 2 (June 27, 2010), downloaded 12 January 2012 from http://www.newdeal20.org/wp-content/uploads/2010/06/tuespage-and-jacobs-public-opinion.pdf

[16] Tax revenue in a given year is immediately deposited in the funds, and then paid back out; the deposit is what creates the budget authority to spend.

[17] All quoted in Brooks Jackson, "Democrats Deny Social Security's Red Ink," FactCheck.org, February 25, 2011.

[18] Allan Sloan, "Useless: The Social Security trust fund." CNNMoney.com, August 10, 2010.

[19] Since its beginning, Social Security has not been allowed to invest surpluses in the private economy because of opposition by conservatives who viewed that as a form of socialism. Hence when current conservatives claim the trust fund is "fake" one might accuse them of having it both ways. However, one could argue that they have always wanted a pay-as-you-go program, if any program at all, in part because that would facilitate keeping the program smaller over time.

[20] The formal name of the program is Old Age, Survivors and Disability Insurance, or OASDI. Disability, DI, has one trust fund, with payroll tax of 0.9% of taxable payroll for employee and employer. The balance, OASI, has a separate fund and payroll tax rate of 5.3%.

[21] The Board of Trustees, Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2011 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds*. Washington, DC May 13, 2011. 112th Congress, First Session, House Document 112-23, page 5. Accessed 10/10/11 from http://www.ssa.gov/oact/tr/2011/tr2011.pdf

[22] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform". Washington DC: The White House, December 2010, accessed at http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf October 10, 2011. I have worded my reference carefully because, in spite of the title, the "report" is not in fact an official recommendation by the Commission. It did not have the necessary supermajority support, and the statements in support by some members were not the same as voting for all the details. For the Social Security proposals, see pp. 48-56 of the report. For discussion of the proposals see Kathy Ruffing and Paul Van de Water, "Bowles-Simpson Social Security Proposal Not a Good Starting Point for Reforms," Center on Budget and Policy Priorities (February 17, 2011), accessed 10/10/11 from http://www.cbpp.org/cms/index.cfm?fa=view&id=3402 . The authors argue the plan "relies far too much on deep benefit cuts to restore solvency to the program and makes a number of harmful changes." Nearly two-thirds of the overall improvement in solvency – and "nearly four fifths of savings in the 75th year" – would come from reducing benefits.

[23] Committee for a Responsible Federal Budget, "Social Security and the Budget," March 24, 2011, p. 5.

[24] President's Commission to Strengthen Social Security, Interim Report (August, 2001) p. 19; accessed 10/10/11 from http://www.ssa.gov/history/reports/pcsss/Report-Final.pdf

[25] Brooks Jackson, "Democrats Deny Social Security's Red Ink," op. cit.

[26] Lori Montgomery, "The debt fallout: How Social Security went 'cash negative' earlier than expected." *Washington Post*, October 29, 2011, downloaded 10/30/11 from http://www.washingtonpost.com/business/economy/the-debt-fallout-how-social-security-went-cash-negative-earlier-than-expected/2011/10/27/gIQACm1QTM_story.html

[27] Kathy Ruffing, "No Need for Social Security Fright on This Halloween," Center on Budget and Policy Priorities Off the Charts blog, October 31, 2011, downloaded from http://www.offthechartsblog.org/no-need-for-social-security-fright-on-this-halloween/ . For a more extensive analysis from CBPP, see Paul N. Van de Water, "Understanding the Social Security Trust Funds," October 5, 2010, downloaded 10/31/2011 from http://www.cbpp.org/cms/index.cfm?fa=view&id=3299

[28] Alicia H. Munnell, "Are the Social Security Trust Funds Meaningful?" *Center for Retirement Research Issue Brief*, May 2005, Number 30, p. 2.

[29] Peter A. Diamond, "Social Security, The Government Budget, and National Savings," MIT Department of Economics Working Paper Series, #05-09, March 17, 2005, p. 6. Accessed 10/10/11 from http://econ-www.mit.edu/files/605

[30] Henry J. Aaron and Lawrence H. Thompson, "Social Security and the Economists," in Edward D. Berkowitz ed., *Social Security after Fifty: Successes and Failures* (Westport, CT: Greenwood Press, 1987). I give Henry the credit because he used this phrase continually in my hearing. For further examples of its ubiquity among what might be called mainline economists associated with the Democratic party in the 1990s, see the chapters by Barry Bosworth and by Edward M. Gramlich in Eric R. Kingson and James M. Schulz eds., *Social Security in the Twenty-First Century* (New York: Oxford University Press, 1997).

[31] See the comments by Lawrence Thompson and Charles Schultze in Henry J. Aaron ed., *Social Security and the Budget* (Lanham, MD: University Press of America, 1990).

[32] It has this effect because, during the period of growth, wages for current workers that are the basis for revenues rise more quickly than prices which are the basis for benefit increases among current retirees. All other things being equal.

[33] Standard forecasts at the time this argument was invented and promoted widely in the 1990s projected that consumption eventually could be about 2.5 percent larger in 2030 as a result of a 3 percent of GDP improvement in the government's budgetary balance. See Joseph White, *False Alarm: Why the Greatest Threat to Social Security and Medicare is the Campaign to "Save" Them.* Baltimore: Johns Hopkins University Press, 2003.78-84. The improvement in revenues would be the larger economy times the federal government's tax percentage of GDP – so perhaps half a percent of GDP. But some of any extra revenues would be offset by extra expenses, such as higher federal wages associated with a higher national wage level.

[34] Paul N. Van de Water, "Understanding the Social Security Trust Funds," Center on Budget and Policy Priorities Oct 5, 2010, p. 4. The discussion in the next few paragraphs mostly follows Van de Water's argument, but a similar discussion can be found in White, *False Alarm* op cit.

[35] White, *False Alarm* op. cit. For more extensive discussion of this issue see Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform: The Great Social Security Debate* (New York: The Century Foundation, 1998).

[36] "Final Report of the Advisory Council on Social Security," republished as part of The Report of the Committee on Economic Security of 1935, 50th Anniversary Edition, (Washington National Conference on Social Welfare, 1985); appendix.

[37] Joseph White, "Budgeting for Social Security, or: When Are Savings Really Savings?" *Public Budgeting & Finance* Fall 2000, 1-28.

[38] If OASI and DI are treated separately, DI would need to be addressed immediately, while OASI might wait a year or two longer than 2023. For some estimates see pages 2-3 of the 2011 Trustees Report.

[39] Munnell op.cit., p. 2.

[40] Politifact Wisconsin (Milwaukee Journal Sentinel) posted Sept 23, 2010 and downloaded 10/11/11. http://www.politifact.com/wisconsin/statements/2010/sep/23/ron-johnson/senate-candidate-ron-johnson-likens-social-securit/

[41] This is not the place for a full history of this development, but see White, *False Alarm* op.cit. chapter 5; the minority report by Senator Moynihan in National Economic Commission, *Report of the National Economic Commission* (Washington, DC: GPO, 1989); and sources cited in the above discussion of the economic capacity perspective. For responses to Senator Moynihan's proposal to cut the payroll tax, see various authors, "Four Reasons Not to Cut Social Security Taxes," *The Brookings Review* (Spring 1990), pp. 3-8. For assorted quotations from Democratic politicians see Kent Smetters, "Is the Social Security Trust Fund a Store of Value?" *American Economic Association Papers and Proceedings*, Vol. 94, No. 2 (May, 2004), p. 178.

[42] For a discussion of Clinton Administration maneuvers, and their fiscal logic or lack thereof, see White, "Budgeting for Social Security" op. cit., pp. 17-19.

[43] Thus CBO discussed the difference between deficits on just "federal funds" or with the effect of trust funds. Congress of the United States, Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986 – 1990 (February 1985), pp. 62-64.

[44] Alan S. Blinder and Alan B. Krueger, "What Does the Public Know About Economic Policy, and How Does It Know It?" *Brookings Papers on Economic Activity* 1: 2004, pp. 327-397, quote p. 345.

[45] "Social Security and the Budget" op. cit., p. 3.

[46] The source cited by CRFB is a manuscript by Kent Smetters, "Is the Social Security Trust Fund Worth Anything?" dated June 2003 and available at http://irm.wharton.upenn.edu/WP-security-Smetters.pdf . For a related formal publication, see Kent Smetters, "Is the Social Security Trust Fund a Store of Value?" op. cit. A similar argument is made in a paper by Sita Nataraj and John Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds?" NBER Working Paper 10953 (December 2004); see also Barry Bosworth and Gary Burtless, "Pension Reform and Saving," National Tax Journal 57(3), 2004, pp. 703-27. These findings have been criticized in a series of studies cited by Alicia Munnell (2005, op. cit.) and by Thomas Hungerford; but Hungerford's own analysis, discussed below, is the most thorough and convincing.

[47] A simple regression of on-budget surplus on the off-budget surplus yields a beta of 0.524; Smetters 2003 op. cit. p. 18.

[48] Smetters 2003 op. cit., p. 19.

[49] Over the years until 1983 there were many times when the Social Security benefits and taxes were adjusted, but the goal was usually not to change the balance but to maintain a balance while also maintaining the adequacy of benefits. For a summary see Geoffrey Kollmann, "Summary of Major Changes in the Social Security Cash Benefits Program: 1935-1996," CRS Report for Congress 94-36 EPW, December 20, 1996.

[50] I do not want to suggest that thinking about games is unhelpful for understanding budget politics; but Smetters' framework is not helpful. For abstractions that explain more about budget dynamics see the similar arguments made in Anthony Downs, "Why the Government Budget is Too Small in a Democracy," *World Politics* Vol. 12, No. 4 (July 1960) and in Joseph White, "Making 'Common Sense' of Federal Budgeting," *Public Administration Review*, Vol. 58, No. 2 (Mar/Apr 1998).

[51] Thomas L. Hungerford, "The Social Security Surplus and Public Saving," Public Finance Review 37 (1), January 2009, pp. 94-114. Thus, when he reestimated the models, Hungerford found a "low Durbin-Watson statistic (about 1.1) and relatively high R-squared (about 0.6)" that "may indicate a problem of spurious regression, so that the independent variables may have no explanatory power whatsoever" (p. 105).

[52] To put this another way, the most basic theory of public budgeting, incrementalism, says one year's numbers are largely determined by the previous year's numbers – that is, autocorrelated. See Aaron Wildavsky, *The Politics of the Budgetary Process 1st ed*. (Boston: Little Brown, 1964), or any of the many editions since.

[53] Ibid pp. 104-111.

[54] Hungerford op. cit., p. 112.

[55] Hungerford and Smetters also do the calculations excluding the interest payments into the Social Security trust funds, but the two approaches show essentially the same story about the timing and relative sizes of trends.

[56] I was not able to obtain the adjusted numbers used by Hungerford and Smetters. They appear to have used calendar years. In order to divide by potential GDP I needed to use the nominal GDP figures that can be obtained from CBO. These were available for 1971 through 2010, as in the table, by fiscal year, along with CBO's figures for "on-budget" and "Social Security" deficits or surpluses. All of these figures were in nominal dollars but, as we are using ratios, that should have no effect. Nor is there any reason why the fiscal/calendar difference should change the trend.

[57] It is difficult, by the way, to fit the situation from 1981 on with his theory of mutual credit-claiming: exactly what benefits were the Democrats providing their constituencies? The Republicans at least got a defense buildup and tax cuts; where's the Democrats' part of the supposed trade?

[58] Paul Pierson, "The New Politics of the Welfare State," World Politics 48(2): 143-179, quote p. 145.

[59] For discussion of this dynamic in terms of public opinion, see Andre Modigliani and Franco Modigliani, "The Growth of the Federal Deficit and the Role of Public Attitudes," *Public Opinion Quarterly* 51(4), 1987: 459-480.

[60] Joseph White, "Budgeting for Social Security Or: When Are Savings Really Savings?" *Public Budgeting & Finance* Fall 2000, pp. 1-23; Eric Patashnik, "The Contractual Nature of Budgeting: A Transaction Cost Perspective on the Design of Budgeting Institutions," *Policy Sciences* 29 (1999), pp. 189-212.

[61] In the extreme, by 2040, benefits for low earners were projected to exceed their earnings while working. See Table 1 in John Snee and Mary Ross, "Social Security Amendments of 1977: Legislative History and Summary of Provisions." *Social Security Bulletin* Vol. 41, No. 3 (March 1978), pp. 3-20. See also Kollman, "Summary of Major Changes" op. cit., pp. 13-14.

[62] In addition to the cites in the two previous footnotes, see Martha Derthick, *Policymaking for Social Security* (Washington, DC: The Brookings Institution, 1979), pp. 407-411, and *CQ Almanac* Vol. 33 (1977)..

[63] Congressional Quarterly Almanac Vol. 33 (1977), p. 95.

[64] Derthick, op. cit. p. 411.

[65] In fact, under those fiscal conditions, there is a plausible argument that failure to stimulate will hurt the economy and so reduce fiscal capacity over the long run. An argument that may seem familiar at present.

[66] Snee and Ross op. cit., p. 17.

[67] The tax cut debate in 1978 was extremely complicated, and a coalition of Republicans and conservative Democrats won major reductions in capital gains – what at that point was considered a "supply side" tax cut. As a result, the individual income tax reductions only partially offset the effects on most tax payers from the combination of Social Security payroll tax increases and income tax bracket creep. And this was a result of lawmakers' concern about budget constraints. Whatever one may think about the 1978 tax legislation, it surely does not fit Smetters' proposed game. See *Congressional Quarterly Almanac* Vol. 34 (1978), pp 217-225.

[68] From the Committee on Ways and Means *1996 Green Book*, p. 76, as quoted in White, "Budgeting for Social Security" op. cit., p. 4.

[69] Philip G. Joyce and Robert D. Reischauer, "Deficit Budgeting: The Federal Budget Process and Budget Reform," Harvard Journal of Legislation 29 (1992), pp. 429-453; quote pp. 440-41.

[70] For the most extensive account through 1990, see Joseph White and Aaron Wildavsky, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and New York: The University of California Press and The Russell Sage Foundation, 1991). For an overview up to 1996 see George Hager and Eric Pianin, *Mirage: Why Neither Democrats Nor Republicans Can Balance the Budget, End the Deficit, and Satisfy the Public* (New York: Random House, 1997). For an explanation of the abstract dynamics that make agreement very difficult yet enable all sides to be self-righteously opposed to the resulting deficits, see White, "Making 'Common Sense'" op. cit. Other book-length sources on aspects of the period are listed in, e.g., White, "Budgeting for Social Security," fn. 26.

[71] Rudolph G. Penner, *Dealing With the Retirement of the Baby Boomers* (Washington DC: The Urban Institute Press, 1994) p. 7.

[72] The following two paragraphs are taken from White, "Budgeting for Social Security," op. cit. p. 16; see also White, *False Alarm*, pp. 45-47.

[73] Well, the formal scorekeeping reports at the time did say, given extremely optimistic assumptions, that the result would be a balanced budget. But policy-makers didn't even say that to the public. Neither public comments by participants, briefing documents for legislators, nor news reports at the time said the deal would balance the budget. The formal scorekeeping was created simply to make it easier to repeal the more noxious elements of the 1985 Gramm/Rudman/Hollings legislation. For an account see White and Wildavsky, *The Deficit and the Public Interest*, op. cit.

[74] The less said about this focus on financial markets, the better. For the story see Bob Woodward, *The Agenda: Inside the Clinton White House* (New York: Simon & Schuster, 1994).

[75] David Maraniss and Michael Weisskopf, *Tell Newt to Shut Up* (New York: Simon & Schuster, 1996).

[76] See White and Wildavsky 1991 for accounts of each.

[77] Daniel J. Parks with Bill Swindell, "Tax Debate Assured a Long Life As Bush, GOP Press for New Cuts," CQ Weekly Report, June 2, 2001, p. 1304. By the time of CBO's Update, in August, the estimated on-budget surplus over ten years had dropped to $847 billion. But even with that missing half a trillion dollars, the largest projected deficit in any year was $18 billion in 2003. That's virtual balance and, in any event, hindsight.

[78] CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (January, 2003), Summary Table 1.

[79] Budget of the United States Government for Fiscal Year 2004, "Charting A Course for the Federal Budget," p. 28. This and the following citations from the document are from sections downloaded on November 1, 2011 from http://www.gpoaccess.gov/usbudget/fy04/browse.html

[80] Ibid, p. 1.

[81] Ibid, p. 25.

[82] Ibid, p. 27. See also Andrew Taylor, "Bush Holds Steady Fiscal Course Even as Deep Deficits Take Hold," *CQ Weekly*, Feb 1 2003, pp. 244-47. Note that the headline does not suggest that the Social Security surpluses were likely to hide the deficits.

[83] Alan K. Ota, "Tax Cut Package Clears Amid Bicameral Rancor," *CQ Weekly* May 24, 2003, pp. 1245-1249.

[84] CBO, "The Budget and Economic Outlook: An Update." August, 2003. The unified budget deficits were to disappear after 2011 because of the expiration of the tax cuts that year. This tactic itself should tell us that the governing coalition was rather cynical about budget numbers, and so not likely to be under any illusions.

[85] White House Office for Homeland Security, "National Strategy for Homeland Security" (July, 2002) p. 65, at http://www.dhs.gov/xlibrary/assets/nat_strat_hls.pdf

[86] The classic explanation of this logic is Anthony Downs, "Why the Government Budget Is Too Small in a Democracy," *World Politics* 12(4) 1960, 541-563.

[87] FactCheck.org, "Bachmann Wrong on Social Security, Jobs, Debt." Dec 19, 2011. Downloaded Jan 15, 2012 from http://www.factcheck.org/2011/12/bachmann-wrong-on-social-security-jobs-debt/ Please do not imagine I am citing FactCheck.org as an indicator of truth – far from it. But it is an indicator of a certain kind of conventional, not-consciously-partisan thinking at a given time.

[88] Brian Faler, "Payroll Tax Cuts Seen by Some Obama Allies as Undermining Social Security," Bloomberg Business News December 5, 2011, downloaded same date from http://www.bloomberg.com/news/2011-12-05/payroll-tax-cuts-seen-by-some-obama-allies-as-undermining-social-security.html

[89] For a good summary of the criticisms see National Committee to Preserve Social Security and Medicare, "Social Security Payroll Tax 'Holiday' Is No Gift to Americans" December 10, 2010. http://www.ncpssm.org/entitledtoknow/?p=1428

[90] For examples of this argument see NCPSSM op. cit.; Chuck Marr and Brian Highsmith, "Letting Payroll Tax Cut Expire Would Shrink Worker Paychecks and Damage Weak Economy," Center on Budget and Policy Priorities Sept 7, 2011. Downloaded 1/16/2012 from http://www.cbpp.org/cms/?fa=view&id=3572; Dean Baker, "Three Things to Love (and a Few More to Hate) About Obama's Job Plan" *The New Republic*, Sept 15, 2011; Merrill Goozner, "Five Ways To Fix The Payroll Tax Cut," The Fiscal Times Dec 6, 2011, http://www.thefiscaltimes.com/Articles/2011/12/06/Five-Ways-To-Fix-The-Payroll-Tax-Cut.aspx#page1

[91] Dean Baker, "Obama's Stimulus Failure," *The Guardian Unlimited* Dec 19, 2011, http://www.guardian.co.uk/commentisfree/cifamerica/2011/dec/19/obama-stimulus-failure-dean-baker

[92] See for example the comment of Senator Lindsey Graham in Scott Wong and Manu Raju, "Senate GOPers: Replace payroll tax," *Politico* Dec 7, 2011.

[93] House Democrat letter and Reischauer quotes from Jackie Calmes, "Disagreement Over Payroll Tax Cut's Impact on Social Security," *New York Times Online*, Dec 15, 2011.

[94] Robert Kuttner, "Social Security: Secure With Obama?" Huffington Post, 1/1/12. http://www.huffingtonpost.com/robert-kuttner/obama-social-security_b_1178904.html

[95] The President even solicited letters from citizens about what they would miss if they had an extra $40 deducted from each paycheck, and then talked about some of the examples to show how voters would be hurt. See, for example, "Remarks by the President on the Payroll Tax Cut," Dec 22, 2011, at http://www.whitehouse.gov/2011/12/22/remarks-president-payroll-tax--cut

[96] The author is a member of a listserve of Social Security experts and advocates on which this issue was debated quite extensively, but cannot cite the comments. For an account that puts the original payroll tax cut decision in the wider context of budget politics, see Joseph White, "From Ambition to Desperation on the Budget," Chapter 11 in James Thurber ed., *Obama in Office* (Paradigm Publishers, 2011).

[97] U.S. Congressional Budget Office, "Social Security Disability Insurance: Participation Trends and Their Fiscal Implications," *Economic and Budget Issue Brief* July 22, 2010. Accessed 1/23/12 from http://cbo.gov/ftpdocs/116xx/doc11673/07-22-SSDisabilityIns_Brief.pdf