The Social Security Trust Fund is Irrelevant (or How Al Gore Was Right)

(by David R. Henderson and Charles L. Hooper)

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One of the least-noted, but most important, statements about Social Security President Bush made in his April 28 press conference is by 2041 Social Security will be bankrupt. In so saying, President Bush seems to have caved and moved away from the clarity he so ably demonstrated on April 5. Back then, in one of his best domestic-policy photo ops, he showed the nation the Trust Fund: $1.5 trillion of government bonds gathering dust in a file cabinet in West Virginia. Scrutiny of the Old-Age and Survivors Insurance (OASI) Trust Fund leads to issues that are both economic and philosophic. Does the trust fund really exist? Is it relevant to policy decisions?

Yes and no, respectively. It exists but its irrelevant, which was precisely Bushs point on April 5. Heres the sense in which it exists. For all but 11 of the last 68 years, payroll tax revenues for Social Security have exceeded the amount the government spent on Social Security. The government used the excess to buy special bonds printed by the federal government. In other words, the government borrowed from itself. It then took the proceeds of the bonds and used it for other government expenditures. The idea all along has been that in 12 to 14 years, in the midst of the baby boom retirement wave, Social Security benefits will exceed payroll taxes earmarked for Social Security. Then the government can sell these bonds- -- to itself, of course -- -and use the proceeds to make up the gap.

And thats why the Trust Fund is irrelevant. To buy the bonds in the Trust Fund from itself, the government must get the money from somewhere. It has four options. It can reduce other government spending. It can sell assets. It can increase taxes. Or, it can sell bonds. In other words, the Trust Fund has no effect -- zero -- on the governments financial situation.

Lets make it more concrete with a personal situation that many people can relate to. Say youre planning to send your kid to college. You have ten years and think you need $100,000. In Scenario A, each year you put an IOU for $10,000 in a jar. At the end of ten years, you pour out the jar, swear a bit more than is proper, and then scramble to come up with $100,000, either through borrowing, selling assets, earning more, or spending less. In Scenario B, you skip the jar and IOU charade and advance to the final step: you swear and scramble. The IOU charade was irrelevant.

Its true that the bonds actually exist and its even true that they're worth something. But that doesn't matter. Consider an analogy with General Electric Company. GE has 10.6 billion shares outstanding and its current share price is $36.32, which gives it a market capitalization of $385 billion. If you wanted to buy GE today, you'd have to cough up $385 billion. Now imagine that GE prints an additional one billion share certificates and puts them in a safe. Can GE claim that it is holding an asset worth $36.3 billon? Why stop at one billion shares? Could GE print 100 billion share certificates and claim to have an asset worth $3.63 trillion? Not by generally accepted accounting rules -- nor by generally accepted common sense. But heres where it gets tricky. Does each share of GE stock have value? Yes. The value of each GE share comes from the value of GE as a company, but each additional share that GE sells reduces the value of currently outstanding shares proportionally. If GE sold an additional one billion shares, GEs value would not change. Each share would then be worth $33.19 ($385 billion divided by 11.6 billion shares). In other words, GE cant simply print value.

Back to Social Security. Do Treasury bonds have value? Certainly. But this value comes from the governments power to tax American residents. The reason the Trust Fund bonds have value is that they can be sold to a branch of the federal government that has the power to tax people. If, one night, an arsonist burned all the bonds in the West Virginia file cabinet, neither the governments ability to float new bonds nor its ability to tax people would be at all diminished.

Interestingly, 2000 presidential candidate Al Gore recognized the irrelevance of the Trust Fund. For all the ridicule he received for his concept of the lock box, what he was getting at was that he wanted to reduce the federal debt in order to make room for the new debt that he knew was coming with the retirement of the baby boomers.

If it were true that the Trust Fund can help save Social Security, then theres an easy solution: quadruple the Trust Fund and save Social Security for much longer. Why stop there? Medicare is in more trouble than Social Security. Lets set up a multi-trillion dollar trust fund for Medicare. The answer is clear. The fact that money changes hands between two branches of the federal government and bond certificates are printed is irrelevant. A bond is an obligation and an obligation to yourself is flimsy and easily broken. A bond becomes binding only when it is sold to another party. The Social Security OASI Trust Fund is irrelevant because the governments actions will be the same with or without it.