



Social Security Basics

by Steven B. Garrison and David Hogberg

In the next few months, this nation will debate the future of Social Security. Given the size and popularity of this government program, this political debate may be the most important one of this generation. To prepare you for this debate, two of this month's INSTITUTE BRIEFS, this BRIEF, BRIEF 8-30 "Privatize Social Security," and the October 2001 issue of IOWA ECONOMIC SCORECARD will be dedicated to the issue of Social Security. This BRIEF will explain the concept of Social Security and some of the challenges it faces in the coming years.

The concept of Social Security can be confusing. We constantly hear reporters, pundits, and politicians alike talk about it, usually in reverend tones. It came to be known as the "third rail of American politics." This is a reference to the third rail of a subway that carries the electricity to power the train. Any person fool enough to touch it will meet with a speedy demise. It has been likewise with politicians and Social Security.

Social Security is a social "insurance" program that pays benefits to retirees, surviving family members, and the disabled. This program is paid for through payroll taxes withheld from an employee's paycheck.¹ This means that Social Security is a "pay-as-you-go" program, which means that the taxes of today's workers pay for the benefits of today's retirees.

The payroll taxes are put into the "Social Security Trust Funds," another confusing concept. What is commonly referred to as the Social Security Trust Fund (SSTF) is actually two separate trusts. They consist of the federal Old Age and Survivors' Insurance (OASI) trust fund, which is used to pay for retirement and survivors' benefits; and the federal Disability Insurance (DI) trust fund, which is used to pay benefits to people with disabilities and their families.

Currently, SSTF is running a surplus; in other words, it is receiving more in payroll taxes than it pays out in benefits. The government uses this surplus money in the SSTF for other purposes. But it must first "borrow" the surplus. This is where the SSTF becomes complicated, and where most people lose track of where that surplus goes. The SSTF exchanges its surplus cash for government bonds from the U.S. Treasury. This leaves the SSTF with government bonds, and the Treasury with the extra cash. The government is now able to spend that cash on anything it sees fit.

A government bond is simply a promise by the government to repay money borrowed, with interest, at a future date. Thus, the U.S. Government must repay those bonds in the SSTF when they come due. For many years when bonds held by the SSTF came due, the government would repay them by borrowing the surplus from the SSTF. The government would exchange new bonds for the surplus, and then use a portion of the surplus to pay off the bonds that had come due. In effect, the government was paying off old bonds by issuing new bonds.

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This scenario works wonderfully until the SSTF is no longer running a surplus. In 2016, the SSTF begins to run a deficit; in other words, it pays out more in benefits than it receives in payroll taxes. The reason this happens in 2016 is that the very large generation of baby-boomers begins to retire around that time, and begin to receive Social Security benefits. At that same time, the number of workers still in the work force will be too small to pay enough payroll taxes to pay for the benefits. This problem will only grow as more and more baby-boomers retire and begin drawing benefits in future years. Table 1 shows the size of those deficits over time.²

Table 1: Social Security Deficits In Future Years

Year	Deficit
2025	\$194 billion
2030	\$271 billion
2035	\$318 billion

Because of this deficit, the SSTF will no longer have the surplus to pay off its own bonds. Yet the government will still have to come up with the money to pay off the bonds in the SSTF that will come due after 2016. To do that, the government will have to come up with money from a portion of the federal budget that is not devoted to Social Security. This will be very costly. The magnitude of this cost, and a possible solution, are explored in INSTITUTE BRIEF 8-30 "Privatize Social Security."

Adding insult to injury, the SSTF will run out of bonds by 2038; thus it will no longer be able to cover its deficits by redeeming bonds.³ This month's "IOWA ECONOMIC SCORECARD: The Burden of Social Security" has more information about the service of the bonds in the SSTF, as well as misconceptions concerning the national debt. It also explains how one particular solution would not only cover the coming Social Security deficit, but also help limit this massive federal debt.

ENDNOTES:

¹The payroll tax is often displayed on a paycheck stub under the heading "FICA" (FICA stands for Federal Insurance Contribution Act.) This tax pays not only for Social Security but also Medicare. The amount of payroll tax withheld from a paycheck is 7.65% of gross pay. The employer must pay a matching amount, often referred to as the "employer's share." That term is misleading, however. Many economists agree that employers pay that share by reducing the wages they pay to employees. Thus, it might be more accurately termed the "employee's share that the employee never sees."

²President's Commission to Strengthen Social Security, "Interim Report," August 2001, p. 15.

³Ibid, p. 17.

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