

Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

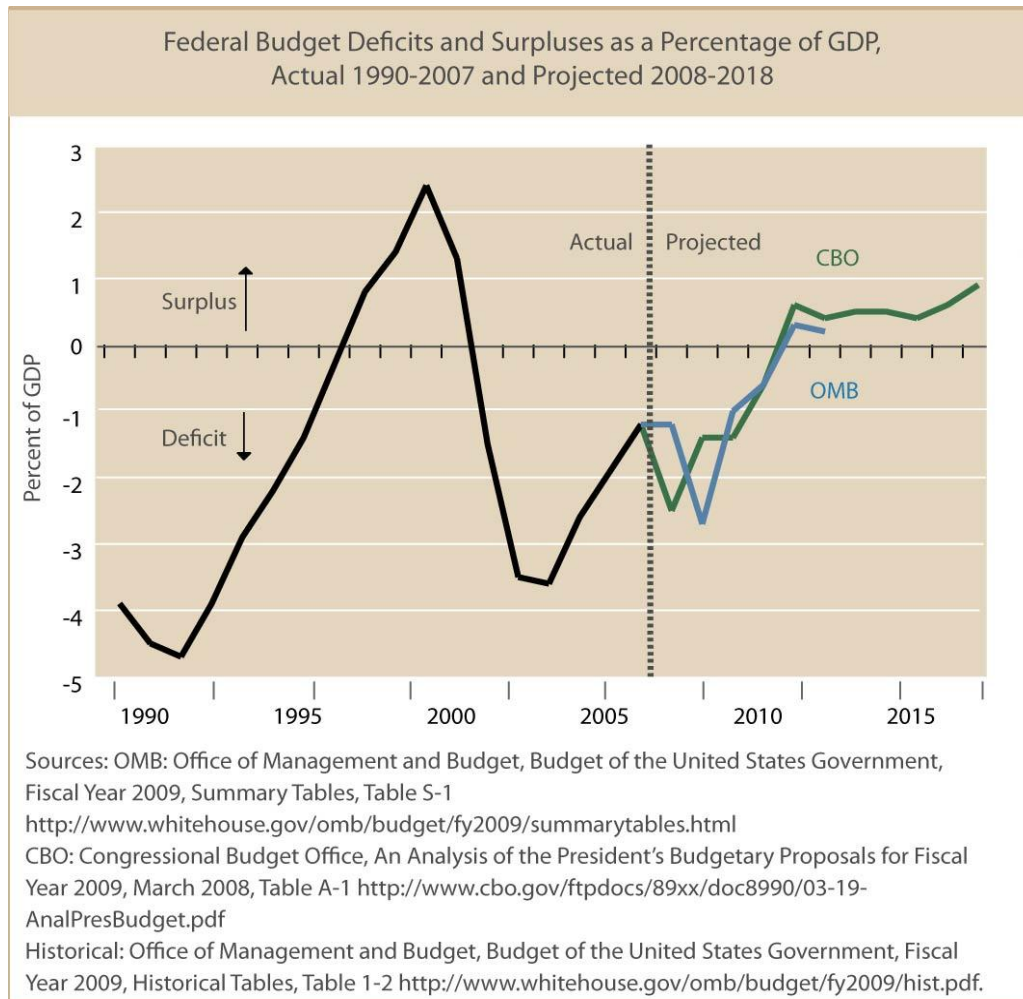
*A Citizens' Guide for the
2008 Election and Beyond*

TAXES AND THE BUDGET

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Taxes and the Budget: What is the short-term budget scenario?

The Congressional Budget Office (CBO) and, within the executive branch, the Office of Management and Budget (OMB) both produce short-term budget scenarios. CBO's scenarios set the budget baseline: the starting point for congressional deliberations on budget policy. The baseline looks forward ten years and assumes that all policies continue as under current law. In contrast, OMB's main scenario assumes implementation of all of the president's proposals and covers only five years.



- CBO's current baseline projections, published in March 2008 (see figure), show a unified budget deficit (that is, including the balance in the Social Security trust fund) of \$357 billion in fiscal 2008, a surplus of \$105 billion in 2012, and a surplus of \$202 billion in 2018. CBO's projections do not, however, consider the impact of extending any portion of President Bush's tax cuts of 2001 and 2003, providing relief from the alternative minimum tax (AMT), or extending any of the many "temporary" tax cuts that are routinely renewed. The baseline also considers only a portion of the likely costs of the wars in Iraq and Afghanistan. Including these items could easily convert the small (0.6 percent of GDP) surplus projected for 2012 into a deficit well in excess of \$200 billion.

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- OMB's current five-year projections, published in February 2008, also show a small surplus for 2012, and unlike the CBO projections they assume that the tax cuts of 2001 and 2003 are made permanent. (As estimated by CBO separately from its baseline projections, the revenue loss from extending the tax cuts is \$250 billion in 2012.) The president makes a number of other tax proposals that are roughly revenue neutral in the aggregate. The most important—a reform of the tax treatment of employer-provided health insurance—would raise \$24 billion in 2012. The president does not request appropriations for the wars in Iraq and Afghanistan beyond 2009, and he requests only one year's relief from the AMT. Moreover, the president's budget assumes that the Congress will cut nonsecurity discretionary spending by \$56 billion below CBO's baseline by 2012. This implies an absolute cut in such spending after adjusting for inflation.

See Also

Taxes and the Budget: What is the long-term budget scenario?

Taxes and the Budget: How accurate are short-term and long-term budget scenarios?

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Author: Rudolph G. Penner
Last Updated: April 22, 2008

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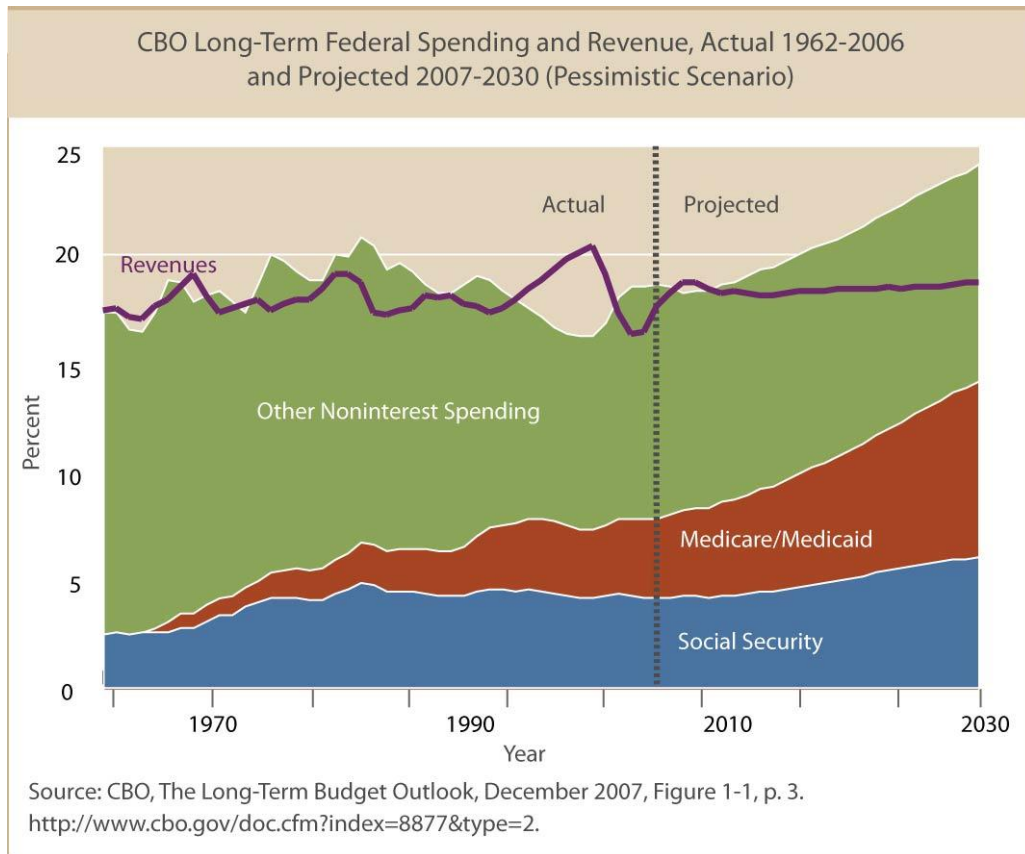
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Taxes and the Budget: What is the long-term budget scenario?

The Office of Management and Budget (OMB), the Congressional Budget Office (CBO), the Government Accountability Office (GAO), and a variety of private groups compile long-run federal budget scenarios. Those scenarios differ one from another because the economic and policy assumptions underlying them differ, but all conclude with the same sad tale: current budget policy is not sustainable.

- Social Security, Medicare, and Medicaid are all affected by the aging of the population as the baby-boom generation reaches retirement age and life expectancy continues to increase. Medicare and Medicaid are also afflicted by soaring health costs as their expenditures per capita grow much faster than income per capita. Consequently, expenditures on these three programs will grow much faster than the economy. The budget pressures from these sources are made worse by an additional fact: low birth rates since the 1960s imply that the labor force and hence the number of taxpayers will grow at a slowing rate.
- CBO and GAO each produce two long-run budget paths, one more optimistic than the other, which they call "scenarios" rather than projections because they are not intended as forecasts but simply illustrate the likely implications of current policy. The huge deficits that emerge in all of their long-run paths could not possibly be financed domestically or internationally; this means that current policy is unsustainable. This analysis focuses on the less optimistic scenarios because their policy assumptions seem more reasonable.
- CBO's more pessimistic scenario (see figure) assumes that Congress makes permanent the Bush tax cuts of 2001 and 2003 and extends all other temporary tax cuts. This scenario assumes that taxes claim 18.9 percent of GDP in 2030, compared with 18.8 percent in 2007 and an average (and relatively constant) tax burden over the past forty years of 18.3 percent. Spending for Social Security, Medicare, and Medicaid is meanwhile projected to grow from 8.4 percent of GDP in 2007 to 14.5 percent in 2030; the total federal tax burden would have to rise by about one-third to finance that increase entirely with higher taxes. Other noninterest spending is assumed to remain roughly constant relative to GDP, but because this budget scenario implies a rapidly growing public debt, the government's interest bill rises from 1.7 percent to 4.8 percent of GDP. The problem feeds on itself as larger deficits impose higher interest bills, which in turn cause still larger deficits. The public debt eventually explodes, climbing from 37 percent of GDP at the end of fiscal 2007 to more than 100 percent in 2030.



- GAO assumes a slightly lower tax burden than CBO and slightly more rapid growth in Social Security, Medicare, and Medicaid. As a result, the debt exceeds GDP in 2027—three years earlier than in the CBO scenario.
- OMB has developed only one projection but uses sensitivity analysis to show the implications of alternative assumptions. The projection assumes that Congress adopts the president’s recommendations for reducing Medicare reimbursements and other savings, so that Medicare costs grow much more slowly than in the CBO and GAO scenarios. Consequently, the debt does not exceed GDP until well after 2040.
- All these long-run budget projections assume that the growth of health spending eventually slows, because it is implausible that such spending will be allowed to absorb an ever-growing share of GDP and eventually squeeze out non-health-related consumption. But all of the projections may be too optimistic about the timing and the extent of the slowdown. Any squeeze on non-health-related consumption can be postponed for a very long time if foreigners continue to finance our budget deficits, and even if they do not, it may be investment rather than consumption that is squeezed out. If projections of health costs prove too optimistic, a budget crisis will arrive sooner than the scenarios anticipate.

See Also

Taxes and the Budget: What is the short-term budget scenario?

Taxes and the Budget: How accurate are the short-term and long-term budget scenarios?

Author: Rudolph G. Penner
Last Updated: April 22, 2008

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Taxes and the Budget: How accurate are short-run and long-run budget scenarios?

Short-run budget projections tend to be highly inaccurate, because of unforeseen changes in economic activity, changes in technical assumptions, and changes in economic and other policies. Typically, the first two types of changes alter projections much more than do changes in policies. Surprisingly, longer-run projections may be more accurate than shorter-run projections.

- Over the period 1983-2005, the average absolute error in the five-year revenue projection of the Congressional Budget Office (CBO) caused by changes in the economic and technical assumptions was 1.6 percent of GDP, which would be \$219 billion at the 2007 level of GDP. Between the earliest official projection of the 2007 budget balance (in the ten-year projection of 1997) and the actual outcome, the projected balance varied over a range of \$844 billion because of changes in economic and technical assumptions.
- If the CBO projection is too pessimistic in one period, it is extremely probable that it will be too pessimistic in the next period as well. Similarly, too much optimism in one period is likely to be repeated in the next. Thus one observes long streaks of overly pessimistic or overly optimistic projections.
- Especially large errors tend to occur after the fifth year of CBO's ten-year projection period, and so one might question the prominence that CBO publications give to the second half of their projection periods. However, these projections serve an important role in estimating the longer-run effects of changes in tax and spending policies. Errors in the underlying economic and technical assumptions shift projections of aggregate revenue and outlays but usually have little effect on estimates of the effects of policy changes. Even so, it might be better to confine those longer-run assumptions to appendices in CBO reports, to avoid giving the appearance of false precision.
- If short-run projections have such huge inaccuracies, can very long budget projections have any credibility? Ironically, such projections may actually be more accurate. One reason is that policy assumptions (as opposed to economic and technical assumptions) made for the long run may be more realistic - for a while at least - than those made for the shorter run. When making its short-run projections, CBO is required to assume the continuation of current law, even if doing so implies unlikely outcomes, such as sharply rising tax burdens or declining nondefense spending relative to GDP. CBO does not face the same constraint when making its long-run projections, but instead may assume that tax burdens will remain roughly constant in the long run and that the ratio of spending to GDP, outside of Social Security, Medicare, and Medicaid, will change little. Such assumptions are much more consistent with past policies than is the assumption of unchanging law.

- However, the whole point of long-run projections is to see whether policies are sustainable over time, and recent analyses indicate that they are not--certainly not much beyond 2030, if even that long. The kind of errors that make short-term projections inaccurate have little effect on the main purpose of long-term analysis.
- Shorter-run revenue projections (after adjusting for policy changes) have incurred large errors over recent periods, because tax revenue has grown faster than GDP over some extended periods and more slowly over others. The effects of such cycles tend to even out over the very long run.
- The main reason for making very long run budget projections is to show how rapidly spending on Social Security, Medicare, and Medicaid will grow if these programs are not reformed. Long-run projections of Social Security outlays relative to GDP tend to be extremely accurate compared with revenue projections. One reason is that Social Security outlays depend heavily on demographic trends, which tend to be easier to project over several decades than economic trends, which are more important in determining revenue. Also, the indexing of initial Social Security benefits to wages and the important role of wages in GDP mean that variations in Social Security outlays and variations in GDP tend to move together. Therefore the long-run projection of the ratio of Social Security outlays to GDP can be quite accurate even when the forecast of GDP goes astray. Unfortunately, it is much more difficult to forecast Medicare and Medicaid outlays, and if long-run budget projections turn out to be misleading, it is very likely because large errors were made in forecasting health expenditure.
- The fiscal disaster portrayed by long-run budget projections is so overwhelming that it is likely to occur eventually in the absence of significant program reforms, even if today's projections turn out to be far too pessimistic. And those projections could easily turn out to be not too pessimistic at all, but rather too optimistic.

See Also

Taxes and the Budget: What is the long-term budget scenario?

Taxes and the Budget: What is the short-term budget scenario?

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Taxes and the Budget: How much spending is uncontrollable?

Certain types of government spending are often described as "uncontrollable." In the case of entitlements, this uncontrollability is more a political matter than based on any legal or real constraints. Total "uncontrollable" spending—entitlements, other mandatory spending, and net interest on the public debt—has been growing much more rapidly than total spending in recent decades and thus accounts for an ever-larger share of the total.

- Whereas discretionary programs are funded by specific appropriations that generally last only one year, entitlement spending, such as for Social Security and Medicare, is ongoing. The laws establishing entitlements specify who is eligible for benefits and describe the nature of the benefit. The government then pays the cost of the benefits for as many eligible individuals as show up to claim them. Thus total entitlement spending cannot be predicted with precision from year to year and is in this sense "uncontrollable."
- As a matter of law, entitlement spending can be curbed by changing eligibility criteria or the nature of the benefit. But this requires Congress to actively intervene to change the law, and the resulting cuts in spending growth are usually highly unpopular. In contrast, unless renewed, a discretionary program will automatically go out of existence when its funding expires. To cut discretionary spending, then, Congress need simply not renew the program. It is therefore often assumed that it is easier to control discretionary than entitlement spending. But the difference should not be exaggerated. Cuts in appropriations from year to year can also be highly unpopular and politically difficult.
- There is another sense in which entitlements are "uncontrollable." The cost of the three largest—Social Security, Medicare, and Medicaid—is rising much more rapidly than tax revenue and than GDP, because of the aging of our society and the explosion of health care costs. But, again, this excess growth is not inevitable. If Social Security were indexed less generously, and if Medicare and Medicaid were placed on a fixed budget like the universal health care systems of Canada and the United Kingdom, they would instantly become more controllable. Other major entitlements, such as the earned income credit, food stamps, and civilian and military pensions are not projected to grow faster than GDP.
- Other forms of mandatory spending usually arise because of contractual obligations, for example for the procurement of goods and services. In addition, the government may have to pay damages when it loses lawsuits.
- In fiscal 1962 mandatory spending (including entitlements) and net interest constituted only 26.1 percent of total spending. By fiscal 2006 they had grown to 61.7 percent. Nevertheless, the overall tax burden has remained relatively constant because defense spending fell over the same period from 49.2 percent of total spending to 19.6 percent. The percentage of total spending devoted to nondefense discretionary programs is about the same in 2006 as it was in 1962, but there have been significant ups and downs over the period.

See Also

Taxes and the Budget: What is generational accounting?

Taxes and the Budget: What does it mean for a government program to be off-budget?

Taxes and the Budget: Are the Social Security trust funds real?

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Taxes and the Budget: What is Generational Accounting?

Almost all public policy decisions have some impact on generations yet unborn. We leave them official debt when we run budget deficits, and we expect them to pay for some of the government benefits that we and our predecessors have promised to the elderly and others. On the other side of the ledger, current taxpayers leave future generations with both tangible assets and a body of government-financed technological knowledge with which to generate additional wealth. And we bequeath a benefit structure that will provide them with social insurance and a public safety net, but they will have to figure out a way to either pay for it, reform it, or pass the bill along to still later generations. Generational accounting—a concept originally developed by Laurence J. Kotlikoff, Alan J. Auerbach, and Jagadeesh Gokhale—attempts to quantify the value of these net assets or liabilities transferred from generation to generation.

- The net tax rate faced by future generations is then calculated by dividing the present value of the net tax burden (taxes minus transfer payments) by the present value of expected future earnings from labor. The calculation can be made either for particular birth cohorts or for all those to be born in the future. A basic assumption is that there is no default and no free lunch—all net liabilities transferred forward must be paid for eventually.
- The present value of the burden passed forward consists of official government debt, net of assets, plus the present value of all future government purchases, plus the present value of all government payments to individuals (such as Social Security benefits) promised to those now alive, minus the present value of all the taxes that will be paid by those now alive. The calculations usually include all levels of government: federal, state, and local.
- The implied tax burden passed to the future is huge, mainly because current generations will not come close to paying for the present value of government purchases plus the benefits that they are promised, most of which go to the elderly. Medicare and Medicaid, the main public health insurance programs, pose a special problem because health care costs are growing so much faster than tax revenue.
- When the present value of the burden being passed to future generations is compared with the present value of their future labor income to arrive at a net tax rate, the calculation suggests that unborn generations will face twice the lifetime tax burden faced by those alive today.
- Generational accounting is often criticized because its calculations are based on numerous assumptions regarding a highly uncertain future. For example, health care costs must be projected to infinity. Historically, these costs have been rising 2 percentage points a year faster than incomes. That cannot continue indefinitely, or else they will eventually exceed total income. But when will their growth slow down? Medicare trustees assume that cost growth in the Hospital Insurance program (Medicare Part A) will begin to slow in about twenty-five years, eventually falling to the GDP growth rate in the early 2080s. But this assumption is completely arbitrary.

- If growth in health care costs does not slow, the rate of growth of Medicare and Medicaid may exceed the discount rate used to compute their present value. Their present value would then be infinite. That would make generational accounting meaningless. Similarly, the discount rate used to calculate the present value of earnings must exceed the growth rate of earnings to avoid infinite values. But that implies that the present value of earnings in, say, 2050 will be lower than today's earnings. That forces the estimate of future tax rates upward.
- The choice of a discount rate to use in computing present values is itself contentious. The arithmetic results are extremely sensitive to this choice. The calculations discussed above assume a real rate of 3.9 percent, approximately the historical rate on long-term government bonds. If we care deeply about the welfare of future generations, we may wish to use a lower discount rate. If instead we reflect on the likelihood that they will be considerably richer than us, we may wish to use a higher rate.
- Another criticism of generational accounting is that it counts only what is easily countable. In particular, it assumes that no benefits accrue to present or future generations from government purchases. Thus, for example, the "greatest generation"-the generation that won World War II-gets no credit for its contribution to the welfare of future generations. At a more mundane level, the long-run benefits of expenditures on education or research are not recorded.
- But these criticisms do not invalidate the basic point, which is that the current generation is leaving a gigantic burden to unborn generations. Whether net taxes will have to increase by 50 percent, 100 percent, or 200 percent is almost beside the point. The results are frightening no matter how one does the calculations, and they suggest that current fiscal policy is not sustainable.

See Also

Taxes and the Budget: How much spending is uncontrollable?

Taxes and the Budget: What does it mean for a government program to be off-budget?

Taxes and the Budget: Are the Social Security trust funds real?

Author: Rudy Penner
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Taxes and the Budget: What are extenders?

Tax "extenders" are tax laws that will expire after a certain date. The Congressional Budget Office (CBO) must assume that these laws will be permanently terminated as scheduled when it compiles the budget baseline that serves as a starting point for congressional budget deliberations. This makes the baseline unrealistic, since temporary tax laws very often are extended. Because the vast majority of extenders involve tax cuts, the assumption that these provisions will be terminated tends to make CBO project a healthier budget balance than is likely to occur. There is one exception to the rule: temporary taxes whose revenue is deposited in trust funds are assumed to continue.

- The most important temporary tax cuts are the Bush tax cuts of 2001 and 2003. They will expire at the end of 2010 unless Congress extends them. If all were extended permanently, the budget surplus that CBO projects for the period 2011-18 would be reduced by a cumulative \$3.2 trillion.
- Congress has recently provided a series of one-year reductions in the burden that would otherwise be imposed by the alternative minimum tax. If the exemption amount of the tax were permanently indexed for inflation, the cumulative budget balance projected by CBO for the period 2009-18 would be worsened by over \$900 billion.
- There are eighty-seven other temporary tax provisions. All but three are temporary tax cuts.
- The most important of the eighty-seven is the research and experimentation tax credit. It has been enacted for one year at a time and has been extended for eleven straight years.
- Why does Congress enact so many temporary provisions? It would be nice to think that it was to force the periodic reevaluation of certain tax subsidies. However, it is more likely that Congress wishes to avoid actions that force it to show a significant deterioration in the long-term budget balance. This tendency is strengthened by the Senate's Byrd rule. It is difficult to pass any legislation in the Senate unless one has the sixty votes necessary to cut off a filibuster. However, that is not true of legislation contained in a reconciliation bill adopted as part of the budget process. This procedure limits debate and allows legislation to be passed with a simple majority of fifty-one votes. But reconciliation may only be used for bills that do not increase the budget deficit beyond the time horizon of the budget resolution. The Bush tax cuts were passed using reconciliation procedures, and that is a major reason that they are temporary.
- There is a curious asymmetry in the rules that specify how the budget baseline should be constructed. Temporary tax provisions are assumed to be ended on schedule, but entitlements that must be reauthorized periodically, such as farm subsidies, are assumed to continue throughout the ten-year projection period.
- Pay-as-you-go rules say that any increase in an entitlement or cut in taxes compared with the baseline must be paid for with some other tax increase or entitlement cut. The asymmetric rules used in designing the baseline thus imply that Congress must pay for a routine extension of a temporary tax cut but can avoid paying for an extension of an entitlement. That would seem to create a strong bias in favor of higher entitlements and higher taxes.

- It is also assumed that appropriations for discretionary programs, most of which last for only one year, are renewed and adjusted for inflation.
- The asymmetry between the spending and tax sides of the budget could be cured by assuming either that all temporary entitlement, appropriation, and tax laws expire as specified by the law, or that all temporary provisions are continued. Because most temporary provisions are renewed routinely on both sides of the budget, the second option would provide a more accurate view of the future size of government and the path of the budget balance. Such a reform, however, would be strongly resisted by those who dislike the controversial Bush tax cuts, because it would make it easier to extend them.

See Also

Budget Process: What is reconciliation?

Budget Process: What is PAYGO?

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Taxes and the Budget: What does it mean for a government program to be "off-budget"?

In the late 1960s the federal government adopted a unified budget that included trust fund operations along with budgets for almost all other federal activities. Since then various agencies have attempted to escape budget discipline by moving off-budget, but most have been brought back under pressure from advocates for fiscal responsibility. Today there are only two off-budget entities that were once on-budget: the Social Security system and the U.S. Postal Service. In the case of Social Security, only the trust funds (for Old-Age and Survivors Insurance and for Disability Insurance) are off-budget; administrative costs are on-budget. The Federal Reserve System and the various government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, have always been off-budget.

- Social Security was temporarily taken off-budget by the Gramm-Rudman-Hollings Act of 1985, and its off-budget status was made permanent by the Budget Enforcement Act of 1990. There were a number of reasons for taking Social Security off-budget:
 - Social Security's off-budget status would protect benefits from being reduced by the reconciliation procedures that are an important part of the budget process. Although Social Security's off-budget status thus provides considerable protection against benefit reductions, the Congress did not want to encourage benefit increases or payroll tax cuts either. The House of Representatives therefore created a point of order against legislation that would increase Social Security's seventy-five-year actuarial deficit by more than 0.02 percent of payroll or reduce the five-year cash flow balance of the system by more than \$250,000. The Senate established a point of order against legislation that would reduce the Social Security surplus during the period covered by the budget resolution (generally five years).
 - Since 1983, Social Security trust funds have accumulated large surpluses that will eventually be needed to pay promised benefits. Indeed, they are not sufficient for that purpose. It was therefore argued that the Social Security surplus was not a true surplus, but rather an advance payment for future benefits that should be separated from the surplus or deficit of the rest of government. It was hoped that this separation would induce greater fiscal discipline in the rest of the government, ideally leading to a balanced budget in the activities of government outside of Social Security.
 - Those goals have not been fulfilled. Despite the formal separation of Social Security from the rest of the budget, budget debates in Congress and the media focus mainly on the unified budget balance, that is, the combined balance of Social Security and the rest of government. Many argue that the Social Security surplus consequently masks the true deficit of the federal government. In the more than two decades that Social Security has been off-budget, the rest of government has run a surplus in only two years: 1999 and 2000.
 - Because the rest of the federal government is, in effect, borrowing from Social Security to finance part of its deficit, some accuse the rest of government of "stealing" from Social Security. In fact, Social Security trust funds invest their surplus in Treasury securities bearing the full faith and credit of the United States. The interest rate on these securities is determined by a formula that reflects market interest rates. The rest of government is no

more stealing from Social Security than it is from an individual who invests some of his or her pension fund in U.S. Treasury securities.

- The U.S. Postal Service was taken off-budget to make it free to adopt efficient business practices, but this is not a sufficient excuse, since many business-type activities of the government, such as selling mortgage insurance, are on-budget. GSEs are off-budget because they are owned by private shareholders, and their debt does not bear the full faith and credit of the U.S. government. However, most observers believe that their close ties to government would lead to a government bailout if they get into financial trouble. It is therefore argued that they should be subjected to controls over their budgets. This is not done within the formal budget process, but strict regulatory controls have been imposed on Fannie Mae and Freddie Mac.
- The central banks of most democratic countries are off-budget. This helps to preserve their independence from the other branches of government. If the Federal Reserve were on-budget and its expenditures had to be appropriated, the Congress might conceivably make its appropriation contingent on lowering interest rates or making some other change in monetary policy.
- Various small agencies have successfully escaped the unified budget for short periods. The special interests that back these agencies believe, probably rightly, that lawmakers will treat them more generously if doing so does not increase the official budget deficit. Advocates of fiscal discipline work hard to bring off-budget agencies back into the fold and to prevent new agencies from going off-budget. With the help of the Gramm-Rudman-Hollings Act of 1985, this effort has been largely successful. The Rural Development Bank, the Export-Import Bank, the Strategic Petroleum Reserve, and the Pension Benefit Guarantee Corporation all were moved off-budget for varying periods in the past but are now on-budget.

See Also

Budget Process: What is reconciliation?

Taxes and the Budget: How much spending is uncontrollable?

Taxes and the Budget: What is generational accounting?

Taxes and the Budget: Are the Social Security trust funds real?

Author: Rudolph G. Penner
 Last Updated: December 13, 2007

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Taxes and the Budget: Are the Social Security trust funds real?

Payroll tax and certain other revenues dedicated to the Social Security system today exceed the cost of paying current benefits. This surplus is used to buy special U.S. Treasury bonds that are then deposited in the system's two trust funds, one dedicated to Old Age and Survivors Insurance and the other to Disability Insurance. The Treasury pays the trust funds interest on these bonds, using a formula that reflects market interest rates. Four questions are commonly raised about the trust funds: Are their assets "real," or are they just worthless pieces of paper? Do the surpluses deposited in the trust funds represent an addition to national saving? Does the existence of the trust funds alter the amount that the U.S. government must borrow from the public? And if the answer to these questions is no, why have trust funds in the first place?

- The trust funds' "pieces of paper" are U.S. Treasury bonds that bear the full faith and credit of the U.S. government. They are just as valuable as the Treasury securities in the hands of a business or an individual. In that sense the trust fund assets are very real.
- The Social Security system can redeem these bonds for cash at any time. That means that after the system starts to run a cash flow deficit in about ten years, Social Security will be able to redeem the bonds to pay scheduled benefits, without additional congressional action. It is now expected that the combined trust funds will have redeemed all their Treasury bonds by sometime in the early 2040s. At that point revenue dedicated to the system from the payroll tax and other sources will cover only about three-quarters of scheduled benefits.
- Whether the trust funds represent an addition to national saving is harder to answer. If the federal government balanced the budget for non-Social Security programs every year, the Social Security surplus would add to national saving, unless the surplus somehow affected business or personal saving or the budget decisions of state and local governments. However, the federal government has balanced the non-Social Security budget only three times in the past fifty years.
- The Social Security surplus might still add to national saving if it reduced the unified budget deficit, that is, the sum of the Social Security surplus and the non-Social Security deficit. That would happen if the two were determined independently. But it is unrealistic to say that the non-Social Security deficit is completely independent of the Social Security surplus. Although the annual congressional budget resolution establishes separate goals for the two balances, political rhetoric and media reports focus on the unified budget deficit. If the unified deficit is really the primary target of fiscal policy, then an increase in the Social Security surplus allows the rest of government to run a bigger deficit. This negates the effect of the larger Social Security surplus on national saving.
- To understand how the existence of the trust funds affects the federal government's borrowing from the public, imagine a situation in which the non-Social Security operations of government run a deficit of \$100 billion while Social Security runs a surplus of \$10 billion. The unified budget deficit is then \$90 billion. The Treasury must borrow \$100 billion to finance the non-Social Security part of government. The Social Security surplus enables it to borrow \$10 billion of that amount from Social Security. It must then borrow the other \$90 billion from the public. (The amount borrowed from the public does not necessarily exactly equal the budget deficit,

because the deficit can be financed by means other than borrowing, for example by drawing down cash balances or issuing currency.) Now imagine that Social Security is operated without any trust funds and that payroll and other dedicated taxes are pooled with all other government revenue, while Social Security and other outlays are also combined. The taxes dedicated to Social Security may still exceed Social Security outlays by \$10 billion, but this surplus need not be separately identified in the budget accounts. If the rest of government is still running a deficit of \$100 billion, the net deficit will be \$90 billion. That is the amount that has to be borrowed from the public - the same with the trust funds as without.

- Why, then, should we have Social Security trust funds if they don't affect national saving or alter the amounts that government must borrow from the public? The answer is that the trust funds are an accounting device that tracks whether the taxes dedicated to Social Security are sufficient to fund its benefits and other costs. With dedicated revenue today more than paying total costs, the system is, in effect, paying for tomorrow's benefits in advance, while receiving interest from the Treasury on the accumulated surpluses. Advocates for Social Security see the trust fund balances as the system's property and effectively argue that they should not be used for any purpose other than Social Security. Thus, although the existence of the trust funds may not be important economically, it is extremely important politically in giving Social Security benefits some protection against budget cuts.

See Also

Taxes and the Budget: How much spending is uncontrollable?

Taxes and the Budget: What is generational accounting?

Taxes and the Budget: What does it mean for a government program to be off-budget?

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Further Reading

Penner, Rudolph G., *Social Security and National Saving* (Washington: Committee for Economic Development, 1989)