If the Trust Funds Are Real, the Surplus Numbers Are Wrong

by

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Abstract of

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At the urging of a Presidential Commission in 1967 the federal government adopted a Unified Budget beginning in 1969. The Unified Budget counts both general and earmarked revenues as receipts and regular and earmarked spending as expenditures. The resulting surplus records the net cash transaction of the government with the public. The Unified Budget worked satisfactorily in a period of time when the U.S. government was not engaged in a systematic program of financial investment (e.g. building up the trust funds of Social Security). However, in the mid-1980s decisions were made to fund the retirement programs for military and civil service government employees and to partially prefund Social Security. The intent of these decisions was undermined by the use a unified budget. The idea of funding and prefunding was to pay more in the present in order to offer some relief to future generations in dealing with the finances of these retirement programs. However, the Unified Budget surplus includes the saving (or capital accumulation) of Social Security and the other retirement plans in its computation. Since 1985 the trust funds have accumulated $2.5 trillion of assets and cumulatively this $2.5 trillion has been recorded as a contributor to the surpluses (or, equivalently, as reducing the deficits). This paper argues that the saving or capital accumulation of the trust funds should have been and should now be separated from the primary budget surplus. Rather than attempting to balance the unified surplus in times of full employment, the goal should be to balance the ex-trust funds budget. In my opinion, most of the $2.5 trillion of wealth accumulated by the trust funds has financed additional government spending and lower personal and corporate income taxes rather than providing incremental wealth to aid future workers and taxpayers.

Among the findings of this paper are:

(1) The facts that the Unified Surplus counts the excess cash flow of the trust funds as general receipts and that the interest on the U.S. government bonds held by the trust funds is not charged as an expense added about $200 billion per year to the surplus in the past few years. To put this in perspective, the ex-trust funds deficit (the Federal Funds deficit) for 2004 is not roughly $300 billion, but rather roughly $500 billion.

(2) The budget mistake was not adopting capital accounting (at least for the trust funds) when the decision was made in the mid-1980s to move from pay as you go financing to funded or partially funded programs.

(3) If the trust fund capital accumulations are not counted in the general surplus, then there never was a meaningful surplus in the past 30+ years. The ex-trust funds or Federal Funds surplus peaked at roughly zero in the year 2000.

(4) Unified budget accounting and the tax and spending decisions that have been made relying on this accounting have significantly reduced national saving and increased the tax burden on workers twenty and more years from now.

My position is that we should immediately remove the capital accumulation of the trust funds from the surplus. This is an example of “better late than never.”

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INTRODUCTION

The U.S. government ran substantial surpluses in the fiscal years 1998, 1999, 2000 and 2001. Or did it? All of the budget documents indicate that it did and few politicians of either party said otherwise; after all, the robust surplus numbers increased the chances of funding favored spending programs or politically popular tax cuts. But, there is something a little fishy about those surpluses and almost all of the budget surplus and deficit numbers issued by the federal government in the past thirty-five years. The problem is hinted at by the lack of connection between the announced unified surplus and deficit numbers and the change in the total federal debt. The last time that the gross federal debt of the United States fell was 1969. In 1998-2001 the total debt kept on increasing, albeit at a slower rate than it had in the early 1990s. Common sense tells you that a surplus should produce a reduction in debt and a deficit an increase in debt. What should we make of this period with relatively large announced surpluses and increasing total debt? It suggests that something is being measured incorrectly. The purpose of this paper is to get to the bottom of this.

The U.S. federal budget is an extraordinarily complicated document and this is not the place and I am not the person to go into all of the details of its roughly 2,000 pages. But the guiding principles of the federal budgets for the past three and one-half decades were set in a landmark report issued by a Presidential Commission (1967). The *Report of the President's Commission on Budget Concepts* was delivered to President Johnson in October of 1967 and urged that from then on the government emphasize a single budget concept rather than the

several alternative budget procedures that had been produced until then. Not only did the Commission recommend a single set of books, but they strongly advocated a unified budget that included in its receipts and expenditures the operations of the several important trust funds within the government. That means that the unified budget would add the earmarked trust fund revenues and general revenues together and similarly would add regular expenditures with those restricted by their trust fund purpose. It also means that interest payments between the rest of the government and the trust funds are "netted out" in the unification. After all, the interest payments and interest receipts are both within the unified government framework, so the net transaction with the public is zero. At the time, the choice of a unified budget approach was not a momentous decision since most of the trust funds more or less operated on a pay as you go basis. That is, by including trust fund revenues and expenses in the surplus measure, the surplus amount was little affected since trust fund revenues and spending roughly matched. However, after the fact the decision turned out to be extraordinarily important and a monumental mistake. I will explain why in the rest of this paper.

In support of its call for a unified or comprehensive budget the Commission argued that the budget should reflect the aggregate transactions of the government with the public, largely for Keynesian macroeconomic reasons, and that separate budgets for different parts of the government would be confusing and counterproductive. They also vigorously argued against establishing capital account budgeting for any government operations because "such a budget would seriously distort the budget as a decision-making tool." (President's Commission, page 9) Their discussion and dismissal of capital budgeting exclusively dealt with the handling of physical investments (e.g. aircraft carriers and office buildings). There

was no discussion of financial capital activities such as the build-up of substantial trust funds holding trillions of dollars of government bonds. I think it is fair to say that the President's Commission did not anticipate the policy actions that would be taken fifteen years later.

The recommendations of the Commission were broadly accepted and first became effective with the budget for Fiscal 1969. Interestingly, and perhaps not coincidentally, the total debt of the federal government has increased in every subsequent year (the official data for alternative surplus measures and government debt measures are shown in an appendix to this paper).

The federal government trust funds and their capital investments are going to be at the heart of this analysis, so a brief introduction to them is appropriate. Several activities of the federal government have been established by law as trust funds. These trust funds receive earmarked collections and taxes for spending on particular purposes. Examples would be the payroll tax receipts of Social Security and Medicare or the revenues of the federal excise tax on gasoline (which are dedicated to highway construction). If the trust funds receive more earmarked money than they spend in a particular year, the excess funds are turned over to the rest of the government (termed Federal Funds). The trust funds are given interest bearing special-issue Treasury bonds in return for the cash transfer they provide the rest of the government. In effect, the trust funds invest their excess cash flows in government bonds; the flip side of the transaction is that the rest of the government (i.e. the Federal Funds) borrows the money from the trust funds. Once the money is transferred to the Federal Funds part of the government it blends with other sources of revenues such as the personal and corporation income tax proceeds and the net borrowing from the public. Its specific use can no longer be traced.

By the way, the interest on the special-issue Treasury Bonds held by the trust funds is paid in the form of additional special-issue Treasury Bonds. The effect is the same as if the Federal Funds paid the interest in cash with the trust funds turning around and using the cash to buy government bonds. In fact, there is no exchange of cash, merely an addition to the government bonds held within the trusts.

Several of the trust funds have been running cash flow surpluses for many years and have built up quite a pile of these Treasury bonds. The largest of them by far are the Social Security (OASDI) Trust Funds which will hold almost $1.5 trillion of the special-issue bonds by the end of fiscal 2003 (OMB, 2003). The Federal Employees Retirement Fund will have $615 billion in it, the Medicare (HI) Trust Fund will have $256 billion and the Military Retirement Fund will have $180 billion by the end of fiscal 2003. There are a number of other trust funds (e.g. Railroad Retirement, Airport, Highways, Unemployment, Veterans Life Insurance), but the big four -- Social Security, Federal Employees Retirement, Medicare, and Military Retirees trust funds -- are by far the most important. They will have more than $2.5 trillion out of the total $2.7 trillion in all of the trust funds at the end of fiscal 2003. They hold an increasing share of and well over one-third of all of the U.S. federal government debt.

The build up of the assets of the trust funds, the big four in particular, was intentional. The 1983 Greenspan Commission set the Social Security payroll tax above the level needed to finance current benefits so that the system would partially prefund the Social Security benefits of the babyboomers (Schieber and Shoven, 1999 and Diamond, 2003). The idea was that higher payroll taxes while the babyboomers were still in the labor market would allow some payroll tax relief for those working when the babyboomers are retired. In effect, the

Commission recommended that Social Security depart from its pure pay as you go nature and build up a significant trust fund to help finance the retirement of the babyboomers. Congress and President Reagan went along and while the OASDI Trust Fund has not grown as fast and as much as the Greenspan Commission projected, it has become substantial and is now projected to have $3.9 trillion in it by 2012. Another decision was made in 1984 to fund the military retirement program as liabilities accrued. Finally, a third similar decision was reached in 1986 for the retirement programs of federal civilian employees hired after December 31, 1983. All told, military and federal civilian retirement programs went from pay as you go financing to funded programs and Social Security became partially prefunded. These were important decisions but they were not accompanied by any changes in the way the surplus of the U.S. budget was and is calculated. I will argue that the attempt at funding these programs was undermined by the emphasis on the Unified Budget surplus.

What is the alternative to the Unified Budget approach? The answer is to divide the activities of the U.S. government into two categories – the Trust Funds and "everything else." In fact, this separation is made within the U.S. government budget documents, but no emphasis is given to the resulting numbers. As I have already mentioned, "everything else" is labeled Federal Funds. With this bifurcation approach, the Trust Funds would keep their own accounts with their own surplus measure. Their surplus would be the excess of earmarked revenues over expenses plus the interest the trust funds receive on their existing assets.[1] The Federal Funds surplus includes all federal revenues other than the proceeds earmarked for trust fund purposes and records all expenditures outside of those of the trust funds. The interest received by the Trust Funds from the rest of the federal government is

recorded as an expense to the Federal Funds. This two part accounting shouldn't be considered radical in any way. It is done by every state government in the United States. The states do not unify their retirement programs for state employees with their general government account. The federal government should follow the lead of the states. The problem with the Unified Surplus is that it counts earmarked surpluses as money that can be spent for general purposes. It seems only common sense that truly earmarked accounts need to be held separate from general revenues.

The identity between the various measures of surplus we have been discussing is given by the simple adding up equation:

(1) Unified Surplus = Federal Funds Surplus + Trust Funds Surplus

Of course, this identity can be rearranged as

(2) Federal Funds Surplus = Unified Surplus – Trust Fund Surplus

I tend to prefer this later presentation because it shows that in order to get to my preferred surplus measure, the Federal Funds Surplus, the Trust Fund Surplus (or build-up of assets in the trust funds) must be subtracted from the currently emphasized Unified Surplus. These identities regarding annual surpluses have exact counterparts in terms of total debt. There the identity would be that the total government debt equals the debt held by the public and the debt held by the government (predominately in the trust funds we are talking about).

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[1] Labeling the capital accumulation of the trust funs as a "surplus" is questionable. I would prefer to simply record it as a capital investment on the part of the trust funds. However, I will follow conventional terminology and refer to

There is an alternative approach to the Federal Funds/Trust Funds split of the government accounts. That would be to divide the books of the trust funds into operating accounts and capital accounts. The operating accounts would include all benefit payments and overhead expenses of the trust fund operations. The operating accounts of the trust fund would by definition balance and could continue to be entered into a unified system of government accounts. However, the cash flow surpluses (or potentially deficits) of the trust funds and the interest received on previous investments would enter in a "below the line" capital account for the trust funds. Quoting from the Presidential Commission, "The entries in the capital account would not be used in the calculation of an ordinary budget surplus or deficit." This approach would preserve the Unified Budget and it would continue to reflect the size and scope of the federal government. However, the surplus would be diminished (or the deficit increased) because it would no longer reflect the excess cash flows received by the trust funds and it would reflect the interest paid to the trust funds on their accumulated investments. The resulting surplus and deficit numbers with the trust fund capital account approach would be identical to the currently calculated Federal Funds numbers.

My view is that all of the current economic and political attention is paid to the wrong surplus measure. There is a widespread understanding that the federal government should try to balance the budget when the economy is operating at full employment. I agree with that wisdom; the question I am raising is which of these budget measures should be balanced at full employment? My view, on which I will elaborate, is that it is the Federal Funds surplus (or the equivalent unified surplus with trust fund capital accounting) that should be balanced at full employment and not the Unified Surplus. In addition, my view is that the focus on balancing the current Unified Surplus has undermined the ability of the Trust Funds to

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it as the surplus of the trust funds.

lighten the tax burden of future generations. The trust funds were intended to allow society to pay more now in order to pay less in the future for Social Security and the other trust fund purposes. However, the current budgetary procedures make it likely that what actually happens is that we pay more in earmarked taxes now, spend more now and enjoy lower personal and corporate income taxes now, eliminating the possible relief for future taxpayers.[2] The difference between balancing the Federal Funds surplus and the Unified Surplus is enormous. It amounts to more than $200 billion per year today and the difference will certainly grow larger over the next several years.

THE RELATIONSHIP BETWEEN THE SURPLUS AND DEBT REDUCTION

The common sense relationship between a surplus and the change in the outstanding debt is not wrong. In fact, each of the surplus measures that we are discussing, the Unified Surplus, the Federal Funds surplus and the Trust Funds surplus has assets and debts associated with it that change in the expected way. The Unified Surplus measures the net cash exchanged between the public and the government; that implies that the Unified Surplus will correspond to the reduction in the U.S. government debt held by the public net of that held by the Federal Reserve Bank.[3] Figure 1 shows that this stock-flow relationship pretty much holds true in the government accounts. The "pretty much" is due to such things as sales of government assets

[2] Diamond (2003) argues that the total capital stock in the future may be enlarged by the attempt to build up the trust funds even if the higher payroll tax proceeds are completely dissipated lower income taxes. His argument is that personal saving may be higher due to the different composition of taxes (higher payroll and lower income taxes). He asserts each dollar of extra payroll tax reduces aggregate private saving by much less than extra saving from one dollar of lower income taxes. This is an interesting argument worthy of additional study.

[3] Throughout the paper I remove the debt held by the Federal Reserve from the analysis. The assets held by the Federal Reserve are owned by the general public. The corresponding liabilities to service that debt is also held by the general public. Therefore, I believe it appropriate to remove this debt from the analysis.

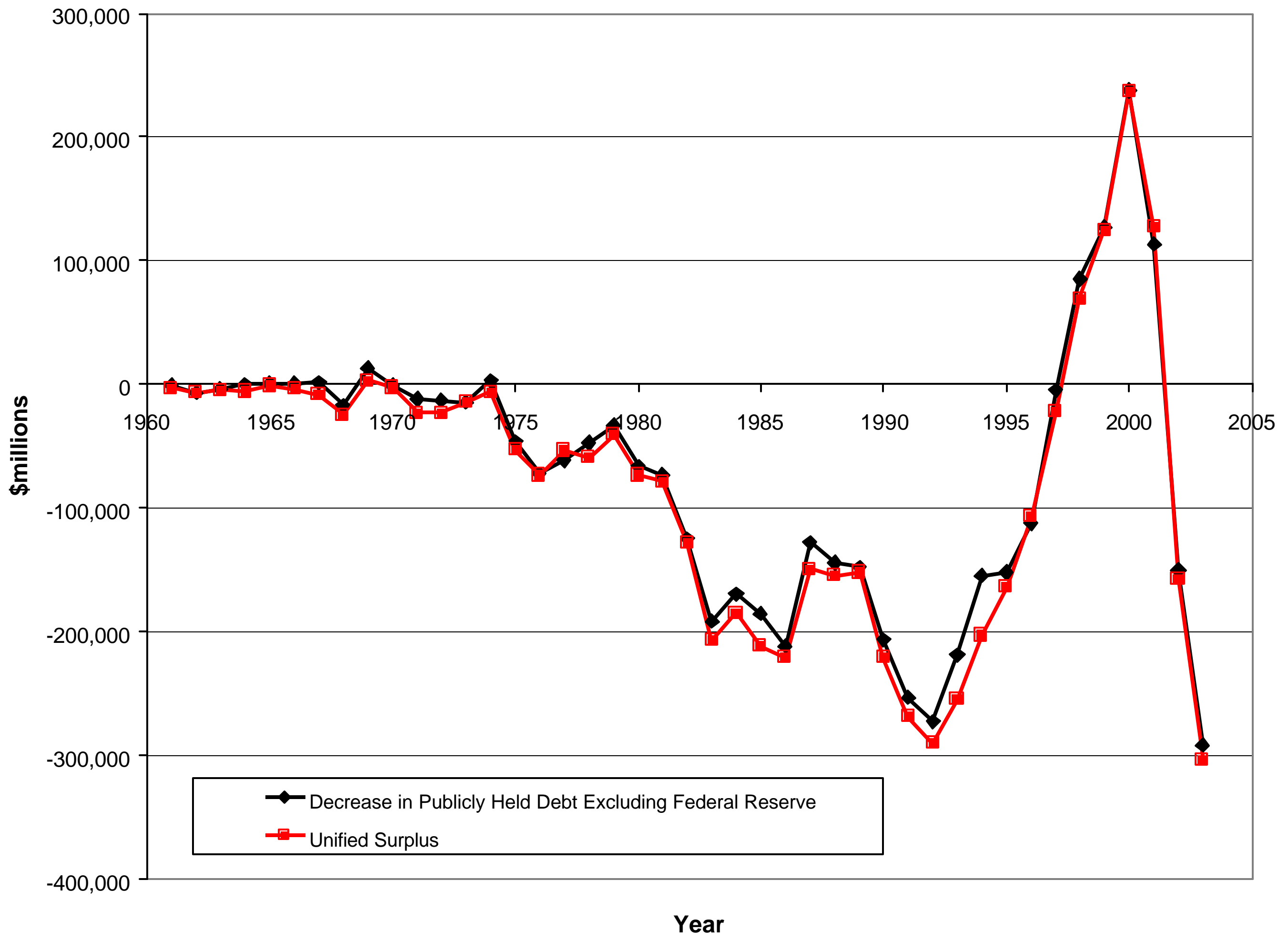


Figure 1
Unified Surplus and Decrease in Publicly Held Debt
300,000
200,000
100,000
0
-100,000
-200,000
-300,000
-400,000
$millions
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
Year
Decrease in Publicly Held Debt Excluding Federal Reserve
Unified Surplus

(spectrum and oil leases, for instance) and a few other minor adjustments. The two time series (Unified Surplus and the change in publicly held debt) track each other so nearly perfectly because they are two ways of presenting the same information.[4]

The Federal Funds surplus is the receipts less expenses of the federal government excluding the operations of the Trust Funds. The Federal Funds surplus corresponds to the reduction in the total federal debt (including that held by the trust funds) less the debt held by the Federal Reserve. Since Federal Funds surpluses have been so rare, perhaps I should state the stock-flow relationship the other way around. Federal funds deficits track the increase in the gross U.S. government debt (excluding that held by the Federal Reserve). This close relationship is shown in Figure 2. Not only should you note that the Federal Funds deficit tracked the increase in the gross debt of the government, but you should also note that there never was a meaningful surplus in the 1998-2001 period when the Unified Surplus reported a substantial surplus. The Federal Funds budget surplus peaked at essentially zero. If we conclude that the Federal Funds surplus is the right measure for policy makers to try to balance in the long-run, then there never was a federal government surplus in the past 30 years. Once again, the tracking of the two time series shown in Figure 2 is so nearly perfect because the two concepts convey the same information.

[4] Figures 1, 2, and 3 plot different surplus measures against decreases in alternative measures of the federal debt. Deficits have become so commonplace that some people think of these figures as upside down. To accommodate those who feel that way, Figures 1A, 2A and 3A in the appendix plot deficit measures against increases in the corresponding debt measures. The information content of the graphs in the main body of the text and those in the appendix is identical.

Figure 2
Federal Funds Surplus and Decrease in Total Federal Debt
100,000
0
-100,000
-200,000
-300,000
-400,000
-500,000
-600,000
$millions
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
Year
Decrease in Gross Federal Debt excluding Federal Reserve
Federal Funds Surplus

Finally, the Trust Fund surpluses correspond to the accumulation of assets held by the Trust Funds. The assets grow in value by the sum of the excess earmarked tax revenues over expenses and the interest from the rest of the government on the accumulated bonds in the trust funds. The trust fund surpluses in the current government accounts would be contributions to capital if the trust funds adopted capital accounting. The reason that I have included Figures 1 and 2 in this paper is to show that the government accounts are consistent in the stock-flow sense.

Whether the policy makers should be attempting to balance the Unified Surplus or the Federal Funds surplus over the long-run comes down to whether the debt held by the Trust Funds is a real liability for future taxpayers or not. Financial assets in society always show up on both sides of balance sheets. Remember, a financial asset is merely a piece of paper or a few bytes in a computer. It has value to its holder only because it is a legally binding obligation (i.e. liability) for someone else. If a financial instrument shows up as someone's asset it must by definition be someone else's liability. This is true of corporate stocks, corporate bonds, private leases, mortgages, bank accounts, municipal bonds, government bonds, and even special-issue U.S. government Treasury Bonds. With financial instruments showing up on both sides of balance sheets in the economy, if one were to aggregate all of the balance sheets in the society, financial instruments would net out to zero and all that you would be left with are real assets. That is exactly how it should be. These special-issue bonds are simply a particular type of financial instrument. My point here is that if they are to be considered genuine assets by their holders (Social Security and the other trust fund entities) then they must be considered genuine liabilities by someone else. Who else would that someone else be other than future taxpayers? These special-issue bonds represent real

liabilities for future taxpayers and the accumulation of these liabilities should enter into the surplus and deficit calculations. The Federal Funds budget treats these liabilities appropriately; the Unified Surplus does not. The Federal Funds deficit includes the build up of bonds held by the Trust Funds and the public; The Unified deficit only includes the change in publicly held debt. Of course, the choice between the Unified Surplus and the Federal Funds Surplus wouldn't make any difference if the Trust Funds were operating completely on a pay as you go basis.

I believe that this point is sufficiently important that it deserves elaboration. Social Security and the other trust funds clearly believe that they hold valuable assets. The latest Social Security Trustee Report (Board of Trustees, 2003) projects that Social Security will remain solvent under intermediate assumptions until 2042 even though the payroll tax proceeds fall short of benefit payments beginning in 2018. How can the system continue to pay full legislated benefits for 24 years while income falls short of expenditures? The answer is with the interest and principle on those special-issue Trust Fund assets. Social Security believes that it has valuable assets backed by the full faith and credit of the U.S. government…. And they are right. But, remember, the Unified surplus doesn't treat the accumulation of these bonds in the trust funds as liabilities and doesn't reflect any interest expense on those bonds. In using the Unified Surplus while the trust funds are accumulating bonds, the government is creating financial assets while ignoring the corresponding liability. My argument is that a very fundamental and serious accounting and logical error is being made in failing to recognize the corresponding liability being accumulated by future taxpayers.

Consider what would happen if the Trust Funds ran a $200 billion surplus while the government balanced the Unified budget. The Trust Funds effectively turn over $200 billion to the rest of the government which then is used for spending or tax cuts. Since the Unified Budget is balanced, the Federal Funds budget by Equation 2 must be running a $200 billion deficit. The Trust Fund surpluses are not saved; the rest of the government spends them. The total government debt increases by $200 billion even though the budget that everyone pays attention to is balanced. The build-up of assets in the Trust Fund would be exactly matched by the additional liabilities of future taxpayers. The potential of using the trust fund accumulations to relieve the burden on future generations would have been lost.[5]

Now consider a similar situation where the Trust Funds are running a $200 billion surplus while the government balances the Federal Funds budget. The total debt of the government is held constant meaning that the debt held by the public drops by $200 billion. The accumulation of trust fund assets still creates new liabilities on future taxpayers of $200 billion, but those extra liabilities are completely offset by the reduction in the publicly held debt. In this case the purpose of the trust fund build-up will be met, namely to help future generations deal with Social Security and the other trust fund purposes. The accumulation of trust fund assets would represent wealth transferred from today's taxpayers to future taxpayers. The government would be genuinely saving the amount of the trust fund capital accumulations. What is required to do this is a Unified Surplus of $200 billion, although I believe it is more sensible to focus on balancing the Federal Funds budget. This scenario approximately describes the budget posture of the U.S. government in Fiscal 2000.

[5] The composition of taxes (payroll and income) would be different and this may change private saving. This is Diamond's (2003) point.

Now, let's look at what I think policy makers are doing. They believe that the trust fund assets are real and genuinely strengthen the solvency of Social Security and the other trust fund activities (such as military pensions). They also monitor the Unified Budget Surplus and attempt (with limited success) to balance this budget over the long-run. Their beliefs and positions are inconsistent. Logic says that if the trust fund assets are real, then the liability to pay interest on those assets and eventually redeem them is real too. In fact, recognizing the assets without appropriately accounting for the corresponding liabilities is an unambiguous mistake. That is exactly what happens if you pay attention to and try in the long-run to balance the Unified Surplus while being concerned about the increase in total debt including that held in the trust funds. Figure 3 shows the time path for the Unified Surplus and the change in the gross federal debt not held by the Federal Reserve System. These two concepts are inconsistent; the gross federal debt includes the bonds held by the trust funds while the Unified Surplus fails to record the interest on trust fund assets as an expense and incorporates the cash flow surplus of the trust funds in the overall surplus measure. What is most notable about Figure 3 is that it shows that this mistake essentially didn't make any difference between 1960 and 1985. The Trust Fund balances and surpluses were sufficiently small that using the Unified Surplus was a mistake, but not a large one. However, beginning in 1985, when the big four trust funds began to purposely accumulate substantial assets, the failure of the Unified Surplus to handle trust fund surpluses is dramatically apparent. A journal article would include some time series econometrics at this juncture to show that the relationship between the Unified Surplus and the change in the gross federal debt was different after 1985 from what it had been before. I am willing to simply refer to Figure 3 and let it tell the story. Besides, it is obvious why the relationship changed in 1985. That is when the big four trust

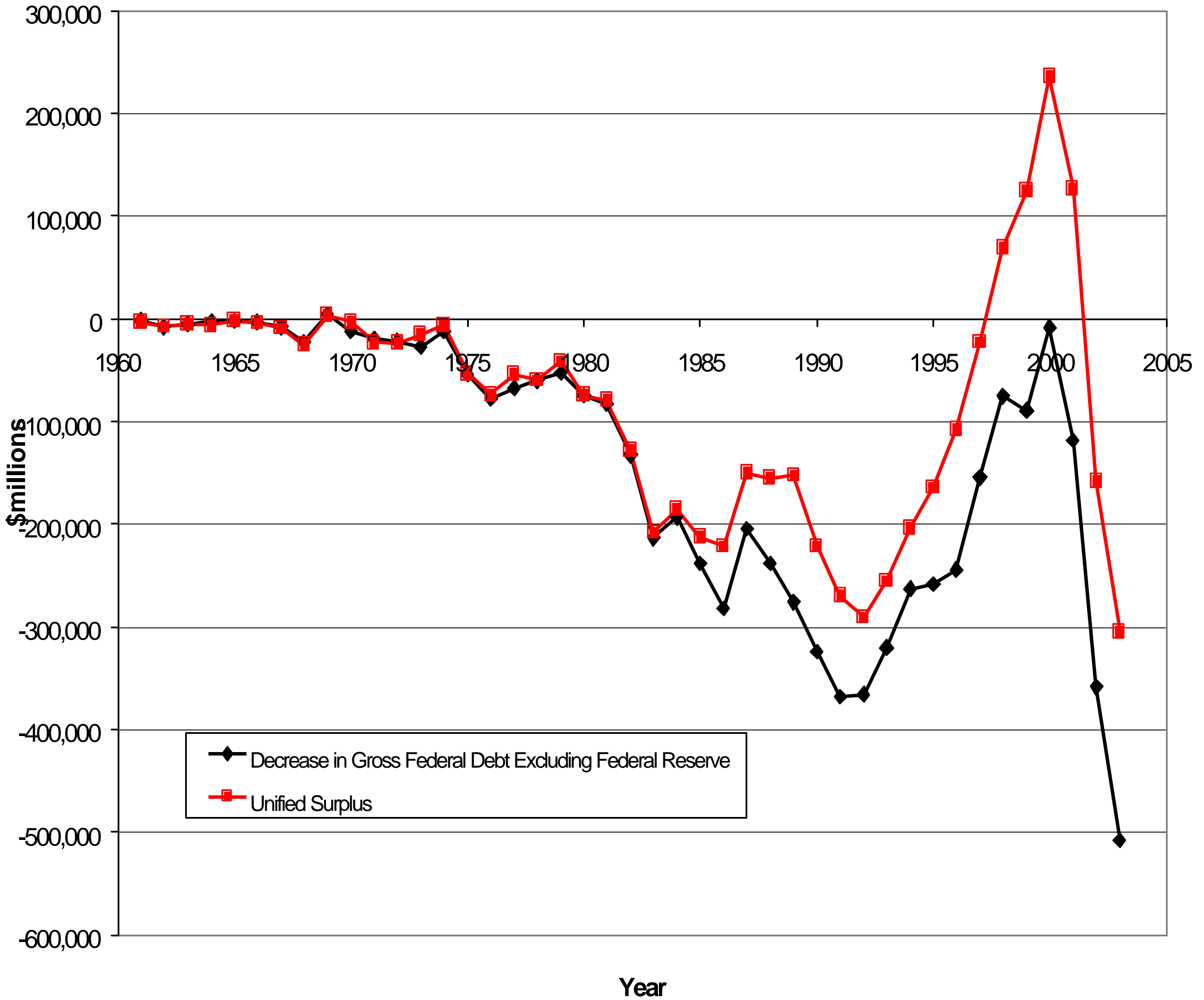
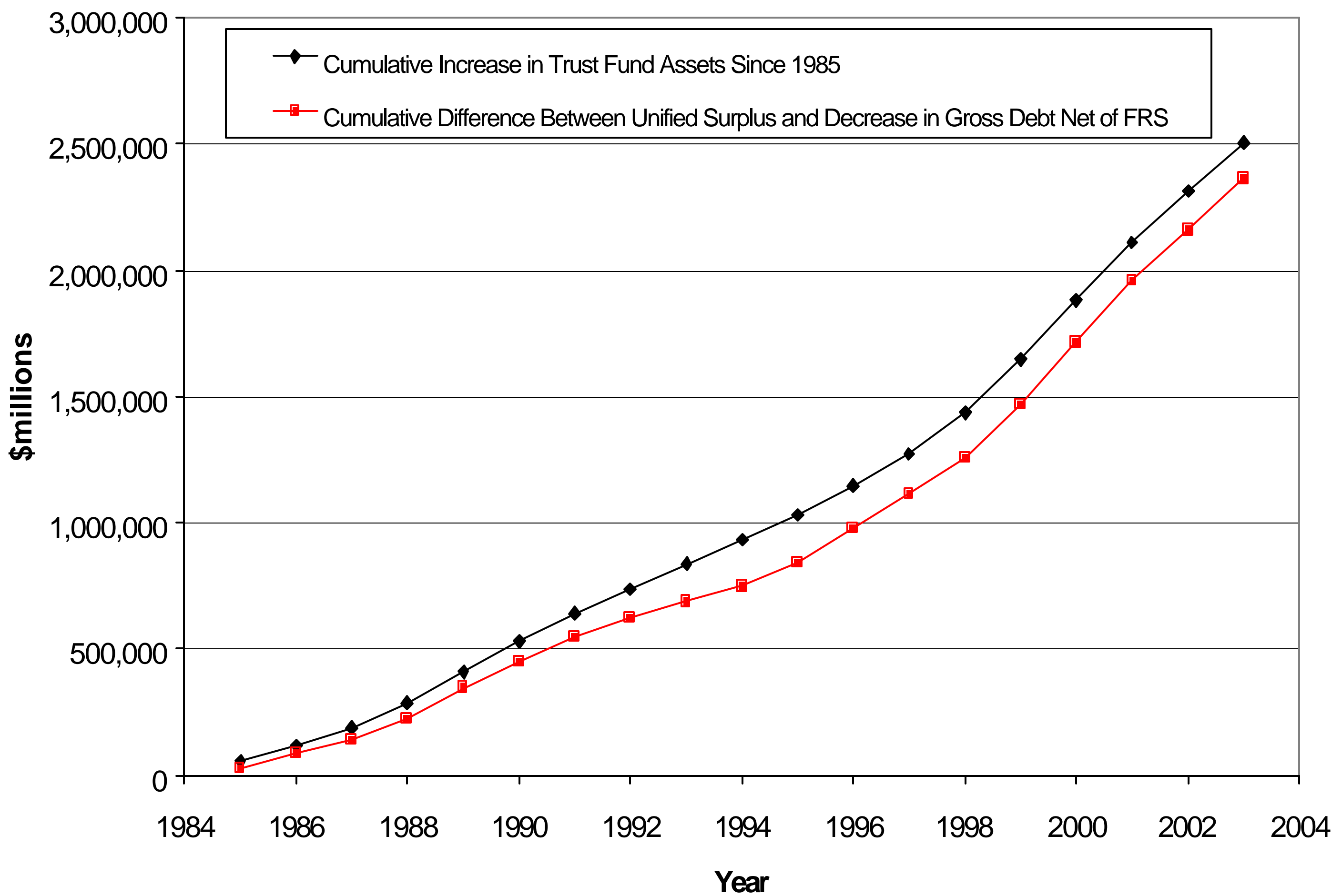


Figure 3
Unified Surplus and Decrease in Gross Federal Debt
300,000
200,000
100,000
0
-100,000
-200,000
-300,000
-400,000
-500,000
-600,000
$millions
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
Year
Decrease in Gross Federal Debt Excluding Federal Reserve
Unified Surplus

funds left pure pay as you go financing and began to intentionally prefund future expenditures.

Figure 4 shows that since 1985 when the differences began to be meaningful, the cumulative Unified Surplus has been roughly $2.5 trillion greater than the cumulative decrease in the gross federal debt outside of the Federal Reserve System. The cumulative Unified Surplus has similarly been roughly $2.5 billion greater than the cumulative Federal Funds Surplus. As Figure 4 shows the cumulative difference is the build up of the trust fund assets since 1985. The important point is that the Unified Surplus fails to recognize the trust fund assets as general government liabilities while the Federal Funds Surplus does recognize this fact. My concern is that this cumulative $2.5 trillion exaggeration of the budget surplus has led to inappropriate tax and spending programs and therefore has undermined the purpose of the trust funds to offer relief to future generations of taxpayers. I am advocating changing the focus of the U.S. budget from the Unified Surplus to the Federal Funds surplus. Further, we should have the same long-term goal of balancing the budget in times of full employment that we have had for the past fifty years or longer. We have just been trying to balance the wrong budget. Switching the long-run goal from balancing the Unified Budget to balancing the Federal Funds budget would not necessarily be deflationary. Presumably monetary policy would be adjusted so that policy makers would still aim for full employment and low inflation.

Figure 4
The Cumulative Increase in Trust Fund Debt Since 1985 vs. The Cumulative Excess of the Unified Surplus over the Decrease in Gross Debt



IT'S ONLY ACCOUNTING

Federal Budget accounting is pretty complicated and boring stuff for most people; besides, or so the argument goes, it's only accounting. The performance of the economy should be judged by measures of unemployment, investment, the distribution of income, etc. Budget accounting is just some arcane score keeping. The argument implies that this is merely a technical matter of second order importance. As you might guess, I don't buy this for a moment.

My view is that the surplus, whichever version is focused upon, is viewed as money available for new spending and tax cuts. As we have seen, the Unified Surplus has indicated to Congress and Administrations since 1985 that they have had $2.5 trillion more for their initiatives than the Federal Funds would have indicated with the same tax and spending policies. Just so this is clear, that $2.5 trillion is the accumulation of trust fund assets. I don't believe that we would have had the same policies if we had focused on the Federal Funds surplus. Elmendorf and Liebman (2001) make essentially this point and Smetters (2002) examined a related question. Even though the vast majority of attention is paid to the Unified Surplus, the government does produce surplus numbers that take Social Security out of the totals. They produce the so-called "on budget" surpluses and the "off budget surpluses" (largely Social Security). Smetters finds empirically that larger Social Security cash-flow surpluses (i.e. "off budget" surpluses) lead to smaller "on budget" surpluses. In fact the connection is more than dollar for dollar. This means all of the Social Security surpluses have been spent via government spending programs and tax cuts. My assertion is that the concentration on the Unified Surplus has generalized this result. The trust fund

surpluses are included in the pool of spendable funds available to politicians; not surprisingly, what is spendable is spent.

THE TRUST FUNDS AREN'T REAL; LET'S MAKE THEM REAL

Given the unified budget approach of the past 35 years, the trust funds are not really trust funds in the normal sense. Their accumulation of bonds will not help future generations pay for the obligations of Social Security, Medicare and the military and federal civilian employee retirement programs. Interestingly, the Chapter 16 of the Analytical Perspectives of the 2004 U.S. Budget lays this out pretty clearly. First, they say that these are not really trust funds…

> "The Federal budget meaning of the term "trust" differs significantly from the private sector usage. The beneficiary of a private trust owns the trust's income and often its assets. A custodian manages the assets on behalf of the beneficiary according to stipulations of the trust, which he or she cannot change unilaterally. In contrast, the Federal Government owns the assets and earnings of most Federal trust funds, and it can unilaterally raise or lower future trust fund collections and payments, or change the purpose for which the collections are used, by changing the existing law."

Later in the same chapter the budget document states that the trust fund bonds aren't real economic assets…

> "These balances are available to finance future benefit payments and other trust fund expenditures – but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. They do not hold real economic assets that can be drawn down in the future to fund benefits. When trust fund holdings are redeemed to pay benefits, Treasury will have to finance the expenditure in the same way as any other Federal expenditure: out of current receipts, by borrowing from the public, or by reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, increase the Government's ability to pay benefits."

This declaration that the trust fund assets aren't real economic assets may justify using the Unified Budget surplus since it doesn't treat the bonds as real liabilities. If we emphasized the Federal Funds budget or if we treated the cash flow surpluses and interest received by the

trust funds as a capital contribution, then the trust fund assets would be real and the liability to pay interest and eventually principal recognized. Hopefully, by this point the title of this paper, "If the Trust Funds Are Real, the Surplus Numbers Are Wrong" makes sense.

I think that the Greenspan Commission had the right idea. The trust funds should be real and they should be allowed to accumulate real assets. Current taxpayers should finance the surplus in the trust funds so as to lighten the burden on future workers and taxpayers. This can all be accomplished if the Trust Fund surpluses are taken out of the surplus --- the pool of spendable money – transmitted to Congress in the budget document. This wouldn't require any new calculations. All we need to do is emphasize the Federal Funds budget and balance it over the long-run.

THE SPECIAL-ISSUE BONDS ARE REAL ASSETS AND LIABILITIES

Several authors calculate the present value of the legislated benefits of the entitlement programs and would treat the growth of this liability in any surplus measure (see two papers from this conference, Jackson (2003) and Gokhale and Smetters (2003)). This is an interesting approach and the numbers are worth calculating and analyzing, but I would not include them in the official surplus and deficit numbers. The liability to pay the interest and principal on U.S. government bonds is far stronger than the liability to pay legislated program benefits. Program benefits can be changed by subsequent legislation and unfunded accrued liabilities thereby reduced or eliminated. In contrast, the full faith and credit of the U.S. government back these special issue bonds. It is because the special-issue Treasury Bonds are such solid assets that we must include the accumulation of the corresponding liabilities in the surplus computation.

CONCLUSIONS

The conclusions of this paper were shown up front in the abstract. I argue that the move to fund military and civil service retirement plans and to partially fund Social Security in the mid-1980s was undermined by our reliance on a Unified Budget. The Unified Budget includes the saving or capital accumulation of the trust funds and therefore invites the rest of the government to offset this saving with lower taxes and higher spending. In order to accomplish the purpose of building up the trust funds, their capital accumulation must be taken out of the surplus measure that we try to balance in times of full employment.

The main conclusions are these:

(1) The facts that the Unified Surplus counts the excess cash flow of the trust funds as gen1eral receipts and that the interest on the U.S. government bonds held by the trust funds is not charged as an expense added about $200 billion per year to the surplus in the past few years. To put this in perspective, the ex-trust funds deficit (the Federal Funds deficit) for 2004 is not roughly $300 billion, but rather roughly $500 billion.

(2) The budget mistake was not adopting capital accounting (at least for the trust funds) when the decision was made in the mid-1980s to move from pay as you go financing to funded or partially funded programs.

(3) If the trust fund capital accumulations are not counted in the general surplus, then there never was a meaningful surplus in the past 30+ years. The ex-trust funds or Federal Funds surplus peaked at roughly zero in the year 2000.

(4) Unified budget accounting and the tax and spending decisions that have been made relying on this accounting have significantly reduced national saving and increased the tax burden on workers twenty and more years from now.

My position is that we should immediately remove the capital accumulation of the trust funds from the surplus. This is an example of "better late than never."

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APPENDIX – DATA FROM BUDGET FOR FISCAL YEAR 2004

Year	Unified Surplus	Federal Funds Surplus	Trust Fund Surplus	Gross Federal Debt	Bonds Held by Government Accounts	Gross Public Debt	Bonds Held by Federal Reserve
1960	301	791	-490	290,525	53,686	236,840	26,523
1961	-3,335	-4,193	858	292,648	54,291	238,357	27,253
1962	-7,146	-6,847	-299	302,928	54,918	248,010	29,663
1963	-4,756	-6,630	1,874	310,324	56,345	253,978	32,027
1964	-5,915	-8,588	2,673	316,059	59,210	256,849	34,794
1965	-1,411	-3,910	2,499	322,318	61,540	260,778	39,100
1966	-3,698	-5,165	1,467	328,498	64,784	263,714	42,169
1967	-8,643	-15,709	7,066	340,445	73,819	266,626	46,719
1968	-25,161	-28,373	3,212	368,685	79,140	289,545	52,230
1969	3,242	-4,871	8,112	365,769	87,661	278,108	54,095
1970	-2,842	-13,168	10,326	380,921	97,723	283,198	57,714
1971	-23,033	-29,896	6,863	408,176	105,140	303,037	65,518
1972	-23,373	-29,299	5,926	435,936	113,559	322,377	71,426
1973	-14,908	-25,687	10,779	466,291	125,381	340,910	75,181
1974	-6,135	-20,148	14,013	483,893	140,194	343,699	80,648
1975	-53,242	-60,669	7,427	541,925	147,225	394,700	84,993
1976	-73,732	-76,143	2,410	628,970	151,566	477,404	94,714
1977	-53,659	-63,162	9,502	706,398	157,294	549,104	105,004
1978	-59,185	-71,882	12,697	776,602	169,476	607,126	115,480
1979	-40,726	-59,065	18,339	829,467	189,161	640,306	115,594
1980	-73,830	-82,633	8,804	909,041	197,118	711,923	120,846
1981	-78,968	-85,791	6,823	994,828	205,418	789,410	124,466
1982	-127,977	-134,221	6,244	1,137,315	212,740	924,575	134,497
1983	-207,802	-230,879	23,077	1,371,660	234,392	1,137,268	155,527
1984	-185,367	-218,272	32,905	1,564,586	257,611	1,306,975	155,122
1985	-212,308	-266,457	54,149	1,817,423	310,163	1,507,260	169,806
1986	-221,215	-283,108	61,893	2,120,501	379,878	1,740,623	190,855
1987	-149,728	-222,346	72,618	2,345,956	456,203	1,889,753	212,040
1988	-155,152	-252,876	97,724	2,601,104	549,487	2,051,616	229,218
1989	-152,456	-275,939	123,483	2,867,800	677,084	2,190,716	220,088
1990	-221,195	-341,341	120,145	3,206,290	794,733	2,411,558	234,410
1991	-269,328	-381,061	111,733	3,598,178	909,179	2,688,999	258,591
1992	-290,376	-386,393	96,018	4,001,787	1,002,050	2,999,737	296,397
1993	-255,087	-355,473	100,385	4,351,044	1,102,647	3,248,396	325,653
1994	-203,250	-298,571	95,322	4,643,307	1,210,242	3,433,065	355,150
1995	-163,972	-263,231	99,259	4,920,586	1,316,208	3,604,378	374,114
1996	-107,473	-222,091	114,618	5,181,465	1,447,392	3,734,073	390,924
1997	-21,958	-147,897	125,939	5,369,206	1,596,862	3,772,344	424,518
1998	69,213	-91,981	161,194	5,478,189	1,757,090	3,721,099	458,182
1999	125,563	-87,164	212,727	5,605,523	1,973,160	3,632,363	496,644
2000	236,445	1,836	234,609	5,628,700	2,218,896	3,409,804	511,413
2001	127,299	-101,422	228,721	5,769,881	2,450,266	3,319,615	534,135
2002	-157,802	-360,201	202,399	6,198,401	2,687,974	3,540,427	604,191
2003	-304,159	-496,503	192,344	6,752,033	2,873,595	3,878,438	650,000

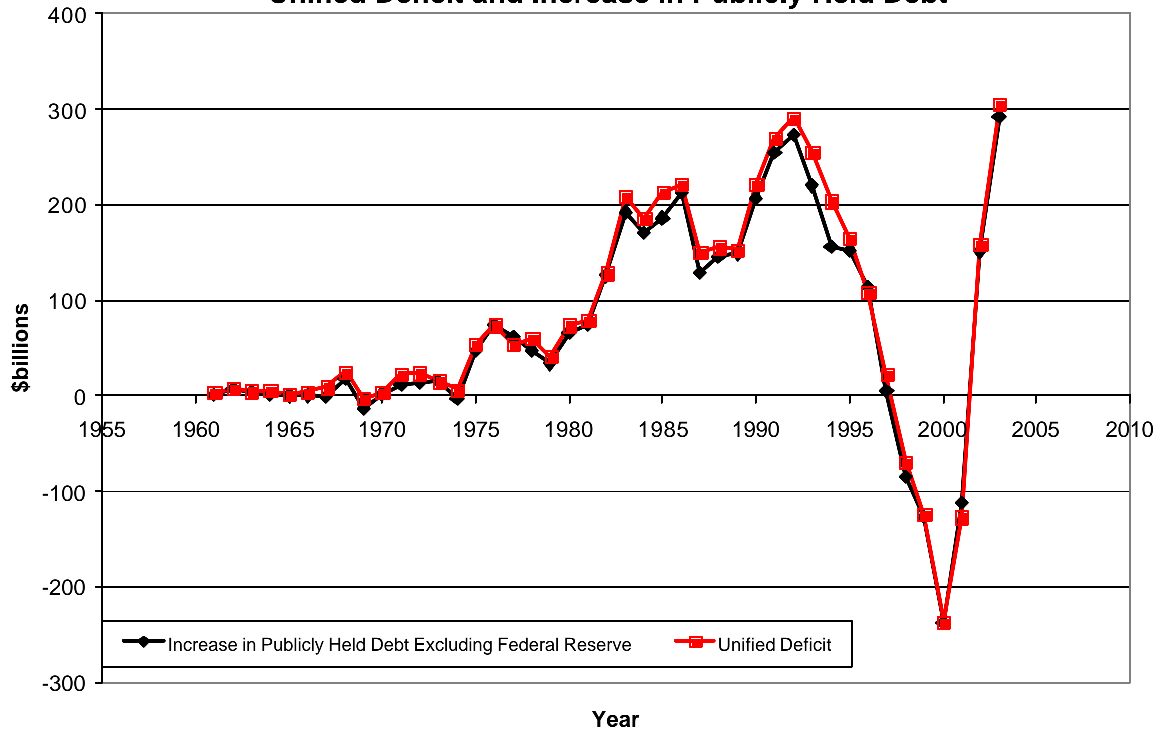
Figure 1A
Unified Deficit and Increase in Publicly Held Debt
400
300
200
100
0
-100
-200
-300
$billions
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
Year
Increase in Publicly Held Debt Excluding Federal Reserve
Unified Deficit

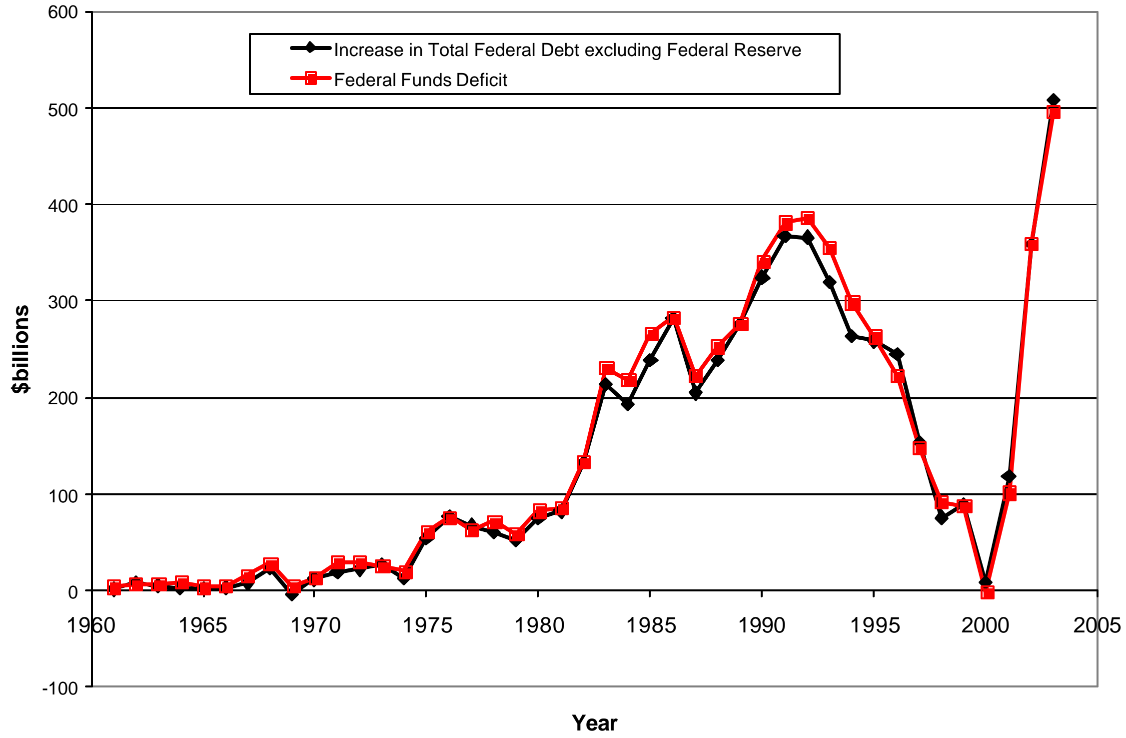
Figure 2A
Federal Funds Deficit and Increase in Total Federal Debt
Increase in Total Federal Debt excluding Federal Reserve
Federal Funds Deficit
$billions
600
500
400
300
200
100
0
-100
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
Year

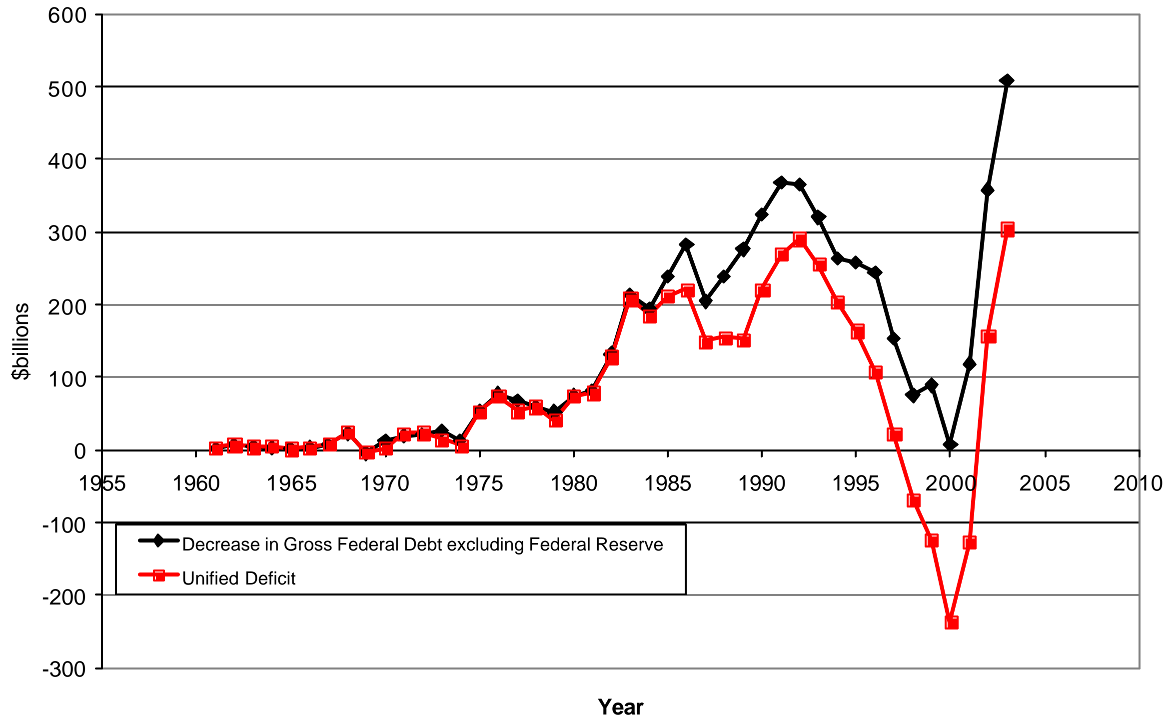
Figure 3A
Unified Deficit and Increase in Gross Federal Debt
600
500
400
300
200
100
0
-100
-200
-300
$billions
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
Year
Decrease in Gross Federal Debt excluding Federal Reserve
Unified Deficit