What Are Federal Trust Funds?

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A federal trust fund is an accounting mechanism used by the federal government to track earmarked receipts (money designated for a specific purpose or program) and corresponding expenditures. The largest and best-known funds finance Social Security, Medicare, highways and mass transit, and pensions for government employees.

Federal trust funds bear little resemblance to their private-sector counterparts. In private-sector trust funds, receipts are deposited and assets are held and invested by trustees on behalf of the stated beneficiaries. In federal trust funds, the federal government does not set aside the receipts or invest them in private assets. Rather, the receipts are recorded as accounting credits in the trust funds, and the receipts themselves are comingled with other receipts that Treasury collects and spends. Further, the federal government owns the accounts and can, by changing the law, unilaterally alter the purposes of the accounts and raise or lower collections and expenditures.

How do federal trust funds work?

The federal government uses trust fund accounting to link receipts designated by law for a specific purpose with the expenditure of those receipts. Those receipts can include receipts from the public (taxes, premiums from program beneficiaries and other fees), as well as intragovernmental transfers from other federal accounts, including Treasury interest payments. Those expenditures can include direct payments to individual beneficiaries (e.g., Social Security benefits), grants to state and local governments (e.g., highway and mass transit grants) and intragovernmental payments (e.g. Treasury interest payments on trust fund balances, which are debits to one government account and credits to another, not net new income).

What happens when a federal trust fund runs a surplus?

When a federal trust fund receives more receipts in a year than it needs to cover the designated expenses, it accumulates a positive balance that is held in the form of non-marketable Treasury securities. These bonds represent intragovernmental debt: one part of the government (the trust fund) “lends” funds to another part of government (Treasury). Treasury uses the surplus cash receipts for spending on other programs and other general purposes, which effectively reduces the amount of debt that it needs to issue to the public to fund the government.

What happens when a federal trust fund runs a deficit?

A trust fund runs a cash deficit when its expenses exceed its receipts (excluding interest). When that happens, the trust fund first uses its interest income on the intragovernmental debt. Once the trust fund’s expenses exceed its total income (receipts plus interest), the trust fund must redeem its nonmarketable Treasury securities to cover the shortfall.

Treasury must finance trust fund interest payments and the redemption of trust fund securities through additional borrowing from the public (unless policymakers raise taxes or cut spending).

What is the current state of the federal trust funds?

The federal government has several trust funds. The three most important trust funds are for Social Security, Medicare, and transportation projects.

Social Security Trust Funds

The Social Security trust funds[1] are the largest federal trust funds. These trust funds record inflows into the accounts from payroll taxes and interest on fund balances (which resulted from positive fund balances caused by cash surpluses following the 1983 reforms). By 2009, the total balance of the Social Security trust funds was $2.5 trillion. In 2010, Social Security began running a cash deficit, as its expenses exceeded its income (excluding interest). The Trustees project that in 2020, its expenses will exceed total income (including interest). At that point, the Trustees will be have to begin redeeming the funds' special non-marketable Treasury securities.

In 2034, unless reforms are enacted, the Social Security trust funds are projected to be fully exhausted, as they will have redeemed all of their special Treasury securities. At that point, Social Security's receipts will only be sufficient to cover 79 percent of benefits. Benefits will then have to be cut by 21 percent to continue making payments to all beneficiaries. The Social Security Disability program is in worse condition. Its trust fund will be depleted in 2023, and unless its finances are addressed, its benefits will be cut by 11 percent.

Medicare Trust Fund

In the Medicare program, payroll taxes are credited to the Medicare Hospital Insurance (HI) fund and premiums paid by Medicare beneficiaries are credited directly to Medicare's Supplemental Medical Insurance (SMI) fund. Unless reforms are enacted, Medicare's Hospital Insurance Trust Fund is expected to be exhausted in 2028, which will precipitate a 13 percent cut in its payments to hospitals and other providers. The SMI fund cannot be depleted — each year, general revenue contributions are set to cover whatever costs remain after beneficiary premiums are taken into account.

Highway Trust Fund

The Highway Trust Fund will be depleted by 2021. In this fund, taxes on gasoline and diesel fuel are credited directly to the Highway Trust Fund, but the fund's income falls short of its spending. This situation has already precipitated a slowdown of highway and other surface transportation projects as states prepare for a shortfall in federal funding.

How do trust funds affect the overall budget?

The Social Security and Medicare Board of Trustees point out that its programs have an immediate impact on the federal budget, even though the actual depletion date of the trust funds is further in the future. Because Social Security and Medicare costs currently exceed their dedicated tax receipts and premium income, the programs are using interest earnings, general revenue transfers, and redemptions of the funds' Treasury securities to cover their shortfalls. That funding need must be financed with other sources of revenue, reducing funds available for other programs and adding to the federal government's overall budget deficits. In 2016, the actuaries estimate that in addition to their dedicated payroll taxes and premiums, Social Security and Medicare will require $401 billion in general revenues, or about 2.1 percent of gross domestic product (GDP). This financing requirement from general revenues will grow to an estimated 4.2 percent of GDP in 2040 — double the 2016 share.

Although many believe that the existence of trust funds guarantees the sustainability of programs in the future, trust funds are simply accounting mechanisms that are part of the way the federal government keeps its books. The actual cash inflows and outflows of the programs are combined with all other federal programs and therefore contribute to federal surpluses and deficits. If a program is in surplus, the federal government's overall deficit balance improves because it uses the additional receipts from the program to fund costs of other programs. In effect, the government is conducting transactions with *itself* but keeping track of inflows and outflows of funds through trust funds. Ultimately, trust fund income and outlays are not separate from the rest of the federal budget, and the sustainability of trust fund programs, like Social Security, depends on the overall sustainability of the federal government.

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[1]The Old-Age and Survivors' Insurance trust fund pays retirement and survivors benefits, and the Federal Disability Insurance Trust Fund pays disability benefits. (Back to citation)
